Palomar Health

Consolidated Financial Statements as of and for the Years Ended June 30, 2012 and 2011, Supplemental Schedules as of and for the Year Ended June 30, 2012, and Independent Auditors' Report

PALOMAR HEALTH

TABLE OF CONTENTS

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. On March 20, 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, 2012 and 2011. Although the 2010 condensed consolidated balance sheet, condensed consolidated statement of revenue, expenses, and changes in net assets, 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

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

Required Financial Statements

Consolidated Balance Sheets — The consolidated balance sheets include all of PH's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to PH's creditors (liabilities) and net assets — the difference between assets and liabilities — of PH and the changes in them. The consolidated balance sheets 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, 2012, 2011, AND 2010
($ in thousands)

	2012	2011	2010
ASSETS			
Current assets	$ 335,433	$ 328,340	$ 308,753
Capital assets — net	1,276,404	1,061,644	795,252
Noncurrent assets	102,573	279,460	279,702
TOTAL	$1,714,410	$1,669,444	$1,383,707
LIABILITIES AND NET ASSETS			
Current liabilities	$ 123,615	$ 126,662	$ 107,265
Other long-term liabilities (long-term workers' compensation)	1,063	1,036	1,482
Deferred revenue	7,778	8,180	8,583
Fair value of interest rate swap	40,375	19,463	24,322
Long-term debt — net of current portion	1,115,598	1,107,689	880,421
Total liabilities	1,288,429	1,263,030	1,022,073
Invested in capital assets — net of related debt	209,281	167,599	137,672
Restricted for repayment of debt	17,071	33,062	33,016
Restricted for capital acquisitions	13,921	14,161	14,350
Restricted for other purposes	326	318	314
Unrestricted	185,382	191,274	176,282
Total net assets	425,981	406,414	361,634
TOTAL	$1,714,410	$1,669,444	$1,383,707

2012: Analysis of the Consolidated Balance Sheets

- Current assets increased by $7,093, in 2012, primarily due to decreases in the current portion of assets whose use is limited of $17,622,000, cash of $5,043,000, investments of $4,890,000, and other receivables of $1,101,000. These were offset by increases in net patient accounts receivable of $22,866,000, prepaid expenses of $3,709,000, the current portion of assets whose use is limited — General Obligation Bonds ("G.O. Bonds") of $1,663,000, estimated third-party settlements receivable of $7,201,000 and inventories of $310,000.

- Capital assets increased by $214,760,000, primarily due to purchases related to major building projects of $234,965,000, which were offset by net disposals of $870,000; depreciation expense of $22,420,000, and others of $110,000. During fiscal year 2012, PH became a guarantor for Arch Health Partners, Inc. (ARCH) (see Note 1).

- Noncurrent assets decreased by $176,887,000 primarily due to a decrease in assets whose use is limited of $175,897,000 and other noncurrent assets of $990,000.

- Current liabilities decreased by $3,047,000, primarily due to a decrease in accounts payable of $12,820,000. These were offset by increases in accrued compensation and related liabilities of $3,157,000, the current portion of the G.O. Bonds of $580,000, the current portion of long-term debt of $375,000, estimated third-party settlements liability of $5,521,000, other accrued liabilities of $109,000, and accrued interest payable of $31,000.

- Long-term liabilities increased by $28,446,000, primarily as a result of the increase in the interest rate swap (adjustment to market value) of $20,912,000, G.O. Bonds of $14,622,000, and the long-term portion of workers' compensation of $27,000. These were offset by decreases in long-term debt of $6,713,000 and deferred revenue of $402,000.

- Net assets increased by $19,567,000, primarily due to results of operations of $10,204,000, property tax revenue of $28,039,000, investment income of $2,014,000, and other nonoperating revenue of $2,458,000, which were offset by the unrealized loss on the interest rate swap of $20,912,000 and interest expense of $3,830,000.

2011: Analysis of the Consolidated Balance Sheets

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

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

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

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

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

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

Consolidated Statements of Revenue, Expenses, and Changes in Net Assets — All of PH's revenue, expenses, and changes in net assets are accounted for in the consolidated statements of revenue, expenses, and changes in net assets. The consolidated statements measure the success of PH's operations during the years presented and can be used to determine whether 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 assets are one indicator of whether its financial health is improving or deteriorating.

CONDENSED CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2012, 2011, AND 2010
($ in thousands)

	2012	2011	2010
OPERATING REVENUE:			
Net patient service revenue	$ 484,922	$ 442,142	$ 422,906
Net premium revenue	53,842	36,673	37,655
Other revenue	13,397	11,192	7,822
Total operating revenue	552,161	490,007	468,383
OPERATING EXPENSES	541,957	478,502	451,354
INCOME FROM OPERATIONS	10,204	11,505	17,029
NONOPERATING INCOME (EXPENSES):			
Investment income	2,014	2,626	3,189
Unrealized (loss) gain on interest rate swap	(20,912)	4,859	(7,570)
Interest expense	(3,830)	(4,720)	(4,628)
Property tax revenue	12,686	12,625	12,926
Property tax revenue — general obligation bonds	15,353	15,019	11,586
Other — net	2,458	3,149	3,536
Total nonoperating income — net	7,769	33,558	19,039
EXCESS OF REVENUE OVER EXPENSES	17,973	45,063	36,068
INTERFUND	(98)	(283)	(3,283)
CHANGE IN INTEREST IN COMPONENT UNIT	1,692		
INCREASE IN NET ASSETS	19,567	45,063	32,785
NET ASSETS — Beginning of year	406,414	361,634	328,849
NET ASSETS — End of year	$ 425,981	$ 406,697	$ 361,634
ADJUSTED DISCHARGES	40,222	40,337	40,414

See notes to consolidated financial statements.

2012: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Assets

- In accordance with accounting principles generally accepted in the United States of America ("generally accepted accounting principles") for governmental health care providers, PH's consolidated statements of revenue, expenses, and changes in net assets reflects the following: (1) net patient service revenue includes the provision for bad debts, which for nongovernmental hospitals is shown as an operating expense and (2) nonoperating income (expenses) includes interest expense, which for nongovernmental hospitals is typically grouped as an operating expense. While these GASB requirements make district hospitals conform to other governmental entities, such as colleges and universities, they are less comparable to nongovernment hospitals because the GASB requirements do not apply to them. This must be considered in order to compare PH to nonprofit and for-profit hospitals. The provision for bad debts was $73,413,000 in fiscal year 2012 and $60,030,000 in fiscal year 2011, and interest expense was $3,830,000 in fiscal year 2012 and $4,720,000 in fiscal year 2011.

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

- Operating revenue is generated by the primary activity of treating patients (providing inpatient and outpatient, ancillary, and other patient care service) and other affiliate revenue. Operating revenue increased by $62,154,000 in fiscal year 2012 due to increases in net patient service revenue of $42,780,000, increase in net premium revenue of $17,169,000, and an increase in other revenue of $2,205,000. 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 $63,455,000 in 2012, primarily due to increases in labor (unionized and non-unionized) costs of approximately $31,563,000, purchased services of $19,741,000, rent expense of $4,471,000, supplies of $4,234,000, and others of $3,446,000.

