# CONSOLIDATED FINANCIAL STATEMENTS

HonorHealth
Years Ended December 31, 2020 and 2019
With Report of Independent Auditors

Ernst & Young LLP

Building a better working world

HonorHealth

Consolidated Financial Statements

Years Ended December 31, 2020 and 2019

## Contents

Ernst & Young LLP
101 E. Washington Street
Suite 910
Phoenix, AZ 85004

Tel: +1 602 322 3000
ey.com

# Report of Independent Auditors

The Board of Directors
HonorHealth

We have audited the accompanying consolidated financial statements of HonorHealth, which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

## Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of 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 conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of HonorHealth at December 31, 2020 and 2019, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

March 19, 2021

HonorHealth

Consolidated Balance Sheets
*(In Thousands)*

| | December 31 | |
|---|---|---|
| | **2020** | **2019** |
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 470,894** | $ 254,786 |
| Short-term investments | **785,183** | 669,068 |
| Accounts receivable, net | **326,739** | 307,238 |
| Inventories | **77,822** | 63,674 |
| Assets whose use is limited | **7,196** | 5,126 |
| Prepaid expenses and other | **82,498** | 63,868 |
| Total current assets | **1,750,332** | 1,363,760 |
| | | |
| Assets whose use is limited, less current portion | **234,543** | 212,485 |
| Trust fund assets | **40,261** | 105,994 |
| Long-term investments | **295,945** | 315,557 |
| Property and equipment, net | **933,943** | 837,803 |
| Right of use assets – finance | **23,403** | 12,546 |
| Right of use assets – operating | **106,654** | 99,247 |
| Other assets | **155,358** | 98,304 |
| | | |
| Total assets | **$ 3,540,439** | $ 3,045,696 |

| | December 31 | |
|---|---|---|
| | **2020** | **2019** |
| **Liabilities and net assets** | | |
| Current liabilities: | | |
| Accounts payable | **$ 119,784** | $ 93,232 |
| Accrued expenses and other | **182,705** | 139,996 |
| Current portion of finance lease obligations | **4,808** | 1,568 |
| Current portion of operating lease obligations | **21,688** | 17,945 |
| Current portion of long-term debt | **21,389** | 20,733 |
| Current portion of CMS advance payment | **74,224** | – |
| Total current liabilities | **424,598** | 273,474 |
| | | |
| CMS advance payment, less current portion | **96,643** | – |
| Long-term debt, less current portion | **846,099** | 871,133 |
| Finance lease obligations, less current portion | **20,900** | 13,236 |
| Operating lease obligations, less current portion | **99,424** | 92,166 |
| Other liabilities | **152,842** | 120,606 |
| | | |
| Net assets: | | |
| Without donor restrictions: | | |
| Controlling | **1,631,511** | 1,481,385 |
| Noncontrolling | **47,931** | 12,251 |
| Total without donor restrictions | **1,679,442** | 1,493,636 |
| With donor restrictions | **220,491** | 181,445 |
| Total net assets | **1,899,933** | 1,675,081 |
| Total liabilities and net assets | **$ 3,540,439** | $ 3,045,696 |

*See accompanying notes.*

HonorHealth

# Consolidated Statements of Operations

*(In Thousands)*

| | Year Ended December 31 | |
|---|---|---|
| | **2020** | **2019** |
| Revenues: | | |
| Net patient service revenue | **$ 1,929,080** | $ 1,936,869 |
| Provider relief fund | **65,165** | – |
| Other | **158,809** | 119,750 |
| Total | **2,153,054** | 2,056,619 |
| Expenses: | | |
| Salaries and benefits | **1,006,572** | 974,630 |
| Supplies, services, and other | **939,335** | 864,612 |
| Depreciation and amortization | **114,958** | 111,966 |
| Interest | **29,904** | 33,437 |
| Total | **2,090,769** | 1,984,645 |
| Operating income | **62,285** | 71,974 |
| Investment income | **93,456** | 134,590 |
| Change in fair value of interest rate swaps | **(7,711)** | (7,581) |
| Other | **918** | 264 |
| Excess of revenues over expenses | **148,948** | 199,247 |
| Less excess of revenues over expenses attributable to noncontrolling interests | **(5,850)** | (5,402) |
| Excess of revenues over expenses attributable to HonorHealth | **$ 143,098** | $ 193,845 |

*See accompanying notes.*

HonorHealth

# Consolidated Statements of Changes in Net Assets

*(In Thousands)*

| | Year Ended December 31 | |
|---|---|---|
| | **2020** | **2019** |
| Net assets without donor restrictions: | | |
| Controlling: | | |
| Excess of revenues over expenses attributable to HonorHealth | **$ 143,098** | $ 193,845 |
| Net assets released from restriction for purchase of property and equipment | **5,672** | 6,167 |
| Amortization of aggregate fair value of interest rate swaps | **201** | 201 |
| Cumulative effect of change in accounting principle | **–** | 10,330 |
| Other changes | **1,155** | (10) |
| Increase in controlling | **150,126** | 210,533 |
| Noncontrolling: | | |
| Excess of revenues over expenses attributable to noncontrolling interests | **5,850** | 5,402 |
| Distributions to noncontrolling partners | **(3,271)** | (4,219) |
| Noncontrolling interest in acquired business venture | **33,075** | – |
| Contributions from noncontrolling partners | **26** | 52 |
| Increase in noncontrolling | **35,680** | 1,235 |
| Increase in net assets without donor restrictions | **185,806** | 211,768 |
| Net assets with donor restrictions: | | |
| Donations received | **32,660** | 24,817 |
| Investment income | **20,134** | 24,723 |
| Net assets released from restriction for purchase of property and equipment | **(5,672)** | (6,167) |
| Net assets released from restriction for use in operations | **(8,076)** | (11,852) |
| Increase in net assets with donor restrictions | **39,046** | 31,521 |
| Increase in net assets | **224,852** | 243,289 |
| Net assets, beginning of year | **1,675,081** | 1,431,792 |
| Net assets, end of year | **$ 1,899,933** | $ 1,675,081 |

