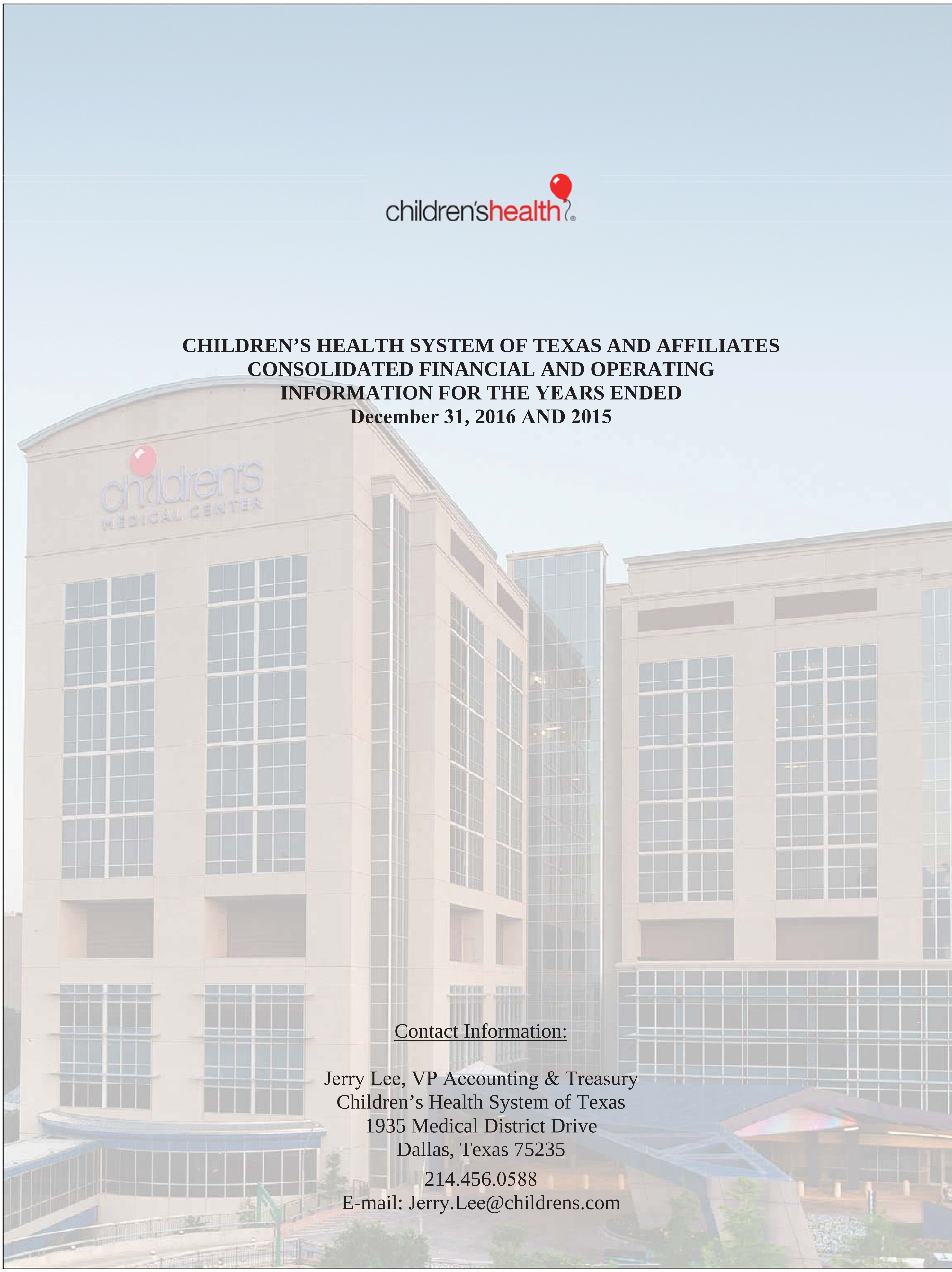

CHILDREN'S HEALTH SYSTEM OF TEXAS AND AFFILIATES
CONSOLIDATED FINANCIAL AND OPERATING INFORMATION FOR THE YEARS ENDED
December 31, 2016 AND 2015

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Report of Independent Auditors

The Board of Directors
Children's Health System of Texas

We have audited the accompanying consolidated financial statements of Children's Health System of Texas and Affiliates, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Children's Health System of Texas and Affiliates at December 31, 2016 and 2015 and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

April 26, 2017

Children's Health System of Texas
Consolidated Balance Sheets
As of December 31, 2016 and December 31, 2015
(In Thousands)

	2016	2015
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 177,869	$ 182,422
Short Term Investments	169,200	186,302
Patient accounts receivable, net of allowances	150,447	157,536
Pledges receivable, net of allowances	11,909	10,989
Inventories	16,971	14,070
Other current assets	102,779	104,495
Total Current Assets	629,175	655,814
Pledges Receivable, net of allowances	17,067	20,563
Receivables From Remainder Trusts	12,348	9,627
Property and Equipment, net	907,743	833,254
Assets Limited As To Use	1,150,750	1,075,460
Other Assets	40,765	41,487
Total Assets	$ 2,757,848	$ 2,636,205
LIABILITIES AND NET ASSETS		
Current Liabilities:		
Accounts payable	$ 111,000	$ 103,408
Accrued liabilities	100,902	77,736
Accrued interest	7,015	7,176
Current portion of long-term debt and capital lease obligations	8,175	3,827
Other current liabilities	8,991	9,475
Total Current Liabilities	236,083	201,622
Long-term Debt and Capital Lease Obligations, net of current portion	356,509	366,050
Other Noncurrent Liabilities	76,305	91,082
Net Assets:		
Unrestricted	1,892,674	1,781,719
Temporarily restricted	76,356	79,968
Permanently restricted	119,921	115,764
Total Net Assets	2,088,951	1,977,451
Total Liabilities and Net Assets	$ 2,757,848	$ 2,636,205

Children's Health System of Texas
Consolidated Statements of Operations
For the years ended December 31, 2016 and 2015
(In Thousands)

	Years 2016	2015
OPERATING REVENUE:		
Patient services revenue less contractual allowances and charity allowances	$ 1,310,225	$ 1,243,070
Provision for doubtful accounts	(54,928)	(36,413)
Net patient service revenue	1,255,297	1,206,657
Other operating revenue	141,412	91,111
Graduate medical education	6,842	6,010
Net assets released from restrictions for operations	20,431	12,331
Total operating revenue	1,423,982	1,316,109
OPERATING EXPENSES:		
Salaries and benefits	742,757	634,388
Professional services	133,338	103,547
Supplies and other	150,819	133,192
General support	279,516	262,024
Depreciation and amotization	64,352	60,277
Interest	17,505	17,668
Total operating expenses	1,388,287	1,211,096
OPERATING INCOME	35,695	105,013
NONOPERATING GAINS (LOSSES):		
Realized investment gains	31,111	38,951
Unrealized investment gains/(losses)	32,046	(65,448)
Other	1,602	(315)
Total nonoperating gains/(losses)	64,759	(26,812)
NET INCOME	$ 100,454	$ 78,201

Children's Health System of Texas

Consolidated Statements of Changes in Net Assets

For the Years Ended December 31, 2016 and 2015

(In Thousands)

	2016	2015
CHANGES IN UNRESTRICTED NET ASSETS:		
Net income	$ 100,454	$ 78,201
Net assets released from restrictions	8,423	6,993
Change in minimum pension liability	5,346	(6,478)
Change in donor designation and other	(3,268)	3,795
Increase in unrestricted net assets	110,955	82,511
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS:		
Contributions	17,344	20,720
Change in split-interest agreements	2,720	845
Realized investment gains	356	255
Unrealized investment gains (losses)	770	(527)
Net assets released from restrictions for operations	(19,749)	(10,331)
Net assets released from restrictions for capital	(8,423)	(6,993)
Grants for pediatric purposes	(38)	(3)
Change in donor designation and other	3,408	(955)
(Decrease) increase in temporarily restricted net assets	(3,612)	3,011
CHANGES IN PERMANENTLY RESTRICTED NET ASSETS:		
Permanently restricted contributions	2,268	15,097
Change in split-interest agreements	(240)	(67)
Realized investment gains	2,857	3,156
Unrealized investment gains (losses)	2,527	(5,505)
Net assets released from restrictions	(682)	(2,000)
Change in donor designation and other	(2,573)	(697)
Increase in permanently restricted net assets	4,157	9,984
INCREASE IN NET ASSETS	111,500	95,506
NET ASSETS AT BEGINNING OF PERIOD	1,977,451	1,881,945
NET ASSETS AT END OF PERIOD	$ 2,088,951	$ 1,977,451

See notes to financial statements

Children's Health System of Texas
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2016 and 2015
(In Thousands)

	2016	2015
CASH FLOW FROM OPERATING AND NONOPERATING ACTIVITIES:		
Increase in net assets	$ 111,500	$ 95,506
Adjustments to reconcile increase in net assets to net cash provided by (used in) operating and nonoperating activities:		
Provision for doubtful accounts	54,928	36,413
Depreciation and amortization	64,352	60,277
Amortization of financing cost and bond discounts	515	516
Amortization of bond premium	(1,881)	(1,949)
Change in unrealized investments	(32,046)	65,448
Loss on the disposal of property and equipment	1,096	2,462
Change in pension liability	(12,945)	8,294
Changes in operating assets and liabilities:		
Patient and other receivables	(46,081)	(61,148)
Pledges receivable, net	2,576	(5,999)
Inventory and other current assets	(2,943)	(7,067)
Other assets	722	(20,493)
Receivables from remainder trusts	(2,721)	(787)
Purchases of assets limited as to use and short-term investments	(26,142)	(292,629)
Accounts payable and accrued liabilities	30,597	(2,961)
Other current liabilities	(484)	7,070
Other noncurrent liabilities	(1,832)	384
Net cash provided by (used in) operating and nonoperating activities	139,211	(116,663)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase and construction of property and equipment	(141,229)	(100,593)
Net cash used by investing activities	(141,229)	(100,593)
CASH FLOW FROM FINANCING ACTIVITIES:		
Receipts of annuities and trust obligations, net	-	452
Payments of long-term debt and capital lease obligations	(2,535)	(1,434)
Net cash used by financing activities	(2,535)	(982)
DECREASE IN CASH AND CASH EQUIVALENTS	(4,553)	(218,238)
CASH AND CASH EQUIVALENTS, beginning of period	182,422	400,660
CASH AND CASH EQUIVALENTS, end of period	$ 177,869	$ 182,422
Supplemental cash flow disclosures:		
Interest paid	$ 19,082	$ 19,165
Capital lease obligation	$ -	$ 1,292

