

CONSOLIDATED FINANCIAL STATEMENTS,
REPORTS, SUPPLEMENTARY INFORMATION,
AND SCHEDULE REQUIRED BY THE UNIFORM
GUIDANCE

City of Hope and Affiliates
Years Ended September 30, 2016 and 2015
With Report of Independent Auditors

Ernst & Young LLP



City of Hope and Affiliates

Consolidated Financial Statements, Reports, Supplementary Information, and
Schedule Required by the Uniform Guidance

Years Ended September 30, 2016 and 2015

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Report of Independent Auditors

Management and the Board of Directors
City of Hope and Affiliates

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of City of Hope and Affiliates, which comprise the consolidated statements of financial position as of September 30, 2016 and 2015, and the related consolidated statements of activities 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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of 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

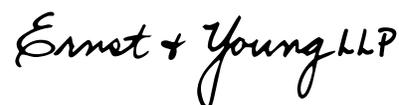
In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of City of Hope and Affiliates as of September 30, 2016 and 2015, and the consolidated results of their activities and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The Schedule of Expenditures of Federal Awards as required by Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* is presented for purposes of additional analysis and is not a required part of the 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 financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the 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 financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we also have issued our report dated December 19, 2016, on our consideration of City of Hope and Affiliates' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering City of Hope and Affiliates' internal control over financial reporting and compliance.



December 19, 2016

City of Hope and Affiliates

Consolidated Statements of Financial Position
(In Thousands)

| | September 30 | |
|---|----------------------------|----------------------------|
| | 2016 | 2015 |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 121,460 | \$ 133,293 |
| Investments | 1,083,215 | 811,802 |
| Self-insurance trust funds | 3,581 | 3,730 |
| Patient accounts receivable, less allowances for uncollectible accounts of \$8,747 in 2016 and \$8,205 in 2015 | 243,508 | 206,151 |
| Grants and other receivables | 66,323 | 49,084 |
| Due from third-party payors | 3,910 | - |
| Donor-restricted unconditional promises to give, net | 22,291 | 18,660 |
| Prepaid and other | 28,886 | 23,512 |
| Total current assets | <u>1,573,174</u> | <u>1,246,232</u> |
| Property and equipment, net | 722,720 | 679,305 |
| Other assets: | | |
| Investments held for long-term purposes | 357,516 | 371,440 |
| Board-designated assets | 715,191 | 653,354 |
| Donor-restricted assets: | | |
| Investments | 345,912 | 311,710 |
| Unconditional promises to give, net | 86,841 | 70,078 |
| Contributions receivable from annuity and split-interest agreements, net | 15,136 | 8,027 |
| Other | 1,580 | 1,880 |
| Intangible assets | 2,768 | 4,020 |
| Other long-term assets | 44,920 | 40,065 |
| Total other assets | <u>1,569,864</u> | <u>1,460,574</u> |
| Total assets | <u><u>\$ 3,865,758</u></u> | <u><u>\$ 3,386,111</u></u> |

| | September 30 | |
|--|----------------------------|----------------------------|
| | 2016 | 2015 |
| Liabilities and net assets | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 139,769 | \$ 85,599 |
| Accrued salaries, wages, and employee benefits | 58,269 | 53,673 |
| Long-term debt, current portion | 90,571 | 72,549 |
| Deferred revenue | 23,117 | 13,990 |
| Due to third-party payors | – | 8,019 |
| Other | 405 | 293 |
| Total current liabilities | <u>312,131</u> | 234,123 |
| Long-term debt, net of current portion | 618,303 | 628,035 |
| Annuity and split-interest agreement obligations | 17,264 | 16,846 |
| Deferred rent | 10,648 | 11,711 |
| Interest rate swap | 16,952 | 11,034 |
| Other | 38,111 | 35,170 |
| Total liabilities | <u>1,013,409</u> | 936,919 |
| Net assets: | | |
| Unrestricted | 2,395,357 | 2,054,965 |
| Temporarily restricted | 288,549 | 224,424 |
| Permanently restricted | 168,443 | 169,803 |
| Total net assets | <u>2,852,349</u> | 2,449,192 |
| | | |
| Total liabilities and net assets | <u><u>\$ 3,865,758</u></u> | <u><u>\$ 3,386,111</u></u> |

See accompanying notes.

City of Hope and Affiliates

Consolidated Statements of Activities
(In Thousands)

Year Ended September 30, 2016

| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total |
|---|---------------------|---------------------------|---------------------------|---------------------|
| Revenues: | | | | |
| Contributions (including \$28,617 of contributions from special events) | \$ 55,675 | \$ 71,567 | \$ 5,978 | \$ 133,220 |
| Special event participation revenue | 4,885 | - | - | 4,885 |
| Less: cost of direct benefits to donors | (6,900) | - | - | (6,900) |
| Contributions and net revenues from special events | 53,660 | 71,567 | 5,978 | 131,205 |
| Net patient service revenues | 1,119,808 | - | - | 1,119,808 |
| Research grants | 87,799 | - | - | 87,799 |
| Investment income | 80,602 | 7,830 | (338) | 88,094 |
| Net unrealized gain on investments | 99,551 | 10,099 | - | 109,650 |
| Royalty revenues | 333,704 | - | - | 333,704 |
| Other | 22,278 | 162 | - | 22,440 |
| Total revenues | 1,797,402 | 89,658 | 5,640 | 1,892,700 |
| Net assets released from restrictions | 32,533 | (32,533) | - | - |
| Total revenues and other increases | 1,829,935 | 57,125 | 5,640 | 1,892,700 |
| Expenses: | | | | |
| Program services: | | | | |
| Patient care | 827,035 | - | - | 827,035 |
| Research | 362,759 | - | - | 362,759 |
| Public information and education | 14,037 | - | - | 14,037 |
| Total program services | 1,203,831 | - | - | 1,203,831 |
| Supporting services: | | | | |
| Administrative and general | 258,386 | - | - | 258,386 |
| Fundraising | 27,326 | - | - | 27,326 |
| Total supporting services | 285,712 | - | - | 285,712 |
| Total expenses | 1,489,543 | - | - | 1,489,543 |
| Changes in net assets | 340,392 | 57,125 | 5,640 | 403,157 |
| Change in donor designation of net assets | - | 7,000 | (7,000) | - |
| Net assets, beginning of year | 2,054,965 | 224,424 | 169,803 | 2,449,192 |
| Net assets, end of year | <u>\$ 2,395,357</u> | <u>\$ 288,549</u> | <u>\$ 168,443</u> | <u>\$ 2,852,349</u> |

See accompanying notes.

City of Hope and Affiliates

Consolidated Statements of Activities
(In Thousands)

Year Ended September 30, 2015

| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total |
|---|--------------|---------------------------|---------------------------|--------------|
| Revenues: | | | | |
| Contributions (including \$28,263 of contributions from special events) | \$ 51,694 | \$ 58,640 | \$ 16,675 | \$ 127,009 |
| Special event participation revenue | 5,537 | - | - | 5,537 |
| Less: cost of direct benefits to donors | (7,861) | - | - | (7,861) |
| Contributions and net revenues from special events | 49,370 | 58,640 | 16,675 | 124,685 |
| Net patient service revenues | 1,005,065 | - | - | 1,005,065 |
| Research grants | 71,703 | - | - | 71,703 |
| Investment income | 76,711 | 9,755 | 197 | 86,663 |
| Net unrealized loss on investments | (123,516) | (12,920) | - | (136,436) |
| Royalty revenues | 290,887 | - | - | 290,887 |
| Other | 21,878 | 130 | - | 22,008 |
| Total revenues | 1,392,098 | 55,605 | 16,872 | 1,464,575 |
| Net assets released from restrictions | 35,204 | (35,204) | - | - |
| Total revenues and other increases | 1,427,302 | 20,401 | 16,872 | 1,464,575 |
| Expenses: | | | | |
| Program services: | | | | |
| Patient care | 730,504 | - | - | 730,504 |
| Research | 321,556 | - | - | 321,556 |
| Public information and education | 18,553 | - | - | 18,553 |
| Total program services | 1,070,613 | - | - | 1,070,613 |
| Supporting services: | | | | |
| Administrative and general | 238,152 | - | - | 238,152 |
| Fundraising | 23,890 | - | - | 23,890 |
| Total supporting services | 262,042 | - | - | 262,042 |
| Total expenses | 1,332,655 | - | - | 1,332,655 |
| Changes in net assets | 94,647 | 20,401 | 16,872 | 131,920 |
| Net assets, beginning of year | 1,960,318 | 204,023 | 152,931 | 2,317,272 |
| Net assets, end of year | \$ 2,054,965 | \$ 224,424 | \$ 169,803 | \$ 2,449,192 |

See accompanying notes.

City of Hope and Affiliates

Consolidated Statements of Cash Flows (In Thousands)

| | Year Ended September 30 | |
|--|--------------------------------|-------------|
| | 2016 | 2015 |
| Operating activities | | |
| Changes in net assets | \$ 403,157 | \$ 131,920 |
| Adjustments to reconcile changes in net assets to net cash provided by operating activities: | | |
| Depreciation and amortization | 95,094 | 81,609 |
| Net loss (gain) on sale of contributed real property held for sale | 66 | (8) |
| Loss on disposal of fixed assets | 2,209 | 631 |
| Loss on impairment of intangible assets | - | 30,137 |
| Net unrealized (gain) loss on investments | (109,650) | 136,436 |
| (Gain) loss on equity method investments | (26,425) | 9,913 |
| Change in value of interest rate swap agreement | 5,917 | 4,370 |
| Contribution proceeds restricted for endowment | (4,846) | (16,765) |
| Changes in assets and liabilities: | | |
| Patient accounts receivable, net | (37,357) | (24,583) |
| Grants and other receivables | (17,239) | (26,845) |
| Unconditional promises to give, net | (20,394) | (17,394) |
| Contributions receivable from split-interest agreements | (7,109) | 2,267 |
| Contributed real property held for sale | (2,223) | (1,650) |
| Other assets | (6,098) | (15,201) |
| Accounts payable and accrued liabilities | 18,459 | 1,110 |
| Accrued salaries, wages, and employee benefits | 4,596 | (2,164) |
| Annuity and split-interest agreement obligations | 418 | (728) |
| Other liabilities | (2,227) | 16,010 |
| Net cash provided by operating activities before net purchases of trading investments | 296,348 | 309,065 |
| Net purchases of trading investments | (97,602) | (171,866) |
| Net cash provided by operating activities | 198,746 | 137,199 |
| Investing activities | | |
| (Increase) decrease in notes receivable | (2,652) | 259 |
| Additions to property and equipment | (85,812) | (55,355) |
| Proceeds from sale of contributed real property held for sale | 978 | 2,322 |
| Net purchases of alternative investments | (119,702) | (87,326) |
| Net cash used in investing activities | (207,188) | (140,100) |
| Financing activities | | |
| Principal payments on long-term debt | (8,237) | (7,178) |
| Contribution proceeds restricted for endowment | 4,846 | 16,765 |
| Net cash (used in) provided by financing activities | (3,391) | 9,587 |
| Net (decrease) increase in cash and cash equivalents | (11,833) | 6,686 |
| Cash and cash equivalents, beginning of year | 133,293 | 126,607 |
| Cash and cash equivalents, end of year | \$ 121,460 | \$ 133,293 |
| Supplemental disclosure of cash flow information: | | |
| Interest paid during the year (net of capitalized interest) | \$ 33,866 | \$ 33,169 |
| Supplemental disclosure of non-cash activity: | | |
| Capital lease obligation | \$ 17,944 | \$ 830 |
| Additions to property and equipment included in accounts payable and accrued liabilities | \$ 42,093 | \$ 6,382 |

See accompanying notes.

City of Hope and Affiliates

Notes to Consolidated Financial Statements

September 30, 2016

1. Organization

City of Hope, a California nonprofit public benefit corporation, with its principal office located in Duarte, California, was formed to be the development organization of City of Hope National Medical Center (the Center), City of Hope Medical Foundation (the Foundation), and Beckman Research Institute of the City of Hope (the Institute) (collectively, the Affiliates or Affiliated Group). City of Hope's management and staff coordinate the fundraising activities of the many volunteers and donors needed to support the patient care and research mission of the Affiliated Group.

The Center, located in Duarte, California, is a California nonprofit public benefit corporation treating primarily cancer and other life-threatening diseases. The Center currently operates a 186-bed tertiary referral center with a licensed capacity of 217 beds. City of Hope is the sole corporate member of the Center.

