

FINANCIAL STATEMENTS AND
SUPPLEMENTARY INFORMATION

Banner University Family Care
Years Ended December 31, 2018 and 2017
With Independent Auditor's Report

Ernst & Young LLP



Banner University Family Care
Financial Statements and Supplementary Information
Years Ended December 31, 2018 and 2017

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Independent Auditor's Report

The Board of Directors
Banner University Family Care

Report on the Financial Statements

We have audited the accompanying financial statements of Banner University Family Care (BUFC), a subsidiary of Banner Health (Banner), which comprise the balance sheets as of December 31, 2018 and 2017, and the related statements of revenues, expenses and changes in net assets, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Cenpatico of Arizona, Inc. (COA), a corporation in which BUFC held a 10% interest. In the financial statements, BUFC's investment in COA is stated at \$6,432,563 as of December 31, 2017 and BUFC's equity in the net losses of COA is stated at \$437,025 for the year ended December 31, 2017. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for COA, is based solely on the report of other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to

design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, based on our audits and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Banner University Family Care, a subsidiary of Banner Health, as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Ernst & Young LLP

May 29, 2019

Banner University Family Care

Balance Sheets

	December 31	
	2018	2017
Assets		
Current assets:		
Cash and cash equivalent	\$ 261,931,962	\$ 192,525,147
Reinsurance receivable	11,517,980	5,538,437
Capitation and supplemental revenues receivable	494,314	10,051,499
Reconciliation receivable	6,297,251	239,951
Other current assets	5,798,668	1,862,044
Total current assets	<u>286,040,175</u>	210,217,078
Reconciliation receivable	23,630,787	4,792,564
Other assets	738,756	6,471,932
Total	<u><u>\$ 310,409,718</u></u>	<u><u>\$ 221,481,574</u></u>
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 5,148,136	\$ 3,713,149
Due to affiliate	85,710,932	55,808,644
Medical claims payable	135,991,931	81,880,171
Reconciliation payable	6,560,306	5,165,513
Alternative payment model	6,017,236	744,696
Other current liabilities	3,635,182	5,641,054
Total current liabilities	<u>243,063,723</u>	152,953,227
Reconciliation and alternative payment model payable	<u>10,240,040</u>	22,827,943
Total liabilities	<u>253,303,763</u>	175,781,170
Commitments and contingencies		
Net assets	<u>57,105,955</u>	45,700,404
Total	<u><u>\$ 310,409,718</u></u>	<u><u>\$ 221,481,574</u></u>

See accompanying notes.

Banner University Family Care

Statements of Revenues, Expenses and Changes in Net Assets

	Year Ended December 31	
	2018	2017
Revenue		
Capitation premiums	\$ 774,762,450	\$ 522,860,575
Delivery supplemental	17,091,495	16,512,935
Reconciliation settlement, net	22,010,153	(9,413,575)
Alternative payment model	16,926,518	—
Investment income, net	3,430,600	147,936
Premium deficiency reserve	2,600,000	700,000
Total revenues	<u>836,821,216</u>	<u>530,807,871</u>
Health care expenses		
Hospitalization	117,047,531	81,546,286
Medical compensation	166,257,026	116,160,689
Ancillary and other medical services	302,927,689	267,490,582
Institutional	123,660,078	22,574,645
Home and community based services	98,178,010	21,235,502
Case management services	11,656,589	2,831,377
Less reinsurance recoveries	(34,162,211)	(23,024,721)
Total healthcare expenses	<u>785,564,712</u>	<u>488,814,360</u>
General and administrative expenses	45,731,332	35,112,961
Premium tax expense	16,719,621	11,275,506
Total operating expenses	<u>848,015,665</u>	<u>535,202,827</u>
Operating loss, before income tax expense	(11,194,449)	(4,394,956)
Income tax expense	—	(1,112,833)
Net loss	<u>(11,194,449)</u>	<u>(5,507,789)</u>
Net assets, beginning of period	45,700,404	20,822,193
Contribution from affiliate	22,600,000	30,386,000
Net assets, end of period	<u>\$ 57,105,955</u>	<u>\$ 45,700,404</u>

See accompanying notes.

