



MEDSTAR HEALTH RESEARCH INSTITUTE

Financial Statements and Supplementary Schedule of
Expenditures of Federal Awards and Reports
under OMB Circular A-133

June 30, 2014 and 2013

(With Independent Auditors' Reports Thereon)

MEDSTAR HEALTH RESEARCH INSTITUTE

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KPMG LLP
1 East Pratt Street
Baltimore, MD 21202-1128

Independent Auditors' Report

The Board of Directors
MedStar Health Research Institute:

Report on the Financial Statements

We have audited the accompanying financial statements of MedStar Health Research Institute (the Institute), a wholly owned subsidiary of MedStar Health, Inc. (MedStar), which comprise the balance sheets as of June 30, 2014 and 2013, and the related statements of activities and changes in net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits 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 financial position of MedStar Health Research Institute as of June 30, 2014 and 2013, and the changes in its net assets and its cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



Other Matters

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis, as required by Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the 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 schedule of expenditure of federal awards is fairly stated, in all material respects, in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated March 13, 2015 on our consideration of MedStar Health Research 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 to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering MedStar Health Research Institute's internal control over financial reporting and compliance.

KPMG LLP

March 13, 2015

MEDSTAR HEALTH RESEARCH INSTITUTE

Balance Sheets

June 30, 2014 and 2013

Assets	2014	2013
Current assets:		
Cash and cash equivalents	\$ 43,544	13,727
Grants receivable, net of allowance for uncollectible accounts of \$915,010 and \$1,301,539 in 2014 and 2013, respectively	10,049,937	9,839,148
Prepaid expenses and other assets	9,405	14,909
Total current assets	<u>10,102,886</u>	<u>9,867,784</u>
Assets limited as to use or restricted	5,041,178	4,402,819
Property and equipment:		
Building and building improvements	3,905,633	3,880,783
Equipment and leasehold improvements	8,147,650	6,637,145
	<u>12,053,283</u>	<u>10,517,928</u>
Less accumulated depreciation and amortization	<u>(9,565,853)</u>	<u>(8,390,191)</u>
Property and equipment, net	2,487,430	2,127,737
Other assets	<u>66,165</u>	<u>66,165</u>
Total assets	<u>\$ 17,697,659</u>	<u>16,464,505</u>
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued expenses	\$ 828,350	1,248,076
Accrued salaries and benefits payable	1,939,825	2,162,398
Deferred grant revenue and other current liabilities	1,392,600	1,618,947
Total current liabilities	<u>4,160,775</u>	<u>5,029,421</u>
Other long-term liabilities	<u>254,867</u>	<u>231,165</u>
Total liabilities	<u>4,415,642</u>	<u>5,260,586</u>
Net assets:		
Unrestricted	12,089,676	10,061,031
Temporarily restricted	943,201	847,829
Permanently restricted	249,140	295,059
Total net assets	<u>13,282,017</u>	<u>11,203,919</u>
Total liabilities and net assets	<u>\$ 17,697,659</u>	<u>16,464,505</u>

See accompanying notes to financial statements.

MEDSTAR HEALTH RESEARCH INSTITUTE

Statements of Activities and Changes in Net Assets

Years ended June 30, 2014 and 2013

	<u>2014</u>	<u>2013</u>
Changes in unrestricted net assets:		
Revenues and gains:		
Grant and contract revenue	\$ 25,225,907	25,992,190
Net gains on investments and investment income	588,737	333,008
Contributions from parent, net	6,047,863	5,160,093
Net assets released from restrictions and other revenue	<u>609,409</u>	<u>782,680</u>
Total revenues and gains	<u>32,471,916</u>	<u>32,267,971</u>
Program expenses:		
Personnel	15,218,241	16,712,481
Purchased services	2,787,210	2,806,854
Supplies	505,978	1,233,725
Facilities	195,009	289,663
Risk management	—	7,919
Applied overhead and other	<u>5,660,884</u>	<u>5,706,578</u>
Total program expenses	<u>24,367,322</u>	<u>26,757,220</u>
General and administrative expenses:		
Unapplied overhead	<u>6,075,949</u>	<u>4,226,097</u>
Increase in unrestricted net assets	<u>2,028,645</u>	<u>1,284,654</u>
Change in temporarily restricted net assets:		
Restricted gifts	302,914	47,729
Net assets released from restrictions	(376,329)	(523,021)
Reclassifications to temporarily restricted net assets	45,919	—
Net gains on investments and investment income	<u>122,868</u>	<u>87,202</u>
Increase (Decrease) in temporarily restricted net assets	<u>95,372</u>	<u>(388,090)</u>
Change in permanently restricted net assets:		
Restricted gifts	—	(3,054)
Reclassifications from permanently restricted net assets	(45,919)	—
Net gains on investments and investment income	<u>—</u>	<u>24,100</u>
(Decrease) increase in permanently restricted net assets	<u>(45,919)</u>	<u>21,046</u>
Increase in net assets	2,078,098	917,610
Net assets at beginning of year	<u>11,203,919</u>	<u>10,286,309</u>
Net assets at end of year	<u>\$ 13,282,017</u>	<u>11,203,919</u>

See accompanying notes to financial statements.

MEDSTAR HEALTH RESEARCH INSTITUTE

Statements of Cash Flows

Years ended June 30, 2014 and 2013

	2014	2013
Cash flows from operating activities:		
Increase in net assets	\$ 2,078,098	917,610
Adjustments to reconcile increase in net assets to net cash and cash equivalents used in operating activities:		
Depreciation expense	487,100	377,037
Loss (gain) on sale of equipment	—	822
Provision for uncollectible accounts	91,203	(53,132)
Unrealized (gains) on investments	(394,217)	(261,876)
Realized (gains) on investments	(270,616)	(129,162)
Restricted gifts	(302,914)	(44,675)
Contributions from parent, net	(6,047,863)	(5,160,093)
Changes in operating assets and liabilities:		
Grants receivable	(301,992)	(489,258)
Prepaid expenses and other assets	5,504	1,992
Accounts payable and accrued expenses	(419,726)	159,228
Accrued salaries and benefits payable	(222,573)	182,136
Deferred grant revenue and other liabilities	(226,347)	204,932
Other long-term liabilities	23,702	59,923
Net cash used in operating activities	(5,500,641)	(4,234,516)
Cash flows from investing activities:		
Proceeds of marketable securities, net	26,474	71,959
Purchases of property and equipment	(846,793)	(1,049,313)
Net cash used in investing activities	(820,319)	(977,354)
Cash flows from financing activities:		
Contributions from parent, net	6,047,863	5,160,093
Restricted gifts	302,914	44,675
Net cash provided by financing activities	6,350,777	5,204,768
Net increase (decrease) in cash and cash equivalents	29,817	(7,102)
Cash and cash equivalents, beginning of year	13,727	20,829
Cash and cash equivalents, end of year	\$ 43,544	13,727

See accompanying notes to financial statements.

