Report of Independent Auditors and
Consolidated Financial Statements for

Palomar Health

June 30, 2016 and 2015

MOSS-ADAMS LLP

Certified Public Accountants | Business Consultants

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Overview

Palomar Health (PH or District) is a public health care 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.

This section of PH's annual financial report presents management's discussion and analysis of the financial performance for the years ended June 30, 2016 and 2015. Although the 2014 condensed consolidated statement of net position, the condensed consolidated statement of revenue, expenses, and changes in net position, and the condensed consolidated 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. We encourage the reader to consider the information presented here in conjunction with the consolidated financial statements as a whole that follow this section.

This annual financial report includes:

- Management's Discussion and Analysis.
- Independent Auditor's Report.
- Consolidated financial statements of PH, including notes that explain in more detail some of the information in the consolidated financial statements.

The consolidated financial statements of PH include the financial statements of Arch Health Partners, Inc. (Arch). In accordance with Governmental Accounting Standards Board (GASB) Codification Section 2100, *The Financial Reporting Entity*, for financial reporting purposes, PH's reporting entity includes Arch as a blended component unit as a result of the fiscal dependency of Arch on PH, and because PH is the sole corporate member of Arch.

Required Financial Statements

Consolidated Statements of Net Position – The consolidated statements of net position include all of PH's assets and liabilities. They also provide information about the nature and amounts of investments in resources (assets), obligations to PH's creditors (liabilities), and net position, which is the difference between assets and liabilities. The consolidated statements of net position also provide the basis for evaluating the capital structure of PH and assessing the liquidity and financial flexibility of PH.

CONDENSED AND CONSOLIDATED STATEMENTS OF NET POSITION
AS OF JUNE 30, 2016, 2015, AND 2014
(DOLLARS IN THOUSANDS)

	2016	2015	2014
ASSETS			
Current assets	$ 400,435	$ 355,385	$ 314,047
Capital assets - net	1,113,730	1,154,277	1,208,784
Noncurrent assets	68,532	71,502	70,017
TOTAL ASSETS	$ 1,582,697	$ 1,581,164	$ 1,592,848
LIABILITIES AND NET POSITION			
Current liabilities	$ 159,745	$ 140,022	$ 113,321
Workers' compensation - net of current portion	530	699	744
Unearned revenue	8,159	8,277	8,388
Fair value of interest rate swap	38,740	28,664	26,528
Long-term debt - net of current portion	1,141,388	1,136,411	1,131,405
Total liabilities	1,348,562	1,314,073	1,280,386
Invested in capital assets - net of related debt	188	49,173	120,027
Restricted, expendable for:			
Repayment of debt	13,867	11,701	10,192
Capital acquisitions	9,843	10,363	11,485
Other purposes	346	345	1,844
Unrestricted	209,891	195,509	168,914
Total net position	234,135	267,091	312,462
TOTAL LIABILITIES AND NET POSITION	$ 1,582,697	$ 1,581,164	$ 1,592,848

2016: Analysis of the Consolidated Statement of Net Position from 2015 to 2016

- Current assets increased by $45,050 or 13% in the year ended June 30, 2016, primarily due to increases in cash and cash equivalents of $14,304, investments of $17,578, net patient accounts receivable of $5,351 and estimated third-party payor settlements of $4,324. Investments increased by $17,578 due to excess cash available from investment and estimated third-party settlements of $4,324 and a shift in payor mix from traditional Medicare and Medi-Cal to Managed Medicare and Managed Medi-Cal programs.

- Capital assets – net decreased by $40,547 or 4% primarily due to depreciation and amortization expense of $54,273 and net disposals of $603, offset by purchases related to major building projects of $14,329.

- Noncurrent assets decreased by $2,967 or 4% primarily due to decreases in restricted noncurrent cash and investments of $511, Owner Controlled Insurance Program (OCIP) receivable of $1,142, prepaid insurance of $571 and loan receivable from affiliates of $92.

- Current liabilities increased by $19,723 or 14% primarily due to an increase in accounts payable of $12,884, an increase in accrued compensation and related liabilities of $7,523, offset by a decrease in estimated third-party payor settlements of $7,577. The decrease in estimated third party settlements is due to prior years cost reports and appeals being settled as well as the elimination of the Medi-Cal reimbursement clawback.

- Long-term liabilities increased by $14,766 or 1% primarily due to an increase in the negative fair value of the interest rate swap of $10,076 and an increase in long-term debt of $4,977.

- Net position decreased by $32,956 or 12% due to income from operations of $6,054 and total nonoperating loss of $39,010

2015: Analysis of the Consolidated Statement of Net Position from 2014 to 2015

- Current assets increased by $41,338 or 13% in the year ended June 30, 2015, primarily due to increases in investments of $46,613 and net patient accounts receivable of $4,832. Investments increased by $46,613 because of $40,400 purchases of marketable securities and net patient accounts receivable increased by $4,832 mainly due to a shift in payor mix as a result of an increase in patients qualifying for governmental programs and a shift from traditional Medicare and Medi-Cal to managed care plans. These increases were offset by a decrease in estimated third-party settlements – receivable for $6,482 due to settlement of prior year receivables.

- Capital assets – net decreased by $54,507 or 5% primarily due to depreciation and amortization expense of $52,537 and net disposals of $10,159, offset by purchases related to major building projects of $8,189. Net disposals included sale of certain properties, which had a combined net book value of $9,854.

- Noncurrent assets increased by $1,485 or 2% primarily due to an increase of $1,098 of a loan receivable from Palomar Health Foundation.

- Current liabilities increased by $26,701 or 24% primarily due to an increase in the current portion of long-term debt of $11,578, accrued compensation and related liabilities of $4,176, and other accrued liabilities of $9,716.

- Long-term liabilities increased by $6,986 or 1% primarily due to an increase in the negative fair value of the interest rate swap of $2,136 and an increase in long-term debt of $5,006.

- Net position decreased by $45,371 or 15% primarily due to loss from operations of $15,513 and interest expense of $63,994, offset by property tax revenue of $32,033.

Consolidated Statements of Revenue, Expenses and Changes in Net Position – All of PH's revenue, expenses, and changes in net position are included in the consolidated statements of revenue, expenses, and changes in net position. The consolidated financial statements measure the success of PH's operations during the years presented and are used to determine if PH 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 PH's net position are one indicator of PH's financial health.

CONDENSED AND CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET POSITION

FOR THE YEARS ENDED JUNE 30, 2016, 2015, AND 2014
(DOLLARS IN THOUSANDS)

	2016	2015	2014
OPERATING REVENUE:			
Net patient service revenue	$ 667,244	$ 619,636	$ 583,616
Shared risk revenue	71,380	66,761	55,113
Other revenue	22,309	17,205	13,962
Total operating revenue	760,933	703,602	652,691
OPERATING EXPENSES	754,879	719,115	680,141
INCOME (LOSS) FROM OPERATIONS	6,054	(15,513)	(27,450)
NONOPERATING INCOME (EXPENSE):			
Investment income	2,496	1,834	1,942
Unrealized loss on interest rate swap	(10,076)	(2,136)	(185)
Interest expense	(67,302)	(66,278)	(64,870)
Property tax revenue - unrestricted	15,145	14,303	13,451
Property tax revenue - restricted	18,923	17,730	16,417
Other - net	1,804	4,689	7,183
Total nonoperating expense - net	(39,010)	(29,858)	(26,062)
CHANGE IN NET POSITION	(32,956)	(45,371)	(53,512)
NET POSITION - Beginning of year	267,091	312,462	365,974
NET POSITION - End of year	$ 234,135	$ 267,091	$ 312,462

2016: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Position from 2015 to 2016

- In accordance with accounting principles generally accepted in the United States of America (also known as GAAP or generally accepted accounting principles) for governmental health care providers, PH's consolidated statements of revenue, expenses, and changes in net position reflect that 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 cities and counties, they may be less comparable to nongovernment hospitals because of these GASB requirements. This must be a consideration of any comparison of PH to nonprofit and for-profit hospitals.

- Operating revenue increased by $57,331 or 8% in the year ended June 30, 2016, primarily due to payor contracts, government payor increases, revenue cycle management programs, case management initiatives, and volume growth. Also included in this amount are various government reimbursements programs including; Medi-Cal Waiver program, Managed Care Rate Range Plan, Outpatient Supplemental Program, and elimination of Medi-Cal reimbursement clawback.

- Operating expenses are those expenses related to the treatment of patients, including overhead and administration expenses. Operating expenses increased by $35,764 or 5% in the year ended June 30, 2016, primarily due to increase in salaries, wages, and benefits of $36,310 as a result of premiums associated with nursing labor shortages, increase in purchased services of $6,836 as a result of an increase in technology services, increase in supplies of $2,533 due to inflation of costs coupled with increased volume in higher cost surgeries, and an increase in other of $2,958 primarily due to $1,359 increase in malpractice insurance premium because of increased volumes and $1,208 increase in the estimated claims reserve for comprehensive insurance liability.

- Nonoperating expense – net increased by $9,152 or 31% in the year ended June 30, 2016, primarily due to an increase in the unrealized loss on interest rate swap of $7,940 and an increase in other non-operating loss of $2,885. Interest expense was $67,302 in the year ended June 30, 2016, and $66,278 in the year ended June 30, 2015.

- As a result of the factors noted above, net position decreased by $33,956 for the year ended June 30, 2016.

