



REPORT OF INDEPENDENT AUDITORS AND
FINANCIAL STATEMENTS WITH REQUIRED SUPPLEMENTARY
INFORMATION

PALOMAR HEALTH

June 30, 2018 and 2017

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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, 2018 and 2017. Although the 2016 condensed statement of net position, the condensed statement of revenue, expenses, and changes in net position, and the condensed statement of cash flows are presented in this section, they are not presented in the accompanying audited financial statements and notes to the financial statements. We encourage the reader to consider the information presented here in conjunction with the audited financial statements that follow this section.

This annual financial report includes:

- Management's Discussion and Analysis.
- Independent Auditor's Report.
- Financial statements of PH, including notes that explain in more detail some of the information in the financial statements.
- Schedule of changes in total OPEB liability and related ratios.

The financial statements of PH include the financial statements of Arch Health Partners, Inc. ("Arch"), Pacific Accountable Management San Diego, LLC (PAM-SD), Pacific Accountable Management, LLC (PAM), and Pacific Accountable Care, LLC (PAC). 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. Effective August 31, 2017, PH, Arch, and US Bank National Association added Arch as an additional member of the Obligated Group created pursuant to the Master Trust Indenture. Unless otherwise indicated, amounts presented in Management's Discussion and Analysis are in thousands.

Required Financial Statements

Statements of Net Position

The 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 statements of net position also provide the basis for evaluating the capital structure of PH and assessing the liquidity and financial flexibility of PH.

The statement of net position as of June 30, 2017 and the related statement of revenue, expenses and changes in net position for the year ended June 30, 2017 have been restated to show the impact of the adoption of GASB 75. See Notes 2 and 3.

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Management's Discussion and Analysis (continued)

Table 1: Assets, Liabilities and Net Position as of June 30,

	2018	2017 (restated)	2016
ASSETS			
Current assets	\$ 423,241	\$ 417,348	\$ 400,435
Capital assets - net	1,049,141	1,074,031	1,113,730
Noncurrent assets	<u>115,522</u>	<u>70,927</u>	<u>68,532</u>
Total assets	1,587,904	1,562,306	1,582,697
Deferred outflow of resources	<u>61,858</u>	<u>44,278</u>	<u>-</u>
TOTAL ASSETS AND DEFERRED OUTFLOW OF RESOURCES	<u>\$ 1,649,762</u>	<u>\$ 1,606,584</u>	<u>\$ 1,582,697</u>
LIABILITIES AND NET POSITION			
Current liabilities	\$ 152,831	\$ 151,699	\$ 159,745
Workers' compensation - net of current portion	2,484	1,963	530
Fair value of interest rate swap	18,971	26,473	38,740
Long-term debt - net of current portion	<u>1,282,242</u>	<u>1,202,333</u>	<u>1,141,388</u>
Total liabilities	1,456,528	1,382,468	1,340,403
DEFERRED INFLOW OF RESOURCES - Deferred Revenue	<u>7,941</u>	<u>8,041</u>	<u>8,159</u>
Total liabilities and deferred inflow of resources	1,464,469	1,390,509	1,348,562
Invested in capital assets - net of related debt	(91,703)	(56,155)	188
Restricted, expendable for:			
Repayment of debt	22,525	21,350	13,867
Capital acquisitions	9,925	9,880	9,843
Other purposes	349	347	346
Unrestricted	<u>244,197</u>	<u>240,653</u>	<u>209,891</u>
Total net position	<u>185,293</u>	<u>216,075</u>	<u>234,135</u>
TOTAL LIABILITIES, DEFERRED INFLOW OF RESOURCES AND NET POSITION	<u>\$ 1,649,762</u>	<u>\$ 1,606,584</u>	<u>\$ 1,582,697</u>

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Management's Discussion and Analysis (continued)

2018: Analysis of the Statement of Net Position from 2017 to 2018

- Current assets increased by \$5,893 or 1% during the year ended June 30, 2018, primarily due to increases in accounts receivable of \$12,152, estimated third-party settlements of \$11,670, and current restricted cash and investments of \$1,633, offset by decreases in cash and cash equivalents of \$17,058 and investments of \$6,257. The increase in accounts receivable is primarily due to increased aging with certain payor classes, respective collection lags and increased denial appeals. PH saw an increase in accounts receivable related to patients and auto liability claims which lead to a higher collection percentage but at a lagged rate. In addition, PH experienced post go-live challenges with a new insurance claim scrubber leading to a billing delay. The increase in third-party settlements is due to management's improved valuation of programs in determining direction to recognize revenue when program funding is available and collectible.
- Capital assets – net decreased by \$24,890 or 2% primarily due to depreciation and amortization expense of \$44,781, sale of capital assets, and write-down of abandoned projects for a total of \$2,776, offset by purchases related to major building projects of \$22,744.
- Noncurrent assets increased by \$44,595, or 63% primarily due to increases in restricted noncurrent cash and investments of \$46,341, prepaid insurance of \$3,980, and deferred outflows of resources from losses incurred in the refinancing of the Series 2007A General Obligation Bonds (G.O. Bonds) of \$17,580, offset by a decrease in loan receivable from affiliates of \$1,745.
- Current liabilities increased by \$1,132 or 1% primarily due to an increase in accounts payable and compensation accruals of \$11,597, offset by a decrease in accrued bond obligations and related liabilities of \$8,630 and a decrease in estimated third-party liabilities of \$2,085.
- Long-term liabilities increased by \$72,928 or 6% primarily due to an increase in long-term debt of \$79,909 resulting from the refinancing of long-term debt (See Note 9) and workers' compensation reserve of \$521, offset by a decrease in the unrealized loss of the fair value of the interest rate swap of \$7,502.

Net position decreased by \$30,782 or 14% due to net loss from operations of \$11,861 and total non-operating expenses of \$18,921.

2017: Analysis of the Statement of Net Position from 2016 to 2017

- Current assets increased by \$16,913 or 4% during the year ended June 30, 2017, primarily due to increases in cash and cash equivalents of \$6,951, estimated third-party payor settlements of \$10,931, other receivables of \$1,543, and current restricted cash and investments of \$6,185, offset by decreases in net patient accounts receivable of \$7,902 and investments of \$913. The decrease in accounts receivable is primarily due to leadership's focus on accounts receivable days and other key revenue cycle matters.
- Capital assets – net decreased by \$39,699 or 4% primarily due to depreciation and amortization expense of \$51,425 and sale and write-down of abandoned projects of \$9,255, offset by purchases related to major building projects of \$20,977.

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Management's Discussion and Analysis (continued)

- Noncurrent assets increased by \$2,395 or 3% primarily due to increases in loan receivable from affiliates of \$4,538, offset by decreases in restricted noncurrent cash and investments of \$727, Owner Controlled Insurance Program (OCIP) receivable of \$130, and prepaid insurance of \$1,546.
- Current liabilities decreased by \$8,046 or 5% primarily due to a decrease in accounts payable of \$6,371 due to the implementation of more efficient processes and a decrease in accrued compensation and related liabilities of \$9,483.
- Long-term liabilities increased by \$50,111 or 4% primarily due to an increase in long-term debt of \$60,945 primarily due to the refinancing of long-term debt (See Note 9) and workers' compensation reserve of \$1,433, offset by a decrease in the unrealized loss of the fair value of the interest rate swap of \$12,267.
- Net position decreased by \$18,060 or 8% due to income from operations of \$5,757 offset by total non-operating expenses of \$23,817.

Statements of Revenue, Expenses and Changes in Net Position – All of PH's revenue, expenses, and changes in net position are included in the statements of revenue, expenses, and changes in net position. The 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.

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 statements of revenue, expenses, and changes in net position reflect that non-operating income (expenses) including 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.

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Management's Discussion and Analysis (continued)

Table 2: Operating Results and Changes in Net Position for the years ended June 30,

	<u>2018</u>	<u>2017</u> (restated)	<u>2016</u>
OPERATING REVENUE:			
Net patient service revenue	\$ 696,948	\$ 691,503	\$ 667,244
Shared risk revenue	82,326	79,798	71,380
Other revenue	<u>14,894</u>	<u>15,423</u>	<u>22,309</u>
Total operating revenue	794,168	786,724	760,933
OPERATING EXPENSES	<u>806,029</u>	<u>780,967</u>	<u>754,879</u>
(LOSS) INCOME FROM OPERATIONS	<u>(11,861)</u>	<u>5,757</u>	<u>6,054</u>
NONOPERATING INCOME (EXPENSE):			
Investment income	181	1,380	2,496
Unrealized gain (loss) on interest rate swap	7,502	12,267	(10,076)
Interest expense	(64,443)	(69,164)	(67,302)
Property tax revenue - unrestricted	16,779	15,910	15,145
Property tax revenue - restricted	19,093	20,077	18,923
Other - net	<u>1,967</u>	<u>(4,287)</u>	<u>1,804</u>
Total nonoperating expense - net	<u>(18,921)</u>	<u>(23,817)</u>	<u>(39,010)</u>
CHANGE IN NET POSITION	(30,782)	(18,060)	(32,956)
NET POSITION - Beginning of year	<u>216,075</u>	<u>234,135</u>	<u>267,091</u>
NET POSITION - End of year	<u>\$ 185,293</u>	<u>\$ 216,075</u>	<u>\$ 234,135</u>

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Management's Discussion and Analysis (continued)

2018: Analysis of the Statement of Revenue, Expenses, and Changes in Net Position from 2017 to 2018

- Operating revenue increased by \$7,744 or 1% during the year ended June 30, 2018, primarily due to annual rate increases, improved pricing from payor contracts, increased billing and collection efficiencies augmented by continued participation in government reimbursement and supplemental programs, including but not limited to: Medi-Cal Expansion program, Managed Care Rate Range Plan, Public Hospital Redesign and Incentives in Medi-Cal (PRIME), and Outpatient Supplemental Program. Other revenue decreased \$32 primarily due to the reduced bed capacity for Rady Children's Hospital (RCH) of \$910. PH and RCH have an affiliation whereby PH transferred the day to day operations of the neo natal intensive care unit to RCH. This decrease is offset by an increase in the Child Abuse Program/Sexual Assault Response Team programs of \$619, and an improvement of \$534 in the Palomar Health Development grants program. The decrease related to RCH's capacity is driven by the move from the Palomar Medical Center Downtown Campus (PHDC) to Palomar Medical Center (PMC) Escondido.
- Operating expenses are those expenses related to the treatment of patients as well as overhead and administrative expenses. Operating expenses increased by \$25,062 or 3% during the year ended June 30, 2018, primarily due to increases in salaries, wages, and benefits of \$29,202 which was driven by additional labor force and premium pay required during union negotiations, surveys and flu season, annual merit increases and increases to the annual health insurance of \$4,510, and workers' compensation premiums and claims of \$1,064. Professional fees increased \$8,758 reflecting PH's continued focus on medical directorships, professional assistance related to the union negotiations, and the initiative to improve revenue cycle processes and cash collection efficiencies. Other direct expenses increased by \$2,492, primarily due to increased utilities usage of \$1,049, medical office building rent of \$821, and remaining operating expenses of \$100. The increase in operating expenses was offset by a decrease in purchased services of \$8,481 due to a restructuring of PH's IT service contract of \$2,911, and \$3,100 due to management's effort to identify cost saving opportunities, a reduction in repairs and maintenance of \$1,534, and a reduction in depreciation expense of \$6,644 from less capital outlay than the previous year and assets reaching end of their useful lives.
- Non-operating expenses (net) decreased by \$4,896 or 21% during the year ended June 30, 2018, primarily due to a decrease in interest expense of \$4,721, the loss on the sale of capital assets of \$3,022 and other non-operating expenses of \$132, offset by a decrease in the unrealized gain on the interest rate swap which was included in non-operating income of \$4,765 and investment income of \$1,198.
- As a result of the factors noted above, net position decreased by \$30,782 or 14% during the year ended June 30, 2018.

