



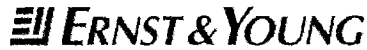
AUDITED FINANCIAL STATEMENTS AND  
OTHER FINANCIAL INFORMATION

VHS Phoenix Health Plan, LLC  
Year Ended June 30, 2011  
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**





Ernst & Young LLP  
One Nashville Place  
Suite 1400  
150 Fourth Avenue North  
Nashville, TN 37219  
Tel: +1 615 252 2000  
Fax: +1 615 242 9128  
www.ey.com

## Report of Independent Auditors

The Board of Directors  
VHS Phoenix Health Plan, LLC

We have audited the accompanying balance sheet of VHS Phoenix Health Plan, LLC, a subsidiary of Vanguard Health Systems, Inc., as of June 30, 2011 and the related statements of earnings, member's equity and cash flows for the year then ended. These financial statements are the responsibility of VHS Phoenix Health Plan, LLC's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of VHS Phoenix Health Plan, LLC at June 30, 2011, and the results of its operations and its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The details of the attached schedules (pages 19 through 26) of other financial information are presented for purposes of additional analysis and are not a required part of the basic financial statements. The attached schedules are the responsibility of VHS Phoenix Health Plan, LLC's management. Such information has not been subjected to the auditing procedures applied in our audit of the basic financial statements and, accordingly, we express no opinion on it.

*Ernst & Young LLP*

October 27, 2011

VHS Phoenix Health Plan, LLC

Balance Sheet

June 30, 2011

**Assets**

Current assets:

Cash and cash equivalents	\$ 246,784,663
AHCCCS receivables	13,641,550
Prepaid expenses and other current assets	1,714,611
Due from affiliates, net	<u>98,275,796</u>
Total current assets	360,416,620

Property and equipment:

Furniture and equipment	3,959,027
Software	2,874,379
Construction in progress	77,634
Less: accumulated depreciation	<u>(5,263,776)</u>
Net property and equipment	1,647,264

Goodwill	79,402,908
Intangible assets, net	<u>10,595,000</u>
Total assets	<u>\$ 452,061,792</u>

**Liabilities and member's equity**

Current liabilities:

Accounts payable	\$ 10,558,116
Medical claims payable	92,514,952
Other accrued expenses	<u>30,150,048</u>
Total current liabilities	133,223,116

Other long-term liabilities	25,659
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Member's equity:

Member's capital	157,035,173
Retained earnings	<u>161,777,844</u>
Total member's equity	<u>318,813,017</u>
Total liabilities and member's equity	<u>\$ 452,061,792</u>

*See accompanying notes.*

VHS Phoenix Health Plan, LLC

Statement of Earnings

Year Ended June 30, 2011

Revenues:	
Capitation	\$ 709,432,725
Supplemental revenues	42,723,882
Other revenues	<u>894,352</u>
Total revenues	<u>753,050,959</u>
Expenses:	
Hospital	215,117,073
Medical compensation	162,200,544
Other medical	<u>279,474,486</u>
	656,792,103
Less: reinsurance and third party liability	<u>28,011,857</u>
Total medical expenses	628,780,246
Administrative expenses	<u>55,227,135</u>
Total expenses	<u>684,007,381</u>
Earnings before premium and income taxes	69,043,578
Premium taxes	15,737,020
Income taxes	<u>18,671,731</u>
Net earnings	<u>\$ 34,634,827</u>

*See accompanying notes*

VHS Phoenix Health Plan, LLC

Statement of Member's Equity

Year Ended June 30, 2011

	<b>Member's Capital</b>	<b>Retained Earnings</b>	<b>Total Member's Equity</b>
Balance at July 1, 2010	\$ 157,035,173	\$ 127,143,017	\$ 284,178,190
Net earnings	-	34,634,827	34,634,827
Balance at June 30, 2011	<u>\$ 157,035,173</u>	<u>\$ 161,777,844</u>	<u>\$ 318,813,017</u>

