



REPORT OF INDEPENDENT AUDITORS AND FINANCIAL
STATEMENTS WITH REQUIRED SUPPLEMENTARY
INFORMATION

PALOMAR HEALTH

June 30, 2020 and 2019



MOSSADAMS

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Overview

Palomar Health ("PH" or the "District") is a public health care district and is a political subdivision of 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, 2020 and 2019. Although the 2018 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
- Report of Independent Auditors
- 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 U.S. Bank National Association added Arch as an additional member of the Obligated Group created pursuant to the Master Trust Indenture. PH and Arch collectively own 100% of PAC, PAM, and PAM-SD. Therefore, PAC, PAM, and PAM-SD are included as blended components of PH's reporting entity. 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, 2018, and the related statement of revenue, expenses, and changes in net position for the year ended June 30, 2018, were restated upon issuance of the June 30, 2019 financial statements, to show the impact of the adoption of GASB 75.

Palomar Health

Management's Discussion and Analysis (continued)

Table 1: Assets, Deferred Outflow of Resources, Liabilities, Deferred Inflow of Resources, and Net Position as of June 30:

ASSETS AND DEFERRED OUTFLOW OF RESOURCES			
	<u>2020</u>	<u>2019</u>	<u>2018</u>
CURRENT ASSETS	\$ 519,681	\$ 442,126	\$ 423,241
CAPITAL ASSETS, net	1,006,984	1,016,133	1,049,141
NONCURRENT ASSETS	<u>74,969</u>	<u>101,425</u>	<u>115,522</u>
Total assets	1,601,634	1,559,684	1,587,904
DEFERRED OUTFLOW OF RESOURCES	<u>56,329</u>	<u>59,093</u>	<u>61,858</u>
Total assets and deferred outflow of resources	<u>\$ 1,657,963</u>	<u>\$ 1,618,777</u>	<u>\$ 1,649,762</u>
LIABILITIES, DEFERRED INFLOW OF RESOURCES, AND NET POSITION			
CURRENT LIABILITIES	\$ 172,346	\$ 157,734	\$ 152,556
OTHER NONCURRENT LIABILITIES	52,994	3,064	2,484
FAIR VALUE OF INTEREST RATE SWAP	35,184	25,541	18,971
LONG-TERM DEBT, net of current portion	<u>1,272,924</u>	<u>1,275,903</u>	<u>1,282,517</u>
Total liabilities	1,533,448	1,462,242	1,456,528
DEFERRED INFLOW OF RESOURCES	<u>7,604</u>	<u>7,822</u>	<u>7,941</u>
Total liabilities and deferred inflow of resources	1,541,052	1,470,064	1,464,469
INVESTED IN CAPITAL ASSETS, net of related debt	(164,396)	(135,563)	(91,703)
RESTRICTED, expendable for			
Repayment of debt	21,176	21,722	22,525
Capital acquisitions	9,911	10,088	9,925
Other purposes	351	350	349
UNRESTRICTED	<u>249,869</u>	<u>252,116</u>	<u>244,197</u>
Total net position	<u>116,911</u>	<u>148,713</u>	<u>185,293</u>
Total liabilities, deferred inflow of resources, and net position	<u>\$ 1,657,963</u>	<u>\$ 1,618,777</u>	<u>\$ 1,649,762</u>

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Management's Discussion and Analysis (continued)

2020: Analysis of the Statement of Net Position from 2019 to 2020

- Current assets increased by \$77,555 or 18% during the year ended June 30, 2020, primarily due to increase in investments of \$117,199, offset by decreases in patient accounts receivable of \$9,820, other receivables of \$2,006, and other current assets of \$27,818.
- Capital assets, net decreased by \$9,149 or 1% primarily due to depreciation and amortization expense of \$42,999, the sale of capital assets and write-down of abandoned projects of \$1,287, offset by purchases related to major building projects of \$35,137.
- Noncurrent assets and deferred outflow of resources decreased by \$29,220 or 18% primarily due to decreases in restricted noncurrent cash and investments of \$25,385, prepaid debt insurance costs of \$644, amortization of deferred outflows of resources from losses incurred in the refinancing of the Series 2007A General Obligation Bonds (G.O. Bonds) of \$2,764, and other assets of \$427.
- Current liabilities increased by \$14,612 or 9% primarily due to increases in current portion of long-term debt-other of \$1,453, other accrued liabilities of \$28,388, and accrued interest payable of \$321, offset by decreases in accounts payable of \$8,247, accrued compensation and related liabilities of \$4,700, and current portion of general obligation bonds of \$2,603.
- Noncurrent liabilities increased by \$56,376 or 4% primarily due to increases in Medicare accelerated payments received of \$55,602 (net of \$6,750 included in current liabilities), general obligation bonds of \$7,556, and unrealized loss in the fair value of the interest rate swap of \$9,643, offset by a decrease in other long-term debt-other of \$10,535.
- Net position decreased by \$31,802 or 21% due to net loss from operations of \$31,826 offset by total non-operating income of \$24.

2019: Analysis of the Statement of Net Position from 2018 to 2019

- Current assets increased by \$18,885 or 4% during the year ended June 30, 2019, primarily due to increases in estimated third-party settlements of \$13,528, investments of \$11,898, and current restricted cash and investments of \$4,376, offset by decreases in patient accounts receivable of \$12,458, and other receivables of \$133. 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 \$33,008 or 3% primarily due to depreciation and amortization expense of \$43,727, the sale of capital assets and write-down of abandoned projects of \$8,684, offset by purchases related to major building projects of \$18,983.
- Noncurrent assets and deferred outflow of resources decreased by \$16,862 or 10% primarily due to decreases in restricted noncurrent cash and investments of \$11,403, prepaid debt insurance costs of \$665, amortization of deferred outflows of resources from losses incurred in the refinancing of the Series 2007A General Obligation Bonds (G.O. Bonds) of \$2,765, and other assets of \$2,029.

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Management's Discussion and Analysis (continued)

- Current liabilities increased by \$5,671 or 4% primarily due to an increase in accounts payable, accrued compensation and related liabilities, current portion of G.O. Bonds and long term debt and accrued interest payable of \$13,028, offset by a decrease in other accrued liabilities of \$6,314 and a decrease in estimated third-party liabilities of \$1,043.
- Noncurrent liabilities and long term debt increased by \$811 or 1% primarily due to an increase in workers' compensation reserve of \$580, and in the unrealized loss of the fair value of the interest rate swap of \$6,570 offset by a decrease in the long-term debt of \$6,339.
- Net position decreased by \$36,580 or 20% due to net loss from operations of \$5,698 and total non-operating expenses of \$30,882.

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 non-operating income (expenses) including interest expense, which for nongovernment 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:

	2020	2019	2018
OPERATING REVENUE			
Net patient service revenue	\$ 670,918	\$ 693,446	\$ 696,948
Shared risk revenue	82,625	82,283	82,326
Other revenue	12,385	13,575	14,894
Total operating revenue	765,928	789,304	794,168
OPERATING EXPENSES	797,754	795,002	806,029
LOSS FROM OPERATIONS	(31,826)	(5,698)	(11,861)
NON-OPERATING INCOME (EXPENSE)			
Investment income	6,762	5,904	181
Unrealized (loss) gain on interest rate swap	(9,643)	(6,570)	7,502
Interest expense	(63,190)	(60,929)	(64,443)
Property tax revenue – unrestricted	18,356	17,609	16,779
Property tax revenue – restricted	28,873	20,333	19,093
Other, net	18,866	(7,229)	1,967
Total non-operating income (expense), net	24	(30,882)	(18,921)
CHANGE IN NET POSITION	(31,802)	(36,580)	(30,782)
NET POSITION, beginning of year	148,713	185,293	216,075
NET POSITION, end of year	\$ 116,911	\$ 148,713	\$ 185,293

2020: Analysis of the Statement of Revenue, Expenses, and Changes in Net Position from 2019 to 2020

- Operating revenue decreased by \$23,376 or 3% during the year ended June 30, 2020, primarily due to the cancellation of elective surgical cases beginning in March 2020 in response to the coronavirus pandemic (COVID-19). Outpatient volume in general declined as a result of the pandemic. Patient volume and net patient revenue increased during May and June 2020 as elective surgical procedures progressively resumed.

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Management's Discussion and Analysis (continued)

- Operating expenses are those expenses related to the treatment of patients as well as overhead and administrative expenses. Operating expenses increased by \$2,752 or 1% during the year ended June 30, 2020, primarily due to wage, supply, and purchased service inflation increases offset by staffing reductions in response to reduced patient volume from the COVID-19 pandemic. Salaries, wages, and benefits decreased by \$5,570 as a result of the elimination of 317 full-time equivalent positions in April 2020. The position eliminations were made in response to reduced patient volume from the state-mandated cancellation of elective surgical cases, as well as a COVID-19 related downturn in outpatient services. Purchased services increased by \$361, resulting from an increase in management fees for COVID-19 lab related testing, unexpected repairs and maintenance for a salt removal project, and a new contract for management of the food and nutrition department. These increases were offset by a decrease in IT repair and maintenance and other purchased services. Professional fees increased by \$8,797 mainly due to increases in legal expenses of \$4,622 and in physician fees of \$2,664.
- Non-operating income (expenses), net increased by \$30,906 or 100% during the year ended June 30, 2020, mainly due to the receipt of the Coronavirus Aid, Relief, and Economic Security ("CARES") Act Provider Relief Funds of \$20,133 combined with an increase in property tax revenue of \$9,287, offset by an increase in unrealized loss on the interest rate swap of \$3,073.
- As a result of the factors noted above, net position decreased by \$31,802 or 21% during the year ended June 30, 2020.

