PETALUMA HEALTH CARE DISTRICT

Petaluma, California

FINANCIAL STATEMENTS WITH INDEPENDENT AUDITORS' REPORT

June 30, 2010 and 2009

Matson and Isom
<table>
<thead>
<tr>
<th>Provision</th>
<th>Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent Auditors' Report</td>
<td>1</td>
</tr>
<tr>
<td>Statements of Net Assets</td>
<td>2</td>
</tr>
<tr>
<td>Statements of Revenues, Expenses, and Changes in Net Assets</td>
<td>3</td>
</tr>
<tr>
<td>Statements of Cash Flows</td>
<td>4</td>
</tr>
<tr>
<td>Notes to the Financial Statements</td>
<td>6</td>
</tr>
</tbody>
</table>
INDEPENDENT AUDITORS’ REPORT

To the Board of Directors
Petaluma Health Care District
Petaluma, California

We have audited the accompanying statements of net assets of Petaluma Health Care District (the District), as of and for the years ended June 30, 2010 and 2009, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the District’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; Government Auditing Standards, issued by the Comptroller General of the United States; and the State Controller’s Minimum Audit Requirements for California Special Districts. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, the financial statements referred to above present fairly, in all material respects, the financial position of the District as of June 30, 2010 and 2009, and the changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America, as well as accounting systems prescribed by the State Controller’s Office and state regulations governing special districts.

The District has not presented management’s discussion and analysis (MD&A) that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

Matson and Isom

October 27, 2010
## STATEMENTS OF NET ASSETS

### Petaluma Health Care District

<table>
<thead>
<tr>
<th>June 30</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>CURRENT ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$37,005</td>
<td>$234,383</td>
</tr>
<tr>
<td>Accounts receivable - net of allowance of $2,000 (2010 and 2009)</td>
<td>425,512</td>
<td>90,436</td>
</tr>
<tr>
<td>Prepaid expenses and deposits</td>
<td>87,634</td>
<td>20,638</td>
</tr>
<tr>
<td>Notes receivable - current portion</td>
<td>37,044</td>
<td>61,990</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>587,195</td>
<td>407,447</td>
</tr>
<tr>
<td><strong>NONCURRENT INVESTMENTS</strong></td>
<td>6,785,883</td>
<td>7,439,596</td>
</tr>
<tr>
<td><strong>OTHER ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred affiliation costs - net</td>
<td>118,671</td>
<td>136,683</td>
</tr>
<tr>
<td>Notes receivable - net of current portion</td>
<td>70,387</td>
<td>43,317</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total Other Assets</strong></td>
<td>189,058</td>
<td>190,000</td>
</tr>
<tr>
<td><strong>CAPITAL ASSETS - NET</strong></td>
<td>9,425,164</td>
<td>9,797,950</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$16,987,300</td>
<td>$17,834,993</td>
</tr>
</tbody>
</table>

### LIABILITIES AND NET ASSETS

<table>
<thead>
<tr>
<th>CURRENT LIABILITIES</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current maturities of long-term debt</td>
<td>$6,637</td>
<td>$39,134</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>539,101</td>
<td>183,040</td>
</tr>
<tr>
<td>Accrued liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll and vacation</td>
<td>81,979</td>
<td>79,891</td>
</tr>
<tr>
<td>Retiree health insurance</td>
<td>418,950</td>
<td>185,216</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td>1,046,667</td>
<td>487,281</td>
</tr>
<tr>
<td><strong>LONG-TERM DEBT</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net of current maturities</td>
<td>-</td>
<td>6,637</td>
</tr>
<tr>
<td><strong>DEFERRED REVENUE - NET</strong></td>
<td>2,741,851</td>
<td>3,160,627</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>3,788,518</td>
<td>3,654,545</td>
</tr>
<tr>
<td><strong>NET ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested in capital assets - net of related debt</td>
<td>9,418,527</td>
<td>9,752,179</td>
</tr>
<tr>
<td>Unrestricted</td>
<td>3,780,255</td>
<td>4,428,269</td>
</tr>
<tr>
<td><strong>Total Net Assets</strong></td>
<td>13,198,782</td>
<td>14,180,448</td>
</tr>
<tr>
<td><strong>Total Liabilities and Net Assets</strong></td>
<td>$16,987,300</td>
<td>$17,834,993</td>
</tr>
</tbody>
</table>

