

Texas Heart Institute

Consolidated Financial Statements
and Single Audit Reports
for the year ended December 31, 2018

Texas Heart Institute

Table of Contents

	Page
Independent Auditors' Report	1
Financial Statements:	
Consolidated Statement of Financial Position as of December 31, 2018	3
Consolidated Statement of Activities for the year ended December 31, 2018	4
Consolidated Statement of Functional Expenses for the year ended December 31, 2018	5
Consolidated Statement of Cash Flows for the year ended December 31, 2018	6
Notes to Consolidated Financial Statements for the year ended December 31, 2018	7
Supplementary Information:	
Schedule of Expenditures of Federal Awards for the year ended December 31, 2018	20
Note to Schedule of Expenditures of Federal Awards for the year ended December 31, 2018	22
Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>	23
Independent Auditors' Report on Compliance for Each Major Program and Report on Internal Control Over Compliance Required by the Uniform Guidance	25
Schedule of Findings and Questioned Costs for the year ended December 31, 2018	27
Corrective Action Plan	32

Independent Auditors' Report

To the Board of Trustees of
Texas Heart Institute:

Report on the Financial Statements

We have audited the accompanying financial statements of Texas Heart Institute, which comprise the consolidated statement of financial position as of December 31, 2018 and the related consolidated statements of activities, of functional expenses and of cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit 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 our audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' 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 Texas Heart Institute as of December 31, 2018 and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Restatement of Beginning Net Assets

As discussed in Note 2 to the financial statements, Texas Heart Institute restated net assets at December 31, 2017. Our opinion is not modified with respect to this matter.

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying supplementary information included in the schedule of expenditures of federal awards for the year ended December 31, 2018 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* is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Report Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated September 4, 2019 on our consideration of Texas Heart Institute'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 solely 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 the effectiveness of Texas Heart Institute's 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 Texas Heart Institute's internal control over financial reporting and compliance.

Blazek & Vetterling

September 4, 2019

Texas Heart Institute

Consolidated Statement of Financial Position as of December 31, 2018

ASSETS

Cash	\$ 6,027,987
Accounts receivable	1,420,163
Prepaid expenses and other assets	92,806
Operating contributions receivable, net (<i>Note 4</i>)	3,813,748
Investments (<i>Note 5</i>)	77,188,752
Beneficial interest in funds held by affiliates (<i>Notes 5 and 6</i>)	72,435,464
Contributions receivable restricted for endowment funds, net (<i>Note 4</i>)	1,173,439
Property and equipment, net (<i>Note 7</i>)	<u>25,007,375</u>
TOTAL ASSETS	<u>\$ 187,159,734</u>

LIABILITIES AND NET ASSETS

Liabilities:	
Accounts payable and accrued expenses	\$ 1,102,472
Payable to CHI St. Luke's Health System (<i>Note 6</i>)	1,209,788
Accrued payroll expenses	339,369
Deferred revenue	2,285,116
Pension obligations (<i>Note 8</i>)	<u>208,739</u>
Total liabilities	<u>5,145,484</u>
Commitments and contingencies (<i>Notes 12 and 14</i>)	
Net assets:	
Without donor restrictions	75,747,600
With donor restrictions (<i>Notes 10 and 11</i>)	<u>106,266,650</u>
Total net assets	<u>182,014,250</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 187,159,734</u>

See accompanying notes to consolidated financial statements.

Texas Heart Institute

Consolidated Statement of Activities for the year ended December 31, 2018

	WITHOUT DONOR <u>RESTRICTIONS</u>	WITH DONOR <u>RESTRICTIONS</u>	<u>TOTAL</u>
REVENUE:			
Contributions from affiliates (<i>Note 6</i>)	\$ 12,596,411		\$ 12,596,411
Other contributions	2,167,910	\$ 1,944,779	4,112,689
Research contracts and grants (<i>Note 12</i>)	1,807,865	4,387,849	6,195,714
Net investment income	(3,493,447)	(2,350,670)	(5,844,117)
Other income	<u>1,374,500</u>		<u>1,374,500</u>
Total revenue	14,453,239	3,981,958	18,435,197
Net assets released from restrictions:			
Program expenditures	11,183,762	(11,183,762)	
Expiration of time restrictions	<u>2,279,391</u>	<u>(2,279,391)</u>	
Total	<u>27,916,392</u>	<u>(9,481,195)</u>	<u>18,435,197</u>
EXPENSES:			
Program services:			
Cardiovascular research	21,481,957		21,481,957
Cardiovascular education	1,196,751		1,196,751
School of perfusion	<u>478,314</u>		<u>478,314</u>
Total program services	23,157,022		23,157,022
Management and general	8,662,136		8,662,136
Fundraising	<u>749,193</u>		<u>749,193</u>
Total expenses	<u>32,568,351</u>		<u>32,568,351</u>
CHANGES IN NET ASSETS BEFORE PENSION LIABILITY ADJUSTMENTS	(4,651,959)	(9,481,195)	(14,133,154)
Pension liability adjustments (<i>Note 8</i>)	<u>373,686</u>		<u>373,686</u>
CHANGES IN NET ASSETS	(4,278,273)	(9,481,195)	(13,759,468)
Net assets, beginning of year (<i>Note 2</i>)	<u>80,025,873</u>	<u>115,747,845</u>	<u>195,773,718</u>
Net assets, end of year	<u>\$ 75,747,600</u>	<u>\$ 106,266,650</u>	<u>\$ 182,014,250</u>

See accompanying notes to consolidated financial statements.

Texas Heart Institute

Consolidated Statement of Functional Expenses for the year ended December 31, 2018

	<u>PROGRAM SERVICES</u>	<u>MANAGEMENT AND GENERAL</u>	<u>FUNDRAISING</u>	<u>TOTAL</u>
Personnel	\$ 14,723,083	\$ 4,555,164	\$ 397,673	\$ 19,675,920
Facilities expense	2,139,175	1,807,937	40,693	3,987,805
Supplies	2,586,303	481,455	38,189	3,105,947
Purchased services	2,001,077	545,476	248,609	2,795,162
Depreciation	1,417,321	617,569	10,102	2,044,992
Professional costs	<u>290,063</u>	<u>654,535</u>	<u>13,927</u>	<u>958,525</u>
Total expenses	<u>\$ 23,157,022</u>	<u>\$ 8,662,136</u>	<u>\$ 749,193</u>	<u>\$ 32,568,351</u>

See accompanying notes to consolidated financial statements.

Texas Heart Institute

Consolidated Statement of Cash Flows for the year ended December 31, 2018

CASH FLOWS FROM OPERATING ACTIVITIES:

Changes in net assets	\$ (13,759,468)
Adjustments to reconcile changes in net assets to net cash provided by operating activities:	
Contributions restricted for endowment funds	(272,761)
Depreciation	2,044,992
Net realized and unrealized loss on investments	5,731,969
Change in value of beneficial interests in funds held by affiliates	1,615,306
Changes in operating assets and liabilities:	
Accounts receivable	1,608,056
Prepaid expenses and other assets	69,932
Operating contributions receivable	3,841,210
Accounts payable and accrued expenses	(135,182)
Payable to CHI St. Luke's Health System	592,360
Accrued payroll expenses	(120,312)
Deferred revenue	419,198
Pension obligations	<u>(85,848)</u>
Net cash provided by operating activities	<u>1,549,452</u>

CASH FLOWS FROM INVESTING ACTIVITIES:

Purchase of investments	(23,953,951)
Proceeds from sale of investments	22,209,771
Change in money market mutual funds held as investments	729,682
Purchase of property and equipment	<u>(220,900)</u>
Net cash used by investing activities	<u>(1,235,398)</u>

CASH FLOWS FROM FINANCING ACTIVITIES:

Proceeds from contributions restricted for endowment funds	<u>457,031</u>
NET CHANGE IN CASH	771,085
Cash, beginning of year	<u>5,256,902</u>
Cash, end of year	<u>\$ 6,027,987</u>

See accompanying notes to consolidated financial statements.