2019: Analysis of the Statement of Revenue, Expenses, and Changes in Net Position from 2018 to 2019

- Operating revenue decreased by \$4,864 or 1% during the year ended June 30, 2019, primarily due to an increase in behavioral health volume, lower than expected surgical cases, and less severe flu season than prior years. Management has implemented a number of operational initiatives which have resulted in improved billing and collections. Continued participation in government reimbursement and supplemental programs, including but not limited to: Medi-Cal Quality Assurance program, Managed Care Rate Range Plan, Public Hospital Redesign and Incentives in Medi-Cal (PRIME), and Outpatient Supplemental Program contributes to operational revenue.
- Operating expenses are those expenses related to the treatment of patients as well as overhead and administrative expenses. Operating expenses decreased by \$11,027 or 1% during the year ended June 30, 2019, primarily due to decreases in salaries, wages, and benefits of \$10,677, which were driven by improvements in productivity, lower utilization of contract labor, and other operational improvement initiatives implemented by management, offset by increase in purchased services of \$5,761. Professional fees decreased \$5,335 reflecting PH's continued focus on restructuring unfavorable contracts and lower utilization of consulting services. Other direct expenses, the combination of rent, utilities, and other expense, decreased by \$2,156, primarily due to a decrease in other expenses of \$4,554, rental equipment of \$554, offset by increases in utilities of \$593 and medical office building rent of \$2,359. The decrease in operating expenses included a reduction in depreciation expense of \$1,054 due to fewer capital outlays than the previous year and assets reaching the end of their useful lives.

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Management's Discussion and Analysis (continued)

- Non-operating expenses, net increased by \$11,961 or 63% during the year ended June 30, 2019, primarily due to an increase in the unrealized loss on the interest rate swap of \$14,072, offset by an increase in property tax revenue of \$2,070, a decrease in interest expense of \$3,514, and an increase in investment income of \$5,723.
- As a result of the factors noted above, net position decreased by \$36,580 or 20% during the year ended June 30, 2019.

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.

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

	<u>2020</u>	<u>2019</u>	<u>2018</u>
CASH FLOWS FROM			
Operating activities	\$ 89,585	\$ 42,206	\$ 14,798
Noncapital financing activities	38,489	17,609	16,779
Capital and related financing activities	(72,651)	(61,397)	(5,805)
Investing activities	<u>(83,232)</u>	<u>2,238</u>	<u>(42,830)</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(27,809)	656	(17,058)
CASH AND CASH EQUIVALENTS, beginning of year	<u>50,136</u>	<u>49,480</u>	<u>66,538</u>
CASH AND CASH EQUIVALENTS, end of year	<u><u>\$ 22,327</u></u>	<u><u>\$ 50,136</u></u>	<u><u>\$ 49,480</u></u>

2020: Analysis of the Statement of Cash Flows from 2019 to 2020

- Net cash inflows provided by operating activities reflected an increase of \$47,379 during the year ended June 30, 2020, over the year ended June 30, 2019. This increase is due to an increase in receipts from patients, insurers, and other third-party payors of \$41,074, and a decrease in payments to employees and suppliers of \$6,305.
- Net cash inflows provided by noncapital financing activities reflected an increase of \$20,880 during the year ended June 30, 2020, due to an increase in district tax revenue receipts of \$747 and proceeds received from the CARES Act Provider Relief Funds of \$20,133.

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Management's Discussion and Analysis (continued)

- Net cash outflows used in capital and related financing activities decreased by \$11,254 primarily due to the increase of restricted tax revenues for G.O. Bond debt service of \$8,540 and other financing activities of \$11,796, offset by the decrease in the acquisition of capital assets and the repayment of principal and interest of \$31,590.
- Net cash used in investing activities during the year ended June 30, 2020, decreased by \$85,470 primarily due to an increase in proceeds from the sale of investments of \$34,522, offset by the increase in purchase of investments of \$121,435.
- The ending cash and cash equivalents of \$22,327 at June 30, 2020, reflect the checking account and overnight investment balances held by PH. In addition, PH held investments of \$280,021 at June 30, 2020, with maturities of one year or less which are classified as current assets.

2019: Analysis of the Statement of Cash Flows from 2018 to 2019

- Net cash inflows provided by operating activities reflected an increase of \$27,408 during the year ended June 30, 2019, over the year ended June 30, 2018. This increase is primarily due to an increase in accounts receivable collections of \$23,021, offset by a decrease in accrued compensation and related liabilities of \$3,395.
- Net cash outflows used in capital and related financing activities increased by \$55,592 primarily due to the decrease in proceeds on bond offerings of \$77,339.
- Net cash inflows provided by noncapital financing activities reflected an increase of \$830 during the year ended June 30, 2019, due to an increase in district tax revenue receipts.
- Net cash provided by investing activities during the year ended June 30, 2019, increased by \$45,068 primarily due to a decrease in proceeds from the sale of investments of \$29,675 and the decrease in purchase of investments of \$73,613.
- The ending cash and cash equivalents of \$50,136 at June 30, 2019, reflect the checking account and overnight investment balances held by PH. In addition, PH held investments of \$162,822 at June 30, 2019, with maturities of one year or less which are classified as current assets.

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 G.O. Bonds. Payment for these bonds was funded by an *ad valorem* property tax levied on District residents. The approximate amount of the tax levy for each taxable property was .029% and .021% of assessed value during the years ended June 30, 2020 and 2019, 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.

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Management's Discussion and Analysis (continued)

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 current building projects include the renovation of existing hospital facilities and at various locations in the District and construction of a medical office building and parking structure.

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 \$12,790 and \$12,290 during the years ended June 30, 2020 and 2019, respectively, reduced the revenue bonds' principal to \$583,445 and \$596,235 as of June 30, 2020 and 2019, respectively. Principal payments of \$9,100 and \$5,234 during the years ended June 30, 2020 and 2019, respectively, reduced the G.O. Bonds' principal to \$422,024 and \$431,124 as of June 30, 2020 and 2019, respectively. All debt payments have been made timely. See Note 9 for long-term debt.

Liquidity and Capital Resources

PH's unrestricted liquid assets as of June 30, 2020, were \$302,348, including \$22,327 in operating cash, and \$280,021 in unrestricted investments stated at fair market value. PH's unrestricted liquid assets as of June 30, 2019, were \$212,958, including \$50,136 in operating cash, and \$162,822 in unrestricted investments stated at fair market value. The current liquidity position represents a \$89,390 increase from the \$212,958 in available liquidity as of June 30, 2019, and equaled 46% of the total outstanding debt as of June 30, 2020 (excluding the existing G.O. Bonds, which are paid from *ad valorem* property taxes), as compared to available liquidity representing 33% of total outstanding debt as of June 30, 2019.

PH's days cash and investments on hand as of June 30, 2020 and 2019, was 146.6 and 103.3, respectively.

Economic and Other Factors

On June 24, 2015, PH's Board of Directors voted to transfer all services from Palomar Medical Center Downtown Campus (PHDC) to other PH-owned facilities. Due to failing infrastructure and absent a seismic retrofit, the Board also voted to close the facility. An agreement to sell the PHDC real estate has been executed and the title is expected to transfer to the buyer on March 26, 2021. PHDC is vacant with the exception of a microbiology and histology laboratory as of June 30, 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.

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Management's Discussion and Analysis (continued)

Government payors continue to present reimbursement challenges for healthcare providers 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 payments, 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.

On March 11, 2020, the World Health Organization officially declared COVID-19, the disease caused by the novel coronavirus, a pandemic. Soon afterward, PH (along with hospitals in the United States) cancelled elective surgical cases, resulting in a significant loss of net patient revenue. The pandemic has resulted in PH incurring additional costs to maintain patient volume as well as to provide care to patients specifically affected by the virus. The duration and intensity of disruption from the pandemic is uncertain, and therefore the long-term impact, if any, cannot be predicted.

Union Contract

PH and two labor unions, the California Nurses Association (CNA) and the Caregivers Healthcare Employees 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
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, 2020 and 2019, 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, 2020 and 2019, 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
October 21, 2020

Palomar Health
Statements of Net Position
(Dollars in Thousands)

ASSETS AND DEFERRED OUTFLOW OF RESOURCES

	June 30,	
	2020	2019
CURRENT ASSETS		
Cash and cash equivalents	\$ 22,327	\$ 50,136
Investments	280,021	162,822
Patient accounts receivable, net of allowances for uncollectible accounts of \$47,755 in 2020 and \$43,305 in 2019	113,941	123,761
Other receivables	8,044	10,050
Supplies and inventories	12,531	12,239
Prepaid expenses and other	5,954	5,552
Estimated third-party payor settlements receivable	40,895	41,373
Assets whose use is limited – current portion	903	-
Restricted cash and investments, current	35,065	36,193
Total current assets	519,681	442,126
RESTRICTED NONCURRENT CASH AND INVESTMENTS		
Held by trustee under indenture agreements	53,894	78,352
Held by trustee under general obligation bonds indenture	35,065	36,041
Held in escrow for street improvements	9,911	10,088
Restricted by donor and other	351	350
Total restricted cash and investments	99,221	124,831
Less amounts required to meet current obligations	35,968	36,193
Total restricted noncurrent cash and investments	63,253	88,638
CAPITAL ASSETS, net	1,006,984	1,016,133
OTHER ASSETS		
Prepaid debt insurance costs	8,727	9,371
Investment in and amounts due from affiliated entities	2,609	2,170
Other	380	1,246
Total other assets	11,716	12,787
Total assets	1,601,634	1,559,684
DEFERRED OUTFLOW OF RESOURCES –		
loss on refunding of debt	56,329	59,093
Total assets and deferred outflow of resources	\$ 1,657,963	\$ 1,618,777