The Foundation, located in Duarte, California, is a California nonprofit public benefit corporation organized as part of a coordinated health care system to provide teaching, education, and research services in support of the Center and the Institute. The Foundation also owns and/or operates outpatient clinic facilities that provide an extensive range of medical care and treatment. City of Hope is the sole corporate member of the Foundation.

The Institute, located in Duarte, California, is a California nonprofit public benefit corporation that owns and operates a number of major research facilities on or near City of Hope's main campus. The Institute conducts basic scientific research in support of and in conjunction with the patient care activities of the Center and the Foundation. City of Hope is the sole corporate member of the Institute.

The accounts of City of Hope include the assets, liabilities, and results of operations of the supporting auxiliaries and industry groups of City of Hope (the Auxiliaries). The Auxiliaries, located throughout the United States, are nonprofit public benefit unincorporated associations that coordinate fundraising activities to support the mission of the Affiliated Group.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

1. Organization (continued)

Principles of Consolidation

The accompanying consolidated financial statements of City of Hope and Affiliates include the accounts of the Affiliated Group and the net assets and activities of the Auxiliaries. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

Collective Bargaining Agreements

City of Hope and Affiliates are subject to six different collective bargaining agreements related to certain members of its labor force. The percentage of employees covered under all collective bargaining agreements as of September 30, 2016, was approximately 53%. Three of the six agreements will expire within one year of September 30, 2016, and City of Hope anticipates these agreements will be renegotiated and renewed for one to three years, depending on the agreement.

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of the Affiliated Group's consolidated 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 consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Principal areas requiring the use of estimates include determination of the net realizable value of patient accounts receivable, cost report settlements and amounts due to/from third-party payors, valuation of annuity and split-interest agreement obligations, and self-insured liabilities. Actual results could differ from those estimates and the amounts could be material to the consolidated financial statements.

Cash and Cash Equivalents

Cash and cash equivalents reflect all unrestricted cash and cash equivalents that include highly liquid investments with original or remaining maturities at purchase of three months or less.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Contributions

All contributions are considered available for the program services of City of Hope and for distribution to the Affiliates, unless specifically restricted by the donor. Amounts received that are designated for future periods or are restricted by the donor for specific purposes are reported as temporarily restricted or permanently restricted contributions.

Temporarily restricted net assets consist of assets restricted by donors for specific purposes until time restrictions lapse and/or the purpose for the restriction is accomplished. These net assets are primarily available for use in future periods or for capital purposes. Permanently restricted net assets have been restricted by donors in perpetuity, the income from which is expendable to support patient care, research, or other designated purposes. All other net assets are unrestricted.

City of Hope holds restricted monetary gifts that are specifically earmarked until such time as the restriction is met. When a donor restriction is met, a stipulated time restriction ends, or a purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of activities as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same fiscal period as the contributions are received are reflected as net assets released from restrictions in the accompanying consolidated statements of activities.

From time to time, donors may release the permanent restrictions on their donations, after which the contribution is reflected as a change in donor designation of net assets in the consolidated statements of activities.

City of Hope is the beneficiary under various wills and trust agreements, the total realizable amount of which is not readily determinable at the date of gift. For wills, such amounts are recognized as contributions when the will is declared valid by a probate court and the proceeds are measurable. For the years ended September 30, 2016 and 2015, valid will and trust agreement amounts that became measurable totaled \$26,534,000 and \$16,836,000, respectively, and are included in contributions in the accompanying consolidated statements of activities.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

City of Hope reports unconditional promises to give as temporarily restricted contributions, unless otherwise restricted by the donor. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. The discounts on these amounts are computed using risk-free interest rates approximating the U.S. Treasury Note rate during the year the unconditional promise is made. The rates used in 2016 and 2015 were 1.25% and 1.55%, respectively.

City of Hope reports conditional promises to give as contribution revenue when the conditions stipulated by the donor are met, at which time the conditional promise becomes unconditional. There are no conditional promises to give as of September 30, 2016 or 2015.

Net unconditional promises to give in the accompanying consolidated statements of financial position consist of the following as of September 30 (amounts in thousands):

| | 2016 | 2015 |
|--|-------------------|-------------|
| Unconditional promises to give | \$ 121,056 | \$ 101,867 |
| Less: | | |
| Discounts | (3,858) | (4,450) |
| Allowance for uncollectible promises to give | (8,066) | (8,679) |
| Total unconditional promises to give, net | 109,132 | 88,738 |
| Less current portion | (22,291) | (18,660) |
| | \$ 86,841 | \$ 70,078 |

The allowances for uncollectible promises to give have been determined based on City of Hope's historical collection experience. Amortization of pledge discounts is included in contribution revenue.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

At September 30, 2016, future cash flows anticipated from unconditional promises to give are as follows (amounts in thousands):

| | | |
|--|----|-----------------------|
| 2017 | \$ | 24,682 |
| 2018 | | 52,528 |
| 2019 | | 20,646 |
| 2020 | | 5,564 |
| 2021 | | 1,837 |
| Thereafter | | 15,799 |
| | | <u>121,056</u> |
| Discounts | | (3,858) |
| Allowance for uncollectible promises to give | | (8,066) |
| | \$ | <u><u>109,132</u></u> |

Split-Interest Obligations

City of Hope receives contributions from various types of split-interest agreements, including charitable gift annuities, charitable remainder annuity trusts, and charitable remainder unitrusts. City of Hope may be named as trustee or as a co-trustee or a financial institution may be named as the trustee.

Under a charitable gift annuity arrangement, City of Hope recognizes the agreement in the period in which the contract is executed. The assets from the donor are recognized at fair value, and the liabilities designated by the donor to various beneficiaries are recognized at the present value of the estimated future payments to be distributed by City of Hope to such beneficiaries. The amount of the temporarily restricted contribution revenue is the difference between these assets and liabilities.

Some states have laws that mandate certain requirements regarding gift annuity reserves. These laws can be based on where the nonprofit entity is located or where the gift annuity donor resides. As of September 30, 2016, City of Hope has state-mandated reserves above the actuarial annuity reserves in the amount of \$319,000. Additionally, City of Hope has voluntary reserves in the amount of \$4,386,000 that are to protect the reserve fund against unexpected market fluctuations and actuarial changes. These voluntary reserves are included in unrestricted investments and net assets in the accompanying consolidated statements of financial position.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Under charitable remainder annuity trust and charitable remainder unitrust arrangements in which City of Hope is not the trustee, in the period the agreement is executed, City of Hope recognizes temporarily restricted long-term receivables and contribution revenues at the present value of the estimated future benefits to be received when the trust assets are expected to be distributed. Trust distributions are recorded as a reduction in receivables, while adjustments to the receivables to reflect amortization of the discount and changes in actuarial assumptions during the term of the trust are recorded as temporarily restricted contributions in the accompanying consolidated statements of activities. The receivables as of September 30, 2016, totaling \$15,136,000 are to be collected over the next 25.4 years and have an average remaining life of 11.8 years.

Under a charitable remainder annuity trust or a charitable remainder unitrust arrangement in which City of Hope is the trustee, City of Hope records the assets contributed to the trust by the donor at fair value when received and the liabilities designated by the donor to various beneficiaries are recognized at the present value of the estimated future payments to be distributed by City of Hope to such beneficiaries. The amount of the temporarily restricted contribution revenue is the difference between these assets and liabilities.

In-Kind Contributions

In-kind contributions are reflected at their estimated fair market value on the date of the donation. City of Hope reports gifts of land, buildings, equipment, and other nonmonetary contributions as unrestricted support, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how and how long the donated assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as temporarily restricted. Absent explicit donor stipulations about how long those long-lived assets must be maintained, City of Hope reports expirations of donor restrictions as net assets released from restrictions when the donated or acquired long-lived assets are placed in service.

Supplies Inventory

Inventories, consisting of materials, pharmaceuticals, and medical supplies for use in program services provided by the Affiliates, are stated at the lower of cost or market using the first-in, first-out method. Inventories are included in prepaid and other current assets in the consolidated statements of financial position and totaled \$16,943,000 and \$15,043,000 at September 30, 2016 and 2015, respectively.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment is stated at cost when purchased or at fair market value on the date of the donation. When property and equipment is sold or otherwise disposed of, the cost and related accumulated depreciation and amortization are removed from the accounts and any resulting gain or loss is included in administrative and general expenses. The costs of normal maintenance, repairs, and minor replacements are charged to expense when incurred.

The Affiliated Group provides for depreciation and amortization using the straight-line method over the following estimated useful lives:

| | |
|----------------------------|---------------|
| Buildings and improvements | 7 to 40 years |
| Equipment and furniture | 5 to 10 years |

Leasehold improvements are amortized on a straight-line basis over the term of the lease or estimated useful life, whichever is shorter. Leases that have been capitalized are amortized over the life of the lease. Capital lease amortization is included with depreciation and amortization expense.

A summary of the cost and accumulated depreciation and amortization of property and equipment as of September 30 is as follows (amounts in thousands):

| | 2016 | 2015 |
|---|------------|------------|
| Land | \$ 15,998 | \$ 15,681 |
| Buildings and improvements | 626,158 | 625,877 |
| Equipment and furniture | 457,046 | 418,529 |
| Software | 190,929 | 157,004 |
| Leased capital assets | 59,600 | 41,656 |
| Construction in progress | 106,137 | 63,507 |
| Total property and equipment | 1,455,868 | 1,322,254 |
| Accumulated depreciation and amortization | (733,148) | (642,949) |
| Property and equipment, net | \$ 722,720 | \$ 679,305 |

Total accumulated amortization for leased capital equipment and facilities totaled \$10,223,000 and \$5,294,000 as of September 30, 2016 and 2015, respectively.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The Affiliated Group reviews long-lived assets for impairment when events or changes in business conditions indicate that their carrying value may not be recoverable. The Affiliated Group considers impairment when the associated expected undiscounted cash flows are less than the carrying value and will write the assets down to fair value at that time. Fair value is the present value of the associated cash flows. The Affiliated Group has determined that no long-lived assets are impaired at September 30, 2016.

Software Development Costs

All software development costs incurred in the planning stage of developing the software are expensed as incurred, as are internal and external training costs and maintenance costs. Internal and external costs, excluding general and administrative costs and overhead costs incurred during the applicable development stage of internally used software, are capitalized. Such costs include external direct costs of materials and services consumed in developing or obtaining the software, payroll, and payroll-related costs for employees who are directly associated with and who devote time to developing the software. Development changes that result in significant enhanced functionality to the software are also capitalized.

Capitalized internally used software development costs are amortized on a straight-line basis over an estimated useful life of five years. Amortization begins when all substantial testing of the software is completed and the software is ready for its intended use.

Unamortized software development costs included within property and equipment totaled \$67,916,000 and \$66,530,000 as of September 30, 2016 and 2015, respectively. Total amortization expense related to capitalized software development costs was \$32,539,000 and \$22,830,000 for the years ended September 30, 2016 and 2015, respectively. Software development costs included in construction in progress totaled \$30,313,000 and \$32,482,000 at September 30, 2016 and 2015, respectively.

Capitalized Interest

Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized by the Affiliates as a component of the cost of acquiring those assets, net of investment income earned from the tax-exempt borrowed proceeds. Total interest cost incurred totaled \$32,044,000 and \$31,645,000 in 2016 and 2015, respectively. Interest cost capitalized totaled \$0 and \$59,000 in 2016 and 2015, respectively.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Deferred Revenue

City of Hope is the recipient of the proceeds of various fundraising events and other fundraising activities. City of Hope receives cash during the year for these fundraising events and defers recognition of the revenue received in advance of fundraising events held subsequent to the fiscal year-end. The Affiliates also defer recognition of certain unexpended grant and royalty monies received from various sources, including research grants and clinical trial agreements prior to the expenditures of funds for such research or prior to such funds being earned. The following is a summary of deferred revenue as of September 30 (amounts in thousands):

| | <u>2016</u> | <u>2015</u> |
|--|------------------|------------------|
| Fundraising events and other efforts | \$ 3,919 | \$ 1,947 |
| Royalty revenue | 5,400 | 7,733 |
| Unexpended grants/agreements | 16,715 | 9,560 |
| Total deferred revenue | <u>26,034</u> | <u>19,240</u> |
| Amount included in other long-term liabilities | <u>(2,917)</u> | <u>(5,250)</u> |
| | <u>\$ 23,117</u> | <u>\$ 13,990</u> |

Income Taxes

The Affiliated Group is exempt from federal income tax under Section 501(c)(3) of the U.S. Internal Revenue Code and is exempt from California state franchise and income tax under Section 23701d of the California Revenue and Taxation Code.

Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic (ASC) 740, *Income Taxes*, clarifies the accounting for income taxes by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FASB ASC 740 also provides guidance on de-recognition, measurement, classification, interest and penalties, disclosure, and transition. The guidance contained in FASB ASC 740 is applicable to pass-through entities and tax-exempt organizations. City of Hope has no significant uncertain tax positions or tax liability for tax benefits, interest, or penalties accrued at September 30, 2016 and 2015.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Workers' Compensation Program

The Affiliated Group has elected to self-insure its workers' compensation liability. Reinsurance has been obtained for this program to cover claims that exceed \$250,000 between 1991 and 2002, \$500,000 in 2003, and \$1,000,000 per individual claim beginning in 2004. The Affiliates have recorded an estimated liability of \$19,908,000 and \$17,418,000 as of September 30, 2016 and 2015, respectively. The estimated current portion of the liability, totaling \$3,635,000, is included in accrued salaries, wages, and benefits and the estimated long-term portion of the liability is included in other long-term liabilities in the consolidated statements of financial position. Accruals for uninsured claims and claims incurred but not reported are estimated by an actuary based on prior claims experience. The estimated liability was recorded using a 1% and 1.67% discount factor as of September 30, 2016 and 2015, respectively. Workers' compensation expense charged to the Affiliated Group's operations totaled \$5,754,000 and \$5,310,000 in 2016 and 2015, respectively.

Accounting Standards Update No. (ASU) 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries*, clarifies that a health care entity should not net insurance recoveries against a related claim liability. The Affiliated Group recorded insurance recoveries related to workers' compensation totaling \$5,148,000 and \$3,739,000, which have been reflected in the accompanying consolidated statements of financial position in other assets as of September 30, 2016 and 2015, respectively.

Professional Liability Insurance

The Affiliated Group maintains professional liability insurance under a claims-made program, which provides coverage for claims arising out of incidents that have occurred from November 1, 1997 to September 30, 2015, with limits up to \$50,000,000 and a deductible of \$100,000 through June 30, 2014, and \$250,000 between July 1, 2014 and September 30, 2016. Accruals for uninsured claims and claims incurred but not reported are estimated by an actuary based on prior claims experience. Such accruals were recorded using a 1% and 1.67% discount factor as of September 30, 2016 and 2015, respectively. City of Hope and the Affiliated Group have recorded an estimated liability of \$2,173,000 and \$1,594,000 as of September 30, 2016 and 2015, respectively, which is included in other current and long-term liabilities in the consolidated statements of financial position. The professional liability insurance expense charged to the Affiliated Group's operations amounted to \$2,274,000 and \$1,188,000 in 2016 and 2015, respectively.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The Affiliated Group recorded insurance recoveries related to professional liability totaling \$799,000 and \$867,000, which have been reflected in the accompanying consolidated statements of financial position in other assets as of September 30, 2016 and 2015, respectively.

Retirement Plans

The Affiliated Group participates in the City of Hope Defined Contribution Plan (the Plan). The Plan was established in 1989 to provide benefits to eligible employees as defined in the plan document and covers substantially all employees. Contributions range between 2% and 10%, depending on years of service, and are calculated on biweekly base salary up to and above the annual Social Security Taxable wage base, not to exceed the maximum covered compensation of \$265,000 in 2016. Employees are eligible upon the completion of one year of service in which they have worked at least 1,000 hours. They may direct these contributions into various funds offered through the Plan.

The Center and the Institute also participate in the City of Hope Research Staff Organization Tax Deferred Annuity Plan (the RSO TDA Plan) that was established in 1983 to provide benefits to eligible members of the City of Hope RSO as defined in the plan document. Employer contributions of 15% of each participant's biweekly eligible salary are made up to a defined annual maximum base salary of \$265,000 in 2016. The participants have the ability to direct these contributions into various funds offered through the RSO TDA Plan.

Contribution expense for the Plans defined above totaled \$18,605,000 and \$17,870,000 in 2016 and 2015, respectively.

Additionally, the Affiliated Group offers eligible employees participation in a City of Hope Tax Deferred Annuity Plan (the TDA Plan) that was established in 1972. The TDA Plan covers substantially all employees and is entirely employee-funded. Participants elect to have pretax compensation contributed to the TDA Plan up to the amount allowable under the plan document and current regulatory limits. Participants direct the investment of these contributions to various funds that are offered through the TDA Plan.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The Affiliates also offer a top hat plan through a Deferred Compensation Plan (the 457(b) Plan). The 457(b) Plan was established in 2002, and participation is available to employees whose base salary equals or exceeds a multiple of the Social Security wage base as defined each year. Participants elect to have pretax compensation contributed to the 457(b) Plan, up to the amount allowable under the plan document and current regulatory limits. Participants direct the investment of these contributions to various funds offered through the 457(b) Plan.

On January 1, 2006, the 2006 Executive Supplemental Accumulation Plan (the 457(f) Plan) was established. This plan provides designated executives with deferred compensation equal to 10% of the executive's base salary (net of City of Hope contributions to the participant's defined contribution plan). A participant becomes fully vested upon completion of three plan years of service, at age 65, or if they leave involuntarily. There is the possibility of substantial forfeiture should the participant leave voluntarily or involuntarily for cause prior to fully vesting. Contribution expense for the 457(f) Plan totaled \$1,314,000 and \$1,027,000 in 2016 and 2015, respectively.

Net Patient Service Revenues

Net patient service revenues are reported at net realizable amounts from third-party payors and others for services rendered. City of Hope's policy includes the evaluation of a patient's ability to pay. The allowances for contractual discounts and uncollectible accounts have been determined based on historical collection data.

The Center and the Foundation have agreements with third-party payors that provide for payments to the Center and the Foundation at amounts different from established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, per diem payments, case rates, and specialized fee schedules. Estimated retroactive adjustments under the Medicare and Medicaid programs are also reflected in net patient service revenues. Patient service revenues, net of contractual allowances, and discounts for the years ended September 30 are as follows (amounts in thousands):

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

| | 2016 | 2015 |
|---|---------------------|--------------|
| Medicare | \$ 245,906 | \$ 222,845 |
| Medi-Cal | 147,596 | 196,334 |
| Managed care (including Medicare and Med-Cal managed care) | 709,900 | 577,820 |
| Indemnity, self-pay, and other | 16,406 | 8,066 |
| Net patient service revenues | \$ 1,119,808 | \$ 1,005,065 |

The Center is reimbursed for services provided to patients under certain programs administered by governmental agencies. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to future governmental review and interpretation, as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medicaid programs. The Center believes that it is in compliance with all applicable laws and regulations, and it is not aware of any pending or threatened investigations involving allegations of potential wrongdoing.

Medicare reimburses the Center for cost-reimbursable items at an interim rate, and final settlements are determined after an audit of the Center's related annual cost reports by the Medicare fiscal intermediary. Estimated provisions to approximate the full expected settlements after review by the intermediary are included in the accompanying consolidated financial statements. The Center's Medicare cost reports have been audited through 2014. The Center has filed appeals to re-open previously audited cost reports for years 2007 through 2013 and, if successful, will record the appeals as net patient service revenues in the period realized. The cost report for 2015 has been filed and a tentative settlement has been received, but has not yet been audited.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Expected settlement amounts are included in due from/due to third-party payors in the consolidated statements of financial position. Estimation differences between final settlements and amounts accrued in previous years are reported as adjustments of the current year's net patient service revenues. In the opinion of management, adequate provision has been made for any adjustments that might result from this review. During 2016 and 2015, the Center received information requiring changes in its estimates of settlements due for certain open cost report years and appeals. Based on this information, the Center recorded additional increases to net patient service revenues totaling \$5,503,000 and \$13,235,000 as of September 30, 2016 and 2015, respectively.

The SB1732 program permits certain health care facilities that meet specific criteria to receive supplemental reimbursement for a portion of debt service for qualified capital projects. The Center has received SB1732 funding for capital projects completed prior to 1998 and has determined it is eligible to receive SB1732 funds related to the construction of a new hospital facility completed in fiscal year 2005. In fiscal years 2016 and 2015, the Center recognized \$1,239,000 and \$1,334,000, respectively, in SB1732 program revenue, which has been included in net patient service revenues. Of these amounts, \$23,000 has not been received and is included in other assets at September 30, 2016.

Patient Accounts Receivable

The Center and the Foundation receive payment for services rendered to patients from federal and state governmental programs, mainly Medicare and Medi-Cal, privately sponsored managed care programs (including Medicare and Medi-Cal managed care) for which payment is made based on terms defined under formal contracts, and other payors. The following table summarizes the percentages of gross accounts receivable from patients and third-party payors as of September 30:

| | <u>2016</u> | <u>2015</u> |
|--|-------------|-------------|
| Medicare | 23% | 22% |
| Medi-Cal | 16 | 19 |
| Managed care, other third-party payors, and patients | 61 | 59 |
| | <u>100%</u> | <u>100%</u> |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Patient Charity Care

The Center and the Foundation approve charity care for patients meeting financial eligibility and clinical criteria at the time of admission or provision of service. A patient is classified as a charity patient by reference to certain established policies of the Center and the Foundation. Essentially, these policies define charity care as those services provided that are medically necessary but are never expected to result in cash receipts. Benefits for the indigent include services provided to persons who cannot afford health care because of inadequate resources or who are uninsured or underinsured. Also, certain medically necessary services may be provided to Medi-Cal patients, which are not reimbursed by the Medi-Cal program. The cost related to these services is included in the estimated cost of patient charity care.

The estimated cost for both patient charity care and Medi-Cal patients represents total direct and indirect cost calculated at the medical procedure level and pertains specifically to the respective charity and Medi-Cal patient populations. Procedure-level cost includes the direct costs, such as labor and supplies, involved in providing the specific service, as well as an applicable allocation of departmental overhead (e.g., departmental management) and institutional overhead (e.g., administration, depreciation, and utilities). For the years ended September 30, 2016 and 2015, these components of charity care costs totaled \$3,223,000 and \$8,566,000, respectively.

See Note 9 for additional disclosure related to benefits for the broader community and support of governmental health care programs.

Performance Indicator

Management considers changes in net assets to be the performance indicator.

Derivative and Hedging Instruments

The Affiliated Group is required to recognize all derivatives at fair value in the statement of financial position. At September 30, 2016, the Affiliated Group's derivative instruments consisted of two interest rate swap agreements with a total notional amount of \$65,000,000 (see Note 5). The Affiliated Group enters into interest swap agreements to manage its interest rate risk. The Affiliated Group's derivatives are not designated as effective hedges and are adjusted to fair value in the consolidated statements of activities, above the operating indicator.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Royalty Revenue

The Affiliated Group receives royalties from Genentech based on Genentech's revenues in the previous quarter from sales of its own drugs, as well as from royalties and other amounts paid by its licensees. The Affiliated Group does not receive information from Genentech or its licensees regarding the amount of royalty revenue owed to the Affiliated Group until the amounts are actually received by the Affiliated Group, usually one quarter in arrears; therefore, royalty revenue is recognized when received. During 2016 and 2015, the Affiliated Group received and recognized royalty revenue totaling \$333,704,000 and \$290,887,000, respectively, primarily from sales of drugs by Genentech and other licensees of monoclonal antibodies, including Rituxan, Herceptin, Avastin, Humira, and others using technology developed at the Institute (see Note 8).

Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the consolidated statements of financial position. These equity and debt securities are designated as trading securities as the investments are externally managed without restrictions within the guidelines of the City of Hope investment policy. Fair value is established based on quoted prices from recognized security exchanges. Management determines the appropriate classification as either trading or other-than-trading for all equity and debt securities at the date of purchase and reevaluates such designations at each balance sheet date. Accordingly, the change in unrealized gains and losses on investments is reported within changes in net assets in the consolidated statements of activities.

Investment income or loss on equity and debt securities included in temporarily or permanently restricted net assets (including realized gains and losses on investments, interest, and dividends) is reported in unrestricted revenues and other increases unless the income or loss is restricted by the donor or by law.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The Affiliated Group's classification of alternative investments includes limited partnerships and limited liability companies that seek to limit the effect of downward market swings on the portfolio and are not restricted to any particular asset class. Some alternative investments invest in other similar partnerships or funds and employ a "fund of funds" strategy, while other alternative investments have specific industry focus in their investment assets. At the investment manager's direction, these alternative investments may invest in both registered and non-registered securities in the U.S. and globally, with exposure to both emerging and developed markets. These entities employ a range of investment strategies, including, but not limited to, long/short equity positions, derivatives, forward and futures contracts, and currency hedges. The Affiliated Group also invests in private equity and private real asset funds that may be structured as drawdown funds, to which the Affiliated Group has committed capital to fund future capital calls as the investment opportunities develop over the initial investment period established by the fund managers. As of September 30, 2016 and 2015, the Affiliated Group based upon most recent available information has outstanding unfunded private equity and private real asset commitments totaling \$278,553,000 and \$321,671,000, respectively.