- Operating income in 2012 was $10,204,000 due to PH income of $13,711,000 and ARCH loss of $3,507,000. This operating income is a result of operating revenues in excess of expenses.

- Nonoperating income (expenses) consists of interest earned on invested monies, interest expense, PH's share of unrestricted property taxes of $12,686,000 collected by the County of San Diego, and restricted property tax revenue for repayment of G.O. Bonds of $15,353,000. PH's nonoperating income was $7,769,000 in 2012 and $33,558,000 in 2011. The $25,789,000 decrease in nonoperating income (expense) is primarily due to the $20,912,000 unrealized loss on the interest rate swap in fiscal year 2012.

  As a result of the factors noted above, net assets increased by $19,567,000 in 2012.

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

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

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

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

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

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

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

- PH provided ARCH, with a capital contribution of $283,000 (see Note 1 — Related Organizations in the consolidated financial statements).

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

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 period.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2012, 2011, AND 2010
($ in thousands)

	2012	2011	2010
CASH FLOWS FROM:			
Operating activities	$ (25,793)	$ 39,447	$ 60,457
Noncapital financing activities	13,153	15,491	8,551
Capital and related financing activities	(191,162)	(41,615)	(12,618)
Investing activities	198,759	(8,618)	(59,489)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(5,043)	4,705	(3,099)
CASH AND CASH EQUIVALENTS — Beginning of year	11,961	7,256	10,355
CASH AND CASH EQUIVALENTS — End of year	$ 6,918	$ 11,961	$ 7,256

See notes to consolidated financial statements.

2012: Analysis of the Consolidated Statement of Cash Flows

- Operating activities cash inflow reflected a decrease of $65,240,000 in 2012 over 2011. This decrease is attributed to increases in cash collections of patient accounts of $41,163,000 offset by increased payments to suppliers and employees of $114,868,000.

- Net cash outflows from capital and related financing activities in 2012 were $191,162,000, primarily due to the funding of PH's building projects of $158,322,000, interest payments of $39,826,000, and the payment of long-term debt of $8,367,0000 offset by the receipt of $15,353,000 of property taxes for debt service.

- Investing activities cash inflows were $198,759,000 in 2012. This outflow is mainly composed of sale of investments.

- The ending cash and cash equivalents of $6,918,000 reflects the checking account and overnight investment balances held by PH. In addition, there were current investments of $171,451,000 at June 30, 2012.

2011: Analysis of the Consolidated Statement of Cash Flows

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

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

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

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

2012: Capital Assets and Long-Term Debt

The Board of Directors has approved a facilities master plan (the "Facilities Master Plan") that is currently budgeted at $1,057,000,000. In November 2004, the residents of the district voted and approved to fund $496,000,000 of this expansion by the issuance of G.O. Bonds. Payment for these bonds is funded by ad valorem property tax levied on the district residents. The approximate levy amount for each resident remains at $23.50 per $100,000 of assessed value for fiscal year 2012. The levy is established each year in an amount sufficient to service the debt for the upcoming year along with a reserve amount.

One of the major components of the Facilities Master Plan includes the construction of a new Palomar Medical Center Campus (named Palomar Medical Center "PMC" in Escondido). Other building projects includes the renovation and expansion of existing hospital facilities at Pomerado; renovation of the existing PMC (renamed to Palomar Health Downtown Campus); and construction of outpatient facilities at several community locations.

New Palomar Medical Center was able to achieve Temporary Certificate of Occupancy (TCO) on April 5, 2012. The receipt of TCO represented substantial completion of the construction activities and allowed the commencement of the activation phase for the building which includes the installation and delivery of all medical equipment, supplies, and the start of staff education. On June 21, 2012, PH received formal certificate of occupancy from the State, which marked the formal end of all construction activities related to the project. Subsequent to year-end, on August 15, 2012, license was received to operate and maintain from the State Department of Public Health,and on August 19,2012, PH opened PMC, West Escondido for patient care. Depreciation will commence as of the licensure date.

The expansion and/or renovation at Pomerado Hospital, which commenced in 2008, includes the construction of a new central power plant and a connecting bridge between the Pomerado Outpatient Pavilion and the Pomerado Hospital as well as various site improvements. The Central plan is in service and the bridge project remains on schedule for placing into service in 2013.

Outpatient facilities expansion plans for the Ramona Satellite Clinic is under construction. Grading operations will be completed in late July and the foundation is currently being readied. The new clinic will offer outpatient services and an 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 Certificates of Participation, the 2009 Certificates of Participation, and the 2010 Certificates of Participation. PH made principal payments on these issues totaling $6,715,000, bringing the net long-term bond principal to $591,095,000. All debt payments were made timely and PH was in good standing on all bond covenants throughout the year. More detailed information about PH debt is presented in Note 8 to the consolidated financial statements. PH has an underlying 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 $1,652,000 reduced the G.O. Bonds' principal to $479,863,000 as of June 30, 2012. PH has an underlying Moody's rating of A1 on its G.O. Bonds.

2011: Capital Assets and Long-Term Debt

The levy amount for each resident was $23.50 per $100,000 of assessed value for fiscal year 2011. The levy is established each year in an amount sufficient to service the debt for the upcoming year along with a reserve amount.

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

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

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

PH had four outstanding revenue bond issues that are classified as long-term debt at June 30, 2011. These are the 1999 Insured Revenue Bonds, the 2006 Certificates of Participation, the 2009 Certificates of Participation, and the 2010 Certificates of Participation. PH made principal payments on these issues totaling $6,370,000, bringing the net long-term bond principal to $597,810,000. All debt payments were made timely and PH was in good standing on all bond covenants throughout the year. More detailed information about PH debt is presented in Note 8 to the consolidated financial statements. PH has an underlying 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 (measured 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 $1,025,000 reduced the G.O. Bonds' principal to $481,515,000 as of June 30, 2011. 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, 2012, was $178,369,000, including $6,918,000 in operating cash and $171,451,000 in unrestricted investments stated at fair market value. PH's unrestricted liquidity position as of June 30, 2011, was $188,302,000, including $11,961,000 in operating cash and $176,341,000 in unrestricted investments stated at fair market value. The available liquidity of $178,369,000 represents a $9,933,000 decrease over the $188,302,000 in available liquidity as of June 30, 2011, and equaled 30.7% of total outstanding debt exclusive of the G.O. Bonds, which are funded separately from ad valorem taxes as of June 30, 2012.

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, aka 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.

Hospital Provider Fee — Assembly Bill 1653 passed by the Assembly on August 31, 2010, and outlined the changes necessary to deliver the supplemental Medi-Cal payments to hospitals. As a District Hospital, PH was not required to participate in the provider fee program, but rather participate in Intergovernmental transfer programs (IGTs). PH participated in a federal match IGT model program and received an additional net $1.2 million fee-for-service payment for fiscal year 2011. PH also received the last installment of $2.4 million for fiscal year 2012 under this delivery method.

Certified Public Expenditures Program — In 2012, the IGT payment program for district hospitals was changed to Certified Public Expenditure (CPE). Additional funding will be provided through uncompensated care funds and the Delivery System Reform Incentive Pool (DSRIP). DSRIP is a five-year program to support efforts by hospital systems to improve the quality of care they provide. PH estimates a net reimbursement of $2.5 million in fiscal year 2013 to help with delivery system reform. The change to CPE funding for Medicaid (Medi-Cal) funding is effective July 1, 2012.