*The accompanying notes are an integral part of these financial statements.*
## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

### Petaluma Health Care District

#### Years Ended June 30

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OPERATING REVENUE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Program service fees</td>
<td>$1,836,200</td>
<td>$1,576,253</td>
</tr>
<tr>
<td>Rental income</td>
<td>807,093</td>
<td>820,825</td>
</tr>
<tr>
<td><strong>Total Operating Revenue</strong></td>
<td>2,643,293</td>
<td>2,397,078</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OPERATING EXPENSES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries, wages, and benefits</td>
<td>1,362,349</td>
<td>1,039,008</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>757,159</td>
<td>739,410</td>
</tr>
<tr>
<td>Professional fees</td>
<td>282,875</td>
<td>178,894</td>
</tr>
<tr>
<td>Purchased services</td>
<td>618,923</td>
<td>634,157</td>
</tr>
<tr>
<td>Bad debt expense</td>
<td>3,217</td>
<td>9,744</td>
</tr>
<tr>
<td>Operating supplies</td>
<td>54,996</td>
<td>53,477</td>
</tr>
<tr>
<td>Office supplies</td>
<td>56,799</td>
<td>56,389</td>
</tr>
<tr>
<td>Insurance</td>
<td>32,238</td>
<td>36,872</td>
</tr>
<tr>
<td>Utilities</td>
<td>36,093</td>
<td>41,282</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>32,313</td>
<td>34,962</td>
</tr>
<tr>
<td>Rents and leases</td>
<td>223,655</td>
<td>224,276</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>115,034</td>
<td>77,464</td>
</tr>
<tr>
<td>Community support</td>
<td>58,088</td>
<td>46,946</td>
</tr>
<tr>
<td>Meetings and training</td>
<td>13,645</td>
<td>14,238</td>
</tr>
<tr>
<td>Dues and subscriptions</td>
<td>13,964</td>
<td>10,919</td>
</tr>
<tr>
<td>Travel</td>
<td>12,716</td>
<td>18,072</td>
</tr>
<tr>
<td>Other</td>
<td>15,266</td>
<td>94,691</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>3,689,330</td>
<td>3,310,801</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating Loss</strong></td>
<td>(1,046,037)</td>
<td>(913,723)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>NONOPERATING REVENUES (EXPENSES)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>495,354</td>
<td>478,307</td>
</tr>
<tr>
<td>Gain on sale of assets</td>
<td>3,250</td>
<td>1,571,898</td>
</tr>
<tr>
<td>Medicare settlement</td>
<td>(419,000)</td>
<td>-</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(15,233)</td>
<td>(2,044)</td>
</tr>
<tr>
<td><strong>Total Nonoperating Revenues</strong></td>
<td>64,371</td>
<td>2,048,161</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Change in Net Assets</strong></td>
<td>(981,666)</td>
<td>1,134,438</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Assets - Beginning of Year</strong></td>
<td>14,180,448</td>
<td>13,046,010</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Assets - End of Year</strong></td>
<td>$13,198,782</td>
<td>$14,180,448</td>
</tr>
</tbody>
</table>

*The accompanying notes are an integral part of these financial statements.*
# STATEMENTS OF CASH FLOWS

<table>
<thead>
<tr>
<th>Years Ended June 30</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CASH FLOWS FROM OPERATING ACTIVITIES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receipts for services and support</td>
<td>$ 1,501,124</td>
<td>$ 1,531,046</td>
</tr>
<tr>
<td>Rental receipts</td>
<td>388,317</td>
<td>402,049</td>
</tr>
<tr>
<td>Payments to suppliers and contractors</td>
<td>(1,699,757)</td>
<td>(1,472,446)</td>
</tr>
<tr>
<td>Payments to and on behalf of employees</td>
<td>(1,126,527)</td>
<td>(1,046,044)</td>
</tr>
<tr>
<td>Other payments</td>
<td>-</td>
<td>(20,323)</td>
</tr>
<tr>
<td><strong>Net Cash Used by Operating Activities</strong></td>
<td>(936,843)</td>
<td>(605,718)</td>
</tr>
</tbody>
</table>

**CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase of capital assets</td>
<td>(368,111)</td>
<td>(516,639)</td>
</tr>
<tr>
<td>Sale of capital assets</td>
<td>15,000</td>
<td>1,750,000</td>
</tr>
<tr>
<td>Disposal of capital assets</td>
<td>-</td>
<td>19,900</td>
</tr>
<tr>
<td>Line of credit (payments) proceeds</td>
<td>-</td>
<td>(75,000)</td>
</tr>
<tr>
<td>Debt payments</td>
<td>(39,134)</td>
<td>(39,012)</td>
</tr>
<tr>
<td>Interest paid on long-term debt</td>
<td>(15,233)</td>
<td>(2,044)</td>
</tr>
<tr>
<td><strong>Net Cash Provided (Used) by Capital and Related Financing Activities</strong></td>
<td>(407,478)</td>
<td>1,137,205</td>
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</table>

**CASH FLOWS FROM INVESTING ACTIVITIES**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment income received</td>
<td>383,613</td>
<td>366,566</td>
</tr>
<tr>
<td>Net transfer of investments</td>
<td>765,454</td>
<td>(740,294)</td>
</tr>
<tr>
<td>Change in physician loans</td>
<td>(2,124)</td>
<td>6,520</td>
</tr>
<tr>
<td><strong>Net Cash Provided (Used) by Investing Activities</strong></td>
<td>1,146,943</td>
<td>(367,208)</td>
</tr>
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</table>

**Net Increase (Decrease) in Cash and Cash Equivalents**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>(197,378)</td>
<td></td>
<td>164,279</td>
</tr>
</tbody>
</table>

**Cash and Cash Equivalents - Beginning of Year**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>234,383</td>
<td>70,104</td>
</tr>
</tbody>
</table>

**Cash and Cash Equivalents - End of Year**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 37,005</td>
<td>$ 234,383</td>
</tr>
</tbody>
</table>

*The accompanying notes are an integral part of these financial statements.*
### RECONCILIATION OF OPERATING LOSS TO NET CASH USED BY OPERATING ACTIVITIES

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating loss</td>
<td>$ (1,046,037)</td>
<td>$ (913,723)</td>
</tr>
<tr>
<td>Adjustments to reconcile operating loss to net cash used by operating activities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>757,159</td>
<td>739,410</td>
</tr>
<tr>
<td>Deferred revenue amortization</td>
<td>(418,776)</td>
<td>(418,776)</td>
</tr>
<tr>
<td>Changes in:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>(335,076)</td>
<td>(45,207)</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>(66,996)</td>
<td>6,642</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(62,939)</td>
<td>53,295</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>235,822</td>
<td>(7,036)</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>-</td>
<td>(20,323)</td>
</tr>
<tr>
<td><strong>Net Cash Used by Operating Activities</strong></td>
<td><strong>$ (936,843)</strong></td>
<td><strong>$ (605,718)</strong></td>
</tr>
</tbody>
</table>

*The accompanying notes are an integral part of these financial statements.*

The District entered into a note payable for equipment in the amount of $60,000 in 2009.

The District reduced the note payable from a physician in the amount of $10,125 in 2010 and $5,439 in 2009 for services provided to the hospital.
1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed in the preparation of the financial statements.

Nature of Operations  Petaluma Health Care District (the District) was organized in 1946 and is governed by elected officials. The District’s purpose is to promote health care services in Petaluma, California, and the surrounding community.

Basis of Accounting  Pursuant to Governmental Accounting Standards Board (GASB) Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, the District 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.

GASB Statement No. 34, Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments, established financial reporting requirements for all state and local governments. The District has adopted the financial reporting provisions of GASB No. 34 but has elected not to present Management’s Discussion and Analysis (MD&A) that GASB has determined is necessary to supplement, although not required to be part of, the basic financial statements.

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

Cash and Cash Equivalents  Cash and cash equivalents include cash on hand and demand deposits in a financial institution.

Investments  Noncurrent investments are designated by the Board of Directors for future programs and expansion over which the Board retains control and may, at its discretion, subsequently use for other purposes.

In accordance with GASB Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools, highly liquid investments with maturities of one year or less at the time of purchase are stated at amortized cost. All other investments are stated at fair value. Fair value is determined from quoted market prices. The District is restricted by state law and the Board’s investment policy in the types of investments that can be made.
Permissible investments include the County treasury, the State Local Agency Investment Fund (LAIF), federally insured deposits, and individual securities. Individual securities must be backed by the federal government or rated AAA, AA, or A by Standard & Poor’s or Aaa, Aa, or A by Moody’s indices. In addition, maturities may not exceed five years, unless authorized by the District’s investment policy. The proportion of investments in each of the permissible categories is restricted as defined in the California Government Code and further limited by the District’s investment policy. The maximum maturity of funds invested is approximately ten years. The District’s investment policy established safety of principal as the primary investment objective. The District’s investment strategy is to realize a reasonable interest yield, and investment decisions are executed with the intent that they will be held to maturity.