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Management's Discussion and Analysis (continued)

2017: Analysis of the Statement of Revenue, Expenses, and Changes in Net Position from 2016 to 2017

- Operating revenue increased by \$25,791 or 3% during the year ended June 30, 2017, primarily due to improved pricing from payor contracts, additional revenue cycle management programs focusing on limiting preventive claim denials, case management initiatives, and volume growth. Other revenue decreased \$6,886 due to RCH of \$3,932, lower Electronic Health Record (EHR) payments of \$1,346 and other of \$454. The decrease related to Rady Children's Hospital was driven by the move from the PHDC to PMC.
- Operating expenses increased by \$26,088 or 3% during the year ended June 30, 2017, primarily due to increases in professional fees arising from consulting services related to the planned closing of the PHDC and the new medical office building under construction of \$7,851; purchased services of \$9,472 as a result of an increase in business development and technology services; salaries and wages of \$8,288 primarily driven by an increase in contract labor as a result of continued nursing shortages and industry hiring challenges; supplies of \$7,898 due to inflation of pharmacy costs coupled with increased volume in higher cost surgeries and emergency department visits. These increases were offset by decreases in workers' compensation and hospital professional liability insurance premiums of \$3,575 due to the transition to a self-insured retention model; offset by a decrease in depreciation and amortization of \$2,848.
- Non-operating expenses (net) decreased by \$15,193 or 39% during the year ended June 30, 2017, primarily due to an increase in the unrealized gain on the interest rate swap which was included in non-operating income of \$22,343, increase in property tax revenue of \$1,919, offset by an increase in bond interest expense of \$1,883, decrease in investment income of \$1,116, loss on the sale of capital assets of \$5,038, and other non-operating expenses of \$762.
- As a result of the factors noted above, net position decreased by \$18,060 or 8% for the year ended June 30, 2017.

Statements of Cash Flows

The statements of cash flows report cash receipts, cash payments, and net changes in cash resulting from operating, investing, and financing activities, which provides answers to such questions as what were the sources and uses of cash, and what was the change in the cash balance during the reporting year.

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Management's Discussion and Analysis (continued)

Table 3: Statement of Cash Flows for the years ended June 30,

	2018	2017	2016
CASH FLOWS FROM:			
Operating activities	\$ 14,798	\$ 52,155	\$ 62,300
Noncapital financing activities	16,779	12,458	16,287
Capital and related financing activities	(5,805)	(53,449)	(49,081)
Investing activities	<u>(42,830)</u>	<u>(4,213)</u>	<u>(15,202)</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(17,058)	6,951	14,304
CASH AND CASH EQUIVALENTS - Beginning of year	<u>66,538</u>	<u>59,587</u>	<u>45,283</u>
CASH AND CASH EQUIVALENTS - End of year	<u>\$ 49,480</u>	<u>\$ 66,538</u>	<u>\$ 59,587</u>

2018: Analysis of the Statement of Cash Flows from 2017 to 2018

- Net cash inflows provided by operating activities reflected a decrease of \$37,357 during the year ended June 30, 2018, over the year ended June 30, 2017. This decrease is primarily due to a decrease in accounts receivable collections, an increase in slow-paying programs, and an increase in payments to suppliers of \$6,490 due to the increased volume in high-cost surgeries.
- Net cash outflows used in capital and related financing activities increased by \$47,644 primarily due to the refinance and issuance of new debt, resulting in an increase of interest payments and cost of issuance of \$30,268 and an increase in restricted property tax revenue of \$1,450, offset by a decrease in repayment of long-term debt of \$20,944 and a decrease in the acquisition of property, plant, and equipment of \$6,740.
- Net cash inflows provided by noncapital financing activities reflected an increase of \$4,321 during the year ended June 30, 2018 due to an increase in district tax revenue receipts.
- Net cash provided investing activities during the year ended June 30, 2018 increased by \$38,617 primarily due to an increase in proceeds from the sale of investments of \$51,846, offset by the purchase of investments of \$41,555.
- The ending cash and cash equivalents of \$49,480 at June 30, 2018 reflect the checking account and overnight investment balances held by PH. In addition, there were current investments of \$150,924 at June 30, 2018.

Palomar Health Management's Discussion and Analysis (continued)

2017: Analysis of the Statement of Cash Flows from 2016 to 2017

- Net cash inflows provided by operating activities reflected a decrease of \$10,145 during the year ended June 30, 2017, over the year ended June 30, 2016. This decrease was mostly attributable to an increase in payments to suppliers of \$18,626 due to the implementation of more efficient processes, payments to employees of \$23,691 and other sources of \$13,972 offset by increases in cash collections of patient accounts of \$46,145 due to improved pricing from payor contracts and additional revenue cycle management programs focusing on limiting preventive claim denials.
- Net cash outflows used in capital and related financing activities increased by \$4,368 primarily due to an increase in the acquisition of property, plant, and equipment of \$27,777, decreases in repayment of long-term debt of \$2,653 and interest paid of \$4,032 due to the refinancing of debt, increases in restricted property tax revenue of \$1,154, proceeds on the sale of capital assets of \$1,795 and other of \$6,234.
- Net cash inflows provided by noncapital financing activities reflect a decrease of \$3,829 during the year ended June 30, 2017 due to an increase in district tax revenue receipts.
- Net cash used in investing activities decreased by \$10,989 primarily due to a decrease in the purchase of investments of \$50,205 and a decrease in proceeds from the sale of investments of \$36,756.
- The ending cash and cash equivalents of \$66,538 at June 30, 2017 reflect the checking account and overnight investment balances held by PH. In addition, there were current investments of \$157,181 at June 30, 2017.

2018 and 2017: Capital Assets and Long-Term Debt

In 2004, the Board of Directors approved 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 was funded by an *ad valorem* property tax levied on the district residents. The approximate amount of the tax levy for each taxable property was decreased to 21.0% from 23.5% of assessed value during the years ended June 30, 2018 and 2017, respectively. The levy was established by the Board of Directors' 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 PMC. On August 19, 2012, PH opened the 288-bed facility, which includes critical, intermediate and general inpatient care, surgical and interventional services, a women's center, and emergency and trauma services.

Other building projects include the renovation of existing hospital facilities at Pomerado Hospital, now known as Palomar Medical Center Poway ("Poway"), and construction of a medical office building, parking structure, and ambulatory and outpatient facilities at various locations in the District.

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Management's Discussion and Analysis (continued)

PH has four outstanding revenue bonds and five outstanding G.O. bonds that are classified as long-term debt. The revenue bonds are comprised of the 2006 Certificates of Participation (COP), the 2017 COP, and the 2016 and 2017 Refunding Revenue Bonds. The G.O. Bonds are comprised of the Series 2007A, 2009A, 2010A, and 2016 A and B bonds. Principal payments of \$169,690 and \$237,730 during the years ended June 30, 2018 and 2017, respectively, reduced the revenue bonds' principal to \$608,525 and \$566,655 as of June 30, 2018 and 2017, respectively. As of June 30, 2018, the outstanding principal balance of the 2010 COP that was advance refunded during fiscal year 2018 was \$158,705. Principal payments of \$7,107 and \$237,014 during the years ended June 30, 2018 and 2017, respectively, reduced the G.O. Bonds' principal to \$436,359 and \$443,466 as of June 30, 2018 and 2017, respectively. All debt payments have been made timely. See Note 10.

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.

In July 2016, the Board of Directors authorized management to commence the due diligence associated with the refunding of the 2005 and 2007 General Obligation Bonds and the 2009 Revenue Bonds.

In October 2016, the \$246,750 Refunding Revenue Bonds Series 2016 were issued with the purpose of refunding the 2009 Certificates of Participation, funding a reserve account and paying the costs of issuance of the Series 2016 Revenue Bonds.

On October 27, 2016, the \$48,520 General Obligation Refunding Bonds Series 2016A were issued with the purpose of refunding the General Obligations Bonds, Election of 2004, Series 2005A and paying a portion of the costs of issuance of the Series 2016 G.O. Bonds.

On October 27, 2016, the \$164,450 General Obligation Refunding Bonds Series 2016B were issued with the purpose of refunding a portion of the General Obligation Bonds, Election of 2004, Series 2007A, funding a reserve account and paying a portion of the costs of issuance of the Series 2016 G.O. Bonds.

On December 11, 2017, the Board of Directors authorized the issuance of the \$151,460 Refunding Revenue Bonds, Series 2017 with the purpose to advance refund the refunding 2010 Certificates of Participation, fund a reserve account for the Refunding Bonds, and pay the costs of issuing the Series 2017 Revenue Bonds. This refunding served to lower interest costs and generate savings creating capacity for a new bond issuance.

In conjunction with the above refunding, the Board of Directors authorized management to commence the due diligence associated with issuing the \$60,100 Series 2017 Certificates of Participation. Proceeds in the related Project Fund will finance the construction, improvement, renovation and equipping of hospital and related health care facilities.

The collective advance refunding as described above resulted in an overall economic gain of \$44,973.

Palomar Health Management's Discussion and Analysis (continued)

Liquidity and Capital Resources

PH's unrestricted liquid assets as of June 30, 2018 were \$200,404, including \$49,480 in operating cash and \$150,924 in unrestricted investments stated at fair market value. The current liquidity position represents a \$23,315 decrease from the \$223,719 in available liquidity as of June 30, 2017, and equaled 31.4% of the total outstanding debt as of June 30, 2018 (excluding the existing G.O. Bonds, which are paid from *ad valorem* property taxes), as compared to available liquidity representing 37.7% of total outstanding debt as of June 30, 2017.

PH's days cash on hand on a basis as of June 30, 2018 and 2017 was 95.1 and 111.8, 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. Due to failing infrastructure and absent a seismic retrofit, the Board also voted to close the facility. The sale of the PHDC remained in escrow at the end of June 30, 2018. The sales contract specifies the transaction must close no later than the third quarter of the calendar year ended December 31, 2020. The remaining downtown services will be relocated as new facilities are completed.

The challenge of meeting constant capital needs and consumer demands becomes more difficult as the health care industry is highly dependent upon a number of factors that could have a significant effect on the operations and financial condition of PH. The healthcare industry is moving towards value-based care which requires improved efficiency and quality measures. As PH shifts towards these patient-centric drivers, inpatient utilization rates will lower with the decrease of readmission rates and improved continuum of care management.

Government payors continue to present reimbursement challenges for healthcare districts as the reimbursement rates are set annually with no ability for negotiation on rates and terms. In addition to the 2% sequestration cuts that were put in place in 2013, Medicare continues to look for additional ways to cut medical costs by way of reimbursement modeling. Quality-based reimbursement methods incentivize health care providers to improve quality outcomes and patient experiences and penalize those who are not able to meet these measures. Contractually negotiated commercial payors, while based on an agreed-upon reimbursement methodology, are susceptible to shifts in demand, patterns of patient services, and sensitive to a more competitive market.

Union Contract

PH and the two unions, the California Nurses Association (CNA) and the California Healthcare Employee Union (CHEU) reached agreements on December 27, 2017. Both contracts are now in effect and valid through May 31, 2021.

Finance Contact – PH's 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 Chief Financial Officer, PH, 456 E. Grand Avenue, Escondido, California 92025.

