



**Unaudited Consolidated
Financial Statements and Supplementary Information**

Banner Health and Subsidiaries

March 31, 2019

Banner Health and Subsidiaries
Unaudited Consolidated Financial Statements
March 31, 2019

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Review Report of Independent Auditors

The Board of Directors
Banner Health

We have reviewed the consolidated financial information of Banner Health and Subsidiaries, which comprise the consolidated balance sheet as of March 31, 2019, and the related consolidated statements of income, changes in net assets and cash flows for the three-month periods ended March 31, 2019 and 2018.

Management's Responsibility for the Financial Information

Management is responsible for the preparation and fair presentation of the interim financial information in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in conformity with U.S. generally accepted accounting principles.

Auditor's Responsibility

Our responsibility is to conduct our review in accordance with auditing standards generally accepted in the United States applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information. Accordingly, we do not express such an opinion.

Conclusion

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial information referred to above for it to be in conformity with U.S. generally accepted accounting principles.

Report on Balance Sheet as of December 31, 2018

We have previously audited, in accordance with auditing standards generally accepted in the United States, the consolidated balance sheet of Banner Health and Subsidiaries as of December 31, 2018, and the related consolidated statements of income, changes in net assets and cash flows for the year then ended (not presented herein), and we expressed an unmodified audit opinion on those consolidated financial statements in our report dated March 22, 2019. In our



opinion, the accompanying consolidated balance sheet of Banner Health and Subsidiaries as of December 31, 2018, is consistent, in all material respects, with the consolidated balance sheet from which it was derived.

Ernst + Young LLP

May 15, 2019

Banner Health and Subsidiaries

Consolidated Balance Sheets

(In Thousands)

	Unaudited March 31 2019	December 31 2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 412,540	\$ 383,096
Short-term investments	81,780	112,196
Collateral held under securities lending program	273,230	210,811
Assets limited as to use	48,369	144,170
Patient receivables, net	971,818	868,127
Inventories	209,611	206,055
Other receivables	260,696	350,731
Other current assets	124,989	86,211
Total current assets	<u>2,383,033</u>	<u>2,361,397</u>
Assets limited as to use:		
Funds designated by:		
Board of Directors	2,156,849	2,031,832
Lease agreements	1,950	1,931
Funds held by trustees under:		
Self-insurance funding arrangements	111,013	103,564
Other funds	162,036	138,238
Total assets limited as to use, less current portion	<u>2,431,848</u>	<u>2,275,565</u>
Property and equipment, net	3,712,786	3,685,196
Right of use assets - operating leases	277,137	-
Right of use assets - finance leases	185,227	-
Leased hospital assets	-	207,847
Other assets:		
Long-term investments	2,236,909	2,114,408
Other	752,586	742,342
Total assets	<u>\$ 11,979,526</u>	<u>\$ 11,386,755</u>

Banner Health and Subsidiaries

Consolidated Balance Sheets

(In Thousands)

	Unaudited March 31 2019	December 31 2018
Liabilities and net assets		
Current liabilities:		
Trade accounts payable	\$ 176,440	\$ 208,932
Current portion of long-term debt	61,873	58,994
Debt subject to self liquidity	200,000	200,000
Current portion of operating lease obligations	67,152	-
Current portion of finance lease obligations	36,186	-
Current portion of hospital lease obligations	-	22,188
Payable under securities lending program	273,230	210,811
Estimated current portion of third-party payor settlements	4,187	3,465
Accrued expenses:		
Salaries and benefits	425,868	460,061
Medical claims payable	207,383	202,849
Other	254,580	238,164
Total current liabilities	1,706,899	1,605,464
Long-term debt, less current portion	3,001,045	3,064,972
Finance lease obligations, less current portion	148,765	-
Operating lease obligations, less current portion	224,388	-
Hospital lease obligations	-	211,515
Estimated self-insurance liabilities, less current portion	217,044	205,055
Estimated third-party payor settlements, less current portion	18,534	17,531
Interest rate swaps	286,027	258,762
Other	171,573	174,853
Total liabilities	5,774,275	5,538,152
Net assets:		
Net assets without donor restrictions	5,975,651	5,613,878
Non-controlling interests	44,754	43,999
Net assets without donor restrictions	6,020,405	5,657,877
Net assets with donor restrictions	184,846	190,726
Total net assets	6,205,251	5,848,603
Total liabilities and net assets	\$ 11,979,526	\$ 11,386,755

See accompanying notes.