City of Hope's alternative investments include equity commingled funds that invest primarily in marketable securities. These funds are subject to certain notice requirements, but can be liquidated at least monthly.

City of Hope's classification of hedge funds consists of direct and multi-manager hedge fund "fund of funds" investments, which implement a range of alternative investment strategies, including, but not limited to, long or short equity, credit, and other strategies. City of Hope's investments in hedge funds have limited liquidity since shares or interests in the hedge funds are not freely transferable and are subject to various lock-up periods, redemption fees, and notice requirements. In addition, the hedge funds typically reserve the right to reduce or suspend redemptions (gating event) and to satisfy redemptions by making distributions in kind, under certain circumstances. Additionally, hedge funds may hold, directly or indirectly, side-pocket investments where no redemptions are permitted until such investments are liquidated or deemed realized. Redemption clauses range from monthly to quarterly and annually with various notice requirements between 30 and 65 days.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

City of Hope's classification of private equity consists of direct and private equity fund of funds investments, including private equity buyout, venture capital, mezzanine, and secondary private equity funds. These private equity investments typically have investment terms greater than ten years. City of Hope may not withdraw, sell, assign, or transfer its interests in the private equity funds except under very limited circumstances, subject to consent by the general partners of the funds.

City of Hope's classification of real assets consists of 23 investment funds – one fund that invests in timberland properties, two funds that invest in global real estate investment trusts securities, two funds that invest in real estate operating company securities, nine funds that invest in distressed real estate, four energy funds, four fund of funds, and one fund that invests in Master Limited Partnerships. The investment terms of the timberland, distressed real estate, and energy funds are typically greater than ten years and City of Hope may not withdraw or sell, assign, or transfer its interests in these funds except in certain very limited circumstances, subject to consent by the general partners of the funds.

The Affiliated Group accounts for its ownership interests in alternative investments at fair value, under which the net asset value ("NAV") is used as a practical expedient to fair value in the accompanying consolidated statements of financial position and its changes in fair value and share of earnings are included in investment income in the consolidated statements of activities. The Affiliated Group's ownership interest in these funds ranges from 0.01% to 40.6% as of September 30, 2016.

Allocation of Joint Costs

City of Hope accounts for joint costs in accordance with FASB ASC 958, *Not-for-Profit Entities*, which specifies criteria for costs to be reported as fundraising costs. City of Hope allocated total joint costs to the following functional expense categories for the years ended September 30, as follows (amounts in thousands):

| | <u>2016</u> | <u>2015</u> |
|--|------------------|------------------|
| Fundraising expense | \$ 9,230 | \$ 8,328 |
| Administrative and general expense | 4,825 | 3,983 |
| Public information and education expense | 2,270 | 2,234 |
| Total joint costs | <u>\$ 16,325</u> | <u>\$ 14,545</u> |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements for Not-for-Profit Entities*, which will require not-for-profit entities to revise financial presentation to include net asset classifications and provide quantitative and qualitative information as to available resources and management of liquidity and liquidity risk, information on investment expenses and returns, and the presentation of operating cash flows. The standard aims to help the reader of the financial statements to better understand the financial position of the organization and enhance consistency among similar organizations. ASU 2016-14 is effective for annual periods beginning after December 15, 2017. The Affiliated Group is evaluating the effect of this standard on the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which amends the existing accounting standard for lease accounting, including requiring lessees to recognize most leases on their balance sheets and making targeted changes to lessor accounting. The new standard requires a modified retrospective transition approach for all leases existing at, or entered into after, the date of initial application, with an option to use certain transition relief. The amendments in the update are effective for annual periods beginning after December 15, 2018. Early adoption is permitted and the Affiliated Group is evaluating the effect of this standard on the consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which amends the accounting and disclosures of financial instruments, including a provision that requires equity investments (except for investments accounted for under the equity method of accounting) to be measured at fair value, with changes in fair value recognized in current earnings. ASU 2016-01 is effective for interim and annual periods beginning after December 15, 2018. The Affiliated Group is evaluating the effect of this standard on the consolidated financial statements.

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 Equivalent)*, which removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient and limits the disclosure requirement. ASU 2015-07 is effective for annual and interim periods beginning after December 15, 2015. The Affiliated Group has elected to early adopt this ASU effective October 1, 2015, and has reflected the change in the fair value hierarchy footnote (see Note 4).

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*, which requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. ASU 2015-03 is effective for fiscal years beginning after December 15, 2015, and would be applied on a retrospective basis. The Affiliated Group has elected to early adopt this ASU effective October 1, 2015, and has reflected the change in the consolidated statements of financial position as of September 30, 2016 and 2015, decreasing other long-term assets and long-term debt, net of current portion as of September 30, 2015, by \$2,141,000 as compared to amounts previously reported.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which requires the recognition of revenue for the transfer of goods or services equal to the amount that it expects to be entitled to receive for those goods or services. ASU 2014-09 is effective for periods beginning after December 15, 2017. The Affiliated Group is currently evaluating the effect of this standard on the consolidated financial statements.

Reclassifications

Certain reclassifications were made to the 2015 accompanying financial statements to conform to the 2016 presentation. These reclassifications had no impact on the changes in net assets or excess of revenues over expenses previously reported. These reclassifications are not considered material to the financial statements of City of Hope.

3. California Hospital Fee Program

The California Hospital Fee Program (the Program) was signed into California law on January 1, 2010. Amended legislation that incorporated changes requested by the Centers for Medicare & Medicaid Services (CMS) during the CMS approval process was signed into California law on September 8, 2010, and CMS gave final approval of the program in January 2011. The primary legislation (AB 1383) and amended legislation (AB 1653) contain two components. The Quality Assurance Fee Act governs the “hospital fee” or “Quality Assurance Fee” (QA Fee) paid by participating hospitals. The Medi-Cal Hospital Provider Stabilization Act governs supplemental Medi-Cal payments (Supplemental Payments) made to providers from the fund. Some of these payments will be made directly by the state, while others will be made by the Medi-Cal managed care plans, which will receive increased rates from the state in amounts equal to the Supplemental Payments. Hospital participation is mandatory, with limited exceptions.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

3. California Hospital Fee Program (continued)

The Center has also entered into various enforceable pledge agreements with the California Health Foundation and Trust (CHFT), agreeing to make contributions to the CHFT based on a pre-described calculation methodology. These funds will be used by CHFT to support charitable activities at various independent hospitals and hospital/health systems in California, including measures to alleviate distortions, interruptions, and disparities potentially resulting from short-term changes in government health care reimbursement programs, including the hospital fee to be imposed on hospitals under the Program.

In December 2014, CMS approved the fee-for-service portion of a new 36-Month program, covering January 1, 2014 through December 31, 2016.

During 2016 and 2015, the Center recognized \$73,542,000 and \$121,652,000 in Supplemental Payments relating to the 36-Month program period from October 1, 2015 through September 30, 2016, and January 1, 2014 through September 30, 2015, respectively. These amounts have been included as an increase to net patient service revenues in the accompanying consolidated statements of activities. As of September 30, 2016 and 2015, \$34,183,000 and \$26,756,000, respectively, is recorded in grants and other receivables in the consolidated statements of financial position. The Center also recognized \$13,984,000 and \$23,576,000 in QA Fees and \$562,000 and \$2,162,000 in CHFT Payments as program expenses in the accompanying consolidated statements of activities as of September 30, 2016 and 2015, respectively. Of these amounts, \$301,000 and \$141,000 is recorded in accounts payable and accrued liabilities in the accompanying consolidated statements of financial position as of September 30, 2016 and 2015, respectively.

During 2016, CMS approved the managed care portion of the 36-Month program for the period from January 1, 2014 through June 30, 2014. The Center recognized \$278,000 in additional net patient service revenues for the year ended September 30, 2016.

Additionally, the Center received refunds from the CHFT related to excess paid-in funds as of the 5-year anniversary of the initial 21-month program (April 1, 2009 to December 31, 2010) and the 6-month extension program (January 1, 2011 to June 30, 2011) totaling \$604,000, which has been reflected as a reduction in program expenses in the accompanying consolidated statement of activities for the year ended September 30, 2016.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

4. Fair Value of Financial Instruments

The consolidated statements of financial position include the following financial instruments: cash and cash equivalents, patient accounts receivable, grants and other receivables, short- and long-term investments, other receivables, accounts payable and accrued liabilities, estimated amounts due to/from third-party payors, interest rate swaps, and long-term debt. The Affiliated Group considers the carrying amounts of current assets and liabilities (except for investment securities, which are carried at fair value, as described in Note 2) in the consolidated statements of financial position to approximate the fair value of these financial instruments because of the relatively short period of time between origination of the instruments and their expected realization. The carrying amount of tax-exempt and taxable long-term financing for the Affiliated Group was \$639,549,000, with a total fair value of \$783,823,000 at September 30, 2016, based on current market rates of debt with similar risks and maturities. Long-term debt would be classified as Level 2 in the fair value hierarchy.

As defined by FASB ASC 820, *Fair Value Measurement*, fair value is based on 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. In order to increase consistency and comparability in fair value measurements, a fair value hierarchy was established that prioritizes observable and unobservable inputs used to measure fair value into three broad levels, which are described below:

- Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.
- Level 2: Observable prices that are based on inputs not quoted on active markets, but corroborated by market data.
- Level 3: Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

4. Fair Value of Financial Instruments (continued)

Assets and liabilities measured at fair value are based on one or more of three valuation techniques as identified in the tables below. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

- (a) *Market approach.* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- (b) *Cost approach.* Amount that would be required to replace the service capacity of an asset (replacement cost).
- (c) *Income approach.* Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option-pricing, and excess earnings models).

In determining fair value, City of Hope utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, as well as considers counterparty credit risk in its assessment of fair value. The fair value of annuity and split-interest obligations has been determined using present value techniques based on mortality tables and discount rates that are consistent with Internal Revenue Service published rates and the American Council on Gift Annuities. The fair value of pledges considers credit risk, which is estimated based on management's assessment of the collectability of pledges receivable.

City of Hope uses interest rate swaps to manage interest rate risk associated with floating-rate debt. The valuation of these instruments is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period of maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The fair values of interest rate swaps are determined using the market standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on an expectation of future interest rates (forward curves) derived from observable market interest rate curves.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

4. Fair Value of Financial Instruments (continued)

The estimated fair values of the interest rate swap instruments have been determined using available market information and valuation methodologies, primarily discounted cash flows. The contracts provide for periodic net cash settlements.

City of Hope incorporated credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements.

Although City of Hope has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of September 30, 2016, City of Hope has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives. As a result, City of Hope has determined that its derivative valuations in their entirety are classified as Level 2 in the fair value hierarchy.