*See accompanying notes.*

# HonorHealth

## Consolidated Statements of Cash Flows
*(In Thousands)*

| | Year Ended December 31 | |
|---|---|---|
| | **2020** | **2019** |
| **Operating activities** | | |
| Increase in net assets | **$ 224,852** | $ 243,289 |
| Adjustments to reconcile increase in net assets to net cash provided by operating activities: | | |
| Depreciation and amortization | **114,958** | 111,966 |
| Bond premium and discount amortization | **(3,014)** | (3,140) |
| Increase in investments designated as trading | **(96,503)** | (226,213) |
| Noncontrolling interest in acquired business venture | **(33,075)** | – |
| Change in fair value of interest rate swaps | **7,711** | 7,581 |
| Cumulative effect of change in accounting principle | **–** | (10,330) |
| Donor-restricted donations | **(32,660)** | (24,817) |
| Net change in operating assets and liabilities, exclusive of cash | | |
| Increase in accounts receivable | **(11,793)** | (32,468) |
| Increase in inventories | **(13,784)** | (4,794) |
| Increase in prepaid expense and other | **(17,711)** | (23,300) |
| Increase in accounts payable and accrued expense | **58,010** | 18,746 |
| Increase in CMS advance payment | **170,867** | – |
| Increase (decrease) in other liabilities | **26,782** | (2,650) |
| Net cash provided by operating activities | **394,640** | 53,870 |
| **Investing activities** | | |
| Purchases of property and equipment, net | **(190,917)** | (121,964) |
| Decrease (increase) in trust fund assets | **65,733** | (84,782) |
| Increase in assets whose use is limited | **(24,128)** | (15,639) |
| Business venture acquisition | **(34,427)** | – |
| (Increase) decrease in other assets | **(2,755)** | 8,812 |
| Net cash used in investing activities | **(186,494)** | (213,573) |
| **Financing activities** | | |
| Payments on long-term debt | **(21,364)** | (17,233) |
| Repayment of Series 2008A Bonds and 2014 taxable note | **–** | (114,147) |
| Proceeds from issuance of debt | **–** | 310,540 |
| Principal payments on finance lease obligations | **(3,334)** | (2,918) |
| Cash distributions to noncontrolling partners | **–** | (4,219) |
| Donor-restricted donations | **32,660** | 24,817 |
| Net cash provided by financing activities | **7,962** | 196,840 |
| Increase in cash and cash equivalents | **216,108** | 37,137 |
| Cash and cash equivalents at beginning of year | **254,786** | 217,649 |
| Cash and cash equivalents at end of year | **$ 470,894** | $ 254,786 |
| **Noncash activity** | | |
| Property and equipment and accounts payable | **$ 8,205** | $ 4,336 |
| Property and equipment and finance lease obligation | **$ 14,564** | $ 6,458 |
| Excess insurance carrier receivable and payable | **$ (2,257)** | $ 3,215 |

*See accompanying notes.*

## 1. Description of Business

HonorHealth is a nonprofit corporation exempt from income taxes under Internal Revenue Code Section 501(c)(3) and applicable state income tax codes. HonorHealth and its subsidiaries (the Company) own six acute care hospitals located in Scottsdale and Phoenix, Arizona; a captive insurance company, HonorHealth Captive Insurance Exchange (the Captive); ambulatory care centers; Innovation Care Partners (ICP), an accountable care organization (ACO); medical practices; HonorHealth Foundation (Foundation), which conducts fundraising and development programs for the benefit of the Company; and Desert Mission, an organization that provides family services, child care services, and health services for low-income families.

The Company also holds a controlling interest in the following business ventures:

- HonorHealth ASC, LLC, formed to create partnerships with physicians and to expand outpatient surgical settings outside of the hospital campuses.

- Global Rehab – Scottsdale, LLC, formed to lease a rehabilitation hospital and provide rehabilitation services to patients.

- HonorHealth-FastMed Ambulatory Holdings, LLC, formed to operate urgent care centers in the state of Arizona (see Note 5).

The Company holds noncontrolling interests in several health-related business ventures that are accounted for using the equity or cost method of accounting.

## 2. Summary of Significant Accounting Policies

### Basis of Consolidation

The accompanying consolidated financial statements include the accounts of HonorHealth and its wholly owned subsidiaries and controlled business ventures. The Company records the unrelated investor's share of the controlled business venture as noncontrolling interests on the accompanying consolidated balance sheets and consolidated statements of operations. All significant intercompany accounts and transactions have been eliminated in consolidation.

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

### Use of Estimates

The preparation of the accompanying consolidated financial statements in conformity with generally accepted accounting principles 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 consolidated financial statements. Estimates also affect the revenues and expenses recorded during the period. Actual results could differ from those estimates.

### Fair Values

Carrying values of financial instruments classified as current assets and current liabilities approximate fair value due to the short-term liquidity of these instruments. The fair values of other financial instruments are disclosed in their respective notes.

### Cash and Cash Equivalents

Cash and cash equivalents include all highly liquid investments with a remaining maturity of three months or less at the date of acquisition.

### Short-Term Investments

Short-term investments include securities with maturity dates of one year or less from the balance sheet date and actively traded equity securities that are expected to be used on a short-term basis for working capital needs. These investments are stated at fair value, based on quoted market prices in active markets.

### Investments

The Company invests in various investment securities, such as equities, bonds, mutual funds, and alternative investments, which are exposed to various risks, such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated financial statements.

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

The Company invests in alternative investments, mainly hedge funds and private equity funds (the funds), through limited partnerships. The Company accounts for its ownership interests in these alternative investments under the equity method of accounting based on the net asset value per share of the fund held by the Company. The fund net asset value is provided to the Company by each of the fund managers and is determined based on the estimated fair value of each of the underlying investments held in the funds. However, the fund's investment holdings may include investments in private investment funds whose values have been estimated by the fund managers in the absence of readily ascertainable fair values. Due to the inherent uncertainty of these estimates, these values may differ from the values that would have been used had a ready market for these investments existed. Certain of the Company's alternative investments include provisions in which the fund can require future capital calls up to approximately $4,412,500. The Company is not aware of any capital calls that will be made through December 31, 2021. Alternative investments of approximately $15,000,000 have a lockup period ranging from six to ten years.

Interest income, realized gains and losses, income on alternative investments, and unrealized gains and losses on investments are included in excess of revenues over expenses attributable to the Company, unless the income is restricted by the donor.

### Patient Accounts Receivable

Patient accounts receivable have been adjusted to the estimated amounts expected to be received for services rendered, inclusive of an estimated allowance for implicit price concessions. These estimated amounts are subject to further adjustments upon review by third-party payors. Management estimates the allowance for price concessions based upon a number of factors, including current contract prices, historical collection experience of each hospital, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with payors, and general economic conditions. Management regularly reviews payment data for each major payor in evaluating the sufficiency of the estimated allowance for price concessions.

### Inventories

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

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

### Assets Whose Use is Limited

Assets whose use is limited include financial instruments that are to be used for the Captive's self-insurance funding arrangements and the Foundation's restricted funds.

### Trust Fund Assets

Trust fund assets include allowable financial instruments that have been designated for payments under bond indenture agreements.

### Property and Equipment

Property and equipment are stated at cost, if purchased, or at fair value on the date received, if donated, less accumulated depreciation and amortization. Upon sale or retirement, cost and accumulated depreciation are eliminated from the respective accounts and any resulting gain or loss is included in excess of revenues over expenses. Depreciation is computed using the straight-line method over the estimated useful life of each class of depreciable asset, primarily ranging from 3 to 30 years. Routine maintenance and repairs are charged to expense when incurred. Expenditures that extend useful lives or increase capacities are capitalized. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

### Goodwill

Purchases of acquired businesses, including purchase of a controlling interest in business ventures, are allocated to the assets and liabilities assumed based on the estimated fair values on the respective acquisition dates. Based on these values, the excess purchase price over the fair value of the net assets acquired is allocated to goodwill.

