Palomar Pomerado Health

Consolidated Financial Statements
as of and for the Years Ended
June 30, 2011 and 2010, and
Independent Auditors’ Report

PALOMAR POMERADO HEALTH

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Overview

Palomar Pomerado Health (PPH) is a public healthcare district and is a political subdivision in the State of California (the "State") organized pursuant to Division 23 of the Health and Safety Code of the State of California.

This section of PPH's annual financial report presents our analysis of PPH's financial performance for the years ended June 30, 2011 and 2010. Although the 2009 condensed consolidated balance sheet, statement of revenue, expenses, and changes in net assets, and statement of cash flows are presented in this section, they are not presented in the accompanying consolidated financial statements and notes to the consolidated financial statements. Please read this analysis in conjunction with the consolidated financial statements that follow this section.

This annual financial report includes:

- Management's Discussion and Analysis

- Independent Auditors' Report

- Consolidated Financial Statements of PPH, including notes that explain in more detail some of the information in the consolidated financial statements

PPH's consolidated financial statements report information using accounting methods required by the Governmental Accounting Standards Board (GASB), which, while similar to those used by private sector healthcare organizations, include some differences as described further in this management's discussion and analysis. These consolidated financial statements contain short-term and long-term financial information about PPH's activities.

Required Financial Statements

Consolidated Balance Sheets — The consolidated balance sheets include all of PPH's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to PPH's creditors (liabilities), and net assets — the difference between assets and liabilities — of PPH and the changes in them. The consolidated balance sheets also provide the basis for evaluating the capital structure of PPH and assessing the liquidity and financial flexibility of PPH.

CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2011, 2010, AND 2009
($ in thousands)

	2011	2010	2009
ASSETS			
Current assets	$ 328,340	$ 308,753	$ 245,862
Capital assets	1,061,644	795,252	568,152
Noncurrent assets	279,460	279,702	287,946
TOTAL	$1,669,444	$1,383,707	$1,101,960
LIABILITIES AND NET ASSETS			
Current liabilities	$ 126,662	$ 107,265	$ 108,901
Other long-term liabilities (long-term workers' compensation)	1,036	1,482	1,714
Deferred revenue	8,180	8,583	
Fair value of interest rate swap	19,463	24,322	16,752
Long-term debt — net of current portion	1,107,689	880,421	645,744
Total liabilities	1,263,030	1,022,073	773,111
Invested in capital assets — net of related debt	167,599	137,672	149,971
Restricted for repayment of debt	33,062	33,016	13,923
Restricted for capital acquisitions	14,161	14,350	14,382
Restricted for other purposes	318	314	312
Unrestricted	191,274	176,282	150,261
Total net assets	406,414	361,634	328,849
TOTAL	$1,669,444	$1,383,707	$1,101,960

2011: Analysis of the Consolidated Balance Sheets

- Current assets increased $19,587,000 in 2011, primarily due to increases in investments of $12,023,000, cash of $4,705,000, other receivables of $3,161,000, the current portion of assets whose use is limited — General Obligation Bonds ("G.O. Bonds") of $2,031,000, and inventories of $215,000, which were offset by decreases in net patient accounts receivable of $1,731,000, prepaid expenses of $444,000, and the current portion of assets whose use is limited of $373,000.

- Capital assets increased by $266,392,000, primarily due to purchases related to PPH's major building projects of $287,900,000, which were offset by net disposals of $200,000 and depreciation expense of $21,300,000.

- Noncurrent assets decreased by $242,000, primarily due to the decrease of trustee-held funds of $2,415,000, which were offset by an increase in deferred financing costs of $2,299,000.

- Current liabilities increased by $19,397,000, primarily due an increase in accounts payable of $10,660,000, other accrued liabilities of $3,036,000, estimated third-party settlements of $2,010,000, accrued interest payable of $1,612,000, compensation and related liabilities of $878,000, the current portion of the General Obligation Bonds of $627,000, and the current portion of long-term debt of $574,000.

- Long-term debt increased by $227,268,000, primarily as a result of the issuance of $163,365,000 of Series 2010 Certificates of Participation and the issuance of $65,782,000 of Series 2010 General Obligation Bonds, plus long-term accrued interest on the 2007, 2009, and 2010 G.O. Bonds of $17,221,000, less the principal payments on all PPH's bond issues of $7,395,000 and the net effect of the amortization of bond premiums and discounts for $3,415,000.

- Net assets increased $44,780,000, primarily due to results of operations of $11,505,000, property tax revenue of $27,644,000, the unrealized gain on interest rate swap of $4,859,000, investment income of $2,626,000, and other nonoperating revenue of $3,149,000, which were offset by interest expense of $4,720,000.

2010: Analysis of the Consolidated Balance Sheets

- Current assets increased $62,891,000 in 2010, primarily due to increases in investments of $57,183,000, inventories of $614,000, and assets whose use is limited — current portion of $22,904,000, which were offset by decreases in cash of $3,099,000, net patient accounts receivable of $12,996,000, and assets whose use is limited — G.O. Bonds of $1,316,000.

- Capital assets increased by $227,100,000, primarily due to purchases related to PPH's major building projects of $248,501,000, which were offset by net disposals of $40,000, and depreciation expense of $21,361,000.

- Noncurrent assets decreased by $8,244,000, primarily due to the decrease of trustee-held funds of $13,458,000, which were offset by an increase in deferred financing costs of $2,260,000.

- Current liabilities decreased by $1,636,000, primarily due to a $3,292,000 increase in compensation and related liabilities and a $2,495,000 increase in accrued interest payable. These increases were offset by a decrease in accounts payable of $3,646,000, a decrease in current portion of long-term debt of $2,361,000, and a decrease in estimated third-party payor settlements of $1,000,000.

- Long-term debt increased by $234,677,000, primarily as a result of the issuance of $233,340,000 of Series 2009 Certificates of Participation, plus long-term accrued interest on the 2007 and 2009 G.O. Bonds of $13,918,000, less the principal payments on all PPH’s bond issues of $9,780,000 and the net effect of the amortization of bond premiums and discounts for $5,690,000.

- Net assets increased $32,785,000, primarily due to results of operations of $17,029,000, property tax revenue of $24,512,000, investment income of $3,189,000, and other nonoperating revenue of $3,536,000, which were offset by unrealized loss on interest rate swap of $7,570,000, and interest expense of $4,628,000.

Consolidated Statements of Revenue, Expenses, and Changes in Net Assets — All of PPH’s revenue, expenses, and other changes in net assets are accounted for in the consolidated statements of revenue, expenses, and changes in net assets. This statement measures the success of PPH’s operations during the years presented and can be used to determine whether PPH has successfully recovered all of its costs through its fees and other sources of revenue. It also shows profitability and creditworthiness. Over time, increases or decreases in PPH’s net assets are one indicator of whether its financial health is improving or deteriorating.

CONDENSED CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEARS ENDED JUNE 30, 2011, 2010, AND 2009 ($ in thousands)

	2011	2010	2009
OPERATING REVENUE:			
Net patient service revenue	$ 442,142	$ 422,906	$ 397,544
Net premium revenue	36,673	37,655	40,890
Other revenue	11,192	7,822	7,571
Total operating revenue	490,007	468,383	446,005
OPERATING EXPENSES	478,502	451,354	436,536
INCOME FROM OPERATIONS	11,505	17,029	9,469
NONOPERATING INCOME (EXPENSES):			
Investment income	2,626	3,189	4,290
Unrealized gain (loss) on interest rate swap	4,859	(7,570)	(10,727)
Interest expense	(4,720)	(4,628)	(5,353)
Property tax revenue	12,625	12,926	13,505
Property tax revenue — general obligation bonds	15,019	11,586	12,000
Other — net	3,149	3,536	286
Total nonoperating income — net	33,558	19,039	14,001
EXCESS OF REVENUE OVER EXPENSES	45,063	36,068	23,470
INTERFUND — Arch Health Partners	(283)	(3,283)	
INCREASE IN NET ASSETS	44,780	32,785	23,470
NET ASSETS — Beginning of year	361,634	328,849	305,379
NET ASSETS — End of year	$ 406,414	$ 361,634	$ 328,849
ADJUSTED DISCHARGES	40,337	40,414	40,052

2011: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Assets

- In accordance with accounting principles generally accepted in the United States of America (“generally accepted accounting principles”) for governmental healthcare providers, PPH’s consolidated statements of revenue, expenses, and changes in net assets reflect the following: (1) net patient service revenues includes the provision for bad debts, which for nongovernmental hospitals is shown as an operating expense, and (2) nonoperating income (expenses) includes interest expense, which for nongovernmental hospitals is typically grouped as an operating expense. While these GASB requirements make district hospitals conform to other governmental entities, such as colleges and universities, they are less comparable to nongovernment hospitals because the GASB requirements do not apply to them. This must be considered in order to compare PPH to nonprofit and for-profit hospitals. The provision for bad debts was $60,030,000 in fiscal year 2011 and $58,768,000 in fiscal year 2010, and interest expense was $4,720,000 in fiscal year 2011 and $4,628,000 in fiscal year 2010.

- Adjusted discharges are utilized as an aggregate indicator of hospital activity. The calculation of adjusted discharges applies factors representing outpatient activity and skilled nursing activity to inpatient discharges.

- Operating revenue is generated by PPH’s primary activity of treating patients and other revenue. Operating revenue increased by $21,624,000 in 2011 due to increases in net patient service revenue of $19,236,000, increase in other revenue of $3,370,000, and a decrease in net premium revenue of $982,000. Increases in inpatient and outpatient ancillary revenue and negotiated increases in contracted rates resulted in an increase in net charges during the year.

