Consolidated Financial Statements

City of Hope and Affiliates
Years Ended September 30, 2017 and 2016
With Report of Independent Auditors

Ernst & Young LLP

Building a better
working world

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Years Ended September 30, 2017 and 2016

Contents

Building a better working world

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Report of Independent Auditors

The Board of Directors
City of Hope and Affiliates

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, 2017 and 2016, 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. 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, 2017 and 2016, 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.

Ernst & Young LLP

December 19, 2017

City of Hope and Affiliates

Consolidated Statements of Financial Position
(In Thousands)

	September 30	
	2017	**2016**
Assets		
Current assets:		
Cash and cash equivalents	**$ 212,067**	$ 121,460
Investments	**1,191,963**	1,083,215
Self-insurance trust funds	**3,352**	3,581
Patient accounts receivable, less allowances for uncollectible accounts of $5,688 in 2017 and $8,747 in 2016	**245,192**	243,508
Grants and other receivables	**66,070**	66,323
Due from third-party payors	**9,817**	3,910
Donor-restricted unconditional promises to give, net	**49,399**	22,291
Prepaid and other	**36,654**	28,886
Total current assets	**1,814,514**	1,573,174
Property and equipment, net	**861,850**	722,720
Other assets:		
Investments held for long-term purposes	**313,812**	357,516
Board-designated assets	**815,638**	715,191
Donor-restricted assets:		
Investments	**442,913**	345,912
Unconditional promises to give, net	**54,036**	86,841
Contributions receivable from annuity and split-interest agreements, net	**13,623**	15,136
Other	**3,535**	1,580
Intangible assets	**6,086**	2,768
Other technology	**4,600**	–
Other long-term assets	**53,211**	44,920
Total other assets	**1,707,454**	1,569,864
Total assets	**$ 4,383,818**	$ 3,865,758

	September 30	
	2017	**2016**
Liabilities and net assets		
Current liabilities:		
Accounts payable and accrued liabilities	**$ 157,051**	$ 139,769
Accrued salaries, wages, and employee benefits	**68,783**	58,269
Long-term debt, current portion	**11,650**	90,571
Deferred revenue	**27,284**	23,117
Other	**834**	405
Total current liabilities	**265,602**	312,131
Long-term debt, net of current portion	**683,411**	618,303
Annuity and split-interest agreement obligations	**18,580**	17,264
Deferred rent	**14,028**	10,648
Interest rate swap	**10,266**	16,952
Other	**56,501**	38,111
Total liabilities	**1,048,388**	1,013,409
Net assets:		
Unrestricted	**2,788,493**	2,395,357
Temporarily restricted	**370,801**	288,549
Permanently restricted	**176,136**	168,443
Total net assets	**3,335,430**	2,852,349
Total liabilities and net assets	**$ 4,383,818**	$ 3,865,758

See accompanying notes.

City of Hope and Affiliates

Consolidated Statements of Activities
(In Thousands)

Year Ended September 30, 2017

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues:				
Contributions (including $25,173 of contributions from special events)	$ 67,258	$ 72,830	$ 7,458	$ 147,546
Special event participation revenue	5,173	–	–	5,173
Less: cost of direct benefits to donors	(8,357)	–	–	(8,357)
Contributions and net revenues from special events	64,074	72,830	7,458	144,362
Net patient service revenues	1,186,167	–	–	1,186,167
Research grants and clinical trials	135,104	–	–	135,104
Investment income	127,714	13,405	173	141,292
Net unrealized gain on investments	165,339	15,054	–	180,393
Royalty and licensing revenues	398,096	–	–	398,096
Other	23,404	119	–	23,523
Total revenues	2,099,898	101,408	7,631	2,208,937
Net assets released from restrictions	44,566	(44,566)	–	–
Total revenues and other increases	2,144,464	56,842	7,631	2,208,937
Expenses:				
Program services:				
Patient care	916,607	–	–	916,607
Research	448,796	–	–	448,796
Public information and education	17,429	–	–	17,429
Total program services	1,382,832	–	–	1,382,832
Supporting services:				
Administrative and general	359,423	–	–	359,423
Fundraising	30,020	–	–	30,020
Total supporting services	389,443	–	–	389,443
Total expenses	1,772,275	–	–	1,772,275
Excess of revenues and other increases over expenses	372,189	56,842	7,631	436,662
Inherent contribution from Affiliation	20,947	25,410	62	46,419
Changes in net assets	393,136	82,252	7,693	483,081
Net assets, beginning of year	2,395,357	288,549	168,443	2,852,349
Net assets, end of year	$ 2,788,493	$ 370,801	$ 176,136	$ 3,335,430

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 and clinical trials	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 and licensing 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
Excess of revenues and other increases over expenses	340,392	57,125	5,640	403,157
Change in donor designation of net assets	–	7,000	(7,000)	–
Changes in net assets	340,392	64,125	(1,360)	403,157
Net assets, beginning of year	2,054,965	224,424	169,803	2,449,192
Net assets, end of year	$ 2,395,357	$ 288,549	$ 168,443	$ 2,852,349

See accompanying notes.

City of Hope and Affiliates

Consolidated Statements of Cash Flows
(In Thousands)