2015: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Position from 2014 to 2015

- Operating revenue is primarily generated through the treatment of patients (providing inpatient and outpatient, ancillary, and other patient care service) as well as other affiliated revenue. Operating revenue increased by $50,911 or 8% in the year ended June 30, 2015, primarily due to increases in net patient service revenue of $36,020, an increase in shared risk revenue of $11,648, and an increase in other revenue of $3,243. The increase in net patient service revenue is primarily due to revenue recognized from various supplemental funding sources, including the Intergovernmental Transfer Program (IGT) (which has been restructured into two programs; Medi-Cal Waiver program and Managed Care Rate Range Plan) and Outpatient Supplemental Program of $14,640 in the year ended June 30, 2015.

- Operating expenses are those expenses related to the treatment of patients, including overhead and administration expenses. Operating expenses increased by $38,974 or 6% in the year ended June 30, 2015, primarily due to increase in salaries, wages, and benefits of $34,268 as a result of increased levels of staffing, increase in purchased services of $5,598 as a result of an increase in information technology services to support the Meaningful Use program, and increase in supplies of $6,731 offset by a decrease in depreciation and amortization expense of $5,845.

- Nonoperating expense – net increased by $3,796 or 15% in the year ended June 30, 2015, primarily due to an increase in the unrealized loss on interest rate swap of $1,951 and an increase in interest expense of $1,408. Nonoperating income includes PH's share of unrestricted property tax revenues of $14,303, collected by the County of San Diego, and restricted property tax revenue for repayment of general obligation bonds of $17,730. Interest expense was $66,278 in the year ended June 30, 2015, and $64,870 in the year ended June 30, 2014.

- As a result of the factors noted above, net position decreased by $45,371 for the year ended June 30, 2015.

Consolidated Statements of Cash Flows – The consolidated 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 from where did cash come, for what was cash used, and what was the change in the cash balance during the reporting year.

CONDENSED AND CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2016, 2015, AND 2014
(DOLLARS IN THOUSANDS)

	2016	2015	2014
CASH FLOWS FROM:			
Operating activities	$ 62,300	$ 54,046	$ 40,086
Noncapital financing activities	16,287	16,649	15,763
Capital and related financing activities	(49,081)	(27,488)	(45,545)
Investing activities	(15,202)	(44,893)	17,317
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	14,304	(1,686)	27,621
CASH AND CASH EQUIVALENTS - Beginning of year	45,283	46,969	19,348
CASH AND CASH EQUIVALENTS - End of year	$ 59,587	$ 45,283	$ 46,969

2016: Analysis of the Consolidated Statement of Cash Flows from 2015 to 2016

- Operating activities cash inflow reflected an increase of $8,254 or 15% in the year ended June 30, 2016, over the year ended June 30, 2015. This increase is mostly attributable to decreases in payments to suppliers of $5,097 and increases in other sources of $4,384 offset by increases in cash collections of patient accounts of $45,691 and increases in payments to employees of $46,918.

- Net cash outflows from capital and related financing activities in 2016 were $49,081, primarily due to interest payments of $45,174, and the payment of long-term debt of $15,324 offset by the receipt of $18,923 of property taxes for debt service and $35 on proceeds from sale of fixed assets.

- Investing activities net cash outflows were $15,202 in 2016. This is primarily due to cash outflows from purchases of investments of $199,050, offset by cash inflow on proceeds from sale of investments of $180,009.

- The ending cash and cash equivalents of $59,587 reflect the checking account and overnight investment balances held by PH. In addition, there were current investments of $158,094 at June 30, 2016.

2015: Analysis of the Consolidated Statement of Cash Flows from 2014 to 2015

- Operating activities cash inflow reflected an increase of $13,960 or 35% in the year ended June 30, 2015, over the year ended June 30, 2014. This increase is mostly attributable to increases in cash collections of patient accounts of $44,599, and other sources of $1,577 offset by increases in payments to employees of $16,770 and increased payments to suppliers for $15,446.

- Net cash outflows from capital and related financing activities in 2015 were $27,488, primarily due to interest payments of $45,122, and the payment of long-term debt of $3,767 offset by the receipt of $17,730 of property taxes for debt service and $12,200 on proceeds from sale of fixed assets.

- Investing activities net cash outflows were $44,893 in 2015. This is primarily due to cash outflows from purchases of investments of $172,652, offset by cash inflow on proceeds from sale of investments of $126,016.

- The ending cash and cash equivalents of $45,283 reflect the checking account and overnight investment balances held by PH. In addition, there were current investments of $140,516 at June 30, 2015.

2016 and 2015: Capital Assets and Long-Term Debt

In 2004, the Board of Directors approved the facilities master plan (the Facilities Master Plan) budgeted at $1,057,000. In November 2004, the residents of the district voted and approved to fund $496,000 of this expansion by the issuance of general obligation bonds (G.O. Bonds). Payment for these bonds is funded by an ad valorem property tax levied on the district residents. The approximate amount of the tax levy for each taxable property remained at 23.5% of assessed value in the years ended June 30, 2016 and 2015. The levy is established by the Board of Director's resolution 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 included the construction of the new Palomar Medical Center Campus named Palomar Medical Center in Escondido. On August 19, 2012, PH opened the 288-bed facility. It includes critical, intermediate and general inpatient care, surgical and interventional services, and emergency and trauma services.

Other building projects include the renovation of existing hospital facilities at Pomerado Hospital, renovation of Palomar Health Downtown Campus (PHDC), and construction of ambulatory and outpatient facilities at various locations in the District. PH has three outstanding revenue bonds issued that are classified as long-term debt. These are the 2006 Certificates of Participation (COP), the 2009 COP, and the 2010 COP. Principal payments of $11,070 and $0 during the years ended June 30, 2016 and 2015, respectively, reduced the Bonds' principal to $557,635 and $568,708 as of June 30, 2016 and 2015, respectively. All debt payments have been made timely.

In July 2005, PH issued its first series of G.O. Bonds authorized by voter approval in 2004 (measure BB) in the amount of $80,000 for use in funding the building expansion project. In December 2007, PH issued its second series of G.O. Bonds totaling $241,083. In March 2009, PH issued its third series of G.O. Bonds in the amount $110,000. In November 2010, PH issued the final series of G.O. Bonds in the amount of $64,917. Principal payments of $3,931 and $3,383 during the years ended June 30, 2016 and 2015, respectively, reduced the G.O. Bonds' principal to $467,510 and $471,441 as of June 30, 2016 and 2015, respectively.

Liquidity and Capital Resources

PH's unrestricted liquidity position as of June 30, 2016 was $209,891, including $59,587 in operating cash and $158,094 in unrestricted investments stated at fair market value. The current liquidity position represents a $14,382 increase over the $195,509 in available liquidity as of June 30, 2015, and equaled 38.1% of the total outstanding debt as of June 30, 2016 (excluding the existing G.O. Bonds, which are paid from *ad valorem* property taxes), as compared to available liquidity representing 34.8% of total outstanding debt as of June 30, 2015.

PH's days' cash on hand on a consolidated basis for the years ended June 30, 2016 and 2015 is 124.9 and 112.6, respectively.

Economic and Other Factors

On June 24, 2015, PH's Board of Directors voted to transfer all services from PHDC to other PH-owned facilities and to close the seismically-challenged facility. Management expects that transition of services will be completed by June 30, 2017. This transition of the downtown services will require additional outlay of capital beyond capital funding needs for Information System upgrades required to meet Meaningful Use requirements and revenue cycle improvements and the replacement of outdated equipment and associated technology.

Health care consumerism, redefined healthcare delivery systems and reimbursement models continue to evolve from volume of service to value of service. The Affordable Care Act (ACA) is driving change from a hospital-based fee-for-service model of care to a risk-based model that emphasizes preventative care, care continuum and positive patient outcomes. As a result, there is a concerted focus on quality of care, cost of care and patient satisfaction measurements.

The challenge of meeting these capital needs and consumer demands becomes more difficult as reimbursement for services continues to be stressed. The outlook for both Medicare and Medi-Cal reimbursements indicate that there will not be a deviation from recent years declination. A shift to high deductible health insurance plans and greater cost sharing will impact PH both as a healthcare provider as well as an employer.

Finance Contact – PH's consolidated financial statements are designed to present users with a general overview of PH's finances and to demonstrate PH's accountability. If you have any questions about the report or need additional financial information, please contact the Executive Vice-President—Finance, Palomar Health, 456 E. Grand Avenue, Escondido, California 92025.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors of
Palomar Health

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Palomar Health, which comprise the consolidated statement of net position as of June 30, 2016, and the related consolidated statement of revenue, expenses, and changes in net position, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the California Code of Regulations, Title 2, Section 1131.2, State Controller's *Minimum Audit Requirements* for California Special Districts. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

MOSS-ADAMS LLP

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Palomar Health as of June 30, 2016, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Required Supplementary Information

Accounting standards generally accepted in the United States of America require that the management's discussion and analysis on pages 1 through 9 be presented to supplement the basic consolidated financial statements. Such information, although not a part of the basic consolidated financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic consolidated financial statements in an appropriate operational, economic, and historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United Statements of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic consolidated financial statements, and other knowledge we obtained during our audit of the basic consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Matter – Financial Statements as of and for the Year Ended June 30, 2015

The consolidated financial statements of Palomar Health as of and for the year ended June 30, 2015, were audited by other auditors whose report dated November 25, 2015, expressed an unmodified opinion on those consolidated financial statements.