Texas Heart Institute

Notes to Consolidated Financial Statements for the year ended December 31, 2018

NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization – Texas Heart Institute (THI) is a Texas nonprofit organization founded by Dr. Denton A. Cooley in 1962 organized to reduce the devastating toll of cardiovascular disease through innovative programs in research, education, and improved patient care. Basic and clinical research is performed in all specialties of cardiovascular disease, including cardiology, cardiovascular surgery, anesthesiology, pathology, and cardiothoracic transplantation. Education involves the training of medical residents and fellows in cardiovascular specialties, as well as continuing education for medical doctors and educational information for the public.

Texas Heart Institute Foundation's (THI Foundation) mission is to help provide for the future financial needs of THI by encouraging financial support from individuals, organizations, and foundations. THI Foundation is a Texas nonprofit corporation.

Cardiopulmonary Perfusion Associates (CPPA) is a wholly-owned Texas nonprofit corporation. CPPA trains and grants post baccalaureate certificates of completion in the field of cardiopulmonary perfusion technology.

Basis of consolidation – These consolidated financial statements include the assets, liabilities, net assets and activities of THI, THI Foundation and CPPA (collectively the Institute). All significant intercompany balances and transactions have been eliminated in consolidation.

Federal income tax status – THI, THI Foundation, and CPPA are each exempt from federal income tax under §501(c)(3) of the Internal Revenue Code (the Code).

Cash – Bank deposits exceed the federally insured limit per depositor per institution.

Contributions receivable that are due within one year are reported at net realizable value. Contributions receivable that are expected to be collected in future years are discounted to estimate the present value of future cash flows.

Allowance for uncollectible accounts – An allowance for accounts receivable or contributions receivable is provided when it is believed accounts may not be collected in full. The Institute's policy is to write off receivables against the allowance when management determines the receivable will not be collected. The amount of bad debt expense or loss on valuation of contributions receivable recognized each period and the resulting adequacy of the allowance at the end of each period are determined using a combination of historical loss experience and analysis of individual balances each period. Management's estimates regarding the collectability of the balances could change in the near term resulting in a change in the carrying value of these receivables.

Investments in marketable securities are reported at fair value. Investments in private equity funds which do not have a readily determinable fair value are reported at cost or at estimated fair value if an other-than-temporary impairment has occurred. Net investment return consists of interest and dividends, realized and unrealized gains and losses, net of external and direct internal investment expenses.

Beneficial interest in funds held by affiliates are reported at the estimated fair value of the Institute's share of the fund assets. Changes in the fair value of beneficial interests are reported as net investment return in the consolidated statement of activities.

Property and equipment are reported at cost if purchased or at fair value at the date of gift if donated. The Institute capitalizes property and equipment that have a cost or fair value of \$5,000 or greater and an estimated useful life of more than one year. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, which range from 5 to 50 years.

Net asset classification – Net assets, revenue, gains, and losses are classified based on the existence or absence of donor-imposed restrictions, as follows:

- *Net assets without donor restrictions* are not subject to donor-imposed restrictions even though their use may be limited in other respects such as by contract or board designation.
- *Net assets with donor restrictions* are subject to donor-imposed restrictions. Restrictions may be temporary in nature, such as those that will be met by the passage of time or use for a purpose specified by the donor, or may be perpetual in nature, where the donor stipulates that resources be maintained in perpetuity. Net assets are released from restrictions when the stipulated time has elapsed, or purpose has been fulfilled, or both. Donor-restricted endowment earnings are released when those earnings are appropriated in accordance with spending policies and are used for the stipulated purpose.

Contributions are recognized as revenue at fair value when an unconditional commitment is received from the donor. Contributions received with donor stipulations that limit their use are classified as restricted support. Conditional contributions are recognized in the same manner when the conditions are substantially met.

Research contracts and grants are recognized as revenue when the related services are provided. Amounts received in advance are reported as deferred revenue.

Functional allocation of expenses – Expenses are reported by their functional classification as program services or supporting activities. Program services are the direct conduct or supervision of activities that fulfill the purposes for which the organization exists. Fundraising activities include the solicitation of contributions of money, securities, materials, facilities, other assets, and time. Management and general activities are not directly identifiable with specific program or fundraising activities. Expenses that are attributable to one or more program or supporting activities are allocated among the activities benefitted. Salaries and related costs are allocated on the basis of estimated time and effort expended. Depreciation and facility costs are allocated based on the number of employees in each department.

Estimates – Management must make estimates and assumptions to prepare financial statements in accordance with generally accepted accounting principles. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, the amounts reported as revenue and expenses, and the allocation of expenses among various functions. Actual results could vary from the estimates that were used.

Recent financial accounting pronouncements – In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, which replaces most existing revenue recognition guidance for exchange transactions not specifically covered by other guidance. This ASU does not apply to non-exchange transactions such as contributions. The core principle of the new guidance is that an entity should recognize revenue in an amount that reflects the consideration to which it expects to be entitled in exchange for transferred goods or services and establishes a 5-step process to determine when performance obligations are satisfied and revenue is recognized. The Institute is required to adopt this ASU for fiscal year 2019 using an appropriate retrospective method. Management expects the impact will be primarily additional disclosures.

In June 2018, the FASB issued ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. The amendments in this ASU clarify and improve current guidance about whether a transfer of assets (or the reduction, settlement, or cancellation of liabilities) is a contribution or an exchange transaction and provide additional guidance on determining whether a contribution is conditional or unconditional. This ASU could impact the timing of revenue recognition and the financial statement disclosures related to such transactions. The Institute is required apply the amendments in its fiscal year 2019 financial statements. The amendments should be applied on a modified prospective basis, but retrospective application also is permitted. Management anticipates the impact to be primarily additional disclosures.

NOTE 2 – ADOPTION OF ACCOUNTING STANDARDS UPDATE 2016-14 AND RESTATEMENT OF BEGINNING NET ASSETS

Adoption of Accounting Standards Update – The Institute adopted the amendments of ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, as of and for the year ended December 31, 2018. Adoption of this ASU had no impact on previously reported net assets as of December 31, 2017.

Restatement of Beginning Net Assets – As of January 1, 2018, the Institute recorded a prior period adjustment to recognize \$74,520,948 of beneficial interest in funds held by affiliates as *net assets with donor restrictions* resulting in a \$74,520,948 increase in total net assets and *net assets with donor restrictions*.

Additionally, the Institute discovered \$14,360,341 of unrestricted net assets had been misclassified as restricted net assets in its financial statements as of and for the year ended December 31, 2017. As of January 1, 2018, the Institute recorded a prior period adjustment to reclassify \$14,360,341 from *net assets with donor restrictions* to *net assets without donor restrictions*. There was no change in total net assets at December 31, 2017 as a result of the reclassification.

