

**Banner Health and Subsidiaries**

**Unaudited Financial Statements**

**As of September 30, 2013**

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Banner Health and Subsidiaries

Consolidated Balance Sheets

As of September 30

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	9/30/2013	9/30/2012	9/30/2013	9/30/2012	9/30/2013	9/30/2012
<b>Assets</b>						
Current assets:						
Cash and cash equivalents	\$ 218,728	\$ 124,251	\$ 90,538	\$ 36,642	\$ 128,190	\$ 87,609
Short-term investments	13,419	71,269	1,167	1,165	12,252	70,104
Collateral held under securities lending program	154,671	180,705	-	-	154,671	180,705
Assets limited as to use	40,636	48,281	39,589	46,934	1,047	1,347
Patient receivables, net of allowance for doubtful accounts	478,728	491,606	49,611	52,929	429,117	438,677
Inventories	131,875	121,712	9,151	9,877	122,724	111,835
Other current assets	164,449	105,876	(47,139)	827	211,588	105,049
Total current assets	1,202,506	1,143,700	142,917	148,374	1,059,589	995,326
Assets held for sale	2,140	2,140	-	-	2,140	2,140
Assets limited as to use:						
Property and equipment replacement and expansion	1,516,094	1,352,307	-	-	1,516,094	1,352,307
Lease and loan agreements	4,417	4,433	-	-	4,417	4,433
Self-insurance funding arrangements	112,341	145,157	99,369	133,377	12,972	11,780
Indenture agreements	113,512	-	-	-	113,512	-
Other funds	214,374	341,470	959	939	213,415	340,531
Total assets limited as to use, less current portion	1,960,738	1,843,367	100,328	134,316	1,860,410	1,709,051
Property and equipment, net of depreciation	2,541,941	2,425,669	50,738	45,235	2,491,203	2,380,434
Assets leased from NCMC, Inc.	191,328	191,434	-	-	191,328	191,434
Other assets:						
Long-term investments	1,827,248	1,511,441	24,700	20,818	1,802,548	1,490,623
Deferred financing costs, net	8,358	8,025	12	21	8,346	8,004
Other non-current assets	278,748	246,249	114,435	92,247	164,313	154,002
Total assets	\$8,013,007	\$7,372,025	\$ 433,130	\$ 441,011	\$7,579,877	\$6,931,014

Banner Health and Subsidiaries

Consolidated Balance Sheets

Banner Health and Subsidiaries

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	9/30/2013	9/30/2012	9/30/2013	9/30/2012	9/30/2013	9/30/2012
<b>Liabilities and net assets</b>						
Current liabilities:						
Current maturities of long-term debt	\$ 48,462	\$ 48,441	\$ 1,270	\$ 1,844	\$ 47,192	\$ 46,597
Lease obligation-NCMC, Inc., current portion	16,984	25,153	-	-	16,984	25,153
Trade accounts payable	116,425	137,056	7,064	6,986	109,361	130,070
Payable under securities lending program	154,671	180,705	-	-	154,671	180,705
Estimated third-party payor settlements	33,935	36,324	(554)	(127)	34,489	36,451
Accrued salaries and benefits	316,304	268,817	59,534	39,973	256,770	228,844
Other current liabilities	172,654	165,553	123,410	98,576	49,244	66,977
Total current liabilities	859,435	862,049	190,724	147,252	668,711	714,797
Long-term debt, less current maturities	2,311,795	2,181,043	15,215	16,436	2,296,580	2,164,607
Lease obligation-NCMC, Inc.	174,254	165,687	-	-	174,254	165,687
Estimated third-party payor settlements	7,798	6,435	-	-	7,798	6,435
Estimated self-insurance liabilities	126,967	157,562	94,946	132,246	32,021	25,316
Other long-term liabilities	450,809	636,173	6,418	6,836	444,391	629,337
Total liabilities	3,931,058	4,008,949	307,303	302,770	3,623,755	3,706,179
Net assets:						
Unrestricted net assets	3,944,249	3,238,933	29,075	46,367	3,915,174	3,192,566
Temporarily restricted net assets	110,966	94,502	70,647	62,917	40,319	31,585
Total Banner Health net assets	4,055,215	3,333,435	99,722	109,284	3,955,493	3,224,151
Noncontrolling interests	26,734	29,641	26,105	28,957	629	684
Total net assets	4,081,949	3,363,076	125,827	138,241	3,956,122	3,224,835
Total liabilities and net assets	\$8,013,007	\$7,372,025	\$ 433,130	\$ 441,011	\$7,579,877	\$6,931,014