- Operating expenses are those expenses related to the treatment of patients, including overhead and administration expenses. Operating expenses increased by $27,148,000 in 2011, primarily due to increases in labor costs of approximately $21,523,000, supplies of $3,208,000, other direct expenses of $1,163,000, professional fees of $884,000, rent expense of $592,000, and purchased services of $42,000, and decreases in utilities expense of $251,000 and depreciation of $13,000. The labor increase is due to contractual wage increases and rising benefit costs. The increase in supplies is due to physicians moving to the IGS Navigation system, a new method of navigation for spine and neurological cases and a rise in the energy price index; directly affecting the pricing for transportation and manufacturing which in turn increases the price of supplies. The increase in professional fees is due to an annual increase in physician fees for ER and Trauma physician and on-call coverage; extended 24 hour, 7 days coverage for Behavioral Medicine; and recruitment of additional physicians.

- Operating income in 2011 was $11,505,000. This operating income is a result of operating revenues in excess of expenses.

- Nonoperating income (expenses) consists of interest earned on invested monies, interest expense, PPH’s share of unrestricted property taxes of $12,625,000 collected by the County of San Diego, and restricted property tax revenue for repayment of General Obligation Bonds of $15,019,000. PPH’s nonoperating income was $33,558,000 in 2011 and $19,039,000 in 2010. Interest rate swap was a gain in 2011 compared to a loss in 2010, resulting in a $12,249,000 increase.

- PPH provided Arch Health Partners, a physician organization, with a capital contribution of $283,000 (See Note 7 — Related Organizations in the consolidated financial statements).

- As a result of the factors noted above, net assets increased by $44,780,000 in 2011, which is $11,995,000 more than the 2010 increase in net assets of $32,785,000.

2010: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Assets

- In accordance with generally accepted accounting principles for governmental healthcare providers, PPH’s consolidated statements of revenue, expenses, and changes in net assets reflect the following: (1) net patient service revenues includes the provision for bad debts, which for nongovernmental hospitals is shown as an operating expense, and (2) nonoperating income (expenses) includes interest expense, which for nongovernmental hospitals is typically grouped as an operating expense. While these GASB requirements make district hospitals conform to other governmental entities, such as colleges and universities, they are less comparable to nongovernment hospitals because the GASB requirements do not apply to them. This must be considered in order to compare PPH to nonprofit and for-profit hospitals. The provision for bad debts was $58,768,000 in fiscal year 2010 and $54,464,000 in fiscal year 2009, and interest expense was $4,628,000 in fiscal year 2010 and $5,353,000 in fiscal year 2009.

- Adjusted discharges are utilized as an aggregate indicator of hospital activity. The calculation of adjusted discharges applies factors representing outpatient activity and skilled nursing activity to inpatient discharges.

- Operating revenue is generated by PPH's primary activity of treating patients and other revenue. Operating revenue increased by $22,378,000 in 2010 due to increases in net patient service revenue of $25,362,000, increase in other revenue of $251,000, and decrease in net premium revenue of $3,235,000. Increases in inpatient and outpatient ancillary revenue and negotiated increases in contracted rates resulted in an increase in net charges during the year.

- Operating expenses are those expenses related to the treatment of patients, including overhead and administration expenses. Operating expenses increased by $14,818,000 in 2010, primarily due to increases in labor costs of approximately $10,008,000, purchased services of $4,556,000, supplies of $900,000, and other expenses of $878,000, and decreases in utilities expense of $868,000, professional fees of $425,000, and rent expense of $375,000. The labor increase is due to contractual wage increases. In addition, bonuses of $3,000,000 have been accrued for employees, according to incentive plan criteria. The increase in supplies is due to increased complexity of cases and increased implantable device surgical cases. The increase in purchased services is for assistance in accounts receivable collection and obtaining insurance for eligible patients previously with self-pay coverage.

- Operating income in 2010 was $17,029,000. This operating income is a result of operating revenues in excess of expenses.

- Nonoperating income (expenses) consists of interest earned on invested monies, interest expense, and PPH's share of property taxes collected by the County of San Diego. PPH's nonoperating income was $19,039,000 in 2010 and $14,001,000 in 2009. Investment income decreased $1,101,000, due to current economic conditions.

- PPH provided Arch Health Partners, a physician organization, with a capital contribution of $3,283,000. (See Note 7 — Related Organizations in the consolidated financial statements).

- As a result of the factors noted above, net assets increased by $32,785,000 in 2010, which is $9,315,000 more than the 2009 increase in net assets of $23,470,000.

Consolidated Statements of Cash Flows — The statements of cash flows report cash receipts, cash payments, and net changes in cash resulting from operating, investing, and financing activities, which provides answers to such questions as where did cash come from, what was cash used for, and what was the change in the cash balance during the reporting period.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2011, 2010, AND 2009
($ in thousands)

	2011	2010	2009
CASH FLOWS FROM:			
Operating activities	$ 39,447	$ 60,457	$ 23,602
Noncapital financing activities	15,491	8,551	20,297
Capital and related financing activities	(41,615)	(12,618)	(97,791)
Investing activities	(8,618)	(59,489)	51,668
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,705	(3,099)	(2,224)
CASH AND CASH EQUIVALENTS — Beginning of year	7,256	10,355	12,579
CASH AND CASH EQUIVALENTS — End of year	$ 11,961	$ 7,256	$ 10,355

See notes to consolidated financial statements.

2011: Analysis of the Consolidated Statement of Cash Flows

- Operating activities cash inflow reflected a decrease of approximately $21,010,000 in 2011 over 2010. This decrease is attributed to increases in cash collections of patient accounts of $6,199,000 offset by increased payments to suppliers and employees of $22,641,000.

- Net cash outflows from capital and related financing activities in 2011 were $41,615,000, primarily due to the funding of PPH's building projects of $232,613,000, interest payments of $37,644,000, and the payment of long-term debt of $7,499,0000 offset by the receipt of $224,728,000 of proceeds from the Series 2010 Certificates of Participation and 2010 General Obligation Bonds, and $15,019,000 of property taxes for debt service.

- Investing activities cash outflows were $8,618,000 in 2011. This outflow is mainly comprised of project fund withdrawals offset by the proceeds of the 2010 Certificates of Participation.

- The ending cash and cash equivalents of $11,961,000 reflect the checking account and overnight investment balances held by PPH. In addition, there were current investments of $176,341,0000 at June 30, 2011.

2010: Analysis of the Consolidated Statement of Cash Flows

- Operating activities cash inflow reflected an increase of approximately $36,855,000 in 2010 over 2009. This increase is attributed to increases in cash collections of patient accounts of $12,996,000 offset by increased payments to suppliers and employees of $429,995,000.

- Net cash outflows from capital and related financing activities in 2010 were $12,618,000, primarily due to the funding of PPH's building projects of $216,316,000, interest payments of $23,330,000, and the payment of long-term debt of $9,780,000 offset by the receipt of $227,840,000 of proceeds from the Series 2009 Certificates of Participation, and $11,586,000 of property taxes for debt service.

- Investing activities cash outflows were $59,489,000 in 2010. This outflow is mainly comprised of the purchases of long-term investments from the proceeds of the Series 2009 Certificates of Participation.

- The ending cash and cash equivalents of $7,256,000 reflect the checking account and overnight investment balances held by PPH. In addition, there were current investments of $164,318,000 at June 30, 2010.

2011: Capital Assets and Long-Term Debt

The Board of Directors has approved a facilities master plan (the "Facilities Master Plan") that is currently budgeted at $1,057,000,000. In November 2004, the residents of the district voted and approved to fund $496,000,000 of this expansion by the issuance of General Obligation Bonds. Payment for these bonds is funded by ad valorem property tax levied on the district residents. The approximate levy amount for each resident remains was $23.50 per $100,000 of assessed value for FY11. The levy is established each year in an amount sufficient to service the debt for the upcoming year along with a reserve amount.

One of the major components of the Facilities Master Plan includes the construction of a new second PMC campus (West) in Escondido. Other building projects will include expansion of existing hospital facilities at Pomerado; renovation of the existing PMC (East) campus; and construction of outpatient facilities at several community locations.

As of June 30, 2011, land purchases of $51 million are reflected in construction in progress to facilitate the overall accounting of the major building expansion. To date, key accomplishments for PMC (West) include commissioning of the central plant; commencement of site improvements (paving, walls, landscaping, etc.); completion of roofing; and commencement of interior finishes including painting, flooring, and casework. The project remains ontime for completion and placing in to service in 2012.

The expansion and/or renovation at Pomerado Hospital, which commenced in 2008 includes the completed and in service central plant, helipad, pharmacy remodel, hyperbaric oxygen therapy (HBO) office, and a variety of site work.

Development of the outpatient facilities includes securing land for the Rancho Penasquitos and Ramona projects as well as entitlements through the City and County of San Diego.

PPH has four outstanding revenue bond issues that are classified as long-term debt. These are the 1999 Insured Revenue Bonds, the 2006 Certificates of Participation, the 2009 Certificates of Participation, and the 2010 Certificates of Participation. PPH made principal payments on these issues totaling $6,370,000, bringing the net long-term bond principal to $597,810,000. All debt payments were made timely and PPH was in good standing on all bond covenants throughout the year. More detailed information about PPH debt is presented in Note 8 to the consolidated financial statements. PPH has an underlying Moody's rating of Baa3 on its revenue bonds and certificates of participation.

In July 2005, PPH issued its first series of G.O. Bonds in the amount of $80,000,000 for use in funding the building expansion project. In December 2007, PPH issued its second series of G.O. Bonds in the amount of $241,083,000. In March 2009, PPH issued its third series of G.O. Bonds in the amount of $110,000,000. In November 2010, PPH issued the final tranche of $64,917,000. A principal payment of $1,025,000 reduced the G.O. Bond principal to $481,515,000 as of June 30, 2011. PPH has an underlying Moody's rating of A1 on its G.O. Bonds.