Banner University Family Care

Statements of Cash Flows

	Year Ended December 31	
	2018	2017
Operating activities		
Net loss	\$ (11,194,449)	\$ (5,507,789)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Decrease in deferred tax asset	–	4,710,540
Changes in assets and liabilities:		
Reinsurance receivable	(5,979,543)	327,489
Capitation and supplemental revenues receivable	9,557,185	(9,656,976)
Reconciliation receivable	(24,895,523)	(41,342)
Other current assets	(3,936,624)	539,804
Accounts payable and other liabilities	(570,885)	(1,538,688)
Medical claims payable	54,111,760	39,229,424
Reconciliation and alternative payment model payable	(5,920,570)	13,839,123
Income tax payable	–	(3,597,707)
Net cash provided by operating activities	11,171,351	38,303,878
Investing activities		
Decrease in other assets	5,733,176	489,517
Net cash provided by investing activities	5,733,176	489,517
Financing activities		
Increase in due to affiliate	29,902,288	29,885,221
Contribution from affiliate	22,600,000	30,386,000
Net cash provided by financing activities	52,502,288	60,271,221
Net increase in cash and cash equivalent	69,406,815	99,064,616
Cash and cash equivalent at beginning of period	192,525,147	93,460,531
Cash and cash equivalent at end of period	\$ 261,931,962	\$ 192,525,147

See accompanying notes.

Banner University Family Care

Notes to Financial Statements

December 31, 2018

1. Organization and Operations

Organizational Structure

Banner University Family Care (BUFC or the Plan) provides health-plan services to enrollees under contracts with the Arizona Health Care Cost Containment System (AHCCCS) in various counties in southern Arizona. Banner Health (Banner) is the sole corporate member of BUFC.

All of the Plan's revenues, except for investment income, were earned under its AHCCCS contracts, which are subject to periodic renewal. The BUFC financial statements include the financial activity associated with the following AHCCCS contracts:

- In March 2013, BUFC was awarded a new five-year Acute-Care Contract (Acute-Care) with AHCCCS through September 30, 2018.
- In March 2018, BUFC was awarded a new AHCCCS Complete Care Contract (ACC) effective October 1, 2018 and extends through September 30, 2025. The ACC contract includes the existing membership and geographic service areas of the Acute-Care contract, which ended September 30, 2018, and increased membership in additional geographic service areas. The ACC contract provides additional member service coverage beyond those services covered under the Acute-Care contract to include behavioral health services, physical health services and coverage for the children's rehabilitation services (CRS). The ACC contract includes a risk reconciliation whereby BUFC and AHCCCS share in the contract gains and losses (see Note 3).
- On October 1, 2017 BUFC began operations for the AHCCCS Arizona Long Term Care System (ALTCS) contract which is a seven-year contract awarded in March 2017. For the 2017 contract year ended September 30, 2018, the ALTCS contract incurred a loss of approximately \$28,000,000 as the premium revenues received were not sufficient to cover claim costs. A contract amendment was entered into in September 2018, retroactive to October 1, 2017, which provides for a risk reconciliation whereby BUFC and AHCCCS share in the contract gains and losses in excess of 7% of capitation revenues as defined in the contract. A contract amendment was also entered into in September 2018 relating to the contract period from October 1, 2018 through September 30, 2019. The contract also included a risk reconciliation whereby BUFC and AHCCCS share in the contract gains and losses as defined in the contract amendment, ranging from 2% to 7% of capitation revenues. Reconciliation revenue of approximately \$16,764,000 has been recorded in the

Banner University Family Care

Notes to Financial Statements (continued)

1. Organization and Operations (continued)

statements of revenues, expenses and changes in net assets for the year ended December 31, 2018 relating to these contract amendments.

Continuation of the AHCCCS programs is dependent upon governmental policies. The loss of these contracts would have an adverse effect on BUFC's future operations.

2. Liquidity

Financial assets available for general expenditure within one year of the balance sheet date, consist of the following as of December 31, 2018

Cash and cash equivalent	\$ 261,931,962
Reinsurance receivable	11,517,980
Capitation and supplemental revenues receivable	494,314
Pharmacy rebate and due from vendors	5,033,491
	<u>\$ 278,977,747</u>

BUFC also has a net reconciliation receivable of approximately \$20,000,000 as of December 31, 2018 which is subject to settlement with AHCCCS. The reconciliation receivable is settled with AHCCCS at the end of the contract year and once claim payment activity has been completed. Historically, AHCCCS has finalized the reconciliation receivable approximately two to three years subsequent to the contract year.