The District realized a loss from sales of investments of $9,511 at June 30, 2010. The calculation of realized gain or loss is independent of the calculation of the net change in the fair value of investments. Realized gains and losses on investments that had been held for more than one fiscal year and subsequently sold in the current year may have been recognized as an increase or decrease in the fair value of investments reported in the prior year. The unrealized gain on investments was $171,827 and $111,741 at June 30, 2010 and 2009, respectively. This amount takes into account all changes in fair value, including purchases and sales that occurred during the year.

**Goodwill**  
Goodwill is the excess of cost over net tangible assets of acquiring a personal response system program. Goodwill is amortized over five years. Accumulated amortization amounted to $50,000 and $40,000 at June 30, 2010 and 2009, respectively. As of June 30, 2010, goodwill had been fully amortized.

**Capital Assets**  
Capital assets are defined by the District as having an initial cost of $5,000 or more and an estimated useful life in excess of one year. All capital assets are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. The range of estimated useful lives in years by type of asset is as follows:

- Buildings: 20-30
- Site Improvements: 5-30
- Equipment: 5-20
- Vehicles: 5

**Operating Income and Expenses**  
The statement of revenues, expenses, and changes in net assets distinguishes between operating and nonoperating income and expenses. Operating revenues result from exchange transactions generated from program service fees and rental income. Nonexchange revenues, including grants and contributions, if any, received for purposes other than capital asset acquisition are reported as nonoperating income. Operating expenses are all expenses incurred to provide operating income, other than financing costs.

**Equity**  
Equity is classified into two components. These components consist of: 1) Invested in capital assets net of related debt, which consists of capital assets net of accumulated depreciation reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets; and 2) Unrestricted, which is the remaining equity that does not meet the other criteria.
Risk Management The District is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The District participates in two joint powers agreements for comprehensive liability coverage and for workers' compensation coverage.

Advertising The District expenses advertising costs when incurred.

Reclassifications Certain amounts in prior-year financial statements have been reclassified for comparative purposes to conform with presentation in the current-year financial statements.

2. CASH AND INVESTMENTS

The following is a summary of cash and investments at June 30:

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH ON HAND</td>
<td>$ 49</td>
<td>$ 98</td>
</tr>
<tr>
<td>DEPOSITS (1)</td>
<td>36,956</td>
<td>234,285</td>
</tr>
<tr>
<td>Subtotal</td>
<td>37,005</td>
<td>234,383</td>
</tr>
<tr>
<td>INVESTMENTS THAT ARE NOT SECURITIES (2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local Agency Investment Fund</td>
<td>759</td>
<td>752</td>
</tr>
<tr>
<td>Commercial paper</td>
<td>108,206</td>
<td>528,731</td>
</tr>
<tr>
<td>Subtotal</td>
<td>108,965</td>
<td>529,483</td>
</tr>
<tr>
<td>INVESTMENT SECURITIES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. government securities</td>
<td>6,806</td>
<td>262,626</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>2,130,344</td>
<td>609,728</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>4,539,768</td>
<td>6,037,759</td>
</tr>
<tr>
<td>Subtotal</td>
<td>6,676,918</td>
<td>6,910,113</td>
</tr>
<tr>
<td>Total Cash and Investments</td>
<td>$ 6,822,888</td>
<td>$ 7,673,979</td>
</tr>
</tbody>
</table>

(1) **Deposits** The carrying amount of deposits includes demand deposits in a financial institution.

(2) **Investments That are Not Securities** A "security" is a transferable financial instrument that evidences ownership, whether in physical or book entry form. Investments that are not securities do not have custodial credit risk because they do not involve a transferable financial instrument. Thus, they are not subject to custodial credit risk.
Custodial Credit Risk – Deposits

Custodial credit risk is the risk that in the event of a bank failure, the District’s deposits may not be returned. The District has a collateralization agreement with the bank, which mitigates custodial credit risk. The cash balance in the bank at June 30, 2010, amounted to $69,983. Deposits amounting to $250,000 are covered by depository insurance and the balance, if any, is subject to the collateralization agreement.

