Houston Methodist

Consolidated Financial Statements as of
and for the Years Ended December 31, 2016
and 2015, Single Audit Reports for the
Year Ended December 31, 2016, and
Independent Auditors' Reports

HOUSTON METHODIST

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Deloitte & Touche LLP
1111 Bagby Street
Suite 4500
Houston, TX 77002-2591
USA

Tel: +1 713 982 2000
Fax: +1 713 982 2001
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Houston Methodist
Houston, Texas

We have audited the accompanying consolidated financial statements of Houston Methodist (Methodist), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to Methodist's preparation and fair presentation of the consolidated 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 Methodist'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 consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Methodist as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements of Methodist taken as a whole. The accompanying schedule of expenditures of federal and state awards, as required by Title 2 U.S. Code of Federal Regulations (CFR) Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards and the State of Texas Uniform Grant Management Standards (UGMS) is presented for the purpose of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 10, 2017 on our consideration of Methodist's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Methodist's internal control over financial reporting and compliance.

Deloitte & Touche LLP

March 10, 2017

CONSOLIDATED BALANCE SHEETS

HOUSTON METHODIST

(In Thousands)

	December 31, 2016	December 31, 2015
Assets		
Current assets		
Cash and cash equivalents	$ 56,619	$ 66,362
Assets limited as to use	1,491,654	1,476,304
Patient accounts receivable, net	542,216	479,421
Inventory and other current assets	90,686	87,154
Total Current Assets	2,181,175	2,109,241
Assets limited as to use, net of amounts required to meet current obligations	2,200,125	2,493,120
Property and equipment, net	3,590,123	3,081,254
Other assets	93,351	91,430
Total Assets	$8,064,774	$ 7,775,045
Liabilities and Net Assets		
Current liabilities		
Accounts payable and accrued expense	$ 591,883	$ 537,398
Estimated third-party settlements	59,169	104,177
Short-term bond debt	1,370,278	1,371,279
Total Current Liabilities	2,021,330	2,012,854
Long-term bond debt	343,358	381,273
Other long-term obligations, primarily related to self-insurance	60,210	79,123
Total Liabilities	2,424,898	2,473,250
Net assets		
Unrestricted	5,330,102	4,980,860
Temporarily restricted	141,356	137,670
Permanently restricted	168,418	154,416
Non-controlling interest – unrestricted	-	28,849
Total Net Assets	5,639,876	5,301,795
Total Liabilities and Net Assets	$8,064,774	$ 7,775,045

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

HOUSTON METHODIST

(In Thousands)

	For the Years Ended December 31,	
	2016	2015
Revenue		
Net patient revenue (net of program and policy-based free, uncompensated care)	$ 3,797,990	$3,401,632
Uncollectible, uncompensated care	(225,736)	(166,281)
Net patient revenue	3,572,254	3,235,351
Other revenue	174,081	172,383
Total Revenue	3,746,335	3,407,734
Expense		
Salaries, wages, and related personnel costs	1,925,800	1,694,279
Supplies and pharmaceuticals	673,544	615,868
Services and other expense	651,819	542,705
	3,251,163	2,852,852
Earnings Before Interest, Depreciation, and Amortization	495,172	554,882
Depreciation and amortization	243,636	221,066
Interest, net	15,847	9,454
	259,483	230,520
Operating Income	235,689	324,362
Other income (loss), primarily investment earnings (loss), net	114,276	(8,068)
Excess of Revenue Over Expense	$ 349,965	$ 316,294

See notes to consolidated financial statements (Continued)

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS – Continued

HOUSTON METHODIST

(In Thousands)

	For the Years Ended December 31,	
	2016	2015
Unrestricted Net Assets		
Excess of revenue over expense	$ 349,965	$ 316,294
Transfer of matching funds to temporarily or permanently restricted net assets	(1,703)	(1,623)
Transfer from temporarily restricted net assets	980	461
Increase in Unrestricted Net Assets	349,242	315,132
Temporarily Restricted Net Assets		
Investment earnings, net	12,169	729
Contributions	15,110	20,532
Transfer to permanently restricted net assets	(2,552)	(690)
Transfer from unrestricted net assets	208	255
Other, primarily assets released from restrictions	(21,249)	(14,810)
Increase in Temporarily Restricted Net Assets	3,686	6,016
Permanently Restricted Net Assets		
Contributions	9,955	5,741
Transfer from temporarily restricted net assets	2,552	690
Transfer from unrestricted net assets	1,495	1,368
Increase in Permanently Restricted Net Assets	14,002	7,799
Non-controlling Interest – Unrestricted		
Acquisition of Christus' minority interest	(28,849)	-
Christus' share of Houston Methodist St. John Hospital's excess of expense over revenue	-	(1,207)
Decrease in Non-controlling Interest	(28,849)	(1,207)
Increase in Net Assets	338,081	327,740
Net Assets, Beginning of Year	5,301,795	4,974,055
Net Assets, End of Year	$ 5,639,876	$ 5,301,795

See notes to consolidated financial statements. (Concluded)

CONSOLIDATED STATEMENTS OF CASH FLOWS

HOUSTON METHODIST

(In Thousands)

	For the Years Ended December 31, 2016	2015
Operating Activities		
Cash received from patient services	$ 3,466,239	$ 3,176,517
Other receipts from operations	168,688	176,331
Interest income, dividends, and other income received	40,177	29,096
Cash paid to or on behalf of employees	(1,922,072)	(1,678,078)
Cash paid for supplies and services	(1,346,697)	(1,124,748)
Interest paid	(25,983)	(10,268)
Net Cash Provided by Operating Activities	380,352	568,850
Investing Activities		
Purchase of property and equipment	(729,997)	(602,355)
Acquisition of Christus' minority interest in joint ventures	(21,570)	-
Purchases of investments	(2,406,519)	(3,922,532)
Sales of investments	2,795,654	3,653,626
Net Cash Used in Investing Activities	(362,432)	(871,261)
Financing Activities		
Principal payments on bond debt	(38,250)	(36,925)
Cash received from issuance of debt	-	308,098
Cash paid for bond issue costs	-	(2,404)
Contributions received for permanently restricted net assets	10,587	5,794
Net Cash (Used in) Provided by Financing Activities	(27,663)	274,563
Net Decrease in Cash and Cash Equivalents	(9,743)	(27,848)
Cash and Cash Equivalents, Beginning of Year	66,362	94,210
Cash and Cash Equivalents, End of Year	$ 56,619	$ 66,362

See notes to consolidated financial statements.

(Continued)

CONSOLIDATED STATEMENTS OF CASH FLOWS – Continued

HOUSTON METHODIST

(In Thousands)

	For the Years Ended December 31,	
	2016	2015
Reconciliation of Increase in Net Assets to Net Cash Provided by Operating Activities		
Increase in Net Assets	$ 338,081	$ 327,740
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Net (gains) losses on investments	(99,519)	23,452
Permanently and temporarily restricted activities not related to operations	(23,278)	(9,353)
Acquisition of fair market value of Christus' minority interest in joint ventures	29,100	-
Depreciation and amortization	243,636	221,066
Uncollectible, uncompensated care	225,736	166,281
Other noncash items	(7,189)	733
Increase in patient accounts receivable	(288,531)	(246,154)
Increase in inventory and other current assets	(3,532)	(4,988)
(Increase) decrease in other assets	(1,921)	10,675
Increase in accounts payable and accrued expense	30,816	38,141
(Decrease) increase in estimated third-party settlements	(45,008)	40,313
(Decrease) increase in other long-term obligations	(18,039)	944
Net Cash Provided by Operating Activities	$ 380,352	$ 568,850

See notes to consolidated financial statements. (Concluded)

NOTE A – MISSION AND ORGANIZATION

The mission of Houston Methodist ("Methodist") is to provide high-quality, cost-effective health care that delivers the best value to the people it serves in a spiritual environment of caring in association with internationally recognized teaching and research. Methodist operates a large academic medical center hospital, a research institute, a physician organization, six community hospitals, and various medical office buildings (MOBs) in Houston, Texas, and the surrounding area.

Methodist is a not-for-profit, nonmember corporation organized and existing under the laws of the State of Texas. It is exempt from federal income taxes. The consolidated financial statements include the accounts of Methodist and its wholly owned and/or controlled affiliates.

