Palomar Health

Consolidated Financial Statements as of and for the Years Ended June 30, 2014 and 2013, and Independent Auditors' Report

PALOMAR HEALTH

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PALOMAR HEALTH

MANAGEMENT'S DISCUSSION AND ANALYSIS

Overview

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

PH was formerly known as Palomar Pomerado Health. In May 2012, the Board of Directors by resolution voted to change the name to Palomar Health.

This section of PH's annual financial report presents our analysis of PH's financial performance for the years ended June 30, 2014 and 2013. Although the 2012 condensed consolidated statement of net position, condensed consolidated statement of revenue, expenses, and changes in net position, and condensed consolidated statement of cash flows are presented in this section, they are not presented in the accompanying consolidated financial statements and notes to the consolidated financial statements. Please read this analysis in conjunction with the consolidated financial statements that follow this section.

This annual financial report includes:

- Management's Discussion and Analysis

- Independent Auditors' Report

- Consolidated financial statements of PH, including notes that explain in more detail some of the information in the consolidated financial statements. During fiscal year 2014, PH terminated the guaranty agreement when Arch Health Partner's (AHP) managed care risk contracts were transferred to an unrelated organization, which eliminated the need for the guarantee with California Department of Managed Healthcare. These circumstances result in a change in reporting entity in accordance with Governmental Accounting Standards Board (GASB) Codification Section 2250, *Reporting a Change in the Entity*. Accordingly, this change in reporting entity has been applied retrospectively in the accompanying consolidated financial statements to discontinue the presentation of AHP as a component unit of PH for all periods presented. The effect of the change as of July 1, 2012, was a reduction of PH's consolidated net position by $24,000. Refer to Note 1 of the consolidated financial statements.

  The accompanying consolidated financial statements include adjustments to 2013 and 2012 amounts to reflect the retrospective adoption in 2014 of GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. PH's consolidated financial statements report information using accounting methods required by the GASB, which, while similar to those used by private sector health care organizations, include some differences as described further in this management's discussion and analysis. In accordance with GASB, the General Obligation Bonds (G.O. Bonds) issued by PH are included on the consolidated statement of net position, and related tax receipts and interest expense are included in the consolidated statements of revenue, expenses, and changes in net position. Repayment of the obligations is from a separate G.O. Bonds tax levy. While the collected funds, the interest expense and the debt are reflected in the consolidated financial statements according to GASB reporting requirements, they are held and treated separately from ongoing operations. These consolidated financial statements contain short-term and long-term financial information about PH's activities.

Required Financial Statements

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

CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2014, 2013, AND 2012
($ in thousands)

	2014	2013 (As Restated, See Note 1)	2012 (As Restated, See Note 1)
ASSETS			
Current assets	$ 308,245	$ 291,027	$ 330,117
Capital assets—net	1,203,540	1,260,581	1,273,281
Noncurrent assets	103,360	91,418	92,565
TOTAL	$ 1,615,145	$ 1,643,026	$ 1,695,963
LIABILITIES AND NET ASSETS			
Current liabilities	$ 103,882	$ 106,610	$ 118,236
Workers' compensation—net of current portion	744	1,068	1,063
Fair value of interest rate swap	26,528	26,343	40,375
Long-term debt—net of current portion	1,131,308	1,123,398	1,115,598
Total liabilities	1,262,462	1,257,419	1,275,272
Deferred inflow of resources—deferred revenue	8,389	7,647	7,778
Total liabilities and deferred inflow of resources	1,270,851	1,265,066	1,283,050
Invested in capital assets—net of related debt	120,027	184,340	196,237
Restricted for repayment of debt	10,192	13,753	17,071
Restricted for capital acquisitions	11,485	13,167	13,921
Restricted for other purposes	1,844	329	326
Unrestricted	200,746	166,371	185,358
Total net position	344,294	377,960	412,913
TOTAL	$ 1,615,145	$ 1,643,026	$ 1,695,963

2014: Analysis of the Consolidated Statements of Net Position

- Current assets increased by $17,218,000 in 2014, primarily due to increases in cash of $27,542,000, net patient accounts receivable of $176,000, other receivables of $248,000 and the current portion of assets whose use is limited—General Obligation Bonds ("G.O. Bonds") of $1,377,000. These were offset by decreases in investments of $5,728,000, inventories of $560,000, prepaid and other expenses of $206,000, estimated third-party settlements receivable of $2,243,000, and the current portion of assets whose use is limited of $3,388,000.

- Capital assets decreased by $57,041,000 primarily due to purchases related to major building projects of $3,620,000, offset by net disposals of $3,950,000, and depreciation and amortization expense of $56,711,000.

- Noncurrent assets increased by $11,942,000 primarily due to an increase in other noncurrent assets of $18,927,000, offset by a decrease in assets whose use is limited of $6,985,000.

- Current liabilities decreased by $2,728,000 primarily due to a decrease in the current portion of long-term debt of $7,465,000, offset by an increase in estimated third-party settlements liability of $2,046,000, other accrued liabilities of $1,524,000, the current portion of the G.O. Bonds of $574,000, accrued compensation and related liabilities of $290,000, accounts payable of $255,000 and accrued interest payable of $48,000.

- Long-term liabilities increased by $7,771,000, primarily as a result of the increase in G.O. Bonds of $15,452,000 and the fair value of the interest rate swap of $185,000, which were offset by decreases in the long-term debt of $7,542,000, and the long-term portion of workers' compensation of $324,000.

- Deferred inflow of resources increased by $742,000. The increase is attributed to an increase in deferred revenue of $742,000.

- Net position decreased by $33,666,000, primarily due to loss from operations of $6,280,000, interest expense of $64,861,000, and the unrealized loss on the interest rate swap of $185,000, as well as an increase in the interfund to AHP of $1,982,000. The decrease is offset by property tax revenue of $29,868,000, investment income of $2,591,000 and other nonoperating-net of $7,183,000.

2013: Analysis of the Consolidated Statements of Net Position

- Current assets decreased by $39,090,000 in 2013, primarily due to decreases in the current portion of assets whose use is limited of $4,732,000, investments of $71,820,000, and prepaid and other expenses of $2,269,000. These were offset by increases in cash of $12,600,000, net patient accounts receivable of $18,064,000, other receivables of $1,789,000, estimated third-party settlements receivable of $3,212,000, the current portion of assets whose use is limited—G.O. Bonds of $1,488,000, and supplies/inventories of $2,578,000.

- Capital assets decreased by $12,700,000 primarily due to purchases related to major building projects of $41,568,000 which were offset by net disposals of $511,000 and depreciation and amortization expense of $53,718,000.

- Noncurrent assets decreased by $1,147,000 primarily due to a decrease in assets whose use is limited of $10,373,000, offset by an increase in other noncurrent assets of $9,226,000.

- Current liabilities decreased by $11,626,000 primarily due to a decrease in accounts payable of $15,609,000, estimated third-party settlements liability of $180,000 and other accrued liabilities of $885,000. These were offset by increases in accrued compensation and related liabilities of $3,994,000, the current portion of the G.O. Bonds of $576,000, the current portion of long-term debt of $406,000, and accrued interest payable of $72,000.

- Long-term liabilities decreased by $6,227,000, primarily as a result of the decrease in the fair value of the interest rate swap of $14,032,000 and long-term debt of $7,139,000. They were offset by an increase in G.O. Bonds of $14,939,000.

- Deferred inflow of Resources decreased by $131,000. The decrease is attributed to a decrease in deferred revenue of $131,000.

- Net position decreased by $34,953,000, primarily due to loss from operations of $22,298,000 and interest expense of $55,692,000, which is offset by property tax revenue of $28,713,000, the unrealized gain on the interest rate swap of $14,032,000, investment income of $1,571,000, and other nonoperating—net of $2,831,000. In addition, net position decreased by the interfund transfer to AHP for $4,110,000.

Consolidated Statements of Revenue, Expenses, and Changes in Net Position—All of PH's revenue, expenses, and changes in net position are included in the consolidated statements of revenue, expenses, and changes in net position. The consolidated financial statements measure the success of PH's operations during the years presented and are used to determine if PH has successfully recovered all of its costs through its fees and other sources of revenue. It also shows profitability and creditworthiness. Over time, increases or decreases in PH's net position are one indicator of PH's financial health.

