AUDIT/COMPLIANCE COMMITTEE
FOR THE BOARD

TUESDAY, OCTOBER 20, 2009

8:00 - 10:00 A.M.

GRAND 1ST FLOOR CONFERENCE ROOM

Palomar Pomerado Health

Internal Audit and Compliance

Board Committee

PPH Grand Office Bldg

Tuesday – October, 2009
8:00 – 10:00 A.M.

456 E. Grand, Escondido
Conference Room - 1st floor

A G E N D A

Call To Order

- Public Comments
- *Approval of Minutes – September 15, 2009

	Item	***Presenter***	***Mins***
1.	Approval of FY 2009 Audit Report	M. Kawauchi (Deloitte)	45
2.	The Legal-Compliance-Internal Audit Triad	J. Sarti, T. Boyle, M. Knutson	20
3.	Committee Work-Plan	L. Greer	20
4.	Internal Audit Update	T. Boyle	10
5.	Hotline publicity efforts	M. Knutson	5
6.	* Date/Time/Location of Next Meeting	L. Greer	5

ADJOURNMENT

Linda Greer, Chairman	Janine Sarti, General Counsel	John Lilley, M.D.
Jerry Kaufman, M.A.P.T.	Bob Hemker, CFO	Lachlan Macleay, M.D,
Michael Covert, CEO	Tom Boyle, Internal Audit Officer	Bruce Krider, M.A., Alt
Marty Knutson, Corporate Compliance Officer	Anna Ha, Administrative Fellow	Donna Goh, IA Assistant

NOTE: Asterisks indicate anticipated action; action is not limited to those designated items.

"In observance of the ADA, Americans with Disabilities Act, please notify us at (858) 675-5230, forty-eight hours prior to meeting so that we may provide reasonable accommodations".

D R A F T

Palomar Pomerado Health
INTERNAL AUDIT & COMPLIANCE
BOARD SUB-COMMITTEE MEETING
PPH Corporate Building
456 E. Grand Ave.
1st Floor Conference Room
September 15, 2009

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
CALL TO ORDER	8:00 A.M. by Dir Greer. Quorum comprised of Directors Greer, Krider, and Kaufman. **Also attending:** Janine Sarti, Michael Covert, Bob Hemker, Lachlan Macleay, MD, Tom Boyle, Marty Knutson, Tammy Boring, and Donna Goh.		
NOTICE OF MEETING	Notice of Meeting was posted consistent with legal requirements.		
PUBLIC COMMENTS	None		
APPROVAL OF MINUTES •	The minutes of August 18, 2009 were reviewed and approved.	**MOTION:** by Dir Kaufmann, 2nd by Dir Krider and carried to approve the August 18, 2009 minutes as submitted. All in favor — none opposed.	
• **Welcome / Introductions**	Mr. Boyle introduced Tammy Boring, Senior Compliance Auditor, who has been on board with Internal Audit Services for a month. Coming from the University of Nevada, Tammy is not only a RN, but also a certified coder, and a HIPAA specialist. The department is thrilled to have such a qualified person on staff to deplete the current back-log that resulted from previous reduction in staff. Dir Greer extended a warm welcome on behalf of the committee.		

D R A F T

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
• **Overview of the Internal Audit Function**	Keeping ever current with ever changing methodologies, Mr. Boyle came across a summary from a survey conducted by Price Waterhouse Coopers that covered audit trends, technology, staffing, and the greater picture of risk management. Using this informational data, Mr. Boyle assessed how close PPH Internal Audit is compared to peer-organizations' auditing functions. Mr. Boyle presented an overview of the Internal Audit function. Highlights include: • Continuous monitoring is now the cutting-edge methodology for auditing. ✓ ACL is the tool and IA is actively using it. ✓ More controls are tested on transactional levels. ✓ Proves to be quicker than traditional audit methods. • Engaging more departments in self-assessment and to independently provide their areas of risk. ✓ Internal Audit (IA) reviews and validates data using various measures, indicators, surveys, including the Balanced Scorecard. ✓ IA identifies hot spots and commonalities. • Current test-project, Billing Assurance, targets major surgical procedures. ✓ Goal is to have report delivered to surgery department within 24 hours of encounter and before bill drops. • Continuous monitoring covers 100% of cases and proves timelier. • Continuous virus protection is the analogy for continuous monitoring.	The Price Waterhouse Coopers article will be electronically e-mailed to members of the committee. Internal Audit Presentation is available on the Leadership Drive.	

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
	• IA is always looking at what makes the best sense when considering outsourcing tasks. • Compliance risk plan includes structure from the OIG plan. • Highly considering using Enterprise Risk Management methodology as ERM is rapidly becoming a trend since it appears to be a more organized approach for risk management. • IA is also currently finalizing the risk assessment for FY10. Assessment include: ✓ Updating risk priorities within organization. ✓ IA's plan for each assessed area. • There is still a need for a non-clinical/operational auditor as the senior compliance auditor that has been filled by Tammy Boring targets mainly clinical functions/areas.	The committee recommends that Mr. Boyle present quantifiable risk assessment to justify this need.	
• **Red Flag Plan**	Ms. Knutson shared that the Federal Trade Commission has issued a regulation that requires a Red Flag Plan to be implemented by the organization on November 1, 2009. This date has been extended several times previously and this will be the final dead-line for implementation. FTC requires that the plan be approved by governing bodies prior to implementation. Ms. Knutson reviewed the documented plan with the committee. The plan identifies what PPH will do to prevent misuse of identification. As all procedures relate to policies, Ms. Knutson will share the policy this plan falls under with Dir. Greer as requested.	Ms. Knutson will share an electronic copy of the policy that covers the Red Flag Plan with Dir. Greer.	

D R A F T

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
	The Red Flag plan was reviewed and approved.	**MOTION:** by Dir Greer, 2nd by Dir Krider and carried to approve the Red Flag Plan as submitted. All in favor — none opposed.	
• **The Legal-Compliance-Internal Audit Function**	The three departments have met and would like to provide to the committee a more detailed presentation at the next meeting in October, 2009.		
• **Date/Time & Location of next meeting**	**Tuesday, October 20, 2009, 8:00 A.M. in the Corporate Conference Room @ 456 E. Grand.**		
(FINAL) ADJOURNMENT	9:40 A.M.	Dir Greer moved to adjourn. Dir Kaufman 2nd motion.	
SIGNATURES ▪ **Committee Chairperson** ▪ **Secretary to Committee**	________________________ [Linda C. Greer, R.N.] ________________________ [Donna Goh]		

Draft Audited Financial Statements for Years Ended June 30, 2009 and 2008

TO: Audit/Compliance Committee for the Board of Directors

MEETING DATE: Tuesday, October 20, 2009

FROM: Tim Nguyen, Corporate Controller

BY: Bob Hemker, CFO

Background: The draft Audited Financial Statements for the Years Ended June 30, 2009 and 2008, and the Independent Auditors' Report are respectfully submitted for approval

Budget Impact: N/A

Staff Recommendation: Approval of the draft Audited Financial Statements for the Years Ended June 30, 2009 and 2008, and the Independent Auditors' Report as submitted.

Committee Questions:

COMMITTEE RECOMMENDATION:

Motion:

Individual Action:

Information:

Required Time:

Deloitte.

Palomar Pomerado Health

Report to the Audit Committee on the Audit of the Fiscal 2009 Consolidated Financial Statements

DRAFT

Deloitte & Touche LLP
October 20, 2009

Audit.Tax.Consulting.Financial Advisory.

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Section 1

Summary of Significant Conclusions

We have performed an audit of the consolidated financial statements of Palomar Pomerado Health (PPH) as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America ("generally accepted auditing standards") and have issued our report thereon dated October , 2009.

Based on our work performed:

- We have issued an unqualified opinion on the consolidated financial statements of PPH.
- Our audit scope was described to you in our engagement letter dated June 30, 2009, and 2009 Audit Service Plan we presented to you on July 21, 2009. Our audit scope was not restricted in any way throughout the course of the audit.
- No significant scope changes resulted from the execution of our 2009 Audit Service Plan.
- Our auditing procedures addressed the risks identified during our planning procedures; no new risk areas were identified during the course of our audit.

The following pages provide the details of our audit procedures and required communications in accordance with AU 380, *The Auditor's Communication with Those Charged with Governance*.

This report is intended solely for the information and use of the Audit Committee, the Board of Directors, management, and others within PPH and is not intended to be, and should not be, used by anyone other than these specified parties.

Section 2

Scope of the Audit

As described in our 2009 Audit Service Plan, we planned and performed our audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether caused by error or fraud. Our risk-based audit approach focuses on certain financial statement items that present greater-than-normal risk. During our planning stages of our audit, we identified certain significant risks. No new risks were identified during our audit procedures. The risks identified and the results of our related audit procedures are as follows:

Significant Risk	Audit Procedures	Results
Due to PPH's outstanding bonds, the organization has significant public accountability	During the course of the audit, Deloitte will review transactions to ensure the substance equals the form. We will meet with management regularly to discuss key issues relevant to PPH.	During the course of the audit, we discussed key issues in detail with PPH management to ensure proper accounting and recording in PPH's consolidated financial statements. In addition, we performed testing over a sample of journal entries using file interrogation software to ensure they were appropriate and properly supported. Further, we reviewed PPH's compliance with debt covenants, noting PPH appeared to be in compliance.
Management Override of Internal Controls	We will (1) scrutinize areas of estimate or judgment for a pattern of bias, (2) examine documentation from independent sources, (3) inquire of others within or outside of PPH, and (4) perform selection sampling using file interrogation software.	We gained a thorough understanding of the estimates and judgments used by PPH management and performed a combination of detailed testing and substantive analytical review to test those estimates. Based on procedures performed, we noted no management bias or override. In addition, we performed testing over a sample of journal entries using file interrogation software to ensure they were appropriate and properly supported. Based on the testing performed on these estimates, we identified two misstatements that we deemed immaterial, both individually and in aggregate, by management. We agreed with management's assessment.

Significant Risk	Audit Procedures	Results
New Significant Transactions and Proper Accounting	From time to time, PPH enters into new joint ventures and/or partnership agreements, such as the Gateway-Parkway Joint Venture. We will work with management to understand all aspects of the transaction and read all related agreements to ensure the accounting for such transactions is appropriately reflected in the consolidated financial statements.	We thoroughly reviewed the Board of Director minutes and followed up on any transactions mentioned within the minutes to ensure proper accounting treatment. Specifically, we reviewed the dissolution of Gateway-Parkway Joint Venture for proper accounting. We noted no adjustments based on our testing.
Unpaid Claims Liability (IBNR)	Deloitte actuaries will assist in evaluating whether PPH's estimates are reasonable. We will also perform detailed testing of the underlying claims data used to estimate the incurred but not reported (IBNR) liability.	Due to the significant estimates involved in the calculation of the potential liability related to IBNR claims, Deloitte actuaries evaluated the liability at year-end utilizing schedules prepared by PPH. The underlying claims data utilized to prepare the IBNR liability was tested by the audit team. Based on testing performed, no adjustments were identified.
Contractual and Bad Debt Allowances	We will assess contractual and bad debt allowances based on historical collections and write-offs, and will perform detailed substantive procedures on individual financial classes.	The contractual and bad debt allowance testing was performed by an experienced member of our audit team with health care experience. PPH's methodology was reviewed for consistency with the prior year. We increased our level of focus on the individual financial classes and identified no adjustments.
Interest Rate Swaps	Deloitte valuation specialists will assist in evaluating whether the swap valuations are reasonable. We will also perform testing of the underlying data used to determine the swap valuations.	We obtained confirmations for the value of the interest rate swaps. Deloitte Capital Markets specialists were utilized to test the reasonableness of the swap valuations. Our specialists, along with our audit team, concluded that the valuation of the swaps, recorded by management, was reasonably stated and no adjustments were recorded.

Significant Risk	Audit Procedures	Results
Accounting for 2009 Capital Appreciation Bonds	The 2009 Capital Appreciation Bonds (CABs) may have complex accounting requirements attached due to the nature of the bonds. We will audit the accounting related to these bonds and consult with our specialists, as needed, to ensure this issuance has been appropriately recorded in the consolidated financial statements.	We assessed whether any embedded derivatives existed within the convertible CABs. We consulted with specialists to review the specific nature of these CABs, and based on the procedures performed, no embedded derivative was identified, and management's accounting treatment appeared to be reasonable.
Classification of Net Assets	This continues to be an area of focus. We will perform a focused level of testing in this area, specifically on the classification of net assets and appropriate reflection in the consolidated financial statements.	We focused our testing of net assets specifically on classification of net assets in fiscal 2009 and found no material errors.
Significant increase in Construction in Progress in fiscal 2009	Due to the significant increase in Construction in Progress (CIP) in fiscal 2009, we will perform a focused level of testing in CIP additions. Additionally, we will review PPH's methodology for capitalizing costs (including construction costs and interest expense) to ensure items are recorded in accordance with generally accepted accounting principles.	A focused level of detailed testing was performed of CIP items to ensure all items being capitalized were properly recorded. In addition, we reviewed PPH's methodology for capitalizing interest costs in accordance with Statement of Financial Accounting Standards ("SFAS") No. 34, *Capitalization of Interest Cost*. No material errors were identified.
Revenue Recognition – Medicare prior year settlements – net premium revenue and deductions to revenue	We will increase our substantive procedures to ensure revenue is recognized in accordance with generally accepted accounting principles ("GAAP") and PPH's policy.	A focused level of detailed testing was performed of this area. Based on procedures performed, no material adjustments were noted.

Section 3

Required Communications with the Audit Committee

We have prepared the following comments to assist you in fulfilling your obligation to oversee the financial reporting and disclosure process for which management of PPH is responsible.

Our Responsibility under Generally Accepted Auditing Standards

Our responsibility under generally accepted auditing standards has been described to you in our engagement letter dated June 30, 2009, a copy of which has been provided to you. As described in that letter, the objective of a financial statement audit conducted in accordance with generally accepted auditing standards is to express an opinion on the fairness of the presentation of PPH's consolidated financial statements for the year ended June 30, 2009, in conformity with generally accepted accounting standards, in all material respects.

Our responsibilities under generally accepted auditing standards include forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of the Audit Committee are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The audit of the consolidated financial statements does not relieve management or the Audit Committee of their responsibilities.

We considered PPH's 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 PPH's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of PPH's internal control over financial reporting.

Our consideration of internal control over financial reporting would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses.

Accounting Estimates

Accounting estimates are an integral part of the consolidated financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and on assumptions about future events.

Significant accounting estimates reflected in PPH's 2009 consolidated financial statements include:

- Contractual allowances
- Allowance for bad debts
- Capitated contracts
- Workers' compensation liabilities:

- Incurred But Not Reported (IBNR)
- Alpha Fund

- Professional tail liability reserves

During the year ended June 30, 2009, there were no significant changes in accounting estimates or in management's judgments relating to such estimates.

Uncorrected Misstatements

Our audit was designed to obtain reasonable, rather than absolute, assurance about whether the consolidated financial statements are free of material misstatement, whether caused by error or fraud. We have attached to this letter, as Appendix A, a summary of uncorrected misstatements and a summary of disclosures passed aggregated by us during the current engagement and pertaining to the latest period and prior period presented that were determined by management to be immaterial, both individually and in the aggregate, to the consolidated financial statements taken as a whole.

Material Corrected Misstatements

Our audit of the consolidated financial statements was designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. We identified two reclassification entries that were brought to the attention of management as a result of our audit procedures and were corrected by management as of June 30, 2009. The two entries related to reclassifying the accrued interest on the 2009 and 2007 CAB issuances from current liabilities to long-term liabilities. As a result of recording these entries, there was no change in total liabilities or net assets in the consolidated balance sheets.

Significant Accounting Policies

PPH's significant accounting policies are set forth in Note 1 to the PPH's 2009 consolidated financial statements. During the year ended June 30, 2009, there were no significant changes in previously adopted accounting policies or their application.

We had no discussions with management regarding alternative accounting treatments within U.S. GAAP for policies and practices related to material items, including recognition, measurement, and disclosure considerations related to the accounting for specific transactions or general accounting policies, related to the year ended June 30, 2009.

Documents Containing Audited Financial Statements

When audited financial statements are included in documents containing other information, such as the pending Offering Documents related to the Series 2009 Certificates of Participation offering, we read such other information and consider whether it, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the consolidated financial statements audited by us. We have read the other information in PPH's pending Offering Documents, as referred to above, and have inquired as to the methods of measurement and presentation of such information. If we noted a material inconsistency or if we obtained any knowledge of a material misstatement of fact in the other information, we discussed this matter with management.

Disagreements with Management

We have not had any disagreements with management related to matters that are material to PPH's June 30, 2009, consolidated financial statements.

Consultation with Other Accountants

We are not aware of any consultations that management may have had with other accountants about auditing and accounting matters during the year ended June 30, 2009.

Significant Issues Discussed, or Subject of Correspondence, with Management Prior to Our Retention

Throughout the year, routine discussions regarding the application principles or accounting principles or auditing standards were held with management in connection with transactions that occurred, transactions that were contemplated, or reassessment of current circumstances. In our judgment, such discussions were not held in connection with our retention as independent auditors.

Significant Difficulties Encountered in Performing the Audit

In our judgment, we received the full cooperation of PPH's management and staff and had unrestricted access to its senior management in the performance of our audits.

Management's Representations

We have made specific inquiries of PPH's management about the representations embodied in the consolidated financial statements. Additionally, we have requested that management provide to us the written representations PPH is required to provide to its independent auditors under generally accepted auditing standards. We have attached to this letter, as Appendix B, a copy of the representation letter we obtained from management. There were no other written communications between management and us that we believe represent material written communications related to the audit of the consolidated financial statements for the year ended June 30, 2009.

* * * * * *

Appendix A

Uncorrected Misstatements

Current Year Likely Misstatements – Uncorrected	Assets Dr (Cr)	Liabilities Dr (Cr)	Net Assets Beginning of Year Dr (Cr)	Statement of Revenue, Expenses, and Changes in Net Assets Dr (Cr)
1. Correction to reserves for IBNR-medical malpractice*		$ (1,400,000)	$ 1,400,000	
2. Correction to Recovery Audit Contractor ("RAC") reserves		$ 801,000		$ (801,000)
Total Current Year Likely Misstatements	$ 0	$ (599,000)	$ 1,400,000	$ (801,000)

* Represents adjustments to prior year Balance Sheet.

Disclosures Passed

Footnote Number	Footnote Title	Description of Omitted or Unclear Disclosure	Authoritative Literature Reference	Dollar Amount of Omitted or Unclear Disclosure (if applicable)
6	Investment in and Amounts Due From Affiliated Entities	The dollar amount of the equipment rental from San Diego Radiosurgery was not disclosed.	GASB Statement No. 13, Appendix A, Paragraph 24 (SFAS No. 13.29)	$1.3M
9	Operating Leases	Equipment rental from San Diego Radiosurgery was not included within minimum lease payment schedule.	GASB Statement No. 13, Appendix A, Paragraph 24 (SFAS No. 13.23(b))	$1.3M/year through 2013

APPENDIX B

October xx, 2009

Deloitte & Touche LLP
701 "B" Street, Suite 1900
San Diego, CA 92101

We are providing this letter in connection with your audits of the consolidated balance sheets of Palomar Pomerado Health ("PPH") as of June 30, 2009 and 2008 and the related consolidated statements of revenue, expenses, and changes in net assets and cash flows for the years then ended for the purpose of expressing an opinion as to whether the consolidated financial statements present fairly, in all material respects, the financial position, results of operations, changes in net assets, and cash flows of PPH in conformity with accounting principles generally accepted in the United States of America.

We confirm that we are responsible for the following:

a. The fair presentation in the consolidated] financial statements of financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America ("GAAP")

b. The fair presentation of the additional information in Management's Discussion and Analysis accompanying the consolidated basic financial statements that is presented for the purpose of additional analysis of the consolidated basic financial statements

c. The design and implementation of programs and controls to prevent and detect fraud

d. Establishing and maintaining effective internal control over financial reporting

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audits.