Moss Adams LLP

Irvine, California
September 21, 2016

PALOMAR HEALTH
CONSOLIDATED STATEMENTS OF NET POSITION
JUNE 30, 2016 AND 2015
(DOLLARS IN THOUSANDS)

	2016	2015
Assets		
Current Assets		
Cash and cash equivalents	$ 59,587	$ 45,283
Investments	158,094	140,516
Patient accounts receivable - net of allowances for uncollectible accounts of $35,721 in 2016 and $34,581 in 2015	131,969	126,618
Other receivables	6,127	6,260
Supplies and inventories	10,420	9,862
Prepaid expenses and other	4,227	3,594
Estimated third-party payor settlements receivable	6,012	1,688
Restricted cash and investments, current	23,999	21,564
Total current assets	400,435	355,385
Restricted Noncurrent Cash and Investments:		
Held by trustee under indenture agreements	44,446	44,362
Held by trustee under G.O. bonds indenture	23,791	21,432
Held in escrow for street improvements	9,843	10,363
Restricted by donor and other	346	345
Total restricted cash and investments	78,426	76,502
Less amounts required to meet current obligations	23,999	21,564
Total restricted noncurrent cash and investments	54,427	54,938
Capital Assets - net	1,113,730	1,154,277
Other Assets:		
Prepaid debt insurance costs	7,602	8,176
Investment in and amounts due from affiliated entities	3,792	3,884
Other	2,711	4,504
Total other assets	14,105	16,564
Total Assets	$ 1,582,697	$ 1,581,164

See accompanying notes.

PALOMAR HEALTH
CONSOLIDATED STATEMENTS OF NET POSITION (CONTINUED)
JUNE 30, 2016 AND 2015
(DOLLARS IN THOUSANDS)

	2016	2015
Liabilities and Net Position		
Current Liabilities:		
Accounts payable	$ 41,310	$ 28,426
Accrued compensation and related liabilities	49,347	41,824
Current portion of general obligation bonds	4,489	3,941
Current portion of long-term debt	11,819	11,383
Estimated third-party payor settlements liability	3,997	11,574
Other accrued liabilities	38,653	33,013
Accrued interest payable	10,130	9,861
Total current liabilities	159,745	140,022
Workers' compensation - net of current portion	530	699
Unearned revenue	8,159	8,277
Long-term debt - G.O. bonds - net of current portion	602,447	586,134
Long-term debt - net of current portion	538,941	550,277
Fair value of interest rate swap	38,740	28,664
Total liabilities	1,348,562	1,314,073
Commitments and Contingencies (Note 14)		
Net Position:		
Net investment in capital assets	188	49,173
Restricted, expendable for:		
Repayment of debt	13,867	11,701
Capital acquisitions	9,843	10,363
Other purposes	346	345
Unrestricted	209,891	195,509
Total net position	234,135	267,091
Total Liabilities and Net Position	$ 1,582,697	$ 1,581,164

See accompanying notes.

PALOMAR HEALTH
CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET POSITION
FOR THE YEARS ENDED JUNE 30, 2016 AND 2015
(DOLLARS IN THOUSANDS)

	2016	2015
Operating Revenue:		
Patient service revenue, net of provision for uncollectible accounts of $50,548 in 2016 and $60,347 in 2015	$ 667,244	$ 619,636
Shared risk revenue	71,380	66,761
Other revenue	22,309	17,205
Total operating revenue	760,933	703,602
Operating Expenses:		
Salaries, wages, and benefits	437,812	401,502
Professional fees	33,676	49,467
Supplies	99,947	97,414
Purchased services	76,861	70,025
Depreciation and amortization	54,273	52,537
Rent expense	18,573	19,072
Utilities	11,031	9,350
Other	22,706	19,748
Total operating expenses	754,879	719,115
Income (Loss) From Operations	6,054	(15,513)
Nonoperating Income (Expenses):		
Investment income	2,496	1,834
Unrealized loss on interest rate swap	(10,076)	(2,136)
Interest expense	(67,302)	(66,278)
Property tax revenue - unrestricted	15,145	14,303
Property tax revenue - restricted	18,923	17,730
Other - net	1,804	4,689
Total nonoperating expenses - net	(39,010)	(29,858)
Change in Net Position	(32,956)	(45,371)
Net Position - Beginning of year	267,091	312,462
Net Position - End of year	$ 234,135	$ 267,091

See accompanying notes.

PALOMAR HEALTH
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2016 AND 2015
(DOLLARS IN THOUSANDS)

	2016	2015
Cash From Operating Activities:		
Receipts from:		
Patients, insurers, and other third-party payors	$ 777,515	$ 731,824
Other sources	23,185	18,801
Payments to:		
Employees	(430,458)	(383,540)
Suppliers	(307,942)	(313,039)
Net cash provided by operating activities	62,300	54,046
Cash Flows From Noncapital Financing Activities:		
Receipt of district taxes	15,145	14,303
Other	1,142	2,346
Net cash provided by noncapital financing activities	16,287	16,649
Cash Flows From Capital and Related Financing Activities		
Acquisition and construction of capital assets	(7,541)	(8,189)
Interest payments on long-term debt	(45,174)	(45,122)
Principal repayment on long-term debt	(15,324)	(3,767)
Proceeds on sale of fixed assets	35	12,200
Receipt of property taxes restricted for debt service on G.O. bonds	18,923	17,730
Other	-	(340)
Net cash used in capital and related financing activities	(49,081)	(27,488)
Cash Flows From Investing Activities:		
Purchases of investments	(199,050)	(172,562)
Proceeds from sale of investments	180,009	126,016
Interest received on investments and notes receivable	2,035	1,249
Receipt of payments on loans receivable	-	414
Increase in loans receivable	-	(1,512)
Other	1,804	1,502
Net cash used in by investing activities	(15,202)	(44,893)
Net Increase (Decrease) in Cash and Cash Equivalents	14,304	(1,686)
Cash and Cash Equivalents - Beginning of year	45,283	46,969
Cash and Cash Equivalents - End of year	$ 59,587	$ 45,283

See accompanying notes.

PALOMAR HEALTH
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2016 AND 2015
(DOLLARS IN THOUSANDS)

	2016	2015
Reconciliation of Income (Loss) from Operations to Net Cash Flows Provided by Operating Activities:		
Income (loss) from operations	$ 6,054	$ (15,513)
Adjustments to reconcile income (loss) from operations to net cash provided by operating activities:		
Depreciation and amortization	54,273	52,537
Provision for bad debts	50,548	60,347
Equity in earnings of affiliates	92	(97)
Loss on disposal of fixed assets	568	-
Changes in assets and liabilities:		
Patient accounts receivable	(55,899)	(65,179)
Other receivables	133	2,578
Supplies and inventories	(558)	(647)
Prepaid expenses and other	(633)	(886)
Estimated third-party payor settlements	(11,901)	7,316
Other - net	651	(885)
Accounts payable	6,096	226
Accrued compensation and related liabilities	7,354	4,131
Other accrued liabilities	5,640	10,228
Unearned revenue	(118)	(110)
Net Cash Provided by Operating Activities	$ 62,300	$ 54,046
Noncash Investing and Capital and Financing Activities:		
Capital expenditures included in accounts payable	$ 7,688	$ 900

See accompanying notes.

Note 1 – Summary of Significant Accounting Policies

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

- Palomar Medical Center (PMC), located in west Escondido, California, includes a 288-bed general acute care hospital, including tertiary services, trauma services, and cardiovascular surgery.

- Pomerado Hospital, located in Poway, California, includes a 107-bed general acute care hospital, and Villa Pomerado, a distinct part skilled nursing facility and sub-acute facility.

- Palomar Health Downtown Campus (PHDC), formerly known as Palomar Medical Center (PMC), located in east Escondido, California, includes women's services, Center for Behavioral Health, and Rehabilitation Institute.

- 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.

- Palomar Health Development, a charitable nonprofit organization created to provide assistance and support for PH by obtaining grant funding from federal state, local, and private sources.

- Palomar Health Express Care clinics, located in select grocery stores in Escondido, Temecula, and San Elijo Hills, California. The Rancho Peñasquitos express care clinic was closed in fiscal year 2016 resulting from the closure of the host grocery store.

- Arch Health Partners, Inc. (Arch), a non-profit medical foundation established under Section 1206(1) of the California Health and Safety Code, with fifteen clinics located in Poway, Escondido, Ramona and San Marcos, California that provide primary and specialty care medical services and add another component in effective health care delivery to residents within PH's community.

Note 1 – Summary of Significant Accounting Policies (continued)

In accordance with Governmental Accounting Standards Board (GASB) Codification Section 2100, *The Financial Reporting Entity*, for financial reporting purposes, PH's reporting entity includes Arch as a blended component unit as a result of the fiscal dependency of Arch on PH, and because PH is the sole corporate member of Arch.

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.

Basis of accounting and presentation – The accompanying financial statements have been prepared using the economic resource measurement focus and the accrual basis of accounting, in accordance with U.S. generally accepted accounting principles for healthcare organizations and the State Controller's Minimum Audit Requirements and Reporting Guidelines, and are presented in accordance with the reporting model as prescribed in GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. PH follows the business-type activities' requirements of GASB Statement No. 34 and No. 63.

Fiscal year – PH has adopted a fiscal year ending June 30. All references to years herein refer to the respective fiscal year.

Reclassifications – Certain prior year amounts were reclassified to conform to current year presentation.

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 statements of net position. Investment income or loss is included in nonoperating income, unless the income or loss is restricted by donor or law.

Supplies and inventories – Supplies and inventories are stated at the lower of cost (first-in, first-out) or market value.

Note 1 – Summary of Significant Accounting Policies (continued)

Restricted cash and investments – Restricted cash and investments primarily includes 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 PH have been classified as current assets in the accompanying consolidated statements of net position.

PH has entered into an agreement with the City of Escondido (the City) to financially participate in street improvements near the site of PMC. Under the agreement, PH was required to deposit $13,000 into an account jointly managed by PH and the City. PH's financial obligation is limited to the deposited amount plus any earned interest on the deposited funds. The balance of $9,843 and $10,363 as of June 30, 2016 and 2015, respectively, is included in restricted cash and investments in the accompanying consolidated statements of net position.