*See accompanying notes.*

VHS Phoenix Health Plan, LLC

Statement of Cash Flows

Year Ended June 30, 2011

<b>Operating activities</b>	
Net earnings	\$ 34,634,827
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Depreciation and amortization	4,182,049
Changes in assets and liabilities:	
Decrease in AHCCCS receivables	62,088,377
Decrease in prepaid expenses and other current assets	126,455
Decrease in medical claims payable	(10,233,491)
Increase in accounts payable	5,261,365
Decrease in other accrued expenses	(33,787,490)
Increase in other long-term liabilities	94,398
Net cash provided by operating activities	<u>62,366,490</u>
<b>Investing activity</b>	
Capital expenditures	<u>(446,064)</u>
<b>Financing activity</b>	
Decrease in due from affiliates	<u>170,395,755</u>
Increase in cash and cash equivalents	232,316,181
Cash and cash equivalents, beginning of year	<u>14,468,482</u>
Cash and cash equivalents, end of year	<u>\$ 246,784,663</u>
Interest paid, net of interest received	<u>\$ 14,535</u>

*See accompanying notes.*

# VHS Phoenix Health Plan, LLC

## Notes to Financial Statements

June 30, 2011

### **1. Organization and Operations**

VHS Phoenix Health Plan, LLC (PHP) is a wholly owned subsidiary of Abrazo Advantage Health Plan, Inc. (AAHP) and an indirect wholly owned subsidiary of Vanguard Health Systems, Inc. (Vanguard). Vanguard also operates general, acute care hospitals and related outpatient service locations complementary to the hospitals. As of June 30, 2011, Vanguard's affiliates owned and managed 26 hospitals with a total of 6,201 licensed beds and related healthcare facilities in six states. Vanguard owns or maintains an interest in certain outpatient diagnostic imaging and surgery centers, clinics, managed health plans, laboratory processing companies and billing companies affiliated with the hospitals.

PHP is a prepaid Medicaid managed health plan that derives substantially all of its revenues through a contract with the Arizona Health Care Cost Containment System (AHCCCS) to provide specified health services to qualified Medicaid enrollees through contracts with providers. AHCCCS is the state agency that administers Arizona's Medicaid program. The contract requires PHP to arrange for healthcare services for enrolled Medicaid patients in exchange for fixed monthly premiums, based on negotiated per capita member rates, reinsurance and other supplemental payments from AHCCCS.

PHP subcontracts with hospitals, physicians and other medical providers in Arizona to provide services to its enrollees in Apache, Coconino, Gila, Maricopa, Mohave, Navajo, Pima, Pinal and Yavapai counties. These services are provided regardless of the actual costs incurred to provide the services. PHP receives reinsurance and other supplemental payments from AHCCCS to cover certain costs of healthcare services that exceed defined thresholds.

#### **Contract With AHCCCS**

PHP's current contract with AHCCCS is effective for the three-year period beginning October 1, 2008 and ending September 30, 2011 and includes two one-year renewal options exercisable at the discretion of AHCCCS that, if exercised, would extend the contract to September 30, 2013. On September 9, 2011, but effective October 1, 2011, PHP and AHCCCS entered into Amendment No. 16 to their contract which, among other things, extended the term of the contract for one year until September 30, 2012. AHCCCS has one additional option to extend the contract, in whole or in part, for one more year commencing on October 1, 2012 and ending on September 30, 2013. The terms of the current contract are similar to the previous contract with the exception of the addition of six new counties awarded to PHP for the contract starting on October 1, 2008 and the adoption of a capitation risk adjustment model (RAM). In

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

#### 1. Organization and Operations (continued)

determining the capitation rates for the contract year ended September 30, 2008 and after, AHCCCS has utilized a national episodic/diagnostic RAM that has been applied to all health plan specific capitation rates for prospective risk groups. Over the term of the contract AHCCCS has applied a gradually increasing weighted amount of the risk adjustment to the capitation rates and for the contract year ended September 30, 2010 and after, the full impact of the model has been applied. PHP has recorded approximately \$3,982,000 of risk factor adjustment in its accompanying June 30, 2011 Statement of Earnings as a reduction in revenue related to the contract years ended September 30, 2011 and September 30, 2010. During the year ended June 30, 2011, PHP and AHCCCS settled the risk adjustment related to the contract year ended September 30, 2010 for approximately \$2,872,000. PHP accrued approximately \$1,110,000 (\$722,000, net of taxes) for an estimate of the RAM settlement liability payable as of June 30, 2011, which is included in other accrued expenses on the accompanying Balance Sheet.