1. The basic consolidated financial statements referred to above are fairly presented in conformity with GAAP. In addition:

   a. The financial statements include all component units as well as joint ventures with an equity interest, and properly disclose all other joint ventures and other related organizations.

   b. The financial statements properly classify all funds and activities, including special and extraordinary items.

   c. All funds that meet the quantitative criteria in Statement No. 34 and Statement No. 37 of the Governmental Accounting Standards Board (GASB), *Basic Financial Statements – and*

Management's Discussion and Analysis – for State and Local Governments, for presentation as major are identified and presented as such and all other funds that are presented as major are particularly important to financial statement users.

d. Net asset components (invested in capital assets, net of related debt; restricted; and unrestricted) and fund balance reserves and designations are properly classified and, if applicable, approved.

e. Expenses have been appropriately classified in or allocated to functions and programs in the statement of activities, and allocations have been made on a reasonable basis.

f. Revenues are appropriately classified in the statement of activities within program revenues, general revenues, contributions to term or permanent endowments, or contributions to permanent fund principal

g. Interfund, internal, and intra- entity activity and balances have been appropriately classified and recorded.

h. Deposits and investment securities are properly classified in category of custodial risk.

i. Capital assets, including infrastructure assets, are properly capitalized, reported, and, if applicable, depreciated.

j. Applicable laws and regulations are followed in adopting, approving and amending budgets.

2. PPH has made available to you all:

   a. Minutes of the meetings of stockholders, directors, and committees of directors or summaries of actions of recent meetings for which minutes have not yet been prepared.

   b. Financial records and related data for all financial transactions of PPH and for all funds administered by PPH. The records, books, and accounts, as provided to you, record the financial and fiscal operations of all funds administered by PPH and provide the audit trail to be used in a review of accountability. Information presented in financial reports is supported by the books and records from which the financial statements have been prepared.

   b. Peer review organization, fiscal intermediary, and third-party payor reports and information.

3. There have been no communications (oral or written) from regulatory agencies, governmental representatives, employees, or others concerning noncompliance with laws and regulations in any jurisdictions (including those related to the Medicare and Medicaid antifraud and abuse statutes) or noncompliance with or deficiencies in financial reporting practices.

4. We believe the effects of any uncorrected financial statement misstatements aggregated by you during the current audit engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such uncorrected misstatements has been attached as Appendix A.

5. We believe the effects of the uncorrected financial statement misstatements detected in the current year that relate to the prior year presented, when combined with those misstatements aggregated by you during the prior-year audit engagement and pertaining to the prior year presented, are

immaterial, both individually and in the aggregate, to the financial statements for the year ended June 30, 2009 taken as a whole.

6. We have completed our procedures to evaluate the accuracy and completeness of the disclosures in our financial statements. As a result of the evaluation process, we identified certain disclosures that, although required by generally accepted accounting principles, have been omitted from our financial statements. Those omitted disclosures that are more than inconsequential are attached as Appendix B. We believe the effects of the omitted disclosures are quantitatively and qualitatively immaterial, both individually and in the aggregate, to the financial statements as a whole.

7. PPH has made available to you the results of management's risk assessment, including the assessment of the risk that the financial statements may be materially misstated as a result of fraud.

8. We have no knowledge of any fraud or suspected fraud affecting the PPH involving:

   a. Management

   b. Employees who have significant roles in the PPH's internal control over financial reporting

   c. Others if the fraud could have a material effect on the financial statements.

9. We have no knowledge of any allegations of fraud or suspected fraud affecting PPH received in communications from employees, former employees, analysts, regulators, short sellers, or others.

10. There are no unasserted claims or assessments that legal counsel has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies.*

11. PPH is a governmental subdivision of the state of California and is exempt from federal income and state franchise taxes.

12. Tax-exempt bonds issued have retained their tax-exempt status.

Except where otherwise stated below, matters less than $200,000 collectively are not considered to be exceptions that require disclosure for the purpose of the following representations. This amount is not necessarily indicative of amounts that would require adjustment to or disclosure in the financial statements.

13. Except as listed in Appendix A, there are no transactions that have not been properly recorded in the accounting records underlying the financial statements.

14. PPH has no plans or intentions that may affect the carrying value or classification of assets and liabilities.

15. The following, to the extent applicable, have been appropriately identified, properly recorded, and disclosed in the financial statements:

    a. Related party transactions and associated amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees (written or oral)

    b. Guarantees, whether written or oral, under which PPH is contingently liable

16. In preparing the financial statements in conformity with GAAP, management uses estimates. All estimates have been disclosed in the financial statements for which known information available prior to the issuance of the financial statements indicates that both of the following criteria are met:

    a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

    b. The effect of the change would be material to the financial statements.

17. Risks associated with concentrations, based on information known to management, that meet all of the following criteria have been disclosed in the financial statements:

    a. The concentration exists at the date of the financial statements.

    b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.

    c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

18. There are no:

    a. Violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes, including but not limited to the Anti-Kickback Act, Limitations on Certain Physician Referrals (commonly referred to as the "Stark law"), and the False Claims Act, in any jurisdiction, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

    b. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5, *Accounting for Contingencie*s.

19. PPH has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral, except as disclosed in the financial statements.

20. PPH has complied with all aspects of contractual agreements, bond indentures or other debt instruments, grants, and donor restrictions that may have an effect on the financial statements in the event of noncompliance.

21. No department or agency of PPH has reported a material instance of noncompliance to us.

22. The Entity has identified all derivative instruments as defined by GASB Technical Bulletin 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets (TB 03-1)*, and appropriately disclosed such derivatives in accordance with TB 03-1.

23. No events have occurred subsequent to June 30, 2009 that requires consideration as adjustments to or disclosures in the financial statements.

24. Management has disclosed whether, subsequent to June 30, 2009, any changes in internal control or other factors that might significantly affect internal control, including any corrective action taken by management with regard to significant deficiencies and material weakness, have occurred.

25. We have disclosed to you any change in PPH's internal control over financial reporting that occurred during PPH's most recent fiscal year that materially affected, or is reasonably likely to affect, PPH's internal control over financial reporting.

26. PPH has disclosed all contracts or other agreements with PPH's service organizations.

27. With regard to the fair value measurements and disclosures of certain assets and liabilities, such as investments and debt, we believe that:

    a. The measurement methods, including the related assumptions, used in determining fair value were appropriate and were consistently applied in accordance with GAAP.

    b. The completeness and adequacy of the disclosures related to fair values are in conformity with accounting principles generally accepted in the United States of America.

    c. Other than disclosed in the notes to the financial statements, no events have occurred subsequent to June 30, 2009 that require adjustment to the fair value measurements and disclosures included in the financial statements

28. PPH, using its best estimates based on reasonable and supportable assumptions and projections, reviews for impairment of long-lived assets in accordance with Governmental Accounting Standards Boards Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and Insurance Recoveries*. Other than those disclosed in the notes to the financial statements, no adjustments under Statement No. 42 were necessary.

29. PPH has no interests in or transactions with (1) variable interest entities ("VIEs"), (2) potential VIEs that we considered but judged not be VIEs, and (3) entities that were afforded the scope exceptions of FASB Interpretation No. 46, Consolidation of Variable Interest Entities (revised December 2003) ("FIN 46R").

30. In June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. PPH will adopt GASB Statement No. 51 effective for the fiscal year beginning July 1, 2009. GASB Statement No. 51 requires that all intangible assets not specifically excluded by its scope provisions to be classified as capital assets. This statement also provides guidance on recognition and amortization of intangible assets. Management is currently evaluating the impact of applying the provisions of this statement on PPH's consolidated financial statements.

31. In November 2007, the GASB issued GASB Statement No. 52, *Land and Other Real Estate Held as Investments as Endowments.* GASB Statement No. 52 is effective for periods beginning after June 15, 2008, and establishes consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported at fair value. Implementation of this statement did not have a material effect on the District's consolidated net assets or revenue, expenses, and changes in net assets.

32. In June 2008, the GASB issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.* GASB Statement No. 53 is effective for periods beginning after June 15, 2009. This Statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. Management is

currently evaluating the impact of applying the provisions of this statement on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

33. In March 2009, the GASB issued GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments.* GASB Statement No. 55 was effective upon issuance, and is intended to assist preparers of state and local government financial statements to identify and apply the GAAP hierarchy. This statement did not have an impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

34. In March 2009, the GASB issued GASB Statement No. 56, *Codification of Accounting and Financial Reporting guidance Contained in the AICPA Statements on Auditing Standards.* GASB Statement No. 56 is an effort to codify all generally accepted accounting principles for state and local governments. GASB Statement No. 56 was effective upon issuance. Statement 56 guidance addresses three issues from the AICPA's literature – related party transactions, going concern considerations, and subsequent events. Adoption of this statement did not have a significant impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

35. In May 2009, the FASB issued FASB Statement No. 165, *Subsequent Events*, which is effective for periods ending after June 15, 2009. FASB Statement No. 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The Company has adopted FASB Statement No. 165 for the Company's financial statements for the year ended June 30, 2009.

36. We agree with the findings of the specialist in evaluating workers' compensation and IBNR reserves for capitation and medical malpractice, and have adequately considered the qualifications of the specialist in determining amounts and disclosures used in the financial statements and underlying accounting records. We did not give any instructions, nor cause any instructions to be given, to the specialist with respect to values or amounts derived in an attempt to bias their work, and we are not aware of any matters that have affected the independence or objectivity of the specialists.

37. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements have been properly disclosed in the financial statements.

38. Financial instruments with significant individual or group concentration of credit risk have been appropriately identified, properly recorded, and disclosed in the financial statements.

39. Receivables recorded in the financial statements represent valid claims against debtors for sales or other charges arising on or before the balance-sheet date and have been appropriately reduced to their estimated net receivable value.

40. Provision has been made to reduced excess or obsolete inventories to their estimated net realizable value. All inventories are the property of PPH and do not include any items consigned to it, any items billed to customers or any items for which the liability has not been recorded.

41. We believe that all expenditures that have been deferred to future periods are recoverable.

42. Employee layoffs that would be otherwise lead to a curtailment of a benefit plan are intended to be temporary.

43. We have no intention of terminating our defined contribution pension plan or taking any other action that could result in an effective termination or reportable event for any of the plans. We are not aware of any occurrences that could result in the termination of our pension plan to which we contribute.

44. Provision has been made for any loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.

45. Provision has been made for any loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

46. Provision has been made for losses to be sustained in the fulfillment of, or from the inability to fulfill, any commitments to purchase or sell securities under forward-placement, financial futures contracts, and standby commitments.

47. PPH's billings to third-party payers comply with applicable coding and principles and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse) and only reflect charges for goods and services that were medically necessary, properly approved by regulatory bodies, if required, and properly documented.

48. There have been no internal or external investigations relating to PPH's compliance with applicable laws and regulations (including investigations in progress) that would have an effect on the amounts reported in the financial statements or on the disclosure in the notes to the financial statements.

49. With respect to third-party cost reports:

   a. All required Medicare, Medicaid, and similar reports have been properly filed.

   b. Management is responsible for the accuracy and propriety of all cost reports filed.

   c. All costs reflected on such reports are appropriate and allowable under applicable reimbursement rules and regulations and are patient-related and properly allocated to applicable payers.

   d. The reimbursement methodologies and principles employed are in accordance with applicable rules and regulations.

   e. Adequate consideration has been given to, and appropriate provision made for, audit adjustments by intermediaries, third-party payers, or other regulatory agencies.

   f. All items required to be disclosed, including disputed costs that are being claimed to establish a basis for a subsequent appeal, have been fully disclosed in the cost report.

   g. Recorded third-party settlements include differences between filed (and to-be-filed) cost reports and calculated settlements, which are necessary based on historical experience or new or ambiguous regulations that may be subject to differing interpretations. While management believes the Entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.

50. The recorded valuation allowances for accounts receivable and settlements with third parties are necessary, appropriate, and properly supported. Provision has been made for estimated retroactive adjustments by third-party payers under reimbursement agreements.

51. In determining the allowance for accounts receivable, adequate consideration has been given to, and adequate provision made for, estimated adjustments to revenue, such as for denied claims and changes to home resource group ("HRG"), resource utilization group ("RUG"), ambulatory payment classification ("APC"), and diagnosis-related group ("DRG") assignments.

52. Accruals for losses from malpractice, workers compensation, and other types of self-insured risk, including accruals for claims incurred but not reported, have been properly recorded and disclosed in the financial statements.

53. PPH has reported to its risk management department all known asserted and unasserted claims and incidents. Adequate and reasonable provision has been made for losses related to the asserted and unasserted malpractice.

54. PPH has recorded all contributions received during the year and has maintained an appropriate composition of assets in amounts needed to comply with all donor restrictions.

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

56. In accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, PPH's interest rate swap agreement is reflected at fair value in the accompanying balance sheets. The fair value of the interest swap agreement will fluctuate, generally based on changes in market rates of interest. Any unrealized gains or losses resulting from changes in fair value are reported in the statements or revenues, expenses and changes in net assets. At June 30, 2009, PPH's interest rate swap agreement was in a liability position, based on market prices of similar financial instruments, of approximately $16,752,000 resulting primarily from an in market interest rates subsequent to the inception of the interest rate swap agreement

57. PPH has recorded as of June 30, 2009 and 2008, its best estimate of its anticipated asset for FY09 and FY08 for its share of the accumulated surplus/deficit of the Association of California Hospital Districts ALPHA Fund.

58. PPH has not met the base criteria of its incentive compensation plan program for the year ended June 30, 2009, and therefore, did not record an incentive payable at June 30, 2009.

Michael Covert, Chief Executive Officer

Robert Hemker, Chief Financial Officer

Tim Nguyen, Controller

APPENDIX A

PALOMAR POMERADO HEALTH
SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS
Year Ended June 30, 2009

Misstatements identified in 2009 year				
	Assets	**Liabilities**	**Retained Earnings Beg of Year**	**Statement of Revenue, Expenses, and Changes in Net Assets**
	Dr (Cr)	**Dr (Cr)**	**Dr (Cr)**	**Dr (Cr)**
1. Correction to reserves for IBNR-medical malpractice**		$ (1,400,000)	$ 1,400,000	
2. Correction to 3rd party settlements for RAC reserves		$ 801,000		$ (801,000)

** Represents adjustment to prior year Balance Sheet

APPENDIX B

PALOMAR POMERADO HEALTH
SUMMARY OF OMITTED DISCLOSURES
Year Ended June 30, 2009

Footnote Number	Footnote Title	Description of Omitted or Unclear Disclosure	Authoritative Literature Reference	Dollar Amount of Omitted or Unclear Disclosure (if applicable)
6	Investment in and Amounts Due From Affiliated Entities	The dollar amount of the equipment rental from San Diego Radiosurgery was not disclosed.	GASB Statement No. 13, Appendix A, Paragraph 24 (SFAS No. 13.29)	$1.3M
9	Operating Leases	Equipment rental from San Diego Radiosurgery was not included within minimum lease payment schedule.	GASB Statement No. 13, Appendix A, Paragraph 24 (SFAS No. 13.23(b))	$1.3M/yr through 2013

Palomar Pomerado Health

Consolidated Financial Statements as of and for the Years Ended June 30, 2009 and 2008, and Independent Auditors' Report

PALOMAR POMERADO HEALTH

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PALOMAR POMERADO HEALTH

MANAGEMENT'S DISCUSSION AND ANALYSIS

Overview

Palomar Pomerado Health (PPH) is a public healthcare 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 of California.

This section of PPH's annual financial report presents our analysis of PPH's financial performance for the years ended June 30, 2009 and 2008. Although the 2007 condensed consolidated balance sheet, statement of revenue, expenses, and changes in net assets, and 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 Palomar Pomerado Health, including notes that explain in more detail some of the information in the consolidated financial statements

PPH'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 healthcare 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 PPH's activities.

Required Financial Statements

Consolidated Balance Sheets — The consolidated balance sheets include all of PPH's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to PPH's creditors (liabilities), and net assets — the difference between assets and liabilities — of PPH and the changes in them. The balance sheets also provide the basis for evaluating the capital structure of PPH and assessing the liquidity and financial flexibility of PPH.

CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2009, 2008, AND 2007
($000s)

	2009	**2008**	**2007**
ASSETS			
Current assets	$ 245,862	$ 217,613	$ 236,948
Capital assets	568,152	379,286	272,211
Noncurrent assets	287,946	351,425	165,152
TOTAL	$ 1,101,960	$ 948,324	$ 674,311
LIABILITIES AND NET ASSETS			
Current liabilities	$ 108,901	$ 102,455	$ 77,105
Other long-term liabilities (long-term workers' compensation)	1,714	2,511	5,024
Fair value of interest rate swap	16,752	6,025	
Long-term debt — net of current portion	645,744	531,954	294,724
Total liabilities	773,111	642,945	376,853
Invested in capital assets — net of related debt	149,971	126,940	92,944
Restricted for repayment of debt	13,923	20,708	29,698
Restricted for capital acquisitions	14,382	14,266	13,747
Restricted for other purposes	312	304	296
Unrestricted	150,261	143,161	160,773
Total net assets	328,849	305,379	297,458
TOTAL	$ 1,101,960	$ 948,324	$ 674,311

2009: Analysis of the Consolidated Balance Sheets

- Current assets increased $28,249,000 in 2009 primarily due to increases in investments of $33,435,000 and Patient Accounts Receivable of $8,057,000, which were offset by decreases in cash of $2,224,000, other receivables of $1,279,000, assets whose use is limited – current portion of $8,032,000 and assets whose use is limited – GO Bonds of $1,435,000.

- Capital assets increased by $188,866,000 primarily due to purchases related to PPH's major building projects of $210,391,000 offset by net disposals of $264,000, and depreciation expense of $21,261,000.

- Noncurrent assets decreased by $63,479,000 primarily due to the decrease of trustee-held funds of $54,706,000; a decrease in Board Designated funds of $12,117,000 and an increase in deferred financing costs of $4,307,000.

- Current liabilities increased by $6,446,000, primarily due to a $4,601,000 increase in accounts payable, a $1,688,000 increase in accrued compensation and related liabilities, a $1,536,000 increase in estimated third-party payor settlements and a $1,182,000 increase in other current liabilities. These increases were offset by a decrease in accrued interest payable of $2,681,000.

- Long-term debt increased by $113,790,000 primarily as a result of the issuance of $110,000,000 of Series 2009 General Obligation Bonds, plus the original issue premium of $5,364,000 less the principal payments on all PPH's bond issues of $9,660,000.

- Net assets increased $23,470,000 primarily due to results of operations of $9,469,000, property tax revenue of $25,505,000, offset by unrealized loss on interest rate swap of $10,727,000.

2008: Analysis of the Consolidated Balance Sheets

- Current assets decreased $19,335,000 in 2008 primarily due to a decreases in investments of $34,148,000; estimated third party payor settlements of $2,580,000 and the current portion of assets whose use is limited of $7,323,000 which were offset by increases in cash of $11,213,000; assets whose use is limited – GO Bonds - of $4,613,000; accounts receivable (net) of $6,741,000 and in prepaid expenses of $1,720,000.

- Capital assets increased by $107,075,000 primarily due to purchases related to PPH's major building projects of $128,511,000 offset by net disposals of $38,000, and depreciation expense of $21,398,000.

- Noncurrent assets increased by $186,273,000 primarily due to the increase of trustee-held funds of $169,955,000 and an increase in Board Designated funds of $12,117,000.

- Current liabilities increased by $25,350,000, primarily due to a $17,000,000 increase in accounts payable owed for the building project, and a $6,159,000 increase in accrued interest payable for the 2007 General Obligation bonds.

- Long-term debt increased by $237,230,000 primarily as a result of the issuance of $241,083,000 of Series 2007 General Obligation Bonds, plus the original issue premium of $5,708,000 less the principal payments on all PPH's bond issues of $13,220,000.

- Net assets increased $7,921,000 primarily due to investment income and tax revenue.

