



**Unaudited Consolidated
Financial Statements and Supplementary Information**

Banner Health and Subsidiaries

September 30, 2019

Banner Health and Subsidiaries
Unaudited Consolidated Financial Statements
September 30, 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 September 30, 2019, and the related consolidated statements of income, changes in net assets and cash flows for the nine-month periods ended September 30, 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

November 20, 2019

Banner Health and Subsidiaries

Consolidated Balance Sheets

(In Thousands)

	Unaudited September 30 2019	December 31 2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 423,391	\$ 383,096
Short-term investments	116,568	112,196
Collateral held under securities lending program	178,677	210,811
Assets limited as to use	41,374	144,170
Patient receivables, net	914,479	868,127
Inventories	217,296	206,055
Other receivables	382,109	350,731
Other current assets	112,898	86,211
Total current assets	2,386,792	2,361,397
Assets limited as to use:		
Funds designated by:		
Board of Directors	2,250,701	2,031,832
Lease agreements	1,983	1,931
Funds held by trustees under:		
Self-insurance funding arrangements	102,253	103,564
Project fund	27,177	-
Other funds	242,923	138,238
Total assets limited as to use, less current portion	2,625,037	2,275,565
Property and equipment, net	3,820,342	3,685,196
Right of use assets - operating leases	331,176	-
Right of use assets - finance leases	180,561	-
Leased hospital assets	-	207,847
Other assets:		
Long-term investments	2,413,174	2,114,408
Other	814,494	742,342
Total assets	\$ 12,571,576	\$ 11,386,755

Banner Health and Subsidiaries

Consolidated Balance Sheets

(In Thousands)

	Unaudited September 30 2019	December 31 2018
Liabilities and net assets		
Current liabilities:		
Trade accounts payable	\$ 238,760	\$ 208,932
Current portion of long-term debt	61,950	58,994
Debt subject to self liquidity	400,000	200,000
Current portion of operating lease obligations	71,917	-
Current portion of finance lease obligations	37,360	-
Current portion of hospital lease obligations	-	22,188
Payable under securities lending program	178,677	210,811
Estimated current portion of third-party payor settlements	10,140	3,465
Accrued expenses:		
Salaries and benefits	393,783	460,061
Medical claims payable	202,589	202,849
Other	241,369	238,164
Total current liabilities	1,836,545	1,605,464
Long-term debt, less current portion	3,215,752	3,064,972
Operating lease obligations, less current portion	273,950	-
Finance lease obligations, less current portion	143,539	-
Hospital lease obligations	-	211,515
Estimated self-insurance liabilities, less current portion	211,509	205,055
Estimated third-party payor settlements, less current portion	16,890	17,531
Interest rate swaps	386,615	258,762
Other	183,516	174,853
Total liabilities	6,268,316	5,538,152
Net assets:		
Net assets without donor restrictions	6,052,819	5,613,878
Non-controlling interests	59,676	43,999
Total net assets without donor restrictions	6,112,495	5,657,877
Net assets with donor restrictions	190,765	190,726
Total net assets	6,303,260	5,848,603
Total liabilities and net assets	\$ 12,571,576	\$ 11,386,755

See accompanying notes.

Banner Health and Subsidiaries

Consolidated Statements of Income

Unaudited

(In Thousands)

	Nine Months Ended September 30	
	2019	2018
Revenues:		
Net patient service revenue	\$ 5,225,789	\$ 4,868,122
Medical insurance premiums	1,471,941	1,100,479
Other revenue	318,741	286,915
Total revenues	7,016,471	6,255,516
Expenses:		
Salaries and benefits	3,198,266	2,997,648
Supplies	1,098,155	1,001,524
Physician and professional fees	178,449	152,175
Medical claims cost, net of Banner claims of \$273,219 and \$280,412 in 2019 and 2018, respectively	1,142,171	810,242
Depreciation and amortization	343,047	305,889
Interest expense	96,549	95,016
Other expenses	843,376	770,885
Total expenses	6,900,013	6,133,379
Operating income	116,458	122,137
Other income:		
Investment income - realized	90,849	112,478
Investment income (loss) - unrealized	262,149	(41,605)
Income from alternative investments	77,888	24,565
Investment income, net	430,886	95,438
Unrealized (loss) gain on interest rate swaps	(128,023)	86,617
Other (loss)	(6,300)	(5,929)
	296,563	176,126
Excess of revenues over expenses	413,021	298,263
Less excess of revenues over expenses attributable to non-controlling interests	19,657	19,916
Excess of revenues over expenses attributable to Banner Health	\$ 393,364	\$ 278,347

See accompanying notes.