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

LIABILITIES, DEFERRED INFLOW OF RESOURCES, AND NET POSITION

	June 30,	
	2020	2019
CURRENT LIABILITIES		
Accounts payable	\$ 36,890	\$ 45,137
Accrued compensation and related liabilities	40,347	45,047
Current portion of general obligation bonds	6,497	9,100
Current portion of long-term debt – other	14,368	12,915
Other accrued liabilities	59,452	31,064
Accrued interest payable	14,792	14,471
Total current liabilities	172,346	157,734
WORKERS' COMPENSATION, net of current portion	4,142	3,064
MEDICARE ACCELERATED PAYMENTS	48,852	-
LONG-TERM DEBT – general obligation bonds, net of current portion	655,007	647,451
LONG-TERM DEBT – other, net of current portion	617,917	628,452
FAIR VALUE OF INTEREST RATE SWAP	35,184	25,541
Total liabilities	1,533,448	1,462,242
DEFERRED INFLOW OF RESOURCES	7,604	7,822
Total liabilities and deferred inflow of resources	1,541,052	1,470,064
COMMITMENTS AND CONTINGENCIES (Note 15)		
NET POSITION		
Net investment in capital assets	(164,396)	(135,563)
Restricted, expendable for		
Repayment of debt	21,176	21,722
Capital acquisitions	9,911	10,088
Other purposes	351	350
Unrestricted	249,869	252,116
Total net position	116,911	148,713
Total liabilities, deferred inflow of resources, and net position	\$ 1,657,963	\$ 1,618,777

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

	Years Ended June 30,	
	2020	2019
OPERATING REVENUE		
Patient service revenue, net of provision for uncollectible accounts of \$74,865 in 2020 and \$60,747 in 2019	\$ 670,918	\$ 693,446
Shared risk revenue	82,625	82,283
Other revenue	12,385	13,575
Total operating revenue	<u>765,928</u>	<u>789,304</u>
OPERATING EXPENSES		
Salaries, wages, and benefits	459,055	464,625
Professional fees	49,831	41,034
Supplies	106,225	109,255
Purchased services	87,590	87,229
Depreciation and amortization	42,999	43,727
Rent expense	23,102	20,587
Utilities	10,689	11,476
Other	18,263	17,069
Total operating expenses	<u>797,754</u>	<u>795,002</u>
LOSS FROM OPERATIONS	<u>(31,826)</u>	<u>(5,698)</u>
NON-OPERATING INCOME (EXPENSES)		
Investment income	6,762	5,904
Unrealized loss on interest rate swap	(9,643)	(6,570)
Interest expense	(63,190)	(60,929)
Property tax revenue – unrestricted	18,356	17,609
Property tax revenue – restricted	28,873	20,333
Other, net	18,866	(7,229)
Total non-operating income (expenses), net	<u>24</u>	<u>(30,882)</u>
CHANGE IN NET POSITION	(31,802)	(36,580)
NET POSITION, beginning of year	<u>148,713</u>	<u>185,293</u>
NET POSITION, end of year	<u>\$ 116,911</u>	<u>\$ 148,713</u>

Palomar Health
Statements of Cash Flows
(Dollars in Thousands)

	Years Ended June 30,	
	2020	2019
CASH FROM OPERATING ACTIVITIES		
Receipts from		
Patients, insurers, and other third-party payors	\$ 871,541	\$ 828,752
Other sources	15,166	16,881
Payments to		
Employees	(462,679)	(463,180)
Suppliers	(334,443)	(340,247)
Net cash provided by operating activities	<u>89,585</u>	<u>42,206</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Receipt of district taxes	18,356	17,609
Provider relief funds	20,133	-
Net cash provided by noncapital financing activities	<u>38,489</u>	<u>17,609</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition and construction of capital assets	(35,137)	(18,702)
Interest payments on long-term debt	(49,034)	(37,918)
Principal repayment on long-term debt	(21,979)	(17,880)
Proceeds from sale of capital assets	60	-
Receipt of property taxes restricted for debt service on general obligation bonds	28,873	20,333
Other	4,566	(7,230)
Net cash used in capital and related financing activities	<u>(72,651)</u>	<u>(61,397)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of investments	(287,131)	(165,696)
Proceeds from sale of investments	201,144	166,622
Interest received on investments and notes receivable	2,755	1,312
Net cash (used in) provided by investing activities	<u>(83,232)</u>	<u>2,238</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(27,809)	656
CASH AND CASH EQUIVALENTS, beginning of year	<u>50,136</u>	<u>49,480</u>
CASH AND CASH EQUIVALENTS, end of year	<u><u>\$ 22,327</u></u>	<u><u>\$ 50,136</u></u>

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

	Years Ended June 30,	
	2020	2019
RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Loss from operations	\$ (31,826)	\$ (5,698)
Adjustments to reconcile loss from operations to net cash provided by operating activities		
Depreciation and amortization	42,999	43,727
Provision for bad debts	74,865	60,747
Equity in losses of affiliates	(439)	646
Loss on disposal of fixed assets	1,224	8,083
Changes in assets and liabilities		
Patient accounts receivable	(65,045)	(48,289)
Other receivables	2,006	133
Supplies and inventories	(292)	(692)
Prepaid expenses and other	(402)	(1,454)
Estimated third-party payor settlements	478	(14,571)
Other, net	864	1,383
Accounts payable	(8,247)	(2,294)
Accrued compensation and related liabilities	(3,622)	1,444
Other accrued liabilities	21,638	(840)
Medicare accelerated payments	55,602	-
Deferred inflow of resources	(218)	(119)
	<u>\$ 89,585</u>	<u>\$ 42,206</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES		
NONCASH INVESTING AND CAPITAL AND FINANCING ACTIVITIES		
Capital expenditures included in accounts payable	<u>\$ 443</u>	<u>\$ 2,329</u>

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 1 – Operations and Reporting Entity

Organization – Palomar Health (“PH” or the “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 The Villas at Poway, a distinct part skilled nursing facility and sub-acute facility.
- Palomar Medical Center Downtown Campus (“PHDC”), located in east Escondido, California, is vacant with the exception of a microbiology and histology laboratory as of June 30, 2020. An agreement to sell the PHDC real estate has been executed and the title is expected to transfer to the buyer on March 26, 2021. During the fiscal year ended June 30, 2020, PH prepared PHDC to serve as a COVID-19 surge hospital. PH and the state of California ultimately decided this would not be necessary.
- 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.
- Arch Health Partners, Inc. (“Arch”), a tax exempt medical foundation established under Section 1206(l) 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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

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 8.
- Pacific Accountable Management, LLC (“PAM”) and Pacific Accountable Management San Diego (“PAM-SD”) operated as management service organizations (MSO). Operations for PAM and PAM-SD ceased in July 2018 when the MSO services were assumed by Arch. See Note 8.

Arch membership of obligated group – On August 31, 2017, PH, Arch, and U.S. Bank National Association, as Master Trustee, entered into a Supplemental Master Indenture agreement providing for the 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 16.

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.

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.

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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 2 – Summary of Significant Accounting Policies (continued)

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 include assets held by trustees under indenture agreements and designated assets set aside by the Board of Directors for future capital improvements over which the Board of Directors retains control and may, at its discretion, subsequently use for other purposes. Amounts required to meet current liabilities of 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 \$9,911 and \$10,088 as of June 30, 2020 and 2019, respectively, was included in restricted cash and investments in the accompanying statements of net position.

Capital assets – Capital asset acquisitions are recorded at cost. The capitalization threshold for individual item cost is \$5 or greater and similar items that have cost less than \$5 but have an aggregate cost of \$20 or greater. Depreciation is computed using the straight-line method over the estimated useful life of each class of depreciable asset (the shorter of the estimated useful life or the lease term for leasehold improvements) as follows:

	<u>Years</u>
Land improvements	10-40
Buildings and building improvements	10-40
Leasehold improvements	3-25
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.

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 2 – Summary of Significant Accounting Policies (continued)

Capital assets are reviewed for impairment when events or changes in circumstances suggest that the service utility of the capital asset may have significantly and unexpectedly declined. Capital assets are considered impaired if both the decline in service utility of the capital asset is large in magnitude and the event or change in circumstance is outside the normal life cycle of the capital asset. Such events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment, or approval of laws or regulations or other changes in environmental factors; technological changes or evidence of obsolescence; changes in the manner or duration of use of a capital asset; and construction stoppage. The determination of the impairment loss is dependent upon the event or circumstance in which the impairment occurred. Impairment losses are recorded in the statements of revenue, expenses, and changes in net position. During the year ended June 30, 2020, an impairment charge of \$1,162 was recorded. During the year ended June 30, 2019, an impairment charge of \$6,100 was 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 effective interest 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.

Deferred outflows of resources – Deferred outflows of resources represent a consumption of net position that applies to future periods 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 inflows of resources reported in the financial statements are unearned rental income that will be recognized as revenue over the life of the rental agreement, the change in assumptions and other inputs related to Other Post-Employment Benefits (OPEB) (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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 2 – Summary of Significant Accounting Policies (continued)

As of June 30, 2020 and 2019, the interest rate swaps were recorded as a liability of \$35,184 and \$25,541, 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 include an estimate of the ultimate costs for both reported claims and claims incurred but not yet reported.

Statements of revenue, expenses, and changes in net position – All revenue 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) consists of those revenue and expenses that result from non-exchange 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.