The Company adopted Accounting Standards Update No. (ASU) 2019-06, *Intangibles – Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities*, in 2019. ASU 2019-06 allows for goodwill to be amortized on a straight-line basis over ten years or less if a shorter useful life is more appropriate. The Company is amortizing goodwill over ten years. Goodwill is subject to

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

impairment evaluation when a triggering event occurs that indicates that the fair value of the entity is below its carrying amount. The Company has not identified any impairment triggering events as of December 31, 2020 or 2019.

### Impairment of Long-Lived Assets

The Company reviews long-lived assets, other than goodwill, for impairment when events or changes in business conditions indicate that their carrying values may not be recoverable. The Company 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. The Company has not identified any impairment event as of December 31, 2020 or 2019.

### Self-Insurance Programs

In connection with the Company's self-insurance programs, accounts have been established for the purpose of accumulating assets based on actuarial determinations. These assets can be used only for the payment of professional liability, general liability, workers' compensation, life insurance claims, and related expenses. It is the Company's policy to record the expense and related liability for professional liability, general liability, workers' compensation, and life insurance claims based upon undiscounted actuarial estimates. Self-insurance liabilities include estimates of the ultimate costs for both asserted and incurred but not reported claims for professional liability, workers' compensation, general liability, and life insurance claims.

### Net Assets

Net assets are classified based on the existence or absence of donor or grantor imposed restrictions. Revenues and gains that are available for general operations and are not subjected to donor restrictions are included in net assets without donor restrictions.

Net assets with donor restrictions are those whose use by the Company has been limited by donors or grantors to a specific time period or purpose. Net assets with donor restrictions also consist of endowment fund donations that have been restricted by donors to be maintained by the Foundation in perpetuity.

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

### Net Patient Service Revenue

The Company has agreements with third-party payors (including government programs) that provide for payments to the Company at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated transaction price to reflect the total consideration expected to be received from patients, third-party payors, and others for providing patient care.

The Company uses a portfolio approach to estimate the transaction price for categories of patient contracts as a collective group rather than recognizing revenue on an individual contract basis. The portfolios consist of major payor classes for inpatient revenue and outpatient revenue. Based on historical collection trends and other analyses, the Company believes that revenue recognized by utilizing the portfolio approach approximates the revenue that would have been recognized if an individual contract approach were used.

The Company estimates the transaction price associated with services provided to patients who have third-party payor coverage based on the reimbursement terms outlined in contractual agreements and historical experience and includes estimated retroactive revenue adjustments under the agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as final settlements are determined. For uninsured and underinsured patients who do not qualify for charity care, the Company determines the transaction price associated with services on the basis of charges reduced by implicit price concessions. Implicit price concessions included in the estimate of the transaction price are based on the Company's historical collection experience for applicable patient portfolios.

Net patient service revenue is recognized as performance obligations are satisfied. Revenue for performance obligations satisfied over time is recognized based on the expected reimbursement for each of the performance obligations. Unsatisfied or partially unsatisfied performance obligations relate to inpatients not discharged at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, which generally occurs within days or weeks of the end of the reporting period. Outpatient services performance obligations are satisfied over a period of time, which is typically less than one day, and revenue is recognized when goods or services are provided, and the Company does not believe it is required to provide additional goods or services.

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

### Contributions

All contributions are considered without restrictions unless specifically restricted by the donor. Amounts received that are designated for future periods or are restricted by the donor for specific purposes are reported as contributions with donor restrictions.

Restricted monetary gifts that are specifically donor designated are held in net assets with donor restrictions until the designation is met. When a donor designation is met, a stipulated time restriction ends, or a purpose restriction is accomplished, net assets with donor restrictions are reclassified to net assets without donor restrictions.

The Company reports unconditional promises to give as donor-restricted contributions. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their estimated future cash flows, using risk-free interest rates when the unconditional promise is made. The discount rates used to record unconditional promises ranged from 0.1% to 1.0% in 2020 and 2019.

The Company reports conditional promises to give as contribution revenue when the conditions stipulated by the donor are met, at which time the conditional promise becomes unconditional.

### Charity Care and Community Benefit

In the furtherance of its charitable purpose, the Company provides charity care and other benefits to the community it serves. The Company's charity care policy is designed to provide traditional charity care without charge or at amounts less than established rates. Because the Company 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, the Company assumes the unpaid costs of public programs, including Medicare and the Arizona Health Care Cost Containment System (AHCCCS), and delivers community outreach programs that include health education, diagnostic screenings, community health assessment surveys, and mobile services.

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

The Company estimates charity care costs based on the Company's cost to charge ratio, which includes both direct and indirect costs. Costs incurred for providing charity care and other community benefits consist of the following for the years ended December 31 (in thousands):

| | **2020** | **2019** |
|---|---|---|
| Unpaid costs relating to the AHCCCS program | **$ 119,219** | $ 86,221 |
| Costs of providing community outreach programs | **30,122** | 26,746 |
| Traditional charity care, at cost | **27,212** | 29,273 |
| | **176,553** | 142,240 |
| Unpaid costs relating to the Medicare program | **215,245** | 117,098 |
| | **$ 391,798** | $ 259,338 |

**Performance Indicator**

The performance indicator is the excess of revenues over expenses attributable to the Company, which includes all changes in net assets without donor restrictions other than the net assets released from restriction for purchase of property and equipment, amortization of aggregate fair value of interest rate swaps, the cumulative effect of change in accounting principles and other changes.

**New Accounting Pronouncements**

In June 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326*): *Measurement of Credit Losses on Financial Instruments*. The accounting standard focuses on estimation of expected losses on credit or loan amounts over the life of the loan and losses on other financial assets. The standard is effective on January 1, 2023. The Company is currently evaluating the impact on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-15, *Intangibles – Goodwill and Other, Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract*. This accounting standard aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The accounting standard is effective for fiscal years beginning after December 15, 2020, with early adoption permitted. The Company is currently evaluating the impact on its consolidated financial statements.

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

### Subsequent Events

Recognized subsequent events are required to be recognized in the financial statements, and non-recognized subsequent events are required to be disclosed. The Company has evaluated subsequent events through the date of issuance, March 19, 2021.

The Company issued Hospital Revenue Bonds Series 2021A, 2021B, and 2021C bonds (2021 Bonds) through the Industrial Development Authority of the County of Maricopa on February 11, 2021. The 2021 bonds comprise $168,180,000 Series 2021A tax-exempt fixed bonds, $50,000,000 Series 2021B taxable fixed bonds, and $76,600,000 Series 2021C tax-exempt variable rate bonds. The Company recorded a loss on bond redemption of approximately $7,611,000 in February 2021, primarily relating to the write-off of the bond insurance premium that was canceled as part of the bond transaction.