Banner Health and Subsidiaries

Consolidated Statements of Changes in Net Assets

Unaudited

(In Thousands)

	Nine Months Ended September 30	
	2019	2018
Net assets without donor restrictions:		
Excess of revenues over expenses attributable to Banner Health	\$ 393,364	\$ 278,347
Cumulative effect of change in accounting principles	24,637	(7,323)
Contributions for property and equipment acquisitions	20,769	4,124
Other changes in net assets	171	172
Increase in net assets without donor restrictions	<u>438,941</u>	<u>275,320</u>
Net assets with donor restrictions:		
Contributions	20,911	16,740
Net unrealized gain on investments	2,331	230
Net assets released from restriction	(23,203)	(11,501)
Increase in net assets with donor restrictions	<u>39</u>	<u>5,469</u>
Noncontrolling interests:		
Excess of revenues over expenses attributable to noncontrolling interests	19,657	19,916
Other changes, primarily distributions of earnings to noncontrolling interests	(3,980)	(8,472)
Increase in noncontrolling interests	<u>15,677</u>	<u>11,444</u>
Increase in net assets	454,657	292,233
Net assets, beginning of period	5,848,603	5,784,480
Net assets, end of period	<u>\$ 6,303,260</u>	<u>\$ 6,076,713</u>

See accompanying notes.

Banner Health and Subsidiaries

Consolidated Statements of Cash Flows

Unaudited

(In Thousands)

	Nine Months Ended September 30	
	2019	2018
Operating activities		
Increase in net assets	\$ 454,657	\$ 292,233
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Loss on early extinguishment of debt	1,782	-
Depreciation and amortization	343,047	305,889
(Increase) decrease in investments designated as trading	(522,637)	155,715
Net unrealized loss (gain) on interest rate swaps	128,023	(86,619)
Cumulative effect of change in accounting principles	(24,637)	7,323
Gain on sale of assets	(1,840)	(635)
Contributions for property and equipment and other	(20,769)	(4,124)
Restricted contributions	(20,911)	(16,740)
Non-controlling interest	17,150	20,335
Changes in operating elements:		
Patient receivables	(46,352)	55,662
Inventories and other current assets	(69,306)	(63,070)
Accounts payable and accrued expenses	(33,505)	(115,539)
Estimated third-party settlements	6,034	(6,901)
Estimated self-insurance liabilities	6,454	20,235
Other liabilities	18,557	3,860
Net cash provided by operating activities	235,747	567,624
Investing activities:		
Net purchases of property and equipment	(428,175)	(424,567)
(Increase) decrease in project fund	(27,177)	44,957
Increase in other assets	(70,893)	(77,942)
Net cash used in investing activities	(526,245)	(457,552)
Financing activities:		
Proceeds from restricted contributions	20,911	16,740
Proceeds from issuance of debt	688,241	-
Payments on finance leases and leased hospital obligations	(24,922)	(17,184)
Payments on long-term debt	(336,287)	(64,975)
Cash distributions to non-controlling interests	(17,150)	(20,335)
Net cash provided by (used in) financing activities	330,793	(85,754)
Net increase in cash and cash equivalents	40,295	24,318
Cash and cash equivalents at beginning of year	383,096	292,911
Cash and cash equivalents at end of period	\$ 423,391	\$ 317,229
Supplemental disclosure of cash flow information		
Interest paid, including amounts capitalized	\$ 121,985	\$ 121,776
Non-cash activities		
Leased hospital assets	\$ -	\$ 8,505
Operating and finance leases - right of use asset and liability	\$ 595,310	\$ -

See accompanying notes.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

September 30, 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 nine months ended September 30, 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

September 30, 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 investments 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 September 30, 2019 and December 31, 2018. As of September 30, 2019, approximately \$594,477,000 of gross derivative assets and approximately \$595,531,000 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 repurchase agreements for approximately \$15,501,000 and \$174,410,000 as of September 30, 2019 and December 31, 2018, respectively. In connection with the repurchase agreements, 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 \$15,828,000 and \$177,973,000 as of September 30, 2019 and December 31, 2018, respectively. The repurchase agreements have been accounted for as collateralized borrowings. The collateral has not been sold or pledged to an external party and accordingly, is not recorded on the consolidated balance sheets.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

