

*Financial Statements*

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**

For the Year Ended September 30, 2016

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## INDEPENDENT AUDITOR'S REPORT

To the Board of Directors  
Huntington Medical Research Institutes

We have audited the accompanying financial statements of Huntington Medical Research Institutes (a nonprofit organization), which comprise the statement of financial position as of September 30, 2016, and the related statements of activities and changes in net assets, functional expenses, and 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.

### **Auditor's 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

To the Board of Directors  
Huntington Medical Research Institutes

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### **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Huntington Medical Research Institutes as of September 30, 2016, 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.

### **Report on Summarized Comparative Information**

We have previously audited Huntington Medical Research Institutes' 2015 financial statements and we expressed an unmodified audit opinion on those audited financial statements in our report dated March 16, 2016. In our opinion, the summarized comparative information presented herein as of and for the year ended September 30, 2015, is consistent, in all material respects, with the audited financial statements from which it has been derived.

A handwritten signature in black ink that reads "Martin Werbelow CPA". The signature is written in a cursive style and is centered within a light gray rectangular box.

March 15, 2017

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**STATEMENT OF FINANCIAL POSITION**  
**SEPTEMBER 30, 2016**  
**With Comparative Totals for 2015**

**ASSETS**

	<b>2016</b>	<b>2015</b>
<b>Assets</b>		
Cash and cash equivalents	\$ 478,817	\$ 693,724
Government and other contract receivables	180,919	192,057
Other receivables	93,200	52,892
Unconditional promises to give	899,336	1,551,995
Prepaid expenses	74,783	69,808
Cash designated for capital expenditures	6,732,549	5,430,488
Investments	39,065,570	40,527,984
Land, buildings, and equipment, net	15,383,472	10,369,701
Beneficial interest in a charitable remainder unitrust	116,524	119,304
Patents, net	134,983	162,436
Patent deposits	224,460	221,863
	<b>Total Assets</b>	<b>Total Assets</b>
	\$ 63,384,613	\$ 59,392,252

**LIABILITIES AND NET ASSETS**

<b>Liabilities</b>		
Accounts payable	\$ 911,685	\$ 548,243
Accrued expenses and deposits	357,582	182,235
Deferred revenue	49,934	506,817
Accrued pension cost	4,971,818	5,132,640
	<b>Total Liabilities</b>	<b>Total Liabilities</b>
	6,291,019	6,369,935
<b>Net Assets</b>		
Unrestricted net assets		
Undesignated	9,468,202	3,477,042
Designated by the Board	34,361,964	29,506,336
	<b>Total Unrestricted Net Assets</b>	<b>Total Unrestricted Net Assets</b>
	43,830,166	32,983,378
Temporarily restricted net assets	7,776,636	14,552,147
Permanently restricted net assets	5,486,792	5,486,792
	<b>Total Net Assets</b>	<b>Total Net Assets</b>
	57,093,594	53,022,317
	<b>Total Liabilities and Net Assets</b>	<b>Total Liabilities and Net Assets</b>
	\$ 63,384,613	\$ 59,392,252

The accompanying notes are an integral part of these statements.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS**  
**FOR THE YEAR ENDED SEPTEMBER 30, 2016**  
**With Comparative Totals for 2015**

	<u>2016</u>			<u>2015</u>	
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>	<u>Total</u>
<b>Support, Revenue, Gains, and Investment Return</b>					
Specific research:					
Government funded grants and contracts	\$ 2,535,507	\$ -	\$ -	\$ 2,535,507	\$ 2,034,853
Privately funded grants, contracts and projects	149,543	304,484	-	454,027	1,622,688
Partnership income	519,552	-	-	519,552	496,231
Donations	803,256	1,231,072	-	2,034,328	1,963,426
Bequests	70,269	-	-	70,269	2,127,922
Rental income	259,218	-	-	259,218	300,950
Loss in value - charitable remainder unitrust	-	(2,261)	-	(2,261)	(11,834)
Gain on disposal of fixed assets	5,494,608	-	-	5,494,608	-
Clinical and royalty income	654,083	-	-	654,083	633,563
<b>Total Support and Revenue</b>	<u>10,486,036</u>	<u>1,533,295</u>	<u>-</u>	<u>12,019,331</u>	<u>9,167,799</u>
<b>Other Gains and Losses</b>					
Special Events					
Special event contributions	61,455	-	-	61,455	-
Special event expense	(46,894)	-	-	(46,894)	-
<b>Net Special Event</b>	<u>14,561</u>	<u>-</u>	<u>-</u>	<u>14,561</u>	<u>-</u>
<b>Net Assets Released Due to Satisfaction of Restrictions</b>	<u>8,711,009</u>	<u>(8,711,009)</u>	<u>-</u>	<u>-</u>	<u>-</u>
<b>Investment Return Designated for Current Operations</b>	<u>3,481,510</u>	<u>-</u>	<u>-</u>	<u>3,481,510</u>	<u>2,710,362</u>
<b>Total Support, Revenue, Gains, and Investment Return</b>	<u>22,693,116</u>	<u>(7,177,714)</u>	<u>-</u>	<u>15,515,402</u>	<u>11,878,161</u>
<b>Expenses</b>					
Research	6,959,193	-	-	6,959,193	7,213,340
Research support services:					
General	1,974,322	-	-	1,974,322	1,521,894
Fundraising	915,404	-	-	915,404	1,088,925
<b>Total Research Support Services</b>	<u>2,889,726</u>	<u>-</u>	<u>-</u>	<u>2,889,726</u>	<u>2,610,819</u>
<b>Total Expenses</b>	<u>9,848,919</u>	<u>-</u>	<u>-</u>	<u>9,848,919</u>	<u>9,824,159</u>
<b>Change in Net Assets from Operations</b>	<u>12,844,197</u>	<u>(7,177,714)</u>	<u>-</u>	<u>5,666,483</u>	<u>2,054,002</u>

The accompanying notes are an integral part of these statements.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS**  
**FOR THE YEAR ENDED SEPTEMBER 30, 2016**  
**With Comparative Totals for 2015**  
**(CONTINUED)**