3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

Banner University Family Care

Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

Fair Value of Financial Instruments

The carrying amounts for cash and cash equivalents, reinsurance receivable, capitation and supplemental revenues receivables, reconciliation receivables and payables, other current assets, accounts payable, due to affiliate, medical claims payable, and other current liabilities approximate fair value due to the short-term nature of these accounts.

Cash and Cash Equivalent

BUFC maintains cash in a bank account that frequently exceeds federally insured limits. To date, BUFC has not experienced any losses on this account.

At December 31, 2018 and 2017, cash and cash equivalent includes a money market account amounting to approximately \$77,189,000 and \$75,966,000, respectively, that is recorded at fair value.

Reinsurance Receivable

Reinsurance receivable represents management's estimate of the medical claims cost it has earned that will be recoverable under its reinsurance contract with AHCCCS and is calculated based on the identification of qualifying incurred inpatient and pharmacy expenses and a percentage of estimated inpatient and other pharmaceutical costs incurred but not yet reported. BUFC recorded additional reinsurance recoveries amounting to approximately \$4,564,000 for the year ended December 31, 2018 relating to the 2017 contract year. There is a possibility that recorded estimates will change by a material amount in the near term.

Other Assets

BUFC is a collaborator with Cenpatico of Arizona, Inc. (COA), which was awarded the contract for the Regional Behavioral Health Authority for all of central and southern Arizona, excluding Maricopa County. BUFC, along with an affiliated insurance plan Banner University Care Advantage (BUCA), collectively held a 20% interest in COA, and accordingly, accounted for the COA investment using the equity method of accounting. On September 30, 2018, BUFC sold its investment interest in COA for \$7,187,000 which approximated the equity investment balance recorded. There was no gain or loss recorded with the sale. BUFC received \$6,448,000 of the sale

Banner University Family Care

Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

proceeds as of December 31, 2018 and the remainder was received in March 2019. BUFC's investment in COA at December 31, 2017 amounted to approximately \$6,432,000 and is recorded within other assets on the accompanying balance sheets.

Total net income of COA for the year ended September 30, 2018, representing COA's fiscal year-end, amounted to approximately \$7,788,000. Total assets, liabilities and net loss of COA as of and for the year ended September 30, 2017 amounted to approximately \$131,675,000, \$66,606,000 and \$5,308,000, respectively.

Medical Claims Payable

The costs of hospital and medical services provided to enrollees served under contract are recognized in the period that the services are rendered. An accrual has been made for unpaid claims in process of review and for claims incurred but not received as of December 31, 2018 and 2017. The amount of this liability is estimated by independent actuaries using historical claims payment experience coupled with a review of experience for similar plans. Estimates are adjusted based upon changes in experience, and such adjustments are reflected in current operations. Because considerable variability is inherent in such estimates, there is a possibility that recorded estimates will change by a material amount in the near term (see Note 6).

Premium Deficiency Reserves

BUFC performs periodic analysis of its expected future health care costs and maintenance costs to determine whether such costs will exceed anticipated future revenues under its contracts. Should expected costs exceed anticipated revenues, a premium deficiency reserve is recognized. Investment income is not included in the calculation of premium deficiency reserves. BUFC contract rates and anticipated expenses required a premium deficiency reserve of approximately \$1,550,000 and \$4,150,000 at December 31, 2018 and 2017, respectively, which is recorded in other current liabilities on the accompanying balance sheets.

Banner University Family Care

Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

Revenue

BUFC adopted Accounting Standard Update (ASU) 2014-09, *Revenue from Contracts with Customers* on January 1, 2018 and has elected to use the modified retrospective adoption method. The modified retrospective adoption method requires a company to record the transition adjustment for ASU 2014-09, if any, as a cumulative effect adjustment to the beginning net assets recorded as of the date of adoption. BUFC has determined that there were no transition adjustment to record on January 1, 2018.