Credit Risk – Investments

California Government Code, Section 53601 limits investments in commercial paper to “prime” quality of the highest ranking or of the highest letter and numerical rating as provided by nationally recognized statistical rating organizations (NRSRO) and limits investments in medium-term notes to a rating of A or better. Individual securities must be backed by the federal government or rated AAA, AA, or A by Standard & Poor’s or Aaa, Aa, or A by Moody’s indices. The District has no investment policy that would further limit its investment choices.

Investments by investment type and ratings are as follows at June 30, 2010:

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Fair Value / Amortized Cost</th>
<th>AAA</th>
<th>A+ or AA</th>
<th>A</th>
<th>Not Rated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Agency Investment Fund</td>
<td>$ 759</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$ 759</td>
</tr>
<tr>
<td>Commercial paper</td>
<td>108,206</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>108,206</td>
</tr>
<tr>
<td>U.S. government securities</td>
<td>6,806</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>6,806</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>2,130,344</td>
<td>206,985</td>
<td>-</td>
<td>1,923,359</td>
<td>-</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>4,539,768</td>
<td>1,941,435</td>
<td>2,598,333</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$6,785,883</strong></td>
<td><strong>$ 206,985</strong></td>
<td><strong>$1,941,435</strong></td>
<td><strong>$4,521,692</strong></td>
<td><strong>$ 115,771</strong></td>
</tr>
</tbody>
</table>

Investments by investment type and ratings are as follows at June 30, 2009:

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Fair Value / Amortized Cost</th>
<th>AAA</th>
<th>A+ or AA</th>
<th>A</th>
<th>Not Rated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Agency Investment Fund</td>
<td>$ 752</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$ 752</td>
</tr>
<tr>
<td>Commercial paper</td>
<td>528,731</td>
<td>-</td>
<td>-</td>
<td>525,000</td>
<td>3,731</td>
</tr>
<tr>
<td>U.S. government securities</td>
<td>262,626</td>
<td>253,615</td>
<td>-</td>
<td>-</td>
<td>9,011</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>609,728</td>
<td>201,957</td>
<td>-</td>
<td>407,771</td>
<td>-</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>6,037,759</td>
<td>3,384,467</td>
<td>2,653,292</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$7,439,596</strong></td>
<td><strong>$ 455,572</strong></td>
<td><strong>$3,384,467</strong></td>
<td><strong>$3,586,063</strong></td>
<td><strong>$ 13,494</strong></td>
</tr>
</tbody>
</table>
Interest Rate Risk – Investments

*California Government Code*, Section 53601 limits investments to maturities of five years unless the governing body has authorized the longer terms. The District has not adopted a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from changing interest rates.

Investments grouped by maturity date at June 30, 2010, are as follows:

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Fair Value/Amortized Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than one year</td>
<td>$ 2,002,235</td>
</tr>
<tr>
<td>One to five years</td>
<td>4,777,049</td>
</tr>
<tr>
<td>Six to ten years</td>
<td>5,584</td>
</tr>
<tr>
<td>More than ten years</td>
<td>1,015</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 6,785,883</strong></td>
</tr>
</tbody>
</table>

Investments grouped by maturity date at June 30, 2009, are as follows:

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Fair Value/Amortized Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than one year</td>
<td>$ 2,174,916</td>
</tr>
<tr>
<td>One to five years</td>
<td>5,253,908</td>
</tr>
<tr>
<td>Six to ten years</td>
<td>9,000</td>
</tr>
<tr>
<td>More than ten years</td>
<td>1,772</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 7,439,596</strong></td>
</tr>
</tbody>
</table>

3. **NOTES RECEIVABLE**

Loans have been made to physicians, which are due in one to five years. The loans have varying interest rates and terms. Notes receivable amounted to $107,831 and $148,734 at June 30, 2010 and 2009, respectively. The allowances for uncollectible amounts totaled $46,644 and $43,427 at June 30, 2010 and 2009, respectively.
4. CAPITAL ASSETS

Capital assets consisted of the following at June 30, 2010:

<table>
<thead>
<tr>
<th></th>
<th>Balance June 30, 2009</th>
<th>Additions</th>
<th>Disposals</th>
<th>Balance June 30, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 1,646,344</td>
<td>$</td>
<td>$ -</td>
<td>$ 1,646,344</td>
</tr>
<tr>
<td>Buildings and improvements</td>
<td>22,748,875</td>
<td>198,750</td>
<td>$ -</td>
<td>22,947,625</td>
</tr>
<tr>
<td>Construction in progress</td>
<td>166,284</td>
<td>1,620</td>
<td>$ -</td>
<td>167,904</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>2,878,159</td>
<td>167,741</td>
<td>(15,000)</td>
<td>3,030,900</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>27,439,662</td>
<td>368,111</td>
<td>(15,000)</td>
<td>27,792,773</td>
</tr>
<tr>
<td>Less: Accumulated depreciation</td>
<td>17,641,712</td>
<td>729,147</td>
<td>(3,250)</td>
<td>18,367,609</td>
</tr>
<tr>
<td><strong>Capital Assets - Net</strong></td>
<td>$ 9,797,950</td>
<td>(361,036)</td>
<td>(11,750)</td>
<td>$ 9,425,164</td>
</tr>
</tbody>
</table>

Capital assets consisted of the following at June 30, 2009:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 1,737,546</td>
<td>$</td>
<td>(91,202)</td>
<td>$ 1,646,344</td>
</tr>
<tr>
<td>Buildings and improvements</td>
<td>24,252,336</td>
<td>10,023</td>
<td>(1,513,484)</td>
<td>22,748,875</td>
</tr>
<tr>
<td>Construction in progress</td>
<td>64,284</td>
<td>102,000</td>
<td>$ -</td>
<td>166,284</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>2,590,792</td>
<td>464,616</td>
<td>(177,249)</td>
<td>2,878,159</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>28,644,958</td>
<td>576,639</td>
<td>(1,781,935)</td>
<td>27,439,662</td>
</tr>
<tr>
<td>Less: Accumulated depreciation</td>
<td>18,514,247</td>
<td>709,303</td>
<td>(1,581,838)</td>
<td>17,641,712</td>
</tr>
<tr>
<td><strong>Capital Assets - Net</strong></td>
<td>$ 10,130,711</td>
<td>(132,664)</td>
<td>(200,097)</td>
<td>$ 9,797,950</td>
</tr>
</tbody>
</table>

Depreciation expense for the years ended 2010 and 2009 was $729,147 and $709,303, respectively.
5. LEASE/AFFILIATION AGREEMENT

On November 4, 1996, the District signed an agreement with SRM Alliance Hospital Services, a California nonprofit public benefit corporation (Alliance), to lease Petaluma Valley Hospital, the facility housing the hospice program, and all of the personal property used in connection with those operations. The agreement also contained provisions to assign the District’s interest in various leased equipment and real estate, third-party participation agreements, licenses, trademarks, and other intangible property, along with the transfer of ownership of inventory and patient medical records. The agreement commenced on January 19, 1997, for a period of 20 years.

In consideration for this agreement, Alliance agreed to pay cash, pay off certain debts, and become the primary obligor on other debts. The amount of lease payments attributable to real estate was recorded as an operating lease, the amount attributed to personal property was recorded as a sales-type lease, and the amount attributed to goodwill was recorded as a sale. The sales-type lease proceeds and sale of goodwill were recognized as income in 1997. The operating lease proceeds are deferred and amortized over the 20-year lease term. The allocation of lease proceeds was based on the related fair market values.

Alliance helps to fund a District-sponsored free clinic for a minimum of $15,000 annually. Alliance also committed to invest at least $14 million in capital improvements to Petaluma Valley Hospital with a minimum investment of $500,000 annually over the lease term to total at least $7 million invested by the tenth anniversary, which was January 19, 2007.

Costs incurred for the lease/affiliation agreement were allocated between costs attributed to the operating lease, costs attributed to the sale of personal property, and goodwill in the same ratio as the proceeds allocated from the agreement. Costs attributed to the operating lease are capitalized and will be amortized over the life of the lease. Accumulated amortization amounted to $241,673 and $223,661 at June 30, 2010 and 2009, respectively.

The deferred revenue consists of the prepaid operating lease payments. The operating lease payments are recognized as rental income over the term of the lease. Deferred revenue recognized in 2010 and in 2009 amounted to $418,753, and accumulated revenue amortized amounted to $5,633,212 and $5,214,436 at June 30, 2010 and 2009, respectively.

