

CONSOLIDATED FINANCIAL STATEMENTS

Banner Health and Subsidiaries  
Years Ended December 31, 2019 and 2018  
With Report of Independent Auditors

Ernst & Young LLP



Banner Health and Subsidiaries  
Consolidated Financial Statements  
Years Ended December 31, 2019 and 2018

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Ernst & Young LLP  
101 E. Washington Street  
Suite 910  
Phoenix, AZ 85004

Tel: +1 602 322 3000  
ey.com

## Report of Independent Auditors

The Board of Directors  
Banner Health

We have audited the accompanying consolidated financial statements of Banner Health and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2019 and 2018, and the related consolidated statements of income, changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### **Management’s Responsibility for the Financial Statements**

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

### **Auditor’s Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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

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

## **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Banner Health and Subsidiaries at December 31, 2019 and 2018, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

## **Change in Accounting Principle**

### ***Adoption of ASU No. 2016-02, Leases (Topic 842)***

As discussed in Note 2 to the Banner Health consolidated financial statements, Banner changed its method of accounting for leases as a result of the adoption of the amendments to the Financial Accounting Standards Board Accounting Standards Codification resulting from Accounting Standards Update (ASU) 2016-02, *Leases* (Topic 842), effective January 1, 2019. Our opinion is not modified with respect to this matter.

*Ernst + Young LLP*

March 17, 2020

## Banner Health and Subsidiaries

### Consolidated Balance Sheets

	<b>December 31</b>	
	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 496,348	\$ 383,096
Short-term investments	113,230	112,196
Collateral held under securities lending program	208,533	210,811
Assets limited as to use	149,512	144,170
Patient receivables	943,316	868,127
Inventories	222,238	206,055
Other receivables	431,578	350,731
Other, primarily prepaid expenses	124,259	86,211
Total current assets	<u>2,689,014</u>	<u>2,361,397</u>
Assets limited as to use:		
Funds designated by:		
Board of Directors	2,371,342	2,031,832
Lease agreements	1,990	1,931
Funds held by trustees under:		
Self-insurance funding arrangements	114,114	103,564
Project fund	9,182	–
Other funds	227,070	138,238
Total assets limited as to use, less current portion	<u>2,723,698</u>	<u>2,275,565</u>
Property and equipment, net	4,238,913	3,685,196
Right of use assets – Operating	252,269	–
Right of use assets – Finance	28,819	207,847
Other assets:		
Long-term investments	2,428,594	2,114,408
Other	805,099	742,342
Total other assets	<u>3,233,693</u>	<u>2,856,750</u>
Total assets	<u><u>\$ 13,166,406</u></u>	<u><u>\$ 11,386,755</u></u>

Banner Health and Subsidiaries  
Consolidated Balance Sheets (continued)

	<b>December 31</b>	
	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
<b>Liabilities and net assets</b>		
Current liabilities:		
Trade accounts payable	\$ 269,057	\$ 208,932
Current portion of long-term debt	376,501	58,994
Debt subject to self-liquidity	400,000	200,000
Current portion of operating lease obligations	67,389	–
Current portion of finance lease obligations	2,952	22,188
Payable under securities lending program	208,533	210,811
Estimated current portion of third-party payor settlements	8,262	3,465
Accrued expenses:		
Salaries and benefits	508,926	460,061
Medical claims payable	224,058	202,849
Other	254,940	238,164
Total current liabilities	2,320,618	1,605,464
Long-term debt, less current portion	3,245,669	3,064,972
Finance lease obligations	27,046	211,515
Operating lease obligations	206,399	–
Estimated self-insurance liabilities, less current portion	176,388	205,055
Estimated third-party payor settlements, less current portion	16,534	17,531
Interest rate swaps	335,259	258,762
Other	188,455	174,853
Total liabilities	6,516,368	5,538,152
Net assets without donor restrictions:		
Attributable to Banner Health	6,393,695	5,613,878
Attributable to non-controlling interests	63,212	43,999
Net assets without donor restrictions	6,456,907	5,657,877
Net assets with donor restrictions	193,131	190,726
Total net assets	6,650,038	5,848,603
Total liabilities and net assets	\$ 13,166,406	\$ 11,386,755

*See accompanying notes.*

Banner Health and Subsidiaries  
Consolidated Statements of Income

	<b>Year Ended December 31</b>	
	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
Revenues:		
Net patient service revenue	\$ 7,000,985	\$ 6,553,649
Medical insurance premiums	1,983,929	1,539,653
Other revenue	441,734	426,477
Total revenues	9,426,648	8,519,779
Expenses:		
Salaries and benefits	4,270,282	4,025,037
Supplies	1,496,296	1,358,488
Physician and professional fees	234,778	209,522
Medical claims cost, net of Banner claims of \$408,291 and \$366,861 in 2019 and 2018, respectively	1,495,898	1,137,340
Depreciation and amortization	468,302	414,841
Interest	132,229	126,438
Purchased services	599,264	545,495
Other	529,241	516,281
Total expenses	9,226,290	8,333,442
Operating income	200,358	186,337
Other income (loss):		
Investment income – realized	170,219	195,642
Investment gain (loss) – unrealized	375,459	(341,150)
Income (loss) from alternative investments	95,464	(16,720)
Income (loss), net	641,142	(162,228)
Unrealized (loss) gain on interest rate swaps	(76,724)	52,015
Other	(10,994)	(5,712)
Total other income (loss)	553,424	(115,925)
Excess of revenues over expenses	753,782	70,412
Less excess of revenues over expenses attributable to non-controlling interests	26,951	26,449
Excess of revenues over expenses attributable to Banner Health	\$ 726,831	\$ 43,963

## Banner Health and Subsidiaries

### Consolidated Statements of Changes in Net Assets

	<b>Year Ended December 31</b>	
	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
Net assets without donor restrictions:		
Excess of revenues over expenses attributable to Banner Health	\$ 726,831	\$ 43,963
Amortization of cumulative loss on interest rate swaps	227	227
Decrease in unfunded pension liability	6,438	1,180
Cumulative effect of change in accounting principle	24,637	(7,323)
Contributions for property and equipment acquisitions	21,684	6,524
Increase attributable to Banner Health	779,817	44,571
Excess of revenue over expenses attributable to non-controlling interests	26,951	26,449
Other changes, primarily distributions of earnings to non-controlling interests	(7,738)	(14,262)
Increase attributable to non-controlling interests	19,213	12,187
Net assets with donor restrictions:		
Contributions	30,505	27,157
Net unrealized gain (loss) on investments	3,213	(1,998)
Net assets released from restrictions for property and equipment additions	(1,513)	(2,990)
Net assets released from restrictions for operations	(29,800)	(14,804)
Increase in net assets with donor restrictions	2,405	7,365
Increase in net assets	801,435	64,123
Net assets, beginning of year	5,848,603	5,784,480
Net assets, end of year	\$ 6,650,038	\$ 5,848,603

*See accompanying notes.*

# Banner Health and Subsidiaries

## Consolidated Statements of Cash Flows

	Year Ended December 31	
	2019	2018
	<i>(In Thousands)</i>	
<b>Operating activities</b>		
Increase in net assets	\$ 801,435	\$ 64,123
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	468,302	414,841
Loss on early extinguishment of debt	1,782	-
(Increase) decrease in investments designated as trading	(880,669)	323,671
Net unrealized loss (gain) on interest rate swaps	76,497	(52,242)
Decrease in unfunded pension liability	(6,438)	(1,180)
Cumulative effect of change in accounting principle	(24,637)	7,323
Gain on sale of business venture	-	(50,443)
Gain on sale of assets, net	(1,856)	(1,525)
Contributions for purchase of property and equipment and other	(21,684)	(6,524)
Restricted contributions	(30,505)	(27,157)
Cash distributions to non-controlling interests	24,010	26,215
Changes in operating elements, net of acquisitions and dispositions:		
Patient receivables	(75,189)	31,762
Inventories and other current assets	(134,209)	(121,235)
Accounts payable and accrued expenses	146,975	32,363
Estimated third-party payor settlements	3,800	(21,751)
Estimated self-insurance liabilities	(28,667)	27,041
Other assets and liabilities	24,159	(7,453)
Net cash provided by operating activities	<u>343,106</u>	<u>637,829</u>
<b>Investing activities</b>		
Net purchases of property and equipment	(914,993)	(561,323)
(Increase) decrease in project fund	(9,182)	44,957
Proceeds from sale of business venture	-	95,200
Acquisitions	(68,079)	-
Increase in other assets	(12,027)	(65,583)
Net cash used in investing activities	<u>(1,004,281)</u>	<u>(486,749)</u>
<b>Financing activities</b>		
Proceeds from restricted contributions	30,505	27,157
Proceeds from issuance of debt	1,000,536	298
Payments of finance lease obligations	(24,002)	(23,278)
Payments of long-term debt	(329,758)	(68,478)
Cash distributions to non-controlling interests	(24,010)	(26,215)
Net cash provided by (used in) financing activities	<u>653,271</u>	<u>(90,516)</u>
Net (decrease) increase in cash and cash equivalents	(7,904)	60,564
Cash, cash equivalents, and restricted cash at beginning of year	798,964	738,400
Cash, cash equivalents, and restricted cash at end of year	<u>\$ 791,060</u>	<u>\$ 798,964</u>
<b>Supplemental disclosure of cash flow information</b>		
Interest paid, including amounts capitalized	<u>\$ 135,434</u>	<u>\$ 139,405</u>
Taxes paid	<u>\$ 5,636</u>	<u>\$ 6,141</u>
<b>Non-cash activities</b>		
Termination of NCMC finance lease obligation	\$ (150,524)	\$ -
Removal of NMC right of use asset – finance	\$ 151,342	\$ -

See accompanying notes.