BUFC receives revenue from AHCCCS in the form of: capitation premium revenue, delivery supplemental revenue, reconciliation settlement revenue and reinsurance recoveries which are recorded as a reduction to health care expenditures. Revenue is recorded at the estimated transaction price based on the terms outlined in the Acute-Care, ACC and ALTCS contracts. BUFC evaluates whether an implicit price concession should be included in the estimate of the transaction price based on historical collection experience. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to revenue in the period of the change. Revenue is recognized as performance obligations are satisfied, which primarily relate to the monthly period in which health care coverage is provided to the enrollees.

Capitation Premiums

Capitation revenues include premiums earned under contracts that require BUFC to provide health care coverage to enrollees of AHCCCS. The monthly capitation revenues have been agreed upon by BUFC and AHCCCS. Capitation revenues are recognized as revenue in the period to which health care coverage relates.

BUFC received capitation payments for Prior Period Coverage (PPC) separately from its prospective capitation payments. PPC capitation payments are intended to cover healthcare costs incurred by individuals while waiting for enrollment in the Plan. PPC revenues are recognized in the month in which the member is eligible for coverage under the Plan.

Amounts receivable under these contracts are recorded as capitation and supplemental revenues receivable. Capitation rates are subject to adjustment based on national episodic/diagnostic risk. There is a possibility that recorded amounts will change by a material amount in the near term. A change in estimate to increase capitation revenue by approximately \$7,800,000 was recorded for the year ended December 31, 2017 related to risk adjustment revenues received for the 2016 contract year.

Banner University Family Care

Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

Delivery Supplemental

Delivery supplemental revenue is recognized upon the delivery of a child by a member assigned to BUFC during a prospective enrollment period. This supplemental payment does not include payment for deliveries of those members who deliver in a prior coverage period.

Reconciliation Receivable (Payable) and Revenue (Contra-Revenue)

Certain AHCCCS programs are subject to settlement with AHCCCS based on the programs' net income or loss realized by BUFC and based on a formula defined by the AHCCCS contracts (reconciliation receivable (payable)). The reconciliation settlement period is based on the AHCCCS contract period of October 1 through September 30 and is subject to review and final settlement with AHCCCS. Through the report issuance date, AHCCCS has settled the reconciliation receivable (payable) with BUFC through the September 30, 2016 contract period. Management has recorded a decrease to revenue of approximately \$4,790,000 and \$9,300,000 for the year ended December 31, 2018 and 2017 respectively, relating to the settlement of prior reconciliation contract years. The estimated reconciliation receivable (payable) for the open reconciliation contract years, has been recorded as estimated reconciliation receivable (payable) on the accompanying balance sheets.

As part of the Acute-Care contract that ended September 30, 2018, amounts due to (from) AHCCCS for PPC reconciliation settlement represents BUFC's profit or loss in excess of 2% of capitation revenue for the PPC members as defined in AHCCCS's policy. Because the reconciliation settlement is subject to change based on claims experience, there is a possibility that the recorded reconciliation settlement will change by a material amount in the near term.

As part of the Acute-Care contract that ended September 30, 2018, amounts due to (from) AHCCCS for the Prospective Tiered reconciliation settlement represents BUFC's profit or loss for the prospective members. This reconciliation settlement represents 50% of BUFC's profit in excess of 3% to 6% of capitation revenue, 100% of BUFC's profit in excess of 6% of capitation revenue and 100% of BUFC's loss in excess of 3% of capitation revenue. Because the reconciliation settlement is subject to change based on claims experience, there is a possibility that the recorded reconciliation settlement will change by a material amount in the near term.

Banner University Family Care

Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

As part of the Acute-Care contract that ended September 30, 2017 and prior, amounts due to (from) AHCCCS for the Adults > 106% of the Federal Poverty Level, Adults > 106, formerly known as Newly Eligible Adults (NEAD) reconciliation settlement represents BUFC profit or loss for these members. The Adults > 106 reconciliation settlement represents BUFC's profit or loss for these members in excess of 1% of capitation revenue. Because the Adults > 106 reconciliation settlement is subject to change based on claims experience, there is a possibility that the recorded reconciliation settlement will change by a material amount in the near term. The policy pertaining to the NEAD reconciliation was closed as of September 30, 2017 and starting October 1, 2017 the NEAD population reconciliation is included in the PPC and Prospective Tiered as applicable.