The 2021 Bond proceeds will be used for the expansion of Deer Valley Medical Center, reimbursement for other capital equipment purchases and the redemption of the Series 2006C, 2006F, 2015A and 2015B Hospital Revenue Bonds.

The Company has an agreement with a real estate investment company to sell certain non-acute facilities located on the Sonoran Crossing and Osborn campuses and enter into a long-term lease for a portion of the facilities.

## 3. Net Patient Service Revenue

The Company has agreements with third-party payors that provide for payments to the Company at amounts different from its established rates.

A summary of the payment arrangements with major third-party payors follows:

> *Commercial and Managed Care Payors*: The Company has entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the Company under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

## 3. Net Patient Service Revenue (continued)

*Medicare*: Inpatient and outpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Defined medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. The Company is reimbursed for cost-reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports by the Company and audits thereof by the Medicare fiscal intermediary. The continuation of the Medicare program is dependent on government policies.

Laws and regulations governing the Medicare program are 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.

*AHCCCS*: Inpatient services rendered to AHCCCS program beneficiaries are reimbursed based on prospectively determined rates based on clinical diagnosis. Outpatient services are reimbursed based on a fee schedule. On October 27, 2020, AHCCCS received federal approval to implement a new supplemental payment program for hospitals through the Hospital Enhanced Access Leading to Health Improvements Initiative (HEALTHII), beginning October 1, 2020. The Company recorded approximately $23,767,000 in HEALTHII revenue within net patient revenue for the year ended December 31, 2020.

In connection with the AHCCCS Medicaid Restoration program, certain hospitals within the state of Arizona were required to pay a hospital assessment fee to assist with the funding of increased Medicaid costs. For the years ended December 31, 2020 and 2019, the Company paid approximately $57,813,000 and $36,190,000, respectively, in AHCCCS hospital assessment fees that are recorded within supplies, services, and other expenses.

*Self-Pay*: Self-pay includes patients without insurance and patients with deductibles and coinsurance associated with third-party payor coverage. For self-pay patients who do not qualify for charity care, the Company recognizes revenue on the basis of uninsured discounted or standard rates.

## 3. Net Patient Service Revenue (continued)

The Company has determined that the nature, amount, timing, and uncertainty of revenue and cash flows are affected by the payors, the lines of business that render services to patients and the timing of when revenue is recognized and billed. Net patient service revenue for the years ended December 31 is as follows (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Commercial and managed care | **$ 913,369** | $ 906,005 |
| Medicare | **803,621** | 818,948 |
| AHCCCS | **199,962** | 198,883 |
| Self-pay | **12,128** | 13,033 |
| Net patient service revenue | **$ 1,929,080** | $ 1,936,869 |

Net patient service revenue for the years ended December 31, by line of business, is as follows (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Hospital | **$ 1,741,850** | $ 1,753,291 |
| Physician services | **118,692** | 117,469 |
| Ambulatory services business venture | **38,120** | 42,743 |
| Rehabilitation business venture | **27,052** | 23,366 |
| Urgent care business venture | **3,366** | – |
| | **$ 1,929,080** | $ 1,936,869 |

## 4. Concentration of Credit Risk

The Company grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor arrangements that include (i) commercial and managed care contracts, (ii) Medicare, (iii) Medicaid funded through AHCCCS, and (iv) self-pay.

**4. Concentration of Credit Risk (continued)**

The following table summarizes the percentage of net accounts receivable as of December 31:

| | **2020** | **2019** |
|---|---|---|
| Commercial and managed care | **55%** | 61% |
| Medicare | **36** | 29 |
| AHCCCS | **8** | 8 |
| Self-pay | **1** | 2 |
| | **100%** | 100% |

The Company recognizes revenue from governmental agencies and managed care organizations is significant to the Company's operations, but management does not believe that there are any significant credit risks associated with these payors.

**5. HonorHealth-FastMed Ambulatory Holdings**

On December 1, 2020, the Company entered a business venture to operate HonorHealth-FastMed Ambulatory Holdings, LLC (FastMed) urgent care centers. The Company holds a controlling interest in the business venture. Total consideration paid for the controlling interest in FastMed amounted to $34,427,000.

The FastMed business venture has been accounted for as an acquisition in accordance with the not-for-profit business combination accounting standards. The FastMed purchase price was allocated to net tangible assets acquired, based upon their estimated fair values as of December 1, 2020. Results of operations of FastMed have been included in the Company's consolidated financial statements since December 1, 2020. The fair values assigned to the assets acquired and liabilities assumed are as follows (in thousands):

| | | |
|---|---|---|
| Current assets | $ | 8,719 |
| Property and equipment | | 2,048 |
| Other assets | | 68,364 |
| Current liabilities | | 3,026 |
| Noncurrent liabilities | | 8,603 |
| Minority interest | | 33,075 |

Included in the purchase price allocation above is approximately $56,785,000 of goodwill.

## 6. Fair Value of Financial Instruments

Fair value measurements used by the Company for all financial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements are based on the premise that fair value is defined as an exit price representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the following three-tier fair value hierarchy has been used in determining the input used in measuring fair value:

- *Level 1*: Pricing is based on observable inputs, such as quoted prices in active markets for identical instruments.

- *Level 2*: Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

- *Level 3*: Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are, therefore, determined using factors that involve considerable judgment and interpretations, including, but not limited to, private and public comparable activity, third-party appraisals, discounted cash flow models, and fund manager estimates.

Assets and liabilities measured at fair value are based on one or more of the following two valuation techniques. Where more than one technique is noted, individual assets or liabilities were valued based upon the lowest level of input that is significant to the fair value estimate. 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) 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).

## 6. Fair Value of Financial Instruments (continued)

The Company's alternative investments were approximately $60,541,000 and $114,377,000 as of December 31, 2020 and 2019, respectively, which are omitted from the fair value hierarchy in the following schedule, as they are accounted for using the equity method of accounting.