CONDENSED CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEARS ENDED JUNE 30, 2014, 2013, AND 2012

($ in thousands)

	2014	2013 (As Restated, See Note 1)	2012 (As Restated, See Note 1)
OPERATING REVENUE:			
Net patient service revenue	$ 555,664	$ 545,689	$ 470,171
Net premium revenue	45,489	34,903	38,552
Other revenue	13,047	13,535	12,994
Total operating revenue	614,200	594,127	521,717
OPERATING EXPENSES	620,480	616,425	508,006
(LOSS) INCOME FROM OPERATIONS	(6,280)	(22,298)	13,711
NONOPERATING INCOME (EXPENSE):			
Investment income	2,591	1,571	2,014
Unrealized gain (loss) on interest rate swap	(185)	14,032	(20,912)
Interest expense	(64,861)	(55,692)	(3,051)
Property tax revenue—unrestricted	13,451	12,914	12,686
Property tax revenue—G.O. bonds	16,417	15,799	15,353
Other—net	7,183	2,831	2,458
Total nonoperating (expense) income—net	(25,404)	(8,545)	8,548
(DEFICIENCY) EXCESS OF REVENUE OVER EXPENSES	(31,684)	(30,843)	22,259
INTERFUND—AHP	(1,982)	(4,110)	(1,991)
(DECREASE) INCREASE IN NET POSITION	(33,666)	(34,953)	20,268
NET POSITION—Beginning of year, as previously reported	377,960	412,913	406,414
ADOPTION OF GASB STATEMENT NO. 65 (Note 1)			(13,769)
NET POSITION—End of year, as restated	$ 344,294	$ 377,960	$ 412,913
ADJUSTED DISCHARGES	46,726	43,334	40,213

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

- In accordance with accounting principles generally accepted in the United States of America (also known as GAAP or "generally accepted accounting principles") for governmental health care providers, PH's consolidated statements of revenue, expenses, and changes in net position reflect the following: (1) net patient service revenue includes the provision for bad debt and (2) nonoperating income (expenses) includes interest expense, which for nongovernmental hospitals is typically grouped as an operating expense. While these GASB requirements make district hospitals conform to other governmental entities, such as colleges and universities, they may be less comparable to nongovernment hospitals because the GASB requirements do not apply to them. This must be a consideration if trying to compare PH to nonprofit and for-profit hospitals. The provision for bad debts was $75,923,000 in the year ended June 30, 2014 and $97,492,000 in the year ended June 30, 2013, and interest expense was $64,861,000 in the year ended June 30, 2014 and $55,692,000 in the year ended June 30, 2013. The provision for bad debts was affected by a change in policy on October 1, 2013, when PH began to provide a 40% discount on all charges billed to self-pay patients. The discount is recorded as an adjustment to gross service revenues to arrive at net service revenues prior to the provision for bad debts. Adjusted discharges are one measure utilized as an aggregate indicator of hospital activity. The calculation of adjusted discharges applies factors representing outpatient activity and skilled nursing activity to acute inpatient discharges.

- Operating revenue is primarily generated through the treatment of patients (providing inpatient and outpatient, ancillary, and other patient care service) as well as other affiliated revenue. Operating revenue increased by $20,073,000 in the year ended June 30, 2014, due to increases in net patient service revenue of $9,975,000, an increase in net premium revenue of $10,586,000, and a decrease in other revenue of $488,000. Increases in inpatient and outpatient ancillary revenue and negotiated increases in contracted payer rates resulted in an increase in net charges during the year.

- Operating expenses are those expenses related to the treatment of patients, including overhead and administration expenses. Operating expenses increased by $4,055,000 in the year ended 2014, primarily due to increases in purchased services of $10,899,000, supplies of $3,308,000 and depreciation and amortization expense of $2,993,000.

- Loss from Operations in the year ended 2014 is $6,280,000 as a result of operating expenses in excess of revenues.

- Nonoperating expense—net is $25,404,000 and $8,545,000 in the years ended June 30, 2014 and 2013, respectively. The increase in nonoperating expense is primarily due to the $14,217,000 decrease in the unrealized gain (loss) on interest rate swap and the $9,169,000 increase in interest expense. Nonoperating income includes PH's share of unrestricted property tax revenues of $13,451,000, collected by the County of San Diego, and restricted property tax revenue for repayment of G.O. Bonds of $16,417,000.

- As a result of the factors noted above, net position decreased by $33,666,000 for the year ended June 30, 2014.

2013: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Position

- In accordance with GAAP for governmental health care providers, PH's consolidated statements of revenue, expenses, and changes in net Position reflect the following: (1) net patient service revenue includes the provision for bad debts and (2) nonoperating income (expense) includes interest expense, which for nongovernmental hospitals is typically grouped as an operating expense. While these GASB requirements make district hospitals conform to other governmental entities, such as colleges and universities, they may be less comparable to nongovernment hospitals because the GASB requirements do not apply to them. This must be a consideration if trying to compare PH to nonprofit and for-profit hospitals. The provision for bad debts was $97,492,000 in the year ended June 30, 2013 and $73,101,000 in the year ended June 30, 2012, and interest expense was $55,692,000 in the year ended June 30, 2013 and $3,051,000 in the year ended June 30, 2012. Beginning with the licensure and opening of Palomar Medical Center in August 2012, capitalization of interest was discontinued and commenced being expensed to nonoperating income (expense) and included in the consolidated statements of revenue, expenses, and changes in net position. Adjusted discharges are one measure utilized as an aggregate indicator of hospital activity. The calculation of adjusted discharges applies factors representing outpatient activity and skilled nursing activity to acute inpatient discharges.

- Operating revenue is primarily generated through the treatment of patients (providing inpatient and outpatient, ancillary, and other patient care service) as well as other affiliated revenue. Operating revenue increased by $72,410,000 in in the year ended June 30, 2013, due to increases in net patient service revenue of $75,518,000, an increase in other revenue of $541,000, and a decrease in net premium revenue of $3,649,000. Increases in inpatient and outpatient ancillary revenue and negotiated increases in contracted payer rates resulted in an increase in net charges during the year.

- Operating expenses are those expenses related to the treatment of patients, including overhead and administration expenses. Operating expenses increased by $108,419,000 in the year ended 2013, primarily due to increases in salaries, wages, and benefits of $52,590,000, depreciation and amortization expense of $32,395,000, supplies of $7,451,000 and other expenses of $15,983,000. Effective August 19, 2012, Palomar Health opened PMC. In conjunction with stocking, staffing, readiness, licensure and post-opening stabilization, PH incurred significant one-time expenses in excess of planned amount by $12,400,000.

- The increase in depreciation and amortization expense of $32,395,000 is attributed to the opening of PMC in August 2012. The depreciable value of the new assets, excluding land cost of $34,853,000, is $1,071,209,000 with a useful life of five to forty years.

- The increase in supplies of $7,451,000 is attributed to acute hospital facility expansion from two acute care facilities to three; which included service growth and new service start-up. Examples of expanded services and new services include: Robotic Surgery and Electrophysiological Lab Services. Additional growth in services includes the Surgical and IR/Cath Lab suites as well as an additional Emergency Department over the prior year. The physical plant expansion required additional supply utilization for janitorial, facilities management, office supply, food, and other supply needs for the third campus. Supplies were necessary and utilized in the third campus for patient ancillary services support areas (Laboratory, Radiology, Pharmacy, Respiratory, Rehabilitation, and Other as reflected on the consolidated statements of net position as an increase in inventory).

- The increase in purchased services of $7,941,000 and professional fees $4,685,000 is due to new contracts effective August 2012 when PMC opened. These contracts are for Labor and Delivery and ExpressCare Plus (subsequently changed to Stand by ER) at PHDC and Emergency and Trauma at PMC.

- Loss from Operations in the year ended 2013 was $22,298,000. This operating loss is a result of operating expenses in excess of revenues.

- Nonoperating income (expense) consists of interest earned on invested monies, interest expense, unrealized gain in interest rate swap for $14,032,000, PH’s share of unrestricted property tax revenues of $12,914,000 collected by the County of San Diego, and restricted property tax revenue for repayment of

G.O. Bonds of $15,799,000. Nonoperating expense—net was $8,545,000 in the year ended June 30, 2013 and nonoperating income—net was $8,548,000 in the year ended June 30, 2012. The decrease in nonoperating income is primarily due to the $52,641,000 increase in interest expense.

- As a result of the factors noted above, net position decreased by $34,953,000 in the year ended June 30, 2013.

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

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2014, 2013, AND 2012

($ in thousands)

	2014	2013 (As Restated, See Note 1)	2012 (As Restated, See Note 1)
CASH FLOWS FROM:			
Operating activities	$ 54,534	$ 14,249	$ (27,322)
Noncapital financing activities	18,094	12,185	13,153
Capital and related financing activities	(43,893)	(91,811)	(190,119)
Investing activities	(1,193)	77,977	198,759
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	27,542	12,600	(5,529)
CASH AND CASH EQUIVALENTS—Beginning of year	19,032	6,432	11,961
CASH AND CASH EQUIVALENTS—End of year	$ 46,574	$ 19,032	$ 6,432

2014: Analysis of the Consolidated Statement of Cash Flows

- Operating activities cash inflow reflected an increase of $40,285,000 in the year ended June 30, 2014 over the year ended June 30, 2013. This increase is mostly attributable to increases in cash collections of patient accounts of $51,476,000 and decreases in payments to employees of $11,706,000 offset by increased payments to suppliers for $26,392,000.

- Net cash outflows from capital and related financing activities in 2014 were $43,893,000, primarily due to interest payments of $45,543,000, and the payment of long-term debt of $18,399,000 offset by the receipt of $16,417,000 of property taxes for debt service.

- Investing activities net cash outflows were $1,193,000 in 2014. This is primarily due to cash outflows from purchases of investments of $145,199,000 and increase in loans receivable of $20,660,000, offset by cash inflow on proceeds from sale of investments of $162,358,000.

- The ending cash and cash equivalents of $46,574,000 reflect the checking account and overnight investment balances held by PH. In addition, there were current investments of $93,903,000 at June 30, 2014.