NOTE B – SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates – The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates. Significant estimates include the allowances for uncollectible accounts and contractuals, estimated third-party settlements, self-insurance reserves, and valuation of investments.

Cash and Cash Equivalents – Investments with maturities of three months or less when purchased are classified as cash equivalents, excluding amounts classified as assets limited as to use.

Patient Accounts Receivable – Patient accounts receivable are reported in the consolidated balance sheets, net of an estimated allowance for uncollectible, uncompensated care of $208.4 million and $160.6 million as of December 31, 2016 and 2015, respectively. Current operations are charged with a provision for uncollectible, uncompensated care based on experience. Methodist routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits payable under their health insurance programs, plans, or policies (e.g., Medicare, Medicaid, and commercial insurance policies).

Patient accounts receivable are stated at their estimated net realizable value. Patient accounts receivable are reduced by an allowance for contractual adjustments, based on expected payment rates from payors under current reimbursement methodologies and signed agreements, and also by an allowance for doubtful accounts. In evaluating the collectibility of patient accounts receivable, Methodist analyzes historical trends for each of its major payor sources of revenue to estimate an appropriate allowance for doubtful accounts and provision for uncollectible accounts. Management regularly reviews data about major payor sources of revenue in evaluating the sufficiency of the allowances for contractual adjustments and doubtful accounts.

NOTE B – SIGNIFICANT ACCOUNTING POLICIES – Continued

Receivables associated with self-pay patients are patients without insurance. Methodist records a provision for uncollectible accounts in the period of service based on its experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the discounted rates and the amounts actually collected after all reasonable collection efforts have been exhausted is written off against the allowance for doubtful accounts in the period they are determined uncollectible.

Methodist's allowance for doubtful accounts was 27.8% and 25.1% of patient accounts receivable (net of allowances for contractual allowances and discounts) as of December 31, 2016 and 2015, respectively. In addition, Methodist's bad debt write-offs totaled $197.3 million and $172.1 million for fiscal years 2016 and 2015, respectively.

The following table shows gross accounts receivable by payor:

	December 31,	
	2016	2015
Managed care	46%	49%
Medicare	32%	29%
Self-pay	10%	8%
Medicaid	5%	7%
Other	7%	7%
Total	100%	100%

Approximately 24% of Methodist's patient accounts receivable at December 31, 2016, is due from two managed care companies.

Net patient service revenue is reported at the estimated net realizable amounts due from third-party payors, patients, and others for services rendered. Methodist has agreements with third-party payors that provide for payments at amounts different from gross charges. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, per diem payments, discounted charges, and estimated retroactive settlements under payment agreements with third-party payors.

NOTE B – SIGNIFICANT ACCOUNTING POLICIES – Continued

Methodist recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. Provisions for contractual adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. For uninsured patients that do not qualify for charity care, Methodist recognizes revenue based on its discounted rates. On the basis of historical experience, a significant portion of Methodist's uninsured patients will be unable or unwilling to pay for the services provided. As a result, Methodist records a significant provision for uncollectible accounts related to uninsured patients in the period the services are provided.

Operating Activities – Methodist considers activities directly related to patient care, education, and research as operating activities. These activities, including earnings from certain fixed income and equity investments used to support these activities of $22.6 million and $13.7 million for 2016 and 2015, respectively, are included in the determination of operating income in the consolidated statements of operations and changes in net assets.

Other Income (Loss), Primarily Investment Earnings (Loss), Net – Activities include certain investment gains and losses realized/unrealized from Methodist's investment portfolio and activities not directly related to patient care, education, and research.

Excess of Revenue Over Expense – The consolidated statements of operations and changes in net assets include excess of revenue over expense. Changes in unrestricted net assets, which are excluded from excess of revenue over expense consistent with industry practice, include certain transfers of funds to or from restricted net assets, contributions of property and equipment, and contributions used to acquire property and equipment.

Uncompensated Care – Uncompensated care represents unrealizable patient charges at standard rates. Uncompensated care is classified as follows:

Community free, uncompensated care (charity care) – Community free, uncompensated care generally represents unrealizable standard charges for care provided to financially and medically indigent (charity) patients with no obligation, or a discounted obligation, to pay. Community free, uncompensated care has been excluded from gross patient revenue in the amount of approximately $547.2 million and $537.7 million in 2016 and 2015, respectively.

Program-based free, uncompensated care (contractual allowances) – Program-based free, uncompensated care generally represents the discount from standard charges as a result of negotiated or government-established contractual arrangements. For the years ended December 31, 2016 and 2015, program-based free, uncompensated care (contractual allowances) resulted from contractual arrangements with the sponsored Medicare programs (principally related to elderly patients), Medicaid (principally related to indigent patients), commercial managed care programs, and in connection with Methodist's self-pay discount policies.

NOTE B – SIGNIFICANT ACCOUNTING POLICIES – Continued

Program-based free, uncompensated care is reported as a deduction from gross patient revenue.

Policy-based free, uncompensated care – Policy-based free, uncompensated care generally represents standard charges that are unrealizable due to discounting in accordance with internally established policies and procedures. Policy-based free, uncompensated care is reported as a deduction from gross patient revenue.

Uncollectible, uncompensated care (bad debt) – Uncollectible, uncompensated care generally represents standard charges that are unrealizable due to the inability or unwillingness to pay by those responsible for payment. Uncollectible, uncompensated care is reported as a deduction from gross patient revenue.

Net Patient Revenue – Net patient revenue is reported at the estimated net realizable amounts due from patients or third-party payors for services rendered, including estimated retroactive adjustments.

Retroactive adjustments are accrued on an estimated basis when the related services are rendered and adjusted in future periods as final settlements are determined. During 2016 and 2015, changes in estimates related to prior years increased net patient revenue by approximately $46.3 million and $5.6 million, respectively.

Net patient revenue (net of program-based and policy-based free, uncompensated care) is computed as follows (in thousands):

	For the Years Ended December 31,	
	2016	2015
Gross patient revenue (net of community free, uncompensated care)	$14,168,663	$12,336,058
Deductions from revenue:		
Program-based free, uncompensated care	(10,267,250)	(8,894,604)
Policy-based free, uncompensated care	(103,423)	(39,822)
Net patient revenue	$ 3,797,990	$ 3,401,632

NOTE B – SIGNIFICANT ACCOUNTING POLICIES – Continued

The following table shows gross (gross of community free, uncompensated care) and net patient revenue (net of program-based and policy-based free, uncompensated care) by payor:

	Gross For the Years Ended December 31,		Net For the Years Ended December 31,	
	2016	2015	2016	2015
Managed care	38%	40%	61%	64%
Medicare	47%	46%	28%	26%
Medicaid	6%	6%	2%	3%
Self-pay	5%	5%	4%	3%
Other	4%	3%	5%	4%
	100%	100%	100%	100%

Financial Instruments – The carrying value of cash and cash equivalents, accounts receivable, and accounts payable approximates fair value due to the short-term nature of these financial instruments.

Investments are exposed to various risks, such as interest rate, credit, and overall market volatility. It is reasonably possible that changes in the values of investments will occur in the near term and that such changes could materially affect the amounts reported in these consolidated financial statements.

Inventory of Pharmaceuticals and Supplies – Inventory is valued at the lower of cost (determined by the weighted-average method) or market.

Property and Equipment – Property and equipment are carried at cost or, if donated, the fair market value at the time of donation, and includes expenditures for new property and equipment and expenditures that substantially increase the useful life of existing property and equipment. Ordinary maintenance and repairs are charged to expense when incurred. Depreciation of property and equipment is provided using the straight-line method. Useful lives assigned are generally as recommended in the American Hospital Association publication *Estimated Useful Lives of Depreciable Hospital Assets*.

Long-lived assets to be held and used are reviewed for impairment whenever circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets that are to be disposed of are reported at the lower of carrying amount or fair value less costs to sell. Methodist records the fair value of a liability for an asset retirement obligation in the period in which it is incurred by capitalizing it as part of the carrying amount of the long-lived assets (see Note J).