MEDSTAR HEALTH RESEARCH INSTITUTE

Notes to Financial Statements

June 30, 2014 and 2013

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

The MedStar Health Research Institute (the Institute or MHRI) is organized for the purpose of conducting scientific research in all fields of medicine, surgery, pharmaceuticals, health care delivery and all other sciences related to the healing and the curing of human ills. The Institute is a controlled entity of MedStar Health, Inc. (MedStar or the Corporation), a not-for-profit corporation.

MedStar is a tax-exempt, Maryland membership corporation which, through its controlled entities and other affiliates, provides and manages healthcare services in the region encompassing Maryland, Washington D.C. and Northern Virginia. The Corporation became operational on June 30, 1998 by the transfer of the membership interests of Helix Health, Inc. (Helix – a not-for-profit Maryland Corporation) and Medlantic Healthcare Group, Inc. (Medlantic – a not-for-profit Delaware Corporation) in exchange for the guarantee of the debt of both Helix and Medlantic by the Corporation. The trade names of the principal tax-exempt and taxable entities of the Corporation are:

Tax-Exempt

- MedStar Ambulatory Services (formerly known as Bay Development Corporation)
- MedStar Franklin Square Medical Center
- MedStar Georgetown University Hospital
- MedStar Good Samaritan Hospital
- MedStar Harbor Hospital
- MedStar Health Research Institute
- MedStar Health Visiting Nurse Association, Inc.
- MedStar Medical Group, LLC
- MedStar Montgomery Medical Center
- MedStar National Rehabilitation Network
- MedStar Southern Maryland Hospital Center
- MedStar St. Mary's Hospital
- MedStar Surgery Center, Inc.
- MedStar Union Memorial Hospital
- MedStar Washington Hospital Center
- Church Home and Hospital of the City of Baltimore, Inc.
- HH MedStar Health, Inc.

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Notes to Financial Statements

June 30, 2014 and 2013

Taxable

- Greenspring Financial Insurance, LTD.
- MedStar Enterprises, Inc. and Subsidiaries
- MedStar Family Choice, Inc.
- MedStar Physician Partners, Inc.
- Parkway Ventures, Inc. and Subsidiaries

(b) Basis of Presentation

The financial statements of the Institute are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles (U.S. GAAP).

Programs for the purpose of scientific research as described in note 1(a) are combined into one program for purposes of reporting on the statement of activities and changes in net assets.

The financial statements reflect the accounts of the Institute, including an allocation of general and administrative expenses from MedStar for financial, legal, accounting, human resources and information technology services. Such allocations, calculated on a percentage of revenue, are based on determinations that management believes to be reasonable. Accordingly, expense allocations to the Institute may not be representative of the costs of such services if the Institute were not affiliated with MedStar.

(c) 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.

(d) Cash and Cash Equivalents

All highly liquid investments with a maturity date of three months or less when purchased are considered to be cash equivalents.

(e) Grants

The Institute has been awarded various cost-reimbursable grants by the federal government and private sources. The Institute has also been awarded various grants from pharmaceutical and device companies, the funding of which is on a per-unit basis. Grant and contract revenue is recognized during the period the related expenses are incurred for cost-reimbursable awards. Fee-based award revenues are recognized when specified milestones are achieved.

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Notes to Financial Statements

June 30, 2014 and 2013

The Institute is reimbursed for a portion of its general and administrative expenses as an overhead component of the awarded grants. Total general and administrative expenses were \$11,346,902 and \$9,531,181 for the years ended June 30, 2014 and 2013, respectively. The Institute allocated \$5,270,953 and \$5,305,084 for the years ended June 30, 2014 and 2013, respectively, to applied overhead based on the amounts that are reimbursable under the grant agreements. The remaining overhead of \$6,075,949 and \$4,226,097 for the years ended June 30, 2014 and 2013, respectively, is included in unapplied overhead in the statement of activities and changes in net assets.

Bad debt expense is included in unapplied overhead as a component of general and administration expenses in the statement of activities and changes in net assets. Amounts recorded for bad debt expense are \$91,203 and \$(53,132) for the years ended June 30, 2014 and 2013, respectively.

Amounts received in excess of incurred expenses are recorded as deferred grant revenue. Expenses incurred in excess of amounts received are recorded as grants receivable, to the extent allowed under the grants. The carrying value of grants receivable approximates their fair value.

(f) *Assets Limited as to Use or Restricted*

The Institute participates in an investment pool with other MedStar affiliates.

MedStar's investment portfolio is considered trading, with the exception of the alternative investments, and is classified as current or noncurrent assets based on management's intention as to use. All securities are reported at fair value principally based on quoted market prices on the consolidated balance sheets. MedStar has elected to use the fair value option to account for its alternative investments. The fair value of alternative investments is determined based on the Net Asset Value (NAV) of the shares in each investment company or partnership. Purchases and sales of securities are recorded on a trade-date basis.

Assets whose use is limited or restricted include assets held by trustees under bond indenture, self-insurance trust arrangements, assets restricted by donor, and assets designated by the Board of Directors for future capital improvements and other purposes over which it retains control and may, at its discretion, use for other purposes. Amounts from these funds required to meet current liabilities have been classified in the consolidated balance sheets as current assets.

The Institute's board of directors has designated funds for purposes of future program development and other future obligations. The principal of the related investments will not be utilized without a two-thirds vote of the board of directors.

Investment income (interest and dividends) including realized gains and losses on investment sales are included in unrestricted net assets in the accompanying statement of activities and changes in net assets unless the income or loss is restricted by the donor or law. Investment income and net gains (losses) that are restricted by the donor are recorded as a component of changes in temporarily or permanently restricted net assets, in accordance with donor imposed restrictions. Realized gains and losses are determined based on the specific security's original purchase price or adjusted cost if the investment was previously determined to be other-than-temporarily impaired. Unrealized gains and losses are included in the Institute's changes in net assets.