The Company held the following investments as of December 31, which are recorded within the consolidated balance sheets as follows:

| | 2020 | Quoted Price in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Valuation Technique (a, b) |
|---|---|---|---|---|---|
| | | | *(In Thousands)* | | |
| **Money market** | $ 42,018 | $ 42,018 | $ – | $ – | a |
| **Debt securities** | | | | | |
| U.S. Treasury/government obligations | 53,279 | – | 53,279 | – | a |
| Corporate bonds | 89,533 | – | 89,533 | – | a |
| Mortgage, asset-backed securities, and commercial paper | 117,951 | – | 117,951 | – | a |
| **Equity securities** | | | | | |
| Marketable U.S. equity securities | 192,195 | 192,195 | – | – | a |
| International equities | 69,352 | 69,352 | – | – | a |
| **Guaranteed investment contract** | 5,617 | – | – | 5,617 | b |
| **Mutual funds** | | | | | |
| Mutual funds – U.S. funds | 654,081 | 654,081 | – | – | a |
| Mutual funds – international | 105,554 | 105,554 | – | – | a |
| Total investments at fair value | $ 1,329,580 | $ 1,063,200 | $ 260,763 | $ 5,617 | |
| Short-term investments | $ 785,183 | | | | |
| Assets whose use is limited | 241,739 | | | | |
| Trust fund assets | 40,261 | | | | |
| Long-term investments | 295,945 | | | | |
| Other assets (457(b) plan assets) | 26,993 | | | | |
| Less alternative investments | (60,541) | | | | |
| Total fair value investments | $ 1,329,580 | | | | |
| Interest rate swap liability (included in other liabilities) | $ (41,023) | $ – | $ (41,023) | $ – | b |

## 6. Fair Value of Financial Instruments (continued)

| | 2019 | Quoted Price in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Valuation Technique (a, b) |
|---|---|---|---|---|---|
| | | | *(In Thousands)* | | |
| **Money market** | $ 37,056 | $ 37,056 | $ – | $ – | a |
| **Debt securities** | | | | | |
| U.S. Treasury/government obligations | 37,578 | – | 37,578 | – | a |
| Corporate bonds | 68,707 | – | 68,707 | – | a |
| Mortgage, asset-backed securities, and commercial paper | 197,419 | – | 197,419 | – | a |
| **Equity securities** | | | | | |
| Marketable U.S. equity securities | 151,208 | 151,208 | – | – | a |
| International equities | 61,154 | 61,154 | – | – | a |
| **Guaranteed investment contract** | 4,288 | – | – | 4,288 | b |
| **Mutual funds** | | | | | |
| Mutual funds – U.S. funds | 569,038 | 569,038 | – | – | a |
| Mutual funds – international | 90,747 | 90,747 | – | – | a |
| Total investments at fair value | $ 1,217,195 | $ 909,203 | $ 303,704 | $ 4,288 | |
| | | | | | |
| Short-term investments | $ 669,068 | | | | |
| Assets whose use is limited | 217,611 | | | | |
| Trust fund assets | 105,994 | | | | |
| Long-term investments | 315,557 | | | | |
| Other assets (457(b) plan assets) | 23,342 | | | | |
| Less alternative investments | (114,377) | | | | |
| Total fair value investments | $ 1,217,195 | | | | |
| | | | | | |
| Interest rate swap liability (included in other liabilities) | $ (33,513) | $ – | $ (33,513) | $ – | b |

The fair value of long-term debt was approximately $906,645,000 and $926,021,000 as of December 31, 2020 and 2019, respectively. The estimated long-term debt fair value is based on quoted market prices for the debt issues or, where such prices are not available, on current interest rates for debt with similar remaining maturities (Level 2 in the fair value hierarchy).

## 7. Assets Whose Use is Limited

Assets whose use is limited primarily include assets held by the Foundation that are restricted for use and assets that have been set aside for payment of medical malpractice, general liability, workers' compensation, and life insurance claims, in accordance with the Company's self-insurance programs.

Assets whose use is limited consist of the following as of December 31 (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Foundation funds | **$ 186,905** | $ 169,351 |
| General and professional liability and workers' compensation funds | **49,603** | 44,223 |
| Rabbi trust retirement plan funds | **5,231** | 4,037 |
| | **241,739** | 217,611 |
| Less current portion | **(7,196)** | (5,126) |
| | **$ 234,543** | $ 212,485 |

A summary of investment income consists of the following for the years ended December 31 (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Interest and dividend income, net of fees | **$ 17,914** | $ 20,585 |
| Net realized gains on sales of investments | **23,345** | 62,648 |
| (Loss) income from alternative investments | **(19,940)** | 3,001 |
| Change in unrealized gains, net | **72,137** | 48,356 |
| | **$ 93,456** | $ 134,590 |

## 8. Property and Equipment

Property and equipment consist of the following as of December 31 (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Land and improvements | **$ 163,379** | $ 159,210 |
| Buildings and improvements | **1,087,734** | 975,723 |
| Equipment | **915,892** | 871,915 |
| Construction-in-progress | **121,913** | 100,742 |
| | **2,288,918** | 2,107,590 |
| Less accumulated depreciation and amortization | **(1,354,975)** | (1,269,787) |
| | **$ 933,943** | $ 837,803 |

A substantial portion of real property and related equipment owned by the Company secures the Company's tax-exempt debt obligations.

## 9. Other Assets

Other assets consist of the following as of December 31 (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Bond insurance, net of amortization | **$ 7,847** | $ 8,230 |
| Insurance recovery receivable | **11,043** | 13,300 |
| 457(b) plan assets | **26,993** | 23,342 |
| Noncontrolling investment in business ventures | **14,461** | 15,820 |
| Goodwill, net of amortization of $5,754 and $2,635 in 2020 and 2019, respectively | **77,507** | 23,715 |
| Intangible asset – trademark | **3,000** | – |
| Other | **14,507** | 13,897 |
| | **$ 155,358** | $ 98,304 |

## 10. Long-Term Debt

| | December 31 2020 | 2019 |
|---|---|---|
| | *(In Thousands)* | |
| Series 2006C Hospital Revenue Bonds with a fixed interest rate of 5.00%. Interest is due semiannually. Bonds were redeemed in February 2021. | **$ 58,350** | $ 58,350 |
| Series 2006F Hospital Revenue Bonds with a variable interest rate determined weekly by an auction agent. Interest is due weekly. At December 31, 2020 and 2019, the interest rate was 0.17% and 1.89%, respectively. Bonds were redeemed in February 2021. | **89,700** | 89,700 |
| Series 2014A Hospital Revenue Bonds with a fixed interest rate of 5.00%. Interest is due semiannually. Principal due in annual debt service payments ranging from $4,155 to $29,115, with final maturity in 2042. | **280,710** | 284,730 |
| Series 2015A Hospital Revenue Bonds with a fixed interest rate of 4.36%. Interest is due semiannually. Bonds were redeemed in February 2021. | **34,380** | 34,380 |
| Series 2015B Hospital Revenue Bonds with a fixed interest rate of 3.35%. Interest is due semiannually. Bonds were redeemed in February 2021. | **13,360** | 13,360 |
| Series 2019A Hospital Revenue Bonds with fixed interest rates of 4.13% and 5.00%. Interest is due semiannually. Principal due in annual debt service payments ranging from $3,625 to $16,425, with final maturity in 2042. | **181,850** | 188,679 |
| Series 2019B Hospital Revenue Bonds with an initial long-term fixed interest rate of 5.00% through 2024, at which time the 2019B Bonds are subject to mandatory mode and interest reset. Interest is due semiannually. Principal due in annual debt service payments starting in 2043 ranging from $14,530 to $15,565, with final maturity in 2045. | **45,135** | 45,136 |