Consolidated Statements of Revenue, Expenses, and Changes in Net Assets — All of PPH's revenue, expenses, and other changes in net assets are accounted for in the consolidated statements of revenue, expenses, and changes in net assets. This statement measures the success of PPH's operations during the years presented and can be used to determine whether PPH 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 PPH'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 YEARS ENDED JUNE 30, 2009, 2008 AND 2007 ($000s)

	2009	2008	2007
OPERATING REVENUE:			
Net patient service revenue	$ 397,544	$ 370,661	$ 336,292
Net premium revenue	40,890	38,003	40,404
Other revenue	7,571	10,904	9,299
Total operating revenue	446,005	419,568	385,995
OPERATING EXPENSES	436,536	429,010	385,356
INCOME (LOSS) FROM OPERATIONS	9,469	(9,442)	639
NONOPERATING INCOME (EXPENSES):			
Investment income	4,290	6,698	7,275
Unrealized (loss) gain on interest rate swap	(10,727)	(10,398)	4,373
Interest expense	(5,353)	(4,514)	(3,337)
Property tax revenue	13,505	13,346	12,562
Property tax revenue — general obligation bonds	12,000	11,708	11,016
Other — net	286	252	468
Total non operating income — net	14,001	17,092	32,357
EXCESS OF REVENUE OVER EXPENSES	23,470	7,650	32,996
OTHER CHANGES IN NET ASSETS		271	193
INCREASE IN NET ASSETS	23,470	7,921	33,189
NET ASSETS — Beginning of year	305,379	297,458	264,269
NET ASSETS — End of year	$ 328,849	$ 305,379	$ 297,458
ADJUSTED DISCHARGES	40,052	40,309	40,507

2009: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Assets

- In accordance with generally accepted accounting principles for governmental healthcare providers, PPH's consolidated statements of revenue and expenses and changes in net assets reflect the following: (1) net patient service revenues 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 PPH to nonprofit and for-profit hospitals. The provision for bad debts was $54,464,000 in fiscal year 2009 and $41,358,000 in fiscal year 2008, and interest expense was $5,353,000 in fiscal year 2009 and $4,514,000 in fiscal year 2008.

- 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 PPH's primary activity of treating patients and other revenue. Operating revenue increased $26,437,000 in 2009 due to increases in net patient service revenue of $26,883,000, increase in net premium revenue of $2,887,000, and decrease in other revenue $3,333,000. Increases in inpatient and outpatient ancillary revenue and negotiated increases in contracted rates resulted in an increase in net charges during the year. Other revenue decreased due to disaster relief revenue and insurance recovery related to the wildfires recorded in prior fiscal year.

- Operating expenses are those expenses related to the treatment of patients, including overhead and administration expenses. Operating expenses increased by $7,526,000 in 2009 primarily due to increases in labor costs of approximately $9,419,000, supplies of $4,204,000, utilities expense of $1,010,000 and rent expense of $912,000, and decreases in professional fees of $4,944,000 and other expenses of $2,655,000. The labor increase is due to PPH's commitment to its employees through contracted wage increases. The increase in supplies is due to increased complexity of cases and increased implantable device surgical cases. The rent increase is due to having one of the first image-guided radiosurgery Novalis Tx machines in the country for the treatment of tumors. Professional fees decreased due to the creation of a legal counsel department within PPH and the completion of an information technology upgrade project last fiscal year. Other expenses decreased due to reductions in advertising, training, and travel expenses.

- Operating income in 2009 was $9,469,000. This operating income is a result of operating revenues in excess of expenses.

- Non operating income (expenses) consists of interest earned on invested monies, interest expense, and PPH's share of property taxes collected by the County of San Diego. PPH's non operating income was $14,001,000 in 2009 and $17,092,000 in 2008. Investment income decreased $2,408,000 due to current economic conditions.

- As a result of the factors noted above, net assets increased by $23,470,000 in 2009, which is $15,549,000 more than the 2008 increase in net assets of $7,921,000.

2008: Analysis of the Consolidated Statement of Revenue, Expenses, and Changes in Net Assets

- In accordance with generally accepted accounting principles for governmental healthcare providers, PPH's consolidated statements of revenue and expenses and changes in net assets reflect the following: (1) net patient service revenues 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 PPH to nonprofit and for-profit hospitals. The provision for bad debts was $41,358,000 in fiscal year 2008 and $41,968,000 in fiscal year 2007, and interest expense was $4,514,000, in fiscal year 2008 and $3,337,000 in fiscal year 2007.

- Operating revenue is generated by PPH's primary activity of treating patients. Operating revenue increased $33,573,000 in 2008 primarily due to an increase in inpatient and outpatient ancillary revenue and negotiated increases in contracted rates, resulting 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 $43,654,000 in 2008 primarily due to increases in labor costs of approximately $21,895,000, purchased services of $4,873,000, professional fees of $4,458,000, depreciation expense of $1,938,000, supplies expense of $5,319,000, and rent expense of $3,704,000. The labor increase is due to PPH's commitment to its employees through contracted wage increases and an enhanced Deferred Compensation Program; which provides for an employer match component. Additionally, premium pay for overtime and contract labor to clinical workforce exceeded budgeted amounts. Increases in purchased services are primarily the result of license and maintenance fees associated with financial and clinical information technology systems. There was also an increase in hospital equipment maintenance. The increase in professional fees is for consulting fees used for information technology systems recently installed and upgraded. PPH's investment in its physician for trauma and emergency on-call coverage also contributed to the increase in professional fees. The increase in supplies is due to increased complexity of cases, increased implantable activity, and implementation of da Vinci Robot technology. The increase in other direct is due to lease rent expense associated with ambulatory services in the new Pomerado Outpatient Pavilion on the Pomerado Hospital campus.

- Operating loss in 2008 was $(9,442,000). This operating loss is a result of operating expenses in excess of revenues.

- Non operating income (expenses) consists of interest earned on invested monies, interest expense, and PPH's share of property taxes collected by the County of San Diego. PPH's non operating income was $17,092,000 in 2008 and $32,357,000 in 2007. The unrealized loss on the 2006 Certificates of Participation of $10,398,000 in 2008 compares unfavorably to the unrealized gain of $4,373,000 posted in 2007. PPH experienced increased property tax revenue of $1,477,000. Property tax revenues applicable to Measure BB ad valorem taxes for general obligation bonds were $11,708,000 and are in addition to the unrestricted property tax revenues of $13,346,000. In June 2008 PPH performed an organization restructure and reduction of system-wide positions. Severance packages paid amounted to $1,452,000 and is included in other nonoperating expenses.

- As a result of the factors noted above, net assets increased by $7,921,000 in 2008, which is $25,268,000 less than the 2007 increase in net assets of $33,189,000.

Consolidated Statements of Cash Flows — The statements of cash flows report cash receipts, cash payments, and net changes in cash resulting from operating, investing, and financing activities, which provides answers to such questions as 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
YEARS ENDED JUNE 30, 2009, 2008, AND 2007
($000s)

	2009	2008	2007
CASH FLOWS FROM:			
Operating activities	$ 23,602	$ 9,980	$ 15,687
Noncapital financing activities	20,297	20,203	13,754
Capital and related financing activities	(97,791)	115,282	50,067
Investing activities	51,668	(134,252)	(80,143)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,224)	11,213	(635)
CASH AND CASH EQUIVALENTS — Beginning of year	12,579	1,366	2,001
CASH AND CASH EQUIVALENTS — End of year	$ 10,355	$ 12,579	$ 1,366

See notes to consolidated financial statements.

2009: Analysis of the Consolidated Statement of Cash Flows

- Operating activities cash inflow reflected an increase of approximately $13,622,000 in 2009 over 2008. This increase is attributed to increases in cash collections of patient accounts of $25,431,000 offset by increased payments to suppliers and employees of $11,802,000.
- Net cash outflows from capital and related financing activities in 2009 were $97,791,000 primarily due to the funding of PPH's building projects of $181,211,000, interest payments of $23,598,000 and the payment of long-term debt of $9,660,000 offset by the receipt of $110,000,000 of proceeds from the 2009 General Obligation Bonds and $12,000,000 of property taxes for debt service.
- Investing activities cash inflows were $51,668,000 in 2009. This inflow is mainly comprised of the sales of longer-term investments to fund the capital activities.
- The ending cash and cash equivalents of $10,355,000 reflect the checking account and overnight investment balances held by PPH. In addition, there were current investments of $107,135,000 at June 30, 2009.

2008: Analysis of the Consolidated Statement of Cash Flows

- Operating activities cash inflows reflected a decrease of approximately $5,707,000 in 2008 over 2007. This decrease is attributed to increased payments to suppliers and employees of $46,474,000 offset by increases in cash collections of patient accounts of $36,628,000.

- Noncapital financing activities consist primarily of property taxes received, which increased by $785,000 in 2008 compared to 2007 due to increased property values in the district.

- Net cash inflows from capital and related financing activities in 2008 were $115,282,000 primarily due to the receipt of $241,083,000 of proceeds from the 2007 General Obligation Bonds and $11,708,000 of property taxes for debt service, offset by the funding of PPH's building projects of $107,156,000, the payment of long-term debt of $13,220,000.

- Investing activities cash outflows were $134,252,000 in 2008. This outflow is mainly comprised of the remaining proceeds of the 2007 Certificates of Participation, which were invested in money market funds.

- The ending cash and cash equivalents of $12,579,000 reflect the checking account and overnight investment balances held by PPH. In addition, there were current investments of $73,700,000 at June 30, 2008.

2009: Capital Assets and Long-Term Debt

The Board of Directors has approved a Master Facility Plan project that is estimated at approximately $983,000,000. In November 2004, the residents of the district voted and approved to fund $496,000,000 of this expansion by the issuance of general obligation bonds. Payment for these bonds will be funded by ad valorem property tax levied on the district residents. The approximate amount for each resident is $17.75 per $100,000 of assessed value.

The major building expansion will include a new acute care hospital and trauma center in the North Inland San Diego area, expansion of the Pomerado Hospital in Poway, renovation of Palomar Medical Center in Escondido, and adding satellite facilities in various geographical locations of the district.

In connection with the major building expansion, three new buildings had been purchased during fiscal year 2008 to expand the Palomar Medical Center site. An additional building was purchased in FY2009. Land purchases of $56 million are reflected in construction in progress to facilitate the overall accounting of the major building expansion. Permitting for the new hospital and Pomerado Hospital expansion has been submitted to the Office of Statewide Health Planning and Development.

Currently, steel erection and other infrastructure projects have been completed for the new hospital; as well as the majority of the expansion efforts at Pomerado Hospital.

PPH has two outstanding insured revenue bond issues that are classified as long-term debt. These are the 1999 Insured Revenue Bonds and the 2006 Certificates of Participation. PPH made principal payments on these issues totaling $8,785,000, bringing the net long-term bond principal to $216,310,000. All debt payments were made timely and PPH was in good standing on all bond covenants throughout the year. More detailed information about PPH debt is presented in Note 8 to the consolidated financial statements. PPH has an underlying Moody’s rating of Baa1 on its revenue bonds and certificates of participation. PPH has an underlying Moody’s rating of A1 on its G.O. bonds. In July 2005, PPH issued its first series of general obligation bonds in the amount of $80,000,000 for use in funding the building expansion project. In December 2007, PPH issued its second series of general obligation bonds in the amount of $241,083,000. In March 2009, PPH issued its third series of general obligation bonds in the amount of $110,000,000. A principal payment of $875,000 reduced the general obligation bond principal to $418,568,000 as of June 30, 2009.

2008: Capital Assets and Long-Term Debt

The Board of Directors has approved a Master Facility Plan project that is estimated at approximately $983,000,000. In November 2004, the residents of the district voted and approved to fund $496,000,000 of this expansion by the issuance of general obligation bonds. Payment for these bonds will be funded by ad valorem property tax levied on the district residents. The approximate amount for each resident is $17.75 per $100,000 of assessed value.

The major building expansion will include a new acute care hospital and trauma center in the North Inland San Diego area, a significant expansion of the Pomerado Hospital in Poway, renovation on the Palomar Medical Center site, and adding satellite facilities in various geographical locations of the district.

In connection with the major building expansion, three new buildings were purchased during fiscal year 2008 to expand the Palomar Medical Center site. Land purchases of $55 million are reflected in construction in progress to facilitate the overall accounting of the major building expansion. Permitting for the new hospital and Pomerado Hospital expansion has been submitted to the Office of Statewide Health Planning and Development.

PPH has two outstanding insured revenue bond issues that are classified as long-term debt. These are the 1999 Insured Revenue Bonds and the 2006 Certificates of Participation. PPH made principal payments on these issues totaling $7,765,000, bringing the net long-term bond principal to $225,095,000. All debt payments were made timely and PPH was in good standing on all bond covenants throughout the year. More detailed information about PPH debt is presented in Note 8 to the consolidated financial statements. In July 2005, PPH issued its first series of general obligation bonds in the amount of $80,000,000 for use in funding the building expansion project. In December 2007, PPH issued its second series of general obligation bonds in the amount of $241,083,000. A principal payment of $5,455,000 reduced the general obligation bond principal to $309,443,000 as of June 30, 2008.

Liquidity and Capital Resources

PPH’s unrestricted liquidity position as of June 30, 2009, was $117,490,000, including $10,355,000 in operating cash and $107,135,000 in unrestricted investments stated at fair market value. PPH’s unrestricted liquidity position as of June 30, 2008, was $86,279,000, including $12,579,000 in operating cash and $73,700,000 in unrestricted investments stated at fair market value. The available liquidity of $117,490,000 represents a 36% increase over the $86,279,000 in available liquidity as of June 30, 2008, and equaled 54% of total outstanding debt exclusive of the general obligation bonds, which are funded separately from ad valorem taxes as of June 30, 2009 (as compared to available liquidity representing 40% of total outstanding debt as of June 30, 2008).

Economic and Other Factors

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

Insurance Reimbursement — Healthcare providers are taking advantage of higher premium increases by insurers in recent years by negotiating improved reimbursements and restoring cost coverage and profitability to the commercial managed care business segment.

Medicare Reimbursement — The Benefits Improvement and Protection Act and the Balanced Budget Relief Act allow for a declining adverse financial impact originally imposed by the Balanced Budget Act of 1997. Medicare reimbursements are not expected to increase materially.

Demand for Services — Due to the aging of the population and a steady growth in overall population in PPH's primary and secondary service areas, there is a continued increase in hospital admissions and overall demand for healthcare services.

Labor Shortages — Lack of availability for nursing and other key technical positions increases the cost for providers significantly. Additionally, the State of California mandated nurse staff ratios have increased demand for nursing personnel and increased salary and wages expenses.

Pharmaceutical Costs — the continued escalation of pharmaceutical drug costs remains a challenge for providers.

State Budget Difficulties — This has a multiple effect on providers as state Medicaid budget is impacted, investment portfolios are depressed, and employers shift more of the cost of healthcare to employees.

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 includes expansion of social welfare provisions and domestic spending in health care. The ARRA provides funds to States in the form of a temporary increase in contributions toward Medicaid. As of June 30, 2009, PPH did not receive any funding from ARRA.

Heightened Competition — Services that have a profit margin are becoming more competitive as entrepreneurial physicians and for-profit entities migrate to services with a return on investment, putting further stress on hospital providers that traditionally cover core and safety net services with returns on profitable services.

The Health Insurance Portability and Accountability Act (HIPAA) – HIPAA among other things establishes privacy and security regulations over patient information that may have significant cost implications for healthcare providers.

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 is possible to extend the SB 1953 deadline to 2013. PPH applied for an extension from the California Department of Health Services, moving PPH's deadline to 2013, and has received approval for the extension.

Finance Contact

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

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Palomar Pomerado Health

We have audited the accompanying consolidated balance sheets of Palomar Pomerado Health (PPH) as of June 30, 2009 and 2008, 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 PPH's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free 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 PPH'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 provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of PPH as of June 30, 2009 and 2008, 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 1–11 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 PPH'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.

_______, 2009

PALOMAR POMERADO HEALTH

CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2009 AND 2008
($000s)

	2009	2008
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 10,355	$ 12,579
Investments	107,135	73,700
Patient accounts receivable — net of allowances for uncollectible accounts of $20,965,000 in 2009 and $18,681,000 in 2008	94,279	86,222
Other receivables	4,443	5,722
Supplies/inventories	6,347	6,826
Prepaid expenses and other	3,996	3,790
Assets whose use is limited — current portion	5,068	13,100
Assets whose use is limited — general obligation bonds — current portion	14,239	15,674
Total current assets	245,862	217,613
ASSETS WHOSE USE IS LIMITED:		
Held by trustee under indenture agreements	42,500	74,384
Held by trustee under general obligation bonds indenture	222,012	254,417
Held in escrow for street improvements	14,382	14,266
Board-designated for capital improvements		12,117
Restricted by donor	312	304
Total assets whose use is limited	279,206	355,488
Less current portion	19,307	28,774
Total assets whose use is limited — long-term portion	259,899	326,714
CAPITAL ASSETS — Net	568,152	379,286
OTHER ASSETS:		
Deferred financing costs — net	19,952	15,645
Investment in and amounts due from affiliated entities	2,803	4,414
Other	5,292	4,652
Total other assets	28,047	24,711
TOTAL	$ 1,101,960	$ 948,324

(Continued)

PALOMAR POMERADO HEALTH

CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2009 AND 2008
($000s)

LIABILITIES AND NET ASSETS	2009	2008
CURRENT LIABILITIES:		
Accounts payable	$ 49,102	$ 44,501
Accrued compensation and related liabilities	25,295	23,607
Current portion of long-term debt	8,835	8,785
Current portion of general obligation bonds	945	875
Estimated third-party payor settlements	2,343	807
Other accrued liabilities	16,997	15,815
Accrued interest payable	5,384	8,065
Total current liabilities	108,901	102,455
WORKERS' COMPENSATION — Net of current portion	1,714	2,511
LONG-TERM DEBT — General obligation bonds — Net of current portion	439,722	317,478
LONG-TERM DEBT — Net of current portion	206,022	214,476
FAIR VALUE OF INTEREST RATE SWAP	16,752	6,025
Total liabilities	773,111	642,945
COMMITMENTS AND CONTINGENCIES (Note 12)		
NET ASSETS:		
Invested in capital assets — net of related debt	149,971	126,940
Restricted for repayment of debt	13,923	20,708
Restricted for capital acquisitions	14,382	14,266
Restricted for other purposes	312	304
Unrestricted	150,261	143,161
Total net assets	328,849	305,379
TOTAL	$ 1,101,960	$ 948,324

See notes to consolidated financial statements. (Concluded)

PALOMAR POMERADO HEALTH

CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEARS ENDED JUNE 30, 2009 AND 2008 ($000s)

	2009	2008
OPERATING REVENUE:		
Net patient service revenue	$ 397,544	$ 370,661
Net premium revenue	40,890	38,003
Other revenue	7,571	10,904
Total operating revenue	446,005	419,568
OPERATING EXPENSES:		
Salaries, wages, and benefits	259,737	250,318
Professional fees	23,708	28,652
Supplies	70,224	66,020
Purchased services	33,873	34,117
Depreciation and amortization	21,215	21,391
Rent expense	8,407	7,495
Utilities expense	5,989	4,979
Other	13,383	16,038
Total operating expenses	436,536	429,010
INCOME (LOSS) FROM OPERATIONS	9,469	(9,442)
NONOPERATING INCOME (EXPENSES):		
Investment income	4,290	6,698
Unrealized loss on interest rate swap	(10,727)	(10,398)
Interest expense	(5,353)	(4,514)
Property tax revenue	13,505	13,346
Property tax revenue — general obligation bonds	12,000	11,708
Other — net	286	252
Total nonoperating income — net	14,001	17,092
EXCESS OF REVENUE OVER EXPENSES	23,470	7,650
OTHER CHANGES IN NET ASSETS		271
INCREASE IN NET ASSETS	23,470	7,921
NET ASSETS — Beginning of year	305,379	297,458
NET ASSETS — End of year	$ 328,849	$ 305,379

See notes to consolidated financial statements.