	<u>2016</u>			<u>2015</u>	
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>	<u>Total</u>
<b>Net Investment Return</b>					
Interest and dividends	\$ 195,025	\$ 66,565	\$ -	\$ 261,590	\$ 442,884
Realized gains on investments	404,715	138,134	-	542,849	185,021
Unrealized gains (losses) on investments	839,878	197,504	-	1,037,382	(2,328,784)
Investment fees	(116,339)	-	-	(116,339)	(293,186)
<b>Total Net Investment Return</b>	1,323,279	402,203	-	1,725,482	(1,994,065)
<b>Less Investment Return Designated for Current Operations</b>	(3,481,510)	-	-	(3,481,510)	(2,710,362)
<b>Investment Return Reduced by the Portion of Net Investment Return Designated for Current Operations</b>	(2,158,231)	402,203	-	(1,756,028)	(4,704,427)
<b>Change in Net Assets Before Pension-related Changes Other Than Net Periodic Pension Cost</b>	10,685,966	(6,775,511)	-	3,910,455	(2,650,425)
<b>Pension-related Changes Other Than Net Periodic Pension Cost</b>	160,822	-	-	160,822	(1,369,339)
<b>Change in Net Assets</b>	10,846,788	(6,775,511)	-	4,071,277	(4,019,764)
<b>Net Assets, Beginning</b>	32,983,378	14,552,147	5,486,792	53,022,317	57,042,081
<b>Net Assets, Ending</b>	<u>\$ 43,830,166</u>	<u>\$ 7,776,636</u>	<u>\$ 5,486,792</u>	<u>\$ 57,093,594</u>	<u>\$ 53,022,317</u>

The accompanying notes are an integral part of these statements.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**STATEMENT OF FUNCTIONAL EXPENSES**  
**FOR THE YEAR ENDED SEPTEMBER 30, 2016**  
**With Comparative Totals for 2015**

	<u>2016</u>				<u>2015</u>
	<u>Research Support Services</u>				<u>Total</u>
	<u>Research</u>	<u>General</u>	<u>Fundraising</u>	<u>Total</u>	
Salaries and wages	\$ 2,480,100	\$ 804,324	\$ 339,061	\$ 3,623,485	\$ 3,973,677
Payroll taxes and employee benefits	1,067,102	346,340	146,649	1,560,091	1,630,522
<b>Total Personnel Costs</b>	3,547,202	1,150,664	485,710	5,183,576	5,604,199
Professional fees and contract service payments	613,667	488,758	269,857	1,372,282	1,329,412
Research and other supplies	763,889	-	38,666	802,555	592,820
Occupancy and related expenses	395,744	284,971	8,994	689,709	441,836
Office and other expenses	293,797	66,791	87,634	448,222	537,656
Repairs, maintenance, and service contracts	300,839	18,092	3,618	322,549	410,959
Insurance	149,217	16,957	3,391	169,565	157,152
Taxes and licenses	76,369	8,678	1,736	86,783	128,654
Impairment loss on patents and patent deposits	60,184	-	-	60,184	186,669
Travel, conferences, conventions and meetings	30,610	2,243	14,029	46,882	56,951
<b>Total Expenses Before Depreciation and Amortization</b>	6,231,518	2,037,154	913,635	9,182,307	9,446,308
Depreciation and amortization	727,675	53,507	1,769	782,951	671,037
<b>Total Expenses</b>	6,959,193	2,090,661	915,404	9,965,258	10,117,345
<b>Less Expenses Included with Investment Return in the Statement of Activities and Changes in Net Assets</b>	-	(116,339)	-	(116,339)	(293,186)
<b>Total Expenses Included in the Expenses Section of the Statement of Activities and Changes in Net Assets</b>	<u>\$ 6,959,193</u>	<u>\$ 1,974,322</u>	<u>\$ 915,404</u>	<u>\$ 9,848,919</u>	<u>\$ 9,824,159</u>

The accompanying notes are an integral part of these statements.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**STATEMENT OF CASH FLOWS**  
**FOR THE YEAR ENDED SEPTEMBER 30, 2016**  
**With Comparative Totals for 2015**

	<u>2016</u>	<u>2015</u>
<b>Cash Flows from Operating Activities</b>		
Cash received from service recipients	\$ 2,962,755	\$ 3,007,487
Cash received from donors	1,102,632	3,728,015
Cash received from interest and dividends	261,590	436,384
Cash paid to suppliers and employees	(8,283,309)	(9,150,824)
<b>Net Cash Used in Operating Activities</b>	<u>(3,956,332)</u>	<u>(1,978,938)</u>
<b>Cash Flows from Investing Activities</b>		
Purchase of land, buildings, and equipment	(6,253,433)	(2,318,101)
Proceeds from sale of land and buildings	5,961,778	-
Purchase of investments	(30,269,281)	(8,146,650)
Proceeds from sale of investments	33,375,078	8,479,988
Distributions from partnership	456,400	21,560
Deposits paid on patents	(45,787)	(90,852)
Proceeds from cash designated for capital expenditures	6,478,448	1,224,602
Purchase of cash designated for capital expenditures	(7,780,509)	(1,068,033)
<b>Net Cash Provided by (Used in) Investing Activities</b>	<u>1,922,694</u>	<u>(1,897,486)</u>
<b>Cash Flows from Financing Activities</b>		
Contributions restricted for capital campaign	1,818,731	968,268
Contributions restricted for permanent endowment	-	2,000,000
Investment income restricted for capital campaign	-	6,500
<b>Net Cash Provided by Financing Activities</b>	<u>1,818,731</u>	<u>2,974,768</u>
<b>Net Decrease in Cash and Cash Equivalents</b>	(214,907)	(901,656)
<b>Cash and Cash Equivalents, Beginning</b>	<u>693,724</u>	<u>1,595,380</u>
<b>Cash and Cash Equivalents, Ending</b>	<u>\$ 478,817</u>	<u>\$ 693,724</u>
<b>Reconciliation of Change in Net Assets to Net Cash Used in Operating Activities</b>		
Change in net assets	\$ 4,071,277	\$ (4,019,764)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Gain on sale of fixed assets	(5,494,608)	-
Depreciation and amortization	782,951	671,037
Investment income restricted for capital expenditures	-	(6,500)
Net realized and unrealized losses (gains) on investments	(1,580,231)	2,143,763
Loss in value - charitable remainder unitrust	2,780	12,339
Partnership income	(519,552)	(496,231)
Loss on write-down of unconditional promises to give	65,000	15,000
Impairment loss on patents and patent deposits	60,184	186,669
Contributions restricted for capital expenditures, net	(1,064,047)	(235,434)
Contributions restricted for permanent endowment	-	(2,000,000)
Amortization of discount on unconditional promises to give	(21,025)	(11,092)
(Increase) decrease in:		
Government and other contract receivables	11,138	1,441,334
Other receivables	(40,308)	45,364
Unconditional promises to give	(146,000)	(1,240,000)
Prepaid expenses	(4,975)	47,528
Increase (decrease) in:		
Accounts payable	363,442	191,543
Accrued expenses and deposits	175,347	(145,256)
Deferred revenue	(456,883)	51,423
Accrued pension cost	(160,822)	1,369,339
<b>Net Cash Used in Operating Activities</b>	<u>\$ (3,956,332)</u>	<u>\$ (1,978,938)</u>

The accompanying notes are an integral part of these statements.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**NOTES TO FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2016**

**Note 1 – Organization and Summary of Significant Accounting Policies**

**Organization**

Huntington Medical Research Institutes (HMRI) is a nonprofit public benefit California Corporation engaged in a program of basic and applied research devoted to new and advanced studies into the causes, nature, prevention, and cure of human diseases. Funding for research is received from the community and the federal government in the form of donations, contracts, and grants. HMRI is subject to, and undergoes, a Single Audit annually in accordance with the Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, due to its expenditure of \$750,000 or more in federal grant awards.