Capital assets – Capital asset acquisitions are recorded at cost. The capitalization threshold for individual item cost is $5 or greater and similar items that have cost less than $5 but have an aggregate cost of $20 or greater. 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	10-40
Buildings and building improvements	10-40
Leasehold improvements	3-15
Equipment	3-20

Gifts of long-lived assets, such as land, buildings, or equipment, are recorded at their fair market value and are reported in nonoperating income. 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 for other purposes in net position. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Note 1 – Summary of Significant Accounting Policies (continued)

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 position. In the years ended June 30, 2016 and 2015, no impairment charges were recorded. On June 24 2015, PH's Board of Directors voted to close PHDC and transfer all services to other PH facilities. The closure of PHDC is expected to be completed near the end of fiscal year 2017.

Compensated absences – PH policies permit most employees to accumulate vacation and sick leave benefits that may be realized as paid time off or, in limited circumstances, as a cash payment. Expense and the related liability are recognized as vacation benefits and are earned whether the employee is expected to realize the benefit as time off or in cash. Compensated absence liabilities are computed using the regular pay and termination pay rates in effect at the statement of net position date plus an additional amount for compensation-related payments such as Social Security and Medicare taxes computed using rates in effect at that date.

Debt discounts, debt premiums, and debt issuance costs – Debt discounts and debt premiums are amortized by the bonds outstanding method over the life of the related bonds. Debt issuance costs, except prepaid insurance costs, are expensed as incurred. Prepaid insurance costs are reported as an asset and recognized as an expense over the duration of the related debt.

Interest rate swaps – PH has entered into variable-to-fixed interest rate swaps, which are reflected at fair value in the consolidated statements of net position. The fair value of the interest rate swaps will fluctuate based generally on changes in market rates of interest. Unrealized gains or losses resulting from changes in fair value are reported as interest expense in nonoperating income (expenses) in the consolidated statements of revenue, expenses, and changes in net position. Interest cost on variable interest rate debt is reported based on the fixed interest rate paid by PH under the interest rate swaps and is also recorded as interest expense. As of June 30, 2016 and 2015, the interest rate swaps are recorded as a liability of $38,740 and $28,664, respectively.

Note 1 – Summary of Significant Accounting Policies (continued)

Net position – Net position of PH is classified in three broad components: net investment in capital assets, restricted (distinguishing between major categories of restrictions), and unrestricted. Net investment in capital assets consists of capital assets, net of accumulated depreciation, and reduced by the outstanding balances of borrowings used to finance the purchase or construction of those assets. Net position restricted for repayment of debt includes amounts deposited with trustees as required by bond indentures, as described in Note 8. Net position restricted for capital acquisitions relates to amounts restricted to acquire capital assets. Net position restricted for other purposes relates to noncapital net position that must be used for a particular purpose, as specified by contributors or others external to PH. Unrestricted net position represents the remaining net position that does not meet the definition of net investment in capital assets or restricted.

Risk management – PH is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters other than medical malpractice and workers' compensation claims. Settled claims have not exceeded this commercial coverage in any of the three preceding years.

PH is self-insured for a portion of its exposure to risk of loss from workers' compensation and malpractice claims. Annual estimated provisions are accrued based on actuarially determined amounts or management's estimate and includes an estimate of the ultimate costs for both reported claims and claims incurred but not yet reported.

Consolidated statements of revenue, expenses, and changes in net position – All revenues and expenses directly related to the delivery of health care services are included in operating revenue and expenses in the consolidated statements of revenue, expenses, and changes in net position. Nonoperating income (expenses) consist of those revenues and expenses that result from nonexchange transactions, financing (interest expense and changes in the fair value of interest rate swaps), and investment income.

Net patient service revenue – PH has agreements with third-party payors that provide for payments to PH 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 a provision for bad debts and estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the year the related services are rendered and adjusted in future years, as final settlements are determined.

Note 1 – Summary of Significant Accounting Policies (continued)

Shared risk revenue – PH and its affiliated medical groups have agreements with various third-party payors to provide medical services to subscribing participants. Under some of these agreements, PH and its affiliated medical groups receive monthly capitation payments based on the number of each payor's participants, regardless of services actually performed by PH. Under these agreements, after deduction of costs incurred by providers outside these agreements for care provided to subscribing participants, PH participates in shared risk pools with medical groups, through which it earns reimbursement or pays additional amounts to the medical groups. In conjunction with the shared risk pools, PH estimates incurred but not reported (IBNR) claims for medical services provided to patients. IBNR of $10,544 and $10,129 are included in other accrued liabilities in the accompanying consolidated statements of net position as of June 30, 2016 and 2015, respectively.

Activity in PH's liability for IBNR claims for medical services provided to patients during 2016 and 2015 is summarized as follows:

	2016	2015
Balance, beginning of the year	$ 10,129	$ 7,962
Current year claims incurred and changes in estimates	35,532	28,569
Claims and expenses paid	(35,117)	(26,402)
Balance, end of the year	$ 10,544	$ 10,129

Charity care – PH 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.

Property taxes – PH receives financial support from property taxes. Property taxes are levied by the County of San Diego on behalf of PH to finance PH's activities. Amounts levied for G.O. Bonds are based on assessed property values and are set annually by the Board of Directors. Property tax revenue for the years ended June 30, 2016 and 2015, consists of the following (in thousands):

	2016	2015
To support operations - unrestricted use	$ 15,145	$ 14,303
For debt service on G.O. bonds - restricted use	18,923	17,730
Total	$ 34,068	$ 32,033

Income taxes – PH is a governmental subdivision of the State of California and is exempt from federal income and state franchise taxes. Arch is exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code (IRC) and Section 23701(d) of the California Revenue and Taxation Code. Accordingly, no provision for income taxes has been included in the accompanying consolidated financial statements.

Note 1 – Summary of Significant Accounting Policies (continued)

Recent accounting pronouncements – In February 2015, the GASB issued Statement No. 72, *Fair Value Measurement and Application*. Statement No. 72 is intended to address accounting and financial reporting issues related to fair value measurements. The definition of fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This Statement provides guidance for determining a fair value measurement for financial reporting purposes. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. This guidance is effective for PH in the year ended June 30, 2016. PH has reviewed and evaluated this Statement and has determined there is no material impact to the consolidated financial statements for the year ended June 30, 2016.

In June 2015, the GASB issued Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. The primary objective of this Statement is to improve accounting and financial reporting by state and local governments for postemployment benefits other than pensions (other postemployment benefits or OPEB). It also improves information provided by state and local governmental employers about financial support for OPEB that is provided by other entities. This Statement results from a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for all postemployment benefits (pensions and OPEB) with regard to providing decision-useful information, supporting assessments of accountability and interperiod equity, and creating additional transparency. This guidance is effective for PH in the year ended June 30, 2018. PH is currently assessing the impact of this standard on the PH's consolidated financial statements.

In June 2015, the GASB issued Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The objective of this Statement is to identify—in the context of the current governmental financial reporting environment—the hierarchy of generally accepted accounting principles (GAAP). The "GAAP hierarchy" consists of the sources of accounting principles used to prepare financial statements of state and local governmental entities in conformity with GAAP and the framework for selecting those principles. This Statement reduces the GAAP hierarchy to two categories of authoritative GAAP and addresses the use of authoritative and nonauthoritative literature in the event that the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP. This guidance is effective for PH in the year ended June 30, 2016. PH has reviewed and evaluated this Statement and has determined there is no material impact to the consolidated financial statements for the fiscal year ended June 30, 2016.

Note 1 – Summary of Significant Accounting Policies (continued)

In December 2015, the GASB issued Statement No. 79, *Certain External Investment Pools and Pool Participants*. This Statement addresses accounting and financial reporting for certain external investment pools and pool participants. Specifically, it establishes criteria for an external investment pool to qualify for making the election to measure all of its investments at amortized cost for financial reporting purposes. An external investment pool qualifies for that reporting if it meets all of the applicable criteria established in this Statement. The specific criteria address (1) how the external investment pool transacts with participants; (2) requirements for portfolio maturity, quality, diversification, and liquidity; and (3) calculation and requirements of a shadow price. Significant noncompliance prevents the external investment pool from measuring all of its investments at amortized cost for financial reporting purposes. Professional judgment is required to determine if instances of noncompliance with the criteria established by this Statement during the reporting period, individually or in the aggregate, were significant. This guidance is effective for PH in the year ended June 30, 2016 with certain provisions effective in the year ended June 30, 2017. PH has reviewed and evaluated this Statement and has determined there is no material impact to the consolidated financial statements for the fiscal year ended June 30, 2016. PH is currently assessing the impact of this standard on PH's consolidated financial statements for the year ended June 30, 2017.

In January 2016, the GASB issued Statement No. 80, *Blending Requirements for Certain Component Units*. This Statement amends the blending requirements for the financial statement presentation of component units of all state and local governments. The additional criterion requires blending of a component unit incorporated as a not-for-profit corporation in which the primary government is the sole corporate member. The additional criterion does not apply to component units included in the financial reporting entity pursuant to the provisions of Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. This guidance is effective for PH in the year ended June 30, 2017. PH is currently assessing the impact of this standard on PH's consolidated financial statements.

Note 2 – Net Patient Service Revenue, Third-Party Reimbursement Programs, and Non-Operating Revenue

Net patient service revenue – PH 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 PH 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.