NOTE 3 – LIQUIDITY AND AVAILABILITY OF RESOURCES

Financial assets available for general expenditure, that is, without donor or other restrictions limiting their use, within one year of December 31, 2018 comprise the following:

Financial assets at December 31, 2018:	
Cash	\$ 6,027,987
Accounts receivable	1,420,163
Operating contributions receivable, net	3,813,748
Investments	77,188,752
Beneficial interest in funds held by affiliates	72,435,464
Contributions receivable restricted for endowment funds, net	<u>1,173,439</u>
Total financial assets	162,059,553
Less financial assets not available for general expenditure:	
Donor-restricted endowment funds	(24,000,585)
Donor-restricted funds not expected to be used within one year	(5,215,124)
Beneficial interest in funds held by affiliates	<u>(72,435,464)</u>
Total financial assets available for general expenditure	<u>\$ 60,408,380</u>

For purposes of analyzing resources available to meet general expenditures over a 12-month period, the Institute considers all expenditures related to its ongoing activities of research, education and improvement of patient services programs, as well as the conduct of services undertaken to support these activities, to be general expenditures.

As part of the Institute’s liquidity management, financial assets have been structured to be available as its general expenditures, liabilities, and other obligations become due by maintaining a significant portion of its assets in cash and investments.

NOTE 4 – CONTRIBUTIONS RECEIVABLE

Contributions receivable at December 31, 2018 are as follows:

Contributions receivable	\$ 5,058,304
Discount to net present value at 1.05% to 1.77%	<u>(71,117)</u>
Contributions receivable, net	4,987,187
Operating contributions receivable, net	<u>(3,813,748)</u>
Contributions receivable restricted for endowment funds, net	<u>\$ 1,173,439</u>

Contributions receivable at December 31, 2018 are expected to be collected as follows:

2019	\$ 3,000,804
2020	1,235,000
2021	<u>822,500</u>
Total contributions receivable	<u>\$ 5,058,304</u>

At December 31, 2018, approximately 96% of contributions receivable is due from five donors. During 2018, contributions from two donors comprised 43% of total other contributions.

NOTE 5 – INVESTMENTS AND FAIR VALUE MEASUREMENTS

Generally accepted accounting principles require that certain assets and liabilities be reported at fair value and establish a hierarchy that prioritizes inputs used to measure fair value. Fair value is 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. The three levels of the fair value hierarchy are as follows:

- *Level 1* – Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the reporting date.
- *Level 2* – Inputs are other than quoted prices included in Level 1, which are either directly observable or can be derived from or corroborated by observable market data at the reporting date.
- *Level 3* – Inputs are not observable and are based on the reporting entity’s assumptions about the inputs market participants would use in pricing the asset or liability.

Assets measured at fair value at December 31, 2018 are as follows:

	<u>LEVEL 1</u>	<u>LEVEL 2</u>	<u>LEVEL 3</u>	<u>TOTAL</u>
Equity securities:				
Information technology	\$ 8,051,934			\$ 8,051,934
Financials	6,825,192			6,825,192
Health care	4,661,551			4,661,551
Energy	3,230,062			3,230,062
Industrials	3,168,519			3,168,519
Consumer staples	2,940,355			2,940,355
Consumer defensive	2,515,358			2,515,358
Communication services	2,201,358			2,201,358
Consumer discretionary	2,096,579			2,096,579
Consumer cyclical	2,084,619			2,084,619
Materials	1,474,250			1,474,250
Utilities	269,910			269,910
Real estate	163,514			163,514
Exchange-traded funds:				
Large-cap	3,988,353			3,988,353
International large-cap	3,836,525			3,836,525
Mid-cap	3,796,486			3,796,486
Small-cap	877,045			877,045
Corporate bonds:				
Domestic		\$ 6,137,160		6,137,160
International		935,432		935,432
Equity mutual funds:				
Market neutral	1,793,201			1,793,201
Commodities	1,618,695			1,618,695
Long/short	1,601,190			1,601,190
Nontraditional bonds	970,303			970,303
Diversified emerging markets	811,311			811,311
Managed futures	490,523			490,523
Government agency securities		3,319,679		3,319,679
Money market mutual funds	1,722,363			1,722,363
U. S. Treasury notes	<u>607,285</u>			<u>607,285</u>
Total investments	61,796,481	10,392,271		72,188,752
Beneficial interest in funds held by affiliates			<u>\$ 72,435,464</u>	<u>72,435,464</u>
Total assets measured at fair value	<u>\$ 61,796,481</u>	<u>\$ 10,392,271</u>	<u>\$ 72,435,464</u>	<u>\$ 144,624,216</u>

Valuation methods used for assets measured at fair value are as follows:

- *Equity securities* and *exchange-traded funds* are valued at the closing price reported on the active market on which the individual securities are traded.
- *Corporate bonds* and *government agency securities* are valued using prices obtained from independent quotation bureaus that use computerized valuation formulas to calculate fair values.
- *Mutual funds* are valued at the daily closing price as reported by the fund.

- *U. S. Treasury notes* are valued using prices obtained from active market maker and inter-dealer brokers on a daily basis.
- *Beneficial interest in funds held by affiliates* are valued based on the Institute’s percentage ownership in the fair value of the underlying assets of the funds managed by the affiliates.

These valuation methods may produce a fair value that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Institute believes its valuation methods are appropriate, the use of different methods or assumptions could result in a different fair value measurement at the reporting date.

Changes in the fair value of Level 3 assets consist of the following:

	BENEFICIAL INTEREST IN FUNDS HELD BY AFFILIATES
Balance at January 1, 2018	\$ 74,520,948
Change in value of beneficial interest in funds held by affiliates	<u>(2,085,484)</u>
Balance at December 31, 2018	<u>\$ 72,435,464</u>

Investments are exposed to various risks such as interest rate, market, and credit risks. Because of these risks, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated statement of financial position and consolidated statement of activities.

Other investments consist of the Institute’s \$5 million private equity investment in 666,667 shares of Series B preferred stock of Miromatrix Medical, Inc. (Miromatrix) purchased in May 2014 (see Note 14).

NOTE 6 – TRANSACTIONS WITH CATHOLIC HEALTH INITIATIVES AND CHI ST. LUKE’S HEALTH – BAYLOR ST. LUKE’S MEDICAL CENTER

Conditional Contribution – The Institute entered into a Mission Support Agreement, effective December 2013, with Catholic Health Initiatives (CHI), a Colorado nonprofit corporation. CHI is a Catholic health care system dedicated to transforming health care delivery and building healthier communities and is the sole corporate member of St. Luke’s Health System Corporation, a Texas nonprofit corporation (SLHS), which comprises an expansive healthcare network throughout the Houston-Baytown-Huntsville, Texas area that includes CHI St. Luke’s Health – Baylor St. Luke’s Medical Center (SLMC). The purpose of this agreement is to collaborate for the purpose of furthering the development and success of the Institute’s mission to reduce the devastating toll of cardiovascular disease through innovative programs in research, education, and improved patient care, and CHI’s commitment to improving the health of the people in communities it serves. The agreement governs the financial support provided by CHI to the Institute.

At December 31, 2018, the Institute has a \$90 million conditional contribution from CHI for financial support. The contributions are contingent upon the Institute meeting certain financial and operational objectives, recruiting research staff, and purchasing research equipment. Annual support of \$12 million may be recognized through fiscal year 2023 as contribution revenue each year if the conditions are substantially met. An additional \$30 million may be recognized as research staff are recruited, equipment is purchased and research programs are operationalized.