Report of Independent Auditors

To the Audit Committee of
Palomar Health

Report on Financial Statements

We have audited the accompanying financial statements of Palomar Health, which comprise the statements of net position as of June 30, 2018 and 2017, and the related statements of revenue, expenses, and changes in net position, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America 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 financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Palomar Health as of June 30, 2018 and 2017, and the results of its operations and its cash flows for the years 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 and schedule of changes in total OPEB liability and related ratios, as listed in the table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic 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 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 States 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 financial statements, and other knowledge we obtained during our audit of the basic 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.

Moss Adams LLP

Irvine, California
November 15, 2018

Palomar Health
Statements of Net Position
(Dollars in Thousands)

	June 30,	
	2018	2017
		(restated)
Assets		
Current Assets		
Cash and cash equivalents	\$ 49,480	\$ 66,538
Investments	150,924	157,181
Patient accounts receivable - net of allowances for uncollectible accounts of \$27,720 in 2018 and \$35,721 in 2017	136,219	124,067
Other receivables	10,183	7,670
Supplies and inventories	11,547	10,556
Prepaid expenses and other	4,458	4,209
Estimated third-party payor settlements receivable	28,613	16,943
Restricted cash and investments, current	31,817	30,184
Total current assets	423,241	417,348
Restricted Noncurrent Cash and Investments:		
Held by trustee under indenture agreements	90,031	43,653
Held by trustee under general obligation bonds indenture	31,553	30,004
Held in escrow for street improvements	9,925	9,880
Restricted by donor and other	349	347
Total restricted cash and investments	131,858	83,884
Less amounts required to meet current obligations	31,817	30,184
Total restricted noncurrent cash and investments	100,041	53,700
Capital Assets - net	1,049,141	1,074,031
Other Assets:		
Prepaid debt insurance costs	10,036	6,056
Investment in and amounts due from affiliated entities	2,816	4,561
Other	2,629	6,610
Total other assets	15,481	17,227
Total assets	1,587,904	1,562,306
Deferred outflow of resources - loss on refunding of debt	61,858	44,278
Total Assets and Deferred Outflow of Resources	\$ 1,649,762	\$ 1,606,584

See accompanying notes.

Palomar Health
Statements of Net Position (continued)
(Dollars in Thousands)

	June 30,	
	2018	2017 (restated)
Liabilities		
Current Liabilities:		
Accounts payable	\$ 42,218	\$ 34,939
Accrued compensation and related liabilities	44,183	40,140
Current portion of general obligation bonds	5,234	7,107
Current portion of long-term debt	12,651	13,662
Estimated third-party payor settlements liability	1,811	3,896
Other accrued liabilities	37,378	43,124
Accrued interest payable	9,356	8,831
Total current liabilities	152,831	151,699
Workers' compensation - net of current portion	2,484	1,963
Long-term debt - general obligation bonds - net of current portion	638,852	622,681
Long-term debt - net of current portion	643,390	579,652
Fair value of interest rate swap	18,971	26,473
Total liabilities	1,456,528	1,382,468
Deferred inflow of resources	7,941	8,041
Total liabilities and deferred inflow of resources	1,464,469	1,390,509
Commitments and Contingencies (Note 16)		
Net Position:		
Net investment in capital assets	(91,703)	(56,155)
Restricted, expendable for:		
Repayment of debt	22,525	21,350
Capital acquisitions	9,925	9,880
Other purposes	349	347
Unrestricted	244,197	240,653
Total net position	185,293	216,075
Total Liabilities, Deferred Inflow of Resources, and Net Position	\$ 1,649,762	\$ 1,606,584

Palomar Health
Statements of Revenue, Expenses, and Changes in Net Position
(Dollars in Thousands)

	Year Ended June 30,	
	2018	2017 (restated)
Operating Revenue:		
Patient service revenue, net of provision for uncollectible accounts of \$59,158 in 2018 and \$49,459 in 2017	\$ 696,948	\$ 691,503
Shared risk revenue	82,326	79,798
Other revenue	14,894	15,423
Total operating revenue	<u>794,168</u>	<u>786,724</u>
Operating Expenses:		
Salaries, wages, and benefits	475,302	446,376
Professional fees	50,285	41,527
Supplies	106,821	107,845
Purchased services	77,552	86,333
Depreciation and amortization	44,781	51,425
Rent expense	18,782	17,789
Utilities	10,883	9,961
Other	21,623	19,711
Total operating expenses	<u>806,029</u>	<u>780,967</u>
(Loss) Income From Operations	<u>(11,861)</u>	<u>5,757</u>
Nonoperating Income (Expenses):		
Investment income	181	1,380
Unrealized gain (loss) on interest rate swap	7,502	12,267
Interest expense	(64,443)	(69,164)
Property tax revenue - unrestricted	16,779	15,910
Property tax revenue - restricted	19,093	20,077
Other - net	1,967	(4,287)
Total nonoperating expenses - net	<u>(18,921)</u>	<u>(23,817)</u>
Net loss before capital contribution	<u>(30,782)</u>	<u>(18,060)</u>
Change in net position	(30,782)	(18,060)
Net Position - Beginning of year	<u>216,075</u>	<u>234,135</u>
Net Position - End of year	<u>\$ 185,293</u>	<u>\$ 216,075</u>

Palomar Health
Statements of Cash Flows
(Dollars in Thousands)

	Year Ended June 30,	
	2018	2017 (restated)
Cash From Operating Activities:		
Receipts from:		
Patients, insurers, and other third-party payers	\$ 807,441	\$ 823,660
Other sources	18,409	9,212
Payments to:		
Employees	(470,739)	(454,149)
Suppliers	(340,313)	(326,568)
Net cash provided by operating activities	<u>14,798</u>	<u>52,155</u>
Cash Flows From Noncapital Financing Activities:		
Receipt of district taxes	16,779	15,910
Other	-	(3,452)
Net cash provided by noncapital financing activities	<u>16,779</u>	<u>12,458</u>
Cash Flows From Capital and Related Financing Activities:		
Acquisition and construction of capital assets	(21,037)	(27,777)
Interest payments on long-term debt	(60,939)	(41,142)
Proceeds from issuance of long-term debt	230,034	518,705
Defeasance of debt	(155,572)	(467,523)
Principal repayment on long-term debt	(20,681)	(63,853)
Proceeds on sale of capital assets	1,255	1,830
Receipt of property taxes restricted for debt service on general obligation bonds	19,093	20,077
Other	2,042	6,234
Net cash used in capital and related financing activities	<u>(5,805)</u>	<u>(53,449)</u>
Cash Flows From Investing Activities:		
Purchases of investments	(239,309)	(148,846)
Proceeds from sale of investments	196,297	143,253
Interest received on investments and notes receivable	182	1,380
Net cash used in by investing activities	<u>(42,830)</u>	<u>(4,213)</u>
Net (Decrease) Increase in Cash and Cash Equivalents	(17,058)	6,951
Cash and Cash Equivalents - Beginning of year	<u>66,538</u>	<u>59,587</u>
Cash and Cash Equivalents - End of year	<u>\$ 49,480</u>	<u>\$ 66,538</u>

Palomar Health
Statements of Cash Flows (continued)
(Dollars in Thousands)

	Year Ended June 30,	
	2018	2017
		(restated)
Reconciliation of Income from Operations to Net Cash		
Flows Provided by Operating Activities:		
(Loss) Income from operations	\$ (11,861)	\$ 5,757
Adjustments to reconcile (loss) income from operations to net cash provided by operating activities:		
Depreciation and amortization	44,781	51,425
Provision for bad debts	59,158	49,459
Equity in losses (earnings) of affiliates	1,745	(769)
Loss on disposal of fixed assets	1,521	7,418
Changes in assets and liabilities:		
Patient accounts receivable	(71,310)	(41,849)
Other receivables	(2,513)	(1,543)
Supplies and inventories	(991)	(136)
Prepaid expenses and other	(249)	18
Estimated third-party payor settlements	(13,755)	(11,032)
Other - net	3,981	(3,899)
Accounts payable	5,573	725
Accrued compensation and related liabilities	4,562	(7,772)
Other accrued liabilities	(5,744)	4,471
Unearned revenue	(100)	(118)
Net Cash Provided by Operating Activities	\$ 14,798	\$ 52,155
Noncash Investing and Capital and Financing Activities:		
Capital expenditures included in accounts payable	\$ 2,590	\$ 884
Premium related to issuance of 2016 General Obligation and Revenue Bonds	\$ 79,078	\$ 60,934
Settlement of future interest payments and fees related to defeasance of debt	\$ 23,567	\$ 58,304

Palomar Health

Notes to Financial Statements

Note 1 – Operations and Reporting Entity

Organization – Palomar Health (PH, or “District”), 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 financial statements include the accounts of the following commonly controlled divisions and related entities of PH. Unless otherwise indicated the following are divisions of PH:

- Palomar Medical Center Escondido (“Escondido”), located in west Escondido, California, includes a 288-bed general acute care hospital, including tertiary services, trauma services, cardiovascular surgery, women’s services, and retail pharmacy.
- Palomar Medical Center Poway (“Poway”), 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 Medical Center Downtown Campus (PHDC), located in east Escondido, California, includes acute rehab, Center for Behavioral Health, radiation therapy, and a crisis stabilization unit.
- Palomar Home Health Services, located in Escondido, California.
- San Marcos Ambulatory Care Center located in San Marcos, California, includes outpatient therapy.
- Jean McLaughlin Women’s Center for Health and Healing, located on the Poway campus.
- Palomar Outpatient Behavioral Health, located in San Marcos, California.
- PH Development, a charitable tax exempt organization created to provide assistance and support for PH by obtaining grant funding from federal state, local, and private sources.
- PH Expresscare clinics, located in select grocery stores in Escondido and San Elijo Hills, California.
- Arch Health Partners, Inc. (“Arch”), a tax exempt 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. 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.

Note 1 – Operations and Reporting Entity (continued)

- Pacific Accountable Care, LLC (PAC), a Medicare approved Accountable Care Organization (ACO) that has contracted with Centers for Medicare & Medicaid Services (CMS) as a participant in a Track 1 Medicare Shared Savings Program (MSSP) to provide coordinated high-quality care to Medicare patients at reduced cost. Arch's reporting entity includes PAC as a blended component unit because Arch is the sole member of PAC. See Note 9.
- Pacific Accountable Management, LLC (PAM), a management service organization (MSO) which is designed to provide administrative and billing services to physicians and physician groups through a series of regional MSOs. PAM provided MSO services to PAC. PH and Arch, collectively own a 100% of the units in PAM and therefore, PAM is included as a blended component unit of PH's reporting entity. See Note 9.
- Pacific Accountable Management San Diego, LLC (PAM-SD), a management service organization (MSO) established to provide administrative and billing services to physicians and physician groups in San Diego County. PAM-SD provided MSO services to Arch. PH and Arch, collectively own a 100% of the units in PAM and therefore, PAM is included as a blended component unit of PH's reporting entity. See Note 9.

Arch membership of obligated group – On August 31, 2017, PH, Arch, and US Bank National Association, as Master Trustee, entered into a Supplemental Master Indenture agreement providing for addition of Arch as a member of the Obligated Group created pursuant to the Master Indenture of Trust Dated December 1, 2006. As such, Arch becomes jointly and severally liable for the repayment of PH's revenue obligations and places its collateral under control of a master trustee for the benefit of lenders and bondholders. In consideration of the agreement of Arch to become an Obligated Group Member, PH has agreed to the extinguishment of Arch Obligations. Related eliminations can be found in Note 17.

The statement of net position as of June 30, 2017 and the related statement of revenue, expenses, and changes in net position for the year ended June 30, 2017 have been restated to show the impact of the adoption of GASB 75. See Notes 2 and 3.