2010: Capital Assets and Long-Term Debt

The Board of Directors has approved the "Facilities Master Plan" that is currently budgeted at $1,057,000,000. In November 2004, the residents of the district voted and approved to fund $496,000,000 of this expansion by the issuance of G.O. Bonds. Payment for these bonds will be funded by ad valorem property tax levied on the district residents. The approximate amount for each resident is $23.50 per $100,000 of assessed value, an increase from the prior year due to declining property values and economic conditions.

One of the major components of the Facilities Master Plan include construction of a new second PMC campus (West) in Escondido. Other building projects will include expansion of existing hospital facilities at Pomerado, renovation of the existing PMC (East) campus, and construction of outpatient facilities at several community locations.

In connection with the major building expansion, four buildings had been purchased during fiscal years 2008 and 2009, to expand the Palomar Medical Center site. As of June 30, 2010, land purchases of $51 million are reflected in construction in progress to facilitate the overall accounting of the major building expansion. Key accomplishments for PMC (West) include commencement of drywall production, completed support steel on Level 1 for medical equipment, exterior cladding system through Level 9, and 12 KV electrical feeds pulled from central plan to hospital.

The expansion and/or renovation at Pomerado, which commenced in 2008 includes the completed and in service Pomerado central plant, helipad, Pharmacy remodel, hyperbaric oxygen therapy (HBO) office, and a variety of site work.

Development of the outpatient facilities includes securing land for the Rancho Penasquitos and Ramona projects as well as entitlements through the City and County of San Diego.

PPH has three outstanding revenue bond issues that are classified as long-term debt. These are the 1999 Insured Revenue Bonds, the 2006 Certificates of Participation, and the 2009 Certificates of Participation. PPH made principal payments on these issues totaling $8,835,000, bringing the net long-term bond principal to $440,815,000. All debt payments were made timely and PPH was in good standing on all bond covenants throughout the year. More detailed information about PPH debt is presented in Note 8 to the consolidated financial statements. PPH has an underlying Moody's rating of Baa2 on its revenue bonds and certificates of participation. PPH has an underlying Moody's rating of Aa3 on its G.O. Bonds. In July 2005, PPH issued its first series of G.O. Bonds in the amount of $80,000,000 for use in funding the building expansion project. In December 2007, PPH issued its second series of G.O. Bonds in the amount of $241,083,000. In March 2009, PPH issued its third series of G.O. Bonds in the amount of $110,000,000. A principal payment of $945,000 reduced the G.O. Bond principal to $417,623,000 as of June 30, 2010.

Liquidity and Capital Resources

PPH's unrestricted liquidity position as of June 30, 2011, was $188,302,000, including $11,961,000 in operating cash and $176,341,000 in unrestricted investments stated at fair market value. PPH's unrestricted liquidity position as of June 30, 2010, was $171,574,000, including $7,256,000 in operating cash and $164,318,000 in unrestricted investments stated at fair market value. The available liquidity of $188,302,000 represents a $16,728,000 increase over the $171,574,000 in available liquidity as of June 30, 2010, and equaled 31.9% of total outstanding debt exclusive of the general obligation bonds, which are funded separately from ad valorem taxes as of June 30, 2011.

Economic and Other Factors

A number of significant factors are affecting the financial health of healthcare providers. Some major factors are as follows:

Patient Projection and Affordable Care Act H.R. 3590 (the "Act") — This Act, aka Federal Healthcare Reform, signed into law in March 2010, will result in extensive changes to the U.S. healthcare system. PPH is exploring the establishment of an Accountable Care Organization (ACO) as a delivery option as well as determining the impact overall to the organization.

Hospital Provider Fee — Assembly Bill 1653 passed the Assembly on August 31, 2010, and outlines the changes necessary to implement the supplemental Medi-Cal payments to hospitals. As a District Hospital, PPH does not participate in the provider fee program, but rather is eligible to participate in Intergovernmental transfer programs (IGTs). PPH does participate in a federal match IGT model program. PPH did not receive the return of the funding nor the additional net fee-for-service payment in fiscal year 2011 due to State administrative delay in the program implementation. PPH anticipates receipt of the funded and net additional payment in fiscal year 2012. PPH did fund the program $2.13 million in June 2011 (reduction of cash on hand).

Insurance Reimbursement — Healthcare providers are taking advantage of higher premium increases by insurers in recent years by negotiating improved reimbursements and restoring cost coverage and profitability to the commercial managed care business segment.

Medicare Reimbursement — The Benefits Improvement and Protection Act and the Balanced Budget Relief Act allow for a declining adverse financial impact originally imposed by the Balanced Budget Act of 1997. Management is in the process of evaluating the impact of the Act on Medicare reimbursements.

Demand for Services — Due to the aging of the population and a steady growth in overall population in PPH's primary and secondary service areas, hospital admissions have remained steady while emergency visits and overall demand for healthcare services has increased.

Labor Cost Increases — The State of California mandated nurse staff ratios have increased demand for nursing personnel and increased salary and wages expenses. PPH has implemented a successful nurse residency program in 2010 to recruit and retain nursing graduates.

Pharmaceutical Costs — The continued escalation of pharmaceutical drug costs remains a challenge for providers.

State Budget Difficulties — Faced with multiyear budget deficits, California's budget proposal to improve Medicaid's efficiencies include program eliminations as well as spending reductions that will directly impact hospitals.

American Recovery & Reinvestment Act of 2009 (ARRA) — ARRA is an economic stimulus package enacted by Congress in February 2009. Among some of the measures included in the Act includes expansion of social welfare provisions and domestic spending in health care. The ARRA provides funds to states in the form of a temporary increase in contributions toward Medicaid. As of June 30, 2011 and 2010, PPH had not received any funding from ARRA.

The Health Information Technology for Economic and Clinical Health Act (*HITECH*) — HITECH is part of the ARRA, which contains incentives related to health care information technology in general (e.g., creation of a national health care infrastructure) and contains specific incentives designed to accelerate the adoption of electronic health record (EHR) systems among providers. PPH had not received any funding from HITECH as of June 30, 2011 and 2010. PPH anticipates meeting the meaningful use criteria in FY12 for the implementation of its certified EHR.

Heightened Competition — Services that have a profit margin are becoming more competitive as entrepreneurial physicians and for-profit entities migrate to services with a return on investment, putting further stress on hospital providers that traditionally cover core and safety net services with returns on profitable services.

The Health Insurance Portability and Accountability Act (HIPAA) — HIPAA among other things establishes privacy and security regulations over patient information that may have significant cost implications for healthcare providers.

Seismic Compliance — California Senate Bill 1953 ("SB 1953") requires hospitals to meet more stringent seismic guidelines, which represent an unfunded mandate and impose a financial burden by 2008 under current regulation. Under certain criteria, it is possible to extend the SB 1953 deadline to 2013. PPH applied for an extension from the California Department of Health Services, moving PPH's deadline to 2013, and has received approval for the extension. PPH's noncompliant buildings were reassessed using HAZUS criteria and now have a structural performance category of SPC-2, which have until 2030 to comply with the structural seismic safety standards.

Finance Contact

PPH's consolidated financial statements are designed to present users with a general overview of PPH's finances and to demonstrate PPH's accountability. If you have any questions about the report or need additional financial information, please contact the Chief Financial Officer, Palomar Pomerado Health, 456 E. Grand Avenue, Escondido, California 92025.

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Palomar Pomerado Health:

We have audited the accompanying consolidated balance sheets of Palomar Pomerado Health (PPH) as of June 30, 2011 and 2010, and the related consolidated statements of revenue, expenses, and changes in net assets and of cash flows for the years then ended. These consolidated financial statements are the responsibility of PPH's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. An audit includes 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 PPH'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 consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of PPH as of June 30, 2011 and 2010, and the results of its operations, its changes in net assets, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 1–12 is not a required part of the basic consolidated financial statements but is supplementary information required by the Government Accounting Standards Board. This supplementary information is the responsibility of PPH's management. We have applied certain limited procedures, which consisted of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information, and we do not express an opinion on it.

Deloitte & Touche LLP

October 21, 2011

PALOMAR POMERADO HEALTH

CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2011 AND 2010
($ in thousands)

ASSETS	2011	2010
CURRENT ASSETS:		
Cash and cash equivalents	$ 11,961	$ 7,256
Investments	176,341	164,318
Patient accounts receivable — net of allowances for uncollectible accounts of $36,037 in 2011 and $24,435 in 2010	79,552	81,283
Other receivables	8,015	4,854
Supplies/inventories	7,176	6,961
Prepaid expenses and other	2,742	3,186
Assets whose use is limited — current portion	27,599	27,972
Assets whose use is limited — general obligation bonds — current portion	14,954	12,923
Total current assets	328,340	308,753
ASSETS WHOSE USE IS LIMITED:		
Held by trustee under indenture agreements	262,444	258,132
Held by trustee under general obligation bonds indenture	14,954	19,838
Held in escrow for street improvements	14,161	14,350
Restricted by donor	318	314
Total assets whose use is limited	291,877	292,634
Less current portion	42,553	40,895
Total assets whose use is limited — long-term portion	249,324	251,739
CAPITAL ASSETS — Net	1,061,644	795,252
OTHER ASSETS:		
Deferred financing costs — net	24,441	22,212
Investment in and amounts due from affiliated entities	2,884	2,035
Other	2,811	3,716
Total other assets	30,136	27,963
TOTAL	$ 1,669,444	$ 1,383,707

(Continued)

PALOMAR POMERADO HEALTH

CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2011 AND 2010
($ in thousands)