September 30, 2019

2. Significant Accounting Policies (continued)

Net Patient Service Revenue

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. 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

September 30, 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 nine months ended September 30 by line of business is as follows (*in thousands*):

	2019	2018
Hospital	\$4,363,510	\$4,098,977
Physician services	487,298	450,785
Home care	58,906	53,714
Laboratory	219,846	210,294
Other	96,229	54,352
	<u>\$5,225,789</u>	<u>\$4,868,122</u>

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 September 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

September 30, 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.

Assets and liabilities measured at fair value are generally based on the market approach, using prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Interest rate swap liabilities are valued using the income approach, which uses 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 \$1,203,596,000 and \$1,069,224,000 as of September 30, 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

September 30, 2019

3. Fair Value Measurements (continued)

	September 30, 2019	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	\$ 224,363	\$ 221,366	\$ 2,997	\$ -
Collateral held under securities lending (primarily cash and debt securities)	178,677	147,308	31,369	
Mutual funds:				
Mutual funds – U.S. funds	1,827,824	1,827,824	-	-
Mutual funds – International	558,867	558,867	-	-
Total mutual funds	2,386,691	2,386,691	-	-
Debt securities:				
U.S. Treasury/government obligations	359,872	-	359,872	-
Corporate bonds/non-U.S. government bonds	350,464	-	350,464	-
Asset-backed securities	189,324	-	189,324	-
Commercial mortgage-backed securities	28,606	-	28,606	-
Non-government-backed collateralized mortgages	29,245	-	29,245	-
Government mortgage-backed securities	131,233	-	131,233	-
Government commercial-backed securities	5,143	-	5,143	-
Total debt securities	1,093,887	-	1,093,887	-
Repurchase agreements	15,501	-	15,501	-
Equity securities:				
U.S. equity securities	713	713	-	-
International equity securities	186,058	186,058	-	-
Total equity securities	186,771	186,771	-	-
Derivative securities:				
Future contracts	371,893	371,893	-	-
Forward contracts	220,755	-	220,755	-
Interest rate swap agreements	492	-	492	-
Options agreements	15	=	15	-
Net credit swaps	1,322	-	1,322	-
Subtotal derivative assets	594,477	371,893	222,584	-
Future contracts	(371,893)	(371,893)	-	-
Forward contracts	(220,577)	-	(220,577)	-
Interest rate swap agreements	(2,998)	-	(2,998)	-
Option agreements	(60)	-	(60)	-
Net credit swaps	(3)	-	(3)	-
Subtotal derivative liabilities	(595,531)	(371,893)	(223,638)	-
Total investments in the fair value hierarchy	\$ 4,084,836	\$ 2,942,136	\$ 1,142,700	\$ -
Investment measured at net asset value: private commingled fund	167,724			
Total fair value investments	<u>\$ 4,252,560</u>			
Short-term investments	\$ 116,568			
Collateral held under securities lending agreements	178,677			
Assets limited as to use	2,666,411			
Long-term investments	2,413,174			
Other assets – Banner Foundation restricted funds	84,557			
Less alternative investments	1,203,596			
Less split-dollar life insurance	3,231			
Total fair value investments	<u>\$ 4,252,560</u>			
Interest rate swaps included in other long-term liabilities	\$ (386,615)	\$ -	\$ (386,615)	\$ -