Banner Health and Subsidiaries

Consolidated Income Statements

For the Nine Months Ending September 30

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	9/30/2013	9/30/2012	9/30/2013	9/30/2012	9/30/2013	9/30/2012
<b>Revenues:</b>						
Net patient service	\$3,683,720	\$3,604,560	\$ 473,472	\$ 395,607	\$3,210,248	\$3,208,953
Provision for doubtful accounts	373,805	330,159	21,835	17,580	351,970	312,579
Net patient service revenue, less provision for doubtful accounts	3,309,915	3,274,401	451,637	378,027	2,858,278	2,896,374
Other revenue	495,451	369,751	478,946	346,827	16,505	22,924
Total net revenue	3,805,366	3,644,152	930,583	724,854	2,874,783	2,919,298
<b>Expenses:</b>						
Salaries and benefits	1,895,130	1,841,034	429,611	341,872	1,465,519	1,499,162
Supplies expense	596,376	566,895	67,473	63,999	528,903	502,896
Physician and professional fees	83,269	89,531	22,381	13,896	60,888	75,635
Depreciation and amortization	221,497	214,622	5,957	6,571	215,540	208,051
Interest expense	98,649	102,264	2,129	1,012	96,520	101,252
Other expenses	714,322	598,325	474,544	319,143	239,778	279,182
Total expenses	3,609,243	3,412,671	1,002,095	746,493	2,607,148	2,666,178
Operating income (loss)	196,123	231,481	(71,512)	(21,639)	267,635	253,120
<b>Other income (losses):</b>						
Investment income-realized	69,178	64,134	1,650	1,093	67,528	63,041
Investment income - unrealized	99,488	130,251	2,771	3,494	96,717	126,757
Income from alternative investments	55,325	31,938	719	376	54,606	31,562
Total investment income	223,991	226,323	5,140	4,963	218,851	221,360
Unrealized gain (loss) on interest rate swaps	142,118	(9,192)	490	(1,497)	141,628	(7,695)
Other	(5,379)	7,624	(2,709)	(1,575)	(2,670)	9,199
	360,730	224,755	2,921	1,891	357,809	222,864
Excess (deficiency) of revenues over expenses	556,853	456,236	(68,591)	(19,748)	625,444	475,984
Less excess (deficiency) of revenues over expenses attributable to noncontrolling interests	14,111	13,577	13,896	13,814	215	(237)
Excess (deficiency) of revenues over expenses attributable to Banner Health	542,742	442,659	(82,487)	(33,562)	625,229	476,221
Amortization of cumulative loss on interest rate swaps	170	170	-	-	170	170
Equity transfers	-	-	54,080	15,742	(54,080)	(15,742)
Other changes in net assets	9,734	14,880	2,373	(28,418)	7,361	43,298
Increase (decrease) in unrestricted net assets	\$ 552,646	\$ 457,709	\$ (26,034)	\$ (46,238)	\$ 578,680	\$ 503,947

Banner Health and Subsidiaries

Consolidated Statements of Changes in Net Assets

For the Nine Months Ending September 30

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	9/30/2013	9/30/2012	9/30/2013	9/30/2012	9/30/2013	9/30/2012
Unrestricted net assets:						
Excess (deficiency) of revenues over expenses	\$ 542,742	\$ 442,659	\$ (82,487)	\$ (33,562)	\$ 625,229	\$ 476,221
Amortization of cumulative loss on interest rate swaps	170	170	-	-	170	170
Equity transfers	-	-	54,080	15,742	(54,080)	(15,742)
Other changes in net assets	9,734	14,880	2,373	(28,418)	7,361	43,298
Increase (decrease) in unrestricted net assets	552,646	457,709	(26,034)	(46,238)	578,680	503,947
Temporarily restricted net assets:						
Contributions and other	16,160	19,640	6,338	8,244	9,822	11,396
Net unrealized gain (loss) on investments	632	1,161	701	1,077	(69)	84
Net assets released from restriction	(11,018)	(20,170)	(6,540)	(6,215)	(4,478)	(13,955)
Increase (decrease) in temporarily restricted net assets	5,774	631	499	3,106	5,275	(2,475)
Noncontrolling interests:						
Excess (deficiency) of revenue over expenses attributable to noncontrolling interests	14,111	13,577	13,896	13,814	215	(237)
Other changes, primarily distributions of earnings to noncontrolling interests	(15,287)	(14,811)	(15,092)	(14,690)	(195)	(121)
(Decrease) increase in noncontrolling interests	(1,176)	(1,234)	(1,196)	(876)	20	(358)
Increase (decrease) in net assets	557,244	457,106	(26,731)	(44,008)	583,975	501,114
Net assets, beginning of period	3,524,705	2,905,970	152,558	182,249	3,372,147	2,723,721
Net assets, end of period	\$4,081,949	\$3,363,076	\$ 125,827	\$ 138,241	\$3,956,122	\$3,224,835