2013: Analysis of the Consolidated Statement of Cash Flows

- Operating activities cash inflow reflected an increase of $41,571,000 in the year ended June 30, 2013 over the year ended June 30, 2012. This increase is mostly attributable to increases in cash collections of patient accounts of $76,381,000 offset by increased payments to suppliers and employees of $33,967,000.

- Net cash outflows from capital and related financing activities in 2013 were $91,811,000, primarily due to acquisition of capital assets of $53,390,000, interest payments of $44,565,000, and the payment of long-term debt of $9,655,000 offset by the receipt of $15,799,000 of property taxes for debt service.

- Investing activities cash inflows were $77,977,000 in 2013. This is primarily due to cash outflows from purchases of investments of $238,690,000 and increase in loans receivable of $9,669,000, offset by cash inflow on proceeds from sale of investments of $320,777,000.

- The ending cash and cash equivalents of $19,032,000 reflect the checking account and overnight investment balances held by PH. In addition, there were current investments of $99,631,000 at June 30, 2013.

2014: Capital Assets and Long-Term Debt

The Board of Directors approved a facilities master plan (the “Facilities Master Plan”) budgeted at $1,057,000,000. In November 2004, the residents of the district voted and approved to fund $496,000,000 of this expansion by the issuance of G.O. Bonds. Payment for these bonds is funded by an ad valorem property tax levied on the district residents. The approximate amount of the tax levy for each taxable property remained at $23.50 per $100,000 of assessed value in the year ended June 30, 2014. The levy is established by the Board of Director’s resolution each year in an amount sufficient to service the debt for the upcoming year along with a reserve amount.

One of the major components of the Facilities Master Plan included the construction of the new Palomar Medical Center Campus (named Palomar Medical Center (“PMC”)) in Escondido. On August 19, 2012, PH opened the 288-bed facility. It includes critical and general inpatient care, surgical and interventional services, and emergency and trauma services.

Other building projects include the renovation of existing hospital facilities at Pomerado Hospital; renovation of PHDC, and construction of ambulatory and outpatient facilities at various locations in the District.

PH has three outstanding revenue bond issues that are classified as long-term debt. These are the 2006 Insured Certificates of Participation, the 2009 Certificates of Participation, and the 2010 Certificates of Participation. There were no principal payments due on these issues, bringing the net long-term bond principal to $568,708,000 at June 30, 2014. All debt payments have been made timely. During Fiscal Year 2014, the 1999 Insured Revenue Bonds were redeemed. More detailed information about PH’s debt and bond redemption is presented in Note 8 to the consolidated financial statements. PH has an underlying Moody’s Investor Service (“Moody’s) rating of Ba1 on its certificates of participation.

In July 2005, PH issued its first series of G.O. Bonds authorized by voter approval in 2004 (measure BB) in the amount of $80,000,000 for use in funding the building expansion project. In December 2007, PH issued its second series of G.O. Bonds totaling $241,083,000. In March 2009, PH issued its third series of G.O.

Bonds in the amount of $110,000,000. In November 2010, PH issued the final series of G.O. Bonds in the amount of $64,917,000. A principal payment of $2,808,000 reduced the G.O. Bonds' principal to $474,824,000 as of June 30, 2014. PH has an underlying Moody's rating of A2 on its G.O. Bonds.

2013: Capital Assets and Long-Term Debt

- The Board of Directors approved a facilities master plan (the "Facilities Master Plan") budgeted at $1,057,000,000. In November 2004, the residents of the district voted and approved to fund $496,000,000 of this expansion by the issuance of G.O. Bonds. Payment for these bonds is funded by an ad valorem property tax levied on the district residents. The approximate amount of the tax levy for each taxable property remained at $23.50 per $100,000 of assessed value for in the year ended June 30, 2013. The levy is established by Board of Director's resolution each year in an amount sufficient to service the debt for the upcoming year along with a reserve amount.

- One of the major components of the Facilities Master Plan included the construction of the new Palomar Medical Center Campus (named Palomar Medical Center ("PMC")) in Escondido. On August 19, 2012, PH opened the 288-bed facility. It includes critical and general inpatient care, surgical and interventional services, and emergency and trauma services.

- Other building projects include the renovation of existing hospital facilities at Pomerado Hospital; renovation of PHDC, and construction of ambulatory and support facilities at various locations in the District.

- The renovations at Pomerado Hospital, which commenced in 2008, include the construction of a new central power plant (the "Central Plant") and various site improvements. The Central Plant was placed in service in the year ended June 30, 2010.

- Outpatient facilities expansion plans include the Ramona Satellite Clinic which opened in March 2013 with AHP as the primary tenant. The new clinic offers outpatient services and after-hours urgent care.

- PH has four outstanding revenue bond issues that are classified as long-term debt. These are the 1999 Insured Revenue Bonds, the 2006 Insured Certificates of Participation, the 2009 Certificates of Participation, and the 2010 Certificates of Participation. PH made principal payments on these issues totaling $7,080,000, bringing the net long-term bond principal to $584,015,000 at June 30, 2013. All debt payments were made timely. More detailed information about PH's debt is presented in Note 8 to the consolidated financial statements. PH has an underlying Moody's Investor Service ("Moody's) rating of Baa3 on its revenue bonds and certificates of participation.

- In July 2005, PH issued its first series of G.O. Bonds authorized by voter approval in 2004 (measure BB) in the amount of $80,000,000 for use in funding the building expansion project. In December 2007, PH issued its second series of G.O. Bonds in the amount of $241,083,000. In March 2009, PH issued its third series of G.O. Bonds in the amount of $110,000,000. In November 2010, PH issued the final series of G.O. Bonds in the amount of $64,917,000. A principal payment of $2,232,000 reduced the G.O. Bonds' principal to $477,632,000 as of June 30, 2013. PH has an underlying Moody's rating of A1 on its G.O. Bonds.

Liquidity and Capital Resources

PH's unrestricted liquidity position as of June 30, 2014, was $140,477,000, including $46,574,000 in operating cash and $93,903,000 in unrestricted investments stated at fair market value. PH's unrestricted liquidity position as of June 30, 2013, was $118,663,000, including $19,032,000 in operating cash and

$99,631,000 in unrestricted investments stated at fair market value. The available liquidity of $140,477,000 at June 30, 2014, represents a $21,814,000 increase over the $118,663,000 in available liquidity as of June 30, 2013, and equaled 24.7% of total outstanding debt exclusive of the G.O. Bonds, payments on which are funded separately from ad valorem taxes, as of June 30, 2014.

Economic and Other Factors

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

Patient Projection and Affordable Care Act H.R. 3590 (the "Act")—This Act, also known as Federal Healthcare Reform, signed into law in March 2010 is focused on reducing Medicare costs and will result in extensive changes to the U.S. health care system. Hospitals face lower Medicare reimbursement related to bundled payments programs and readmissions and continued recovery audit (RAC) contractor reviews. PH continues to explore the establishment of an Accountable Care Organization (ACO) and strategic development of network relationships to establish viable delivery options that will provide provider reimbursement to quality metrics and reductions in cost.

Sequestration Transparency Act—The sequester cuts mandated by the Budget Control Act of 2011 went into effect April 1, 2013, putting into place a 2% cut in Medicare spending. The resulting impact of these cuts threatens to weaken an already compromised payment system with total effect to revenues and jobs yet to be determined.

California's Health Insurance Exchange (Covered California)—On October 1, 2013, the state of California implemented the American Health Benefit Exchange provisions of the Act. More than 1.3 million Californians have enrolled in private plans and nearly 2 million have been added to Medi-Cal, the state's Medicaid program. While the impact to Palomar Health is under evaluation, PH anticipates increased demand for emergency and urgent care services and primary and specialty care.

Hospital Provider Fee—Assembly Bill ("AB") 1653 was passed by the California Legislature on August 31, 2010, and outlined the changes necessary to deliver the supplemental Medi-Cal payments to hospitals. As a District Hospital, PH is not eligible to participate in the provider fee program, but rather is allowed to participate in non-designated public hospital intergovernmental transfer programs (NDPH-IGTs). PH participated in a federal match NDPH-IGT model program and received $2.4 million fee-for-service payment for program year 2012-2013. PH also participated in the NDPH-IGT program year 2013-2014 and received an additional net $5,200,000.

Medi-Cal Provider Rate Cuts—In June 2014, the State of California passed the 2014-2015 budget to include the retroactive reduction in rates paid to hospital-based Distinct Part Skilled Nursing Facilities (DPSNF). Palomar Health has calculated a $5,200,000 potential liability for Villa Pomerado should this clawback withstand efforts to be repealed. An application for exemption is underway for Palomar Continuing Care Center as it was closed in August 2013.

Health Information Technology for Economic and Clinical Health Act (*HITECH*)—HITECH is part of the ARRA, which contains incentives related to health care information technology in general (e.g., creation of a national health care infrastructure) and contains specific incentives designed to accelerate the adoption of electronic health record (EHR) systems among providers. PH received EHR incentive funds in the amount of $1,031,000 from Medi-Cal in FY14 for meeting the Year 1 Stage 1 meaningful use criteria. PH has attested for Medicare's Year 2 Stage 1 and anticipates receiving $2,500,000 in FY15 for meeting this criteria.