6. LINE OF CREDIT

The District entered into a revolving line of credit agreement with Bank of Marin, which provides for advances up to $750,000. Interest is payable monthly on the outstanding advances at the rate of 1% over the prime rate as published in the Wall Street Journal. The balance was zero for the years ended June 30, 2010 and 2009, respectively. The line of credit expires on December 5, 2010.
# 7. LONG-TERM DEBT

Long-term debt consisted of the following:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable to Sonoma County in annual installments, including interest at a variable rate between 5.6% and 7.75%</td>
<td>$3,666</td>
<td>$-</td>
<td>$1,772</td>
<td>$1,894</td>
<td>$-</td>
<td>$-</td>
<td>$1,894</td>
</tr>
<tr>
<td>Note payable to Ford Motor Credit, payable in monthly installments of $603 through May 2011 with no interest. The note is secured by a vehicle.</td>
<td>$21,117</td>
<td></td>
<td>7,240</td>
<td>13,877</td>
<td></td>
<td>7,240</td>
<td>6,637</td>
</tr>
<tr>
<td>Note payable to Helene Speak, M.D., payable in four quarterly installments of $15,000 through October 2009, with no interest. The note is unsecured.</td>
<td></td>
<td>60,000</td>
<td>30,000</td>
<td></td>
<td>30,000</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Total Long-Term Debt</td>
<td>$24,783</td>
<td>$60,000</td>
<td>$39,012</td>
<td>$45,771</td>
<td>$-</td>
<td>$39,134</td>
<td>$6,637</td>
</tr>
</tbody>
</table>
8. OPERATING LEASE AGREEMENTS

The District is the lessor of certain land and buildings under noncancelable operating leases. Future minimum rental receipts under the operating leases are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$773,935</td>
</tr>
<tr>
<td>2012</td>
<td>$459,432</td>
</tr>
<tr>
<td>2013</td>
<td>$419,609</td>
</tr>
<tr>
<td>2014</td>
<td>$418,777</td>
</tr>
<tr>
<td>2015</td>
<td>$418,777</td>
</tr>
<tr>
<td>Thereafter</td>
<td>$648,110</td>
</tr>
</tbody>
</table>

The District entered into operating leases for professional and office space, which expire in various years through July 2012. Minimum future rental payments under noncancelable operating leases having remaining terms in excess of one year as of June 30, 2010, are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$153,653</td>
</tr>
<tr>
<td>2012</td>
<td>$92,871</td>
</tr>
<tr>
<td>2013</td>
<td>$5,738</td>
</tr>
</tbody>
</table>

Rent expense amounted to $184,181 and $197,796 at June 30, 2010 and 2009, respectively.

9. PENSION PLANS

The District sponsors the Deferred Compensation Plan of Petaluma Health Care District, a defined contribution retirement plan under Internal Revenue Code, Section 457. All permanent employees 21 years of age or older are eligible to participate. Participants may contribute up to 22% of their annual salary. The District will match 50% of the participant’s contribution to a maximum of 2.5% of their salary. Total participant and District contributions are immediately 100% vested.

The District also sponsors the Employees’ Retirement Plan of Petaluma Health Care District, a defined contribution profit sharing plan under Internal Revenue Code, Section 401(a). All permanent employees 21 years of age or older are eligible to participate. The District contributes 2% of the participant’s annual salary, and contributions are immediately 100% vested. Contributions to the two plans amounted to $24,993 and $21,661 for 2010 and 2009, respectively.
10. **RETIREE HEALTH INSURANCE**

**Plan Description**

Under an amended policy adopted by the Board of Directors (directors) in July 2000, retired directors who were in office on January 1, 1991, or retired directors who served in office through December 31, 2000, and who completed 12 years of service prior to retirement were eligible to receive health benefits, upon termination, afforded to the employees of the District. The District pays the premiums for such retired directors and their eligible dependents. Such benefits extend after a director’s term expires for the number of years equal to the number of years served by the director. The Board of Directors adopted a new policy in 2003 whereby the District will not provide medical benefits to directors assuming office on or after January 1, 2001, or to re-elected directors assuming office on or after January 1, 2001, but will continue to provide medical benefits both to those who are in office now for the rest of their term (ending this year or two years hence) and to former directors who are subject to the amended policy adopted in July 2000.