HMRI conducts medical research in nine different areas, the results of which are published in peer-reviewed papers presented in scientific and medical journals, and displayed at scientific meetings as platform presentations and poster sessions. The nine areas include development of electronic neural implants; development of new magnetic resonance imaging technology; studies of new hepatitis drugs and post-hepatitis cancer detection methods; gene-sequencing studies of cancer; development of new tissue engineering methods; proteomic profiling of cerebrospinal fluid in neurological diseases; research on colorectal cancer; and studies of potential new biomarkers in breast and prostate cancer. HMRI also conducts post-doctoral fellowship training programs and a summer student medical research program.

**Basis of Accounting**

HMRI accounts for its financial transactions using the accrual basis of accounting. The accrual basis of accounting recognizes revenues in the accounting period in which revenues are earned regardless of when cash is received and recognizes expenses in the accounting period in which expenses are incurred regardless of when cash is disbursed.

**Basis of Presentation**

HMRI's financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). Under U.S. GAAP, HMRI is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

**Comparative Financial Information**

The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with U.S. GAAP. Accordingly, such information should be read in conjunction with HMRI's financial statements as of and for the year ended September 30, 2015, from which the summarized information was derived.

**Support and Revenue**

Unrestricted donations are recognized as income in the year they are received.

Amounts received or promised that are designated for future periods or restricted by the donor for specific purposes are reported as temporarily or permanently restricted support that increases those net asset classes.

When a temporary restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restriction.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**NOTES TO FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2016**

**Note 1 – Organization and Summary of Significant Accounting Policies** (continued)

**Support and Revenue** (continued)

Unconditional promises to give are recognized as revenues or gains in the period received. Promises to give that are due in the next year are recorded at their net realized value; those due in subsequent years are recorded at the present value of their net realizable value, discounted using low-risk interest rates applicable to the year in which the promise was received. Management has evaluated unconditional promises to give and believes that all such unconditional promises are fully collectible based on the history of collections from the donors. Accordingly, no allowance for uncollectible promises to give has been established.

Conditional promises to give are not included as donations until the conditions are substantially met.

Revenues from government agencies are recorded as of the date HMRI has the right to receive such revenue under cost reimbursement contracts currently in force. With most of these contracts, HMRI incurs expenses while fulfilling the terms of the contract and then requests reimbursement from the government for those expenses. HMRI adheres to the cost reimbursement guidelines as set forth in OMB Circular A-122 *Cost Principles for Non-profit Organizations*. Allowable costs incurred in excess of amounts reimbursed under these contracts are included under government and other contracts receivable in the statement of financial position. One contract permits HMRI to draw down amounts in advance of expenses incurred under the contract. Amounts advanced in excess of these expenditures are recorded as deferred revenue in the accompanying statement of financial position.

Management believes that government and other contracts receivable are fully collectible as of September 30, 2016; accordingly, no allowance for doubtful accounts has been established for these receivables.

**Cash and Cash Equivalents**

For the purpose of financial statement reporting, HMRI considers all money market accounts and all highly liquid debt investments purchased with original maturity dates of three months or less to be cash equivalents.

**Cash Designated for Capital Expenditures**

Cash designated for capital expenditures consists of Board-designated funds and temporarily restricted contributions received as part of HMRI's capital campaign, which are awaiting expenditure according to the HMRI's facilities' expansion plan (Note 8).

**Patents**

The legal costs to secure patents are capitalized and amortized using the straight-line method over 20 years.

**Patent Deposits**

Patent deposits represent accumulated legal and other costs related to registration and development of future patents. Upon approval of the patent, the costs are reclassified as patents and are amortized as described above.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**NOTES TO FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2016**

**Note 1 – Organization and Summary of Significant Accounting Policies (continued)**

**Asset Impairment Estimates**

HMRI evaluates the recoverability of identifiable long-term assets whenever events or changes in circumstances indicate that the asset's carrying amount may not be recoverable. Such circumstances could include, but are not limited to: 1) a significant decrease in the market value of the asset; 2) a significant adverse change in the extent or manner in which an asset is used; or 3) an accumulation of costs significantly in excess of the amount originally expected for the acquisition of an asset. HMRI measures the carrying amount of the asset against the estimated undiscounted future cash flows associated with it. Should the sum of the expected future net cash flows be less than the carrying value of the asset being evaluated, an impairment loss would be recognized. The impairment loss would be calculated as the amount by which the carrying value of the asset exceeds its fair value. The fair value is measured based on quoted market prices, if available. If quoted market prices are not available, the estimate of fair value is based on various valuation techniques, including the discounted value of estimated future cash flows. The evaluation of asset impairment requires HMRI to make assumptions about future cash flows over the life of the asset being evaluated. These assumptions require significant judgment and actual results may differ from assumed and estimated amounts. For the years ended September 30, 2016 and 2015, HMRI recorded an impairment loss of \$60,184 and \$186,669, respectively, related to patents and patent deposits.

**Land, Buildings, and Equipment**

Land, buildings, and equipment are recorded at cost if purchased and at fair market value if contributed. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets as follows:

Buildings and improvements	3 - 30 years
Lab and other equipment	3 - 10 years

Depreciation on construction in process begins when the related assets are placed in service.

Expenditures for maintenance and repairs are charged to expense; betterments and major renewals are capitalized.

**Net Assets**

HMRI's net assets comprise the following:

**Unrestricted Net Assets**

The unrestricted net assets include expendable net assets available to support the general research, administration, and fundraising of HMRI. At September 30, 2016, the unrestricted net assets include Board-designated balances of \$34,361,964 for investment activities and capital expenditures (Note 8).