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Notes to Financial Statements

June 30, 2014 and 2013

(g) Property and Equipment

Property and equipment acquisitions are recorded at cost and are depreciated or amortized over the estimated useful lives of the assets. Estimated useful lives range from three to forty years. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. In 2014 and 2013, no interest was capitalized. Depreciation expense is computed on a straight-line basis. The Institute recognized depreciation expense of \$487,100 and \$377,037 for the years ended June 30, 2014 and 2013, respectively. Major classes and estimated useful lives of property and equipment are as follows:

Leasehold improvements	Lease term
Buildings and improvements	10 – 40 years
Equipment	3 – 20 years

(h) Contributions

Unconditional promises to give cash and other assets to the Institute are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of activities and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

(i) Income Taxes

The principal operations of the Institute are exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code and the applicable income tax regulations of the District of Columbia. The Institute accounts for uncertain tax positions in accordance with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 740, *Income Taxes*.

(j) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Institute has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Institute in perpetuity.

(k) Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of financial instruments:

Cash and cash equivalents, receivables, other current assets, other assets, current liabilities and long-term liabilities: The carrying amount reported in the balance sheets for each of these assets and liabilities approximates their fair value.

The fair value of assets limited as to use or restricted is discussed in note 4.

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Notes to Financial Statements

June 30, 2014 and 2013

(1) Reclassifications

Certain prior year amounts have been reclassified to conform with current period presentation, the effect of which is not material.

(2) Related-Party Transactions

The Institute's board of directors is comprised of members of the community, physicians, and certain members of the board of trustees of MedStar and its subsidiaries.

The Institute provides and receives various management and support services from MedStar and its subsidiaries. Charges for services received in 2014 and 2013 are \$2,336,272 and \$2,022,258, respectively.

MedStar has committed to fund the continued operations of the Institute to July 1, 2014 by funding operating cash deficits and capital expenditures. The amount of cash contributions from MedStar during the years ended June 30, 2014 and 2013 were \$6,047,863 and \$5,160,093, respectively. These amounts correspond to cash needs for the Institute during the years ended June 30, 2014 and 2013, respectively.

(3) Assets Limited as to Use or Restricted

The Institute pools its portfolio of marketable securities with other MedStar marketable securities to centralize investment management and custody. The Institute's interest in the pooled investment funds and related investment income is accounted for on a percentage basis. Investment income earned from the Institute's ownership of interests in the pooled investment funds reflect its proportionate share of the interest, dividends, realized gains and losses and unrealized appreciation and depreciation of the securities held in the pool. The Institute's proportionate share of the pool's investment income from the underlying securities is reported as such in the Institute's consolidated statement of operations and changes in net assets.

MedStar's investments and assets whose use is limited or restricted, in the MedStar Corporate Investment Pool, as of June 30, 2014 and 2013, at fair value consist of the following (in millions):

	2014	2013
Collateralized guaranteed investment contract and cash	\$ 39.5	40.2
Fixed income securities and funds	184.5	224.2
Equity securities	508.3	461.4
Alternative investments:		
Commingled equity funds	146.4	90.7
Inflation hedging, commodity, fixed income fund	72.4	62.6
Hedge fund of funds and private equity	251.1	154.3
Total investments and assets whose use is limited or restricted	\$ 1,202.2	1,033.4

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Notes to Financial Statements

June 30, 2014 and 2013

The Institute has \$5,041,178 and \$4,402,819 of investable assets included in the MedStar Corporate Investment Pool above representing approximately 0.4% and 0.5% of the total shares at June 30, 2014 and 2013, respectively. The Institute's assets limited as to use or restricted as of June 30, 2014 and 2013, at fair value, identified by restriction is as follows:

	2014	2013
Board/management designated assets	\$ 3,984,320	3,220,718
Self-insurance trust funds	86,210	39,213
Temporarily and permanently restricted programs/research funds	970,648	1,142,888
	\$ 5,041,178	4,402,819

The Institute's investment income and gains for investments and assets whose use is limited or restricted as to use, and cash equivalents and other investments are comprised of the following for the year ending June 30, 2014 and 2013:

	2014	2013
Changes in unrestricted net assets:		
Investment income	\$ 46,772	53,272
Net realized gains on sale of investments	216,305	86,958
Unrealized gains on trading investments	325,660	192,778
	588,737	333,008
Other changes in net assets:		
Realized net gains on temporarily and permanently restricted net assets	54,311	42,204
Changes in unrealized gains on temporarily and permanently restricted net assets	68,557	69,098
Total investment return	\$ 711,605	444,310

(4) Fair Value of Financial Instruments

MedStar follows the guidance within FASB ASC Topic 820, *Fair Value Measurement (ASC 820)*, which defines fair value and establishes methods used to measure fair value. The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of the fair value hierarchy under ASC 820 are described below:

- Level 1 – Quoted prices in active markets for identical assets or liabilities at the measurement date;
- Level 2 – Observable inputs other than quoted prices for the asset, either directly or indirectly observable, that reflect assumptions market participants would use to price the asset based on market data obtained from sources independent of the Corporation;

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Notes to Financial Statements

June 30, 2014 and 2013

- Level 3 – Unobservable inputs that reflect the Corporations own assumptions about the assumptions market participants would use to price an asset based on the best information available in the circumstances.

MedStar has incorporated an Investment Policy Statement (IPS) into the investment program. The IPS, which has been formally adopted by MedStar’s Board of Directors, contains numerous standards designed to ensure adequate diversification by asset class and geography. The IPS also limits all investments by manager and position size, and limits fixed income position size based on credit ratings, which serves to further mitigate the risks associated with the investment program. At June 30, 2014 and 2013, management believes that all investments were being managed in a manner consistent with the IPS.