The contract is terminable without cause on 90 days' written notice from AHCCCS or for cause upon written notice from AHCCCS if PHP fails to comply with any term or condition of the contract or fails to take corrective action as required to comply with the terms of the contract. AHCCCS may also terminate the contract with PHP in the event of unavailability of state or federal funding. PHP can terminate the contract without cause. If PHP elected to terminate, PHP would be subject to various administrative guidelines to assist AHCCCS in transitioning enrollees to coverage under a new health plan. PHP may choose not to pursue the two one-year renewal options, subject to payment of certain transition costs. Should AHCCCS terminate its contract with PHP, PHP would cease operations.

Member months, by geographic service area (GSA), covered by PHP during the month of June 2011, are as follows:

Maricopa	106,626
Gina/Pinal	34,907
Yavapai	18,671
Pima	20,256
Apache, Coconino, Mohave and Navajo	26,221
	<u>206,681</u>

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

#### **2. Summary of Significant Accounting Policies**

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

Cash equivalents include all highly liquid investments with an initial maturity of three months or less when purchased. At various times during the year, PHP's cash and cash equivalents balances exceeded the federally insured limit. Cash and cash equivalents are maintained at high quality financial institutions, and management believes exposure to credit risk is not significant.

##### **AHCCCS Receivables**

PHP had approximately \$13,642,000 of receivables due from AHCCCS as of June 30, 2011, including reinsurance reimbursement receivable for amounts paid by PHP for enrollee healthcare services that exceeded maximum limits set forth in its contract with AHCCCS and other supplemental reimbursement receivables. The reinsurance reimbursement receivables are determined on an enrollee-specific basis and are stated at net realizable value. PHP writes off 100% of reinsurance receivables related to completed AHCCCS contract years that exceed the AHCCCS reinsurance timely filing limits.

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

Property and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful life of the assets. The estimated useful lives of PHP's property and equipment range from three to eight years. Routine maintenance and repairs are charged to expense as incurred. Expenditures that increase values, change capacities or extend useful lives are capitalized.

Depreciation expense was approximately \$918,000 for the year ended June 30, 2011, which is included in administrative expenses in the accompanying Statement of Earnings.

##### **Revenues**

PHP receives monthly capitation payments under the AHCCCS contract based on the number of enrollees and type of enrollee coverage. Capitation premiums are recognized as revenues in the month in which PHP is notified that a member is eligible for healthcare coverage provided by PHP. Included in these monthly payments are capitation amounts applicable to Title XIX Waiver Group (TWG) Members. The TWG Medical Expense Deduction (MED) population includes TWG members whose income exceeds the limits of all other Title XIX categories and have

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

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

medical expenses that reduce income to at or below 40% of the federal poverty level. The TWG non-Medical Expense Deduction (Non-Med) population includes adults or childless couples at or below 100% of the federal poverty level (Non-Med) that do not meet the requirements of another categorically linked Title XIX program. For the year ended June 30, 2011, PHP recognized prospective capitation revenues of approximately \$234,830,000 related to Title XIX Waiver Member enrollees. AHCCCS limits the profitability and loss that health plans may recognize for both the TWG prospective MED population and the TWG prospective Non-Med population.

The MED reconciliation limits PHP's profits or losses related to this population to 3% of related capitation revenues (net of reinsurance, administrative expenses and premium taxes) as defined in the applicable AHCCCS contract. As of June 30, 2011, PHP had an estimated net MED settlement payable of approximately \$5,395,000, which is included in other accrued expenses on the accompanying Balance Sheet. Of this amount, approximately \$1,713,000 and \$3,682,000 related to the contract years ending September 30, 2010 and 2011, respectively. During the fiscal year ended June 30, 2011, PHP increased its MED settlement payable related to prior AHCCCS contract year's reconciliations by approximately \$44,000 (\$28,600, net of taxes). Additionally, during the fiscal year ended June 30, 2011, AHCCCS collected approximately \$1,945,000 from PHP related to the MED reconciliation for contract year ended September 30, 2009.