## 10. Long-Term Debt (continued)

| | December 31 2020 | December 31 2019 |
|---|---|---|
| | *(In Thousands)* | |
| Series 2019C Hospital Revenue Bonds with a variable interest rate. Interest is due monthly. At December 31, 2020 and 2019, the interest rate was 0.89% and 2.41%, respectively. The 2019C Bonds are subject to mandatory mode and interest reset in 2024, at which time the interest rate and mode will be determined. Principal due in annual debt service payments starting in 2046 ranging from \$16,250 to \$17,405, with final maturity in 2048. | **\$ 50,470** | \$ 50,470 |
| Equipment note with fixed interest rate of 2.10%. Interest is due monthly. Principal due in annual debt service payments ranging from \$8,541 to \$11,093, with final maturity in 2027. The note is collateralized by certain hospital equipment, as defined in the note agreement. | **71,741** | 81,523 |
| Other notes payable | **770** | 1,119 |
| Unamortized premiums and discounts, net | **46,780** | 50,639 |
| Bond issuance cost | **(5,758)** | (6,220) |
| | **867,488** | 891,866 |
| Less current portion | **(21,389)** | (20,733) |
| | **\$ 846,099** | \$ 871,133 |

All of the bond issues are limited obligations of the Industrial Development Authority of the City of Scottsdale, Industrial Development Authority of the County of Maricopa, and the Arizona Health Facilities Authority and are payable from payments to be made under related loan agreements by the Company's Obligated Group (the Obligated Group) as defined in the Master Trust Indenture. In connection with the 2014 bond transaction, the Master Trust Indenture was amended to include all of the wholly owned entities of the Company, excluding the Foundation, Desert Mission, ACO, and the Captive. The 2014 Master Trust Indenture amendment will be effective in 2021. The loan agreements require the Obligated Group to make payments on the notes to the trustee in amounts that are sufficient to pay the principal and interest on the bonds when due. In addition, the loan agreements require the Obligated Group to maintain compliance with certain financial covenants. At December 31, 2020 and 2019, the Obligated Group was in compliance with these debt covenants.

## 10. Long-Term Debt (continued)

The Series 2006C and Series 2006F Hospital Revenue Bonds are insured by Financial Security Assurance, Inc. (FSA) for scheduled principal and interest payments or mandatory sinking account redemption. FSA holds the right to consent on behalf of bond owners to amendments of the bond indentures, loan agreements, deed of trust, or the Master Trust Indenture without notice or consent of the bond owners. In addition, FSA requires the Obligated Group to maintain compliance with certain financial covenants. At December 31, 2020 and 2019, the Obligated Group was in compliance with these debt covenants. The Series 2006C and Series 2006F Hospital Revenue Bonds were redeemed in full on February 11, 2021, and the FSA insurance policy was canceled. The Series 2014A, Series 2015A, Series 2015B, Series 2019A, Series 2019B, and Series 2019C Hospital Revenue Bonds are not insured.

Future maturities of long-term debt at December 31, 2020 are as follows (in thousands). The future maturities of long-term debt exclude net unamortized premiums, discounts, and bond issuance costs included within long-term debt, and also do not present the redemption of the Series 2006C, 2006F, 2015A, or 2015B bonds that occurred in February 2021.

| | |
|---|---|
| 2021 | $ 21,389 |
| 2022 | 22,418 |
| 2023 | 24,580 |
| 2024 | 26,046 |
| 2025 | 26,862 |
| Thereafter | 705,171 |
| | $ 826,466 |

Interest expense consists of the following for the years ended December 31 (in thousands):

| | **2020** | 2019 |
|---|---|---|
| Interest paid during the year | **$ 32,482** | $ 29,810 |
| Interest costs capitalized | **(6,354)** | (2,072) |
| Interest rate swap payments | **3,664** | 2,447 |
| Change in accrued interest | **112** | 3,252 |
| | **$ 29,904** | $ 33,437 |

## 10. Long-Term Debt (continued)

### Interest Rate Swap Agreements

In May 2006, the Company entered into multiple interest rate swap agreements that effectively convert the variable rate of the 2006 Bonds into fixed rates. The interest rate swaps are insured by Assurance Guaranty and are subject to collateral posting if the rating of Assurance Guaranty falls below a threshold defined in the swap agreement. There were no collateral postings as of December 31, 2020 or 2019. The Company entered into a two-year Swap Management Agreement with Assurance Guaranty on February 11, 2021, which maintained the same collateral posting levels.

The interest rate swaps did not qualify for hedge accounting treatment under accounting standards for derivative instruments and hedging activity. As of December 31, 2020 and 2019, the estimated fair value of the interest rate swaps resulted in a net imputed obligation of approximately $41,023,000 and $33,513,000, respectively, which is recorded in other long-term liabilities on the accompanying consolidated balance sheets. For the years ended December 31, 2020 and 2019, the Company recognized a loss of approximately $7,711,000 and $7,581,000, respectively, for the aggregate change in the fair value of the interest rate swaps. The fair value of the interest rate swaps is based on the forward London Interbank Offered Rate curve, with a blended average duration of approximately 20 years.

The net realized portion of the interest rate swaps for the years ended December 31, 2020 and 2019, recorded in interest expense, was approximately $3,664,000 and $2,447,000, respectively.

## 11. Leases

The Company leases office and clinical facilities as well as equipment under operating and finance type leases. The Company adopted ASU 2016-02, *Leases (Topic 842)*, which requires leases to be recognized on the consolidated balance sheets, effective January 1, 2019, using the modified retrospective approach. The Company recognized a right of use asset of approximately $111,793,000, a lease obligation of $124,915,000, and a cumulative effect of change in accounting principle of $10,330,000 as of January 1, 2019. The cumulative effect of change in accounting principle relates to the reversal of the deferred gain on sale leaseback transactions as of January 1, 2019. For leases with terms greater than 12 months, management records the related right of use assets and lease obligations at the present value of lease payments over the lease term. The Company has elected to exclude non-lease components from the minimum rent payment used to

## 11. Leases (continued)

calculate the right of use assets and liabilities. The Company uses a risk-free discount rate commensurate with the lease term to determine the present value of lease payments. Several of the Company's leases include rental escalation clauses and renewal options that are factored into management's determination of lease payments, when appropriate.

