

**Children's Hospital of
Pittsburgh Foundation**

Financial Statements
June 30, 2017 and 2016



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Children's Hospital of Pittsburgh Foundation

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Independent Auditors' Report

Board of Directors
Children's Hospital of Pittsburgh Foundation

We have audited the accompanying financial statements of Children's Hospital of Pittsburgh Foundation, which comprise the statement of financial position as of June 30, 2017 and 2016, and the related statements of activities and changes in net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from 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 financial position of Children's Hospital of Pittsburgh Foundation as of June 30, 2017 and 2016, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Baker Tilly Virchow Krause, LLP

Pittsburgh, Pennsylvania
November 8, 2017

Children's Hospital of Pittsburgh Foundation

Statement of Financial Position

(Amounts in Thousands)

June 30, 2017 and 2016

	<u>2017</u>	<u>2016</u>		<u>2017</u>	<u>2016</u>
Assets			Liabilities and Net Assets		
Current Assets			Current Liabilities		
Cash and cash equivalents	\$ 1,888	\$ 3,337	Due to Children's Hospital of Pittsburgh of UPMC:		
Current portion of pledges receivable	3,707	5,152	Operating expenses	\$ 623	\$ 505
Current portion of assets whose use is limited	13,790	13,400	Annual financial support	1,543	1,938
Current portion of investments	<u>4,416</u>	<u>4,290</u>	Accrued expenses	<u>22</u>	<u>42</u>
Total current assets	23,801	26,179	Total current liabilities	2,188	2,485
Assets Whose Use is Limited, Board Designated	125,771	105,926	Other Long-Term Liabilities	<u>14</u>	<u>17</u>
Investments, Donor Restricted	110,877	100,703	Total liabilities	<u>2,202</u>	<u>2,502</u>
Pledges Receivable, Net	3,565	5,599	Net Assets		
Beneficial Interest in Charitable			Unrestricted	128,278	114,006
Remainder Trusts	266	245	Temporarily restricted	83,753	72,292
Beneficial Interest in Perpetual Trusts	<u>11,021</u>	<u>10,311</u>	Permanently restricted	<u>61,068</u>	<u>60,163</u>
Total assets	<u>\$ 275,301</u>	<u>\$ 248,963</u>	Total net assets	<u>273,099</u>	<u>246,461</u>
			Total liabilities and net assets	<u>\$ 275,301</u>	<u>\$ 248,963</u>

See notes to financial statements

Children's Hospital of Pittsburgh Foundation

Statement of Activities and Changes in Net Assets

(Amounts in Thousands)

Years Ended June 30, 2017 and 2016

	2017				2016			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues and Other Support								
Contributions and bequests	\$ 7,190	\$ 10,894	\$ 187	\$ 18,271	\$ 7,205	\$ 14,600	\$ 338	\$ 22,143
Interest and dividends, net of fees	2,935	2,193	-	5,128	1,802	1,262	-	3,064
Contributed services	157	-	-	157	157	-	-	157
Allowance for doubtful pledges and pledges written off	-	(107)	-	(107)	-	(262)	-	(262)
Total revenues and other support before net assets released from restrictions	10,282	12,980	187	23,449	9,164	15,600	338	25,102
Net assets released from restrictions used for:								
Annual financial support and other operating expenses	15,345	(15,345)	-	-	14,652	(14,652)	-	-
Special events	-	-	-	-	363	(363)	-	-
Total revenues and other support	25,627	(2,365)	187	23,449	24,179	585	338	25,102
Expenses								
Contributions to Children's Hospital of Pittsburgh of UPMC, annual financial support and petition requests	21,031	-	-	21,031	19,228	-	-	19,228
General, administrative, and fundraising	7,141	-	-	7,141	8,075	-	-	8,075
Total expenses	28,172	-	-	28,172	27,303	-	-	27,303
(Decrease) Increase in Net Assets Before Other Changes in Net Assets	(2,545)	(2,365)	187	(4,723)	(3,124)	585	338	(2,201)
Other Changes in Net Assets								
Net realized and unrealized gain (loss) on investments	16,835	14,360	1	31,196	(5,486)	(4,889)	(2)	(10,377)
Valuation gain (loss), beneficial interest in charitable remainder trusts	-	21	-	21	-	(10)	-	(10)
Valuation gain (loss), beneficial interest in perpetual trusts	-	-	710	710	-	-	(1,084)	(1,084)
Reclassification of net assets	-	-	-	-	(1,680)	-	1,680	-
Other changes	(18)	-	-	(18)	-	-	(40)	(40)
Transfer of net assets (to) from Children's Hospital of Pittsburgh of UPMC	-	(555)	7	(548)	-	-	-	-
Increase (Decrease) in Net Assets	14,272	11,461	905	26,638	(10,290)	(4,314)	892	(13,712)
Net Assets, Beginning of Year	114,006	72,292	60,163	246,461	124,296	76,606	59,271	260,173
Net Assets, End of Year	\$ 128,278	\$ 83,753	\$ 61,068	\$ 273,099	\$ 114,006	\$ 72,292	\$ 60,163	\$ 246,461