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

American Recovery & Reinvestment Act of 2009 (ARRA) — ARRA is an economic stimulus package enacted by Congress in February 2009. Among some of the measures included in the Act include expansion of social welfare provisions and domestic spending in health care. PH received $24,000 as of June 30, 2012, and $104,000 as of June 30, 2011, in Consolidated Omnibus Budget Reconciliation Act (COBRA) coverage credits.

The Health Information Technology for Economic and Clinical Health Act (*HITECH*) — HITECH is part of the ARRA, which contains incentives related to health care information technology in general (e.g., creation of a national health care infrastructure) and contains specific incentives designed to accelerate the adoption of electronic health record (EHR) systems among providers. PH had not received any funding from HITECH as of June 30, 2011 and 2010. PH anticipates meeting the meaningful use criteria in fiscal year 2013 for the implementation of its certified EHR.

Seismic Compliance — California Senate Bill 1953 ("SB 1953") requires hospitals to meet more stringent seismic guidelines, which represent an unfunded mandate and impose a financial burden by 2008 under current regulation. Under certain criteria, it was possible to extend the SB 1953 deadline to 2013. PH applied for an extension from the California Department of Health Services, moving PH's deadline to 2013. PH's noncompliant buildings were reassessed using HAZUS criteria and now have a structural performance category of SPC-2, which have until 2030 to comply with the structural seismic safety standards further extending the economical and functional use of the majority of the acute inpatient beds at Palomar Health Downtown Campus. Some Palomar Health Downtown Campus buildings, Pomerado Hospital, and the new 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.

Deloitte.

Deloitte & Touche LLP
350 S. Grand Ave.
Suite 200
Los Angeles, CA 90071-3462
USA

Tel: +1 213 688 0800
Fax: +1 213 688 0100
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Palomar Health:

We have audited the accompanying consolidated balance sheets of Palomar Health (PH) as of June 30, 2012 and 2011, and the related consolidated statements of revenue, expenses, and changes in net assets and of cash flows for the years then ended. These consolidated financial statements are the responsibility of PH's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of Arch Health Partners, Inc. (a blended component unit) as of and for the year ended December 31, 2011, which statements reflect total assets constituting 1% , of consolidated total assets as of June 30, 2012, and total revenues constituting 6% of consolidated total revenues for the year ended June 30, 2012. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Arch Health Partners, Inc., is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of PH's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, such consolidated financial statements present fairly, in all material respects, the financial position of PH as of June 30, 2012 and 2011, and the results of its operations, its changes in net assets, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplemental schedules listed in the table of contents pages 40–42 is presented for the purpose of additional analysis and is not a required part of the consolidated financial statements. These schedules are the responsibility of PH's management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. Such schedules have been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such schedules directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, based on our audits and (as to the amounts included for Arch Health Partners Inc.) the report of the other auditors, such schedules is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Deloitte & Touche LLP

October 30, 2012

PALOMAR HEALTH

CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2012 AND 2011
($ in thousands)

ASSETS	2012	2011
CURRENT ASSETS:		
Cash and cash equivalents	$ 6,918	$ 11,961
Investments	171,451	176,341
Patient accounts receivable — net of allowances for uncollectible accounts of $37,383 in 2012 and $36,037 in 2011	102,418	79,552
Other receivables	6,914	8,015
Supplies/inventories	7,486	7,176
Prepaid expenses and other	6,451	2,742
Estimated third-party payor settlements receivable	7,201	
Assets whose use is limited — current portion	9,977	27,599
Assets whose use is limited — general obligation bonds — current portion	16,617	14,954
Total current assets	335,433	328,340
ASSETS WHOSE USE IS LIMITED:		
Held by trustee under indenture agreements	69,157	262,444
Held by trustee under general obligation bonds indenture	16,617	14,954
Held in escrow for street improvements	13,921	14,161
Restricted by donor	326	318
Total assets whose use is limited	100,021	291,877
Less current portion	26,594	42,553
Total assets whose use is limited — long-term portion	73,427	249,324
CAPITAL ASSETS — Net	1,276,404	1,061,644
OTHER ASSETS:		
Deferred financing costs — net	23,059	24,441
Investment in and amounts due from affiliated entities	3,064	2,884
Other	3,023	2,811
Total other assets	29,146	30,136
TOTAL	$ 1,714,410	$ 1,669,444

PALOMAR HEALTH

CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2012 AND 2011
($ in thousands)

LIABILITIES AND NET ASSETS	2012	2011
CURRENT LIABILITIES:		
Accounts payable	$ 43,296	$ 56,116
Accrued compensation and related liabilities	32,622	29,465
Current portion of long-term debt	7,423	7,048
Current portion of general obligation bonds	2,232	1,652
Estimated third-party payor settlements liability	8,874	3,353
Other accrued liabilities	19,646	19,537
Accrued interest payable	9,522	9,491
Total current liabilities	123,615	126,662
WORKERS' COMPENSATION — Net of current portion	1,063	1,036
DEFERRED REVENUE	7,778	8,180
LONG-TERM DEBT — General obligation bonds — net of current portion	539,826	525,204
LONG-TERM DEBT — Net of current portion	575,772	582,485
FAIR VALUE OF INTEREST RATE SWAP	40,375	19,463
Total liabilities	1,288,429	1,263,030
COMMITMENTS AND CONTINGENCIES (Note 14)		
NET ASSETS:		
Invested in capital assets — net of related debt	209,281	167,599
Restricted for repayment of debt	17,071	33,062
Restricted for capital acquisitions	13,921	14,161
Restricted for other purposes	326	318
Unrestricted	185,382	191,274
Total net assets	425,981	406,414
TOTAL	$ 1,714,410	$ 1,669,444

See notes to consolidated financial statements.

(Concluded)

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEARS ENDED JUNE 30, 2012 AND 2011
($ in thousands)

	2012	2011
OPERATING REVENUE:		
Net patient service revenue	$ 484,922	$ 442,142
Net premium revenue	53,842	36,673
Other revenue	13,397	11,192
Total operating revenue	552,161	490,007
OPERATING EXPENSES:		
Salaries, wages, and benefits	322,831	291,268
Professional fees	25,715	24,167
Supplies	78,566	74,332
Purchased services	58,212	38,471
Depreciation and amortization	22,346	21,346
Rent expense	13,095	8,624
Utilities expense	5,512	4,870
Other	15,680	15,424
Total operating expenses	541,957	478,502
INCOME FROM OPERATIONS	10,204	11,505
NONOPERATING INCOME (EXPENSES):		
Investment income	2,014	2,626
Unrealized (loss) gain on interest rate swap	(20,912)	4,859
Interest expense	(3,830)	(4,720)
Property tax revenue	12,686	12,625
Property tax revenue — general obligation bonds	15,353	15,019
Other — net	2,458	3,149
Total nonoperating income — net	7,769	33,558
EXCESS OF REVENUE OVER EXPENSES	17,973	45,063
INTERFUND — ARCH	(195)	(283)
INTERFUND — PIMG	97	
CHANGE IN INTEREST IN COMPONENT UNIT	1,692	
INCREASE IN NET ASSETS	19,567	44,780
NET ASSETS — Beginning of year	406,414	361,634
NET ASSETS — End of year	$ 425,981	$ 406,414

See notes to consolidated financial statements.