# Banner Health and Subsidiaries

## Notes to Consolidated Financial Statements

December 31, 2019

### 1. Description of Business

Banner Health is a nonprofit corporation exempt from income taxes under Internal Revenue Code Section 501(c)(3) and applicable state income tax codes. Banner Health and its subsidiaries (collectively, Banner) own, control, or lease hospitals, clinics, nursing homes, clinical laboratories, ambulatory surgery centers, urgent care centers, free-standing imaging centers, home health agencies, a captive insurance company, a foundation, an accountable health care organization, a Medicaid managed care health plan and related Medicare Advantage health plan, and other health care-related organizations in six western states. Banner also holds controlling interests in several health care-related business ventures (see Note 2) and non-controlling interests in several other entities that are accounted for under the equity method of accounting (see Note 8).

### 2. Significant Accounting Policies

#### Basis of Consolidation

The accompanying consolidated financial statements reflect the consolidated operations of all owned and leased operating units of Banner and its wholly owned subsidiaries. Banner also holds controlling interests in the following business ventures. The business venture financial results are included within Banner's consolidated financial statements. Banner records the unrelated investor's ownership share of these business ventures as non-controlling interest.

#### *Sonora Quest Laboratories, LLC*

The Sonora Quest Laboratories, LLC (SQL) business venture was formed in 1997. Banner holds a 51% controlling interest, and Quest Diagnostics of Arizona, Inc. (Quest) holds a 49% non-controlling interest. SQL provides a broad range of laboratory services to Arizona physicians, hospitals and other health care providers. The non-controlling interest balance as of December 31, 2019 and 2018, primarily relates to Quest's investment in SQL.

#### *BHSM Rehabilitation, LLC*

In December 2017, Banner and Select Medical (Select) entered into a business venture that operates Banner's and Select's Arizona inpatient and outpatient rehabilitation services. The business venture, BHSM Rehabilitation, LLC (BHSM), began operations on May 1, 2018. Banner holds a 51% controlling interest in BHSM and Select holds a 49% non-controlling interest.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

##### *Banner Atlas JV, LLC*

In December 2018, Banner entered into a business venture with Atlas Healthcare Partners, LLC (Atlas) that operates Banner's ambulatory surgery centers. The business venture is named Banner Atlas JV, LLC, with Banner holding a 75% controlling interest and Atlas holding a 25% non-controlling interest. Atlas manages the ambulatory surgery centers via a management service agreement and works with Banner to develop additional ambulatory surgical facilities in Banner's primary markets. Banner Atlas JV, LLC will always maintain a controlling interest in each surgery center.

All significant intercompany accounts and transactions have been eliminated in consolidation.

##### **Subsequent Events**

Subsequent events have been evaluated through March 17, 2020, the date the consolidated financial statements were issued. There were no subsequent events requiring recognition in the consolidated financial statements.

##### **Fair Values**

The carrying values of financial instruments classified as current assets and current liabilities approximate fair value. The fair values of other financial instruments are disclosed in their respective notes.

##### **Cash and Cash Equivalents**

Cash and cash equivalents consist primarily of cash and highly liquid marketable securities with an original maturity of three months or less when purchased by Banner.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within the statement of financial position that sum to the total of the same such amounts shown in the statement of cash flows for the years ended December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
	<i>(In Thousands)</i>	
Cash and cash equivalents	\$ 496,348	\$ 383,096
Investments	20,142	99,176
Assets limited as to use	274,570	316,692
Cash, cash equivalents, and restricted cash	<u>\$ 791,060</u>	<u>\$ 798,964</u>

#### Short-Term Investments

Short-term investments include debt securities with maturity dates of one year or less from the balance sheet date and actively traded equity securities that are expected to be used on a short-term basis for working capital needs. These investments are stated at fair value, based on quoted market prices in active markets.

#### Investments

Investment income, including interest and dividends, realized gains and losses on investments, unrealized gains and losses on investments, and income on alternative investments, is included in excess of revenues over expenses, unless the income or loss is restricted by donor or law.

Banner invests in various investment securities that are exposed to various risks, such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated financial statements.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

Banner invests in various commingled funds, which are assets from multiple accounts, primarily equities, blended into a single fund. Commingled funds do not have a readily determinable fair value, despite the nature of the underlying securities; therefore, the net asset value, as reported by the fund manager, is used as a practical expedient for fair value. As such, they are excluded from the fair value hierarchy (see Note 5) and noted as investments measured at net asset value: private commingled funds.

Banner invests in alternative investments, mainly hedge funds, through limited partnerships. Banner accounts for its ownership interests in these alternative investments under the equity method of accounting, based on the net asset value per share of the fund held by Banner. The hedge fund net asset value is provided to Banner by each of the hedge fund managers. The net asset value is determined based on the estimated fair value of each of the underlying investments held in the hedge fund. However, the hedge fund investment holdings may include investments in private investment funds whose values have been estimated by the hedge fund managers in the absence of readily ascertainable fair values. Due to the inherent uncertainty of these estimates, these values may differ from the values that would have been used had a ready market for these investments existed. The investment income recorded is based on Banner's proportionate share of the hedge fund portfolio's change in net asset value during the year. The alternative investment income is primarily recorded within income from alternative investments on the consolidated statement of income, with the remainder recorded as a change to restricted net assets for those funds that have been restricted by the donor. Banner has recorded approximately \$95,464,000 and (\$16,720,000) of alternative investment unrestricted realized and unrealized gains/losses for the years ended December 31, 2019 and 2018, respectively. Banner's foundation has recorded approximately \$941,000 and \$245,000 of alternative investment restricted realized and unrealized gains for the years ended December 31, 2019 and 2018, respectively.

Certain of Banner's alternative investments are subject to redemption lockup periods or have capital call commitments. As of December 31, 2019, approximately \$146,304,000 of Banner's alternative investments were subject to a two-year redemption lockup period. In addition, certain of Banner's alternative investment agreements follow a capital call structure, of which Banner has committed up to approximately \$360,500,000. Of that total, Banner has made capital contributions of \$151,269,000 as of December 31, 2019, resulting in up to approximately \$209,231,000 in uncalled commitments.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

Banner uses derivative financial instruments in its investment portfolio to moderate changes in value due to fluctuations in the financial markets. Banner has not designated its derivatives related to marketable securities as hedged financial instruments. Accordingly, the change in the fair value of derivatives is recognized as a component of investment income. Banner's fixed-income manager has executed a master netting arrangement for each of the derivative instruments held by the same counterparty, which are legally offset as the instrument is settled. Banner's derivative contracts in a net loss position were reported on a net basis on the accompanying consolidated balance sheets as of December 31, 2019 and 2018. As of December 31, 2019, approximately \$175,008,000 of gross derivative assets and approximately \$174,803,000 of gross derivative liabilities were netted together within investments. As of December 31, 2018, approximately \$1,429,581,000 of gross derivative assets and approximately \$1,425,776,000 of gross derivative liabilities were netted together within investments (see Note 5).

Banner has entered into a repurchase agreement for approximately \$11,100,000 and \$174,410,000 as of December 31, 2019 and 2018, respectively. In connection with the repurchase agreement, Banner has loaned cash to certain financial institutions in exchange for purchased securities that serve as collateral. The fair value of the collateral provided by these financial institutions, based on quoted market prices in active markets, was approximately \$11,374,000 and \$177,973,000 as of December 31, 2019 and 2018, respectively. The repurchase agreement has been characterized as a collateralized borrowing. The collateral has not been sold or pledged to an external party as of December 31, 2019 and 2018, and, accordingly, is not recorded on the consolidated balance sheets. The executed repurchase agreements as of December 31, 2019, will mature during 2020.

#### **Assets Limited as to Use**

Assets limited as to use include marketable securities that have been designated for use as determined by the Banner Board of Directors, such as for property and equipment replacement and expansion, payments under lease agreements, assets held by trustees, and assets held as collateral by counterparties under interest rate swap agreements.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

##### **Securities Lending Program**

Banner participates in securities lending transactions through its custodian, whereby Banner lends a portion of its investments to various brokers in exchange for collateral for the securities loaned, usually on a short-term basis. Collateral provided by the brokers consists of cash and securities and is maintained at levels approximating 104% of the fair value of the securities on loan, adjusted for market fluctuations. Banner maintains effective control of the loaned securities through its custodian during the term of the arrangement in that the securities may be recalled at any time. Under the terms of the agreement, the borrower must return the same, or substantially the same, investments that were borrowed. The value of collateral held for loaned securities is reported in current assets as collateral held under securities lending program, and a corresponding obligation is reported in current liabilities as a payable under securities lending program in the accompanying consolidated balance sheets. At December 31, 2019 and 2018, the fair value of the collateral provided on behalf of Banner was approximately \$208,533,000 and \$210,811,000, respectively. At December 31, 2019 and 2018, the fair value of securities on loan was approximately \$200,303,000 and \$203,175,000, respectively. The securities loaned under the securities lending program as of December 31, 2019 will mature during 2020.

##### **Patient Receivables**

Net patient accounts receivable and net patient service revenues have been adjusted to the estimated amounts expected to be received based on contractual rates for services rendered, inclusive of an estimated implicit price concession. These estimated amounts are subject to further adjustments upon review by third-party payors.

##### **Inventories**

Inventories, consisting principally of supplies, are stated at the lower of cost or net realizable value, determined on a first-in, first-out basis.