Note 2 – Net Patient Service Revenue, Third-Party Reimbursement Programs, and Non-Operating Revenue (continued)

Revenue from the Medicare and Medi-Cal programs inclusive of risk (capitated) and non-risk managed care programs, accounted for approximately 56% and 63% of PH's net patient service revenue for the years ended June 30, 2016 and 2015, respectively.

Third-party cost reports for the Medicare program have been settled through the year ended June 30, 2011, and the cost reports for Medi-Cal programs have been settled through the year ended June 30, 2013. Results of cost report settlements as well as estimates for settlements of all years through 2016 have been reflected in the accompanying consolidated financial statements.

As of June 30, 2016 and 2015, estimated third-party settlements resulted in a receivable of $6,012 and $1,688, respectively, and a liability of $3,997 and $11,574, respectively. During the years ended June 30, 2016 and 2015, PH settled various prior-year cost reports and appeal issues. These settlements resulted in approximately $29,171 and $13,580 of additional revenues for the years ended June 30, 2016 and 2015, respectively, which are included in net patient service revenue in the accompanying consolidated statements of revenue, expenses, and changes in net position.

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

Beginning October 1, 2013, PH implemented a policy to provide a 40% discount on all charges billed to self-pay patients. The discount is recorded as an adjustment to gross patient service revenues to arrive at net patient service revenues prior to the provision for bad debts.

Various state supplemental funding programs and transfer agreements were available to Palomar Health for fiscal years 2016 and 2015. These programs and agreements include, but are not limited to: Quality Assurance Fee Programs (SB335 and SB239), Nondesignated Public Intergovernmental Transfer Agreements (IGT), Medi-Cal Expansion, Managed Care Rate Range plan and Outpatient Supplemental Program (AB915). Under these various legislations and programs PH recognized approximately $10,486 and $14,640 during the years ended June 30, 2016 and June 30, 2015, respectively.

In an effort to close the state's budget deficit, the legislature approved cuts (AB97) in 2011 to Medi-Cal reimbursement for Distinct Part Skilled Nursing Facilities (DP/SNFs) as well as approved a retroactive reimbursement recovery (clawback) to be implemented late in fiscal year 2016. In February 2016, the California legislature voted to eliminate the clawback and Palomar Health reversed the related $5,900 reserve.

Note 2 – Net Patient Service Revenue, Third-Party Reimbursement Programs, and Non-Operating Revenue (continued)

The American Recovery & Reinvestment Act of 2009 (ARRA) established 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. PH received incentive payments of $1,762 and $2,676 for the years ended June 30, 2016 and 2015, respectively.

Note 3 – Cash and Cash Equivalents and Investments

The State of California Government Code (the Government Code) authorizes PH 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 and limited maturity dates, as defined in the Government Code.

PH'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 $65,000 of unrestricted monies in the fund and an unlimited amount of qualified bond proceeds. PH had invested $64,782 and $49,061 of unrestricted funds in this fund as of June 30, 2016 and 2015, respectively. PH had invested $9,841 and $10,171 in jointly managed funds under an escrow agreement with the City of Escondido as of June 30, 2016 and 2015, respectively. Investments in the LAIF are highly liquid, as deposits can be converted to cash within 24 hours without loss of interest. PH is a voluntary participant in the LAIF. The fair value of PH's investments in the LAIF is reported in the accompanying consolidated statements of net position based on PH's pro rata share of the fair value provided by LAIF for the entire LAIF portfolio.

Note 3 – Cash and Cash Equivalents and Investments (continued)

As of June 30, 2016 and 2015, PH had the following investments (in thousands):

	2016	2015
Investments - current	$ 158,094	$ 140,516
Restricted cash and investments - current	23,999	21,564
Restricted cash and investments - noncurrent	54,427	54,938
Total	$ 236,520	$ 217,018

As of June 30 2016 and 2015, PH had investments by type and maturity as follows (in thousands):

	2016		
		Investment Maturities (in Years)	
Investment Type	Fair Value	Less Than 1	1-5
External investment pool - LAIF	$ 74,623	$ 74,623	$ -
U.S. government bonds	40,744	-	40,744
U.S. Treasury bills	24,181	7,215	16,966
Corporate bonds	26,986	2,632	24,354
Money market mutual funds	69,986	69,986	-
Total	$ 236,520	$ 154,456	$ 82,064

	2015		
		Investment Maturities (in Years)	
Investment Type	Fair Value	Less Than 1	1-5
External investment pool - LAIF	$ 59,232	$ 59,232	$ -
U.S. government bonds	39,635	-	39,635
U.S. Treasury bills	23,601	2,268	21,333
Corporate bonds	25,388	1,257	24,131
Money market mutual funds	69,162	69,162	-
Total	$ 217,018	$ 131,919	$ 85,099

GASB Statement No. 72, *Fair Value Measurement and Application,* defines fair value as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability.

The fair value should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk.

Note 3 – Cash and Cash Equivalents and Investments (continued)

In addition to defining fair value, this guidance expands the disclosure requirements around fair value and establishes a fair value hierarchy for valuation inputs. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which are determined by the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the measurement date.

Level 2: Pricing inputs are based on quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in inactive markets, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Financial assets and liabilities in this category generally include asset-backed securities, corporate bonds and loans, municipal bonds and interest rate swap instruments.

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

Note 3 – Cash and Cash Equivalents and Investments (continued)

The following table summarizes Palomar Health's assets and liabilities measured at fair value on a recurring basis as of June 30, 2016 and 2015 (in thousands):

	Fair Market Value as of June 30, 2016			
Investments	Total	Level 1	Level 2	Level 3
Money market mutual funds	$ 69,986	$ 69,986	$ -	$ -
External investment pool - LAIF	74,623	-	74,623	-
U.S. government bonds	40,744	-	40,744	-
U.S. Treasury bills	24,181	24,181	-	-
Corporate bonds	26,986	-	26,986	-
Total Investments	$ 236,520	$ 94,167	$ 142,353	$ -
Liabilities				
Interest rate swap	$ (38,740)	$ -	$ (38,740)	$ -

	Fair Market Value as of June 30, 2015			
Investments	Total	Level 1	Level 2	Level 3
Money market mutual funds	$ 69,162	$ 69,162	$ -	$ -
External investment pool - LAIF	59,232	-	59,232	-
U.S. government bonds	39,635	-	39,635	-
U.S. Treasury bills	23,601	23,601	-	-
Corporate bonds	25,388	-	25,388	-
Total Investments	$ 217,018	$ 92,763	$ 124,255	$ -
Liabilities				
Interest rate swap	$ (28,664)	$ -	$ (28,664)	$ -

There are many factors affecting 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, PH's investment policy, as per statutory requirements, limits the term of any investment to a maturity not exceeding five years.

Note 3 – Cash and Cash Equivalents and Investments (continued)

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 PH's investment in commercial paper, corporate bonds, and bond mutual funds with an "A" rating issued by nationally recognized statistical rating organizations. PH has no investment policy that would further limit investment choices. As of June 30, 2016 and 2015, PH's investments, excluding U.S. government obligations, consisted of the following: corporate bond investments rated "A" or better by Standard & Poor's (S&P) and Moody's Investors Service (Moody's), U.S. Government Agency investments rated "AA+" by S&P and "AAA" by Moody's, and PH'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 PH 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, 2016 and 2015, are as follows (in thousands):

	2016		2015	
Investment Type	Fair Value	Percentage of Total Investments	Fair Value	Percentage of Total Investments
Federal Agency Securities	$ 27,205	17%	$ 28,519	20%
Federal Agency Securities	13,539	9%	11,116	8%
U.S. Bank Money Market	44,446	28%	44,362	32%
U.S. Government Money Market Funds	23,794	15%	21,624	15%

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

Note 3 – Cash and Cash Equivalents and Investments (continued)

Custodial credit risk – deposits – Custodial credit risk is the risk that in the event of a bank failure, PH's deposits may not be returned to it. PH does not have a policy for custodial credit risk. As of June 30, 2016 and 2015, PH's bank balances totaled $62,780 and $50,159, 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 PH's name. Arch maintains bank deposit accounts that are insured by the Federal Deposit Insurance Corporation (FDIC) up to a limit of $250,000 per depositor. Arch had a cash balance of $690 and $1,526 that was above the insured limit at June 30, 2016 and 2015, respectively.

Investment income – Investment income for the years ended June 30 consisted of the following (in thousands):

	2016	2015
Interest, dividends and realized gains on sale of investments	$ 2,035	$ 2,133
Net increase (decrease) in fair value of investments	461	(299)
Total	$ 2,496	$ 1,834

Note 4 – Concentrations of Credit Risk

PH 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, 2016 and 2015, is as follows:

	2016	2015
Medicare	17%	15%
Medi-Cal	8%	11%
HMO/PPO/commercial	59%	63%
Patient	10%	5%
Others	6%	6%
Total	100%	100%

Note 5 – Capital Assets

A summary of changes in capital assets for the years ended June 30, 2016 and 2015, is as follows (in thousands):

	Beginning Balance June 30, 2015	Additions	Disposals	Transfers	Ending Balance June 30, 2016
Land improvements	$ 75,421	$ -	$ -	$ 4,929	$ 80,350
Buildings and leasehold improvements	1,113,541	5,651	(137)	7,608	1,126,663
Equipment	292,186	2,984	(967)	(557)	293,646
Land	62,770	-	-	-	62,770
Construction in progress	35,084	5,694	(476)	(11,980)	28,322
	1,579,002	14,329	(1,580)	-	1,591,751
Less accumulated depreciation and amortization	(424,725)	(54,273)	977	-	(478,021)
Capital assets - net	$ 1,154,277	$ (39,944)	$ (603)	$ -	$ 1,113,730

	Beginning Balance June 30, 2014	Additions	Disposals	Transfers	Ending Balance June 30, 2015
Land improvements	$ 50,107	$ -	$ (15)	$ 25,329	$ 75,421
Buildings and leasehold improvements	1,133,574	623	(6,014)	(14,642)	1,113,541
Equipment	289,651	2,333	(827)	1,029	292,186
Land	77,096	-	(6,593)	(7,733)	62,770
Construction in progress	33,855	5,233	(21)	(3,983)	35,084
	1,584,283	8,189	(13,470)	-	1,579,002
Less accumulated depreciation and amortization	(375,499)	(52,537)	3,311	-	(424,725)
Capital assets - net	$ 1,208,784	$ (44,348)	$ (10,159)	$ -	$ 1,154,277

During the construction of PMC, PH was insured under an Owner Controlled Insurance Program (OCIP) and the insurance premiums for the OCIP were capitalized as part of the cost of construction. PH received $1,142 during the year ended June 30, 2016 and $6,000 during the year ended June 30, 2015, as a result of a favorable loss experience. The remaining $858 is included in other assets in the accompanying consolidated statement of net position at June 30, 2016.