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2012 AND 2011
($ in thousands)

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from:		
Patients, insurers, and other third-party payors	$ 544,940	$ 503,777
Other sources	16,552	8,087
Payments to:		
Employees	(319,647)	(290,836)
Suppliers	(267,638)	(181,581)
Net cash (used in) provided by operating activities	(25,793)	39,447
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Receipt of district taxes	12,686	12,625
Other	467	2,866
Net cash provided by noncapital financing activities	13,153	15,491
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(158,322)	(232,613)
Interest paid	(39,826)	(37,664)
Deferred financing costs		(3,586)
Proceeds from issuance of debt		224,728
Repayment of long-term debt	(8,367)	(7,499)
Receipt of property taxes restricted for debt service on general obligation bonds	15,353	15,019
Net cash used in capital and related financing activities	(191,162)	(41,615)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(173,137)	(431,955)
Sale of investments	371,769	423,408
Interest received on investments and notes receivable	127	(71)
Net cash provided by (used in) investing activities	198,759	(8,618)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(5,043)	4,705
CASH AND CASH EQUIVALENTS — Beginning of year	11,961	
CASH AND CASH EQUIVALENTS — End of year	$ 6,918	$ 11,961

(Continued)

PALOMAR HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2012 AND 2011
($ in thousands)

	2012	2011
RECONCILIATION OF OPERATING INCOME TO NET CASH FLOWS FROM OPERATING ACTIVITIES:		
Income from operations	$ 10,204	$ 11,505
Adjustments to reconcile income from operations to net cash (used in) /provided by operating activities:		
Depreciation and amortization	22,346	21,346
Provision for bad debts	73,413	60,030
Equity in earnings of affiliates	(180)	(849)
Change in interest in component unit	428	
Changes in assets and liabilities:		
Patient accounts receivable	(96,279)	(58,299)
Other receivables	1,101	(3,161)
Supplies/inventories	(310)	(215)
Prepaid expenses and other	(3,709)	444
Estimated third-party payor settlements receivable	(7,201)	
Other — net	(213)	905
Accounts payable	(33,805)	2,666
Accrued compensation and related liabilities	3,184	432
Other accrued liabilities	109	3,176
Estimated third-party payor settlements liability	5,521	2,010
Deferred revenue	(402)	(543)
NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES	$ (25,793)	$ 39,447
NONCASH INVESTING AND CAPITAL AND FINANCING ACTIVITIES — Capital expenditures included in accounts payable	$ 20,986	$ 36,942

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. PH was formerly known as Palomar Pomerado Health. On March 20, 2012, the Board of Directors by resolution voted to change the name to Palomar Health. The accompanying consolidated financial statements include the accounts of the following commonly controlled divisions and entities of PH:

- Pomerado Hospital, located in Poway, California, includes Villa Pomerado, a convalescent and sub-acute facility
- Palomar Health Downtown Campus, (PHDC), also known as Palomar Medical Center, is located in East Escondido, California, includes Women's and Children's Hospital, Center for Behavioral Health, Rehabilitation Institute, and Palomar Continuing Care Center, a convalescent facility
- Home Health, located in Escondido, California
- San Marcos Ambulatory Care Center, located in San Marcos, California
- San Marcos Behavioral Medicine Center, located in San Marcos, California
- Central Office, providing management, financial, data processing, materials management, and public affairs services to the other divisions
- 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, located in Albertson Grocery stores in Escondido, Rancho Penasquitos, and Temecula
- Arch Health Partners, Inc. (ARCH), a Medical Foundation, located in Poway, California, with nine additional offices in Escondido, Poway, Ramona, and San Marcos

In April 2010, PH aligned with ARCH a 1206(l) Medical Foundation, for the purpose of improving the patient experience and providing comprehensive and high-quality medical care. ARCH provides primary and specialty care medical services and adds another component in health care delivery to residents within PH's community.

PH entered into a guaranty agreement (the "agreement") with ARCH in September 2011 under which PH guarantees to assist ARCH in meeting the minimum financial responsibility and regulation requirements of the California Department of Managed Healthcare (DMHC). In accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity,* for financial reporting purposes, PH's reporting entity includes ARCH as a blended component unit as there is financial accountability as a result of fiscal dependency to PH. The financial statements for ARCH, as of and for the fiscal year ended December 31, 2011, has been blended (reported as if it is part of PH) with those of PH.

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. As a result of the different fiscal years between PH and ARCH, inconsistencies in amounts have been reported in the following activities:

	June 30, 2012
Other receivable	$ 489
Line of credit	2,087
Other Accrued Liabilities	172
Professional Fees	1,595

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

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

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

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

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

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

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

PH has entered into an agreement with the City of Escondido (the "City") to jointly finance street improvements near the site of PH's new hospital being constructed in the City. Under the agreement, PH was required to deposit $13,000,000 into a jointly managed account between the City and PH. The balance of $13,921,000 and $14,161,000 on June 30, 2012 and 2011, respectively, is included in assets whose use is limited in the accompanying 2012 consolidated balance sheets.

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

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

Interest cost incurred on borrowed funds during the period of construction of capital assets, net of interest earned of $839,000 and $425,000 for the years ended June 30, 2012 and 2011, respectively, on temporary investments of the proceeds for construction projects funded by tax-exempt borrowings, is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized was $60,234,000 and $48,577,000 for the years ended June 30, 2012 and 2011, respectively.

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

Capital assets are reviewed for impairment when events or changes in circumstances suggest that the service utility of the capital asset may have significantly and unexpectedly declined. Capital assets are considered impaired if both the decline in service utility of the capital asset is large in magnitude and the event or change in circumstance is outside the normal life cycle of the capital asset. Such events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment, or approval of laws or regulations or other changes in environmental factors; technological changes or evidence of obsolescence; changes in the manner or duration of use of a capital asset; and construction stoppage. The determination of the impairment loss is dependent upon the event or circumstance in which the impairment occurred. Impairment losses are recorded in the consolidated statements of revenue, expenses, and changes in net assets. There were no impairment losses in the years ended June 30, 2012 and 2011.

Debt Discounts, Debt Premiums and Deferred Financing Costs — Debt discounts, debt premiums and deferred financing costs are amortized by the bonds' outstanding method over the life of the related bonds. Deferred financing costs included $23,059,000 and $31,312,000, net of accumulated amortization of $8,253,000 and $6,871,000, as of June 30, 2012 and 2011, respectively.

Interest Rate Swaps — PH has entered into variable-to-fixed interest rate swaps, which are reflected at fair value in the 2012 consolidated balance sheets. The fair value of the interest rate swaps will fluctuate based generally on changes in market rates of interest. Any unrealized gains or losses resulting from changes in fair value are reported as nonoperating income (expenses) in the consolidated statements of revenue, expenses, and changes in net assets. Interest cost on variable interest rate debt is reported based on the fixed interest rate paid by PH under the interest rate swaps. Severe fluctuations in the municipal bond market resulted in an interest rate increase of 2006 auction rate securities (ARS) obligations. As of June 30, 2012 and 2011, the interest rate swaps were recorded as a liability of $40,375,000 and $19,463,000, respectively.