As part of the ACC contract that was entered into on October 1, 2018, amounts due to (from) AHCCCS for the reconciliation settlement represents BUFC's profit or loss for all members enrolled in the ACC plan. This reconciliation settlement represents 50% of BUFC's profit in excess of 2% to 6% of capitation revenue, 100% of BUFC's profit in excess of 6% of capitation revenue and 100% of BUFC's loss in excess of 2% capitation revenue. Because the reconciliation settlement is subject to change based on claims experience, there is a possibility that recorded reconciliation settlements will change by a material amount in the near term.

Alternative Payment Model

AHCCCS has developed an alternative payment model policy with the intent to drive innovative arrangements that will further enhance cost control and result in quality improvements, while also offering providers an incentive to participate in these arrangements. BUFC is required to participate in these payment reform efforts as delineated by AHCCCS. As of December 31, 2018 and 2017, BUFC has a payable to AHCCCS related to this policy of approximately \$13,705,000 and \$17,739,000, respectively, which is primarily included in reconciliation and alternative payment model payable on the accompanying balance sheets. In 2018, AHCCCS closed and finalized the alternative payment model for contract years 2014, 2015, and 2016. BUFC recorded approximately \$16,926,000 as an increase to revenue associated with the finalization of these contract years.

Banner University Family Care

Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

General and Administrative Expenses

General and administrative expenses are recognized as incurred and consist of administrative expenses that directly relate to the AHCCCS program and a corporate allocation from Banner for general and administrative expenses (see Note 8). These expenses are repaid by BUFC through intercompany settlements to Banner. These settlements are reflected as due to affiliate on the accompanying balance sheets.

Premium Tax Expense

The state of Arizona imposes a premium tax on capitation payments paid to BUFC by AHCCCS. BUFC receives the premium tax from AHCCCS and remits the entire amount to the appropriate taxing authority. BUFC includes the taxes collected as capitation revenues and taxes remitted as a premium tax expense on the accompanying statements of revenues, expenses and changes in net assets.

Risk Management

BUFC is exposed to various risks of loss from torts, business interruption, errors and omissions, and natural disasters. Commercial insurance coverage is purchased by Banner for claims arising from such matters.

BUFC receives reinsurance coverage from AHCCCS to reduce the risk of catastrophic loss on services provided under the AHCCCS program. The gross capitation rates were reduced by the reinsurance cost. Under the AHCCCS program, risk of loss for inpatient claims is generally limited to an annual deductible of \$25,000 per member, per policy year for the Acute-Care and ACC Contracts and \$20,000 or \$30,000 for the ALTCS contract. Eligible claims in excess of the deductible are generally paid at either 75% or 85%, depending on the type of claim, with no maximum annual benefit. Eligible reinsurance claims are reported in the accompanying financial statements as a reduction of health care expenses at the amount expected to be collected from AHCCCS.

Subsequent Events

BUFC has evaluated events and transactions occurring subsequent to December 31, 2018 through May 29, 2019, the date of issuance of the accompanying financial statements. There were no subsequent events requiring recognition in the financial statements.

Banner University Family Care

Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

Adopted Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, a new financial statement accounting standard for not-for-profit entities. This accounting standard also allows companies to elect to use either the direct or indirect cash flow method, and requires additional liquidity disclosure and presentation of expenses by both natural and functional classification. This accounting standard is effective for fiscal years beginning after December 15, 2017. BUFC has retrospectively adopted this financial statement accounting standard and has added additional liquidity and functional expense disclosures. BUFC elected to continue to use the indirect cash flow method.

4. Other Current Assets

Other current assets as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Pharmacy rebate receivable	\$ 1,221,950	\$ 348,091
Due from vendors	3,811,541	924,660
Prepaid expenses and other	578,624	413,219
Third party liability receivable	89,247	161,412
Share of cost receivable	97,306	14,662
	<u>\$ 5,798,668</u>	<u>\$ 1,862,044</u>

BUFC estimates the amount that will be received in pharmacy rebates based on contractual arrangements with the drug manufacturers. Changes to the pharmacy rebate contracts and membership growth has resulted in an increase to the pharmacy rebate receivable in 2018.