The following table illustrates the actual allocations of the Corporate investment portfolio as of June 30:

	Actual allocation June 30, 2014	Actual allocation June 30, 2013
Publicly traded equities – domestic	26%	29%
Publicly traded equities – international	14	14
Fixed income securities	16	22
Alternative investments:		
Commingled equity funds	12	9
Inflation hedging equity, commodity, fixed income fund	9	9
Hedge funds	20	13
Private equities	1	2
Cash	2	2
Total	100%	100%

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Notes to Financial Statements

June 30, 2014 and 2013

The table below presents the MedStar Corporate Investment Pool investable assets as of June 30, 2014, aggregated by the three-level valuation hierarchy (in millions):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 39.5	—	—	39.5
U.S. Treasury bonds	38.1	—	—	38.1
U.S. agency mortgage backed securities	26.8	—	—	26.8
Corporate bonds	—	50.1	—	50.1
Fixed income mutual funds	—	48.6	—	48.6
All other fixed income securities	3.7	17.1	—	20.8
Equity mutual funds & ETF's	120.3	—	—	120.3
Common stocks	388.0	—	—	388.0
Alternative investments:				
Commingled equity funds	—	146.4	—	146.4
Inflation hedging equity, commodity, fixed income fund	—	72.4	—	72.4
Private equity	—	—	17.0	17.0
Hedge funds	—	—	234.2	234.2
	<u>\$ 616.4</u>	<u>334.6</u>	<u>251.2</u>	<u>1,202.2</u>

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Notes to Financial Statements

June 30, 2014 and 2013

The table below presents the MedStar Corporate Investment Pool investable assets as of June 30, 2013, aggregated by the three level valuation hierarchy (in millions):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 40.2	—	—	40.2
U.S. Treasury bonds	36.0	—	—	36.0
U.S. agency mortgage backed securities	44.5	—	—	44.5
Corporate bonds	—	63.7	—	63.7
Fixed income mutual funds	0.1	53.1	—	53.2
All other fixed income securities	3.1	23.7	—	26.8
Equity mutual funds & ETF's	100.5	—	—	100.5
Common stocks	360.9	—	—	360.9
Alternative investments:				
Commingled equity funds	—	90.7	—	90.7
Inflation hedging equity, commodity, fixed income fund	—	62.6	—	62.6
Private equity	—	—	16.4	16.4
Hedge funds	—	—	137.9	137.9
	<u>\$ 585.3</u>	<u>293.8</u>	<u>154.3</u>	<u>1,033.4</u>

The Institute's investable assets in the MedStar Corporate Investment Pool would approximate MedStar's allocation in the above three level valuation hierarchies. For the years ended June 30, 2014 and 2013, there were no significant transfers between Levels 1, 2 or 3.

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Notes to Financial Statements

June 30, 2014 and 2013

Changes to the fair values based on the Level 3 inputs are summarized as follows (in millions):

	<u>Private equity</u>	<u>Hedge funds</u>	<u>Total</u>
Balance as of June 30, 2012	\$ 19.4	101.4	120.8
Additions:			
Contributions/purchases	0.9	26.7	27.6
Disbursements:			
Withdrawals/sales	(2.8)	—	(2.8)
Net change in value	<u>(1.1)</u>	<u>9.8</u>	<u>8.7</u>
Balance as of June 30, 2013	16.4	137.9	154.3
Additions:			
Contributions/purchases	1.4	180.8	182.2
Disbursements:			
Withdrawals/sales	(3.4)	(101.9)	(105.3)
Net change in value	<u>2.6</u>	<u>17.4</u>	<u>20.0</u>
Balance as of June 30, 2014	\$ <u><u>17.0</u></u>	<u><u>234.2</u></u>	<u><u>251.2</u></u>

The following summarizes redemption terms for the hedge fund-of-funds vehicles held as of June 30, 2014:

	<u>Fund 1</u>	<u>Fund 2</u>	<u>Fund 3</u>	<u>Fund 4</u>
Redemption timing:				
Redemption frequency	Quarterly	95% within 1 year ⁽¹⁾ 5% in 1 year or longer	Quarterly	Quarterly
Required notice	70 days	up to 90 days	90 days	65 days
Audit reserve:				
Percentage held back for audit reserve	10%	up to 10%	10%	10%
Gates:				
Potential gate holdback	—	up to 7.5%	—	—
Potential gate release timeframe	—	—	—	—

⁽¹⁾ One-third of this fund is redeemable within 90 days and the remainder of the investment is redeemable within one year.

Investments in hedge fund-of-funds are typically carried at estimated fair value. Fair value is based on the Net Asset Value (NAV) of the shares in each investment company or partnership. Such investment companies or partnerships mark-to-market or mark-to-fair value the underlying assets and liabilities in accordance with U.S. GAAP. Realized and unrealized gains and losses of the investment companies and partnerships are included in their respective operations in the current year. Changes in unrealized gains or losses on investments, including those for which partial liquidations were effected in the course of the year, are calculated as the difference between the NAV of the investment at year-end less the NAV of the

MEDSTAR HEALTH RESEARCH INSTITUTE

Notes to Financial Statements

June 30, 2014 and 2013

investment at the beginning of the year, as adjusted for contributions and redemptions made during the year and certain lock-up provisions. Generally, no dividends or other distributions are paid.

The following summarizes the status of contributions to the private equity fund-of-funds vehicles held as of June 30, 2014 (in millions):

	Total commitment	Percentage of commitment contributed	Percentage of commitment remaining
Fund 1	\$ 11.0	92.7%	7.3%
Fund 2	7.1	95.0	5.0
Fund 3	7.1	81.5	18.5
Fund 4	10.0	6.3	93.7
Total	\$ 35.2		

Investments in private equity funds, typically structured as limited partnership interests, are carried at fair value using NAV or equivalent as determined by the General Partner in the absence of readily ascertainable market values. Distributions under this investment structure are made to investors through the liquidation of the underlying assets. It is expected to take up to ten years to fully distribute the proceeds of those assets. The fair value of limited partnership interests is generally based on fair value capital balances reported by the underlying partnerships, subject to management review and adjustment. Security values of companies traded on exchanges, or quoted on NASDAQ, are based upon the last reported sales price on the valuation date. Security values of companies traded over the counter, but not quoted on NASDAQ, and securities for which no sale occurred on the valuation date are based upon the last quoted bid price. The value of any security for which a market quotation is not readily available may be its cost, provided however, that the General Partner adjusts such cost value to reflect any bona fide third party transactions in such a security between knowledgeable investors, of which the General Partner has knowledge. In the absence of any such third party transactions, the General Partner may use other information to develop a good faith determination of value. Examples include, but are not limited to, discounted cash flow models, absolute value models, and price multiple models. Inputs for these models may include, but are not limited to, financial statement information, discount rates, and salvage value assumptions.

The valuation of both marketable and nonmarketable securities may include discounts to reflect a lack of liquidity or extraordinary risks, which may be associated with the investment. Determination of fair value is performed on a quarterly basis by the General Partner. Because of the inherent uncertainty of valuation, the determined values may differ significantly from the values that would have been used had a ready market for those investments existed.