Note 2 – Summary of Significant Accounting Policies

Use of estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Palomar Health

Notes to Financial Statements

Note 2 – Summary of Significant Accounting Policies (continued)

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, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*.

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, equity, and fixed income securities are carried at fair value, as determined by quoted market prices in the statements of net position. Investment income or loss is included in non-operating 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.

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 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 Escondido. 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 \$9,925 and \$9,880 as of June 30, 2018 and 2017, respectively, was included in restricted cash and investments in the accompanying statements of net position.

Palomar Health Notes to Financial Statements

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:

	<u>Years</u>
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 non-operating 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.

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 statements of revenue, expenses, and changes in net position. During the years ended June 30, 2018 and 2017, no impairment charges were recorded.

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.

Palomar Health

Notes to Financial Statements

Note 2 – Summary of Significant Accounting Policies (continued)

Deferred outflows of resources – Deferred outflows of resources represent a consumption of net position that applies to a future period(s) and so will not be recognized as an outflow of resources (expense) until that time. The deferred outflows of resources reported in the financial statements is loss on refunding of debt which is amortized over the shorter of the remaining life of the refunded bonds or the refunding debt as a component of interest expense. See Note 9.

Deferred inflows of resources – Deferred inflows of resources represent an increase in net position that applies to future periods and so will not be recognized as an inflow of resources (revenue) until that time. The deferred outflows of resources reported in the financial statements are unearned rental income that will be recognized as revenue over the life of the rental agreement and the change in assumptions and other inputs related to Other Post-Employment Benefits. See Note 14.

Interest rate swaps – PH has entered into variable-to-fixed interest rate swaps, which are reflected at fair value in the 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 non-operating income (expenses) in the 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, 2018 and 2017, the interest rate swaps were recorded as a liability of \$18,971 and \$26,473, respectively.

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 9. 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.

Note 2 – Summary of Significant Accounting Policies (continued)

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 statements of revenue, expenses, and changes in net position. Non-operating 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 during the year the related services are rendered and adjusted in future years, as final settlements are determined.

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 members for each payor, 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 \$8,176 and \$10,966 are included in other accrued liabilities in the accompanying statements of net position as of June 30, 2018 and 2017, respectively.

Activity in PH's liability for IBNR claims for medical services provided to patients as of and for the years ended June 30, 2018 and 2017 is summarized as follows (in thousands):

	2018	2017
Balance, beginning of the year	\$ 10,966	\$ 10,544
Current year claims incurred and changes in estimates	41,547	43,148
Claims and expenses paid	(44,337)	(42,726)
Balance, end of the year	\$ 8,176	\$ 10,966

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 financial statements.

Palomar Health

Notes to Financial Statements

Note 2 – Summary of Significant Accounting Policies (continued)

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 General Obligation (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, 2018 and 2017, consists of the following (in thousands):

	<u>2018</u>	<u>2017</u>
To support operations - unrestricted use	\$ 16,779	\$ 15,910
For debt service on G.O. bonds - restricted use	19,093	20,077
	<u>\$ 35,872</u>	<u>\$ 35,987</u>

Income taxes – PH is a governmental subdivision of the State of California and is exempt from federal income and state franchise taxes. Arch and PAC are 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. PAM and PAM-SD, which are limited liability companies (LLC) are classified as partnerships for federal and state income tax purposes, and, as such, are exempt from federal income and state franchise taxes.

Accordingly, no provision for income taxes has been included in the accompanying financial statements.

Recent accounting pronouncements – In January 2017, the GASB issued Statement No. 84, *Fiduciary Activities*. This statement establishes fiduciary criteria and requires PH to report separate fiduciary funds financial statements within the District's financial statement. This guidance is effective July 1, 2018. PH is evaluating the impact of adopting this standard on the financial statements.

In June 2017, the GASB issued Statement No.87 *Leases*, establishing a single approach to the accounting for and reporting of leases by state and local governments requiring that all leases be considered as financing. Under the new guidance, PH must recognize a lease liability and an intangible asset in the financial statements. The statement is effective July 1, 2020. PH is evaluating the impact of adopting this standard on the financial statements.

Note 2 – Summary of Significant Accounting Policies (continued)

In June 2018, the GASB issued Statement No. 89, *Accounting for Interest Cost Before the End of a Construction Period*. This standard requires that interest costs incurred before the end of a construction period be recognized as an expense in the period in which the cost is incurred for financial statements prepared using the economic resources measurement focus. As a result, interest costs incurred before the end of a construction period will not be included in the historical cost of a capital asset reported in a business-type activity or enterprise fund. This statement is effective July 1, 2019. PH is evaluating the impact of adopting this standard on the financial statements.

In November 2017, Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU), 2017-14, *Revenue Recognition (Topic 605), and Revenue From Contracts with Customer (Topic 606)*, and mandates that revenue is realizable when services are exchanged for cash or claims to cash and is earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. This statement is effective July 1, 2018. Per GASB Statement No. 55, *Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, Issue 03/09, states that other accounting literature should be considered if a transaction is not specified by a GASB pronouncement. In this instance, PH would follow FASB guidance and is evaluating the impact of adopting this standard on the financial statements.

Note 3 – Implementation of GASB Statement No. 75 Accounting and Financial Reporting for Postemployment Benefits Other than Pensions

In June 2015, the GASB issued Statement No. 75 (GASB 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). PH implemented this standard effective July 1, 2016 in the financial statements. Accordingly, salaries, wages and benefits expense was increased by approximately \$276 for the year ended June 30, 2017 to reflect the adoption of GASB 75. In addition, an increase in accrued compensation and related liabilities of \$276 and a corresponding decrease in the unrestricted net position were recognized as of June 30, 2017. See Note 15.

Note 4 – 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.

Palomar Health

Notes to Financial Statements

Note 4 – 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 54% and 53% of PH's net patient service revenue for the years ended June 30, 2018 and 2017, respectively.

Third-party cost reports for the Medicare program have been settled through the year ended June 30, 2014 with the exception of PMC Escondido's fiscal years 2011 and 2013 reports which are pending administrative review by Centers for Medicare & Medicaid Services (CMS). The cost reports for Medi-Cal programs have been settled through the year ended June 30, 2014. Results of cost report settlements as well as estimates for settlements of all years through 2016 have been reflected in the accompanying financial statements.

As of June 30, 2018 and 2017, estimated third-party settlements resulted in a receivable of \$28,613 and \$16,943, respectively, and a liability of \$1,811 and \$3,896, respectively.

Laws and regulations governing Medicare and Medi-Cal programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. During the years ended June 30, 2018 and 2017, PH settled various prior-year cost reports and appeal issues. These settlements and normal estimation differences between subsequent cash collections on patient accounts receivable resulted in approximately \$59,204 and \$52,605 of additional revenues for the years ended June 30, 2018 and 2017, respectively, which was included in net patient service revenue in the accompanying statements of revenue, expenses, and changes in net position.

Third-Party Reimbursement Programs – *Public hospital redesign and incentives in Medi-Cal program (PRIME or “the Program”)* – The program was approved via the California's Section 1115(a) demonstration waiver, titled “California's Medi-Cal 2020 Demonstration.” The PRIME program intends to close the gap by incentivizing hospitals to identify critical objectives to improve delivery of care for Medi-Cal beneficiaries. The program is effective beginning January 1, 2016 and is a five-year program. The program has both reporting metrics as well as performance metrics. Revenue is recognized based on approval from CMS for the achievement of reporting metrics and when metrics are achieved for the performance metrics component.

Medi-Cal managed care rate range Intergovernmental Transfer (IGT) – The Affordable Care Act (ACA) recognized the formation and maintenance of a network of primary care providers to service Medi-Cal Managed Care plans would require funding assistance. IGT is a payment methodology to partially fund the gap between what Medi-Cal Managed Care plans pay and the full cost of providing the service.

Senate Bill 239 quality assurance fee supplemental payment – A state-legislated supplemental program that distributed funds to hospitals based on the volume of care to Medi-Cal funded patients. The intention is to strengthen the ability of hospitals to meet the increased demand resulting from implementing programs, service, and capital required by ACA.

Note 4 – Net Patient Service Revenue, Third-Party Reimbursement Programs, and Non-Operating Revenue (continued)

Assembly Bill 113 Medi-Cal rate stabilization – A state-legislated program which provides a cost supplement for Medi-Cal Managed Care Seniors and Persons with Disabilities.

Assembly Bill 915 outpatient supplement payment program – This bill provides for the payment of a supplemental reimbursement to acute care hospitals owned by certain public entities that provide outpatient services to Medi-Cal beneficiaries. The state legislated a supplemental reimbursement for uncompensated Medi-Cal Fee-For-Service (FFS) outpatients. PH receives 50% of reported uncompensated costs.

QAF managed care funds – part of the hospital Quality Assurance Fee (QAF) – Under the California Hospital Fee Program, PH receives net supplemental funds under a managed care methodology.

The following table summarizes amounts recognized as net patient service revenue from the various state supplemental funding programs and transfer agreements available to PH for the years ended June 30, 2018 and 2017, respectively (in thousands):

	2018	2017
PRIME	\$ 10,168	\$ 19,020
Managed Care Rate Range IGT	16,737	13,175
Quality Assurance Supplement	9,327	3,691
Medi-Cal Rate Stabilization	5,173	5,264
Outpatient Supplemental Payment	9,197	2,004
Medi-Cal Expansion	5,565	5,008
Totals	\$ 56,167	\$ 48,162

With respect to the above described programs, revenue is recognized when management is reasonably assured all performance and satisfaction of obligations have been met, the amount of revenue is available and has been considered in estimating the amount of revenue to be recognized.

Meaningful use incentive payments – The American Recovery & Reinvestment Act of 2009 (ARRA) established incentives under the Medicare and Medicaid programs for certain professionals and hospitals that meaningfully use certified electronic health record (EHR) technology. The Medicaid program will provide incentive payments to hospitals and eligible professionals as they adopt, implement, and upgrade or demonstrate meaningful use in the first year of participation and demonstrate meaningful use for up to five remaining participation years. PH received its final incentive payment of \$1,196 for the year ended June 30, 2017 which is recognized in other revenue in the statements of revenue, expenses and changes in net position. The Medicare EHR meaningful use attestation is subject to audit by CMS and the State of California. As part of this process, a final settlement amount for the incentive payments could be established that differs from the initial calculation. There are no payment adjustments under the Medicaid EHR incentive program during the year ended June 30, 2018.

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Notes to Financial Statements

Note 5 – 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 \$63,172 and \$64,260 of unrestricted funds in this fund as of June 30, 2018 and 2017, respectively. PH also had invested \$9,925 and \$9,880 in jointly managed funds under an escrow agreement with the City of Escondido as of June 30, 2018 and 2017, 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 investment in this pool is reported in the accompanying statements of net position at amounts based upon PH's pro-rata share of the fair value provided by LAIF for the entire LAIF portfolio (in relation to the amortized cost of that portfolio). The balance available for withdrawals is based on the accounting records maintained by LAIF, which are recorded on an amortized cost basis and therefore is excluded from the fair value hierarchy.

