Report of Independent Auditors and
Consolidated Financial Statements with
Supplementary Information

Sonoma Valley Health Care District

June 30, 2012 and 2011

MOSS-ADAMS LLP

Certified Public Accountants | Business Consultants

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CONTENTS

Introduction – This management's discussion and analysis of the financial performance of Sonoma Valley Health Care District (the "District") provides an overview of the District's financial activities for the years ended June 30, 2012 and 2011. It should be read in conjunction with the accompanying consolidated financial statements and footnotes of the District.

Financial highlights

- The District's net assets increased in 2012 by approximately $1,408,000 or 19% and increased in 2011 by approximately $1,217,000 or 19%.

- Cash, cash equivalents, and total investments decreased in 2012 by approximately $4,776,000 or 17% and increased in 2011 by approximately $19,578,000 or 230%. This increase was due to the receipt of the Series B GO bond issuance.

- Net patient accounts receivable increased in 2012 by approximately $1,221,000 or 26% and increased in 2011 by approximately $460,000 or 11%.

- The District reported operating losses in both 2012 ($4,673,000) and 2011 ($3,021,000). The operating loss in 2012 increased by approximately $1,651,000 or 55% more than the operating loss reported in 2011. The increase in the operating loss in 2012 was caused by the 2 material factors: 1) employee health insurance cost increased 12% starting in January, $450,000; 2) and exceptional amount of repair costs were incurred due to the resolution of many years of deferred maintenance costs, $800,000. The operating loss in 2011 increased by approximately $361,000 or 14% more than the operating loss reported in 2010.

- Net nonoperating revenues increased by approximately $148,000 or 4 % in 2012 compared to 2011 and increased by approximately $596,000 or 18% in 2011 compared to 2010.

Using this annual report – The District's consolidated financial statements consist of three statements—a balance sheet, a statement of operations and changes in net assets, and a statement of cash flows. These statements provide information about the activities of the District, including resources held by the District but restricted for specific purposes by creditors, contributors, grantors or enabling legislation. The District is accounted for as a business-type activity and presents its consolidated financial statements using the economic resources measurement focus and the accrual basis of accounting.

The balance sheet and statement of operations and changes in net assets – The balance sheet and the statement of operations and changes in net assets report information about the District's resources and its activities. One of the most important questions asked about the District's finances is: "Is the District as a whole, better or worse off as a result of the year's activities?" The balance sheet and the statement of revenues, expenses, and changes in net assets report information about the District's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the District's net assets and changes in them. You can think of the District's net assets – the difference between assets and liabilities – as one way to measure the District's financial health, or financial position. Over time, increases or decreases in the District's net assets are one indicator of whether its financial health is improving or deteriorating. You will need to consider other non financial factors, such as: changes in the District's patient base and measures of the quality of service it provides to the community, as well as local economic factors to assess the overall health of the District.

The statement of cash flows – The final required statement is the statement of cash flows. The statement reports cash receipts, cash payments, and net changes in cash and cash equivalents resulting from four defined types of activities. It provides answers to such questions as where did cash come from, what was cash used for, and what was the change in cash and cash equivalents during the reporting period.

The District's net assets – The District's net assets are the difference between its assets and liabilities reported in the balance sheet. The District's net assets increased by $1,408,000 or 19% in 2012 over 2011 and increased by $1,217,000 or 19% in 2011 over 2010, as shown in Table 1.

The increases in net assets in 2012 are largely the result of the Capital Campaign in that the District is working with the Sonoma Valley Hospital Foundation to raise funds for the building expansion.

In 2012, noncurrent investments decreased by $3,120,000 or 12% as compared to 2011. The reason for the decrease is the use of the General Obligation Bonds for renovating and retrofitting the District's existing hospital facility and to purchase equipment outlined in Note 11 to the financial statements.

In 2012, net patient accounts receivable increased by $1,221,000 or 26% compared to 2011. The reason for the increase was a slowdown in insurance payments on older patient accounts. Other receivables increased $917,000 or 17% from 2011, which is due in part to General Obligation Bonds receivable. Estimated third-party payor settlements increased $774,000 or 96%, which is due to a Medicare SNF settlement.

Table 1: Assets, Liabilities, and Net Assets

	2012	2011	2010
ASSETS			
Current assets			
Cash and cash equivalents	$ 926,083	$ 1,034,649	$ 1,643,393
Short-term investments	460,008	2,008,280	-
Patient accounts receivable, net of allowances for doubtful accounts of $1,899,621 and $1,687,892 in 2012 and 2011, respectively	5,927,300	4,706,558	4,246,278
Estimated third-party payor settlements	1,578,006	804,181	1,488,050
Other receivables	6,346,479	5,429,602	5,078,195
Supplies	872,171	881,875	686,189
Prepaid expenses	569,843	1,199,012	955,340
Total current assets	16,679,890	16,064,157	14,097,445
Noncurrent investments			
Board-designated funds	185,910	253,214	251,557
Restricted for capital acquisitions	20,978,806	23,660,829	4,960,088
Funds held by trustee	276,368	892,813	290,696
Principal of permanent endowments	36,839	36,060	36,131
Other long-term investments	449,562	204,075	1,330,291
	21,927,485	25,046,991	6,868,763
Capital assets, net of accumulated depreciation	25,216,306	17,616,232	10,875,405
Other assets	241,990	261,916	823,825
Total assets	$ 64,065,671	$ 58,989,296	$ 32,665,438
LIABILITIES AND NET ASSETS			
Current liabilities			
Accounts payable and accrued expenses	$ 7,331,294	$ 3,221,241	$ 4,099,273
Accrued payroll and related liabilities	3,123,748	3,020,680	3,207,727
Deferred tax revenues	4,769,308	4,783,007	4,913,860
Current portion of capital lease obligations	832,323	701,696	649,228
Current portion of notes payable	738,924	592,489	-
Total current liabilities	16,795,597	12,319,113	12,870,088
Bonds payable	35,292,111	35,276,998	12,261,887
Capital lease obligations, net of current portion	2,419,748	2,947,991	1,189,322
Notes payable, net of current portion	588,888	884,038	-
Total liabilities	55,096,344	51,428,140	26,321,297
Net assets			
Invested in capital assets, net of related debt	9,787,516	5,966,547	1,646,556
Restricted			
For debt service	276,368	892,813	290,696
Expendable for capital assets	2,043,087	348,873	497,688
Nonexpendable permanent endowments	36,839	36,060	30,373
Unrestricted (deficit)	(3,174,483)	316,863	3,878,828
Total net assets	8,969,327	7,561,156	6,344,141
Total liabilities and net assets	$ 64,065,671	$ 58,989,296	$ 32,665,438

In 2011, net patient accounts receivable increased by $460,000 or 11% compared to 2010. The reason for the increase was the implementation of a new billing system resulting in a more streamlined billing process. Other receivables increased $351,000 or 7% from 2010, which is due in part to the receivable from the Beta Healthcare Group.

