



CONSOLIDATED FINANCIAL STATEMENTS

Banner Health and Subsidiaries  
Years Ended December 31, 2008 and 2007  
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Banner Health and Subsidiaries  
Consolidated Financial Statements  
Years Ended December 31, 2008 and 2007

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## Report of Independent Auditors

To the Board of Directors of  
Banner Health

We have audited the accompanying consolidated balance sheets of Banner Health (a nonprofit corporation) and subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Banner Health and subsidiaries at December 31, 2008 and 2007, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

*Ernst & Young LLP*

March 20, 2009

## Banner Health and Subsidiaries

### Consolidated Balance Sheets

	<b>December 31</b>	
	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 89,724	\$ 69,656
Short-term investments	110,517	92,069
Collateral held under securities lending program	88,208	187,382
Assets limited as to use-held for repurchase agreement	72,000	-
Assets limited as to use	129,750	71,098
Patient receivables, net of allowance for doubtful accounts of \$99,912 in 2008 and \$92,198 in 2007	509,138	434,733
Inventories	90,374	74,558
Other	59,918	47,304
Total current assets	<u>1,149,629</u>	<u>976,800</u>
Assets limited as to use:		
Funds designated by Board for:		
Property and equipment replacement and expansion	864,769	1,347,064
Lease agreements	3,336	3,123
Funds held by trustees under:		
Self-insurance funding arrangements	154,023	154,932
Indenture agreements	595,313	611,995
Other funds	319,192	50,379
Total assets limited as to use, less current portion	<u>1,936,633</u>	<u>2,167,493</u>
Assets held for sale	4,565	4,068
Property and equipment, net	2,030,808	1,413,253
Other assets:		
Long-term investments	124,218	441,371
Deferred financing costs, net	9,902	20,957
Other	217,513	164,279
Total other assets	<u>351,633</u>	<u>626,607</u>
	<u>\$ 5,473,268</u>	<u>\$ 5,188,221</u>

	<b>December 31</b>	
	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
<b>Liabilities and net assets</b>		
Current liabilities:		
Trade accounts payable	\$ 144,415	\$ 103,054
Current portion of long-term debt	51,386	38,495
Payable under securities lending program	88,208	187,382
Payable under repurchase agreement	72,000	–
Estimated third-party payor settlements	27,957	35,607
Accrued expenses:		
Salaries and benefits	235,102	199,252
Other	184,409	111,304
Total current liabilities	<u>803,477</u>	<u>675,094</u>
Long-term debt, less current portion	2,362,746	1,794,563
Estimated third-party payor settlements	5,846	6,894
Estimated self-insurance liabilities	162,730	161,719
Other, primarily interest rate swaps and employee benefit	469,152	104,590
Total liabilities	<u>3,803,951</u>	<u>2,742,860</u>
Minority interests	25,623	24,992
Net assets:		
Unrestricted	1,574,874	2,362,361
Temporarily restricted	68,820	58,008
	<u>1,643,694</u>	<u>2,420,369</u>
	<u><u>\$ 5,473,268</u></u>	<u><u>\$ 5,188,221</u></u>

*See accompanying notes.*

## Banner Health and Subsidiaries

### Consolidated Statements of Income

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
<b>Revenues:</b>		
Net patient service	<b>\$ 3,787,360</b>	\$ 3,229,319
Other revenue	<b>183,444</b>	125,961
Total revenues	<b>3,970,804</b>	3,355,280
<b>Expenses:</b>		
Salaries and benefits	<b>2,080,663</b>	1,746,826
Supplies	<b>642,568</b>	559,139
Physician and professional fees	<b>118,050</b>	104,724
Depreciation and amortization	<b>172,448</b>	144,495
Provision for doubtful accounts	<b>218,494</b>	181,979
Interest	<b>73,214</b>	43,477
Other	<b>539,620</b>	435,646
Total expenses	<b>3,845,057</b>	3,216,286
Operating income	<b>125,747</b>	138,994
<b>Other income (losses):</b>		
Investment (loss) income – realized	<b>(127,878)</b>	142,675
Investment loss– unrealized	<b>(288,838)</b>	(45,557)
(Loss) income from alternative investments	<b>(119,001)</b>	34,747
Investment (loss) income	<b>(535,717)</b>	131,865
Unrealized loss on interest rate swaps	<b>(310,481)</b>	(43,529)
Loss on early extinguishment of debt	<b>(21,605)</b>	–
Minority interest	<b>(22,738)</b>	(20,779)
Other	<b>(1,914)</b>	(9,167)
	<b>(892,455)</b>	58,390
(Deficiency) excess of revenues over expenses	<b>(766,708)</b>	197,384
Net unrealized gain on interest rate swaps	<b>227</b>	3,518
Change in minimum pension obligation	<b>(25,363)</b>	1,319
Other	<b>4,357</b>	2,449
(Decrease) increase in unrestricted net assets	<b>\$ (787,487)</b>	\$ 204,670

*See accompanying notes.*

## Banner Health and Subsidiaries

### Consolidated Statements of Changes in Net Assets

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Unrestricted net assets:		
(Deficiency) excess of revenues over expenses	\$ (766,708)	\$ 197,384
Net unrealized gain on interest rate swaps	227	3,518
Change in minimum pension obligation	(25,363)	1,319
Other	4,357	2,449
(Decrease) increase in unrestricted net assets	<u>(787,487)</u>	<u>204,670</u>
Temporarily restricted net assets:		
Contributions and other	32,946	18,557
Net unrealized loss on investments	(100)	(89)
Net assets released from restrictions	(22,034)	(11,237)
Increase in temporarily restricted net assets	<u>10,812</u>	<u>7,231</u>
(Decrease) increase in net assets	(776,675)	211,901
Net assets, beginning of year	2,420,369	2,208,468
Net assets, end of year	<u><u>\$ 1,643,694</u></u>	<u><u>\$ 2,420,369</u></u>

*See accompanying notes.*

**Banner Health and Subsidiaries**  
**Consolidated Statements of Cash Flows**

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
<b>Operating activities</b>		
(Decrease) increase in net assets	\$ (776,675)	\$ 211,901
Adjustments to reconcile (decrease) increase in net assets to net cash provided by (used in) operating activities:		
Depreciation and amortization	172,448	144,495
Loss on extinguishment of debt	21,605	-
Decrease (increase) in investments designated as trading	481,335	(555,395)
Net unrealized loss on interest rate swaps	310,254	40,011
Change in minimum pension obligation	25,363	(1,319)
Gain on sale of assets	(1,260)	(208)
Restricted contributions and other	(32,946)	(18,557)
Changes in operating elements, net of assets acquired and liabilities assumed in purchase transactions		
Patient receivables	(18,626)	(47,645)
Inventories and other current assets	5,806	(8,281)
Accounts payable and accrued expenses	56,487	58,032
Estimated third-party payor settlements	(11,937)	4,417
Estimated self-insurance liabilities	(16,813)	6,589
Other liabilities	(5,852)	6,903
Net cash provided by (used in) operating activities	<u>209,189</u>	<u>(159,057)</u>
<b>Investing activities</b>		
Net purchase of property and equipment	(469,803)	(371,781)
Purchase of Sun Health net assets, net of cash assumed	(296,899)	-
Other acquisitions, net of cash assumed	1,293	-
Purchase of Arizona Medical Clinic, net of cash assumed	-	(32,338)
Increase in other assets	(13,126)	(5,340)
Net cash used in investing activities	<u>(778,535)</u>	<u>(409,459)</u>
<b>Financing activities</b>		
Proceeds from restricted contributions and other	32,946	18,557
Proceeds from issuance of debt	1,934,147	602,113
Payments of long-term debt, net	(1,377,679)	(26,339)
Net cash provided by financing activities	<u>589,414</u>	<u>594,331</u>
Net increase in cash and cash equivalents	<u>20,068</u>	<u>25,815</u>
Cash and cash equivalents at beginning of year	<u>69,656</u>	<u>43,841</u>
Cash and cash equivalents at end of year	<u>\$ 89,724</u>	<u>\$ 69,656</u>
<b>Supplemental disclosure of cash flow information</b>		
Interest paid, including amounts capitalized	<u>\$ 83,575</u>	<u>\$ 54,777</u>

**Non-cash investing activities**

\$19,000,000 relating to amounts due from Sun Health for working capital and contributions.  
\$24,978,000 relating the obligation and funding from Sun Health for the Sun Health Plan.

*See accompanying notes.*

# Banner Health and Subsidiaries

## Notes to Consolidated Financial Statements

December 31, 2008

### 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 and other healthcare-related organizations, including a captive insurance company and foundation, in seven western states.