(5) Retirement Plans

The Institute participates in the MedStar Health, Inc. Cash Balance Retirement Plan (the Plan), a contributory defined benefit pension plan administered by MedStar, which covers substantially all employees of the Institute who have completed all service and age vesting requirements.

MEDSTAR HEALTH RESEARCH INSTITUTE

Notes to Financial Statements

June 30, 2014 and 2013

Benefits under the plan are substantially based on years of service and the employees' career earnings. The Institute contributes to the plan based on actuarially determined amounts necessary to provide assets sufficient to meet benefits to be paid to plan participants and to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974, as amended by the Pension Protection Act of 2006, and Internal Revenue Service regulations. Pension expense of \$(13,945) and \$1,301 was allocated to the Institute by MedStar during the years ended June 30, 2014 and 2013, respectively. At June 30, 2014, the Plan's zone status was considered to be green as the Plan was funded greater than 80%. Additional disclosures are not included in this report, as separate information on pension assets and liabilities for the Institute's employees is not available.

(6) Leases

The Institute leases office space at a number of locations and several pieces of equipment under noncancelable operating leases expiring through 2020. Rent expense for office space and equipment for the years ended June 30, 2014 and 2013 was \$1,118,220 and \$1,147,832, respectively.

Future minimum lease payments existing as of June 30, 2014 are as follows:

2015	\$	994,255
2016		1,018,268
2017		1,014,964
2018		1,031,271
2019		1,057,627
2020 and thereafter		<u>688,277</u>
	\$	<u>5,804,662</u>

(7) Self-Insurance Programs

MedStar maintains self-insurance programs for professional and general liability risks, employee health and workers' compensation. Estimated liabilities have been recorded based on actuarial estimation of reported and incurred but not reported claims. MedStar indemnifies the Institute for all reported self-insurance liability claims and for incurred but not reported claims.

MedStar's self insurance program for professional and general liability is responsible for the following exposures at June 30, 2014:

- (a) For professional liability during the periods of July 1, 2012 to June 30, 2013 and July 1, 2013 to June 30, 2014, the Corporation is responsible for the first \$5,000,000 exposure for each and every claim plus an additional exposure above \$5,000,000 self-insured retention referred to as an "inner aggregate."

For the period July 1, 2011 to December 31, 2012 the applicable inner aggregate was the inner aggregate that was in effect for the 24 month period January 1, 2010 through December 31, 2012. This inner aggregate exposed the Corporation to up to \$2,500,000 per claim with an aggregate for the 24 month period of \$5,000,000 above the \$5,000,000 per claim self-insured retention for all claims incurred during the period January 1, 2011 through December 31, 2012.

MEDSTAR HEALTH RESEARCH INSTITUTE

Notes to Financial Statements

June 30, 2014 and 2013

For the period January 1, 2013 to June 30, 2013 the applicable inner aggregate was the inner aggregate that was in effect for the 12 month period January 1, 2013 through December 31, 2013. This inner aggregate exposes the Corporation to up to \$3,000,000 with an annual aggregate of \$6,000,000 above the \$5,000,000 per claim self-insured retention for all claims incurred during the period January 1, 2013 through December 31, 2013.

For the period January 1, 2014 to June 30, 2014, the applicable inner aggregate was in effect for the 12 month period of January 1, 2014 to December 31, 2014. This inner aggregate exposes the Corporation to up to \$3,000,000 per claim with a \$6,000,000 annual aggregate above the Corporation's \$5,000,000 per claim self-insured retention for all claims incurred during the period January 1, 2014 to December 31, 2014.

- (b) For general liability, MedStar is responsible for the first \$3,000,000 exposure for each claim. General liability claims are not subject to the inner aggregate excess retention as described above.
- (c) Commercial excess re-insurance has been purchased above the self-insured retentions described above in multiple layers and in twin towers; one for professional and one for general liability. During the period of July 1, 2011 to December 31, 2012, each tower has seven layers of excess re-insurance coverage which provides coverage of up to \$100,000,000 per claim and \$100,000,000 in the annual aggregate. Effective January 1, 2013, the Corporation purchased an additional layer of commercial excess re-insurance. During the period of January 1, 2013 through June 30, 2014, each tower has eight layers of excess re-insurance which provides coverage of up to \$125,000,000 per claim and \$125,000,000 in the annual aggregate. The Corporation maintains reinsurance contracts with various "A" rated commercial insurance companies.

Contributions required to fund professional and general liability, employee health benefits and workers' compensation programs are determined by the plans' administrators based on appropriate actuarial assumptions. The professional and general liability programs are administered through an offshore wholly owned captive insurance company, Greenspring Financial Insurance Limited (GFIL), which is domiciled in Grand Cayman Island.

GFIL determines premiums for participating entities based on the individual entities' experiences and exposures. The Institute records premiums on an annual basis as allocated by GFIL. Premiums allocated to the Institute were \$3,393 and \$3,595 in fiscal years 2014 and 2013, respectively.

The Institute has an accrued liability for workers' compensation of \$107,824 and \$134,580 as of June 30, 2014 and 2013, respectively, which is included in deferred grant revenue and other current liabilities on the balance sheet. The workers' compensation liabilities at June 30, 2014 and 2013 have been discounted at a rate of 1.50%.

(8) Certain Significant Risks and Uncertainties

MedStar and the Institute, in the normal course of business, are parties to a number of legal and regulatory proceedings. Management does not expect that the results of these proceedings will have a material adverse effect on the financial position or results of operations of the Institute.