Quality of Care—On October 1, 2015 the U.S. healthcare industry will transition to ICD-10 (International Statistical Classification of Diseases) to accurately evaluate the outcome of new procedures and emerging health care conditions using a more precise code. Anticipated benefits include claims accurately reflecting current technology and medical treatments by utilizing the more expansive coding system.

Seismic Compliance—California Senate Bill ("SB") 1953 requires hospitals to meet more stringent seismic guidelines. PH's noncompliant buildings have been reassessed using HAZUS criteria and have a structural performance category of SPC-2, which have until 2030 to comply with the structural seismic safety standards further extending the economical and functional use of the majority of the acute inpatient beds at PHDC. Some PHDC buildings, Pomerado Hospital, and PMC have no seismic restriction.

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

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Palomar Health:

We have audited the accompanying consolidated financial statements of Palomar Health (PH), which comprise the consolidated statements of net position as of June 30, 2014 and 2013, and the related consolidated statements of revenue, expenses, and changes in net position and of cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PH as of June 30, 2014 and 2013, 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.

Emphasis of Matters

As discussed in Note 1 to the consolidated financial statements, the accompanying 2013 consolidated financial statements have been restated as a result of a change in reporting entity. Our opinion is not modified with respect to this matter.

As discussed in Note 1 to the consolidated financial statements, in the year ended June 30, 2014, PH adopted new accounting guidance, Governmental Accounting Standards Board Statement No. 65, *Items Previously Reported as Assets and Liabilities*. Our opinion is not modified with respect to this matter.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 1 through 12 be presented to supplement the basic consolidated financial statements. Such information, although not a part of the basic consolidated financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic consolidated financial statements in an appropriate operational, economic, or 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 consolidated financial statements, and other knowledge we obtained during our audit of the basic consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Deloitte + Touche LLP

November 14, 2014

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF NET POSITION
AS OF JUNE 30, 2014 AND 2013
(Dollars in thousands)

	2014	2013 (As Restated, See Note 1)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 46,574	$ 19,032
Investments	93,903	99,631
Patient accounts receivable—net of allowances for uncollectible accounts of $48,001 in 2014 and $60,878 in 2013	118,261	118,085
Other receivables	7,859	7,611
Supplies/inventories	9,215	9,775
Prepaid expenses and other	2,924	3,130
Estimated third-party payor settlements receivable	8,170	10,413
Assets whose use is limited—current portion	1,857	5,245
Assets whose use is limited—general obligation bonds—current portion	19,482	18,105
Total current assets	308,245	291,027
ASSETS WHOSE USE IS LIMITED:		
Held by trustee under indenture agreements	44,598	54,803
Held by trustee under general obligation bonds indenture	19,482	18,105
Held in escrow for street improvements	11,485	13,167
Restricted by donor and other	1,843	329
Total assets whose use is limited	77,408	86,404
Less current portion	21,339	23,350
Total assets whose use is limited—long-term portion	56,069	63,054
CAPITAL ASSETS—Net	1,203,540	1,260,581
OTHER ASSETS:		
Prepaid debt insurance costs	8,759	9,380
Investment in and amounts due from affiliated entities	3,787	3,159
Other	34,745	15,825
Total other assets	47,291	28,364
TOTAL	$ 1,615,145	$ 1,643,026

(Continued)

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF NET POSITION
AS OF JUNE 30, 2014 AND 2013
(Dollars in thousands)

LIABILITIES AND NET POSITION	2014	2013 (As Restated, See Note 1)
CURRENT LIABILITIES:		
Accounts payable	$ 26,501	$ 26,246
Accrued compensation and related liabilities	36,401	36,111
Current portion of general obligation bonds	3,382	2,808
Current portion of long-term debt	364	7,829
Estimated third-party payor settlements liability	10,740	8,694
Other accrued liabilities	16,852	15,328
Accrued interest payable	9,642	9,594
Total current liabilities	103,882	106,610
WORKERS' COMPENSATION—Net of current portion	744	1,068
LONG-TERM DEBT—General obligation bonds—net of current portion	570,217	554,765
LONG-TERM DEBT—Net of current portion	561,091	568,633
FAIR VALUE OF INTEREST RATE SWAP	26,528	26,343
Total liabilities	1,262,462	1,257,419
DEFERRED INFLOW OF RESOURCES—Deferred revenue	8,389	7,647
Total liabilities and deferred inflow of resources	1,270,851	1,265,066
COMMITMENTS AND CONTINGENCIES (Note 15)		
NET POSITION:		
Net investment in capital assets	120,027	184,340
Restricted for repayment of debt	10,192	13,753
Restricted for capital acquisitions	11,485	13,167
Restricted for other purposes	1,844	329
Unrestricted	200,746	166,371
Total net position	344,294	377,960
TOTAL	$ 1,615,145	$ 1,643,026

See notes to consolidated financial statements. (Concluded)

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET POSITION FOR THE YEARS ENDED JUNE 30, 2014 AND 2013 (Dollars in thousands)

	2014	2013 (As Restated, See Note 1)
OPERATING REVENUE:		
Net patient service revenue	$ 555,664	$ 545,689
Net premium revenue	45,489	34,903
Other revenue	13,047	13,535
Total operating revenue	614,200	594,127
OPERATING EXPENSES:		
Salaries, wages, and benefits	347,111	362,850
Professional fees	33,355	32,066
Supplies	87,009	83,701
Purchased services	62,312	51,413
Depreciation and amortization	56,711	53,718
Rent expense	10,323	8,987
Utilities	8,672	8,248
Other	14,987	15,442
Total operating expenses	620,480	616,425
LOSS FROM OPERATIONS	(6,280)	(22,298)
NONOPERATING INCOME (EXPENSES):		
Investment income	2,591	1,571
Unrealized (loss) gain on interest rate swap	(185)	14,032
Interest expense	(64,861)	(55,692)
Property tax revenue	13,451	12,914
Property tax revenue—general obligation bonds	16,417	15,799
Other—net	7,183	2,831
Total nonoperating expenses—net	(25,404)	(8,545)
DEFICIENCY OF REVENUE OVER EXPENSES	(31,684)	(30,843)
INTERFUND—AHP	(1,982)	(4,110)
DECREASE IN NET POSITION	(33,666)	(34,953)
NET POSITION—Beginning of year, as previously reported	377,960	425,957
ADOPTION OF GASB STATEMENT NO. 65 (Note 1)		(13,044)
NET POSITION—End of year, as restated	$ 344,294	$ 377,960

See notes to consolidated financial statements.

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2014 AND 2013
(Dollars in thousands)

	2014	2013 (As Restated, See Note 1)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from:		
Patients, insurers, and other third-party payors	$ 635,722	$ 584,246
Other sources	14,411	10,916
Payments to:		
Employees	(347,145)	(358,851)
Suppliers	(248,454)	(222,062)
Net cash provided by operating activities	54,534	14,249
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Receipt of district taxes	13,451	12,914
Other	4,643	(729)
Net cash provided by noncapital financing activities	18,094	12,185
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(9,189)	(53,390)
Interest paid	(45,543)	(44,565)
Repayment of long-term debt	(18,399)	(9,655)
Recovery of owner controlled insurance program (OCIP) premiums	6,000	
Proceeds on sale of fixed assets	6,821	
Receipt of property taxes restricted for debt service on general obligation bonds	16,417	15,799
Net cash used in capital and related financing activities	(43,893)	(91,811)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(145,199)	(238,690)
Sale of investments	162,358	320,777
Interest received on investments and notes receivable	1,659	4,921
Receipt of payments on loans receivable	2,150	638
Increase in loans receivable	(20,660)	(9,669)
Other	(1,501)	
Net cash (used in) provided by investing activities	(1,193)	77,977
NET INCREASE IN CASH AND CASH EQUIVALENTS	27,542	12,600
CASH AND CASH EQUIVALENTS—Beginning of year	19,032	6,432
CASH AND CASH EQUIVALENTS—End of year	$ 46,574	$ 19,032

(Continued)

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2014 AND 2013
(Dollars in thousands)

	2014	2013 (As Restated, See Note 1)
RECONCILIATION OF OPERATING LOSS TO NET CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:		
Loss from operations	$ (6,280)	$ (22,298)
Adjustments to reconcile income from operations to net cash used in by operating activities:		
Depreciation and amortization	56,711	53,718
Provision for bad debts	75,923	97,492
Gain on disposal of fixed assets	(4,313)	
Equity in earnings of affiliates	(628)	(95)
Changes in assets and liabilities:		
Patient accounts receivable	(76,099)	(115,556)
Other receivables	1,752	(1,789)
Supplies/inventories	560	(2,578)
Prepaid expenses and other	206	2,269
Estimated third-party payor settlements receivable	2,243	(3,212)
Other—net	240	(735)
Accounts payable	(59)	4,230
Accrued compensation and related liabilities	(34)	3,999
Other accrued liabilities	1,524	(885)
Estimated third-party payor settlements liability	2,046	(180)
Deferred revenue	742	(131)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 54,534	$ 14,249
NONCASH INVESTING AND CAPITAL AND FINANCING ACTIVITIES—Capital expenditures included in accounts payable	$ 1,461	$ 1,147

See notes to consolidated financial statements. (Concluded)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

- Palomar Medical Center, located in West Escondido, California (opened August 19, 2012) includes a 288-bed general acute care hospital including tertiary services, trauma services, and cardiovascular surgery
- Pomerado Hospital, located in Poway, California, includes a 107-bed general acute care hospital, and Villa Pomerado, a distinct part skilled nursing facility and sub-acute facility
- Palomar Health Downtown Campus, (PHDC), formerly known as Palomar Medical Center, is located in East Escondido, California, includes women's services, Center for Behavioral Health, and Rehabilitation Institute.
- Home Health, located in Escondido, California
- San Marcos Ambulatory Care Center, located in San Marcos, California
- San Marcos Behavioral Medicine Center, located in San Marcos, California
- Central Office, providing management, financial, data processing, materials management, and public affairs services to the other divisions
- Palomar Health Development, a charitable nonprofit organization created to provide assistance and support for PH by obtaining grant funding from federal, state, local, and private sources
- Palomar Health expressCare clinics, located in Albertson Grocery stores in Escondido, Rancho Penasquitos, Temecula and San Elijo Hills, California

On October 1, 2013, Palomar Continuing Care Center (PCCC), a 96-bed skilled nursing facility terminated its operations and the facility was sold in June 2014 with net gain on sale of $4,900,000 which is included in other—net nonoperating income in the accompanying 2014 consolidated statement of revenue, expenses, and changes in net position.