Beneficial Interest in Funds Held by Affiliates – In 2006, SLHS received \$10 million from a foundation for the support and benefit of the Institute. These funds are held and invested by SLHS and the income from the investment portfolio is distributed by SLHS annually. In the event the investment portfolio yield does not permit a minimum distribution of 4% on an annualized basis, the corpus of the gift is to be invaded to permit this minimum distribution to the Institute. In fiscal year 2018, the change in beneficial interest of \$470,178 is reported in net investment income and a distribution of approximately \$470,178 was received from SLHS. At December 31, 2018, the fair value of these funds held by SLHS is \$10 million and is included in beneficial interest in funds held by affiliates.

In 2013, the Institute received a \$50 million contribution from a foundation, which is held by CHI and is to be deployed for the support and benefit of the Institute. These funds are expected to be disbursed and used over the term of the affiliation agreement with CHI. At December 31, 2018, the fair value of these funds held by CHI is \$62,435,464 and is included in beneficial interest in funds held by affiliates and the change in beneficial interest of \$2,085,484 is reported in net investment income.

Other Transactions with Affiliates – The Institute and SLMC jointly own the Denton A. Cooley Building, an approximately 310,000 square foot cardiovascular center. The Institute occupies approximately 43% of the building. SLMC pays facility operations expenses on behalf of the Institute and the Institute reimburses SLMC quarterly for expenses paid on its behalf. At December 31, 2018, \$1,209,788 is payable to SLMC for expenses paid on behalf of the Institute.

The Institute leases space from SLMC for the purposes of furthering its mission. The lease agreement expired on December 31, 2018. Rent expense was \$890,330 in 2018.

NOTE 7 – PROPERTY AND EQUIPMENT

Property and equipment at December 31, 2018 consists of the following:

Building	\$ 46,155,436
Furniture and equipment	16,390,556
Leasehold improvements	425,096
Software	351,877
Artwork	<u>89,840</u>
Total property and equipment, at cost	63,412,805
Accumulated depreciation	<u>(38,405,430)</u>
Property and equipment, net	<u>\$ 25,007,375</u>

NOTE 8 – PENSION PLAN

The Institute's retirement plan (the Plan) is a noncontributory cash balance defined benefit pension plan covering substantially all employees of the Institute. The Institute makes annual contributions to the Plan to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974. The Plan obtained its latest determination letter on October 13, 2011, in which the Internal Revenue Service (IRS) stated that the Plan and related trust, as then designed, were in compliance with the applicable requirements of the Code and, therefore, exempt from taxation. Effective September 30, 2012, the Plan was amended to freeze the grandfathered benefit accrual formula. However, Plan management believes that the Plan and related trust are currently designed and being operated in compliance with the applicable requirements of the Code.

The assets of the Plan are not segregated for plan valuation or payment of benefits and should not be construed as being segregated among the subsidiaries. The accounting and valuation for the Plan are determined by prescribed accounting and actuarial methods that consider a number of assumptions and estimates. The selection of appropriate assumptions and estimates is significant due to the long-term period over which benefits will be considered. The most sensitive assumptions in using actuarial methods to value the Institute's pension obligations and determine the related expense amounts are discount rates, expected long-term investment returns on Plan assets and future salary increases. Additionally, other assumptions made with respect to retirement ages, mortality and employee turnover affect the valuations. Actual results and future changes in these assumptions could result in future costs significantly different than those recorded in the results of operations.

The following table sets forth the Plan's funded status, factors assumed, and amounts as of the measurement date of December 31, 2018. These amounts materially agree with the amounts recognized in the accompanying consolidated financial statements as follows:

Changes in projected benefit obligation:	
Projected benefit obligation, beginning of year	\$ 11,167,602
Service cost	58,000
Interest cost on projected benefit obligation	356,890
Actuarial gain	(619,674)
Benefits paid from Plan assets	(284,465)
Administrative expenses paid	(41,191)
Plan settlements	<u>(1,944,165)</u>
Projected benefit obligation, end of year	<u>8,692,997</u>
Change in Plan assets:	
Fair value of Plan assets, beginning of year	10,873,015
Actual return of Plan assets	(468,936)
Employer contributions	350,000
Benefits paid	(284,465)
Administrative expenses paid	(41,191)
Plan settlements	<u>(1,944,165)</u>
Fair value of Plan assets, end of year	<u>8,484,258</u>
Unfunded status	<u>\$ 208,739</u>
Amounts recognized in the consolidated statement of financial position:	
Pension obligation	<u>\$ (208,739)</u>
Amounts recognized in the consolidated statement of activities:	
Pension costs included in personnel expenses	<u>\$ 637,838</u>
Components of net periodic benefit cost:	
Service cost	\$ 58,000
Interest cost on projected benefit obligation	356,890
Expected return on Plan assets	(417,788)
Recognized net actuarial loss	52,046
Settlement loss	<u>588,690</u>
Net periodic benefit cost	<u>\$ 637,838</u>

The estimated net loss that will be amortized from net assets into net periodic benefit cost over the next fiscal year will be based on the average expected future service of Plan participants. There is no estimated prior service credit that will be amortized from net assets into net periodic benefit cost over the next fiscal year.

Other changes in Plan assets and benefit obligations recognized as changes in *net assets without donor restrictions*:

Net loss arising during the year	\$ 267,050
Amortization of net actuarial gain	<u>(640,736)</u>

Other changes in Plan assets and benefit obligations \$ (373,686)

Weighted-average assumptions used to determine benefit obligations for the Plan measurement date:

Discount rate	4.31%
Rate of compensation return	N/A

Weighted-average assumptions used to determine net periodic benefit cost for the Plan measurement date:

Discount rate	3.62%
Expected return on Plan assets	4.35%
Rate of compensation return	N/A

The Plan's expected return on assets is derived from a review of the Plan's asset allocation strategy, anticipated long-term performance of individual asset classes, risks and correlations of asset classes, and general economic conditions of the investment marketplace.

The assets of the Plan by weighted-average asset allocation categories are as set forth in the following table:

Asset category:

Mutual funds	11%
Common collective trusts	<u>89%</u>

Total 100%

The Plan's general investment objective is to achieve attractive long-term total return from income and growth of capital over a full market cycle, with a low to moderate level of risk, through investments in a well-diversified portfolio of equity, fixed-income, and short-term liquid securities.

Plan assets measured at fair value at December 31, 2018 are as follows:

	<u>LEVEL 1</u>	<u>LEVEL 2</u>	<u>LEVEL 3</u>	<u>TOTAL</u>
Equity mutual funds:				
High yield bond	\$ 349,047			\$ 349,047
Global real estate	176,738			176,738
Infrastructure	159,299			159,299
Commodities	130,191			130,191
Large value exchange-traded funds	<u>134,893</u>			<u>134,893</u>
Total assets measured at fair value	<u>\$ 950,168</u>	<u>\$ 0</u>	<u>\$ 0</u>	950,168

Plan assets measured at net asset value as practical expedient:

Collective trust funds (a)	<u>7,534,090</u>
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Total Plan assets measured at fair value \$ 8,484,258

- (a) The collective trust funds have no redemption restrictions; however, should the Plan initiate a full redemption of the collective trust funds, the investment advisor reserves the right to temporarily delay withdrawal from the funds. There were no unfunded commitments at December 31, 2018.