See notes to financial statements

Children's Hospital of Pittsburgh Foundation

Statement of Cash Flows

(Amounts in Thousands)

Years Ended June 30, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Cash Flows from Operating Activities		
Increase (decrease) in net assets	\$ 26,638	\$ (13,712)
Adjustments to reconcile increase (decrease) in net assets to net cash used in operating activities:		
Provision for doubtful pledges	25	-
Net realized and unrealized (gains) losses on investments	(31,196)	10,377
Valuation (gain) loss, beneficial interest in charitable remainder trusts	(21)	10
Valuation (gain) loss, beneficial interest in perpetual trusts	(710)	1,084
Contributions of permanently restricted net assets	(187)	(338)
Distribution from liquidation of perpetual trust	-	(424)
Depreciation	-	1
Changes in assets and liabilities:		
Pledges receivable	3,454	540
Due to Children's Hospital of Pittsburgh of UPMC:		
Operating expenses	118	(357)
Annual financial support	(395)	376
Accrued expenses	(20)	(12)
Other long-term liabilities	(3)	(2)
Net cash used in operating activities	<u>(2,297)</u>	<u>(2,457)</u>
Cash Flows from Investing Activities		
Net sales (purchases) and maturities of investments and assets whose use is limited	661	(431)
Distribution from liquidation of perpetual trust	<u>-</u>	<u>424</u>
Net cash provided by (used in) investing activities	<u>661</u>	<u>(7)</u>
Cash Flows Provided by Financing Activities		
Contributions of permanently restricted endowment funds	<u>187</u>	<u>338</u>
Net decrease in cash and cash equivalents	(1,449)	(2,126)
Cash and Cash Equivalents, Beginning of Year	<u>3,337</u>	<u>5,463</u>
Cash and Cash Equivalents, End of Year	<u>\$ 1,888</u>	<u>\$ 3,337</u>

See notes to financial statements

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

June 30, 2017 and 2016

1. Organization

Children's Hospital of Pittsburgh Foundation (the "Foundation") was created on July 1, 2000, primarily to support the fund-raising and development efforts of the Children's Hospital of Pittsburgh. The Foundation is a non-profit organization as described in Section 501(c)(3) of the Internal Revenue Code (the "IRC") and is exempt from federal income taxes on related income pursuant to Section 501(a) of the IRC.

2. Affiliation Agreement

On October 31, 2001, Children's Hospital of Pittsburgh consummated an affiliation with University of Pittsburgh Medical Center ("UPMC Health System" or "UPMC") pursuant to the terms of the Integration and Affiliation Agreement (the "Affiliation Agreement") by and among the Children's Hospital of Pittsburgh, the Foundation, and UPMC Health System (collectively the "Parties"). As a result of the Affiliation Agreement, Children's Hospital of Pittsburgh became Children's Hospital of Pittsburgh of UPMC (the "Hospital"). Under the terms of the Affiliation Agreement, the Foundation was reorganized such that the Children's Hospital of Pittsburgh was no longer the sole corporate member of the Foundation and the Foundation has no corporate member. The Foundation is structured as a supporting organization of the Hospital.