MEDSTAR HEALTH RESEARCH INSTITUTE

Notes to Financial Statements

June 30, 2014 and 2013

(9) Subsequent Events

Management evaluated all events and transactions that occurred after June 30, 2014 and through March 13, 2015. The Institute did not have any subsequent events that were required to be recognized or disclosed.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Expenditures of Federal Awards

Year ended June 30, 2014

<u>Federal awarding agency/program title</u>	<u>Federal CFDA #</u>	<u>Federal expenditures</u>
Research and development:		
U.S. Department of Health and Human Services:		
Passed through DC:		
HIV Hope	93.940	\$ 141,768
Ryan White Title III Program	93.918	476,165
Passed through Benton Technologies Inc.:		
Sexually Active Adolescent Focused Education	93.865	8,931
GUH Post-Grad Residents		
93.855	93.855	103,474
Passed through George Washington University:		
ARRA NIH/GWU DC Cohort HIV	93.855	130,789
Passed through University of California - San Francisco:		
Organ Transplant in HIV	93.855	189
Total 93.855		<u>234,452</u>
Passed through Georgetown University:		
NINDS	93.853	12,889
NIH/GU/NRH Protect DC	93.853	8,531
NIH/University of Southern California ICARE	93.853	510
Geo Univ: EMR Translation CTSA	93.853	80,279
GHU CCTS: MEDIC	93.853	7,416
SCANR	93.853	123,850
Total 93.853		<u>233,475</u>
Dietary Studies		
93.847	93.847	569,107
Passed through Texas Biomedical Research Institute:		
NIDDK/TX Bio: Uric Acid Nephro	93.847	2,213
Passed through George Washington University:		
NIDDK/GWU: GRADE	93.847	496,215
Passed through Tufts University:		
NIDDK/Tufts D2D-	93.847	241,293
Passed through University of North Carolina at Chapel Hill		
Univ of North Carolina -URIC ACID NE	93.847	10,466
Total 93.847		<u>1,319,294</u>
Passed through University of North Carolina:		
Chapel Hill Kaushik	93.846	19,666
Passed through University of Washington:		
NIH/U Washington Cerebrovascular Disease	93.837	271,824
Passed through University of Rochester:		
NIH/U Rochester: RAID	93.837	9,113
Gocadan Project	93.837	3,596
NHLBI: Strong Heart VI	93.837	394,765
Cardiovascular Outcomes in Renal Atherosclerotic Lesions	93.837	89
Total 93.837		<u>679,387</u>
Passed through Georgetown University:		
Georgetown Univ. - Alternative to Psychiatric Residential	93.789	4,662
CDC: Hepatitis	93.736	208,635
Passed through University of Washington		
CNPFD	93.399	61,270
NSABP: P5 Recruit Support	93.399	46,882
Total 93.399		<u>108,152</u>

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Expenditures of Federal Awards

Year ended June 30, 2014

<u>Federal awarding agency/program title</u>	<u>Federal CFDA #</u>	<u>Federal expenditures</u>
Passed through University of Chicago:		
WHC Cancer Research – CALGB Services	93.395	\$ 39,298
NCI/Birmingham CALGB Services	93.395	6,468
Total 93.395		<u>45,766</u>
Passed through Georgetown University:		
NIH-NCCR/Georgetown University CTSA DBPS	93.389	318,853
NIH-NCCR/Georgetown University CTSA PCIR	93.389	158,210
NIH-NCCR/Georgetown University CTSA BI	93.389	51,862
NIH-NCCR/Georgetown University CTSA RETCD	93.389	90,000
NCCR/Geo U: Chemo-Induced Ovar	93.389	3,604
NCATS/Geo U: MetaGENomic	93.389	12,297
Passed through George Washington University:		
CTSA - Improved Understanding of Trauma	93.389	6,404
Total 93.389		<u>641,230</u>
Passed through Georgetown University:		
NIH/Geo U: MHRI GOV	93.350	4,436
Geo Univ: BRCA CTSA	93.350	73,338
Total 93.350		<u>77,774</u>
Passed through University of Maryland – Baltimore:		
U Cal/UMB: POINT	93.310	6,548
Passed through Boston Medial Center:		
Boston Medical Center-National Estimates for Inpatient Care	93.307	12,837
Passed through Georgetown University:		
NIMHD/Geo U: P60 CEHD-RTEC	93.307	41,617
NIMHD/Geo U: P60 CEHD-STROKE	93.307	85,990
Total 93.307		<u>140,444</u>
Passed through Georgetown University:		
NIH/Geo U: Gabapentin Opiod Us	93.279	17,405
NIH/NIBIB HFE Image System	93.286	34,093
Passed through State University of New York at Buffalo:		
AHRQ/NYU Improving Patient Safety	93.226	135,056
Passed through CAN Analysis Solution:		
AHRQ/CNA: HAI Action	93.226	177,222
AHRQ: OB Simulation	93.226	265,285
AHRQ: F32 High Risk Healthcare	93.226	44,321
Passed through University of Massachusetts:		
AHRQ/U MASS: Patient Breakdown	93.226	219,512
Passed through Health Research Educational Trust:		
AHRQ: Action II RFTO#29	93.226	106,364
AHRQ-ED Interruption	93.226	10,261
Passed through University of Illinois – Chicago:		
AHRQ/U.Chicago: 7 Pillars	93.226	44,955
Total 93.226		<u>1,002,976</u>
Stroke Study	93.173	12,584
Ryan White Title IV Program	93.153	395,556
Passed through John Hopkins University:		
NIH/JHU: Arsenic/Gene/Diabetes	93.133	34,853

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Expenditures of Federal Awards

Year ended June 30, 2014

<u>Federal awarding agency/program title</u>	<u>Federal CFDA #</u>	<u>Federal expenditures</u>
NIA	93.000	\$ 3,458,068
Passed through Children's Research Institute:		
Child Research Inst: 5908-08-02	93.000	165,171
NCI/Black Hills CINCO Study	93.000	192,223
Passed through RTI International		
NHLBI/RTI GenTAC II Registry	93.000	273,625
Passed through State University of New York of Buffalo		
NHLBI/UNY WHI Extension	93.000	308,635
FDA: Mini Pig Study	93.000	109,104
Passed through American Burn Association:		
USAMRAA/ABA: RESCUE Trial	93.000	2,453
Passed through Duke University:		
NHLBI/Duke: CABANA	93.000	2,580
NIH: Stroke Contract 2012	93.000	145,925
NIH: Stroke Bridging 2013/2014	93.000	688,930
NRH- ARTC-MOU	93.000	(3,162)
Total 93.000		<u>5,343,552</u>
Total U.S. Department of Health and Human Services		<u>11,187,366</u>
U.S. Department of Education (ED):		
RRTC	84.133	745,592
Smart Over-Ground Gait	84.133	122,836
Passed through Georgetown University		
DOE/Geo U: Neurorehabilitation	84.133	46,644
Total U.S. Department of Education		<u>915,072</u>
U.S. Department of Defense (DOD):		
Army Coagulopathy Burn Patients	12.431	327,790
DoD: SBS SDS Mus Musculus	12.431	381,993
Total 12.431		<u>709,783</u>
Passed through Denver Hospital Health Authority		
DOD/Denver HHA: ABX Wounded Wa	12.420	154,039
Passed through National Rehabilitation Hospital		
DOD/NRH ARTC Army Medical Research ACQ	12.420	6,417
DOD ACQ: Hypothesis Dev Award	12.420	38,379
Total 12.420		<u>198,835</u>
Passed through Walter Reed Medical Center		
DOD/Gynecologic Oncology Group	12.000	2,554
Passed through SCITOR Corporation:		
DOD/CIA/Scitor: Iris Scan	12.000	15,138
DOD/CIA/Scitor: FIEF-DOM	12.000	6,989
Total 12.000		<u>24,681</u>
Total U.S. Department of Defense		<u>933,299</u>
U.S. Department of Agriculture:		
USDA: REQ AG-32SD-P-12-0029	10.000	6,755
Total U.S. Department of Agriculture		<u>6,755</u>