### 2. Significant Accounting Policies

#### Basis of Consolidation

The accompanying consolidated financial statements reflect the consolidated operations of all owned and leased operating units of Banner and its wholly owned subsidiaries. The consolidated financial statements include the following joint ventures in which Banner holds a controlling interest and, accordingly, the financial results are consolidated:

- New River Surgical Arts – Banner holds a 63% interest
- Loveland Surgical Enterprises, LLC – Banner holds a 61% interest
- North Colorado Surgery Center – Banner holds a 60% interest
- Inland Imaging AZ, LLC. – Banner holds a 51% interest
- Sonora Quest Laboratories, LLC (SQL) – Banner holds a 51% interest
- Loveland Medical Enterprise, Inc. – Banner holds a 70% interest

Banner holds a non-controlling interest in the following companies: 50% interest in City of Hope Samaritan, LLC; 50% interest in Banner Physician Hospital Organization; 50% interest in Mountain Shadows Medical Association; 25% interest in Loveland Endoscopy Center LLC; 49% interest in Peoria Multi Ambulatory Surgery Center; 25% interest in Arizona Medical Sleep Institute, LLC, and a 15% interest in Sun City Ophthalmologists LLC. Banner accounts for its interest in each of these companies, during the periods in which it had the ability to exercise significant influence but did not have a majority voting interest, using the equity method of accounting.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

On September 1, 2008, Banner acquired substantially all of the net assets of Sun Health Corporation (Sun Health). Pursuant to the terms of the transaction, Banner purchased Sun Health Boswell Hospital and Sun Health Del E. Webb Hospital, each in the northwestern section of the Phoenix metropolitan area; and acquired, by contribution, certain other provider operations of Sun Health, all of the outstanding stock of Sun Health MediSun, Inc. (MediSun), an Arizona insurance corporation which operates a Medicare Advantage health plan, and the sole membership of Sun Health Research Institute (SHRI), a nonprofit research facility focusing on aspects of the aging process. The initial purchase price was approximately \$316 million, plus the assumption of certain Sun Health current and non-current liabilities. The \$316 million initial purchase price was adjusted by an estimated working capital settlement of \$4 million and contribution of \$19 million, for a net purchase price of \$293 million. Sun Health used a portion of the purchase price to defease approximately \$201 million of its outstanding long-term indebtedness. The transaction did not include acquisition of The Sun Health Foundation or Sun Health Properties, Inc. and its affiliates, which hold the long-term investment portfolio of the Sun Health as well as a portfolio of partnership interests in medical office buildings, assisted living facilities, and other real estate assets. In connection with the acquisition however, Sun Health, the Sun Health Foundation, Sun Health Properties, Inc. and their controlled affiliates (Sun Health Services), entered into an agreement to provide an annual contribution calculated under the terms of the agreement and, subject to certain contractual limitations and conditions, to support projects at the facilities acquired from Sun Health or at other future Banner projects in the northwestern section of the Phoenix metropolitan area.

The Sun Health purchase price was allocated to the net tangible assets acquired, based upon their estimated fair values as of September 1, 2008. Results of operations of the acquired Sun Health net assets have been included in the consolidated financial statements since September 1, 2008. The fair values of assets acquired and liabilities assumed were as follows (in thousands):

Current assets, includes \$16,035,000 in cash received	\$ 96,725
Property and equipment	300,977
Other assets	16,577
Current liabilities	(94,486)
Non-current liabilities	(25,519)
Restricted equity	(914)
Net assets acquired	<u>\$ 293,360</u>

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

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

##### **Fair Values**

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

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

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

##### **Short-Term Investments**

Short-term investments include debt securities with maturity dates of one year or less from the balance sheet date and actively traded equity securities. These investments are stated at fair market value, based on quoted market prices in active markets.

##### **Investments**

Banner has designated substantially all of its investment portfolio as trading. Investment income, including realized gains and losses on investments, unrealized gains and losses on investments, income earned on alternative investments, and interest and dividends is included in (deficiency) excess of revenues over expenses unless the income or loss is restricted by donor or law.

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 hedges, in accordance with Statement of Financial Accounting Standards (FAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Accordingly, the change in the fair value of derivatives is recognized as a component of investment income as described above.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

Banner invests in alternative investments through limited partnerships. Alternative investments are comprised mostly of hedge funds. These alternative investments provide Banner with a proportionate share of the investment gains and losses. The limited partnerships generally contract with a manager who has full discretionary authority over the investment decisions. Banner accounts for its ownership interests in these alternative investments under the equity method. Accordingly, Banner's share of the alternative investment's (loss) income approximated \$(119,001,000) and \$34,747,000 for the years ended December 31, 2008 and 2007, respectively. The alternative investment (loss) income is primarily recorded within investment (loss) income on the consolidated statements of income, with the remainder recorded as an increase to restricted equity for those funds which have been restricted by the donor.

Banner accounts for its derivative instruments in accordance with FAS Interpretation No. 39 (FIN 39), *Offsetting of Amounts Related to Certain Contracts*. FIN 39 permits the offsetting of the fair value recognized 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 accounts for its repurchase and reverse repurchase agreements in accordance with FAS Interpretation No. 41 (FIN 41), *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, and FAS No. 140 (FAS 140), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. FIN 41 permits the offsetting of the fair value of repurchase and reverse repurchase agreements if they are executed with the same counterparty, have the same settlement date and a master netting arrangement has been executed. Banner has entered into several repurchase and reverse repurchase agreements through a fixed income manager that has executed a master netting arrangement whereby some of the agreements are legally offset as they are settled. As of December 31, 2008, Banner held one repurchase agreement that did not have the right of offset, amounting to \$72,000,000, and accordingly recorded as a payable under repurchase agreement in the accompanying consolidated balance sheets. In connection with this repurchase agreement, Banner set aside \$81,971,000, as collateral, which has been recorded within funds held by trustee under self-insurance funding agreements in the accompanying consolidated balance sheets.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

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

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

##### **Net Patient Accounts Receivable**

Net patient accounts receivable and net patient services revenues have been adjusted to the estimated amounts expected to be received. These estimated amounts are subject to further adjustments upon review by third-party payors. Management estimates bad debt expense and the allowance for doubtful accounts based upon the historical collection experience of each operating entity.

##### **Inventories**

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

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

Banner participates in securities lending transactions through its custodian whereby Banner lends a portion of its investments to various brokers in exchange for collateral for the securities loaned, usually on a short-term basis. Collateral provided by the brokers consists of cash and securities and is maintained at levels approximating 102% of the fair value of the securities on loan, adjusted for market fluctuations. Banner maintains effective control of the loaned securities through its custodian during the term of the arrangement in that they may be recalled at any time. Under the terms of the agreement, the borrower must return the same, or substantially the same, investments that were borrowed. The value of collateral held for loaned securities is reported as a current asset entitled collateral held under securities lending program and a corresponding obligation is reported as a current liability entitled payable under securities lending program in the accompanying consolidated balance sheets. At December 31, 2008 and 2007 the fair value of the collateral provided, on behalf of Banner, was approximately \$88,208,000 and \$187,382,000, respectively. At December 31, 2008 and 2007, the fair market value of securities on loan was approximately \$82,000,000 and \$178,000,000, respectively, and is included in assets limited as to use.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

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

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

Amortization is provided on a straight-line basis over the shorter of the lease period or the estimated useful lives for leasehold improvements. Depreciation is provided on a straight-line basis over the estimated useful lives of the property and equipment, ranging from 3 to 40 years.

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

Banner reviews long-lived assets for impairment when events or changes in business conditions indicate that their carrying value may not be recoverable. Banner considers assets to be impaired and writes them down to fair value if expected undiscounted cash flows are less than the carrying amounts. Fair value is the present value of the associated discounted cash flows. Banner has determined that no long-lived assets are impaired at December 31, 2008.

##### **Costs of Borrowing**

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

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

##### **Self-Insurance Programs**

In connection with self-insurance programs, accounts have been established for the purpose of accumulating assets based on actuarial determinations. These assets, which can be used only for the payment of medical malpractice, general liability and employment discrimination claims, related expenses and the cost of administering the self-insurance programs are included in assets limited as to use. It is Banner's policy to record the expense and related liability for medical malpractice, general liability, workers' compensation, and employment discrimination losses based upon actuarial estimates. Self-insurance liabilities include discounted estimates of the ultimate costs for both asserted and incurred but not reported claims for professional liability, workers' compensation and general liability claims.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

##### **Contributions**

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

##### **Temporarily Restricted Net Assets**

Temporarily restricted net assets are those whose use by Banner has been limited by donors to a specific time period or purpose.

##### **Performance Indicator**

The performance indicator is (deficiency) excess of revenues over expenses which includes all changes in unrestricted net assets other than changes in unrealized gains on interest rate swaps through March 31, 2007, net assets released from restrictions for property acquisitions, and the change in minimum pension obligation.