PALOMAR POMERADO HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED JUNE 30, 2009 AND 2008 ($000s)

	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from:		
Patients, insurers, and other third-party payors	$ 456,372	$ 431,941
Other sources	9,821	8,828
Payments to:		
Employees	(258,846)	(251,618)
Suppliers	(183,745)	(179,171)
Net cash provided by operating activities	23,602	9,980
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Receipt of district taxes	13,505	13,346
Other	6,792	6,857
Net cash provided by noncapital financing activities	20,297	20,203
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(181,211)	(107,156)
Interest paid	(23,598)	(13,868)
Deferred financing costs	(5,322)	(3,266)
Proceeds from issuance of debt	110,000	241,084
Repayment of long-term debt	(9,660)	(13,220)
Receipt of property taxes restricted for debt service on general obligation bonds	12,000	11,708
Net cash (used in) provided by capital and related financing activities	(97,791)	115,282
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(211,161)	(567,037)
Sale of investments	262,309	432,217
Interest received on investments and notes receivable	520	568
Net cash provided by (used in) investing activities	51,668	(134,252)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,224)	11,213
CASH AND CASH EQUIVALENTS — Beginning of year	12,579	1,366
CASH AND CASH EQUIVALENTS — End of year	$ 10,355	$ 12,579

(Continued)

PALOMAR POMERADO HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2009 AND 2008
($000s)

	2009	2008
RECONCILIATION OF OPERATING INCOME TO NET CASH FLOWS FROM OPERATING ACTIVITIES:		
Income (loss) from operations	$ 9,469	$ (9,442)
Adjustments to reconcile income (loss) from operations to net cash provided by operating activities:		
Depreciation and amortization	21,215	21,391
Provision for bad debts	54,464	41,358
Equity in earnings of affiliates	1,611	(831)
Changes in assets and liabilities — net of effect of acquisition of controlling interest in Escondido Surgery Center:		
Patient accounts receivable	(62,521)	(48,099)
Other receivables	1,279	(628)
Supplies/inventories	479	200
Prepaid expenses and other	(206)	(1,720)
Accounts payable	(5,157)	2,552
Accrued compensation and related liabilities	891	(1,300)
Other accrued liabilities	1,182	1,070
Estimated third-party payor settlements	1,536	3,387
Other — net	(640)	2,042
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 23,602	$ 9,980
NONCASH INVESTING AND CAPITAL AND FINANCING ACTIVITIES — Capital expenditures included in accounts payable	$ 36,163	$ 26,405

See notes to consolidated financial statements. (Concluded)

PALOMAR POMERADO HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED JUNE 30, 2009 AND 2008

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

- Palomar Medical Center, located in Escondido, California, including Palomar Continuing Care Center, a convalescent facility
- Pomerado Hospital, located in Poway, California, includes Villa Pomerado, a convalescent and sub-acute 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
- Health Development, a charitable nonprofit organization created to provide assistance and support for PPH by obtaining grant funding from federal, state, local, and private sources
- PPH expresscare, located in Albertson Grocery stores in Escondido and Rancho Penasquitos, retail health centers

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). PPH uses proprietary (enterprise) fund accounting. Revenues and expenses are recognized on the accrual basis using the economic resources measurement focus.

Use of Estimates — The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) 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 — PPH 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*, PPH 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 PPH have been classified as current assets in the accompanying consolidated balance sheets.

PPH has entered into an agreement with the City of Escondido (the "City") to finance jointly street improvements near the site of PPH's new hospital to be constructed in the City. Under the agreement, PPH was required to deposit $13,000,000 into a jointly managed account between the City and PPH. The balance of $14,382,000 and $14,266,000 on June 30, 2009 and 2008, respectively, is included in assets whose use is limited in the accompanying 2009 consolidated balance sheet.

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 $4,457,000 and $6,982,000 for the years ended June 30, 2009 and 2008, 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 $25,331,000 and $10,960,000 for the years ended June 30, 2009 and 2008, 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 lifecycle 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. Impairment losses were $218,000 and $0 for the years ended June 30, 2009 and 2008, respectively.

Debt Discounts and Deferred Financing Costs — Debt discounts and deferred financing costs are amortized by the bonds' outstanding method over the life of the related bonds. Deferred financing costs included $24,246,000 and $18,924,000, net of accumulated amortization of $4,294,000 and $3,279,000, as of June 30, 2009 and 2008, respectively.

Interest Rate Swap — PPH has entered into a variable-to-fixed interest rate swap, which is reflected at fair value in the 2009 consolidated balance sheet. The fair value of the interest rate swap 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 gains or losses in the 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 PPH under the interest rate swap. Severe fluctuations in the municipal bond market resulted in an interest rate increase of 2006 auction rate securities (ARS) obligations. As of June 30, 2009, the interest rate swap was recorded as a liability of $16,752,000.

Net Assets — Net assets of PPH are classified in four 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 other purposes are noncapital net assets that must be used for a particular purpose, as specified by contributors external to PPH. 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 healthcare 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 — PPH has agreements with third-party payors that provide for payments to PPH at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per-diem payments. 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 — PPH has agreements with various third-party payors to provide medical services to subscribing participants. Under some of these agreements, PPH receives monthly capitation payments based on the number of each payor's participants, regardless of services actually performed by PPH. Under these agreements, PPH 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, PPH estimates incurred but not reported (IBNR) claims for medical services provided to patients. IBNR liabilities of $4,750,000 and $5,090,000 are included in other accrued liabilities in the accompanying consolidated balance sheets as of June 30, 2009 and 2008, respectively.

Charity Care — PPH 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, 2009 and 2008, were approximately $20,093,000 and $22,601,000, respectively.

Property Taxes — PPH receives financial support from property taxes. Property taxes are levied by the county on behalf of PPH to finance PPH's activities. Amounts levied are based on assessed property values. Property tax revenue for the years ended June 30, 2009 and 2008, consists of the following:

	2009	**2008**
To support operations, unrestricted use	$ 13,505,000	$ 13,346,000
For debt service on general obligation bonds, restricted use	12,000,000	11,708,000
Total	$ 25,505,000	$ 25,054,000

Recent Accounting Pronouncements — In June 2007, the GASB issued GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. PPH will adopt GASB Statement No. 51 effective for the fiscal year beginning July 1, 2009. GASB Statement No. 51 requires that all intangible assets not specifically excluded by its scope provisions to be classified as capital assets. This statement also provides guidance on recognition and amortization of intangible assets. Management is currently evaluating the impact of applying the provisions of this statement on PPH's consolidated financial statements.

In November 2007, the GASB issued GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments.* GASB Statement No. 52 is effective for periods beginning after June 15, 2008, and establishes consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value and other information that they currently present for other investments reported at fair value. Implementation of this statement did not have a material effect on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

In June 2008, the GASB issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.* GASB Statement No. 53 is effective for periods beginning after June 15, 2009. This statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. Management does not believe that the adoption of this statement will have a material impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

In March 2009, the GASB issued GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments.* GASB Statement No. 55 was effective upon issuance and is intended to assist preparers of state and local government financial statements to identify and apply the GAAP hierarchy. This statement did not have an impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

In March 2009, the GASB issued GASB Statement No. 56, *Codification of Accounting and Financial Reporting guidance Contained in the AICPA Statements on Auditing Standards.* GASB Statement No. 56 is an effort to codify all generally accepted accounting principles for state and local governments. GASB Statement No. 56 was effective upon issuance. GASB Statement No. 56 guidance addresses three issues from the AICPA's literature — related party transactions, going concern considerations, and subsequent events. Adoption of this statement did not have a significant impact on PPH's consolidated net assets or revenue, expenses, and changes in net assets.

In May 2009, the FASB issued FASB Statement No. 165, *Subsequent Events*, which is effective for periods ending after June 15, 2009. FASB Statement No. 165 establishes general standards of accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. PPH has adopted FASB Statement No. 165 for the year ended June 30, 2009. PPH has assessed subsequent events through the date of this report.

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

2. NET PATIENT SERVICE REVENUE

PPH 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 PPH 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 56% of PPH's net patient service revenue for the year ended June 30, 2009, and 59% for the year ended June 30, 2008.

Third-party settlements are recorded when received, which includes tentative settlements, lump sum adjustments, for prior or current cost reporting periods. The cost reports for Medicare and Medi-Cal programs have been settled through fiscal year 2007. Results of cost report settlements, as well as estimates for settlements of all fiscal years through 2009, have been reflected in the accompanying consolidated financial statements.

As of June 30, 2009 and 2008, estimated third-party settlements resulted in a $2,343,000 and $807,000 liability, respectively. During fiscal 2009 and 2008, PPH settled various prior-year cost reports and appeal issues. These settlements resulted in approximately $3,840,000 and $1,722,000 of additional revenues in fiscal 2009 and 2008, respectively, which are included in net patient service revenue in the accompanying consolidated statements of revenue, expenses, and changes in net assets.

PPH also has entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to PPH 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 PPH 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.

PPH'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 $40,000,000 of unrestricted monies in the fund and an unlimited amount of qualified bond proceeds. As of June 30, 2009, PPH has invested $77,717,000 of their bond proceeds in this fund and $34,062,000 in unrestricted funds. Investments in the LAIF are highly liquid, as deposits can be converted to cash within 24 hours without loss of interest. PPH is a voluntary participant in the LAIF. The fair value of PPH's investments in the LAIF is reported in the accompanying consolidated financial statements based on PPH's pro rata share of the fair value provided by LAIF for the entire LAIF portfolio.

As of June 30, 2009 and 2008, PPH had investments and maturities as follows:

	2009		
		Investment Maturities (in years)	
Investment Type	**Fair Value**	**Less Than 1**	**1–5**
LAIF	$ 111,779,000	$ 111,779,000	$ -
U.S. Government Bonds	35,929,000	7,957,000	27,972,000
U.S. Treasury Bills	23,017,000	3,146,000	19,871,000
Corporate Bonds	13,617,000	1,794,000	11,823,000
Money Market Mutual Funds	201,999,000	201,999,000	
Total	$ 386,341,000	$ 326,675,000	$ 59,666,000

	2008		
		Investment Maturities (in years)	
Investment Type	**Fair Value**	**Less Than 1**	**1–5**
LAIF	$ 166,168,000	$ 166,168,000	$ -
U.S. Government Bonds	29,630,000	6,374,000	23,256,000
U.S. Treasury Bills	28,453,000	5,069,000	23,384,000
Corporate Bonds	10,498,000	1,001,000	9,497,000
Money Market Mutual Funds	194,439,000	194,439,000	
Total	$ 429,188,000	$ 373,051,000	$ 56,137,000

There are many factors that can affect the value of investments. Some, such as credit risk, custodial credit risk, and concentration of credit risk and interest rate 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, PPH's investment policy, as per statutory requirements, limits the term of any investment to a maturity not exceeding five years.

Similarly, PPH 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. PPH'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 PPH's investment in commercial paper, corporate bonds, and bond mutual funds with an "A" rating issued by nationally recognized statistical rating organizations. PPH has no investment policy that would further limit investment choices. As of June 30, 2009 and 2008, PPH'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, negotiable certificates of deposit rated Superior or better by Interactive Data Corp., and PPH's investments in LAIF 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 PPH 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 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 at June 30, 2009 and 2008, are as follows:

Issuer	Investment Type	2009	2008
Federal National Mortgage Association	Federal Agency Securities	$ 23,018,000	$ -
US Bank, Trustee	First American Treasury Obligation Class D		64,428,000
US Bank, Trustee	US Bank Money Market	42,485,000	
Wells Fargo Advantage Government Money Market	US Government Money Market Funds	158,692,000	118,878,000
Total		$ 224,195,000	$ 183,306,000

Custodial Credit Risk — Investments — All of PPH's investments are insured or registered or are held by PPH's agent in the agent's nominee name, with subsidiary records listing PPH as the legal owner. For these reasons, PPH 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, PPH's deposits may not be returned to it. PPH does not have a policy for custodial credit risk. As of June 30, 2009 and 2008, PPH's bank balances totaled $19,843,000 and $14,394,000, 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.

4. CONCENTRATIONS OF CREDIT RISK

PPH grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at June 30, 2009 and 2008, was as follows:

	2009	**2008**
Medicare	19 %	20 %
Medi-Cal	15	13
HMO/PPO/commercial	38	40
Patient	15	16
Others	13	11
Total	100 %	100 %

5. CAPITAL ASSETS

A summary of changes in capital assets for the years ended June 30, 2009 and 2008, is as follows:

	Beginning Balance Fiscal 2009	**Additions**	**Disposals**	**Transfers**	**Ending Balance Fiscal 2009**
Land improvements	$ 5,038,000	$ -	$ (639,000)	$ 10,819,000	$ 15,218,000
Buildings and leasehold improvements	190,420,000	4,000	(2,240,000)	(10,069,000)	178,115,000
Equipment	181,607,000	3,906,000	(18,194,000)	19,078,000	186,397,000
Land	10,346,000			4,939,000	15,285,000
Construction in progress	218,854,000	206,481,000		(24,767,000)	400,568,000
	606,265,000	210,391,000	(21,073,000)	-	795,583,000
Less accumulated depreciation and amortization	(226,979,000)	(21,261,000)	20,809,000		(227,431,000)
Capital assets — net	$ 379,286,000	$ 189,130,000	$ (264,000)	$ -	$ 568,152,000

	Beginning Balance Fiscal 2008	**Additions**	**Disposals**	**Transfers**	**Ending Balance Fiscal 2008**
Land improvements	$ 5,221,000	$ -	$ (188,000)	$ 5,000	$ 5,038,000
Buildings and leasehold improvements	172,599,000	15,979,000	(370,000)	2,212,000	190,420,000
Equipment	185,819,000	4,105,000	(16,203,000)	7,886,000	181,607,000
Land	9,632,000	714,000			10,346,000
Construction in progress	121,244,000	107,713,000		(10,103,000)	218,854,000
	494,515,000	128,511,000	(16,761,000)	-	606,265,000
Less accumulated depreciation and amortization	(222,304,000)	(21,398,000)	16,723,000		(226,979,000)
Capital assets — net	$ 272,211,000	$ 107,113,000	$ (38,000)	$ -	$ 379,286,000

6. INVESTMENT IN AND AMOUNTS DUE FROM AFFILIATED ENTITIES

PPH's investments in affiliated entities are accounted for under the equity method because PPH does not control these entities. At June 30, 2009 and 2008, these investments include $1,413,000 and $2,923,000, respectively, related to PPH's investment in PDP Pomerado, LLC, and $1,385,000 and $1,304,000, respectively, related to PPH's investment in the ALPHA fund (see Note 12).

During fiscal year 2007, PPH entered into a partnership agreement with PDP Pomerado, LLC in exchange for a ground lease agreement.

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

During fiscal year 2009, the radiology agreement between PPH and Valley Radiology Consultants was discontinued.

During fiscal year 2008, two partnerships were dissolved. The partnership with Escondido Surgery Center (EASCI Investors, L.P.) was dissolved on September 17, 2007, and the partnership with 343 E. 2nd Avenue Investors, LTD was dissolved on November 12, 2007. Escondido Surgery Center is now one of the outpatient departments of PPH effective December 1, 2007. Since Escondido Surgery Center is 100% owned by PPH, all the intercompany transactions, including partnership investment accounts, were eliminated.

7. RELATED ORGANIZATIONS

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

The Foundation funds various programs on behalf of PPH. Funding for these programs provided by the Foundation totaled $1,700,000 and $1,667,000 for the years ended June 30, 2009 and 2008, respectively.

In September 2005, PPH entered into a management services agreement with the Foundation, whereby PPH provides administrative support to the Foundation. Support provided to the Foundation totaled $1,721,000 and $2,494,000 for the years ended June 30, 2009 and 2008, respectively. The management services agreement includes a line of credit with a $5,000,000 limit that expires on June 30, 2010. The amount drawn on the line of credit was $1,569,000 and $1,341,000 as of June 30, 2009 and 2008, respectively.

A summary of the Foundation's assets, liabilities, and net assets at June 30, 2009 and 2008, is as follows:

	2009	2008
Assets	$7,555,000	$8,207,000
Liabilities	$4,794,000	$4,382,000
Net assets	2,761,000	3,825,000
Total liabilities and net assets	$7,555,000	$8,207,000

8. LONG-TERM DEBT AND OTHER NONCURRENT LIABILITIES

PPH's long-term debt and other noncurrent liabilities for 2009 and 2008 were as follows:

	Beginning Balance Fiscal 2009	Additions	Reductions	Ending Balance Fiscal 2009	Amounts Due Within One Year
Bonds payable:					
Series 2009 general obligation bonds	$ -	$ 115,364,000	$ (74,000)	$ 115,290,000	$ -
Series 2007 general obligation bonds	246,663,000		(256,000)	246,407,000	
Series 2006 certificates of participation	177,050,000	93,000	(3,000,000)	174,143,000	2,775,000
Series 2005 general obligation bonds	71,689,000		(1,069,000)	70,620,000	945,000
Series 1999 insured refunding revenue bonds	46,212,000	322,000	(5,818,000)	40,716,000	6,060,000
Accrued interest on capital appreciation bonds		8,348,000		8,348,000	
Total long-term debt	541,614,000	124,127,000	(10,217,000)	655,524,000	9,780,000
Other liabilities — workers' compensation reserves	3,385,000	2,221,000	(3,221,000)	2,385,000	671,000
Total long-term liabilities	$ 544,999,000	$ 126,348,000	$ (13,438,000)	$ 657,909,000	$ 10,451,000

	Beginning Balance Fiscal 2008	Additions	Reductions	Ending Balance Fiscal 2008	Amounts Due Within One Year
Bonds payable:					
Series 2007 general obligation bonds	$ -	$ 246,663,000	$ -	$ 246,663,000	$ -
Series 2006 certificates of participation	179,176,000	99,000	(2,225,000)	177,050,000	3,000,000
Series 2005 general obligation bonds	77,342,000		(5,653,000)	71,689,000	875,000
Series 1999 insured refunding revenue bonds	51,425,000	364,000	(5,577,000)	46,212,000	5,785,000
Total long-term debt	307,943,000	247,126,000	(13,455,000)	541,614,000	9,660,000
Other liabilities — workers' compensation reserves	6,820,000	619,000	(4,054,000)	3,385,000	874,000
Total long-term liabilities	$ 314,763,000	$ 247,745,000	$ (17,509,000)	$ 544,999,000	$ 10,534,000

The terms and due dates of PPH's long-term debt at June 30, 2009 and 2008, are as follows:

- Series 2009A General Obligation Bonds, accreted interest compounds at 6.84% to 9.00% on $50,001,000 Capital Appreciation Bonds with the first payment to bondholders on August 1, 2019. Accreted interest compounds at 7.00% 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 $5,290,000 in 2009.

- Series 2007A General Obligation Bonds, interest at 4.50% 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 $5,324,000 and $5,580,000 at June 30, 2009 and 2008, 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 PPH 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 $632,000 and $725,000 at June 30, 2009 and 2008, respectively, collateralized by PPH revenues as defined in the indenture.

- Series 2005A General Obligation Bonds, interest at 3.00% to 5.00% 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 $3,135,000 and $3,329,000 at June 30, 2009 and 2008, 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 $95,000 and $128,000 at June 30, 2009 and 2008, respectively, and unamortized loss on defeasance of $914,000 and $1,236,000 at June 30, 2009 and 2008, respectively, collateralized by PPH revenues as defined in the indenture agreement.

During March 2009, PPH 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 PPH 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 PPH’s service area (see Note 12).

During December 2007, PPH 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 PPH 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 PPH’s service area (see Note 12).

During December 2006, PPH issued $180,000,000 of Palomar Pomerado Health Certificates of Participation. The net proceeds of the 2006 Certificates of Participation will be used by PPH 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 PPH’s service area (see Note 12). 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, PPH 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 PPH 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 PPH’s service area (see Note 12).

All the G.O. Bonds represent the general obligation of PPH, in an amount sufficient to service the obligation, and PPH 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 PPH's boundaries subject to taxation by PPH for payment when due of the principal of and interest on the bonds. However, PPH is legally required to repay the 2005, 2007, and 2009 G.O. Bonds if collected ad valorem taxes are insufficient.