Change in Reporting Unit—In April 2010, PH aligned with Arch Health Partners, Inc. (AHP), a 1206(l) medical foundation that provides primary and specialty medical care services. AHP is comprised of 80 physicians and surgeons providing primary and specialty care medical services as well as ten physician extender providers, which added another component in health care delivery to residents within PH's community. In September 2011, PH entered into an agreement with AHP under which PH guaranteed to assist AHP in meeting the minimum financial responsibility and regulation requirements of the California Department of Managed Healthcare (CDMHC). For financial reporting purposes, PH's guaranty required the inclusion of AHP as a blended component unit of PH as a result of the fiscal dependency of AHP on PH. During fiscal year 2014, PH terminated the guaranty agreement when AHP's managed care risk contracts were transferred to an unrelated organization, which eliminated the need for the guarantee with CDMHC. These circumstances result in a change in reporting entity in accordance with GASB Codification Section 2250, *Reporting a Change in the Entity*. Accordingly, this change in reporting entity has been applied retrospectively in the accompanying consolidated financial statements to discontinue the presentation of AHP as a component unit of PH for all periods presented. The effect of the change as of July 1, 2012, was a reduction of PH's consolidated net position by $24,000.

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

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

Accounting Standards—Pursuant to GASB Codification Section P80, *Proprietary Fund Accounting and Financial Reporting*, PH follows applicable pronouncements of the GASB. PH also applies the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), Accounting Principles Board, and the AICPA Committee on Accounting Procedure issued on or before November 30, 1989, that have been incorporated into GASB's authoritative literature, and the provisions of all relevant FASB pronouncements issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

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

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

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

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

PH has entered into an agreement with the City of Escondido (the "City") to financially participate in street improvements near the site of PH's new Palomar Medical Center. Under the agreement, PH was required to deposit $13,000,000 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 $11,485,000 and $13,167,000 as of June 30, 2014 and 2013, respectively, is included in assets whose use is limited in the accompanying consolidated statements of net position.

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

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

Interest cost incurred on borrowed funds during the period of construction of capital assets, net of interest earned of $117,000 and $153,000 for the years ended June 30, 2014 and 2013, respectively, is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized was $117,000 and $8,017,000 for the years ended June 30, 2014 and 2013, respectively.

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

Capital assets are reviewed for impairment when events or changes in circumstances suggest that the service utility of the capital asset may have significantly and unexpectedly declined. Capital assets are considered impaired if both the decline in service utility of the capital asset is large in magnitude and the event or change in circumstance is outside the normal life cycle of the capital asset. Such events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment or approval of laws or regulations or other changes in environmental factors; technological changes or evidence of obsolescence; changes in the manner or duration of use of a capital asset; and construction stoppage. The determination of the impairment loss is dependent upon the event or circumstance in which the impairment occurred. Impairment losses are recorded in the consolidated statements of revenue, expenses, and changes in net position. In the years ended June 30, 2014 and 2013, no impairment charges were recorded.

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

Interest Rate Swaps—PH has entered into variable-to-fixed interest rate swaps, which are reflected at fair value in the consolidated statements of net position. The fair value of the interest rate swaps will fluctuate based generally on changes in market rates of interest. Any unrealized gains or losses resulting from changes in fair value are reported as nonoperating income (expenses) in the consolidated statements of revenue, expenses, and changes in net position. Interest cost on variable interest rate debt is reported based on the fixed interest rate paid by PH under the interest rate swaps. As of June 30, 2014 and 2013, the interest rate swaps are recorded as a liability of $26,528,000 and $26,343,000, 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 8. Net position restricted for capital acquisitions relates to amounts restricted to acquire capital assets. Net position restricted for other purposes relates to noncapital net position that must be used for a particular purpose, as specified by contributors or others external to PH. Unrestricted net position represents the remaining net position that does not meet the definition of net investment in capital assets or restricted.

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

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

Net Premium Revenue—PH has agreements with various third-party payors to provide medical services to subscribing participants. Under some of these agreements, PH receives monthly capitation payments based on the number of each payor's participants, regardless of services actually performed by PH. Under these agreements, PH also participates in shared risk pools with medical groups, through which it could receive additional reimbursement or pay additional amounts to the medical groups. In conjunction with the shared risk pools, PH estimates incurred but not reported (IBNR) claims for medical services provided to patients. IBNR of $7,962,000 and $5,862,000 are included in other accrued liabilities in the accompanying consolidated statements of net position as of June 30, 2014 and 2013, respectively.

Charity Care—PH provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are not reported as revenue in the accompanying consolidated financial statements. Charity care charges forgone, at established rates, for the years ended June 30, 2014 and 2013, were $11,291,000 and $14,696,000, respectively. PH's cost of providing charity care for years ended June 30, 2014 and 2013, were $2,852,000 and $3,320,000, respectively. The cost of providing charity care is calculated using the cost-to-charge ratio.

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 set annually by the Board of Directors. Property tax revenue for the years ended June 30, 2014 and 2013, consists of the following:

	2014	2013
To support operations—unrestricted use	$ 13,451,000	$ 12,914,000
For debt service on general obligation bonds—restricted use	16,417,000	15,799,000
Total	$ 29,868,000	$ 28,713,000

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

Recent Accounting Pronouncements—In June 2012, the GASB issued GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities.* This statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities. It also requires that, for current refundings and advance refundings resulting in defeasance of debt, the difference between the reacquisition price and the net carrying amount of the old debt be presented as a deferred inflow or deferred outflow of resources and recognized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. GASB Statement No. 65 also requires debt issuance costs (except prepaid insurance costs) to be recognized as an expense in the period incurred. Previously, these costs were amortized over the life of the related debt issuance. Prepaid insurance costs are required to be reported as an asset and recognized as an expense in a systematic and rational manner over the duration of the related debt. In fiscal year 2014, the District adopted the provisions of GASB Statement No. 65 and restated its fiscal year 2013 consolidated financial statements in accordance with the statement's transition requirements. Upon adoption of GASB Statement No. 65, PH recorded the $13,044,000 cumulative effect of the adoption as a restatement of beginning net position in the 2013 statement of revenues, expenses and changes in net position.

In March 2012, the GASB issued GASB Statement No. 66, *Technical Corrections—2012—an amendment of GASB Statements No. 10 and No. 62*. The objective of this statement is to improve accounting and financial reporting for a governmental financial reporting entity by resolving conflicting guidance that resulted from the issuance of two pronouncements, Statements No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions,* and No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The provisions of this statement are effective for financial statements for years beginning after December 15, 2012. The adoption of this statement did not have a material impact on PH's consolidated financial statements.

In June 2012, the GASB issued GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*. The primary objective of this statement is to improve accounting and financial reporting by state and local governments for pensions. It also improves information provided by state and local governmental employers about financial support for pensions that is provided by other entities. This Statement establishes standards for measuring and recognizing liabilities, deferred outflows and inflows of resources, and expenses. For defined benefit pensions, this statement identifies the methods and assumptions that should be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. Note disclosure and required supplementary information requirements about pensions also are addressed. The provisions of this statement are effective for financial statements for years beginning after June 15, 2014. Management has not determined the effect of GASB Statement No. 68 on the consolidated financial statements.

In January 2013, the GASB issued GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*. This Statement establishes accounting and financial reporting standards related to government combinations and disposals of government operations. As used in this Statement, the term *government combinations* includes a variety of transactions referred to as mergers, acquisitions, and transfers of operations. The requirements of this Statement are effective for government combinations and disposals of government operations occurring in financial reporting years beginning after December 15, 2013, and should be applied on a prospective basis. Management does not believe that the adoption of this statement will have a material impact on PH's consolidated financial statements.

In April 2013, the GASB issued GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*. This Statement requires a government that extends a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not that the government will be required to make a payment on the guarantee. The provisions of this Statement are effective for reporting years beginning after June 15, 2013. The adoption of this statement did not have a material impact on PH's consolidated financial statements.