As of June 30, 2018 and 2017, PH had the following investments (in thousands):

	<u>2018</u>	<u>2017</u>
Investments - current	\$ 150,924	\$ 157,181
Restricted cash and investments - current	31,817	30,184
Restricted cash and investments - noncurrent	<u>100,041</u>	<u>53,700</u>
Total	<u>\$ 282,782</u>	<u>\$ 241,065</u>

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Notes to Financial Statements

Note 5 – Cash and Cash Equivalents and Investments (continued)

As of June 30 2018 and 2017, PH had investments by type and maturity as follows (in thousands):

Investment Type	2018		
	Fair Value	Investment Maturities (in Years)	
		Less Than 1	1-5
External investment pool - LAIF	\$ 73,095	\$ 73,095	\$ -
U.S. government bonds	17,127	4,027	13,100
U.S. treasury bills	19,726	1,843	17,883
Corporate bonds	15,029	3,376	11,653
Money market mutual funds	157,805	157,805	-
Total	<u>\$ 282,782</u>	<u>\$ 240,146</u>	<u>\$ 42,636</u>

Investment Type	2017		
	Fair Value	Investment Maturities (in Years)	
		Less Than 1	1-5
External investment pool - LAIF	\$ 74,140	\$ 74,140	\$ -
U.S. government bonds	42,068	2,295	39,773
U.S. treasury bills	23,127	6,999	16,128
Corporate bonds	26,697	3,638	23,059
Money market mutual funds	75,033	75,033	-
Total	<u>\$ 241,065</u>	<u>\$ 162,105</u>	<u>\$ 78,960</u>

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.

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Notes to Financial Statements

Note 5 – 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.

Marketable securities and financial instruments – Where quoted market prices are available in an active market, securities or instruments are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated using pricing models, quoted prices of securities or instruments with similar characteristics, or discounted cash flows. These securities or instruments are classified within Level 2 of the valuation hierarchy. In certain cases, where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the valuation hierarchy.

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Notes to Financial Statements

Note 5 – Cash and Cash Equivalents and Investments (continued)

The following table summarizes PH’s assets and liabilities measured at fair value on a recurring basis as of June 30, 2018 and 2017 (in thousands):

	2018			
	Total	Level 1	Level 2	Level 3
Investments				
Money market mutual funds	\$ 157,805	\$ 157,805	\$ -	\$ -
U.S. government bonds	17,127	-	17,127	-
U.S. treasury bills	19,726	19,726	-	-
Corporate bonds	15,029	-	15,029	-
	<u>209,687</u>	<u>\$ 177,531</u>	<u>\$ 32,156</u>	<u>\$ -</u>
 Investments not subject to the fair value hierarchy:				
State investment pool - LAIF	<u>73,095</u>			
 Total Investments	<u>\$ 282,782</u>			
 Liabilities				
Interest rate swap	<u>\$ (18,971)</u>	<u>\$ -</u>	<u>\$ (18,971)</u>	<u>\$ -</u>
	2017			
	Total	Level 1	Level 2	Level 3
Investments				
Money market mutual funds	\$ 75,033	\$ 75,033	\$ -	\$ -
U.S. government bonds	42,068	-	42,068	-
U.S. treasury bills	23,127	23,127	-	-
Corporate bonds	26,697	-	26,697	-
	<u>166,925</u>	<u>\$ 98,160</u>	<u>\$ 68,765</u>	<u>\$ -</u>
 Investments not subject to the fair value hierarchy:				
State investment pool - LAIF	<u>74,140</u>			
 Total Investments	<u>\$ 241,065</u>			
 Liabilities				
Interest rate swap	<u>\$ (26,473)</u>	<u>\$ -</u>	<u>\$ (26,473)</u>	<u>\$ -</u>

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.

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Notes to Financial Statements

Note 5 – Cash and Cash Equivalents and Investments (continued)

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.

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, 2018 and 2017, 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. 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, 2018 and 2017, was as follows (in thousands):

Investment Type	2018		2017	
	Fair Value	Percentage of Total Investments	Fair Value	Percentage of Total Investments
Federal National Mortgage Association	\$ -	-	\$ 25,009	16%
Federal Home Loan Mortgage Corp.	10,122	7%	17,059	11%
U.S. Bank, Trustee	12,701	8%	24,988	16%
U.S. Bank, Trustee	77,331	51%	18,665	12%
Wells Fargo Advantage Government Money Market	31,555	21%	30,007	19%
Fidelity Investments	36,146	24%	-	-

Note 5 – Cash and Cash Equivalents and Investments (continued)

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.

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, 2018 and 2017, PH's bank balances totaled \$50,449 and \$67,413, 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 per depositor. Arch had a cash balance of \$2,013 and \$852 that was above the insured limit at June 30, 2018 and 2017, respectively.

Investment income

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

	2018	2017
Interest, dividends, and realized gains on sale of investments	\$ 1,475	\$ 3,189
Net decrease in fair value of investments	(1,294)	(1,809)
Total	\$ 181	\$ 1,380

Note 6 – 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, 2018 and 2017, was as follows:

	2018	2017
Medicare	19%	16%
Medi-Cal	9%	12%
HMO/PPO/commercial*	62%	63%
Patient	5%	4%
Others	5%	5%
Total	100%	100%

* In addition to various commercial insurance plans, this category includes Medi-Cal HMOs and Medicare Advantage HMOs

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Notes to Financial Statements

Note 7 – Capital Assets

A summary of changes in capital assets for the years ended June 30, 2018 and 2017, was as follows (in thousands):

	Balance as of June 30, 2017	Additions	Disposals	Transfers	Balance as of June 30, 2018
Land improvements	\$ 80,342	\$ -	\$ -	\$ -	\$ 80,342
Buildings and leasehold improvements	1,122,495	147	(47)	2,945	1,125,540
Equipment	295,163	6,473	(9,274)	2,573	294,935
Land	61,912	-	(1,197)	-	60,715
Construction in progress	33,408	16,124	-	(5,518)	44,014
	<u>1,593,320</u>	<u>22,744</u>	<u>(10,518)</u>	<u>-</u>	<u>1,605,546</u>
Less accumulated depreciation and amortization	<u>(519,289)</u>	<u>(44,781)</u>	<u>7,665</u>	<u>-</u>	<u>(556,405)</u>
Capital assets - net	<u>\$ 1,074,031</u>	<u>\$ (22,037)</u>	<u>\$ (2,853)</u>	<u>\$ -</u>	<u>\$ 1,049,141</u>

	Balance as of June 30, 2016	Additions	Disposals	Transfers	Balance as of June 30, 2017
Land improvements	\$ 80,350	\$ -	\$ (8)	\$ -	\$ 80,342
Buildings and leasehold improvements	1,126,663	279	(5,807)	1,360	1,122,495
Equipment	293,646	6,023	(4,849)	343	295,163
Land	62,770	-	(858)	-	61,912
Construction in progress	28,322	14,679	(7,890)	(1,703)	33,408
	<u>1,591,751</u>	<u>20,981</u>	<u>(19,412)</u>	<u>-</u>	<u>1,593,320</u>
Less accumulated depreciation and amortization	<u>(478,021)</u>	<u>(51,425)</u>	<u>10,157</u>	<u>-</u>	<u>(519,289)</u>
Capital assets - net	<u>\$ 1,113,730</u>	<u>\$ (30,444)</u>	<u>\$ (9,255)</u>	<u>\$ -</u>	<u>\$ 1,074,031</u>

Construction commitments outstanding as of June 30, 2018, were \$2,695.

Note 8 – 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 \$7,115 and \$7,222 in the accompanying statements of net position as of June 30, 2018 and 2017, 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. The renewal is considered inevitable.

Note 8 – Investment in and Amounts Due from Affiliated Entities (continued)

In October 2017, PH entered into an Investment Interests Purchase Agreement, whereby Arch conveyed 100% of its interest in PHS-PAM Holdings, Inc. (PHS-PAM) to PH. PH purchased 1,000 or 100% of the issued and outstanding shares of PHS-PAM Holdings, Inc. which owns 50% of PAM and 50% of PAM-SD. The remaining 50% ownership interests in PAM and PAMSD are held by Arch and or its subsidiaries. PH paid \$2.5M via PHS-PAM for its 50% interest in PAM-SD. This investment was eliminated in the financial statements.

PH's investment in affiliated entities, which are generally accounted for under the equity method because PH does not control the entities, was \$5,961 and \$5,760 at June 30, 2018 and 2017, respectively. The total income from PH's investment in affiliates was \$1,273 and \$1,604 for the years ended June 30, 2018 and 2017, respectively.

Note 9 – 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 financial statements.

The Foundation provides a funding source for various programs on behalf of PH. Funding for these programs provided by the Foundation totaled \$4,448 and \$1,244 for the years ended June 30, 2018 and 2017, respectively.

PH has entered into a management services agreement (MSA) with the Foundation, whereby PH provides administrative support to the Foundation. Support provided to the Foundation totaled \$1,490 and \$1,997 for the years ended June 30, 2018 and 2017, respectively.

Under the management services agreement renewed on December 31, 2016 and expiring on June 30, 2017, PH provided a line of credit to the Foundation with a \$5,000 limit with interest at 2.5% above LIBOR. The Ninth Amendment to the MSA was signed on June 30, 2017, extending the LOC through June 30, 2018 and increasing the credit limit to \$8,000. The amount outstanding on the line of credit was \$0 and \$2,759 as of June 30, 2018 and 2017, respectively. The Tenth Amendment to the MSA will be signed in fiscal year 2019 to extend the LOC through June 30, 2019.

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Notes to Financial Statements

Note 9 – Related Organizations (continued)

An unaudited summary of the Foundation's assets, liabilities, and net assets as of June 30, 2018 and 2017, was as follows:

	2018	2017
Assets	\$ 7,702	\$ 11,726
Liabilities	\$ 1,145	\$ 4,038
Net assets	6,557	7,688
Total liabilities and net assets	\$ 7,702	\$ 11,726

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, 2018 and 2017, PIMG provided professional services to Arch in the amounts of \$11,855 and \$12,674, respectively. Any amounts advanced are to be repaid upon Arch's request and do not bear interest. There are no outstanding amounts at June 30, 2018 and 2017, respectively.

Pacific Accountable Care, LLC – In April, 2016, Arch formed PAC, a partnership with Medicare Fee For Service (FFS) participants, to develop an ACO with the intent to manage, coordinate, and promote accountability for the quality, patient safety, cost and overall care of 12,000 Medicare patients with Arch as the sole member. In January, 2017, CMS awarded PAC a Track 1 MSSP contract for calendar years January 1, 2017 through December 31, 2019. PAC is eligible for payments from CMS if able to achieve medical cost savings as compared to predetermined benchmarks. As a Track I MSSP, PAC has no risk with CMS for any increase in medical cost. For FY18, PAC recorded a receivable of \$3,946 for its share of the 2017/2018 plan year savings with a related payable of \$921 due to the CMS approved physicians participating in the PAC ACO.

Pacific Accountable Management, LLC – In September, 2016, Arch formed PAM, an MSO, which leveraged existing Arch workforce to enhance relationships with ACO-affiliated physician practices. At June 30, 2018 16.6% of PAM was owned by PH through its subsidiary PHS-PAM and 83.4% was owned by Arch. These ownership interests were granted with no cash transfers. PAM was established to provide physician management and billing services and to provide operational management services to PAC.

Pacific Accountable Management San Diego, LLC – In May, 2017, Arch formed PAM-SD, an MSO, to provide management and billing services to physicians and physician group in San Diego, California. Per a restated PAM-SD Operating Agreement dated June 26, 2017, PHS-PAM holds a 50% ownership interest in PAM-SD. The remaining 50% ownership is held by Arch.