The following table summarizes the weighted average lease term and discount rate as of December 31:

| | **2020** | **2019** |
|---|---|---|
| Weighted average remaining term: | | |
| Operating leases | **5 years** | 7 years |
| Finance leases | **8 years** | 13 years |
| | | |
| Weighted average discount rate: | | |
| Operating leases | **2.7%** | 2.5% |
| Finance leases | **1.7** | 3.0 |

The following table reconciles the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recorded on the balance sheet as of December 31, 2020 (in thousands):

| | **Operating Leases** | **Finance Leases** |
|---|---|---|
| 2021 | $ 24,843 | $ 5,508 |
| 2022 | 22,233 | 5,416 |
| 2023 | 19,358 | 5,237 |
| 2024 | 15,542 | 3,419 |
| 2025 | 12,624 | 1,390 |
| Thereafter | 37,229 | 9,698 |
| Total minimum lease payments | 131,829 | 30,668 |
| Less amount of lease payments representing interest | (10,717) | (4,960) |
| Present value of future minimum lease payments | 121,112 | 25,708 |
| Less current obligations under leases | (21,688) | (4,808) |
| Long-term lease obligations | $ 99,424 | $ 20,900 |

## 11. Leases (continued)

The lease cost components, by lease type, for the years ended December 31 are as follows (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Finance lease expense: | | |
| Amortization of leased assets | **$ 3,686** | $ 527 |
| Interest on lease liabilities | **224** | 53 |
| Operating leases | **30,176** | 26,386 |
| Short-term leases | **9,809** | 8,187 |
| Total lease cost | **$ 43,895** | $ 35,153 |

The Company accounts for all rent holidays, tenant improvement allowances, and escalation clauses by recognizing the total operating lease rent expense on a straight-line basis over the term of each operating lease. The difference between the lease expense recognized and the actual lease payment is recorded as deferred rent. Supplemental lease cash flow information for the years ended December 31 is as follows (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Cash paid for amounts included in the measurement of lease liabilities: | | |
| Operating cash flows for operating leases | **$ 31,146** | $ 22,575 |
| Operating cash flows for finance leases | **224** | 53 |

## 12. Other Liabilities

Other liabilities consist of the following as of December 31 (in thousands):

| | 2020 | 2019 |
|---|---|---|
| Accrued medical malpractice and general insurance liability | **$ 42,357** | $ 37,352 |
| Executive deferred compensation 457(b) | **26,993** | 23,342 |
| Supplemental executive retirement plan | **5,494** | 4,307 |
| Fair value of interest and basis rate swaps | **41,023** | 33,513 |
| Deferred ground lease revenue | **7,573** | 7,682 |
| Accrued workers' compensation liability | **9,543** | 11,911 |
| CARES Act employer tax deferral | **16,843** | – |
| Charitable gift annuities and other | **3,016** | 2,499 |
| | **$ 152,842** | $ 120,606 |

## 13. Net Assets

Net assets with donor restrictions are restricted for the following purposes as of December 31 (in thousands):

| | 2020 | 2019 |
|---|---|---|
| **Subject to expenditure for specified purpose** | | |
| Hospital programs | **$ 40,474** | $ 22,160 |
| Education and research | **11,280** | 9,671 |
| Facilities and equipment | **1,419** | 1,473 |
| Community service | **6,250** | 3,586 |
| | **59,423** | 36,890 |
| **Subject to spending policy and appropriation** | | |
| Endowment fund to be held in perpetuity, for which the investment earnings are used to support: | | |
| Hospital programs | **129,021** | 115,846 |
| Education and research | **19,513** | 17,595 |
| Community service | **12,172** | 10,782 |
| Facilities and equipment | **362** | 332 |
| | **161,068** | 144,555 |
| Total net assets with donor restrictions | **$ 220,491** | $ 181,445 |

**13. Net Assets (continued)**

Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions. The Foundation classifies permanent endowment donations and investment earnings accumulated on the permanent endowment funds within net assets with donor restrictions. The Foundation adopted a policy to appropriate for distribution a percentage of the endowment fund investment earnings as determined annually by the Foundation, in the absence of donor imposed restrictions.

The Foundation considers the following factors in making a determination as to the annual endowment fund distribution:

(1) The duration and preservation of the fund

(2) The purposes of the Foundation and the donor-restricted endowment fund

(3) General economic conditions

(4) The possible effect of inflation and deflation

(5) The expected total return from income and the appreciation of investments

(6) The investment policies of the Foundation

The Foundation has adopted an endowment investment and spending policy that attempts to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Under this policy, the endowment assets are invested in a manner that is intended to produce a rate of return, net of inflation and investment management costs, to retain the purchasing power of the endowment assets.

**13. Net Assets (continued)**

The Foundation targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term objectives within prudent risk constraints.

Changes in endowment net assets for the years ended December 31, 2020 and 2019, consisted of the following (in thousands):

| | Without Donor Restrictions | With Donor Restrictions | Total |
|---|---|---|---|
| Endowment net assets, January 1, 2019 | $ 17,890 | $ 121,966 | $ 139,856 |
| Investment gain, net | – | 24,723 | 24,723 |
| Contributions | – | 10,161 | 10,161 |
| Appropriation of endowment assets for expenditure | – | (5,389) | (5,389) |
| Endowment net assets, December 31, 2019 | 17,890 | 151,461 | 169,351 |
| Investment gain, net | **–** | **20,134** | **20,134** |
| Contributions | **–** | **2,210** | **2,210** |
| Appropriation of endowment assets for expenditure | **–** | **(4,790)** | **(4,790)** |
| Endowment net assets, December 31, 2020 | **$ 17,890** | **$ 169,015** | **$ 186,905** |

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires the Foundation to retain as a fund of perpetual duration. No deficiencies of this nature were reported as of December 31, 2020 or 2019.

## 14. Functional Expenses

The Company provides health care services, including inpatient, outpatient, physician, rehab, ambulatory and urgent care services to individuals within its geographic areas supported by its acute care centers. Administrative and other includes support services such as finance and accounting, information technology, human resources, marketing, and supply chain, as well as the Foundation, ACO, the Captive, Desert Mission, and all eliminations. The following statement of functional expenses reports the Company's operating expenses, as presented on the consolidated statements of operations, by the Company's major operating functions for the years ended December 31, 2020 and 2019. Operating expenses attributable to more than one operating function have been allocated using a basis representative of the operating expenditure, such as patient volume, full-time equivalent, or facility size.

| | **Operating Expenses December 31, 2020** | | |
|---|---|---|---|
| | **Health Care Services** | **Administrative and Other** | **Total** |
| | | *(In Thousands)* | |
| Expenses: | | | |
| Salaries and benefits | **$ 775,998** | **$ 230,574** | **$ 1,006,572** |
| Supplies, services, and other | **788,390** | **150,945** | **939,335** |
| Depreciation and amortization | **80,210** | **34,748** | **114,958** |
| Interest | **18,060** | **11,844** | **29,904** |
| Total expenses | **$ 1,662,658** | **$ 428,111** | **$ 2,090,769** |

| | **Operating Expenses December 31, 2019** | | |
|---|---|---|---|
| | **Health Care Services** | **Administrative and Other** | **Total** |
| | | *(In Thousands)* | |
| Expenses: | | | |
| Salaries and benefits | $ 755,129 | $ 219,501 | $ 974,630 |
| Supplies, services, and other | 715,890 | 148,722 | 864,612 |
| Depreciation and amortization | 75,861 | 36,105 | 111,966 |
| Interest | 21,005 | 12,432 | 33,437 |
| Total expenses | $ 1,567,885 | $ 416,760 | $ 1,984,645 |

## 15. Commitments and Contingent Liabilities

### 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 limited to, matters such as licensure, accreditation, and government health care program participation requirements; reimbursement for patient services; and Medicare and Medicaid fraud and abuse. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes the Company is in compliance with fraud and abuse regulations 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.