See notes to financial statements

Note 1 - Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation

Children's Health System of Texas (Children's Health®), was incorporated in 1985, as a nonprofit Texas corporation that is exempt from federal income taxes under Section 501(a) of the Internal Revenue Code (IRC) of 1986 as an organization described in Section 501(c)(3) of the IRC. Children's Health operates two pediatric teaching hospitals licensed for 562 beds, a rehabilitation hospital licensed for 54 beds, ambulatory clinics, 18 primary care physician clinics and a foundation. Children's Health wholly-owned operating entities are included in the following table:

Entity	Business Purpose / Activities
Children's Medical Center of Dallas (CMC)	Nonprofit Texas corporation that operates pediatric teaching hospitals and ambulatory clinics in Dallas, Plano and Southlake, Texas (Southlake closed in November, 2016)
Our Children's House (OCH)[1]	Nonprofit Texas corporation that operates a pediatric rehabilitation hospital and outpatient clinics that provide coordinated, comprehensive services to children with special health needs.
Physicians for Children dba Children's Health Pediatric Group (CHPG)	Nonprofit Texas corporation that operates 18 primary care physician offices primarily providing care to children in critically underserved areas of Dallas, Collin, and Tarrant counties.
Anesthesiologists for Children (AFC)	Nonprofit Texas corporation that provides physician staffing for anesthesiology services.
Dallas Physician Medical Services for Children (DPMSC) dba Children's Health Medical Group	Nonprofit Texas corporation that provides physician staffing for urgent care and hospital services.
Complex Care Medical Services (CCMS)	Nonprofit Texas corporation that serves as a medical home for children with complex medical illnesses where a multi-disciplinary team of care givers oversee and coordinate their care.
Pediatric Partners	Nonprofit Texas corporation that works toward the formation of networks (clinical and financial) comprised of community based primary care physicians in order to improve outcomes across a spectrum of indicators.
Children's Medical Center Foundation (CMCF)	Nonprofit Texas corporation that administers and invests funds in support of CMC and its affiliates.
Children's Medical Center Pediatric Research Institute at UT Southwestern (Research Institute)	Nonprofit Texas corporation organized to conduct pediatric research.
Children's Population Health (CPH)	Nonprofit Texas corporation that strives to improve the health of children across the continuum of care.
Children's Medical Center Health Plan (CMCHP)	Nonprofit Texas corporation involved in health maintenance organization activities.
Texas Bluebonnet Insurance Company (TBIC)	For-profit Texas organization that will provide commercial health maintenance organization activities.
The Health and Wellness Alliance for Children (H&W)	Nonprofit Texas corporation that partners with communities, businesses, advocates and other nonprofits to improve the health and wellness of children in underserved areas.
Children's Insurance (CIC)	For-profit self-insurance organization domiciled in Vermont. CIC merged into TTRAC in November, 2016.
Texas Trinity River Assurance Company (TTRAC)	For-profit self-insurance organization domiciled in Grand Cayman.

Entity	Business Purpose/Activities
Children's BMG dba Connect 2 Care[1]	Nonprofit Texas corporation that provides for family health clinics.
Physician Quality Alliance of North Texas (PQA)	Nonprofit Texas corporation involved in healthcare collaborative activities.
NTPSS, Inc.	Nonprofit Texas corporation that will function as an aggregator and supplier of goods and back-office services to community physicians.
Alternative Care Systems Inc. (ACS)	For-profit Texas corporation that was formed to participate in ventures that have included investments in companies that brought new medical supplies and pharmaceuticals to market and participation in a medical device consortium.
Pediatric Imaging	Provides a broad range of diagnostic services, all tailored for children newborn to 18 years.

[1] Entity's application for exemption from federal income tax under Section 501(a) of the Internal Revenue Code (IRC) of 1986 as an organization described in Section 501(c)(3) of the IRC, is pending.

All significant intercompany balances and transactions have been eliminated in consolidation.

Cash and Cash Equivalents

Cash and cash equivalents include all cash balances and highly liquid investments with initial maturities of three months or less.

Concentration of Credit Risk

Children's Health grants credit without collateral to its patients, most of whom are area residents and many of whom are insured under third-party payer agreements. Management does not believe these receivables represent any concentrated credit risk; furthermore, management continually monitors and adjusts its reserves and allowances associated with these receivables.

The mix of receivables from patients and third-party payers (excluding affiliates) at December 31, 2016 and 2015, is as follows:

	2016	2015
Commercial	49 %	50 %
Managed Medicaid	28	28
Medicaid	21	20
Other	2	2
	100 %	100 %

Patient Accounts Receivable and Net Patient Service Revenue

Net patient service revenue is recorded at the estimated net realizable amounts due from guarantors, third-party payers, and others for services rendered. Reimbursement for inpatient services for Traditional Medicaid, Children with Special Healthcare Needs (CSHCN), Children's Health Insurance Program (CHIP) and certain Managed Medicaid contracts are based on All Patient Refined Diagnosis Related Groups (APR-DRG). Children's Health's base rate under APR-DRG's was approximately $12,500 for 2016 and 2015. For outpatient services these same payers are fixed fee or cost-based reimbursed. Commercial and certain managed care payers are reimbursed based on a percent of charges. For all services related to Medicare patients reimbursement is cost-based. Net patient accounts receivable arising from government programs were approximately $102.6 million at December 31, 2016, and $87.9 million at December 31, 2015.

For cost-based reimbursement, Children's Health is reimbursed for their actual audited allowable cost of providing care to Medicaid enrollees using the Tax Equity and Fiscal Responsibility Act of 1982 cost principles. Children's Health files an annual cost report that is subject to administrative review and audit by third parties. As a result, there is a reasonable possibility that recorded estimates may change by a material amount as interpretations are clarified and cost reports are settled. The initial estimates are revised as needed until the cost report is final settled. Children's Health believes that the balance sheet amounts recorded are adequate to cover any such adjustments. At December 31, 2016 and 2015, Children's Health had a liability of $9.7 million and $10.8 million, respectively, recorded in accrued liabilities in the accompanying consolidated balance sheets. Net patient service revenue increased by approximately $0.7 million and increased $2.6 million for the years ended December 31, 2016 and 2015, respectively, due to the change in cost report allowances previously estimated, as a result of interim and final settlements.

Health Plan

Children's Medical Center Health Plan (CMCHP) earns premium revenue from the Medicaid State of Texas Access Reform (STAR) program. For the year ended December 31, 2016, CMCHP received 100% of its premium from the STAR Kids program in the Dallas service area. The program started November 1, 2016 so there are no prior year premiums for comparison. CMCHP recognizes revenue during the coverage period of the member agreement. Under these agreements, CMCHP receives monthly payments from the Health and Human Services Commission (HHSC) based on the number of members enrolled in the CMDHP plan, regardless of the actual medical claims incurred. For the year ended December 31, 2016, CMCHP recognized $38.6 million in premium revenues which are including in other operating revenue in the accompanying consolidated statements of operations.

CMCHP is subject to an experience rebate if operating income, as a percentage of revenue, is greater than the percentage set forth by the State of Texas. As of December 31, 2016, CMCHP had no estimated experience rebate liability.

A liability was recorded on CMCHP financials for incurred but not reported (IBNR) medical claims for the year ending December 31, 2016. The reserve was prepared by CMCHP inhouse actuary and a report was filed with the Texas Department of Insurance on the methodology used. There were no provider incentive programs or risk sharing programs that needed quantification. There is a reinsurance program in place effective November 1, 2016, but due to the start-up of business, claims that might qualify had not hit the reporting threshold.

Allowance for Doubtful Accounts

Patient accounts receivable is presented net of allowances for doubtful accounts of approximately $43.1 million and $34.1 million in 2016 and 2015, respectively. Children's Health does not require collateral or other security to support patient accounts receivable balances.

Children's Health maintains allowances for doubtful accounts to reserve for potential write-offs relating to a payer's inability to make payments on an account. Accounts are written off when collection efforts have been exhausted. Children's Health routinely monitors its accounts receivable balances and utilizes historical collection experience to support the basis for its estimates of the provision for doubtful accounts.

Charity Care

Children's Health maintains records of the value of services and supplies furnished to financially and medically indigent patients under its charity policy. Financially indigent patients are uninsured or underinsured patients accepted for care with no obligation, or a discounted obligation, to pay. Medically indigent patients are those whose medical obligations exceed a certain percentage of their family's annual gross income.

In 1993, the Texas legislature passed Senate Bill 427, which established annual reporting requirements and certain standards for the delivery of community benefits, charity care, and government-sponsored indigent healthcare. Nonprofit hospitals must meet these standards in order to maintain their exemption from state and local taxes. Children's Health meets these state standards with respect to charity care. Charity care is not included in net patient service revenue in the accompanying consolidated statements of operations.

Disproportionate Share Hospital Program and 1115 Waiver Programs

Children's Health participates in the Disproportionate Share Hospital Program (DSH) and the Uncompensated Care Program (UCP) administered by the Texas Department of Human Services. Under these programs, local, state, and federal funds are accessed and distributed to hospitals providing a high volume of services to Medicaid and indigent patients.

Children's Health also participates in the Delivery System Reform Incentive Payment (DSRIP) pool. The DSRIP program provides incentives to hospitals and other providers to enhance access to care and patient health.

Community Service

Children's Health is an active, caring member of the communities it serves. Children whose families meet the criteria of its charity care policy are provided care without charge or at amounts less than established rates. Children's Health participates in the Medicaid, Medicare, CSHCN, and CHIP government programs, and provides services to the indigent children of Dallas County under an agreement with the Dallas County Hospital District.