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

September 30, 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)
Cash and cash equivalents	\$ 415,868	\$ 384,365	\$ 31,503	\$ –
Collateral held under securities lending (primarily cash and debt securities)	210,811	190,062	20,749	
Mutual funds:				
Mutual funds – U.S. funds	1,541,010	1,541,010	–	–
Mutual funds – International	522,942	522,942	–	–
Total mutual funds	2,063,952	2,063,952	–	–
Debt securities:				
U.S. Treasury/government obligations	179,202	–	179,202	–
Corporate bonds/non-U.S. government bonds	181,970	–	181,970	–
Asset-backed securities	69,195	–	69,195	–
Commercial mortgage-backed securities	8,238	–	8,238	–
Non-government-backed collateralized mortgages	6,155	–	6,155	–
Government mortgage-backed securities	158,367	–	158,367	–
Government commercial-backed securities	5,027	–	5,027	–
Total debt securities	608,154	–	608,154	–
Repurchase agreements	174,410	–	174,410	–
Equity securities:				
U.S. equity securities	78,969	78,969	–	–
International equity securities	174,006	174,006	–	–
Total equity securities	252,975	252,975	–	–
Derivative securities:				
Future contracts	842,371	842,371	–	–
Forward contracts	583,000	–	583,000	–
Interest rate swap agreements	3,489	–	3,489	–
Net credit swaps	721	–	721	–
Subtotal derivative assets	1,429,581	842,371	587,210	–
Future contracts	(842,371)	(842,371)	–	–
Forward contracts	(582,752)	–	(582,752)	–
Interest rate swap agreements	(381)	–	(381)	–
Option agreements	(92)	–	(92)	–
Net credit swaps	(180)	–	(180)	–
Subtotal derivative liabilities	(1,425,776)	(842,371)	(583,405)	–
Total investments in the fair value hierarchy	\$ 3,729,975	\$ 2,891,354	\$ 838,621	\$ –
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	\$ (258,762)	\$ –	\$ (258,762)	\$ –

Banner Health and Subsidiaries
Notes to Unaudited Consolidated Financial Statements
September 30, 2019

3. Fair Value Measurements (continued)

Investment income consisted of the following for the nine months ended September 30:

	2019	2018
	<i>(In Thousands)</i>	
Interest and dividend income	\$ 59,510	\$ 47,873
Net realized gain on sales of marketable securities	35,547	69,885
Realized and unrealized gain from alternative investments, including amount recorded in net assets with donor restriction	78,640	25,088
Net realized loss on derivative instruments	(391)	(3,846)
Net unrealized gain (loss) on marketable securities	264,516	(49,785)
Net unrealized (loss) gain on derivative instruments	(849)	9,542
	<u>436,973</u>	<u>98,757</u>
Less investment gain credited to other revenue, restricted equity, and capitalized bond project funds	6,087	3,319
Investment income, net	<u>\$ 430,886</u>	<u>\$ 95,438</u>

4. Liquidity

Financial assets available for general expenditure within one year of the balance sheet date, consist of the following as of September 30, 2019 (in thousands):

Cash and cash equivalents	\$ 423,391
Patient receivables, net	914,479
Short-term investments	116,568
Funds designated by Board of Directors	2,250,701
Long-term investments	2,413,174
	<u>\$ 6,118,313</u>

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 currently maintains one line of credit vehicle to support interim working capital and capital financing needs: a \$400,000,000 line of credit initiated on April 30, 2019 as a syndicate with five banks, with no amounts drawn as of September 30, 2019.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

September 30, 2019

5. Debt

At September 30, 2019 and December 31, 2018, the estimated fair value of Banner's debt, excluding unamortized net premiums, was \$3,775,792,000 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.

6. Interest Rate Swap Agreements

Banner is party to multiple interest rate swaps that currently do not qualify for hedge accounting. For the nine months ended September 30, 2019 and 2018, the mark-to-market adjustment resulted in an unrealized loss of \$128,023,000 and an unrealized gain of \$86,617,000 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 nine months ended September 30, 2019 and 2018, by \$18,873,000 and \$22,491,000, 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 September 30, 2019 and December 31, 2018, Banner had \$127,378,000 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

On June 10, 2019, Banner executed a Letter of Intent with NCMC Inc, a health care authority of Weld County in northern Colorado, for Banner to purchase the hospital and related assets operating since 1995 under Banner Health as North Colorado Medical Center (NCMC). The transaction includes the purchase of the medical center and equipment at a price of \$266,000,000, plus the acquisition of certain off-campus properties currently leased by Banner to support NCMC operations. This transaction will terminate the current finance lease obligation between Banner and NCMC Inc, which has an outstanding book liability of approximately \$151,000,000 as of September 30, 2019. Termination of the lease will also terminate any and all related covenants and rent guarantees between the parties and will convey lien-free title of NCMC assets to Banner Health. The transaction closed on October 9, 2019.