The terms of the Affiliation Agreement provide that UPMC Health System would construct a new pediatric hospital (the "New CHP") for the Hospital. Pursuant to an amendment entered into by the Parties on September 28, 2004, the Foundation was required to provide funding for the New CHP in the amount of \$50,000 (the "Initial Funding Commitment"). The Initial Funding Commitment was fulfilled upon completion of the New CHP in May 2009.

In January 2007, the Affiliation Oversight Committee approved an increase to the projected cost for the design and construction of the New CHP of \$46,800 and the Foundation agreed in September 2007 to fund the \$46,800 increased project costs ("Additional Funding Commitment"). The Additional Funding Commitment was fulfilled in October 2013.

The Affiliation Agreement required the Hospital, after receiving Orphan's Court and regulatory approval, to transfer to the Foundation certain unrestricted, temporarily restricted and permanently restricted investments, as well as the Hospital's beneficial interests in certain perpetual trusts. The Affiliation Agreement requires that the Foundation, for a minimum of 20 years, will provide annual financial support equal to 5% of the rolling average corpus of such transferred investments, beneficial interests in certain perpetual trusts and donations received thereafter, unless the original donor specified a different spending provision. This annual funding commitment is conditional upon the Hospital delivering to the Foundation a broad range of funding requests, and to meet certain standards selected by the Parties as indicators of the Hospital's continued or improved performance.

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

June 30, 2017 and 2016

3. Summary of Significant Accounting Policies

Basis of Presentation

The Foundation is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. The classification is determined according to the existence or absence of donor-imposed restrictions. The use of temporarily restricted net assets has been limited to specified purposes or time periods.

Use of Estimates

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

Subsequent Events

The Foundation evaluated subsequent events for recognition or disclosure through November 8, 2017, the date the financial statements were available to be issued.

Cash and Cash Equivalents

Cash and cash equivalents include highly liquid investments with an original maturity of three months or less at the date of purchase, excluding assets whose use is limited and investments.

No collateral or security is provided on these investments, other than the insurance on interest bearing deposits per financial institution by the Federal Deposit Insurance Corporation. The Foundation has not experienced any losses from maintaining these accounts in excess of federally insured limits. Management believes it is not subject to significant risks associated with these accounts.

Pledges Receivable

Unconditional pledges to contribute cash and other assets are reported at their estimated fair value at the date the promise is received. Pledges receivable that are expected to be collected within one year are recorded at their net realizable value. Pledges receivable that are expected to be collected in future years are recorded at the present value of estimated net realizable future cash flows. The discount rate used was 1.55% at June 30, 2017 and 0.71% at June 30, 2016.

The Foundation annually evaluates the collectability of its pledges receivable and either reserves for or writes off uncollectible pledges when it is determined the pledge is uncollectible.

Conditional promises to give are not included as support until such time as the conditions are substantially met.

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

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Investments and Assets Whose Use Is Limited

The Foundation's investments are reported in the statement of financial position as follows:

- **Assets Whose Use is Limited, Board Designated** - These investments represent funds where the Board of Directors (the "Board") has restricted the use over the corpus, and funds of which the Board retains control and may at its discretion subsequently use for other purposes.
- **Investments, Donor Restricted** - These investments represent primarily endowed funds for which the corpus is restricted and the related investment income is restricted for specifically designated expenditures.

Investments are primarily maintained in a trust administered using a bank as the trustee. Investments are in equity investments, fixed income investments and alternative investment strategies including hedge funds and private equity.

Investments with readily determinable fair values and all investments in debt securities are measured at fair value in the statement of financial position. Investment income or loss (including realized and unrealized gains and losses on investments, interest, and dividends) is included in the determination of increase (decrease) in unrestricted net assets unless the income is restricted by donor or law. Interest income is recorded as earned on the accrual basis using the effective yield method. Dividends are recorded on the accrual basis based on the ex-dividend date.

The fair value of the Foundation's alternative investments is based on the beginning value of the Foundation's interest in the investment plus actual contributions and allocated investment income or loss less actual distributions and allocated administrative expense. If available, quoted market prices are used to value alternative investments. Securities that have no available quoted market price are presented at estimated fair value as determined by the trustee.