Responding to community needs, Children's Health operates a Level I Trauma Center, provides speakers to community organizations to convey information about child health, participates in major community health fairs, and provides support to numerous family support groups and other community organizations serving children.

Pledge Discounts and Allowances

The Foundation receives pledges on behalf of Children's Health and records pledges at fair value using the present value method. For pledges in excess of one year and greater than or equal to $50,000, the Foundation provides a discount based on the net present value of the pledge receivable. The Foundation uses a discount rate based on U.S. Treasury bonds at the time of the pledge. An allowance for uncollectible pledges is also provided based on historical experience and an analysis of the composition of the donors.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is computed using the straight-line method based on the estimated useful lives of the related assets. Amortization on assets under capital lease is computed using the straight-line method based on the term of the lease or the useful life of the asset, whichever is shorter, and is included in depreciation and amortization expense.

The estimated useful lives of the classes of depreciable assets are as follows:

Land improvements	8 to 20 years
Buildings and improvements	10 to 40 years
Fixed equipment	5 to 25 years
Movable equipment	3 to 20 years

Children's Health evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision or that the carrying value of an asset may not be recoverable. The assessment of possible impairment is based on whether the carrying value of the asset exceeds its fair value. The fair value of impaired assets is estimated based on market value of similar assets at quoted market prices, if available, or the expected total value of the cash flows on a discounted basis. There were no impairments of property and equipment in 2016 or 2015.

Assets Limited as to Use

Assets limited as to use include investments designated by the Board of Directors (the Board), which consist primarily of debt securities, marketable equity securities, mutual funds, common/collective trusts, alternative investments and bond indentures. Investments designated by the Board are held under a custodial agreement, with investments directed by a professional investment management firm. These assets, other than certain alternative investments, are stated at fair value and are held for trading purposes.

Children's Health invests in alternative investments through limited partnerships. Those alternative investments held in the Foundation are reported using fair value; while the remainder are reported using the equity method of accounting based on information provided by the respective partnerships. The values provided by the respective partnerships are based on fair value, appraisals, or other estimates of fair value that require varying degrees of judgment. Generally, the net asset value of Children's Health holdings reflects net contributions to the partnership and an allocated share of realized and unrealized investment income and expenses.

The Board has adopted a policy that separately designates certain investments for facilities replacement and for strategic planning initiatives. Disbursements from these funds must be approved by the Board.

Other Assets

Other assets include investments in joint ventures, insurance recoveries under insurance policies, physician guarantees, land and improvements, intangibles, and oil and gas investments.

Recoveries under life insurance policies, which are recorded at cash surrender value, were $0.6 million and $0.5 million at December 31, 2016 and 2015, respectively, and oil and gas investments, which are recorded at cost, were $1.3 million at December 31, 2016 and 2015.

Children's Health investment in joint ventures total $12.5 million in 2016 and $8.7 million in 2015. Children's Health accounts for its investments in Methodist Health under the equity method of accounting. Children's Health accounts for its equity investment in Go Noodle and Pieces Technology under the cost-based method of accounting. In 2016, Children's Health acquired 100% of Pediatric Partners Imaging, which had previously been accounted for as a joint venture.

Other assets include $9.0 million and $8.9 million in physician guarantees at December 31, 2016 and 2015, respectively. The physician guarantees are amortized on a straight line basis over the guarantee period. See Note 14 for a further description of physician guarantees.

Land and improvements held for sale include in Sachse, Texas valued at $0.6 million.

Self-Insurance

Children's Health self-insures professional and general liability risk through its wholly-owned captive insurance company, Texas Trinity River Assurance Company (TTRAC) domiciled in Grand Cayman. The policies are written on an occurrence basis and funded according to actuarial studies performed twice yearly. Excess insurance for these lines of coverage is also issued by TTRAC but the excess policy is 100% reinsured in the commercial markets. The estimated cost of self-insurance is recognized at the time incidents occur. The accompanying consolidated financial statements include the estimated liability for known claims, as well as incurred but not reported claims, based on actuarial calculations expected to be covered by self-insurance.

All Children's Health entities are covered by policies issued by TTRAC. The policies issued by TTRAC cover claims from the first dollar up to $3 million for both professional and general liability. Above these policies an excess insurance program is in place with an additional $100 million in limits.

Children's Health employee health benefits are provided through a self-insurance program that requires the development of a loss reserve to cover claims incurred but not reported. This reserve, in the amount of $6.4 million and $6.1 million, is included in accrued liabilities in the accompanying consolidated balance sheets as of December 31, 2016 and 2015, respectively.

Physician Income Guarantees

In the interest of expanding the availability of Children's Health services, Children's Health enters into physician income guarantee contracts (see Note 14). Through these contracts, Children's Health agrees to fund deficits generated between a physician's collections and direct expenses. The guarantees are typically two to three years in duration and are intended to support the physician in the start-up phase of his or her practice.

Employee Retirement Benefit Plan

Children's Health accounts for its Defined Benefit Retirement Plan (Defined Retirement Plan) in accordance with the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 715, *Compensation – Retirement Benefits*. This topic requires an employer to (1) recognize, in its statement of financial position, an asset for a plan's overfunded status or a liability for a plan's underfunded status; (2) measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year; and (3) recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes are required to be reported in other changes in net assets.

Gifts and Bequests

Unconditional unrestricted gifts and bequests of cash and other assets are included in unrestricted net assets when pledged. Conditional unrestricted gifts and bequests are included in unrestricted net assets when the conditions have been satisfied. Donor-restricted gifts are reported as either temporarily restricted net assets or permanently restricted net assets based upon the donor's intentions. When a time or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions. Endowment gifts donated with stipulations that they be invested to provide a permanent source of income are reported as permanently restricted net assets. Reclassifications between net asset classes (i.e., unrestricted, temporarily restricted, or permanently restricted) may occur when a donor changes their designation of a gift or if subsequent review and interpretation of documentation necessitates a change.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

During 2016, Children's Health determined that certain short-term investments should not be included in cash equivalents and has included them within short term investments in the accompanying consolidated balance sheets. Additionally, short term investments of approximately $172.3 million at December 31, 2015 have been reclassified from cash and cash equivalents. This reclassification impacted the 2015 consolidated balance sheet, statement of cash flows and Note 7.

Performance Indicator

The performance indicator is net income, which includes all changes in unrestricted net assets other than changes in the pension liability funded status, net assets released from restrictions for property acquisitions, the cumulative effect of changes in accounting principles, discontinued operations, contributions of property and equipment, and other changes not required to be included within the performance indicator under generally accepted accounting principles.

New Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) No. ASU 2014-09, *Revenue from Contracts with Customers.* ASU 2014-09 provides for a single comprehensive principles-based standard for the recognition of revenue across all industries through the application of the following five-step process:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations within the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

Among other provisions and in addition to expanded disclosure about the nature, amount, timing, and uncertainty of revenue, as well as certain additional quantitative and qualitative disclosures, ASU 2014-09 changes the health care industry-specific presentation guidance under ASU 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU 2015-14 delayed the effective date of ASU 2014-09, including related amendments, for public business entities to annual periods beginning after December 15, 2017, including interim periods within those years. Management is in the process of evaluating the impact of adoption.

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.* The adoption of the guidance did not have a material impact to the Children's Health consolidated financial statements. This standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. An entity must provide certain disclosures if conditions or events raise substantial doubt about the entity's ability to continue as a going concern. The ASU applies to all entities and was effective for annual periods ending after December 15, 2016, and interim periods thereafter. Management does not believe that Children's Health has a going concern risk.

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs.* This guidance requires companies to present debt issuance costs the same way they present debt discounts, as a direct deduction from the carrying value of the debt. Debt issuance costs moved from assets to the liability section to offset the debt and the amortization of debt issuance costs will be recorded as a component of interest expense. This pronouncement was effective January 1, 2016. The adoption of this statement did not have a material impact on its financial position or statement of operations.

In May 2015, the FASB issued ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (Or Its Equivalents).* This pronouncement removes the requirement to categorize investments as Level 2 or Level 3 for which fair value is measured using the net asset value per share practical expedient. Disclosure requirements are limited to investments for which the entity has elected to measure the fair value using the practical expedient. This pronouncement is effective for fiscal years beginning after 2017. Management is in the process of evaluating the impact of adoption.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842).* This guidance requires lease assets and lease liabilities to be recognized on the balance sheet and the disclosure key information. Additionally, the guidance eliminates real-estate specific provisions and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs for all entities. This pronouncement is effective for periods beginning after December 15, 2018 and interim periods within those years. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. Full retrospective application is prohibited. Management is in the process of evaluating the impact of adoption.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958)*: *Presentation of Financial Statements of Not-for-Profit Entities*. The intent of this pronouncement is to improve how not-for-profits communicate their financial performance and condition, while reducing certain costs and the complexities of preparing financial statements. The key provisions of this new pronouncement are as follows:

- Net asset classification revised to two classes, net asset with donor restrictions and net assets without donor restrictions
- Net presentation of investment expenses against investment return on statement of activities and elimination of requirement to disclose investment expenses that have been netted
- Requirement to present expenses by nature as well as function, including analysis of expenses showing the relationship between functional and natural classification for all expenses
- Disclosure requirements on liquidity and availability of not-for-profit resources to meet cash needs
- Presentation of operating cash flows may be either direct or indirect methods

This pronouncement is effective for fiscal years beginning after 2017. Management is in the process of evaluating the impact of adoption.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash.* This guidance clarifies how entities should present restricted cash and restricted cash equivalents in the statement of cash flows. It requires entities to present the change in restricted cash and restricted cash equivalents with cash and cash equivalents to reconcile amounts on the balance sheet to the statement of cash flows. Entities are required to disclose the nature of the restrictions, as well as reconcile the totals in the statement of cash flows to cash, cash equivalents, restricted cash, and restricted cash equivalents on the balance sheet when these are shown in more than one line item. This pronouncement is effective for fiscal

years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. The guidance is to be applied retrospectively and early adoption is permitted. Management is in the process of evaluating the impact of adoption.
In March 2017, the FASB issues ASU 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.* The ASU amends ASC 715, Compensation – Retirement Benefits, to require employers that present a measure of operating income in their statement of income to include only the service cost component of net periodic pension cost and net periodic postretirement benefit cost in operating expenses. The other components of net benefit cost, including amortization of prior service cost/credit, and settlement and curtailment effects, are to be included in nonoperating expenses. The ASU also stipulates that only the service cost component of net benefit cost is eligible for capitalization. The changes are intended to classify costs according to their natures, and better align the effect of defined benefit plans on operating income with International Financial Reporting Standards (IFRS). Retrospective application of the change in income statement presentation is required, while the change in capitalized benefit cost is to be applied prospectively. The ASU is effective for fiscal years beginning after December 15, 2018 for non-public entities. Early adoption is permitted in the first financial statements (interim or annual) issued for a fiscal year, provided all provisions of the ASU are adopted. Management is evaluating the impact of adoption.