Banner Health and Subsidiaries
Consolidated Statements of Income

Unaudited

(In Thousands)

	Three Months Ended March 31	
	2019	2018
Revenues:		
Net patient service revenue	\$ 1,768,138	\$ 1,662,173
Medical insurance premiums	465,074	348,815
Other revenue	94,548	84,078
Total revenues	2,327,760	2,095,066
Expenses:		
Salaries and benefits	1,057,151	997,432
Supplies	363,218	333,487
Physician and professional fees	57,092	48,573
Medical claims cost, net of Banner claims of \$86,999 and \$98,998 in 2019 and 2018, respectively	354,382	255,956
Depreciation and amortization	107,309	101,070
Interest expense	28,984	30,937
Other expenses	272,221	245,382
Total expenses	2,240,357	2,012,837
Operating income	87,403	82,229
Other income:		
Investment income - realized	19,524	4,604
Investment income (loss) - unrealized	208,735	(34,432)
Income from alternative investments	45,163	6,848
Investment income (loss)	273,422	(22,980)
Unrealized (loss) gain on interest rate swaps	(27,321)	45,090
Other gain (loss)	595	(2,505)
	246,696	19,605
Excess of revenues over expenses	334,099	101,834
Less excess of revenues over expenses attributable to non-controlling interests	6,637	7,281
Excess of revenues over expenses attributable to Banner Health	\$ 327,462	\$ 94,553

See accompanying notes.

Banner Health and Subsidiaries

Consolidated Statements of Changes in Net Assets

Unaudited

(In Thousands)

	Three Months Ended March 31	
	2019	2018
Net assets without donor restrictions:		
Excess of revenues over expenses attributable to Banner Health	\$ 327,462	\$ 94,553
Cumulative effect of change in accounting principle	24,637	(7,323)
Contributions for property and equipment acquisitions	9,613	3,303
Other changes in net assets	61	59
Increase in net assets without donor restrictions	361,773	90,592
Net assets with donor restrictions:		
Contributions	6,000	6,376
Net unrealized gain (loss) on investments	1,565	(14)
Net assets released from restriction	(13,445)	(3,897)
(Decrease) increase in net assets with donor restrictions	(5,880)	2,465
Noncontrolling interests:		
Excess of revenues over expenses attributable to noncontrolling interests	6,637	7,281
Other changes, primarily distributions of earnings to noncontrolling interests	(5,882)	(6,126)
Increase in noncontrolling interests	755	1,155
Increase in net assets	356,648	94,212
Net assets, beginning of period	5,848,603	5,784,480
Net assets, end of period	\$ 6,205,251	\$ 5,878,692

See accompanying notes.

Banner Health and Subsidiaries
Consolidated Statements of Cash Flows

Unaudited

(In Thousands)

	Three Months Ended March 31	
	2019	2018
Operating activities		
Increase in net assets	\$ 356,648	\$ 94,212
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	107,309	101,070
(Increase) decrease in investments designated as trading	(152,567)	99,579
Net unrealized loss (gain) on interest rate swaps	27,265	(45,147)
Cumulative effect of change in accounting principle	(24,637)	7,323
(Gain) loss on sale of assets	(1,211)	9
Contributions for property and equipment and other	(9,613)	(3,303)
Restricted contributions	(6,000)	(6,376)
Payments of operating lease obligations	(21,115)	-
Non-controlling interest	6,125	6,125
Changes in operating elements:		
Patient receivables	(103,691)	(36,108)
Inventories and other current assets	47,701	40,272
Accounts payable and accrued expenses	(45,735)	(23,881)
Estimated third-party settlements	1,725	(1,107)
Estimated self-insurance liabilities	11,989	(444)
Other liabilities	12,084	2,685
Net cash provided by operating activities	206,277	234,909
Investing activities:		
Net purchases of property and equipment	(115,214)	(141,212)
Decrease in project fund	-	44,942
Decrease (increase) in other assets	11,612	(36,047)
Net cash used in investing activities	(103,602)	(132,317)
Financing activities:		
Proceeds from restricted contributions	6,000	6,376
Proceeds from issuance of debt	375	-
Payments of finance leases and leased hospital obligations	(12,058)	(5,778)
Payments of long-term debt	(61,423)	(58,854)
Cash distributions to non-controlling interests	(6,125)	(6,125)
Net cash used in financing activities	(73,231)	(64,381)
Net increase in cash and cash equivalents	29,444	38,211
Cash and cash equivalents at beginning of year	383,096	292,911
Cash and cash equivalents at end of period	\$ 412,540	\$ 331,122
Supplemental disclosure of cash flow information		
Interest paid, including amounts capitalized	52,929	49,823
Non-cash activities		
Leased hospital assets	-	2,167
Operating and financing leases - right of use asset and liability	507,533	-