Operating results and changes in the District's net assets – In 2012 and 2011, the District's operating loss increased by $1,651,000 or 55% and $361,000 or 14% from 2011 and 2010, as shown in Table 2 below:

Table 2: Operating results and changes in net assets

	2012	2011	2010
Operating revenues			
Net patient service revenue, net of provision for bad debts of $3,567,000 and $3,515,000 in 2012 and 2011, respectively	$ 44,906,433	$ 43,416,941	$ 37,489,746
Capitation revenue	2,223,114	2,347,347	2,573,773
Other revenue	48,820	41,469	207,907
Total operating revenues	47,178,367	45,805,757	40,271,426
Operating expenses			
Salaries and wages	24,601,200	24,436,306	22,840,610
Purchased services	6,363,019	5,123,091	3,797,721
Supplies	6,277,110	6,372,996	5,132,163
Employee benefits	5,393,819	4,713,779	4,317,062
Medical fees	4,127,471	3,951,616	3,036,570
Other	2,042,418	1,341,855	1,119,738
Depreciation	1,970,238	1,833,672	1,641,257
Utilities	845,029	822,797	779,375
Insurance	230,967	231,144	267,412
Total operating expenses	51,851,271	48,827,256	42,931,908
Operating loss	(4,672,904)	(3,021,499)	(2,660,482)
Non operating revenues and (expenses)			
Property tax revenues	4,757,571	4,794,000	3,685,017
Investment income (loss)	32,190	29,154	(1,745)
Non capital grants and gifts	576,711	7,711	47,010
Interest expense	(736,084)	(605,587)	(397,365)
Contribution to Prima Medical Foundation	(782,817)	(365,100)	-
Other	190,417	29,463	(38,967)
Total non operating revenues and (expenses)	4,037,988	3,889,641	3,293,950
(Deficit) excess of revenues over expenses before capital grants and contributions	(634,916)	868,142	633,468
Capital grants and contributions	2,043,087	348,873	208,222
Transfers to Community Foundation Sonoma County	-	-	-
Increase in net assets	1,408,171	1,217,015	841,690
Total net assets, beginning of year	7,561,156	6,344,141	5,502,451
Total net assets, end of year	$ 8,969,327	$ 7,561,156	$ 6,344,141

Operating losses – The first component of the overall change in the District's net assets is its operating income or loss—generally, the difference between net patient service and other operating revenues and the expenses incurred to perform those services. In each of the past three years, the District has reported an operating loss. This is consistent with the District's recent operating history as the District was formed and is operated primarily to serve residents of Sonoma Valley, regardless of their ability to pay. The District levies property taxes to provide sufficient resources to enable the facility to serve lower income and other residents. The increase in the operating loss for 2012 was due to the completion of several deferred maintenance projects that were completed during the fiscal year. One of these projects temporarily removed approximately one half of the skilled nursing beds from operations.

The operating loss for 2012 increased by $1,651,000 or 55% as compared to 2011 and increased by $361,000 or 14% as compared to 2010. The major components of those changes in operating loss are:

- Total operating revenues increased by $1,373,000 or 3% in 2012. This is primarily due to a Medicare settlement for $1,032,000.

  The increase in operating revenues in 2011 was primarily due to a 8% increase in outpatient volume over 2010 levels, which resulted in an increase in net patient service revenues of approximately $2,500,000. Additionally, Skilled Nursing volume continued to grow, experiencing an 11% SNF days increase in 2011, or $1,175,000.

- Salaries, wages, and benefits increased in 2012 by $845,000 or 3% due to an across the board salary increase of 3% in January 2012 and adjusting employees salaries to market. Health insurance, a component of employee benefits, increased in 2012 as compared to 2012 due to a significant increase in health insurance costs. Salaries, wages, and benefits increased in 2011 by $1,992,000 or 7% due to an across the board salary increase of 3% in January 2011 and a slight increase in average headcount for 2011. The cost of the health insurance increase was approximately $450,000. Workers' compensation expense, a component of employee benefits, increased in 2011 as compared to 2010 due to increases in open claims and claim reserves required for payments made on outstanding claims.

- Medical fees increased in 2012 by $176,000 or 4% compared to 2011 and increased by $915,000 or 30% in 2011 compared to 2010. The increase in 2012 is due to the aforementioned contract to provide services to the State of California, higher fees to Emergency Department physicians, and ongoing practice support and surgeons recruited by the hospital. In 2011, medical fees increased in part due to the successful recruitment of one general and one orthopedic surgeon who receive practice support from the District. Increases to anesthesiologist contracts also contributed to the 2010 increase in medical fees.

- Purchased services increased in 2012 by $1,240,000 or 24% compared to 2011 and increased in 2011 by $1,325,000 or 35% compared to 2010. Increased use of outside consultants for $172,000, increased repair and maintenance for $120,000, and implementation of the Electronic Health Record for $250,000, accounted for the increase in 2012. Increased use of outside agency services accounted for $600,000 of the increase in 2011 and reduced use of outside agency services account for $698,000 of the total purchased services decrease in 2010. Professional fees increased by $778,000 over 2011 due to the hospital entering into a contract with an outside service provider to manage the Pharmacy and increased use of outside consultants for the capital campaign and the Medicare settlement.

- Depreciation expense increased in 2012 by $137,000 or 7% as compared to 2011 and increased $192,000 or 12% in 2011 as compared to 2010. During 2012 there were a lot of needed repairs done to the building.

- Other expenses increased in 2012 by $701,000 or 52% as compared to 2011 and increased by $222,000 or 20% in 2011 compared to 2010. The major factor in 2012 increase was approximately $800,000 in repairs completed due to deferred maintenance completed during the 2012 year. The 2012 increase is primarily due to higher advertising expenses, PRIMA support and the Inter Governmental Transfer program.

The primary driver of the increase in the operating loss in 2011 was an increase in operating revenues of $5,534,000 or 14% as compared to 2010. Total net patient service revenue increased by $5,927,000 or 16% in 2011 as compared to 2010. This is primarily due to an 8% decrease in outpatient volume over 2010 levels, which resulted in a reduction in net patient service revenue of approximately $2,500,000. Additionally, Skilled Nursing volume continued to grow, experiencing an 11% volume increase in 2011, or $1,175,000. Operating expenses increased in 2011 as compared to 2010, increasing $222,000 or 20%.

Nonoperating revenues and expenses – Nonoperating revenues and expenses consist of property taxes levied by the District, investment income, interest expense and noncapital grants and gifts. Parcel taxes remained relatively unchanged in 2012 as compared to 2011. Tax assessments for the general obligation bonds decreased by $36,000 over 2012. Interest expense increased by $130,000 or 22% in 2012 due to capital leases entered into for the acquisition of the Electronic Health Records. Investment income increased by $3,000 in 2012 and increased by $31,000 in 2011. Noncapital grants and gifts increased by $569,000 in 2012 and decreased by $39,000 in 2011. The 2012 increase is due to the receipt of governmental funds for the Electronic Health Records of $427,000.

Capital grants and gifts – The District received gifts of $2,043,000 from a foundation and various individuals to purchase capital assets in 2012 and $349,000 in 2011, an increase of $1,694,000 and an increase of $141,000, from 2011 and 2010, respectively.

The District's cash flows – Changes in the District's cash flows are consistent with changes in operating losses and nonoperating revenues and expenses, as discussed earlier.