Banner Health and Subsidiaries

Consolidated Statements of Cash Flows

For the Nine Months Ending September 30

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	9/30/2013	9/30/2012	9/30/2013	9/30/2012	9/30/2013	9/30/2012
<b>Operating activities:</b>						
Increase (decrease) in net assets	\$ 557,244	\$ 457,106	\$ (26,731)	\$ (44,008)	\$ 583,975	\$ 501,114
Adjustments to reconcile increase (decrease) in net assets to net cash provided by (used in) operating activities:						
Depreciation and amortization	221,497	214,622	5,957	6,571	215,540	208,051
(Increase) decrease in investments designated as trading	(137,461)	(367,690)	41,461	(2,473)	(178,922)	(365,217)
Equity transfers	-	-	(54,080)	(15,742)	54,080	15,742
Net unrealized (gain) loss on interest rate swaps	(142,288)	9,022	(490)	1,497	(141,798)	7,525
(Gain) loss on sale of assets	(48)	(13,738)	13	(21)	(61)	(13,717)
Restricted contributions and other	(16,160)	(19,640)	(6,338)	(8,244)	(9,822)	(11,396)
Changes in operating elements:						
Patient receivables	9,851	3,176	982	(6,849)	8,869	10,025
Inventories and other current assets	(67,487)	(21,357)	(21,631)	(35,077)	(45,856)	13,720
Accounts payable and accrued expenses	52,309	47,467	67,111	69,760	(14,802)	(22,293)
Estimated third-party settlements	8,419	(10,562)	112	(521)	8,307	(10,041)
Estimated self-insurance liabilities	(11,113)	9,946	(32,870)	16,107	21,757	(6,161)
Other liabilities	11,642	12,171	294	116	11,348	12,055
Net cash provided by (used in) operating activities	486,405	320,523	(26,210)	(18,884)	512,615	339,407
<b>Investing activities:</b>						
Net purchase of property and equipment	(318,959)	(198,973)	(14,524)	(7,654)	(304,435)	(191,319)
Less: intercompany transfer of property and equipment	-	-	-	9,997	-	(9,997)
Decrease in funds held under indenture agreements	50,838	-	-	-	50,838	-
(Increase) decrease in other assets	(21,995)	(1,096)	(2,352)	(4,072)	(19,643)	2,976
Net cash used in investing activities	(290,116)	(235,560)	(16,876)	(42,264)	(273,240)	(193,296)
<b>Financing activities:</b>						
Proceeds from restricted contributions and other	16,160	19,640	6,338	8,244	9,822	11,396
Change in intercompany balances	-	-	87,490	63,758	(87,490)	(63,758)
Proceeds from issuance of debt	509	27,934	73	64	436	27,870
Payments of long-term debt	(47,078)	(76,174)	(1,405)	(2,303)	(45,673)	(73,871)
Net cash (used in) provided by financing activities	(30,409)	(28,600)	92,496	69,763	(122,905)	(98,363)
Net increase in cash and cash equivalents	165,880	56,363	49,410	8,615	116,470	47,748
Cash and cash equivalents at beginning of period	52,848	67,888	41,128	28,027	11,720	39,861
Cash and cash equivalents at end of period	\$ 218,728	\$ 124,251	\$ 90,538	\$ 36,642	\$ 128,190	\$ 87,609

**Supplemental disclosure of cash flow information**

**Noncash activities**

Lease obligation - NCMC, Inc.	\$ 14,478	\$ 203,344	\$ -	\$ -	\$ 14,478	\$ 203,344
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## Banner Health and Subsidiaries

### Notes to Consolidated Unaudited Financial Statements

September 30, 2013

#### 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 (Banner) own or lease hospitals, clinics, nursing homes, clinical laboratories, ambulatory surgery centers, home health agencies, a captive insurance company, two foundations, an accountable health care organization and other health care-related organizations in seven western states. Banner also holds an interest in several healthcare related organizations, including:

- A 51% controlling interest in Sonora Quest Laboratories (SQL); the financial results of SQL have been included in Banner's consolidated financial statements.
- A 50% noncontrolling interest in Veritage LLC (Veritage) which is accounted for under the equity method of accounting. Banner's share of Veritage LLC's net income has been recorded within other operating revenue. The Veritage joint venture was formed September 1, 2012 between Banner and Blue Cross and Blue Shield of Arizona (BCBS), each holding a 50% noncontrolling interest in Veritage. As part of the initial capitalization, Banner contributed cash and all of its stock in Banner MediSun, Inc. which resulted in a gain of \$13,785,000 that is recorded within other nonoperating income for the nine months ended September 30, 2012.