See accompanying notes.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 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, 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 and non-controlling interests in several other entities.

2. Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) for interim financial reporting, applied on a basis substantially consistent with that of the 2018 audited financial statements of Banner. They do not include all of the information and footnotes required by GAAP for annual financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2019 are not necessarily indicative of the results to be expected for the year ending December 31, 2019. For more information, refer to the audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2018.

The separate details of the Obligated and Non-Obligated Group financial statements are presented for purposes of additional analysis and are not a required part of the consolidated financial statements.

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 several business ventures, the financial results of which are included in Banner's consolidated financial statements. Banner records the unrelated investor's ownership share of these business ventures as non-controlling interest.

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

Short-Term Investments

Short-term investments primarily include debt securities with maturity dates of one year or less from the balance sheet date, U.S. Treasury government obligations 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 (see Note 3).

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

2. Significant Accounting Policies (continued)

Investments

Banner invests in alternative investments, mainly hedge funds, through limited partnerships. Banner accounts for its ownership share in these alternative investments under the equity method based on the hedge funds' 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 investment in private investment funds whose values have been estimated by the hedge fund manager 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 net asset value.

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 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 March 31, 2019 and December 31, 2018. As of March 31, 2019, approximately \$552,773,000 of gross derivative assets and approximately \$550,928,000 of gross derivative liabilities were netted together within investments. As of December 31, 2018, approximately \$1,429,581,000 of gross derivative assets and \$1,425,776,000 of gross derivative liabilities were netted together within investments. (see Note 3)

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

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

2. Significant Accounting Policies (continued)

Net Patient Service Revenue

Banner adopted Accounting Standards Update 2014-09, *Revenue from Contracts with Customers (Topic 606)* on January 1, 2018 and elected to use the modified retrospective adoption method, which required a transition adjustment as a cumulative effect adjustment to the beginning unrestricted net assets without donor restriction recorded as of the date of adoption. As of January 1, 2018, net patient service revenue is reported at the amount that reflects the consideration 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 (reductions to revenue) for retroactive revenue adjustments due to settlement of ongoing and future audits, reviews, and investigations. In addition, as of January 1, 2018, the net patient service revenue reported includes an implicit price concession which was previously reported as provision for doubtful accounts on the consolidated statements of income.

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.

Net patient service revenue is recognized as performance obligations are satisfied, despite the fact that 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 in relation to total 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 Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

2. Significant Accounting Policies (continued)

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 three months ended March 31 by line of business is as follows (*in thousands*):

	2019	2018
Hospital	\$1,491,811	\$1,400,061
Physician services	159,921	156,237
Home care	18,921	18,286
Laboratory	72,356	69,895
Other	25,129	17,694
	\$1,768,138	\$1,662,173

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements.

Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made in the areas of patient accounts receivable, accruals for settlements with third-party payors, risk pool and insurance settlements, medical claim liabilities, contingent liabilities, and accrued liabilities resulting from self-insurance programs.

New Accounting Pronouncements

In June 2018, the FASB issued ASU No. 2018-08, *Not-for-Profit (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.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

2. Significant Accounting Policies (continued)

In January 2017, the FASB issued 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 year beginning after December 15, 2020. Management is currently evaluating the impact of adopting this accounting standard.

3. 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.

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.