Subsequent Events

Children's Health has evaluated events and transactions occurring subsequent to December 31, 2016, through April 26, 2017, the date the accompanying consolidated financial statements were issued. During this period, there was no subsequent events requiring recognition in the financial statements.

Note 2 – Unconditional Pledges Receivable

Unconditional pledges receivable at December 31, 2016, are as follows (in thousands):

	Less than 1 year	1-5 years	More than 5 years	Total
Pledges receivable	$ 12,445	$ 17,564	$ 160	$ 30,169
Discount on long-term pledges receivable	(397)	(453)	(6)	(856)
Allowance for uncollectible pledges	(139)	(196)	(2)	(337)
Net pledges receivable	$ 11,909	$ 16,915	$ 152	$ 28,976

Note 3 – Conditional Pledges Receivable

As of December 31, 2016, the Foundation had $4.4 million in pledges that contained donor conditions. As of December 31, 2016, $2.6 million is contingent upon Children's Medical Center reaching specific milestones in the expansion of the Foster Care Program, $0.5 million is contingent upon the donor's successful fundraising campaign and $0.8 million is contingent upon submission of a satisfactory progress report. Since these pledges are conditional, they are not recorded as contributions until the donor conditions are met.

Note 4 – Receivables from Remainder Trusts

The Foundation has received, as contributions, split-interest agreements including charitable gift annuities and charitable remainder unitrusts. Trust assets currently consist of cash and cash equivalents, U.S.

government securities, common stocks, and mineral rights. As of December 31, 2016 and 2015, the fair value of the receivables from remainder trusts is $12.3 million and $9.6 million, respectively.

Under the charitable gift annuity arrangements for which the Foundation is the trustee of the assets, the Foundation records the assets at fair value and the liabilities to the beneficiaries at the present value of the estimated future payments to be distributed by the Foundation to such beneficiaries. The amount of the contribution is the difference between the asset and the liability and is recorded as temporarily restricted contributions unless otherwise restricted by the donor.

Under the charitable remainder unitrust arrangements for which the Foundation is the trustee of the assets, the Foundation records as donor-restricted contributions the present value of the residual interest in the trust in the period in which the trust is established. The assets held in trust are recorded at fair value when received, and the liabilities to the beneficiaries are recorded at the present value of the estimated future payments to be distributed by the Foundation to such beneficiaries. The amount of the contribution is the difference between the asset and the liability and is recorded as temporarily restricted or permanently restricted contributions, as applicable. Subsequent changes in fair value for charitable remainder unitrusts are recorded as changes in value of split-interest agreements in the appropriate net asset class.

Under the charitable gift annuity and charitable remainder unitrust arrangements for which the Foundation is not the trustee of the assets, the Foundation records a receivable and restricted contribution revenue at the present value of the estimated future distributions expected to be received by the Foundation over the expected term of the agreement.

The discount rates used are commensurate with the risks involved at the time the contributions are initially recognized and are adjusted annually. At December 31, 2016, the Internal Revenue Service discount rate, which is used to determine the charitable deduction for planned gifts, was 1.8%.

Note 5 - Property and Equipment

Property and equipment consist of the following as of December 31, 2016 and 2015 (in thousands):

	2016	2015
Land and improvements	$ 60,466	$ 60,466
Buildings and improvements	844,434	831,527
Leasehold improvements	32,810	24,811
Fixed equipment	20,906	20,608
Movable equipment	378,585	340,462
	$ 1,337,201	$ 1,277,874
Accumulated depreciation and amortization	(588,213)	(523,767)
Construction in progress	158,755	79,147
Property and equipment, net	$ 907,743	$ 833,254

Note 6 - Assets Limited as to Use

Assets limited as to use consist of the following as of December 31, 2016 and 2015 (in thousands):

Assets Limited as to Use		
	2016	**2015**
Investments designated by the Board	$ 1,029,275	$ 963,482
Investments of temporarily restricted funds	12,491	7,581
Investments of donor-restricted funds for fixed assets	7,672	13,994
Investments of permanently restricted funds	101,312	90,403
	$ 1,150,750	$ 1,075,460

Note 7 - Fair Value of Financial Instruments

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e., an exit price). To measure fair value, a hierarchy has been established that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs. As such, the hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets and liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

Level 1: Unadjusted quoted prices in active markets that are accessible to the reporting entity at the measurement date for identical assets or liabilities.

Level 2: Inputs other than quoted prices in active markets for identical or similar assets and liabilities that are observable either directly or indirectly for substantially the full term of the asset or liability. Level 2 inputs include the following:

- quoted prices for identical or similar assets and liabilities in active markets
- quoted prices for identical or similar assets or liabilities in markets that are not active
- observable inputs other than quoted prices that are used in the valuation of the asset or liabilities (e.g., interest rate and yield curve quotes at commonly quoted intervals)
- inputs that are derived principally from or corroborated by observable market data by correlation or other means

Level 3: Unobservable inputs for the asset or liability (i.e., supported by little or no market activity). Level 3 inputs include management's own assumption about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

The level in the fair value hierarchy within which the fair value measurement is classified is determined based on the lowest level input that is significant to the fair value measure in its entirety.

Following is a description of the valuation techniques and inputs used for each major class of assets and liabilities measured at fair value.

Cash and Cash Equivalents

Cash and cash equivalents include all cash balances and highly liquid investments when purchased with initial maturities of three months or less. The carrying amount approximates fair value because of the short maturity of these instruments.

U.S. Government Securities, Common Stocks, Mutual Funds, Common/Collective Trusts, and Debt Securities

The fair values of the investments included in Level 1 were determined through quoted market prices, while the fair values of Level 2 investments were determined primarily using a market approach, with inputs such as evaluated bid prices provided by third-party pricing services where quoted market values are not available.

The underlying investments of common/collective trusts and pooled investment funds consist of marketable debt and equity securities with readily determinable market values without any lock-up or gate provisions.

Alternative Investments

Children's Health alternative investments have similar risks as traditional fixed income and equity securities, although there may be some additional risk. The alternative investment strategy is to invest in hedge funds in order to obtain attractive risk-adjusted returns that are uncorrelated with equities and fixed income. These funds are invested through limited partnerships that employ various investment strategies, including long-term and short-term equity, multi-strategy, private equity and credit. Performance is driven by individual manager selection and their ability to obtain superior results. Certain alternative investments have lock-up periods and other liquidity limitations that are generally one year from the date of the original investment. Earlier redemptions are allowed with an early redemption penalty.

The net asset values (NAV) of alternative investments are based on valuations provided by the managers of the specified funds. Children's Health accounts for its alternative investments held outside the Foundation and Defined Retirement Plan using the equity method of accounting; accordingly, these investments are excluded from the fair value hierarchy in ASC 820, *Fair Value Measurements and Disclosures*.

Estimated fair values of financial instruments were as follows at December 31, 2016 (in thousands):

		Assets at Fair Value		
	Total	Level 1	Level 2	Level 3
Investment portfolio:				
Cash and cash equivalents	$ 33,892	$ 33,892	$ -	$ -
U.S. government securites	205,051	205,051	-	-
Common stocks	26,757	26,757	-	-
Debt securities:				
Corporate bonds	65,555	-	65,555	-
Mortgage-backed securities	14,054	-	14,054	-
Mutual funds:				
Registered:				
Domestic equity	27,333	27,333	-	-
International equity	55,900	55,900	-	-
Fixed income	22,668	22,668	-	-
Common/collective trusts:				
Domestic equity	182,697	-	182,697	-
International equity	168,456	-	168,456	-
Fixed income	52,661	-	52,661	-
Hedge Funds	252,304	14,108	24,339	213,857
Private Equity	19,927	-	-	19,927
Total investments at fair value	1,127,255	$ 385,709	$ 507,762	$ 233,784
Hedge Funds	178,892			
Private Equity	13,803			
Total investment portfolio	1,319,950			
Included in short term investments	169,200			
Total assets limited to use	$ 1,150,750			
Receivable from remainder trusts	$ 12,348	$ -	$ 12,348	$ -

Estimated fair values of financial instruments were as follows at December 31, 2015 (in thousands):

	Total	Assets at Fair Value Level 1	Level 2	Level 3
Investment portfolio:				
Cash and cash equivalents	$ 114,699	$ 114,699	$ -	$ -
U.S. government securites	111,187	111,187	-	-
Common stocks	11,004	11,004	-	-
Debt securities:				
Corporate bonds	100,018	-	100,018	-
Mortgage-backed securities	80,865	-	80,865	-
Mutual funds:				
Registered:				
Domestic equity	63,458	63,458	-	-
International equity	67,115	50,011	17,104	-
Fixed income	31,677	31,677	-	-
Common/collective trusts:				
Domestic equity	158,340		158,340	-
International equity	209,097	-	209,097	-
Fixed income	40,087	-	40,087	-
Hedge Funds	108,919	8,053	9,110	91,756
Private Equity	7,709	-	-	7,709
Total investments at fair value	1,104,175	$ 390,089	$ 614,621	$ 99,465
Hedge Funds	151,527			
Private Equity	6,060			
Total investment portfolio	1,261,762			
Included in short term investments	186,302			
Total assets limited to use	$ 1,075,460			
Receivable from remainder trusts	$ 9,627	$ -	$ 9,627	$ -

The following table is a rollforward of the financial instruments classified within Level 3 of the valuation hierarchy (in thousands):

	Alternative Investments 2016	2015
Fair value at beginning of year	$ 99,465	$ 30,379
Purchases	133,082	87,765
Sales	(135)	(16,570)
Realized gains (losses)	54	(151)
Unrealized gains (losses) attributable to assets still held at the reporting date	1,318	(1,958)
Fair value at end of year	$ 233,784	$ 99,465

Children's Health currently has no other material financial instruments subject to fair value measurement on a recurring basis.