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

September 30, 2019

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 nine months ended September 30, 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	\$23,265
Interest on lease liabilities	4,201
Operating lease cost	48,666
Short-term lease cost	6,879
Variable lease cost	4,772
Total lease cost	<u>\$87,783</u>
Weighted-average remaining lease term-finance leases (yrs)	10.0
Weighted-average remaining lease term-operating leases (yrs)	7.8
Weighted-average discount rate-finance leases	3.10%
Weighted-average discount rate-operating leases	2.57%

The following table presents supplemental cash flow information for the quarter ended September 30, 2019:

Cash paid for amounts included in the measurement of lease liabilities (in thousands):

Operating cash flows for operating leases	\$ 43,318
Operating cash flows for finance leases	\$ 4,030
Financing cash flows for finance leases	\$ 20,892

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

September 30, 2019

8. Leases (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 September 30, 2019 (in thousands):

	Operating Leases	Finance Leases
2019	\$21,686	\$12,267
2020	67,851	34,521
2021	60,021	29,319
2022	52,028	25,195
2023	38,471	22,577
Thereafter	153,149	84,350
Total minimum lease payments	\$393,206	\$208,229
Less: amount of lease payments representing interest	(47,339)	(27,330)
Present value of future minimum lease payments	345,867	180,899
Less: current obligations under leases	(71,917)	(37,360)
Long-term lease obligations	\$273,950	\$143,539

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 functions for the nine months ended September 30, 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.

Expenses September 30, 2019

	Delivery	Insurance Operations	Corporate Services	Other/ Eliminations	Banner Health Consolidated
	<i>(In Thousands)</i>				
Expenses:					
Salaries and benefits	\$2,751,363	\$70,016	\$472,152	(\$95,265)	\$3,198,266
Supplies	1,116,885	867	(7,737)	(11,860)	1,098,155
Physician and professional fees	171,983	8,459	27,458	(29,451)	178,449
Medical claims costs	-	1,419,267	(3,877)	(273,219)	1,142,171
Depreciation and amortization	284,166	1,363	57,518	-	343,047
Interest expense	98,964	2,143	(4,487)	(71)	96,549
Other	1,470,880	58,572	-	(686,076)	843,376
Total expenses	\$5,894,241	\$1,560,687	\$541,027	(\$1,095,942)	\$6,900,013

Banner Health and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

September 30, 2019

9. Statement of Functional Expenses (continued)

Expenses September 30, 2018

	Delivery	Insurance Operations	Corporate Services	Other/ Eliminations	Banner Health Consolidated
	<i>(In Thousands)</i>				
Expenses:					
Salaries and benefits	\$2,587,379	\$58,492	\$441,875	(\$90,098)	\$2,997,648
Supplies	1,017,433	300	(13,603)	(2,606)	1,001,524
Physician and professional fees	149,682	9,992	18,376	(25,875)	152,175
Medical claims costs	-	1,090,654	-	(280,412)	810,242
Depreciation and amortization	249,197	1,042	55,650	-	305,889
Interest expense	91,070	1,203	2,766	(23)	95,016
Other	1,398,854	40,188	-	(668,157)	770,885
Total expenses	<u>\$5,493,615</u>	<u>\$1,201,871</u>	<u>\$505,064</u>	<u>(\$1,067,171)</u>	<u>\$6,133,379</u>

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

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

In early October 2019, Banner drew down \$303,600,000 on its bank syndicate line of credit, in order to fund the acquisition of the NCMC assets (see Note 7) and to retire the then outstanding capital lease obligation with NCMC Inc.

Supplementary Information

Banner Health

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

September 30, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Assets				
Current assets:				
Cash and cash equivalents	\$ 10,403	\$ 412,988	\$ -	\$ 423,391
Short-term investments	116,537	31	-	116,568
Collateral held under securities lending program	178,677	-	-	178,677
Assets limited as to use	3,633	37,741	-	41,374
Patient receivables, net	881,418	101,612	(68,551)	914,479
Inventories	182,963	34,333	-	217,296
Other receivables	235,805	150,579	(4,275)	382,109
Other current assets	595,857	(482,959)	-	112,898
Total current assets	2,205,293	254,325	(72,826)	2,386,792
Assets limited as to use:				
Funds designated by:				
Board of Directors	2,250,701	-	-	2,250,701
Lease agreements	1,983	-	-	1,983
Funds held by trustees under:				
Self-insurance funding arrangements	(180)	102,433	-	102,253
Project fund	27,177	-	-	27,177
Other funds	242,054	869	-	242,923
Total assets limited as to use, less current portion	2,521,735	103,302	-	2,625,037
Property and equipment, net	3,672,707	147,635	-	3,820,342
Right of use assets - operating leases	97,699	233,477	-	331,176
Right of use assets - finance leases	176,069	4,492	-	180,561
Other assets:				
Long-term investments	2,383,742	29,432	-	2,413,174
Other	568,473	192,352	53,669	814,494
Total assets	\$ 11,625,718	\$ 965,015	\$ (19,157)	\$ 12,571,576