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 2 – Summary of Significant Accounting Policies (continued)

Shared risk revenue – PH and its affiliated medical groups have agreements with various third-party payors to provide medical services to subscribing participants. Under some of these agreements, PH and its affiliated medical groups receive monthly capitation payments based on the number of 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 \$7,579 and \$8,467 are included in other accrued liabilities in the accompanying statements of net position as of June 30, 2020 and 2019, respectively.

Activity in PH's liability for IBNR claims for medical services provided to patients as of and for the years ended June 30, 2020 and 2019, is summarized as follows (in thousands):

	2020	2019
BALANCE, beginning of the year	\$ 8,467	\$ 8,176
Current year claims incurred and changes in estimates	36,699	44,378
Claims and expenses paid	(37,587)	(44,087)
BALANCE, end of the year	\$ 7,579	\$ 8,467

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.

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 Bonds (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, 2020 and 2019, consists of the following (in thousands):

	2020	2019
To support operations – unrestricted use	\$ 18,356	\$ 17,609
For debt service on G.O. Bonds – restricted use	28,873	20,333
	\$ 47,229	\$ 37,942

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 2 – Summary of Significant Accounting Policies (continued)

Grants and contributions – PH receives grants from various governmental agencies and private organizations. PH also receives contributions from Palomar Health Foundation and Palomar Health Development, Inc. Revenues from grants and contributions are recognized when all eligibility requirements, including time requirements, are met. Grants and contributions may be restricted for either specific operating purposes or capital acquisitions. These amounts, when recognized upon meeting all requirements, are reported as components of the statements of revenues, expenses, and changes in net position.

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 statements. This statement is effective July 1, 2020. PH is evaluating the impact of adopting this statement 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, 2021. PH is evaluating the impact of adopting this statement on the financial statements.

In June 2018, the GASB issued Statement No. 89, *Accounting for Interest Cost Before the End of a Construction Period*. This statement 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, 2020. PH is evaluating the impact of adopting this statement on the financial statements.

Reclassifications – Certain reclassifications have been made to the prior year amounts to conform to the current year presentation.

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 3 – 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 (FFS) 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.

Revenue from the Medicare and Medi-Cal programs inclusive of risk (capitated) and non-risk managed care programs accounted for approximately 53% and 52% of PH's net patient service revenue for the years ended June 30, 2020 and 2019, respectively.

Third-party cost reports for the Medicare program have been settled through the year ended June 30, 2016 for Escondido and through the year ended June 30, 2017, for Poway, 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 the Medi-Cal program have been settled through the year ended June 30, 2016, for Escondido, and through the year ended June 30, 2018, for Poway. Results of cost report settlements as well as estimates for settlements of all years through 2020 have been reflected in the accompanying financial statements. As of June 30, 2020 and 2019, estimated third-party settlements resulted in a receivable of \$40,895 and \$42,373, 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, 2020 and 2019, 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 \$488 and \$3,901 of additional revenues for the years ended June 30, 2020 and 2019, 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 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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 3 – Net Patient Service Revenue, Third-Party Reimbursement Programs, and Non-Operating Revenue (continued)

Senate Bill 239 quality assurance fee (QAF) supplemental payment – A state-legislated supplemental program that distributes 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.

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

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 – 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 FFS outpatients. PH receives 50% of reported uncompensated costs.

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, 2020 and 2019, respectively, (in thousands):

	2020	2019
PRIME	\$ 13,740	\$ 8,265
Managed care rate range IGT	26,895	24,277
Quality assurance fee (QAF)	11,335	32,661
Medi-Cal rate stabilization	1,906	2,951
Outpatient supplemental payment	458	3,854
	<hr/>	<hr/>
Totals	<u>\$ 54,334</u>	<u>\$ 72,008</u>

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.

Note 4 – 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.

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 4 – Cash and Cash Equivalents and Investments (continued)

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 \$75,000 of unrestricted monies in the fund and an unlimited amount of qualified bond proceeds. PH had invested \$74,293 and \$63,464 of unrestricted funds in this fund as of June 30, 2020 and 2019, respectively. PH also had invested \$9,908 and \$10,088 in jointly managed funds under an escrow agreement with the City of Escondido as of June 30, 2020 and 2019, 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 withdrawal 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, 2020 and 2019, PH had the following investments (in thousands):

	<u>2020</u>	<u>2019</u>
Investments – current	\$ 280,021	\$ 162,822
Restricted cash and investments – current	35,968	36,193
Restricted cash and investments – noncurrent	<u>63,253</u>	<u>88,638</u>
Total	<u>\$ 379,242</u>	<u>\$ 287,653</u>

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 4 – Cash and Cash Equivalents and Investments (continued)

As of June 30, 2020 and 2019, PH had investments by type and maturity as follows (in thousands):

Investment Type	2020		
	Fair Value	Investment Maturities (in Years)	
		Less Than 1	1-5
External investment pool - LAIF	\$ 84,201	\$ 84,201	\$ -
U.S. government bonds	16,435	-	16,435
U.S. treasury bills	37,434	3,439	33,995
Corporate bonds	21,832	6,185	15,647
Money market mutual funds	219,340	219,340	-
Total	\$ 379,242	\$ 313,165	\$ 66,077

Investment Type	2019		
	Fair Value	Investment Maturities (in Years)	
		Less Than 1	1-5
External investment pool - LAIF	\$ 73,552	\$ 73,552	\$ -
U.S. government bonds	15,041	7,746	7,295
U.S. treasury bills	22,564	3,944	18,620
Corporate bonds	15,658	2,594	13,064
Money market mutual funds	160,838	160,838	-
Total	\$ 287,653	\$ 248,674	\$ 38,979

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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 4 – 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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 4 – 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, 2020 and 2019 (in thousands):

	2020			
	Total	Level 1	Level 2	Level 3
Investments				
Money market mutual funds	\$ 219,340	\$ 219,340	\$ -	\$ -
U.S. government bonds	16,435	-	16,435	-
U.S. treasury bills	37,434	37,434	-	-
Corporate bonds	21,832	-	21,832	-
	<u>295,041</u>	<u>\$ 256,774</u>	<u>\$ 38,267</u>	<u>\$ -</u>
Investments not subject to the fair value hierarchy				
State investment pool – LAIF	<u>84,201</u>			
Total investments	<u>\$ 379,242</u>			
Liabilities				
Interest rate swap	<u>\$ (35,184)</u>	<u>\$ -</u>	<u>\$ (35,184)</u>	<u>\$ -</u>
	2019			
	Total	Level 1	Level 2	Level 3
Investments				
Money market mutual funds	\$ 160,838	\$ 160,838	\$ -	\$ -
U.S. government bonds	15,041	-	15,041	-
U.S. treasury bills	22,564	22,564	-	-
Corporate bonds	15,658	-	15,658	-
	<u>214,101</u>	<u>\$ 183,402</u>	<u>\$ 30,699</u>	<u>\$ -</u>
Investments not subject to the fair value hierarchy				
State investment pool – LAIF	<u>73,552</u>			
Total investments	<u>\$ 287,653</u>			
Liabilities				
Interest rate swap	<u>\$ (25,541)</u>	<u>\$ -</u>	<u>\$ (25,541)</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.

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.

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 4 – Cash and Cash Equivalents and Investments (continued)

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, 2020 and 2019, 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, 2020 and 2019, were as follows (in thousands):

Investment	Investment Type	2020		2019	
		Fair Value	Percentage of Total Investments	Fair Value	Percentage of Total Investments
U.S. Bank, Trustee	First American Govt Oblig Fund CL D	\$ 40,594	11%	\$ 65,746	23%
Wells Fargo Advantage Government Money Market	U.S. Government Money Market Funds	35,067	9%	36,042	13%
Fidelity Investments	FIMM-Treasury Port Instl CL 2644	129,578	34%	45,756	16%

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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 4 – Cash and Cash Equivalents and Investments (continued)

Custodial credit risk – deposits – Custodial credit risk is the risk that in the event of a bank failure, PH's deposits may not be returned to it. PH does not have a policy for custodial credit risk. As of June 30, 2020 and 2019, PH's bank balances totaled \$21,095 and \$52,250, 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 cash balances of \$3,235 and \$1,671 that were above the insured limit at June 30, 2020 and 2019, respectively.