Although the Foundation's investments are invested in a variety of financial instruments, the related fair values, as reported in the statement of financial position, are subject to various market risks including changes in the equity markets, the interest rate environment, and economic conditions. Due to the level of risk associated with investment securities and the level of uncertainty related to changes in the fair value of investment securities, it is reasonably possible that the fair value of investments reported in the accompanying statement of financial position could materially change in the near future.

Because the Foundation's alternative investments are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investments existed and such differences could be material.

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

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Beneficial Interest in Charitable Remainder Trusts

The Foundation has been designated as the beneficiary of certain charitable remainder trusts created by donors and held by entities other than the Foundation. Under the terms of the trusts, the Foundation will receive a portion of the assets that remain in the trusts when they are terminated, typically upon death of the current beneficiary. Upon being designated as the beneficiary, the Foundation recorded an asset and recognized temporarily and permanently restricted contribution revenues. The beneficial interest recorded by the Foundation is measured at the present value of the estimated future cash payments to be distributed to the Foundation. Subsequent changes in fair value are recorded as valuation gains or losses in temporarily and permanently restricted net assets.

During 2016, a charitable remainder trust in which the Foundation had an interest in the amount of \$927 was terminated and converted to two pledges receivable.

Beneficial Interest in Perpetual Trusts

The Foundation has been designated as the beneficiary of certain perpetual trusts created by donors and held by entities other than the Foundation. Under the terms of the trusts, the Foundation will receive a portion of the income earned on trust assets in perpetuity. Upon being designated as the beneficiary, the Foundation recorded an asset and recognized permanently restricted contribution revenues. The beneficial interest recorded by the Foundation is measured at the fair value of the Foundation's interest in the trust assets. Subsequent changes in fair value are recorded as valuation gains or losses in permanently restricted net assets.

During 2016, a perpetual trust in which the Foundation had an interest in the amount of \$424 was liquidated and distributed to the Foundation.

Donor Restricted Gifts

The Affiliation Agreement provides that all contributions from donors received for the benefit of the Hospital will be recorded and maintained by the Foundation. Contributions are considered to be available for unrestricted use unless specifically restricted by the donor. Amounts received that are designated for future periods or restricted by the donor for specific purposes are reported as temporarily restricted or permanently restricted support. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of activities and changes in net assets as net assets released from restrictions.

Income Tax Status

The Foundation is a non-profit organization as described in Section 501(c)(3) of the IRC, and is exempt from federal taxes on its exempt income under Section 501(a) of the IRC. Accordingly, no provision for federal and state income taxes is recorded.

The Foundation accounts for uncertainty in income taxes using a recognition threshold of more-likely-than-not to be sustained upon examination by the appropriate taxing authority. Measurement of the tax uncertainty occurs if the recognition threshold is met. Management determined there were no tax uncertainties that met the recognition threshold at June 30, 2017 and 2016.

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

June 30, 2017 and 2016

New Accounting Pronouncements

In May 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)*. ASU 2015-07 was issued to address diversity in practice related to how certain investments measured at net asset value with redemption dates in the future are categorized within the fair value hierarchy. Under ASU 2015-07, investments for which fair value is measured using the net asset value per share as a practical expedient are no longer required to be categorized within the fair value hierarchy. ASU 2015-07 also removes certain disclosure requirements for investments eligible to be measured using the net asset value per share practical expedient; however, it does not remove such disclosures for investments for which the entity has elected to measure fair value using that practical expedient. The Foundation will be required to retrospectively adopt the guidance in ASU 2015-07 for its year ending June 30, 2018; early adoption is permitted. The Foundation is currently assessing the effect that the adoption of ASU 2015-07 will have on its financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU No. 2016-01: a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (g) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (h) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. ASU No. 2016-01 is effective for annual periods beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Foundation is currently assessing the effect that ASU No. 2016-01 will have on its results of operations, financial position and cash flows.

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In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. ASU 2016-14 is intended to improve and simplify the current net asset classification requirements and information presented in financial statements and notes that is useful in assessing a not-for-profit's liquidity, financial performance and cash flows. The Foundation will be required to retrospectively adopt the guidance in ASU 2016-14 for its year ending June 30, 2019; early adoption is permitted. The Foundation is currently assessing the effect that the adoption of ASU 2016-14 will have on its financial statements.