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 Unaudited Consolidated Financial Statements

March 31, 2019

3. Fair Value Measurements (continued)

Assets and liabilities measured at fair value are based on one or more of three valuation techniques identified in the tables below. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. 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) *Cost approach.* Amount that would be required to replace the service capacity of an asset (replacement cost).
- (c) *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's alternative investments, of approximately \$1,065,430,000 and \$1,069,224,000 as of March 31, 2019 and December 31, 2018, respectively, are 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 financial instruments' fair value classification between Level 1 and Level 2 since December 31, 2018. Banner has no Level 3 financial instruments.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

3. Fair Value Measurements (continued)

	March 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)
Cash and cash equivalents	\$ 140,420	\$ 129,554	\$ 10,866	\$ –	a
Collateral held under securities lending (primarily cash and debt securities)	273,230	211,107	62,123		a
Mutual funds:					
Mutual funds – U.S. funds	1,672,720	1,672,720	–	–	a
Mutual funds – International	528,066	528,066	–	–	a
Total mutual funds	2,200,786	2,200,786	–	–	
Debt securities:					
U.S. Treasury/government obligations	424,113	–	424,113	–	a
Corporate bonds/non-U.S. government bonds	326,665	–	326,665	–	a
Asset-backed securities	156,008	–	156,008	–	a
Commercial mortgage-backed securities	18,960	–	18,960	–	a
Non-government-backed collateralized mortgages	20,024	–	20,024	–	a
Government mortgage-backed securities	89,996	–	89,996	–	a
Government commercial-backed securities	5,021	–	5,021	–	a
Total debt securities	1,040,787	–	1,040,787	–	
Equity securities:					
U.S. equity securities	89,412	89,412	–	–	a
International equity securities	191,064	191,064	–	–	a
Total equity securities	280,476	280,476	–	–	
Derivative securities:					
Future contracts	164,078	164,078	–	–	a
Forward contracts	387,861	–	387,861	–	a
Interest rate swap agreements	575	–	575	–	a
Net credit swaps	259	–	259	–	a
Subtotal derivative assets	552,773	164,078	388,695	–	
Future contracts	(164,078)	(164,078)	–	–	a
Forward contracts	(386,654)	–	(386,654)	–	a
Interest rate swap agreements	(100)	–	(100)	–	a
Option agreements	(28)	–	(28)	–	a
Net credit swaps	(68)	–	(68)	–	a
Subtotal derivative liabilities	(550,928)	(164,078)	(386,850)	–	
Total investments in the fair value hierarchy	\$ 3,937,544	\$ 2,821,923	\$ 1,115,621	\$ –	
Investment measured at net asset value: private commingled fund	156,633				
Total fair value investments	<u>\$ 4,094,177</u>				
Short-term investments	\$ 81,780				
Collateral held under securities lending agreements	273,230				
Assets limited as to use	2,480,217				
Long-term investments	2,236,909				
Other assets – Banner Foundation restricted funds	90,823				
Less alternative investments	1,065,430				
Less split-dollar life insurance	3,352				
Total fair value investments	<u>\$ 4,094,177</u>				
Interest rate swaps included in other long-term liabilities	\$ (286,027)	\$ –	\$ (286,027)	\$ –	c

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

3. 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, c)
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	1,541,010	1,541,010	-	-	a
Mutual funds – International	522,942	522,942	-	-	a
Total mutual funds	<u>2,063,952</u>	<u>2,063,952</u>	<u>-</u>	<u>-</u>	
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	<u>608,154</u>	<u>-</u>	<u>608,154</u>	<u>-</u>	
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	<u>252,975</u>	<u>252,975</u>	<u>-</u>	<u>-</u>	
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	<u>1,429,581</u>	<u>842,371</u>	<u>587,210</u>	<u>-</u>	
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	<u>(1,425,776)</u>	<u>(842,371)</u>	<u>(583,405)</u>	<u>-</u>	
Total investments in the fair value hierarchy	<u>\$ 3,729,975</u>	<u>\$ 2,591,354</u>	<u>\$ 838,621</u>	<u>\$ -</u>	
Investment measured at net asset value: private commingled fund	142,383				
Total fair value investments	<u>\$ 3,872,358</u>				
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	<u>\$ 3,872,358</u>				
Interest rate swaps included in other long-term liabilities	<u>\$ (258,762)</u>	<u>\$ -</u>	<u>\$ (258,762)</u>	<u>\$ -</u>	c