Capital assets – At the end of 2012 and 2011, the District had $25,216,000 and $17,616,000, respectively, invested in capital assets, net of accumulated depreciation, as detailed in Note 6 to the financial statements. In 2012 and 2011, the District purchased new equipment and made capital improvements costing $9,575,000 and $8,574,500, respectively. The majority of the 2012 improvements related to the preparation of a master plan, detailed planning, acquisition of equipment, and installation of the information systems wiring for the District's renovation project.

Debt – At June 30, 2012 and 2011, the District had $39,872,000 and $40,403,000, respectively, in bonds and equipment notes payable outstanding as detailed in Note 10 to the financial statements. In 2012, the District entered into equipment leases totaling $333,640 for purchases of an Electronic Health Record.

Future plans – The District issued $23,000,000 in general obligation bonds in August 2010, in order to finance the second and final phase of the facilities project. During this phase, which the District expects to complete in 2013, the District will complete all construction and improvements and finish purchasing the equipment budgeted in the project. Total project costs are estimated to be at least $39,000,000 and will be financed by bond proceeds, interest earned on temporarily invested bond proceeds and operations, philanthropic giving, and potentially other sources, including financing for the equipment components of the project.

The District was awarded a loan of approximately $1,065,000 from the California Energy Commission ("CEC"). The intended purpose of the loan is to finance energy efficient projects for the District. The loan has an interest rate of 3.0% Qualifying projects are being identified and reported to the CEC. The loan funds may be utilized in part or up to the full amount of the loan, the District will determine which, if any, of these funds will be applied to such projects. At June 30, 2012, the District is still in the planning process for these projects. The projects should be completed in fiscal year 2013.

The District has historically provided salary and practice supports for recruitment and retention of new physicians whose services meet the needs of our community. In the past, certain of these arrangements have been provided via contractual agreements with Prima Medical Group, a regional physician organization. The District has implemented plans to convert and consolidate these arrangements to a master agreement with Prima Medical Foundation. The District has made capital contributions to Prima Medical Foundation, which is a non-profit medical care, research, and community benefit organization. This is a more cost effective and longer term vehicle for physician support.

Contacting the District's financial management – This financial report is designed to provide our patients, suppliers, taxpayers and creditors with a general overview of the District's finances and to show the District's accountability for the money it receives. Questions about this report and requests for additional financial information should be directed to the Chief Financial Officer by telephoning (707) 935-5003.

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors
Sonoma Valley Health Care District

We have audited the accompanying consolidated balance sheets of Sonoma Valley Health Care District (the "District") as of June 30, 2012 and 2011, and the related consolidated statements of revenues, expenses, and changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the District'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 audits 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 the District'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 consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the financial position of Sonoma Valley Health Care District as of June 30, 2012 and 2011, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis on pages 1 through 6 is not a required part of the basic consolidated financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the District's management. We have applied certain limited procedures, which consisted principally 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.

The accompanying supplementary information related to community benefit on page 23 is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. This schedule is the responsibility of the District's management. Such information has not been subjected to the auditing procedures applied in the audit of the consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Moss Adams LLP

San Francisco, California
October 26, 2012

CONSOLIDATED FINANCIAL STATEMENTS

SONOMA VALLEY HEALTH CARE DISTRICT
CONSOLIDATED BALANCE SHEETS
June 30, 2012 and 2011

		2012		2011
ASSETS				
Current assets				
Cash and cash equivalents	$	926,083	$	1,034,649
Short-term investments		460,008		2,008,280
Patient accounts receivable, net of allowances for doubtful accounts of $1,899,621 and $1,687,892 in 2012 and 2011, respectively		5,927,300		4,706,558
Estimated third-party payor settlements		1,578,006		804,181
Other receivables		6,346,479		5,429,602
Supplies		872,171		881,875
Prepaid expenses		569,843		1,199,012
Total current assets		16,679,890		16,064,157
Noncurrent investments				
Board-designated funds		185,910		253,214
Restricted for capital acquisitions		20,978,806		23,660,829
Funds held by trustee		276,368		892,813
Principal of permanent endowments		36,839		36,060
Other long-term investments		449,562		204,075
		21,927,485		25,046,991
Capital assets, net of accumulated depreciation		25,216,306		17,616,232
Other assets		241,990		261,916
Total assets	$	64,065,671	$	58,989,296
LIABILITIES AND NET ASSETS				
Current liabilities				
Accounts payable and accrued expenses	$	7,331,294	$	3,221,241
Accrued payroll and related liabilities		3,123,748		3,020,680
Deferred tax revenues		4,769,308		4,783,007
Current portion of capital lease obligations		832,323		701,696
Current portion of notes payable		738,924		592,489
Total current liabilities		16,795,597		12,319,113
Bonds payable		35,292,111		35,276,998
Capital lease obligations, net of current portion		2,419,748		2,947,991
Notes payable, net of current portion		588,888		884,038
Total liabilities		55,096,344		51,428,140
Net assets				
Invested in capital assets, net of related debt		9,787,516		5,966,547
Restricted				
For debt service		276,368		892,813
Expendable for capital assets		2,043,087		348,873
Nonexpendable permanent endowments		36,839		36,060
Unrestricted (deficit)		(3,174,483)		316,863
Total net assets		8,969,327		7,561,156
Total liabilities and net assets	$	64,065,671	$	58,989,296

See accompanying notes.

	2012	2011
Operating revenues		
Net patient service revenue, net of provision for bad debts of $3,567,000 and $3,515,000 in 2012 and 2011, respectively	$ 44,906,433	$ 43,416,941
Capitation revenue	2,223,114	2,347,347
Other revenue	48,820	41,469
Total operating revenues	47,178,367	45,805,757
Operating expenses		
Salaries and wages	24,601,200	24,436,306
Purchased services	6,363,019	5,123,091
Supplies	6,277,110	6,372,996
Employee benefits	5,393,819	4,713,779
Medical fees	4,127,471	3,951,616
Other	2,042,418	1,341,855
Depreciation	1,970,238	1,833,672
Utilities	845,029	822,797
Insurance	230,967	231,144
Total operating expenses	51,851,271	48,827,256
Operating loss	(4,672,904)	(3,021,499)
Nonoperating revenues and (expenses)		
Property tax revenues	4,757,571	4,794,000
Investment income	32,190	29,154
Noncapital grants and contributions	576,711	7,711
Interest expense	(736,084)	(605,587)
Contribution to Prima Medical Foundation	(782,817)	(365,100)
Other	190,417	29,463
Total nonoperating revenues and (expenses)	4,037,988	3,889,641
(Deficit) excess of revenues over expenses before capital grants and contributions	(634,916)	868,142
Capital grants and contributions	2,043,087	348,873
Increase in net assets	1,408,171	1,217,015
Total net assets, beginning of year	7,561,156	6,344,141
Total net assets, end of year	$ 8,969,327	$ 7,561,156

See accompanying notes.