NOTE B – SIGNIFICANT ACCOUNTING POLICIES – Continued

Other Assets – Other assets consist primarily of goodwill ($64.0 million), trade name, non-compete, and licenses. Methodist tests for impairment of goodwill if indicators of impairment are present. Methodist did not record any goodwill impairments for the years ended 2016 or 2015.

Paid Time Off (Vacation, Holiday, and Sick Leave) Benefits – The cost of employees' paid time off benefits is recorded at the time benefits are earned.

Professional and General Liability Self-Insurance – Methodist has a separate, revocable self-insurance trust for which funding has been actuarially determined for the payment of professional and general liability losses, related expenses, and the cost of administering the trust. The assets of the revocable trust are reported in assets limited as to use in the consolidated balance sheets. Income from the trust assets is reported in other revenue in the consolidated statements of operations and changes in net assets. Professional and general liability losses and administrative costs are reported in services and other expense in the consolidated statements of operations and changes in net assets.

Unrestricted Contributions and Pledges – Unrestricted contributions and pledges are recorded as other income (loss), primarily investment earnings (loss), net in the consolidated statements of operations and changes in net assets in the period of the contribution or pledge commitment. Donor-restricted pledges and contributions are recorded as temporarily or permanently restricted net assets when the pledge or contribution is made. Pledges receivable are reported at their net present value, discounted at rates ranging from 1% to 3.4%. As of December 31, 2016 and 2015, the amount of the discount was $5.5 million and $6.3 million, respectively.

Temporarily and Permanently Restricted Net Assets – Temporarily restricted net assets are those limited as to use by donors to a specific time period or purpose. Permanently restricted net assets are those that have been restricted by donors to be maintained in perpetuity. Temporarily restricted net assets released from restriction are recorded as increases in unrestricted net assets when costs are incurred for their restricted purposes or when time restrictions have expired.

NOTE B – SIGNIFICANT ACCOUNTING POLICIES – Continued

Temporarily restricted net assets as of December 31, 2016 and 2015, were available for the following purposes. Permanently restricted net assets are invested in perpetuity, with the income expendable to support the purposes set forth below (in thousands):

	2016	
	Temporarily Restricted	Permanently Restricted
Patient care	$ 40,865	$ 62,067
Research	81,213	76,282
Education	19,278	30,069
	$ 141,356	$ 168,418

	2015	
	Temporarily Restricted	Permanently Restricted
Patient care	$ 39,830	$ 59,931
Research	78,339	71,269
Education	19,501	23,216
	$ 137,670	$ 154,416

Methodist's permanently restricted net assets consist of individual endowment accounts. Unless otherwise directed by the donor, gifts received for endowment accounts are invested consistent with Methodist's board-approved investment policy. Unless otherwise directed by the donor, Methodist has a policy of annually appropriating a certain percentage of each endowment account, which is then available to be spent consistent with donor intent. In order to preserve the real value of a donor's gift and to sustain funding consistent with donor intent, the annual appropriation rate is set to strike a reasonable balance between long-term objectives of preserving and growing each endowment fund for the future and providing stable, year-to-year appropriation amounts. From time to time, the fair value of assets associated with a permanently restricted endowment account may fall below the applicable endowment's gift amount(s) due to unfavorable investment returns.

As of December 31, 2016, the endowment accounts included in temporarily restricted net assets totaled $47.6 million. This amount was increased in 2016 by investment gains totaling $11.3 million, reduced by expenditures consistent with donor intent totaling $4.4 million and reduced by transfers between funds totaling $2.9 million.

As of December 31, 2015, the endowment accounts included in temporarily restricted net assets totaled $43.6 million. This amount was increased in 2015 by investment gains totaling $523,000, reduced by expenditures consistent with donor intent totaling $2.9 million and reduced by transfers between funds totaling $600,000.

NOTE B – SIGNIFICANT ACCOUNTING POLICIES – Continued

Income Taxes – Methodist and most of its affiliates are 501(c)(3) organizations generally exempt from income taxes. As a result of its unrelated business taxable income activity and taxable subsidiary operations, there are net operating losses of approximately $112.8 million that are available to offset net taxable income through 2025. Substantially, all of the related deferred tax assets of $38.3 million have been offset by a valuation allowance. The income tax provision and related tax assets and liabilities are immaterial. Methodist did not recognize any adjustments related to uncertain tax positions as of December 31, 2016.

Acquisitions – In connection with the February 1, 2014, formation of Houston Methodist St. John Hospital, Christus contributed the property, plant, and equipment of Christus St. John Hospital for a 30% minority interest and Houston Methodist paid Christus $67.9 million for a 70% majority interest. The difference between the fair value of the contributed assets and the purchase price of Houston Methodist St. John Hospital was $42.2 million and has been accounted for as goodwill ($34.0 million), trade name ($6.8 million), covenant not to compete ($0.7 million), and license ($0.7 million). Houston Methodist St. John Hospital is being operated as an acute care hospital in the Clear Lake area South of Houston. Houston Methodist St. John Hospital reported income from operations of $1.2 million and a loss from operations of $4.1 million for the years ended December 31, 2016 and 2015, respectively. Methodist received notice on February 11, 2016, that Christus exercised its option to require Methodist to acquire its 30% interest in Houston Methodist St. John. The acquisition by Houston Methodist of the remaining 30% interest in the joint venture was effective on July 5, 2016. Effective February 1, 2014, Houston Methodist acquired Christus St. Catherine Hospital for $60 million ($46.0 million in cash and a $14.0 million interest-free, long-term note). Houston Methodist paid a $21.6 million installment in 2016 for the remaining interests, with a final installment due in 2017 for the same amount.

New Accounting Standards – The Financial Accounting Standards Board issued authoritative guidance, which requires that debt issuance costs be presented as a direct deduction from the related debt liability for fiscal years beginning after December 15, 2015. This change in accounting principle was applied as of December 31, 2015 (see Note F), and resulted in $2.8 million being reclassified from other assets to long-term bond debt in the consolidated balance sheets.

Subsequent Events – Methodist has evaluated subsequent events through March 15, 2017, which is the date the consolidated financial statements were issued.

NOTE C – SERVICES PROVIDED TO THE COMMUNITY

Under legislation passed in the state of Texas, not-for-profit hospitals are required to provide a mandated amount of "Charity Care" and "Community Benefits," as defined by the legislation. Methodist was in compliance with the legislation, providing an estimated total of $1.0 billion and $907.0 million in combined Charity Care and Community Benefits based on estimated unreimbursed costs for the years ended December 31, 2016 and 2015, respectively, which exceeded the mandated amounts.

Through its controlled corporations, Methodist has a program to address specific health care needs that are not being met in the local community. Estimated charity care unreimbursed cost under this program for the years ended December 31, 2016 and 2015, totaled $236.5 million and $196.6 million, respectively. The method to estimate charity care costs is based on the cost to charge ratio, as defined by state of Texas statutory legislation, and then multiplying that ratio by the gross patient charges associated with providing care to financially or medically indigent patients, reduced by any payments received.

Methodist contributed to the advancement of medical science through direct financial support of research and medical education during 2016 and 2015. Approximately $127.5 million and $125.8 million in 2016 and 2015, respectively, was incurred in direct and indirect expense for Methodist's internally funded research and educational programs, support of its multiyear primary affiliations with Weill Medical College at Cornell University and New York-Presbyterian Hospital, and its support of other affiliates, including Baylor College of Medicine. Methodist also provided financial support for education in several allied health professions.

NOTE C – SERVICES PROVIDED TO THE COMMUNITY– Continued

The estimated unreimbursed costs of charity care and community benefits were as follows (in millions):

	For the Years Ended December 31, 2016	2015
Charity Care:		
Unreimbursed cost of providing care to financially and medically indigent patients	$ 132.8	$ 142.8
Unreimbursed cost of providing government-sponsored indigent health care (Medicaid)	-	3.3
Unreimbursed support provided through others	103.7	50.5
Total Charity Care	236.5	196.6
Community Benefits:		
Health care professional education and other	41.7	40.7
Unreimbursed research-related costs	85.8	85.1
Unreimbursed cost of providing government-sponsored health care (Medicare)	678.4	584.6
Total Community Benefits	805.9	710.4
Total Charity Care and Community Benefits	$ 1,042.4	$ 907.0

Methodist's participation in an 1115 State of Texas Medicaid waiver program with other hospitals and a resident support program with Baylor College of Medicine in 2016 and 2015, resulted in a decrease in the unreimbursed cost of providing government-sponsored indigent health care (Medicaid) and an increase in unreimbursed support provided through others. The operating income attributable to the programs described above totaled $48.0 million and $56.2 million for the years ended December 31, 2016 and 2015, respectively.