##### **Property and Equipment**

Property and equipment are stated at cost, if purchased, or at fair value on the date received, if donated, less accumulated depreciation and amortization.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

Depreciation is provided on a straight-line basis over the estimated useful lives of the property and equipment, which range from 2 to 20 years for major moveable equipment and from 5 to 40 years for buildings and fixed equipment. Amortization of leasehold improvements is provided on a straight-line basis over the shorter of the lease period or the estimated useful lives.

#### **Long-Lived Asset Impairment**

Banner reviews long-lived assets, other than goodwill, for impairment when events or changes in business conditions indicate that their carrying values may not be recoverable. Banner considers assets to be impaired and writes them down to fair value if expected undiscounted cash flows are less than the carrying amounts. Fair value is the present value of the associated discounted cash flows.

#### **Goodwill**

Purchases of acquired businesses are allocated to the assets and liabilities assumed based on the estimated fair values on the respective acquisition dates. Based on these values, the excess purchase price over the fair value of the net assets acquired is allocated to goodwill.

Banner evaluates goodwill for impairment at least annually, and more frequently if indicators of impairment are encountered. Goodwill is tested at the reporting unit level, defined as an operating segment or one level below an operating segment, with the fair value of the reporting unit being compared to its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to be impaired.

Banner completes its annual impairment test during the fourth quarter to determine whether there are events or circumstances that indicate it is more likely than not that the reporting units' fair values are less than their carrying amounts. Banner determined that there was no goodwill impairment for 2019 or 2018.

#### **Costs of Borrowing**

Debt issuance costs are deferred and amortized over the term of the related bond using the straight-line method, which approximates the effective interest method.

Interest incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

##### Self-Insurance Programs

In connection with self-insurance programs, accounts have been established for the purpose of accumulating assets based on actuarial determinations. These assets can be used only for the payment of professional liability, general liability, workers' compensation, employment liability, employee group life insurance claims, health plan stop-loss coverage, and related expenses. It is Banner's policy to record the expense and related liability for professional liability, general liability, workers' compensation, employment liability, and employee group life insurance losses based upon undiscounted actuarial estimates.

##### Net Assets

Net assets, revenues, gains, and losses are classified based on the existence or absence of donor or grantor-imposed restrictions. Net assets and changes therein are classified and reported as follows:

*Net Assets Without Donor Restrictions* – Net assets available for use in general operations and not subject to donor restrictions.

*Net Assets With Donor Restrictions* – Net assets subject to donor-imposed restrictions. Some donor-imposed restrictions are temporary in nature, such as those that will be met by the passage of time or other events specified by the donor. Other donor-imposed restrictions are perpetual in nature, where the donor stipulates that resources be maintained in perpetuity. Donor-imposed restrictions are released when a restriction expires, that is, when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. Net assets with donor restrictions are primarily restricted for capital projects, Alzheimer's research, oncology, and pediatric programs.

##### Contributions

Banner records contributions upon receipt of an unconditional promise to give. Gifts, bequests, and other promises or receipts restricted by donors as to use or time period are recorded as net assets with donor restriction until used in the manner designated or upon expiration of the time period restriction. Donated property and equipment are recorded at fair value at the date received. Unrestricted contributions received are recorded as other income.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

##### Performance Indicator

Banner's performance indicator is the excess of revenues over expenses, which includes all changes in net assets without donor restrictions other than changes in the amortization of cumulative loss on interest rate swaps, contributions for property and equipment acquisitions, changes in pension funded status, and the cumulative effect of changes in accounting principle.

##### Net Patient Service Revenue

Net patient service revenue is reported at the amount to which Banner expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payors (including health insurers and government programs), and others and include variable consideration for retroactive revenue adjustments due to settlement of ongoing and future audits, reviews, and investigations.

Banner uses a portfolio approach to account for categories of patient contracts as a collective group, rather than recognizing revenue on an individual contract basis. The portfolios consist of major payor classes for inpatient revenue and major payor classes and types of services provided for outpatient revenue. Based on historical collection trends and other analyses, Banner believes that revenue recognized by utilizing the portfolio approach approximates the revenue that would have been recognized if an individual contract approach were used.

Banner's initial estimate of the transaction price for services provided to patients is determined by reducing the total standard charges related to the patient services provided by various elements of variable consideration, including contractual adjustments, discounts, implicit price concessions, and other reductions to Banner's standard charges. Banner determines the transaction price associated with services provided to patients who have third-party payor coverage based on the reimbursement terms outlined in contractual agreements, Banner's discount policies and historical experience. For uninsured and under-insured patients who do not qualify for charity care, Banner determines the transaction price associated with services on the basis of charges reduced by implicit price concessions. Implicit price concessions included in the estimate of the transaction price are based on Banner's historical collection experience for applicable patient portfolios. Patients who meet Banner's criteria for free care are provided care without charge; such amounts are not reported as revenue. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to net patient service revenue in the period of the change.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

Net patient service revenue is recognized as performance obligations are satisfied, even though Banner bills patients and third-party payors several days after the services are performed and/or the patient is discharged. Performance obligations are determined based on the nature of the services provided by Banner. Net patient service revenue for performance obligations satisfied over time is recognized based on actual charges incurred to date in relation to total expected charges. Banner believes that this method provides a reasonable depiction of the transfer of services over the term of the performance obligation based on the services needed to satisfy the obligation. Generally, performance obligations satisfied over time relate to patients receiving inpatient acute care services. Banner measures the performance obligation from admission into the hospital to the point when it is no longer required to provide services to that patient, which is generally at the time of discharge. Revenue for performance obligations satisfied at a point in time is recognized when goods or services are provided, and Banner does not believe it is required to provide additional goods or services to the patient.

Banner has determined that the nature, amount, timing and uncertainty of revenue and cash flows are affected by the payors, the lines of business that render services to patients and the timing of when revenue is recognized and billed. Net patient service revenue for the years ended December 31, 2019 and 2018, by payor is as follows (in thousands):

	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
Commercial and contracted payors	<b>\$ 3,307,456</b>	\$ 3,154,525
Medicare	<b>2,482,209</b>	2,322,556
Medicaid	<b>1,043,125</b>	981,011
Self-pay	<b>168,195</b>	95,557
	<b><u>\$ 7,000,985</u></b>	<b><u>\$ 6,553,649</u></b>

Deductibles, copayments, and coinsurance under third-party payment programs, which are the patient's responsibility, are included within the primary payor category in the table above.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

Net patient service revenue for the years ended December 31, 2019 and 2018, by line of business, is as follows (in thousands):

	<u>2019</u>	<u>2018</u>
	<i>(In Thousands)</i>	
Hospital	\$ 5,824,260	\$ 5,515,814
Physician services	668,198	615,673
Laboratory	291,924	281,202
Ambulatory and other	216,603	140,960
	<u>\$ 7,000,985</u>	<u>\$ 6,553,649</u>

#### State Supplemental Programs

Banner's academic medical centers are eligible to receive supplemental payments from the Arizona Health Care Cost Containment System (AHCCCS), Arizona's Medicaid program, by qualifying as sponsoring institutions of Graduate Medical Education (GME) programs. Supplemental payments are paid annually after the completion of the state's fiscal year and are based on each hospital's inpatient Medicaid days, number of residents and actual costs to maintain the program. Banner accrues the estimated supplemental payments over the fiscal year, as they are earned based on Medicaid utilization. The payments are recorded as part of net patient service revenue, as they are considered additional reimbursement for care provided to AHCCCS patients. The total revenue recognized for the years ended December 31, 2019 and 2018, was approximately \$124,213,000 and \$103,004,000, respectively.

#### Medical Insurance Premiums and Medical Claim Costs

Banner Health Network (BHN) has entered into risk contracts with insurance companies, whereby BHN receives a monthly capitation fee, and is responsible for the payment of the enrolled members' claims. For the years ended December 31, 2019 and 2018, BHN recorded premium revenue from insurance companies of approximately \$500,591,000 and \$516,891,000, respectively. BHN paid health care claims for services rendered to enrolled members of approximately \$536,516,000 and \$553,066,000 for the years ended December 31, 2019 and 2018, respectively. Included in the total paid health care claims were payments to Banner Health of approximately \$202,086,000 and \$229,258,000 for the years ended December 31, 2019 and 2018, respectively, which are eliminated upon consolidation. BHN has recorded a medical claim liability,

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

associated with claims incurred but not yet paid, of approximately \$41,258,000 and \$43,885,000 as of December 31, 2019 and 2018, respectively, which are eliminated upon consolidation. Included in the medical claim liability were amounts owed to Banner Health of approximately \$20,904,000 and \$18,681,000 for the years ended December 31, 2019 and 2018, respectively, which are eliminated upon consolidation. BHN is also a participant in the Medicare Shared Savings Plan (MSSP), a shared risk program with the Centers for Medicare and Medicaid Services (CMS). In 2019, BHN received a \$4,471,000 MSSP shared risk gain for the 2018 contract year.

The Banner-University Health Plans (BUHP) include University Care Advantage and University Family Care. BUHP has entered into contracts with AHCCCS and CMS to provide health insurance services for enrolled members. In October 2018, University Family Care was awarded a three-year AHCCCS Complete Care contract, with the option to extend up to four years, which is in addition to the AHCCCS long-term care contract that was awarded on October 1, 2017.

University Care Advantage's contract with CMS is a calendar year contract, which can be renewed annually. For the years ended December 31, 2019 and 2018, BUHP recorded premium revenue from AHCCCS and CMS of approximately \$1,483,338,000 and \$1,018,090,000, respectively. BUHP paid health care claims for services rendered to enrolled members of approximately \$1,371,550,000 and \$943,192,000 for the years ended December 31, 2019 and 2018, respectively. Included in the total paid health care claims were payments to Banner Health of approximately \$201,987,000 and \$125,725,000 for the years ended December 31, 2019 and 2018, respectively, which are eliminated upon consolidation. BUHP has recorded a medical claim liability, associated with claims incurred but not yet paid and/or received, of approximately \$199,494,000 and \$161,230,000 as of December 31, 2019 and 2018, respectively, which are eliminated upon consolidation. Included in the medical claim liability were amounts owed to Banner Health of approximately \$44,057,000 and \$30,098,000 for the years ended December 31, 2019 and 2018, respectively, which are eliminated upon consolidation.