	Year Ended September 30	
	2017	**2016**
Operating activities		
Changes in net assets	**$ 483,081**	$ 403,157
Adjustments to reconcile changes in net assets to net cash provided by operating activities:		
Depreciation and amortization	**118,861**	95,094
Amortization of bond issue costs	**305**	319
Net (gain) loss on sale of contributed real property held for sale	**(43)**	66
Inherent contribution from Affiliation	**(46,419)**	–
Loss on disposal of fixed assets	**1,161**	2,209
Loss on impairment of intangible assets	**3,910**	–
Provision for bad debt	**7,769**	3,110
Net unrealized gain on investments	**(180,393)**	(109,650)
Gain on equity method investments	**(49,600)**	(26,425)
Change in value of interest rate swap	**(6,686)**	5,917
Contribution proceeds restricted for endowment	**(5,261)**	(4,846)
Changes in assets and liabilities:		
Patient accounts receivable, net	**(8,589)**	(40,467)
Grants and other receivables	**5,740**	(17,239)
Unconditional promises to give, net	**15,054**	(20,394)
Contributions receivable from split-interest agreements	**1,513**	(7,109)
Contributed real property held for sale	**457**	(2,223)
Other assets	**(20,103)**	(6,098)
Accounts payable and accrued liabilities	**(24,461)**	18,459
Accrued salaries, wages, and employee benefits	**9,370**	4,596
Annuity and split-interest agreement obligations	**1,316**	418
Other liabilities	**(2,562)**	(2,546)
Net cash provided by operating activities before net sales (purchases) of trading investments	**304,420**	296,348
Net sales (purchases) of trading investments	**33,774**	(97,602)
Net cash provided by operating activities	**338,194**	198,746
Investing activities		
Increase in notes receivable	**(3,061)**	(2,652)
Additions to property and equipment	**(201,385)**	(85,812)
Cash from Affiliation	**10,598**	–
Proceeds from sale of contributed real property held for sale	**73**	978
Net purchases of alternative investments	**(50,969)**	(119,702)
Net cash used in investing activities	**(244,744)**	(207,188)
Financing activities		
Repayment of long-term debt	**(65,000)**	–
Proceeds from long-term debt borrowing, net	**67,855**	–
Principal payments on long-term debt	**(10,959)**	(8,237)
Contribution proceeds restricted for endowment	**5,261**	4,846
Net cash used in financing activities	**(2,843)**	(3,391)
Net increase (decrease) in cash and cash equivalents	**90,607**	(11,833)
Cash and cash equivalents, beginning of year	**121,460**	133,293
Cash and cash equivalents, end of year	**$ 212,067**	$ 121,460
Supplemental disclosure of cash flow information:		
Interest paid during the year (net of capitalized interest)	**$ 33,881**	$ 33,866
Supplemental disclosure of non-cash activity:		
Assets constructed by landlord	**$ 23,127**	–
Capital lease obligation	**$ –**	$ 17,944
Additions to property and equipment included in accounts payable and accrued liabilities	**$ 39,433**	$ 42,093

See accompanying notes.

1. Organization

City of Hope, a California nonprofit public benefit corporation, with its principal office located in Duarte, California, is the development organization of City of Hope National Medical Center (the Center), City of Hope Medical Foundation (the Foundation), Beckman Research Institute of the City of Hope (the Institute) (collectively, the Obligated Group), The Translational Genomics Research Institute (TGen) and the City of Hope Auxiliaries (the Auxiliaries) (collectively, with the Obligated Group, the Affiliates). 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 Affiliates.

The Auxiliaries, located throughout the United States, are nonprofit public benefit unincorporated associations that coordinate fundraising activities to support the mission of the Affiliates.

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.

TGen, located in Phoenix, Arizona, is an Arizona nonprofit public benefit corporation that translates genomic discoveries into advances in human health. TGen employs innovative advances arising from the Human Genome Project and applies them to the development of diagnostics. City of Hope became the sole corporate member of TGen effective upon an affiliation on November 17, 2016 (the Affiliation) (see Note 7).

1. Organization (continued)

The accounts of TGen include the assets, liabilities, and results of operations of TGen Foundation and certain other controlled entities that were created to support TGen through its various functions.

Principles of Consolidation

The accompanying consolidated financial statements of City of Hope and Affiliates includes the accounts of the Affiliates. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

Investments in companies for which City of Hope and Affiliates does not exercise control and where there is significant influence over the operations of the company are accounted for under the equity method of accounting.

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, 2017, was approximately 53%. Two of the six agreements will expire within one year of September 30, 2017, 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 City of Hope and Affiliates' 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, valuation of unconditional promises to give, cost report settlements and amounts due to/from third-party payors, valuation of annuity and split-interest agreement obligations, fair value of interest rate swap agreements, fair value of business combinations, impairment of goodwill, and self-insured liabilities. Actual results could differ from those estimates and the amounts could be material to the consolidated financial statements.

2. Summary of Significant Accounting Policies (continued)

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 and exclude amounts whose use is limited under contractual and donor agreements.

Cash is held in depository accounts at various financial institutions. The combined account balance at any given institution may exceed the Federal Deposit Insurance Corporation (FDIC) insurance coverage of $250,000 and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage. Management believes, based on the quality of the financial institutions, that the risk is not significant.

Contributions

All contributions are considered available for the program services of 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.

Restricted monetary gifts that are specifically earmarked are held 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.

2. Summary of Significant Accounting Policies (continued)

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, 2017 and 2016, valid will and trust agreement amounts that became measurable totaled $29,504,000 and $26,534,000, respectively, and are included in contributions in the accompanying consolidated statements of activities.

City of Hope and Affiliates report 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 at the end of the fiscal year the unconditional promise is made. The rates used in 2017 and 2016 were 1.72% and 1.25%, respectively.

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

	2017	**2016**
Unconditional promises to give	**$ 116,109**	$ 121,056
Less:		
Discounts	**(3,423)**	(3,858)
Allowance for uncollectible promises to give	**(9,251)**	(8,066)
Total unconditional promises to give, net	**103,435**	109,132
Less current portion	**(49,399)**	(22,291)
	$ 54,036	$ 86,841

The allowance for uncollectible promises to give has been determined based on historical collection experience. Amortization of pledge discounts is included in contribution revenue.

2. Summary of Significant Accounting Policies (continued)

At September 30, 2017, future cash flows anticipated from unconditional promises to give are as follows (amounts in thousands):

2018	$ 51,880
2019	23,402
2020	8,434
2021	5,871
2022	4,804
Thereafter	21,718
	116,109
Discounts	(3,423)
Allowance for uncollectible promises to give	(9,251)
	$ 103,435

City of Hope and Affiliates report conditional promises to give as contribution revenue when the conditions stipulated by the donor are met, at which time the conditional promise becomes unconditional. During the year ended September 30, 2017, City of Hope received a conditional promise in the amount of $35,000,000. There are specific project goals and milestones that must be met in order to receive the payments under the agreement. As of September 30, 2017, $17,500,000 has been recorded in contribution revenue in recognition of attaining project goals and milestones. The remaining $17,500,000 of this conditional promise has not been recognized in contribution revenue due to remaining project goals and milestones still subject to completion by City of Hope.