#### 2. Significant Accounting Policies

##### Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting, applied on a basis substantially consistent with that of the 2012 audited financial statements of Banner. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete 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, 2013 are not necessarily indicative of the results to be expected for the year ended December 31, 2013. For more information, refer to the audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2012.

Subsequent events have been evaluated through November 15, 2013, the date of the issuance of the consolidated unaudited financial statements.

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 a controlling interest in several joint ventures, the financial results of which are included in Banner's consolidated financial statements. Banner records the unrelated investors' ownership share of these joint ventures as noncontrolling interest. The noncontrolling interest balance as of September 30, 2013 and 2012 primarily relates to Banner's investment in SQL, in which Banner holds a 51% interest and Quest Diagnostics, Inc. holds the remaining 49% interest.

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

September 30, 2013

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

**Banner Medical Group**

Beginning in November, 2011, and continuing through the first quarter of 2013, Banner Health transferred its employed physician clinics from the Banner hospitals into Banner Medical Group (BMG), a wholly-owned not for profit subsidiary of Banner. As the employed physician clinics were transferred into BMG from the Banner hospitals, the net assets of the employed physician clinics were transferred from the obligated group to the non-obligated group, as BMG is not a member of the obligated group. The transfer of net assets into BMG is recorded as an equity transfer in the consolidated statements of changes in net assets. There is no financial impact to the Banner consolidated financial statements associated with the employed physician clinic transfer.

**Short-Term Investments**

Short-term investments primarily include debt securities with maturity dates of one year or less from the balance sheet date, US Treasury government obligations and actively traded equity securities. These investments are stated at fair value (Refer to Note 3).

**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. Banner's share of the alternative investments' unrestricted realized and unrealized gains approximated \$55,325,000 and \$31,938,000 for the nine months ended September 30, 2013 and 2012, respectively. The restricted share of alternative investment realized and unrealized gains is approximately \$154,000 and \$82,000 for the nine months ended September 30, 2013 and 2012, respectively.

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. Banner offsets the fair value for various derivative instruments including forwards, interest rate swaps, currency swaps, options and other conditional or exchange contracts, if they are executed with the same counterparty under a master netting arrangement. Banner invests in a variety of derivative instruments through a fixed income manager that has executed a master netting arrangement with each of its forward and future purchase and sale contracts, interest and credit swap agreements and options, whereby the financial instruments are held by the same counterparty and are legally offset as the instrument is settled. Banner's derivative contracts in a net loss position were immaterial at September 30, 2013 and 2012 and were reported on the accompanying consolidated balance sheets on a net basis. As of September 30, 2013 and 2012, the gross derivative assets and liabilities held and netted together within the investment accounts amounted to assets of approximately \$387,024,000 and \$488,412,000 and liabilities of approximately \$386,578,000 and \$487,796,000, respectively. (See Note 3 for a more complete description of derivative assets and liabilities.)



September 30, 2013

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

### **Electronic Health Records Incentive Payments**

Starting in 2011, the Medicare and state Medicaid programs are providing an incentive payment to eligible hospitals and professionals if meaningful use certified electronic health record (EHR) technology is adopted and utilized. The incentive payment is recognized when management is reasonably assured that Banner has complied with the conditions set forth by Medicare and the state Medicaid programs. During the nine months ended September 30, 2012, management determined that Banner had demonstrated meaningful use of its certified EHR technology for the applicable attestation period and filed for approximately \$44,533,000 in Medicare and state Medicaid incentive payments with the Center for Medicare and Medicaid Services (CMS) and the state Medicaid programs. Accordingly, \$44,533,000 in Medicare and state Medicaid incentive payments were recognized in other revenue for the nine months ended September 30, 2012. For the nine months ended September 30, 2013, management recorded Medicare and state Medicaid incentive payments of \$25,669,000 representing the prorata portion of the incentive payment to be received in 2013. Banner's attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. Additionally, EHR incentive payments are subject to retrospective adjustment upon final settlement of the applicable cost report from which payments were initially calculated.