LIABILITIES AND NET ASSETS	2011	2010
CURRENT LIABILITIES:		
Accounts payable	$ 56,116	$ 45,456
Accrued compensation and related liabilities	29,465	28,587
Current portion of long-term debt	7,048	6,474
Current portion of general obligation bonds	1,652	1,025
Estimated third-party payor settlements	3,353	1,343
Other accrued liabilities	19,537	16,501
Accrued interest payable	9,491	7,879
Total current liabilities	126,662	107,265
WORKERS' COMPENSATION — Net of current portion	1,036	1,482
DEFERRED REVENUE	8,180	8,583
LONG-TERM DEBT — General obligation bonds — Net of current portion	525,204	451,945
LONG-TERM DEBT — Net of current portion	582,485	428,476
FAIR VALUE OF INTEREST RATE SWAP	19,463	24,322
Total liabilities	1,263,030	1,022,073
COMMITMENTS AND CONTINGENCIES (Note 13)		
NET ASSETS:		
Invested in capital assets — net of related debt	167,599	137,672
Restricted for repayment of debt	33,062	33,016
Restricted for capital acquisitions	14,161	14,350
Restricted for other purposes	318	314
Unrestricted	191,274	176,282
Total net assets	406,414	361,634
TOTAL	$ 1,669,444	$ 1,383,707

See notes to consolidated financial statements. (Concluded)

PALOMAR POMERADO HEALTH

CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEARS ENDED JUNE 30, 2011 AND 2010 ($ in thousands)

	2011	2010
OPERATING REVENUE:		
Net patient service revenue	$ 442,142	$ 422,906
Net premium revenue	36,673	37,655
Other revenue	11,192	7,822
Total operating revenue	490,007	468,383
OPERATING EXPENSES:		
Salaries, wages, and benefits	291,268	269,745
Professional fees	24,167	23,283
Supplies	74,332	71,124
Purchased services	38,471	38,429
Depreciation and amortization	21,346	21,359
Rent expense	8,624	8,032
Utilities expense	4,870	5,121
Other	15,424	14,261
Total operating expenses	478,502	451,354
INCOME FROM OPERATIONS	11,505	17,029
NONOPERATING INCOME (EXPENSES):		
Investment income	2,626	3,189
Unrealized gain (loss) on interest rate swap	4,859	(7,570)
Interest expense	(4,720)	(4,628)
Property tax revenue	12,625	12,926
Property tax revenue — general obligation bonds	15,019	11,586
Other — net	3,149	3,536
Total nonoperating income — net	33,558	19,039
EXCESS OF REVENUE OVER EXPENSES	45,063	36,068
INTERFUND — Arch Health Partners	(283)	(3,283)
INCREASE IN NET ASSETS	44,780	32,785
NET ASSETS — Beginning of year	361,634	328,849
NET ASSETS — End of year	$ 406,414	$ 361,634

See notes to consolidated financial statements.

PALOMAR POMERADO HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010
($ in thousands)

	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from:		
Patients, insurers, and other third-party payors	$ 503,777	$ 497,578
Other sources	8,087	12,655
Payments to:		
Employees	(181,581)	(266,685)
Suppliers	(290,836)	(183,091)
Net cash provided by operating activities	39,447	60,457
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Receipt of district taxes	12,625	12,926
Other	2,866	(4,375)
Net cash provided by noncapital financing activities	15,491	8,551
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(232,613)	(216,316)
Interest paid	(37,664)	(23,330)
Deferred financing costs	(3,586)	(2,618)
Proceeds from issuance of debt	224,728	227,840
Repayment of long-term debt	(7,499)	(9,780)
Receipt of property taxes restricted for debt service on general obligation bonds	15,019	11,586
Net cash used in capital and related financing activities	(41,615)	(12,618)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(431,955)	(315,498)
Sale of investments	423,408	251,716
Interest received on investments and notes receivable	(71)	(2,479)
Receipts from liquidation of interest in PDP Pomerado, LLC.		6,772
Net cash (used in) by investing activities	(8,618)	(59,489)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,705	(3,099)
CASH AND CASH EQUIVALENTS — Beginning of year	7,256	10,355
CASH AND CASH EQUIVALENTS — End of year	$ 11,961	$ 7,256

(Continued)

PALOMAR POMERADO HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010
($ in thousands)

	2011	2010
RECONCILIATION OF OPERATING INCOME TO NET CASH FLOWS FROM OPERATING ACTIVITIES:		
Income from operations	$ 11,505	$ 17,029
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation and amortization	21,346	21,359
Provision for bad debts	60,030	58,768
Equity in earnings of affiliates	(849)	768
Changes in assets and liabilities:		
Patient accounts receivable	(58,299)	(45,772)
Other receivables	(3,161)	(411)
Supplies/inventories	(215)	(614)
Prepaid expenses and other	444	810
Other — net	905	1,576
Accounts payable	2,666	3,569
Accrued compensation and related liabilities	432	3,060
Other accrued liabilities	3,176	(496)
Estimated third-party payor settlements	2,010	(1,000)
Deferred revenue	(543)	1,811
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 39,447	$ 60,457
NONCASH INVESTING AND CAPITAL AND FINANCING ACTIVITIES — Capital expenditures included in accounts payable	$ 36,942	$ 28,948

See notes to consolidated financial statements. (Concluded)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization — Palomar Pomerado Health (PPH), a public healthcare district, is organized under the provisions of the Health and Safety Code of the State of California to provide and operate healthcare facilities. The accompanying consolidated financial statements include the accounts of the following commonly controlled divisions and entities of PPH:

- Palomar Medical Center, located in Escondido, California, including Palomar Continuing Care Center, a convalescent facility
- Pomerado Hospital, located in Poway, California, includes Villa Pomerado, a convalescent and sub-acute facility
- Home Health, located in Escondido, California
- San Marcos Ambulatory Care Center, located in San Marcos, California
- San Marcos Behavioral Medicine Center, located in San Marcos, California
- Central Office, providing management, financial, data processing, materials management, and public affairs services to the other divisions
- Health Development, a charitable nonprofit organization created to provide assistance and support for PPH by obtaining grant funding from federal, state, local, and private sources
- PPH expresscare, located in Albertson Grocery stores in Escondido and Rancho Penasquitos

Basis of Presentation — The consolidated financial statements have been prepared in accordance with the applicable provisions of the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Health Care Organizations*, and pronouncements of the Governmental Accounting Standards Board (GASB). PPH uses proprietary (enterprise) fund accounting. Revenues and expenses are recognized on the accrual basis using the economic resources measurement focus.

Use of Estimates — The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Proprietary Fund Accounting — PPH utilizes the proprietary fund method of accounting, whereby revenue and expenses are recognized on the accrual basis.

Accounting Standards — Pursuant to GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* PPH has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

Cash and Cash Equivalents — Cash and cash equivalents include highly liquid debt instruments with original maturities of three months or less and are intended for use in daily operations.

Investments — Investments in debt securities are carried at fair value, as determined by quoted market prices, in the consolidated balance sheets. Investment income or loss is included in nonoperating income, unless the income or loss is restricted by donor or law.

Supplies/Inventories — Inventories are stated at the lower of cost (first-in, first-out) or market value.

Assets whose Use is Limited — Assets whose use is limited primarily include assets held by trustees under indenture agreements and designated assets set aside by the Board of Directors for future capital improvements over which the Board of Directors retains control and may, at its discretion, subsequently use for other purposes. Amounts required to meet current liabilities of PPH have been classified as current assets in the accompanying consolidated balance sheets.

PPH has entered into an agreement with the City of Escondido (the "City") to jointly finance street improvements near the site of PPH's new hospital to be constructed in the City. Under the agreement, PPH was required to deposit $13,000,000 into a jointly managed account between the City and PPH. The balance of $14,161,000 and $14,350,000 on June 30, 2011 and 2010, respectively, is included in assets whose use is limited in the accompanying 2011 consolidated balance sheets.

Capital Assets — Property, plant, and equipment acquisitions are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful life of each class of depreciable asset (the shorter of the estimated useful life or the lease term for leasehold improvements) as follows:

	Years
Land improvements	15
Buildings and building improvements	10–40
Leasehold improvements	3–15
Equipment	3–15

Interest cost incurred on borrowed funds during the period of construction of capital assets, net of interest earned of $425,000 and $1,161,000 for the years ended June 30, 2011 and 2010, respectively, on temporary investments of the proceeds for construction projects funded by tax-exempt borrowings, is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized was $48,577,000 and $40,239,000 for the years ended June 30, 2011 and 2010, respectively.

Gifts of long-lived assets, such as land, buildings, or equipment are reported as unrestricted support in other changes in net assets and are excluded from the excess of revenue over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support in other changes in net assets. Absent explicit donor stipulations about how long those long-lived assets must be maintained and expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Capital assets are reviewed for impairment when events or changes in circumstances suggest that the service utility of the capital asset may have significantly and unexpectedly declined. Capital assets are considered impaired if both the decline in service utility of the capital asset is large in magnitude and the event or change in circumstance is outside the normal life cycle of the capital asset. Such events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment, or approval of laws or regulations or other changes in environmental factors; technological changes or evidence of obsolescence; changes in the manner or duration of use of a capital asset; and construction stoppage. The determination of the impairment loss is dependent upon the event or circumstance in which the impairment occurred. Impairment losses are recorded in the consolidated statements of revenue, expenses, and changes in net assets. There were no impairment losses in the years ended June 30, 2011 and 2010.

Debt Discounts, Debt Premiums and Deferred Financing Costs — Debt discounts, debt premiums and deferred financing costs are amortized by the bonds' outstanding method over the life of the related bonds. Deferred financing costs included $31,312,000 and $27,726,000, net of accumulated amortization of $6,871,000 and $5,514,000, as of June 30, 2011 and 2010, respectively.