Prior to fiscal year end September 30, 2017, TGen received conditional promises to give from two funding agencies in the aggregate amount of $19,000,000. During the year ended September 30, 2017, TGen recognized $4,745,000 in contribution revenue based upon attaining recognition criteria. As of September 30, 2017, $3,751,000 of these conditional promises to give have not been recognized in contribution revenue.

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.

2. Summary of Significant Accounting Policies (continued)

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, 2017, City of Hope has state-mandated reserves above the actuarial annuity reserves in the amount of $312,000. Additionally, City of Hope has voluntary reserves in the amount of $4,218,000 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.

Under charitable remainder annuity trust and charitable remainder unitrust arrangements in which City of Hope is not the trustee, City of Hope recognizes, in the period the agreement is executed, 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. Receivables totaling $13,623,000 as of September 30, 2017 are to be collected over the next 30.4 years and have an average remaining life of 14.6 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.

2. Summary of Significant Accounting Policies (continued)

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 net realizable value 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 $19,744,000 and $16,943,000 at September 30, 2017 and 2016, respectively.

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.

City of Hope and Affiliates provide 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
Software	3 to 5 years

2. Summary of Significant Accounting Policies (continued)

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):

	2017	2016
Land	**$ 15,998**	$ 15,998
Buildings and improvements	**765,495**	626,158
Equipment and furniture	**442,324**	457,046
Software	**217,957**	190,929
Leased capital assets	**40,036**	59,600
Construction in progress	**181,025**	106,137
Total property and equipment	**1,662,835**	1,455,868
Accumulated depreciation and amortization	**(800,985)**	(733,148)
Property and equipment, net	**$ 861,850**	$ 722,720

Included in construction in progress is capital costs associated with an Electronic Medical Record (EMR) totaling $96,065,000 and $21,445,000 as of September 30, 2017 and 2016, respectively. The EMR will be placed into service in December 2017 with a useful life of five years.

Total accumulated amortization for leased capital assets totaled $14,771,000 and $10,223,000 as of September 30, 2017 and 2016, respectively.

City of Hope and Affiliates review long-lived assets for impairment when events or changes in business conditions indicate that their carrying value may not be recoverable. Impairment is considered when the associated expected undiscounted cash flows are less than the carrying value and the assets will be written down to fair value at that time. Fair value is the present value of the associated cash flows. As of September 30, 2017, no long-lived assets are considered impaired.

2. Summary of Significant Accounting Policies (continued)

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 $36,033,000 and $67,916,000 as of September 30, 2017 and 2016, respectively. Total amortization expense related to capitalized software development costs was $46,260,000 and $32,539,000 for the years ended September 30, 2017 and 2016, respectively. Software development costs included in construction in progress totaled $100,771,000 and $30,313,000 at September 30, 2017 and 2016, respectively.

Capitalized Interest

Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Interest cost incurred totaled $32,581,000 and $32,363,000 in 2017 and 2016, respectively. Interest cost capitalized totaled $4,950,000 and $0 in 2017 and 2016, respectively.

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 other 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):

	2017	2016
Fundraising events and other efforts	**$ 4,672**	$ 3,919
Royalty revenue	**3,066**	5,400
Unexpended grants/agreements	**20,580**	16,715
Total deferred revenue	**28,318**	26,034
Amount included in other long-term liabilities	**(1,034)**	(2,917)
	$ 27,284	$ 23,117

Income Taxes

City of Hope and Affiliates are exempt from federal income tax under Section 501(c)(3) of the U.S. Internal Revenue Code. City of Hope, the Center, Foundation and Institute are exempt from California state franchise and income tax under Section 23701d of the California Revenue and Taxation Code. TGen is exempt from Arizona corporate income tax under Section 43-1201(A) of the Arizona Revised Statutes (A.R.S.).

The 100% wholly-owned entities of TGen are single-member, limited liability companies and are considered disregarded entities for tax purposes.

2. Summary of Significant Accounting Policies (continued)

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. ASC 740 also provides guidance on de-recognition, measurement, classification, interest and penalties, disclosure, and transition. The guidance contained in ASC 740 is applicable to pass-through entities and tax-exempt organizations. City of Hope and Affiliates has no significant uncertain tax positions or tax liability for tax benefits, interest, or penalties accrued at September 30, 2017 and 2016.

Workers' Compensation Program

City of Hope, the Center, the Foundation and the Institute have elected to self-insure their 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. As of September 30, 2017 and 2016, an estimated liability of $20,726,000 and $19,908,000, respectively, has been recorded. The estimated current portion of the liability, totaling $3,523,000 and $3,635,000 as of September 30, 2017 and 2016, respectively, 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 1.75% and 1% discount factor as of September 30, 2017 and 2016, 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. As of September 30, 2017 and 2016, insurance recoveries related to workers' compensation totaling $4,650,000 and $5,148,000, respectively, has been reflected in the accompanying consolidated statements of financial position in other assets.

Workers' compensation expense charged to operations totaled $5,893,000 and $5,754,000 in 2017 and 2016, respectively.

2. Summary of Significant Accounting Policies (continued)

Professional Liability Insurance

The Affiliates maintain 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, 2017. 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 1.75% and 1% discount factor as of September 30, 2017 and 2016, respectively. The Affiliates have recorded an estimated liability of $2,125,000 and $2,173,000 as of September 30, 2017 and 2016, 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 Affiliates' operations amounted to $1,845,000 and $2,274,000 in 2017 and 2016, respectively.

The Affiliates recorded insurance recoveries related to professional liability totaling $748,000 and $799,000, which have been reflected in the accompanying consolidated statements of financial position in other assets as of September 30, 2017 and 2016, respectively.

Retirement Plans

City of Hope, the Center, Foundation, and the Institute participate 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 $270,000 in 2017. 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 $270,000 in 2017. The participants have the ability to direct these contributions into various funds offered through the RSO TDA Plan.

2. Summary of Significant Accounting Policies (continued)

TGen has a defined contribution Profit Sharing Plan (PSP Plan) that covers all employees who are 21 years of age and who have completed one month of service. Under the terms of the PSP Plan, employees may make voluntary contributions, subject to Internal Revenue Service limitations. TGen matches employee contributions up to 4% of the employee's annual compensation, subject to certain eligibility criteria as stated in the plan document.