#### **Use of Estimates**

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

##### New Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases* (Topic 842), a new lease accounting standard, which was codified as Accounting Standards Codification 842, *Leases* (ASC 842). This accounting standard requires companies that lease assets to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in their balance sheets. This accounting standard also requires additional disclosures about the amount, timing, and uncertainty of cash flows arising from leases and is effective for fiscal years beginning after December 15, 2018. Banner adopted this accounting standard on January 1, 2019, and recorded right-of-use assets of approximately \$491,695,000, lease obligations of approximately \$507,599,000, and a transition adjustment, which increased net assets without donor restriction by approximately \$24,637,000.

In June 2018, the FASB issued ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made*, a new accounting standard relating to accounting for contributions received and made. This accounting standard provides a more robust framework to determine when a transaction should be accounted for as a contribution or as an exchange transaction and provides additional guidance about how to determine whether a contribution is conditional. The accounting standard was adopted by Banner on January 1, 2019, using a modified prospective basis, and did not have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other*, a new intangibles-goodwill accounting standard. The accounting standard simplified the test used to evaluate goodwill and other intangibles for impairment. Under the new accounting standard, a company will perform its annual goodwill impairment test by comparing the fair value of the reporting unit with its carrying amount. An impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the impairment loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. A company will still have the option to perform the qualitative assessment for a reporting unit. This accounting standard is effective for fiscal years beginning after December 15, 2020. Management is currently evaluating the impact of adopting this accounting standard.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*, which changes the disclosure requirements for fair value measurement. The accounting standard is effective for the Company as of December 31, 2020, and will be applied using a retrospective approach. The Company is currently evaluating the impact on its consolidated financial statements.

#### **3. Charity Care and Services That Benefit the Community**

In furtherance of its charitable purpose, Banner provides a broad range of benefits to the communities it serves, including offering various community-based social service programs and several health-related educational programs. These services are designed and provided to improve the general standards of health for the communities.

Included in services to the communities are programs directed at the poor and persons who cannot afford health care due to inadequate resources and/or who are uninsured or under-insured. Non-elective, medically necessary care provided by Banner is rendered, regardless of the patient's ability to pay, and Banner's charity care policy offers various discounts from billed charges based on the patient's family's income.

In addition to providing traditional charity care, Banner: assumes the unpaid costs of Medicaid and other indigent public programs; provides services for the community through health promotion and education, health clinics, and screenings, all of which cannot be billed or can be operated only on a deficit basis; assumes the unpaid costs of training health professionals, such as medical residents, nursing students, and students in allied health professions; provides community health research; and provides cash and in-kind donations of equipment, supplies, or staff time made on behalf of the community.

Banner's cost accounting system is used to quantify the estimated charity care costs, which include both direct and indirect costs, for providing patient care at each facility. During 2019 and 2018, costs incurred by Banner in the provision of charity care, the unpaid costs of programs directed at the poor, the education of health professionals, research activities, and the costs of supporting other community programs were approximately \$732,709,000 and \$707,819,000, respectively. Charity care is recorded based on the cost of services provided for which charges are written off in accordance with Banner's charity care policy, but does not include the amount, if any, for which the patient remains responsible.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 3. Charity Care and Services That Benefit the Community (continued)

The following summary of Banner's net community benefit for the years ended December 31 represents services to both the poor and broader community:

	<b>2019</b>	<b>% of Total Expense</b>	<b>2018</b>	<b>% of Total Expense</b>
	<i>(In Thousands)</i>		<i>(In Thousands)</i>	
Traditional charity care, at cost	\$ 78,937	0.9%	\$ 83,904	1.0%
Unpaid cost of public programs, Medicaid, and other indigent care programs	502,546	5.4	515,527	6.2
Health professional education	83,894	0.9	59,991	0.8
Community health services	8,607	0.1	8,037	0.1
Research activities	15,678	0.2	7,406	0.1
Community-building activities	347	—	364	—
Subsidized health services	38,383	0.4	29,164	0.3
Contributions and in-kind donations	4,238	—	3,394	—
Community benefit operations	79	—	32	—
Total cost of community benefit	<b>732,709</b>	<b>7.9</b>	<b>707,819</b>	<b>8.5</b>
Unpaid cost of Medicare	<b>106,207</b>	<b>1.2</b>	<b>83,627</b>	<b>1.0</b>
Total cost of community benefit and unpaid cost of Medicare	<b>\$ 838,916</b>	<b>9.1%</b>	<b>\$ 791,446</b>	<b>9.5%</b>

*Traditional Charity Care* is the cost of services for which reimbursement is not pursued, in accordance with Banner's policy to provide health care services free of charge or on a discounted fee schedule to those who cannot afford health care due to inadequate resources and/or who are uninsured or under-insured.

*Unpaid Cost of Public Programs* is the shortfall created when Banner receives payments below the cost for patients enrolled in publicly supported programs, such as Medicare and Medicaid, exclusive of supplemental payment programs.

*Health Professional Education* includes the unpaid costs of training health professionals, such as medical residents, nursing students, and students in allied health professions.

*Community Health Services* include costs for health education and related activities designed to improve the health of the community. Community health education programs, community-based clinical services, and health care support services are included. No patient bills are generated for these services.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 3. Charity Care and Services That Benefit the Community (continued)

*Research Activities* include clinical and community health research, as well as studies on health care delivery.

*Community-Building Activities* include the costs of programs that develop the community through physical improvements, economic development, support system enhancements, environmental improvements, leadership development, coalition building, community health improvement advocacy, and workforce enhancement.

*Subsidized Health Services* include costs for billed services that are subsidized by Banner. These include services offered despite a financial loss, because they are needed in the community and either other providers are unwilling to provide the services or the services would, otherwise, be unable to meet patient demand.

*Contributions and In-Kind Donations* include cash donations, grants, and in-kind donations to the community at large and other tax-exempt organizations.

*Community Benefit Operations* include costs of directly planning, evaluating, and managing community benefit activities.

#### 4. Concentrations of Credit Risk

Banner grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors as of December 31 was as follows:

	<u>2019</u>	<u>2018</u>
Commercial and contracted payors	42.8%	44.1%
Medicare	32.1	30.1
Medicaid	19.2	19.2
Self-pay	5.9	6.6
	<u>100.0%</u>	<u>100.0%</u>

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 5. Fair Value Measurements

Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, Banner utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

- *Level 1* – Pricing inputs into the determination of fair value are generally observable inputs, such as quoted prices for identical instruments in active markets. Financial assets in Level 1 primarily include listed equities and mutual funds.
- *Level 2* – Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Financial assets and liabilities in Level 2 include asset-backed securities, mortgage-backed securities, collateralized mortgage obligations, U.S. Treasury securities, corporate bonds and loans, forward contracts, interest and credit swap agreements, options, and interest rate swap obligations.

*Level 3* – Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are, therefore, determined using factors that involve considerable judgment and interpretation, including, but not limited to, private and public comparables, third-party appraisals, discounted cash flow models, and fund manager estimates.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 5. Fair Value Measurements (continued)

Assets and liabilities measured at fair value are based on one or more of the two valuation techniques identified in the tables below. The valuation techniques are as follows:

- (a) *Market approach* – prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities
- (b) *Income approach* – techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option pricing, and excess earnings models)

Banner received restricted pledges and contributions of approximately \$30,505,000 and \$27,157,000 for the years ended December 31, 2019 and 2018, respectively, which were subject to fair value measurement on a non-recurring basis. The restricted contributions were measured based on the actual cash received or for pledges receivable, using discounted cash flow projections. Approximately \$7,981,000 and \$9,268,000 of these restricted contributions were recorded as pledges receivable as of December 31, 2019 and 2018, respectively.

Banner's investment in alternative investments of approximately \$1,141,939,000 and \$1,069,224,000 as of December 31, 2019 and 2018, respectively, is accounted for using the equity method of accounting. Accordingly, the alternative investments are omitted from the following schedule of financial instruments measured at fair value. There have not been any changes in any of the investments' fair value level classification between Level 1 and Level 2 in 2019 or 2018. Banner has no Level 3 investments. As a result of further analysis of the characteristics of certain private commingled funds, amounts that were previously reported as Level 1 at December 31, 2018 have been reclassified as investments measured at net asset value: private commingled funds, consistent with the 2019 presentation