The Non-Med reconciliation limits PHP's profits or losses related to this population to 2% of related capitation revenues (net of reinsurance, administrative expenses and premium taxes) as defined in the applicable AHCCCS contract for specific contract years. As of June 30, 2011, PHP had an estimated net Non-Med settlement payable of approximately \$18,092,000, which is included in other accrued expenses on the accompanying Balance Sheet and relates to the contract years ending September 30, 2010 and 2011.

PHP receives capitation payments for Prior Period Coverage (PPC) separately from its prospective capitation payments. PPC capitation payments are applicable to all types of enrollee coverages in PHP and are intended to cover those healthcare costs incurred by individuals while they are awaiting enrollment in PHP and prior to PHP's ability to manage the healthcare of those enrollees. PPC revenues are recognized in the month in which PHP is notified that a member is eligible for coverage provided by PHP. AHCCCS limits the profitability and loss that health plans may recognize during the PPC eligibility period to 2% of related capitation revenues (net of administrative expenses and premium taxes) and reconciles the PPC member costs incurred by PHP. For the year ended June 30, 2011, PHP recognized approximately \$83,682,000 of PPC

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

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

revenues, excluding PPC settlement estimates. As of June 30, 2011, PHP had a net settlement payable for PPC payments received in excess of PPC costs incurred of approximately \$3,483,000 for contract years ending September 30, 2010 and 2011, which is included in other accrued expenses on the accompanying Balance Sheet.

PHP also receives supplemental payments for delivery premiums to cover the cost of maternity care for qualified members under the federally funded Sixth Omnibus Budget Reconciliation Act (SOBRA) program. PHP recognizes supplemental revenues during the month in which AHCCCS notifies PHP of payment.

#### **Goodwill and Intangible Assets**

As of June 30, 2011, PHP had approximately \$79,403,000 of goodwill, which represents the allocation of the excess purchase price paid for PHP's net assets in connection with the Blackstone Group's, Vanguard's primary equity sponsor, purchase of a majority equity interest in Vanguard's parent affiliate on September 23, 2004. The excess purchase price attributable to PHP was determined based upon the fair value of PHP as set forth in an independent appraisal adjusted for income taxes.

As of June 30, 2011, PHP's intangible assets included the AHCCCS contract of \$10,195,000 (net of accumulated amortization of \$21,175,000) and provider network of \$400,000 (net of accumulated amortization of \$830,000). These intangible assets are reviewed for impairment as management becomes aware of impairment indicators.

The AHCCCS contract and the provider network are being amortized over a period of 120 months. Amortization expense of intangible assets was \$3,264,000 for the year ended June 30, 2011 and the estimated amortization expense during the subsequent years follows: 2012- \$3,260,000; 2013 - \$3,260,000; 2014 - \$3,260,000 and; 2015 - \$815,000.

Goodwill is not amortized but is subject to annual impairment reviews. PHP conducts the annual impairment review during the fourth quarter of each fiscal year by comparing the carrying value of PHP's net assets to the net present value of PHP's future cash flows. If the carrying value exceeds the net present value of future cash flows, an impairment indicator exists and an estimate of the impairment loss is calculated. PHP completed its 2011 annual impairment review noting no impairment. Approximately \$13,100,000 of PHP's goodwill is deductible for tax purposes.

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

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

##### **Due From Affiliates**

Due from affiliates primarily represents the net excess of funds transferred to the centralized cash management account of Vanguard Health Management, Inc. (VHM), a wholly owned subsidiary of Vanguard, over funds transferred to or paid on behalf of PHP by VHM. Due from affiliates balances are readily available to PHP for settlement of its current liabilities as they become due.

Generally, this balance is decreased by automatic cash transfers from VHM's centralized cash management account to reimburse PHP's bank accounts for operating expenses and capital expenditures and to pay PHP's fees and services provided by VHM, including information systems services and other operating expenses, such as payroll, interest and insurance. Generally, the due from affiliates balance is increased through daily cash deposits by PHP to VHM's centralized cash management account. As of June 30, 2011, due from affiliates was reduced by \$1,285,000 related to outstanding checks for disbursements by PHP that had not cleared the bank.