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Notes to Financial Statements

Note 10 – Long-term Debt

The following is a summary of long-term debt transactions for PH for the years ended June 30, 2018 and 2017 (in thousands):

	Balance June 30, 2017	Additions	Reductions	Balance June 30, 2018	Amounts Due within One Year
Bonds payable:					
Series 2017 Refunding Revenue Bonds	\$ -	\$ 168,646	\$ -	\$ 168,646	\$ -
Series 2017 Certificates of Participation	-	61,378	-	61,378	935
Series 2016 Refunding Revenue Bonds	276,460	-	(6,690)	269,770	5,530
Series 2016A&B General Obligation Bonds	242,245	-	(5,385)	236,860	1,520
Series 2010 Certificates of Participation	155,572	-	(155,572)	-	-
Series 2010A General Obligation Bonds	65,597	-	-	65,597	-
Series 2009 Certificates of Participation	-	-	(31)	(31)	-
Series 2009A General Obligation Bonds	113,514	-	(222)	113,292	-
Series 2007A General Obligation Bonds	56,431	-	(3,182)	53,249	3,714
Series 2006 Certificates of Participation	161,065	-	(5,590)	155,475	5,825
Accrued interest on capital appreciation bonds	152,001	23,393	-	175,394	1,971
Note payable	76	-	(11)	65	288
Capital leases	141	291	-	432	73
Total long-term debt	\$ 1,223,102	\$ 253,708	\$ (176,683)	\$ 1,300,127	\$ 19,856

	Balance June 30, 2016	Additions	Reductions	Balance June 30, 2017	Amounts Due within One Year
Bonds payable:					
Series 2016 Refunding Revenue Bonds	\$ -	\$ 276,460	\$ -	\$ 276,460	\$ 5,360
Series 2016A&B General Obligation Bonds	-	242,245	-	242,245	3,790
Series 2010 Certificates of Participation	157,784	-	(2,212)	155,572	2,530
Series 2010A General Obligation Bonds	65,628	-	(31)	65,597	-
Series 2009 Certificates of Participation	225,946	-	(225,946)	-	-
Series 2009A General Obligation Bonds	113,736	-	(222)	113,514	-
Series 2007A General Obligation Bonds	237,030	-	(180,599)	56,431	3,317
Series 2006 Certificates of Participation	166,525	-	(5,460)	161,065	5,625
Series 2005A General Obligation Bonds	60,978	-	(60,978)	-	-
Accrued interest on capital appreciation bonds	129,564	22,437	-	152,001	1,231
Note payable	87	-	(11)	76	12
Capital leases	418	-	(277)	141	135
Total long-term debt	\$ 1,157,696	\$ 541,142	\$ (475,736)	\$ 1,223,102	\$ 22,000

The terms and due dates of PH's long-term debt as of June 30, 2018 and 2017, are as follows:

- Series 2017 Refunding Revenue Bonds (Series 2017 Bonds) bear interest at 5.0%, with interest payments due semi-annually. Principal payments are due in annual amounts ranging from \$15,785 in fiscal year 2041 to \$22,405 in fiscal year 2048. The Series 2017 Bonds are net of unamortized original issue premium of \$17,186 at June 30, 2018 and are collateralized by PH revenues as defined in the indenture agreement. The net unamortized loss on refunding is \$19,594 at June 30, 2018 and is included as deferred outflow of resources and amortized.

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Notes to Financial Statements

Note 10 – Long-term Debt (continued)

- Series 2017 Certificates of Participation (2017 COPs) bear interest at rates between 4.0% to 5.0%, with interest payments due semiannually. Principal payments are due in annual amounts ranging from \$935 in fiscal year 2019 to \$3,450 in fiscal year 2048. The 2017 COPs are net of unamortized original issue premium of \$1,278 at June 30, 2018, and are collateralized by PH revenues as defined in the indenture agreement.
- Series 2016 Refunding Revenue Bonds (Series 2016 Revenue Bonds) bear interest at rates between 3.0% to 5.0%, with interest payments due semiannually. Principal payments are due in annual amounts ranging from \$5,360 in fiscal year 2018 to \$27,440 in fiscal year 2040. The Series 2016 Revenue Bonds are net of unamortized original issue premium of \$28,380 and \$29,710 at June 30, 2018 and 2017, respectively, and are collateralized by PH revenues as defined in the indenture agreement. The net unamortized loss on refunding is \$38,388 and \$40,188 at June 30, 2018 and 2017, respectively and is included as deferred outflow of resources and amortized.
- Series 2016A General Obligation Bonds (Series 2016A G.O. Bonds) bear interest at rates between 2.0% to 5.0%, with interest payments due semiannually. Principal payments are due in annual amounts ranging from \$1,520 in fiscal year 2019 to \$4,345 in fiscal year 2035. The Series 2016A G.O. Bonds are net of unamortized original issue premium of \$9,015 and \$9,778 at June 30, 2018 and 2017, respectively.
- Series 2016B General Obligation Bonds (Series 2016B G.O. Bonds) bear interest at rates between 2.0% to 5.0%, with interest payments due semiannually. Principal payments are due in annual amounts ranging from \$1,615 in fiscal year 2018 to \$19,305 in fiscal year 2038. The Series 2016B G.O. Bonds are net of unamortized original issue premium of \$18,475 and \$19,497 at June 30, 2018 and 2017, respectively. The net unamortized loss on refunding is \$3,876 and \$4,090 at June 30, 2018 and 2017, respectively and is included as deferred outflow of resources and amortized.
- Series 2010 Certificates of Participation (2010 COPs) were advance refunded on December 11, 2017 with proceeds from the issuance of the Series 2017 Bonds. Additional 2010 COP reserves were deposited in an escrow trust account held with the escrow agent to provide for all future debt service payments. As a result, the 2010 COPs are considered to be defeased and the liability for these bonds has been removed from the statement of net position. PH refunded the Series 2010 COP to reduce its total debt service payments over the next 16 years and to obtain an economic gain of \$16,678.
- Series 2010A General Obligation Bonds (Series 2010A G.O. Bonds), accreted interest compounded at rates between 6.84% to 7.85% on \$64,917 Capital Appreciation Bonds (CABs) with the first payment to bondholders due 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 payments are due in annual amounts ranging from \$1,476 in fiscal year 2038 to \$33,159 in fiscal year 2041. The Series 2010A G.O. Bonds are net of unamortized premium of \$649 and \$680 at June 30, 2018 and 2017, respectively.

Note 10 – Long-term Debt (continued)

- Series 2009 Certificates of Participation (2009 COPs) were advance refunded on October 20, 2016 with proceeds from the issuance of the Series 2016 Revenue Bonds. Additional 2009 COP reserves were deposited in an escrow trust account held with the escrow agent to provide for all future debt service payments. As a result, the 2009 COPs are considered to be defeased and the liability for these bonds has been removed from the statement of net position. PH refunded the Series 2009 COP to reduce its total debt service payments over the next 23 years by \$48,600 and to obtain an economic gain of \$33,200.
- Series 2009A General Obligation Bonds (Series 2009 G.O. Bonds), accreted interest compounded at rates between 6.84% to 9% on \$50,001 CABs with the first payment to bondholders on August 1, 2019. Accreted interest compounded at 7% on \$59,999 Convertible CABs with the first payment to bondholders on August 1, 2033. Principal payments are due in annual amounts ranging from \$327 in fiscal year 2021 to \$18,868 in fiscal year 2039. The Series 2009 G.O. Bonds are net of unamortized premium of \$3,293 and \$3,514 at June 30, 2018 and 2017, respectively.
- Series 2007A General Obligation Bonds (Series 2007A G.O. Bonds), \$66,083 CABs are compounded at interest rates between 3.67% to 4.92% with the first payment paid to bondholders on August 1, 2011. Principal payments are due in annual amounts ranging from \$557 in fiscal 2012 to \$6,585 in fiscal 2027. The Series 2007A G.O. Bonds are net of unamortized premium of \$711 and \$852 at June 30, 2018 and 2017, respectively. A portion of the Series 2007A G.O. Bonds, the current interest bonds, was advance refunded on October 27, 2016 with proceeds from the issuance of the Series 2016B G.O. Bonds. As a result, the Series 2007A G.O. current interest bonds are considered to be defeased and the liability for these bonds has been removed from the statement of net position. PH refunded the 2007A G.O. Bonds to reduce its total debt service payments over the next 21 years by \$50,200 and to obtain an economic gain of \$38,200.
- Series 2006 Certificates of Participation (2006 COPs), were issued as auction rate securities, whereby the interest rate for each series is generally determined during successive seven-day auction periods (a portion of the Series 20016 COPs refunded the Series 1993 Insured Refunding Revenue Bonds). In addition, PH entered into an interest rate swap agreement with Citibank, N.A., New York, with respect to the 2006 COPs in a notional amount of \$180,000 (the Swap Agreement) (see Note 11). Interest on the 2006 COP is accrued at 3.218%, which is the fixed rate to be paid by PH under the Swap Agreement; interest payments are due semiannually and principal payments are due annually in amounts ranging from \$5,500 in fiscal year 2017 to \$12,350 in fiscal year 2037. The 2006 COPs are net of unamortized loss on refunding of \$100 and \$135 at June 30, 2018 and 2017, respectively, and are collateralized by PH revenues as defined in the indenture agreement.
- The 2005A General Obligation Bonds (2005A G.O. Bonds), were redeemed on October 27, 2016 with proceeds from the issuance of the Series 2016B G.O. Bonds. The liability for these bonds has been removed from the statement of net position as of June 30, 2018.

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Notes to Financial Statements

Note 10 – Long-term Debt (continued)

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.

PH is required to maintain certain debt covenants (Days Cash on Hand, Maximum Annual Debt Service, and Cushion Ratio) under its indenture agreements for the COPs. 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, 2018 and 2017, long-term capital leases, net of current portion, amounted to \$359 and \$6, respectively. Related net book value of leased equipment totaled \$478 and \$135, and depreciation expense totaled \$100 and \$243 for the years ended June 30, 2018 and 2017, respectively.

The estimated fair value of PH's long-term debt was approximately \$1,431,066 and \$1,385,790 as of June 30, 2018 and 2017 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, 2018, are as follows (in thousands):

<u>Years Ending June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2019	\$ 17,885	\$ 49,452	\$ 67,337
2020	21,981	54,094	76,075
2021	19,875	59,813	79,688
2022	21,210	63,956	85,166
2023	22,531	65,073	87,604
2024 - 2028	133,462	343,219	476,681
2029 - 2033	221,106	343,588	564,694
2034 - 2038	278,453	266,102	544,555
2039 - 2043	191,526	145,751	337,277
2044 - 2048	117,626	14,857	132,483
Sub-total	<u>1,045,655</u>	<u>1,405,905</u>	<u>2,451,560</u>
Net premium on bonds	79,078	-	79,078
Accrued interest on capital appreciation bonds	<u>175,394</u>	<u>-</u>	<u>175,394</u>
Total	<u>\$ 1,300,127</u>	<u>\$ 1,405,905</u>	<u>\$ 2,706,032</u>

Note 11 – Interest Rate Swap

In 2006, PH entered into the Swap Agreement as a means to lower its borrowing costs on the 2006 COPs (see Note 10) 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 2006 COPs and terminates on November 1, 2036 simultaneously with the maturity of the 2006 COPs.

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 London Interbank Offered Rate, LIBOR, plus 0.23% (2.23% and 2.14% at June 30, 2018 and 2017, respectively).

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, 2018	\$ 155,575
Notional amount as of June 30, 2017	\$ 1,161,200
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, 2018	\$ 3,408
PH receives	56% of 30-day LIBOR + 0.23%
Swap fair value as of June 30, 2018	\$ (18,971)
Change in fair value for the year ended June 30, 2018	\$ 7,502
Classification	Liability

Fair value – As of June 30, 2018 and 2017, the swap had a negative fair value of \$18,971 and \$26,473, 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 statements of net position as a long-term liability. The change in the fair value of the swap is reported in the accompanying statements of revenue, expenses, and changes in net position as unrealized gain on interest rate swap.