# Banner Health and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### 5. Fair Value Measurements (continued)

	December 31, 2019	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b)
Cash and cash equivalents	\$ 294,712	\$ 283,496	\$ 11,216	\$ –	a
Collateral held under securities lending (primarily cash and debt securities)	208,533	141,635	66,898	–	a
Mutual funds:					
Mutual funds – U.S. funds	1,014,628	1,014,628	–	–	a
Mutual funds – International	356,225	356,225	–	–	a
Total mutual funds	1,370,853	1,370,853	–	–	
Debt securities:					
U.S. Treasury/government obligations	274,353	–	274,353	–	a
Corporate bonds/non-U.S. government bonds	353,431	–	353,431	–	a
Asset-backed securities	190,195	–	190,195	–	a
Commercial mortgage-backed securities	32,465	–	32,465	–	a
Non-government-backed collateralized mortgages	31,382	–	31,382	–	a
Government mortgage-backed securities	131,716	–	131,716	–	a
Government commercial-backed securities	5,339	–	5,339	–	a
Total debt securities	1,018,881	–	1,018,881	–	
Repurchase agreements	11,100	–	11,100	–	a
Equity securities:					
U.S. equity securities	957	957	–	–	a
International equity securities	208,767	208,767	–	–	a
Total equity securities	209,724	209,724	–	–	
Derivative securities:					
Future contracts	120,151	120,151	–	–	a
Forward contracts	53,128	–	53,128	–	a
Interest rate swap agreements	45	–	45	–	a
Net credit swaps	1,684	–	1,684	–	a
Subtotal derivative assets	175,008	120,151	54,857	–	
Future contracts	(120,151)	(120,151)	–	–	a
Forward contracts	(53,214)	–	(53,214)	–	a
Interest rate swap agreements	–	–	–	–	a
Option agreements	(121)	–	(121)	–	a
Net credit swaps	(1,317)	–	(1,317)	–	a
Subtotal derivative liabilities	(174,803)	(120,151)	(54,652)	–	
Total investments in the fair value hierarchy	\$ 3,114,008	\$ 2,005,708	\$ 1,108,300	\$ –	
Investments measured at net asset value: private commingled funds	1,450,599				
Total fair value investments	\$ 4,564,607				
Short-term investments	\$ 113,230				
Collateral held under securities lending agreements	208,533				
Assets limited as to use	2,873,210				
Long-term investments	2,428,594				
Other assets – Banner Foundation restricted funds	85,886				
Less alternative investments	1,141,939				
Less split-dollar life insurance	2,907				
Total fair value investments	\$ 4,564,607				
Interest rate swaps included in other long-term liabilities	\$ (335,259)	\$	\$ (335,259)	\$ –	b

# Banner Health and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### 5. Fair Value Measurements (continued)

	December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b)
Cash and cash equivalents	\$ 415,868	\$ 384,365	\$ 31,503	–	a
Collateral held under securities lending (primarily cash and debt securities)	210,811	190,062	20,749	–	a
Mutual funds:					
Mutual funds – U.S. funds	730,408	730,408	–	–	a
Mutual funds – International	322,746	322,746	–	–	a
Total mutual funds	1,053,154	1,053,154	–	–	
Debt securities:					
U.S. Treasury/government obligations	179,202	–	179,202	–	a
Corporate bonds/non-U.S. government bonds	181,970	–	181,970	–	a
Asset-backed securities	69,195	–	69,195	–	a
Commercial mortgage-backed securities	8,238	–	8,238	–	a
Non-government-backed collateralized mortgages	6,155	–	6,155	–	a
Government mortgage-backed securities	158,367	–	158,367	–	a
Government commercial-backed securities	5,027	–	5,027	–	a
Total debt securities	608,154	–	608,154	–	
Repurchase agreements	174,410	–	174,410	–	a
Equity securities:					
U.S. equity securities	78,969	78,969	–	–	a
International equity securities	174,006	174,006	–	–	a
Total equity securities	252,975	252,975	–	–	
Derivative securities:					
Future contracts	842,371	842,371	–	–	a
Forward contracts	583,000	–	583,000	–	a
Interest rate swap agreements	3,489	–	3,489	–	a
Net credit swaps	721	–	721	–	a
Subtotal derivative assets	1,429,581	842,371	587,210	–	
Future contracts	(842,371)	(842,371)	–	–	a
Forward contracts	(582,752)	–	(582,752)	–	a
Interest rate swap agreements	(381)	–	(381)	–	a
Option agreements	(92)	–	(92)	–	a
Net credit swaps	(180)	–	(180)	–	a
Subtotal derivative liabilities	(1,425,776)	(842,371)	(583,405)	–	
Total investments in the fair value hierarchy	\$ 2,719,177	\$ 1,880,556	\$ 838,621	–	
Investments measured at net asset value: private commingled funds	1,153,181				
Total fair value investments	\$ 3,872,358				
Short-term investments	\$ 112,196				
Collateral held under securities lending agreements	210,811				
Assets limited as to use	2,419,735				
Long-term investments	2,114,408				
Other assets – Banner Foundation restricted funds	87,778				
Less alternative investments	1,069,224				
Less split-dollar life insurance	3,346				
Total fair value investments	\$ 3,872,358				
Interest rate swaps included in other long-term liabilities	\$ (258,762)	\$ –	\$ (258,762)	\$ –	b

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 5. Fair Value Measurements (continued)

Investment income (loss) consisted of the following for the years ended December 31:

	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
Interest and dividend income	\$ 86,584	\$ 70,517
Net realized gain on sales of marketable securities	84,810	127,152
Realized and unrealized gain (loss) from alternative investments, including amount recorded in net assets with donor restriction	96,064	(16,475)
Net realized gain on derivative instruments	3,477	1,644
Net unrealized gain (loss) on marketable securities	376,498	(346,702)
Net unrealized gain on derivative instruments	136	3,579
	<b>647,569</b>	<b>(160,285)</b>
Less investment loss credited to other revenue, restricted equity, and capitalized bond project funds	6,427	1,943
Investment income (loss), net	<b>\$ 641,142</b>	<b>\$ (162,228)</b>

#### 6. Liquidity

Financial assets available for general expenditure within one year of the balance sheet date consist of the following as of December 31:

	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
Cash and cash equivalents	\$ 496,348	\$ 383,096
Patient receivables, net	943,316	868,127
Other receivables	431,578	350,731
Short-term investments	113,230	112,196
Funds designated by Board of Directors and lease agreements	2,373,332	2,033,763
Long-term investments	2,428,594	2,114,408
	<b>\$ 6,786,398</b>	<b>\$ 5,862,321</b>

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 6. Liquidity (continued)

Banner has the ability to structure its financial assets to be available as its general expenditures and other obligations come due. Cash in excess of daily requirements is invested in short-term investments. Banner also maintains a \$400,000,000 line of credit as discussed in Note 9. As of December 31, 2019, \$98,600,000 remained available on the line of credit.

#### 7. Property and Equipment

Property and equipment consisted of the following as of December 31:

	<u>2019</u>	<u>2018</u>
	<i>(In Thousands)</i>	
Land and land improvements	\$ 373,413	\$ 341,021
Buildings and fixed equipment	4,947,061	4,145,859
Major movable equipment	3,363,107	2,960,428
Construction-in-progress	257,981	509,156
	<u>8,941,562</u>	<u>7,956,464</u>
Less accumulated depreciation and amortization	4,702,649	4,271,268
Property and equipment, net	<u>\$ 4,238,913</u>	<u>\$ 3,685,196</u>

#### Hospital Lease Obligation

Banner has previously subleased North Colorado Medical Center (NCMC) and other real and personal property, comprising substantially all of the NCMC, Inc. assets located in Weld County, Colorado, and used by Banner for health care operations from NCMC, Inc. since 1995. As of December 31, 2018, Banner carried \$179,886,000 as a capital lease asset and \$202,830,000 as a capital lease obligation. On January 1, 2019, upon adoption of ASC 842, these balances were revalued to \$171,000,000 as a finance right-of-use asset and lease obligation.

Effective October 9, 2019, Banner purchased the hospital assets, major moveable equipment, and certain off campus properties previously leased by Banner to support NCMC operations at a price of \$344,000,000. The assets were assigned useful lives ranging from 1 month to 20 years. The transaction terminated the long-term lease between Banner and NCMC, Inc., including all related covenants and rent guarantees, and conveyed lien-free title of NCMC assets to Banner. Banner also removed the right-of-use assets and lease obligation from the balance sheet.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 8. Other Non-Current Assets

Non-current assets consisted of the following as of December 31:

	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
Restricted assets	\$ 192,059	\$ 191,430
Goodwill	314,475	262,536
Investments in unconsolidated affiliates	219,707	200,731
Due from Sun Health Services	30,786	27,973
Intangible assets, net of accumulated amortization of \$18,384,000 in 2019 and \$14,622,000 in 2018	8,478	8,427
Other	39,594	51,245
Total other non-current assets	<u>\$ 805,099</u>	<u>\$ 742,342</u>

#### Investments in Unconsolidated Affiliates

Investments in unconsolidated affiliates are primarily comprised of the following investments that are accounted for under the equity method or cost method of accounting, as described herein:

##### *Banner Health and Aetna Health Insurance Holding Company LLC*

Banner and Aetna, Inc. formed an insurance holding company in 2017, owned 49% by Banner and 51% by Aetna. The holding company became the parent of two Arizona insurance companies that began issuing policies in 2018. Banner, through its subsidiary, Banner Plan Administration, Inc., and Aetna, through certain affiliates, provide various administrative services to the insurance companies.

Banner accounts for its 49% investment in the holding company using the equity method of accounting. Banner's investment in the holding company was approximately \$100,699,000 and \$94,345,000 as of December 31, 2019 and 2018, respectively, and Banner's share of earnings (losses) was \$6,392,000 and \$(2,819,000) for the years ended December 31, 2019 and 2018, respectively. Total assets, liabilities, and net income (loss) as reported by the holding company were approximately \$253,361,000, \$80,872,000, and \$12,968,000 as of December 31, 2019, respectively, and \$276,629,000, \$99,400,000, and \$(5,711,000) as of December 31, 2018, respectively.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **8. Other Non-Current Assets (continued)**

##### *Premier Inc.*

Banner is a member of the group-purchasing organization Premier Inc. (Premier) and, in connection with this membership, Banner holds a non-controlling interest in Premier that is accounted for under the equity method of accounting. Banner's investment in Premier was approximately \$107,043,000 and \$92,996,000 as of December 31, 2019 and 2018, respectively. Banner's share of Premier's net income recorded under the equity method of accounting and Class B units vendor incentive was approximately \$14,047,000 and \$20,671,000 in 2019 and 2018, respectively, and is recorded as a reduction to supplies expense.