##### **Net Patient Revenue**

Banner has agreements with third-party payors that provide for payments at amounts different from its established rates. Net patient revenue is reported at estimated net realizable amounts from patients, third-party payors and others for services rendered. Contractual adjustments resulting from agreements with various organizations to provide services for amounts which differ from billed charges, including services under the Medicare, Medicaid, and certain managed care programs, are recorded as deductions within net patient revenue. Banner recognizes that revenue from government agencies and managed care organizations are significant to Banner's operations, but management does not believe that there are any significant credit risks associated with these payors. A summary of the payment arrangements with major third-party payors follows:

##### *Medicare*

Approximately 21% in 2008 and 22% in 2007, of Banner's net patient revenue was derived from the Medicare program. Most inpatient acute care and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

according to a patient classification system that is based on clinical and diagnostic factors. Teaching facility programs related to Medicare beneficiaries, and services provided at critical access hospitals to Medicare beneficiaries, are paid based on a cost reimbursement methodology. Banner is reimbursed for cost reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. Laws and regulations governing the Medicare program are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded third-party payor settlement estimates will change by a material amount in the near term as cost report adjustments become known or as cost report years are no longer subject to such audit.

#### *Medicaid*

Approximately 13% in 2008 and 14% in 2007, of Banner's net patient revenue was derived from various state Medicaid programs. Inpatient and outpatient services rendered to Medicaid program beneficiaries are paid according to the terms of the state program under which services are provided, which may allow for reimbursement based on per diem rates, percent of eligible charges, cost reimbursement, or prospectively determined based on clinical and diagnostic factors. Certain Medicaid payments are subject to final settlement after audit by fiscal intermediaries.

#### *Other Third-Party Payors*

Banner has also entered into payment agreements with certain commercial insurance carriers and health maintenance organizations. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined per diem and capitated rates. Approximately 64% in 2008 and 2007, of Banner's net patient revenue was derived from other third-party payors.

#### **Charity Care and Services that Benefit the Community**

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

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

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

based on the patient's family's income. Because Banner does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

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

During 2008 and 2007, costs incurred by Banner in the provision of charity care, the unpaid costs of programs directed at the poor and broader community, the education of health professionals, research activities and the costs of supporting other community programs were approximately \$275,562,000 and \$221,052,000, respectively. Charity care is recorded based on the cost of services provided for which charges are written off in accordance with Banner's charity care policy, but does not include the amount, if any, for which the patient remains responsible.

The following is a summary of Banner's net community benefit for the years ended December 31. This summary is in accordance with guidelines and standards for community benefit inventory and social accountability and represents services to both the poor and broader community (in thousands):

	2008	% of Total Expense	2007	% of Total Expense
Traditional charity care, at cost	\$ 77,654	2.0%	\$ 63,764	2.0%
Unpaid cost of public programs – Medicaid	88,028	2.3	68,461	2.1
Unpaid cost of public programs – Medicare	66,806	1.8	60,614	1.9
Health professional education	18,765	0.5	8,227	0.3
Community health services	8,397	0.2	8,097	0.3
Community building activities	7,085	0.2	4,038	0.1
Research activities	4,835	0.1	3,755	0.1
Subsidized health services	2,327	–	2,690	0.1
Contributions and in-kind donations	1,642	–	1,347	–
Community benefit operations	23	–	59	–
	<b>\$ 275,562</b>	<b>7.2%</b>	<b>\$ 221,052</b>	<b>6.9%</b>

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

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

*Unpaid Costs of Public Programs* is the shortfall created when Banner Health receives payments below the cost for patients enrolled in publicly supported Medicaid and Medicare programs.

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

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

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

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

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

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

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

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

##### **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 disclosure 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, and accrued liabilities resulting from self-insurance programs.

For the years ended December 31, 2008 and 2007, net patient service revenue increased each year by approximately \$21,000,000 for changes in estimates related to third-party payor settlements associated with the Medicare program, and the provision for doubtful accounts decreased each year by approximately \$48,000,000 for outside collection recoveries on patient receivables previously written off.

##### **New Accounting Pronouncement**

In March 2008, the Financial Accounting Standards Board issued FAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an Amendment of FASB Statement No. 133* (FAS 161). The objective of FAS 161 is to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal year and interim periods beginning after November 15, 2008. The adoption of FAS 161 is not expected to have a material impact on Banner's financial condition and results of operations. However, Banner believes it will likely be required to provide additional disclosures as part of future financial statements.

##### **Reclassifications**

Certain reclassifications have been made to the 2007 financial statements to conform to the 2008 financial statement presentation.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 3. Concentrations of Credit Risk

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

	<u>2008</u>	<u>2007</u>
Commercial/HMO/PPO/other third-party payors	49%	50%
Medicare	24	22
Medicaid/AHCCCS	18	20
Self-pay	9	8
	<u>100%</u>	<u>100%</u>

#### 4. Fair Value Measurements

Banner adopted FAS No. 157, *Fair Value Measurements*, on January 1, 2008, for all financial assets and liabilities that are recognized or disclosed at fair value in the financial statements. This statement defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. FAS 157 clarifies that fair value is 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, FAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

- *Level 1.* Pricing is based on observable inputs such as quoted prices in active markets. Financial assets and liabilities in Level 1 include US Treasury securities and 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-backed securities, corporate bonds and loans, municipal bonds, forward contracts, future contracts, interest and credit swap agreements, options and interest rate swaps.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

- *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 part 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 noted in FAS 157. The three valuation techniques are 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 Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

Banner's alternative investments amounting to \$401,742,000 as of December 31, 2008, are accounted for using the equity method of accounting. Approximately \$374,381,000 of Banner's alternative investments are reported in property and equipment replacement and expansion, \$19,600,000 in long term investments and \$7,761,000 in Banner Health Foundation restricted funds. The alternative investments are omitted from the following schedule as they are accounted for using the equity method of accounting, which is not a fair value measurement.

	December 31, 2008	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>Banner Health</b>					
Short-term investments	\$ 110,517	\$ 16,967	\$ 93,550	\$ —	a, c
Collateral under securities lending program	88,208	88,208	—	—	a
Assets limited as to use – held for repurchase agreement	72,000	72,000	—	—	a
Assets limited to use	129,750	129,750	—	—	a
Property and equipment replacement and expansion	490,388	402,633	87,755	—	a c
Lease agreements	3,336	733	2,603	—	a, c
Self-insurance funding arrangements	154,023	52,636	101,387	—	a, c
Indenture agreements	595,313	530,707	64,606	—	a
Other funds	319,192	238,818	80,374	—	a, c
Long-term investments	104,618	20,252	84,366	—	a, c
Interest rate swaps	(360,168)	—	(360,168)	—	a
<b>Banner Health Foundation restricted funds</b>					
Other	42,007	19,614	22,393	—	a, c

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **4. Fair Value Measurements (continued)**

Banner has received restricted pledges and contributions amounting to \$32,946,000, for the year ended December 31, 2008, that were subject to fair value measurement in accordance with FAS 157. The restricted contributions were measured based on the actual cash received, or for pledge receivables, using discounted cash flow projections as outlined in the income valuation approach. Approximately \$9,960,000 of the restricted contributions received in 2008 were recorded as a pledge receivable as of December 31, 2008.

Included in the Banner Health Retirement Income Plan asset portfolio is a hedge fund with an estimated fair value of \$11,541,000 as of December 31, 2008. Hedge funds held within a company's pension plan assets are subject to the FAS 157 fair value measurement. The hedge fund's fair value was measured at the December 31, 2008 net asset value, which was based on quoted prices for comparable market transactions.

The adoption of FAS 157 did not have a material impact on Banner's consolidated financial statements other than the FAS 157 adjustment to Banner's interest rate swap agreements (see note 8). Banner does not currently expect the application of the fair value framework established by FAS 157 to non-financial assets and liabilities measured on a non-recurring basis to have a material impact on the consolidated financial statements. However, Banner will continue to assess the potential effect of FAS 157 as additional information becomes available.