In June 1999, PPH 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, 2007 G.O. Bonds, 2006 Certificates of Participation, the 2005 G.O. Bonds, and the Series 1999, PPH is subject to compliance with certain debt covenants, including restrictions on additional indebtedness, which PPH believes it is in compliance with as of June 30, 2009 and 2008.

The estimated fair value of PPH's long-term debt was approximately $534 million and $501 million as of June 30, 2009 and 2008, respectively, based on quotations from independent third parties.

Future principal and interest payments on long-term debt as of June 30, 2009 are as follows:

Years Ending June 30	**Principal**	**Interest**	**Total**
2010	$ 9,780,000	$ 19,849,000	$ 29,629,000
2011	7,395,000	19,404,000	26,799,000
2012	8,367,000	19,109,000	27,476,000
2013	9,312,000	18,880,000	28,192,000
2014	10,263,000	18,601,000	28,864,000
2015–2019	52,499,000	91,952,000	144,451,000
2020–2024	74,411,000	145,790,000	220,201,000
2025–2029	105,690,000	183,782,000	289,472,000
2030–2034	183,244,000	209,053,000	392,297,000
2035–2039	173,917,000	98,757,000	272,674,000
Total	$634,878,000	$825,177,000	$1,460,055,000

9. OPERATING LEASES

PPH leases certain office space and equipment under operating leases. Lease expense on all such leases for the years ended June 30, 2009 and 2008, totaled $9,380,000 (including $973,000 in nonoperating expense) and $7,495,000, respectively. PPH also leases to others office space under operating leases. Future minimum lease payments and receipts under noncancelable space leases as of June 30, 2009 are as follows:

Years Ending June 30	Lease Payments	Lease Receipts
2010	$ 3,457,000	$ 1,096,000
2011	3,450,000	991,000
2012	3,274,000	373,000
2013	3,021,000	70,000
2014	3,011,000	70,000
2015–2019	15,994,000	211,000
2020–2024	16,585,000	
2025–2029	9,990,000	
Total	$ 58,782,000	$ 2,811,000

10. DEFERRED ANNUITY CONTRACTS

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

The investments of PPH's IRC Section 457 plan and earnings thereon are held in trust for the exclusive benefit of the plan participants and their beneficiaries. Accordingly, the accompanying consolidated balance sheets do not include the funds deposited with financial institutions pursuant to deferred annuity contracts.

11. RETIREMENT PLAN

PPH sponsors a defined contribution retirement plan under which benefits are limited to amounts accumulated from total contributions by PPH and by the employees, plus accrued interest. Prior to January 1, 2004, all employees with three years of service are covered by the plan. On January 1, 2004, the plan was revised to change the eligibility for all employees with one year of service. Contributions under the plan by PPH equal 6% of covered employees' basic compensation and are funded as accrued. Total PPH contributions expensed for the years ended June 30, 2009 and 2008, were $11,132,000 and $10,922,000, respectively.

12. COMMITMENTS AND CONTINGENCIES

Legal Matters — The healthcare 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.

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

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

PPH 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 — PPH 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. PPH pays premiums to ALPHA Fund that are adjusted annually. Effective July 1, 2002, PPH changed its participation in ALPHA Fund from first dollar coverage of workers' compensation claims to self-insured retention by PPH of the first $350,000 of each claim. Effective July 1, 2003, PPH increased its retention level to the first $500,000 of each claim. Effective July 1, 2004, PPH increased its retention level to the first $750,000 of each claim. Effective July 1, 2008, PPH eliminated its retention and currently has a guaranteed loss/zero deductible. At June 30, 2009 and 2008, estimated claims liabilities for workers' compensation totaled $2,385,000 and $3,385,000, 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, PPH would be liable for its share of any additional premiums necessary for final disposition of claims and losses covered by ALPHA Fund. If PPH were to withdraw from ALPHA Fund, it would be required to fund its share of a deficit as defined under the joint powers agreement. In fiscal years 2009, 2008, and 2007, the ALPHA Fund has been in a surplus position. PPH accounts for its investment in the ALPHA Fund under the equity method and has recorded its share of $1,385,000 and $1,304,000 as an asset within other assets at June 30, 2009 and 2008, respectively.

Comprehensive Liability Insurance Coverage — PPH 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. PPH's comprehensive liability insurance was renewed effective July 1, 2009, and the current policy expires on June 30, 2010. PPH has reserved for estimated claims through 2009, including an estimate of IBNR. Such reserves totaled $425,000 and $289,000 as of June 30 2009 and 2008, respectively.

Seismic Compliance — California Senate Bill 1953 (SB 1953) requires hospital acute care buildings to meet more stringent seismic guidelines by 2008. In fiscal 2005, PPH 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 PPH has approved a $982 million expansion plan, which includes 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. This plan will enable PPH 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 PPH's non-compliant buildings are in fact compliant at a SPC-2 rating. This has resulted in those buildings being eligible for rendering acute inpatient care until 2030.

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The PPH Legal-Compliance-Internal Audit Triad

TO: Audit/Compliance Committee for the Board of Directors

MEETING DATE: Tuesday, October 20, 2009

FROM: Tom Boyle, District Audit Officer

BY: Donna Goh, Internal Audit Services

Background: Upon request by the Board, this is an overview of the workings and interactions of the 3 entities — Legal, Compliance, and Internal Audit — at PPH.

Budget Impact: N/A

Staff Recommendation:

Committee Questions:

COMMITTEE RECOMMENDATION:

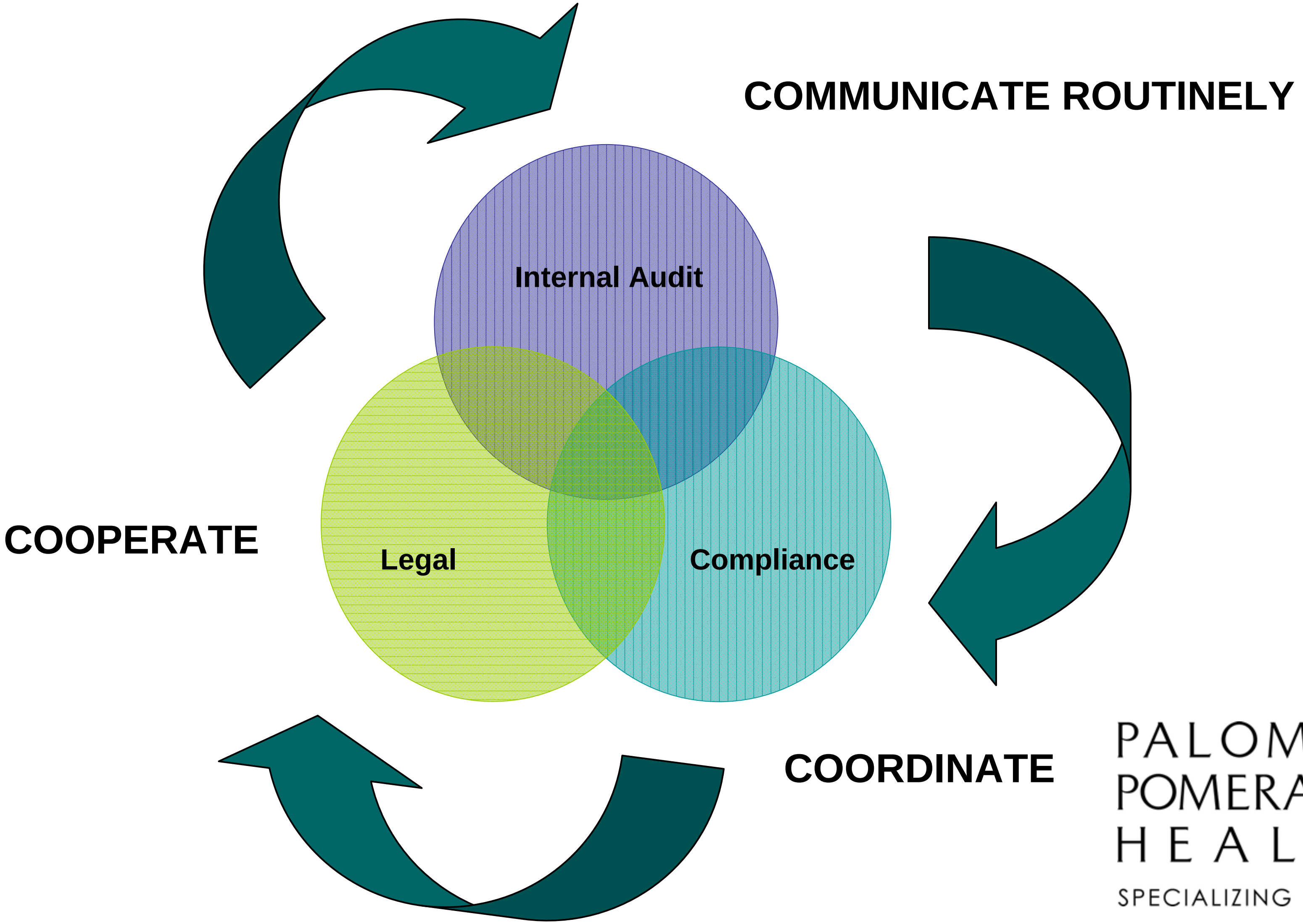
Motion:

Individual Action:

Information:

Required Time:

The PPH Legal-Compliance-Internal Audit Triad Essentials

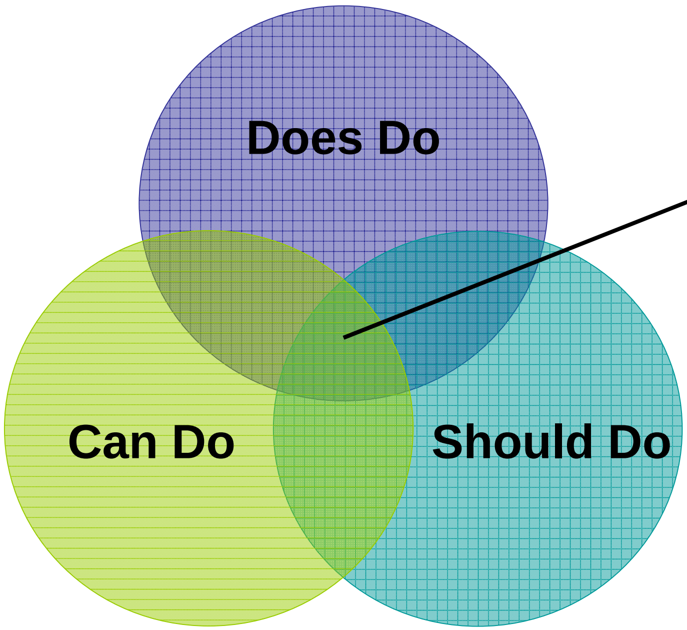


PALOMAR POMERADO HEALTH
SPECIALIZING IN YOU

The PPH Legal-Compliance-Internal Audit Triad

Internal Audit

- Risk Assessment
- Evaluate Internal Controls/Improvements
- Identify/Report Control Deficiencies
- Recommend Operational Effectiveness/Efficiency
- Act as Resource to Mgmt.
- Follow Generally-Accepted Auditing Standards



- Speak the truth to the Board & CEO
- Goal is for PPH to do the Right Thing

Legal

- Manage Legal Matters
- Governance
- Joint Ventures
- Contracts

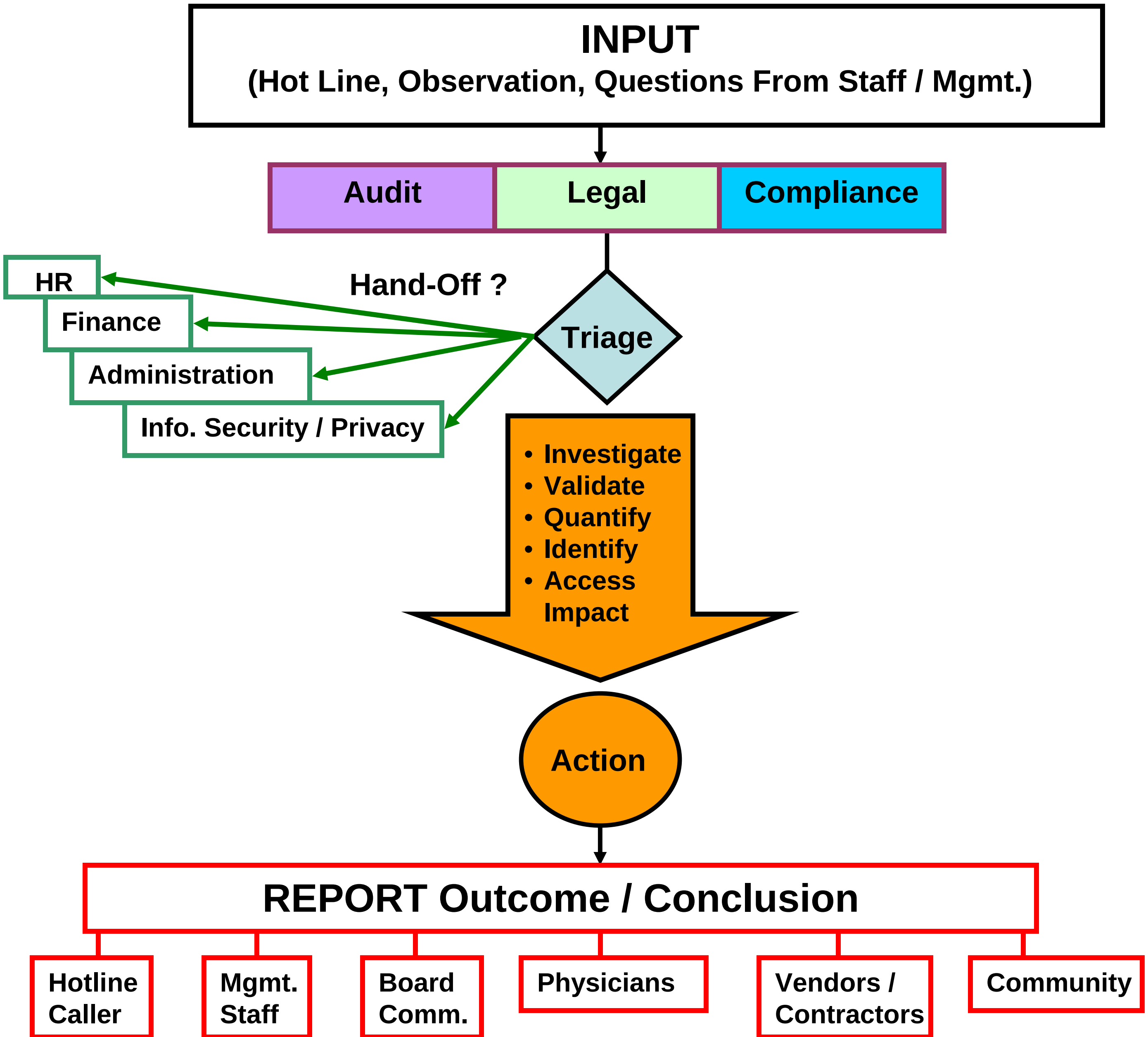
Compliance

- Evaluate New/Old Requirements
- Document Procedures
- Training/ Education
- Awareness Activities
- Monitoring
- Reporting

PALOMAR POMERADO HEALTH

SPECIALIZING IN YOU

The PPH Legal-Compliance-Internal Audit Triad Flow



PPH Audit-Compliance Committee for the Committee Work-Plan

TO: Audit/Compliance Committee for the Board of Directors

MEETING DATE: October 20, 2009

FROM: Linda Greer, RN, Sub-Committee Board Chair

BY: Martha Ann Knutson, Corporate Compliance Officer

Background: The Committee's Charter sets out various tasks that is to be completed annually and/or periodically.

Budget Impact: N/A

Staff Recommendation: Adoption of a Committee calendar will promote completion of the Committee's assigned tasks.

Committee Questions:

COMMITTEE RECOMMENDATION:

Motion:

Individual Action:

Information:

Required Time:

DRAFT

Palomar Pomerado Health

Internal Audit and Compliance

Board Committee

Proposed Calendar

October	Review of Financial Statements and External Auditor's Report Certifications by the CEO and CFO
November	Self-Assessment of Committee
December	Review results of Internal Customer Satisfaction Survey
January	Review Charter and Committee Policies Approve Internal Audit Plan
February	Review external audit engagement
March	
April	
May	
June	Report on Internal Audit and Compliance Officer's independence Review results of Internal Customer Satisfaction Survey
July	
August	Review IA certification of travel expenses
September	

Task list based on the Committee Charter:

<u>Annual tasks</u>

- Review charter and Committee Policies
- Appoint external auditors

- Including review of report re their internal quality review practices and past problems (if any) with governmental authorities

- Approval “overall audit scope” (internal audit plan?)

- Obtain and review report on Internal Audit and Compliance Officer’s independence

- Require the CEO and CFO to certify various matters regarding the financial statements

- Self-assessment

- Annual customer satisfaction survey for the internal audit and compliance functions.

- Certification of all travel expenses of the Board, CEO, and the Executive Management Team by Internal Audit

<u>Regular tasks (no set frequency)</u>

Review and discuss with Administration:

- Annual financial statements
- Internal quality reports
- Any other reports provided by external auditors

Review audit and compliance policies and procedures, including all changes

Direct special investigations for the Board

Review or seek reports on significant risk exposures and steps taken to mitigate them

a. Financial Reporting Oversight:

Review any audit or non-audit services provided by external auditors

Review integrity of PPH’s financial reporting processes and the internal control structure.

Review major issues regarding accounting principles and financial statement presentations, particularly changes, including analyses by Administration and/or external auditors

Review the effect of regulatory and accounting initiatives

Review any correspondence from or with regulatory agencies, any employee complaints or any published reports that raise material issues regarding PPH's financial statements, financial reporting process, internal audit controls or accounting policies**.**

b. Compliance function Oversight:

Establish procedures for the receipt, retention and treatment of complaints, including anonymous reporting function

Commission periodic audits to monitor the implementation and integrity of the compliance program

Review Compliance procedures for review of complaints

Review implementation of Compliance program

Review PPH’s ethics and compliance training program

Monitor any audits or examinations by governmental or other regulatory agencies as applicable.

Internal Audit Update

TO: Audit/Compliance Committee for the Board of Directors

MEETING DATE: Tuesday, October 20, 2009

FROM: Tom Boyle, District Audit Officer

BY: Donna Goh, Internal Audit Services

Background: Provide an update on Internal Audit activities to date.

Budget Impact: N/A

Staff Recommendation:

Committee Questions:

COMMITTEE RECOMMENDATION:

Motion:

Individual Action:

Information:

Required Time:

PPH Hotline Publicity Efforts

TO: Audit/Compliance Committee for the Board of Directors

MEETING DATE: October 20, 2009

FROM: Martha Ann Knutson, Corporate Compliance Officer

BY: Martha Ann Knutson, Corporate Compliance Officer

Background: Various efforts have been undertaken to publicize the PPH Hotline as reflected in the attached materials.

Budget Impact: N/A

Staff Recommendation: Review and provide feedback on publicity efforts in alignment of the Committee's oversight function.

Committee Questions:

COMMITTEE RECOMMENDATION:

Motion:

Individual Action:

Information:

Required Time:

SPEAKING UP

The PPH values of **Integrity**, **Teamwork** and **Stewardship** require each of us to speak up when we see something that may be wrong or inappropriate.

One way to do that is simply to speak directly to the person(s) involved. That gives them the benefit of the doubt and may reveal information you didn't know.

Another way is to speak to someone in a position to do something about what you have seen – for example, a supervisor, Human Resources, Security, etc... Try to be specific about your concern and avoid prejudging.

You can also speak to the **PPH Corporate Compliance Officer, Marty Knutson.** She can be reached at **858.675.5259** (**office**), **760.781.6809 (pager)** or by email at **compliance.officer@pph.org**.

Finally, you can call the confidential **PPH Compliance Hotline** at **800.850.2551** to report concerns. There is also a Web site where you can raise concerns – **www.integrity-helpline.com/PPH_compliance.jsp.** Both the Hotline and the Web site will allow you to raise concerns anonymously.

But whatever route you choose, the important thing is to speak up – it's part of keeping this the kind of place where we all want to work and care for members of our community.