##### **Due From Sun Health Services**

Banner and Sun Health Services are parties to a Support and Maintenance Agreement in which Sun Health Services provides an annual contribution to Banner, calculated under the terms of the agreement and, subject to certain contractual limitations and conditions, to support projects at facilities previously owned by Sun Health Corporation (the predecessor of Sun Health Services), or at other future Banner projects in the northwestern section of the Phoenix metropolitan area. Capital project commitments from Sun Health Services as of December 31, 2019 and 2018, were approximately \$50,416,000 and \$59,862,000, respectively, and are recorded as restricted assets within other non-current assets.

In addition to the capital project commitment, Sun Health Services also funds the Sun Health defined pension plan obligation (see Note 12), which was acquired by Banner and in accordance with the terms outlined in the acquisition agreement. Banner has recorded a receivable from Sun Health Services of approximately \$30,786,000 and \$27,973,000 as of December 31, 2019 and 2018, respectively, representing the unfunded plan obligation.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 9. Long-Term Debt

Long-term debt consisted of the following as of December 31:

	2019	2018
	<i>(In Thousands)</i>	
Taxable Revenue Bonds, Series 2019, interest 3.76%, due through 2049	\$ 125,000	\$ —
Revenue Bonds, Series 2019A, interest 4.00%, due through 2044	94,050	—
Floating Rate Bonds, Series 2019B-C, interest determined weekly, average interest 1.72%–1.91% in 2019, interest due through 2035	161,900	—
Revenue Bonds, Series 2019D, interest 5.00%, due through 2046	83,600	—
Weekly Rate Securities Revenue Bonds, Series 2019E-F, interest determined weekly, average interest 1.35% in 2019, due through 2049	200,000	—
Revenue Bonds, Series 2017A, interest 4.00% to 5.00%, due through 2041	188,985	188,985
Revenue Bonds, Series 2017B-C, interest 5.00%, due through 2048	171,890	171,890
Weekly Rate Securities Revenue Bonds, Series 2017D, interest determined weekly, average interest 1.47% in 2019 and 1.42% in 2018, due through 2048	100,000	100,000
Revenue Bonds, Series 2016A, interest 3.13% to 5.00%, due through 2038	782,465	803,500
Revenue Bonds, Series 2015A, interest 5.00%, due through 2025	72,480	83,890
Daily Rate Securities Revenue Bonds, Series 2015B-C, interest determined daily, average interest 1.41%–1.43% in 2019 and 1.36% in 2018, due through 2046	201,260	201,260
Direct Purchase Rate Securities Revenue Bonds, Series 2015D, interest determined monthly, average interest 2.72% in 2019 and 2.32% in 2018, due through 2025	—	100,290
Taxable loan, interest determined monthly, average interest 2.82% in 2019 and 2.53% in 2018, due through 2022	100,556	100,556
Commercial paper, interest determined by dealer, average interest 2.38% in 2019 and 2.06% in 2018.	100,000	100,000
Revenue Bonds, Series 2014A, interest 4.00% to 5.00%, due through 2044	200,600	200,600
Revenue Bonds, Series 2012A, interest 3.75% to 5.00%, due through 2043	179,090	179,090
Taxable Revenue Bonds, Series 2012B, interest 4.16%, due 2030	67,840	67,840
Series 2012 Bank of America obligation, interest 1.91%, due through 2019	—	810
Direct Purchase Rate Securities Revenue Bonds, Series 2008B-C, interest determined monthly, average interest 2.67%–3.27% in 2019 and 2.36%–2.87% in 2018, due through 2035	—	160,950
Weekly Rate Securities Revenue Bonds, Series 2008E-H, interest determined weekly, average interest 1.45%–1.48% in 2019 and 1.42%–1.43% in 2018, due through 2029	281,405	306,390
Index Rate Bonds, Series 2007B, interest determined quarterly, average interest 2.47% in 2019 and 2.27% in 2018, due through 2037	400,000	400,000
Syndicated Line of Credit – Bank of America, N.A., as Administrative Agent	301,400	—
Other	48,743	6,963
	<b>3,861,264</b>	<b>3,173,014</b>
Premiums on long-term debt, net	169,370	160,209
Less deferred debt issuance costs	8,464	9,257
Total long-term debt	<b>4,022,170</b>	<b>3,323,966</b>
Less current portion, including debt subject to self-liquidity	776,501	258,994
Total long-term debt, less current portion, including debt subject to self-liquidity	<b>\$ 3,245,669</b>	<b>\$ 3,064,972</b>

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 9. Long-Term Debt (continued)

During 2019, Banner issued \$664,550,000 of new debt and, using the proceeds, refunded \$261,240,000 of long-term debt.

Scheduled maturities of debt, excluding bond premiums and deferred debt issuance costs not yet amortized, for the years ending December 31 and thereafter are as follows (in thousands):

2020	\$ 776,501
2021	68,077
2022	157,118
2023	74,390
2024	163,629
Thereafter	<u>2,621,549</u>
	<u>\$ 3,861,264</u>

Total interest incurred was approximately \$139,309,000 and \$143,914,000 in 2019 and 2018, respectively, of which \$7,080,000 and \$17,476,000 was capitalized in 2019 and 2018, respectively.

#### Master Indenture and Bond Indentures

Substantially all of Banner's indebtedness, including its obligations on interest rate swaps, is secured by obligations issued under a master indenture, as supplemented from time to time (the Master Indenture). The Master Indenture provides that all indebtedness secured by obligations issued thereunder is on equal parity with all other such indebtedness. The Master Indenture contains covenants that, among other matters, restrict the transfer of assets and require the maintenance of specified levels of cash on hand and compliance with certain other financial ratios. Pursuant to the Master Indenture, as supplemented, Banner has pledged its gross revenues, including all accounts receivable, to secure all indebtedness and other obligations governed by the Master Indenture. Banner was in compliance with these covenants as of December 31, 2019. Banner Health and its two wholly owned subsidiaries, Banner – University Medical Center Tucson Campus, LLC and Banner – University Medical Center South Campus, LLC, are the only members of the Obligated Group and are responsible for payment of obligations issued under the Master Indenture.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **9. Long-Term Debt (continued)**

Under the terms of the bond indentures, periodic deposits are made to a trustee-held fund to meet interest and principal payments. Trustee held funds are included as assets limited as to use on the accompanying consolidated balance sheets.

Certain of Banner's bonds are subject to a remarketing agreement, whereby bond holders have the right to tender their bonds to Banner for repurchase at the end of the interest rate period if the bonds are not resold to a new purchaser. Banner has entered into several direct pay letter of credit agreements with third-party banks, which will pay for any tendered bonds if they are not resold to a new purchaser. As of December 31, 2019, Banner had entered into direct pay letter of credit agreements associated with the Revenue Bonds Series 2015B-C and Revenue Bonds Series 2008E-H. There were no advances outstanding on the direct pay letter of credit agreements as of December 31, 2019. The direct pay letter of credit agreements support the debt's long-term debt classification.

#### **Interest Rate Swap Agreements**

Banner has multiple interest rate swap contracts that effectively convert the variable rate of certain bonds into fixed rates. Banner's obligations under the swap agreements are secured by the Master Indenture.

The interest rate swaps did not qualify for hedge accounting treatment under accounting standards for derivative instruments and hedging activities. The derivative mark-to-market adjustments resulted in unrealized (losses) or gains of approximately \$(76,724,000) and \$52,015,000 for the years ended December 31, 2019 and 2018, respectively, recorded in excess of revenues over expenses. The net realized portion of the interest rate swaps for the years ended December 31, 2019 and 2018, recorded as an increase to interest expense, was approximately \$26,432,000 and \$28,940,000, respectively.

Each of the interest rate swap agreements has collateral posting thresholds based on the counterparties' bond ratings. At the AA- rating level, Banner and its counterparty must post collateral when the mark-to-market value exceeds \$35,000,000–\$75,000,000, depending on the counterparty. At December 31, 2019 and 2018, Banner had approximately \$101,619,000 and approximately \$43,740,000, respectively, of collateral outstanding with its counterparties. The fair value of the collateral is reported as assets limited as to use – other funds on the accompanying consolidated balance sheets.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **9. Long-Term Debt (continued)**

As of December 31, 2019 and 2018, the estimated fair value of the interest rate swaps resulted in an imputed obligation of \$335,259,000 and \$258,762,000, respectively, which is recorded in interest rate swaps on the accompanying consolidated balance sheets. The fair value of the swaps is based on the forward London Interbank Offered Rate curve, with a blended average duration of 7 to 21 years.

#### **Fair Value of Debt**

As of December 31, 2019 and 2018, the estimated fair value of Banner's debt, excluding unamortized net premiums, was \$3,763,816,000 and \$3,288,626,000, respectively. The estimated fair value is based on quoted market prices for these issues or, where such prices are not available, on current interest rates for debt with similar remaining maturities.

#### **10. Estimated Self-Insurance Liabilities**

Banner has obtained insurance through a combination of purchased and self-insurance programs for professional and general liability claims, workers' compensation claims, and several other insurance programs to address claims incurred as part of Banner's ongoing business operations, including directors and officers, auto, environmental, aviation, cybersecurity, property, employee life insurance, and certain physicians' prior acts coverage. Banner is self-insured for several of its insurance programs through its wholly owned captive, Banner Indemnity, Ltd. (BIL).