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

	2020	2019
Interest, dividends, and realized gains on sale of investments	\$ 5,167	\$ 4,700
Net increase in fair value of investments	1,595	1,204
Total	<u>\$ 6,762</u>	<u>\$ 5,904</u>

Note 5 – Concentrations of Credit Risk

PH grants credit without collateral to its patients, most of whom 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, 2020 and 2019, was as follows:

	2020	2019
Medicare	16%	16%
Medi-Cal	12%	13%
HMO/PPO/commercial*	64%	62%
Patient	7%	6%
Others	1%	3%
Total	<u>100%</u>	<u>100%</u>

* 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 (Dollars in Thousands)

Note 6 – Capital Assets

A summary of changes in capital assets for the years ended June 30, 2020 and 2019, is as follows (in thousands):

	Balance as of June 30, 2019	Additions	Disposals	Transfers	Balance as of June 30, 2020
Land improvements	\$ 80,342	\$ -	\$ -	\$ -	\$ 80,342
Buildings and leasehold improvements	1,128,194	339	-	24,119	1,152,652
Equipment	300,652	6,910	(4,037)	9,734	313,259
Land	60,715	-	-	-	60,715
Construction in progress	40,582	27,888	(1,162)	(33,853)	33,455
	<u>1,610,485</u>	<u>35,137</u>	<u>(5,199)</u>	<u>-</u>	<u>1,640,423</u>
Less accumulated depreciation and amortization	<u>(594,352)</u>	<u>(42,999)</u>	<u>3,912</u>	<u>-</u>	<u>(633,439)</u>
Capital assets, net	<u>\$ 1,016,133</u>	<u>\$ (7,862)</u>	<u>\$ (1,287)</u>	<u>\$ -</u>	<u>\$ 1,006,984</u>
	Balance as of June 30, 2018	Additions	Disposals	Transfers	Balance as of June 30, 2019
Land improvements	\$ 80,342	\$ -	\$ -	\$ -	\$ 80,342
Buildings and leasehold improvements	1,125,540	165	(423)	2,912	1,128,194
Equipment	294,935	11,306	(6,401)	812	300,652
Land	60,715	-	-	-	60,715
Construction in progress	44,014	7,512	(7,220)	(3,724)	40,582
	<u>1,605,546</u>	<u>18,983</u>	<u>(14,044)</u>	<u>-</u>	<u>1,610,485</u>
Less accumulated depreciation and amortization	<u>(556,405)</u>	<u>(43,726)</u>	<u>5,779</u>	<u>-</u>	<u>(594,352)</u>
Capital assets, net	<u>\$ 1,049,141</u>	<u>\$ (24,743)</u>	<u>\$ (8,265)</u>	<u>\$ -</u>	<u>\$ 1,016,133</u>

Construction commitments outstanding as of June 30, 2020, were \$102.

Note 7 – 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 \$6,279 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 \$6,903 and \$7,009 included in deferred inflow of resources in the accompanying statements of net position as of June 30, 2020 and 2019, respectively, is 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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 7 – 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, which owns 50% of PAM and 50% of PAM-SD. The remaining 50% ownership interests in PAM and PAM-SD are held by Arch and/or its subsidiaries. PH paid \$2,500 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 \$6,309 and \$5,870 at June 30, 2020 and 2019, respectively. The total income from PH’s investment in affiliates was \$444 and \$908 for the years ended June 30, 2020 and 2019, respectively.

Note 8 – 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 \$3,018 and \$1,310 for the years ended June 30, 2020 and 2019, 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 \$2,036 and \$1,651 for the years ended June 30, 2020 and 2019, respectively.

Under the MSA, PH provided a credit line to the Foundation of \$8,000 with interest at 2.5% above LIBOR. The credit line expires June 30, 2021. There were no amounts outstanding on the line of credit as of June 30, 2020 or 2019.

An unaudited summary of the Foundation’s assets, liabilities, and net assets as of June 30, 2020 and 2019, was as follows:

	<u>2020</u>	<u>2019</u>
Assets	<u>\$ 6,605</u>	<u>\$ 7,595</u>
Liabilities	\$ 325	\$ 1,274
Net assets	<u>6,280</u>	<u>6,321</u>
Total liabilities and net assets	<u>\$ 6,605</u>	<u>\$ 7,595</u>

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 8 – Related Organizations (continued)

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, 2020 and 2019, PIMG provided professional services to Arch in the amounts of \$11,508 and \$11,967, 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, 2020 and 2019, respectively.

Pacific Accountable Care, LLC – In April 2016, Arch formed PAC, a partnership with Medicare 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 1 MSSP, PAC has no risk with CMS for any increase in medical cost. For fiscal year 2018, 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. There are no outstanding amounts at June 30, 2020.

Pacific Accountable Management, LLC and Pacific Accountable Management San Diego, LLC – PAM and PAM-SD operated as MSO and provided administrative and billing services to Arch during the year ended June 30, 2018. PH and Arch collectively hold 100% of PAM and PAM-SD and closed operations for both entities in July 2018.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 9 – Long-Term Debt

The following is a summary of long-term debt transactions for PH for the years ended June 30, 2020 and 2019 (in thousands):

	Balance June 30, 2019	Additions	Reductions	Balance June 30, 2020	Amounts Due within One Year
Bonds payable					
Series 2017 Refunding Revenue Bonds	\$ 167,988	\$ -	\$ (659)	\$ 167,329	\$ -
Series 2017 Certificates of Participation	60,373	-	(1,054)	59,319	1,035
Series 2016 Refunding Revenue Bonds	262,910	-	(7,085)	255,825	5,985
Series 2016A&B General Obligation Bonds	233,748	-	(3,204)	230,544	1,720
Series 2010A General Obligation Bonds	65,535	-	(31)	65,504	-
Series 2009A General Obligation Bonds	113,070	-	(3,615)	109,455	327
Series 2007A General Obligation Bonds	49,128	-	(4,211)	44,917	4,450
Series 2006 Certificates of Participation	149,680	-	(6,025)	143,655	6,275
Accrued interest on capital appreciation bonds	195,071	16,013	-	211,084	7,195
Note payable	50	4,794	-	4,844	959
Capital leases	365	-	(52)	313	114
Long Term Debt-Crisis Stabilization Unit	-	1,000	-	1,000	-
Total long-term debt	\$ 1,297,918	\$ 21,807	\$ (25,936)	\$ 1,293,789	\$ 28,060

	Balance June 30, 2018	Additions	Reductions	Balance June 30, 2019	Amounts Due within One Year
Bonds payable					
Series 2017 Refunding Revenue Bonds	\$ 168,646	\$ -	\$ (658)	\$ 167,988	\$ -
Series 2017 Certificates of Participation	61,378	-	(1,005)	60,373	985
Series 2016 Refunding Revenue Bonds	269,770	-	(6,860)	262,910	5,755
Series 2016A&B General Obligation Bonds	236,862	-	(3,114)	233,748	1,610
Series 2010A General Obligation Bonds	65,566	-	(31)	65,535	-
Series 2009A General Obligation Bonds	113,292	-	(222)	113,070	3,400
Series 2007A General Obligation Bonds	52,973	-	(3,845)	49,128	4,090
Series 2006 Certificates of Participation	155,475	-	(5,795)	149,680	6,050
Accrued interest on capital appreciation bonds	175,394	19,677	-	195,071	7,150
Note payable	339	-	(289)	50	14
Capital leases	432	-	(67)	365	111
Total long-term debt	\$ 1,300,127	\$ 19,677	\$ (21,886)	\$ 1,297,918	\$ 29,165

The terms and due dates of PH's long-term debt as of June 30, 2020 and 2019, are as follows:

- Series 2017 Refunding Revenue Bonds ("Series 2017 Bonds") bear interest at 5.00%, 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 \$15,869 and \$16,527 at June 30, 2020 and 2019, respectively, and are collateralized by PH revenues as defined in the indenture agreement. The net unamortized loss on refunding is \$18,092 and \$18,843 at June 30, 2020 and 2019, respectively, and is included as deferred outflow of resources and amortized. As an alternative to maintaining a cash reserve to fund principal and interest payments in the event of default, PH purchased a Municipal Bond Debt Service Reserve Insurance policy with a policy limit of \$11,827. The cost of the insurance premium is being amortized over the life of the bonds.

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 9 – Long-Term Debt (continued)

- Series 2017 Certificates of Participation (“2017 COP”) bear interest at rates between 4.00% to 5.00%, 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 COP are net of unamortized original issue premium of \$1,139 and \$1,208 at June 30, 2020 and 2019, respectively, and are collateralized by PH revenues as defined in the indenture agreement. As an alternative to maintaining a cash reserve to fund principal and interest payments in the event of default, PH purchased a Municipal Bond Debt Service Reserve Insurance policy with a policy limit of \$3,522. The cost of the insurance premium is being amortized over the life of the bonds.
- Series 2016 Refunding Revenue Bonds (“Series 2016 Revenue Bonds”) bear interest at rates between 3.00% to 5.00%, 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 \$25,719 and \$27,050 at June 30, 2020 and 2019, respectively, and are collateralized by PH revenues as defined in the indenture agreement. The net unamortized loss on refunding is \$34,789 and \$36,589 at June 30, 2020 and 2019, 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 2.00% to 5.00%, 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 \$8,061 and \$8,633 at June 30, 2020 and 2019, respectively.
- Series 2016B General Obligation Bonds (“Series 2016B G.O. Bonds”) bear interest at rates between 2.00% to 5.00%, 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 \$16,432 and \$17,453 at June 30, 2020 and 2019, respectively. The net unamortized loss on refunding is \$3,447 and \$3,661 at June 30, 2020 and 2019, respectively, and is included as deferred outflow of resources and amortized.
- Series 2010 Certificates of Participation (“2010 COP”) 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 COP are considered to be defeased and the liability for these bonds has been removed from the statements 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.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 9 – Long-Term Debt (continued)

- 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 \$588 and \$619 at June 30, 2020 and 2019, respectively.
- Series 2009 Certificates of Participation (“2009 COP”) 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 COP is considered to be defeased and the liability for these bonds has been removed from the statements 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 9.00% 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 \$2,855 and \$3,071 at June 30, 2020 and 2019, 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 \$460 and \$580 at June 30, 2020 and 2019, 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 statements 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 COP”), 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 COP 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 COP in a notional amount of \$180,000 (the Swap Agreement) (see Note 10). Interest on the 2006 COP is accrued at 3.22%, 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 COP are net of unamortized loss on refunding of \$44 and \$70 at June 30, 2020 and 2019, respectively, and are collateralized by PH revenues as defined in the indenture agreement.

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Notes to Financial Statements (Dollars in Thousands)

Note 9 – Long-Term Debt (continued)

- 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.