Overpayments to health care providers are reported as due from vendors. The provider is required to reimburse the Plan for the overpayment or have future claims offset the overpayment. Due from vendors increased in 2018 due to increased membership and increased claims activity in the ALTCS population.

Banner University Family Care
Notes to Financial Statements (continued)

5. Other Assets

Other assets as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Cenpatico receivable	\$ 738,756	\$ –
Cenpatico investment	–	6,432,563
Other long-term assets	–	39,369
	<u>\$ 738,756</u>	<u>\$ 6,471,932</u>

6. Medical Claims Payable

Medical claims payable consists of the following at December 31:

	<u>2018</u>	<u>2017</u>
Claims payable or pending approval	\$ 73,626,553	\$ 40,311,506
Provisions for claims incurred but not yet reported	62,365,378	41,568,665
	<u>\$ 135,991,931</u>	<u>\$ 81,880,171</u>

The cost of health care services is recognized in the period in which care is provided and includes an estimate of the cost of services that has been incurred but not yet reported. BUFC estimates accrued claims payable based on historical claims payments and other relevant information. Unpaid claims adjustment expenses are an estimate of the cost to process the incurred but not reported claims and are included in medical claims payable. Estimates are continually monitored and reviewed, and as medical claims are paid or estimates adjusted, differences are recorded in the statement of revenues, expenses and changes in net assets. Such estimates are subject to the impact of changes in the regulatory environment and economic conditions. Given the inherent variability of such estimates, the actual liability could differ significantly from the amounts recorded. While the ultimate amount of claims paid is dependent on future developments, management is of the opinion that the accrued medical claims payable is adequate.

Banner University Family Care

Notes to Financial Statements (continued)

6. Medical Claims Payable (continued)

The following is a reconciliation of the accrued medical claims payable for the year ended December 31:

	2018	2017
Beginning balance	\$ 81,880,171	\$ 42,650,747
Incurred:		
Current	812,235,013	510,608,848
Prior	7,491,910	1,230,233
Total	819,726,923	511,839,081
Paid:		
Current	676,243,082	428,728,677
Prior	89,372,081	43,880,980
Total	765,615,163	472,609,657
Ending balance	\$ 135,991,931	\$ 81,880,171

Amounts incurred related to prior years vary from previously estimated liabilities as the claims are ultimately adjudicated and paid. Liabilities at any year-end are continually reviewed and re-estimated as information regarding actual claim payments become known. This information is compared to the originally established year-end liability. Positive amounts reported for incurred, related to prior years, result from claims being adjudicated and paid for amounts greater than originally estimated.

7. Related-Party Transactions

BUFC purchases physician and hospital-based health care services for its members from Banner. During the years ending December 31, 2018 and 2017, BUFC paid claims for medical expenses to Banner totaling approximately \$103,540,000 and \$76,874,000, respectively.

BUFC purchases administrative services from Banner, which are recognized as administrative expenses on the accompanying statement of revenues, expenses and changes in net assets. For the years ended December 31, 2018 and 2017, BUFC incurred approximately \$23,400,000 and \$26,400,000, respectively, of corporate and health plan allocations from Banner and affiliated entities for administrative services and program activities (see Note 8).

Banner University Family Care

Notes to Financial Statements (continued)

7. Related-Party Transactions (continued)

At December 31, 2018 and 2017, BUFC had a payable to Banner recorded as due to affiliate of \$85,710,932 and \$55,808,644, respectively.

8. Functional Expense

The following statement of functional expenses reports BUFC's operating expenses by natural classification for the years ended December 31, 2018 and 2017. BUFC operating expenditures include allocations of Banner corporate expenditures of approximately \$1,365,000 and \$2,577,000 and Banner health plan expenditures of approximately \$22,035,000 and \$23,823,000 for the years ended December 31, 2018 and 2017, respectively. The Banner health plan expenditures relate to costs to operate Banner's insurance programs, primarily relating to claims management costs. Banner allocates the health plan expenditures based on plan enrollment. The Banner corporate expenditure allocation primarily relates to general and administrative functions that is provided by Banner for each of its operating units including BUFC. Banner corporate allocations primarily relate to salary and benefit costs associated with information technology, patient financial services, accounting, human resources, and other overhead type services (see Note 1).