NOTE D – ASSETS LIMITED AS TO USE

The fair values of investments that are part of assets limited as to use were as follows (in thousands):

	December 31, 2016		
Investment Types	Total Fair Value	Level 1	Level 2
Assets:			
Cash and cash equivalents	$ 64,637	$ 64,637	$ -
Fixed-income securities:			
U.S. agencies and U.S. Treasuries	1,523,022	-	1,523,022
Debt securities	24,532	24,532	-
U.S. equity securities	1,547,664	1,547,664	-
International equity securities	479,633	479,633	-
Total investments at fair value	3,639,488	$2,116,466	$1,523,022
Pledges receivable and other	52,291		
Less current portion	(1,491,654)		
Noncurrent portion	$ 2,200,125		

	December 31, 2015		
Investment Types	Total Fair Value	Level 1	Level 2
Assets:			
Cash and cash equivalents	$ 68,175	$ 68,175	$ -
Fixed-income securities:			
U.S. agencies and U.S. Treasuries	1,946,852	-	1,946,852
Debt securities	24,051	24,051	-
U.S. equity securities	1,419,037	1,419,037	-
International equity securities	456,925	456,925	-
Total investments at fair value	3,915,040	$1,968,188	$1,946,852
Pledges receivable and other	54,384		
Less current portion	(1,476,304)		
Noncurrent portion	$2,493,120		

Level 1 – Quoted prices (unadjusted) in active markets for identical assets that Methodist can access at the measurement date.

Level 2 – Observable inputs other than quoted prices included in Level 1.

Level 3 – Unobservable inputs. Methodist has no investments defined as Level 3 investments.

NOTE D – ASSETS LIMITED AS TO USE – Continued

The fair value of the Level 1 securities represents the quoted market price multiplied by the quantity held. Level 2 securities include those that are valued using significant other observable inputs or quoted prices for similar assets. Methodist employs the market approach to value these securities. In this approach, the models used are primarily industry-standard models that consider various assumptions, including time value, volatility factors, and current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Substantially, all of these assumptions are observable in the market place throughout the full term of the instrument, can be derived from observable data, or are supported by observable levels at which transactions are executed in the market place.

Of the above investment amounts, $259.8 million and $240.9 million was available to support restricted net assets amounts at December 31, 2016 and 2015, respectively, and $133.4 million and $114.8 million was available to support payment of professional and general liability claims via a revocable self-insurance trust at December 31, 2016 and 2015, respectively. The remainder of the restricted net asset balances at December 31, 2016 and 2015, not supported by the above investment amounts, were supported by pledges receivable and other asset amounts. The balance of the above investment amounts not available as described were limited as to use by the Methodist board for capital investment.

The following table sets forth the components of the return on Methodist's investments (in thousands):

	For the Years Ended December 31,	
	2016	2015
Investment income	$ 53,106	$ 46,402
Net gains (loss)	101,167	(33,126)
Total	$154,273	$ 13,276

Investment income and net gains (loss) on certain U.S. agency and U.S. Treasury investments and self-insurance trust fund investments are recorded in other revenue in the consolidated statements of operations and changes in net assets. Investment income and net gains (loss) on permanently restricted fund investments are recorded directly to temporarily restricted net assets in the consolidated statements of operations and changes in net assets. Investment income and net gains (loss) on all other investments are recorded in other income (loss), primarily investment earnings (loss), net in the consolidated statements of operations and changes in net assets.

NOTE D – ASSETS LIMITED AS TO USE – Continued

Below is a summary of the classification of investment results in the consolidated financial statements (in thousands):

	For the Years Ended December 31, 2016	2015
Other revenue	$ 22,629	$ 13,752
Other income (loss), primarily investment earnings (loss), net	119,475	(1,205)
Temporarily restricted net assets–investment earnings, net	12,169	729
Total	**$ 154,273**	**$ 13,276**

Methodist accounts for its investments in equity securities with readily determinable fair value and its investments in debt securities as trading securities. Accordingly, such investments are reported at fair value with changes in fair value reported in excess of revenue over expense or as additions (deductions) from temporarily restricted net assets as shown above.

NOTE E – PROPERTY AND EQUIPMENT

Below is a summary of property and equipment (in thousands):

	December 31, 2016	2015
Buildings and improvements	$ 3,266,775	$ 2,956,113
Equipment	1,966,503	1,670,494
	5,233,278	4,626,607
Less accumulated depreciation	(2,599,238)	(2,358,863)
	2,634,040	2,267,744
Land	329,436	324,873
Construction in progress	626,647	488,637
Property and equipment, net	**$3,590,123**	**$3,081,254**

Depreciation expense for the years ended December 31, 2016 and 2015, was $243.9 million and $220.7 million, respectively. As of December 31, 2016 and 2015, property additions, included in accounts payable and accrued expense, were $98.2 million and $82.1 million, respectively.

NOTE F – DEBT

Below is a summary of bonds payable (in millions):

	December 31,	
	2016	2015
Series 2008A	$ 339.4	$ 341.6
Series 2008B	75.8	111.8
Series 2008C	406.3	406.3
Series 2009C	586.5	586.5
Series 2015	300.0	300.0
Unamortized premium – 2008B	0.6	1.2
Unamortized premium (discount) net – 2015	7.6	8.0
Less debt issuance costs (net)	(2.5)	(2.8)
	1,713.7	1,752.6
Short-term bond debt	(1,370.3)	(1,371.3)
Long-term bond debt	$ 343.4	$ 381.3

The carrying value of Methodist's fixed-rate debt was $384.0 million and $421.0 million as of December 31, 2016 and 2015, respectively, and the estimated fair value of Methodist's fixed-rate debt, based on current traded values, was $393.8 million and $446.2 million as of December 31, 2016 and 2015, respectively. The carrying amount of Methodist's variable rate debt approximates fair value.

Methodist and certain other Methodist–controlled entities ("restricted affiliates") are obligated in certain respects by agreements governing the 2008, 2009, and 2015 series bonds.

A summary of consolidated financial information, excluding intercompany liabilities, for entities that are not restricted affiliates (including the 2014 acquisition of Houston Methodist St. John Hospital), as defined by the master trust indenture, as of December 31, 2016 and 2015, and for the years then ended, is as follows (in thousands):

	2016	2015
Total assets	$160,103	$187,222
Total liabilities	15,609	13,670
Revenue in excess of (less than) expense	4,065	(3,092)

As of December 31, 2016 and 2015, the 2008A Bonds and 2008C Bonds were in the daily interest rate mode. The 2009C Bonds were in the commercial paper mode with interest rate periods of between 21 to 244 days.

NOTE F – DEBT – Continued

On August 6, 2015, Methodist issued Series 2015 fixed-rate tax-exempt bonds ("2015 Bonds") in the principal amount of $300.0 million ($150.0 million each in premium and discount par bonds). The 2015 Bonds were sold at a premium (net of discount) over par of $8.1 million. Principal payments are due on the 2015 Bonds in the years 2042-2045, and the effective interest rate is 4.4%. The Series 2015 Bonds are subject to optional redemption prior to maturity on June 1, 2025, or on any date thereafter. The unamortized costs of issuing the Series 2015 Bonds totaled $2.3 million as of December 31, 2016.

While bonds are in the daily rate or commercial paper mode, they may be tendered by bondholders ("put") on business days for full payment of principal and interest. The Series 2008B Bonds were issued on August 21, 2008, in the fixed-rate serial mode.

To provide assurance of its ability to purchase tendered 2008A Bonds, 2008C Bonds, and 2009C Bonds, Methodist maintains unencumbered cash, cash equivalents, immediately saleable fixed-income obligations (e.g., high-grade, fixed-income investments), and readily saleable equity investments with a market value at least equal to the maximum aggregate purchase price that could become due on all bonds in a daily rate mode, weekly rate mode, or commercial paper rate mode.