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 Coverage, and Cushion Ratio) under its indenture agreements for the COP. The covenants stipulate that in the event of underachievement, the Insurers may require PH to call in mutually agreed-upon consultants to perform mutually agreed-upon scope of services to assist PH in achieving the covenants.

At June 30, 2020 and 2019, long-term capital leases, net of current portion, amounted to \$199 and \$255, respectively. Related net book value of leased equipment totaled \$325 and \$387, and depreciation expense totaled \$85 and \$81 for the years ended June 30, 2020 and 2019, respectively.

The estimated fair value of PH’s long-term debt was approximately \$1,475,026 and \$1,482,767 as of June 30, 2020 and 2019, respectively, based on quotations from independent third parties.

During the year ended June 30, 2020, Arch applied for and received a Paycheck Protection Loan from a bank in the amount of \$2,487, included in Notes payable in the table above. The note bears interest at 1%, with monthly equal payments to be made beginning December 1, 2020, with a maturity of 2 years from the date of the note (which was May 1, 2020). Arch is in the process of applying for loan forgiveness and expects the loan will be forgiven in its entirety, though the outcome is uncertain at this time. Should the loan not be forgiven, payments of \$967 are due during the year ended June 30, 2021, with the remaining \$1,520 due during the year ended June 30, 2022.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 9 – Long-Term Debt (continued)

Estimated future principal and interest payments on long-term debt, including capital leases, as of June 30, 2020, are as follows (in thousands):

Years Ending June 30,	Principal	Interest	Total
2021	\$ 20,865	\$ 51,140	\$ 72,005
2022	24,915	54,363	79,278
2023	23,152	55,362	78,514
2024	24,016	56,536	80,552
2025	25,343	57,878	83,221
2026 - 2030	166,226	296,442	462,668
2031 - 2035	247,328	299,036	546,364
2036 - 2040	271,061	247,691	518,752
2041 - 2045	134,774	62,937	197,711
2046 - 2048	73,947	5,514	79,461
	<hr/>	<hr/>	<hr/>
Sub-total	1,011,627	1,186,899	2,198,526
Net premium on bonds	71,078	-	71,078
Accrued interest on capital appreciation bonds	211,084	-	211,084
	<hr/>	<hr/>	<hr/>
Total	<u>\$ 1,293,789</u>	<u>\$ 1,186,899</u>	<u>\$ 2,480,688</u>

Note 10 – Interest Rate Swap

In 2006, PH entered into the Swap Agreement as a means to lower its borrowing costs on the 2006 COP (see Note 9) 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 COP and terminates on November 1, 2036, simultaneously with the maturity of the 2006 COP.

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% (.069% and 1.57% at June 30, 2020 and 2019, respectively).

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Notes to Financial Statements (Dollars in Thousands)

Note 10 – Interest Rate Swap (continued)

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, 2020	\$ 143,700
Notional amount as of June 30, 2019	\$ 149,750
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, 2020	\$ 2,982
PH receives	56% of 30-day LIBOR + 0.23%
Swap fair value as of June 30, 2020	\$ (35,184)
Change in fair value for the year ended June 30, 2020	\$ (9,643)
Classification	Liability

Fair value – As of June 30, 2020 and 2019, the swap had a negative fair value of \$35,184 and \$25,541, 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 (loss) on interest rate swap.

Credit risk – PH seeks to limit its counterparty risk by contracting only with highly rated entities. As of June 30, 2020, the counterparty of the interest rate swap was rated “Aa3” 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.

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.

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Notes to Financial Statements (Dollars in Thousands)

Note 10 – Interest Rate Swap (continued)

Termination risk – The swap uses the International Swaps & Derivatives 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 A3 by Moody’s with a stable outlook effective August 2020.

Note 11 – Operating Leases

PH leases certain office space and equipment under operating leases. Lease expense on all such leases for the years ended June 30, 2020 and 2019, totaled \$23,325 and \$20,883 (including \$67 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, 2020, were as follows (in thousands):

	Lease Payments	Lease Receipts
Years Ending June 30,		
2021	\$ 14,962	\$ 603
2022	13,855	573
2023	8,912	360
2024	8,521	331
2025	8,523	330
2026 - 2030	30,002	1,629
2031 - 2035	24,470	1,431
2036 - 2040	24,580	1,250
2041 - 2081	38,201	625
	<u>\$ 172,026</u>	<u>\$ 7,132</u>
Total		

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Notes to Financial Statements (Dollars in Thousands)

Note 12 – 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 13 – 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, 2020 and 2019, 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, 2020 and 2019, were \$18,568 and \$18,966, respectively.

Note 14 – 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 Discovery Benefits. 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:

	July 1, 2018	July 1, 2016
Inactive employees currently receiving benefit payments	8	12
Active employees	3,634	3,617
Total	3,642	3,629

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Notes to Financial Statements (Dollars in Thousands)

Note 14 – Postemployment Healthcare Plan (continued)

Total OPEB liability – PH's total OPEB liability of \$1,404 was measured as of June 30, 2020, and was determined by an actuarial valuation as of that date.

Actuarial assumptions and other inputs – The total OPEB liability in the June 30, 2020 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, 2020 valuation were based on the results of an actuarial experience study for the period June 30, 2019 to June 30, 2020.

Inflation	2.50%
Salary increases	3.00% - 18.50%, including inflation
Discount rate	2.21%
Healthcare cost trend rates	7% for 2019, 6.75% for 2020, 6.50% for 2021 and decreasing to an ultimate rate of 4% in 2031

The discount rate was based on Bond Buyer 20-Bond General Obligation Index. Mortality rates were based on the RP-2000. Combined mortality table rates projected with mortality improvement scale BB.

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Notes to Financial Statements (Dollars in Thousands)

Note 14 – Postemployment Healthcare Plan (continued)

Changes in the total OPEB liability (in thousands):

	Year Ended June 30,	
	2020	2019
Total OPEB liability – prior measurement date	\$ 1,230	\$ 1,193
Changes in total OPEB liability		
(a) Service cost	67	69
(b) Interest on the total OPEB liability	44	46
(c) Changes on benefit terms	-	(48)
(d) Differences between expected and actual experience	-	-
(e) Changes of assumptions or other inputs	120	34
(f) Benefit payments	(57)	(64)
Total OPEB liability – current measurement date	<u>\$ 1,404</u>	<u>\$ 1,230</u>
Covered-employee payroll	\$ 227,447	\$ 258,493
Total OPEB liability as a % of covered-employee payroll	0.62%	0.48%
Key information		
Valuation date	July 1, 2018	July 1, 2018
Reporting date	June 30, 2020	June 30, 2019
Measurement date	June 30, 2020	June 30, 2019
Discount rate as of the measurement date	2.21%	3.48%
Municipal bond index rate	2.21%	3.48%
Municipal bond index date	June 30, 2020	June 11, 2019

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 2.21% and preliminary discount rate of 3.48% for June 30, 2020 and 2019 measurement dates, respectively, as well as what the total OPEB liabilities would be if 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, 2020			June 30, 2019		
	1% Decrease 1.21%	Discount Rate 2.21%	1% Increase 3.21%	1% Decrease 2.48%	Discount Rate 3.48%	1% Increase 4.48%
Net OPEB liability	\$ 1,509	\$ 1,404	\$ 1,308	\$ 1,323	\$ 1,230	\$ 1,145

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 14 – 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, 2020			June 30, 2019		
	1% Decrease 6.0% to 3.0%	Current 7.0% to 4.0%	1% Increase 8.0% to 5.0%	1% Decrease 5.5% to 3.0%	Current 6.5% to 4.0%	1% Increase 7.5% to 5.0%
	Net OPEB liability	\$ 1,258	\$ 1,404	\$ 1,574	\$ 1,114	\$ 1,230

OPEB expense and deferred outflows of resources and deferred inflows of resources related to OPEB – For the fiscal year ended June 30, 2020, PH recognized OPEB expense of \$74. At June 30, 2020, the deferred outflows of resources and deferred inflows of resources related to OPEB are as follows (in thousands):

	June 30, 2020			June 30, 2019		
	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	110	32	78	26	49	(23)
Total	<u>\$ 110</u>	<u>\$ 32</u>	<u>\$ 78</u>	<u>\$ 26</u>	<u>\$ 49</u>	<u>\$ (23)</u>

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):

Years Ending June 30,	Amount
2021	\$ 19
2022	24
2023	27
2024	8
2025	-
Thereafter	-
	<u>\$ 78</u>

Note 15 – 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, 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.

PH filed civil litigation against a third-party payor claiming breach of contract regarding payment denial of numerous healthcare service claims. PH had previously fully reserved the patient receivable balances for those claims to zero. The parties are engaged in mediation. The payor tendered a \$9,857 "good faith" payment to PH in May 2020. In June 2020, the payor agreed to not contest a total \$705 of disputed claims, and PH recognized that amount as net patient revenue as of June 30, 2020. The remaining \$9,152 of the May 2020 good faith payment is included in Other Accrued Liabilities on the Statement of Net Position as of June 30, 2020. The parties continue to engage in the mediation process.

COVID-19 – On March 11, 2020, the World Health Organization officially declared COVID-19, the disease caused by the novel coronavirus, a pandemic. Soon afterward, PH (along with hospitals in the United States) cancelled elective surgical cases, resulting in a significant loss of net patient revenue. The pandemic has resulted in PH incurring additional costs to maintain patient volume as well as to provide care to patients specifically affected by the virus. The duration and intensity of disruption from the pandemic is uncertain, and therefore the long-term impact, if any, cannot be predicted. In response, Congress passed legislation to provide financial support to hospitals.