PALOMAR
POMERADO
HEALTH
SPECIALIZING IN YOU

Fun facts about our Hotline and the New Web Reporting Site

An independent company - Global Compliance Inc. - runs both the Hotline and the Web Site for PPH

Global provides similar services for companies all over the world – including half of the businesses listed on the Fortune Magazine Top 100 list.

They have been providing hotline services since 1981. From 1992 – 2003 they were owned by Pinkerton Security.

Global has 90 operators sitting in Charlotte, North Carolina just waiting for us to call them. They have Spanish speaking operators and interpreter services in 150 languages. Yes, that includes Tagalog.

All reports submitted to both the Web Site and the Hotline are sent to the Corporate Compliance Officer – unless you mention her, in which case the call or report will be sent to the General Counsel.

Reports can be made to both the Hotline and the Web Site anonymously.

Both the Web Site and the Hotline give callers a “report number” that they can use to get feedback at a later time – again without giving their name.

It is not true – yet – that the Department with the most calls to the Hotline gets a pizza party.

It is true that our patients and members of the community can use both the Hotline and the Web Site.

It’s also true that the District’s Board of Directors has specifically prohibited retaliation of any kind against those who make reports to either the Hotline and / or the Web Site.

PALOMAR
POMERADO
HEALTH

SPECIALIZING IN YOU

From: Knutson, Martha (Marty)
Sent: Monday, October 12, 2009 10:23 AM
To: Goh, Donna
Subject: FW: Speaking Up
From: Information Security
Sent: Monday, September 28, 2009 4:37 PM
To: L_PPH All
Subject: Speaking Up

Did you know?

The PPH values of Integrity, Teamwork, and Stewardship require each of us to speak up when we see something that may be wrong or inappropriate. Unauthorized access or disclosure is a perfect example of when you should speak up!

Examples of Unauthorized Access or Disclosure:

- After seeing media coverage about a patient, you become curious about the patient's status and access the patient's record to get more details.

- You gain knowledge of an employee or PPH business partner that is accessing patient or confidential employee information and using it to make a profit.
  "Two Florida hospital employees learn just how costly it can be to sell patient information" *To read this article and others go to PPH.NET, Departments, choose Corporate Compliance, click on the "Learning from Others" link.*

- You receive a call about a patient's records being faxed or sent to the wrong facility.

Reporting Concerns

- Compliance Hotline 1-800-850-2551 or www.integrity-helpline.com/pph_compliance.jsp
- Marty Knutson, PPH Corporate Compliance Officer
  - (858)675-5259 Office
  - (760)781-6809 Pager
  - Compliance.Officer@pph.org
- Kim Jackson, PPH Privacy Officer (760)739-3290
- Luba Halich, PPH Information Security Officer (858)675-5115

If you have any questions, please contact Information Security at InfoSec@pph.org.

Luba Halich, MPH, CISM
Director, IS Quality & Service
Information Security Officer

and Water Measures ented at ilities

Here are some ways Facility Operations is eliminating water waste and saving money for the district:

PPH is trying to be a good community partner and also sympathetic to our resources that we depend on so much. We are working with our landscape contractor on reducing grass areas along with new low water plants.

Exterior watering areas being addressed:

- Switching to low flow sprinkler heads for irrigation
- Using low flow soaker hoses covered by bark to minimize evaporation.
- Removing areas of grass and replacing it with bark and drought tolerant plants.
- Cutting watering schedule to existing grass by 50% and using an organic lawn dye that keeps the grass a lush green color (similar to what the PGA uses for events).

Grass has been removed in several areas around PMC and replaced with concrete and bark. This effort will save PMC alone approximately 120,000 gallons per year in irrigation water.

Interior water saving measures:

- Flow restrictor valves. These valves will ensure that each sink at PMC and POM are only outputting 1.5 to 2.0 gallons per minute. As of right now many sinks are putting out 8 to 10 gallons per minute. By regulating the flow of water PPH will be able save a massive amount on our water bill. The rough calculations figured show a savings of several hundred thousand gallons that PPH can save annually.
- Reusing the waste water from the central plant and cooling towers that come from Plant Operations. We are close to having a plan that will allow us to reuse the waste water from the plant for irrigation purposes.
- Ensure all flush valves on toilets are 1.6 gal not 3.0 gal. Old toilets had the large 3.0 gal flush valves and now we are making sure we are converting all toilets to saving half of the water being flushed down the drain.

You will receive more updates as more conservation efforts are implemented. If you have any questions, please contact Steve Fox at PMC at 760.739.3170. M

SPEAKING UP

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One way to do that is simply to speak directly to the person(s) involved. That gives them the benefit of the doubt and may reveal information you didn't know.

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But whatever route you choose, the important thing is to speak up – it's part of keeping this the kind of place where we all want to work and care for members of our community.

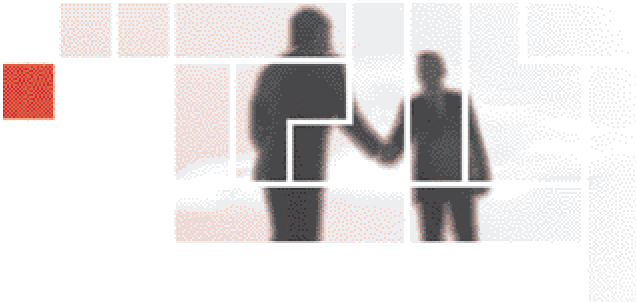
PALOMAR POMERADO HEALTH
SPECIALIZING IN YOU

What's New in Compliance:

PPH has a new Compliance Officer, Marty Knutson, a new "hotline" service that will answer calls 24 hours a day and a new Web site – www.integrity-helpline.com/PPH_compliance.jsp – through which anyone at PPH or the community can raise concerns. Both the new service and the Web site are provided by Global Compliance, Inc., one of the nation's leading companies in this area. The service is available in more than 120 languages so that callers can feel comfortable expressing concerns. Both the hotline and the Web site permit those raising concerns to remain anonymous. All reports are given to the PPH Compliance Officer for follow up.

With all these Compliance innovations also comes a renewed emphasis on something "old" – the PPH core values, particularly those of Integrity, Teamwork and Stewardship.

Managers all throughout the organization have been making time this month to talk about these values and why they require each of us to speak up when we see something that may be wrong or inappropriate. The flier pictured above should be evident around the organization – just a quick reminder to each of us that if we see something and fail to speak up then we are just part of the problem, not part of its solution. M



SAI GLOBAL WHITEPAPER

REPORTING OF WRONGDOING, AND USING HOTLINE DATA TO IMPROVE THE ORGANIZATION

Alice Peterson

Introduction

Employees know what's really going on in an organization. Partners and vendors also have a window into certain operational activity. Organizations will be more successful over the long term when all the people involved regularly communicate what's going right and what's going wrong, and when the information is appropriately acted upon.

Encouraging open and honest communication is not enough. Organizations must provide employees and partners an easy and safe way to provide information on a confidential basis, too. Knowing about problems is the first step to fixing problems. When employees are comfortable coming forward either on an identified basis or anonymously, they will speak up when they learn of relevant information that is not known or not being properly acted upon. This is a huge benefit in more ways than one. As organizations grow and become more complex, it is advisable to have a systematic way to collect and organize risk information.

By having proven processes to (1) learn of problems, (2) analyze noncompliance trends, (3) take appropriate action, and (4) track issues, organizations are able to successfully focus the majority of their energy on achieving their primary purpose.

Reporting wrongdoing:
To be (identified), or not to be

Anonymous communication mechanisms are an effective way to uncover fraud, illegal acts, and code-of-conduct violations. What was known as the "hotline" in the latter part of the 20th century has evolved into a multi-channel, disciplined program to deter and detect wrongdoing. Today's comprehensive ethics reporting initiatives involve the receipt of tips, the intelligent use of technology to identify patterns of unwanted behavior, collaboration among the ethics office and affected units of the organization, and effective action to manage identified risks.

Anyone who has been in a management role would express a preference for employees with sensitive information disclosing it on an identified basis. However, human nature precludes the possibility of habitually open and honest communication. The reasons humans choose to keep certain information to themselves are too numerous to list. It is futile for organizations to fight these human traits, and we should instead work with them.

This is not to suggest that it isn't a worthy goal to have as much open, direct daily communication as possible. There is actually evidence that the more management encourages people to speak up, including using confidential mechanisms, the more

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people come forward on an identified basis and disclose what they know.

Cultural international differences

While some things are the same for people of every country, cultural and legal differences do exist around the globe which must be understood and considered in planning and implementing an effective anonymous reporting program.

Helpline versus hotline

Organizations use their two-way confidential communication mechanisms not only for reporting wrongdoing and code-of-conduct violations, but also to open up a safe channel of communication to address ethical dilemmas with which employees are grappling. This "helpline" concept takes the confidential ethics conversation from one only about past sins to proactive business ethics.

Prevent and detect

Our goal in this chapter is to provide practical information about how to implement a business hotline to both prevent and detect wrongdoing. While the term "hotline" is a misnomer, we use it here to mean the comprehensive set of practices and systems for receiving confidential ethics reports from employees and vendors, documenting violations and risks that are reported on an identified basis, maintaining a single database of compliance and ethics issues, responding to submitters, handling reports, performing investigations, analyzing ethics reporting data, and communicating with various constituencies in the organization as and when appropriate. The mere existence of a serious employee feedback program prevents misbehavior, and prevention, as they say, is the best medicine.

Purposes Served by Ethics Reporting Mechanisms

If truth be told, some companies have a hotline in place solely because they must. There are a number of laws and judicial guidelines in existence today which require that employees be provided an independent mechanism for reporting wrongdoing. Thankfully, companies with such "necessary evil" attitudes towards anonymous reporting services are dwindling in number.

The primary reason that companies formerly resented having a hotline was that their flawed processes created more hassles than positive outcomes. There were also companies (and we still see this from time to time) where leadership seemed to fear losing power by virtue of letting the sun shine on their enterprise. Today, we have the experience, knowledge and tools for operating highly effective whistleblower hotline programs. Moreover, running organizations like fiefdoms is no longer allowed by most owners, shareholders, patrons and employees.

Governance

The word "governance" was barely heard before 1985. It describes the integrity, accountability, and risk management connected to the way an organization is run. Although initially used in the context of publicly owned companies, the term also applies to not-for-profits, colleges and universities, and governmental organizations. Governance is bandied about so frequently today that if we don't pause to reflect on what it means in a specific context, it can be relegated to cliché.

The analytical argument for enhanced governance in corporations stemmed from the value of shifting from oligarchic corporate structures, where CEOs set the agenda and held unaccountable power, towards those with systems of accountability and which encouraged the input of long-term shareholders and employees in corporate decision-making.

The governance revolution included enhanced corporate monitoring as a key tenet from its earliest history.

The key purpose served by effective confidential employee reporting structures is, by and large, the same as the key purpose of good governance in general:

- Achievement of the organization's mission
- Strong reputation
- Increased transparency and accuracy of financial reporting
- Enhanced investor and patron confidence
- Mitigated risk of adverse volatility in public companies' security prices
- Reduced probability of misappropriation of assets
- Access to capital
- Fewer adverse findings by auditors and regulators
- Lower litigation risk and experience
- Reduced insurance costs

Laws Stipulating Requirements for Hotlines

As this book goes to press, the United States is in the process of rolling out unprecedented economic stimulus packages. Accompanying each of them are safeguards against fraud, waste, and abuse. The **American Recovery and Reinvestment Act of 2009** ("ARRA"), which is expected to put nearly $500 billion into the domestic economy, requires recipients of funds to have a comprehensive compliance program in place; an effective hotline to detect mismanagement, unlawful activity, and waste of funds is de rigueur.

The **Federal Sentencing Guidelines** were issued by the U. S. Sentencing Commission in the mid 1990's in their original form, and underwent a serious update in late 2004. They were designed to guide the United States federal courts system in uniformly sentencing those found guilty of federal crimes. They apply not only to public companies, but to "all organizations whether publicly or privately held, and of whatever nature, such as corporations, partnerships, labor unions, pension funds, trusts, not-for-profit entities, and governmental units." (United States Sentencing Commission – An Overview of the Organizational Guidelines – 2004).

Under the Guidelines, companies weren't mandated to have an anonymous reporting option, but if they wanted to be in a position to mitigate fines and sentences under the sentencing rules, they needed to do so. The original Guidelines asked organizations to implement a system whereby employees could report misconduct without fear of retribution. Since it has been an accepted fact for a long time that many individuals will only report improper conduct when they are assured they will be safe in doing so, designing a process with confidentiality and anonymity for submitters was a given.

The Federal Sentencing Guidelines as updated in 2004 explicitly defined seven minimally required elements of an "effective compliance and ethics program." An anonymous reporting mechanism is among the required elements.

The U.S. Department of Health and Human Services' **Office of the Inspector General** has a specific rule in place in its Compliance Program Guidance for Hospitals which requires seven elements including, "The maintenance of a process, such as a hotline, to receive complaints, and the adoption of procedures to protect the anonymity of complainants and to protect whistleblowers from retaliation"

On the heels of the corporate accounting scandals in the U.S. just after the turn of the century (notably Enron, WorldCom, Adelphia and Tyco), the **Sarbanes-Oxley Act of 2002 (or SOX)** was enacted. This sweeping legislation established new or enhanced standards around business controls for all U.S. public companies. Section 301(4) included the requirement that the audit committee establish procedures for:

> "(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
>
> "(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

While SOX was unwelcome by many executives claiming that it placed an unnecessary burden on them, the whistleblower hotline requirement was significantly less taxing than the other aspects of this law. Many large companies already had a confidential reporting mechanism in place in 2004 when SOX became effective, but most small and medium-sized companies had to put such a program in place for the first time.

A whole slew of other rules and bills introduced after 2002 created additional impetus to have a hotline.

Federal Acquisition Regulation – For all contracts and subcontracts with a value in excess of $5 million, and a performance period of more than 120 days, contractors must have in place a written code of business ethics and conduct, certain internal controls, and a compliance program including a whistleblower hotline and other fraud awareness initiatives. There is also a flow-down requirement for covered subcontracts. Contractors must implement control procedures that demonstrate "exercise of due diligence to prevent and detect criminal conduct."

FAR's minimum internal controls don't apply to small businesses. Small businesses are, however, subject to a mandatory disclosure rule. In order to be able to comply with the requirement to disclose evidence of violations, an effective mechanism for employees and partners to report (anonymously and confidentially if they choose) the violations, and a disciplined program for investigating and stopping the violations, is de rigueur.

Federal contractors of any type and size should have an appropriately scaled anonymous reporting option for employees. Should a contractor ever be accused of failing to discover or disclose evidence of a suspected violation, the organization will want to be prepared to show the government its strong procedures for assuring a culture of compliance and ethical behavior.

New York Stock Exchange and other exchange listing rules also include a hotline-type requirement. Rule 10A-3(b)(3)(ii) under the NYSE Corporate Governance Rules requires that each audit committee must:

> "establish procedures for the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. In view of the external management structure often employed by closed-end and open-end funds, the Exchange also requires the audit committees of such companies to establish such procedures for the confidential, anonymous submission by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the management company, as well as employees of the management company. This responsibility must be addressed in the audit committee charter."

Enterprise Risk Management

Maybe ERM is a buzzword that will sound silly in 2050, but the concept will undoubtedly be around forever: organizations must understand the risks that go along with their opportunities and take appropriate steps to mitigate and manage risk.

All sorts of elaborate ERM initiatives are being proposed by consultants in the wake of the great economic collapse of 2008-2009. Whatever form these initiatives take, organizations are wise to systematically identify their risks and assign accountability to specific individuals for tracking and managing each risk. While a top-down, historically based approach to risk identification is well and good, case reports from the ethics database will also inform the process.

Other Purposes Served by Ethics Reporting Mechanisms

More often than not, problems get harder to fix the longer they are allowed to fester. With well executed ethics reporting programs, issues are surfaced early, allowing management to address them immediately. As with any calamity that is arrested, one never knows how bad things would have gotten had action not been taken. We do know the outcomes of issues that were not surfaced and therefore not addressed: lawsuits, even class action lawsuits, penalties and fines, huge organizational distractions, stock price drops, and even irreparable reputation damage.

Some public companies choose to have the ethics hotline serve also as the method to allow any interested parties to communicate with the non-management directors, which is a stock exchange provision. There are considerations for and against this. Companies which choose to have a separate way for interested parties to contact non-management directors may be concerned that if it's too easy and too safe, the board could get more suggestions and agenda items than otherwise. Companies which combine the two like the fact that only one set of contact instructions has to be kept updated from year to year, and the focus on issues entered into the ethics database get regular focus and are tracked. The better ethics hotline services can set up alerts such that an interested party case is sent to a specific member or members of the board of directors.

Last but certainly not least, a great purpose for the ethics reporting hotline is the surfacing of valuable information for running operations more effectively. Often, information communicated anonymously is information that can't be gleaned any other way.

The Value of a Disciplined Process and System for Handling Hotline Issues

Finding out about wrongdoing is a great start. But unless disciplined processes are employed for tracking data, following up, and acting on the information, just knowing has limited value.

No matter what size or type of organization, it is imperative to have a plan for what will happen as a result of submissions. The plan will inform the selection and set-up of your case management system. In turn, reading this entire chapter and making notes about which aspects of this discussion are relevant to your situation will suggest a plan outline.

Another idea with regards to planning the hotline processes is to envision an ethics reporting policy (see Sample Ethics Reporting Policy at the end of this chapter). If your organization already has such a document, re-read it and think about aspects that might need an overhaul. If one does not exist, think about what purpose it might serve in your organization and what should go into it. This document typically details how the process works and is a useful reference in a number of circumstances. Putting it together for the first time is a catalyst for re-thinking the status quo and for making key decisions about the ethics reporting program.

The Computer System

When outsourcing anonymous submission intake to a third party (more on this later), the hotline provider will likely supply a case tracking system as part of the package. Even if submissions are taken internally, an ethics case management system license may be obtained from a third-party vendor. Some organizations have home-grown or proprietary systems already developed for this purpose. Whatever the situation, know that disciplined case tracking will pay for itself in spades over time.

There are great efficiencies when the ethics case management system is linked or directly fed by the hotline phone and web intake. This is the typical situation with the major hotline vendors. When one source of intake (internal, or Vendor A) is paired up with a case management system from another source (Vendor B, or internal), programming is required to get the data from one place and format into the database that drives the case management system. The more capable hotline vendors have one master application which runs the call center as well as the case tracking and management system. There are security advantages to this closed loop approach – in addition to the streamlined efficiency.

Many of the available case management systems operate on a software-as-a-service model. This means managers and investigators who are handling cases can access a secure case database from wherever they are in the world so long as there is Internet connectivity.

Some organizations make the mistake of thinking that they get too few submissions to warrant a case management system to track them. The user licenses pay for themselves with more than 5 or 10 cases a year, and sometimes the hotline providers discount the user fees for very small or not-for-profit organizations.

Case Management Process Considerations

There are a number of chicken-and-egg arguments about what comes first when planning the ideal hotline program. The reality is that many organizations hold certain things sacred, and if this is the case, the answer is to start there and then use an iterative process to get other aspects lined up and consistent. It is common to find along this journey that it is desirable to change what was once considered sacred.

Determining who will handle case submissions is as good a place to start as any. This will be a function of the size and complexity of your organization, as well as its organizational structure and unique culture. Primary accountability for handling cases of a particular type must be established. It is recommended that Secondary accountability also be determined to assure that checks and balances are built into the resolution and dismissal of cases. In simple terms, a case handling structure may look like this:

Illustrative Only — Simplified case handling architecture

Member of Management Responsible for Handling	Acctg, Auditing, Finance	People, Labor, Employment, Organization	Safety and Security	Regulatory	General Code of Conduct	Suggestions
Miriam Hsu, Head of Human Resources		Primary				Secondary
Bill Marlin, Head of Internal Audit	Primary				FYI	
Caroline Betts, General Counsel	Secondary	FYI		Primary	Secondary	
Greg Jones, Ethics and Compliance Officer	FYI	Secondary	Secondary	FYI	Primary	Primary
Vivian Moss, Head of Field Operations			Primary	Secondary		

In large organizations, it makes sense to have multiple escalation levels. For example, perhaps certain types of submissions from the employees or vendors of a business unit are handled by the management of that business unit. However, should the business unit issue be of major significance, it would be escalated to corporate staff. Similarly, decisions must be made regarding cases which should come to the attention of the board of directors, or the audit committee. This would be a submission which, for example, alleges that senior management is involved in serious wrongdoing.