2. NET PATIENT SERVICE REVENUE

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

Revenue from the Medicare and Medi-Cal programs, inclusive of risk (capitated) and non-risk managed care programs, accounted for approximately 52% and 53% of PH's net patient service revenue for the years ended June 30, 2014 and 2013, respectively.

Third-party settlements are recorded when received, which includes tentative settlements and lump-sum adjustments and final settlements for current and prior cost reporting years. The cost reports for the Medicare program have been settled through the year ended June 30, 2010, and the cost reports for Medi-Cal programs have been settled through the year ended June 30, 2012. Results of cost report settlements, as well as estimates for settlements of all years through 2014, have been reflected in the accompanying consolidated financial statements.

As of June 30, 2014 and 2013, estimated third-party settlements resulted in a receivable of $8,170,000 and $10,413,000, respectively, and a liability of $10,740,000 and $8,694,000, respectively. During the years ended June 30, 2014 and 2013, PH settled various prior-year cost reports and appeal issues. These settlements resulted in approximately $22,344,000 and $13,373,000 of additional revenues for the years ended June 30, 2014 and 2013, respectively, which are included in net patient service revenue in the accompanying consolidated statements of revenue, expenses, and changes in net position.

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

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

3. CASH AND CASH EQUIVALENTS AND INVESTMENTS

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

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

The California State Treasury makes available the Local Agency Investment Fund (LAIF) through which local governments may pool investments. Each governmental entity may invest up to $50,000,000 of unrestricted monies in the fund and an unlimited amount of qualified bond proceeds. PH had invested $42,932,000 and $29,331,000 of unrestricted funds in this fund as of June 30, 2014 and 2013, respectively. PH had invested $10,147,000 and $10,122,000 in jointly managed funds under an escrow agreement with the City of Escondido as of June 30, 2014 and 2013, respectively. Investments in the LAIF are highly liquid, as deposits can be converted to cash within 24 hours without loss of interest. PH is a voluntary participant in the LAIF. The fair value of PH's investments in the LAIF is reported in the accompanying consolidated statements of net position based on PH's pro rata share of the fair value provided by LAIF for the entire LAIF portfolio.

As of June 30, 2014 and 2013, PH had the following investments:

	2014	2013
Investments—current	$ 93,903,000	$ 99,631,000
Assets whose use is limited—current	21,339,000	23,350,000
Assets whose use is limited—long-term	56,069,000	63,054,000
Total	$ 171,311,000	$ 186,035,000

As of June 30, 2014 and 2013, PH had investments by type and maturity as follows:

	2014		
		Investment Maturities (in Years)	
Investment Type	**Fair Value**	**Less than 1**	**1–5**
LAIF	$ 53,079,000	$ 53,079,000	$ -
U.S. government bonds	22,009,000		22,009,000
U.S. Treasury bills	13,242,000	2,477,000	10,765,000
Corporate bonds	14,642,000		14,642,000
Money market mutual funds	66,838,000	66,838,000	
Other	1,501,000	1,501,000	
Total	$ 171,311,000	$ 123,895,000	$ 47,416,000

	2013		
		Investment Maturities (in Years)	
Investment Type	**Fair Value**	**Less than 1**	**1–5**
LAIF	$ 39,453,000	$ 39,453,000	$ -
U.S. government bonds	31,567,000	1,545,000	30,022,000
U.S. Treasury bills	17,733,000	2,379,000	15,354,000
Corporate bonds	19,634,000	2,786,000	16,848,000
Money market mutual funds	77,648,000	77,648,000	
Total	$ 186,035,000	$ 123,811,000	$ 62,224,000

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

Interest Rate Risk—Interest rate risk is the risk that the value of fixed income securities will decline due to increasing interest rates. The terms of a debt investment may cause its fair value to be highly sensitive to interest rate changes. As a means of limiting exposure to fair value losses arising from increasing interest rates, PH's investment policy, as per statutory requirements, limits the term of any investment and equity 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, 2014 and 2013, 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 Investor s Service (Moody's), U.S. Government Agency investments rated "AAA" by Moody's and "AA+" by S&P, and PH's investments in the LAIF, which were not rated.

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

Investments in any one issuer (other than U.S. Treasury securities and external investment pools) that represent 5% or more of the total investments as of June 30, 2014 and 2013, are as follows:

	Investment Type	2014	2013
Federal National Mortgage Association	Federal Agency Securities	$ 12,255,000	$ 17,756,000
Federal Home Loan Mortgage Corp.	Federal Agency Securities	9,753,000	13,811,000
U.S. Bank, Trustee	U.S. Bank Money Market	44,598,000	54,801,000
Wells Fargo Advantage Government Money Market	U.S. Government Money Market Funds	20,727,000	21,150,000
Total		$ 87,333,000	$ 107,518,000

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

Custodial Credit Risk—Deposits—Custodial credit risk is the risk that in the event of a bank failure, PH's deposits may not be returned to it. PH does not have a policy for custodial credit risk. As of June 30, 2014 and 2013, PH's bank balances totaled $48,707,000 and $19,697,000, respectively, and were not exposed to custodial credit risk, as the uninsured deposits are with financial institutions that are individually required by state law to have government deposits collateralized at a rate of 110% of the deposits. Such collateral is considered to be held in PH's name.

4. CONCENTRATIONS OF CREDIT RISK

PH grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of gross receivables from patients and third-party payors as of June 30, 2014 and 2013, was as follows:

	2014	2013
Medicare	18 %	18 %
Medi-Cal	11	9
HMO/PPO/commercial	47	40
Patient	20	23
Others	4	10
Total	100 %	100 %

5. CAPITAL ASSETS

A summary of changes in capital assets for the years ended June 30, 2014 and 2013, is as follows:

	Beginning Balance Fiscal 2014	Additions	Disposals	Transfers	Ending Balance Fiscal 2014
Land improvement	$ 48,507,000	$ -	$ (78,000)	$ 1,678,000	$ 50,107,000
Buildings and leasehold improvements	1,163,650,000	44,000	(9,598,000)	(23,764,000)	1,130,332,000
Equipment	283,421,000	1,384,000	(5,308,000)	2,856,000	282,353,000
Land	50,572,000		(244,000)	26,768,000	77,096,000
Construction in progress	33,111,000	8,192,000		(7,538,000)	33,765,000
	1,579,261,000	9,620,000	(15,228,000)	-	1,573,653,000
Less accumulated depreciation and amortization	(318,680,000)	(56,711,000)	5,278,000		(370,113,000)
Capital assets—net	$1,260,581,000	$(47,091,000)	$ (9,950,000)	$ -	$1,203,540,000

	Beginning Balance Fiscal 2013	Additions	Disposals	Transfers	Ending Balance Fiscal 2013
Land improvement	$ 15,416,000	$ -	$ -	$ 33,091,000	$ 48,507,000
Buildings and leasehold improvements	210,293,000	168,000	(384,000)	953,575,000	1,163,652,000
Equipment	201,654,000	1,345,000	(4,123,000)	84,543,000	283,419,000
Land	15,719,000			34,853,000	50,572,000
Construction in progress	1,099,157,000	40,055,000		(1,106,101,000)	33,111,000
	1,542,239,000	41,568,000	(4,507,000)	(39,000)	1,579,261,000
Less accumulated depreciation and amortization	(268,958,000)	(53,718,000)	3,996,000		(318,680,000)
Capital assets—net	$1,273,281,000	$(12,150,000)	$ (511,000)	$ (39,000)	$1,260,581,000

During the construction of Palomar Medical Center, PH was insured under an Owner Controlled Insurance Program ("OCIP") and the insurance premiums for the OCIP were capitalized as part of the cost of construction. During fiscal year 2014, PH was informed that $8,000,000 of the previously paid OCIP premiums would be returned to PH as a result of favorable loss experience and was reversed from the carrying value of Palomar Medical Center. PH received $6,000,000 during fiscal 2014 and the remaining $2,000,000 is included in other receivables in the accompanying consolidated statement of net position at June 30, 2014.

6. INVESTMENT IN AND AMOUNTS DUE FROM AFFILIATED ENTITIES

During the year ended June 30, 2007, PH entered into a partnership agreement with PDP Pomerado, LLC in exchange for a ground lease agreement. During fiscal year 2010, the partnership with PDP Pomerado, LLC, was terminated, and the ground lease agreement was transferred to NHP/PMP Pomerado, LLC. In conjunction with the termination of the partnership, PDP Pomerado, LLC was dissolved, and its assets were liquidated. PH received proceeds of $9,672,000 for its interest in PDP Pomerado, LLC, which is included in deferred revenue in the accompanying consolidated statements of net position. Unamortized deferred revenue of $7,541,000 and $7,647,000 as of June 30, 2014 and 2013, respectively, will be recognized as income based on the terms of the ground lease agreement.

PH's investment in affiliated entities, which are generally accounted for under the equity method because PH does not control the entities, was $3,787,000 and $3,159,000 at June 30, 2014 and 2013, respectively.

7. RELATED ORGANIZATIONS

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

The Foundation funds various programs on behalf of PH. Funding for these programs provided by the Foundation totaled $2,041,000 and $1,228,000 for the years ended June 30, 2014 and 2013, respectively.