### **City of Phoenix Access to Care Tax**

In April, 2013, CMS approved a new Access to Care Tax, under which Banner hospitals located in Phoenix will be assessed a tax which will be used by the City of Phoenix to draw federal Medicaid matching funds to provide care to uninsured and low income patients. The first installment of the tax was paid in May 2013, and payments to hospitals for uncompensated care began in June 2013. Through September 30, 2013, Banner has recognized net income of \$34,707,000 from this program, comprised of \$76,161,000 in net healthcare revenue and \$41,454,000 in other operating expenses.

### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 settlements, contingent liabilities, and accrued liabilities resulting from self-insurance programs.

### **New Accounting Pronouncements**

The Financial Accounting Standards Board released an accounting standard relating to the disclosure of offsetting assets and liabilities which was effective for Banner on January 1, 2013. The accounting standard requires additional financial statement disclosures relating to master netting arrangements, collateral received or paid, gross amount of assets and liabilities subject to master netting arrangement and collateral postings, and a reconciliation of the net offsetting balance recorded on the balance sheet. Banner has adopted the accounting standard as of January 1, 2013 (Refer to Note 3).

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

September 30, 2013

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

**Reclassifications**

Certain reclassifications have been made to the 2012 financial statements to conform to the 2013 financial statement presentation, primarily related to the reclassification of the North Colorado Medical Center lease as a lease financing obligation based on revisions to the lease agreement effective January 1, 2012, which is recorded as assets leased from NCMC, Inc. and lease obligation NCMC, Inc. on the consolidated balance sheet and also resulted in a \$595,000 increase to excess of revenues over expenses for the nine months ended September 30, 2012 representing the difference between the depreciation and interest cost recorded based on the lease financing obligation as compared to the previously recorded operating lease expense, and recording of Banner's restricted equity method investment in Community Partnership of Arizona which resulted in a \$7,610,000 increase to other long term assets and temporarily restricted net assets as of September 30, 2012,

## Banner Health and Subsidiaries

### Notes to Consolidated Unaudited Financial Statements

September 30, 2013

#### 3. Fair Value of Financial Instruments

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 in active markets. Financial assets and liabilities in Level 1 generally include listed equities.

**Level 2.** Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Financial assets and liabilities in this category generally include asset and mortgage-backed securities, U.S. Treasury Securities/government obligations, corporate bonds and loans, municipal bonds, commercial paper, forward contracts, interest and credit swap agreements, options and interest rate swaps.

**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 interpretations, 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 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 investment in alternative investments, amounting to approximately \$1,112,703,000 and \$845,600,000 as of September 30, 2013 and 2012, 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. Approximately \$1,102,113,000 and \$838,663,000 of Banner's alternative investments are reported in long term assets and \$10,590,000 and \$6,937,000 in Banner Health Foundation restricted funds as of September 30, 2013 and 2012, respectively. Also included in assets limited as to use are premium payments to be received from Banner's split dollar life insurance policies amounting to \$29,202,000 and \$30,197,000 as of September 30, 2013 and 2012, respectively, which are not measured at fair value.

## Banner Health and Subsidiaries

## Notes to Consolidated Unaudited Financial Statements

September 30, 2013

**3. Fair Value of Financial Instruments (continued)****Financial Instruments Measured at Fair Value**

(\$ in thousands)