One of the basic differences in philosophy regarding case handling is centralization versus decentralization. In the centralized approach, a single ombudsman or ethics officer, or perhaps an ethics committee, receives every case regardless of type or category, and determines how the case should be handled. In the decentralized approach, multiple pre-determined teams receive and handle cases based on type or category without going through a central filter.

For small organizations, multiple teams might not be called for. In medium and larger sized organizations, however, requiring that all cases first be previewed by an individual or a group can create a bottleneck. There are ways to build in the controls and permissions that are desirable without having every case go through someone before it hits the ultimate handler. Also, the chief ethics officer or other person charged with overseeing the hotline program can have access to all cases to monitor proper and timely handling.

When considering who will be involved in handling cases, it's best to think through a wide variety of situations which many assume they'll never be faced with. For example, what steps would be followed if a case alleging serious wrongdoing by a senior member of management were received? What if a call came in on a Saturday threatening to take information about fraud to the Securities and Exchange Commission? To a local newspaper? How would the company respond to an anonymous request by a middle manager that he or she be provided legal counsel prior to divulging serious conduct in which the submitter was complicit?

Sophisticated case management systems have the ability to escalate a case to a higher level review team when events such as these occur. Let's take the circumstance where a senior manager or executive is accused of significant wrongdoing. If you designate that in this situation the case be automatically routed to the board, or to another "bypass" review team, the general notification team for that type or category of case should not ever see the case – that means no view to the case diary, and it shouldn't show up in analyses, graphs or charts. This assures that a proper investigation can be done without jeopardizing important evidence.

What to look for in an ethics case management system

At the most basic level, an ethics case management system simply organizes ethics case data into a logical database. The services available today go several steps beyond the basics, providing capabilities that save time, save money, and result in better case resolutions. Here are a few:

- Web based, so that cases may be handled anywhere, anytime
- System architecture allows user access restrictions by individual case, by level of case detail, by significance of case, by category of case, etc.
- Built-in checks and balances in the review process, along with complete audit trails
- Auto-notifications, set according to the client organization's specification, which lead users directly to the case activity requiring action
- Landing page selection options – for example, case listings for users who handle cases, a high-level drillable report for overseers, such as directors
- The flexibility to match the client's organizational structure and workflow preferences
- The ability of users at the client organization to directly enter ethics cases into database
- The ability to grant case access – for example, allow an investigator, legal advisor, or other expert to access a single case diary, with case rights as determined by the client
- Pictures, Analytics and Metrics – having ready-made and highly professional charts, tables and graphs, with the ability to customize titles data, saves time and puts communication tools at the ethics officer's fingertips
- Search – an intelligent database should allow the user to confirm a hunch, look for trends, or use data to support key ethics initiatives
- The ability to set reminders, document actions and ideas, and attach files to a case
- Intuitive Navigation – users should be able to find what they need quickly, take the action desired, and use the sophistication of the system without being bogged down technically

Confidential Employee Communication Options

The organization should make it as easy and as safe as possible for an employee or partner to report an issue using the hotline. It's a good idea to give submitters choice as to how they make their report.

Phone

From the perspective of the organization looking to receive the best information, the phone is a great way to collect reports. When the phone operators are skilled and trained and provided job aids to assist in a high quality pre-investigative conversation, the phone mode provides the organization the best opportunity to obtain the most relevant facts about the issue.

Whether the phone is an attractive choice from the submitter's point of view depends in part on the age of the submitter. Phone usage as a rule increases with age.

While it may be tempting from a cost point of view to limit ethics report submissions to the web, doing so may preclude older workers from filing reports, and is likely to limit the overall quality of the information captured.

For the phone submission method to work optimally for ethics reporting, several features should be noted.

- The call center should be available every minute of every day of the year. Ask whether the operators work from a professional call center location, or whether some or all of the operators take ethics calls from their homes. A greater degree of security and confidentiality can be provided when all operators work from a central, supervised location.
- The call center should be staffed to assure a reasonable likelihood that calls will be live-answered. Getting a recording every now and again is going to happen in most call centers, even the best-operated ones. To staff for 100% guaranteed live answer of every call would be extremely costly.
- Interpreters should be available to assist with submitters requiring language services, and/or local foreign call centers with native language-speaking operators can be used.
- To assure submitters requiring anonymity that their identity is being protected, call centers should not capture the caller's phone ID.
- Some call centers require operators to use scripts, and where less skilled operators are employed, this approach is logical. To meet the needs of all levels of employees and partners, and to obtain the most relevant information, call centers should employ highly trained and seasoned operators with the ability to conduct an unscripted interview.
- The operator should put the submitter at ease and should not burden the submitter with a barrage of administrative questions before the issue to be reported has been learned. Allowing the submitter to feel in control results in a greater willingness to divulge key facts.

Web

We now have extensive research which informs web usability. Designing web submission sites that employees and partners will use to effectively report wrongdoing is important, because increasingly, some workers' first choice as to mode of reporting is via the computer and the Internet.

Although in general web usage declines with age, an important covariant is the age at which people start using the Internet. A growing number of the world's employees have been using the web from an early age, affording them the experience and comfort level that explains why they prefer the web to the phone when given a choice in communication methods.

There is also a strong correlation between income level and web usage. For lower-paid employee populations, therefore, the Internet may not be a frequently used choice for making ethics and compliance reports – a good reason to provide employees with submission choice.

Note that web submissions are not e-mails. Technology is changing rapidly, and terminology is evolving. What is important is that the report be secure, and encrypting content submitted to a web site is at present a more straightforward undertaking than encrypting email. As a general rule, e-mail has historically been inherently insecure, and no one wants their most sensitive organizational information in an insecure form.

For organizations which feel they just can't afford a hotline program with multiple submission choices, the web is certainly better than nothing, and can actually be structured to be fairly effective.

Keep the following points in mind when designing or selecting a web submission offering:

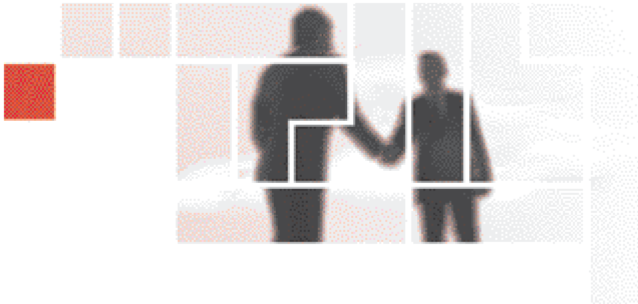
- Keep the submitter in mind when making choices about content and design. It's easy to get caught up in envisioning all the colorful pie charts you'll be able to show the board of directors if submitters answer the twenty questions required to obtain the chart data. Forget that, and focus on obtaining the most critical and relevant information about important risks which, when acted upon, will result in a stronger organization.
- Box-filling fatigue will result in submitter abandonment. Keep the requirements as simple as possible, and focus on the important function of the site: to obtain relevant information.
- The web submission site should be easy to understand and easy to navigate. People scan. They don't read every word on a web page. Use simple fonts and break up the content to make filing a report a straightforward process.
- If at all possible, avoid the need to scroll. Scrolling is correlated with abandonment, and abandonment means the important information within reach will slip away.
- Make it easy to translate the site on-the-fly to each of the foreign languages likely to be spoken by the organization's employees. Even though many foreign employees are comfortable submitting their issue in English, they may find it helpful to study the web submission site in their native language before typing their English report.
- There are pros and cons to customizing the web submission site to reflect the organization's branding. Nervous submitters who are attracted to going through an independent third-party service don't like to see their employer's presence on the site. Alternatively, it's nice to be able to reflect the organization's specific terminology when guiding the submitter to make the best report. The ideal middle ground is a customized report submission site which incorporates the best of both worlds: the independence is there, yet the language and content aid the submitter in making the best possible report. Whatever the choice, the communication regarding the hotline (posters in break rooms, Intranet page, blip on employee pay stubs, mention in the code of conduct) must match what the submitter finds when they go to the web submission site.
- Allow submitters to attach documents which relate to or support their report. Neither the third-party hotline provider nor the user organization wants any possibility of malicious payloads, so be sure the method of collecting attachments is prudent.

Letter

In our Internet age, letter-writing is becoming a lost art. However, there are still a number of letters written every year informing management or the board of directors of wrongdoing and even scandalous activity. When an outsource provider of ethics reporting is used, adding a Post Office box option is a simple selection. Organizations which handle report receipt in-house should provide employees and partners the name and address to which anonymous letters may be sent.

Fax

The lines continue to blur when it comes to electronic transmission of information. Faxes as they were known in 1985 are becoming a thing of the past, as documents to be sent electronically are now increasingly scanned and sent as attachments



to web submissions or emails. It is accordingly becoming less important that a fax option be provided for ethics reporting.

Other Report Submission Choices

It is always important to put oneself in the shoes of the various units of the organization’s employees or vendors, and ask, “What would I do if I knew of wrongful acts?” Doing so helps to determine possible program gaps. For example, Chinese workers in a plant owned by a US corporation may not be inclined to use any of the methods discussed above to report workplace violations.

Cultural sensitivity is essential to understanding worldwide risk. Ingenuity and deeper digging are often required to devise the optimal ethics reporting program internationally. The use of a traveling ombudsman can be effective in certain circumstances. Including addressed and stamped postcards with paychecks or pay stubs works in some places. And the possibilities are limited only by one’s imagination.

Determining How the Hotline Will Work, and Who Will Do What

The term “hotline” is being used in this chapter as shorthand for the overall set of practices and systems for receiving ethics reports from employees and vendors, documenting over-the-transom reports (for example, from employee to supervisor, or walk-ins to the chief ethics and compliance officer or to human resources), maintaining issues and incidents in a single database, responding to submitters, handling reports, performing investigations, analyzing ethics reporting data, and communicating with various constituencies as and when appropriate (business runners, human resources and other staff areas, executive committee, board of directors, etc.).

Using this broad hotline definition, there are a lot of decisions that must be made to put a highly effective hotline program in place, and to operate it effectively on and ongoing basis.

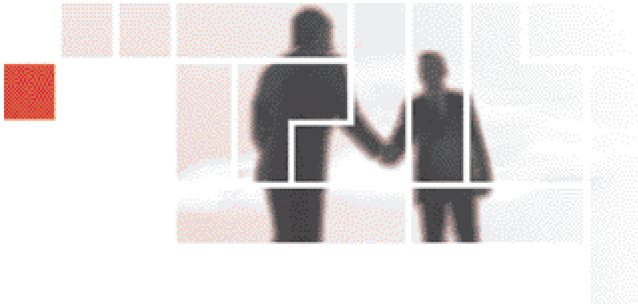
Why employees don’t use hotlines

Research shows that the number one reason employees don’t use anonymous reporting mechanisms is that they believe nothing will be done as a result of their submission. It is often presumed that the top reason is fear of identification and reprisal, which is actually a strong #2. The other key reasons cited by employees for not using confidential reporting services fall under the heading of “barriers to usage.” This insight should inform the structuring of a successful hotline initiative.

Link to mission, values and other elements of ethical culture

There are myriad choices and considerations when it comes to implementing an effective hotline. Consistency with the organization’s mission and values is absolutely critical. Employees can smell insincerity, and when they do, cynicism and morale problems result.

Integration of the hotline into all the other components of the ethics and compliance program is also important. A few examples are these:



Ethics and Compliance Program Element	Hotline Linkage and Integration
Tone at the Top (moral leadership throughout the organization)	The CEO, Executive Director, business runners, and senior staff should encourage employees to use the hotline during town hall meetings, in written communication, in other organizational forums; the board of directors should oversee and regularly review all activities of the chief ethics and compliance officer, including hotline activity.
Ethics Education and Training	Include anonymous reporting as an acceptable action in resolving an ethical dilemma. Include a link to the ethics reporting web submission site right in web-based training modules. In a learning moment, it is natural for employees to identify their colleagues; and their own shortcomings related to the training topic, and therefore an ideal opportunity to report.
Assessments and Surveys	Include questions related to the hotline to identify areas for improvement (for example, Would you feel safe using the hotline? If not, why? If you needed to report wrongdoing using the hotline, would you know where to get the access information? Etc.)

One Size Does Not Fit All

Some form of hotline should be in place for all variety of organizations: large and small; public and private; for and not-for-profit; domestic and international; service organizations and manufacturers; government agencies and NGOs; colleges, universities, and schools.

It would be impractical to say the least to suggest that these highly varied organizations should make similar selections with respect to their hotline. Even the legislation and regulatory guidance provides significant leeway to scale and design compliance programs, including hotlines, to best address the unique need of each organization.

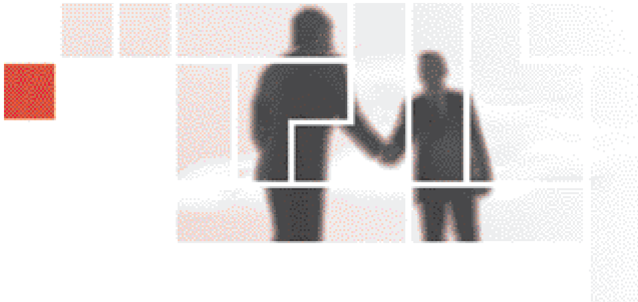
Oversight, Administration, and Handling Submissions: Who will do what?

Even though in most organizations a group of people will be involved in the execution of the hotline program, it is important that one person be designated as ultimately accountable and responsible. This doesn't mean that key decisions won't be discussed as a group or that input won't be sought. It does, however, assure that this important activity is not a sideline for several people and the responsibility of no one.

For the purposes of this treatise, we will call the person in this oversight role the Single Point of Contact, or SPOC. The SPOC would very logically be the chief ethics and compliance officer. In organizations that aren't sufficiently large to warrant having such a person, it could be a chief administrative officer, the internal auditor, the human resources leader, or other senior officer. Although it is not ideal that this person be the general counsel or chief legal officer, this too can work. [discuss why this position?]

Who will be invited to use the ethics reporting service?

The seemingly obvious answer to this question is "employees." While it may be just that simple, the SPOC should consider the broadest employee concept possible. If a large group of the



organization's employees are seasonal workers (road construction, for example, or winter resort staff), or volunteers, or part-time employees, it makes sense to include information about the hotline in the materials they receive and/or to assure that these people have access to the intranet or other places here the access information is posted.

What if the organization is an extensive outsourcer of work? When a third-party is performing key services, those employees should also be informed of the hotline, and it should be communicated that it is an obligation that they report any wrongdoing that comes to their attention either through the normal channels of open communication, or through the hotline. In a company, for example, which outsources accounts payable, or technology, or customer service, these partner employees are in a position to witness serious defalcations, and the same safe and easy reporting alternatives should be available to them.

Whether agents and franchisees are invited to use the organization's hotline often depends on the business model. The organization may feel that access to the hotline creates the sort of link they seek to these key partners, or they may leave the hotline to their discretion.

It's a good idea to make it a policy that vendor contracts include some language around the vendor's obligation to make known wrongdoing, and to state the hotline phone numbers, web URLs and any other access information such as Post Office box right in the contract. Compliance with the contract would include posting the hotline information in appropriate places in the vendor organization.

The line is typically drawn at clients or customers. A customer complaint calls for different handling than an ethics concern.

However, an ethics concern raised by shareholders is usually fair game. Accordingly, in addition to including the hotline information in the proxy, it might also be available in the Investor Relations section of a company's website. Sometimes the same hotline that is used for ethics submissions is, for convenience and efficiency, also used to satisfy the exchange listing rule which provides that shareholders or other interested parties may request that a topic be added to the agenda for the executive session at a board meeting. The infrastructure of the major independent ethics reporting providers easily accommodates this.

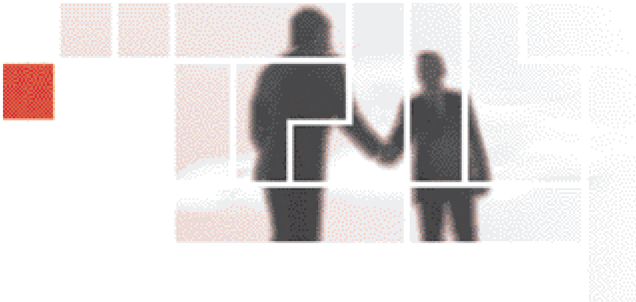
Similarly, a not-for-profit organization would make the access phone numbers and web site addresses available to donors, and possibly to other key constituencies.

Organizations should cast a sufficiently wide net to assure that the people engaged in pursuing its mission have the information they need report misbehavior and know that it is their obligation to do so. The key costs are getting the infrastructure and processes in place; adding potential users to the mix adds little or no cost. It is impossible to predict where a problem may be lurking. Accordingly, it is wise to adopt a strategy whereby anyone who could see or know of wrongdoing is positioned to speak up.

Who will handle reports?

Needless to say, there is no one right way to structure ethics report handling. Even though there are many permutations that can work, at a very high level, one of two main themes governs the way that organizations structure report handling: centralized or distributed.

Under a centralized approach, one person or a small group of people handle all categories and all significance levels of cases. After an initial review,



this central person or group might delegate handling of the case to someone else in the organization. This is a logical approach for a smaller organization. It may also make sense for a larger organization where the ethics and business compliance group has established a strong history of independence.

The distributed model assigns case handlers to categories of cases, eliminating the need for issues to be vetted centrally prior to assignment. For example, a human resources leader or lawyer may be the primary handler of labor and employment issues (and to provide check-and-balance, someone from the legal department may also be assigned to such cases.

In both approaches, it is possible and desirable to have a SPOC overseeing all hotline activity.

How will the service be publicized?

Like any effective marketing message, communication regarding the hotline needs to be clear and repeated. If organizations put the same focus on marketing the hotline as they do on their products and services, the message will have the desired effect. Unfortunately, many organizations bury the hotline information in their code of conduct, or they do one roll-out and expect employees to act.

In 1885, Thomas Smith wrote a marketing guide called Successful Advertising. Borrowing from his model, which is still used today, keep the following in mind when planning the frequency with which the hotline should be publicized.

> The first time people look at hotline information, they don't even see it.
>
> The second time, they don't notice it.

The third time, they are aware that it is there.

The fourth time, they have a fleeting sense that they've seen it somewhere before.

The fifth time, they actually read the publicity.

The sixth time they thumb their nose at it.

The seventh time, they start to get a little irritated with it.

The eighth time, they start to think, "Here's that confounded message again."

The ninth time, they start to wonder if they're missing out on something.

The tenth time, they ask their colleagues what they think of it.

The eleventh time, they wonder why the organization is focusing on it so much.

The twelfth time, they start to think that it must be a good thing.

The thirteenth time, they start to feel the hotline has value.

The fourteenth time, they start to remember wanting a service exactly like this for a long time.

The fifteenth time, they start to think about what they would say or write in their ethics report.

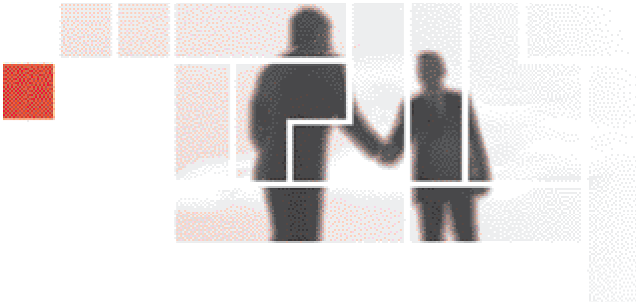
The sixteenth time, they accept the fact that they may use it sometime in the future.

The seventeenth time, they make note of the toll-free number and URL.

The eighteenth time, they curse their lack of courage to use it.

The nineteenth time, they review the information provided by the organization.