Banner Health and Subsidiaries
Notes to Unaudited Consolidated Financial Statements
March 31, 2019

3. Fair Value Measurements (continued)

Investment income (loss) consisted of the following for the three months ended March 31:

	2019	2018
	<i>(In Thousands)</i>	
Interest and dividend income	\$ 20,899	\$ 10,703
Net realized gain (loss) on sales of marketable securities	2,245	(6,520)
Realized and unrealized gain from alternative investments, including amount recorded in net assets with donor restriction	45,489	7,236
Net realized (loss) gain on derivative instruments	(2,344)	1,072
Net unrealized gain (loss) on marketable securities	209,669	(37,220)
Net unrealized gain on derivative instruments	255	2,630
	276,213	(22,099)
Less investment loss credited to other revenue, restricted equity, and capitalized bond project funds	2,791	881
Investment income (loss), net	\$ 273,422	\$ (22,980)

4. Liquidity

Financial assets available for general expenditure within one year of the balance sheet date, consist of the following as of March 31, 2019 (in thousands):

Cash and cash equivalents	\$ 412,540
Patient receivables, net	971,818
Short-term investments	81,780
Funds designated by Board of Directors and lease agreements	2,158,799
Long-term investments	2,236,909
	\$ 5,861,846

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 are invested in short-term investments. Banner also maintains a \$75,000,000 line of credit. As of March 31, 2019, \$74,625,000 remained available on the line of credit.

5. Fair Value of Debt

At March 31, 2019 and December 31, 2018, the estimated fair value of Banner's debt, excluding unamortized net premiums, was \$3,271,579,000 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.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

6. Interest Rate Swap Agreements

Banner entered into multiple interest rate swaps that currently do not qualify for hedge accounting. For the three months ended March 31, 2019 and 2018, the mark-to-market adjustment resulted in an unrealized loss of \$27,321,000 and an unrealized gain of \$45,090,000 respectively, recorded in excess of revenue over expenses. The net effect of the interest rate swaps, recorded in interest expense, was to increase the overall cost of borrowing for the three months ended March 31, 2019 and 2018, by \$6,207,000 and \$8,184,000, 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 counterparties must post collateral when the mark-to-market adjustment exceeds between \$35,000,000 and \$75,000,000 depending on the counterparty. At March 31, 2019 and December 31, 2018, Banner had \$58,641,000 and \$43,740,000 of collateral outstanding with its counterparties, respectively. The fair value of the collateral is reported as other funds under the assets limited as to use category in the accompanying consolidated balance sheets.

7. Hospital Lease Obligation

Banner has 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. The NCMC, Inc. lease extends through December 31, 2027.

Banner has guaranteed payment of the principal and interest on various debt offerings of NCMC, Inc. pursuant to the limited guaranty agreements entered into with the bond trustee. The aggregate amount payable under the limited guaranty agreements is limited to the rent otherwise payable under the lease agreement. Banner's annual lease payment is in excess of the NCMC, Inc. maximum annual debt service and, in the event of default by NCMC, Inc., Banner will pay the trustee portion of the rent equal to NCMC, Inc.'s debt service obligation. Such payments are to be credited against rent and all other payment obligations to NCMC, Inc. Banner did not record a liability for the limited guaranty agreements at March 31, 2019 or December 31, 2018.

8. Leases

Banner adopted Accounting Standards Update 2016-02, *Leases* (Topic 842), on January 1, 2019. Banner elected a practical expedient to apply the new standard at the adoption date and not recast the comparative periods presented. 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 three months ended March 31, 2019 (in thousands), followed by disclosure of weighted average remaining lease term and weighted average discount rate by type:

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

8. Leases (continued)

Finance lease cost:	
Amortization of right-of-use assets	\$7,725
Interest on lease liabilities	1,446
Operating lease cost	15,106
Short-term lease cost	2,737
Variable lease cost	1,340
Total lease cost	<u>\$28,354</u>
Weighted-average remaining lease term-finance leases (yrs)	7.6
Weighted-average remaining lease term-operating leases (yrs)	5.4
Weighted-average discount rate-finance leases	3.04%
Weighted-average discount rate-operating leases	2.61%