SONOMA VALLEY HEALTH CARE DISTRICT
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended June 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Receipts from patients and third-party payors	$ 45,908,805	$ 45,398,118
Other receipts	788,178	673,707
Payments to employees for services	(30,891,951)	(29,301,104)
Payments to physicians, suppliers, and contractors	(14,826,868)	(17,765,649)
Net cash from operating activities	978,164	(994,928)
Cash flows from noncapital financing activities:		
Noncapital grants and contributions	576,711	7,711
Contribution to Prima Medical Foundation	(782,817)	(365,100)
Parcel taxes supporting operations	3,503,314	2,963,279
Net cash from noncapital financing activities	3,297,208	2,605,890
Cash flows from capital and related financing activities:		
Purchases of capital assets	(9,241,382)	(6,024,550)
Principal payments on capital lease obligations	(731,256)	(738,812)
Principal payments on notes payable	(592,103)	(523,473)
Interest paid on long-term debt	(1,714,230)	(1,459,262)
Proceeds from issuance of notes payable	443,388	2,000,000
Proceeds from issuance of bonds	-	23,015,111
Tax revenue related to general obligation bonds	2,751,677	1,668,634
Capital grants and gifts	2,043,087	348,873
Net cash from capital and related financing activities	(7,040,819)	18,286,521
Cash flows from investing activities:		
Purchase of investments	-	(20,535,381)
Proceeds from sale of investments	2,624,691	-
Interest and dividends on investments	32,190	29,154
Net cash from investing activities	2,656,881	(20,506,227)
Net change in cash and cash equivalents	(108,566)	(608,744)
Cash and cash equivalents at beginning of year	1,034,649	1,643,393
Cash and cash equivalents at end of year	$ 926,083	$ 1,034,649
Reconciliation of operating loss to net cash from operating activities		
Operating loss	$ (4,672,904)	$ (3,021,499)
Adjustments to reconcile operating loss to net cash from operating activities		
Depreciation	1,970,238	1,833,672
Provision for bad debts	3,567,000	3,515,000
Loss on disposal of fixed assets	4,710	-
Changes in assets and liabilities		
Patient accounts receivable	(4,787,742)	(3,975,280)
Estimated amounts due from and to third-party payors	(773,825)	683,869
Accounts payable and accrued expenses	5,824,283	516,066
Other assets and liabilities	(153,596)	(546,756)
Net cash used for operating activities	$ 978,164	$ (994,928)
Supplemental disclosure of noncash transactions		
Acquisition of capital assets financed with long-term debt	$ 333,640	$ 2,549,949

See accompanying notes.

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization – Sonoma Valley Health Care District (the "Health Care District") is a political subdivision of the State of California organized under the State of California Local Health Care District Law as set forth in the Health and Safety Code of the State of California. The Health Care District is governed by an elected Board of Directors and is considered the primary government for financial reporting purposes.

The Health Care District owns and operates Sonoma Valley Hospital (the "Hospital"). The Hospital is located in Sonoma, California, and is licensed for 56 general acute care beds and 27 skilled nursing beds. It also provides 24-hour basic emergency care, outpatient diagnostic and therapeutic services, and operates a home health agency. The Hospital derives a significant portion of its revenues from third-party payors, including Medicare, Medi-Cal, and commercial insurance organizations.

Sonoma Valley Hospital Auxiliary (the "Auxiliary") was formed to render non-medical services on a volunteer basis to Sonoma Valley Hospital. The Auxiliary also raises monies for the benefit of the Hospital and its activities. As the sole purpose of the Auxiliary is to support the Hospital, the Auxiliary has been consolidated with the Hospital's financial statements.

Principles of consolidation – The accompanying consolidated financial statements include the accounts of the Hospital and the Auxiliary (collectively referred to as the "District"). All significant inter-company accounts and transactions have been eliminated in the consolidated financial statements.

Accounting standards – Pursuant to Government Accounting Standard Board ("GASB") Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 Financial Accounting Standards Board ("FASB") and AICPA Pronouncements*, the District's proprietary fund accounting and financial reporting practices are based on all applicable GASB pronouncements as well as codified pronouncements issued on or before November 30, 1989.

Proprietary fund accounting – The District utilizes the proprietary fund method of accounting whereby revenues and expenses are recognized on the accrual basis and consolidated financial statements are prepared using the economic resources measurement focus.

Use of estimates – The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect 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 deposits with financial institutions and investments in highly liquid debt instruments with an original maturity of three months or less. Cash and cash equivalents exclude amounts whose use is limited by board designation or by legal restriction.

Investments – The District maintains the majority of its cash in the State of California Local Agency Investment Fund ("LAIF") pooled investment. The funds deposited in LAIF are invested in accordance with Government Code Sections 16340 and 16480, the stated investment authority for the Pooled Money Investment Account. Balances are stated at fair market value.

Noncurrent investments consist of Board-designated and restricted funds set aside by the board for future capital improvements and other operational reserves, over which the board retains control and may at its discretion, use for other purposes; assets set aside for qualified capital outlay projects in compliance with state law and assets restricted by donors or grantors.

Investment income, realized gains and losses, and unrealized gains and losses on investments are reflected as non operating income or expense.

Other assets – Other assets consisting of deferred financing costs incurred with the issuance of bonds are amortized over the term of the bonds using a method that approximates the effective interest rate method. Amortization of these costs is included in interest expense.

Funds held by trustee – According to the terms of the General Obligation Bond indenture agreements, these certain amounts are held by the bond trustee and paying agent and are maintained and managed by the trustee and are invested in noncurrent investments. These assets are available for the settlement of future current bond obligations.

Capital assets – Capital asset acquisitions over $500 are capitalized and recorded at cost. Donated property is recorded at its fair-market value on the date of donation. Equipment under capital lease is amortized on the straight-line basis over the shorter of the lease term or the estimated useful life of the equipment. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the related assets. Depreciation is computed using the straight-line method over the estimated useful lives of the following asset groups:

Land improvements	10 – 20 years
Buildings and fixtures	20 – 40 years
Equipment	2 – 10 years
Software	5 – 7 years

The District evaluates prominent events or changes in circumstances affecting capital assets to determine whether impairment of a capital asset has occurred. Impairment losses on capital assets are measured using the method that best reflects the diminished service utility of the capital asset.

Costs of borrowing – Except for capital assets acquired through gifts, contributions or capital grants, interest cost on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

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.

Self-insurance plans – The District maintains professional liability insurance on a claims-made basis, with liability limits of $15,000,000 in aggregate, and which is subject to a $5,000 deductible. Additionally, the District is self-insured for workers' compensation benefits. The District purchases a Workers' Compensation Excess Policy that insures claims with no limits in the amounts and a $500,000 deductible. Actuarial estimates of uninsured losses for professional liability and workers' compensation have been accrued as liabilities in the accompanying consolidated financial statements.

Net assets – Net assets of the District are classified as invested in capital assets, net of related debt, restricted net assets, and unrestricted net assets.

> **Invested in capital assets, net of related debt** – Invested in capital assets, net of related debt consists of capital assets, net of accumulated depreciation and reduced by the outstanding balances of any borrowings that are attributable to the acquisition, construction, or improvement of those assets.
>
> **Restricted net assets** – Restricted net assets consists of net assets with limits on their use that are externally imposed by creditors (such as through debt covenants), grantors, contributors or by laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.
>
> **Unrestricted net assets** – Unrestricted net assets are remaining net assets that do not meet the definition of invested in capital assets, net of related debt or restricted.