Interest income of approximately \$746,000 was earned by PHP on outstanding due from affiliates balances during the year ended June 30, 2011, which is included in other revenues in the accompanying Statement of Earnings. PHP earned interest at an average rate of 0.25% during the year ended June 30, 2011. The interest rate earned approximated the variable portion of the total interest rate paid by Vanguard under LIBOR contracts for its outstanding term loan debt. PHP also earned approximately \$33,000 of interest income on its outstanding cash balances during the year ended June 30, 2011, which is included in other revenues in the accompanying Statement of Earnings.

PHP incurred interest expense of approximately \$48,000 related to letters of credit fees paid by Vanguard on its behalf during the year ended June 30, 2011, which is included as a reduction to other revenues in the accompanying Statement of Earnings. The letters of credit collateralize the outstanding performance bonds used to satisfy guaranty requirements set forth by AHCCCS.

##### **Medical Expenses and Reinsurance Proceeds**

Monthly capitation payments to primary care physicians and other healthcare providers are expensed in the month services are contracted to be performed. Claims expense for non-capitated arrangements are accrued as services are rendered by hospitals, physicians and other healthcare providers during the year. PHP is at risk for hospitalization and medical service claims, including

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

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

medical compensation and other medical expenses, which exceed its capitation payments from AHCCCS. Medical compensation includes primary care and specialty physician services. Other medical expenses include hospital outpatient services and other ancillary services such as radiology and lab.

PHP is reimbursed by AHCCCS for costs incurred for those enrollees with severe illnesses to the extent such costs exceed \$35,000 per enrollee, including for Title XIX Waiver Group members for the contract year end September 30, 2011. PHP estimates reinsurance recoveries monthly based on reported claims by member and the provisions of the AHCCCS contract. Reinsurance recoveries are deducted from gross medical expenses on the accompanying Statement of Earnings. PHP is at risk for excess medical costs under reinsurance claims that are disputed and not honored by AHCCCS. Medical claims payable includes claims received but not paid as well as estimated claims incurred but not reported (IBNR). During fiscal year ended June 30, 2011, PHP adjusted medical claims payable related to prior fiscal year health claims experience by approximately \$2.6 million (\$1.7 million net of taxes). Medical claims payable is estimated using a combination of historical claims payment data and current cost per member estimates. In order to test the reasonableness of its June 30, 2011 medical claims payable estimate, PHP engaged an actuary to provide an independent estimate of medical claims payable. While management believes that its estimation methodology captures trends in medical claims costs in a timely manner, actual payments could differ significantly from its estimates given changes in the healthcare cost structure or adverse experience.

#### **Income Taxes**

Vanguard files consolidated Federal and state income tax returns that include the operating results of PHP. Vanguard allocates taxes to PHP pursuant to the asset and liability method, as if PHP was a separate taxpayer. For balance sheet purposes, such allocations are deducted from due from affiliates in the accompanying Balance Sheet.

#### **Fair Value of Financial Instruments**

The carrying amounts of cash and cash equivalents, receivables, amounts due from affiliates and payables approximate fair value because of the short maturity of these financial instruments.

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

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

##### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Financial statement areas involving significant estimation include reinsurance receivables, PPC, MED, and Non-MED settlements, and medical claims IBNR. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and will be accounted for in the period identified.

##### **Subsequent Events**

PHP has evaluated subsequent events for the year ended June 30, 2011 through October 27, 2011, the date these financial statements were available to be issued. On September 9, 2011, but effective October 1, 2011, PHP and AHCCCS entered into Amendment No. 16 to their contract which, among other things, extended the term of the contract for one year until September 30, 2012. AHCCCS has one additional option to extend the contract, in whole or in part, for one more year commencing on October 1, 2012 and ending on September 30, 2013.

#### **3. Transactions With Affiliates**

Effective October 1, 2010 PHP entered into a management agreement with Advantage Health Care Management Company, Inc. ("AHCMC"), a wholly owned subsidiary of Vanguard, to manage the general and administrative functions related to PHP inclusive of payroll, advertising and related expenses. Since the effective date of the agreement with AHCMC, PHP has recorded expenses for approximately \$40,645,000 for services provided by AHCMC. Expenses for AHCMC services are included in administrative expenses on the accompanying Statement of Earnings. At June 30, 2011, approximately \$4,372,000 payable to AHCMC for services provided is included within the net amount due from affiliates on the accompanying Balance Sheet.