4. Pledges Receivable

Pledges receivable consist of the following at June 30:

	<u>2017</u>	<u>2016</u>
Pledges due within one year	\$ 3,732	\$ 5,152
Pledges due in one to five years	2,965	4,894
Pledges due in more than five years	916	913
	<hr/>	<hr/>
Total pledges receivable, gross	7,613	10,959
Less allowance for doubtful pledges	25	-
Less discount to net present value	316	208
	<hr/>	<hr/>
Total pledges receivable, net	7,272	10,751
Less current portion of pledges receivable	3,707	5,152
	<hr/>	<hr/>
Non-current portion of pledges receivable	<u>\$ 3,565</u>	<u>\$ 5,599</u>

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

June 30, 2017 and 2016

5. Investments and Assets Whose Use is Limited

Investments and assets whose use is limited consist of the following at June 30:

	<u>2017</u>	<u>2016</u>
Cash and cash equivalents	\$ 1,718	\$ 3,572
U.S. government obligations	8,024	10,256
Corporate bonds	13,643	16,924
Mutual funds:		
International	70,615	59,295
Large-Cap	66,319	58,942
Mid-Cap	9,158	7,772
Small-Cap	9,141	-
Common stock	8,190	6,558
Alternative investments:		
Long-short strategy fund	33,912	30,718
Private investment partnership funds	28,764	24,473
Distressed debt funds	5,370	5,809
Total investments and assets whose use is limited	<u>\$ 254,854</u>	<u>\$ 224,319</u>

Investments and assets whose use is limited are reported in the accompanying statement of financial position as follows:

	<u>2017</u>	<u>2016</u>
Current portion of assets whose use is limited	\$ 13,790	\$ 13,400
Current portion of investments	4,416	4,290
Assets whose use is limited, board designated	125,771	105,926
Investments, donor restricted	110,877	100,703
Total investments and assets whose use is limited	<u>\$ 254,854</u>	<u>\$ 224,319</u>

The current portions of assets whose use is limited and investments are based upon management's estimate of the amounts required to meet the Foundation's annual financial support to the Hospital in the following year.

The Foundation's investments, primarily held with PNC Bank, consist of cash and cash equivalents, mutual funds, common stock, corporate bonds, government obligations and certain alternative investments. The fair value of the Foundation's alternative investments have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners of these investments.

The Foundation's private investment partnership investment fund and distressed debt fund agreements obligate the Foundation to provide advance funding periodically up to specified levels. The Foundation had unfunded commitments of \$10,775 at June 30, 2017 and \$9,791 at June 30, 2016 to a variety of private equity, natural resources, venture capital and international funds. The Foundation expects these commitments to be funded over the next several years, depending on market conditions.

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

June 30, 2017 and 2016

The Foundation's private investment partnership funds and distressed debt funds cannot be redeemed. Instead, the nature of these investments is that distributions are received through the liquidation of the underlying assets of the funds. The Foundation does have the ability to sell these funds on secondary markets.

Total investment return, net of related investment fees, consists of the following:

	<u>2017</u>	<u>2016</u>
Interest and dividends	\$ 5,213	\$ 3,312
Less investment fees	(85)	(248)
Interest and dividends, net	5,128	3,064
Net realized and unrealized gains (losses)	31,196	(10,377)
Total investment return	<u>\$ 36,324</u>	<u>\$ (7,313)</u>

6. Fair Value Measurements

The Foundation measures its investments and assets whose use is limited, beneficial interest in charitable remainder trusts, and beneficial interest in perpetual trusts at fair value on a recurring basis in accordance with accounting principles generally accepted in the United States of America. Fair value is defined as the price that would be received to sell an asset or the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. The framework that the authoritative guidance establishes for measuring fair value includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement.

The levels of the fair value hierarchy are as follows:

Level 1 - Fair value is based on unadjusted quoted prices in active markets that are accessible to the Foundation for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.

Level 2 - Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices in markets that are not active for identical or similar assets, and other observable inputs.

Level 3 - Fair value is based on significant unobservable inputs. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows, and other similar techniques.