Consistent with the put feature of Methodist's 2008A Bonds, 2008C Bonds, and 2009C Bonds, these bonds have been classified as current liabilities. The 2015 Bonds and 2008B Bonds have been classified as long-term liabilities, other than amounts due in 2016, which have been classified as current liabilities, as indicated below.

The 2008A Bonds, 2008C Bonds, and 2009C Bonds may be converted to fixed-rate obligations or other variable rate modes (e.g., weekly, commercial paper) at the option of Methodist.

The restricted affiliates have covenanted to abide by guidelines regarding repayment, financial performance, and organizational changes defined in agreements and indentures related to the 2008, 2009, and 2015 Series Bonds. Management believes Methodist is in compliance with its debt covenants.

The aggregate annual maturities of bonds payable as of December 31, 2016, are as follows (in millions):

2017	$ 39.6
2018	41.0
2019	41.7
2020	43.1
2021	44.6
Thereafter	1,498.0
Total	$ 1,708.0

NOTE F – DEBT – Continued

The amortization of bond premium on the 2015 and 2008B Bonds and the amortization of bond discount on the 2015 Bonds was accounted for as a net reduction in interest expense, totaling $894,000 and $1.0 million for the years ended December 31, 2016 and 2015, respectively. The average annual interest rate paid on all bonds was 1.45% and 0.91% for the years ended December 31, 2016 and 2015, respectively.

NOTE G – OPERATING LEASE EXPENSE AND REVENUE

Minimum lease payments (in thousands) for all long-term, noncancelable operating leases for the five years subsequent to December 31, 2016, are approximately 2017 - $16,469; 2018 - $11,264; 2019 - $9,719; 2020 - $8,359; 2021 - $5,874; and years after 2021 - $13,537.

Rental expense under operating leases, including short-term leases, was $30.5 million and $24.3 million for the years ended December 31, 2016 and 2015, respectively.

Rental revenue (in thousands) for operating leases for the five years subsequent to December 31, 2016, is approximately 2017 - $16,744; 2018 - $12,816; 2019 - $10,351; 2020 - $6,943; 2021 - $4,212; and years after 2021 - $8,362. This revenue primarily relates to the leasing of Medical Office Buildings (“MOBs”) space to physician practices at market rates. The approximate carrying value of the MOBs is $230.7 million with accumulated depreciation of $185.0 million as of December 31, 2016.

NOTE H – RETIREMENT PLANS

Most Methodist corporations participate in a noncontributory, defined contribution plan. Amounts contributed to the plan during 2016 and 2015 totaled $47.7 million and $39.0 million, respectively, and are included in salaries, wages, and related personnel costs in the consolidated statements of operations and changes in net assets.

Additionally, Methodist has a tax-sheltered annuity plan that includes an employer match calculated at 50% of an employee’s contribution up to 4% of pay. The contributions for the employer match on the tax-sheltered annuity plan totaled $18.7 million and $16.2 million during 2016 and 2015, respectively. These amounts are included in salaries, wages, and related personnel costs in the consolidated statements of operations and changes in net assets.

Certain executives participate in a Supplemental Executive Retirement Plan. The expense associated with this plan was $2.5 million and $2.1 million during 2016 and 2015, respectively. These amounts are included in salaries, wages, and related personnel costs in the consolidated statements of operations and changes in net assets.

NOTE I – FUNCTIONAL EXPENSES

The functional classification of expense was as follows (in thousands):

	For the Years Ended December 31,	
	2016	2015
Patient care, research, and medical education	$ 2,616,777	$ 2,371,454
General and administrative	893,869	711,918
Total operating expense	$ 3,510,646	$ 3,083,372

NOTE J – COMMITMENTS AND CONTINGENCIES

Methodist arranges for the issuance of bank letters of credit in connection with its financial obligations, such as claims administration funding and support of fronted insurance programs. As of December 31, 2016, outstanding letters of credit totaled $11.9 million and expire after a one-year term.

Laws and regulations governing the Medicare and Medicaid programs and certain other third-party programs are complex and subject to interpretation. As a result, there is a reasonable possibility that recorded estimates of third-party settlements will change by a material amount in the near term. Methodist's intent is to be in compliance with all applicable laws and regulations, and it is not aware of any significant pending or threatened investigations involving allegations of potential wrongdoing. Compliance with such laws and regulations can be subject to future review and interpretation. Changes in the Medicare and Medicaid programs and a reduction of funding could have an adverse effect on Methodist.

Methodist accounts for asset retirement obligations in accordance with authoritative guidance, which clarifies that an entity is required to recognize a liability for the fair market value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. The corresponding cost is capitalized as part of the carrying amount of the related long-lived asset. The liability is accreted to its present value each period and the capitalized cost is depreciated over the useful life of the related asset. The asset retirement obligation, totaling $5.8 million and $6.5 million as of December 31, 2016 and 2015, respectively, has been classified as a long-term liability. This liability was reduced by $618,000 and $538,000 in payments, increased by $217,000 and $233,000 in accretion expense, and reduced by a $298,000 and $195,000 change in estimate for the years ended December 31, 2016 and 2015, respectively. The change in estimate was recorded as a decrease in the carrying value of Methodist's various building facilities as of December 31, 2016 and 2015.

Deloitte.

Deloitte & Touche LLP
1111 Bagby Street
Suite 4500
Houston, TX 77002-2591
USA

Tel: +1 713 982 2000
Fax: +1 713 982 2001
www.deloitte.com

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF CONSOLIDATED FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

The Board of Directors of
Houston Methodist
Houston, Texas

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the consolidated financial statements of Houston Methodist ("Methodist") as of and for the year ended December 31, 2016, and the related notes to the consolidated financial statements, and have issued our report thereon dated March 10, 2017.

Internal Control over Financial Reporting

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

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

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

Compliance and Other Matters

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

Purpose of this Report

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

Deloitte & Touche LLP

March 10, 2017

Deloitte & Touche LLP
1111 Bagby Street
Suite 4500
Houston, TX 77002-2591
USA

Tel: +1 713 982 2000
Fax: +1 713 982 2001
www.deloitte.com

REPORT ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM AND REPORT ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH *UNIFORM GUIDANCE*

The Board of Directors of
Houston Methodist
Houston, Texas

Report on Compliance for Each Major Federal Program

We have audited Houston Methodist's ("Methodist") compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on each of Methodist's major federal programs for the year ended December 31, 2016. Methodist's major federal programs are identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs.

Management's Responsibility

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

Auditors' Responsibility

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

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

Opinion on Each Major Federal Program

In our opinion, Methodist complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended December 31, 2016.

Report on Internal Control over Compliance

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

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

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

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

Deloitte & Touche LLP

March 10, 2017

Deloitte.

Deloitte & Touche LLP
1111 Bagby Street
Suite 4500
Houston, TX 77002-2591
USA

Tel: +1 713 982 2000
Fax: +1 713 982 2001
www.deloitte.com

REPORT ON COMPLIANCE FOR EACH MAJOR STATE PROGRAM AND INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY THE STATE OF TEXAS *UNIFORM GRANT MANAGEMENT STANDARDS*

The Board of Directors of
Houston Methodist
Houston, Texas

Report on Compliance for Each Major State Program

We have audited Houston Methodist's ("Methodist") compliance with the types of compliance requirements described in the State of Texas *Uniform Grant Management Standards* (UGMS) that could have a direct and material effect on each of Methodist's major state programs for the year ended December 31, 2016. Methodist's major state program is identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its state programs.

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for each of Methodist's major state programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; *Audits of States, Local Governments, and Nonprofit Organizations*; and the State of Texas *UGMS.* Those standards require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major state program occurred. An audit includes examining, on a test basis, evidence about Methodist's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major state program. However, our audit does not provide a legal determination of Methodist's compliance.

Opinion on Each Major State Program

In our opinion, Methodist complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major state programs for the year ended December 31, 2016.

Other Matters

The results of our auditing procedures disclosed an instance of noncompliance, which is required to be reported in accordance with UGMS and which is described in the accompanying Schedule of Findings and Questioned Costs as item 2016-001. Our opinion on each major state program is not modified with respect to these matters.