	Year Ended December 31	
	2018	2017
Expenses:		
Salaries and benefits	\$ 20,947,685	\$ 23,830,896
Supplies	3,700,937	3,590,666
Professional fees	3,751,351	1,390,412
Medical claims costs	785,564,712	488,814,360
Depreciation	618,047	933,954
Interest expense	2,161,586	804,715
Corporate allocations	1,365,410	2,577,900
Other	13,186,316	1,984,418
Total expenses	<u>\$ 831,296,044</u>	<u>\$ 523,927,321</u>

Banner University Family Care

Notes to Financial Statements (continued)

9. Income Taxes

BUFC is a nonprofit corporation exempt from income taxes under Internal Revenue Code Section 501(c)(3).

BUFC has not recorded any expense or accrued for any related expense for any uncertain tax positions. BUFC's 2015 through 2018 tax years remain subject to examination for federal income tax purposes, whereas the 2014 through 2018 tax years remain subject to examination for state taxing jurisdictions in which BUFC operates.

10. Commitments and Contingencies

Litigation

BUFC is party to various legal actions and is subject to various claims arising in the ordinary course of business. Management believes that the disposition of these matters will not have a material adverse effect on BUFC's financial position or results of operations.

AHCCCS Performance Measures

BUFC's contract with AHCCCS requires BUFC to be in compliance with certain financial and nonfinancial performance measures, as well as certain prerequisites to maintain BUFC's eligibility as a party to the contract with AHCCCS. For the contract years ended September 30, 2012 through September 30, 2015, management determined that BUFC did not meet certain AHCCCS nonfinancial performance measures. In response to these violations, AHCCCS may require BUFC to submit a corrective action plan to cure the violations and may subject BUFC to sanctions. At December 31, 2018, BUFC accrued estimated sanctions of \$517,000 related to this potential liability. Due to the uncertainty of the outcome of AHCCCS' review, it is reasonably possible that recorded estimates will change by a material amount in the near term. Management believes that BUFC is in compliance with these nonfinancial performance measures for contract periods ending after September 30, 2016 and through December 31, 2018. Compliance with these nonfinancial performance measures can be subject to future review by AHCCCS and may result in sanctions unknown or unasserted at this time.

During 2018 and 2017, Banner and affiliated entities provided capital contributions of approximately \$22,600,000 and \$30,386,000, respectively which resulted in BUFC being in compliance with the required equity per member AHCCCS ratio. As of December 31, 2018, BUFC's equity per member was in compliance with the AHCCCS requirement.

Banner University Family Care

Notes to Financial Statements (continued)

10. Commitments and Contingencies (continued)

Performance Bond

BUFC secured annual performance bonds in the amounts of \$65 million and \$25 million with an unrelated third-party insurance company to satisfy the performance bond requirement of BUFC's AHCCCS contracts. The bonds satisfy BUFC's contractual obligation as prescribed by AHCCCS. The current performance bonds expire September 30, 2019.

Health Care Regulatory Environment

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

Supplementary Information



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Report of Independent Auditors on Supplementary Information

The Board of Directors
Banner University Family Care

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying financial information of the AHCCCS Acute (collectively the Acute-Care and ACC Contracts) and ALTCS Contracts, and the detail of sub-capitated expenses are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Ernst + Young LLP

May 29, 2019

Banner University Family Care

Balance Sheet – Acute and ALTCS Contracts

December 31, 2018

	Acute	ALTCS	Total
Assets			
Current assets:			
Cash and cash equivalent	\$ 208,754,395	\$ 53,177,567	\$ 261,931,962
Reinsurance receivable	8,478,931	3,039,049	11,517,980
Capitation and supplemental revenues receivable	494,314	–	494,314
Reconciliation receivable	3,613,589	2,683,662	6,297,251
Other current assets	4,955,465	843,203	5,798,668
Total current assets	226,296,694	59,743,481	286,040,175
Reconciliation receivable	9,765,064	13,865,723	23,630,787
Other assets	738,756	–	738,756
Total	\$ 236,800,514	\$ 73,609,204	\$ 310,409,718
Liabilities and net assets			
Current liabilities:			
Accounts payable	\$ 4,922,064	\$ 226,072	\$ 5,148,136
Due to affiliate	74,265,842	11,445,090	85,710,932
Medical claims payable	93,490,601	42,501,330	135,991,931
Reconciliation payable	6,560,306	–	6,560,306
Alternative payment model	6,014,236	3,000	6,017,236
Other current liabilities	3,003,720	631,462	3,635,182
Total current liabilities	188,256,769	54,806,954	243,063,723
Reconciliation and alternative payment model payable	7,054,610	3,185,430	10,240,040
Total liabilities	195,311,379	57,992,384	253,303,763
Net assets	41,489,135	15,616,820	57,105,955
Total	\$ 236,800,514	\$ 73,609,204	\$ 310,409,718