**Funding Policy**

The District’s agreement with retirees is for monthly contributions for members who meet the eligibility criteria. The members receiving benefit contributions vary depending on the level of coverage selected.

**Postemployment Benefit Cost and Net Obligation**

As of June 30, 2010, the District's total unfunded liability was $418,950.

**Funded Status and Funding Progress**

The District finances the obligation on a pay-as-you-go basis.

**Actuarial Methods and Assumptions**

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

The District accrued an estimated liability for future costs of benefits provided under this policy based on an actuarial study conducted as of July 1, 2010. This study utilized an entry-age normal actuarial cost method with an interest rate assumption of 5% and a health inflation assumption ranging from 7% to 5% per year. As of June 30, 2010, there were four former board members that were eligible and participating in the benefits.

A copy of the actuarial report is available by contacting the District’s main office.
11. COMMITMENTS AND CONTINGENCIES

Joint Powers Agreements

The District participates in a joint venture under a joint powers agreement (JPA) with the Association of California Healthcare Districts, Inc. – ALPHA FUND (the Fund). The Fund arranges for and provides certain member health care entities with pooled workers’ compensation self-insurance.

The District also participates in a joint venture under a joint powers agreement (JPA) with the Program BETA Risk Management Authority (the Program). The Program was formed for the purpose of operating a comprehensive liability self-insurance program for certain healthcare districts of the Association of California Healthcare Districts, Inc. (ACHD). The Program operates as a separate JPA established as a public agency separate and distinct from ACHD. Each member hospital pays a premium commensurate with the level of coverage requested and shares surpluses and deficits proportionate to its participation in the Program. The Program provides coverage on a claims-made basis.

Condensed financial information of BETA Healthcare Group (which includes the Program BETA JPA) for the year ended December 31, 2009, and of the ALPHA Fund JPA for the year ended June 30, 2009, is as follows:

<table>
<thead>
<tr>
<th></th>
<th>ALPHA Fund</th>
<th>BETA Healthcare Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$73,093,296</td>
<td>$453,890,498</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>63,818,662</td>
<td>302,866,793</td>
</tr>
<tr>
<td><strong>Fund Balance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$9,274,634</td>
<td>$151,023,705</td>
</tr>
<tr>
<td>Total revenues</td>
<td>$21,552,282</td>
<td>$89,434,805</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>(19,512,350)</td>
<td>(58,325,343)</td>
</tr>
<tr>
<td>Member surplus funds contributed</td>
<td>-</td>
<td>1,500</td>
</tr>
<tr>
<td>Change in unrealized gains on investments</td>
<td>(739,538)</td>
<td>4,051,825</td>
</tr>
<tr>
<td>Member dividends</td>
<td>(1,050,000)</td>
<td>(6,000,000)</td>
</tr>
<tr>
<td><strong>Net Increase in Fund Balance</strong></td>
<td>$250,394</td>
<td>$29,162,787</td>
</tr>
</tbody>
</table>

Revenue Bonds

Health Facility Revenue Bonds Series 1990A were advance funded in 1997. Funds were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments (for the 1990A Series A Bonds). The 1990A Series A Bonds are considered defeased, and the related liability has been removed from the books. Total principal outstanding on the 1990A Series A Bonds as of June 30, 2010, was $2,470,000.
Contingencies

On July 29, 2009, the District entered into an agreement to purchase an industrial building at 1460 Cader Lane in Petaluma, California, for $5,500,000 and paid a $100 non-refundable consideration fee. On August 19, 2009, the District paid a refundable deposit of $50,000. The District terminated the agreement in May of 2010 and expects to have the deposit refunded. The seller of the property is currently disputing the refund of the deposit. The deposit is included in prepaid expenses and deposits as of June 30, 2010.

12. MEDICARE SETTLEMENT

In June 2010, SRM Alliance Hospital Services (Alliance) entered into an agreement with Medicare to pay $790,000 for prior-year charges that were not supported by corresponding medical records. The contested charges were from January 1994 to December 1997. In June 2010, the District entered into an agreement with Alliance to pay $419,000 of the total amount due to Medicare. This amount was recorded as a liability and as an expense as of June 30, 2010.

13. FUTURE GASB IMPLEMENTATION

In February 2009, the GASB issued GASB Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions, with required implementation for the District during the 2010-11 fiscal year. The statement establishes accounting and financial reporting standards for classifying the fund balance into specifically defined classifications.