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Expenditures of Federal Awards

Year ended June 30, 2014

<u>Federal awarding agency/program title</u>	<u>Federal CFDA #</u>	<u>Federal expenditures</u>
U.S. Department of Veterans Affairs:		
Passed through DC VA Medical Center:		
VA Med Center: PACEART	64.013	\$ 5,824
VA APA Study	64.013	18,443
VA: Stroke Biomechanics\Chan	64.013	10,725
VA: IPA Tsai	64.013	7,981
VA: Stroke Biomechanics\Tiffan	64.013	9,177
Total U.S. Department of Veterans Affairs		<u>52,150</u>
Total research and development		<u>13,094,642</u>
Total federal expenditures		<u>\$ 13,094,642</u>

See accompanying notes to schedule of expenditures of federal awards.

MEDSTAR HEALTH RESEARCH INSTITUTE

Notes to Schedule of Expenditures of Federal Awards

Year ended June 30, 2014

(1) Basis of Presentation

The accompanying Schedule of Expenditures of Federal Awards (the Schedule) includes federal grant activity of the MedStar Health Research Institute (the Institute or MHRI) and is presented on the accrual basis of accounting. The information in this Schedule is presented in accordance with the requirements of *OMB Circular A-133, Audits of States, Local Governments, and Non Profit Organizations*. Therefore, some amounts presented in the Schedule may differ from amounts presented in, or used in the preparation, of the basic financial statements.

(2) Indirect Costs

The Institute operates under predetermined fixed indirect cost rates. The indirect cost rate effective at the grant award date was effective throughout the grant period. The indirect rate for eligible nonpayroll costs during the year ended June 30, 2014 for on-site programs ranged from 10% to 57% for most studies and was 44% for all off-site programs. The indirect rate for fringe benefits during the year ended June 30, 2014 is 40% of payroll costs.

(3) Subrecipients

Of the federal expenditures presented in the Schedule, the Institute provided federal awards to subrecipients as follows:

<u>Federal awarding agency/program title</u>	Federal CFDA number	Amount provided to subrecipients
Catholic University of America	84.133	\$ 3,986
National Spinal Cord Injury Association	84.133	7,500
Memorial Hermann Institute for Rehabilitation & Research	84.133	40,876
University of Miami	84.133	106,912
Mary's Center	93.153	48,889
Metro TeenAids	93.153	2,903
		<u>\$ 211,066</u>



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**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***

The Board of Directors
MedStar Health Research 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 MedStar Health Research Institute (the Institute or MHRI), which comprise the balance sheet as of June 30, 2014, and the related statement of activities and changes in net assets and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 13, 2015.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Institute'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 the Institute's internal control. Accordingly, we do not express an opinion on the effectiveness of the Institute'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 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. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Institute'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*.



Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Institute'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 Institute's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

March 13, 2015



KPMG LLP
1 East Pratt Street
Baltimore, MD 21202-1128

Independent Auditors' Report on Compliance for Each Major Federal Program and Report on Internal Control Over Compliance by OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

The Board of Directors
MedStar Health Research Institute:

Report on Compliance for Each Major Federal Program

We have audited MedStar Health Research Institute's (the Institute or MHRI) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Institute's major federal programs for the year ended June 30, 2014. The Institute's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

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

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for each of the Institute'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 OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 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 the Institute'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 the Institute's compliance.

Opinion on Each Major Federal Program

In our opinion, the Institute 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 June 30, 2014.



Other Matters

The results of our auditing procedures disclosed instances of noncompliance, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items 14-01, 14-02 and 14-03. Our opinion on each major federal program is not modified with respect to these matters.

The Institute's responses to the noncompliance findings identified in our audit are described in the accompanying schedule of findings and questioned costs. The Institute's responses were not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

Report on Internal Control over Compliance

Management of the Institute 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 the Institute'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 OMB Circular A-133, 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 the Institute's internal control over compliance.

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

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, we identified certain deficiencies in internal control over compliance, as described in the accompanying schedule of findings and questioned costs as items 14-01, 14-02 and 14-03, that we consider to be significant deficiencies.

The Institute's responses to the internal control over compliance findings identified in our audit are described in the accompanying schedule of findings and questioned costs. The Institute's responses were not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.



The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

KPMG LLP

March 13, 2015

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Section I – Summary of Auditors’ Results

Financial Statements

Type of auditors’ report issued: Unmodified

Internal control over financial reporting:

- Material weaknesses No
- Significant deficiencies No

Noncompliance material to financial statements: No

Federal Awards

Internal control over major programs:

- Material weaknesses No
- Significant deficiencies Yes

Type of auditors’ report issued on compliance for major programs: Unmodified

Audit findings disclosed that are required to be reported in accordance with section 510(a) of OMB Circular A-133 for the year ended June 30, 2014: Yes findings 14-01 through 14-03

Identification of Major Programs:

<u>CFDA number</u>	<u>Name of federal program or cluster</u>
Various	Research and development cluster

Dollar threshold used to distinguish between type A and type B programs: \$ 300,000

Auditee qualified as low-risk auditee? Yes

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Section II – Findings Relating to the Financial Statements Reported in Accordance with *Government Auditing Standards*

None

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Section III – Federal Award Findings and Questioned Costs

Finding 14-01

Federal Agency

Various

Program Title

Research and Development Cluster

CFDA Number

Various

Area

Completeness and Accuracy of the Schedule of Expenditures of Federal Awards (SEFA)

Criteria or Requirement

OMB Circular A-133 specifies that the auditee shall identify, in its accounts, all federal awards received and expended and the federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the federal agency, and name of the pass-through entity. The auditee shall also prepare appropriate financial statements, including the schedule of expenditures of federal awards in accordance with OMB Circular A-133.