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 March 31, 2019 (in thousands):

	Operating Leases	Finance Leases
2019	\$51,366	\$27,529
2020	68,748	33,595
2021	60,382	28,439
2022	51,325	24,379
2023	36,739	21,828
Thereafter	<u>84,728</u>	<u>82,683</u>
Total minimum lease payments	353,287	218,453
Less: amount of lease payments representing interest	<u>(61,747)</u>	<u>(33,502)</u>
Present value of future minimum lease payments	291,540	184,951
Less: current obligations under leases	<u>(67,152)</u>	<u>(36,186)</u>
Long-term lease obligations	<u>\$224,388</u>	<u>\$148,765</u>

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

9. 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 three months ended March 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 March 31, 2019

	Delivery	Insurance Operations	Corporate Services	Other/ Eliminations	Banner Health Consolidated
	<i>(In Thousands)</i>				
Expenses:					
Salaries and benefits	\$ 910,466	\$ 23,620	\$ 158,701	\$ (35,636)	\$ 1,057,151
Supplies	367,056	165	(2,170)	(1,833)	363,218
Physician and professional fees	54,405	2,921	9,114	(9,348)	57,092
Medical claims costs	-	441,380	-	(86,998)	354,382
Depreciation and amortization	88,874	443	17,991	1	107,309
Interest expense	30,229	536	(1,737)	(44)	28,984
Other	482,337	22,692	(189,746)	(43,062)	272,221
Total expenses	\$ 1,933,367	\$ 491,757	\$ (7,847)	\$ (176,920)	\$ 2,240,357

Operating Expenses March 31, 2018

	Delivery	Insurance Operations	Corporate Services	Other/ Eliminations	Banner Health Consolidated
	<i>(In Thousands)</i>				
Expenses:					
Salaries and benefits	\$ 875,535	\$ 19,132	\$ 136,045	\$ (33,280)	\$ 997,432
Supplies	338,284	107	(3,866)	(1,038)	333,487
Physician and professional fees	47,454	3,325	5,520	(7,726)	48,573
Medical claims costs	-	354,955	-	(98,999)	255,956
Depreciation and amortization	82,735	360	17,975	-	101,070
Interest expense	30,285	196	471	(15)	30,937
Other	450,418	14,550	(177,752)	(41,834)	245,382
Total expenses	\$ 1,824,711	\$ 392,625	\$ (21,607)	\$ (182,892)	\$ 2,012,837

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

March 31, 2019

10. Commitments and Contingencies

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.

11. Subsequent Events

In April 2019, Banner acquired 20 free-standing outpatient imaging centers currently owned and operated by Associated Valley Radiologists Ltd., a radiology group in the greater Phoenix Metropolitan area and subsidiary of Radiology Partners, Inc.

On April 30, 2019 Banner entered into a \$400,000,000 syndicated revolving line of credit with Bank of America, N.A., JPMorgan Chase Bank, N.A., PNC Bank, N.A., The Northern Trust Company, and Wells Fargo Bank, N.A. As of May 15, 2019, there were no draws on the line of credit.

Subsequent events have been evaluated through May 15, 2019, the date of issuance of the accompanying consolidated financial statements.