Methodist's responses to the noncompliance finding identified in our audit is described in the accompanying Corrective Action Plan. Methodist's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

Report on Internal Control over Compliance

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

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

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses. However, we identified a deficiency in internal control over compliance, as described in the accompanying Schedule of Findings and Questioned Costs as item 2016-001 that we consider to be a significant deficiency.

Methodist's response to the internal control over compliance finding identified in our audit is described in the accompanying Corrective Action Plan. Methodist's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

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

Deloitte & Touche LLP

March 10, 2017

HOUSTON METHODIST

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS FOR THE YEAR ENDED DECEMBER 31, 2016

	Pass-Through Entity Identifying Number	CFDA/ Contract Number	Total Expenditures	Amounts Passed Through to Subrecipients
FEDERAL AWARDS—Research & Development Cluster:				
Department of Health & Human Services—National Institutes of Health:				
Oral Diseases and Disorders Research	N/A	93.121	$ 766,935	$ 237,544
Drug Abuse and Addiction Research Programs	N/A	93.279	720,108	3,325
Discovery and Applied Research for Technological Innovations to				
Improve Human Health	N/A	93.286	68,026	
Cancer Cause and Prevention Research	N/A	93.393	839,997	
Cancer Detection and Diagnosis Research	N/A	93.394	1,367,264	632,501
Cancer Treatment Research	N/A	93.395	337,118	
Cancer Biology Research	N/A	93.396	1,181,374	332,236
Cancer Centers Support Grants	N/A	93.397	830,414	283,621
Cardiovascular Diseases Research	N/A	93.837	2,124,821	195,381
Blood Diseases and Resources Research	N/A	93.839	13,921	
Extramural Research Programs in the Neurosciences and				
Neurological Disorders	N/A	93.853	822,149	33,127
Allergy, Immunology and Transplantation Research	N/A	93.855	1,944,476	94,915
Biomedical Research and Research Training	N/A	93.859	830,159	
Aging Research	N/A	93.866	361,363	171,571
National Heart, Lung, & Blood Institute contract				
# HHSN268201100026C through University of Michigan	HHSN268201100026C	93.RD	54,866	
National Cancer Institute contract # HHSN261201500039C through				
Omega Optics, Inc.	HHSN261201500039C	93.RD	19,408	
Cancer Cause and Prevention Research through University of				
California, Berkeley	P01 CA092584	93.393	25,507	
Cancer Detection and Diagnosis Research through TELOVISION, LLC	R41 CA183428	93.394	7,295	
Cancer Treatment Research through University of Michigan	S0812	93.395	1,924	
Cancer Treatment Research through Laser Tissue Welding, Inc	R44 CA203052	93.395	122,721	
Cancer Treatment Research through ACRIN Medical Research Foundation	U10 CA180820	93.395	5,949	
Cancer Centers Support Grants through Baylor College of Medicine	P50 CA126752	93.397	105,837	
Cancer Centers Support Grants through The University of Texas				
Health Science Center at Houston	U54 CA151668	93.397	43,539	
Cardiovascular Diseases Research through University of Virginia	U01 HL117006	93.837	8,590	
Cardiovascular Diseases Research through University of Maryland,				
Baltimore	U01 HL099997	93.837	53,302	
Cardiovascular Diseases Research through Baylor College of Medicine	K25 HL121149	93.837	4,348	
Cardiovascular Diseases Research through Temple University				
Health Science Center	R01 HL117654	93.837	20,152	
Cardiovascular Diseases Research through Children's Hospital				
Medical Center	R24 HL105333	93.837	10,513	
Cardiovascular Diseases Research through Joan & Sanford L Weill				
Medical College of Cornell University	R01 HL118019	93.837	92,574	
Cardiovascular Diseases Research through University of Florida	U01 HL119178	93.837	99,833	
Lung Diseases Research through Vanderbilt University	R01 HL111111	93.838	266	
Diabetes, Digestive, and Kidney Diseases Extramural Research				
through Baylor College of Medicine	R01 DK097160	93.847	11,940	
Diabetes, Digestive, and Kidney Diseases Extramural Research				
through Baylor College of Medicine	K12 DK083014	93.847	90,027	
Diabetes, Digestive, and Kidney Diseases Extramural Research				
through Northwestern University	R01 DK104876	93.847	1,138	
Diabetes, Digestive, and Kidney Diseases Extramural Research				
through University of Houston	R00 DK082644	93.847	703	
Extramural Research Programs in the Neurosciences and				
Neurological Disorders through Emmes Corporation	R01 NS062835	93.853	29,798	
Extramural Research Programs in the Neurosciences and				
Neurological Disorders through Rutgers University	R01 NS038384	93.853	12,038	
Extramural Research Programs in the Neurosciences and				
Neurological Disorders through Yale University	U01 NS044876	93.853	162	
Extramural Research Programs in the Neurosciences and				
Neurological Disorders through Mayo Clinic	U01 NS080168	93.853	13,868	
Extramural Research Programs in the Neurosciences and				
Neurological Disorders through The University of Texas Health Science	R01 NS081854	93.853	3,386	

(Continued)

HOUSTON METHODIST

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED DECEMBER 31, 2016

	Pass-Through Entity Identifying Number	CFDA/ Contract Number	Total Expenditures	Amounts Passed Through to Subrecipients
Allergy, Immunology and Transplantation Research through Baylor Research Institute	U19 AI082715	93.855	$ 56,274	$ -
Biomedical Research and Research Training through University of California, San Francisco	U01 GM094614	93.859	715	
Biomedical Research and Research Training through University of Texas MD Anderson Cancer Center	R01 GM083031	93.859	880	
Biomedical Research and Research Training through Aptitude Medical Systems	R43 GM112356	93.859	21,051	
Child Health and Human Development Extramural Research through Joan & Sanford L Weill Medical College of Cornell University	P01 HD067244	93.865	86,166	
Child Health and Human Development Extramural Research through Nano3d Biosciences, Inc	R41 HD081795	93.865	28,751	
Child Health and Human Development Extramural Research through The University of Texas Health Science Center at Houston	R21 HD082947	93.865	95,760	
International Research and Research Training through Prince of Songkla University	D43 TW009522	93.989	11,272	
Total Department of Health & Human Services—National Institutes of Health			13,348,678	1,984,221
Department of Defense/U.S. Army Medical Command:				
Military Medical Research and Development	N/A	12.420	2,176,909	484,062
Military Medical Research and Development through Joan & Sanford L Weill Medical College of Cornell University	W81XWH-13-1-0313	12.420	58,685	
Total Department of Defense/U.S. Army Medical Command			2,235,594	484,062
National Aeronautics and Space Administration:				
National Aeronautics and Space Administration through Tietronix Software, Inc	NNX16CC52P	43.RD	14,370	
Space Operations through Center for the Advancement of Science in Space, Inc.	NNH11CD70A	43.001	220,677	
Aeronautics through Baylor College of Medicine	CA03402	43.002	8,139	
Exploration	N/A	43.003	238,951	
Total National Aeronautics and Space Administration			482,137	-
National Science Foundation:				
Engineering Grants through William Marsh Rice University	CBET-1547838	47.041	12,923	
Mathematical and Physical Sciences	N/A	47.049	140,272	42,140
Computer and Information Science and Engineering	N/A	47.070	296,678	
Office of International Science and Engineering	N/A	47.079	8,129	
Total National Science Foundation			458,002	42,140
Department of the Navy—				
Department of Navy contract # N6311614MPHX083 through BrainScope Company, Inc.	N6311614MPHX083	12.RD	24,681	
Total Research & Development Cluster			16,549,092	2,510,423
FEDERAL AWARDS—Other Programs:				
Department of Health and Human Services—Center for Medicare and Medicaid Services Health Care Innovation Awards	N/A	93.610	2,305,823	693,721
Department of Homeland Security - Federal Emergency Management Agency through Texas Department of Public Safety—Disaster Recovery	FEMA 1791-DR-TX	97.036	59,082	
TOTAL EXPENDITURES OF FEDERAL AWARDS			$ 18,913,997	$ 3,204,144

See notes to the schedules of expenditures of federal and state awards. (Concluded)