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 15 – Commitments and Contingencies (continued)

In April 2020, PH applied for and received advances from Medicare under the Medicare Accelerated Payment Program, administered by CMS, of \$55,602. This amount is treated as a loan bearing no interest, and was scheduled to be recouped beginning 120 days following receipt of the accelerated payments and repaid in full not later than one year following payment receipt. On September 30, 2020, a new funding bill was enacted which delays recoupment of such funds. The recently finalized funding bill now gives hospitals one year before Medicare can claim payments to repay the loans. Additionally, the measure lowers the interest rate on outstanding payments after the 29-month period from 10.25% to 4%. PH expects recoupment to begin in April 2021 and will have 29 months since the first payment to fully repay the loan if not recouped by Medicare at that time. As such, PH has classified the advances as a noncurrent liability as of June 30, 2020, net of approximately \$6,750 included in current other accrued liabilities based on the estimated amount expected to be recouped during the year ended June 30, 2021.

During April, May, and June 2020, PH received funds under the Provider Relief Fund, administered by the U.S. Department of Health & Human Services (HHS), under the CARES Act of \$20,133. PH was required to and did timely sign attestations agreeing to the terms and conditions of payment. Those terms and conditions include measures to prevent fraud and misuse. Documentation is required to ensure that these funds are to be used for healthcare-related expenses or lost revenue attributable to coronavirus, limitations of out of pocket payments from certain patients, and the acceptance of several other reporting and compliance requirements. Also anti-fraud monitoring and auditing will be done by HHS and the Office of the Inspector General. Management is currently assessing the compliance requirements of these funds. HHS may issue more specific guidance in the future on how the lost revenue and costs should be calculated, which may result in modification to management's estimates in future periods.

Workers' compensation program – Effective July 1, 2016, PH 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, 2020 and 2019, estimated claims liabilities for workers' compensation recorded were \$6,524 and \$5,441, respectively.

Activity in PH's workers' compensation claims liability during the years ended June 30, 2020 and 2019, is summarized as follows (in thousands):

	2020	2019
BALANCE, beginning of the year	\$ 5,441	\$ 4,491
Current year claims incurred and changes in estimates for claims incurred in the prior year	4,380	4,223
Claims and expenses paid	<u>(3,298)</u>	<u>(3,273)</u>
BALANCE, end of year	6,523	5,441
Less current portion, included in other accrued liabilities	<u>(2,381)</u>	<u>(2,377)</u>
BALANCE, end of year, less current portion	<u>\$ 4,142</u>	<u>\$ 3,064</u>

Palomar Health
Notes to Financial Statements (Dollars in Thousands)

Note 15 – Commitments and Contingencies (continued)

Comprehensive liability insurance coverage – PH is insured for comprehensive liability (professional liability, bodily injury and property damage liability, personal injury, advertising injury and discrimination liability, and employee benefit liability) under a claims-made policy, which covers asserted claims and incidents reported to the insurance carrier, and has a per-claim deductible of \$100 for professional liability. PH’s comprehensive liability insurance was renewed effective July 1, 2019, and the current policy expires on June 30, 2020. PH has reserves for estimated claims through 2015, including an estimate of IBNR. Such reserves remained unchanged at \$2,463 from previous year and are recorded as other accrued liabilities in the accompanying statements of net position.

Effective July 1, 2019, PH withdrew its membership from its insurance carrier and has contracted with CNA to provide comprehensive liability insurance. PH is self-insured for the first \$1,000 for each claim and \$7,000 in aggregate.

Activity in PH’s comprehensive liability insurance coverage liability during the years ended June 30, 2020 and 2019, is summarized as follows (in thousands):

	2020	2019
BALANCE, beginning of the year	\$ 2,463	\$ 2,463
Current year claims incurred and changes in estimates	1,484	377
Claims and expenses paid	-	(377)
BALANCE, end of the year	\$ 3,947	\$ 2,463

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. RAC audits resulted in recoupments of \$104 and \$0 for the years ended June 30, 2020 and 2019, respectively. There are currently no RAC audits in process nor any reserves recorded at June 30, 2020 or 2019.

Seismic compliance – California Senate Bill (SB) 1953 requires hospital acute care buildings to meet more stringent seismic guidelines by 2020. The California Office of Statewide Health Planning & Development (OSHPD) assigns structural performance category (SPC) ratings to each acute care hospital facility in the state. As of June 18, 2020, the Escondido and Poway facilities were assigned SPC-5 and SPC-4 ratings, respectively, and may be used beyond January 1, 2030. The PHDC buildings were assigned SPC-4 and SPC-2 ratings. A building with a SPC-2 rating can be used for inpatient care without structural improvement until January 1, 2030. During June 2020, PH relocated its Acute Rehabilitation Unit and Behavioral Health Unit from PHDC to Poway and does not intend to conduct further inpatient care activities at PHDC.

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Notes to Financial Statements (Dollars in Thousands)

Note 16 – Condensed Combining Information

A summary of the condensed combining information for PH and Arch as of June 30, 2020, is as follows (in thousands):

ASSETS AND DEFERRED OUTFLOW OF RESOURCES							
CONDENSED COMBINING STATEMENT OF NET POSITION AS OF JUNE 30, 2020							
	PH	Arch	PAM	PAM-SD	PAC	Eliminations	Total
Current assets	\$ 516,538	\$ 8,874	\$ 391	\$ 1,895	\$ 94	\$ (8,111)	\$ 519,681
Capital assets, net	1,004,012	2,972	-	-	-	-	1,006,984
Noncurrent assets	78,400	1,227	-	-	-	(4,658)	74,969
Total assets	1,598,950	13,073	391	1,895	94	(12,769)	1,601,634
Deferred outflow of resources	56,329	-	-	-	-	-	56,329
Total assets and deferred outflow of resources	<u>\$ 1,655,279</u>	<u>\$ 13,073</u>	<u>\$ 391</u>	<u>\$ 1,895</u>	<u>\$ 94</u>	<u>\$ (12,769)</u>	<u>\$ 1,657,963</u>
LIABILITIES, DERERRED INFLOW OF RESOURCES, AND NET POSITION							
Current liabilities	\$ 164,327	\$ 12,571	\$ 2,326	\$ -	\$ 1,636	\$ (8,514)	\$ 172,346
Long-term liabilities	1,357,219	3,883	-	-	-	-	1,361,102
Total liabilities	1,521,546	16,454	2,326	-	1,636	(8,514)	1,533,448
Deferred inflow of resources	7,604	-	-	-	-	-	7,604
Total liabilities and deferred inflow of resources	1,529,150	16,454	2,326	-	1,636	(8,514)	1,541,052
Net investment in capital assets	(167,331)	2,935	-	-	-	-	(164,396)
Restricted	31,438	-	-	-	-	-	31,438
Unrestricted	262,022	(6,316)	(1,935)	1,895	(1,542)	(4,255)	249,869
Total net position	126,129	(3,381)	(1,935)	1,895	(1,542)	(4,255)	116,911
Total liabilities, deferred inflow of resources, and net position	<u>\$ 1,655,279</u>	<u>\$ 13,073</u>	<u>\$ 391</u>	<u>\$ 1,895</u>	<u>\$ 94</u>	<u>\$ (12,769)</u>	<u>\$ 1,657,963</u>

PH is the sole corporate member of Arch and Arch is dependent upon PH for financial support. Arch received \$18,959 and \$16,382 in financial support for years ending June 30, 2020 and 2019, respectively.

Subsequent to June 30, 2020, Arch has received an additional \$2,800 of financial support.

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Notes to Financial Statements (Dollars in Thousands)

Note 16 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF REVENUE, EXPENSES, AND CHANGES IN NET POSITION FOR THE YEAR ENDED JUNE 30, 2020							
	PH	Arch	PAM	PAM-SD	PAC	Elimination	Total
OPERATING REVENUE							
Net patient service revenue	\$ 642,723	\$ 28,195	\$ -	\$ -	\$ -	\$ -	\$ 670,918
Shared risk revenue	71,732	10,893	-	-	-	-	82,625
Other revenue	10,948	1,522	-	-	-	(85)	12,385
PH program revenue	-	1,914	-	-	-	(1,914)	-
Total operating revenue	<u>725,403</u>	<u>42,524</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,999)</u>	<u>765,928</u>
OPERATING EXPENSES							
DEPRECIATION AND AMORTIZATION	691,182	64,990	94	-	488	(1,999)	754,755
	41,698	1,233	-	68	-	-	42,999
Total operating expenses	<u>732,880</u>	<u>66,223</u>	<u>94</u>	<u>68</u>	<u>488</u>	<u>(1,999)</u>	<u>797,754</u>
LOSS FROM OPERATIONS	<u>(7,477)</u>	<u>(23,699)</u>	<u>(94)</u>	<u>(68)</u>	<u>(488)</u>	<u>-</u>	<u>(31,826)</u>
NON-OPERATING INCOME (EXPENSE)							
Investment income	6,762	-	-	-	-	-	6,762
Unrealized gain on interest rate swap	(9,643)	-	-	-	-	-	(9,643)
Interest expense	(63,150)	(40)	-	-	-	-	(63,190)
Property tax revenue	47,229	-	-	-	-	-	47,229
Other, net	(1,072)	19,888	63	(13)	-	-	18,866
Total nonoperating (expense) income, net	<u>(19,874)</u>	<u>19,848</u>	<u>63</u>	<u>(13)</u>	<u>-</u>	<u>-</u>	<u>24</u>
CHANGE IN NET POSITION	<u>(27,351)</u>	<u>(3,851)</u>	<u>(31)</u>	<u>(81)</u>	<u>(488)</u>	<u>-</u>	<u>(31,802)</u>
NET POSITION, beginning of year	<u>153,482</u>	<u>468</u>	<u>(1,904)</u>	<u>1,977</u>	<u>(1,055)</u>	<u>(4,255)</u>	<u>148,713</u>
NET POSITION, end of year	<u>\$ 126,131</u>	<u>\$ (3,383)</u>	<u>\$ (1,935)</u>	<u>\$ 1,896</u>	<u>\$ (1,543)</u>	<u>\$ (4,255)</u>	<u>\$ 116,911</u>