Banner Health

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

September 30, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Liabilities and net assets				
Current liabilities:				
Trade accounts payable	\$ 179,338	\$ 59,422	\$ -	\$ 238,760
Current portion of long-term debt	61,232	1,512	(794)	61,950
Debt subject to self liquidity	400,000	-	-	400,000
Current portion of operating lease obligations	22,749	49,168	-	71,917
Current portion of finance lease obligations	36,504	856	-	37,360
Payable under securities lending program	178,677	-	-	178,677
Estimated current portion of third-party payor settlements	10,140	-	-	10,140
Accrued expenses:				
Salaries and benefits	310,275	97,814	(14,306)	393,783
Medical claims payable	-	257,607	(55,018)	202,589
Other	164,000	80,375	(3,006)	241,369
Total current liabilities	1,362,915	546,754	(73,124)	1,836,545
Long-term debt, less current portion	3,214,900	852	-	3,215,752
Operating lease obligations, less current portion	84,172	189,778	-	273,950
Finance lease obligations, less current portion	138,776	4,763	-	143,539
Estimated self-insurance liabilities, less current portion	94,022	117,982	(495)	211,509
Estimated third-party payor settlements, less current portion	16,890	-	-	16,890
Interest rate swaps	386,615	-	-	386,615
Other	179,366	4,150	-	183,516
Total liabilities	5,477,656	864,279	(73,619)	6,268,316
Net assets:				
Net assets without donor restrictions	6,073,583	(75,226)	54,462	6,052,819
Non-controlling interests	-	59,676	-	59,676
Total net assets without donor restrictions	6,073,583	(15,550)	54,462	6,112,495
Net assets with donor restrictions	74,479	116,286	-	190,765
Total net assets	6,148,062	100,736	54,462	6,303,260
Total liabilities and net assets	\$ 11,625,718	\$ 965,015	\$ (19,157)	\$ 12,571,576

Banner Health
Statement of Income and Changes in Net Assets -
Obligated and Non-Obligated Group Details of Consolidation
Nine Months Ended September 30, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Revenues:				
Net patient service revenue	\$ 4,706,008	\$ 837,432	\$ (317,651)	\$ 5,225,789
Medical insurance premiums	(3,005)	1,474,946	-	1,471,941
Other revenue	174,546	289,975	(145,780)	318,741
Total revenues	4,877,549	2,602,353	(463,431)	7,016,471
Expenses:				
Salaries and benefits	2,256,859	1,034,227	(92,820)	3,198,266
Supplies	902,146	207,868	(11,859)	1,098,155
Physician and professional fees	145,398	60,970	(27,919)	178,449
Medical claims cost, net of Banner claims of \$273,219	(3,877)	1,366,007	(219,959)	1,142,171
Depreciation and amortization	326,578	16,469	-	343,047
Interest expense	89,658	6,963	(72)	96,549
Other expenses	775,303	177,003	(108,930)	843,376
Total expenses	4,492,065	2,869,507	(461,559)	6,900,013
Operating income	385,484	(267,154)	(1,872)	116,458
Other income:				
Investment income - realized	83,767	7,154	(72)	90,849
Investment income - unrealized	258,780	3,369	-	262,149
Income from alternative investments	75,933	1,955	-	77,888
Investment income, net	418,480	12,478	(72)	430,886
Unrealized loss on interest rate swaps	(128,023)	-	-	(128,023)
Other (loss)	(6,230)	(3,085)	3,015	(6,300)
	284,227	9,393	2,943	296,563
Excess of revenues over expenses	669,711	(257,761)	1,071	413,021
Less excess of revenues over expenses attributable to non-controlling interests	-	19,657	-	19,657
Excess of revenues over expenses attributable to Banner Health	669,711	(277,418)	1,071	393,364
Equity transfers	(285,942)	285,942	-	-
Cumulative effect of change in accounting principles	24,637	-	-	24,637
Contributions for property and equipment acquisitions	21,839	-	(1,070)	20,769
Other changes in net assets	(9,350)	9,668	(147)	171
Increase in net assets without donor restrictions	\$ 420,895	\$ 18,192	\$ (146)	\$ 438,941
Net assets with donor restrictions:				
Contributions	4,071	16,840	-	20,911
Net unrealized gain on investments	19	2,312	-	2,331
Net assets released from restriction	(3,476)	(19,727)	-	(23,203)
Increase (decrease) in net assets with donor restrictions	\$ 614	\$ (575)	\$ -	\$ 39
Non-controlling interests:				
Less excess of revenues over expenses attributable to non-controlling interests	-	19,657	-	19,657
Other changes, primarily distributions of earnings to non-controlling interests	-	(3,980)	-	(3,980)
Increase in non-controlling interests	-	15,677	-	15,677
Increase in net assets	421,509	33,294	(146)	454,657
Net assets, beginning of period	5,726,553	67,442	54,608	5,848,603
Net assets, end of period	\$ 6,148,062	\$ 100,736	\$ 54,462	\$ 6,303,260