Banner did not elect to adopt the provisions of FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 5. Investments

##### Assets Limited as to Use

Assets limited as to use, with the exception of alternative investments, are stated at fair value, based on quoted market prices. The alternative investments are recorded using the equity method of accounting. Assets limited as to use, as of December 31, were as follows:

	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Funds designated by Board of Directors		
Cash and cash equivalents	\$ 3,667	\$ 3,068
U.S. Treasury/government obligations	22,399	48,970
Alternative investments	374,381	472,102
Equities	406,855	765,988
Corporate bonds	60,803	60,059
	<b>868,105</b>	1,350,187
Funds held by trustees:		
Cash and cash equivalents	220,295	54,264
U.S. Treasury/government obligations	175,325	125,487
Equities	3,080	5,488
Corporate bonds	86,791	41,367
Receivable under repurchase agreement	393,595	569,803
Unsecured investment agreements	–	41,616
	<b>879,086</b>	838,025
Other:		
Cash	195,965	3,483
U.S. Treasury/government obligations	96,199	16,059
Equities	27,028	30,837
	<b>319,192</b>	50,379
Total assets limited as to use	<b>2,066,383</b>	2,238,591
Less amounts required for current liabilities	<b>129,750</b>	71,098
Assets limited as to use, less current portion	<b>\$ 1,936,633</b>	\$ 2,167,493

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 5. Investments (continued)

##### Other Investments

Other investments, with the exception of the alternative investments, are stated at fair value based on quoted market prices. The alternative investments are recorded using the equity method of accounting. Other investments as of December 31 were as follows:

	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Cash and cash equivalents	\$ <b>13,309</b>	\$ 8,720
U.S. Treasury/government obligations	<b>122,488</b>	169,927
Alternative investments	<b>19,600</b>	27,058
Equities	<b>15,621</b>	38,584
Corporate bonds	<b>63,717</b>	289,151
	<b>234,735</b>	533,440
Less: short-term investments	<b>110,517</b>	92,069
Long-term investments	<b>\$ 124,218</b>	\$ 441,371

Included in the funds designated by Board of Directors and other long term investments are several derivative instruments including forward purchase and sale contracts, future purchase and sale contracts, options and swap agreements that are reported in accordance with FIN 39. Banner's derivative contracts in a net loss position were immaterial at December 31, 2008 and 2007, and were reported on a net basis. As of December 31, 2008 and 2007, the gross derivative assets and liabilities held and netted together within the investment accounts amounted to assets of \$986,000,000 and \$1,595,000,000, respectively, and liabilities of \$1,004,000,000 and \$1,588,000,000, respectively.

Included in the funds designated by Board of Directors and other long term investments are repurchase and reverse repurchase agreements that are reported in accordance with FIN 41. As of December 31, 2008, the gross assets and liabilities held and netted together within the investment accounts amounted to assets of \$148,000,000 and liabilities of \$147,000,000.

Included in funds held by trustees is a receivable under repurchase agreements amounting to \$393,595,000 and \$569,803,000 as of December 31, 2008 and 2007, respectively. Banner has entered into the repurchase agreements, through its Bond Trustee, whereby Banner has loaned cash to two brokers in exchange for collateral. Collateral provided by the two brokers consists of securities and is maintained at levels ranging from 104% to 106% of the cash loaned. At any time, Banner can request repayment and the cash is typically available to Banner within one week.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 5. Investments (continued)

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

	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Interest and dividend income	\$ <b>52,631</b>	\$ 108,383
Net realized (loss) gain on sale of investments	<b>(141,813)</b>	73,469
(Loss) income from alternative investments	<b>(119,001)</b>	34,747
Net unrealized loss on investments	<b>(288,838)</b>	<b>(45,557)</b>
	<b>(497,021)</b>	171,042
Less: investment income credited to other revenue or capitalized	<b>38,696</b>	39,177
Investment (loss) income	<b>\$ (535,717)</b>	\$ 131,865

#### 6. Property and Equipment

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

	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Land and land improvements	\$ <b>179,773</b>	\$ 136,075
Buildings and fixed equipment	<b>1,668,512</b>	1,378,680
Major movable equipment	<b>1,227,305</b>	1,081,652
Construction in progress	<b>481,086</b>	178,427
	<b>3,556,676</b>	2,774,834
Less accumulated depreciation and amortization	<b>1,525,868</b>	1,361,581
Property and equipment, net	<b>\$ 2,030,808</b>	\$ 1,413,253

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 7. Other Noncurrent Assets

Noncurrent assets consisted of the following as of December 31:

	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Restricted assets	\$ 67,698	\$ 58,692
Goodwill, net of amortization	83,160	83,716
Investments in unconsolidated affiliates	9,567	9,481
Due from Sun Health Services	44,142	–
Other	12,946	12,390
Total other noncurrent assets	<u>\$ 217,513</u>	<u>\$ 164,279</u>

The goodwill balance primarily relates to the Cardiac Institute General Partnership (CIGP) acquisition that was completed in January 2003, acquisition of reference laboratories by Sonora Quest Laboratories, the purchase of the majority interest in Samaritan Surgicenters in May 2005, purchase of Big Thompson Medical Group in September 2006 and the purchase of AMC in August 2007. Goodwill of approximately \$28,000,000, \$24,000,000, \$7,000,000 and \$6,000,000 was recorded in connection with the CIGP, Samaritan Surgicenters, Big Thompson Medical Group, and AMC acquisitions, respectively. Goodwill associated with these transactions is being amortized, using a straight-line basis, over 20 years.

Due from Sun Health Services relates to monies to be received for the completion of the construction project at Banner Del E. Webb Medical Center and to fund a defined benefit pension obligation in accordance with the terms outlined in the acquisition agreement.

#### 8. Long-Term Debt

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

	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Revenue Bonds, Series 2008A, interest from 3.25% to 5.25%, due through 2035	\$ 227,160	\$ –
Weekly Rate Securities Revenue Bonds, Series 2008B, interest determined weekly, due through 2035	98,750	–
Weekly Rate Securities Revenue Bonds, Series 2008C, interest determined weekly, due through 2035	98,750	–
Revenue Bonds, Series 2008D, interest from 5.00% to 6.00%, due through 2038	917,860	–

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
Weekly Rate Securities Revenue Bonds, Series 2008E, interest determined weekly, due through 2029	<b>\$ 124,195</b>	\$ –
Weekly Rate Securities Revenue Bonds, Series 2008F, interest determined weekly, due through 2029	<b>101,890</b>	–
Weekly Rate Securities Revenue Bonds, Series 2008G, interest determined weekly, due through 2029	<b>96,000</b>	–
Weekly Rate Securities Revenue Bonds, Series 2008H, interest determined weekly, due through 2029	<b>75,000</b>	–
Revenue Bonds, Series 2007A, interest 5%, due through 2025	<b>184,510</b>	190,920
Index Rate Bonds, Series 2007B, interest determined quarterly, due through 2037	<b>400,000</b>	400,000
Weekly Rate Securities Revenue Bonds, Series 2005A	–	393,330
Weekly Rate Securities Revenue Bonds, Series 2005B	–	154,315
Weekly Rate Securities Revenue Bonds, Series 2005C	–	43,745
Auction Rate Securities Revenue Bonds, Series 2005D	–	77,600
Auction Rate Securities Revenue Bonds, Series 2005E	–	77,600
Auction Rate Securities Revenue Bonds, Series 2005F	–	72,700
Auction Rate Securities Revenue Bonds, Series 2002A	–	73,225
Auction Rate Securities Revenue Bonds, Series 2002B	–	73,175
Non-Putable Remarketed Securities Revenue Bonds, Series 2002C	–	146,325
Revenue Bonds, Series 1999A, interest from 4.80% to 5.20%, due through 2010	<b>2,965</b>	3,815
Weekly Rate Securities Revenue Bonds, Series 1999B	–	52,100
Revenue Bonds, Series 1998A, interest from 4.20% to 5.25%, due through 2019	<b>52,085</b>	58,005
Other	<b>34,967</b>	16,203
	<b>2,414,132</b>	1,833,058
Less: current portion	<b>51,386</b>	38,495
Total long-term debt, less current portion	<b>\$ 2,362,746</b>	\$ 1,794,563

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

Scheduled maturities of debt for the years ending December 31 are as follows:

	<i>(In thousands)</i>
2009	\$ 51,386
2010	46,145
2011	43,214
2012	45,122
2013	47,704
Thereafter	2,180,561
	<u>\$ 2,414,132</u>

Total interest incurred amounted to \$105,455,000 in 2008 and \$68,643,000 in 2007, of which \$32,241,000 and \$25,166,000 has been capitalized in 2008 and 2007, respectively.

#### Series 2008 Bonds (Series A through H)

In response to the 2008 auction rate securities (ARS) market disruption and the down-grade of municipal bond insurers, Banner restructured most of its outstanding variable rate debt, and re-issued the bonds as uninsured fixed or variable bonds with a direct letter of credit. The Series 2008 Bonds were issued by The Arizona Health Facilities Authority (AHFA) and are governed by a master indenture covering substantially all of the Obligated Group's (consisting solely of Banner) long-term indebtedness. Banner recorded a loss on early extinguishment of debt of \$21,605,000 related to the transactions described below.

In March, Banner exercised the call option on the ARS Series 2005D-F bonds and retired the bonds with a draw on a fully collateralized bridge loan entered into with JPMorgan Chase Bank, N.A. Banner issued \$227,160,000 Series 2008A fixed rate bonds in April, using the majority of the proceeds to re-pay the bridge loan. The Series 2008A bonds bear interest at an annual fixed rate ranging from 3.25% to 5.25% and are due in annual installments beginning in 2009 through 2035. The average interest rate for the year ended December 31, 2008 was 3.25%.