**Temporarily Restricted Net Assets**

Temporarily restricted net assets include assets held in a charitable remainder unitrust and donor-restricted grants, contracts, and projects designated for specific research activities, program expenditures, or equipment acquisitions. Assets donated with explicit restrictions regarding their use and contributions of cash that must be used to acquire property and equipment are reported as restricted contributions. Absent donor stipulations regarding how long those donated assets must be maintained, HMRI reports expirations of donor restrictions when the donated or acquired assets are placed in service, or in the case of buildings and building improvements, when capital expenses are paid. HMRI reclasses temporarily restricted net assets to unrestricted net assets at that time. At September 30, 2016, the temporarily restricted net assets totaled \$7,776,636.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**NOTES TO FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2016**

**Note 1 – Organization and Summary of Significant Accounting Policies** (continued)

**Net Assets** (continued)

**Permanently Restricted Net Assets**

The Ross McCollum Endowment Trust was created in 1991 pursuant to the provisions of a trust created under the Will of Ross McCollum. Under the provisions of the trust, the principal of \$3,486,792 is to remain intact and kept separate from the other assets of HMRI. The income from the fund is available for HMRI's unrestricted use.

The Marylou Ingram fund was created in 2015 pursuant to the provisions of a trust that was created by Marylou Ingram in 2006 and restated in 2012 and that became irrevocable upon her death in 2013. Under the provisions of the trust, the principal of \$2,000,000 is to remain intact and kept separate from other assets of HMRI. The income from the fund is available for research in tissue engineering, cancer molecular genetics, and other related research programs.

**Donated Assets**

Donations and bequests are recorded as made. All donations are considered to be available for unrestricted use unless specifically restricted by the donor.

Donated securities and other noncash donations are recorded as contributions at their estimated fair values at the date of donation.

**Expense Allocations**

The costs of providing various programs and other activities have been summarized on a functional basis in the statement of activities. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

**Use of Estimates**

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Income Taxes**

HMRI qualifies as a nonprofit organization under Section 501(c)(3) of the Internal Revenue Code (IRC). HMRI has been classified as an organization that is not a private foundation as defined in Section 509(a) of the IRC. Further, it has been determined that HMRI is a "publicly supported" organization. Accordingly, contributions by individual donors qualify for the maximum limitation under Section 170(b)(1)(A) of the IRC. Nonprofit organizations are generally not liable for taxes on income; therefore, no provision is made for such taxes in the financial statements.

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
**NOTES TO FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2016**

**Note 1 – Organization and Summary of Significant Accounting Policies (continued)**

**Income Taxes (continued)**

HMRI considers many factors when evaluating and estimating its tax positions and tax benefits, which may require periodic adjustments and which may not accurately anticipate actual outcomes. HMRI evaluates its uncertain tax positions in accordance with standards set forth under U.S. GAAP. These standards require management to perform an evaluation of all income tax positions taken, or expected to be taken, in the course of preparing HMRI's tax returns. Management believes the tax positions taken more likely than not will be sustained under examination by the applicable tax authorities. Examples of tax positions taken include the tax-exempt status of HMRI and various positions related to potential sources of unrelated business taxable income. Since matters are subject to some degree of uncertainty, there can be no assurance that HMRI's tax returns will not be challenged by the tax authorities and that HMRI will not be subject to additional tax, penalties, and interest as a result of such challenge. Generally, HMRI's tax returns remain open for three years for federal tax examination and four years for state tax examination.

**Reclassifications**

Certain accounts in the prior-year financial statements have been reclassified for comparative purposes to conform to the presentation in the current-year financial statements.

**Note 2 – Unconditional Promises to Give**

As of September 30, 2016, unconditional promises to give are scheduled to be collected as follows:

Promises scheduled to be collected in one year or less	\$ 256,212
Promises scheduled to be collected in one to five years	560,492
Promises scheduled to be collected in five years or more	<u>136,110</u>
Gross unconditional promises to give	952,814
Less discount to present value at 2%	<u>53,478</u>
Unconditional promises to give at present value	<u>\$ 899,336</u>

**Note 3 – Conditional Promises to Give**

In 2007, HMRI received a conditional promise to give of \$1,000,000. The first payment of \$300,000 was received in 2007, and the second payment of \$100,000 was received in 2008. HMRI also received \$100,000 each year during the years ended September 30, 2011 and September 30, 2012 for a total of \$600,000 received as of September 30, 2015. All of those payments were recorded as a donation at the time the donation was received. The remaining balance is receivable in equal amounts of \$100,000 each year over the next several years provided that the donor has sufficient funds and the donor's Board of Directors ratifies the continuance of the pledge at each succeeding annual meeting. These payments will be recorded as donations when the conditions are substantially met.

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**Note 3 – Conditional Promises to Give** (continued)

In 2011, HMRI received a conditional promise to give of \$500,000. The first payment of \$250,000 was received in March 2016 when HMRI received a building permit and began construction as part of its expansion plan (Note 8). It was recorded as a donation at the time the donation was received. The second payment of \$250,000 will be paid when construction is complete and HMRI receives its certificate for occupancy of the new building. As of September 30, 2016, this condition has not been met; therefore, the conditional promise to give was not recorded as a donation.

Also in 2011, HMRI received a conditional promise to give of \$1,000,000. Payments on this conditional promise to give are expected to commence once HMRI completes construction of the building (Note 8). As of September 30, 2016, this condition has not been met; therefore, the conditional promise to give was not recorded as a donation.

**Note 4 – Other Receivables**

Other receivables consist of the following as of September 30, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Liver Center salaries	\$ 55,855	\$ 30,758
Huntington Outpatient Imaging Center (Note 14)	6,936	15,684
Other miscellaneous receivables	<u>30,409</u>	<u>6,450</u>
	<u>\$ 93,200</u>	<u>\$ 52,892</u>

No provision for doubtful accounts has been made since HMRI anticipates full collection of these amounts.

**Note 5 – Investments**

Investments in marketable securities are stated at their fair value. Contributed securities are recorded at their fair value at the date of donation.

Security transactions are generally accounted for in the Investment Fund. Dividend and interest income is recorded in the Undesignated Fund. HMRI invests for total return, which may reduce the annual yield. Transfers from the Investment Fund to the Undesignated Fund are allowed to offset such reduced yield.

HMRI's investment spending policy seeks to preserve and build its Investment Fund. Accordingly, HMRI has established an investment spending policy that generally allows for four percent of the aggregate fair value of its investments to be expendable.