Condition Found, Including Perspective

In connection with our non-payroll expense testwork, we noted 14 instances out of a sample of 65 invoices inspected, where grant expenses related to the year ended June 30, 2013 were included on the SEFA for the year ended June 30, 2014. Total expenditures related to this finding was \$51,338 out of total sampled amount of \$314,658.

Possible Asserted Cause and Effect

MHRI did not maintain adequate internal control over the completeness and accuracy of the SEFA to ensure that it was in compliance with the requirements referenced above. As a result, MHRI is not in compliance with the requirements referenced above that nonfederal entities maintain internal controls to ensure that costs are reported on the SEFA during the period that they are incurred.

Questioned Costs

There are no questioned costs related to this finding.

Recommendation

We recommend that MHRI establish an appropriate level of monitoring to ensure that costs are reported on the SEFA during the period that they are incurred.

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Views of Responsible Officials

MedStar Health Research Institute (MHRI) is committed to accruing invoices in the proper period. Procedures are in place to ensure that invoices are accrued within the appropriate fiscal year. Annually, communications are sent to all manager-level staff providing guidance on the accrual process and requesting timely submissions of invoices for any goods and/or services received in the current fiscal year. For the year ended June 30, 2014, the communication was issued on May 22, 2014.

In order to ensure that costs are properly accrued to projects reported on the Schedule of Expenditures of Federal Assistance, the Institute will: 1) contact vendors to obtain appropriate year-end invoices in a timely manner; 2) provide communications with greater advance notice; 3) include reminders; 4) provide greater emphasis on the need to carefully consider potentially eligible but unbilled expenses to support an accrual; and 5) accrue expenses to projects when deemed appropriate to ensure they are included in the appropriate SEFA period.

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Finding 14-02

Federal Agency

Various

Program Title

Research and Development Cluster

CFDA Number

Various

Area

Activities Allowed or Unallowed; Allowable Costs/Costs Principles

Criteria or Requirement

The specific requirements for activities allowed or unallowed are unique to each program and are documented in the applicable award documents. OMB Circular A-122 establishes cost principles for grants awarded to nonprofit organizations. Nonfederal entities receiving federal awards must establish and maintain internal control designed to reasonably ensure that all activities and costs are allowable.

Condition Found, Including Perspective

During our test of compliance over the allowability of payroll and nonpayroll costs, it was determined that one payroll item with a value of \$92 out of a population of 65 items with a value of \$34,822 and one nonpayroll item with a value of \$1,370 out of a population of 65 items with a value of \$314,658 did not have proper documentation of approvals to be submitted for reimbursement.

Possible Asserted Cause and Effect

MHRI did not maintain a proper level of review to ensure that payroll and nonpayroll costs are being accurately charged to the federal grants and supported by proper documentation. As a result, failure to maintain appropriate review over payroll and nonpayroll costs could result in unallowed costs being charged to the grant and an under/overstatement of expenditures reported to the awarding agency.

Questioned Costs

Total questioned costs amounted to \$1,462.

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Recommendation

We recommend that MHRI maintain proper documentation of a review process to ensure that payroll and nonpayroll costs are being appropriately and accurately charged to the respective grants and the proper documentation is maintained in accordance with OMB Circular A-110.

Views of Responsible Officials

MHRI recognizes the importance of formally documenting the review of expenses charged to federally funded projects. Controls exist prior to posting a charge to a federally funded project and prior to reporting or billing for a federally funded project. We are committed to ensuring that the review is formally documented and available for the audit.

The finding related to the non-payroll item was for an expenditure that was processed under the prior accounting system. The subsequent implementation of workflow in the PeopleSoft Financial System ensures that the review of non-payroll expenditures is properly documented in the system.

Regarding the finding relating to the payroll item, we are implementing procedures to ensure reviews are properly documented. Submissions of timesheets within PeopleSoft that are done by the pay cycle deadline are properly documented in the system. We have been reviewing payroll processing to ensure that timesheets are submitted and reviewed in a timely manner in the system. In addition, we will be implementing procedures to review the payroll cycle processed in the system for instances that do not fully conform to our review process and take measures to ensure proper documentation of the review.

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Finding 14-03

Federal Agency

Various

Program Title

Research and Development Cluster

CFDA Number

12.431

Area

Reporting

Criteria or Requirement

OMB Circular A-110 requires that nonfederal entities receiving federal awards establish and maintain internal control designed to reasonably ensure compliance with federal laws, regulations, and program compliance. In addition, nonfederal entities must ensure proper internal controls are in place to maintain compliance with the frequency and timeliness of reporting to the cognizant agencies as specified in the grant agreements.

Condition Found, Including Perspective

MHRI did not submit certain of its annual progress reports to the cognizant agencies within the required time frame as specified by the grant agreement. MHRI is generally required to submit such reports within 30 to 120 days after the period end date. We identified one report that was not submitted within the time period as required by the grant agreement. The length of delinquency in reporting was 11 months.

Possible Asserted Cause and Effect

MHRI did not maintain adequate internal control over reporting to ensure compliance with the requirements of OMB Circular A-110. Accordingly, MHRI failed to submit a required report within the time frame as specified by the grant agreement, hence, MHRI is not in compliance with the grant agreement's reporting requirements. As a result, MHRI is not in compliance with OMB Circular A-110 and the applicable grant agreement that requires nonfederal entities to submit reports to the cognizant agency within the time periods established by the grant agreements.

Questioned Costs

There are no questioned costs related to this finding.

MEDSTAR HEALTH RESEARCH INSTITUTE

Schedule of Findings and Questioned Costs

Year ended June 30, 2014

Recommendation

We recommend that MHRI establish an appropriate level of monitoring to ensure that reports are submitted to the cognizant agencies within the required periods as specified by the grant agreements.

Views of Responsible Officials

MHRI is committed to the timely filing of all required reports. In addition, for the report in question, the sponsor requested details for a calendar year as opposed to a grant year. We will be utilizing milestone functionality in the new financial system to send communications to responsible parties and facilitate central review of deadlines. Upcoming progress report due dates and timely submission are incorporated into the monthly review of federal grants conducted by the finance, administrative, and research teams.