Interest Rate Swaps — PPH has entered into variable-to-fixed interest rate swaps, which are reflected at fair value in the 2011 consolidated balance sheet. The fair value of the interest rate swaps will fluctuate based generally on changes in market rates of interest. Any unrealized gains or losses resulting from changes in fair value are reported as nonoperating income (expenses) in the consolidated statements of revenue, expenses, and changes in net assets. Interest cost on variable interest rate debt is reported based on the fixed interest rate paid by PPH under the interest rate swaps. Severe fluctuations in the municipal bond market resulted in an interest rate increase of 2006 auction rate securities (ARS) obligations. As of June 30, 2011 and 2010, the interest rate swaps were recorded as a liability of $19,463,000 and $24,322,000, respectively.

Net Assets — Net assets of PPH are classified in five components. Net assets invested in capital assets — net of related debt consist of capital assets net of accumulated depreciation and reduced by the current balances of any outstanding borrowing used to finance the purchase or construction of those assets. Net assets restricted for repayment of debt are amounts deposited with trustees as required by bond indentures, as described in Note 8. Net assets restricted for capital acquisitions relate to amounts restricted to acquire capital assets. Net assets restricted for other purposes are noncapital net assets that must be used for a particular purpose, as specified by contributors external to PPH. Unrestricted net assets are remaining net assets that do not meet the definition of invested in capital assets — net of related debt or restricted.

Consolidated Statements of Revenue, Expenses, and Changes in Net Assets — All revenues and expenses directly related to the delivery of healthcare services are included in operating revenue and expenses in the consolidated statements of revenue, expenses, and changes in net assets. Nonoperating income and expenses consist of those revenues and expenses that result from nonexchange transactions and interest expense and investment income.

Net Patient Service Revenue — PPH has agreements with third-party payors that provide for payments to PPH at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and daily rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined.

Premium Revenue — PPH has agreements with various third-party payors to provide medical services to subscribing participants. Under some of these agreements, PPH receives monthly capitation payments based on the number of each payor's participants, regardless of services actually performed by PPH. Under these agreements, PPH also participates in shared risk pools with medical groups, through which it could receive additional reimbursement or pay additional amounts to the medical groups. In conjunction with the shared risk pools, PPH estimates incurred but not reported (IBNR) claims for medical services provided to patients. IBNR of $7,394,000 and $6,054,000 are included in other accrued liabilities in the accompanying consolidated balance sheets as of June 30, 2011 and 2010, respectively.

Charity Care — PPH provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are not reported as revenue in the accompanying consolidated financial statements. Charity care charges forgone, at established rates, for the years ended June 30, 2011 and 2010, were approximately $21,857,000 and $23,245,000, respectively.

Property Taxes — PPH receives financial support from property taxes. Property taxes are levied by the County of San Diego on behalf of PPH to finance PPH's activities. Amounts levied are based on assessed property values. Property tax revenue for the years ended June 30, 2011 and 2010, consists of the following:

	2011	2010
To support operations — unrestricted use	$12,625,000	$12,926,000
For debt service on general obligation bonds — restricted use	15,019,000	11,586,000
Total	$27,644,000	$24,512,000

Income Taxes — PPH is a governmental subdivision of the state of California and is exempt from federal income and state franchise taxes.

Recent Accounting Pronouncements — In June 2010, the GASB issued GASB Statement No. 59, *Financial Instruments Omnibus*. The objective of this statement is to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. The provisions of this statement are effective for periods beginning after June 15, 2010. Implementation of this statement did not have a material impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

In November 2010, the GASB issued GASB Statement No. 61, *The Financial Reporting Entity: Omnibus — an amendment of GASB Statements No. 14 and No. 34*. The objective of this statement is to improve financial reporting for a governmental financial reporting entity. The requirements of GASB Statement No. 14, *The Financial Reporting Entity*, and the related financial reporting requirements of GASB Statement No. 34, *Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments*, were amended to better meet user needs and to address reporting entity issues that have arisen since the issuance of those statements. The provisions of this statement are effective for periods beginning after June 15, 2012. Management does not believe that the adoption of this statement will have a material impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

In June 2011, the GASB issued GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. This statement provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. The provisions of this statement are effective for periods beginning after December 31, 2011. Management does not believe that the adoption of this statement will have a material impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

In June 2011, the GASB issued GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions* — an amendment of GASB Statement No. 54. The objective of this statement is to clarify whether an effective hedging relationship continues after the replacement of a swap counterparty or a swap counterparty's credit support provider. This statement sets forth criteria that establish when the effective hedging relationship continues and hedge accounting should continue to be applied. The provisions of this statement are effective for periods beginning after June 15, 2011. Management does not believe that the adoption of this statement will have a material impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

2. NET PATIENT SERVICE REVENUE

PPH renders services to certain patients under contractual arrangements with the Medicare and Medi-Cal programs and various health maintenance and preferred provider organizations. The Medicare program generally pays a prospectively determined fee for services rendered to Medicare patients. Additionally, Medicare reimburses PPH for certain inpatient services (primarily mental health unit services) on the basis of costs incurred. The Medi-Cal program provides for payment on a prospectively negotiated contractual rate per day, percentage of charges for services rendered, or capitated payment arrangement.

Revenue from the Medicare and Medi-Cal programs, inclusive of risk (capitated) and nonrisk managed care programs, accounted for approximately 58% and 57% of PPH's net patient service revenue for the years ended June 30, 2011 and 2010, respectively.

Third-party settlements are recorded when received, which includes tentative settlements, lump-sum adjustments, for prior or current cost reporting periods. The cost reports for Medicare and Medi-Cal programs have been settled through fiscal year 2007. Results of cost report settlements, as well as estimates for settlements of all fiscal years through 2010, have been reflected in the accompanying consolidated financial statements.

As of June 30, 2011 and 2010, estimated third-party settlements resulted in a $3,353,000 and $1,343,000 liability, respectively. During fiscal years 2011 and 2010, PPH settled various prior-year cost reports and appeal issues. These settlements resulted in approximately $10,791,000 and $6,871,000 of additional revenues in fiscal years 2011 and 2010, respectively, which are included in net patient service revenue in the accompanying consolidated statements of revenue, expenses, and changes in net assets.

PPH also has entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to PPH under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

3. CASH AND CASH EQUIVALENTS AND INVESTMENTS

The State of California Government Code (the "Government Code") generally authorizes PPH to invest unrestricted and board-designated assets in obligations of the U.S. Treasury and certain U.S. government agencies, obligations of the State of California and local government entities, bankers' acceptances, commercial paper, certificates of deposit, repurchase agreements, and mortgage securities. Certain of these investments may be purchased only in limited amounts, as defined in the Government Code.

PPH's bond indenture agreements authorize trustee-held assets to be invested in obligations of the U.S. Treasury and certain U.S. government agencies, repurchase agreements, and obligations of financial institutions meeting certain criteria defined in the indentures.

The California State Treasury makes available the Local Agency Investment Fund (LAIF) through which local governments may pool investments. Each governmental entity may invest up to $50,000,000 of unrestricted monies in the fund and an unlimited amount of qualified bond proceeds. As of June 30, 2011, PPH had invested $48,664,000 of unrestricted funds in this fund and $10,060,000 jointly managed funds under an escrow agreement with the City of Escondido. Investments in the LAIF are highly liquid, as deposits can be converted to cash within 24 hours without loss of interest. PPH is a voluntary participant in the LAIF. The fair value of PPH's investments in the LAIF is reported in the accompanying consolidated balance sheets based on PPH's pro rata share of the fair value provided by LAIF for the entire LAIF portfolio.

As of June 30, 2011 and 2010, PPH had the following investments:

	2011	2010
Investments — current	$176,341,000	$164,318,000
Assets whose use is limited — current	42,553,000	40,895,000
Assets whose use is limited — long-term	249,324,000	251,739,000
Total	$468,218,000	$456,952,000

As of June 30, 2011 and 2010, PPH had investments by type and maturity as follows:

	2011		
		Investment Maturities (in Years)	
Investment Type	**Fair Value**	**Less Than 1**	**1–5**
LAIF	$ 58,724,000	$ 58,724,000	$ -
U.S. government bonds	45,063,000	17,783,000	27,280,000
U.S. Treasury bills	55,230,000	11,567,000	43,663,000
Corporate bonds	21,245,000	1,782,000	19,463,000
Money market mutual funds	287,956,000	287,956,000	-
Total	$468,218,000	$377,812,000	$90,406,000

	2010		
		Investment Maturities (in Years)	
Investment Type	**Fair Value**	**Less Than 1**	**1–5**
LAIF	$ 43,806,000	$ 43,806,000	$ -
U.S. government bonds	31,027,000	6,920,000	24,107,000
U.S. Treasury bills	31,161,000	572,000	30,589,000
Corporate bonds	13,022,000	3,873,000	9,149,000
Money market mutual funds	337,936,000	337,936,000	-
Total	$456,952,000	$393,107,000	$63,845,000

There are many factors that can affect the value of investments. Some, such as interest rate risk, credit risk, concentration of credit risk, and custodial credit risk, may affect both equity and fixed income securities. Equity and debt securities respond to such factors as economic conditions, individual company earnings performance, and market liquidity, while fixed income securities are particularly sensitive to credit risks and changes in interest rates.

Interest Rate Risk — Interest rate risk is the risk that the value of fixed income securities will decline due to increasing interest rates. The terms of a debt investment may cause its fair value to be highly sensitive to interest rate changes. As a means of limiting exposure to fair value losses arising from increasing interest rates, PPH's investment policy, as per statutory requirements, limits the term of any investment to a maturity not exceeding five years.

Similarly, PPH has an exposure to variable interest rate risk stemming from volatility in the auction-rate bond market. The auction-rate bond market allows public agencies to issue long-term debt at short-term rates that typically reset in weekly or monthly auctions. PPH's ARS are subject to weekly resets.