Statements of revenues, expenses, and changes in net assets – For purposes of display, transactions deemed by management to be ongoing, major, or central to the provisions of health care services are reported as revenues and expenses. Peripheral or incidental transactions are reported as gains and losses. These peripheral activities include investment income, property tax revenue, gifts and contributions, grants and bequests, and change in net unrealized gains and losses on investments in marketable securities and are reported as nonoperating.

Net patient service revenue and patient accounts receivable – 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. At June 30, 2012 and 2011, the District provided allowances for losses on amounts receivable directly from patients totaling $1,899,621 and $1,687,892, respectively. The distribution of gross patient accounts receivable by payor at June 30, 2012 and 2011 is as follows:

	2012	2011
Medicare	30%	34%
Medi-Cal	25%	21%
Blue Cross	2%	5%
Other third-party payors	32%	31%
Self-pay	11%	9%
	100%	100%

Uncollectible accounts – The District provides care to patients without requiring collateral or other security. Patient charges not covered by a third-party payor are billed directly to the patient if it is determined that the patient has the ability to pay. A provision for uncollectible accounts is recognized based on management's estimate of amounts that ultimately may be uncollectible.

Capitation revenues – The District, in association with Meritage Medical Network (formerly Marin Independent Practice Association) ("Meritage") has agreements with various health maintenance organizations ("HMOs") to provide medical services to subscribing participants. Under two of these agreements, the District receives monthly capitation payments based on the number of each HMO's participants, regardless of the services actually performed by the District. The District is not responsible for the cost of services provided to subscribing participants by other hospitals. The District reassesses the profitability of the agreements for exposure risks in the event future medical costs to provide medical services exceed the related future capitation payments.

Property tax revenues – Taxes for District operations and for debt service payments related to District General Obligation Bonds are levied annually on the taxable property within the District.

In March 2002, the District voters adopted a special tax on each taxable parcel of land within the District at an annual rate of up to $130 per parcel for five years. In March 2007, the District voters extended the special tax at an annual rate of up to $195 per parcel through June 30, 2012. The purpose of the special parcel tax is to ensure continued local access to emergency room and acute hospital care and other medical services for residents of the District and for visitors to the area.

The District received approximately 338% in 2012 and 394% in 2011 of its total increase in net assets from property taxes. These funds were designated as follows:

	2012	2011
Designated for hospital operations	$ 2,914,774	$ 2,930,000
Levied for hospital operations and debt service payments	$ 1,842,797	$ 1,864,000

The District recognizes property taxes receivable when the enforceable legal claim arises (January 1) and recognizes revenues over the period for which the taxes are levied (July 1 to June 30). Property taxes are considered delinquent on the day following each payment due date. Property tax revenues are nonexchange transactions that are reported as nonoperating revenues.

Charity care – The District provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the District does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

Grants and contributions – From time to time, the District receives grants as well as contributions from individuals and private organizations. Revenues from grants and contributions are recognized when all eligibility requirements, including time requirements are met. Grants and contributions may be restricted for either specific operating purposes or for capital purposes. Amounts that are unrestricted or that are restricted to a specific operating purpose are reported as nonoperating revenues.

Compensated absences – District policies permit most employees to accumulate paid time-off benefits that may be realized as paid time-off or as a cash payment upon termination. Expense and the related liability are recognized as paid time-off benefits when earned. Compensated absence liabilities are computed using the regular pay and termination pay rates in effect at the balance sheet date plus an additional amount for compensation-related payments, such as social security and Medicare taxes computed using rates in effect at the date of computation.

Income taxes – The District operates under the purview of the Internal Revenue Code, Section 115, and corresponding California Revenue and Taxation Code provisions. As such, it is not subject to state or federal taxes on income. However, income from the unrelated business activities of the District and the Auxiliary may be subject to income taxes.

Reclassifications – Certain amounts in the 2011 consolidated financial statements have been reclassified to conform to the 2012 presentation. These reclassifications did not have a change on the previously reported increase in net assets.

New accounting pronouncements – The GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus* ("GASB No. 61"), which is effective for financial statements for periods beginning after June 15, 2012. GASB No. 61 modifies certain requirements for inclusion of component units in the financial reporting entity and amends the criteria for reporting component units as if they were part of the primary government (that is, blending) in certain circumstances. It also clarifies the reporting of equity interests in legally separate organizations. It requires a primary government to report its equity interest in a component unit as an asset. The District is currently evaluating the impact of the adoption of GASB No. 61 for the fiscal year ending June 30, 2013.

In June 2011, the GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources*, and Net Position ("GASB 63"), which is effective for financial statements for periods beginning after December 31, 2011. The objective of GASB 63 is to clarify where deferred outflows and deferred inflows of resources should be reported in the statement of net assets and the balance sheet. It will provide users with information about how past transactions that are not assets or liabilities will continue to impact a government's financial statements in the future periods. Under these new standards, consolidated financial statements will include deferred outflows of resources and deferred inflows of resources ("deferrals"), in addition to assets and liabilities, and will report net position instead of net assets. The District is reviewing the impact of the adoption of GASB 63 for the fiscal year ending June 30, 2013.

In April 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities* ("GASB 65"), which is effective for consolidated financial statements for periods beginning after December 31, 2012. GASB 65 reclassifies certain items currently being reported as assets and liabilities as deferred outflows of resources and deferred inflows of resources. In addition, this statement recognizes certain items currently being reported as assets and liabilities as outflows of resources and inflows of resources. The District is reviewing the impact of the adoption of GASB 65 for the fiscal year ending June 30, 2014.

NOTE 2 – NET PATIENT SERVICE REVENUES

The District has agreements with third-party payors that provide for payments to the District at amounts different from its established rates. Medicare and Medi-Cal settlements are estimated and recorded in the consolidated financial statements in the year services are provided. Laws and regulations governing the Medicare and Medi-Cal programs are complex and subject to interpretation. The District believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquires have been made, compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medi-Cal programs. Changes in Medicare, Medi-Cal, or other programs or the reduction of program funding could have an adverse impact on future net patient service revenues. A summary of the payment arrangements with major third-party payors is as follows:

> **Medicare** – Payments for most services rendered to Medicare program beneficiaries are based on prospectively determined rates. Inpatient acute rates vary according to a patient diagnostic classification system and skilled nursing care and outpatient services are paid at rates based upon resource utilization or specific procedures performed. Medicare settlements are estimated and recorded in the consolidated financial statements in the year in which they occur. The estimated settlements recorded at June 30, 2012, could differ from the actual settlements based on the results of cost report audits. At June 30, 2012, cost reports through June 30, 2008, have been final settled.
>
> **Medi-Cal** – Payments for inpatient services rendered to Medi-Cal patients are based on allowable costs while outpatient payment is based on pre-determined charge screens. The District is paid for Medi-Cal services at tentative rates with final settlements determined after submission of annual cost reports by the District and audits thereof by Medi-Cal representatives. The District's Medi-Cal cost reports have been audited or otherwise settled through June 30, 2010.

Others – Payments for services rendered to other than Medicare and Medi-Cal patients are based on established rates or agreements with certain commercial insurance companies, health maintenance organizations, Napa State, and preferred provider organizations which provide for various discounts from established rates.