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

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

Net Patient Service Revenue — 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 period the related services are rendered and adjusted in future periods, as final settlements are determined.

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 $7,434,000 and $7,394,000 are included in other accrued liabilities in the accompanying consolidated balance sheets as of June 30, 2012 and 2011, 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, 2012 and 2011, were $24,639,000 and $21,857,000, respectively.

Property Taxes — PH receives financial support from property taxes. Property taxes are levied by the County of San Diego on behalf of PH to finance PH's activities. Amounts levied for G.O. Bonds are based on assessed property values set annually by the Board of Directors. Property tax revenue for the years ended June 30, 2012 and 2011, consists of the following:

	2012	**2011**
To support operations — unrestricted use	$12,686,000	$12,625,000
For debt service on general obligation bonds — restricted use	15,353,000	15,019,000
Total	$28,039,000	$27,644,000

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

ARCH is exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code (IRC) and Section 23701(d) of the California Revenue and Taxation Code. ARCH, however, may be subject to tax on income, which is not related to its exempt purpose. ARCH is reporting no such unrelated business taxable income, and therefore, no provision for income taxes has been made at December 31, 2011.

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

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

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

In March 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 and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The provisions of this statement are effective for financial statements for periods beginning after December 15, 2012. Management does not believe that the adoption of this statement will have a material impact on PH's consolidated net assets or revenue, expenses, and changes in net assets.

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 periods beginning after December 15, 2012. Management does not believe that the adoption of this statement will have a material impact on PH's consolidated net assets or revenue, expenses, and changes in net assets.

In June 2012, the GASB issued GASB Statement No. 67, *Financial Reporting for Pension Plans — an amendment of GASB Statement No. 25.* The objective of this statement is to improve financial reporting by state and local governmental pension plans. This statement results from a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for pensions with regard to providing decision-useful information, supporting assessments of accountability and interperiod equity, and creating additional transparency. This statement replaces the requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 50, *Pension Disclosures*, as they relate to pension plans that are administered through trusts or equivalent arrangements (hereafter jointly referred to as "trusts") that meet certain criteria. The requirements of Statements No. 25 and 50 remain applicable to pension plans that are not administered through trusts covered by the scope of this statement and to defined contribution plans that provide postemployment benefits other than pensions. The provisions of this statement are effective for financial statements for periods beginning after June 15, 2013. Management does not believe that the adoption of this statement will have a material impact on PH's consolidated net assets or revenue, expenses, and changes in net assets.

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 results from a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for pensions with regard to providing decision-useful information, supporting assessments of accountability and interperiod equity, and creating additional transparency. The provisions of this statement are effective for financial statements for periods beginning after June 15, 2014. Management does not believe that the adoption of this statement will have a material impact on PH's consolidated net assets or revenue, expenses, and changes in net assets.

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 nonrisk managed care programs, accounted for approximately 55% and 58% of PH's net patient service revenue for the years ended June 30, 2012 and 2011, respectively.

Third-party settlements are recorded when received, which includes tentative settlements and lump-sum adjustments and final settlements for prior or current cost reporting periods. The cost reports for the Medicare program have been settled through fiscal year 2007 and the costs reports for Medi-Cal programs have been settled through fiscal year 2010. Results of cost report settlements, as well as estimates for settlements of all fiscal years through 2012, have been reflected in the accompanying consolidated financial statements.

As of June 30, 2012 and 2011, estimated third-party settlements resulted in a receivable of $7,201,000 and $0, respectively and a liability of $8,874,000 and $3,353,000, respectively. During fiscal years 2012 and 2011, PH settled various prior-year cost reports and appeal issues. These settlements resulted in approximately $8,765,000 and $10,791,000 of additional revenues in fiscal years 2012 and 2011, respectively, which are included in net patient service revenue in the accompanying consolidated statements of revenue, expenses, and changes in net assets.

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.

3. CASH AND CASH EQUIVALENTS AND INVESTMENTS

The State of California Government Code (the "Government Code") generally 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, 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. As of June 30, 2012, PH had invested $47,641,000 of unrestricted funds in this fund and $10,088,000 jointly managed funds under an escrow agreement with the City of Escondido. Investments in the LAIF are highly liquid, as deposits can be converted to cash within 24 hours without loss of interest. PH is a voluntary participant in the LAIF. The fair value of PH's investments in the LAIF is reported in the accompanying consolidated balance sheets based on PH's pro rata share of the fair value provided by LAIF for the entire LAIF portfolio.

As of June 30, 2012 and 2011, PH had the following investments:

	2012	2011
Investments — current	$171,451,000	$176,341,000
Assets whose use is limited — current	26,594,000	42,553,000
Assets whose use is limited — long-term	73,427,000	249,324,000
Total	$271,472,000	$468,218,000

As of June 30, 2012 and 2011, PH had investments by type and maturity as follows:

	2012		
		Investment Maturities (in Years)	
Investment Type	**Fair Value**	**Less Than 1**	**1–5**
LAIF	$ 57,730,000	$ 57,730,000	$ -
U.S. government bonds	50,128,000	3,758,000	46,370,000
U.S. Treasury bills	46,884,000	12,750,000	34,134,000
Corporate bonds	24,254,000	2,374,000	21,880,000
Money market mutual funds	92,476,000	92,476,000	
Total	$271,472,000	$169,088,000	$102,384,000

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

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

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

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

Credit Risk — Fixed income securities are subject to credit risk, which is the chance that an issuer will fail to pay interest or principal in a timely manner or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline. Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk. State law limits 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, 2012 and 2011, PH's investments, excluding U.S. government obligations, consisted of the following: corporate bond investments rated "A" or better by Standard & Poor's and Moody's Investor Services, U.S. Government Agency investments rated "AAA" by Standard & Poor's and Moody's Investor Services, and 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, 2012 and 2011, are as follows:

	Investment Type	2012	2011
Federal National Mortgage Association	Federal Agency Securities	$ 24,391,000	$ -
Federal Home Loan Mortgage Corp.	Federal Agency Securities	24,286,000	
U.S. Bank, Trustee	U.S. Bank Money Market	69,157,000	262,444,000
Wells Fargo Advantage Government Money Market	U.S. Government Money Market Funds	20,449,000	
Total		$138,283,000	$262,444,000

Custodial Credit Risk — Investments — All of PH's investments are insured or registered or are 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, 2012 and 2011, PH's bank balances totaled $19,058,000 and $17,861,000, 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, 2012 and 2011, was as follows:

	2012	2011
Medicare	18 %	18 %
Medi-Cal	8	10
HMO/PPO/commercial	43	38
Patient	18	22
Others	13	12
Total	100 %	100 %

5. CAPITAL ASSETS

A summary of changes in capital assets for the years ended June 30, 2012 and 2011, is as follows:

	Beginning Balance Fiscal 2012	Additions	Disposals	Transfers	Ending Balance Fiscal 2012
Land improvements	$ 15,416,000	$ -	$ -	$ -	$ 15,416,000
Buildings and leasehold improvements	208,144,000	1,465,000	(1,000)	2,153,000	211,761,000
Equipment	188,619,000	6,515,000	(4,401,000)	14,129,000	204,862,000
Land	15,717,000				15,717,000
Construction in progress	884,799,000	230,748,000		(16,392,000)	1,099,155,000
	1,312,695,000	238,728,000	(4,402,000)	(110,000)	1,546,911,000
Less accumulated depreciation and amortization	(251,051,000)	(22,988,000)	3,532,000		(270,507,000)
Capital assets — net	$1,061,644,000	$215,740,000	$ (870,000)	$ (110,000)	$1,276,404,000

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

6. INVESTMENT IN AND AMOUNTS DUE FROM AFFILIATED ENTITIES

During fiscal year 2007, PH entered into a partnership agreement with PDP Pomerado, LLC in exchange for a ground lease agreement. During fiscal year 2010, the partnership with PDP Pomerado, LLC, was terminated, and the ground lease agreement was transferred to NHP/PMP Pomerado, LLC. In conjunction with the termination of the partnership, PDP Pomerado, LLC was dissolved, and its assets were liquidated. PH received proceeds of $9,672,000 for its interest in PDP Pomerado, LLC, which is presented as deferred revenue in the accompanying consolidated financial statements. The deferred revenue of $7,778,000 and $8,180,000 as of June 30, 2012 and 2011, respectively, is recognized as income based on the terms of the ground lease agreement.

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

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

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

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

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 net assets and results of operations are not included in the accompanying consolidated financial statements of PH.

The Foundation funds various programs on behalf of PH. Funding for these programs provided by the Foundation totaled $2,334,000 and $4,620,000 for the years ended June 30, 2012 and 2011, respectively.

In September 2005, PH entered into a management services agreement with the Foundation, whereby PH provides administrative support to the Foundation. Support provided to the Foundation totaled $2,246,000 and $2,481,000 for the years ended June 30, 2012 and 2011, respectively. The management services agreement includes a line of credit with a $5,000,000 limit that renewed on June 30, 2010. The amount outstanding on the line of credit was $617,000 and $0 as of June 30, 2012 and 2011, respectively.

A summary of the Foundation's assets, liabilities, and net assets (unaudited) as of June 30, 2012 and 2011, is as follows:

	2012	2011
Assets	$10,214,000	$8,032,000
Liabilities	$ 1,758,000	$1,305,000
Net assets	8,456,000	6,727,000
Total liabilities and net assets	$10,214,000	$8,032,000

8. LONG-TERM DEBT

PH's long-term debt for 2012 and 2011 were as follows:

	Beginning Balance Fiscal Year 2012	Additions	Reductions	Ending Balance Fiscal Year 2012	Amounts Due Within One Year
Bonds payable:					
Series 2010 certificates of participation	$ 159,056,000	$ 196,000	$ -	$ 159,252,000	$ -
Series 2010 general obligation bonds	65,782,000		(30,000)	65,752,000	
Series 2009 certificates of participation	228,231,000	246,000		228,477,000	
Series 2009 general obligation bonds	114,846,000		(222,000)	114,624,000	
Series 2007 general obligation bonds	245,896,000		(812,000)	245,084,000	1,052,000
Series 2006 certificates of participation	171,534,000	73,000		171,607,000	
Series 2005 general obligation bonds	68,269,000		(1,280,000)	66,989,000	1,180,000
Series 1999 insured refunding revenue bonds	28,741,000		(6,551,000)	22,190,000	7,080,000
Accrued interest on capital appreciation bonds	32,063,000	17,547,000		49,610,000	198,000
Capital leases	1,971,000		(303,000)	1,668,000	343,000
Total long-term debt	$1,116,389,000	$ 18,062,000	$ (9,198,000)	$1,125,253,000	$ 9,853,000

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

The terms and due dates of PH's long-term debt as of June 30, 2012 and 2011, are as follows:

- Series 2010 Certificates of Participation, 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 $4,112,000 and $4,308,000 at June 30, 2012 and 2011, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2010A General Obligation Bonds, accreted interest compounds at 6.84% to 7.85% on $14,917,000 Capital Appreciation Bonds with the first payment to bondholders on August 1, 2034. Accreted interest compounds at 6.75% on $49,999,000 Convertible Capital Appreciation Bonds with the first payment to bondholders also due on August 1, 2034. Principal amounts due in annual amounts ranging from $1,476,000 in fiscal 2038 to $33,159,000 in fiscal 2041, net of unamortized premium of $835,000 and $865,000 at June 30, 2012 and 2011, 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 $4,863,000 and $5,109,000 at June 30, 2012 and 2011, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2009A General Obligation 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 $4,624,000 and $4,846,000 at June 30, 2012 and 2011, respectively.

- Series 2007A General Obligation 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 $4,557,000 and $4,812,000 at June 30, 2012 and 2011, respectively.

- Series 2006 Certificates of Participation, a portion of which refunded the Series 1993 Insured Refunding Revenue Bonds, interest at 3.218%, which is the fixed rate to be paid by PH under the swap agreement, due semiannually, principal due in annual amounts ranging from $2,775,000 in fiscal 2009 to $12,350,000 in fiscal 2037, net of unamortized loss on refunding of $393,000 and $466,000 at June 30, 2012 and 2011, respectively, collateralized by PH revenues as defined in the indenture agreement.

- Series 2005A General Obligation 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 $2,569,000 and $2,754,000 at June 30, 2012 and 2011, 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 $23,000 and $42,000 at June 30, 2012 and 2011, respectively, and unamortized loss on defeasance of $223,000 and $406,000 at June 30, 2012 and 2011, respectively, collateralized by PH revenues as defined in the indenture agreement.

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

During November 2010, PH issued $64,916,678 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2010A (the "2010 G.O. Bonds"). This bond issue consists of $14,917,000 Capital Appreciation Bonds and $49,999,000 Convertible Capital Appreciation Bonds. The net proceeds of the 2010 G.O. Bonds will be used by PH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and the development of satellite ambulatory care facilities in PH's service area (see Note 15).

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

During March 2009, PH issued $110,000,000 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2009A (the "2009 G.O. Bonds"). This bond issue consists of $50,001,000 Capital Appreciation Bonds and $59,999,000 Convertible Capital Appreciation Bonds. The net proceeds of the 2009 G.O. Bonds will be used by PH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and the development of satellite ambulatory care facilities in PH's service area (see Note 15).

During December 2007, PH issued $241,083,000 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2007A (the "2007 G.O. Bonds"). The net proceeds of the 2007 G.O. Bonds will be used by PH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and open satellite ambulatory care facilities in PH's service area (see Note 15).

During December 2006, PH issued $180,000,000 of Palomar Pomerado Health Certificates of Participation. The net proceeds of the 2006 Certificates of Participation will be used by PH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and open satellite ambulatory care facilities in PH's service area (see Note 15). The refunding of the 1993 Insured Revenue Bonds ($23,348,000) resulted in a loss on extinguishment of debt of $884,000, which has been deferred and is being amortized as a component of interest expense over 16 years.