Banner Health

Statement of Cash Flows -

Obligated and Non-Obligated Group Details of Consolidation

Nine Months Ended September 30, 2019

Unaudited

(In Thousands)

	Obligated Group	Non-Obligated Group	Eliminations	Total Consolidated
Operating activities				
Increase in net assets	\$ 421,509	\$ 33,294	\$ (146)	\$ 454,657
Adjustments to reconcile increase in net assets to net cash provided by (used in) operating activities:				
Loss on early extinguishment of debt	1,782	-	-	1,782
Equity transfers	285,942	(285,942)	-	-
Depreciation and amortization	326,578	16,469	-	343,047
Increase in investments designated as trading	(522,723)	86	-	(522,637)
Net unrealized loss on interest rate swaps	128,023	-	-	128,023
Cumulative effect of change in accounting principles	(24,637)	-	-	(24,637)
(Gain) loss on sale of assets	(1,859)	19	-	(1,840)
Contributions for property and equipment and other	(21,839)	-	1,070	(20,769)
Restricted contributions	(4,071)	(16,840)	-	(20,911)
Noncontrolling interest	17,150	-	-	17,150
Changes in operating elements:				
Patient receivables	(53,346)	(586)	7,580	(46,352)
Inventories and other current assets	(18,229)	(39,859)	(11,218)	(69,306)
Accounts payable and accrued expenses	(80,819)	49,704	(2,390)	(33,505)
Estimated third-party settlements	6,034	-	-	6,034
Estimated self-insurance liabilities	184	241	6,029	6,454
Other liabilities	20,552	(1,995)	-	18,557
Net cash provided by (used in) operating activities	480,231	(245,409)	925	235,747
Investing activities:				
Net purchases of property and equipment	(376,427)	(50,678)	(1,070)	(428,175)
Increase in project fund	(27,177)	-	-	(27,177)
Increase (decrease) in other assets	(74,374)	2,543	938	(70,893)
Net cash used in investing activities	(477,978)	(48,135)	(132)	(526,245)
Financing activities:				
Proceeds from restricted contributions	4,071	16,840	-	20,911
Intercompany activity, including equity transfers	(323,592)	323,592	-	-
Proceeds from issuance of debt	686,615	1,626	-	688,241
Payments of finance lease obligations	(25,166)	244	-	(24,922)
Payments of long-term debt	(330,683)	(4,810)	(794)	(336,287)
Cash distributions to noncontrolling interests	(17,150)	-	-	(17,150)
Net cash (used in) provided by financing activities	(5,905)	337,492	(794)	330,793
Net (decrease) increase in cash and cash equivalents	(3,653)	43,948	-	40,295
Cash and cash equivalents at beginning of year	14,056	369,040	-	383,096
Cash and cash equivalents at end of period	\$ 10,403	\$ 412,988	\$ -	\$ 423,391