Net patient service revenues for the years ended June 30, 2012 and 2011, were as follows:

	2012	2011
Patient service revenues at established charge rates		
Services provided to Medicare patients	$ 86,636,216	$ 82,893,397
Services provided to Medi-Cal patients	23,990,502	18,432,234
Services provided to other patients	66,897,311	58,480,578
Gross patient service revenues	177,524,029	159,806,209
Less contractual adjustments and provision for uncollectible accounts	(132,617,596)	(116,389,268)
Net patient service revenues	$ 44,906,433	$ 43,416,941

NOTE 3 – CASH DEPOSITS

At June 30, 2012 and 2011, District cash deposits had carrying amounts of $926,083 and $1,034,649, respectively, and bank balances of $2,120,931 and $1,882,385, respectively. Of the bank balances at June 30, 2012 and 2011, $2,120,931 and $1,882,385, respectively, were covered by federal depository insurance.

NOTE 4 – BOARD - DESIGNATED, RESTRICTED FUNDS, AND OTHER LONG-TERM INVESTMENTS

District investment balances and average maturities were as follows at June 30, 2012 and 2011, respectively:

	2012		
		Investment Maturities (in years)	
Investment Type	Fair-Value	Less than 1	1 to 5
Short-term money market mutual funds	$ 276,368	$ 276,368	$ -
Interest in irrevocable trust held in LAIF	36,839	-	36,839
LAIF (State Pool Demand Deposits)	22,074,286	22,074,286	-
Total fair-value	$ 22,387,493	$ 22,350,654	$ 36,839

	2011		
		Investment Maturities (in years)	
Investment Type	Fair-Value	Less than 1	1 to 5
Short-term money market mutual funds	$ 892,813	$ 892,813	$ -
Interest in irrevocable trust held in LAIF	36,060	-	36,060
LAIF (State Pool Demand Deposits)	26,126,398	26,126,398	-
Total fair-value	$ 27,055,271	$ 27,019,211	$ 36,060

Except for the investment of unexpended funds borrowed for construction, the District's investment policy limits the first $5,000,000 of investments to the LAIF. Once investments exceed $5,000,000, the policy (California Government Code) limits investments to bonds and other obligations of the U.S. Treasury, U.S. agencies or instrumentalities, or the state of California; bonds of any city, county, school district, or special road district of the state of California; bonds of banks for cooperatives, federal land banks, federal intermediate credit banks, federal home loan banks, Federal Home Loan Bank, Tennessee Valley Authority, and the National Mortgage Association or certificates of deposit.

The investment policy does not specifically address interest rate risk, credit risk, custodial credit risk, concentration of credit risk or foreign currency risk.

Interest rate risk – Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest. The money market mutual funds are presented as an investment with a maturity of less than one year because they are redeemable in full immediately.

Credit risk – Credit risk is the risk that the issuer or other counterparty to an investment will not fulfill its obligations. At June 30, 2012 and 2011, the District's investments in money market mutual funds were rated AAA by Standard and Poor's and AAA by Moody's Investors Service and the District's investments in LAIF were not rated.

Custodial credit risk – For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the District will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. The District's investments in U.S. agency securities, LAIF, and money market mutual funds are held by the broker or by the bank's trust department in other than the District's name.

Concentration of credit risk – This risk relates to the risk of loss attributed to the magnitude of the District's investment in a single issuer. The District had the following investments in a single issuer in excess of 5% of total investments as of June 30, 2012 and 2011:

	2012			2011		
LAIF (State Pool Demand Deposits)	$	22,074,286	98.6%	$	26,126,398	96.6%

NOTE 5 – OTHER RECEIVABLES

Other receivables consisted of the following as of June 30, 2012 and 2011:

	2012		2011	
Property tax receivables				
Special parcel tax	$	3,029,119	$	3,050,373
Tax for general obligation bond debt service payments		2,668,528		1,937,216
		5,697,647		4,987,589
Other		648,832		442,013
Total other receivables	$	6,346,479	$	5,429,602

NOTE 6 – CAPITAL ASSETS

Capital assets activity for the year ended June 30, 2012, is as follows:

	Balance June 30, 2011	Increases	Decreases, Transfers, and Retirements	Balance June 30, 2012
Nondepreciable capital assets				
Land	$ 197,659	$ -	$ -	$ 197,659
Construction work in progress	10,222,497	8,161,372	(797,148)	17,586,721
	10,420,156	8,161,372	(797,148)	17,784,380
Depreciable capital assets				
Land improvements	758,155	37,560	42,621	838,336
Buildings and improvements	21,969,061	506,243	254,011	22,729,315
Equipment	15,695,820	869,847	310,131	16,875,798
	38,423,036	1,413,650	606,763	40,443,449
Less accumulated depreciation	(31,226,960)	(1,970,238)	185,675	(33,011,523)
	7,196,076	(556,588)	792,438	7,431,926
	$ 17,616,232	$ 7,604,784	$ (4,710)	$ 25,216,306

Capital assets activity for the year ended June 30, 2011, is as follows:

	Balance June 30, 2010	Increases	Decreases, Transfers, and Retirements	Balance June 30, 2011
Nondepreciable capital assets				
Land	$ 197,659	$ -	$ -	$ 197,659
Construction work in progress	3,066,940	7,568,241	(412,684)	10,222,497
	3,264,599	7,568,241	(412,684)	10,420,156
Depreciable capital assets				
Land improvements	750,441	7,714	-	758,155
Buildings and improvements	21,713,084	69,717	186,260	21,969,061
Equipment	14,530,166	928,827	236,827	15,695,820
	36,993,691	1,006,258	423,087	38,423,036
Less accumulated depreciation	(29,382,885)	(1,833,672)	(10,403)	(31,226,960)
	7,610,806	(827,414)	412,684	7,196,076
	$ 10,875,405	$ 6,740,827	$ -	$ 17,616,232

NOTE 7 – EMPLOYEE BENEFIT PLANS

Defined contribution plan – The District contributes to a defined contribution pension plan (the "Plan") covering substantially all employees. Pension expense is recorded for the amount of the District's required contributions, determined in accordance with the terms of the Plan. The Plan is administered by the District's Board of Directors. The Plan provides retirement benefits to plan members and death benefits to beneficiaries of plan members. Benefit provisions are contained in the plan document and are established and can be amended by action of the District's governing body. Contribution rates for plan members and the District, expressed as a percentage of covered payroll, were 12% and 3.5% for 2012 and 2011, respectively.

Deferred compensation plan – The District offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The deferred compensation plan is available to all employees and permits them to defer a portion of their salary. An employer match is also provided and is vested at the rate of 16.7% per year.

The District's contributions to the defined contribution plan and deferred compensation plan totaled $503,685 and $377,933 during 2012 and 2011, respectively.

NOTE 8 – MEDICAL MALPRACTICE COVERAGE AND CLAIMS

The District has joined together with other providers of health care services to form Beta Healthcare Group ("Beta"), a public entity risk pool (the "Pool") currently operating as a common risk management and insurance program for its members. The District purchases medical malpractice insurance from the Pool under a claims-made policy. The District pays an annual premium to the Pool for its torts insurance coverage. The District purchases excess liability insurance through a commercial insurer for amounts in excess of the coverage provided under Beta. The Pool's governing agreements specifies that the Pool will be self-sustaining through member premiums and will reinsure through commercial carriers for claims in excess of stop-loss amounts. Accounting principles generally accepted in the United States of America require a health care provider to accrue the expense of its share of malpractice claim costs, if any, for any reported and unreported incidents of potential improper professional service occurring during the year by estimating the probable ultimate costs of the incidents. Based upon the District's claims experiences, an estimated accrual of $0 and $21,000, as of June 30, 2012 and 2011, respectively, for malpractice costs was recorded and is included in accounts payable and accrued expenses in the consolidated balance sheets.