Banner's professional and general liability is self-insured through BIL. Since July 1, 2015, Banner is self-insured, on a claims-made basis, for the first \$15,000,000 of each professional liability claim and the first \$10,000,000 in aggregate of general liability claims. BIL also provides an integrated excess liability policy with a single limit of \$200,000,000 per occurrence and \$200,000,000 aggregate for a two-year term expiring July 1, 2020. This policy is fully reinsured by A.M. Best reinsurance carriers with a minimum rating of A-VII or better.

Under its self-insured professional and general liability program, Banner contributes actuarially determined amounts to BIL to fund estimated ultimate losses. Banner has accrued estimates for asserted and incurred but not reported claims. The actuarially determined claim liabilities were approximately \$181,990,000 and \$196,883,000, of which \$45,995,000 and \$40,511,000 has been recorded as current liabilities on the accompanying consolidated balance sheets as of December 31, 2019 and 2018, respectively. Self-insurance liabilities are undiscounted at December 31, 2019 and 2018.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 11. Non-Current Liabilities

Other non-current liabilities consisted of the following as of December 31:

	<u>2019</u>	<u>2018</u>
	<i>(In Thousands)</i>	
Non-current employee benefit liabilities	\$ 123,798	\$ 92,032
Banner Health retirement income plan	–	14,792
Sun Health Services pension plan	30,786	27,973
Asset retirement obligation	27,419	15,625
Other	6,452	24,431
Total other non-current liabilities	<u>\$ 188,455</u>	<u>\$ 174,853</u>

#### 12. Retirement Plans

##### Defined Contribution Plan

Substantially all of Banner's eligible employees may elect to participate in Banner's defined contribution plan. Employees may contribute up to 21% of eligible compensation, subject to plan restrictions. Banner may provide a matching contribution equal to the first 4% of eligible compensation contributed for each participant, as defined under the defined contribution plan. Contribution expense was approximately \$86,577,000 and \$79,166,000 for the years ended December 31, 2019 and 2018, respectively.

##### Defined Benefit Plans

Banner has two defined benefit plans; Banner Retirement Income Plan and Sun Health Pension Plan. Banner's Pension and Retirement Committee oversee the investment policy and strategy associated with both of these defined benefit plans. The expected long-term rate of return on plan assets for both pension plans is based on historical and projected rates of return for current and planned asset categories in the Plan's investment portfolio. Assumed projected rates of return for each asset category were selected after analyzing historical experience and future expectations of the returns and volatility for assets of that category using benchmark rates. Based on the target asset allocation among the asset categories, the overall expected rate of return for the portfolio was developed and adjusted for historical and expected experience of active portfolio management results compared to benchmark returns and for the effect of expenses paid from plan assets.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 12. Retirement Plans (continued)

Banner's benefit plan investment strategy is to achieve a mix of approximately 70% of investments for long-term growth and 30% for near-term benefit payments with a wide diversification of asset types, fund strategies, and fund managers. Due to the pending termination of Banner's Retirement Income Plan, the Pension and Retirement Committee resolved to revise the target allocation to a more conservative 15% equity securities, 75% fixed-income securities, and 10% global assets to remove volatility in the plan. The target allocation for Sun Health's plan assets is 50% equity securities, 30% fixed-income securities, 10% global assets, and 10% alternative investments. Equity securities include U.S. and international investments and range from large-cap to small-cap companies. Fixed-income securities include corporate bonds of companies from diversified industries, mortgage-backed securities, and U.S. Treasuries. Alternative investments include mainly hedge funds that invest in several different strategies.

##### *Banner Retirement Income Plan*

Banner has a non-contributory defined benefit plan (the Plan) that provides certain eligible employees with retirement and death benefits. Banner annually contributes amounts to the Plan as necessary to meet the Employee Retirement Income Security Act of 1974 (ERISA) minimum funding requirements. Benefits are based on years of service and the employee's compensation during the last five years of employment. Benefit accruals under the Plan have been frozen since 2002.

Banner's Board of Directors resolved to terminate the Plan via an amendment effective December 31, 2018. An IRS determination letter is expected to be received in the first half of 2020, and the termination process is expected to be completed by the end of 2020.

In order to terminate the Plan, Banner must fully fund participant benefits and purchase annuities through an insurance company. At plan termination, Banner will recognize the accumulated plan losses as pension expense, within non-operating expense. The Plan's accumulated losses recorded in net assets without donor restrictions were approximately \$41,365,000 as of December 31, 2019.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 12. Retirement Plans (continued)

The following tables set forth the benefit obligation and assets of the Plan at December 31 (using measurement dates as of December 31, 2019 and 2018, respectively) and components of net periodic benefit costs for the years then ended:

	2019	2018
	<i>(In Thousands)</i>	
<b>Change in projected benefit obligation</b>		
Projected benefit obligation at beginning of year	\$ 63,672	\$ 70,700
Interest cost	2,550	2,462
Actuarial loss (gain)	3,490	(3,926)
Benefits paid	(6,239)	(5,564)
Projected benefit obligation at end of year	63,473	63,672
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	48,880	53,541
Actual return on plan assets	9,610	(1,747)
Employer contributions	2,060	2,650
Benefits paid	(6,239)	(5,564)
Fair value of plan assets at end of year	54,311	48,880
Funded status – accrued benefit recorded	\$ (9,162)	\$ (14,792)
Unrecognized net loss recorded in net assets	\$ 41,365	\$ 47,803

The assumptions used to determine the projected benefit obligation include the weighted average discount rate of 3.18% and 4.25% as of December 31, 2019 and 2018, respectively, and weighted average expected long-term rate of return on plan assets of 5.50% and 7.00% as of December 31, 2019 and 2018, respectively.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 12. Retirement Plans (continued)

The funded status of the Plan of approximately \$(9,162,000) and \$(14,792,000) at December 31, 2019 and 2018, respectively, is included in other non-current liabilities in the accompanying consolidated balance sheets. No plan assets are expected to be returned to Banner during the year ending December 31, 2020.

	2019	2018
	<i>(In Thousands)</i>	
<b>Components of net periodic benefit cost</b>		
Interest cost	\$ 2,550	\$ 2,462
Expected return on plan assets	(2,904)	(3,848)
Amortization of actuarial loss	2,121	2,300
Recognized settlement loss	1,101	549
Net periodic benefit cost	\$ 2,868	\$ 1,463

The assumptions used to determine the net periodic benefit cost include the weighted average discount rate of 4.25% and 3.63% as of December 31, 2019 and 2018, respectively, and weighted average expected long-term rate of return on plan assets of 5.50% and 7.00% as of December 31, 2019 and 2018, respectively.

The fair value of the Plan's assets at December 31, 2019, by asset category, is as follows:

	December 31, 2019	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
	<i>(In Thousands)</i>				
<b>Asset category</b>					
Registered investment company funds:					
U.S. funds	\$ 4,594	\$ 4,594	\$ —	\$ —	a
International funds	3,530	3,530	—	—	a
Common/collective trust funds	45,614	—	45,614	—	a
Total assets in the fair value hierarchy	53,738	\$ 8,124	\$ 45,614	\$ —	
Investments measured at net asset value:					
Alternative investments	573				
	\$ 54,311				

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 12. Retirement Plans (continued)

The fair value of the Plan's assets at December 31, 2018, by asset category, is as follows:

Asset category	December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
<i>(In Thousands)</i>					
Registered investment company funds:					
U.S. funds	\$ 28,687	\$ 28,687	\$ –	\$ –	a
International funds	8,904	8,904	–	–	a
Common/collective trust funds	5,655	–	5,655	–	a
Total assets in the fair value hierarchy	43,246	<u>\$ 37,591</u>	<u>\$ 5,655</u>	<u>\$ –</u>	
Investments measured at net asset value:					
Alternative investments		5,634			
		<u>\$ 48,880</u>			

Information about the expected cash flows for the Plan are as follows (in thousands):

Expected employer contributions in 2020	\$ 9,200
Expected benefit payments: 2020	64,475

#### *Sun Health Pension Plan*

Under the terms of the agreement for the purchase of Sun Health Corporation, Banner assumed sponsorship of the Sun Health Pension Plan, a defined benefit plan, and the Sun Health Pension Plan Trust (the Trust). Sun Health Services retained the obligation to fund any required contributions to the Trust to meet the ERISA minimum funding requirements, and Sun Health Services retains the right to any excess assets that may exist upon termination of the Sun Health Pension Plan. Benefit accruals under the Sun Health Pension Plan have been frozen since May 2007, except for certain employees whose salary benefits were not frozen until 2014. At December 31, 2019 and 2018, Banner recorded a non-current liability of approximately \$30,786,000 and \$27,973,000, respectively, representing the unfunded liability under the Sun Health Pension Plan, and a long-term receivable from Sun Health Services in the same amount on the accompanying consolidated balance sheets (see Note 8).