Supplementary Information

Banner Health

Balance Sheet - Obligated and Non-Obligated Group Details of Consolidation

March 31, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Assets				
Current assets:				
Cash and cash equivalents	\$ 10,440	\$ 402,100	\$ -	\$ 412,540
Short-term investments	81,743	37	-	81,780
Collateral held under securities lending program	273,230	-	-	273,230
Assets limited as to use	10,628	37,741	-	48,369
Patient receivables, net	923,643	110,054	(61,879)	971,818
Inventories	179,579	30,032	-	209,611
Other receivables	156,121	110,733	(6,158)	260,696
Other current assets	598,416	(473,427)	-	124,989
Total current assets	2,233,800	217,270	(68,037)	2,383,033
Assets limited as to use:				
Funds designated by:				
Board of Directors	2,156,849	-	-	2,156,849
Lease agreements	1,950	-	-	1,950
Funds held by trustees under:				
Self-insurance funding arrangements	(259)	111,272	-	111,013
Other funds	161,171	865	-	162,036
Total assets limited as to use, less current portion	2,319,711	112,137	-	2,431,848
Property and equipment, net	3,598,397	114,389	-	3,712,786
Right of use assets - operating leases	101,369	175,768	-	277,137
Right of use assets - finance leases	185,220	7	-	185,227
Other assets:				
Long-term investments	2,208,409	28,500	-	2,236,909
Other	503,033	189,301	60,252	752,586
Total assets	\$ 11,149,939	\$ 837,372	\$ (7,785)	\$ 11,979,526

Banner Health

Balance Sheet - Obligated and Non-Obligated Group Details of Consolidation

March 31, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Liabilities and net assets				
Current liabilities:				
Trade accounts payable	\$ 146,322	\$ 30,118	\$ -	\$ 176,440
Current portion of long-term debt	61,401	472	-	61,873
Debt subject to self liquidity	200,000	-	-	200,000
Current portion of operating lease obligations	22,774	44,378	-	67,152
Current portion of finance lease obligations	36,178	8	-	36,186
Payable - securities lending program	273,230	-	-	273,230
Estimated current portion of third-party payor settlements	4,187	-	-	4,187
Accrued expenses:				
Salaries and benefits	349,913	91,146	(15,191)	425,868
Medical claims payable	-	255,580	(48,197)	207,383
Other	176,329	79,254	(1,003)	254,580
Total current liabilities	1,270,334	500,956	(64,391)	1,706,899
Long-term debt, less current portion	2,995,998	5,047	-	3,001,045
Finance lease obligations, less current portion	148,765	-	-	148,765
Operating lease obligations, less current portion	87,377	137,011	-	224,388
Estimated self-insurance liabilities, less current portion	93,682	127,008	(3,646)	217,044
Estimated third-party payor settlements, less current portion	18,534	-	-	18,534
Interest rate swaps	286,027	-	-	286,027
Other	169,387	2,186	-	171,573
Total liabilities	5,070,104	772,208	(68,037)	5,774,275
Net assets:				
Net assets without donor restrictions	6,005,845	(90,446)	60,252	5,975,651
Non-controlling interests	-	44,754	-	44,754
Net assets without donor restrictions	6,005,845	(45,692)	60,252	6,020,405
Net assets with donor restrictions	73,990	110,856	-	184,846
Total net assets	6,079,835	65,164	60,252	6,205,251
Total liabilities and net assets	\$ 11,149,939	\$ 837,372	\$ (7,785)	\$ 11,979,526