NOTE 9 – WORKERS' COMPENSATION CLAIMS

The District is self-insured for workers' compensation claims of its employees up to $750,000, with commercial stop-loss insurance coverage purchased for claims in excess of these amounts through December 31, 2008. Beginning January 1, 2009, the District is at risk for all costs of its workers' compensation claims. A provision is accrued for self-insured workers' compensation claims, including both claims reported and claims incurred but not yet reported of $506,000 and $592,000 as of June 30, 2012 and 2011, respectively, and are included in accounts payable and accrued expenses in the consolidated balance sheets. The District utilizes an actuary to estimate the ultimate costs to settle such claims. Estimated future payments related to workers' compensation claims have been discounted at a rate of 1% at June 30, 2012 and 2011. It is reasonably possible that the District's estimate will change by a material amount in the near term.

NOTE 10 – LONG-TERM DEBT

The following is a summary of the District's long-term debt transactions for the years ended June 30, 2012 and 2011:

	Balance June 30, 2011	Additions	Decreases/ Amortization	Balance June 30, 2012
General obligation bonds payable				
Principal	$ 35,000,000	$ -	$ -	$ 35,000,000
Original issue premium	405,521	-	(31,654)	373,867
Deferred loss on early retirement of revenue bonds	(128,523)	-	46,767	(81,756)
	35,276,998	-	15,113	35,292,111
Note payable	1,476,527	443,388	(592,103)	1,327,812
Total long-term debt	$ 36,753,525	$ 443,388	$ (576,990)	$ 36,619,923

	Balance June 30, 2010	Additions	Decreases/ Amortization	Balance June 30, 2011
General obligation bonds payable				
Principal	$ 12,000,000	$ 23,000,000	$ -	$ 35,000,000
Original issue premium	437,177	-	(31,656)	405,521
Deferred loss on early retirement of revenue bonds	(175,290)	-	46,767	(128,523)
	12,261,887	23,000,000	15,111	35,276,998
Note payable	-	2,000,000	(523,473)	1,476,527
Total long-term debt	$ 12,261,887	$ 25,000,000	$ (508,362)	$ 36,753,525

General obligation bonds payable – On November 4, 2008, the District electorate approved the authorization to issue a total of $35,000,000 in general obligation bonds. On April 1, 2009, the District issued $12,000,000 principal amount of general obligation bonds (Sonoma Valley Health Care District General Obligation Bonds, Election of 2008, Series A 2009). Bond proceeds are to be used to pay for a portion of the costs of renovating and retrofitting the District's existing hospital facility, to purchase equipment, to refund outstanding indebtedness, to pay costs of issuance and to pay bond interest due August 1, 2009. $4,000,000 of the proceeds will be used to refund all of the then outstanding Revenue Bonds. $8,000,000 of the proceeds and the proceeds from all future bonds authorized by the election will be used to construct a new central utility plant, improve utility infrastructure, make all necessary seismic upgrades to existing facilities, and purchase additional medical equipment and install information systems wiring (the "Project").

Interest on the Bonds is payable semi annually at rates ranging from 5.375% to 8.750% with principal payments due annually beginning August 1, 2013.

Bonds maturing on or before August 1, 2014, are not subject to redemption prior to their respective stated maturity dates. Bonds maturing on or after August 1, 2015, may be redeemed prior to maturity at the District's option at redemption prices equal to the par amount of Bonds redeemed. The Bonds are general obligations of the District payable from ad valorem taxes. In the event the District fails to provide sufficient funds for payment of principal and interest when due, a commercial insurance company has guaranteed to pay that portion of principal and interest for which funds are not available.

In the first phase of the Project, extending through mid-2011, the District prepared a master plan, completed the detailed planning for the Project, acquired some equipment, installed the information systems wiring, and began construction.

In August 2010, the District issued $23,000,000 of additional general obligation bonds (Sonoma Valley Health Care District General Obligation Bonds, Election of 2008, Series B 2010) in order to finance the second and final phase of the Project. During this phase, which the District expects to complete in fiscal year 2013, the District will complete all construction and improvement aspects of the Project and finish purchasing the equipment budgeted in the Project. Total project costs are estimated to be at least $39,000,000 and will be financed by bond proceeds, interest earned on temporarily invested bond proceeds and operations. Through June 30, 2012, the District has incurred $12,179,716 in project costs and has made commitments for additional planning, construction and project management costs in the amount of $39,737,358.

Line of credit – On December 31, 2011, the District entered into a line of credit agreement with a bank for $1,000,000, with an interest rate of 4.25% and maturing on December 31, 2012. The District is required to comply with certain restrictive covenants, including maintaining working capital in excess of $3,000,000, maintaining a current ratio of 1.20 to 1.00, and maintaining a minimum tangible net worth of not less than $5,000,000. In March 2012, the District closed its account for the line of credit.

Debt service requirements – Debt service requirements for long-term debt are as follows at June 30, 2012:

	General Obligation Bonds		Note Payable	
Year Ending June 30,	Principal	Interest	Principal	Interest
2013	$ -	$ 1,714,230	$ 738,924	$ 44,225
2014	25,000	1,712,225	221,386	6,083
2015	95,000	1,704,423	39,184	3,574
2016	1,095,000	1,661,380	39,568	3,189
2017	1,200,000	1,608,202	39,973	2,784
2018 - 2022	7,665,000	6,919,851	248,777	8,152
2023 - 2027	10,350,000	4,411,198	-	-
2028 - 2032	14,570,000	1,149,639	-	-
	$ 35,000,000	$ 20,881,148	$ 1,327,812	$ 68,007

Interest costs – Interest costs incurred during the years ended June 30, 2012 and 2011, are summarized as follows:

	2012	2011
Interest cost		
Paid	$ 1,714,230	$ 1,459,262
Accrued	315,767	396,130
Total incurred	2,029,997	1,855,392
Amortization of deferred financing costs, original issue premium and deferred loss on early retirement of revenue bonds	31,655	33,966
Interest capitalized	(1,325,568)	(1,283,771)
Total interest expense	$ 736,084	$ 605,587

NOTE 11 – CAPITAL LEASE OBLIGATIONS

Capital lease obligations outstanding as of June 30, 2012, are as follows:

Description	Maturity	Interest Rates	Original Issue	June 30, 2012
Capital leases - equipment net of interest	October 2011 - July 2017	4.37% - 7.54%	$ 6,070,902	$ 3,252,071
Less current portion				(832,323)
				$ 2,419,748

Description	June 30, 2011	Increases	Decreases	Outstanding June 30, 2012
Capital lease - equipment	$ 3,649,687	$ 333,640	$ (731,256)	$ 3,252,071

Description	June 30, 2010	Increases	Decreases	Outstanding June 30, 2011
Capital lease - equipment	$ 1,838,550	$ 2,549,949	$ (738,812)	$ 3,649,687

Debt service requirements for capital lease obligations are as follows:

Year Ending June 30,	
2013	$ 1,032,375
2014	953,812
2015	899,423
2016	646,970
2017	170,781
Thereafter	12,904
Less interest	(464,194)
	3,252,071
Less current portion	(832,323)
	$ 2,419,748

NOTE 12 – TRANSACTIONS WITH SONOMA VALLEY HOSPITAL FOUNDATION

Sonoma Valley Hospital Foundation, Inc. (the "Foundation") is authorized by the District to solicit contributions on behalf of the Hospital. In the absence of donor restrictions, the Foundation has discretionary control over the amounts, timing, and use of their distributions. The District recorded contributions from the Foundation of $2,139,201 in 2012 and $240,883 in 2011. At June 30, 2012 and 2011, the Foundation's unaudited cash basis financial statements reported net assets of $154,480 and $226,778, respectively. The Foundation is not considered a component unit of the District because management believes the resources of the Foundation are not significant to the District.

