Marin Healthcare District

Report on Audits of Financial Statements

for the years ended June 30, 2003 and 2002

MARIN HEALTHCARE DISTRICT

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BURR, PILGER & MAYER LLP

Accountants and Consultants

INDEPENDENT AUDITORS' REPORT

To the Board of Directors
of Marin Healthcare District

We have audited the balance sheets of Marin Healthcare District as of June 30, 2003 and 2002, and the related statements of revenue, expenses, and changes in accumulated deficit, 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 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 Marin Healthcare District as of June 30, 2003 and 2002, and the results of its operations and its 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 and State regulations governing special districts.

Burr, Pilger, Mayer, LLP

San Francisco, California
September 26, 2003

MARIN HEALTHCARE DISTRICT

BALANCE SHEETS

June 30, 2003 and 2002

ASSETS	2003	2002
	(in thousands)	
Current assets–cash and cash equivalents	$ 173	$ 188
Total current assets	173	188
Property, plant, and equipment, net of accumulated depreciation	14,091	15,625
Total assets	$ 14,264	$ 15,813

LIABILITIES AND ACCUMULATED DEFICIT		
Current liabilities:		
Accounts payable	$ 51	$ 40
Accrued election expenses	101	101
Total current liabilities	152	141
Deferred revenue–lease	14,357	15,602
Deferred rent	-	164
Total liabilities	14,509	15,907
Accumulated deficit	(245)	(94)
Total liabilities and accumulated deficit	$ 14,264	$ 15,813

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

MARIN HEALTHCARE DISTRICT

STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN ACCUMULATED DEFICIT
for the years ended June 30, 2003 and 2002

	2003	2002
	(in thousands)	
Operating revenue:		
Lease income–Marin General Hospital Corporation		
Minimum cash payment	$ 255	$ 243
Required capital payment	1,245	1,257
Total lease income	1,500	1,500
Reimbursement of operating expenses–Marin General Hospital Corporation	150	150
Total operating revenue	1,650	1,650
Operating expenses:		
Depreciation	1,524	1,620
Administration	281	322
Total operating expenses	1,805	1,942
Excess of operating expenses over revenue	(155)	(292)
Nonoperating revenue (expenses):		
Interest revenue	4	10
Other expenses	-	(12)
Total nonoperating revenue (expense)	4	(2)
Net loss	(151)	(294)
(Accumulated deficit) retained earnings, beginning of year	(94)	200
Accumulated deficit, end of year	$ (245)	$ (94)

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

MARIN HEALTHCARE DISTRICT

STATEMENTS OF CASH FLOWS

for the years ended June 30, 2003 and 2002

	2003	2002
	(in thousands)	
Cash flows from operating activities:		
Net loss	$ (151)	$ (294)
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	1,524	1,620
Loss on retirement of fixed assets	5	12
Increase (decrease) in:		
Accounts payable and accrued election expenses	11	(3)
Deferred revenue	(1,245)	(1,257)
Deferred rent	(163)	(243)
Net cash used in operating activities	(19)	(165)
Cash flows from investing activities-proceeds from sale of fixed assets	4	1
Net cash provided by investing activities	4	1
Net decrease in cash	(15)	(164)
Cash and cash equivalents, beginning of year	188	352
Cash and cash equivalents, end of year	$ 173	$ 188

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

1. Accounting Policies

Description of Business

Marin Healthcare District (the District), a political subdivision of the State of California, is the lessor of the Marin General Hospital facility. The District operated the hospital facility until December 1, 1985, at which time the District reorganized in compliance with local hospital district law of the State of California and agreed to lease the hospital facility to Marin General Hospital Corporation (the Hospital Corporation), a California nonprofit public benefit corporation.

The lessee is a general acute-care hospital located in Marin County that provides both inpatient and outpatient healthcare services. The Hospital Corporation inpatient facilities consist of medical-surgical, pediatrics, maternity, nursery, intensive care, coronary, psychology, radiology and laboratory care services.

As further described in Note 4, the District leases the hospital facility to the Hospital Corporation for a term of 30 years. During the term of this lease, the District derives substantially all of its revenue from the lease obligation.

The District incurs operating losses due to excess operating expenses (principally depreciation) over the annual rent of $1,500,000. The depreciation expense is significant in the early years of the lease, due to the shorter life of equipment. In September 1999, the parties entered into a settlement agreement whereby the District will receive $150,000 annually from the Hospital Corporation to cover administrative expenses. Commencing in 2005 the amount paid to the District will increase annually by a Consumer Price Index factor with a minimum of 3% and a maximum of 5%.

In addition to providing oversight of the Hospital Corporation's compliance with the Lease Agreement, the District provides a community forum for discussion of local healthcare issues, promotes healthcare services in the community, and acts as an advocate for the public for quality, reasonably priced, healthcare services.