The down-grade of municipal bond insurers resulted in a decrease in the marketability of the Series 2005B-C variable rate demand bonds and in March 2008 the majority of these bonds were tendered to the liquidity provider, The Bank of Nova Scotia. In April, Banner redeemed the Series 2005B-C bonds using a fully collateralized bridge loan entered into with JPMorgan Chase Bank, N.A. Banner issued \$197,500,000 Series 2008B-C variable rate demand bonds in June and used the majority of the proceeds to re-pay the bridge loan. The Series 2008B-C bonds bear

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

interest, based on successive interest rate periods of seven days, at an interest rate determined by the Remarketing Agent. The average interest rate for the year ended December 31, 2008 was approximately 2.02%. Security for the payment of the Series 2008B-C variable rate demand bonds is provided for with a direct pay letter of credit with The Bank of Nova Scotia. The direct letter of credit terminates on June 19, 2013. There were no advances outstanding as of December 31, 2008.

In August, Banner issued \$917,860,000 Series 2008D fixed rate securities bonds using the majority of the proceeds to acquire certain assets of Sun Health, fund capital projects and redeem the Series 1999B, and ARS Series 2002A-C bonds. At the time of their redemption, some of the Series 1999B, variable rate demand bonds, had been tendered to the liquidity provider JPMorgan Chase Bank, N.A. The new Series 2008D bonds bear interest at an annual fixed rate ranging from 5% to 6% and are due in annual installments beginning in 2009 through 2038. The average interest rate for the year ended December 31, 2008 was 5%.

In September, Banner issued \$397,085,000 Series 2008E-H and used the majority of the proceeds to redeem the Series 2005A variable rate demand bonds, some of which had been tendered to the liquidity provider Citibank, N.A. The Series 2008E-H bonds bear interest, based on successive interest rate periods of seven days, at an interest rate determined by the Remarketing Agent. The average interest rate for the year ended December 31, 2008 was approximately 2.5%. Security for the payment of the Series 2008E-H variable rate demand bonds is provided for with direct pay letters of credit with the following banks: Landesbank Baden-Württemberg supplies credit for the Series 2008E; JPMorgan Chase, N.A. supplies credit for the Series 2008F; U.S. Bank, N.A. supplies credit for the Series 2008G; and The Northern Trust Company supplies credit for the Series 2008H. All the direct letters of credit terminate on September 16, 2011. There were no advances outstanding as of December 31, 2008.

#### **Series 2007 Bonds (Series A and B)**

In May 2007, Banner issued \$590,920,000 of tax-exempt revenue bonds. The proceeds of these bonds were used to finance capital projects. The Series 2007A bonds are fixed rate securities due in annual installments beginning in 2008 through 2025. The bonds bear interest at an annual fixed rate of 5%.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

The Series 2007B bonds are indexed rate bonds due in annual installments beginning in 2025 through 2037. The bonds bear interest computed quarterly based on the Three-Month LIBOR rate as determined by the Index Agent. The average interest rate for the years ended December 31, 2008 and 2007 was 3.16% and 4.37% respectively.

The Series 2007 bonds are governed by a Master Indenture covering substantially all of the Obligated Group's (consisting solely of Banner) long-term indebtedness.

#### **Series 1999A Bonds**

In September 1999, Banner issued \$366,545,000 of tax-exempt revenue bonds, Series 1999A, to acquire substantially all of the assets of Samaritan Health System (Samaritan) and to pay for capital projects. In May 2005, Banner legally defeased \$356,175,000 of the Series 1999A bonds and used the proceeds from the Series 2005A bonds to fund sufficient escrow to pay the outstanding obligation on the bonds. The Series 2005A bonds were redeemed in September 2008.

The outstanding Series 1999A bonds, which are to be redeemed on January 1, 2010, are serial bonds due in annual installments through 2010. The average interest rate for the years ended December 31, 2008 and 2007 was approximately 4.9% and 4.8%, respectively.

The Series 1999A bonds are guaranteed by MBIA and are governed by a master indenture covering substantially all of the Obligated Group's (consisting solely of Banner) long-term indebtedness.

#### **Series 1998A Bonds**

In November 1998, Banner issued \$115,325,000 of Series 1998A refunding revenue bonds. \$82,340,000 of the Series 1998A bonds were issued as serial bonds due in annual installments through 2012 and \$32,985,000 were issued as term bonds due in 2028. The average interest rate for the years ended December 31, 2008 and 2007 was approximately 5.0%.

The Series 1998A bonds are guaranteed by MBIA and are governed by a master indenture covering substantially all of the Obligated Group's (consisting solely of Banner) long-term indebtedness.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

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

###### **2005 Swaps**

In March 2005, Banner entered into multiple interest rate swap contracts which effectively converted the variable rate of certain bonds into fixed rates of 3.661% or 3.690% depending upon the stated maturity of the swaps (the 2005 Swaps). The original notional amount of the 2005 Swaps was \$601,230,000. Banner restructured the 2005 Swaps in 2008, removing the insurance and increasing the fixed rate to 3.676% and 3.705% respectively.

The 2005 Swaps qualified for hedge accounting under FAS 133 until the April 1, 2007 implementation of DIG Issue G26, *Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities that are not based on a Benchmark Rate*. For the three months ended March 31, 2007, the derivative mark-to-market adjustments resulted in an increase in unrestricted net assets of \$1,701,000. As a result of the hedging designation change, the accumulated unrealized derivative loss of \$5,324,000 at March 31, 2007, is being amortized into (deficiency) excess of revenues over expenses over the 27 year remaining life of the 2005 Swaps.

Subsequent to the adoption of DIG Issue G26, the derivative mark-to market adjustments resulted in an unrealized loss of \$97,936,000 for 2008 and \$18,859,000 for 2007, recorded in (deficiency) 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 in 2008 and 2007 by approximately \$10,842,000 and \$260,000, respectively.

###### **2006 Swaps**

In March 2006, Banner entered into two forward swap agreements (the 2006 Swaps) with an initial notional amount of \$425,000,000. The 2006 Swaps qualified for hedge accounting under FAS 133, until the April 1, 2007 implementation of DIG Issue G26. The 2006 swaps were amended and extended in May 2007 to be used with any of Banner's future debt offerings through 2011. The 2006 Swaps will convert the future variable rate bonds to a fixed rate of 3.71% against a floating rate of 61.8% of one-month LIBOR plus 31 basis points. For the three months ended March 31, 2007, the derivative mark-to-market adjustment resulted in an increase in unrestricted net assets of \$1,746,000. As a result of the hedging designation change, the accumulated unrealized derivative loss of \$1,072,000 at March 31, 2007, is being amortized into (deficiency) excess of revenues over expenses over the 33 year remaining life of the 2006 Swaps.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

Subsequent to the adoption of DIG Issue G26, the derivative mark-to-market adjustments resulted in an unrealized loss of \$108,171,000 for 2008 and \$7,922,000 for 2007, recorded in (deficiency) excess of revenue over expenses.

#### **2007 Swaps**

In May 2007, Banner entered into two interest rate swaps (the 2007 Swaps) which effectively convert the \$400,000,000 LIBOR based index rate bonds to a fixed rate of 4.413% against a floating rate of 67% of three-month LIBOR plus 81 basis points. The agreements hedged initial notional amounts of \$400,000,000 and are reduced over the term of the agreements. The interest rate swaps did not qualify for hedge accounting treatment under FAS 133. The derivative mark-to-market adjustments resulted in an unrealized loss of \$104,373,000 for 2008 and \$16,747,000 for 2007, recorded in (deficiency) 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 in 2008 and 2007 by approximately \$4,974,000 and \$35,000, respectively.

Each of the interest rate swap agreements has collateral posting thresholds based on the counterparties' bond rating. At the AA-rating level, Banner and its counterparty must post collateral when the mark-to-market exceeds \$35 million. In September 2008, the decline in the mark-to-market reached the threshold posting level and Banner began posting collateral with its counterparties. At December 31, 2008 Banner had \$273,000,000 of collateral outstanding with its counterparties. The fair value of the collateral is reported as assets limited as to use in the accompanying balance sheets.

#### **Bond Indentures**

The master indenture, as supplemented, contains covenants which, among other matters, restrict the transfer of assets and require the maintenance of specified levels of cash on hand and compliance with certain other financial ratios. Pursuant to the master indenture, as supplemented, Banner has pledged its gross revenues to secure all indebtedness governed by the master indenture. Banner was in compliance with these covenants as of December 31, 2008.

Under the terms of the bond indentures, periodic deposits are made to a trustee-held fund to meet semiannual interest and annual principal payments. Trustee-held funds are included as assets limited as to use in the accompanying consolidated balance sheets. Payment of principal and interest on some of the revenue bonds is insured by a bond insurer.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

##### **Letters of Credit**

Banner has the following letters of credit outstanding: Travelers Indemnity Company of Illinois in the amount of \$819,000 expiring January 16, 2010; Sentry Insurance in the amount of \$2,750,000 expiring January 1, 2010; Liberty Mutual Insurance Company in the amount of \$879,000 expiring May 1, 2010; Zurich America Insurance Company in the amount of \$3,300,000 expiring October 31, 2009; and First American Title Company in the amount of \$175,922 expiring January 31, 2010. No amounts were drawn upon the letters of credit as of December 31, 2008 and 2007.