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**Note 5 – Investments** (continued)

As of September 30, 2016 and 2015, investments consist of the following:

<b>2016</b>	<b>Aggregate Fair Value</b>	<b>Cost</b>
Cash being held for investment	\$ 727,827	\$ 727,827
Mutual funds	30,851,639	29,687,650
Limited partnership interests	4,433,397	3,622,151
Offshore funds	3,044,079	3,027,956
Life insurance	8,628	8,628
	<u>\$ 39,065,570</u>	<u>\$ 37,074,212</u>

  

<b>2015</b>	<b>Aggregate Fair Value</b>	<b>Cost</b>
Cash being held for investment	\$ 3,962,910	\$ 3,962,910
Common stock	5,948,858	3,617,418
Mutual funds	14,838,863	13,486,933
Pooled funds	1,723,528	1,381,925
Limited partnership interests	5,933,379	5,040,235
Offshore funds	8,111,818	6,619,143
Life insurance	8,628	8,628
	<u>\$ 40,527,984</u>	<u>\$ 34,117,192</u>

Investments by net asset class were as follows as of September 30, 2016 and 2015:

	<b>2016</b>	<b>2015</b>
Unrestricted	\$ 29,074,047	\$ 30,002,922
Temporarily restricted	4,504,731	5,038,270
Permanently restricted	5,486,792	5,486,792
	<u>\$ 39,065,570</u>	<u>\$ 40,527,984</u>

Investments by intended purpose were as follows as of September 30, 2016 and 2015:

	<b>2016</b>	<b>2015</b>
Undesignated	\$ 673,861	\$ 610,709
Capital campaign	331,619	420,776
Endowments	38,060,090	39,496,499
	<u>\$ 39,065,570</u>	<u>\$ 40,527,984</u>

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**Note 6 – Charitable Remainder Unitrust**

During 2003, HMRI became the beneficiary and administrator of a charitable remainder unitrust (CRUT). The CRUT provides the donor income for the donor’s lifetime, after which the remaining funds will be distributed to HMRI. These amounts are recorded at present value, which represents the current fair market value of the trust, reduced by the estimated actuarial liability necessary to meet the future payments to the life income beneficiary. The portion of the gift attributable to the present value of the future benefits to be received by HMRI was recorded in the statement of activities as a temporarily restricted donation in the period the gift was established. The valuation of the CRUT falls into the Level 3 category of the fair value hierarchy, as discussed in Note 15.

The CRUT at September 30, 2016 and 2015 comprises the following:

	<u>2016</u>	<u>2015</u>
Asset	\$ 139,950	\$ 151,058
Liability	(23,426)	(31,754)
	<u>\$ 116,524</u>	<u>\$ 119,304</u>

**Note 7 – Land, Buildings, and Equipment**

Land, buildings, and equipment consist of the following as of September 30, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Land	\$ 2,506,062	\$ 1,612,298
Buildings and improvements	4,278,891	5,213,957
Leasehold improvements	99,101	99,101
Lab equipment	6,461,615	6,416,689
Other equipment	786,540	777,733
Construction in progress	7,866,040	1,675,975
Assets held for future development (Note 8)	1,962,563	3,162,563
	23,960,812	18,958,316
Less accumulated depreciation	8,577,340	8,588,615
	<u>\$ 15,383,472</u>	<u>\$ 10,369,701</u>

Depreciation expense for the years ended September 30, 2016 and 2015 was \$772,492 and \$654,479, respectively.

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**Note 8 – Assets Held for Future Development**

In order to continue its efforts to provide excellence in medical research, HMRI has developed a facilities expansion plan. As of September 30, 2016, HMRI has purchased several parcels of real property in Pasadena, California. The aggregate purchase cost for these properties is approximately \$3.2 million. Development of some of these parcels began during the year ended September 30, 2016. As of September 30, 2016, \$1.2 million is included in land and approximately \$2 million is included in assets held for future development. In addition, HMRI incurred approximately \$7.9 million in capital expenditures, which are included in construction in progress.

**Note 9 – Patents**

Patents at September 30, 2016 and 2015 comprise the following:

	<u>2016</u>	<u>2015</u>
Patents	\$ 376,162	\$ 433,557
Less accumulated amortization	241,179	271,121
	<u>\$ 134,983</u>	<u>\$ 162,436</u>

Amortization expense for the years ended September 30, 2016 and 2015 was \$10,459 and \$16,558, respectively.

The estimated aggregate amortization expense for the five years ending subsequent to September 30, 2016 is as follows:

<u>Years Ending September 30,</u>	
2017	\$ 9,122
2018	9,122
2019	9,122
2020	9,122
2021	9,122

**Note 10 – Temporary Restrictions on Net Assets**

Temporarily restricted net assets are subject to the following restrictions as of September 30, 2016:

Research activities	\$ 1,495,275
Capital expenditures	1,991,726
General operations	4,173,112
Time restrictions	<u>116,523</u>
	<u>\$ 7,776,636</u>

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**Note 11 – Defined Benefit Pension Plan**

HMRI has a defined benefit pension plan covering substantially all of its employees hired prior to July 1, 2009. The benefits are based on years of service and the employee’s compensation during the highest five of the last ten years of employment. HMRI’s funding policy is to contribute monthly the amount needed to satisfy the minimum funding standard required by the Employee Retirement Income Security Act of 1974.

At its January 2016 meeting, the Board passed a resolution to amend the defined benefit pension plan. As a result of this amendment, employee compensation levels earned and hours of service credited after February 14, 2016, will not factor into future benefit calculations. In addition, an employee’s pension benefit shall not be less than his or her accrued pension benefit as of February 14, 2016.

As of September 30, 2009, HMRI adopted provisions of U.S. GAAP, which requires the recognition of the funded status of the pension plan in the statement of financial position, and recognize changes in the funded or unfunded status through the changes in unrestricted net assets. U.S. GAAP also requires the pension plan’s measurement date be the same as HMRI’s financial statement date.

The following provides further information about HMRI’s pension plan as of September 30, 2016 and 2015:

Benefit obligations and funded status:

	<u>2016</u>	<u>2015</u>
Benefit obligation at September 30	\$ 15,315,944	\$ 15,143,688
Employer contributions	799,066	593,316
Benefit payments	761,661	741,930
Fair value of plan assets at September 30	10,344,126	10,011,048
Net unfunded status of plan	(4,971,818)	(5,132,640)
Accrued pension cost	(4,971,818)	(5,132,640)

Amounts recognized in the statement of financial position consist of:

	<u>2016</u>	<u>2015</u>
Liabilities	\$ 4,971,818	\$ 5,132,640

Amounts recognized as changes in unrestricted net assets but not yet reclassified as components of net periodic benefit cost consist of:

	<u>2016</u>	<u>2015</u>
Prior service cost	\$ -	\$ -
Actuarial loss	6,061,016	5,933,919
Net amount recognized	<u>\$ 6,061,016</u>	<u>\$ 5,933,919</u>

**HUNTINGTON MEDICAL RESEARCH INSTITUTES**  
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**Note 11 – Defined Benefit Pension Plan** (continued)

Other changes in net assets not yet included in net periodic benefit cost and reclassifications to net periodic benefit cost of amounts previously recognized as changes in unrestricted net assets but not included in net periodic benefit cost when they arose:

	<u>2016</u>	<u>2015</u>
Actual loss (gain)	\$ (160,822)	\$ 1,421,636
Recognized prior service cost	<u>-</u>	<u>(52,297)</u>
Total of other changes in unrestricted net assets	<u>\$ (160,822)</u>	<u>\$ 1,369,339</u>

The projected benefit obligation, accumulated obligation, and fair value of plan assets for plans with accumulated benefit obligations in excess of plan assets were as follows:

	<u>2016</u>	<u>2015</u>
Projected benefit obligation	\$ 15,315,944	\$ 15,143,688
Accumulated benefit obligation	15,315,044	14,632,137
Fair value of plan assets	10,344,126	10,011,048

The net periodic benefit cost recognized in the change in net assets is as follows:

	<u>2016</u>	<u>2015</u>
Net periodic benefit cost	\$ 511,147	\$ 596,337

Amounts expected to be recognized in net periodic cost in the coming year:

	<u>2016</u>	<u>2015</u>
Loss recognition	\$ 447,130	\$ 397,799
Prior service cost recognition	-	-

The weighted-average assumptions used to determine benefit obligations at September 30, 2016 and 2015 were as follows:

	<u>2016</u>	<u>2015</u>
Discount rate	4.50%	4.50%
Rate of compensation increase	2.00%	2.00%

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**Note 11 – Defined Benefit Pension Plan** (continued)

The weighted-average assumptions used to determine net periodic benefit cost for the years ended September 30, 2016 and 2015 were as follows:

	<u>2016</u>	<u>2015</u>
Discount rate	4.50%	4.50%
Expected return on plan assets	5.50%	5.50%
Rate of compensation increase	2.00%	2.00%

The expected rate of return on pension plan assets is determined by those assets' historical long-term investment performance, current asset allocation, and estimates of future long-term returns by asset class.

HMRI's investments are invested in a fixed income portfolio whose assets are held in a segment of Aetna's general account, with main holdings of bonds and mortgage loans. The investment strategy for the bond portfolio is to improve the income and long-term potential by maintaining a minimal U.S. Treasury position and a significant corporate bond position. Holdings continue to be primarily in investment grade corporate bonds. The investment strategy of the mortgage loan portfolio is to continue to seek opportunity in the commercial mortgage loan markets as existing loans mature and prepay. The target allocations for plan assets are 84% bonds, 14% mortgage loans, and 2% cash and short-term equity. Bond portfolio includes investments in corporate industrial, corporate foreign, corporate utilities, corporate financial, commercial mortgage backed, government, agency mortgage backed, and asset backed. Mortgage loan portfolio includes investments in apartment, retail, office, industrial, and others.

The fair values of HMRI's pension plan assets for the year ended September 30, 2016, by asset class are as follows:

	<b>Assets at Fair Value as of September 30, 2016</b>			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Insurance contract	<u>\$ 10,344,126</u>	<u>\$ -</u>	<u>\$ 10,344,126</u>	<u>\$ -</u>

The fair values of HMRI's pension plan assets for the year ended September 30, 2015, by asset class are as follows:

	<b>Assets at Fair Value as of September 30, 2015</b>			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Insurance contract	<u>\$ 10,011,048</u>	<u>\$ -</u>	<u>\$ 10,011,048</u>	<u>\$ -</u>

Expected future benefit payments are as follows as of September 30, 2016:

<u>Years Ending September 30,</u>	
2017	\$ 816,405
2018	825,180
2019	871,777
2020	883,210
2021	908,513
2022-2026	4,506,981

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**Note 11 – Defined Benefit Pension Plan** (continued)

HMRI expects to contribute approximately \$820,000 to the pension plan for the year ending September 30, 2017. No plan assets are expected to be returned to HMRI for the year ending September 30, 2017.

**Note 12 – Defined Contribution Plans**

On October 1, 2010, HMRI established a defined contribution retirement plan (the 401(k) Plan) for the benefit of all employees meeting the eligibility requirements as set forth in the 401(k) Plan documents. HMRI may make an annual discretionary contribution up to 4% of employees' compensation and may match up to an additional 4% based on voluntary contributions by employees to the 403(b) plan. During the years ended September 30, 2016 and 2015, HMRI contributed \$199,846 and \$29,419, respectively, to the 401(k) Plan.

HMRI also maintains a 403(b) defined contribution retirement program for all employees who have attained 21 years of age and have completed one year of service. The plan is voluntary on behalf of the employees and HMRI has no obligation to contribute to the plan. HMRI has no liability for the administration or payment of benefits of the plan.

**Note 13 – Concentrations**

**Concentration of Credit Risk**

HMRI maintains cash balances at high credit-quality financial institutions where account balances are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. At September 30, 2016, account balances at two financial institutions exceeded the aforementioned FDIC insurance limit by approximately \$6,806,000. HMRI has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk related to cash and cash equivalents.

HMRI maintains cash balances with various securities' brokerage firms in money market mutual fund accounts. Investments at these institutions are insured by the Securities Investors Protection Corporation (SIPC) up to \$500,000, and cash balances are insured by FDIC up to \$250,000. At September 30, 2016, HMRI's cash balance in one investment account exceeded FDIC insurance limit by approximately \$831,000. However, HMRI has not experienced any loss in such accounts to date and does not anticipate non-performance by the brokerage firm.

**Concentration of Grants and Revenue**

HMRI received approximately 16% and 17% of its support and revenue from federal government programs in 2016 and 2015, respectively. A significant reduction in the level of this support, if it were to occur, would have a pronounced effect on programs and activities.

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**Note 14 – Related Party Transactions**

HMRI owns 28% of Huntington Outpatient Imaging Center (HOPIC). HMRI's share of the partnership income from HOPIC was \$519,552 and \$496,231 for the years ended September 30, 2016 and 2015, respectively.

HMRI leases real property to a Board member. The lease calls for base monthly payments of \$7,650 for sixty months commencing on September 1, 2010, with annual consumer price index adjustments, if any. In addition, starting from April 2014, a storage facility was also rented on a month-to-month basis for \$750 per month. For the years ended September 30, 2016 and 2015, rental income from these leases was approximately \$100,465 and \$105,064, respectively.

**Note 15 – Fair Value Measurements**

U.S. GAAP establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted market prices in active markets for identical assets or liabilities (Level 1 measurements), and the lowest priority to unobservable inputs in which little or no market data exists (Level 3 measurements). HMRI uses appropriate valuation techniques based on the available inputs to measure the fair value of its investments. When available, HMRI measures fair value using Level 1 inputs because they generally provide the most reliable evidence of fair value. Level 2 inputs are used for other observable inputs other than Level 1 prices in active markets that are either directly or indirectly observable. Level 3 inputs are used only when Level 1 or Level 2 inputs are not available. HMRI's alternative investments, including its limited partnership interests, offshore funds, and a life insurance policy, utilize Level 3 measurements.