Valuation methods used for Plan assets measured at fair value are as follows.

- *Mutual funds* are valued at the daily closing price as reported by the fund.
- *Exchange-traded funds* are valued at the closing price reported on the active market on which the individual securities are traded.
- *Collective trust funds* are valued at net asset value (NAV) of the shares held by the Plan. The NAV is used as a practical expedient to estimate fair value. The NAV is based on the fair value of the underlying investments held by the fund, less liabilities.

These valuation methods may produce a fair value that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Plan believes its valuation methods are appropriate, the use of different methods or assumptions could result in a different fair value measurement at the reporting date.

Investments are exposed to various risks such as interest rate, market, and credit risks. Because of these risks, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated statement of financial position and consolidated statement of activities.

The Institute expects to contribute \$150,000 to the Plan in fiscal year 2019.

The following benefit payments, which reflect expected future service as appropriate, are expected to be paid as follows:

2019	\$1,246,528
2020	\$895,743
2021	\$714,134
2022	\$815,280
2023	\$1,094,374
2024 to 2028	\$2,521,405

NOTE 9 – RETIREMENT PLAN

The Institute has a tax-sheltered annuity plan (the TSA Plan) established under §403(b) of the Code. Under the terms of the TSA Plan, the Institute matches 50% of employees' contributions for amounts contributed by employees up to a maximum of 3% of employees' wages. Employees are fully vested in their own contributions and become 100% vested in the employer's matching contributions after completing three years of service. Vested service is based on 1,000 hours or more of paid service during each year. The Institute contributed to the TSA Plan approximately \$416,000 in 2018.

NOTE 10 – NET ASSETS WITH DONOR RESTRICTIONS

Net assets with donor restrictions at December 31, 2018 are restricted as follows:

Subject to expenditure for specified purpose:

Cardiovascular excellence, research, prevention services and education	\$ 62,435,464
O’Quinn James T. Willerson Chair	5,000,000
O’Quinn O. H. Frazier Chair	5,000,000
Center for Women’s Heart and Vascular	4,521,534
Denton A. Cooley Building operating costs	1,154,385
Regenerative cardiovascular research	1,000,000
Stem cell research	421,958
Health care	310,068
Other	<u>839,144</u>

Total subject to expenditure for specified purpose 80,682,553

Subject to passage of time:

Contributions receivable that are not otherwise restricted by donors but which are unavailable for expenditures until due	<u>1,583,512</u>
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Total subject to passage of time 1,583,512

Endowments:

Subject to spending policy and appropriation:

General endowment funds	4,852,456
Stem cell research	7,895,325
Artificial heart research and development	4,923,371
Huffington Foundation Bicentennial Endowment Fund	2,486,790
Cardiovascular surgical research with a focus on children	2,821,075
Cardiology research	697,639
Annual cardio symposium	<u>323,929</u>

Total endowments 24,000,585

Total net assets with donor restrictions \$ 106,266,650

NOTE 11 – ENDOWMENT FUNDS

THI Foundation has donor-restricted endowment funds to support operations which are maintained in accordance with explicit donor stipulations. The Board of Trustees of THI Foundation has interpreted the Texas Uniform Prudent Management of Institutional Funds Act (TUPMIFA) 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, THI Foundation classifies the original value of gifts donated to the perpetual endowment as *net assets with donor restrictions* required to be maintained in perpetuity. The remaining portion of the donor-restricted endowment fund is classified as *net assets with donor restrictions* accumulated net investment return until those amounts are appropriated for expenditure by THI Foundation in a manner consistent with the standard of prudence prescribed by TUPMIFA. In accordance with TUPMIFA, THI Foundation considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- The duration and preservation of the funds
- The purpose of the Institute and the donor-restricted endowment funds

- General economic conditions
- The possible effect of inflation and deflation
- The expected total return from income and the appreciation of investments
- Other resources of the Institute
- The investment policies of the Institute

Investment Objectives and Spending Policy

THI Foundation has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowments while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that THI Foundation must hold in perpetuity or for a donor-specified period.

To satisfy its long-term objectives, THI Foundation targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term objectives within prudent risk constraints. The investment policy allows for approximately 70% of endowment investments to be invested in equities with the balance invested in fixed-income securities.

Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or TUPMIFA requires THI Foundation to retain as a fund of perpetual duration. There are no such deficiencies at December 31, 2018.

Changes in the donor-restricted endowment fund are as follows:

	<u>WITH DONOR RESTRICTIONS</u>		<u>TOTAL</u>
	<u>ACCUMULATED NET INVESTMENT RETURN</u>	<u>REQUIRED TO BE MAINTAINED IN PERPETUITY</u>	
Endowment net assets, December 31, 2017	\$ 7,662,293	\$ 18,111,014	\$ 25,773,307
Contributions		272,761	272,761
Net investment return	(646,791)	(88,573)	(735,364)
Distributions	<u>(1,310,119)</u>		<u>(1,310,119)</u>
Endowment net assets, December 31, 2018	<u>\$ 5,705,383</u>	<u>\$ 18,295,202</u>	<u>\$ 24,000,585</u>

Endowment net asset composition as of December 31, 2018:

Donor-restricted endowment funds:

Original donor-restricted gift and amounts required to be maintained in perpetuity	\$ 18,295,202
Accumulated net investment return	<u>5,705,383</u>
Endowment net assets	<u>\$ 24,000,585</u>

NOTE 12 – RESEARCH CONTRACTS AND GRANTS

Revenue from research contracts and grants at December 31, 2018 includes the following:

Federal government contracts and grants:	
U. S. Department of Health and Human Services	\$ 1,651,603
National Aeronautics and Space Administration	567,331
U. S. Department of the Interior	<u>52,104</u>
Total federal government contracts and grants	<u>2,271,038</u>
State government contracts and grants:	
State of Texas General Appropriations Act	1,665,253
Other	<u>451,558</u>
Total federal government contracts and grants	<u>2,116,811</u>
Private research contracts and grants	<u>1,807,865</u>
Total research contracts and grants	<u>\$ 6,195,714</u>

The Institute receives grants from federal and state government funding sources that require fulfillment of certain conditions as set forth in the related contracts and are subject to review and audit by the awarding agencies. Such reviews and audits could result in the discovery of unallowable activities and unallowable costs. Consequently, any of the funding sources may, at their discretion, request reimbursement for expenses or return of funds as a result of non-compliance by the Institute with the terms of the contracts. Management believes such disallowances, if any, would not be material to the Institute's financial position or changes in net assets.

NOTE 13 – RELATED PARTY TRANSACTIONS

A trustee of the Institute is a partner in a law firm that provides legal services to the Institute. Fees paid by the Institute to this firm totaled approximately \$392,000 in 2018.

NOTE 14 – COMMITMENTS

Miromatrix Medical, Inc. Preferred Stock

Pursuant to a Sub-License agreement effective October 1, 2013, between Miromatrix and the Institute, both parties agreed to sub-license certain patents and patent applications, as described in the agreement. Under terms of the Sub-License agreement, Miromatrix shall pay to the Institute a royalty of 5% of the net sales price from commercial sales of products by Miromatrix or its affiliates, while the Institute shall pay to Miromatrix a royalty of 10% of the net sales price from commercial sales of products by the Institute or its affiliates or sub-licensees. No amounts were received or paid under this Sub-License agreement in fiscal year 2018.