##### **Fair Value of Debt and Interest Rate Swaps**

As of December 31, 2008 and 2007, the estimated fair value of Banner's debt was \$2,014,849,000 and \$1,794,779,000, 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.

As of December 31, 2008 and 2007, the estimated fair value of the 2005 Swaps resulted in an imputed obligation of \$121,938,000 and \$24,197,000, respectively, which is recorded in other long-term liabilities in the accompanying balance sheets. The fair value of the 2005 Swaps is based on the forward LIBOR curve with a blended average duration of approximately 16 years.

As of December 31, 2008 and 2007, the estimated fair value of the 2006 Swaps resulted in an imputed obligation of \$117,109,000 and \$8,970,000, respectively, which is recorded in other long-term liabilities in the accompanying balance sheets. The fair value of the 2006 Swaps is based on the forward LIBOR curve with a blended average duration of approximately 21 years.

As of December 31, 2008 and 2007, the estimated fair value of the 2007 Swaps resulted in an imputed obligation of \$121,121,000 and \$16,747,000 respectively, which is recorded in other long-term liabilities in the accompanying balance sheets. The fair value of the interest rate swaps is based on the forward LIBOR curve with a blended average duration of approximately 26 years.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

##### **Fair Value Swap Adjustment**

FAS 157 defines fair value as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability. The fair value should be calculated based on assumptions that the market participant would use in pricing the asset or liability, and in the case of liabilities, the fair values should include consideration of non-performance risk including Banner's own risk. Banner's swaps are categorized as Level 2 liabilities because a quoted price is obtained from a number of dealer counterparties and other market sources. A mid-market valuation is obtained from each of Banner's counterparties and adjusted for non-performance risk.

As of December 31, 2008 the uncollateralized portion of Banner's swaps subject to non-performance risk was approximately \$101,300,000. The application of FAS 157 resulted in a reduction in unrealized loss on interest rate swaps of \$13,699,097. The resulting mark-to-market unrealized gain of \$13,699,097 has been recorded in (deficiency) excess of revenue over expenses for the year ended December 31, 2008.

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

Banner has obtained insurance through a combination of purchased and self-insurance programs for professional and general liability claims and workers' compensation claims. Banner is self-insured for workers' compensation in Arizona and Colorado. Banner facilities outside of Arizona and Colorado are insured for workers' compensation by a commercial insurance company with a deductible of \$250,000 per occurrence. Banner is also required to contribute to certain states' mandated programs.

Under its self-insured professional and general liability programs, Banner contributes actuarially determined amounts to Samaritan Insurance Funding, Ltd., a captive insurance company wholly owned by Banner, to fund estimated ultimate losses. In connection with the professional and general liability and workers' compensation self-insurance program, Banner has accrued estimates for asserted and incurred but not reported claims. The actuarially determined claim liabilities amounting to \$209,199,000 and \$193,165,000, of which \$57,909,000 and \$42,711,000 has been recorded as other current liabilities in the accompanying balance sheets, as of December 31, 2008 and 2007, respectively, have been discounted to present value using a discount rate of 5.9% in 2008 and 2007.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **9. Estimated Self-Insurance Liabilities (continued)**

The self-insured occurrence based coverage has a per claim limit of \$10,000,000 in 2008 and 2007 and applies to all entities for general and professional liability claims. Individual professional liability claims in excess of the \$10,000,000 self-insured retention, and aggregate general liability claims in excess of the \$10,000,000 self-insured retention, are insured through claims-made excess liability policies. The first \$20,000,000 of this excess coverage is also self-insured through Samaritan Insurance Funding, Ltd. The balance of this excess coverage is provided through reinsurance policies issued by unaffiliated third party insurers. These excess policies, together with the self-insured components, were in force with aggregate coverage of \$200,000,000 in 2008 and 2007 for professional and general liabilities as of December 31, 2008.

Under the laws of the state of Arizona, MediSun is required to maintain a \$500,000 investment on deposit with the Department of Insurance of the State of Arizona (DOI). In addition, MediSun is required to maintain a statutory reserve based on 2% of charges collected from enrollees up to a maximum reserve of \$1,000,000 and maintain an insolvency fund of \$278,000 based on an actuarial analysis. US government securities, at amortized cost, totaling approximately \$1,850,000 at December 31, 2008, are held by a financial institution to comply with these requirements.

#### **10. Retirement Plans**

##### **Defined Contribution Plan**

Substantially all of Banner's eligible employees may elect to participate in Banner's defined contribution plan. Employees may contribute up to 21% of eligible compensation, subject to plan restrictions. Banner may provide a matching contribution equal to the first 4% of eligible compensation contributed for each participant, as defined under the defined contribution plan. Pension expense was \$39,694,000 and \$32,294,000 for the years ended December 31, 2008 and 2007, respectively.

##### **Defined Benefit Plan**

###### *Banner Health Retirement Income Plan*

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

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 10. Retirement Plans (continued)

On December 31, 2007, Banner adopted the recognition and disclosure provisions of FAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. FAS 158 required Banner to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan in the December 31, 2007 consolidated balance sheet. The adoption of FAS 158 did not have a material impact on Banner's consolidated financial statements.

The following table sets forth the benefit obligation and assets of the Plan at December 31, 2008 and 2007, (using measurement dates as of December 31, 2008 and 2007, respectively) and components of net periodic benefit costs for the years then ended:

	<b>December 31</b>	
	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
<b>Change in projected benefit obligation</b>		
Projected benefit obligation at beginning of year	\$ 70,122	\$ 72,438
Interest cost	4,127	4,064
Actuarial loss	(2,280)	(1,399)
Benefits paid	(5,131)	(4,981)
Projected benefit obligation at end of year	66,838	70,122
 Change in plan assets		
Fair value of plan assets at beginning of year	66,170	66,556
Actual return on plan assets	(22,682)	4,594
Employer contributions	764	-
Benefits paid	(5,131)	(4,980)
Fair value of plan assets at end of year	39,121	66,170
Funded status – accrued benefit recorded	\$ (27,717)	\$ (3,952)
 Unrecognized net loss recorded in net assets	 \$ 41,337	 \$ 15,973

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 10. Retirement Plans (continued)

The underfunded status of the Plan of \$27,717,000 at December 31, 2008, is recognized in the accompanying consolidated balance sheets as an other long-term liability. No plan assets are expected to be returned to Banner during the year ended December 31, 2009.

	<b>Year Ended December 31</b>	
	<b>2008</b>	<b>2007</b>
	<i>(In thousands)</i>	
<b>Components of net periodic benefit</b>		
Interest cost	\$ 4,127	\$ 4,064
Expected return on plan assets	(5,369)	(5,215)
Amortization of prior service cost	–	9
Amortization of actuarial loss	406	525
Net periodic benefit	\$ (836)	\$ (617)

The assumptions used to determine the projected benefit obligation and net periodic benefit cost for the Plan are set forth below:

	<b>December 31</b>	
	<b>2008</b>	<b>2007</b>
Weighted average discount rate	6.1%	5.8%
Weighted average expected long-term rate of return on plan assets	8.5%	8.5%

The Plan's asset allocation and investment strategies are designed to earn superior returns on plan assets consistent with a reasonable and prudent level of risk. Investments are diversified across classes, sectors, and manager style to minimize the risk of large losses. Derivatives may be used to bridge specific exposure, reduce transaction costs, or modify the portfolio's duration or yield. Banner uses investment managers specializing in each asset category and, where appropriate, provides the investment manager with specific guidelines which include allowable and/or prohibited investment types. Banner regularly monitors manager performance and compliance with investment guidelines.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 10. Retirement Plans (continued)

The weighted-average asset allocation for the Plan at the end of 2008 and 2007 and the target allocation for 2009, by asset category, are as follows:

<b>Asset category</b>	<b>Target Allocation</b>	<b>Percentage of Plan Assets at Year-End</b>	
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Equity securities	60%	54%	68%
Fixed income	20%	16%	9
Absolute value	20%	30%	23
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

The expected long-term rate of return on Plan assets is based on historical and projected rates of return for current and planned asset categories in the Plan's investment portfolio. Assumed projected rates of return for each asset category were selected after analyzing historical experience and future expectations of the returns and volatility for assets of that category using benchmark rates. Based on the target asset allocation among the asset categories, the overall expected rate of return for the portfolio was developed and adjusted for historical and expected experience of active portfolio management results compared to benchmark returns and for the effect of expenses paid from Plan assets.