CONDENSED COMBINING STATEMENT OF CASH FLOWS FOR THE YEAR ENDED JUNE 30, 2020							
	PH	Arch	PAM	PAM-SD	PAC	Elimination	Total
CASH FLOWS FROM							
Operating activities	\$ 110,766	\$ (21,115)	\$ (63)	\$ 13	\$ (16)	\$ -	\$ 89,585
Noncapital financing activities	38,489	-	-	-	-	-	38,489
Capital and related financing activities	(95,831)	23,130	63	(13)	-	-	(72,651)
Investing activities	(83,232)	-	-	-	-	-	(83,232)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	<u>(29,808)</u>	<u>2,015</u>	<u>-</u>	<u>-</u>	<u>(16)</u>	<u>-</u>	<u>(27,809)</u>
CASH AND CASH EQUIVALENTS, beginning of year	<u>48,934</u>	<u>1,092</u>	<u>-</u>	<u>-</u>	<u>110</u>	<u>-</u>	<u>50,136</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 19,126</u>	<u>\$ 3,107</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 94</u>	<u>\$ -</u>	<u>\$ 22,327</u>

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 16 – Condensed Combining Information (continued)

A summary of the condensed combining information for PH and Arch as of June 30, 2019, is as follows (in thousands):

ASSETS AND DEFERRED OUTFLOW OF RESOURCES							
CONDENSED COMBINING STATEMENT OF NET POSITION AS OF JUNE 30, 2019							
	PH	Arch	PAM	PAM-SD	PAC	Eliminations	Total
Current assets	\$ 437,210	\$ 7,066	\$ 404	\$ 1,895	\$ 126	\$ (4,575)	\$ 442,126
Capital assets, net	1,013,355	2,696	-	82	-	-	1,016,133
Noncurrent assets	104,974	1,110	-	-	-	(4,659)	101,425
Total assets	1,555,539	10,872	404	1,977	126	(9,234)	1,559,684
Deferred outflow of resources	59,093	-	-	-	-	-	59,093
Total assets and deferred outflow of resources	\$ 1,614,632	\$ 10,872	\$ 404	\$ 1,977	\$ 126	\$ (9,234)	\$ 1,618,777
LIABILITIES, DERERRED INFLOW OF RESOURCES, AND NET POSITION							
Current liabilities	\$ 148,856	\$ 10,368	\$ 2,308	\$ -	\$ 1,181	\$ (4,979)	\$ 157,734
Long-term liabilities	1,304,472	36	-	-	-	-	1,304,508
Total liabilities	1,453,328	10,404	2,308	-	1,181	(4,979)	1,462,242
Deferred inflow of resources – deferred revenue	7,822	-	-	-	-	-	7,822
Total liabilities and inflow of resources	1,461,150	10,404	2,308	-	1,181	(4,979)	1,470,064
Invested in capital assets, net of related debt	(138,291)	2,646	-	82	-	-	(135,563)
Restricted	32,160	-	-	-	-	-	32,160
Unrestricted	259,613	(2,178)	(1,904)	1,895	(1,055)	(4,255)	252,116
Total net position	153,482	468	(1,904)	1,977	(1,055)	(4,255)	148,713
Total liabilities, deferred inflow of resources, and net position	\$ 1,614,632	\$ 10,872	\$ 404	\$ 1,977	\$ 126	\$ (9,234)	\$ 1,618,777

Palomar Health

Notes to Financial Statements (Dollars in Thousands)

Note 16 – Condensed Combining Information (continued)

CONDENSED COMBINING STATEMENT OF REVENUE, EXPENSES AND CHANGES IN NET POSITION FOR THE YEAR ENDED JUNE 30, 2019							
	PH	Arch	PAM	PAM-SD	PAC	Elimination	Total
OPERATING REVENUE							
Net patient service revenue	\$ 667,103	\$ 27,658	\$ -	\$ -	\$ (1,315)	\$ -	\$ 693,446
Shared risk revenue	70,901	11,432	-	-	-	(50)	82,283
Other revenue	11,477	2,098	(647)	-	-	647	13,575
PH Program revenue	-	1,936	-	-	-	(1,936)	-
Total operating revenue	749,481	43,124	(647)	-	(1,315)	(1,339)	789,304
OPERATING EXPENSES							
DEPRECIATION AND AMORTIZATION	690,057	62,678	518	(3)	(636)	(1,339)	751,275
	42,340	1,328	-	59	-	-	43,727
Total operating expenses	732,397	64,006	518	56	(636)	(1,339)	795,002
INCOME (LOSS) FROM OPERATIONS	17,084	(20,882)	(1,165)	(56)	(679)	-	(5,698)
NON-OPERATING INCOME (EXPENSE)							
Investment income	5,833	71	-	-	-	-	5,904
Unrealized loss on interest rate swap	(6,570)	-	-	-	-	-	(6,570)
Interest expense	(60,857)	(5)	(67)	-	-	-	(60,929)
Property tax revenue	37,942	-	-	-	-	-	37,942
Other, net	(6,663)	(4,641)	1,350	368	-	2,357	(7,229)
Total nonoperating (expense) income, net	(30,315)	(4,575)	1,283	368	-	2,357	(30,882)
CHANGE IN NET POSITION	(13,231)	(25,457)	118	312	(679)	2,357	(36,580)
INTERFUND – ARCH HEALTH PARTNERS	(16,569)	16,569	-	-	-	-	-
NET POSITION, beginning of year	183,281	9,358	(2,023)	1,666	(376)	(6,613)	185,293
NET POSITION, end of year	<u>\$ 153,481</u>	<u>\$ 470</u>	<u>\$ (1,905)</u>	<u>\$ 1,978</u>	<u>\$ (1,055)</u>	<u>\$ (4,256)</u>	<u>\$ 148,713</u>

CONDENSED COMBINING STATEMENT OF CASH FLOWS FOR THE YEAR ENDED JUNE 30, 2019 (dollars in thousands)							
	PH	Arch	PAM	PAM-SD	PAC	Elimination	Total
CASH FLOWS FROM							
Operating activities	\$ 57,908	\$ (14,428)	\$ 1,126	\$ (286)	\$ 110	\$ (2,224)	\$ 42,206
Noncapital financing activities	17,609	-	(1,836)	-	-	1,836	17,609
Capital and related financing activities	(76,511)	14,507	(67)	286	-	388	(61,397)
Investing activities	2,167	71	-	-	-	-	2,238
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,173	150	(777)	-	110	-	656
CASH AND CASH EQUIVALENTS, beginning of year	47,761	942	777	-	-	-	49,480
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 48,934</u>	<u>\$ 1,092</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 110</u>	<u>\$ -</u>	<u>\$ 50,136</u>

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									
	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
1. Total OPEB liability - prior measurement date	\$ 1,230	\$ 1,193	\$ 1,176	\$ 1,190	n/a	n/a	n/a	n/a	n/a	n/a
2. Changes in total OPEB liability										
(a) Service cost	67	69	60	72	n/a	n/a	n/a	n/a	n/a	n/a
(b) Interest on the total OPEB liability	44	46	43	35	n/a	n/a	n/a	n/a	n/a	n/a
(c) Changes on benefit terms	-	(48)	-	-	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
(e) Changes of assumptions or other inputs	120	34	(24)	(63)	n/a	n/a	n/a	n/a	n/a	n/a
(f) Benefit payments	(57)	(64)	(62)	(58)	n/a	n/a	n/a	n/a	n/a	n/a
(g) Total	<u>\$ 1,404</u>	<u>\$ 1,230</u>	<u>\$ 1,193</u>	<u>\$ 1,176</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
3. Total OPEB liability - current measurement date	\$ 1,404	\$ 1,230	\$ 1,193	\$ 1,176	\$ 1,190	\$ -	\$ -	\$ -	\$ -	\$ -
4. Estimated covered-employee payroll	\$ 227,447	\$ 258,493	\$ 209,718	\$ 240,492	n/a	n/a	n/a	n/a	n/a	n/a
5. Total OPEB liability as a % of covered-employee payroll	0.62%	0.48%	0.60%	0.50%	n/a	n/a	n/a	n/a	n/a	n/a
Key information										
Valuation date	July 1, 2019	July 1, 2018	July 1, 2016	July 1, 2016	July 1, 2016	n/a	n/a	n/a	n/a	n/a
Reporting date	June 30, 2020	June 30, 2019	June 30, 2018	June 30, 2017	n/a	n/a	n/a	n/a	n/a	n/a
Measurement date	June 30, 2020	June 30, 2019	June 30, 2018	June 30, 2017	June 30, 2016	n/a	n/a	n/a	n/a	n/a
Discount rate as of the measurement date	2.21%	3.48%	3.87%	3.58%	2.85%	n/a	n/a	n/a	n/a	n/a
Bond index rate	2.21%	3.48%	3.87%	3.58%	2.85%	n/a	n/a	n/a	n/a	n/a
Bond index date	June 30, 2020	June 11, 2019	June 30, 2018	June 30, 2017	June 30, 2016	n/a	n/a	n/a	n/a	n/a

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.