HOUSTON METHODIST

SCHEDULE OF EXPENDITURES OF STATE AWARDS
FOR THE YEAR ENDED DECEMBER 31, 2016

	CFDA/ Contract Number	Total Expenditures	Amounts Passed Through to Subrecipients
STATE OF TEXAS:			
Cancer Prevention and Research Institute of Texas:			
Cancer Biology & Genetics	R1112	$ 677,460	
Cancer Biology & Genetics	R1113	1,037,462	
Cancer Biology & Genetics	RP110444-C2	147,453	
Cancer Biology & Genetics	RP110444-P3	247,055	
Cancer Biology & Genetics	RP140181	159,479	
Cancer Treatment	RP110532	124,935	
Cancer Treatment	RP130573	102,411	
Cancer Treatment	RP140315	276,814	$ 53,906
Cancer Treatment	RP150343	66,015	
Cancer Treatment	RP160501	82,092	52,386
Core Facilities Support Awards	RP150611	891,150	78,017
Early detection, diagnosis, and prognosis	RP160054	186,712	
Evidence-Based Cancer Prevention Services—See, Test & Treat® Program	PP160105	10,551	
Product Development Programs	DP150099	315,663	
Research Training through University of Houston	RP140113	11,326	
Total Cancer Prevention and Research Institute of Texas		4,336,578	184,309
Texas Higher Education Coordinating Board:			
Family Practice Residency Program—Houston Methodist Hospital	15656, 17934, 14632, 16228, 18077, 18078	976,489	
Family Practice Residency Program—Houston Methodist San Jacinto Hospital	15656	148,000	
Rural Rotation—Houston Methodist Hospital	N/A	2,500	
Total Texas Higher Education Coordinating Board		1,126,989	-
TOTAL EXPENDITURES OF STATE AWARDS		$5,463,567	$184,309

See notes to the schedules of expenditures of federal and state awards. (Concluded)

HOUSTON METHODIST

NOTES TO SCHEDULES OF EXPENDITURES OF FEDERAL AND STATE AWARDS FOR THE YEAR ENDED DECEMBER 31, 2016

1. BASIS OF PRESENTATION

The accompanying schedules of expenditures of federal and state awards includes the federal and state grant activity of Houston Methodist ("Methodist") and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of Title 2 U.S. Code of Federal Regulations Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards ("Uniform Guidance"), and the State of Texas *Uniform Grant Management Standards* (UGMS).

2. PROCUREMENT PROVISIONS

Methodist has elected to defer adoption of the procurement standards under the Uniform Guidance at 2 CFR 200 until the required adoption date as of January 1, 2017.

3. DE MINIMIS COST RATE

Methodist has negotiated an indirect cost rate with the federal government and therefore has not elected to use the 10 (ten) percent de minimis cost rate as covered in Uniform Guidance at 2 CFR 200.414, Indirect (F&A) Costs.

* * * * * *

HOUSTON METHODIST

SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED DECEMBER 31, 2016

I. Summary of Auditors' Results

Consolidated Financial Statements

Type of auditors' report issued:	Unmodified
Internal control over financial reporting:	
Material weakness(es) identified?	No
Significant deficiency(ies) identified not considered to be material weaknesses?	None Reported
Noncompliance material to consolidated financial statements noted?	No

Federal Awards

Internal control over major programs:	
Material weakness(es) identified?	No
Significant deficiency(ies) identified not considered to be material weakness(es)?	None Reported
Type of auditors' report issued on compliance for major programs:	Unmodified
Any audit findings disclosed that are required to be reported in accordance with Uniform Guidance?	No

State Awards

Internal control over major programs:	
Material weakness(es) identified?	No
Significant deficiency (ies) identified not considered to be material weakness(es)?	Yes
Type of auditors' report issued on compliance for major programs:	Unmodified
Any audit findings disclosed that are required to be reported in accordance with the UGMS?	Yes

Identification of major programs:

Federal:

- Research and Development (R&D) Cluster

State:

- Cancer Prevention and Research Institute of Texas (CPRIT) grant

US dollar threshold used to distinguish between Type A and Type B programs:

- Federal: $750,000
- State: $300,000

Auditee qualified as low-risk auditee?	Yes

II. Findings Related to the Consolidated Financial Statements

None noted.

III. Findings and Questioned Costs Related to the Expenditures of Federal and State Awards

	Finding 2016-001—Noncompliance Finding and Significant Deficiency—State CPRIT—Reporting	Questioned Cost
Grant Information	Cancer Prevention and Research Institute of Texas (CPRIT) grant	
Criteria	Grant documents require quarterly, annual, and final financial, performance and historically underutilized business (HUB) reports. Methodist shall use reasonable efforts to purchase materials, supplies, or services from a HUB. Methodist shall complete a HUB report with each annual report submitted to CPRIT in accordance with the template within the grant agreement.	
Condition/Context	Methodist did not monitor and ensure that performance reporting requirements were satisfied in a complete and timely manner. **Scientific Progress Reports:** We noted two of seven required federal progress reports were not submitted on or before the required deadline, as noted per the grant agreements. **HUB Reports:** We noted three of seven HUB reports were not completed accurately. Specifically, the underlying spreadsheets to complete the HUB report for the three of seven samples were not prepared with complete and accurate data and nor were the reports reviewed in detail prior to submission.	None
Cause	Methodist did not monitor and ensure that progress and HUB reporting requirements were satisfied in a complete and timely manner. The principal investigator did not effectively prepare and review the progress report to ensure all report requirements are completed prior to submission. The HUB reports were not prepared with the correct information resulting in expenses being understated. Methodist did not effectively prepare and review the submitted HUB reports to ensure the reports were complete and accurate.	

	Finding 2016-001—Noncompliance Finding and Significant Deficiency—State CPRIT—Reporting	**Questioned Cost**
Effect	A lack of preparation and review of the HUB and progress reports could lead to incorrect reporting to the grantor.	
Recommendation	Methodist should prepare and review all reports prior to submission for accuracy and completeness to ensure all components are completed and submitted for the correct grant year	
View of Responsible Officials	See corrective action plan.	

IV. Corrective Action Plan for the Year Ended December 31, 2016

Finding 2016-001—State CPRIT

Reporting—Noncompliance Finding and Significant Deficiency

See management’s corrective action plan on the next page.

HOUSTON Methodist LEADING MEDICINE

March 7, 2017

Re: **2016 Single Audit**
Corrective Action Plan

To Whom It May Concern:

In response to Audit Finding 2016-001, "Noncompliance Finding and Significant Deficiency — State CPRIT— Reporting" we submit the following corrective action plan.

All CPRIT financial reports (Financial Status Reports and HUB Reports) are prepared by the accountant assigned to that department. The report is submitted via the CPRIT Grant Management System (CGMS) to the Authorized Signing Official (ASO). The ASO will add a review step in the CGMS and delegate to the Grants post-award manager for review. This individual will ensure that the amounts reflected in financial reports always agree with the general ledger before approving the report. If changes need to be made she will disapprove the report and the accountant will revise accordingly.

With regard to timely submission of progress reports, we will continue to monitor deadlines and ensure our PI's provide the necessary reports and other deliverables in a timely manner.

This change will be implemented by March 31, 2017.

Should you have any questions about this, or need clarification about the item mentioned above, please do not hesitate to contact me at (713) 441-7885, or via email at GLingle@houstonmethodist.org.