City of Hope's assets and liabilities, measured at fair value on a recurring basis as of September 30 aggregated by the level in the fair value hierarchy, are included in cash equivalents, investments, annuity and split-interest agreement obligations, and other long-term liabilities in the consolidated statements of financial position and are as follows (amounts in thousands):

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

4. Fair Value of Financial Instruments (continued)

| 2016 | Investments at Fair Value | | | Investments at Net | Total | Valuation Technique (a,b,c) |
|--|---------------------------|-------------------|---------------------|-----------------------|---------------------|-----------------------------------|
| | Level 1 | Level 2 | Fair Value | Asset Value | | |
| Investments: | | | | | | |
| U.S. government and agency obligations | \$ - | \$ 201,856 | \$ 201,856 | \$ - | \$ 201,856 | a,b |
| Corporate obligations | - | 1,609 | 1,609 | - | 1,609 | a,b |
| Marketable securities | 686,586 | - | 686,586 | - | 686,586 | a |
| Public real assets | 237,997 | - | 237,997 | - | 237,997 | a |
| Municipal obligations | - | 2,088 | 2,088 | - | 2,088 | a |
| Hedge funds | - | - | - | 388,292 | 388,292 | |
| Equity commingled funds | - | - | - | 657,533 | 657,533 | |
| Private equity funds | - | - | - | 122,171 | 122,171 | |
| Private real assets | - | - | - | 170,309 | 170,309 | |
| Cash equivalents | 65,272 | - | 65,272 | - | 65,272 | a |
| Total investments at fair value | <u>\$ 989,855</u> | <u>\$ 205,553</u> | <u>\$ 1,195,408</u> | <u>\$ 1,338,305</u> | <u>\$ 2,533,713</u> | |
| | | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> | |
| Liabilities at fair value: | | | | | | |
| Annuity and split-interest obligations | \$ - | \$ - | \$ 17,264 | \$ 17,264 | \$ 17,264 | c |
| Interest rate swaps | - | 16,952 | - | 16,952 | 16,952 | a,b |
| Total liabilities | <u>\$ -</u> | <u>\$ 16,952</u> | <u>\$ 17,264</u> | <u>\$ 17,264</u> | <u>\$ 34,216</u> | |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

4. Fair Value of Financial Instruments (continued)

| | Investments at Fair Value | | | Investments at Net Asset | Total | Valuation Technique (a,b,c) |
|--|---------------------------|-------------------|---------------------|-----------------------------|---------------------|-----------------------------------|
| | Level 1 | Level 2 | Fair Value | Value | | |
| 2015 | | | | | | |
| Investments: | | | | | | |
| U.S. government and agency obligations | \$ - | \$ 100,580 | \$ 100,580 | \$ - | \$ 100,580 | a,b |
| Corporate obligations | - | 3,326 | 3,326 | - | 3,326 | a,b |
| Marketable securities | 670,421 | - | 670,421 | - | 670,421 | a |
| Public real assets | 207,832 | - | 207,832 | - | 207,832 | a |
| Municipal obligations | - | 2,086 | 2,086 | - | 2,086 | a |
| Hedge funds | - | - | - | 366,536 | 366,536 | |
| Equity commingled funds | - | - | - | 533,849 | 533,849 | |
| Private equity funds | - | - | - | 72,134 | 72,134 | |
| Private real assets | - | - | - | 154,118 | 154,118 | |
| Cash equivalents | 82,086 | - | 82,086 | - | 82,086 | a |
| Total investments at fair value | <u>\$ 960,339</u> | <u>\$ 105,992</u> | <u>\$ 1,066,331</u> | <u>\$ 1,126,637</u> | <u>\$ 2,192,968</u> | |
| | | Level 1 | Level 2 | Level 3 | Total | |
| Liabilities at fair value: | | | | | | |
| Annuity and split-interest obligations | \$ - | \$ - | \$ 16,846 | \$ 16,846 | | c |
| Interest rate swaps | - | 11,035 | - | 11,035 | | a,b |
| Total liabilities | <u>\$ -</u> | <u>\$ 11,035</u> | <u>\$ 16,846</u> | <u>\$ 27,881</u> | | |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

4. Fair Value of Financial Instruments (continued)

The table below sets forth a summary of changes in fair value of the Level 3 assets and liabilities for the year ended September 30, 2016 (amounts in thousands):

| | Liabilities |
|--|--------------------|
| Beginning balance at September 30, 2015 | \$ 16,846 |
| Additions | 1,535 |
| Investment activity, adjustments, maturities | 513 |
| Distributions | (1,379) |
| Change in fair value | (251) |
| Ending balance at September 30, 2016 | \$ 17,264 |

The following reconciles fair value amounts to the consolidated statements of financial position as of September 30 (amounts in thousands):

| | 2016 | 2015 |
|---|--------------|--------------|
| Cash and cash equivalents | \$ 121,460 | \$ 133,293 |
| Investments, current | 1,083,215 | 811,802 |
| Self-insurance trust funds | 3,581 | 3,730 |
| Investments held for long-term purposes | 357,516 | 371,440 |
| Board-designated assets | 715,191 | 653,354 |
| Donor-restricted investments, other | 345,912 | 311,710 |
| | 2,626,875 | 2,285,329 |
| Less: investment at net asset value | (1,338,305) | (1,126,637) |
| Less: amounts held in cash | (93,162) | (92,361) |
| Investments at fair value | \$ 1,195,408 | \$ 1,066,331 |

Board-designated assets include funds either set aside as institutionally designated endowments or established by the Board of Directors for future research, program services, and capital expenditures of the Affiliates.

Investment income in the consolidated statements of activities includes changes in fair value of equity interests in alternative investments. For the years ended September 30, 2016 and 2015, these changes in fair value of equity interests totaled a gain of \$26,425,000 and a loss of \$9,913,000, respectively.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

5. Long-Term Debt

The following is a summary of the Affiliated Group's long-term debt as of September 30 (amounts in thousands):

| | 2016 | | 2015 |
|--|-------------------|----|-------------|
| The City of Hope, 3.75% to 5.00% fixed rate Tax-Exempt Revenue Bonds Series 2012A, originally \$234,635, issued through the California Health Facilities Financing Authority, with varying maturities annually on November 15, 2014 through November 15, 2039. Interest payable semiannually on May 15 and November 15 (Series 2012A Revenue Bonds). | \$ 224,549 | \$ | 229,715 |
| The City of Hope, Tax-Exempt Variable Rate Revenue Bonds Series 2012B, originally \$32,500, issued through the California Health Facilities Financing Authority. Interest payable monthly, principal payments annually beginning on November 15, 2039 through November 15, 2042 (Series 2012B Revenue Bonds). | 32,500 | | 32,500 |
| The City of Hope, Tax-Exempt Variable Rate Revenue Bonds Series 2012C, originally \$32,500, issued through the California Health Facilities Financing Authority. Interest payable monthly, principal payments annually beginning on November 15, 2039 through November 15, 2042 (Series 2012C Revenue Bonds). | 32,500 | | 32,500 |
| The City of Hope, 5.623% fixed rate, Taxable Direct Obligation Notes, originally \$350,000. Interest payable semiannually on May 15 and November 15, principal payment due in full on November 15, 2043 (Series 2013 Notes). | 350,000 | | 350,000 |
| Capital lease obligations: | | | |
| Equipment | 3,744 | | 4,712 |
| Facilities | 48,420 | | 32,582 |
| | 691,713 | | 682,009 |
| Less: Current maturities of long-term debt and capital lease obligations | (90,571) | | (72,549) |
| Unamortized bond issue costs | (2,017) | | (2,141) |
| Unamortized discount | (3,865) | | (4,062) |
| Unamortized premium | 23,043 | | 24,778 |
| | \$ 618,303 | \$ | 628,035 |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

5. Long-Term Debt (continued)

Long-term debt maturities and capital lease obligations as of September 30, 2016, and payments for the subsequent years are as follows (amounts in thousands):

| | |
|------------|-------------------|
| 2017 | \$ 25,571 |
| 2018 | 9,407 |
| 2019 | 9,426 |
| 2020 | 9,780 |
| 2021 | 9,949 |
| Thereafter | <u>627,580</u> |
| | <u>\$ 691,713</u> |

Series 2012 Revenue Bonds (Tax-Exempt) – In November 2012, pursuant to a Master Trust Indenture (MTI), the City of Hope Obligated Group (consisting of City of Hope, the Center, the Foundation, and the Institute) issued \$234,635,000 of Tax-Exempt Series 2012A fixed rate Revenue Bonds (Series 2012A Revenue Bonds), \$32,500,000 of Tax-Exempt Series 2012B Variable Rate Revenue Bonds (Series 2012B Revenue Bonds), and \$32,500,000 of Tax-Exempt Series 2012C Variable Rate Revenue Bonds (Series 2012C Revenue Bonds) through the California Health Facilities Financing Authority. The proceeds from the issuance of the Series 2012A, Series 2012B, and Series 2012C Revenue Bonds (collectively, the Series 2012 Revenue Bonds) were used to refund, repay, or redeem the then-outstanding principal and interest on the Series 1999 Certificates, the 2007 Note Payable, and the Series 2006 Bonds, and to finance or reimburse City of Hope for certain costs of constructing, renovating, and equipping health care and research-related facilities. The obligations issued under the MTI, including those securing the Series 2012 Revenue Bonds, are secured by a gross receivables pledge. The Series 2012A Revenue Bonds accrue interest at fixed rates between 3.75% and 5.00% annually, and were issued at a premium totaling \$29,887,000.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

5. Long-Term Debt (continued)

Interest on the Series 2012B and the Series 2012C Revenue Bonds accrues at a weekly interest rate as determined by the Remarketing Agent every Tuesday. The average interest rate on the Series 2012B was 0.2421% and the Series 2012C was 0.2249% during the year ended September 30, 2016. The bonds can be converted to another interest rate period as defined in the bond indenture related to the Series 2012B and Series 2012C Revenue Bonds. If such bonds are tendered and not remarketed, the Obligated Group will be obligated to purchase such variable rate bonds from its own funds. As a result, the Series 2012B and Series 2012C Revenue Bonds are classified as current liabilities in the accompanying consolidated statements of financial position.

Series 2013 Notes (Taxable) – In July 2013, City of Hope, as representative of the Obligated Group, issued \$350,000,000 in Series 2013 fixed rate Direct Obligation Notes (the Series 2013 Notes) under the MTI. The proceeds from the Series 2013 Notes will be used for the Obligated Group's capital needs in furtherance of the implementation of the Obligated Group's strategic plan, including the construction of a new inpatient/outpatient facility and the expansion of one or more existing research buildings. The Series 2013 Notes are secured by a gross receivables pledge and accrue interest at a fixed rate of 5.623% annually.

Capital Lease Obligations – City of Hope and Affiliates have entered into various capital lease agreements for equipment and program and administrative facilities. Assets are capitalized using interest rates commensurate with City of Hope's incremental borrowing rate.

In October 2015, City of Hope entered into a long-term capital lease for a research building. In March 2016, City of Hope exercised an option to purchase the facility within the next year for \$15,500,000. The obligation for this lease buyout has been recorded as long-term debt, current portion in the accompanying consolidated statements of financial position.

Assets Constructed by Landlord – In April 2016, the Foundation entered into an affiliation agreement with Providence Little Company of Mary Medical Center (PLCMMC). As one of several components of the affiliation, PLCMMC and the Foundation entered into a 15-year lease, pursuant to which the Foundation will lease space in a medical office building to be constructed by PLCMMC. The Foundation expects to begin operating a multi-disciplinary community cancer center at this location in 2018.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

5. Long-Term Debt (continued)

Under U.S. GAAP Accounting Standards Codification (ASC) 840, *Leases*, a build-to-suit arrangement exists when a lessee, among other things, is financially involved in the construction of certain structural improvements prior to the commencement of the lease. Under this lease agreement, the Foundation will be financially involved in the construction of non-normal tenant improvements of the building, which results in the Foundation being considered the owner of the assets during the construction period. As construction of the medical office building progresses, the Foundation will record the costs paid by the landlord to construct the building as construction in progress and a related long-term financing obligation. The estimated construction in progress is not material as the project is in the early stage. As such, the Foundation has not recorded construction in progress or a related long-term financing obligation as of September 30, 2016.

Upon completion of construction, the project will be evaluated for sales lease-back treatment and, should the criteria not be met, the Foundation will carry and amortize the financing obligation to the extent that lease payments are applied to the liability and depreciate the building over the estimated useful life. The aggregate lease payments that the Foundation expects to make under the 15-year lease agreement are approximately \$13,200,000.

Interest Rate Swap Transactions – In November 2012, the Obligated Group entered into two swap contracts to synthetically convert the Series 2012B and Series 2012C Revenue Bonds from a variable rate to a fixed rate of 2.715% and 2.720%, respectively. The Obligated Group receives a floating rate equal to 70% of the USD-LIBOR-BBA for both Series 2012B and Series 2012C Revenue Bonds. The swaps were not designated as cash flow hedges, so the changes in fair value totaling \$5,917,000 and \$4,370,000 are recorded within program and supporting services expenses in the accompanying consolidated statements of activities as of September 30, 2016 and 2015, respectively. The effect of counterparty payments and receipts on interest expense was an expense increase of \$1,586,000 and \$1,686,000 in 2016 and 2015, respectively.

Financial Covenants – Under the Series 2012 Revenue Bonds and the Series 2013 Notes, the Obligated Group must maintain certain financial covenants. The Obligated Group was in compliance with the respective covenants at September 30, 2016.

Line of Credit – The Affiliated Group maintains a consolidated unsecured revolving bank line of credit in the amount of \$50,000,000, which expires on June 30, 2017. Interest is charged at the London Interbank Offered Rate (LIBOR) plus 0.75%. As of September 30, 2016, there was no outstanding balance on the line of credit.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

5. Long-Term Debt (continued)

Stand-by Letter of Credit – The Affiliated Group maintains a stand-by letter of credit in the amount of \$50,000 that expires on August 26, 2017.