Contribution expense for the plans defined above totaled $21,765,000 and $18,605,000 in 2017 and 2016, respectively.

Additionally, City of Hope, the Center, the Foundation, and the Institute offer 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.

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, the Center, the Foundation, and the Institutes contribution 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 $1,099,000 and $1,314,000 in 2017 and 2016, respectively.

2. Summary of Significant Accounting Policies (continued)

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 and other factors, including changes to contract terms.

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 Medi-Cal 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):

	2017	**2016**
Medicare	**$ 260,353**	$ 245,906
Medi-Cal	**78,656**	147,596
Managed care (including Medicare and Medi-Cal managed care)	**827,832**	709,900
Indemnity, self-pay, and other	**19,326**	16,406
Net patient service revenues	**$ 1,186,167**	$ 1,119,808

The Center and the Foundation are reimbursed for services provided to patients under certain programs administered by governmental agencies. Laws and regulations governing the Medicare and Medi-cal 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 Medi-Cal programs. The Center and the Foundation believe that they are in compliance with all applicable laws and regulations, and they are not aware of any pending or threatened investigations involving allegations of potential wrongdoing.

2. Summary of Significant Accounting Policies (continued)

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 2015. The Center has open appeals for previously audited cost reports for years 2007 and 2008 and, if successful, will record the appeals as net patient service revenues in the period realized. The cost report for 2016 has been filed and a tentative settlement has been received, but has not yet been audited.

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 2017 and 2016, 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 $2,114,000 and $5,503,000 for the years ended September 30, 2017 and 2016, respectively.

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:

	2017	**2016**
Medicare	**25%**	23%
Medi-Cal	**8**	16
Managed care, other third-party payors, and patients	**67**	61
	100%	100%

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, 2017 and 2016, these components of charity care costs totaled $6,541,000 and $3,223,000, respectively.

See Note 10 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

City of Hope and Affiliates are required to recognize all derivatives at fair value in the statements of financial position. At September 30, 2017, derivative instruments consisted of two interest rate swap agreements with a total notional amount of $65,000,000 (see Note 5). Interest swap agreements are entered into to manage interest rate risk. The derivatives are not designated as effective hedges and are adjusted to fair value in the consolidated statements of activities, above the performance indicator.

2. Summary of Significant Accounting Policies (continued)

Royalty and Licensing Revenue

City of Hope and Affiliates receive 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. Royalty revenue is recognized when received. Information from Genentech or its licensees regarding the amount of royalty revenue is not available until the amounts are actually received, usually one quarter in arrears. During 2017 and 2016, City of Hope and Affiliates received and recognized royalty and licensing revenue totaling $398,096,000 and $333,704,000, 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 9).

City of Hope and Affiliates have entered into various licensing agreements, whereby City of Hope and Affiliates received equity interests in the licensee as compensation. The stock and membership units related to these agreements are recorded at fair value.

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 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 statement of financial position 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.

2. Summary of Significant Accounting Policies (continued)

The 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 an 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. City of Hope and Affiliates also invest in private equity and private real asset funds that may be structured as drawdown funds, to which City of Hope and Affiliates have 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, 2017 and 2016, based upon most recent available information, the outstanding unfunded private equity and private real asset commitments total $313,544,000 and $278,553,000, respectively.

City of Hope and Affiliates' 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 and Affiliates' 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. 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 90 days.

2. Summary of Significant Accounting Policies (continued)

City of Hope and Affiliates' 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 and Affiliates 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 and Affiliates' classification of real assets consists of 22 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, five energy funds, two 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 and Affiliates 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.

City of Hope and Affiliates account 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. Ownership interest in these funds ranges from 0.01% to 40.13% as of September 30, 2017.

Recent Accounting Pronouncements

In January 2017, the FASB issued ASU 2017-01, *Business Combinations: (Topic 805) Clarifying the Definition of a Business*, which seeks to clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for a acquisitions (or disposals) of assets or businesses. The definition of a business affects many areas of accounting, including acquisitions, disposals, goodwill, and consolidation. ASU 2017-01 is effective for annual periods beginning after December 15, 2017. City of Hope and Affiliates are evaluating the effect of this standard on the consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, which requires restricted cash and cash equivalents to be included with cash and cash equivalents on the statement of cash flows. ASU 2016-18 is effective for annual periods beginning after December 15, 2017. City of Hope and Affiliates are evaluating the effect of this standard on the consolidated financial statements.

2. Summary of Significant Accounting Policies (continued)

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. City of Hope and Affiliates are 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 City of Hope and Affiliates are 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. City of Hope and Affiliates are evaluating the effect of this standard on the consolidated financial statements.

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 annual periods beginning after December 15, 2017. City of Hope and Affiliates are currently evaluating the effect of this standard on the consolidated financial statements.

2. Summary of Significant Accounting Policies (continued)

Reclassifications

Certain reclassifications were made to the 2016 accompanying consolidated financial statements to conform to the 2017 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 consolidated 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.

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 2017 and 2016, the Center recognized $18,829,000 and $73,542,000 in Supplemental Payments relating to the 36-Month program period from October 1, 2016 through December 31, 2016 and October 1, 2015 through September 30, 2016, 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, 2017 and 2016, $20,905,000 and $34,183,000, respectively, is recorded in grants and other

3. California Hospital Fee Program (continued)

receivables in the consolidated statements of financial position. The Center also recognized $7,450,000 and $13,984,000 in QA Fees and $154,000 and $562,000 in CHFT Payments as program expenses in the accompanying consolidated statements of activities for the years ended September 30, 2017 and 2016, respectively. Of these amounts, $404,000 and $301,000 are recorded in accounts payable and accrued liabilities in the accompanying consolidated statements of financial position as of September 30, 2017 and 2016, respectively.

During 2017 and 2016, CMS approved certain portions of the managed care 36-Month program for the periods from July 1, 2014 through June 30, 2015 and January 1, 2014 through June 30, 2014, respectively. The Center recognized $2,492,000 and $278,000 in additional net patient service revenues for the years ended September 30, 2017 and 2016, respectively.