NOTE 15 – SUBSEQUENT EVENTS

Management has evaluated subsequent events through September 4, 2019, which is the date that the financial statements were available for issuance. As a result of this evaluation, no events were identified that are required to be disclosed or would have a material impact on reported net assets or changes in net assets.

Texas Heart Institute

Schedule of Expenditures of Federal Awards for the year ended December 31, 2018

<u>GRANTOR</u>							
<u>Pass-through Grantor</u>			<u>Contract Number</u>		<u>Award</u>	<u>Federal</u>	
<u>Program Title & Period</u>	<u>CFDA #</u>		<u>or Pass-through</u>	<u>Grantor Number</u>	<u>Amount</u>	<u>Expenditures</u>	
						<u>Subrecipient</u>	
						<u>Expenditures</u>	
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION							
Direct:							
Space Operations							
Vascular Health in Space							
#1	11/01/14 – 12/31/19	43.007		NNX14AB55G	\$750,000	\$ 567,331	
						\$ 521,764	
Total National Aeronautics and Space Administration						<u>567,331</u>	<u>521,764</u>
U. S. DEPARTMENT OF HEALTH AND HUMAN SERVICES							
Direct:							
Cardiovascular Diseases Research:							
Cardiovascular Cell Therapy							
#2	03/01/17 – 02/28/18	93.837		5UM1HL087365-11	\$675,419	78,771	
#3	03/01/17 – 02/28/19	93.837		5UM1HL087365-12	\$669,043	384,116	
Hippo and WNT Signaling in Cardiac Regeneration							
#4	01/01/18 – 12/31/18	93.837		5R01HL127717-03	\$499,306	499,006	
Magnetic Levitation to Improve Hemocompatibility of a Percutaneous LVAD (MicroVasc) for Early Intervention							
#5	09/24/18 – 08/31/19	93.837		1R56HL143489-01	\$601,380	33,975	
Passed through University of Texas Health Science Center at Houston:							
Cardiovascular Diseases Research:							
Cardiovascular Cell Therapy							
#6	03/01/17 – 02/28/18	93.837		0011624F	\$89,991	17,918	
#7	03/01/18 – 02/28/19	93.837		0011624F	\$108,525	74,295	
Data Coordinating Center for the Cardiovascular Cell Therapy Research Network							
#8	03/01/17 – 02/28/18 and 03/01/18 – 02/28/19	93.837		0011624J-14 and 011624J-15	N/A	117,085	
Passed through BIVACOR:							
Cardiovascular Diseases Research							
BIVACOR Rotary Total Artificial Heart							
#9	09/01/18 – 08/31/19	93.837		1R44HL137454-01A1	\$499,202	95,776	

(continued)

Texas Heart Institute

Schedule of Expenditures of Federal Awards for the year ended December 31, 2018 *(continued)*

<u>GRANTOR</u>			<u>Contract Number</u>			
<u>Pass-through Grantor</u>			<u>or Pass-through</u>	<u>Award</u>	<u>Federal</u>	<u>Subrecipient</u>
<u>Program Title & Period</u>	<u>CFDA #</u>		<u>Grantor Number</u>	<u>Amount</u>	<u>Expenditures</u>	<u>Expenditures</u>

U. S. DEPARTMENT OF HEALTH AND HUMAN SERVICES *(continued)*

Passed through Baylor College of Medicine:

	Cardiovascular Diseases Research					
#10	08/01/18 – 07/31/19	93.837	T32-HL00676-27-28	\$64,642		31,449

Passed through Icahn School of Medicine Mount Sinai:

	Cardiovascular Diseases Research					
	Network for Cardiothoracic Surgical Investigations in Cardiovascular Medicine					
#11	04/01/17 – 03/31/18	93.837	0255-3100-4609	\$78,911	<u>5,365</u>	

Total 93.837					<u>1,337,756</u>	
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Passed through 7 Hills Pharma, LLC:

	Cancer Treatment Research					
	Development of a Small Molecule Activator of Integrin Cell Adhesion to Enhance Therapeutic Responses to Checkpoint Blockade in Cancer					
#12	04/09/18 – 03/31/19	93.395	2R41CA203456-THI	\$185,962	<u>97,992</u>	

Total U. S. Department of Health and Human Services					<u>1,435,748</u>	
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TOTAL FEDERAL AWARDS					<u>\$ 2,003,079</u>	<u>\$ 521,764</u>
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Research and Development Cluster:

93.837	Cardiovascular Diseases Research					\$ 1,337,756
43.007	Space Operations					567,331
93.395	Cancer Treatment Research					<u>97,992</u>

Total Research and Development Cluster						<u>\$ 2,003,079</u>
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See accompanying note to schedule of expenditures of federal awards.

Texas Heart Institute

Note to Schedule of Expenditures of Federal Awards for the year ended December 31, 2018

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation – The schedule of expenditures of federal awards is prepared 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 (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Federal expenditures include allowable costs funded by federal grants. Allowable costs are subject to the cost principles of the Uniform Guidance and include both costs that are capitalized and costs that are recognized as expenses in the Institute’s financial statements in conformity with generally accepted accounting principles. The Institute does not utilize the 10% de minimus indirect rate, but uses a rate equal to or less than the indirect rate approved by the U. S. Department of Health and Human Services.

Because the schedule presents only a selected portion of the operations of the Institute, it is not intended to and does not present the financial position, changes in net assets, or cash flows of the Institute.

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

To the Board of Trustees of
Texas Heart Institute:

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 financial statements of Texas Heart Institute (THI), which comprise the consolidated statement of financial position as of December 31, 2018 and the related consolidated statements of activities, of functional expenses, and of cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated September 4, 2019.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered THI's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of THI's internal control. Accordingly, we do not express an opinion on the effectiveness of THI'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 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 and therefore, material weaknesses or significant deficiencies may exist that have not been identified. We did identify certain deficiencies in internal control, described in the accompanying schedule of findings and questioned costs as findings #2018-001 and #2018-002 that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether THI's 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*.

Institute's Responses to Findings

THI's responses to the findings identified in our audit are described in the accompanying Corrective Action Plan. THI's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the 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.

Blazek & Vetterling

September 4, 2019

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

To the Board of Trustees of
Texas Heart Institute:

Report on Compliance for Each Major Federal Program

We have audited Texas Heart Institute's (THI) compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on each of THI's major federal programs for the year ended December 31, 2018. THI's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of 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 THI'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 THI'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 THI's compliance.

Opinion on Each Major Federal Program

In our opinion, THI 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, 2018.

Other Matters

The results of our auditing procedures disclosed instances of noncompliance, which are required to be reported in accordance with the Uniform Guidance and which are described in the accompanying

schedule of findings and questioned costs as findings #2018-004 and #2018-005. Our opinion on each major federal program is not modified in respect to these matters.

THI's responses to the noncompliance findings identified in our audit are described in the accompanying Corrective Action Plan. THI's responses were not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the responses.

Report on Internal Control Over Compliance

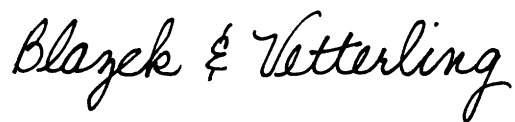
Management of THI is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered THI's internal control over compliance with the types of requirements 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 THI'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 a 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 have not been identified. We identified certain deficiencies in internal control over compliance, described in the accompanying schedule of findings and questioned costs as findings #2018-003 through #2018-005, that we consider to be material weaknesses.