Fair values for mutual funds and equity securities are determined by reference to quoted market prices. Fair values for pooled funds are determined by reference to quoted market prices for similar assets and other relevant information generated by market transactions. The fair value of the limited partnership interests and offshore funds are based on information received from the partnerships and offshore funds. Pooled funds, limited partnership interests, offshore funds, and life insurance were measured at fair value using significant unobservable inputs (Level 3) that have quantitative unobservable inputs that are not developed by HMRI when measuring fair value, such as prices from prior transactions or third party pricing information, without adjustment.

HMRI measured the charitable remainder unitrust at fair value using significant unobservable inputs (Level 3) with various quantitative information used in the measurement. On an annual basis, HMRI revalues the liability to make distributions to the life income beneficiary based on actuarial assumptions. The present value of the estimated future payments is calculated using a discount rate, as provided in Internal Revenue Service tables, and applicable mortality tables. The discount rate was 2.2% for the amounts owed at September 30, 2016 and 2015.

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**Note 15 – Fair Value Measurements** (continued)

Fair values of assets measured on a recurring basis at September 30, 2016 are as follows:

<u>2016</u>	<u>Assets at Fair Value as of September 30, 2016</u>			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments:				
Cash held for investment	\$ 727,827	\$ 727,827	\$ -	\$ -
Mutual funds	30,851,639	30,851,639	-	-
Limited partnership interests	4,433,397	-	-	4,433,397
Offshore funds	3,044,079	-	-	3,044,079
Life insurance	8,628	-	-	8,628
Charitable remainder unitrust	116,524	-	-	116,524
	<u>\$ 39,182,094</u>	<u>\$ 31,579,466</u>	<u>\$ -</u>	<u>\$ 7,602,628</u>

The following table summarizes the changes in the fair value of the Level 3 assets for the year ended September 30, 2016:

	<b>Pooled Funds, Limited Partnership Interests, Offshore Funds, and Life Insurance</b>	<b>Charitable Remainder Unitrust</b>
Balance, September 30, 2015	\$ 12,275,580	\$ 119,304
Additions	1,967,648	-
Net income	413,056	140
Unrealized gains	129,107	7,668
Withdrawals and distributions	<u>(7,299,287)</u>	<u>(10,588)</u>
Balance, September 30, 2016	<u>\$ 7,486,104</u>	<u>\$ 116,524</u>

The change in value of the pooled funds, limited partnership interests, and offshore funds, which include net income and realized and unrealized gains and losses, are included in the statement of activities for the year ended September 30, 2016. The change in value of the charitable remainder unitrust is attributable to the revaluation of the present value of the remainder interest and is included in the statement of activities for the year ended September 30, 2016.

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**Note 15 – Fair Value Measurements** (continued)

Fair values of assets measured on a recurring basis at September 30, 2015 are as follows:

<u>2015</u>	<u>Assets at Fair Value as of September 30, 2015</u>			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments:				
Cash held for investment	\$ 3,962,910	\$ 3,962,910	\$ -	\$ -
Common stock	5,948,858	5,948,858	-	-
Mutual funds	14,838,863	14,838,863	-	-
Pooled funds	1,723,528	-	1,723,528	-
Limited partnership interests	5,933,379	732,058	1,046,187	4,155,134
Offshore funds	8,111,818	-	-	8,111,818
Life insurance	8,628	-	-	8,628
Charitable remainder unitrust	119,304	-	-	119,304
	<u>\$ 40,647,288</u>	<u>\$ 25,482,689</u>	<u>\$ 2,769,715</u>	<u>\$ 12,394,884</u>

The following table summarizes the changes in the fair value of the Level 3 assets for the year ended September 30, 2015:

	<u>Pooled Funds, Limited Partnership Interests, Offshore Funds, and Life Insurance</u>	<u>Charitable Remainder Unitrust</u>
Balance, September 30, 2014	\$ 13,320,575	\$ 131,643
Additions	1,836,308	-
Net income	1,202,156	15
Unrealized losses	(627,524)	(37)
Withdrawals and distributions	(3,455,935)	(12,317)
Balance, September 30, 2015	<u>\$ 12,275,580</u>	<u>\$ 119,304</u>

The change in value of the pooled funds, limited partnership interests, and offshore funds, which include net income and realized and unrealized gains and losses are included in the statement of activities for the year ended September 30, 2015. The change in value of the charitable remainder unitrust is attributable to the reevaluation of the present value of the remainder interest and is included in the statement of activities for the year ended September 30, 2015.

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**Note 16 – Endowment**

HMRI's endowment consists of unrestricted Board-designated endowment funds including the Hacker Fund, and the permanently restricted McCollum Fund and Ingram Fund. The unrestricted Board-designated endowment funds are comprised of gifts received over the years that could be used at HMRI's discretion for unrestricted use. In 1991, HMRI received a permanently restricted endowment contribution and the McCollum Fund was created pursuant to the provisions of the trust created under the Will of Ross McCollum. Under the trust provisions, the corpus of the endowment is to remain intact and the income earned from appreciation of the corpus is available for HMRI's unrestricted use. In 2015, HMRI received a permanently restricted endowment contribution and the Ingram Fund was created pursuant to the provisions of the trust created by Marylou Ingram. Under the trust provisions, the corpus of the endowment is to remain intact and the income earned from appreciation of the corpus is available for research in tissue engineering, cancer molecular genetics, and other related research programs. As required by U.S. GAAP, net assets associated with the endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

HMRI adheres to U.S. GAAP with respect to the endowment funds. The State of California has adopted a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). The Board has interpreted UPMIFA 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. The Board has further interpreted this to mean that there is an implicit understanding that the market value of the donor-restricted endowment may from time to time fall below the fair value of the original gift as of the gift date due to market conditions or continued prudent expenditures by the Board of certain amounts of the endowment. If such a temporary deficit condition occurred, the Board would take all prudent steps, given ongoing market conditions, to restore the fair value of the fund to an amount at or above the amount of the original gift.

As a result of this interpretation, HMRI classifies as permanently restricted net assets a) the original value of gifts donated to the permanent endowment, b) the original value of subsequent gifts to the permanent endowment, and c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by HMRI in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, HMRI considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

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

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**Note 16 – Endowment** (continued)

The endowment consists of a portfolio of investments comprised of mutual funds, common stock, pooled funds, limited partnership interests, and offshore funds. The fiduciary responsibility for HMRI's portfolio is assigned to the Board delegated Investment Committee (Committee). The Committee takes responsibility for allocation of funds to various asset classes; Board approved policy, and the engagement of investment managers. The Committee will normally review the portfolio's asset allocation, manager structure, and performance quarterly in order to evaluate diversification, adherence to policies, and progress towards long-term objectives. While short-term results will be monitored, it is understood that the objectives of the portfolio are long-term in nature and that progress toward these objectives will be evaluated from a long-term prospective.