In August 2017, the Center made a payment of $3,740,000 for QA Fees associated with the managed care portion of the 36-Month program for the period from July 1, 2015 through June 30, 2016. This period of the 36-Month program has not yet been approved by CMS; as such, this amount has been included in prepaid and other in the accompanying consolidated statement of financial position as of September 30, 2017.

During 2016, 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.

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, prepaid and other, accounts payable and accrued liabilities, estimated amounts due to/from third-party payors, interest rate swaps, and long-term debt. City of Hope and Affiliates consider 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 Affiliates was $638,978,000 and $639,549,000, with a total fair value of $753,652,000 and $783,823,000 as of September 30, 2017 and 2016, respectively. Long-term debt would be classified as Level 2 in the fair value hierarchy.

4. Fair Value of Financial Instruments (continued)

As defined by 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.

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).

4. Fair Value of Financial Instruments (continued)

In determining fair value, City of Hope and Affiliates utilize 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 and Affiliates use 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.

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 and Affiliates 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 and Affiliates have 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, 2017 and 2016, City of Hope and Affiliates have assessed the significance of the impact of the credit valuation adjustments on the overall valuation of their derivative positions and have determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives. As a result, City of Hope and Affiliates have determined that their derivative valuations in their entirety are classified as Level 2 in the fair value hierarchy.

4. Fair Value of Financial Instruments (continued)

City of Hope and Affiliates' 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, other long-term assets, 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):

2017	Investments at Fair Value Level 1	Level 2	Level 3	Fair Value	Investments at Net Asset Value	Total	Valuation Technique (a,b,c)
Investments:							
U.S. government and agency obligations	$ –	$ 51,835	$ –	$ 51,835	$ –	$ 51,835	a,b
Corporate obligations	–	91,359	–	91,359	–	91,359	a,b
Marketable securities	741,043	–	–	741,043	–	741,043	a
Public real assets	234,073	–	–	234,073	–	234,073	a
Municipal obligations	–	1,967	–	1,967	–	1,967	a
Preferred stock	–	–	62	62	–	62	c
Hedge funds	–	–	–	–	443,784	443,784	
Equity commingled funds	–	–	–	–	803,023	803,023	
Private equity funds	–	–	–	–	150,510	150,510	
Private real assets	–	–	–	–	175,582	175,582	
Cash equivalents	161,018	–	–	161,018	–	161,018	a
Total investments	$ 1,136,134	$ 145,161	$ 62	$ 1,281,357	$ 1,572,899	$ 2,854,256	
Other long-term assets:							
Marketable securities	$ 21,428	$ –	$ –	$ 21,428	$ –	$ 21,428	a
Cash equivalents	$ 433	$ –	$ –	$ 433	$ –	$ 433	a
Total investments and other long-term assets	$ 1,157,995	$ 145,161	$ 62	$ 1,303,218	$ 1,572,899	$ 2,876,117	

	Level 1	Level 2	Level 3	Total	Valuation Technique (a,b,c)
Liabilities at fair value:					
Annuity and split-interest obligations	$ –	$ –	$ 18,580	$ 18,580	c
Interest rate swaps	–	10,266	–	10,266	a,b
Total liabilities	$ –	$ 10,266	$ 18,580	$ 28,846	

4. Fair Value of Financial Instruments (continued)

2016	**Investments at Fair Value**			**Investments at Net Asset Value**	**Total**	**Valuation Technique (a,b,c)**
	Level 1	**Level 2**	**Fair 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	$ 989,855	$ 205,553	$1,195,408	$1,338,305	$2,533,713	
Other long-term assets:						
Marketable securities	$ 17,009	$ –	$ 17,009	$ –	$ 17,009	a
Total investments and other long-term assets	$1,006,864	$ 205,553	$1,212,417	$1,338,305	$2,550,722	

	Level 1	**Level 2**	**Level 3**	**Total**	
Liabilities at fair value:					
Annuity and split-interest obligations	$ –	$ –	$ 17,264	$ 17,264	c
Interest rate swaps	–	16,952	–	16,952	a,b
Total liabilities	$ –	$ 16,952	$ 17,264	$ 34,216	

Included in other long-term assets are associated marketable securities related to City of Hope and Affiliates 457(b) Plan that is funded by plan participants.

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, 2017 (amounts in thousands):

	Assets	**Liabilities**
Beginning balance at September 30, 2016	$ –	$ 17,264
Additions	62	867
Investment activity, adjustments, maturities	–	196
Distributions	–	(1,020)
Change in fair value	–	1,273
Ending balance at September 30, 2017	$ 62	$ 18,580

4. Fair Value of Financial Instruments (continued)

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

	2017	2016
Cash and cash equivalents	**$ 212,067**	$ 121,460
Investments, current	**1,191,963**	1,083,215
Self-insurance trust funds	**3,352**	3,581
Investments held for long-term purposes	**313,812**	357,516
Board-designated assets	**815,638**	715,191
Donor-restricted investments	**442,913**	345,912
	2,979,745	2,626,875
Less: investment at net asset value	**(1,572,899)**	(1,338,305)
Less: amounts held in operating cash	**(125,489)**	(93,162)
Plus: amounts in other long-term assets	**21,861**	17,009
Investments at fair value	**$ 1,303,218**	$ 1,212,417

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, 2017 and 2016, these changes in fair value of equity interests totaled a gain of $49,600,000 and $26,425,000, respectively.

5. Long-Term Debt

The following is a summary of City of Hope and Affiliates' long-term debt as of September 30 (amounts in thousands):