	September 30, 2013	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)
<b>Short term investments</b>					
Cash and cash equivalents	\$ 669	\$ 669	\$ -	\$ -	a
Commercial paper	224	-	224	-	a
Equities	397	397	-	-	a
Asset backed securities	646	-	646	-	a
Commercial mortgage backed securities	247	-	247	-	a
Government mortgage backed securities	2,725	-	2,725	-	a
Non-Government backed collateralized mortgages	341	-	341	-	a
Corporate bonds/non-U.S. government bonds	2,071	-	2,071	-	a
US Treasury/government obligations	6,099	801	5,298	-	a
<b>Total short term investments</b>	<b>\$ 13,419</b>	<b>\$ 1,867</b>	<b>\$ 11,552</b>	<b>\$ -</b>	
<b>Collateral under securities lending program</b>					
Cash and cash equivalents	\$ 154,671	\$ 154,671	\$ -	\$ -	a
<b>Total collateral under securities lending program</b>	<b>\$ 154,671</b>	<b>\$ 154,671</b>	<b>\$ -</b>	<b>\$ -</b>	
<b>Assets limited as to use</b>					
Cash and cash equivalents	\$ 250,449	\$ 250,449	\$ -	\$ -	a
Commercial paper	5,561	-	5,561	-	a
Equities	1,060,101	1,060,101	-	-	a
Asset backed securities	16,022	-	16,022	-	a
Commercial mortgage backed securities	6,136	-	6,136	-	a
Government mortgage backed securities	123,951	56,365	67,586	-	a
Non-Government backed collateralized mortgages	8,459	-	8,459	-	a
Corporate bonds/non-U.S. government bonds	194,852	143,491	51,361	-	a
US Treasury/government obligations	306,641	175,244	131,397	-	a
<b>Total assets limited as to use plus current portion</b>	<b>\$ 1,972,172</b>	<b>\$ 1,685,650</b>	<b>\$ 286,522</b>	<b>\$ -</b>	
<b>Long term investments</b>					
Cash and cash equivalents	\$ 1,291	\$ 1,291	\$ -	\$ -	a
Commercial paper	1,368	-	1,368	-	a
Equities	225,959	225,959	-	-	a
Asset backed securities	3,941	-	3,941	-	a
Commercial mortgage backed securities	1,509	-	1,509	-	a
Government mortgage backed securities	16,625	-	16,625	-	a
Non-Government backed collateralized mortgages	2,081	-	2,081	-	a
Corporate bonds/non-U.S. government bonds	102,674	34,670	68,004	-	a
US Treasury/government obligations	369,687	16,407	353,280	-	a
<b>Total long term Investments</b>	<b>\$ 725,135</b>	<b>\$ 278,327</b>	<b>\$ 446,808</b>	<b>\$ -</b>	
Interest rate swaps, included in other long-term liabilities	\$ (276,223)	\$ -	\$ (276,223)	\$ -	c
<b>Banner Health Foundation Restricted Funds</b>					
Cash and cash equivalents	\$ 741	\$ 741	\$ -	\$ -	a
Equities	23,677	23,677	-	-	a
Corporate bonds	6,957	6,957	-	-	a
US Treasury/government obligations	10,991	10,991	-	-	a
<b>Total Banner Health Foundation restricted funds</b>	<b>\$ 42,366</b>	<b>\$ 42,366</b>	<b>\$ -</b>	<b>\$ -</b>	

Banner Health and Subsidiaries  
Notes to Consolidated Unaudited Financial Statements

September 30, 2013

**3. Fair Value of Financial Instruments (continued)**

**Financial Instruments Measured at Fair Value**

(\$ in thousands)	September 30, 2012	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)
<b>Short term investments</b>					
Cash and cash equivalents	\$ 12,638	\$ 12,638	\$ -	\$ -	a
Commercial paper	152	-	152	-	a
Equities	487	487	-	-	a
Asset backed securities	3,968	-	3,968	-	a
Commercial mortgage backed securities	1,755	-	1,755	-	a
Government mortgage backed securities	15,114	-	15,114	-	a
Non-Government backed collateralized mortgages	1,622	-	1,622	-	a
Corporate bonds/non-U.S. government bonds	12,183	-	12,183	-	a
Repurchase Agreements	100	-	100	-	a
US Treasury/government obligations	23,250	-	23,250	-	a
<b>Total short term investments</b>	<b>\$ 71,269</b>	<b>\$ 13,125</b>	<b>\$ 58,144</b>	<b>\$ -</b>	
<b>Collateral under securities lending program</b>					
Cash and cash equivalents	\$ 180,705	\$ 180,705	\$ -	\$ -	a
<b>Total collateral under securities lending program</b>	<b>\$ 180,705</b>	<b>\$ 180,705</b>	<b>\$ -</b>	<b>\$ -</b>	
<b>Assets limited as to use</b>					
Cash and cash equivalents	\$ 332,693	\$ 332,693	\$ -	\$ -	a
Commercial paper	667	-	667	-	a
Equities	873,890	873,890	-	-	a
Asset backed securities	17,360	-	17,360	-	a
Commercial mortgage backed securities	7,680	-	7,680	-	a
Government mortgage backed securities	118,063	51,935	66,128	-	a
Non-Government backed collateralized mortgages	65,522	58,427	7,095	-	a
Corporate bonds/non-U.S. government bonds	173,553	120,029	53,524	-	a
US Treasury/government obligations	272,023	170,080	101,943	-	a
<b>Total assets limited as to use plus current portion</b>	<b>\$ 1,861,451</b>	<b>\$ 1,607,054</b>	<b>\$ 254,397</b>	<b>\$ -</b>	
<b>Long term investments</b>					
Cash and cash equivalents	\$ 31,440	\$ 31,440	\$ -	\$ -	a
Commercial paper	447	-	447	-	a
Equities	135,985	135,985	-	-	a
Asset backed securities	11,642	-	11,642	-	a
Commercial mortgage backed securities	5,150	-	5,150	-	a
Government mortgage backed securities	44,348	-	44,348	-	a
Non-Government backed collateralized mortgages	4,758	-	4,758	-	a
Corporate bonds/non-U.S. government bonds	136,677	44,843	91,834	-	a
US Treasury/government obligations	302,331	33,957	268,374	-	a
<b>Total long term investments</b>	<b>\$ 672,778</b>	<b>\$ 246,225</b>	<b>\$ 426,553</b>	<b>\$ -</b>	
Interest rate swaps, included in other long-term liabilities	\$ (422,906)	\$ -	\$ (422,906)	\$ -	c
<b>Banner Health Foundation Restricted Funds</b>					
Cash and cash equivalents	\$ 748	\$ 748	\$ -	\$ -	a
Equities	19,628	19,628	-	-	a
Corporate bonds	6,022	6,022	-	-	a
US Treasury/government obligations	9,600	9,600	-	-	a
<b>Total Banner Health Foundation restricted funds</b>	<b>\$ 35,998</b>	<b>\$ 35,998</b>	<b>\$ -</b>	<b>\$ -</b>	