During July 2005, PH issued $80,000,000 of Palomar Pomerado Health General Obligation Bonds, Election of 2004, Series 2005A (the "2005 G.O. Bonds"). The net proceeds of the 2005 G.O. Bonds will be used by PH to pay a portion of the costs to construct a new acute care and trauma hospital facility, expand Pomerado Hospital, renovate Palomar Medical Center, and open satellite ambulatory care facilities in PH's service area (see Note 15).

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 when due of the principal of and interest on the bonds. However, PH is legally required to repay the 2005, 2007, 2009, and 2010 G.O. Bonds if collected ad valorem taxes are insufficient.

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

Under the indenture agreements of the 2009 G.O. Bonds, 2009 Certificates of Participation, 2007 G.O. Bonds, 2006 Certificates of Participation, the 2005 G.O. Bonds, and the Series 1999, PH is subject to compliance with certain debt covenants, including restrictions on additional indebtedness, which PH believes it is in compliance with as of June 30, 2012 and 2011.

At June 30, 2012, long-term capital leases, net of current portion, amounted to $1,325,000. Related net book value of leased equipment is $1,555,000 and depreciation expense totaled $353,000 for the current year.

The estimated fair value of PH's long-term debt was approximately $1,247,000,000 and $1,101,000,000 as of June 30, 2012 and 2011, 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, 2012, are as follows:

Years Ending June 30	Principal	Interest	Total
2013	$ 9,655,000	$ 43,849,000	$ 53,504,000
2014	10,623,000	43,555,000	54,178,000
2015	11,587,000	43,321,000	54,908,000
2016	15,261,000	43,140,000	58,401,000
2017	16,243,000	42,992,000	59,235,000
2018–2022	100,894,000	252,833,000	353,727,000
2023–2027	134,008,000	314,200,000	448,208,000
2028–2032	219,725,000	314,200,000	533,925,000
2033–2037	297,947,000	264,678,000	562,625,000
2038–2042	256,683,000	163,778,000	420,461,000
Total	$1,072,626,000	$1,526,546,000	$2,599,172,000

9. PROFESSIONAL SERVICE AGREEMENTS AND ADVANCE TO PIMG, INC.

ARCH entered into professional service agreements with PIMG, Inc. (PIMG) and Orthopedic Surgery Associates of North County, Inc. (OSANC), in April 2010 and August 2011, respectively, where PIMG and OSANC are to provide professional medical services to patients seeking services from and enrolled with the ARCH. The agreements expire in March 2035 and July 2036, respectively. ARCH compensates the companies on a monthly basis for services performed the previous month. For the year ended December 31, 2011, ARCH expensed $11,008,000 as compensation to PIMG. For the year ended December 31, 2011, ARCH expensed $1,631,000 as compensation to OSANC. As part of the professional service agreement with PIMG, ARCH advanced $702,000 to PIMG. The amount advanced is to be repaid upon the ARCH's request and does not bear interest. The outstanding amount at December 31, 2011, was $702,000. No such advance was made to OSANC.

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, 2012 and 2011, totaled $13,641,000 (including $1,023,000 in nonoperating expense) and $9,816,000 (including $1,192,000 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, 2012, are as follows:

Years Ending June 30	Lease Payments	Lease Receipts
2013	$ 7,588,000	$1,336,000
2014	7,524,000	934,000
2015	7,250,000	630,000
2016	7,200,000	227,000
2017	7,183,000	125,000
2018–2022	37,924,000	35,000
2023–2027	20,629,000	
2028–2032	3,076,000	
2033-2037	3,251,000	
Total	$101,625,000	$3,287,000

11. DEFERRED ANNUITY CONTRACTS

PH offers its employees a deferred compensation plan, which has an employer-match component created in accordance with IRC Section 457. Employees who elect to participate in the plan make contributions through a reduction in salary. All participating employees manage their contribution and investment choices through a funding agency selected by 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 Section 457 plan and earnings are not subject to claims of PH's general creditors. Accordingly, the accompanying consolidated balance sheets 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 certain employees, plus accrued interest. Prior to January 1, 2004, all employees with three years of service were covered by the plan. On January 1, 2004, the retirement plan was revised to change the eligibility to all employees with one year of service. Contributions under the retirement plan by PH were equal to 5% of covered employees' basic compensation and are funded as accrued through August 2010. Starting September 1, 2010, the employer contribution rate was 6%. Starting January 2011, the employer contribution rate increased to 6.5%. Total PH contributions expensed for the years ended June 30, 2012 and 2011, were $15,153,000 and $13,573,000, respectively.

13. POSTEMPLOYMENT HEALTHCARE PLAN

In June 2004, the GASB issued GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (OPEB)*, which is effective for periods ending after December 15, 2006. GASB Statement No. 45 established standards for accounting and financial reporting to accurately reflect the financial effect of OPEB. PH implemented GASB Statement No. 45 in fiscal 2010, which resulted in additional disclosures as shown below, as well as recording of the Annual Required Contribution (ARC) in the accompanying consolidated financial statements. As of June 30, 2012, the ARC was $300,000 and is included in accrued compensation and related liabilities in the accompanying consolidated balance sheets.

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 that have provided 10 years of consecutive service, are below the age of 65 and do not receive coverage from other sources. The contribution requirements of Plan members and 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 year ended June 30, 2012, PH contributed $101,000 to the Plan, which consisted entirely of current premiums and included no additional contribution to prefund benefits.

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

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

For the year ended June 30, 2012, the actuarial assumptions included a 3% discount rate, which is approximately based on the employer's own rate of return on investments. The unfunded actuarial accrued liability (UAAL) of $3,277,000 is being amortized over the maximum permissible amortization period of 30 years on an open basis. The actuarial valuation used the projected unit credit and the entry-age normal actuarial cost methods.

Funded Status and Funding Progress — As of June 30, 2012, the most recent actuarial valuation date, the plan was unfunded. The actuarial accrued liability for benefits was $3,277,000 and the actuarial value of assets was $0, resulting in an UAAL of $3,277,000. The estimated covered payroll was$163,850,000, and the ratio of the UAAL to the covered payroll was 2%.

14. COMMITMENTS AND CONTINGENCIES

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

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

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

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 ALPHA Fund that are adjusted annually. Effective July 1, 2002, PH changed its participation in 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, 2012 and 2011, estimated claims liabilities for workers' compensation totaled $1,328,000 and $1,371,000, respectively.

ALPHA Fund was in a deficit position for several years prior to fiscal year 2007 as actuarial claims estimates had exceeded cash reserves. However, ALPHA Fund has been able to maintain positive cash flow. If ALPHA Fund were terminated, PH would be liable for its share of any additional premiums necessary for final disposition of claims and losses covered by ALPHA Fund. If PH were to withdraw from ALPHA Fund, it would be required to fund its share of a deficit as defined under the joint powers agreement. From fiscal year 2007 onwards, the ALPHA Fund has been in a surplus position. PH accounts for its investment in the ALPHA Fund under the equity method and has recorded its share of $2,449,000 and $2,210,000 as of June 30, 2012 and 2011, respectively, as an asset within other assets in the accompanying consolidated balance sheets.