PH has entered into a management services agreement with the Foundation, whereby PH provides administrative support to the Foundation. Support provided to the Foundation totaled $1,801,000 and $1,933,000 for the years ended June 30, 2014 and 2013, respectively. Under the management services agreement renewed on June 30, 2014 and expiring on June 30, 2015, PH provides a line of credit to the Foundation with a $5,000,000 limit with interest at 2.5% above London InterBank Offered Rate (LIBOR). The amount outstanding on the line of credit was $1,083,000 and $1,322,000 as of June 30, 2014 and 2013, respectively.

A summary of the Foundation's assets, liabilities, and net assets (unaudited) as of June 30, 2014 and 2013, is as follows:

	2014	2013
Assets	$ 8,675,000	$ 10,323,000
Liabilities	$ 2,066,000	$ 2,587,000
Net assets	6,609,000	7,736,000
Total liabilities and net assets	$ 8,675,000	$ 10,323,000

AHP—PH has provided a line of credit to AHP with a $33,500,000 limit that matures on June 30, 2015. Principal and interest amounts outstanding on the line of credit were $33,343,000 and $14,184,000 as of June 30, 2014 and 2013, respectively. The line of credit is included in other long-term assets in the accompanying statements of net position as the intent is to extend the due date of the principal amounts due to PH, which is consistent with prior periods.

8. LONG-TERM DEBT

A summary of changes in long-term debt for the years ended June 30, 2014 and 2013, is as follows:

	Beginning Balance Fiscal Year 2014	Additions	Reductions	Ending Balance Fiscal Year 2014	Amounts Due within One Year
Bonds payable:					
Series 2010 certificates of participation	$ 159,449,000	$ 198,000	$ -	$ 159,647,000	$ -
Series 2010A general obligation bonds	65,721,000		(32,000)	65,689,000	
Series 2009 certificates of participation	228,724,000	246,000		228,970,000	
Series 2009A general obligation bonds	114,402,000		(222,000)	114,180,000	
Series 2007A general obligation bonds	243,778,000		(1,786,000)	241,992,000	2,002,000
Series 2006 certificates of participation	171,673,000	58,000		171,731,000	
Series 2005A general obligation bonds	65,626,000		(1,453,000)	64,173,000	1,380,000
Series 1999 insured refunding revenue bonds	15,227,000		(15,227,000)		
Accrued interest on capital appreciation bonds	68,047,000	19,518,000		87,565,000	855,000
Capital leases	1,388,000		(281,000)	1,107,000	364,000
Total long-term debt	$1,134,035,000	$20,020,000	$(19,001,000)	$1,135,054,000	$ 4,601,000

	Beginning Balance Fiscal Year 2013	Additions	Reductions	Ending Balance Fiscal Year 2013	Amounts Due within One Year
Bonds payable:					
Series 2010 certificates of participation	$ 159,252,000	$ 197,000	$ -	$ 159,449,000	$ -
Series 2010A general obligation bonds	65,752,000		(31,000)	65,721,000	
Series 2009 certificates of participation	228,477,000	247,000		228,724,000	
Series 2009A general obligation bonds	114,624,000		(222,000)	114,402,000	
Series 2007A general obligation bonds	245,084,000		(1,306,000)	243,778,000	1,533,000
Series 2006 certificates of participation	171,607,000	66,000		171,673,000	
Series 2005A general obligation bonds	66,989,000		(1,363,000)	65,626,000	1,275,000
Series 1999 insured refunding revenue bonds	22,190,000		(6,963,000)	15,227,000	7,455,000
Accrued interest on capital appreciation bonds	49,610,000	18,437,000		68,047,000	353,000
Capital leases	1,668,000		(280,000)	1,388,000	374,000
Total long-term debt	$1,125,253,000	$18,947,000	$(10,165,000)	$1,134,035,000	$10,990,000

The terms and due dates of PH's long-term debt as of June 30, 2014 and 2013, are as follows:

- Series 2010 Certificates of Participation (COPs), interest at 5.25% to 6% due semiannually, principal due in annual amounts ranging from $2,255,000 in fiscal 2016 to $20,725,000 in fiscal 2042, net of unamortized original issue discount of $3,718,000 and $3,915,000 at June 30, 2014 and 2013, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2010A G.O. Bonds, accreted interest compounds at 6.84% to 7.85% on $14,917,000 Capital Appreciation Bonds with the first payment to bondholders on August 1, 2034. Accreted interest compounds at 6.75% on $49,999,000 Convertible Capital Appreciation Bonds with the first payment to bondholders also due on August 1, 2034. Principal amounts due in annual amounts ranging from $1,476,000 in fiscal 2038 to $33,159,000 in fiscal 2041, net of unamortized premium of $773,000 and $804,000 at June 30, 2014 and 2013, respectively.

- Series 2009 Certificates of Participation, interest at 4.50% to 6.75% due semiannually, principal due in annual amounts ranging from $3,515,000 in fiscal 2016 to $28,730,000 in fiscal 2040, net of unamortized original issue discount of $4,370,000 and $4,616,000 at June 30, 2014 and 2013, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2009A G.O. Bonds, accreted interest compounds at 6.84% to 9% on $50,001,000 Capital Appreciation Bonds with the first payment to bondholders on August 1, 2019. Accreted interest compounds at 7% on $59,999,000 Convertible Capital Appreciation Bonds with the first payment to bondholders on August 1, 2033. Principal amounts due in annual amounts ranging from $327,000 in fiscal 2021 to $18,868,000 in fiscal 2039, net of unamortized premium of $4,180,000 and $4,402,000 at June 30, 2014 and 2013, respectively.

- Series 2007A G.O. Bonds, interest at 4.5% to 5.125% is due semiannually on $175,000,000 of Current Interest Bonds. Interest on the $66,083,000 Capital Appreciation Bonds is compounded at 3.67% to 4.92% with the first payment to bondholders on August 1, 2011. Principal amounts due in annual amounts ranging from $557,000 in fiscal 2012 to $21,585,000 in fiscal 2038, net of unamortized premium of $4,050,000 and $4,303,000 at June 30, 2014 and 2013, respectively.

- Series 2006 Certificates of Participation, a portion of which refunded the Series 1993 Insured Refunding Revenue Bonds. In addition, PH entered into an interest rate agreement with Citibank, N.A., New York with respect to the Series 2006 Certificates of Participation in a notional amount of $180,00,000 (the "Swap Agreement") (See Note 9). Interest on the Series 2006 Certificates of Participation is 3.218%, which is the fixed rate to be paid by PH under the Swap Agreement, due semiannually, principal due in amounts ranging from $2,775,000 in fiscal 2009 to $12,350,000 in fiscal 2037, net of unamortized loss on refunding of $269,000 and $328,000 at June 30, 2014 and 2013, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2005A G.O. Bonds, interest at 3% to 5% due semiannually, principal due in annual amounts ranging from $945,000 in fiscal 2009 to $5,115,000 in fiscal 2035, net of unamortized premium of $2,208,000 and $2,386,000 at June 30, 2014 and 2013, respectively.

- Series 1999 Insured Refunding Revenue Bonds, interest at 4.375% to 5.375% due semiannually, principal due in annual amounts ranging from $6,060,000 in fiscal 2009 to $7,855,000 in fiscal 2015, net of unamortized premium of $10,000 at June 30, 2013, and unamortized loss on defeasance of $93,000 at June 30, 2013, collateralized by PH revenues as defined in the indenture agreement. In May 2014, PH legally defeased the remaining $7,855,000 of outstanding Series 1999 Insured Refunding Revenue Bonds. As a result, the liability for these bonds has been removed from the consolidated statements of net position as of June 30, 2014.

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 (DCOH), Maximum Annual Debt Service, and Cushion Ratio) under its indenture agreements for COPs and revenue bonds. The covenant stipulates 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. As of June 30, 2013, under the terms of its master indenture, PH did not achieve the Insurer requirement for DCOH for the 1999 insured revenue bonds and the 2006 COPs, and so advised the Insurers, MBIA Inc. and Assured Guaranty, Corp. (Assured Guaranty). PH also advised the Insurers of the initiatives which PH has implemented to remedy its underachievement, including the scope of services which will be performed by a consultant engaged by PH to assist PH in remedying its underachievement, which initiatives have been acknowledged as acceptable by the Insurers. As of June 30, 2014, PH was in compliance with all required debt covenants.

At June 30, 2014, long-term capital leases, net of current portion, amounted to $743,000. Related net book value of leased equipment is $981,000 and depreciation expense totaled $343,000 for the year ended June 30, 2014.

The estimated fair value of PH's long-term debt was approximately $1,205,255,000 and $1,219,800,000 as of June 30, 2014 and 2013, respectively, based on quotations from independent third parties.

Estimated future principal and interest payments on long-term debt, including capital leases, as of June 30, 2014, are as follows:

Years Ending June 30	Principal	Interest	Total
2015	$ 3,746,000	$ 43,132,000	$ 46,878,000
2016	15,315,000	43,145,000	58,460,000
2017	16,297,000	42,994,000	59,291,000
2018	17,209,000	42,879,000	60,088,000
2019	18,164,000	45,320,000	63,484,000
2020–2024	114,471,000	286,507,000	400,978,000
2025–2029	160,230,000	315,368,000	475,598,000
2030–2034	257,869,000	315,399,000	573,268,000
2035–2039	310,158,000	240,162,000	550,320,000
2040–2043	131,176,000	64,055,000	195,231,000
Total	$1,044,635,000	$1,438,961,000	$2,483,596,000

9. INTEREST RATE SWAP

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

The Series 2006 Certificates of Participation were issued as auction rate securities (ARS), whereby the auction rate for each series is generally determined during successive seven-day auction periods.