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

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.



September 4, 2019

Section II – Financial Statement Findings

Finding #2018-001 – Material Weakness

Criteria: Management is responsible for establishing and maintaining an effective system of internal control to ensure proper segregation of duties are maintained over disbursement processes so that authorization, recording, custody of and access to assets, and supervisory reviews be assigned to different individuals.

Condition and context: There is a lack of segregation of duties over vendor and payroll disbursements. The Controller has access to check stock, has the ability to print checks, and posts transactions to the general ledger. Additionally, the Controller has the ability to prepare and record journal entries into the general ledger and there is no independent review of his journal entries. The Senior Accountant prepares the bank reconciliation, but does not review the images of the cancelled checks. The Human Resources Manager approves payroll for processing, but the final payroll registers and change reports are not reviewed by the Controller or Chief Administrative Officer.

Effect: A lack of effective internal control over transactions processed and journal entries posted could result in unauthorized disbursements due to fraud or error.

Recommendation: Implement segregation of duties over vendor payments, where possible. Where segregation is not possible, supplement the prevention control of segregated duties by detection controls such as formalized independent supervisory reviews. Implement policies and procedures for the Controller or Chief Administrative Officer to perform a formal review of the final payroll register and the change report and independent review of journal entries.

Views of responsible officials and planned corrective actions: Management agrees with the finding. See Correction Action Plan.

Finding #2018-002 – Material Weakness

Criteria: Management of THI is responsible for establishing and maintaining an effective system of internal control to ensure that contributions are recorded in a timely manner, are posted to the correct period, and restricted purpose and underlying net asset records are maintained.

Condition and context: THI's net asset subledger did not reconcile to its audited fiscal year 2017 financial statements. Additionally, during our testing of contributions and net assets, we identified the following errors:

- The prior year *net assets with donor restrictions* were overstated \$14.4 million and *net assets without donor restrictions* were understated by approximately \$14.4 million as releases were reported incorrectly.
- Beneficial interests of \$72 million in funds held by an affiliate were not reported in THI's financial statements.
- During our testing of 17 contributions, we noted two instances where the remaining amounts due from bequests were not recorded as bequests receivable.

Effect: A lack of effective internal controls over contributions and net assets could result in errors in amounts reported as contributions, misappropriation of funds, contributions being recorded in the wrong fiscal period, and restrictions on contributions not being tracked correctly.

Recommendation: Implement policies and procedures to properly record the estimated amount of total funds expected to be received from bequests and reconcile net asset subledgers to amounts reported in the financial statements.

Views of responsible officials and planned corrective actions: Management agrees with the finding. See Correction Action Plan.

Section III – Federal Award Findings and Questioned Costs

Finding #2018-003 – Material Weakness

Applicable federal programs:

National Aeronautics and Space Administration

CFDA #43.007	Space Operations	NNX14AB55G	11/01/14 – 12/31/19
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U. S. Department of Health and Human Services

CFDA #93.837	Cardiovascular Diseases Research	5UM1HL087365-11	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	5UM1HL087365-12	03/01/17 – 02/28/19
CFDA #93.837	Cardiovascular Diseases Research	5R01HL127717-03	01/01/18 – 12/31/18
CFDA #93.837	Cardiovascular Diseases Research	1R56HL143489-01	09/24/18 – 08/31/19

Passed through University of Texas Health Science Center at Houston:

CFDA #93.837	Cardiovascular Diseases Research	0011624F	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	0011624F	03/01/18 – 02/28/19
CFDA #93.837	Cardiovascular Diseases Research	0011624J-14	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	011624J-15	03/01/18 – 02/28/19

Passed through BIVACOR:

CFDA #93.837	Cardiovascular Diseases Research	1R44HL137454-01A1	09/01/18 – 08/31/19
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Passed through Baylor College of Medicine:

CFDA #93.837	Cardiovascular Diseases Research	T32-HL00676-27-28	08/01/18 – 07/31/19
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Passed through Icahn School of Medicine Mount Sinai:

CFDA #93.837	Cardiovascular Diseases Research	0255-3100-4609	04/01/17 – 03/31/18
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Passed through 7 Hills Pharma, LLC:

CFDA #93.395	Cancer Treatment Research	2R41CA203456-THI	04/09/18 – 03/31/19
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Criteria: Same as finding #2018-001

Condition and context: Same as finding #2018-001

Cause: The finding occurred as a result of THI having a limited number of administrative staff and not implementing compensating controls.

Effect: Same as finding #2018-001

Recommendation: Same as finding #2018-001

Views of responsible officials and planned corrective actions: Management agrees with the finding. See Correction Action Plan.

Finding #2018-004 – Material Weakness and Other Non-Compliance

Applicable federal programs:

National Aeronautics and Space Administration

CFDA #43.007	Space Operations	NNX14AB55G	11/01/14 – 12/31/19
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U. S. Department of Health and Human Services

CFDA #93.837	Cardiovascular Diseases Research	5UM1HL087365-11	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	5UM1HL087365-12	03/01/17 – 02/28/19
CFDA #93.837	Cardiovascular Diseases Research	5R01HL127717-03	01/01/18 – 12/31/18
CFDA #93.837	Cardiovascular Diseases Research	1R56HL143489-01	09/24/18 – 08/31/19

Passed through University of Texas Health Science Center at Houston:

CFDA #93.837	Cardiovascular Diseases Research	0011624F	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	0011624F	03/01/18 – 02/28/19
CFDA #93.837	Cardiovascular Diseases Research	0011624J-14	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	011624J-15	03/01/18 – 02/28/19

Passed through BIVACOR:

CFDA #93.837	Cardiovascular Diseases Research	1R44HL137454-01A1	09/01/18 – 08/31/19
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Passed through Baylor College of Medicine:

CFDA #93.837	Cardiovascular Diseases Research	T32-HL00676-27-28	08/01/18 – 07/31/19
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Passed through Icahn School of Medicine Mount Sinai:

CFDA #93.837	Cardiovascular Diseases Research	0255-3100-4609	04/01/17 – 03/31/18
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Passed through 7 Hills Pharma, LLC:

CFDA #93.395	Cancer Treatment Research	2R41CA203456-THI	04/09/18 – 03/31/19
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Criteria: Procurement – The Uniform Guidance §200.318 requires that THI maintain records sufficient to document procurement decisions. The records must include the rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis for the contract price.

Condition and context: During our testing of federal expenditures, we noted a lack of documentation for procurement decisions for supplies which is required to be procured in accordance with the Uniform Guidance and THI's policies and procedures. All three vendors selected for testing had no documentation of procurement.

Cause: THI has not recently performed procurement procedures for supplies and relied upon prior year procurement decisions.

Effect: Failure to perform and document the procurement process can result in noncompliance and lack of competition in selected vendors.

Questioned costs: Unknown

Recommendation: Maintain documentation of procurement decisions reflecting the rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis for the contract price.

Views of responsible officials and planned corrective actions: Management agrees with the finding. See Correction Action Plan.