Information about the expected cash flows for the Plan follow (*In thousands*):

Expected employer contributions in 2009	\$ 428
Expected benefit payments:	
2009	4,895
2010	5,107
2011	5,393
2012	5,457
2013	5,565
2014-2018	28,143

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 10. Retirement Plans (continued)

##### *Sun Health Pension Plan*

Under the terms of the Sun Health purchase agreement, Banner assumed sponsorship of the Sun Health Pension Plan, a defined benefit plan, and the Sun Health Pension Plan Trust. Sun Health Services retained the obligation to fund any required contributions to the Trust to meet the Employee Retirement Income Security Act of 1974 minimum funding requirement, and Sun Health Services retains the right to any excess assets that may exist upon termination of the Plan. Benefit accruals under the Sun Health Pension Plan have been frozen since May 2007. At December 31, 2008, Banner recorded a non-current liability of \$24,978,000, representing the unfunded liability under the Sun Health Pension Plan, and a long-term receivable from Sun Health in the same amount in the accompanying consolidated balance sheet.

The following table sets forth the benefit obligation and assets of the Sun Health Pension Plan at December 31, 2008, (using measurement dates as of December 31, 2008 and in thousands):

<b>Change in projected benefit obligation</b>	
Projected benefit obligation at acquisition date	\$ 60,683
Interest cost	1,527
Actuarial loss	7,707
Benefits paid	<u>(947)</u>
Projected benefit obligation at end of year	68,970
Change in plan assets	
Fair value of plan assets at acquisition date	56,058
Actual return on plan assets	(11,119)
Benefits paid	<u>(947)</u>
Fair value of plan assets at end of year	<u>43,992</u>
Funded status – accrued benefit recorded	<u>\$ (24,978)</u>

The assumptions used to determine the projected benefit obligation include the weighted average discount rate of 6.1% and weighted average expected long-term rate of return on plan assets of 8.7%.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 10. Retirement Plans (continued)

The weighted-average asset allocation for the Sun Health Pension Plan as of December 31, 2008 and the target allocation, by asset category, are as follows:

<b>Asset category</b>	<b>Target Allocation</b>	<b>Percentage of Plan Assets at Year-End</b>
Cash equivalents	1%	3%
Fixed income	29	36
Equity securities	66	54
Real estate	4	5
Other	–	2
<b>Total</b>	<b>100%</b>	<b>100%</b>

The expected long-term rate of return on plan assets is based on historical and projected rates of return for current and planned asset categories in the Sun Health Pension Plan's investment portfolio. Assumed projected rates of return for each asset category were selected after analyzing historical experience and future expectations of the returns and volatility for assets of that category using benchmark rates. Based on the target asset allocation among the asset categories, the overall expected rate of return for the portfolio was developed and adjusted for historical and expected experience of active portfolio management results compared to benchmark returns and for the effect of expenses paid from plan assets.

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

Expected employer contributions in 2009	\$	–
Expected benefit payments:		
2009		2,432
2010		2,654
2011		2,863
2012		3,187
2013		3,467
2014-2018		21,630

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **10. Retirement Plans (continued)**

##### **Health and Dental Plan**

Employees of Banner are provided health and dental coverage through a combination of several programs, purchased and self-insured. Health, dental, and group life coverage is funded through employee and employer contributions. Banner's health, dental, and group life expense was \$161,327,000 and \$128,191,000 for the years ended December 31, 2008 and 2007, respectively.

##### **Long-Term Disability Plan**

Employees of Banner are provided long-term disability coverage through a self-insured plan that is funded by employee and employer contributions. Banner's long-term disability expense was \$2,772,000 and \$1,120,000 for the years ended December 31, 2008 and 2007, respectively.

In connection with the long-term disability program, Banner has accrued estimates for asserted and incurred but not reported claims. The actuarially determined claim liabilities have been discounted to present value using a discount rate of 6.3% in 2008 and 2007.

##### **Supplemental Executive Retirement Plan**

Banner has a supplemental executive retirement plan for certain of its senior executives for retirement and death benefits. Banner's executive retirement plan expense was \$2,405,000 and \$5,044,000 for the years ended December 31, 2008 and 2007, respectively. The actuarially determined liability has been discounted to present value using a discount rate of 6.3% in 2008 and 5.5% in 2007.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 11. Commitments and Contingencies

##### Leases

Future minimum lease payments, excluding operating agreements, at December 31, 2008, by year and in the aggregate, under noncancelable operating lease arrangements with initial or remaining terms of one year or more consist of the following (*in thousands*):

2009	\$ 20,727
2010	18,830
2011	14,511
2012	12,822
2013	10,380
Thereafter	31,626
	<u>\$ 108,896</u>

##### Operating Agreements

On January 1, 2003, Banner entered into a 15-year Amended and Restated Operating Agreement with NCMC, Inc., (lease amendment) under which Banner subleases North Colorado Medical Center (NCMC) and other real and personal property from NCMC, Inc. Banner is required to pay rent to NCMC, Inc. monthly in two components (i) Basic Rent, and (ii) Return on Assets.

Basic Rent is in an amount equal to total actual asset depreciation expense of NCMC, Inc. Return on Assets is an amount equal to 8% of the year-end net book value of NCMC, Inc.'s assets. Starting in 2004, NCMC, Inc. was required to pay Banner \$500,000 on a quarterly basis to compensate Banner for indigent care at the healthcare facility for the years 2004 and 2005. In years 2006 through 2009, the quarterly payment is \$625,000; from 2010 through the end of the lease the quarterly payment is \$500,000.

Total rent payments to NCMC, Inc. of \$30,917,000 and \$31,114,000 were recorded as other operating expenses for the year ended December 31, 2008 and 2007, respectively.

As part of the operating agreement, Banner must meet certain performance criteria in its operation of the healthcare facility, measuring quality, patient satisfaction, employee satisfaction, and physician satisfaction. Banner was in compliance with the lease provisions as of December 31, 2008. The rent payable under the operating agreement was reduced by \$3,000,000, \$2,000,000, and \$1,000,000 in 2006, 2007, and 2008, respectively, from what otherwise would have been payable in those years; these rent reductions will be recaptured through rent increases in the same amounts in 2014, 2013 and 2012, respectively. If at the end of years five, 10 and 15

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

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

of the Amended and Restated Operating Agreement, the cumulative operating income exceeds 5% of the cumulative net operating revenue during each five-year period, Banner must pay NCMC, Inc. 50% of the difference between the operating income and 5% of the net operating revenue. If cumulative operating income for the period is less than zero, then NCMC, Inc. must pay Banner 50% of the amount by which the operating income is less than zero; provided that the aggregate Basic Rent paid by Banner during a five-year period, less the reconciliation payment, may not be less than the amount of the scheduled annual debt service payments made by NCMC, Inc. on the tax-exempt bonds.

Banner leases from the Greater Fairbanks Community Hospital Foundation (the Foundation), a hospital facility (the Hospital), a skilled nursing facility (the Home) and, as of February 28, 2008, a physician clinic (the Clinic) under a cancelable operating lease agreement. The entities together are referred to as the Facility. The lease obligates Banner to operate the Facility and pay basic rent based on the fair market value per square foot for the Facility adjusted annually. In exchange for rents to be paid, the lease obligates the Foundation to purchase all future equipment for the Facility. In addition to the Basic Rent, additional rent payments are required to be made by Banner to the Foundation based on excess cash flows, net of expenses, as defined. The net effect of the additional rent payments is that Banner retains the net operating income from the Facility up to 4.5% of the net operating revenue, and pays the balance of the net income to the Foundation. Total rental expense under the Facility's operating leases totaled \$17,295,000 and \$13,335,000 for the years ended December 31, 2008 and 2007, respectively. The operating agreement can be terminated at any time by either Banner or the Foundation on one-year's notice.

Amounts charged to expense for all operating leases totaled \$114,664,000 in 2008 and \$101,116,000 in 2007.

#### **Debt Guarantee**

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. Under the limited guaranty agreement, Banner agrees to pay, solely from the revenues generated by the operation of the facility, the principal and interest on the NCMC, Inc. Series 1999 bonds in the event of default by NCMC, Inc. Under the limited guaranty agreements applicable to the NCMC, Inc. Series 2008, 2005, and 2003 bonds, Banner agrees to pay the principal and interest on such bonds in the event of default by NCMC, Inc.; however, the aggregate amount payable under the limited guaranty agreements applicable to the Series 2008, 2005 and 2003 bonds is limited to the rent otherwise payable under the lease. As of December 31, 2008, \$191,952,000

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 11. Commitments and Contingencies

(unaudited) was outstanding under the NCMC, Inc. Series 1999, 2003, 2005 and 2008 bonds, net of an amount held in escrow. The maximum annual debt service on the NCMC, Inc. Series 1999, 2003, 2005, and 2008 bonds is approximately \$16,757,000 (unaudited). Banner has agreed to pay directly to the trustee monthly the portion of the Basic Rent and Return on Assets equal to NCMC, Inc.'s debt service obligation. Such payments are credited against the Basic Rent and Return on Assets obligations to NCMC, Inc. Banner is not obligated to pay any amounts which become due on such Bonds as a result of acceleration of the principal of the Bonds under the Indenture. Banner's obligations under the limited guaranty agreements cease upon the termination of the Amended and Restated Operating Agreement. Banner did not record a liability for the limited guaranty agreements at December 31, 2008 or 2007.