Banner Health
Statement of Income and Changes in Net Assets -
Obligated and Non-Obligated Group Details of Consolidation
Three Months Ended March 31, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Revenues:				
Net patient service revenue	\$ 1,603,105	\$ 267,593	\$ (102,560)	\$ 1,768,138
Medical insurance premiums	-	465,074	-	465,074
Other revenue	56,214	86,569	(48,235)	94,548
Total revenues	1,659,319	819,236	(150,795)	2,327,760
Expenses:				
Salaries and benefits	756,907	335,064	(34,820)	1,057,151
Supplies	300,783	64,268	(1,833)	363,218
Physician and professional fees	47,641	18,771	(9,320)	57,092
Medical claims cost, net of Banner claims of \$86,999	-	423,028	(68,646)	354,382
Depreciation and amortization	102,869	4,440	-	107,309
Interest expense	26,988	2,040	(44)	28,984
Other expenses	246,451	61,645	(35,875)	272,221
Total expenses	1,481,639	909,256	(150,538)	2,240,357
Operating income	177,680	(90,020)	(257)	87,403
Other income:				
Investment income - realized	17,473	2,095	(44)	19,524
Investment income - unrealized	206,022	2,713	-	208,735
Income from alternative investments	44,193	970	-	45,163
Investment income	267,688	5,778	(44)	273,422
Unrealized loss on interest rate swaps	(27,321)	-	-	(27,321)
Other	681	(507)	421	595
	241,048	5,271	377	246,696
Excess of revenues over expenses	418,728	(84,749)	120	334,099
Less excess of revenues over expenses attributable to non-controlling interests	-	6,637	-	6,637
Excess of revenues over expenses attributable to Banner Health	418,728	(91,386)	120	327,462
Equity transfers	(100,014)	99,997	17	-
Cumulative effect of change in accounting principle	24,637	-	-	24,637
Contributions for property and equipment acquisitions	9,750	-	(137)	9,613
Other changes in net assets	56	(5,639)	5,644	61
Increase in net assets without donor restrictions	\$ 353,157	\$ 2,972	\$ 5,644	\$ 361,773
Net assets with donor restrictions:				
Contributions	1,493	4,507	-	6,000
Net unrealized gain on investments	11	1,554	-	1,565
Net assets released from restriction	(1,379)	(12,066)	-	(13,445)
Increase (decrease) in net assets with donor restrictions	\$ 125	\$ (6,005)	\$ -	\$ (5,880)
Non-controlling interests:				
Less excess of revenues over expenses attributable to non-controlling interests	-	6,637	-	6,637
Other changes, primarily distributions of earnings to non-controlling interests	-	(5,882)	-	(5,882)
Increase in non-controlling interests	-	755	-	755
Increase (decrease) in net assets	353,282	(2,278)	5,644	356,648
Net assets, beginning of period	5,726,553	67,442	54,608	5,848,603
Net assets, end of period	\$ 6,079,835	\$ 65,164	\$ 60,252	\$ 6,205,251

Banner Health

Statement of Cash Flows -

Obligated and Non-Obligated Group Details of Consolidation

Three Months Ended March 31, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Operating activities				
Increase in net assets	\$ 353,282	\$ (2,278)	\$ 5,644	\$ 356,648
Adjustments to reconcile increase in net assets to net cash provided by (used in) operating activities:				
Equity transfers	100,014	(99,997)	(17)	-
Depreciation and amortization	102,869	4,440	-	107,309
Increase in investments designated as trading	(144,744)	(7,823)	-	(152,567)
Net unrealized loss on interest rate swaps	27,265	-	-	27,265
Cumulative effect of change in accounting principle	(24,637)	-	-	(24,637)
(Gain) loss on sale of assets	(1,235)	24	-	(1,211)
Contributions for property and equipment and other	(9,750)	-	137	(9,613)
Restricted contributions	(1,493)	(4,507)	-	(6,000)
Payments of operating lease obligations	(10,841)	(10,274)	-	(21,115)
Noncontrolling interest	6,125	-	-	6,125
Changes in operating elements:				
Patient receivables	(95,571)	(9,028)	908	(103,691)
Inventories and other current assets	54,278	2,758	(9,335)	47,701
Accounts payable and accrued expenses	(61,868)	10,584	5,549	(45,735)
Estimated third-party settlements	1,725	-	-	1,725
Estimated self-insurance liabilities	(156)	9,267	2,878	11,989
Other liabilities	11,558	526	-	12,084
Net cash provided by (used in) operating activities	306,821	(106,308)	5,764	206,277
Investing activities:				
Net purchases of property and equipment	(103,387)	(11,690)	(137)	(115,214)
Decrease in other assets	129	17,127	(5,644)	11,612
Net cash (used in) provided by investing activities	(103,258)	5,437	(5,781)	(103,602)
Financing activities:				
Proceeds from restricted contributions	1,493	4,507	-	6,000
Intercompany activity, including equity transfers	(134,970)	134,953	17	-
Proceeds from issuance of debt	375	-	-	375
Payments of finance lease obligations	(6,558)	(5,500)	-	(12,058)
Payments of long-term debt	(61,394)	(29)	-	(61,423)
Cash distributions to noncontrolling interests	(6,125)	-	-	(6,125)
Net cash used (provided by) in financing activities	(207,179)	133,931	17	(73,231)
Net (decrease) increase in cash and cash equivalents	(3,616)	33,060	-	29,444
Cash and cash equivalents at beginning of year	14,056	369,040	-	383,096
Cash and cash equivalents at end of period	\$ 10,440	\$ 402,100	\$ -	\$ 412,540