Affiliates of PHP include healthcare service providers for eligible PHP members that are also affiliated with Vanguard. Medical services provided by these affiliates to eligible PHP members totaled approximately \$26,544,000 during the year ended June 30, 2011. At June 30, 2011, medical claims payable included approximately \$3,840,000 payable to these affiliates for medical services provided to PHP enrollees.

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

#### **3. Transactions With Affiliates (continued)**

Prior to entering into the agreement with AHCMC, mentioned above, certain accounting and administrative services and other management services, including payroll, information services, and human resources, among others, were provided by VHM and certain other Vanguard subsidiaries. These related fees charged to PHP by VHM and certain other Vanguard subsidiaries prior to entering into the agreement with AHCMC totaled approximately \$4,084,000 for the year ended June 30, 2011, and are included in administrative expenses in the accompanying Statement of Earnings.

Prior to entering into the agreement with AHCMC, PHP shared certain overhead costs with AAHP including enrollment, claims processing, case management, finance and information technology functions, among others. Allocations of these costs were made between AAHP and PHP using the best information available regarding the utilization of these resources by each entity. The use of other reasonable allocation methods could lead to significantly different results.

#### **4. Commitments and Contingencies**

##### **Operating Leases**

Prior to entering into the agreement with AHCMC, PHP leased its office facilities and certain equipment under non-cancelable operating leases. As a result of the agreement with AHCMC, AHCMC assumed the remaining office facility and equipment leases. Prior to the agreement with AHCMC, lease expense totaled approximately \$322,000 for the year ended June 30, 2011, which is included in administrative expenses in the accompanying Statement of Earnings. Subsequent to the agreement with AHCMC, the related expenses are included within the management fee charged by AHCMC, which is included in administrative expenses in the accompanying Statement of Earnings.

##### **Professional, General, and Other Liability Insurance**

In the normal course of business, PHP is subject to claims and lawsuits relating to injuries arising from patient treatment and denials thereof. PHP believes that its liability for damages resulting from such claims and lawsuits is adequately covered by insurance and is adequately provided for in its financial statements. PHP's contract with AHCCCS requires that it maintain professional liability insurance, comprehensive general insurance and automobile liability insurance coverage

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

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

of at least \$1,000,000 for each occurrence. PHP is covered under Vanguard's wholly-owned captive insurance subsidiary or Vanguard's self-insurance program for professional and general liability claims. For professional and general liability claims incurred from June 1, 2002 through June 30, 2011, Vanguard's wholly owned captive subsidiary or other Vanguard subsidiaries insures PHP's professional and general liability risks at a \$10,000,000 retention level.

Vanguard carries professional and general liability insurance in excess of its self-insured retention and the captive insurance subsidiary's retention through unrelated commercial insurance carriers for aggregate claims up to \$75,000,000, but limited to annual payments of \$65,000,000 in the aggregate. There is no guarantee that existing coverage will be sufficient for professional and general liability claims either individually or in the aggregate. Professional and general liability insurance expense allocated from Vanguard was approximately \$372,000 for the year ended June 30, 2011, and is included in administrative expenses in the accompanying Statement of Earnings.

PHP is covered under Vanguard's self-insurance program for workers' compensation claims. Vanguard maintains coverage for workers' compensation claims exceeding its \$1,000,000 retention level at amounts PHP believes to be adequate. Workers' compensation insurance expense allocated from Vanguard was approximately \$3,000 for the year ended June 30, 2011, and is included in administrative expenses in the accompanying Statement of Earnings.

Vanguard maintains reserves for general and professional liability and workers' compensation risks and makes any necessary claims payments on PHP's behalf. Accordingly, no reserve for liability risks is recorded on the accompanying Balance Sheet. PHP is currently not a party to any such proceedings that, in management's opinion, would have a material adverse effect on PHP's business, results of operations or financial position.