Finding #2018-005 – Material Weakness and Other Non-compliance

Applicable federal program:

National Aeronautics and Space Administration
Space Operations – Vascular Health in Space
CFDA #43.007
Contract Year: 11/01/14 – 12/31/19
Contract #: NNX14AB55G

Criteria: Subrecipient monitoring – 2 CFR §200.331 requires that the activities of subrecipients be monitored to ensure that subawards are used for authorized purposes, in compliance with federal statutes, regulations, and the terms and conditions of the subaward, and that subaward performance goals be achieved.

Condition and context: No evidence of subrecipient monitoring performed for the NASA contract was maintained. The cost reimbursement request was submitted and paid by THI, but there was no evidence that the detail costs were reviewed or that ongoing monitoring was performed for the subrecipient.

Effect: Without sufficient monitoring, use of federal funding could be improperly reported, and funds could be held by the subrecipient for a period that is in excess of the allowable timeframe.

Questioned costs: Unknown

Recommendation: Implement policies over financial monitoring of subrecipients to ensure compliance with federal requirements.

Views of responsible officials and planned corrective actions: Management agrees with the finding. See Corrective Action Plan.

CORRECTIVE ACTION PLAN

September 4, 2019

U. S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Texas Heart Institute respectfully submits the following corrective action plan for the year ended December 31, 2018. The audit was performed by: Blazek & Vetterling, 2900 Wesleyan, Suite 200, Houston, Texas, 77027.

The findings from the December 31, 2018 schedule of findings and questioned costs are discussed below. The findings are numbered consistently with the numbers assigned in the schedule.

FINDINGS – FINANCIAL STATEMENT FINDINGS AND FEDERAL AWARD FINDINGS AND QUESTIONED COSTS**Finding #2018-001** – Material Weakness

Recommendation: Implement segregation of duties over vendor payments, where possible. Where segregation is not possible, supplement the prevention control of segregated duties by detection controls such as formalized independent supervisory reviews. Implement policies and procedures for the Controller or Chief Administrative Officer to perform a formal review of the final payroll register and the change report and independent review of journal entries.

Planned corrective action: The Chief Administrative Officer will review the bank reconciliations including the cancelled check images for unauthorized disbursements. Additionally, he will review the final payroll registers and payroll change reports to verify the appropriateness of payroll disbursements.

Responsible officer: Howard K. Schramm

Estimated completion date: December 15, 2019

Finding #2018-002 – Material Weakness

Recommendation: Implement policies and procedures to properly record the estimated amount of total funds expected to be received from bequests and reconcile net asset subledgers to amounts reported in the financial statements.

Planned corrective action: Net asset subledgers will be maintained and will be reconciled to the financial statements. Additionally, the development department will notify the accounting department of

any bequests received so that the accounting department can determine any additional amount due from bequests.

Responsible officer: Howard K. Schramm

Estimated completion date: December 15, 2019

Finding #2018-003 – Material Weakness

Applicable federal programs:

National Aeronautics and Space Administration

CFDA #43.007	Space Operations	NNX14AB55G	11/01/14 – 12/31/19
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U. S. Department of Health and Human Services

CFDA #93.837	Cardiovascular Diseases Research	5UM1HL087365-11	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	5UM1HL087365-12	03/01/17 – 02/28/19
CFDA #93.837	Cardiovascular Diseases Research	5R01HL127717-03	01/01/18 – 12/31/18
CFDA #93.837	Cardiovascular Diseases Research	1R56HL143489-01	09/24/18 – 08/31/19

Passed through University of Texas Health Science Center at Houston:

CFDA #93.837	Cardiovascular Diseases Research	0011624F	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	0011624F	03/01/18 – 02/28/19
CFDA #93.837	Cardiovascular Diseases Research	0011624J-14	03/01/17 – 02/28/18
CFDA #93.837	Cardiovascular Diseases Research	011624J-15	03/01/18 – 02/28/19

Passed through BIVACOR:

CFDA #93.837	Cardiovascular Diseases Research	1R44HL137454-01A1	09/01/18 – 08/31/19
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Passed through Baylor College of Medicine:

CFDA #93.837	Cardiovascular Diseases Research	T32-HL00676-27-28	08/01/18 – 07/31/19
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Passed through Icahn School of Medicine Mount Sinai:

CFDA #93.837	Cardiovascular Diseases Research	0255-3100-4609	04/01/17 – 03/31/18
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Passed through 7 Hills Pharma, LLC:

CFDA #93.395	Cancer Treatment Research	2R41CA203456-THI	04/09/18 – 03/31/19
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Recommendation: Same as finding #2018-001

Planned corrective action: Same as finding #2018-001

Responsible officer: Howard K. Schramm

Estimated completion date: December 15, 2019

Finding #2018-004 – Material Weakness and Other Non-Compliance

Applicable federal programs:

National Aeronautics and Space Administration

CFDA #43.007 Space Operations NNX14AB55G 11/01/14 – 12/31/19

U. S. Department of Health and Human Services

CFDA #93.837 Cardiovascular Diseases Research 5UM1HL087365-11 03/01/17 – 02/28/18

CFDA #93.837 Cardiovascular Diseases Research 5UM1HL087365-12 03/01/17 – 02/28/19

CFDA #93.837 Cardiovascular Diseases Research 5R01HL127717-03 01/01/18 – 12/31/18

CFDA #93.837 Cardiovascular Diseases Research 1R56HL143489-01 09/24/18 – 08/31/19

Passed through University of Texas Health Science Center at Houston:

CFDA #93.837 Cardiovascular Diseases Research 0011624F 03/01/17 – 02/28/18

CFDA #93.837 Cardiovascular Diseases Research 0011624F 03/01/18 – 02/28/19

CFDA #93.837 Cardiovascular Diseases Research 0011624J-14 03/01/17 – 02/28/18

CFDA #93.837 Cardiovascular Diseases Research 011624J-15 03/01/18 – 02/28/19

Passed through BIVACOR:

CFDA #93.837 Cardiovascular Diseases Research 1R44HL137454-01A1 09/01/18 – 08/31/19

Passed through Baylor College of Medicine:

CFDA #93.837 Cardiovascular Diseases Research T32-HL00676-27-28 08/01/18 – 07/31/19

Passed through Icahn School of Medicine Mount Sinai:

CFDA #93.837 Cardiovascular Diseases Research 0255-3100-4609 04/01/17 – 03/31/18

Passed through 7 Hills Pharma, LLC:

CFDA #93.395 Cancer Treatment Research 2R41CA203456-THI 04/09/18 – 03/31/19

Recommendation: Maintain documentation of procurement decisions reflecting the rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis for the contract price.

Planned corrective action: Management will provide additional training on THI's procurement policy for maintaining documentation of procurement decisions and performing procurement analysis on an annual basis.

Responsible officer: Howard K. Schramm

Estimated completion date: December 15, 2019

Finding #2018-005 – Material Weakness and Other Non-Compliance

Applicable federal program:

National Aeronautics and Space Administration

Space Operations – Vascular Health in Space

CFDA #43.007

Contract Year: 11/01/14 – 12/31/19

Contract #: NNX14AB55G

Recommendation: Implement policies over financial monitoring of subrecipients to ensure compliance with federal requirements.

Planned corrective action: Management will develop policies and procedures for financial monitoring of subrecipients in compliance with federal requirements.

Responsible officer: Howard K. Schramm

Estimated completion date: December 15, 2019

If the U. S. Department of Health and Human Services has questions regarding this plan, please call Howard K. Schramm at (713) 443-5754.

Sincerely,



Howard K. Schramm
Chief Administrative Officer