Credit risk – PH seeks to limit its counterparty risk by contracting only with highly rated entities. As of June 30, 2018, the counterparty of the interest rate swap was rated "A1" by Moody's, "A+" by S&P, and "A+" by Fitch Ratings (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.

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Notes to Financial Statements

Note 11 – Interest Rate Swap (continued)

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 (1) Moody's rating of Baa2, (2) S&P rating of BBB, and (3) Fitch rating of BBB.

The negative swap fair value in the accompanying 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 May 2018.

Note 12 – Operating Leases

PH leases certain office space and equipment under operating leases. Lease expense on all such leases for the years ended June 30, 2018 and 2017, totaled \$19,319 (including \$387 in non-operating expense) and \$18,167 (including \$378 in non-operating 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, 2018, was as follows (in thousands):

Consolidated Years Ending June 30	Lease Payments	Lease Receipts
2019	\$ 12,780	\$ 576
2020	13,271	337
2021	13,151	338
2022	11,965	333
2023	7,620	330
2024-2028	30,489	330
2029-2033	16,884	1,584
2034-2038	17,710	-
2039-2081	35,383	-
Total	<u>\$ 159,253</u>	<u>\$ 3,828</u>

Note 13 – 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 statements of net position do not include the funds deposited with financial institutions pursuant to deferred annuity contracts.

Note 14 – 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. For the years ended June 30, 2018 and June 30, 2017, contributions under the retirement plan by PH were 6% of covered employees' basic compensation. Contributions are funded as accrued. Total PH contributions expensed for the years ended June 30, 2018 and 2017, were \$18,333 and \$19,080, respectively.

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Notes to Financial Statements

Note 15 – Postemployment Healthcare Plan

The Company accounts for its postemployment healthcare plan under GASB Codification Section P50, *Postemployment Benefits Other Than Pensions-Employer Reporting*.

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.

Employees covered by benefit terms – As of the current and prior valuation dates, the following employees were covered by the Plan:

	<u>July 1, 2014</u>	<u>July 1, 2016</u>
Inactive employees currently receiving benefit payments	11	12
Active employees	<u>3,276</u>	<u>3,617</u>
Total	<u><u>3,287</u></u>	<u><u>3,629</u></u>

Total OPEB liability – PH's total OPEB liability of \$1,193 was measured as of June 30, 2018, and was determined by an actuarial valuation as of that date.

Actuarial assumptions and other inputs – The total OPEB liability in the June 30, 2018 actuarial valuation is determined using the following actuarial assumptions and other inputs, applied to all periods included in the measurement, unless otherwise specified. The actuarial assumptions used in the June 30, 2018 valuation were based on the results of an actuarial experience study for the period June 30, 2017 to June 30, 2018.

Inflation	2.50%
Salary Increases	3.5% - 18.5%, including inflation
Discount Rate	3.87%
Healthcare Cost Trend Rates	5% for 2017 and 2018, 6.5% for 2019 and decreasing to an ultimate rate of 4% in 2029

The discount rate was based on Bond Buyer 20-Bond General Obligation Index.
Mortality rates were based on the RP-2000 disabled Life.

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Notes to Financial Statements

Note 15 – Postemployment Healthcare Plan (continued)

Changes in the total OPEB liability (in thousands):

	Year Ended June 30,	
	2018	2017
Total OPEB liability - prior measurement date	\$ 1,176	\$ 1,190
Changes in total OPEB liability		
(a) Service cost	60	72
(b) Interest on the total OPEB liability	43	35
(c) Changes on benefit terms	-	-
(d) Differences between expected and actual experience	-	-
(e) Changes of assumptions or other inputs	(24)	(63)
(f) Benefit payments	(62)	(58)
Total OPEB liability - current measurement date	\$ 1,193	\$ 1,176
Covered-employee payroll	\$ 209,718	\$ 240,492
Total OPEB liability as a % of covered-employee payroll	0.60%	0.50%

Key Information

Valuation date	July 1, 2016	July 1, 2016
Reporting date	June 30, 2018	June 30, 2017
Measurement date	June 30, 2018	June 30, 2017
Discount rate as of the measurement date	3.87%	3.58%
Municipal bond index rate	3.87%	3.58%
Municipal bond index date	June 30, 2018	June 30, 2017

Sensitivity of the net OPEB liability to changes in the discount rate – The following presents PH’s total OPEB liability using the final discount rate of 3.58% and preliminary discount rate of 3.87% for June 30, 2018 and 2017 measurement dates, respectively, as well as what the total OPEB liabilities would be they were calculated using a discount rate that is one-percentage-point lower or one-percentage-point higher than the current rate (in thousands).

	June 30, 2018			June 30, 2017		
	1% Decrease 2.87%	Discount Rate 3.87%	1% Increase 4.87%	1% Decrease 2.58%	Discount Rate 3.58%	1% Increase 4.58%
Net OPEB liability	\$ 1,278	\$ 1,193	\$ 1,115	\$ 1,264	\$ 1,176	\$ 1,097

Palomar Health

Notes to Financial Statements

Note 15 – Postemployment Healthcare Plan (continued)

Sensitivity of the net OPEB liability to changes in the healthcare trend rates – The following presents PH’s total OPEB liability using the current health trend rates, as well as what the total OPEB liability would be if it were calculated using healthcare trend rates that are one-percentage-point lower or one-percentage-point higher than the current healthcare trend rates (in thousands).

	June 30, 2018			June 30, 2017		
	1% Decrease	Current	1% Increase	1% Decrease	Current	1% Increase
	5.5% to 3%	6.5% to 4%	7.5% to 5%	5.5% to 3%	6.5% to 4%	7.5% to 5%
Net OPEB liability	\$ 1,076	\$ 1,193	\$ 1,327	\$ 1,068	\$ 1,176	\$ 1,301

OPEB expense and deferred outflows of resources and deferred inflows of resources related to OPEB – For the fiscal year ended June 30, 2018, PH recognized OPEB expense of \$35. At June 30, 2018, the deferred outflows of resources and deferred inflows of resources related to OPEB are as follows (in thousands):

	June 30, 2018			June 30, 2017		
	Deferred Outflows of Resources	Deferred Inflows of Resources	Net Amount	Deferred Outflows of Resources	Deferred Inflows of Resources	Net Amount
Differences between expected and actual experience	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Changes of assumptions and other inputs	-	18	(18)	-	-	-
Total	\$ -	\$ 18	\$ (18)	\$ -	\$ -	\$ -

Amounts reported as deferred outflows of resources and deferred inflows of resources related to OPEB will be recognized in OPEB expense as follows (in thousands):

June 30,	Amount
2019	\$ (6)
2020	(6)
2021	(5)
2022	(1)
2023	-
Thereafter	-
	<u>\$ (18)</u>

Note 16 – 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.

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 – Effective July 1, 2016, PH withdrew its membership from Alpha Fund and has contracted with Safety National Casualty Corporation to provide workers' compensation insurance coverage. PH is self-insured for the first \$1,000 of each occurrence with a maximum limit of indemnity per occurrence of \$1,000. At June 30, 2018 and 2017, estimated claims liabilities for workers' compensation recorded were \$4,491 and \$2,704, respectively.

Upon withdrawal from the ALPHA Fund, PH is required to fund its share of a deficit as defined under the joint powers agreement. PH accounts for its investment in the ALPHA Fund under the equity method and had recorded its share of \$0 and \$2,427 as of June 30, 2018 and 2017, respectively as an asset within investments in and amounts due from affiliated entities in the accompanying statements of net position.

Palomar Health

Notes to Financial Statements

Note 16 – Commitments and Contingencies (continued)

Activity in PH's workers' compensation claims liability during the years ended June 30, 2018 and 2017 is summarized as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Balance, beginning of the year	\$ 2,704	\$ 571
Current year claims incurred and changes in estimates for claims incurred in the prior year	4,873	3,677
Claims and expenses paid	<u>(3,086)</u>	<u>(1,544)</u>
Balance, end of year	4,491	2,704
Less current portion, included in other accrued liabilities	<u>(2,007)</u>	<u>(741)</u>
Balance, end of year, less current portion	<u>\$ 2,484</u>	<u>\$ 1,963</u>

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 \$100 for professional liability. PH's comprehensive liability insurance was renewed effective July 1, 2018, and the current policy expires on June 30, 2019. PH has reserved for estimated claims through 2015, including an estimate of IBNR. Such reserves totaled \$2,463 and \$2,463 as of June 30, 2018 and 2017, respectively, and are recorded as other accrued liabilities in the accompanying statements of net position.

Activity in PH's comprehensive liability insurance coverage liability during the years ended June 30, 2018 and 2017 is summarized as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Balance, beginning of the year	\$ 2,463	\$ 2,963
Current year claims incurred and changes in estimates	487	70
Claims and expenses paid	<u>(487)</u>	<u>(570)</u>
Balance, end of the year	<u>\$ 2,463</u>	<u>\$ 2,463</u>

Palomar Health Notes to Financial Statements

Note 16 – Commitments and Contingencies (continued)

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 CMS on a contingent fee basis, receiving a percentage of the improper overpayments and underpayments they recover from or return to providers. There was an increase in RAC audits during the year ended June 30, 2018 for a total recoupment of \$30 compared to \$110 in year ending June 30, 2017. There are currently no RAC audits in process nor any reserves recorded at June 30, 2018 or 2017. 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 17 – Condensed Combining Information

A summary of the condensed combining information for PH and Arch as of June 30, 2018 and 2017 is as follows (in thousands):

	CONDENSED COMBINING STATEMENT OF NET POSITION AS OF JUNE 30, 2018						Total
	PH	Arch	PAM	PAM-SD	PAC	Eliminations	
ASSETS							
Current assets	\$ 412,667	\$ 13,750	\$ 3,026	2,559	\$ 3,947	\$ (12,708)	\$ 423,241
Capital assets - net	1,045,505	3,435	-	601	-	(400)	1,049,141
Noncurrent assets	116,766	2,456	2,512	-	-	(6,212)	115,522
Total assets	1,574,938	19,641	5,538	3,160	3,947	(19,320)	1,587,904
Deferred outflow of resources	61,858	-	-	-	-	-	61,858
TOTAL ASSETS AND DEFERRED OUTFLOW OF RESOURCES	\$ 1,636,796	\$ 19,641	\$ 5,538	3,160	\$ 3,947	\$ (19,320)	\$ 1,649,762
LIABILITIES AND NET POSITION							
Current liabilities	\$ 141,928	\$ 10,232	\$ 5,844	1,494	\$ 4,323	\$ (10,990)	\$ 152,831
Long-term Liabilities	1,303,646	51	1,717	-	-	(1,717)	1,303,697
Total liabilities	1,445,574	10,283	7,561	1,494	4,323	(12,707)	1,456,528
Deferred inflow of resources - deferred revenue	7,941	-	-	-	-	-	7,941
Total liabilities and deferred inflow of resources	1,453,515	10,283	7,561	1,494	4,323	(12,707)	1,464,469
Invested in capital assets - net of related debt	(95,275)	3,372	-	601	-	(401)	(91,703)
Restricted	32,799	-	-	-	-	-	32,799
Unrestricted	245,757	5,986	(2,023)	1,065	(376)	(6,212)	244,197
Total net position	183,281	9,358	(2,023)	1,666	(376)	(6,613)	185,293
TOTAL LIABILITIES, DEFERRED INFLOW OF RESOURCES, AND NET POSITION	\$ 1,636,796	\$ 19,641	\$ 5,538	3,160	\$ 3,947	\$ (19,320)	\$ 1,649,762

Palomar Health

Notes to Financial Statements

Note 17 – Condensed Combining Information (continued)

In June, 2017 Palomar Health Board and Arch Health Partners (AHP) Board passed respective resolutions to extinguish the existing line of credit agreement, related debt currently in place between the District and Arch and any other debt of Arch. As a result, the outstanding principal and accrued interest was forgiven effective June 30, 2017. PH will continue to financially support the growth and operation of Arch for the benefit of the community. Arch has received \$20,254 and \$13,000 in financial support for years ending June 30, 2018 and 2017, respectively.