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

The significant terms of the swap are as follows:

Corresponding bond series	Series 2006 Certificate of Participation bonds
Swap type	Fixed income
Notional amount	$180,000,000
Effective date	December 28, 2006
Termination date	November 1, 2036
Final bond maturity	November 1, 2036
PH pays	3.218 %
Cash payments remitted by PH for year ended June 30, 2014	$4,931,000
PH receives	56% of 30-day LIBOR + 0.23%
Swap fair value—June 30, 2014	$(26,528,000)
Change in fair value for the year ended June 30, 2014	$(185,000)
Classification	Liability

Fair Value—As of June 30, 2014 and 2013, the swap had a negative fair value of $26,528,000 and $26,343,000, respectively, developed by a mark-to-market pricing service using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap. The negative fair value of the swap is reported in the accompanying consolidated statements of net position as a long-term liability. The change in the fair value of the swap is reported in the accompanying consolidated statements of revenue, expenses and changes in net position as unrealized 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, 2014, the counterparty of the interest rate swap was rated A2 by Moody's, A by Standard & Poor's (S&P), and A by Fitch Investor Services (Fitch). To mitigate the potential for credit risk, under the terms of the Swap Agreement, if the counterparty's credit quality falls below (1) Moody's rating of Baa2, (2) S&P's rating of BBB or (3) Fitch's rating of BBB, the fair value of the swap will be collateralized by the counterparty with cash and/or treasury securities.

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

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

The negative swap fair value is the termination payment that would be owed by PH to the swap counterparty if the swap was terminated. The payments from PH to the swap counterparty are insured by Assured Guaranty. This insurance provides protection to the swap counterparty in the event PH fails to make payments due under the swap. Under the terms of the Swap Agreement, an “insurer event” will occur if both Moody’s and S&P’s ratings for Assured Guaranty fall below the A category. If an insurer event happens, PH would be required to post collateral by a first priority perfected security interest in the gross revenues of PH. Assured Guaranty was rated A2 by Moody’s with a stable outlook effective July 2, 2014.

10. OPERATING LEASES

PH leases certain office space and equipment under operating leases. Lease expense on all such leases for the years ended June 30, 2014 and 2013, totaled $10,453,000 (including $130,000 in nonoperating expense) and $9,726,000 (including $739,000 in nonoperating expense), respectively. PH also leases to others office space under operating leases. Future minimum lease payments and receipts under office space and equipment leases as of June 30, 2014, are as follows:

Years Ending June 30	Lease Payments	Lease Receipts
2015	$ 3,784,000	$ 1,222,000
2016	3,595,000	419,000
2017	3,539,000	319,000
2018	3,532,000	60,000
2019	3,589,000	
2020–2024	17,973,000	
2025–2029	11,472,000	
2030–2034	1,564,000	
2035–2081	25,345,000	
Total	$ 74,393,000	$ 2,020,000

11. DEFERRED ANNUITY CONTRACTS

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

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

12. RETIREMENT PLAN

PH sponsors a defined contribution retirement plan under which benefits are limited to amounts accumulated from total contributions by PH and by participating employees, plus earnings thereon. Generally, all employees with one year of service are eligible to participate. Contributions under the retirement plan by PH for the years ended June 30, 2014 and 2013, were 4% of covered employees' basic compensation (6% prior to January 1, 2014) and 6% (6.5% prior to January 1, 2013), respectively. Contributions are funded as accrued. Total PH contributions expensed for the years ended June 30, 2014 and 2013, were $12,997,000 and $15,447,000, respectively.

13. SEVERANCE

Severance expense related to closing of PCCC and operational terminations of $1,000,000 and $818,000 are included in operating expenses in the accompanying consolidated financial statements for the years ended June 30, 2014 and 2013, respectively.

14. POSTEMPLOYMENT HEALTHCARE PLAN

The Company accounts for its postemployment healthcare plan under GASB Codification Section P50, *Postemployment Benefits Other Than Pensions—Employer Reporting*. As of June 30, 2014 and 2013, the annual required contribution was $282,000 and $420,000, respectively, and is included in accrued compensation and related liabilities in the accompanying consolidated statements of net position.

Plan Description and Funding Policy—PH's Postemployment Healthcare Plan (the "Plan") is a single-employer defined benefit healthcare plan administered by Tri-Ad Actuaries Inc. The Plan provides medical and dental insurance benefits to qualified postemployment participants on a gap coverage basis. Coverage is limited to those employees who have provided 10 years of consecutive service, are below the age of 65, and do not receive coverage from other sources. The contribution requirements of the Plan members and PH are established and may be amended by the Board of Directors. The required contribution is based on estimated pay-as-you-go financing requirements. For the years ended June 30, 2014 and 2013, PH contributed $88,000 and $121,000, respectively, to the Plan, which consisted entirely of current premiums and included no additional contribution to prefund benefits.

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

Actuarial Methods and Assumptions—Projections of benefits for financial reporting purposes are based on the substantive plan (the Plan as understood by the employer and the Plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing the benefit costs between the employer and the Plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. The actuarial valuations are effective for the years ended June 30, 2014 and 2013.

For the years ended June 30, 2014 and 2013, the actuarial assumptions included a 3% discount rate, which approximates PH's own rate of return on investments, and a healthcare cost trend rate of 7% declining by 1% annually to stabilize at 3% per year for the year ended June 30, 2016 and thereafter. The unfunded actuarial accrued liability (UAAL) of $2,478,000 is being amortized over the maximum permissible amortization period of 30 years on an open basis. The actuarial valuation uses the projected unit credit and the entry-age normal actuarial cost methods.

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

Funded Status and Funding Progress—As of June 30, 2014, the most recent actuarial valuation date, the plan was unfunded. The actuarial accrued liability for benefits was $2,478,000 and the actuarial value of assets was $0, resulting in an UAAL of $2,478,000. The estimated covered payroll was $179,505,000 and the ratio of the UAAL to the covered payroll was 1%.

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

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

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

Workers' Compensation Program—PH is a participant in the Association of California Healthcare Districts ALPHA Fund ("ALPHA Fund") that administers a self-insured workers' compensation plan for participating districts and other qualifying nonprofit entities. PH pays premiums to the ALPHA Fund that are adjusted annually. Effective July 1, 2002, PH changed its participation in the ALPHA Fund from first dollar coverage of workers' compensation claims to self-insured retention by PH of the first $350,000 of each claim. Effective July 1, 2003, PH increased its retention level to the first $500,000 of each claim. Effective July 1, 2004, PH increased its retention level to the first $750,000 of each claim. Effective July 1, 2008, PH eliminated its retention and currently has a guaranteed loss/zero deductible. At June 30, 2014 and 2013, estimated claims liabilities for workers' compensation recorded is $1,016,000 and $1,299,000, respectively.

If the ALPHA Fund were terminated, PH would be liable for its share of any additional premiums necessary for final disposition of claims and losses covered by the ALPHA Fund. If PH were to withdraw from the ALPHA Fund, it would be required to fund its share of a deficit as defined under the joint powers agreement. From fiscal year 2007 onwards, the ALPHA Fund has been in a surplus position. PH accounts for its investment in the ALPHA Fund under the equity method and has recorded its share of $1,948,000 and $2,244,000 as of June 30, 2014 and 2013, respectively, as an asset within investment in and amounts due from affiliated entities in the accompanying consolidated statements of net position.

Comprehensive Liability Insurance Coverage—PH is insured for comprehensive liability (professional liability, bodily injury and property damage liability, personal injury, advertising injury and discrimination liability, and employee benefit liability) under a claims-made policy, which covers asserted claims and incidents reported to the insurance carrier, and has a per-claim deductible of $50,000 for professional liability. PH's comprehensive liability insurance was renewed effective July 1, 2014, and the current policy expires on June 30, 2015. PH has reserved for estimated claims through 2014, including an estimate of IBNR. Such reserves totaled $1,963,000 as of June 30 2014 and 2013, and are recorded as other accrued liabilities in the accompanying consolidated statements of net position.

Medicare Recovery Audit Contractor (RAC) Program—PH is subject to the Medicare RAC Program, which is a program designed to identify improper Medicare payments—both underpayments and overpayments. RAC auditors are contracted by the Centers for Medicare and Medicaid Services on a contingent fee basis, receiving a percentage of the improper overpayments and underpayments they collect from providers. PH has established a reserve to account for potential negative settlements when these cost reports are audited and final settled. The reserve amount is $0 and $412,000 as of June 30, 2014 and 2013, respectively, and is recorded as an estimated third-party payor settlement in the accompanying consolidated statements of net position.

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

16. SUBSEQUENT EVENTS

PH evaluated events or transactions through November 14, 2014, the date the consolidated financial statements were available to be issued, and concluded that no subsequent events have occurred that would require recognition in the consolidated financial statements or disclosure in the notes to the consolidated financial statements.

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