Construction commitments outstanding as of June 30, 2016, were $3,954.

Note 6 – Investment in and Amounts Due From Affiliated Entities

During fiscal year 2007, PH 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. PH received proceeds of $9,672 for its interest in PDP Pomerado, LLC, which was recorded as unearned revenue as it was attributed to the difference in contractual lease payments and the fair value of lease payments. Unamortized unearned revenue of $7,328 and $7,434 in the accompanying consolidated statements of net position as of June 30, 2016 and 2015, respectively, will be recognized as income over the remaining term of the ground lease agreement, which expires in April 2061 and has two, ten year options to renew at $1 per year. Thus renewal is considered inevitable.

PH's investment in affiliated entities, which are generally accounted for under the equity method because PH does not control the entities, was $3,792 and $3,884 at June 30, 2016 and 2015, respectively.

Note 7 – Related Organizations

Palomar Health Foundation – Palomar Health Foundation (the Foundation) is a charitable nonprofit organization created to provide assistance and support for PH. The Foundation is a separately governed organization. Its financial position, results of operations and cash flows are not included in the accompanying consolidated financial statements.

The Foundation provides a funding source for various programs on behalf of PH. Funding for these programs provided by the Foundation totaled $2,089 and $553 for the years ended June 30, 2016 and 2015, respectively.

PH has entered into a management services agreement with the Foundation, whereby PH provides administrative support to the Foundation. Support provided to the Foundation totaled $1,713 and $1,512 for the years ended June 30, 2016 and 2015, respectively. Under the management services agreement renewed on June 30, 2015 and expiring on December 31, 2016, PH provides a line of credit to the Foundation with a $5,000 limit with interest at 2.5% above LIBOR. The amount outstanding on the line of credit was $1,862 and $2,180 as of June 30, 2016 and 2015, respectively.

Note 7 – Related Organizations (continued)

An unaudited summary of the Foundation's assets, liabilities, and net assets as of June 30, 2016 and 2015, is as follows:

	2016	2015
Assets	$ 7,921	$ 9,277
Liabilities	$ 2,170	$ 2,486
Net Assets	5,751	6,791
Total liabilities and net assets	$ 7,921	$ 9,277

PIMG, Inc. – In April 2010, Arch entered into a 25-year professional services agreement with PIMG, Inc. (PIMG) under which PIMG provides professional medical services to patients seeking services from and enrolled with Arch. For the years ended June 30, 2016 and 2015, PIMG provided professional services to Arch in the amounts of $13,947 and $13,355 respectively. At the inception of the professional service agreement with PIMG in 2010, Arch also advanced $702 to PIMG. The amount advanced is to be repaid upon Arch's request and does not bear interest. The outstanding amount at June 30, 2016 and 2015 was $0 and $702, respectively.

Note 8 – Long-term Debt

The following is a summary of long-term debt transactions for PH for the years ended June 30, 2016 and 2015 (in thousands):

	Beginning Balance June 30, 2015	Additions	Reductions	Ending Balance June 30, 2016	Amounts Due within One Year
Bonds payable:					
Series 2010 certificates of participation	$ 159,844	$ 195	$ (2,255)	$ 157,784	$ 2,405
Series 2010A general obligation bonds	65,659	-	(31)	65,628	-
Series 2009 certificates of participation	229,217	244	(3,515)	225,946	3,620
Series 2009A general obligation bonds	113,958	-	(222)	113,736	-
Series 2007A general obligation bonds	239,739	-	(2,709)	237,030	2,899
Series 2006 certificates of participation	171,781	44	(5,300)	166,525	5,500
Series 2005A general obligation bonds	62,618	-	(1,640)	60,978	1,590
Accrued interest on capital appreciation bonds	108,091	21,473		129,564	1,231
Note payable	97	-	(10)	87	11
Capital leases	731	-	(313)	418	283
Total long-term debt	$ 1,151,735	$ 21,956	$ (15,995)	$ 1,157,696	$ 17,539

	Beginning Balance June 30, 2014	Additions	Reductions	Ending Balance June 30, 2015	Amounts Due within One Year
Bonds payable:					
Series 2010 certificates of participation	$ 159,647	$ 197	$ -	$ 159,844	$ 2,255
Series 2010A general obligation bonds	65,689	-	(30)	65,659	-
Series 2009 certificates of participation	228,970	247	-	229,217	3,515
Series 2009A general obligation bonds	114,180	-	(222)	113,958	-
Series 2007A general obligation bonds	241,992	-	(2,253)	239,739	2,461
Series 2006 certificates of participation	171,731	50	-	171,781	5,300
Series 2005A general obligation bonds	64,173	-	(1,555)	62,618	1,470
Accrued interest on capital appreciation bonds	87,565	20,526	-	108,091	1,231
Note payable	97	-	-	97	10
Capital leases	1,107	-	(376)	731	313
Total long-term debt	$ 1,135,151	$ 21,020	$ (4,436)	$ 1,151,735	$ 16,555

The terms and due dates of PH's long-term debt as of June 30, 2016 and 2015, are as follows:

- Series 2010 Certificates of Participation (COP), interest at 5.25% to 6% due semiannually, principal due in annual amounts ranging from $2,405 in fiscal 2017 to $20,725 in fiscal 2042, net of unamortized original issue discount of $3,326 and $3,521 at June 30, 2016 and 2015, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2010A G.O. Bonds, accreted interest compounds at 6.84% to 7.85% on $14,917 Capital Appreciation Bonds (CABs) with the first payment to bondholders on August 1, 2034. Accreted interest compounds at 6.75% on $49,999 Convertible CABs with the first payment to bondholders also due on August 1, 2034. Principal amounts due in annual amounts ranging from $1,476 in fiscal 2038 to $33,159 in fiscal 2041, net of unamortized premium of $711 and $742 at June 30, 2016 and 2015, respectively.

Note 8 – Long-term Debt (continued)

- Series 2009 COP, interest at 4.50% to 6.75% due semiannually, principal due in annual amounts ranging from $3,620 in fiscal 2017 to $28,730 in fiscal 2040, net of unamortized original issue discount of $3,879 and $4,123 at June 30, 2016 and 2015, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2009A G.O. Bonds, accreted interest compounds at 6.84% to 9% on $50,001 CABs with the first payment to bondholders on August 1, 2019. Accreted interest compounds at 7% on $59,999 Convertible CABs with the first payment to bondholders on August 1, 2033. Principal amounts due in annual amounts ranging from $327 in fiscal 2021 to $18,868 in fiscal 2039, net of unamortized premium of $3,736 and $3,958 at June 30, 2016 and 2015, respectively.

- Series 2007A G.O. Bonds, interest at 4.5% to 5.125% is due semiannually on $175,000 of Current Interest Bonds. Interest on the $66,083 CABs 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 $2,899 in fiscal 2017 to $21,585 in fiscal 2038, net of unamortized premium of $3,551 and $3,799 at June 30, 2016 and 2015, respectively.

- Series 2006 COP, a portion of which refunded the Series 1993 Insured Refunding Revenue Bonds. This series was issued as auction rate securities, whereby the interest rate for each series is generally determined during successive seven-day auction periods. In addition, PH entered into an interest rate swap agreement with Citibank, N.A., New York, with respect to the Series 2006 COP in a notional amount of $180,000 (the Swap Agreement) (see Note 9). Interest on the Series 2006 COP is 3.218%, which is the fixed rate to be paid by PH under the Swap Agreement, due semiannually, principal due annually in amounts ranging from $5,500 in fiscal 2017 to $12,350 in fiscal 2037, net of unamortized loss on refunding of $175 and $219 at June 30, 2016 and 2015, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2005A G.O. Bonds, interest at 3% to 5% due semiannually, principal due in annual amounts ranging from $1,590 in fiscal 2017 to $5,115 in fiscal 2035, net of unamortized premium of $1,863 and $2,033 at June 30, 2016 and 2015, respectively.

All the G.O. Bonds represent the general obligation of PH, in an amount sufficient to service the obligation, and PH 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 PH's boundaries subject to taxation by PH for payment of the principal of and interest on the bonds when due. However, PH is legally required to repay the G.O. Bonds if collected ad valorem taxes are insufficient.

Note 8 – Long-term Debt (continued)

PH is required to maintain certain debt covenants (Days Cash on Hand, Maximum Annual Debt Service and Cushion Ratio) under its indenture agreements for COP. The covenants stipulate that in the event of underachievement, the Insurers may require PH to call in mutually agreed-upon consultants to perform mutually agreed-upon scope of services to assist PH in achieving the covenants.