	2017	2016
City of Hope, 3.75% to 5.00% fixed rate Tax-Exempt Revenue Bonds Series 2012A, originally $234,635, issued through the California Health Facilities Financing Authority, with varying maturities annually on November 15, 2014 through November 15, 2039. Interest payable semiannually on May 15 and November 15 (Series 2012A Revenue Bonds).	**$ 219,115**	$ 224,549
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
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
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
City of Hope, Tax-Exempt Variable Rate Revenue Notes Series 2017A, originally $32,680, issued through the California Health Facilities Financing Authority. Interest payable monthly, principal payments annually beginning on November 15, 2039 through November 15, 2042 (Series 2017 Notes).	**32,680**	–
City of Hope, Tax-Exempt Variable Rate Revenue Notes Series 2017B, originally $32,680, issued through the California Health Facilities Financing Authority. Interest payable monthly, principal payments annually beginning on November 15, 2039 through November 15, 2042 (Series 2017 Notes).	**32,680**	–
TGen, 3.27% to 4.22% fixed rates. Principal and interest payable monthly through April 2020 (TGen Notes).	**2,903**	–
TGen, 2% fixed rate. Principal and interest payable annually through 2022 (TGen Notes).	**1,600**	–
Assets constructed by landlord	**8,194**	–
Capital lease obligations:		
Equipment	**2,657**	3,744
Facilities	**29,430**	48,420
	679,259	691,713
Less: current maturities of long-term debt and capital lease obligations	**(11,650)**	(90,571)
Less: unamortized bond issue costs	**(2,004)**	(2,017)
Less: unamortized discount	**(3,545)**	(3,865)
Plus: unamortized premium	**21,351**	23,043
	$ 683,411	$ 618,303

5. Long-Term Debt (continued)

Long-term debt maturities and capital lease obligations as of September 30, 2017, and payments for the subsequent years are as follows (amounts in thousands):

2018	$	11,650
2019		10,808
2020		10,587
2021		10,581
2022		11,027
Thereafter		624,606
	$	679,259

Series 2012 Revenue Bonds (Tax-Exempt) – In November 2012, pursuant to a Master Trust Indenture (MTI), the Obligated Group 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 Series 2012A Revenue Bonds were issued at a premium totaling $29,887,000. 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.

Interest on the Series 2012B and the Series 2012C Revenue Bonds accrued 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 Series 2012B and Series 2012C Revenue Bonds were classified as current liabilities in the accompanying consolidated statements of financial position as of September 30, 2016. During 2017, the Obligated Group refunded its Series 2012B and 2012C revenue bonds. See **Series 2017 Notes (Tax-Exempt)** below.

5. Long-Term Debt (continued)

Series 2013 Notes (Taxable) – In July 2013, City of Hope, as representative of the Obligated Group, issued $350,000,000 of Series 2013 fixed rate Direct Obligation Notes (the Series 2013 Notes) under the MTI. The proceeds from the Series 2013 Notes are used for the Obligated Group's capital needs in furtherance of the implementation of the Obligated Group's strategic plan. The Series 2013 Notes are secured by a gross receivables pledge and accrue interest at a fixed rate of 5.623% annually.

Series 2017 Notes (Tax-Exempt) – In February 2017, City of Hope as representative of the Obligated Group, refunded all of the Series 2012B in the amount of $32,500,000 and Series 2012C in the amount of $32,500,000 California Health Facilities Financing Authority Variable Rate Revenue Bonds with two new issues through the California Health Facilities Financing Authority, Variable Rate Revenue Notes Series 2017A in the amount of $32,680,000 and Series 2017B in the amount of $32,680,000. The Series 2017 Notes were directly purchased by a commercial bank and have the same maturity and approximate principal amortization as the refunded Series 2012B and Series 2012C Revenue Bonds and bear interest based on 70% of one-month of the London Interbank Offered Rate (LIBOR) plus a spread.

TGen Notes – TGen Notes are comprised of notes payable with a bank for laboratory equipment and a promissory note for the purchase of the outstanding 50% interest in a subsidiary company. The TGen Notes for laboratory equipment are secured by the equipment financed and accrue interest at fixed rates between 3.27% and 4.22% annually. The other TGen notes accrue interest at 2% 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 and Affiliates' 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 and recorded the obligation in the amount of $15,500,000 as long-term debt, current portion in the accompanying consolidated statement of financial position as of September 30, 2016. In May 2017, City of Hope purchased the building under the option for the same amount.

5. Long-Term Debt (continued)

Assets Constructed by Landlord – 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 both of these lease agreements discussed below, 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 buildings 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.

Upon completion of construction, projects 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.

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 lease agreement is subject to build to suit accounting under ASC 840, *Leases*. As of September 30, 2017, the Foundation has recorded build to suit construction in progress of $23,127,000 which has been reflected in property and equipment in the accompanying consolidated statements of financial position. The long-term financing obligation under the build to suit accounting of $23,127,000 has been recorded at the estimated net present value of the minimum lease payments of $8,194,000 in long-term debt and the remaining $14,933,000 has been reflected in other long-term liabilities as of September 30, 2017. The Foundation expects to begin operating a multi-disciplinary community cancer center at this location in 2018.

In December 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. The lease agreement is subject to build to suit accounting under ASC 840, *Leases*. The Foundation expects to begin operating a multi-disciplinary community cancer center at this location in 2019. As of September 30, 2017, the estimated build to suit construction in progress is not material, as the project is still in an early stage. As such, the Foundation has not recorded construction in progress or a related long-term financing obligation as of September 30, 2017.

5. Long-Term Debt (continued)

The estimated total aggregate lease payments that the Foundation is obligated to make under both of these lease agreements is $23,700,000.

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 are recorded within program and supporting services expenses in the accompanying consolidated statements of activities totaling an expense reduction of $6,686,000 for the year ended September 30, 2017, and an expense increase of $5,917,000 for the year ended September 30, 2016. The effect of counterparty payments and receipts on interest expense was an expense increase of $1,356,000 and $1,586,000 for the years ended September 30, 2017 and 2016, respectively.

Financial Covenants – Under the Series 2012 Revenue Bonds, the Series 2013 Notes, and the Series 2017 Notes, the Obligated Group must maintain certain financial covenants. The Obligated Group was in compliance with the respective covenants at September 30, 2017.

Line of Credit – City of Hope maintains a consolidated unsecured revolving bank line of credit in the amount of $50,000,000, which expires on June 30, 2018. Interest is charged at LIBOR plus 0.75%. As of September 30, 2017 and 2016, there was no outstanding balance on the line of credit.

TGen maintains an unsecured revolving line of credit in the amount of $6,000,000, which expires on November 20, 2018. There were no outstanding balances on the line of credit as of September 30, 2017.

6. City of Hope Medical Foundation

City of Hope has established a nonprofit medical foundation to in order to create 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

6. City of Hope Medical Foundation (continued)

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.