6. City of Hope Medical Foundation

City of Hope has established a nonprofit medical foundation to help move the Center toward a more integrated health care delivery system, to continue to enhance the quality of the clinical care provided to its patients and the research it conducts, and to respond to federal health care reform legislation.

The Foundation has entered into a five-year professional services agreement with the City of Hope Medical Group (COHMG), an unconsolidated medical group. Under the terms of the professional services agreement, COHMG physicians provide exclusive patient care services and academic services, such as teaching, administrative, and research services, to the Foundation. As part of City of Hope's goal of creating greater integration and coordination of City of Hope's patient care, research, and educational services, the Foundation provides for or arranges for the provision of certain patient care and on-call coverage services and teaching, administrative, and research services for the operations and activities of the Center pursuant to several agreements between the Foundation and the Center. The professional fees associated with the contract between the Foundation and the Center are eliminated in consolidation.

In addition, in furtherance of the goal of achieving greater clinical integration between the Center and the COHMG physicians, the Foundation and the Center have entered into a contract for the Foundation to manage and operate the Center's Geri and Richard Brawerman Center for Ambulatory Care.

Pursuant to the professional services agreement, COHMG assigns to the Foundation the right to bill and collect for professional services rendered by COHMG physicians and other professional employees, and the Foundation contracts directly with payors in connection with the provision of patient care services. Accordingly, net patient service revenues for the Foundation include amounts for services provided by COHMG physicians on behalf of the Foundation. Professional fees incurred by the Foundation substantially include the professional fees negotiated with COHMG for physician services.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

7. Goodwill and Other Intangible Assets

Goodwill and other intangible assets consist of costs in excess of the fair value of the tangible assets of acquired entities. The Affiliated Group assesses the carrying value of goodwill for impairment at the reporting unit level on an annual basis, or more frequently if significant indicators of impairment exist. The Affiliated Group primarily uses the income approach to valuation, which includes the discounted cash flow method, to determine the fair value of its reporting units.

The Affiliated Group has elected an annual measurement date of July 1 and performed a quantitative goodwill impairment analysis under FASB ASC 350, *Intangibles – Goodwill and other*, during 2015. Upon completion of the quantitative impairment assessment, the Affiliated Group determined that impairment was indicated as the estimated fair value of the reporting unit with goodwill did not exceed its respective carrying value. Accordingly, a goodwill impairment charge of \$30,137,000 was recognized in the accompanying consolidated statement of activities as a supporting services expense for the year ended September 30, 2015.

The gross carrying amount of intangible assets subject to amortization comprises a trade-name and electronic medical records, which total \$9,463,000. The accumulated amortization on those intangible assets at September 30, 2016 and 2015, totaled \$6,695,000 and \$5,444,000, respectively. The Foundation has recorded \$1,251,000 of amortization expense for intangible assets acquired during the years ended September 30, 2016 and 2015. Intangible assets are amortized on a straight-line basis between seven and ten years. Future amortization of these intangibles is reflected below (amounts in thousands):

| | | |
|------|----|--------------|
| 2017 | \$ | 1,251 |
| 2018 | | 910 |
| 2019 | | 228 |
| 2020 | | 228 |
| 2021 | | 151 |
| | \$ | <u>2,768</u> |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

8. Commitments and Contingencies

Leases

The Affiliated Group has non-cancelable operating leases for office space and equipment that expire on various dates through 2029. As of September 30, 2016, future minimum lease payments required under these operating leases are as follows (amounts in thousands):

| | | |
|------------|----|---------------|
| 2017 | \$ | 6,187 |
| 2018 | | 5,301 |
| 2019 | | 4,713 |
| 2020 | | 4,325 |
| 2021 | | 3,857 |
| Thereafter | | 10,186 |
| | \$ | <u>34,569</u> |

Lease expense for the leases shown above and other month-to-month rental agreements totaled \$9,821,000 and \$9,435,000 in 2016 and 2015, respectively.

Litigation and Administrative Actions

The Affiliated Group from time to time is subject to claims arising in the ordinary course of business. In the opinion of management, with the exception of the matters discussed below, the ultimate resolution of legal proceedings and other claims currently pending against the Affiliated Group will not have a material adverse effect on the consolidated financial position, statements of activities, or cash flows of the Affiliated Group.

City of Hope has been engaged in various proceedings involving challenges to the validity of U.S. Patent No. 6,331,415 issued December 18, 2001, entitled “Methods of Producing Immunoglobulins, Vectors and Transformed Host Cells for Use Therein” (the Cabilly II patent) and U.S. Patent No. 7,923,221 entitled “Methods of Making Antibody Heavy and Light Chains Having Specificity for a Desired Antigen” (the Cabilly III patent, and together with Cabilly II patent, the Cabilly patents). Both Cabilly patents are co-owned by City of Hope and Genentech, and are set to expire in 2018.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

8. Commitments and Contingencies (continued)

On July 27, 2015, Sanofi-Aventis U.S. LLC (Sanofi) and Regeneron Pharmaceuticals, Inc. (Regeneron) filed a lawsuit against City of Hope and Genentech in the United States District Court (USDC) challenging the validity of the Cabilly III patent. Sanofi and Regeneron also challenged the validity of the Cabilly II patent in a petition for inter partes review (IPR) filed July 27, 2015, in the United States Patent Trademark Office (PTO). On December 30, 2015, Genzyme Corporation (Genzyme) filed a lawsuit against City of Hope and Genentech in the USDC challenging the validity of the Cabilly III patent. Genzyme also challenged the patentability of the Cabilly II patent in two separate petitions for IPR filed December 30, 2015 and January 15, 2016. The suits and challenges filed by Sanofi, Regeneron, and Genzyme were settled in August 2016. City of Hope made no payment in connection with any of the foregoing settlements.

On March 3, 2016, Mylan Pharmaceuticals Inc. (Mylan) filed a petition for IPR of Cabilly II.

On July 7, 2016, Merck Sharp & Dohme Corp. (Merck) filed a lawsuit against City of Hope and Genentech in the USDC challenging the validity of the Cabilly III patent and seeking a declaratory judgment that its antibody drug Keytruda (pembrolizumab) and/or its bezlotoxumab product do not infringe the patent. On the same date, Merck also challenged the patentability of the Cabilly II patent in a petition for IPR filed in the PTO.

On October 11, 2016, Merck filed a second petition in the PTO seeking IPR on the same basis as raised in the petition for an IPR filed by Mylan. Merck also filed a motion for joinder with the Mylan IPR.

The complaint and petitions filed by Merck and the petition for an IPR filed by Mylan contain allegations that are similar in significant respects to the allegations made in prior challenges to the Cabilly patents. These proceedings are at a very early stage. The final outcome of the Mylan and Merck litigation cannot be determined at this time. If either the Cabilly II or Cabilly III patent is ultimately declared invalid, royalties under the two Cabilly patents could be significantly reduced or eliminated in the future, which could have a material adverse impact on the consolidated financial condition of the Affiliated Group.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

8. Commitments and Contingencies (continued)

Health Care Regulations

The Center 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, governmental health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Federal laws prohibit submission of claims for reimbursement to the Medicare and Medicaid programs for services not rendered in accordance with applicable rules, laws, and regulations. Any overpayments received must be refunded to the government payor. Violation of these laws can result in substantial civil and criminal penalties and fines, including treble damages and mandatory penalties of up to \$11,000 per claim, as well as possible debarment from future participation in government health care programs. Management believes that the Center is presently in compliance with fraud and abuse laws, as well as other applicable government laws and regulations. While no material regulatory inquiries about past or present conduct 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.

Capital Commitments (Unaudited)

As of September 30, 2016, the Affiliates have committed to spend approximately \$61,189,000 through 2017 for building renovations, multiple campus facility renovations, and various information technology projects, including a clinical information system.

9. Community Benefit Expense (Unaudited)

City of Hope supports a variety of programs and services that provide a direct benefit to its patients, as well as to the broader community. The primary categories of community benefit are as follows:

- Benefits for the Broader Community – Clinical Research
- Benefits for the Broader Community – Support of Basic Science Research
- Public Information and Education

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

9. Community Benefit Expense (Unaudited) (continued)

Benefits for the Broader Community and Support of Governmental Health Care Programs – Medi-Cal and Medicare

The Affiliates support a variety of clinical and basic science research activities focused on finding cures and treatments for cancer and other life-threatening diseases for which grant and other extramural funding is not available. The cost of these institutionally funded research efforts is considered a benefit to the broader community. In addition, the cost of providing public information and education is also considered a community benefit.

The Center and the Foundation accept all patients who are covered by governmental subsidized programs – primarily Medi-Cal and Medicare fee for service and who meet certain clinical criteria. These programs typically remit payments substantially less than charges and below the cost of providing the services. The Center and the Foundation have estimated the costs of treating patients less payments received for these costs. The residual amount of cost in excess of payments has been included as a component of the Center’s community benefit.

The following is a summary of the Affiliates’ estimated community benefit expense, and Support of Governmental Health Care Programs – Medi-Cal and Medicare expense, at cost, in terms of service to the indigent and benefits to the broader community for the years ended September 30 (amounts in thousands):

| | 2016 | 2015 |
|--|-------------|-------------|
| Benefits for the broader community | | |
| Support for research (unaudited): | | |
| Estimated institutionally supported research costs, net of grants received of \$87,391 and \$71,703 in 2016 and 2015, respectively | | |
| Center | \$ 63,410 | \$ 64,310 |
| Institute | 147,356 | 132,471 |
| Total estimated benefits for the broader community, at cost | \$ 210,766 | \$ 196,781 |
| Support of governmental health care programs (unaudited): | | |
| Estimated unreimbursed cost of the Medi-Cal Program | \$ 65,915 | \$ 51,077 |
| Estimated unreimbursed cost of the Medicare Program | 104,690 | 77,767 |
| | 170,605 | 128,844 |
| Total estimated benefits for the broader community and unreimbursed costs to governmental health care programs | \$ 381,371 | \$ 325,625 |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Donor-Restricted Endowments

FASB ASC 958 provides guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA). UPMIFA was enacted in California on September 30, 2008, with an effective date of January 1, 2009. The net asset classification provisions of FASB ASC 958 were adopted by City of Hope in 2009 when UPMIFA was enacted into law in California. FASB ASC 958 also contains disclosure provisions, which are included below.

Endowment: City of Hope's endowment includes all permanently and certain temporarily restricted as well as unrestricted net assets that contain donor-restricted funds as well as board-designated funds.

Funds With Deficiencies: From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires City of Hope to retain as a fund of perpetual duration. Deficiencies of this nature are reported in unrestricted net assets unless the income from such endowment funds is restricted as to use, in which case such amounts are reflected in temporarily restricted net assets. As of September 30, 2016 and 2015, there were no material deficiencies of this nature.

Return Objectives and Risk Parameters: City of Hope's financial objective is to achieve a long-term rate of return that will enhance and preserve the real (inflation-adjusted) purchasing power of the corpus without subjecting the investment portfolio to large investment losses. Assets are invested in a manner that is intended to produce results that exceed the respective benchmark, while assuming a moderate level of investment risk. Actual returns in any given year may vary from this amount.

Strategies Employed for Achieving Objectives: To satisfy its long-term rate-of-return objectives, City of Hope relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). City of Hope targets a diversified asset allocation to achieve its long-term return objectives within prudent risk constraints.

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Donor-Restricted Endowments (continued)

Interpretation of Relevant Law: City of Hope has interpreted the Uniform Management of Institutional Funds Act (UMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, City of Hope classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until the donor's restriction is met, at which time it is classified as unrestricted.