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, 2011, and the current policy expires on June 30, 2012. PH has reserved for estimated claims through 2011, including an estimate of IBNR. Such reserves totaled $1,963,000 and $1,663,000 as of June 30 2012, and 2011, respectively, and are recorded as other accrued liabilities in the accompanying consolidated balance sheets.

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 paid by Centers for Medicare and Medicaid Services on a contingency fee basis, receiving a percentage of the improper overpayments and underpayments they collect from providers. PH files annual Medicare cost reports, which detail the total amount of reimbursement received from the Medicare program. PH has established a reserve to account for potential negative settlements when these cost reports are audited and final settled. The reserve amount is $1,274,000 and $1,873,000 as of June 30, 2012 and 2011, respectively, and is recorded as estimated third-party payor settlements in the accompanying consolidated balance sheets.

Seismic Compliance — California Senate Bill 1953 (SB 1953) requires hospital acute care buildings to meet more stringent seismic guidelines by 2008. In fiscal 2005, PH received approval from the Office of Statewide Health Planning and Development of a time extension for compliance with SB 1953 until January 1, 2013. The Board of Directors of PH has approved a $1.057 billion expansion plan, which included building a new hospital in the City, downsizing the existing facility in the City (altering the use of the sections that are not compliant with SB 1953), expanding the hospital facility in Poway, and building new outpatient satellite clinics. The plan will enable PH to comply with SB 1953 seismic guidelines. Subsequently, as a result of new criteria established by the State of California (HAZUS), it was determined that PH's noncompliant buildings are in fact compliant at a SPC-2 rating. This has resulted in those buildings being eligible to render acute inpatient care until 2030.

15. SUBSEQUENT EVENTS

In August 2012, PH opened Palomar Medical Center, Escondido, for patient care. Palomar Medical Center opened as a licensed 288-bed acute care hospital, providing inpatient care, surgical and interventional services, and emergency and trauma services.

16. HEALTH CARE REFORM ACT

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

******

SUPPLEMENTAL SCHEDULES

PALOMAR HEALTH

CONSOLIDATING BALANCE SHEETS
AS OF JUNE 30, 2012
($ in thousands)

ASSETS	PH and Entities	ARCH	Elimination	Total
CURRENT ASSETS:				
Cash and cash equivalents	$ 6,432	$ 486	$ -	$ 6,918
Investments	171,451			171,451
Patient accounts receivable — net of allowances for uncollectible accounts of $37,383 in 2012	100,021	2,397		102,418
Other receivables	5,822	1,645	(553)	6,914
Supplies/inventories	7,197	289		7,486
Prepaid expenses and other	5,399	1,052		6,451
Estimated third-party payor settlements receivable	7,201			7,201
Assets whose use is limited — current portion	9,977			9,977
Assets whose use is limited — general obligation bonds — current portion	16,617			16,617
Total current assets	330,117	5,869	(553)	335,433
ASSETS WHOSE USE IS LIMITED:				
Held by trustee under indenture agreements	69,157			69,157
Held by trustee under general obligation bonds indenture	16,617			16,617
Held in escrow for street improvements	13,921			13,921
Restricted by donor	326			326
Total assets whose use is limited	100,021	-	-	100,021
Less current portion	26,594			26,594
Total assets whose use is limited — long-term portion	73,427	-	-	73,427
CAPITAL ASSETS — Net	1,273,281	3,123		1,276,404
OTHER ASSETS:				
Deferred financing costs — net	23,059			23,059
Investment in and amounts due from affiliated entities	3,064			3,064
Other	6,059		(3,036)	3,023
Total other assets	32,182	-	(3,036)	29,146
TOTAL	$ 1,709,007	$ 8,992	$ (3,589)	$ 1,714,410

PALOMAR HEALTH

CONSOLIDATING BALANCE SHEETS
AS OF JUNE 30, 2012
($ in thousands)

LIABILITIES AND NET ASSETS	PH and Entities	ARCH	Elimination	Total
CURRENT LIABILITIES:				
Accounts payable	$ 41,855	$ 1,441	$ -	$ 43,296
Accrued compensation and related liabilities	32,117	505		32,622
Current portion of long-term debt	7,423			7,423
Current portion of general obligation bonds	2,232			2,232
Estimated third-party payor settlements	8,874			8,874
Other accrued liabilities	16,213	3,986	(553)	19,646
Accrued interest payable	9,522			9,522
Total current liabilities	118,236	5,932	(553)	123,615
WORKERS' COMPENSATION — Net of current portion	1,063			1,063
DEFERRED REVENUE	7,778			7,778
LONG-TERM DEBT — General obligation bonds — net of current portion	539,826			539,826
LONG-TERM DEBT — Net of current portion	575,772			575,772
FAIR VALUE OF INTEREST RATE SWAP	40,375			40,375
LINE OF CREDIT — PH		3,036	(3,036)	-
Total liabilities	1,283,050	8,968	(3,589)	1,288,429
COMMITMENTS AND CONTINGENCIES (Note 14)				
NET ASSETS:				
Invested in capital assets — net of related debt	209,281			209,281
Restricted for repayment of debt	17,071			17,071
Restricted for capital acquisitions	13,921			13,921
Restricted for other purposes	326			326
Unrestricted	185,358	24		185,382
Total net assets	425,957	24	-	425,981
TOTAL	$ 1,709,007	$ 8,992	$ (3,589)	$ 1,714,410

(Concluded)

PALOMAR HEALTH

CONSOLIDATING STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2012
($ In thousands)

	PH and Entities	ARCH	Eliminations	Total
OPERATING REVENUE:				
Net patient service revenue	$ 470,171	$ 14,751	$ -	$ 484,922
Net premium revenue	38,552	15,290		53,842
Other revenue	12,994	2,421	(2,018)	13,397
Total operating revenue	521,717	32,462	(2,018)	552,161
OPERATING EXPENSES:				
Salaries, wages, and benefits	310,260	12,571		322,831
Professional fees	27,381	352	(2,018)	25,715
Supplies	76,250	2,316		78,566
Purchased services	43,472	14,740		58,212
Depreciation and amortization	21,323	1,023		22,346
Rent expense	8,904	4,191		13,095
Utilities	5,512			5,512
Other	14,904	776		15,680
Total operating expenses	508,006	35,969	(2,018)	541,957
INCOME FROM OPERATIONS	13,711	(3,507)	-	10,204
NONOPERATING INCOME (EXPENSES):				
Investment income	2,014			2,014
Unrealized (loss) gain on interest rate swap	(20,912)			(20,912)
Interest expense	(3,776)	(54)		(3,830)
Property tax revenue	12,686			12,686
Property tax revenue — general obligation bonds	15,353			15,353
Other — net	2,458			2,458
Total nonoperating income — net	7,823	(54)	-	7,769
EXCESS OF REVENUE OVER EXPENSES	21,534	(3,561)	-	17,973
INTERFUND — ARCH	(1,991)	1,796		(195)
INTERFUND — PIMG		97		97
CHANGE IN INTEREST IN COMPONENT UNIT			1,692	1,692
INCREASE IN NET ASSETS	19,543	(1,668)		19,567
NET ASSETS — Beginning of year	406,414	1,692	(1,692)	406,414
NET ASSETS — End of year	$ 425,957	$ 24	$ -	$ 425,981