Long-Term Debt

ASC Topic 825, *Financial Instruments*, requires disclosure of fair value information, whether or not recognized on the balance sheet, for which it is practicable to estimate that value. Certain financial instruments and all nonfinancial instruments are excluded from these disclosure requirements. Accordingly, the aggregate carrying value amounts presented do not represent the underlying value of the long-term debt. The fair value of long-term debt is $400.1 million at December 31, 2016, compared to $396.2 million at December 31, 2015. The carrying value of long-term debt was $364.7 million at December 31, 2016, compared to $369.9 million at December 31, 2015. Estimates are based on available market quotes, which constitute a Level 2 estimate.

Note 8 - Operating Leases

Children's Health leases office space and medical equipment under agreements classified as operating leases extending through 2023. The minimum future obligations under these agreements as of December 31, 2016, are as follows (in thousands):

2017	$	15,373
2018		13,068
2019		11,955
2020		10,899
2021		10,410
Thereafter		33,262
	$	94,967

Operating lease and rental expense of approximately $17.0 million in 2016 and $12.7 million in 2015 is included in general support in the accompanying consolidated statements of operations.

Note 9 - Long-Term Obligations

Long-term obligations consist of the following as of December 31, 2016 and 2015 (in thousands):

	2016	2015
North Central Texas Health Facilities Development Corporation Hospital Revenue Bonds, Series 2012; secured by Children's Health revenue:		
Serial bonds payable August 15, 2017 through 2027, in amounts ranging from $1,305 to $10,465; interest rates range from 3.25% to 5.00%	$ 91,580	$ 94,115
Term bonds payable August 15, 2028 through 2032; 5.00% interest	40,625	40,625
Term bonds payable August 15, 2031 through 2032; 4.125% interest	20,000	20,000
North Central Texas Health Facilities Development Corporation Hospital Revenue Bonds, Series 2009; secured by Children's Health revenue:		
Term bonds payable August 15, 2017 through 2024; 5.00% interest	16,415	16,415
Term bonds payable August 15, 2025 through 2029; 5.50% interest	14,620	14,620
Term bonds payable August 15, 2030 through 2039; 5.75% interest	168,965	168,965
Other, primarily a $10.2 million note at 1% interest	10,185	11,477
	362,390	366,217
Unamortized bond premium/issue costs, net	2,294	3,660
Less current portion	(8,175)	(3,827)
	$ 356,509	$ 366,050

CHST, CMC and the Foundation comprise the Children's Health Medical Center Obligated Group (Obligated Group) for the outstanding Series 2012 and 2009 bonds. Children's Health is not in default on any debt covenants, which include certain financial ratios, insurance coverage minimums, and revenue adequate to cover debt service.

Deferred financing costs of $2.3 million and $3.6 million at December 31, 2016 and 2015 respectively, are amortized over the terms of the respective bonds using the effective interest method.

Scheduled principal payments on long-term debt and capital lease obligations, net of imputed interest, over the next five years are as follows (in thousands):

	Long-Term Debt-Bonds	Long-Term Debt-Other	Long-Term Debt-Total
2017	8,175		8,175
2018	8,585	-	8,585
2019	8,745	-	8,745
2020	9,550	-	9,550
2021	10,030	-	10,030
Thereafter	309,414	10,185	319,599
	$ 354,499	$ 10,185	$ 364,684

Note 10 - Employee Retirement Benefit Plans

Children's Health's Defined Retirement Plan covers substantially all full-time employees hired before December 24, 2006. As of December 24, 2006, the Defined Retirement Plan was frozen to new employees.

The Defined Retirement Plan was amended generally effective January 1, 2012, to (1) offer a one-time, lump-sum cash out opportunity in 2012 to terminated vested participants; (2) provide an automatic rollover distribution for participants who terminate employment on or after July 1, 2012, with a Vested Accrued Benefit that exceeds $1,000 but is less than or equal to $5,000 and who do not elect to receive a lump-sum distribution upon termination; and (3) offer a lump-sum distribution upon termination for participants who terminate on or after July 1, 2012, with a Vested Retirement Benefit of more than $5,000.

The Defined Retirement Plan was further amended, effective December 31, 2013, to curtail the accrual of benefits for all active participants of the Defined Retirement Plan, and to freeze any future service benefits.

Benefits are based on the employee's years of service and compensation during the years immediately preceding the earlier of their termination of employment or December 31, 2013. Employees do not make contributions to the Defined Retirement Plan. Children's Health's policy is to contribute funds sufficient to meet or exceed the minimum annual funding standards under Section 412 of the Employee Retirement Income Security Act of 1974. Plan assets are held in a separate trust under a custodial agreement, with investments directed by the investment committee. Plan assets consist of U.S. government securities, high-grade debt securities, mutual funds, alternative investments, and marketable equity securities. Benefit plans are accounted for in accordance with ASC Topic 715, *Compensation – Retirement Benefits.*

Effective January 1, 2014, Children's Health increased the matching contributions under The Children's Medical Center 401a Employee Savings Plan (Savings Plan) and it became the primary retirement program for all employees. The Savings Plan offers a common matching scale for all participants and normalizes Children's Health's retirement contribution for all employees. Employees who choose to participate in the Savings Plan receive a matching contribution of 4.0% to 7.5% based on years of service. Substantially all employees may participate in Children's Health Savings Plan. In 2016 and 2015, Children's Health made contributions to the Savings Plan of $22.6 million and $15.7 million, respectively.

The information reflected below sets forth the defined benefit plan's benefit obligation, fair value of plan assets, and the funded status as of December 31, 2016 and 2015 (in thousands):

	2016	2015
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	$ 242,914	$ 254,235
Interest cost	10,454	10,209
Actuarial (gain) loss	(1,955)	(6,500)
Benefits paid	(20,994)	(15,030)
Projected benefit obligation, end of year	$ 230,419	$ 242,914
Change in plan assets:		
Fair value of plan assets, beginning of year	$ 170,331	$ 189,946
Actual return on plan assets	7,920	(4,585)
Employer contributions	13,524	-
Benefits paid	(20,994)	(15,030)
Fair value of plan assets, end of year	$ 170,781	$ 170,331
Funded status at end of year	$ (59,638)	$ (72,583)

Amounts recognized in the consolidated balance sheets as of December 31, 2016 and 2015, consist of (in thousands):

	2016	2015
Other noncurrent liabilities	$ 59,638	$ 72,583

The net periodic pension cost as of December 31, 2016 and 2015, includes the following components (in thousands):

	2016	2015
Net periodic benefit expense (income):		
Interest cost	$ 10,455	$ 10,209
Expected return on plan assets	(12,710)	(14,226)
Amortization of net actuarial loss	4,022	2,979
Net periodic benefit expense (income):	$ 1,767	$ (1,038)

Fair values of plan assets by asset category (see Note 8) as of December 31, 2016 and 2015, were (in thousands):

Asset Category	Target Asset Allocation	Plan Assets at December 31 2016			Plan Assets at December 31 2015		
Cash and cash equivalents	- %	$	208	0.1 %	$	2,807	1.7 %
U.S. government securities[2]	-		-	-		-	-
Common stocks[1]	-		2,788	1.6		18,492	10.9
Debt securities	35.0		48,158	28.2		53,761	31.4
Common/collective trusts	50.0		89,192	52.2		69,813	41.0
Hedge Funds	15.0		30,435	17.8		25,458	15.0
	100.0 %	$	170,781	100.0 %	$	170,331	100.0 %

[1] Common stocks target allocation is included in mutual funds.

[2] U.S. government securities' target allocation is included with debt securities.

Fair values of plan assets by asset category at December 31, 2016, were as follows (in thousands):

	Total	Assets at Fair Value Level 1	Level 2	Level 3
Cash - interest bearing	$ 208	$ 208	$ -	$ -
U.S. government securities	-	-	-	-
Common stocks	2,788	2,788	-	-
Common/collective trusts:				
Domestic equities	42,096	34,146	7,950	-
International equities	47,096	9,002	38,094	-
Fixed income	48,158	48,158	-	-
Hedge Funds	30,435	-	-	30,435
Total	$ 170,781	$ 94,302	$ 46,044	$ 30,435

Fair values of plan assets by asset category at December 31, 2015, were as follows (in thousands):

		Assets at Fair Value		
	Total	**Level 1**	**Level 2**	**Level 3**
Cash - interest bearing	$ 2,807	$ 2,807	$ -	$ -
U.S. government securities	-	-	-	-
Common stocks				
Domestic equities	10,557	10,557	-	-
International equities	7,935	7,935	-	-
Common/collective trusts:				
Domestic equities	29,709	22,994	6,715	-
International equities	40,104	-	40,104	-
Fixed income	53,761	-	53,761	-
Hedge Funds	25,458	-	-	25,458
Total	$ 170,331	$ 44,293	$ 100,580	$ 25,458

The following table is a rollforward of the pension plan assets classified within Level 3 of the valuation hierarchy (in thousands):

	Alternative Investments	
	2016	**2015**
Fair value at beginning of year	$ 25,458	$ 17,696
Purchases	4,749	18,898
Sales	(3)	(9,600)
Realized losses	(562)	(1,634)
Unrealized gains attributable to assets still held at the reporting date	793	98
Fair value at end of year	$ 30,435	$ 25,458

Pension assets are managed by professional managers based on an investment policy recommended by investment consultants and approved by the Board. The pension asset allocation is weighted toward equity investments, which reflect the long-term nature of the pension plan. The strategy behind the asset allocation is for the largest holdings to reflect the broad U.S. equity markets, while providing some potential for the enhanced returns that can be provided by small cap, mid cap, and international equities. The fixed income portion provides some protection from the risks of equity investments. Common/collective trusts are used to gain access to liquid investment instruments through a vehicle with lower fees and enhanced diversification. The alternative investment strategy is to invest in hedge funds in order to obtain attractive risk-adjusted returns that are uncorrelated with equities and fixed income. The expected long-term rate of return on plan assets of 7.7% is based on a long-range investment model developed during an asset allocation study performed by investment consultants.