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

September 30, 2013

**3. Fair Value of Financial Instruments (continued)**

Included within short-term investments, assets limited as to use and other long-term investments are the following gross derivative instruments, recorded at fair value, as of September 30:

(\$ in thousands)

	2013	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)
Derivative assets:					
Future contracts	\$ 52,684	\$ 52,684	\$ -	\$ -	a
Forward contracts	331,913	-	331,913	-	a
Interest rate swap agreements	1,519	-	1,519	-	c
Option agreements	114	-	114	-	a
Net credit swaps	794	-	794	-	a
<b>Total derivative assets</b>	<b>\$ 387,024</b>	<b>\$ 52,684</b>	<b>\$ 334,340</b>	<b>\$ -</b>	

Derivative liabilities:					
Future contracts	\$ (52,684)	\$ (52,684)	\$ -	\$ -	a
Forward contracts	(331,403)	-	(331,403)	-	a
Interest rate swap agreements	(1,184)	-	(1,184)	-	c
Option agreements	(88)	-	(88)	-	a
Net credit swaps	(1,219)	-	(1,219)	-	a
<b>Total derivative liabilities</b>	<b>\$ (386,578)</b>	<b>\$ (52,684)</b>	<b>\$ (333,894)</b>	<b>\$ -</b>	

	2012	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)
Derivative assets:					
Future contracts	\$ 59,347	\$ 59,347	\$ -	\$ -	a
Forward contracts	418,677	-	418,677	-	a
Interest rate swap agreements	9,752	-	9,752	-	c
Option agreements	155	-	155	-	a
Net credit swaps	481	-	481	-	a
<b>Total derivative assets</b>	<b>\$ 488,412</b>	<b>\$ 59,347</b>	<b>\$ 429,065</b>	<b>\$ -</b>	

Derivative liabilities:					
Future contracts	\$ (59,347)	\$ (59,347)	\$ -	\$ -	a
Forward contracts	(418,093)	-	(418,093)	-	a
Interest rate swap agreements	(8,734)	-	(8,734)	-	c
Option agreements	(640)	-	(640)	-	a
Net credit swaps	(982)	-	(982)	-	a
<b>Total derivative liabilities</b>	<b>\$ (487,796)</b>	<b>\$ (59,347)</b>	<b>\$ (428,449)</b>	<b>\$ -</b>	

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

September 30, 2013

**3. Fair Value of Financial Instruments (continued)**

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

(\$ in thousands)