The primary long-term financial objectives of the portfolio are to maintain and grow the real value (purchasing power) of the fund in perpetuity, while providing a relatively stable and growing source of funding to support HMRI's operations. The primary long-term investment objective of the portfolio is to earn an average annual real (after adjusting for inflation) total return that exceeds the Board approved total spending rate (generally 4%), net of consultant and management fees, over long time periods (rolling twenty-year periods). The Board recognizes that the investment objectives involve risk and though it cannot be eliminated, can be mitigated by diversification and other risk management methods.

HMRI maintains master investment accounts for its donor-restricted and Board-designated endowments. Pooling endowment funds for investment purposes has many benefits, including but not limited to spreading the total risk for each endowment fund and making the risk equal for all funds invested in the master investment accounts, enhancing the investment performance relative to that of an individual fund, and reducing management fees. Realized and unrealized gains and losses from securities in the master investment accounts are allocated monthly to the individual endowments based on the relationship of the fair value of each endowment to the total fair value of the master investment accounts, as adjusted for additions to or deductions from those accounts.

A summary of endowment fund balances by type of fund as of September 30, 2016 is as follows:

	<b>Unrestricted</b>	<b>Temporarily Restricted</b>	<b>Permanently Restricted</b>	<b>Total</b>
Donor-restricted endowment	\$ -	\$ 4,173,112	\$ 5,486,792	\$ 9,659,904
Board-designated endowment	28,400,186	-	-	28,400,186
Endowment net assets, end of year	<u>\$ 28,400,186</u>	<u>\$ 4,173,112</u>	<u>\$ 5,486,792</u>	<u>\$ 38,060,090</u>

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**Note 16 – Endowment** (continued)

Changes in endowment net assets for the year ended September 30, 2016 are as follows:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$ 29,506,336	\$ 4,617,494	\$ 5,486,792	\$ 39,610,622
Investment return:				
Investment income	195,025	66,565	-	261,590
Realized gains on investments	404,715	138,134	-	542,849
Unrealized gains on investments	839,878	286,661	-	1,126,539
<b>Total Investment Return</b>	1,439,618	491,360	-	1,930,978
Appropriation of endowment assets for expenditure	(2,545,768)	(935,742)	-	(3,481,510)
Endowment net assets, end of year	<u>\$ 28,400,186</u>	<u>\$ 4,173,112</u>	<u>\$ 5,486,792</u>	<u>\$ 38,060,090</u>

A summary of endowment fund balances by type of fund as of September 30, 2015 is as follows:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment	\$ -	\$ 4,617,494	\$ 5,486,792	\$ 10,104,286
Board-designated endowment	29,506,336	-	-	29,506,336
Endowment net assets, end of year	<u>\$ 29,506,336</u>	<u>\$ 4,617,494</u>	<u>\$ 5,486,792</u>	<u>\$ 39,610,622</u>

Changes in endowment net assets for the year ended September 30, 2015 are as follows:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$ 32,795,448	\$ 5,511,315	\$ 3,486,792	\$ 41,793,555
Contributions	-	-	2,000,000	2,000,000
Investment Return:				
Investment income	341,019	92,219	-	433,238
Realized gains on investments	1,415,670	382,829	-	1,798,499
Unrealized losses on investments	(2,996,636)	(707,672)	-	(3,704,308)
<b>Total Investment Return</b>	(1,239,947)	(232,624)	-	(1,472,571)
Appropriation of endowment assets for expenditure	(2,049,165)	(661,197)	-	(2,710,362)
Endowment net assets, end of year	<u>\$ 29,506,336</u>	<u>\$ 4,617,494</u>	<u>\$ 5,486,792</u>	<u>\$ 39,610,622</u>

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**Note 16 – Endowment** (continued)

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 UPMIFA requires HMRI to retain as a fund of perpetual duration. In accordance with U.S. GAAP, deficiencies of this nature that are reported in unrestricted net assets were \$114,123 as of September 30, 2015. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions. There were no such deficiencies as of September 30, 2016.

**Note 17 – Commitments and Contingencies**

**Operating Leases**

HMRI is committed to a lease agreement for a building, expiring in June 2020. The future minimum rental commitments under the lease are as follows:

<u>Years Ending September 30,</u>	
2017	\$ 253,266
2018	260,864
2019	268,690
2020	<u>206,018</u>
	<u>\$ 988,838</u>

Rent expense for the years ended September 30, 2016 and 2015 was approximately \$491,000 and \$241,000, respectively.

In April 2016, HMRI entered into a sale and leaseback agreement for a property used as HMRI's main office and research facility. Under this agreement, HMRI is not required to make lease payments until March 2018. Consequently, HMRI recorded \$240,000 of in-kind rent expense and in-kind contributions for the year ended September 30, 2016. The lease is renewable and requires monthly payments after the initial 24-month period. However, HMRI does not intend to renew the lease and plans to move to a new location before March 2018 (Note 8). Sale proceeds of \$5,961,778 are designated by the Board for capital expenditures and are included in cash designated for capital expenditures and net assets designated by the Board in the accompanying statement of financial position. Gain from sale totaling \$5,494,608 is included in the accompanying statement of activities and changes in net assets as gain on disposal of fixed assets.

**Unfunded Capital Commitments**

HMRI is committed to provide additional capital to certain limited partnerships based on the capital call provisions of those partnerships. As of September 30, 2016 and 2015, HMRI's unfunded commitments to these limited partnerships were \$731,500 and \$1,082,500, respectively.

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**Note 17 – Commitments and Contingencies** (continued)

**Noncompliance with Laws and Regulations**

As of September 30, 2016, HMRI is involved in proceedings with the U.S. Department of Health and Human Services (HSS) concerning noncompliance with certain provisions of the Health Insurance Portability and Accountability Act of 1996 (HIPAA). HMRI self-reported the noncompliance to HSS once the violation was discovered. At the conclusion of proceedings, HSS may impose a noncompliance penalty on HMRI. The noncompliance penalty is based on the level of negligence and ranges from \$100 to \$50,000 per violation, with a maximum penalty of \$1,500,000 per year for violations of an identical requirement or provision. Management believes any actions that may result from these proceedings will not have a material effect on HMRI's future financial position or results of operations.

**Note 18 – Subsequent Events**

Management has evaluated subsequent events through March 15, 2017, the date the financial statements were available to be issued. No subsequent events requiring disclosure were noted.