#### **Other Claims**

PHP is subject to claims and suits arising in the ordinary course of business. Plaintiffs in these matters may request punitive or other damages that may not be covered by insurance. PHP is not aware that it is currently a party to any such proceeding that, in management's opinion, if adversely decided, would have a material effect on PHP's results of operations or financial position.

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

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

##### **Subcontracted Services**

PHP subcontracts with physician specialists, affiliated hospitals and unaffiliated hospitals to provide covered services to certain patients enrolled in or assigned to PHP on either a capitated or fee-for-service basis.

##### **AHCCCS Plan Compliance**

Under PHP's contract with AHCCCS, PHP is required to maintain a performance guaranty. As of June 30, 2011, PHP maintained performance bonds totaling \$55,000,000 to meet this performance guaranty. Vanguard also maintained letters of credit totaling \$5,000,000 on PHP's behalf to collateralize the outstanding performance bonds.

The AHCCCS contract contains certain financial viability standards and performance guidelines that PHP reports on a quarterly and annual basis. These standards and guidelines enable AHCCCS to monitor the financial health of its contracted health plans. PHP must meet the financial viability standards, which include a current ratio requirement of at least one (1.0) and equity per member requirement of at least \$100. As of June 30, 2011, PHP met these financial viability standards.

AHCCCS also monitors certain performance guidelines, which include a medical expense ratio as defined in the AHCCCS contract (at least 84%), and an administrative cost percentage ratio as defined in the AHCCCS contract (no more than 10%). AHCCCS does not automatically penalize or sanction health plans that do not meet these guidelines but utilizes these guidelines in combination with other measures to determine the overall operational health and compliance of its contracted health plans. Management believes that PHP operated within the parameters of AHCCCS' administrative cost percentage ratio and medical loss ratio performance guidelines for the year ended June 30, 2011.

PHP is also subject to minimum performance standards for certain clinical quality performance measures under its contract with AHCCCS. In July 2007, AHCCCS notified PHP that it had failed to meet certain performance standards. AHCCCS provided PHP a timeframe within which to achieve compliance with or improvement upon these standards or else face monetary sanctions. PHP implemented processes and procedures to address these standards, and AHCCCS

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

#### 4. Commitments and Contingencies (continued)

decided to waive the sanctions related to the 2008 and 2007 contract years given the significant progress made in these areas. Management believes that possible additional sanctions beyond those already accrued related to contract years ending September 30, 2009, 2010 and 2011 as of June 30, 2011 would not be material to the financial position, results of operations or cash flows of PHP.

#### Compliance With Laws and Regulations

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services and Medicare and Medicaid fraud and abuse regulations. Management believes that PHP is in compliance with fraud and abuse regulations as well as other applicable government laws and regulations. While no regulatory inquiries have been made, 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.

#### 5. Income Taxes

Income tax expense allocated to PHP by Vanguard on a separate return basis for the year ended June 30, 2011, consisted of the following.

Current:	
Federal	\$ 18,735,618
State	<u>                    -</u>
	18,735,618
Deferred:	
Federal	(63,887)
State	<u>                    -</u>
	<u>(63,887)</u>
	<u>\$ 18,671,731</u>

Income tax expense allocated to PHP by Vanguard approximated the federal statutory rate for the year ended June 30, 2011.

## VHS Phoenix Health Plan, LLC

### Notes to Financial Statements (continued)

#### **5. Income Taxes (continued)**

The tax effects of temporary differences that give rise to deferred tax assets and liabilities are included in due from affiliates in the accompanying Balance Sheet.

#### **6. Retirement Plan**

Substantially all employees of PHP, upon qualification, are eligible to participate in Vanguard's defined contribution 401(k) Plan. The 401(k) Plan allows eligible employees to make contributions of 2% to 20% of their annual compensation, subject to annual limitations. Employer matching contributions, calculated as 50% of up to the first 6% of the employee contribution amount, vest 20% after two years of service and continue vesting at 20% per year until fully vested. Prior to entering into the management agreement with AHCMC, in October 2010, PHP's matching expense for the year ended June 30, 2011 was approximately \$59,000, which is included in administrative expenses in the accompanying Statement of Earnings. Subsequent to the agreement with AHCMC, the related expenses are included within the management fee charged by AHCMC which is included in administrative expenses in the accompanying statement of earnings.