Children's Hospital of Pittsburgh Foundation

Notes to Financial Statements

(Amounts in Thousands)

June 30, 2017 and 2016

The following tables present the Foundation's financial instruments measured and reported at fair value at June 30, 2017 and 2016:

	2017		
	Level 1	Level 2	Level 3
Investments and assets whose use is limited:			
Cash and cash equivalents	\$ 1,718	\$ -	\$ -
U.S. government obligations	8,024	-	-
Corporate bonds	13,643	-	-
Mutual funds	155,233	-	-
Common stock	8,190	-	-
Long-short strategy fund	-	33,912	-
Private investment partnership funds	-	-	28,764
Distressed debt funds	-	-	5,370
Total	<u>186,808</u>	<u>33,912</u>	<u>34,134</u>
Beneficial interest in charitable remainder trusts	-	-	266
Beneficial interest in perpetual trusts	-	-	11,021
Total	<u>\$ 186,808</u>	<u>\$ 33,912</u>	<u>\$ 45,421</u>
	2016		
Investments and assets whose use is limited:			
Cash and cash equivalents	\$ 3,572	\$ -	\$ -
U.S. government obligations	10,256	-	-
Corporate bonds	16,924	-	-
Mutual funds	126,009	-	-
Common stock	6,558	-	-
Long-short strategy fund	-	30,718	-
Private investment partnership funds	-	-	24,473
Distressed debt funds	-	-	5,809
Total	<u>163,319</u>	<u>30,718</u>	<u>30,282</u>
Beneficial interest in charitable remainder trusts	-	-	245
Beneficial interest in perpetual trusts	-	-	10,311
Total	<u>\$ 163,319</u>	<u>\$ 30,718</u>	<u>\$ 40,838</u>

Children's Hospital of Pittsburgh Foundation

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(Amounts in Thousands)

June 30, 2017 and 2016

The changes in the assets measured at fair value on a recurring basis included in Level 3 assets are summarized as follows for the years ending June 30:

	2017				
	Private Investment Partnership Funds	Distressed Debt Funds	Beneficial Interest in Remainder Trusts	Beneficial Interest in Perpetual Trusts	Total
Balance, beginning of year	\$ 24,473	\$ 5,809	\$ 245	\$ 10,311	\$ 40,838
Net realized and unrealized gains (losses)	2,987	21	-	-	3,008
Transfers in	6,628	570	-	-	7,198
Transfers out	(5,324)	(1,030)	-	-	(6,354)
Valuation gain	-	-	21	710	731
Balance, end of year	<u>\$ 28,764</u>	<u>\$ 5,370</u>	<u>\$ 266</u>	<u>\$ 11,021</u>	<u>\$ 45,421</u>
Gain (loss) included in change in net assets attributable to assets held at end of year	<u>\$ 2,987</u>	<u>\$ 21</u>	<u>\$ 21</u>	<u>\$ 710</u>	<u>\$ 3,739</u>
	2016				
Balance, beginning of year	\$ 24,822	\$ 7,666	\$ 1,182	\$ 11,395	\$ 45,065
Net realized and unrealized gains (losses)	1,405	(680)	-	-	725
Transfers in	1,059	290	-	-	1,349
Transfers out	(2,813)	(1,467)	(927)	-	(5,207)
Valuation loss	-	-	(10)	(1,084)	(1,094)
Balance, end of year	<u>\$ 24,473</u>	<u>\$ 5,809</u>	<u>\$ 245</u>	<u>\$ 10,311</u>	<u>\$ 40,838</u>
Gain (loss) included in change in net assets attributable to assets held at end of year	<u>\$ 1,405</u>	<u>\$ (680)</u>	<u>\$ (10)</u>	<u>\$ (1,084)</u>	<u>\$ (369)</u>

The private investment partnership funds' investment objective is to seek the preservation of capital and to provide long-term rates of return in excess of the publicly traded markets. The Foundation is invested in seven separate funds invested in a variety of markets, including venture capital, domestic private equity, international private equity, and natural resources.

The distressed debt funds' investment objective is to seek the preservation of capital and to provide long-term rates of return comparable to returns generated by top performing domestic fixed income funds. The Foundation is invested in four separate funds invested in a variety of corporate equity and debt instruments.