Effective January 1, 2009, the state of California adopted UPMIFA, which added certain prudent spending measures to UMIFA. In accordance with UPMIFA, City of Hope considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- (1) The duration and preservation of the fund
- (2) The purposes of the donor-restricted endowment fund
- (3) General economic conditions
- (4) The possible effects of inflation and deflation
- (5) The expected total return from income and appreciation of investments
- (6) Other resources of City of Hope
- (7) The investment policies of City of Hope

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Donor-Restricted Endowments (continued)

The endowment net asset composition by type of fund as of September 30 consists of the following (amounts in thousands):

| | 2016 | | | Total |
|------------------------------------|---------------------|-------------------------------|-------------------------------|-------------------|
| | Unrestricted | Temporarily Restricted | Permanently Restricted | |
| Donor-restricted endowment funds | \$ (1,538) | \$ – | \$ 161,344 | \$ 159,806 |
| Temporarily restricted donor funds | – | 40,624 | – | 40,624 |
| Board-designated funds | 716,729 | – | – | 716,729 |
| Total funds | \$ 715,191 | \$ 40,624 | \$ 161,344 | \$ 917,159 |

| | 2015 | | | Total |
|------------------------------------|---------------------|-------------------------------|-------------------------------|-------------------|
| | Unrestricted | Temporarily Restricted | Permanently Restricted | |
| Donor-restricted endowment funds | \$ (2,364) | \$ – | \$ 160,647 | \$ 158,283 |
| Temporarily restricted donor funds | – | 28,143 | – | 28,143 |
| Board-designated funds | 655,718 | – | – | 655,718 |
| Total funds | \$ 653,354 | \$ 28,143 | \$ 160,647 | \$ 842,144 |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Donor-Restricted Endowments (continued)

The changes in endowment net assets for the years ended September 30 are as follows (amounts in thousands):

| | 2016 | | | Total |
|---|---------------------|-------------------------------|-------------------------------|-------------------|
| | Unrestricted | Temporarily Restricted | Permanently Restricted | |
| Endowment net assets, October 1, 2015 | \$ 653,354 | \$ 28,143 | \$ 160,647 | \$ 842,144 |
| Contributions and additions | – | 162 | 8,035 | 8,197 |
| Change in donor designation | – | 7,000 | (7,000) | – |
| Investment returns: | | | | |
| Investment income/(loss) | 11,981 | 3,659 | (377) | 15,263 |
| Net appreciation – realized and unrealized | 50,826 | 13,415 | 39 | 64,280 |
| Appropriation of endowment assets for expenditure or transfers | (970) | (11,755) | – | (12,725) |
| Endowment net assets, September 30, 2016 | \$ 715,191 | \$ 40,624 | \$ 161,344 | \$ 917,159 |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Donor-Restricted Endowments (continued)

| | 2015 | | | Total |
|---|---------------------|-------------------------------|-------------------------------|-------------------|
| | Unrestricted | Temporarily Restricted | Permanently Restricted | |
| Endowment net assets, October 1, 2014 | \$ 662,774 | \$ 36,483 | \$ 146,892 | \$ 846,149 |
| Contributions and additions | 9,662 | 98 | 13,555 | 23,315 |
| Investment returns: | | | | |
| Investment income | 12,893 | 3,187 | 6 | 16,086 |
| Net appreciation – realized and unrealized | (31,192) | (7,380) | 194 | (38,378) |
| Appropriation of endowment assets for expenditure | (783) | (4,245) | – | (5,028) |
| Endowment net assets, September 30, 2015 | <u>\$ 653,354</u> | <u>\$ 28,143</u> | <u>\$ 160,647</u> | <u>\$ 842,144</u> |

11. Restricted Net Assets

Temporarily restricted net assets are available for the following purposes as of September 30 (amounts in thousands):

| | 2016 | 2015 |
|---|-------------------|-------------------|
| Time restricted under annuity and split-interest obligations and other | \$ 122,547 | \$ 91,210 |
| Patient care | 8,501 | 6,665 |
| Education | 5,238 | 4,156 |
| Research | 148,252 | 119,411 |
| Medical equipment and buildings | 4,011 | 2,982 |
| Total temporarily restricted net assets | <u>\$ 288,549</u> | <u>\$ 224,424</u> |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

11. Restricted Net Assets (continued)

Net assets were released from donor restrictions by satisfying the restricted purposes in the years ended September 30 (amounts in thousands):

| | 2016 | 2015 |
|--|------------------|-------------|
| Time restricted under annuity and split-interest obligations and other | \$ 1,233 | \$ 1,334 |
| Patient care | 443 | 1,143 |
| Education | 1,072 | 1,180 |
| Research | 28,357 | 29,496 |
| Medical equipment and buildings | 1,428 | 2,051 |
| Total temporarily and permanently restricted net assets released from restrictions | \$ 32,533 | \$ 35,204 |

Permanently restricted net assets are restricted investments to be held in perpetuity, the income from which is expendable to support the following purposes as of September 30 (amounts in thousands):

| | 2016 | 2015 |
|--|-------------------|-------------|
| Time restricted under annuity and split-interest obligations and other | \$ 8,253 | \$ 10,826 |
| Patient care | 14,492 | 14,444 |
| Education | 17,763 | 17,667 |
| Research | 124,425 | 123,356 |
| Medical equipment and buildings | 3,510 | 3,510 |
| Total permanently restricted net assets | \$ 168,443 | \$ 169,803 |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

12. Expenses

The Affiliated Group provides critical patient care services and research to the community, along with public information and education. Expenses related to providing these services, and administrative and fundraising support, for the years ended September 30 are as follows (amounts in thousands):

| | 2016 | 2015 |
|--|----------------------------|----------------------------|
| Salaries, wages, and employee benefits | \$ 522,811 | \$ 474,773 |
| Purchased services | 186,981 | 138,857 |
| Professional fees | 131,284 | 118,707 |
| Supplies and pharmaceuticals | 338,866 | 273,668 |
| Equipment rental and maintenance | 19,391 | 17,932 |
| Interest | 32,363 | 31,969 |
| Change in fair value of swap agreement | 5,917 | 4,370 |
| Depreciation and amortization | 95,094 | 81,609 |
| Occupancy | 18,428 | 18,559 |
| Royalty sharing | 102,146 | 89,871 |
| Hospital provider fee | 13,942 | 25,738 |
| Bad debt | 3,110 | 10,240 |
| Goodwill impairment | – | 30,137 |
| Other | 19,210 | 16,225 |
| Total expenses | <u>\$ 1,489,543</u> | <u>\$ 1,332,655</u> |

City of Hope and Affiliates

Notes to Consolidated Financial Statements (continued)

13. Subsequent Events

On November 16, 2016, City of Hope and The Translational Genomics Research Institute (T-Gen), announced that the two organizations entered into an Affiliation Agreement (the Agreement). Pursuant to the terms of the Agreement, City of Hope will become the sole corporate member of T-Gen. T-Gen will remain an Arizona-based nonprofit with headquarters in Phoenix. T-Gen and its wholly owned and related affiliates had total unrestricted revenues and support of \$40,700,000 for the fiscal year ended December 31, 2015, and total assets of \$60,300,000 as of December 31, 2015. Pursuant to the Agreement, City of Hope will annually provide T-Gen with a specified amount of funding over a five-year period.

On December 4, 2016, the Foundation entered into a 15-year lease agreement with San Antonio Regional Hospital (SARH) for an outpatient cancer center to be owned and operated by the Foundation. The lease agreement provides for the design and construction of a medical office building by SARH in Upland, California. Foundation management expects to begin operating a multi-disciplinary community cancer center at this location in 2019. The lease agreement is subject to build to suit accounting under U.S. GAAP Accounting Standards Codification (ASC) 840, *Leases*. The aggregate lease payments that the Foundation will be obligated to make under the original term of the 15-year lease agreement is approximately \$10,500,000.

City of Hope has evaluated subsequent events occurring between the end of the most recent fiscal year and December 19, 2016, the date the financial statements were issued.

Reports Required by the Uniform Guidance



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Report of Independent Auditors on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Management and the Board of Directors
City of Hope and Affiliates

We have audited, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of City of Hope and Affiliates (City of Hope), which comprise the consolidated statement of financial position as of September 30, 2016, and the related consolidated statements of activities, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated December 19, 2016.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered City of Hope's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of City of Hope's internal control. Accordingly, we do not express an opinion on the effectiveness of City of Hope's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether City of Hope's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Ernst + Young LLP

December 19, 2016



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Report of Independent Auditors on Compliance for Each Major Federal Program and Report on Internal Control Over Compliance Required by the Uniform Guidance

Management and the Board of Directors
City of Hope and Affiliates

Report on Compliance for Each Major Federal Program

We have audited City of Hope and Affiliates' (City of Hope) compliance with the types of compliance requirements described in the US Office of Management and Budget (OMB) *Compliance Supplement* that could have a direct and material effect on City of Hope's major federal program for the year ended September 30, 2016. City of Hope's major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with federal statutes, regulations and the terms and conditions of its federal awards applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for City of Hope's major federal program based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit requirements of Title 2 U.S. *Code of Federal Regulations Part 200, Uniform Administrative Requirements, Costs Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about City of Hope's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for the major federal program. However, our audit does not provide a legal determination of City of Hope's compliance.

Opinion on Each Major Federal Program

In our opinion, City of Hope complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on its major federal program for the year ended September 30, 2016.

Report on Internal Control Over Compliance

Management of City of Hope is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered City of Hope's internal control over compliance with the types of requirements that could have a direct and material effect on the major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for the major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of City of Hope's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. *A material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. *A significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.



The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

Ernst + Young LLP

December 19, 2016

Supplementary Information

City of Hope and Affiliates

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2016

| Federal Grantor/Program or Cluster Title/Pass Through Grantor | CFDA No. | Pass Through Grantor Identifying No. | Federal Expenditures | Expenditures to Subrecipients |
|---|-----------------|---|---------------------------------|--|
| Research and Development Cluster | | | | |
| Department of Defense | | | | |
| Basic and Applied Scientific Research | 12.300 | Letter 12-17-15 | \$ 31,733 | \$ - |
| Military Medical Research and Development | 12.420 | | 2,009,584 | - |
| Pass Through- <i>SRI International</i> | 12.420 | W81XWH-13-1-0411 | 9,382 | - |
| Pass Through- <i>University of Tennessee Health Science Center</i> | 12.420 | W81XWH-14-2-0189 | 10,142 | - |
| Total Pass Through-Military Medical Research and Development | | | <u>19,524</u> | - |
| Total Military Medical Research and Development | | | 2,029,108 | - |
| Basic Scientific Research | | | | |
| Pass Through- <i>University of Chicago</i> | 12.431 | W911NF-14-1-0333 | 46,232 | - |
| Total Department of Defense | | | 2,107,073 | - |
| National Science Foundation | | | | |
| Engineering Grants | | | | |
| Pass Through- <i>California Institute of Technology</i> | 47.041 | NSF-68-1094366 | 103,200 | - |
| Biological Sciences | | | | |
| Pass Through- <i>Miami University</i> | 47.074 | IOS-1257455 | 64,691 | - |
| Total National Science Foundation | | | 167,891 | - |
| Department of Health and Human Services | | | | |
| National Institutes of Health | 93.RD | | 4,589 | - |
| Pass Through- <i>Oregon Health and Science University</i> | 93.RD | Agreement 1-27-14 | 183,276 | - |
| Pass Through- <i>University of California, Davis</i> | 93.RD | N01 CM17003 | 122,396 | - |
| Total Pass Through-National Institutes of Health | | | <u>305,672</u> | - |
| Total National Institutes of Health | | | 310,261 | - |
| Food and Drug Administration Research | 93.103 | | 331,268 | - |
| Maternal and Child Health Federal Consolidated Programs | | | | |
| Pass Through- <i>Children's Hospital of Orange County</i> | 93.110 | H30 MC0003606 | 200,618 | - |
| Pass Through- <i>Center for Comprehensive Care</i> | 93.110 | H30 MC24045 | 1,697 | - |
| Total Pass Through-Maternal and Child Health Federal Consolidated Programs | | | <u>202,315</u> | - |
| Total Maternal and Child Health Federal Consolidated Programs | | | 202,315 | - |
| Environmental Health | 93.113 | | 740,576 | 61,243 |
| Oral Disease and Disorder Research | 93.121 | | 271,108 | - |
| Pass Through- <i>University of Arizona</i> | 93.121 | R01 DE23534 | 164,802 | - |
| Total Oral Disease and Disorder Research | | | <u>435,910</u> | - |
| Disabilities Prevention | | | | |
| Pass Through- <i>Center for Comprehensive Care</i> | 93.184 | US27 DD0862 | 8,503 | - |
| Mental Health Research Grants | 93.242 | | 258,631 | 97,774 |
| Minority Health and Health Disparities Research | | | | |
| Pass Through- <i>University of Tennessee Health Science Center</i> | 93.307 | | 122 | - |

City of Hope and Affiliates

Schedule of Expenditures of Federal Awards (continued)