The accumulated benefit obligation was $230.4 million and $242.9 million at December 31, 2016 and 2015, respectively.

As of December 31, 2016, benefits expected to be paid for each of the following five fiscal years and in aggregate for the next five fiscal years are as follows (in thousands):

2017	$	10,810
2018		11,093
2019		11,436
2020		11,774
2021		12,140
Aggregate next five fiscal years		60,809
Total	$	118,062

Other changes in plan assets and benefit obligations recognized in changes in unrestricted net assets for the years ended December 31, 2016 and 2015, are (in thousands):

		2016		**2015**
Net loss (gain)	$	(1,324)	$	9,457
Other		(4,022)		(2,979)
Total recognized in changes in unrestricted net assets	$	(5,346)	$	6,478

The net loss for the defined benefit pension plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year is $3.6 million.

Amounts in unrestricted net assets that have not been recognized in net periodic benefit cost, as of December 31, 2016 and 2015, consist of (in thousands):

		2016		**2015**
Net actuarial loss	$	56,553	$	61,900

Weighted-average assumptions used in the accounting for net periodic benefit costs and the benefit obligation and funded status were:

	2016	**2015**
Net periodic benefit costs:		
Discount rate	4.40%	4.10%
Expected long-term rate of return on plan assets	7.70%	7.70%
Compensation increase rate	N/A	N/A

	2016	**2015**
Benefit obligation and funded status:		
Discount rate	4.40%	4.40%
Expected long-term rate of return on plan assets	7.70%	7.70%
Compensation increase rate	N/A	N/A

Note 11 - Temporarily Restricted Net Assets

Temporarily restricted net assets are available for the following purposes (in thousands):

	2016	2015
Patient care	$ 29,237	$ 31,168
Construction	2,873	7,548
Research	17,176	16,180
Education	1,923	1,439
Equipment	4,672	1,613
Time-restricted	12,784	10,048
Plano campus	5,537	10,038
Other	2,154	1,934
	$ 76,356	$ 79,968

Note 12 - Permanently Restricted Net Assets

Permanently restricted net assets at December 31 are restricted to (in thousands):

	2016	2015
Patient care	$ 40,542	$ 38,227
Research	54,876	53,001
Education	4,036	4,011
Legacy campus	209	141
General operations	20,701	20,525
Other	(443)	(141)
	$ 119,921	$ 115,764

The Foundation adopted *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds* under ASC Topic 958, *Not for Profit Entities*, on December 31, 2008. This guidance provides for the proper net asset classification of donor-restricted endowment funds for not-for-profits in states that have adopted an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006.

All permanently restricted funds are donor-restricted endowment funds established primarily to fund specific activities at Children's Health. Board designated endowments classified as unrestricted and Child Life Centennial Fund were $25.9 million and $1.9 million, respectively, as of December 31, 2016 compared to $23.3 million at December 31, 2015. As required by generally accepted accounting principles, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

The State Prudent Management of Institutional Funds Act provides statutory guidelines for the management, investment, and expenditure of endowment funds held by charitable organizations in the absence of explicit donor stipulations.

The Foundation classifies the historic value of donor-restricted gifts to be held in perpetuity as permanently restricted net assets. The intent of the Foundation is to preserve the historic value of permanently restricted gifts. The endowment distribution policy allows a 0% to 5% distribution of the endowment asset, which is defined as the simple average of the previous 12 fiscal quarters' ending values. At December 31, 2016 and 2015, permanently restricted net assets representing donor-restricted perpetual endowment funds were approximately $119.9 million and $115.8 million, respectively.

Note 13 - Accrued Liabilities

Accrued liabilities consist of the following as of December 31 (in thousands):

	2016	2015
Accrued salaries and benefits	$ 37,912	$ 29,318
Accrued paid time off	41,760	37,298
Accrued Medical Claims Payable	10,540	-
Third-party settlements payable	9,713	10,819
Other	977	301
	$ 100,902	$ 77,736

Note 14 - Physician Income Guarantees

Physician income guarantees are accounted for in accordance with ASC Topic 460, *Guarantees*. Children's Health records an asset and liability for the estimated payments to be made under physician income guarantees. The assets are amortized using the straight-line amortization method for the guarantee period, and the liabilities are released as payments are made. The unamortized portion of these physician guarantees, included in other assets, is $9.0 million and $8.9 million, as of December 31, 2016 and December 31, 2015, respectively. The current portion of the guarantees is included in other current liabilities and the noncurrent portion of the guarantees is included in other noncurrent liabilities on the consolidated balance sheets. Total guarantees were $10.2 million and $11.5 million as of December 31, 2016 and December 31, 2015, respectively. The maximum amount that could be paid under Children's Health's physician income guarantees was approximately $18.3 million as of December 31, 2016.

Note 15 - Commitments and Contingencies

Under terms of an agreement, as amended, originally dated October 29, 1964, and most recently renewed on October 1, 2000, Children's Health and UT Southwestern (UTSW) affiliated to provide for the delivery of preeminent pediatric medical and surgical services. The agreement specifies that Children's Health and its affiliate centers will serve as the primary pediatric clinical service and teaching sites for the delivery of such services. Children's Health's expenditures under this and related agreements are determined each year working with UTSW during its annual budgeting process.

Children's Health is involved in certain litigation and is subject to claims that may arise in the normal course of its operations. It is the opinion of management, based on consultation with legal counsel, that such litigation and claims will be resolved without a material adverse effect on Children's Health's consolidated financial position or results of operations.

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed.

Management believes that Children's Health is in compliance with government laws and regulations related to fraud and abuse, and other applicable areas. While no material regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

Children's Health continues to upgrade and improve its facilities as well as its Information Technology (IT) capabilities and infrastructure. For the year ended December 31, 2016, outstanding commitments for construction are approximately $71.0 million, outstanding commitments for equipment are approximately $0.4 million, and outstanding commitments for IT-related projects are approximately $0.7 million.

At December 31, 2016, Children's Health had commitments to fund private equity investments totaling $147.2 million.

Note 16 - Professional Liability

The net amount of Children's Health's professional liability was $5.8 million and $4.6 million as of December 31, 2016 and 2015, respectively. ASU 2010-24, *Presentation of Insurance Claims and Related Recoveries*, requires professional liabilities to be reported at gross, without the consideration of insurance recoveries. Accordingly, Children's Health has recorded professional liabilities of $8.2 million and $7.5 million, discounted at 3%, in other noncurrent liabilities in the consolidated balance sheet and an asset representing insurance recoveries of $2.4 million and $2.9 million in other assets in the consolidated balance sheets at December 31, 2016 and 2015, respectively.

Note 17- Supplemental Income

The state of Texas secured a waiver from certain federal Medicaid requirements for the five-year period ending September 30, 2016. The waiver was subsequently extended for 18 months to December 31, 2017. Under the terms of the waiver, the State implemented changes to the way in which it compensates Children's Health and other providers for care to patients covered by the Medicaid program. The waiver established two new pools of funds, UCP and DSRIP.

Under the terms of the waiver, the UCP provides funding for hospitals which have substantial uncompensated care costs or unreimbursed costs for Medicaid patients, reduced by DSH payments to the hospitals. UCP revenue, included in patient services revenue, for 2016 and 2015 was $23.3 million and $44.3 million, respectively.

The DSRIP program provides funding incentives to hospitals and other providers to enhance access to care and the health of patients. DSRIP revenue, included in other operating revenue, for 2016 and 2015 was $55.2 million and $50.4 million, respectively.

Children's Health also participates in the DSH Program, which provides funds to the hospitals that serve a significantly disproportionate number of low-income patients. DSH revenue, included in patient services revenue, for 2016 and 2015 was $20.8 million and $19.9 million, respectively.

Note 18 - Provision for Doubtful Accounts

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, Children's Health analyzes its past history and identifies trends for each of its major payer sources to estimate the appropriate allowance for doubtful accounts and provision for doubtful accounts. Management regularly reviews data for these major payer sources in evaluating the sufficiency of the allowance. For receivables associated with services provided to patients who have third-party coverage, Children's Health analyzes contractually due amounts and provides an allowance for doubtful accounts. For receivables associated with self-pay patients (which includes both patients without insurance and those patients with insurance where deductible and copayment balances exist), Children's Health records a provision for doubtful accounts in the period of service on the basis of its past experience. The difference between the standard rates (or the discounted rates if applicable) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

Children's Health's allowance for doubtful accounts increased from $34.1 million or 11.7% of total gross accounts receivable at December 31, 2015 to $43.1 million or 12.5% of total gross accounts receivable as of December 31, 2016. Children's Health does not maintain a material allowance for doubtful accounts from third-party payers, nor did it have significant write-offs from third-party payers during 2016 or 2015.

A summary of activity of for the allowance for doubtful accounts follows (in thousands):

	Balance at Beginning of Year	Provision for Doubtful Accounts	Accounts Written off, Net of Recoveries	Balance at End of Year
Allowance for doubtful accounts:				
Year Ended December 31, 2015	$ (30,547)	$ (36,413)	$ 32,842	$ (34,118)
Year Ended December 31, 2016	(34,118)	(54,928)	45,946	(43,100)

Children's Health recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, Children's Health recognized revenue on the basis of its standard rates for services provided, or on the basis of discounted rates if negotiated, and as provided by policy. On the basis of historical experience, Children's Health records a provision for doubtful accounts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and charity care (but before the provision for doubtful accounts), recognized year-to-date from these major payer sources is as follows (in thousands):

Patient service revenue less contractuals:	Government	Commercial	Other	Total All Payers
Twelve Months Ended December 31, 2016	$ 546,101	$ 624,545	$ 139,577	$ 1,310,225
Twelve Months Ended December 31, 2015	562,623	549,874	130,573	1,243,070

Note 19 - Functional Expenses

FASB ASC Topic 958, *Not for Profit Entities,* requires the presentation of information about expenses reported by their functional classification, such as program services and supporting activities. Program services are those activities that fulfill the mission of Children's Health, which is to make life better for children. Supporting services include management, general, and fundraising activities.