In addition to general and professional liability claims, the Company 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 the Company's consolidated financial position, results of operations, or cash flows.

## 16. Medical Malpractice Claims

The Company currently self-insures medical malpractice and general liability claims for the first $3,000,000 per occurrence, with no aggregate. Insurance coverage has been purchased by the Company to cover excess claim settlements up to $20,000,000 per occurrence and in aggregate.

It is the Company's policy to record the expense and related liability for medical malpractice and general liability losses based on actuarial estimates on an undiscounted basis. Included on the accompanying consolidated balance sheets is an actuarially computed accrual of approximately $46,470,000 and $40,486,000 at December 31, 2020 and 2019, respectively, for medical malpractice and general liability claims, which includes $6,139,000 and $6,239,000 estimated obligation for medical malpractice and general liability claims that will be covered by the excess insurance carrier. Of the amounts recorded at December 31, 2020 and 2019, approximately $4,113,000 and $3,134,000, respectively, represents the current portion of the medical malpractice and general liability claims recorded in accrued expenses on the consolidated balance sheets.

## 17. Retirement Plans

### Defined Contribution Plan

The Company has a defined contribution plan covering all eligible employees who elect to contribute at least 2% of defined earnings to the plan. The Company matched 100% of eligible employee contributions up to 4% in 2020 and 2019. Company contributions to the defined contribution plan were approximately $26,765,000 and $24,369,000 for the years ended December 31, 2020 and 2019, respectively.

### 457(b) Retirement Plan

The Company has a 457(b) retirement plan that covers certain members of management who elect to participate under the terms of the plan. Both the eligible employees and the Company contribute to the plan in order to meet the future benefit obligation. The Company retains title to all of the assets and obligations of these plans. At December 31, 2020 and 2019, plan investments and liabilities were approximately $26,993,000 and $23,342,000, respectively.

## 18. Income Taxes

The Company calculates income taxes using the liability method, under which deferred tax assets and liabilities are determined based upon the differences between the financial accounting and tax bases of assets and liabilities. The Company recognizes the tax benefit from uncertain tax positions, only if it is more likely than not that the tax positions will be sustained on examination by the tax authorities, based on the technical merits of the position. The tax benefit is measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The Company annually reviews its uncertain tax positions and, based on this review, has not recorded any expense or accrued for any uncertain tax positions as of December 31, 2020 or 2019. The statute of limitations for tax returns filed for years 2017 through 2020 remains open in U.S. tax jurisdictions in which the Company is subject to taxation.

## 19. Liquidity

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

| | 2020 | 2019 |
|---|---|---|
| Cash and cash equivalents | **$ 470,894** | $ 254,786 |
| Patient accounts receivable | **326,739** | 307,238 |
| Short-term investments | **785,183** | 669,068 |
| Other receivables | **42,642** | 18,313 |
| | **$ 1,625,458** | $ 1,249,405 |

The Company has the ability to structure its financial assets to be available as its general expenditures and other obligations come due. Cash in excess of daily requirements is invested in short-term investments.

## 20. ACO Shared Savings

ICP is a participant in the Medicare Shared Savings Program (MSSP) and has also entered into several shared savings contracts and risk share contracts with other unrelated commercial insurance companies. ICP has established a provider network consisting of HonorHealth facilities, employed HonorHealth providers and participating independent provider networks. The shared savings and risk share contracts outline the payment fee schedules that each of the health care providers will receive for services rendered, as well as the distribution of any settlements with ICP. Each of the commercial insurance companies retains the responsibility to pay the health care provider claims. The Company recorded net gain share settlements of approximately $35,256,000 for the year ended December 31, 2020, which included approximately $14,583,000 of MSSP gain share settlements related to the 2019 contract year, and $4,288,000 for the year ended December 31, 2019. The net gain share settlements have been recorded as an increase to other revenue.

**21. COVID-19**

In March 2020, the World Health Organization (WHO) designated COVID-19 as a global pandemic. Patient volumes and related revenue for most services were significantly impacted beginning mid-March 2020 as various policies were implemented by federal, state and local governments in response to the COVID-19 pandemic, including suspension of elective and nonemergent medical procedures, stay-at-home orders, business closures and social distancing. In early May, certain of these policies such as the suspension of elective and emergent procedures were lifted and the Company experienced gradual improvement in volumes and related revenue. During this time, the Company also experienced supply chain disruptions, including significant price increases in medical supplies and personal protective equipment. The COVID-19 outbreak could still negatively affect future financial results of the Company as the duration of the pandemic is unknown.

The federal government provided sources of pandemic relief through the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was enacted on March 27, 2020, and the Paycheck Protection Program and Health Enhancement Act (PPHCE Act), which was enacted on April 24, 2020. Together, the CARES Act and the PPHCE Act provided additional funding to hospitals and other healthcare providers through the Public Health and Social Services Fund (PHSSEF). Grant payments from the PHSSEF are intended to reimburse healthcare providers for lost revenue and increased expenditures during the pandemic. During 2020, the Company has received $84,264,000 through the PHSSEF, of which $65,165,000 was recognized on the accompanying consolidated statement of operations for the year ended December 31, 2020, and $19,099,000 was recorded within accrued expenses on the accompanying consolidated balance sheet as of December 31, 2020. The Company recognizes grant payments as income when there is reasonable assurance that the grant conditions are met. These estimates could change materially based on lost revenues or expenses related to COVID-19 as the grant compliance and reporting guidance provided by the government are finalized.

The CARES Act provides for an expansion of the Centers for Medicare and Medicaid Services (CMS) Medicare Accelerated and Advance Payment Program (Accelerated Payment Program), which allows inpatient acute care hospitals to request accelerated payments of up to 100% of their Medicare payment for a six-month period. In April 2020, the Company received approximately $170,867,000 from the Accelerated Payment Program. The Accelerated Payment Program requires CMS to recoup the payment by withholding future Medicare payments starting April 2021 at through July 2022. At the end of this repayment period, any balance outstanding is to be paid to CMS. The Company has recorded $74,224,000 of the Medicare advance payment within current liabilities and $96,643,000 within long-term liabilities on the accompanying consolidated balance sheets.

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