The twentieth time, they pick up the phone and dial the hotline, or they go to a computer and type in the hotline URL.



Among the many ways and places the hotline might be publicized:

- posters – in break rooms and every now and then on sandwich boards in the hallway)
- wallet cards
- brochures
- small cards in placed around the work and restroom areas
- reminders on pay stubs
- incorporated into ethics training
- code of conduct
- blast brief emails or voice mails

Get creative. An organization's specific circumstances provide opportunities to get to the "twentieth time."

In addition to frequency, content is important. Be sure employees and partners at all levels are given permission to use the hotline. Negative aspersions have been cast on hotlines in the past – sometimes inadvertently – making it all the more important to create inclusive messages and ones which communicate that not only is it OK to use the hotline, but also that it's your duty and it's a good thing to use it.

The Board of Directors' Role in Overseeing the Hotline, Ethical Culture

An ethical culture is arguably the single most important factor in protecting and building a strong overall corporate reputation. Countless organizations have suffered irreparable reputation damage due to ethical lapses - accounting malfeasance, consumer misinformation, conflicts of interest, the taking of bribes, hostile workplaces, and just plain lying, cheating and stealing.

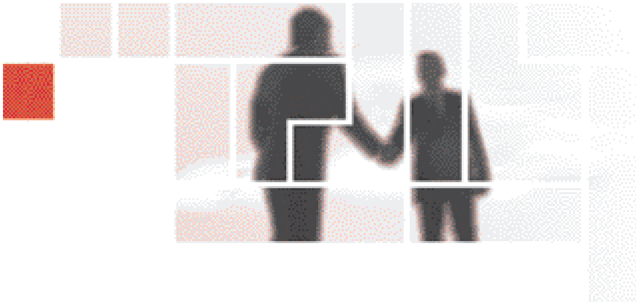
Corporate directors, who are charged with providing the oversight necessary to ensure a strong system of corporate governance, can play a meaningful role in assuring a culture of professional responsibility. Boards have begun to take the serious steps necessary to become better stewards for shareholders and other corporate constituencies. The chief ethics and compliance officer can assist them in doing their part to oversee a culture of integrity.

It starts with the hiring of the CEO. If the CEO is already in place and successfully running the company, the annual review is an important opportunity to talk about what the CEO is personally doing to create that all-important tone at the top. Is he or she encouraging use of the hotline, for example?

Another area of focus is the aggressiveness level of the company's plans and incentives. If they are extremely aggressive, there is fertile ground for temptation to step across acceptable boundaries. The board would want to be watchful for hotline submissions related to such behavior.

The board should regularly assess the effectiveness of the company's overall professional responsibility initiatives, including the hotline. Whether the company served by directors is large or small, or in an industry requiring a large ethics and compliance department or not, the board should know what sorts of things are done to model the desired behavior. At least annually, the board should address the company's ethics initiatives with the chief ethics and compliance officer and other key executives and seek answers to the following questions:

- What is done to assure that every employee understands the Code of Conduct? Do employees (directors too) commit annually to abide by it?



- Is the Code of Conduct alive and real, or are people merely going through the motions?
- What are the established practices for handling Code of Conduct violations? Does the board know what it would do if a senior executive were allegedly involved in serious wrongdoing?
- Do employees perceive the hotline to be a safe way to speak up?
- Are reports and findings of ethical lapses from internal audit, the hotline, and throughout the company collected into one place and regularly analyzed for trends?
- Is ethics training provided to employees? What is taught to whom and with what frequency? Is effectiveness measured?
- Are confidential surveys administered periodically to measure employee attitudes and perceptions about management style and ethical climate?
- Do hiring practices employ integrity screens?
- Are departing employees provided an anonymous exit interview?

The board itself must focus on sending the right messages to management through its questions and directives. Directors shouldn't limit their information to receiving a board room report. They can talk to employees on the way to and from meetings, they can review anonymous employee reports, and they can talk to vendors and partners.

Over and above the audit committee's responsibilities related to hotlines as described in Section 301 of Sarbanes-Oxley, directors should have the ability to monitor what employees are saying confidentially. Provide them access to the case management system, and set up their default page to the summary, high-level reports that quickly tell the main story. Also allow them to drill down to detail.

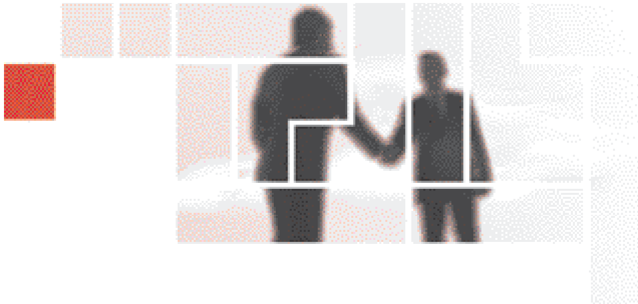
The board should also monitor the findings of wrongdoing and review management's actions. Although it is the CEO's job to run the company, directors are charged with ensuring that the management team serves the company's and the shareholders' long-term interests.

There is nothing more essential to long-term success than a sound reputation, and to ignore oversight of the company's culture of professional responsibility puts corporate reputation at risk. Directors must be accountable to shareholders for the governance required to achieve the company's vision and mission. To do this, they must put corporate culture on the board agenda, and they must diligently and vigilantly oversee the company's ethics processes and programs.

Privacy and Data Protection

Organizations today must address a multitude of issues related to the privacy and protection of employee and other data. Legislation in countries around the globe requires the establishment of policies and procedures to protect individuals' personal information. Without a strategy and plan to address data privacy and protection issues, an organization is potentially exposed to serious legal liabilities, not to mention reputation damage.

Applying ethics and compliance programs to employees in numerous countries requires particular care and thoughtfulness in order that the initiatives be both effective and compliant with local laws. The right to data privacy is particularly heavily regulated in Europe. Specifically, under EU legislation, organizations obtaining, processing, or even just holding personal data must comply with rigidly enforced directives. This creates a conflict with mandates of the Sarbanes-Oxley Act of 2002.



At this writing, judicial guidance on EU privacy laws continues to evolve. Clearly, EU privacy will present ongoing challenges for the implementation of whistleblower hotlines. However, it is completely possible to structure a program that complies with the requirements of multiple jurisdictions simultaneously and yet achieve the main objective of facilitating the reporting of legal and ethical issues.

Although it is tempting for multinationals to establish one master hotline that in one fell swoop accommodates applicable laws in multiple countries, this approach is fraught with danger. Despite the administrative ease of having one set of processes for ethics reporting everywhere in the world, in order to comply with all laws, this approach necessarily applies the lowest common denominator to all countries where the hotline is used, and the result is a watered down and ineffective result. For example, if French rules drove an organization's global processes, use of the hotline would not be encouraged anywhere, and, depending on a variety of factors, information collected about a reported issue could be limited.

Tailoring the anonymous reporting mechanism to a company's unique operations and locations is required to have an effective and legal employee reporting service.

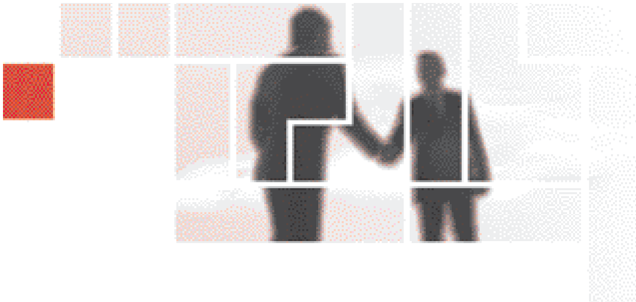
Sarbanes-Oxley and EU Privacy Laws – Fitting Them Together Properly

Section 301 of the Sarbanes-Oxley Act requires, among other things, that the audit committee of public U.S. companies establish procedures for "the receipt, retention and treatment" of accounting and auditing-related reports. The law goes on to say that the mechanism for collecting such information must be confidential and anonymous, and includes specific protections for the whistleblower from retaliation. The various U.S. stock exchange rules around codes of conduct contain similar provisions.

In structuring whistleblower mechanisms, U.S. companies typically adopt comprehensive practices for receiving and handling reports of a broad spectrum of code-of-conduct and legal violations, and seldom limit the hotline to accounting and auditing issues only. For example, hotlines usually encourage the reporting of labor and employment issues, theft, bribery and conflicts of interest. From the employee's or vendor's perspective, they need to clearly understand that anything they observe or know of which is not right should be reported, and they shouldn't need to keep track of more than one set of reporting procedures whatever the category of the issue.

EU labor and data protection laws go further than U.S. laws to protect due process and the rights of the accused. Adding to the challenge, EU member countries have put forth disparate guidance around Sarbanes-Oxley compliance, creating a dilemma for U.S. companies with EU subsidiaries (and foreign private issuers who sell securities on a U.S. stock exchange).

In early 2006, the European Union Data Protection Working Party adopted a nonbinding opinion (called the "EU Opinion") dealing with the application of the EU data protection and privacy laws to whistleblower programs. It essentially encouraged EU member states to issue and implement guidance on their own, while providing assurances that U.S. multinationals could comply with Sarbanes-Oxley and still meet EU requirements.



Practical Tips

Establishing phone and web reporting practices which are targeted specifically to employees in a particular country is the way to accomplish all goals simultaneously. This approach allows organizations to achieve best practices in encouraging broad-based reporting in non-EU countries while specific requirements in local EU jurisdictions are adhered to.

There are many combinations and permutations of approaches which work in this regard. For example, separate phone lines might be procured for each of France, Germany, Norway, and other EU countries where specific differences apply. The call-takers can be provided the training, scripts and job aids to handle calls from each country appropriately.

Consult attorneys with current knowledge in EU privacy as to what is required where; at this writing there is ongoing movement in the various EU member states' positions.

Regarding web submissions, a multinational might direct employees wishing to report issues electronically to a landing page where the submitter is asked to select from a drop-down box or other choice mechanism the country the employee works in and the country where the violation occurred. These selections would determine the next page served up to the submitter.

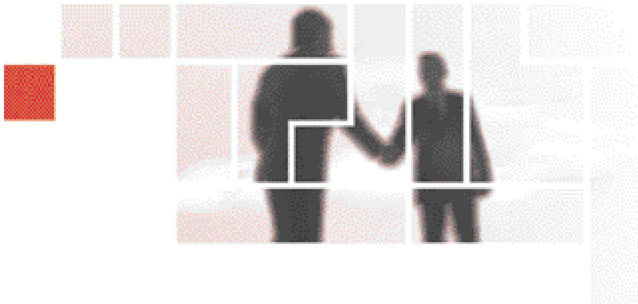
For example, if the submitter said he or she was from France and was reporting about an issue that occurred in France, the next web page would have text specifically geared to meet the rule requirements for France. It might provide specific information to employees about the whistleblower service and code of conduct. It might clearly state the types of issues that should (e.g., Accounting, Auditing, Bribery) and issues that should not (e.g., Employment) be reported here. It might provide contact information for a local human resources individual should the issue be inappropriate for submission through the anonymous service.

A unique web page would be developed in this way for each country where specific rules applied.

While it takes time and money up-front for a multinational company to craft an approach that both meets all applicable laws and results in the best information for running a better operation, the pay-off justifies it. Once the system is set up and the processes are established to accommodate EU privacy, companies can focus their time productively on taking action – wiping out wrongdoing and creating a culture of professional responsibility. Tweaks and changes can be made to accommodate EU directive changes as this issue evolves.

This is often accomplished through a detailed reconciliation of the laws across the multiple countries.

Developing an enterprise trust strategy and privacy stance, and successfully integrating it into your organization, is a complex process. It is important to evaluate business requirements, associated costs, actual and potential use, return on investment, market relationships and, most importantly, brand alignment in developing your strategy for personal data. This process requires a broad multidisciplinary approach that considers each business function within your organization.

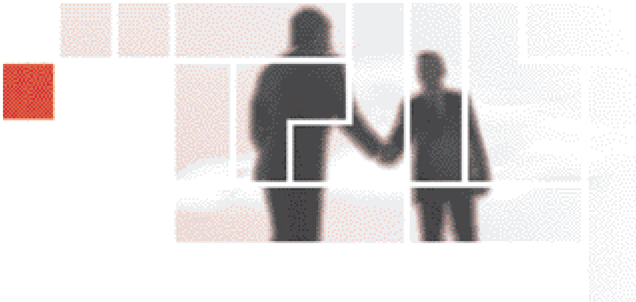


SAI GLOBAL WHITEPAPER

Summary

Even though for some the word hotline conjures up visions of the “red phone” that connected the White House and the Kremlin during the cold war years, the business ethics profession uses the term to describe something very different. It’s not hot, and it’s not a line anymore. Done well, it’s a set of processes which collects knowledge about wrongdoing or code-of-conduct gaps, documents it all in one place, provides the tools to efficiently act on the information, and makes it easy to track and follow up to assure the highest levels of governance.

We’ve come a long way in the business ethics world over the last decade, but the journey ahead is a long one. Teaching professional responsibility, demanding that our leaders exhibit integrity that is above reproach, and doing the myriad practical things required to create an ethical culture --- all are essential for building and protecting organizational reputations. A highly effective ethics reporting, helpline and case management program is a keystone to accomplishing these overarching goals.



Sample Ethics Hotline Policy

The purpose of this policy is to:

1. Describe each individual's responsibilities, as well as our practices as an organization, regarding the reporting of violations of law and breaches of our code of conduct
2. Inform individuals about their options for communicating instances of wrongful conduct
3. Assure individuals that they will not experience retaliation as a result of having made a good faith disclosure

Our goal and intention with respect to this policy

Achieving our mission requires that the people who work here be honest, law-abiding, respectful, fair and decent individuals. While our code of conduct describes specific principled behavior that is required, it doesn't attempt to make rules for everything. It is up to each one of us as individuals to understand our core values and apply them to our unique assignments; when we're not sure about a decision, it's our responsibility to contact our boss or someone in the Ethics Office for guidance.

It is in our organization's best interest to know of any legal or code of conduct violations as early as possible. When we learn about problems, action can be taken to stop the wrongful acts. Addressing problems forthwith not only reduces the negative impact of the error, but also assures that our reputation remains strong, putting us in the best stead to achieve our mission.

We intend to take the necessary action to prevent ethical lapses, and to swiftly correct our employees' and other associates' failure to follow the law and our code of conduct.

Employee, partner, volunteer and board member responsibility

It is the responsibility of each individual working with us to communicate activity which may be a violation of:

- the laws which govern our work, or
- our code of conduct

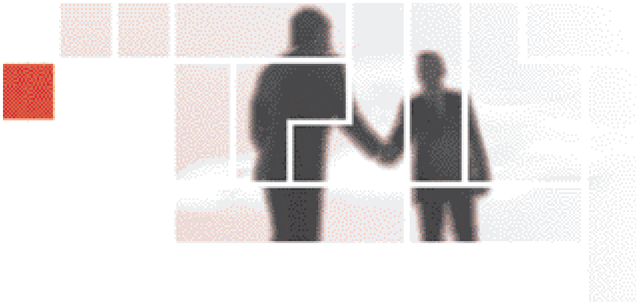
As outlined below, there are multiple reporting options available to employees who have knowledge that would be useful to our organization. Employees must take seriously their obligation to communicate knowledge of wrongful behavior.

We also expect our employees to challenge openly and in-the-moment any actions that violate the spirit of our values and our code of conduct, regardless of the status of the person whose questionable behavior is being addressed.

Our whistleblower and reporting practices

We strive to create an atmosphere where individuals will be comfortable coming forward on an identified basis to communicate legal and code of conduct violations.

Our organization knows that in many situations anonymity and confidentiality are essential in order for individuals to feel safe reporting wrongdoing. Accordingly, communicating issues through the normal channels and through the established organizational hierarchy may not always be feasible. For this reason, an independent anonymous reporting service has been established to assure confidentiality when it is needed.



Employees' Reporting Options:

1. Tell your direct supervisor
2. Report the incident to the Ethics Office
3. Tell our [HR manager] [general counsel] [audit committee chairman]
4. Use the independent service called Listen Up™
   - Call toll-free 1-888-XXX-XXXX (available 24x7)
   - Go to www.abcde.com
   - [Write a letter to:]
   - Name of service, PO Box ABC, City, State, Zip
   - [Send a fax to:]

Employees using the phone or web option of our Listen Up service will be provided a 7-digit case number which may be used to dialog with management anonymously. Submitters should write down the 7-digit number and keep it in a safe place. The phone and web may be used interchangeably; in other words, even if an original submission is made over the phone, the submitter may go to the web to check for a management reply or to add new information to the case. We encourage submitters to make their reports as complete as possible, detailing timelines, names and places.

What the Submitter Can Expect:

Regardless of the manner in which issues are reported, individuals who make a submission in good faith are protected from retaliatory actions such as discharge, demotion or any type of discrimination.

Select members of senior management have been designated to handle submissions. They will supply a management response within a few business days following the submission. The management responses are accessed in the same way that reports are submitted (see above).

If the submitter elects anonymity, the company will do its best to keep the submitter's identity anonymous.

Definitions:

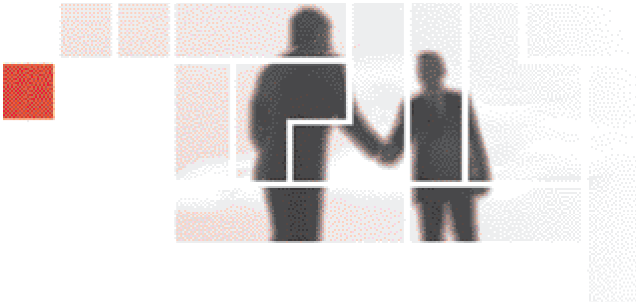
Wrongdoing, wrongful conduct

- a violation of applicable state and/or federal laws and regulations
- a violation of our Code of Business Conduct
- behavior which, if not ceased, could lead to a legal or code-of-conduct violation
- actions which are not in keeping with our values in general

Good Faith

- having honest intentions
- a submission is made in good faith when the allegation is made by someone who believes that wrongful conduct has occurred
- an allegation is not made in good faith when it is made with reckless disregard for or willful ignorance of facts that would disprove the allegation

Nothing in this policy is intended to interfere or negate information in the Employee Handbook.



About the Author:

Alice Peterson is the founder and former President of Syrus Global and the Listen Up™ ethics reporting, helpline and case management solutions. Syrus was acquired by SAI Global in 2009 after which Ms. Peterson joined SAI Global Compliance (Americas) as the Chief Ethics Officer. In that role she leads the company's efforts to assure the creation and maintenance of a culture of integrity for long-term outperformance.

Ms. Peterson is a recognized authority on the planning, execution and integration of whistleblower hotline programs. She previously held executive positions at Sears, Kraft and PepsiCo prior to founding Syrus Global in 2002. Ms. Peterson launched and ran Sears Online, where she oversaw significant growth in e-commerce revenues between 1998 and 2000. She was the Vice President and Treasurer of Sears from 1993 through 1998, during which time she had a leadership role in the company's strategic transformation activities, including the IPOs and spin-offs of Allstate and Dean Witter Discover. Before Sears, she held strategy, corporate finance and treasury positions at PepsiCo and Kraft.

Ms. Peterson has served on public company boards of directors for twelve years. Her board committee work has included audit, compensation, CEO search, and conflicts committees. She is also on the board of trustees of the Institute for Business & Professional Ethics at DePaul University and the National Association of Corporate Directors-Chicago Chapter. Ms. Peterson participates in a number of other civic and professional activities in and around Chicago.

Ms. Peterson holds a Master of Business Administration degree from Vanderbilt University's Owen Graduate School of Management, and a Bachelor of Arts degree from the University of Louisville.

Read Ms. Peterson's contributions to SAI Global's blog Viewpoint at

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SAI Global provides legal, compliance and risk management professionals with a broad range of technology enabled programs and consulting services which facilitate good governance and awareness of compliance, ethics and policy issues. This includes risk and culture assessments; complete Code of Conduct services and training; award-winning, innovative online training and awareness; training needs assessments; risk- and region-specific online databases, regulatory alerts and newsfeeds; and GRC workflow solutions.

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