Subsequent to June 30, 2018, Arch has received an additional \$5,600 of operating support.

CONDENSED COMBINING STATEMENT OF REVENUE, EXPENSES, AND CHANGES IN NET POSITION FOR THE YEAR ENDED JUNE 30, 2018							
	PH	Arch	PAM	PAM-SD	PAC	Elimination	Total
OPERATING REVENUE:							
Net patient service revenue	\$ 665,630	\$ 27,371	\$ -	\$ -	\$ 3,947	\$ -	\$ 696,948
Shared risk revenue	70,148	12,178	-	-	-	-	82,326
Other revenue	11,996	3,019	9,356	8,011	-	(17,488)	14,894
PH Program revenue	-	2,057	-	-	-	(2,057)	-
Total operating revenue	<u>747,774</u>	<u>44,625</u>	<u>9,356</u>	<u>8,011</u>	<u>3,947</u>	<u>(19,545)</u>	<u>794,168</u>
OPERATING EXPENSES							
DEPRECIATION AND AMORTIZATION	694,271	61,570	13,839	6,947	4,321	(19,700)	761,248
	43,205	1,150	-	426	-	-	44,781
Total operating expenses	<u>737,476</u>	<u>62,720</u>	<u>13,839</u>	<u>7,373</u>	<u>4,321</u>	<u>(2,454)</u>	<u>806,029</u>
INCOME (LOSS) FROM OPERATIONS	10,298	(18,095)	(4,483)	638	(374)	(17,091)	(11,861)
NONOPERATING INCOME (EXPENSE):							
Investment income	131	50	-	-	-	-	181
Unrealized gain on interest rate swap	7,502	-	-	-	-	-	7,502
Interest expense	(64,386)	(6)	(51)	-	-	-	(64,443)
Property tax revenue	35,872	-	-	-	-	-	35,872
Other - net	(110,478)	14,779	(1)	1	(2)	97,668	1,967
Total nonoperating expense - net	<u>(131,359)</u>	<u>14,823</u>	<u>(52)</u>	<u>1</u>	<u>(2)</u>	<u>97,668</u>	<u>(18,921)</u>
Net (loss) income before capital contribu	(121,061)	(3,272)	(4,535)	639	(376)	97,823	(30,782)
CAPITAL CONTRIBUTIONS							
	-	-	2,512	1,027	-	(3,539)	-
CHANGE IN NET POSITION	(121,061)	(3,272)	(2,023)	1,666	(376)	94,284	(30,782)
Net Position - Beginning of year	304,342	3,272	-	-	-	(91,539)	216,075
Net Position - End of year	<u>\$ 183,281</u>	<u>\$ -</u>	<u>\$ (2,023)</u>	<u>\$ 1,666</u>	<u>\$ (376)</u>	<u>\$ 2,745</u>	<u>\$ 185,293</u>

CONDENSED COMBINING STATEMENT OF CASH FLOW FOR THE YEAR ENDED JUNE 30, 2018 (dollars in thousands)

	PH	Arch	PAM	PAM-SD	PAC	Elimination	Total
CASH FLOWS FROM:							
Operating activities	\$ 126,246	\$ (24,583)	\$ (3,520)	\$ (1,028)	\$ 600	\$ (82,917)	\$ 14,798
Noncapital financing activities	(92,680)	-	4,347	727	-	104,385	16,779
Capital and related financing activities	(9,001)	25,013	(51)	-	-	(21,766)	(5,805)
Investing activities	(42,882)	52	-	-	-	-	(42,830)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(18,317)	482	776	(301)	600	(298)	(17,058)
CASH AND CASH EQUIVALENTS -							
Beginning of year	66,078	460	-	-	-	-	66,538
CASH AND CASH EQUIVALENTS - End of year	<u>\$ 47,761</u>	<u>\$ 942</u>	<u>\$ 776</u>	<u>\$ (301)</u>	<u>\$ 600</u>	<u>\$ (298)</u>	<u>\$ 49,480</u>

Palomar Health
Notes to Financial Statements

Note 17 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF NET POSITION				
AS OF JUNE 30, 2017				
	PH	Arch	Elimination	Total
ASSETS				
Current assets	\$ 410,588	\$ 6,760	\$ -	\$ 417,348
Capital assets - net	1,068,813	5,218	-	1,074,031
Noncurrent assets	70,441	4,619	(4,133)	70,927
Other receivables	5,247	570	(5,817)	-
Line of credit and note payable Arch	82,268	-	(82,268)	-
Total assets	1,637,357	17,167	(92,218)	1,562,306
Deferred outflow of resources	44,278	-	-	44,278
TOTAL ASSETS AND DEFERRED OUTFLOW OF RESOURCES	\$ 1,681,635	\$ 17,167	\$ (92,218)	\$ 1,606,584
LIABILITIES AND NET POSITION				
Current liabilities	\$ 138,270	\$ 13,831	\$ (678)	\$ 151,423
Long-term liabilities	1,230,705	65	-	1,230,770
Total liabilities	1,368,975	13,895	(678)	1,382,192
Deferred inflow of resources - deferred revenue	8,041	-	-	8,041
Total liabilities and inflow of resources	1,377,016	13,895	(678)	1,390,233
Invested in capital assets - net of related debt	(61,297)	5,142	-	(56,155)
Restricted	31,577	-	-	31,577
Unrestricted	334,339	(1,870)	(91,540)	240,929
Total net position	304,619	3,272	(91,540)	216,351
TOTAL LIABILITIES, DEFERRED INFLOW OF RESOURCES, AND NET POSITION	\$ 1,681,635	\$ 17,167	\$ (92,218)	\$ 1,606,584

Palomar Health

Notes to Financial Statements

Note 17 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF REVENUE, EXPENSES AND CHANGES IN NET POSITION FOR THE YEAR ENDED JUNE 30, 2017				
	PH	Arch	Elimination	Total
OPERATING REVENUE:				
Net patient service revenue	\$ 662,784	\$ 28,720	\$ -	\$ 691,503
Shared risk revenue	65,143	14,654	-	79,798
Other revenue	12,777	3,127	(678)	15,226
PH Program revenue	-	2,455	(2,258)	197
Total operating revenue	<u>740,704</u>	<u>48,956</u>	<u>(2,936)</u>	<u>786,724</u>
OPERATING EXPENSES	669,235	62,967	(2,936)	729,266
DEPRECIATION AND AMORTIZATION	49,762	1,664	-	51,425
Total operating expenses	<u>718,997</u>	<u>64,630</u>	<u>(2,936)</u>	<u>780,691</u>
INCOME (LOSS) FROM OPERATIONS	<u>21,707</u>	<u>(15,675)</u>	<u>-</u>	<u>6,033</u>
NONOPERATING INCOME (EXPENSE):				
Investment income	4,019	-	(2,639)	1,380
Unrealized loss on interest rate swap	12,267	-	-	12,267
Interest expense	(69,164)	(12)	12	(69,164)
Property tax revenue	35,987	-	-	35,987
Other - net	(805)	(48)	(3,433)	(4,287)
Total nonoperating expense - net	<u>(17,697)</u>	<u>(60)</u>	<u>(6,060)</u>	<u>(23,817)</u>
Change in Net Position	4,011	(15,735)	(6,060)	(17,784)
Interfund - Arch Health Partners	(2,422)	90,834	(88,412)	-
Net Position - Beginning of year (as restated)	<u>303,029</u>	<u>(71,827)</u>	<u>2,933</u>	<u>234,135</u>
Net Position - End of year	<u>\$ 304,618</u>	<u>\$ 3,272</u>	<u>\$ (91,539)</u>	<u>\$ 216,351</u>

Palomar Health
Notes to Financial Statements

Note 17 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF CASH FLOWS FOR THE YEAR ENDED JUNE 30, 2017				
	PH	Arch	Elimination	Total
CASH FLOWS FROM:				
Operating activities	\$ 49,416	\$ (13,882)	\$ 16,621	\$ 52,155
Noncapital financing activities	12,458	-	-	12,458
Capital and related financing activities	(51,069)	(2,380)	-	(53,449)
Investing activities	(4,202)	16,610	(16,621)	(4,213)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	6,603	348	-	6,951
CASH AND CASH EQUIVALENTS - Beginning of year	59,475	112	-	59,587
CASH AND CASH EQUIVALENTS - End of year	\$ 66,078	\$ 460	\$ -	\$ 66,538

Note 18 – Subsequent Events

PAM and PAM-SD effectively ceased business on or about June 30, 2018. Arch has brought both companies' management functions in house, and is in the process of repurchasing practice management assets that it originally contributed to PAM-SD in exchange for cancellation of debt. The business activities of both companies will be terminated in due course.

Required Supplementary Information

Palomar Health

Schedule of Changes in the Net OPEB Liability and Related Ratios – Last 10 Fiscal Years (shown in thousands)

	Fiscal Year End Reporting Periods								
	2018 *	2017 *	2016	2015	2014	2013	2012	2011	2010
1. Total OPEB liability - prior measurement date	\$ 1,176	\$ 1,190	n/a	n/a	n/a	n/a	n/a	n/a	n/a
2. Changes in total OPEB liability									
(a) Service cost	60	72	n/a	n/a	n/a	n/a	n/a	n/a	n/a
(b) Interest on the total OPEB liability	43	35	n/a	n/a	n/a	n/a	n/a	n/a	n/a
(c) Changes on benefit terms	-	-	n/a	n/a	n/a	n/a	n/a	n/a	n/a
(d) Differences between expected and actual experience	-	-	n/a	n/a	n/a	n/a	n/a	n/a	n/a
(e) Changes of assumptions or other inputs	(24)	(63)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
(f) Benefit payments	(62)	(58)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
(g) Total	\$ 1,193	\$ 1,176	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3. Total OPEB liability - current measurement date	\$ 1,193	\$ 1,176	\$ 1,190	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
4. Estimated covered-employee payroll	\$ 209,718	\$ 240,492	n/a	n/a	n/a	n/a	n/a	n/a	n/a
5. Total OPEB liability as a % of covered-employee payroll	0.60%	0.50%	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Key Information									
Valuation date	July 1, 2016	July 1, 2016	July 1, 2016	n/a	n/a	n/a	n/a	n/a	n/a
Reporting date	June 30, 2018	June 30, 2017	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Measurement date	June 30, 2018	June 30, 2017	June 30, 2016	n/a	n/a	n/a	n/a	n/a	n/a
Discount rate as of the measurement date	3.87%	3.58%	2.85%	n/a	n/a	n/a	n/a	n/a	n/a
Bond index rate	3.87%	3.58%	2.85%	n/a	n/a	n/a	n/a	n/a	n/a
Bond index date	June 30, 2018	June 30, 2017	June 30, 2016	n/a	n/a	n/a	n/a	n/a	n/a

* June 30, 2017 measurement date results use a final discount rate of 3.58% which is the municipal bond rate as of June 30, 2017. June 30, 2018 measurement date results use a final discount rate of 3.87% which is the municipal bond rate as of June 30, 2018.

Notes: PH has no assets that are accumulated in a trust to pay related benefits that meet the criteria in paragraph 4 of Statement 75.