Sincerely,

Gary Lingle

Gary Lingle, CPA
Director, Grants Administration

V. Status of Prior-Year Consolidated Financial Statement Findings and Questioned Costs

Findings Related to the Consolidated Financial Statements

	Finding 2015-001—Noncompliance Finding and Significant Deficiency—State CPRIT and R&D Cluster—Reporting	Questioned Cost
Grant Information	CPRIT grant and R&D (CFDA No. 43.003 (Direct Award) and No. 43.007 (Pass-through Center for the Advancement of Science in Space))	
Criteria	Grant documents require quarterly, annual, and final financial, performance and historically underutilized business (HUB) reports. Methodist shall use reasonable efforts to purchase materials, supplies, or services from a HUB. Methodist shall complete a HUB report with each annual report submitted to CPRIT in accordance with the template within the grant agreement.	
Condition/Context	Methodist did not monitor and ensure that performance reporting requirements were satisfied in a complete and timely manner. **R&D Cluster—Scientific Progress Reports:** We noted one of nine required federal progress reports was not submitted on or before the required deadline, as noted per the federal grant agreements. Further, management did not complete and submit the one required negative report related to the annual utilization of subject invention report. **CPRIT—HUB Reports:** We noted two of seven HUB reports were not completed in their entirety and were submitted incorrectly. Additionally, the underlying spreadsheets to complete the HUB report for the two of seven samples were not prepared and submitted as required.	None
Cause	Methodist did not monitor and ensure that progress and HUB reporting requirements were satisfied in a complete and timely manner.	
Effect	Methodist did not have a control in place to prepare the spreadsheet at the time of the HUB report submission. The preparer of the HUB reports did not	

Finding 2015-001—Noncompliance Finding and Significant Deficiency—State CPRIT and R&D Cluster—Reporting | **Questioned Cost**

submit the reports for the correct grant years into the CPRIT reporting system. Therefore, the submitted HUB reports were incomplete and reported for the incorrect time periods. Methodist did not effectively prepare and review the submitted HUB reports to ensure the underlying spreadsheet and all conditions of the report were completed.

Late reporting could prevent adequate monitoring by the grantor.

Recommendation

Management should establish training for all individuals in the grant management department, including principal investigators, to understand their specific roles in the grant reporting process. Management should ensure that all responsible parties are timely submitting their required information to the grant department. Additionally, Methodist should ensure that reporting deadlines for federal grants are met on a timely basis.

Methodist should prepare and review the HUB reports prior to submission for accuracy and completeness to ensure all components are completed and submitted to the correct grant year.

Corrective Action Plan of Management

The Grants office will strengthen procedures to ensure compliance with this reporting requirement. At the time of award, a "Reporting Requirement" document will be prepared that will summarize the type of reports and due dates. This document will be reviewed by the manager or director in the Grants office for accuracy and sent to the principal investigator. Based on this information, a calendar will be maintained in MS Outlook, with reminders set for two weeks prior to the deadline. The director will receive a reminder from MS Outlook that a report is due and will immediately remind the principal investigator of the requirement.

Expected completion date: June 30, 2016

The two HUB reports were submitted out of sequence. That is, the 2016 HUB report was submitted in 2015 and the 2016 HUB report was submitted in 2015. Effective immediately, the preparer will be required to submit the HUB reports to the authorized signing official for the organization for an additional level of

	Finding 2015-001—Noncompliance Finding and Significant Deficiency—State CPRIT and R&D Cluster—Reporting	Questioned Cost
	review prior to submission to the agency. Completion date: March 31, 2016	
Status	We maintain a schedule of reports due for each federal and state award. The schedule includes the award number, type of report, responsible party, and deadline. The principal investigator is sent a Terms and Conditions document with those reporting deadlines at the time of award. An email reminder is sent to the responsible party at 30 days before the deadline and subsequent reminders are sent each week. The schedule is updated whenever any new or revised award is received by the organization. **D&T noted this finding occurred again with CPRIT in FY2016 (see Finding 2016-001) and has not yet been remedied.**	

	Finding 2015-002—Noncompliance Finding and Significant Deficiency—R&D Cluster and CPRIT—Payroll and Time and Effort Reporting	Questioned Cost
Grant Information	R&D Cluster (CFDA No. 93.837 (Direct Award and Pass-through University of Maryland, Baltimore, and Pass-through Stanford University), No. 93.846 (Pass-through Stanford University), No. 93.855 (Direct Award), No. 93.397 (Direct Award and Pass-through University of Texas Health Science Center at Houston), No. 93.865 (Pass-through Nano3D Biosciences, Inc.), No. 93.853 (Direct Award), No. 93.396 (Direct Award), and DE-AC02-05CH11231) and CPRIT grant	
Criteria	OMB A-122 Attachment B.8 requires that a confirmation of salaries is performed by a person with first-hand knowledge of the effort or the principal investigator or responsible official(s) using suitable means of verification that the work was performed.	
Condition/Context	Methodist requires that employees sign the time and effort certification reports. For the R&D Cluster payroll compliance testing, we noted several instances related to inaccurate reporting of time and effort reports. • Certified 0% Effort—Individuals had certified 0% on their time and effort reports, but payroll expenses were paid from grant funds when individuals did not have effort on the grant. Therefore, these expenses should be transferred from the grant and schedule of federal and state awards. Discussions should be held with the granting agencies to determine if these expenses should be reimbursed. • Salary Distribution not reallocated—Individuals certified their time and effort report incorrectly and matched their salary distribution rather than actual effort spent on the grant. In other instances, the salary distribution was not updated accurately and timely to adjust for salary expenses charged to the grant to ensure payroll does not exceed the amounts allowed under the grant. • Unsupported Salary—Individuals certified their time and effort report incorrectly resulting in salary expense in excess of effort.	None

For the CPRIT grant, we noted an instance where there was no evidence of the employee's review and signature on the time and effort certification.

R&D Cluster:

Description	**CFDA Number**	**Number of Samples Tested**	**Total in Population**	**Questioned Cost**
Certified 0% Effort	DE-AC02-05CH11231, 93.846, 93.855, 93.397, and 93.837	3 individuals (4 instances)	8 individuals 26 instances $17,126.52	$2,719.54
Salary Distribution not Reallocated	93.837, 93.865, 93.853, and 93.396	6 individuals (6 instances)	6 individuals 37 instances $15,579.80	$3,137.26
Unsupported Salary	93.396, 93.397, 93.837, and 93.846	3 individuals	29 individuals	$2,758.29

CPRIT:

Description	**# of Samples Tested**	**# of Total Population Tested**
Missing Signed Certified Time and Effort Report	1 individual	1 individual
Description	**Award Number**	**Questioned Costs**
Unsupported Salary	RP110532	$1,077.80

	Finding 2015-002—Noncompliance Finding and Significant Deficiency—R&D Cluster and CPRIT—Payroll and Time and Effort Reporting	Questioned Cost
Cause	Department Administrators and Office of Grants and Contracts did not monitor payroll expenses to ensure salary distribution was appropriately updated to reflect current level of effort percentages. Further, Methodist employees did not accurately complete the time and effort reports for the selected pay periods. As a result, the grant was overcharged for salaries. Methodist did not closely monitor both salary cap and effort reporting as management's payroll spreadsheet failed to detect the identified errors prior to the reimbursement of these expenses. Additionally, the payroll spreadsheet did not have the accurate salary cap amounts effective for 2015 and, therefore, some salary cap calculations were missed in the review process. As a result, the grant was overcharged for salaries for the selected individuals.	
Effect	Improper review and certification of time and effort forms could result in costs charged inappropriately to the grant.	
Recommendation	Management should ensure that all time and expense reports are signed and completed on a timely basis. Additionally, department administrators should prepare monthly salary allocation reconciliations to ensure that salaries are appropriately paid from the correct grant projects based on current effort. Management should review and perform checks to ensure that all projects and applicable key personnel are accurately reporting the correct salary distribution in the system. Additionally, management should provide additional training to all individuals certifying time and effort reports of the guidelines and importance of completing these reports accurately and timely.	
Corrective Action Plan of Management	Monitoring of effort report compliance will be performed monthly. Per our policy, reminders will go out at 30 days and 60 days to the department administrators reminding them of the requirement and provide a list of employees who have not certified their time. If at 90 days the effort is still not certified, the salary expense (and associated payroll tax and fringe benefits) will be moved to an unrestricted source.	

	Finding 2015-002—Noncompliance Finding and Significant Deficiency—R&D Cluster and CPRIT—Payroll and Time and Effort Reporting	Questioned Cost
	Completion date: April 30, 2016	
Status	Effort reports are reviewed each month by the Grants office. Individuals that have not certified receive an email each pay period that they have uncertified effort reports. If after 90 days, the effort has not been certified, that effort is removed from the grant to an unrestricted source of funds. Further, the Grants office reviews the certified effort reports to ensure that an adequate effort percentage was entered that supports the salary charge to the grant. If the salary expense exceeds the effort, the difference is transferred to an unrestricted source.	