NOTE 13 – RELATED PARTY TRANSACTIONS

During 2010, the District contributed $100,000 to Meritage for the development of Prima Medical Foundation ("PMF"), a joint venture with Meritage, Marin Healthcare District ("MHD"), and Marin Medical Practice Concepts, Inc. ("MMPC"). The PMF's purpose is establishing, operating, and maintaining multi-specialty medical clinics. The successful establishment and operation of PMF in Marin and Sonoma Counties is expected to be a cornerstone in the District's plans to ensure adequate health care services to the greater Sonoma Area. The District's contribution to PMF totaled $782,817 and $365,100 for the years ended June 30, 2012 and 2011, respectively.

NOTE 14 – COMMITMENTS AND CONTINGENCIES

Litigation – The District is a defendant in various legal proceedings arising out of the normal conduct of its business. In the opinion of management and its legal representatives, the District has valid and substantial defenses, and settlements or awards arising from legal proceedings, if any, will not exceed existing insurance coverage, nor will they have a material adverse effect on the financial position, results of operations, or liquidity of the District.

Operating leases – The District leases certain facilities and equipment under long-term, noncancelable operating lease agreements. Total rental expense for all operating leases amounted to $789,547 and $712,906 in 2012 and 2011, respectively, and is included in other expenses in the consolidated statements of revenues, expenses, and changes in net assets. The following is a schedule by year of future minimum lease payments under operating leases that have initial or remaining terms in excess of one year:

Year Ending June 30,		
2013	$	949,864
2014		917,485
2015		809,224
2016		311,364
2017		101,724
	$	3,089,661

Regulatory environment – The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, and Medicare and Medi-Cal fraud and abuse. Recently, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. The District is subject to routine surveys and reviews by federal, state, and local regulatory authorities. The District has also received inquiries from health care regulatory authorities regarding its compliance with laws and regulations. Although the District's management is not aware of any violations of laws and regulations, it has received corrective action requests as a result of completed and on-going surveys from applicable regulatory authorities. Management continually works in a timely manner to implement operational changes and procedures to address all corrective action requests from regulatory authorities. Breaches of these laws and regulations and non-compliance with survey corrective action requests could result in expulsion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

NOTE 15 – CHARITY CARE

During the years ended June 30, 2012 and 2011, the District provided $413,329, and $156,964, respectively, in free or discounted services for the poor and underserved. This includes services provided to persons who have health care needs and are uninsured, under-insured, and ineligible for a government program and are otherwise unable to pay for medically necessary care based on their individual financial situation. Costs are computed based on a relationship of costs to charges similar to a Medicare cost to charge ratio. During the year ended June 30, 2012, there were approximately 51 patient cases under this policy. During the year ended June 30, 2011, there were approximately 19 patient cases under this policy.

NOTE 16 – HEALTH CARE REFORM

In March 2010, President Obama signed the Health Care Reform Legislation into law. The new law may result in changes across the health care industry. The primary goal of this comprehensive legislation is to extend health care coverage to approximately 32,000,000 uninsured legal U.S. residents through a combination of public program expansion and private sector health insurance reforms. To fund the expansion of insurance coverage, the legislation contains measures designated to promote quality and cost efficiency in health care delivery and to generate budgetary savings in the Medicare and Medicaid programs. The District is unable to predict the full impact of the Health Care Reform Legislation at this time due to the law's complexity and current lack of implementing regulations and or interpretive guidance. However, the District expects that several provisions of the Health Care Reform Legislation will have a material effect on its business.

SUPPLEMENTARY INFORMATION

UNCOMPENSATED CARE AND COMMUNITY BENEFIT

Uncompensated care – In September 2004, the District adopted a formal community benefits policy, developed under guidelines provided by the California Hospital Association, and began to identify those patients who are medically indigent. The District's policy is to provide service to all who require it, regardless of their ability to pay. As such, it provides substantial amounts of uncompensated care. When this care is provided to patients who lack financial resources (and therefore are deemed medically indigent), it is classified as community benefits. When it is provided to patients who have the means to pay but decline to do so, it is classified as a provision for uncollectible accounts. Neither community benefits nor the provision for uncollectible accounts is reflected in net patient service revenues.

In addition, the District provides services to other medically indigent patients under certain government-reimbursed public aid programs. Such programs pay providers amounts that are less than established charges for the services provided to the recipients and frequently the payments are less than the cost of rendering the services. Finally, some undetermined portion of the provision for uncollectible accounts represents care to indigent patients who the District has been unable to identify.

Uncompensated charges relating to these services are as follows:

	2012	2011
Community benefits (charity care) allowances	$ 480,900	$ 360,000
State Medi-Cal and other public aid programs	17,716,700	14,317,000
Provision for uncollectible accounts	3,567,000	3,515,000
Total	$ 21,764,600	$ 18,192,000

The District's estimated costs of providing uncompensated care and community benefits to the poor and the broader community for 2012 and 2011 are as follows:

	2012	2011
Uncompensated costs of community benefits and uncollectible accounts	$ 1,188,300	$ 1,192,000
Medi-Cal and other public aid programs	942,400	1,605,000
	2,130,700	2,797,000
Benefits for the broader community	7,375,100	4,171,000
Total estimated community benefit costs	$ 9,505,800	$ 6,968,000

Benefits for the broader community include the unpaid costs of providing service to the elderly, providing health screenings and other health-related services, training health professionals, educating the community with various seminars and classes, and the costs associated with providing free clinics and other community service programs.

Community benefit – The District also commits significant time and resources to endeavors and critical services that meet otherwise unfilled community needs. Many of these activities are sponsored with the knowledge that they will not be self-supporting or financially viable. Such programs include recruitment of physicians, health screening and assessments, prenatal education and care, community educational services, and various support groups.

During 2012 and 2011, the District recorded the following amounts related to community support:

	2012	2011
Noncapital gifts and grants included in non operating revenues	$ 576,711	$ 7,711
Capital grants and contributions from		
Sonoma Valley Hospital Foundation	1,501,000	243,142
Others	542,087	105,731
	2,043,087	348,873
Total community support	2,619,798	356,584
Fundraising expenses included in operating expenses	$ 224,138	$ 9,381