At June 30, 2016 and 2015, long-term capital leases, net of current portion, amounted to $135 and $418, respectively. Related net book value of leased equipment totaled $412 and $675, and depreciation expense totaled $278 and $367 for the years ended June 30, 2016 and 2015, respectively.

The estimated fair value of PH's long-term debt was approximately $1,403,310 and $1,306,726 as of June 30, 2016 and 2015 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, 2016, are as follows (in thousands):

Years Ending June 30	Principal	Interest	Total
2017	$ 16,308	$ 42,993	$ 59,301
2018	17,197	42,879	60,076
2019	18,164	45,320	63,484
2020	22,660	49,823	72,483
2021	20,697	55,403	76,100
2022 - 2026	126,245	308,192	434,437
2027 - 2031	198,736	313,973	512,709
2032 - 2036	284,872	286,687	571,559
2037 - 2041	299,968	206,789	506,757
2042	20,725	622	21,347
Total	$ 1,025,572	$ 1,352,681	$ 2,378,253

Note 9 – Interest Rate Swap

In 2006, PH entered into the Swap Agreement as a means to lower its borrowing costs on the Series 2006 COP (see Note 8) when compared against fixed-rate bonds at the time of issuance. The Swap Agreement was effective December 28, 2006, with an initial notional amount of $180,000 for the Series 2006 COP and terminates on November 1, 2036 simultaneously with the maturity of the 2006 COP.

Note 9 – Interest Rate Swap (continued)

The Series 2006 COP were issued as auction rate securities, whereby the interest rate for each series is generally determined during successive seven-day auction periods.

Under the Swap Agreement, PH pays the swap provider amounts based on a fixed interest rate of 3.218%, and the swap provider pays to PH amounts based on 56% of the British Banker's Association 30-day LIBOR, plus 0.23%.

The significant terms of the Swap Agreement are as follows:

Corresponding bond series	Series 2006 Certificate of Participation bonds
Swap type	Fixed income
Initial notional amount	\$180,000
Notional amount as of June 30, 2016	\$166,700
Notional amount as of June 30, 2015	\$172,000
Effective date	December 28, 2006
Termination date	November 1, 2036
Final bond maturity	November 1, 2036
PH pays	3.218 %
Cash payments remitted by PH for year ended June 30, 2016	\$4,752
PH receives	56% of 30-day LIBOR + 0.23%
Swap fair value as of June 30, 2016	(\$38,740)
Change in fair value for the year ended June 30, 2016	(\$10,076)
Classification	Liability

Fair value – As of June 30, 2016 and 2015, the swap had a negative fair value of \$38,740 and \$28,664, respectively, developed by a mark-to-market pricing service using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap. The negative fair value of the swap is reported in the accompanying consolidated statements of net position as a long-term liability. The change in the fair value of the swap is reported in the accompanying consolidated statements of revenue, expenses, and changes in net position as unrealized loss on interest rate swap.

Note 9 – Interest Rate Swap (continued)

Credit risk – PH seeks to limit its counterparty risk by contracting only with highly rated entities. As of June 30, 2016, the counterparty of the interest rate swap was rated "A1" by Moody's, "A" by S&P, and "A+" by Fitch Investor Services (Fitch). To mitigate the potential for credit risk, under the terms of the Swap Agreement, if the counterparty's credit quality falls below (1) Moody's rating of Baa2, (2) S&P's rating of BBB, or (3) Fitch's rating of BBB, the fair value of the swap will be collateralized by the counterparty with cash and/or treasury securities.

Basis risk – PH is exposed to basis risk on its Swap Agreement because the variable rate payments received by PH on the instruments are based on a rate or index other than the interest rate paid on its variable rate debt.

Termination risk – The swap uses the International Swap Dealers Association Master Agreement (the Master Agreement), which includes standard termination events such as failure to pay and bankruptcy. The Master Agreement also includes an "additional termination event." The Master Agreement can be terminated if, at any time, a relevant credit rating with respect to a party declines below the termination level or is withdrawn, or if any party has no relevant rating but was previously rated by such rating agency. The termination levels are with respect to Moody's, Baa2; S&P, BBB; and Fitch, BBB.

The negative swap fair value in the accompanying consolidated statements of net position approximates the termination payment that would be owed by PH to the swap counterparty if the swap was terminated. The payments from PH to the swap counterparty are insured by Assured Guaranty. This insurance provides protection to the swap counterparty in the event PH fails to make payments due under the swap. Under the terms of the Swap Agreement, an "insurer event" will occur if both Moody's and S&P's ratings for Assured Guaranty fall below the A category. If an insurer event happens, PH would be required to post collateral by a first priority perfected security interest in the gross revenues of PH. Assured Guaranty was rated A2 by Moody's with a stable outlook effective August 2016.

Note 10 – Operating Leases

PH leases certain office space and equipment under operating leases. Lease expense on all such leases for the years ended June 30, 2016 and 2015, totaled $18,952 (including $379 in nonoperating expense) and $16,841 (including $402 in nonoperating expense), respectively. PH also leases office space to others which qualify as operating leases. Future minimum lease payments and receipts under office space and equipment leases as of June 30, 2016, are as follows (in thousands):

Years Ending June 30	Lease Payments	Lease Receipts
2017	$ 9,346	$ 215
2018	9,188	105
2019	9,159	74
2020	9,115	66
2021	8,934	66
2022-2026	27,554	315
2027-2031	10,496	264
2032-2036	7,284	115
2037-2081	25,969	-
Total	$ 117,045	$ 1,220

Note 11 – Deferred Annuity Contracts

PH offers its employees a deferred compensation plan, which has an employer-match component created in accordance with Internal Revenue Code (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 PH.

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

Note 12 – Retirement Plan

PH sponsors a defined contribution retirement plan under which benefits are limited to amounts accumulated from total contributions by PH and by participating employees, plus earnings thereon. Generally, all employees with one year of service are eligible to participate. Contributions under the retirement plan by PH for the years ended June 30, 2016 and 2015, were 7% and 5% (6% prior to January 1 2014), respectively, of covered employees' basic compensation. Contributions are funded as accrued. Total PH contributions expensed for the years ended June 30, 2016 and 2015, were $19,520 and $14,374, respectively.

Note 13 – Postemployment Healthcare Plan

The Company accounts for its postemployment healthcare plan under GASB Codification Section P50, *Postemployment Benefits Other Than Pensions-Employer Reporting*. As of June 30, 2016 and 2015, the annual required contribution was $383 and $282, respectively, and is included in accrued compensation and related liabilities in the accompanying consolidated statements of net position.

Plan description and funding policy – PH'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 who 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 the Plan members and PH 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 years ended June 30, 2016 and 2015, PH contributed $102 and $102, respectively to the Plan, which consisted entirely of current premiums and included no additional contribution to prefund benefits.

Annual cost – PH's annual cost of the Plan is calculated based on its annual required contribution and the amount actuarially determined in accordance with the guidelines of GASB Codification Section P50.

Actuarial methods and assumptions – 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 the 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. The actuarial valuations are effective for the years ended June 30, 2016 and 2015.

Note 13 – Postemployment Healthcare Plan (continued)

For the years ended June 30, 2016 and 2015, the actuarial assumptions included a 3% discount rate, which approximates PH's own rate of return on investments, and a healthcare cost trend rate of 7% declining by 1% annually to stabilize at 3% per year for the year ended June 30 2016, and thereafter. The unfunded actuarial accrued liability (UAAL) of $2,840 is being amortized over the maximum permissible authorization period of 30 years on an open basis. The actuarial valuation uses the projected unit credit and the entry-age normal actuarial cost methods.

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future, and actuarially determined amounts are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future.

Funded status and funding progress – As of June 30, 2016, the most recent actuarial valuation date, the plan was unfunded. The actuarial accrued liability for benefits was $2,840 and the actuarial value of assets was $0, resulting in an UAAL of $2,840. The estimated covered payroll was $179,505 and the ratio of the UAAL to the covered payroll was 1.6%.

Note 14 – Commitments and Contingencies

Legal matters – The health care 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.

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

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

Note 14 – Commitments and Contingencies (continued)

PH 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 – PH 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. PH pays premiums to the ALPHA Fund that are adjusted annually. Effective July 1, 2008, PH changed its participation in the ALPHA Fund from self-insured retention to a guaranteed loss/zero deductible. At June 30, 2016 and 2015, estimated claims liabilities for workers' compensation recorded were $571 and $878, respectively.

If the ALPHA Fund were terminated, PH would be liable for its share of any additional premiums necessary for final disposition of claims and losses covered by the ALPHA Fund. If PH were to withdraw from the 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. PH accounts for its investment in the ALPHA Fund under the equity method and has recorded its share of $2,427 and $2,177 as of June 30, 2016 and 2015, respectively as an asset within investment income and amounts due from affiliated entities in the accompanying consolidated statements of net position.

Effective July 1, 2016, PH terminated its relationship with Alpha Fund and has contracted with Safety National Casualty Corporation to provide workers' compensation insurance coverage. PH is self-insured for the first $750 of each occurrence with a maximum limit of indemnity per occurrence of $1,000.

Activity in PH's workers' compensation claims liability during 2016 and 2015 is summarized as follows:

	2016	2015
Balance, beginning of the year	$ 878	$ 1,016
Current year claims incurred and changes in estimates for claims incurred in the prior year	3,381	3,884
Claims and expenses paid	(3,688)	(4,022)
Subtotal	$ 571	$ 878
Less current portion	(41)	(179)
Balance, end of year	$ 530	$ 699

Note 14 – Commitments and Contingencies (continued)

Comprehensive liability insurance coverage – PH 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 for professional liability. PH's comprehensive liability insurance was renewed effective July l, 2015, and the current policy expires on June 30, 2016. PH has reserved for estimated claims through 2015, including an estimate of IBNR. Such reserves totaled $2,963 and $1,755 as of June 30, 2016 and 2015, respectively, and are recorded as other accrued liabilities in the accompanying consolidated statements of net position.