7. Acquisitions and Affiliations

City of Hope accounts for acquisitions and affiliations in accordance with ASC 958-805, *Not-for-Profit Entities Business Combinations,* in determining the appropriate accounting treatment for acquisitions and affiliations. Under ASC 958-805, business combinations are classified as either a merger or an acquisition, which results in differing accounting treatment.

Effective November 17, 2016, City of Hope and TGen entered into an Affiliation Agreement (Agreement), pursuant to which City of Hope became the sole corporate member of TGen. Based on ASC 958-805, the Affiliation is classified as an acquisition rather than a merger. The accounting for acquisitions requires extensive use of estimates and judgments to measure the fair value of the identifiable tangible and intangible assets acquired. Fair value is estimated at the acquisition date and is measured using an income and market approach with significant unobservable inputs. City of Hope engaged an independent third-party valuation firm to assist in determining the fair value of identifiable intangible assets. City of Hope believes that the fair values assigned to the assets acquired and liabilities assumed are based on reasonable assumptions. However, actual values may differ and unanticipated events and circumstances may occur.

7. Acquisitions and Affiliations (continued)

The Affiliation did not involve consideration and resulted in an excess of assets acquired over liabilities assumed which has been recorded as a contribution to City of Hope of $46,419,000. City of Hope recognized the following tangible and intangible assets acquired and liabilities assumed in connection with the Affiliation based upon their estimated fair values at the transaction date (amounts in thousands):

Cash and cash equivalents	$	10,598
Accounts receivable		5,037
Prepaid and other assets		4,312
Property and equipment		8,251
Leasehold interests		590
Tradename		4,000
Intellectual property research and development (IPR&D)		4,600
Donor-restricted assets		25,472
Other long-term assets		2,701
Current liabilities		(12,586)
Long-term debt		(2,261)
Other non-current liabilities		(4,295)
Total identifiable net assets assumed	$	46,419

8. Intangible Assets and Other Technology

Intangible assets is comprised of tradenames, electronic medical records, and favorable leasehold interests totaling $14,053,000 and is subject to amortization.

The accumulated amortization on those intangible assets at September 30, 2017 and 2016 totaled $7,967,000 and $6,695,000, respectively. City of Hope and Affiliates have recorded $1,272,000 and $1,251,000 of amortization expense for acquired intangible assets during the years ended September 30, 2017 and 2016, respectively. Intangible assets are amortized on a straight-line basis between seven and ten years. Future amortization of these intangibles subject to amortization is reflected below (amounts in thousands):

8. Intangible Assets and Other Technology (continued)

2018	$	935
2019		353
2020		353
2021		177
2022		25
Thereafter		243
	$	2,086

Other technology is comprised of IPR&D resulting from the Affiliation with TGen. Under ASU Topic 350, *Intangibles – Goodwill and Other*, IPR&D is subject to annual impairment assessment, or more frequently if significant indicators or impairment exist. City of Hope and Affiliates have elected an annual measurement date of July 1. The qualitative review of IPR&D for impairment indicated no impairment in value as of September 30, 2017.

9. Commitments and Contingencies

Leases

City of Hope and Affiliates have non-cancelable operating leases for office space and equipment that expire on various dates through 2040. As of September 30, 2017, future minimum payments required under these operating leases, net of sub-lease income through 2020, are as follows (amounts in thousands):

2018	$	11,624
2019		10,652
2020		10,402
2021		10,169
2022		8,085
Thereafter		69,531
	$	120,463

Lease expense for the leases shown above and other month-to-month rental agreements totaled $14,167,000 and $9,821,000 in 2017 and 2016, respectively.

Subsequent to September 30, 2017, TGen entered into a long-term capital lease to purchase a building that will reduce the operating lease commitments in the above table by $54,547,000 through 2039 (see Note 14).

9. Commitments and Contingencies (continued)

Litigation and Administrative Actions

From time to time, City of Hope and Affiliates 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 will not have a material adverse effect on the consolidated financial position, statements of activities, or cash flows of City of Hope and Affiliates.

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.

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

On July 7, 2016, Merck Sharp & Dohme Corp. (Merck) filed a lawsuit against City of Hope and Genentech in the United States District Court (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 Patent Trademark Office (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.

On January 3, 2017, the PTO denied institution of review under Merck’s first IPR petition, granted institution of review under Merck’s second petition and granted Merck’s motion for joinder with the Mylan IPR.

9. Commitments and Contingencies (continued)

In March 2017, a settlement was reached with Mylan, ending its challenge to the Cabilly II patent in the PTO. The IPR initiated by Mylan, in which Merck was joined, continued with Merck as sole petitioner. In May 2017, a settlement was reached with Merck ending Mercks' challenges to the Cabilly II patent in the PTO and to the Cabilly III patent in the USDC. City of Hope made no payment in connection with any of the settlements.

In May 2017, a settlement was reached with Merck ending its challenges to the Cabilly II patent in the PTO and to the Cabilly III patent in the USDC. City of Hope made no payment in connection with the settlement.

Health Care Regulations

The Center and the Foundation are 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 and the Foundation are 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, 2017, the Affiliates have committed to spend approximately $39,989,000 through 2018 for building renovations, multiple campus facility renovations, and various information technology projects, including a clinical information system.

10. Community Benefit Expense (Unaudited)

City of Hope and Affiliates support 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

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 and the development of diagnostics 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 benefits for the broader community through internally funded research support and Support of Governmental Health Care Programs – Medi-Cal and Medicare expense, at cost, in terms of service to the indigent for the years ended September 30 (amounts in thousands):

10. Community Benefit Expense (Unaudited) (continued)

		2017		2016
Benefits for the broader community Support for research (unaudited)				
Estimated institutionally supported research costs, net of grants received of $135,104 and $87,799 in 2017 and 2016, respectively				
Center	**$**	**73,564**	$	63,410
Institute		**165,235**		147,356
TGen		**4,225**		–
Total estimated benefits for the broader community, at cost	**$**	**243,024**	$	210,766
Support of governmental health care programs (unaudited)				
Estimated unreimbursed cost of the Medi-Cal Program	**$**	**66,634**	$	65,915
Estimated unreimbursed cost of the Medicare Program		**135,920**		104,690
		202,554		170,605
Total estimated benefits for the broader community and unreimbursed costs to governmental health care programs	**$**	**445,578**	$	381,371

11. Donor-Restricted Endowments

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). ASC 958 also contains disclosure provisions, which are included below.