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 12. Retirement Plans (continued)

The following table sets forth the benefit obligation and assets of the Sun Health Pension Plan at December 31 (using measurement dates as of December 31, 2019 and 2018, respectively):

	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
<b>Change in projected benefit obligation</b>		
Projected benefit obligation at beginning of year	\$ <b>98,919</b>	\$ 107,556
Interest cost	<b>4,198</b>	3,943
Actuarial loss (gain)	<b>10,788</b>	(7,377)
Benefits paid	<b>(5,420)</b>	(5,203)
Projected benefit obligation at end of year	<b>108,485</b>	98,919
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	<b>70,946</b>	76,955
Actual return on plan assets	<b>9,833</b>	(3,946)
Employer contributions	<b>2,340</b>	3,140
Benefits paid	<b>(5,420)</b>	(5,203)
Fair value of plan assets at end of year	<b>77,699</b>	70,946
Funded status – accrued benefit recorded	<b>\$ (30,786)</b>	\$ (27,973)

The assumptions used to determine the projected benefit obligation include the weighted average discount rate of 3.37% and 4.37% as of December 31, 2019 and 2018, respectively, and weighted average expected long-term rate of return on plan assets of 7.00% as of December 31, 2019 and 2018.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 12. Retirement Plans (continued)

The fair value of Sun Health Pension Plan assets at December 31, 2019, by asset category, is as follows:

December 31, 2019	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
<i>(In Thousands)</i>				
<b>Asset category</b>				
Registered investment company funds:				
U.S. funds	\$ 23,579	\$ 23,579	\$ —	a
International funds	22,526	22,526	—	a
Common/collective trust funds	<u>23,452</u>	—	<u>23,452</u>	a
Total assets in the fair value hierarchy	<u>69,557</u>	<u>\$ 46,105</u>	<u>\$ 23,452</u>	—
 Investments measured at net asset value:				
Alternative investments	<u>8,142</u>			
	<u>\$ 77,699</u>			

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 12. Retirement Plans (continued)

Asset category	December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
<i>(In Thousands)</i>					
Registered investment company funds:					
U.S. funds	\$ 28,177	\$ 28,177	\$ —	\$ —	a
International funds	22,938	22,938	—	—	a
Common/collective trust funds	11,912	—	11,912	—	a
Total assets in the fair value hierarchy	63,027	\$ 51,115	\$ 11,912	\$ —	
Investments measured at net asset value:					
Alternative investments	7,919				
	\$ 70,946				

Information about the expected cash flows for the Sun Health Pension Plan follows (in thousands):

Expected employer contributions in 2020	\$ 6,835
Expected benefit payments:	
2020	5,957
2021	6,133
2022	6,238
2023	6,393
2024	6,468
2025–2029	32,429

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 13. Income Taxes

Banner's deferred tax assets and liabilities primarily relate to BHN. Deferred tax assets and liabilities consist of the following as of December 31:

	<b>2019</b>	<b>2018</b>
	<i>(In Thousands)</i>	
Deferred tax assets:		
Net loss carryforwards	\$ 113,464	\$ 94,726
Accrued expenses	375	688
Total deferred tax assets	<b>113,839</b>	95,414
Deferred tax liabilities:		
Depreciation	–	(1)
Total deferred tax liabilities	–	(1)
Valuation allowance	<b>(113,839)</b>	<b>(95,413)</b>
Net deferred tax assets after valuation allowance	<b>\$ –</b>	<b>\$ –</b>

As of December 31, 2019, Banner had estimated federal net operating loss carryforwards of approximately \$456,212,000 that begin to expire in the year 2033 and estimated state net operating loss carryforwards of approximately \$456,211,000 that begin to expire in 2033.

On December 22, 2017, the Tax Cuts and Jobs Act (Enactment) was enacted, which reduced the corporate statutory income tax rate from 35% to 21%, beginning January 1, 2018. This reduction in the corporate statutory income tax rate required Banner to re-evaluate certain of its deferred tax assets and liabilities, as of the date of Enactment, to reflect the revised income tax rates applicable to future periods. For tax-exempt entities, the Enactment also requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income, pay an excise tax on remuneration above certain thresholds that is paid to executives by the organization, and report income or loss from unrelated business activities on an activity-by-activity basis, among other provisions.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 14. Statement of Functional Expenses

The following statement of functional expenses reports Banner's operating expenses, as presented on the consolidated statements of income, by each of Banner's major operating function for the years ended December 31, 2019 and 2018. Operating expenses that are attributable to more than one operating function have been allocated using a basis representative of the operating expenditure such as patient volume, full-time equivalent, or facility size.

	Operating Expenses at December 31, 2019				
	Delivery	Insurance Operations	Corporate Services	Other/ Eliminations	Banner Health Consolidated
	<i>(In Thousands)</i>				
Expenses:					
Salaries and benefits	\$ 3,688,057	\$ 93,977	\$ 606,077	\$ (117,829)	\$ 4,270,282
Supplies	1,518,685	1,448	(10,176)	(13,661)	1,496,296
Physician and professional fees	234,801	11,294	27,013	(38,330)	234,778
Medical claims costs	–	1,908,066	(3,877)	(408,291)	1,495,898
Depreciation and amortization	387,381	1,810	79,110	1	468,302
Interest expense	134,063	2,761	(4,531)	(64)	132,229
Purchased services	445,557	29,953	292,973	(169,219)	599,264
Other	745,297	47,666	(261,824)	(1,898)	529,241
Total expenses	\$ 7,153,841	\$ 2,096,975	\$ 724,765	\$ (749,291)	\$ 9,226,290

	Operating Expenses at December 31, 2018				
	Delivery	Insurance Operations	Corporate Services	Other/ Eliminations	Banner Health Consolidated
	<i>(In Thousands)</i>				
Expenses:					
Salaries and benefits	\$ 3,459,528	\$ 79,308	\$ 595,276	\$ (109,075)	\$ 4,025,037
Supplies	1,380,013	417	(14,622)	(7,320)	1,358,488
Physician and professional fees	204,131	13,101	27,613	(35,323)	209,522
Medical claims costs	–	1,504,200	–	(366,860)	1,137,340
Depreciation and amortization	338,800	1,375	74,665	1	414,841
Interest expense	122,166	2,302	2,018	(48)	126,438
Purchased services	410,903	23,727	272,576	(161,711)	545,495
Other	735,413	30,213	(247,792)	(1,553)	516,281
Total expenses	\$ 6,650,954	\$ 1,654,643	\$ 709,734	\$ (681,889)	\$ 8,333,442

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 15. Commitments and Contingencies

##### Leases

As of January 1, 2019, Banner recorded a right-of-use asset of approximately \$491,695,000, a lease obligation of approximately \$507,599,000, and a cumulative effect adjustment to the opening balance of net assets without donor restriction of \$24,637,000. The transition adjustment relates to the reversal of the property and equipment lease obligations that were recognized as a sale leaseback as of December 31, 2018. Banner also elected a package of practical expedients to not reassess existing or expired contracts, lease classification, or initial direct costs for existing leases. Short-term leases (12 months or less) will not be subject to the new standard per Banner's accounting policy. Included in the lease term are any renewal options reasonably certain of being exercised. Banner uses a risk-free discount rate commensurate with the lease term to determine the present value of lease payments used to record the right-of-use asset and related lease liability. The table below summarizes the components of lease cost by lease type for the year ended December 31, 2019 (in thousands), followed by disclosure of weighted average remaining lease term and weighted average discount rate by type:

Finance lease cost:	
Amortization of right-of-use assets	\$ 24,903
Interest on lease liabilities	4,599
Operating lease cost	65,929
Short-term lease cost	8,488
Variable lease cost	7,200
Total lease cost	<u>\$ 111,119</u>
Weighted average remaining lease term – finance leases (yrs)	21.2
Weighted average remaining lease term – operating leases (yrs)	5.6
Weighted average discount rate – finance leases	4.83%
Weighted average discount rate – operating leases	2.52%

The following table presents cash paid for amounts included in the measurement of lease liabilities for the year ended December 31, 2019 (in thousands):

Operating cash flows for operating leases	\$ 64,729
Operating cash flows for finance leases	\$ 4,372
Financing cash flows for finance leases	\$ 24,002

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 15. Commitments and Contingencies (continued)

##### Maturities of Lease Liabilities

The following table reconciles the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recorded on the balance sheet at December 31, 2019 (in thousands):

	<b>Operating Leases</b>	<b>Finance Leases</b>
2020	\$ 69,741	\$ 3,146
2021	60,528	3,175
2022	51,535	3,204
2023	37,138	3,175
2024	29,192	2,912
Thereafter	53,791	24,814
Total minimum lease payments	301,925	40,426
Less: amount of lease payments representing interest	(28,137)	(10,428)
Present value of future minimum lease payments	273,788	29,998
Less: current obligations under leases	(67,389)	(2,952)
Long-term lease obligations	<u>\$ 206,399</u>	<u>\$ 27,046</u>

##### Facility Construction

Banner is undertaking significant renovation and expansion projects at several of its facilities. The committed cost to complete these construction projects is estimated to be approximately \$201,000,000.

##### Academic Affiliation Agreement

On February 28, 2015, the University of Arizona Health Network (UAHN) and its wholly owned subsidiary, University Medical Center Corporation, were acquired by Banner. As part of the transaction, Banner and the University of Arizona (UA) entered into a 30-year academic affiliation agreement (the AAA), providing for ongoing support of the UA Colleges of Medicine in Tucson and Phoenix, and for Banner – University Medical Center Phoenix (B-UMCP) to become the primary teaching affiliate of the UA College of Medicine – Phoenix. Under the terms of the transaction, Banner and UA contributed \$300,000,000 to an Academic Enhancement Fund to

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **15. Commitments and Contingencies (continued)**

provide \$20,000,000 of annual support for academic enhancements, faculty recruitment, and program development at the UA College of Medicine – Tucson and College of Medicine – Phoenix. In addition, Banner agreed to fund such additional amounts as may be needed to meet the \$20,000,000 annual commitment during the 30-year term of the AAA to the extent that the Academic Enhancement Fund, and earnings thereon, is insufficient to do so. Banner must fund a minimum amount of \$151,300,000 for funds flow and mission support. The annual funds flow commitment is subject to adjustment based upon fluctuations in governmental funding for graduate medical education. Banner funded approximately \$302,872,000 and \$267,242,000 relating to the AAA funds flow and mission support for the years ended December 31, 2019 and 2018, respectively.

#### **Compliance With Laws and Regulations**

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with such laws and regulations can be subject to future review and interpretation, as well as regulatory actions unknown or unasserted at this time.

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