In October 2004, Banner entered into a limited guarantee of the scheduled payments of principal and interest owed by the Greater Fairbanks Community Hospital Foundation with respect to the \$120,000,000 Revenue Bonds (the Bonds) issued simultaneously by the Alaska Industrial Development and Export Authority (the Authority), the proceeds of which were used to finance expansion and improvements of the Hospital. The limited guarantee is only in effect during the period that the lease for the Facility is in effect. If the lease is terminated by either Banner or the Foundation, the limited guarantee will cease to be effective. Moreover, Banner receives a credit against its rent obligation for any amount that it pays under the limited guarantee. The annual scheduled debt service for the Bonds is projected to be approximately \$6,900,000, which is less than the Basic Rent currently owed under the lease, and substantially less than the sum of the Basic Rent and projected additional rent. Under certain circumstances, the annual scheduled debt service can be increased in accordance with an accelerated redemption of the Bonds. In those circumstances, the amount payable under the limited guarantee is expressly limited to the amount of the rent otherwise payable by Banner under the lease. Under any reasonably foreseeable circumstance management believes that the amount payable under the limited guarantee will never exceed the rent otherwise payable under the lease, and Banner did not record a liability for the limited guarantee at December 31, 2008 or 2007.

In November 2003, Banner guaranteed partial payment of a construction note between Loveland Medical Enterprises, LLC (LME) and JPMorgan Chase & Co. Banner is the sole member of McKee Medical Holdings, L.L.C., (MMH), an entity that owned approximately 35% of LME until December, 2008, at which time it acquired an additional 35% interest in LME, for a total ownership interest of 70%. As of December 31, 2008, Banner's limited and several guaranty is in an amount proportionate to MMH's 70% ownership interest in LME, not to exceed \$12,400,000. Banner will be obligated to perform under this guaranty if LME defaults on the payment terms of the note. Management believes that the probability of performance under these obligations is remote as of December 31, 2008 and 2007, and, accordingly, has not accrued for any obligations due under these guarantees.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **11. Commitments and Contingencies**

Banner enters into agreements with nonemployed physicians that include minimum revenue guarantees. The terms of the guarantees vary. The carrying amounts of the liability for Banner's obligation under these guarantees were \$3,610,000 and \$4,035,000 at December 31, 2008 and 2007, and are included in other noncurrent liabilities in the accompanying consolidated balance sheets. The maximum amount of future payments that Banner could be required to make under these guarantees is \$5,165,000.

#### **Phoenix Children's Hospital**

In 1999, Phoenix Children's Hospital (PCH) entered into an agreement with Banner to lease and operate the neonatal intensive care unit at Banner Good Samaritan Medical Center commencing in 2003. Under the agreement, PCH paid an initial, nonrefundable lease fee of \$10,000,000 in 2002, which is being recognized on a straight-line basis over the term of the lease. In addition, PCH is required to pay annual rent starting at \$3,000,000 and increasing to \$5,300,000 by May 2007. On April 1, 2006, Banner entered into an amended and restated facility lease with PCH. The agreement extends the term of the lease for the neonatal intensive care unit to May 31, 2027, although Banner and PCH will each have the right to terminate the lease on or after May 31, 2020. Under the amendment to the lease, PCH will pay to Banner an additional annual payment of approximately \$1,260,000 to cover its share of the NICU space renovation costs, which totaled \$16,399,000.

#### **Facility Construction**

Banner is undertaking significant renovation and expansion projects at Banner Baywood Medical Center, Banner Ironwood Medical Center, Banner Corporate Center Mesa, Banner Desert Medical Center, Banner Del E. Webb Medical Center, and Banner Thunderbird Medical Center, all of which are located within the greater Phoenix, Arizona metropolitan area.

The cost to complete construction and purchase equipment for these projects is estimated to be \$611 million (unaudited).

#### **Compliance with Laws and Regulations**

The healthcare 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 healthcare 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 healthcare providers.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **11. Commitments and Contingencies**

Violations of these laws and regulations could result in expulsion from government healthcare programs, together with the imposition of significant fines and penalties as well as significant repayments for patient services previously billed. Management believes that Banner is in material compliance with fraud and abuse laws and regulations. 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.

In the course of Banner's routine contract processing and compliance function, situations have been identified that may indicate noncompliance in some respect with the strict requirements of the Stark Law (42 U.S.C. Section 1395nn), as refined by the amendments to 42 CFR Section 411.353(c) that became effective as of October 1, 2008. As these situations arise, they are carefully analyzed in order to determine whether in fact noncompliance has occurred. In situations where noncompliance is verified, it is the intention of Banner to disclose the noncompliance to the government or a representative thereof in the most appropriate manner for the type of noncompliance identified, and to accrue an estimate of the potential exposure.

#### **AZHHA Nurse Registry Class Action Litigation**

Banner, together with the Arizona Hospital and Healthcare Association (AZHHA) and several other Arizona hospitals, were named as defendants in an antitrust class action filed in federal district court in July 2007, by nurses who worked for nurse registry agencies that participated in a pooled purchasing program sponsored by AZHHA. The plaintiffs seek to certify a statewide class of all nurses who worked for such agencies. The plaintiffs allege that the nurse registry program constituted an unlawful boycott and price fixing conspiracy in violation of federal and state antitrust statutes. Banner believes that it has substantial defenses to the lawsuit, that the plaintiffs lack standing to bring the claims, that the matter is not appropriate for class certification, and that the program, even if proved to have been in violation of any antitrust laws, did not have a material impact on the rates paid for registry and traveling nurses. The case is currently in the discovery phase and no classes have yet been certified. Banner has submitted a claim for coverage of this matter under its directors and officers insurance coverage, the first \$10 million of which is covered by self insurance; it is unknown at this time whether the commercial excess reinsurer for the directors and officers coverage will accept coverage in the event the costs of this claim exceed the self-insured retention.

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **11. Commitments and Contingencies**

##### **Saguaro Medical Associates Litigation**

On February 8, 2008, a hospitalist group, Saguaro Medical Associates (Saguaro), having a semi-exclusive contract to provide hospitalist services at Banner Thunderbird Medical Center filed a lawsuit against Banner, alleging breach of contract and the implied covenant of good faith and fair dealing, and seeking a declaratory judgment against, and damages from Banner. Two amended complaints were subsequently filed, adding claims for tortious interference with contractual relations between Saguaro and physicians employed by Saguaro, and for a violation of civil rights relating to enjoyment of property under 42 U.S.C. Section 1891. Saguaro has stated that it believes that it is entitled not only to damages for lost profits under the agreement, but for damages relating to the decline of Saguaro as an ongoing viable business entity. Banner disputes all of the allegations, and intends to contest the allegations vigorously. It is difficult to provide a realistic estimate of the range of damages if the outcome were to be unfavorable, but counsel for Saguaro has demanded approximately \$1,950,000 for damages allegedly caused by Banner's improper conduct. Even if the outcome were to be unfavorable on the substantive liability issues, Banner believes that the claimed damages are not only unsubstantiated, but that few, if any, of the claimed damages were the result of any alleged wrongful conduct by Banner.

In addition to the general and professional liability claims, Banner is involved in litigation and regulatory investigations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, these matters are expected to be resolved without material adverse effect on Banner's consolidated financial position, results of operations or cash flows.

#### **12. Subsequent Event**

##### **HD Partners Peoria, LLC Claim**

In connection with the acquisition of assets from Sun Health on September 1, 2008, Banner received assignment of, and assumed a lease dated October 31, 2006, between Sun Health Corporation and HD Partners Peoria, LLC (HDP), for the lease of space in medical office buildings to be built by HDP in Peoria, Arizona. Under the lease, Sun Health was obligated to lease 12,000 square feet upon completion of the building, and an additional 8,000 square feet upon a certain amount of additional space being leased to independent physicians. Banner has received a letter from counsel for HDP, dated January 27, 2009, alleging that Banner has anticipatorily breached the lease and/or tortiously interfered with HDP's ability to lease the building by not committing to construct an ambulatory care center in the building, and allegedly informing physicians who were considering leases in the building of Banner's intentions. HDP is

## Banner Health and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **12. Subsequent Event**

demanding that Banner provide assurances and a plan to occupy a full 20,000 square feet in the buildings immediately, and pay rent or otherwise compensate HDP for an additional 20,000 square feet in the medical office buildings currently under construction, and to commit to using space in the medical office buildings as an ambulatory care center. HDP further claimed in the letter that Banner's failure to "cure" its alleged breaches of the lease will result in a damages exposure to Banner in excess of \$15 million. Banner vigorously contests all of the claims of HDP, and has repeatedly stated its intent to honor the written obligations as set forth in the lease. Banner intends to contest it vigorously.

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