Credit Risk — Fixed income securities are subject to credit risk, which is the chance that an issuer will fail to pay interest or principal in a timely manner or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline. Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk. State law limits PPH's investment in commercial paper, corporate bonds, and bond mutual funds with an "A" rating issued by nationally recognized statistical rating organizations. PPH has no investment policy that would further limit investment choices. As of June 30, 2011 and 2010, PPH's investments, excluding U.S. government obligations, consisted of the following: corporate bond investments rated "A" or better by Standard & Poor's and Moody's Investor Services, U.S. Government Agency investments rated "AAA" by Standard & Poor's and Moody's Investor Services, and PPH's investments in the LAIF, which were not rated.

Concentration of Credit Risk — Concentration of credit risk is the risk associated with a lack of diversification, such as having substantial investments in a few individual issuers, thereby exposing PPH to greater risks resulting from adverse economic, political, regulatory, geographic, or credit developments. Investments issued or guaranteed by the U.S. government and investments in external investment pools, such as the LAIF, are not considered subject to concentration of credit risk. In accordance with state law, no more than 5% of total investments may be invested in the securities of any one issuer, except obligations of the U.S. government, no more than 10% may be invested in any one mutual fund, and no more than 30% may be invested in bankers' acceptances of any one commercial bank.

Investments in any one issuer (other than U.S. Treasury securities and external investment pools) that represent 5% or more of the total investments as of June 30, 2011 and 2010, are as follows:

Issuer	Investment Type	2011	2010
Federal National Mortgage Association	Federal Agency Securities	$ -	$ -
Morgan Stanley	Morgan Stanley Active Assets Money Market Trust		55,510,000
U.S. Bank, Trustee	U.S. Bank Money Market	262,444,000	258,132,000
Wells Fargo Advantage Government Money Market	U.S. Government Money Market Funds		24,188,000
Total		$ 262,444,000	$ 337,830,000

Custodial Credit Risk — Investments — All of PPH's investments are insured or registered or are held by PPH's agent in the agent's nominee name, with subsidiary records listing PPH as the legal owner. For these reasons, PPH is not exposed to custodial credit risk for its investments.

Custodial Credit Risk — Deposits — Custodial credit risk is the risk that in the event of a bank failure, PPH's deposits may not be returned to it. PPH does not have a policy for custodial credit risk. As of June 30, 2011 and 2010, PPH's bank balances totaled $17,861,000 and $17,562,000, respectively, and were not exposed to custodial credit risk, as the uninsured deposits are with financial institutions that are individually required by state law to have government deposits collateralized at a rate of 110% of the deposits. Such collateral is considered to be held in PPH's name.

4. CONCENTRATIONS OF CREDIT RISK

PPH grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of gross receivables from patients and third-party payors as of June 30, 2011 and 2010, was as follows:

	2011	**2010**
Medicare	18 %	19 %
Medi-Cal	10	14
HMO/PPO/commercial	38	39
Patient	22	16
Others	12	12
Total	100 %	100 %

5. CAPITAL ASSETS

A summary of changes in capital assets for the years ended June 30, 2011 and 2010, is as follows:

	Beginning Balance Fiscal 2011	Additions	Disposals	Transfers	Ending Balance Fiscal 2011
Land improvements	$ 15,416,000	$ -	$ -	$ -	$ 15,416,000
Buildings and leasehold improvements	206,631,000	41,000	(9,000)	1,481,000	208,144,000
Equipment	178,901,000	9,606,000	(2,956,000)	3,068,000	188,619,000
Land	15,552,000			165,000	15,717,000
Construction in progress	611,235,000	278,278,000		(4,714,000)	884,799,000
	1,027,735,000	287,925,000	(2,965,000)	-	1,312,695,000
Less accumulated depreciation and amortization	(232,483,000)	(21,346,000)	2,778,000		(251,051,000)
Capital assets — net	$ 795,252,000	$ 266,579,000	$ (187,000)	$ -	$ 1,061,644,000

	Beginning Balance Fiscal 2010	Additions	Disposals	Transfers	Ending Balance 2010
Land improvements	$ 15,218,000	$ 188,000	$ -	$ 10,000	$ 15,416,000
Buildings and leasehold improvements	178,115,000	3,000	(4,318,000)	32,831,000	206,631,000
Equipment	186,397,000	2,583,000	(12,031,000)	1,952,000	178,901,000
Land	15,285,000			267,000	15,552,000
Construction in progress	400,568,000	245,727,000		(35,060,000)	611,235,000
	795,583,000	248,501,000	(16,349,000)	-	1,027,735,000
Less accumulated depreciation and amortization	(227,431,000)	(21,361,000)	16,309,000		(232,483,000)
Capital assets — net	$ 568,152,000	$ 227,140,000	$ (40,000)	$ -	$ 795,252,000

6. INVESTMENT IN AND AMOUNTS DUE FROM AFFILIATED ENTITIES

During fiscal year 2007, PPH entered into a partnership agreement with PDP Pomerado, LLC in exchange for a ground lease agreement. During fiscal year 2010, the partnership with PDP Pomerado, LLC, was terminated, and the ground lease agreement was transferred to NHP/PMP Pomerado, LLC. In conjunction with the termination of the partnership, PDP Pomerado, LLC was dissolved, and its assets were liquidated. PPH received proceeds of $9,672,000 for its interest in PDP Pomerado, LLC, which is presented as deferred revenue in the accompanying consolidated financial statements. This deferred revenue will be recognized as income based on the terms of the ground lease agreement.

A partnership with San Diego Radiosurgery (SDRS) was created in April 2008. SDRS offers a method for treating harmful tumors that does not require an invasive procedure or anesthesia and lets the patient go home immediately afterwards. Under this partnership, PPH and SDRS entered into a reciprocal leasing arrangement wherein the equipment is leased in exchange for office and clinical space in Palomar Medical Center.

In an effort to strengthen the pediatric/NICU services in the North County, PPH and Rady Children's Hospital, San Diego ("Rady") entered into an affiliation in April 2010, whereby PPH transferred day to day operation of the inpatient pediatric and neonatal program, including licensure of beds to Rady. As of August 2010, Rady provides these services at Palomar Medical Center and leases this space from PPH under what is commonly known as a hospital in a hospital arrangement. On a fee basis, PPH directly provides ancillary services including lab, imaging, and pharmacy as well as other support services. Because certain costs are allocated to the parties, an oversight committee was created to oversee administrative, operational, and clinical components of the Affiliated Program Agreement.

PPH acquired a minority interest of 2.5% in Parkway Endoscopy in September 2010 to allow community members and physicians to utilize state-of-the-art equipment at one convenient location.

To position itself in outpatient imaging services in North County, in April 2011, PPH and Imaging Services Associates, LLC created a joint venture, Palomar Pomerado Imaging, LLC to provide high-tech medical imaging services.

7. RELATED ORGANIZATIONS

Palomar Pomerado Health Foundation — Palomar Pomerado Health Foundation (the “Foundation”) is a charitable nonprofit organization created to provide assistance and support for PPH. The Foundation is a separately governed organization. Its net assets and results of operations are not included in the accompanying consolidated financial statements of PPH.

The Foundation funds various programs on behalf of PPH. Funding for these programs provided by the Foundation totaled $4,620,000 and $4,533,000 for the years ended June 30, 2011 and 2010, respectively.

In September 2005, PPH entered into a management services agreement with the Foundation, whereby PPH provides administrative support to the Foundation. Support provided to the Foundation totaled $2,481,000 and $2,354,000 for the years ended June 30, 2011 and 2010, respectively. The management services agreement includes a line of credit with a $5,000,000 limit that renewed on June 30, 2010. The amount outstanding on the line of credit was $0 and $1,630,000 as of June 30, 2011 and 2010, respectively.

A summary of the Foundation’s assets, liabilities, and net assets (unaudited) as of June 30, 2011 and 2010, is as follows:

	2011	2010
Assets	$ 8,032,000	$ 10,295,000
Liabilities	$ 1,305,000	$ 2,434,000
Net assets	6,727,000	7,861,000
Total liabilities and net assets	$ 8,032,000	$ 10,295,000

Arch Health Partners (“ARCH”) — In April 2010, PPH aligned with ARCH a 1206(l) Medical Foundation operating under 501(c)(3) of the Internal Revenue Code (IRC), for the purpose of improving the patient experience and providing comprehensive and high-quality medical care. ARCH was comprised of 43 physicians and surgeons providing primary and specialty care medical services as well as six physician extender providers, and will add another component in health care delivery to residents within PPH’s community.

As part of the alliance, PPH contributed $3,566,000 to ARCH, $3,283,000 towards the setup and organization of ARCH as well as acquisition of the hard assets of a medical group and $283,000 for an acquisition of the hard assets of an ENT practice. PPH and ARCH entered into a line of credit with a

$3,467,000 limit that expires on June 30, 2015. The amount drawn on the line of credit was $2,272,000 as of June 30, 2011, and is recorded in other assets in the accompanying consolidated balance sheets.