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The following is a description of the valuation methodologies used for financial instruments reported at fair value. There have been no changes in methodologies used at June 30, 2017 and 2016.

The carrying amounts of cash and cash equivalents approximate fair value due to the short-term nature of these instruments.

Corporate bonds and U.S. government obligations are valued at fair value based on quoted market prices for identical securities in active markets that the Foundation has the ability to access at the measurement date.

Mutual funds and common stock are valued at fair value, based on quoted market prices for identical securities in active markets that the Foundation has the ability to access at the measurement date.

The Foundation's long-short strategy fund is valued based upon the fair value of the fund's underlying assets. Due to the nature of this fund, there are no unfunded commitments or redemption restrictions.

The Foundation's private investment partnership funds and distressed debt funds have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners of these investments.

The beneficial interest in charitable remainder trusts is valued at fair value based on the net present value of the future distributions of the trust assets.

The beneficial interest in perpetual trusts is valued at fair value based on the Foundation's interest in the fair value of the assets held by the trust, which represents a proxy for the discounted present value of future cash flows.

The following is a description of the valuation methodologies used for financial instruments disclosed at fair value. There have been no changes in methodologies used at June 30, 2017 and 2016.

The carrying amounts of cash and cash equivalents not included in investments and assets whose use is limited approximate fair value due to the short-term nature of these instruments.

The carrying value of pledges receivable is based on the original contributions amount, adjusted by a discount rate that a market participant would demand and an evaluation for uncollectible contributions.

The preceding methods may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while Foundation believes its valuation method is appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

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7. Restrictions on Net Assets

Temporarily restricted net assets are available for the following purposes at June 30:

	<u>2017</u>	<u>2016</u>
Research	\$ 23,089	\$ 18,981
Healthcare services and programs	<u>60,664</u>	<u>53,311</u>
Total temporarily restricted net assets	<u>\$ 83,753</u>	<u>\$ 72,292</u>

Permanently restricted net assets consist of the following at June 30:

	<u>2017</u>	<u>2016</u>
Endowment funds	\$ 49,647	\$ 49,452
Beneficial interest in perpetual trusts	11,021	10,311
Pledge receivable, proceeds to be permanently restricted	<u>400</u>	<u>400</u>
Total permanently restricted net assets	<u>\$ 61,068</u>	<u>\$ 60,163</u>

The income earned from endowment funds is primarily restricted to support research activities. The income generated from beneficial interests in perpetual trusts is available for operations unless restricted as established by each trust agreement. The restricted purposes as established by certain trusts includes benevolent care and special purpose funds.

8. Endowment Funds

The Foundation's endowments were established for a variety of purposes, and include both donor-restricted endowment funds and funds designated by the Board to function as endowments. As required by FASB authoritative guidance, net assets associated with endowment funds, including funds designated by the Board to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

Interpretation of Relevant Law

The Foundation interprets the Commonwealth of Pennsylvania Act 141 ("PA Act 141") 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. Further it is also the Foundation's interpretation that the PA Act 141 allows for the use of 5% of the fair value of the gift to the extent that the investment return was not sufficient to fund the purpose of the gift during the year. As a result of this interpretation, the Foundation classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, and (b) the original value of subsequent gifts to the permanent endowment. 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 those amounts are appropriated for expenditure by the Foundation in a manner consistent with the standard of prudence prescribed by PA Act 141.

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Endowment Fund Activity

The Foundation's endowment funds are included in the following net asset classifications at June 30:

	<u>2017</u>	<u>2016</u>
Temporarily restricted	\$ 42,394	\$ 34,218
Permanently restricted	<u>49,647</u>	<u>49,452</u>
Total endowment funds	<u>\$ 92,041</u>	<u>\$ 83,670</u>

The changes in endowment net assets is comprised of the following for the years ended June 30, 2017 and 2016:

	<u>2017</u>		
	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$ 34,218	\$ 49,452	\$ 83,670
Investment return	16,553	1	16,554
Contributions	-	187	187
Reclassifications and other changes	-	7	7
Appropriation of endowment assets for expenditures, annual transfer for operations	<u>(8,377)</u>	<u>-</u>	<u>(8,377)</u>
Endowment net assets, end of year	<u>\$ 42,394</u>	<u>\$ 49,647</u>	<u>\$ 92,041</u>
	<u>2016</u>		
	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$ 41,014	\$ 46,949	\$ 87,963
Investment return	(3,627)	(2)	(3,629)
Contributions	-	338	338
Reclassifications and other changes	-	2,104	2,104
Receipts of pledges receivable	-	63	63
Appropriation of endowment assets for expenditures, annual transfer for operations	<u>(3,169)</u>	<u>-</u>	<u>(3,169)</u>
Endowment net assets, end of year	<u>\$ 34,218</u>	<u>\$ 49,452</u>	<u>\$ 83,670</u>

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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 or PA Act 141 requires the Foundation to retain as a fund of perpetual duration. In accordance with FASB authoritative guidance, deficiencies of this nature that are reported in temporarily restricted net assets were \$1 and \$50 at June 30, 2017 and 2016, respectively.

Return Objectives and Risk Parameters

The investment philosophy of the Foundation is based on a disciplined, consistent, and diversified approach utilizing multiple asset classes and multiple managers. The Foundation's intent is to accommodate styles and strategies considered reasonable and prudent. Assets are invested with investment managers who invest in mutual funds, common and preferred stock, and corporate bonds and governmental obligations. Additionally, a portion of the funds are invested in alternative investments which include investments in private investment partnership funds, a long-short strategy fund, and distressed debt funds. The primary objective is to grow the assets to ensure the Foundation can continue to support the Hospital's operations.

Strategies Employed for Achieving Objectives

To satisfy its long-term rate of return objectives, the Foundation 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). The Foundation targets a diversified asset allocation that is set by the Foundation's Finance and Investment Committee. The investment assets are invested according to the following asset allocation guideline:

	<u>Current Targets</u>	<u>Long-Term Future Target Range</u>
Domestic large-cap equity	20.00 %	15.00 - 30.00 %
Domestic mid to small-cap equity	7.50	5.00 - 15.00
International developed equity	13.75	8.00 - 18.50
Emerging markets	13.75	8.00 - 18.50
Fixed income	10.00	8.00 - 25.00
Hedge funds	15.00	5.00 - 20.00
Private equity	20.00	10.00 - 30.00

Spending Policy and How the Investment Objectives Relate to Spending Policy

PA Act 141 states that provided an organization adopts and follows an investment policy seeking a total return for the assets held, the organization may annually select a spending percentage between 2% and 7% of the three year average fair market value of the assets held by an organization.

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The Affiliation Agreement requires that the Foundation, for a minimum of 20 years, will provide annual financial support equal to 5% of the rolling 12 quarter average of the corpus (defined as the value of all of the Foundation's assets less any funds held by the Foundation where the donor has directed a different spending provision). Such calculation includes the endowment funds. Any shortfalls of earnings may be made from excess earnings in prior years.

9. Related Party Transactions

Annual Financial Support

The Foundation entered into an agreement to provide annual financial support to the Hospital for a period of 20 years (Note 2). The Foundation provided annual financial support of \$21,031 in 2017 and \$19,228 in 2016. Amounts owed to the Hospital under this agreement were \$1,543 at June 30, 2017 and \$1,938 at June 30, 2016.

Operating Expenses

Certain expenditures, primarily operating expenses, are paid by the Hospital and subsequently reimbursed by the Foundation. Accounts payable relating to these transactions were \$623 at June 30, 2017 and \$505 at June 30, 2016.

Contributed Services

The Foundation entered into a lease agreement with the Hospital in 2010 which was amended in 2015. Under the amended agreement, the Hospital agreed to provide office space to the Foundation through August 2020.

The Hospital contributed \$157 of office space to the Foundation in 2017 and 2016. Expenses related to these contributed services are included in general, administrative, and fund-raising expense in the statement of activities and changes in net assets.

10. Functional Expenses

The Foundation incurred expenses in the following functional areas during the years ended June 30:

	<u>2017</u>	<u>2016</u>
Program (contributions to Hospital)	\$ 21,031	\$ 19,228
Fundraising	6,019	7,040
General and administrative	<u>1,122</u>	<u>1,035</u>
Total	<u>\$ 28,172</u>	<u>\$ 27,303</u>