	<b>2013</b>	<b>2012</b>
Interest and dividend Income	\$ 29,703	\$ 50,970
Net realized gain on sales of investments	36,800	27,374
Gain from alternative investments	55,479	32,020
Net realized gain on sales of future contracts	307	1,010
Net realized loss on sales of interest rate swap agreements	(81)	(21)
Net realized gain (loss) on sales of option agreements	698	(1)
Net realized gain (loss) on sales of net credit swaps	65	(76)
Net unrealized gain on investments	102,224	131,220
Net unrealized loss on interest rate swap agreements	(606)	(2,332)
Net unrealized gain on option agreements	133	150
Net unrealized (loss) gain on net credit swaps	(1,705)	2,208
	<u>223,017</u>	<u>242,522</u>
Less: Investment income credited to other revenue, restricted funds, and capitalized bond project funds	(974)	16,199
Investment income	<u>\$ 223,991</u>	<u>\$ 226,323</u>

**4. Interest Rate Swap Agreements**

Banner entered into multiple interest rate swaps that currently do not qualify for hedge accounting. For the nine months ended September 30, 2013 and 2012 the mark-to-market adjustment resulted in an unrealized gain of \$142,118,000 and unrealized loss of \$(9,192,000), 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, 2013 and 2012 by \$34,953,000 and \$34,631,000 respectively.

Each of the interest rate swap agreements, except the Loveland Medical Enterprise Swap, has collateral posting thresholds based on the counterparties' bond ratings. At the AA- rating level, Banner and its counterparty must post collateral when the mark-to-market exceeds between \$35,000,000 and \$75,000,000 depending on the counterparty. In September 2008, the decline in the mark-to-market reached the threshold posting level and Banner began posting collateral with its counterparties. At September 30, 2013 and 2012, Banner had \$123,588,000 and \$260,356,000 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.

## Banner Health and Subsidiaries

### Notes to Consolidated Unaudited Financial Statements

September 30, 2013

#### **5. Long-Term Debt**

On October 7, 2013 Banner extended the direct pay letter of credit with The Northern Trust Company for the Series 2008H bonds until September 28, 2018.

On October 9, 2013 Standard & Poor's Ratings Services affirmed its 'AA-' long-term rating and underlying rating on existing debt issued by Arizona Health Facilities Authority on behalf of Banner Health. The outlook is stable.

On November 13, 2013 Banner replaced U.S. Bank, N.A which provided credit with a direct pay letter of credit for the Series 2008G bonds with Wells Fargo Bank, N.A. The direct pay letter of credit terminates on November 12, 2018.

#### **6. Banner Health Network Pioneer Program**

During 2013, Banner Health Network received confirmation from CMS of its savings under the Pioneer Accountable Care Organization Program for the contract period ending December 31, 2012 (2012 savings). The 2012 savings, less primary care physician incentive payments, has been recognized in the consolidated unaudited financial statements as of and for the nine months ending September 30, 2013. The 2012 shared savings increased other revenue by \$13,369,000 and other expenses by \$2,334,000. Banner Health Network has not recorded an estimated settlement as of September 30, 2013, related to the December 31, 2013 contract year.

#### **7. Subsequent Event**

Banner is a participant, along with other health care providers, in Premier, Inc.'s group purchasing program and Banner also holds an investment in Premier, Inc. that is accounted for under the cost method. On October 1, 2013, Premier, Inc. completed an initial public offering and was reorganized from a privately held company to a public company. As a result of the reorganization, Banner received proceeds of \$11,382,000 in October 2013 based on Banner's pre-IPO ownership share in Premier, Inc.



# BANNER HEALTH

## CONSOLIDATED UTILIZATION

YTD September 30	2013	2012
<b>Hospital (Acute Care):</b>		
Licensed Beds <sup>(a)</sup>	4,243	4,155
Admissions (excl. newborns)	164,241	171,916
Average Length of Stay	3.94	3.83
Patient Days	647,376	657,581
Licensed Beds Occupancy % <sup>(b)</sup>	56.43%	57.87%
Observation Days	60,462	49,455
Emergency Room Visits <sup>(c)</sup>	547,263	551,967
Outpatient Visits (excl. ER)	681,865	704,065
<b>Long-Term Care:</b>		
Licensed Beds <sup>(a)</sup>	264	281
Resident Days	66,990	70,145
Licensed Beds Occupancy % <sup>(b)</sup>	92.95%	91.10%
<b>Behavioral/Rehabilitation:</b>		
Licensed Beds <sup>(a)</sup>	395	417
Resident Days	63,848	72,670
Licensed Beds Occupancy % <sup>(b)</sup>	59.21%	63.60%
Home Health Visits	109,751	113,352

*(a) Licensed beds at quarter-end.*

*(b) Occupancy % adjusted for timing when beds went in service.*

*(c) Includes outpatient and admitted, excludes patients who left without treatment.*