8. LONG-TERM DEBT

PPH's long-term debt for 2011 and 2010 were as follows:

	Beginning Balance Fiscal Year 2011	Additions	Reductions	Ending Balance Fiscal Year 2011	Amounts Due Within One Year
Bonds payable:					
Series 2010 certificates of participation	$ -	$163,365,000	$ (4,309,000)	$ 159,056,000	$ -
Series 2010 general obligation bonds		65,782,000		65,782,000	
Series 2009 certificates of participation	227,984,000	247,000		228,231,000	
Series 2009 general obligation bonds	115,068,000		(222,000)	114,846,000	
Series 2007 general obligation bonds	246,152,000		(256,000)	245,896,000	557,000
Series 2006 certificates of participation	171,454,000	80,000		171,534,000	
Series 2005 general obligation bonds	69,483,000		(1,214,000)	68,269,000	1,095,000
Series 1999 insured refunding revenue bonds	34,904,000	231,000	(6,394,000)	28,741,000	6,715,000
Accrued interest on capital appreciation bonds	22,267,000	17,221,000	(7,425,000)	32,063,000	
Capital leases	608,000	1,533,000	(170,000)	1,971,000	333,000
Total long-term debt	$887,920,000	$248,459,000	$(19,990,000)	$1,116,389,000	$8,700,000

	Beginning Balance Fiscal Year 2010	Additions	Reductions	Ending Balance Fiscal Year 2010	Amounts Due Within One Year
Bonds payable:					
Series 2009 certificates of participation	$ -	$227,984,000	$ -	$ 227,984,000	$ -
Series 2009 general obligation bonds	115,290,000		(222,000)	115,068,000	
Series 2007 general obligation bonds	246,407,000		(255,000)	246,152,000	
Series 2006 certificates of participation	174,143,000	86,000	(2,775,000)	171,454,000	
Series 2005 general obligation bonds	70,620,000		(1,137,000)	69,483,000	1,025,000
Series 1999 insured refunding revenue bonds	40,716,000	277,000	(6,089,000)	34,904,000	6,370,000
Accrued interest on capital appreciation bonds	8,348,000	13,919,000		22,267,000	
Capital leases		608,000		608,000	104,000
Total long-term debt	$655,524,000	$242,874,000	$(10,478,000)	$ 887,920,000	$7,499,000

The terms and due dates of PPH's long-term debt as of June 30, 2011 and 2010, are as follows:

- Series 2010 Certificates of Participation, interest at 5.25% to 6.0% due semiannually, principal due in annual amounts ranging from $2,255,000 in fiscal 2016 to $20,725,000 in fiscal 2042, net of unamortized original issue discount of $4,308,000 at June 30, 2011, collateralized by PPH revenues as defined in the indenture agreement.

- Series 2010A General Obligation Bonds, accreted interest compounds at 6.84% to 7.85% on $14,917,000 Capital Appreciation Bonds with the first payment to bondholders on August 1, 2034. Accreted interest compounds at 6.75% on $49,999,000 Convertible Capital Appreciation Bonds with the first payment to bondholders also due on August 1, 2034. Principal amounts due in annual amounts ranging from $1,476,000 in fiscal 2038 to $33,159,000 in fiscal 2041, net of unamortized premium of $865,000 at June 30, 2011.

- Series 2009 Certificates of Participation, interest at 4.50% to 6.75% due semiannually, principal due in annual amounts ranging from $3,515,000 in fiscal 2016 to $28,730,000 in fiscal 2040, net of unamortized original issue discount of $5,109,000 and $5,356,000 at June 30, 2011 and 2010, collateralized by PPH revenues as defined in the indenture agreement.

- Series 2009A General Obligation Bonds, accreted interest compounds at 6.84% to 9.00% on $50,001,000 Capital Appreciation Bonds with the first payment to bondholders on August 1, 2019. Accreted interest compounds at 7.00% on $59,999,000 Convertible Capital Appreciation Bonds with the first payment to bondholders on August 1, 2033. Principal amounts due in annual amounts ranging from $327,000 in fiscal 2021 to $18,868,000 in fiscal 2039, net of unamortized premium of $4,846,000 and $5,068,000 at June 30, 2011 and 2010, respectively.

- Series 2007A General Obligation Bonds, interest at 4.50% to 5.125% is due semiannually on $175,000,000 of Current Interest Bonds. Interest on the $66,083,000 Capital Appreciation Bonds is compounded at 3.67% to 4.92% with the first payment to bondholders on August 1, 2011. Principal amounts due in annual amounts ranging from $557,000 in fiscal 2012 to $21,585,000 in fiscal 2038, net of unamortized premium of $4,812,000 and $5,068,000 at June 30, 2011 and 2010, respectively.

- Series 2006 Certificates of Participation, a portion of which refunded the Series 1993 Insured Refunding Revenue Bonds, interest at 3.218%, which is the fixed rate to be paid by PPH under the swap agreement, due semiannually, principal due in annual amounts ranging from $2,775,000 in fiscal 2009 to $12,350,000 in fiscal 2037, net of unamortized loss on refunding of $466,000 and $546,000 at June 30, 2011 and 2010, respectively, collateralized by PPH revenues as defined in the indenture agreement.

- Series 2005A General Obligation Bonds, interest at 3.00% to 5.00% due semiannually, principal due in annual amounts ranging from $945,000 in fiscal 2009 to $5,115,000 in fiscal 2035, net of unamortized premium of $2,754,000 and $2,943,000 at June 30, 2011 and 2010, respectively.

- Series 1999 Insured Refunding Revenue Bonds, interest at 4.375% to 5.375% due semiannually, principal due in annual amounts ranging from $6,060,000 in fiscal 2009 to $7,855,000 in fiscal 2015, net of unamortized premium of $42,000 and $66,000 at June 30, 2011 and 2010, respectively, and unamortized loss on defeasance of $406,000 and $637,000 at June 30, 2011 and 2010, respectively, collateralized by PPH revenues as defined in the indenture agreement.

During November 2010, PPH issued $163,365,000 of Palomar Pomerado Health Certificates of Participation. The net proceeds of the 2010 Certificates of Participation will be used by PPH to finance or reimburse PPH for its prior payment of certain costs relating to the construction, renovation, expansion, and equipping of its hospital and medical facilities included in PPH's facilities master plan (the "Facilities Master Plan").

During November 2010, PPH issued $64,916,678.80 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2010A (the "2010 G.O. Bonds"). This bond issue consists of $14,917,000 Capital Appreciation Bonds and $49,999,000 Convertible Capital Appreciation Bonds. The net proceeds of the 2010 G.O. Bonds will be used by PPH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and the development of satellite ambulatory care facilities in PPH's service area (see Note 13).

During November 2009, PPH issued $233,340,000 of Palomar Pomerado Health Certificates of Participation. The net proceeds of the 2009 Certificates of Participation will be used by PPH to finance or reimburse PPH for its prior payment of certain costs relating to the construction, renovation, expansion, and equipping of its hospital and medical facilities included in PPH's Facilities Master Plan.

During March 2009, PPH issued $110,000,000 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2009A (the "2009 G.O. Bonds"). This bond issue consists of $50,001,000

Capital Appreciation Bonds and $59,999,000 Convertible Capital Appreciation Bonds. The net proceeds of the 2009 G.O. Bonds will be used by PPH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and the development of satellite ambulatory care facilities in PPH's service area (see Note 13).

During December 2007, PPH issued $241,083,000 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2007A (the "2007 G.O. Bonds"). The net proceeds of the 2007 G.O. Bonds will be used by PPH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and open satellite ambulatory care facilities in PPH's service area (see Note 13).

During December 2006, PPH issued $180,000,000 of Palomar Pomerado Health Certificates of Participation. The net proceeds of the 2006 Certificates of Participation will be used by PPH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and open satellite ambulatory care facilities in PPH's service area (see Note 13). The refunding of the 1993 Insured Revenue Bonds ($23,348,000) resulted in a loss on extinguishment of debt of $884,000, which has been deferred and is being amortized as a component of interest expense over 16 years.

During July 2005, PPH issued $80,000,000 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2005A (the "2005 G.O. Bonds"). The net proceeds of the 2005 G.O. Bonds will be used by PPH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and open satellite ambulatory care facilities in PPH's service area (see Note 13).

All the G.O. Bonds represent the general obligation of PPH, in an amount sufficient to service the obligation, and PPH has the power and is obligated to cause to be levied and collected by the County of San Diego annual ad valorem taxes upon all property within PPH's boundaries subject to taxation by PPH for payment when due of the principal of and interest on the bonds. However, PPH is legally required to repay the 2005, 2007, 2009, and 2010 G.O. Bonds if collected ad valorem taxes are insufficient.

In June 1999, PPH issued its Series 1999 insured refunding revenue bonds to refund its Series 1989A bonds. The refunding resulted in a loss on extinguishment of debt of $5,241,000, which has been deferred and is being amortized as a component of interest expense over 15 years.

Under the indenture agreements of the 2009 G.O. Bonds, 2009 Certificates of Participation, 2007 G.O. Bonds, 2006 Certificates of Participation, the 2005 G.O. Bonds, and the Series 1999, PPH is subject to compliance with certain debt covenants, including restrictions on additional indebtedness, which PPH believes it is in compliance with as of June 30, 2011 and 2010.

At June 30, 2011, long-term capital leases, net of current portion, amounted to $1,638,000. Related net book value of leased equipment is $1,898,000 and depreciation expense totaled $245,000 for the current year.

The estimated fair value of PPH's long-term debt was approximately $1,101 million and $909 million as of June 30, 2011 and 2010, respectively, based on quotations from independent third parties.