Activity in PH’s comprehensive liability insurance coverage liability during 2016 and 2015 is summarized as follows:

	2016	2015
Balance, beginning of the year	$ 1,755	$ 1,963
Current year claims incurred and changes in estimates	1,826	-
Claims and expenses paid	(618)	(208)
Balance, end of the year	$ 2,963	$ 1,755

Medicare Recovery Audit Contractor (RAC) Program – PH is subject to the Medicare RAC Program, which is a program designed to identify improper Medicare payments-both underpayments and overpayments. RAC auditors are contracted by the Centers for Medicare and Medicaid Services on a contingent fee basis, receiving a percentage of the improper overpayments and underpayments they recover from or return to providers. There are currently no RAC audits in process nor any reserves recorded at June 30, 2016 or 2015. PH will establish a reserve to account for potential negative settlements when improper payments are identified by RAC.

Seismic compliance – California Senate Bill (SB) 1953 requires hospital acute care buildings to meet more stringent seismic guidelines by 2020. PH's buildings are compliant with an SPC-2 rating and are eligible to render acute inpatient care until 2030.

Note 15 – Condensed Combining Information

A summary of the condensed combining information for PH and Arch for the years ended June 30, 2016 and 2015 is as follows (in thousands):

CONDENSED COMBINING STATEMENT OF NET POSITION
AS OF JUNE 30, 2016
(dollars in thousands)

	PH	Arch	Elimination	Total
ASSETS				
Current assets	$ 393,762	$ 6,673	$ -	$ 400,435
Capital assets - net	1,109,234	4,496	-	1,113,730
Noncurrent assets	68,532	-	-	68,532
Other receivables	1,977	-	(1,977)	-
Line of credit and note receivable - PH	66,649	-	(66,649)	-
TOTAL ASSETS	$ 1,640,154	$ 11,169	$ (68,626)	$ 1,582,697
LIABILITIES AND NET POSITION				
Current liabilities	$ 148,384	$ 11,361	$ -	$ 159,745
Long-term liabilities	1,188,741	76	-	1,188,817
Other payables	-	4,910	(4,910)	-
Line of credit and note payable ARCH	-	66,649	(66,649)	-
Total liabilities	1,337,125	82,996	(71,559)	1,348,562
Invested in capital assets - net of related debt	188	-	-	188
Restricted	24,056	-	-	24,056
Unrestricted	278,785	(71,827)	2,933	209,891
Total net position	303,029	(71,827)	2,933	234,135
TOTAL LIABILITIES AND NET POSITION	$ 1,640,154	$ 11,169	$ (68,626)	$ 1,582,697

PH has provided a line of credit to Arch that bears interest at London InterBank Offer Rate (LIBOR) plus 2% and is partly secured by certain assets of Arch including amounts on deposit in business bank accounts, furniture, fixtures and equipment, and accounts receivable. The outstanding principal and related accrued interest on the line of credit were $63,000 and $3,649 respectively, at June 30, 2016, and $49,000 and $2,187 respectively, at June 30, 2015.

On July 1, 2015, the line of credit agreement was amended to increase the maximum advances available to Arch to $63,900 through June 30, 2016, and $76,900 through June 30, 2017, and to change the repayment terms to 120 equal monthly installments beginning on July 1, 2017. The line of credit agreement may be terminated without cause upon 90 days' written notice by either PH or Arch, except PH must provide one year's notice if termination of the agreement is due to determination by PH's Board of Directors that Arch's performance does not meet the standards previously agreed upon by PH and Arch. Subsequent to June 30, 2016, Arch has drawn an additional $3,200 on the line of credit.

Note 15 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF REVENUE, EXPENSES, AND CHANGES IN NET POSITION
FOR THE YEAR ENDED JUNE 30, 2016
(dollars in thousands)

	PH	Arch	Elimination	Total
OPERATING REVENUE:				
Net patient service revenue	$ 636,810	$ 30,434	$ -	$ 667,244
Shared risk revenue	56,348	15,032	-	71,380
Other revenue	18,129	4,180	-	22,309
PH Program revenue	-	2,887	(2,887)	-
Total operating revenue	711,287	52,533	(2,887)	760,933
OPERATING EXPENSES	637,486	66,007	(2,887)	700,606
DEPRECIATION AND AMORTIZATION	52,608	1,665	-	54,273
Total operating expenses	690,094	67,672	(2,887)	754,879
INCOME (LOSS) FROM OPERATIONS	21,193	(15,139)	-	6,054
NONOPERATING INCOME (EXPENSE):				
Investment income	4,268	-	(1,772)	2,496
Unrealized loss on interest rate swap	(10,076)	-	-	(10,076)
Interest expense	(67,281)	(1,793)	1,772	(67,302)
Property tax revenue	34,068	-	-	34,068
Other - net	(2,348)	1,219	2,933	1,804
Total nonoperating expense - net	(41,369)	(574)	2,933	(39,010)
CHANGE IN NET POSITION	(20,176)	(15,713)	2,933	(32,956)
NET POSITION - Beginning of year	323,205	(56,114)	-	267,091
NET POSITION - End of year	$ 303,029	$ (71,827)	$ 2,933	$ 234,135

Note 15 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF CASH FLOW
FOR THE YEAR ENDED JUNE 30, 2016
(dollars in thousands)

	PH	Arch	Elimination	Total
CASH FLOWS FROM:				
Operating activities	$ 77,298	$ (14,998)	$ -	$ 62,300
Noncapital financing activities	15,004	1,283	-	16,287
Capital and related financing activities	(47,808)	12,727	(14,000)	(49,081)
Investing activities	(29,202)	-	14,000	(15,202)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	15,292	(988)	-	14,304
CASH AND CASH EQUIVALENTS - Beginning of year	44,183	1,100	-	45,283
CASH AND CASH EQUIVALENTS - End of year	$ 59,475	$ 112	$ -	$ 59,587

Note 15 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF NET POSITION
AS OF JUNE 30, 2015
(dollars in thousands)

	PH	Arch	Elimination	Total
ASSETS				
Current assets	$ 350,864	$ 4,521	$ -	$ 355,385
Capital assets - net	1,149,305	4,972	-	1,154,277
Noncurrent assets	71,502	-	-	71,502
Other receivables	-	502	(502)	-
Line of credit and note receivable - PH	52,563	-	(52,563)	-
TOTAL ASSETS	$ 1,624,234	$ 9,995	$ (53,065)	$ 1,581,164
LIABILITIES AND NET POSITION				
Current liabilities	$ 126,563	$ 13,459	$ -	$ 140,022
Long-term liabilities	1,173,964	87	-	1,174,051
Other payables	502	-	(502)	-
Line of credit and note payable ARCH	-	52,563	(52,563)	-
Total liabilities	1,301,029	66,109	(53,065)	1,314,073
Invested in capital assets - net of related debt	49,173	-	-	49,173
Restricted	22,409	-	-	22,409
Unrestricted	251,623	(56,114)	-	195,509
Total net position	323,205	(56,114)	-	267,091
TOTAL LIABILITIES AND NET POSITION	$ 1,624,234	$ 9,995	$ (53,065)	$ 1,581,164

Note 15 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF REVENUE, EXPENSES, AND CHANGES IN NET POSITION
FOR THE YEAR ENDED JUNE 30, 2015
(dollars in thousands)

	PH	Arch	Elimination	Total
OPERATING REVENUE:				
Net patient service revenue	$ 591,916	$ 27,720	$ -	$ 619,636
Shared risk revenue	50,662	16,099	-	66,761
Other revenue	16,189	1,016	-	17,205
PH Program revenue	-	2,950	(2,950)	-
Total operating revenue	658,767	47,785	(2,950)	703,602
OPERATING EXPENSES	598,854	70,674	(2,950)	666,578
DEPRECIATION AND AMORTIZATION	50,779	1,758	-	52,537
Total operating expenses	649,633	72,432	(2,950)	719,115
INCOME (LOSS) FROM OPERATIONS	9,134	(24,647)	-	(15,513)
NONOPERATING INCOME (EXPENSE):				
Investment income	2,968	-	(1,134)	1,834
Unrealized loss on interest rate swap	(2,136)	-		(2,136)
Interest expense	(66,270)	(1,142)	1,134	(66,278)
Property tax revenue	32,033	-	-	32,033
Other - net	3,182	1,507	-	4,689
Total nonoperating expense - net	(30,223)	365	-	(29,858)
CHANGE IN NET POSITION	(21,089)	(24,282)	-	(45,371)
NET POSITION - Beginning of year	344,294	(31,832)	-	312,462
NET POSITION - End of year	$ 323,205	$ (56,114)	$ -	$ 267,091

Note 15 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF CASH FLOW
FOR THE YEAR ENDED JUNE 30, 2015
(dollars in thousands)

	PH	Arch	Elimination	Total
CASH FLOWS FROM:				
Operating activities	$ 69,754	$ (15,708)	$ -	$ 54,046
Noncapital financing activities	15,142	1,507	-	16,649
Capital and related financing activities	(25,994)	14,906	(16,400)	(27,488)
Investing activities	(61,293)	-	16,400	(44,893)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,391)	705	-	(1,686)
CASH AND CASH EQUIVALENTS - Beginning of year	46,574	395	-	46,969
CASH AND CASH EQUIVALENTS - End of year	$ 44,183	$ 1,100	$ -	$ 45,283