Program and supporting services expenses were as follows (in thousands):

	2016	2015
Program services	$ 869,521	$ 727,845
Management and general	516,316	481,766
Fundraising	2,450	1,485
	$ 1,388,287	$ 1,211,096

Note 20 - Charity Care

The value of charity care provided by Children's Health, excluding subsidiaries, based upon its established rates, was approximately $42.6 million in 2016 and $58.2 million in 2015. Children's Health utilizes the cost to charge ratios, as calculated based on its most recent cost reports filed with the Centers for Medicare and Medicaid Services, to determine the total cost. Children's Health's cost of providing charity care was $13.2 million and $18.2 million for the years ended December 31, 2016 and 2015, respectively.

Note 21 - Volunteer Services

Volunteers contribute significantly to Children's Health's mission by enabling the organization to multiply its resources to exceed the needs of patients and their families. Services performed by volunteers include delivering flowers and mail, escorting visitors throughout the hospital, assisting in playrooms during activities, tutoring patients, sitting with patients whose parents are away from the hospital, assisting patient families in ambulatory care and critical care areas, and working in the gift shop. The value of these services has not been included in the accompanying consolidated financial statements as it is not readily determinable.

Supplementary Information

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Report of Independent Auditors on Supplementary Information

The Board of Directors
Children's Health System of Texas

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating statement of operations of Children's Health System of Texas and combining balance sheet and statement of operations of Children's Medical Center Obligated Group are presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Ernst + Young LLP

April 26, 2017

Children's Health System of Texas
Consolidating Statement of Operations
For the Year Ended December 31, 2016
(Unaudited, In Thousands)

	Clinical Services	Physician / Academic	Pop Health / Insurance	CHST Ventures	Corporate Services	Foundation	Eliminations	Consolidated
Operating Revenue								
Net patient services revenue	$ 1,225,952	$ 38,693	$ 216	$ 589	$ 3	$ -	$ (10,156)	$ 1,255,297
Other operating revenue	60,524	51,721	60,158	9,029	8,035	6,578	(27,360)	168,685
Total Operating Revenue	1,286,476	90,414	60,374	9,618	8,038	6,578	(37,516)	1,423,982
Operating Expenses								
Salaries & fringe benefits	480,353	88,799	27,289	15,097	124,530	6,861	(173)	742,757
Professional services	5,597	35,494	434	947	112,576	-	(21,710)	133,338
Supplies	148,665	2,740	22	97	(697)	-	(8)	150,819
General support	70,645	27,538	55,839	10,738	127,891	2,835	(15,970)	279,516
Depreciation	47,037	2,153	455	127	14,589	1	(10)	64,352
Interest	17,492	-	-	-	13	-	-	17,505
Shared Services	353,474	(23,233)	11,395	-	(341,636)	-	-	-
Total Operating Expenses	1,123,263	133,491	95,434	27,006	37,266	9,697	(37,871)	1,388,287
Operating Income	163,213	(43,077)	(35,060)	(17,388)	(29,228)	(3,119)	355	35,695
Non Operating Income (Loss)								
Realized investment gains (losses)	13,818	-	-	-	(496)	17,790	-	31,111
Unrealized investment gains	15,518	-	-	-	58	16,472	-	32,046
Other	-	-	-	1,602	-	-	-	1,602
Total Non Operating Income (Loss)	29,336	-	-	1,602	(438)	34,262	-	64,759
Net Income (Loss)	$ 192,549	$ (43,077)	$ (35,060)	$ (15,786)	$ (29,666)	$ 31,143	$ 355	$ 100,454

Children's Health System of Texas
Children's Medical Center Obligated Group
Combining Balance Sheet
As of December 31, 2016
(Unaudited, In Thousands)

	CHST	CMC	Foundation	Eliminations	Combined
ASSETS					
Current Assets:					
Cash and cash equivalents	$ 119,300	$ (11,397)	$ 17,935	$ -	$ 125,838
Patient accounts receivable, net of allowances	(249)	147,099	-	-	146,850
Pledges receivable, net of allowances	-	-	11,909	-	11,909
Inventories	1,236	15,641	-	-	16,877
Other current assets	31,760	19,326	409	-	51,495
Short-term investment	-	145,621	23,579	-	169,200
Total Current Assets	152,047	316,290	53,832	-	522,169
Pledges Rececivable, net of allowances	-	-	17,067	-	17,067
Receivables From Remainder Trusts	-	-	12,348	-	12,348
Property and Equipment, net	99,824	767,111	53	(114)	866,874
Assets Limited As To Use	-	485,079	665,670	-	1,150,749
Net Assets of the Foundation	-	733,238	-	(733,238)	-
Other Assets	50,897	34,348	9,294	-	94,539
Total Assets	$ 302,768	$ 2,336,066	$ 758,264	$ (733,352)	$ 2,663,746
LIABILITIES AND NET ASSETS					
Current Liabilities:					
Accounts payable	$ 75,454	$ 24,074	$ 446	$ -	$ 99,974
Accrued liabilities	19,041	63,774	910	-	83,725
Accrued interest	-	7,015	-	-	7,015
Current portion of long-term debt and	-	-	-	-	-
capital lease obligations	-	8,175	-	-	8,175
Other current liabilities	8,992	-	-	-	8,992
Total Current Liabilities	103,487	103,038	1,356	-	207,881
Long-term Debt and Capital Lease Obligations,					
net of current portion	-	356,509	-	-	356,509
Other Noncurrent Liabilities	5,703	68,198	1,936	-	75,837
Intercompany	978,815	(1,220,023)	21,734	138,584	(80,890)
Net Assets:					
Unrestricted	(785,237)	2,294,859	537,208	(138,698)	1,908,132
Temporarily restricted	-	613,564	76,109	(613,317)	76,356
Permanently restricted	-	119,921	119,921	(119,921)	119,921
Total Net Assets	(785,237)	3,028,344	733,238	(871,936)	2,104,409
Total Liabilities and Net Assets	$ 302,768	$ 2,336,066	$ 758,264	$ (733,352)	$ 2,663,746

Children's Health System of Texas
Children's Medical Center Obligated Group
Combining Statement of Operations
For the Year Ended December 31, 2016
(Unaudited, In Thousands)

	CHST	CMC	Foundation	Eliminations	Combined
Operating Revenue					
Net patient services revenue	$ (428)	$ 1,187,531	$ -	$ -	$ 1,187,103
Other operating revenue	14,466	60,601	6,578	(2,981)	78,664
Total Operating Revenue	14,038	1,248,132	6,578	(2,981)	1,265,767
Operating Expenses					
Salaries & fringe benefits	172,423	456,011	6,861	-	635,295
Professional services	128,733	4,832	-	-	133,565
Supplies	(662)	147,002	1	-	146,341
General support	137,952	65,066	2,835	(2,981)	202,872
Depreciation	14,747	46,704	1	(10)	61,442
Interest	14	17,491	-	-	17,505
Shared Services	(382,593)	353,475	-	-	(29,118)
Total Operating Expenses	70,614	1,090,581	9,698	(2,991)	1,167,902
Operating (Loss) Income	(56,576)	157,551	(3,120)	10	97,865
Non Operating (Loss) Income					
Realized investment gains (losses)	(496)	13,817	17,790	-	31,111
Unrealized investment gains (losses)	-	15,517	16,472	-	31,989
Other	-	-	-	-	-
Total Non Operating (Loss) Income	(496)	29,334	34,262	-	63,100
Net (Loss) Income	$ (57,072)	$ 186,885	$ 31,142	$ 10	$ 160,965

Children’s Medical Center Obligated Group
Note to Combining Obligated Group
December 31, 2016

Note 1 – Basis of Presentation

Children’s Health Medical Center Obligated Group (Obligated Group), as defined in the Master Trust Indenture dated September 1, 1988, as supplemented, and further supplemented by Supplemental Indenture Number 16, dated May 1, 2012, comprises Children’s Health System of Texas, Children’s Medical Center and Children’s Medical Center Foundation.

Management's Discussion and Analysis of Financial Condition and Results of Operations (Unaudited)

Children's Health System of Texas and Affiliates
Management's Discussion and Analysis of Financial Condition and Results of Operations
Quarter and Year Ended December 31, 2016
(Unaudited)

The following discussion and analysis should be read in conjunction with the Children's Health Consolidated Financial Statements and the Notes thereto.

Summary of Utilization
Quarters and Years Ended December 31, 2016 and 2015

	Fourth Quarter		Year Ended	
	2016	**2015**	**2016**	**2015**
Inpatient Discharges	4,060	3,659	15,561	14,401
Patient Days	26,490	25,503	109,004	101,533
- ICU Days	8,354	8,982	34,722	33,478
ED Visits	44,359	41,837	167,923	164,335
Ambulatory Visits	99,609	95,968	396,563	368,780
Professional Services	90,843	78,549	330,649	272,066
- CHPG Visits	69,940	62,454	254,326	215,460
Surgeries	7,207	6,976	29,658	28,442
Case Mix Index	2.36	2.50	2.29	2.40
- Medicaid CMI	2.58	2.75	2.59	2.54
Payor Mix				
Commercial	34%	31%	33%	32%
Managed Medicaid	43%	33%	37%	33%
Medicaid	17%	32%	26%	31%
Other	6%	4%	4%	4%

Volumes

Inpatient discharges increased by 401 (11%) and 1,160 (8%) for the quarter and year ended December 31, 2016, respectively, compared to the same period in the prior year.

Patient days increased by 987 days (4%) and 7,471 days (7%) for the quarter and year ended December 31, 2016, respectively, compared to the same period in the prior year.

ICU days decreased by 628 days (7%) and increased 1,244 (4%) for the quarter and year ended December 31, 2016, respectively, compared to the same period in the prior year.

ED visits increased by 2,522 (6%) and 3,588 (2%) for the quarter and year ended December 31, 2016, respectively, compared to the same period in 2015.

Ambulatory visits increased by 3,641 (4%) and 27,783 (8%) for the quarter and year ended December 31, 2016, respectively, compared to the same period in the prior year.