Estimated future principal and interest payments on long-term debt, including capital leases as of June 30, 2011, are as follows:

Years Ending June 30	Principal	Interest	Total
2012	$ 8,699,492	$ 44,119,418	$ 52,818,910
2013	9,652,906	43,847,977	53,500,883
2014	10,621,380	43,553,767	54,175,147
2015	11,576,113	43,320,279	54,896,392
2016	15,245,116	43,140,166	58,385,282
2017–2021	94,953,821	236,416,379	331,370,200
2022–2026	126,245,095	308,192,610	434,437,705
2027–2031	198,736,192	313,973,312	512,709,504
2032–2036	284,872,177	286,687,485	571,559,662
2037–2041	299,968,137	206,788,984	506,757,121
2042–2046	20,725,000	621,750	21,346,750
Total	$1,081,295,429	$1,570,662,127	$2,651,957,556

9. OPERATING LEASES

PPH leases certain office space and equipment under operating leases. Lease expense on all such leases for the years ended June 30, 2011 and 2010, totaled $9,816,000 (including $1,192,000 in nonoperating expense) and $9,057,000 (including $1,025,000 in nonoperating expense), respectively. PPH also leases to others office space under operating leases. Future minimum lease payments and receipts under noncancelable space leases as of June 30, 2011, are as follows:

Years Ending June 30	Lease Payments	Lease Receipts
2012	$ 3,731,000	$1,154,000
2013	3,399,000	734,000
2014	3,381,000	743,000
2015	3,260,000	479,000
2016	3,143,000	70,000
2017–2021	16,576,000	105,000
2022–2026	16,488,000	
2027–2031	3,407,000	
Total	$53,385,000	$3,285,000

10. DEFERRED ANNUITY CONTRACTS

PPH offers its employees a deferred compensation plan, which has an employer-match component created in accordance with IRC Section 457. Employees who elect to participate in the plan make contributions through a reduction in salary. All participating employees manage their contribution and investment choices through a funding agency selected by PPH.

The investments of PPH’s IRC Section 457 plan and earnings thereon are held in trust for the exclusive benefit of the plan participants and their beneficiaries. The Section 457 plan and earnings are not subject to claims of PPH’s general creditors. Accordingly, the accompanying consolidated balance sheets do not include the funds deposited with financial institutions pursuant to deferred annuity contracts.

11. RETIREMENT PLAN

PPH sponsors a defined contribution retirement plan under which benefits are limited to amounts accumulated from total contributions by PPH and by the employees, plus accrued interest. Prior to January 1, 2004, all employees with three years of service were covered by the plan. On January 1, 2004, the retirement plan was revised to change the eligibility to all employees with one year of service. Contributions under the retirement plan by PPH were equal to 5% of covered employees' basic compensation and are funded as accrued through August 2010. Starting September 1, 2010, the employer contribution rate was 6%. Starting January 2011, the employer contribution rate increased to 6.5%. Total PPH contributions expensed for the years ended June 30, 2011 and 2010, were $13,573,000 and $10,718,010, respectively.

12. POSTEMPLOYMENT HEALTHCARE PLAN

In June 2004, the GASB issued GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (OPEB)*, which is effective for periods ending after December 15, 2006. GASB Statement No. 45 established standards for accounting and financial reporting to accurately reflect the financial effect of OPEB. PPH implemented GASB Statement No. 45 in fiscal 2010, which resulted in additional disclosures as shown below, as well as recording of the Annual Required Contribution (ARC) in the accompanying consolidated financial statements. As of June 30, 2011, the ARC was $200,000 and is included in accrued compensation and related liabilities in the accompanying consolidated balance sheets.

Plan Description and Funding Policy — PPH's Postemployment Healthcare Plan (the "Plan") is a single employer-defined benefit healthcare plan administered by Tri-Ad Actuaries Inc. The Plan provides medical and dental insurance benefits to qualified postemployment participants on a gap coverage basis. Coverage is limited to those employees that have provided 10 years of consecutive service, are below the age of 65 and do not receive coverage from other sources. The contribution requirements of Plan members and PPH are established and may be amended by the Board of Directors. The required contribution is based on estimated pay-as-you-go financing requirements. For the year ended June 30, 2011, PPH contributed $77,000 to the Plan, which consisted entirely of current premiums and included no additional contribution to prefund benefits.

Annual OPEB Cost — PPH's annual OPEB cost is calculated based on the ARC of the employer, and the amount actuarially determined in accordance with the guidelines of GASB Statement No. 45.

Actuarial Methods and Assumption — Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing the benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

For the year ended June 30, 2011, the actuarial assumptions included a 4% discount rate, which is approximately based on the employer's own rate of return on investments. The unfunded actuarial accrued liability (UAAL) of $2,264,000 is being amortized over the maximum permissible amortization period of 30 years on an open basis. The actuarial valuation used the projected unit credit and the entry-age normal actuarial cost methods.

Funded Status and Funding Progress — As of June 30, 2011, the most recent actuarial valuation date, the plan was unfunded. The actuarial accrued liability for benefits was $2,264,000 and the actuarial value of assets was $0, resulting in an (UAAL) of $2,264,000. The covered payroll was $143,355,000, and the ratio of the UAAL to the covered payroll was 2%.

13. COMMITMENTS AND CONTINGENCIES

Legal Matters — The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with these laws and regulations, specifically those relating to the Medicare and Medi-Cal programs, is subject to government review and interpretation, as well as regulatory actions. Claims for payment for services rendered to Medicare and Medi-Cal beneficiaries must meet applicable billing laws and regulations, which, among other things, require that the services are medically necessary, accurately coded, and sufficiently documented in the beneficiaries' medical records. Allegations concerning possible violations of regulations can result in the imposition of significant fines and penalties, as well as significant repayment of previously billed and collected revenues for patient services.

PPH has ongoing efforts to comply with laws and regulations and to assess its prior compliance and the potential impact of noncompliance. PPH with its ongoing compliance program will continue to monitor, investigate, and correct any potential areas of noncompliance. No regulatory action has been asserted against PPH to date, although such action could occur in the future.

PPH is a party to certain other legal actions arising in the ordinary course of business. In the opinion of PPH management, the liability, if any, under these claims is adequately covered by insurance. PPH is insured for medical malpractice under a claims made and reported policy.

PPH is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; natural disasters; and employee health and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters.

Workers' Compensation Program — PPH is a participant in the Association of California Healthcare Districts ALPHA Fund ("ALPHA Fund") that administers a self-insured workers' compensation plan for participating districts and other qualifying nonprofit entities. PPH pays premiums to ALPHA Fund that are adjusted annually. Effective July 1, 2002, PPH changed its participation in ALPHA Fund from first dollar coverage of workers' compensation claims to self-insured retention by PPH of the first $350,000 of each claim. Effective July 1, 2003, PPH increased its retention level to the first $500,000 of each claim. Effective July 1, 2004, PPH increased its retention level to the first $750,000 of each claim. Effective July 1, 2008, PPH eliminated its retention and currently has a guaranteed loss/zero deductible. At June 30, 2011 and 2010, estimated claims liabilities for workers' compensation totaled $1,371,000 and $1,865,000, respectively.

ALPHA Fund was in a deficit position for several years prior to fiscal year 2007 as actuarial claims estimates had exceeded cash reserves. However, ALPHA Fund has been able to maintain positive cash flow. If ALPHA Fund were terminated, PPH would be liable for its share of any additional premiums necessary for final disposition of claims and losses covered by ALPHA Fund. If PPH were to withdraw from ALPHA Fund, it would be required to fund its share of a deficit as defined under the joint powers agreement. From fiscal year 2007 onwards, the ALPHA Fund has been in a surplus position. PPH accounts for its investment in the ALPHA Fund under the equity method and has recorded its share of $2,210,000 and $1,974,000 as of June 30, 2011 and 2010, respectively, as an asset within other assets in the accompanying consolidated balance sheets.

Comprehensive Liability Insurance Coverage — PPH is insured for comprehensive liability (professional liability, bodily injury and property damage liability, personal injury, advertising injury and discrimination liability, and employee benefit liability) under a claims-made policy, which covers asserted claims and incidents reported to the insurance carrier, and has a per-claim deductible of $50,000 for professional liability. PPH's comprehensive liability insurance was renewed effective July 1, 2011, and the current policy expires on June 30, 2012. PPH has reserved for estimated claims through 2011, including an estimate of IBNR. Such reserves totaled $1,663,000 and $697,000 as of June 30 2011, and 2010, respectively, and is recorded as other accrued liabilities in the accompanying consolidated balance sheets.

Recovery Audit Contractor (RAC) Program — PPH is subject to the Medicare RAC Program, which is a program designed to identify improper Medicare payments — both underpayments and overpayments. RAC auditors are paid by Centers for Medicare and Medicaid Services on a contingency fee basis, receiving a percentage of the improper overpayments and underpayments they collect from providers. PPH files annual Medicare cost reports, which detail the total amount of reimbursement received from the Medicare Program. PPH has established a reserve to account for potential negative settlements when these cost reports are audited and final settled. The reserve amount is $1,873,000 and $1,343,000 as of June 30, 2011 and 2010, respectively, and is recorded as estimated third-party payor settlements in the accompanying consolidated balance sheets.

Seismic Compliance — California Senate Bill 1953 (SB 1953) requires hospital acute care buildings to meet more stringent seismic guidelines by 2008. In fiscal 2005, PPH received approval from the Office of Statewide Health Planning and Development of a time extension for compliance with SB 1953 until January 1, 2013. The Board of Directors of PPH has approved a $982 million expansion plan, which includes building a new hospital in the City, downsizing the existing facility in the City (altering the use of the sections that are not compliant with SB 1953), expanding the hospital facility in Poway, and building new outpatient satellite clinics. This plan will enable PPH to comply with SB 1953 seismic guidelines. Subsequently, as a result of new criteria established by the state of California (HAZUS), it was determined that PPH's noncompliant buildings are in fact compliant at a SPC-2 rating. This has resulted in those buildings being eligible to render acute inpatient care until 2030.

14. SUBSEQUENT EVENTS

On September 12, 2011, PPH entered into a Guaranty Agreement as a sponsoring organization on behalf of ARCH in an effort to assist ARCH meeting their minimum financial responsibility requirements set forth within California Managed Health Care Health and Safety Code Section 1375.4. PPH has unconditionally guaranteed the liabilities of ARCH upto $5,000,000.

15. HEALTH CARE REFORM ACT

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act into law, and then, on March 30, 2010, President Obama signed into law the Health Care and Education Affordability Reconciliation Act of 2010 (collectively, "health insurance reform"). PPH is evaluating the effect that health insurance reform may have on its financial position and changes in net assets.

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