Year Ended September 30, 2016

| Federal Grantor/Program or Cluster Title/Pass Through Grantor | CFDA No. | Pass Through Grantor Identifying No. | Federal Expenditures | Expenditures to Subrecipients |
|--|-----------------|---|---------------------------------|--|
| Trans-NIH Research Support | 93.310 | | \$ 30,279 | \$ - |
| Research Infrastructure Programs | 93.351 | | 201,166 | 25,109 |
| Nursing Research | 93.361 | | 647,758 | 356,321 |
| Pass Through- <i>Duke University</i> | 93.361 | U24 NR14637 | 152,598 | - |
| Total Nursing Research | | | 800,356 | 356,321 |
| National Center for Research Resources | | | | |
| Pass Through- <i>Arizona State University</i> | 93.389 | HHSO100201000008C | 42,007 | - |
| Pass Through- <i>Fred Hutchinson Cancer Research Center</i> | 93.389 | R44 HL106868 | 2,643 | - |
| Pass Through- <i>Mount Sinai Hospital</i> | 93.389 | R25 CA190186 | 53,212 | - |
| Total Pass Through-National Center for Research Resources | | | 97,862 | - |
| Total National Center for Research Resources | | | 97,862 | - |
| Cancer Cause and Prevention Research | 93.393 | | 10,667,256 | 2,708,744 |
| Pass Through- <i>Memorial Sloan Kettering Cancer Center</i> | 93.393 | R01 CA129639 | 13,677 | - |
| Pass Through- <i>Memorial Sloan Kettering Cancer Center</i> | 93.393 | R01 CA172119 | 338,358 | - |
| Pass Through- <i>Memorial Sloan Kettering Cancer Center</i> | 93.393 | R01 CA179992 | 17,911 | - |
| Pass Through- <i>Georgetown University</i> | 93.393 | R01 CA129769 | 86,645 | - |
| Pass Through- <i>Baylor University</i> | 93.393 | U01 CA170930 | 175,763 | - |
| Pass Through- <i>Cancer Prevention Institute</i> | 93.393 | R01 CA170394 | (723) | - |
| Pass Through- <i>St. Jude Children's Research Hospital</i> | 93.393 | U01 GM92666 | (1,716) | - |
| Pass Through- <i>University of Alabama</i> | 93.393 | R01 CA139633 | 2,181 | - |
| Pass Through- <i>University of Alabama</i> | 93.393 | R01 CA140245 | 9,135 | - |
| Pass Through- <i>University of California, San Francisco</i> | 93.393 | R01 CA181191 | 41,761 | - |
| Pass Through- <i>University of California, San Francisco</i> | 93.393 | UM1 CA181255 | 9,244 | - |
| Pass Through- <i>Mayo Clinic</i> | 93.393 | R01 CA192393 | 115,337 | - |
| Total Pass Through-Cancer Cause and Prevention Research | | | 807,573 | - |
| Total Cancer Cause and Prevention Research | | | 11,474,829 | 2,708,744 |
| Cancer Detection and Diagnosis Research | 93.394 | | 1,121,764 | 12,246 |
| Pass Through- <i>University of Kentucky</i> | 93.394 | U01 CA151648 | (1,164) | - |
| Total Cancer Detection and Diagnosis Research | | | 1,120,600 | 12,246 |
| Cancer Treatment Research | 93.395 | | 7,023,706 | 1,384,050 |
| Pass Through- <i>St. Jude Children's Research Hospital</i> | 93.395 | U24 CA55727 | (5,145) | - |
| Pass Through- <i>Children's Hospital of Philadelphia</i> | 93.395 | U10 CA98543 | 17,858 | - |
| Pass Through- <i>Children's Hospital of Philadelphia</i> | 93.395 | Agreement 08-29-13 | 714 | - |
| Pass Through- <i>University of Hawaii</i> | 93.395 | R01 CA161931 | 64,698 | - |
| Pass Through- <i>University of Rochester</i> | 93.395 | R01 CA177592 | 95,663 | - |
| Pass Through- <i>University of California, Irvine</i> | 93.395 | U10 CA27469 | 73 | - |
| Pass Through- <i>University of Alabama</i> | 93.395 | R01 CA166559 | 56,057 | - |
| Pass Through- <i>University of Alabama</i> | 93.395 | R01 CA174683 | 19,083 | - |
| Pass Through- <i>Ohio State University</i> | 93.395 | R01 CA158350 | 58,838 | - |
| Pass Through- <i>Ohio State University</i> | 93.395 | R01 CA135332 | 80,285 | - |
| Pass Through- <i>Ohio State University</i> | 93.395 | U10 CA180861 | 74,742 | - |
| Pass Through- <i>Hope Foundation</i> | 93.395 | Letter 04-19-12 | 14,640 | - |
| Pass Through- <i>American College of Radiology</i> | 93.395 | U10 CA21661 | 22,849 | - |
| Total Pass Through-Cancer Treatment Research | | | 500,355 | - |
| Total Cancer Treatment Research | | | 7,524,061 | 1,384,050 |

City of Hope and Affiliates

Schedule of Expenditures of Federal Awards (continued)

Year Ended September 30, 2016

| Federal Grantor/Program or Cluster Title/Pass Through Grantor | CFDA No. | Pass Through Grantor Identifying No. | Federal Expenditures | Expenditures to Subrecipients |
|---|-----------------|---|---------------------------------|--|
| Cancer Biology Research | 93.396 | | \$ 2,581,614 | \$ - |
| Pass Through-Tufts University School of Medicine | 93.396 | R01 CA170851 | 120,547 | - |
| Pass Through-University of California, San Francisco | 93.396 | R01 CA192914 | 59,511 | - |
| Pass Through-Stanford University | 93.396 | U01 CA154209 | (14,845) | - |
| Total Pass Through-Cancer Biology Research | | | 165,213 | - |
| Total Cancer Biology Research | | | 2,746,827 | - |
| Cancer Center Support Grants | 93.397 | | 4,839,923 | 525,967 |
| Pass Through-Northwestern University | 93.397 | U54 CA151880 | 1 | - |
| Pass Through-Children's Hospital of Los Angeles | 93.397 | U54 CA163117 | 151,926 | - |
| Total Pass Through-Cancer Center Support Grants | | | 151,927 | - |
| Total Cancer Center Support Grants | | | 4,991,850 | 525,967 |
| Cancer Research Manpower | 93.398 | | 1,980,079 | 151,044 |
| Pass Through-Icahn School of Medicine at Mount Sinai | 93.398 | R25 CA138494 | 117,866 | - |
| Pass Through-Icahn School of Medicine at Mount Sinai | 93.398 | R25 CA168551 | (40) | - |
| Pass Through-Yale University | 93.398 | R25 CA177553 | 9,533 | - |
| Total Pass Through-Cancer Research Manpower | | | 127,359 | - |
| Total Cancer Research Manpower | | | 2,107,438 | 151,044 |
| Cancer Control | 93.399 | | 43,203 | - |
| Cardiovascular Diseases Research | 93.837 | | 289,850 | - |
| Blood Diseases and Resources Research | 93.839 | | 400,178 | - |
| Pass Through-University of Minnesota | 93.839 | R01 HL12216 | 13,830 | - |
| Total Blood Diseases and Resources Research | | | 414,008 | - |
| Diabetes, Digestive, and Kidney Diseases Extramural Research | 93.847 | | 8,354,602 | 105,364 |
| Pass Through-Los Angeles Biomedical Research | 93.847 | T32 DK07571 | (3,397) | - |
| Pass Through-Stanford University | 93.847 | R01 DK78424 | (949) | - |
| Pass Through-University of Irvine | 93.847 | R01 DK098446 | 136,864 | - |
| Pass Through-Broad Institute | 93.847 | U01DK105554 | 3,264 | - |
| Pass Through-Children's Hospital of Los Angeles | 93.847 | R25-DK078385 | 540 | - |
| Total Pass Through-Diabetes, Digestive, and Kidney Diseases Extramural Research | | | 136,322 | - |
| Total Diabetes, Digestive, and Kidney Diseases Extramural Research | | | 8,490,924 | 105,364 |
| Extramural Research Programs in the Neurosciences and Neurological Disorders | 93.853 | | 1,032,356 | 384,832 |
| Pass Through-University of Chicago | 93.853 | U01 NS069997 | (98) | - |
| Total Extramural Research Programs in the Neurosciences and Neurological Disorders | | | 1,032,258 | 384,832 |
| Allergy and Infectious Diseases Research | 93.855 | | 3,789,923 | 157,902 |
| Pass Through-University of California, Davis | 93.855 | R01 AI63356 | 31,937 | - |
| Pass Through-Fred Hutchinson Cancer Research Center | 93.855 | U19 AI96111 | 139,668 | - |
| Pass Through-Scripps Health | 93.855 | P01 AI99783 | 93,935 | - |
| Total Pass Through-Allergy and Infectious Diseases Research | | | 265,540 | - |
| Total Allergy and Infectious Diseases Research | | | 4,055,463 | 157,902 |

City of Hope and Affiliates

Schedule of Expenditures of Federal Awards (continued)

Year Ended September 30, 2016

| Federal Grantor/Program or Cluster Title/Pass Through Grantor | CFDA No. | Pass Through Grantor Identifying No. | Federal Expenditures | Expenditures to Subrecipients |
|--|-----------------|---|---------------------------------|--|
| Biomedical Research and Research Training | 93.859 | | \$ 1,767,598 | \$ 94,267 |
| Child Health and Human Development Extramural Research | | | | |
| Pass Through- <i>California Institute of Technology</i> | 93.865 | R01 HD075605 | 36,737 | – |
| Pass Through- <i>University of Minnesota</i> | 93.865 | R01 HD079918 | 107,653 | – |
| Total Pass Through-Child Health and Human Development Extramural Research | | | <u>144,390</u> | <u>–</u> |
| Total Child Health and Human Development Extramural Research | | | 144,390 | – |
| Aging Research | 93.866 | | 654,732 | 216,630 |
| Total Research and Development Cluster | | | <u>52,550,244</u> | <u>6,281,493</u> |
| National Bioterrorism Hospital Preparedness Program | | | | |
| Pass Through- <i>County of Los Angeles</i> | 93.889 | 702027 | 30,780 | – |
| Total Department of Health and Human Services | | | <u>50,306,060</u> | <u>6,281,493</u> |
| Total Expenditures of Federal Awards | | | <u>\$ 52,581,024</u> | <u>\$ 6,281,493</u> |

See accompanying notes to Schedule of Expenditures of Federal Awards.

City of Hope and Affiliates

Notes to Schedule of Expenditures of Federal Awards

Year Ended September 30, 2016

1. Federal awards expended are reported on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States, as described in the notes to the consolidated financial statements. The information on the schedule of expenditures of federal awards (the Schedule) is presented in accordance with the requirements of Title 2 U.S. *Code of Federal Regulations Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (the Uniform Guidance). Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the consolidated financial statements of City of Hope. For purposes of the Schedule, federal awards include any assistance provided by a federal agency directly or indirectly in the form of grants, contracts, cooperative agreements, loan and loan guarantees, or other non-cash assistance.

Direct and indirect costs are charged to awards in accordance with cost principles contained in the United States Department of Health and Human Services Cost Principles for Hospitals at 45 CFR Part 75 Appendix IX for Federal awards subject to the requirements of the Uniform Guidance, and at 45 CFR Part 74 Appendix E for Federal awards funded prior to the Uniform guidance effective date. Under these cost principles, certain types of expenditures are not allowable or are limited as to reimbursement. The Uniform Guidance provides for a 10% de minimis indirect cost rate election; however, City of Hope did not make this election and uses a negotiated indirect cost rate.

The Schedule includes Federal awards subject to the requirements of the Uniform Guidance, as well as Federal awards that were funded prior to the Uniform Guidance effective date of December 26, 2014.

2. Federal Expenditures of \$52,581,024 are reported in City of Hope's consolidated financial statements as research expenses in the consolidated statement of activities. Negative amounts shown on the Schedule of Expenditures of Federal Awards represent adjustments or credits made in the normal course of business to amounts reported as expenditures in prior years.

Schedule Required by the Uniform Guidance

City of Hope and Affiliates

Schedule of Findings and Questioned Costs

Year Ended September 30, 2016

Section I—Summary of Auditor’s Results

Financial Statements

Type of report the auditor issued on whether the financial statements audited were prepared in accordance with GAAP (unmodified, qualified, adverse or disclaimer):

Unmodified

Internal control over financial reporting:

Material weakness(es) identified?

_____ **yes** X **no**

Significant deficiency(ies) identified?

_____ **yes** X **none reported**

Noncompliance material to financial statements noted?

_____ **yes** X **no**

Federal Awards

Internal control over major federal programs:

Material weakness(es) identified?

_____ **yes** X **no**

Significant deficiency(ies) identified?

_____ **yes** X **none reported**

Type of auditor’s report issued on compliance for major federal programs (unmodified, qualified, adverse or disclaimer):

Unmodified

Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)?

_____ **yes** X **no**

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