Professional services visits increased by 12,294 (16%) and 58,583 (22%) for the quarter and year ended December 31, 2016, compared to the same period in the prior year. CHPG clinic visits increased by 7,486 (12%) and 38,866 (18%) for the quarter and year ended December 31, 2016, respectively, compared to the same periods in 2016. CHPG operated 18 clinics for the year ended December 31, 2016 compared to 21 clinics for the year ended December 31, 2015.

Surgeries increased 231 (3%) and increased 1,216 (4%) for the quarter and year ended December 31, 2016, respectively, compared to the same period in the prior year.

Net Patient Service Revenue

Patient service revenue is derived from charges for services provided to patients. Physicians order all services provided to patients such as inpatient care and ancillary services, lab tests, drugs, radiology procedures, and surgical procedures. Children's Health records charges as revenue at the time the service is provided.

Children's Health has contractual agreements with third-party payers including managed care health plans, such as HMOs and PPOs, and government programs, such as Medicaid and the Children's Health Insurance Program (CHIP), which are both administered by the state of Texas. Payments from these payers are based on charges, fixed per diem rates, the costs of providing services, and discounts from established charges. Children's Health reports revenue at net realizable value after reflecting adjustments provided for in these contracts.

Children's Health provides financial counseling to assist patients with no third-party coverage to qualify for government programs. Children's Health records revenue for these patients at net realizable value based on historical qualification rates. Charges for patients that do not qualify for government assistance, but fall within Children's Health charity guidelines, are recorded as charity care and excluded from net patient service revenue.

Accounts receivable on Children's Health balance sheets is recorded net of allowances for contractual adjustments, doubtful accounts, and charity care.

The volume of inpatient, outpatient and day surgery patients, as well as the acuity or intensity of care required, drives the level of Children's Health revenue. Volumes in intensive care units have a disproportionately large influence on the level of revenue due to the very high acuity and resource consumption of these patients and because contractual arrangements provide an adequate level of reimbursement for these cases.

Expenses

Healthcare is a very labor-intensive industry. For the quarters ended December 31, 2016 and 2015, salaries and benefits were 51% and 52% of Children's Health operating expenses, respectively. Salaries and benefits were 54% and 52% of operating expenses for the years ended December 31, 2016 and 2015, respectively. The salaries and benefits expense category represents salaries for all employees and all employee benefits and payroll-related taxes.

Professional services, which includes the costs associated with residents and the cost of contract labor including medical administrative and physician coverage fees, were 9% and 7% of the operating expenses for the quarters ended December 31, 2016 and 2015, respectively. For the years ended December 31, 2016 and 2015, professional services were 10% and 9% of operating expenses, respectively.

Supplies and other expenses, the cost of supplies, pharmaceuticals, and services directly related to patient care, were 10% and 11% of the operating expenses for the quarters ended December 31, 2016 and 2015, respectively. For years ended December 31, 2016 and 2015, supplies and other expenses were 11%.

The general support expense category represents non-clinical supply and service costs in areas such as information services, medical records, and billing and collections. For the quarters ended December 31, 2016 and 2015, general support expense was 24% and 23% of operating expenses, respectively. For the years ended December 31, 2016 and 2015, general support expense was 20% and 22% of operating expenses, respectively.

The depreciation and amortization expense category represents the cost of property and equipment and capital leases recognized over the estimated useful lives of the assets and terms of the leases. Depreciation expense, as a percentage of operating expenses, for the quarters and years ended December 31, 2016 and 2015, was 5% of operating expenses. Depreciation and amortization is computed using the straight-line method over a period of 3 to 40 years based on the asset classification or terms of the leases.

The interest expense category represents the cost of financing the outstanding bond issues and capital leases. Interest expense was 1% of operating expenses for the quarters and years ended December 31, 2016 and 2015. No interest was capitalized for the years ended December 31, 2016 and 2015.

Results of Operations

Operating income of $3.6 million for the quarter ended December 31, 2016, represents a $24.0 million decrease over the same period in 2015. Operating income for the year ended December 31, 2016, decreased $69.3 million to $35.7 million, from the same period in 2015.

Net patient service revenue decreased $15.2 million (5%) for the quarter ended December 31, 2016, compared to the same period in 2015. For the year ended December 31, 2016, net patient service revenue increased $48.6 million (4%) over 2015. The decrease is related to a decrease in ICU and Heart Center patients. The increases were due primarily to an increase in the number of patient days and outpatient visits along with revenue related to acquisition of OCH. Children's Health acquired OCH on September 20, 2015. Additional components of net patient service revenue are the provision for doubtful accounts, disproportionate share, and uncompensated care.

The provision for doubtful accounts represents the charges for patient services that are not recovered from patients that are deemed able to pay (and therefore do not qualify for Children's Health charity). These amounts include account balances from uninsured patients and unpaid deductible and co-pay amounts from insured patients. The provision for doubtful accounts increased $11.8 million (173%) for the quarter ended December 31, 2016, and increased $18.5 million (51%) for the year ended December 31, 2016, when compared to the same periods in 2015. As a percentage of net patient service revenue, the provision for doubtful accounts was 4% and 3% for the years ended December 31, 2016 and 2015, respectively. For the quarters ended December 31, 2016 and 2015, the provision for doubtful accounts was 6% and 2% of net patient service revenue, respectively.

Children's Health's portion of the DSH program administered by the Texas Department of Human Services decreased $2.0 million (27%) and increased $0.9 million (4%) for the quarter and year ended December 31, 2016, compared to the same period in 2015. Under the program, local, state, and federal funds are accessed and distributed to hospitals providing a high volume of services to Medicaid and indigent patients.

Children's Health's portion of the UCP program administered by the Texas Department of Human Services decreased $9.2 million (77%) and $21.0 million (47%) for the quarter and year ended December 31, 2016, compared to the same period in 2015.

Children's Health provided charity care of $3.3 million and $42.6 million, based on charges, in the quarter and years ended December 31, 2016, respectively, compared to $18.0 million and $58.2 million in the quarter and year ended December 31, 2015.

The Children's Hospital Graduate Medical Education (CHGME) program receipts increased $0.3 to $1.2 million for the quarter ended December 31, 2016 as compared to the same quarter in 2015. Program receipts increased $0.8 million to $6.8 million for year ended December 31, 2016, as compared to the year ended 2015.

Other operating revenue of $61.3 million increased by $37.2 million (155%) and increased $50.3 million (55%) to $141.4 million for the quarter and year ended December 31, 2016, compared to the same time period in 2015. Other operating revenue is primarily derived from premium revenue from Starkids program, DSRIP funds, dietary revenue, user fees, retail pharmacy revenue and other miscellaneous revenue. Children's Health began participating in Starkids program on November 1, 2016 and recorded premium revenue of $38.6 million. DSRIP revenue was $10.2 million and $55.2 million for the quarter and year ended December 31, 2016, respectively, compared to $14.3 million and $50.4 million in the quarter and year ended December 31, 2015.

Salaries and benefits increased $26.2 million (16%) for the quarter ended December 31, 2016, and increased $108.4 million (17%) for the year ended December 31, 2016, compared to the same periods in the prior year. Salaries and benefits are 64% of net patient service revenue for the quarter ended December 31, 2016, compared to 53% for the same period in 2015. For the years ended December 31, 2016 and 2015, salaries and benefits were 59% and 53% of net patient service revenue, respectively.

Professional services increased $9.5 million (41%) for the quarter ended December 31, 2016, and increased $29.8 million (29%) for the year ended December 31, 2016, compared to the same periods in 2015. As a percentage of net patient service revenue for the quarters ended December 31, 2016 and 2015, professional services were 11% and 7%, respectively. For the years ended December 31, 2016 and 2015, professional services were 11% and 9% of net patient service revenue, respectively.

Supply costs increased $2.9 million (8%) for the quarter ended December 31, 2016, and increased $17.6 million (13%) for the year ended December 31, 2016, over the same periods in 2015. Supply costs as a percentage of net patient service revenue were 13% and 11% for the quarters ended December 31, 2016 and 2015, respectively. For the year ended December 31, 2016 and 2015, supply costs were 12% and 11%, respectively.

General support increased $16.5 million (22%) for the quarter ended December 31, 2016, and $17.5 million (7%) for the year ended December 31, 2016, over the same periods in 2015. General support costs were 30% and 23% of net patient service revenue for the years ended December 31, 2016 and 2015, respectively, 22% for the quarters and years ended December 31, 2016 and 2015 respectively. This increase is primarily due to consulting and professional fees, software maintenance fees, contract services and facilities costs.

Depreciation and amortization expense increased $1.6 million (10%) for the quarter ended December 31, 2016, and $4.1 million (7%) for the year ended December 31, 2016, over the same periods in 2015. As a percentage of net patient service revenue, depreciation and amortization expense was 6% and 5% for the quarters ended December 31, 2016 and 2015, respectively. For the years ended December 31, 2016 and 2015, depreciation and amortization expense was 5% of net patient service revenue, respectively.

Interest expense decreased $0.1 million (3%) for the quarter ended December 31, 2016, and $0.2 million (1%) for the year ended December 31, 2016, compared to the same periods in 2015.

Investment income (realized and unrealized investment gains and losses) was a gain of $2.8 million for the quarter ended December 31, 2016 and a gain of $18.9 million for the quarter ended December 31, 2015. For the year ended December 31, 2016, investment income was a gain of $63.2 million compared to a loss of $26.5 million for the year ended December 31, 2015. Market conditions drove the gains and losses in 2016 as well as in 2015.

Liquidity and Capital Resources

Children's Health continues to experience strong financial liquidity, with cash and investments of $1.5 billion, at December 31, 2016, or 381 days of cash on hand.

Net cash provided by operating and nonoperating activities was $139.2 million for the year ended December 31, 2016, compared to net cash used in operating activities of $116.7 million for the same period in 2015, primarily due to a decrease in purchases of assets limited as to use in 2016 as compared to 2015.

Net cash used in investing activities was $141.2 million for the year ended December 31, 2016, compared to $100.6 million for the year ended December 31, 2015.

Net cash used in financing was $2.5 million for the year ended December 31, 2016, compared to net cash used in financing of $1.0 million for the same period in 2015.

Off-Balance Sheet Financing

Children's Health does not have any debt of material guarantee obligations that are not reflected on the accompanying consolidated balance sheets and does not have an ownership stakes in any special purpose entities.