Endowment: City of Hope and Affiliates endowment includes certain permanently and 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 and Affiliates 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, 2017 and 2016, there were no material deficiencies of this nature.

11. Donor-Restricted Endowments (continued)

Return Objectives and Risk Parameters: City of Hope and Affiliates' 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 and Affiliates rely 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 and Affiliates target a diversified asset allocation to achieve its long-term return objectives within prudent risk constraints.

Interpretation of Relevant Law: City of Hope and Affiliates have 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 and Affiliates classify 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.

In accordance with UPMIFA, City of Hope and Affiliates consider 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

11. Donor-Restricted Endowments (continued)

(6) Other resources of City of Hope and Affiliates

(7) The investment policies of City of Hope and Affiliates

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

	2017			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted endowment funds	**$ (596)**	**$ –**	**$ 168,038**	**$ 167,442**
Temporarily restricted donor funds	**–**	**65,724**	**–**	**65,724**
Board-designated funds	**816,234**	**–**	**–**	**816,234**
Total funds	**$ 815,638**	**$ 65,724**	**$ 168,038**	**$ 1,049,400**

	2016			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
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

11. Donor-Restricted Endowments (continued)

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

	2017			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, October 1, 2016	$ 715,191	$ 40,624	$ 161,344	$ 917,159
Contributions and additions	75	5,327	6,520	11,922
Investment returns:				
Investment income	10,918	3,629	11	14,558
Net appreciation – realized and unrealized	90,363	22,693	163	113,219
Appropriation of endowment assets for expenditure or transfers	(909)	(6,549)	–	(7,458)
Endowment net assets, September 30, 2017	$ 815,638	$ 65,724	$ 168,038	$ 1,049,400

11. Donor-Restricted Endowments (continued)

	2016			
	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**	**Total**
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

12. Restricted Net Assets

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

	2017	**2016**
Time restricted under annuity and split-interest obligations and other	**$ 114,017**	$ 122,547
Patient care	**12,668**	8,501
Education	**5,670**	5,238
Research	**234,458**	148,252
Medical equipment and buildings	**3,988**	4,011
Total temporarily restricted net assets	**$ 370,801**	$ 288,549

12. 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):

	2017	2016
Time restricted under annuity and split-interest obligations and other	**$ 1,181**	$ 1,233
Patient care	**172**	443
Education	**887**	1,072
Research	**40,945**	28,357
Medical equipment and buildings	**1,381**	1,428
Total temporarily restricted net assets released from restrictions	**$ 44,566**	$ 32,533

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):

	2017	2016
Time restricted under annuity and split-interest obligations and other	**$ 9,233**	$ 8,253
Patient care	**14,572**	14,492
Education	**18,472**	17,763
Research	**130,349**	124,425
Medical equipment and buildings	**3,510**	3,510
Total permanently restricted net assets	**$ 176,136**	$ 168,443

13. Expenses

City of Hope and Affiliates provide 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):

	2017	2016
Salaries, wages, and employee benefits	**$ 613,639**	$ 522,811
Purchased services	**274,013**	186,981
Professional fees	**145,263**	131,284
Supplies and pharmaceuticals	**376,564**	338,866
Equipment rental and maintenance	**22,606**	19,391
Interest	**27,631**	32,363
Change in fair value of swap agreement	**(6,686)**	5,917
Depreciation and amortization	**118,861**	95,094
Occupancy	**24,569**	18,428
Royalty sharing	**123,015**	102,146
Hospital provider fee	**7,604**	13,942
Bad debt	**7,769**	3,110
Loss on impairment of intangible assets	**3,910**	–
Other	**33,517**	19,210
Total expenses	**$ 1,772,275**	$ 1,489,543

14. Subsequent Events

On October 3, 2017, TGen entered into a long-term capital lease agreement to purchase the building where its primary operations are conducted in Phoenix, Arizona through a subsidiary limited liability company (the TGen LLC). The aggregate lease payments that TGen will be obligated to make under the agreement are approximately $67,500,000, beginning in October 2017 through April 2037.

In order to secure its obligation under the long-term capital lease agreement, the TGen LLC purchased an irrevocable standby letter of credit in the amount of up to $25,000,000 for the benefit of the lessor. The standby letter of credit is guaranteed by City of Hope and it will renew annually based on a pre-agreed amortization schedule unless terminated with 60 days notice prior to the annual anniversary date by the lender. Unless it has expired earlier, this Letter of Credit shall finally expire on October 1, 2035.

14. Subsequent Events (continued)

On October 6, 2017, Amgen Inc. filed a lawsuit against Genentech, Inc. and City of Hope in the USDC, seeking a declaratory judgment of patent non-infringement, invalidity and unenforceability with respect to certain specified patents related to Genentech's antibody drug Avastin (collectively, the patents-in-suit). City of Hope co-owns with Genentech two of the patents-in-suit: the Cabilly II and Cabilly III patents. City of Hope is not an owner or co-owner of any of the other patents-in-suit. On the same date, Genentech and City of Hope filed a lawsuit against Amgen in the USDC for the District of Delaware for patent infringement, declaratory judgment and additional relief relating to the patents-in-suit. On October 18, 2017, Genentech and City of Hope filed a second lawsuit in the USDC for the District of Delaware against Amgen for infringement, and declaratory judgment and additional relief. The claims in the second lawsuit are in addition to those brought in the first. These cases arise from Amgen's application for Food and Drug Administration approval under the Biologics Price Competition and Innovation Act to commercialize a bio-similar copy of Avastin called "Mvasi". The proceedings are at a very early stage and the final outcome of the litigation cannot be determined at this time. If either the Cabilly II or Cabilly III patents 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 financial condition of City of Hope.

Effective December 15, 2017, the Foundation entered into definitive agreements pursuant to which the Foundation will own certain freestanding radiation therapy centers in Southern California and will form a new joint venture company to manage the centers, with an expected capital commitment of approximately $45,000,000. Management expects the transaction to close by the end of the Obligated Group's second fiscal quarter.

City of Hope and Affiliates has evaluated subsequent events occurring between the end of the most recent fiscal year and December 19, 2017, the date the financial statements were issued.

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