Banner University Family Care

Statement of Revenues and Expenses – Acute and ALTCS Contracts

Year Ended December 31, 2018

	Acute	ALTCS	Total
Revenue			
Capitation premiums	\$ 514,624,045	\$ 260,138,405	\$ 774,762,450
Delivery supplemental	17,091,495	–	17,091,495
Reconciliation settlement, net	5,245,761	16,764,392	22,010,153
Alternative payment model	16,926,518	–	16,926,518
Investment income, net	2,931,664	498,936	3,430,600
Premium deficiency reserve	2,600,000	–	2,600,000
Total revenues	<u>559,419,483</u>	<u>277,401,733</u>	<u>836,821,216</u>
Health care expenses			
Hospitalization	108,067,072	8,980,459	117,047,531
Medical compensation	150,069,126	16,187,900	166,257,026
Ancillary and other medical services	284,252,662	18,675,027	302,927,689
Institutional	–	123,660,078	123,660,078
Home and community based services	–	98,178,010	98,178,010
Case management services	–	11,656,589	11,656,589
Less reinsurance recoveries	(26,423,894)	(7,738,317)	(34,162,211)
Total healthcare expenses	<u>515,964,966</u>	<u>269,599,746</u>	<u>785,564,712</u>
General and administrative expenses	30,624,426	15,106,906	45,731,332
Premium tax expense	11,278,163	5,441,458	16,719,621
Total operating expenses	<u>557,867,555</u>	<u>290,148,110</u>	<u>848,015,665</u>
Net income (loss)	<u>\$ 1,551,928</u>	<u>\$ (12,746,377)</u>	<u>\$ (11,194,449)</u>

Banner University Family Care

Statement of Cash Flows – Acute and ALTCS Contracts

Year Ended December 31, 2018

	Acute	ALTCS	Total
Operating activities			
Net income (loss)	\$ 1,551,928	\$ (12,746,377)	\$ (11,194,449)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Changes in assets and liabilities:			
Reinsurance receivable	(3,260,705)	(2,718,838)	(5,979,543)
Capitation and supplemental revenues receivable	9,557,185	–	9,557,185
Reconciliation receivable	(8,346,138)	(16,549,385)	(24,895,523)
Other current assets	(3,267,292)	(669,332)	(3,936,624)
Accounts payable and other liabilities	(1,047,777)	476,892	(570,885)
Medical claims payable	46,588,378	7,523,382	54,111,760
Reconciliation and alternative payment model payables	(8,487,991)	2,567,421	(5,920,570)
Net cash provided by (used in) operating activities	33,287,588	(22,116,237)	11,171,351
Investing activities			
Decrease in other assets	5,733,176	–	5,733,176
Net cash provided by investing activities	5,733,176	–	5,733,176
Financing activities			
Increase in due to affiliate	20,430,606	9,471,682	29,902,288
Contribution from affiliate	7,200,000	15,400,000	22,600,000
Net cash provided by financing activities	27,630,606	24,871,682	52,502,288
Net increase in cash and cash equivalent	66,651,370	2,755,445	69,406,815
Cash and cash equivalent at beginning of period	142,103,025	50,422,122	192,525,147
Cash and cash equivalent at end of period	\$ 208,754,395	\$ 53,177,567	\$ 261,931,962

Banner University Family Care

Detail of Sub-Capitated Expenses

	Year Ended December 31	
	2018	2017
Dental expenses	\$ 20,662,601	\$ 17,342,281
Primary care physician services	<u>2,303,550</u>	<u>167,890</u>
Total sub-capitated expenses	<u>\$ 22,966,151</u>	<u>\$ 17,510,171</u>

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