Accounting Method

The District's accounting records are maintained on the accrual method with all activity recorded in a single enterprise fund.

Cash and Cash Equivalents

For purposes of the statement of cash flows, the District considers all highly liquid financial instruments with maturities of three months or less when purchased to be cash equivalents.

Property, Plant, and Equipment

Property, plant, and equipment are stated at cost. Depreciation is estimated by using the straight-line method over estimated useful lives of 40 years for buildings and 3 to 20 years for equipment. Upon sale or retirement of property, plant, and equipment, the related costs and accumulated depreciation or amortization are removed from the accounts and any resulting gain or loss is included in revenues and expenses.

Continued

1. **Accounting Policies**, continued

Deferred Revenue–Lease

Deferred revenue represents capital expenditures by the Hospital Corporation in excess of the current commitment, which will be recognized as rental revenue in future years (Note 4).

Revenue Recognition

The District recognizes lease income and reimbursement of operating expenses when earned and paid.

Use of Estimates

The preparation of 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 amounts reported in the financial statements and accompanying notes. Significant estimates used in preparing these financial statements include those used in calculating the carrying value of the District's property, plant, and equipment. Actual results could differ from those estimates.

2. **Cash and Cash Equivalents**

Cash and cash equivalents included the following at June 30, 2003 and 2002:

	2003	2002
	(in thousands)	
Operating accounts	$ -	$ 1
Local agency investment fund (LAIF)	173	187
	$ 173	$188

3. **Property, Plant and Equipment**

Property, plant and equipment at June 30, 2003 and 2002 consisted of the following:

	2003	2002
	(in thousands)	
Land, including improvements	$ 2,244	$ 2,244
Building	26,294	26,294
Equipment	22,761	25,769
	51,299	54,307
Less accumulated depreciation	(37,208)	(38,682)
	$ 14,091	$ 15,625

Continued

3. **Property, Plant and Equipment**, continued

The District's property, plant, and equipment are leased to and used exclusively, by the Hospital Corporation (Note 4). Depreciation expense for the years ended June 30, 2003 and 2002 was $1,524,000 and $1,620,000, respectively.

4. **Lease of Marin Healthcare District Facility**

Annual Rental Payments

Effective December 1, 1985, the District leased the Marin General Hospital facility to the Hospital Corporation for a term of 30 years pursuant to Section 32126 of the Local Hospital District Law. Per the amended lease agreement dated August 25, 1987, rent is due in annual installments of $1,500,000.

The annual rent payments comprise capital expenditures and a $125,000 minimum cash payment. The minimum cash payment, which is payable in quarterly installments, increases annually by 5% throughout the lease term. The lessee has satisfied this provision of the lease for the years ended June 30, 2003 and 2002. Under the terms of the lease, the minimum cash components of the annual rental payments from the Hospital Corporation for the next five fiscal years and thereafter are as follows:

Fiscal year ended June 30:	(in thousands)
2004	$ 267
2005	281
2006	295
2007	310
2008	325
Thereafter	2,974
	$4,452

Due to the significant capital investment required for the hospital modernization program completed in June 1989, the Hospital Corporation's rental payment commitment for capital expenditures due under the entire lease has been satisfied. Additionally, the Hospital Corporation has exceeded its capital commitment by approximately $183,000 as of June 30, 2003 and 2002. The advanced capital commitment (including the excess capital commitment) has been recorded as deferred revenue. As of June 30, 2003 and 2002, the total deferred lease revenue (in thousands) was $14,357 and $15,602, respectively.

Capital Improvement Payments

In addition to the capital rental obligation described under annual rental payments, the lease agreement requires the Hospital Corporation to make minimum annual capital expenditures (buildings and equipment) during the lease term. The obligation was approximately $2,610,000 for the year ended June 30, 2003 and $2,485,000 for the year ended June 30, 2002 and will increase thereafter for inflation (not to exceed 5% per year). These assets automatically revert to the District upon termination of the lease. Accordingly, these assets are a part of the Hospital Corporation's financial statements, and are not included in the accompanying financial statements. Many of these assets will revert without payment by the District; however, reversion of certain assets may also include liabilities (including required payments by the District) related to such assets. The lessee has satisfied this provision of the lease for the years ended June 30, 2003 and 2002.

Continued

5. **Related Party Transactions**

The Hospital Corporation has floated revenue bonds totaling approximately fifty million dollars. If the Hospital Corporation is in default of the lease, the District can terminate the lease. If the lease is terminated the District, however, must pledge all revenues from the operation of the hospital as security for the payment of all the Hospital Corporation's bond obligations.

Under its lease obligations, the Hospital Corporation is currently paying some of the operating expenses incurred by the District. Examples of expenses paid include supplies, telephone charges, office equipment, and business insurance premiums. Total expenses paid by the Hospital Corporation on behalf of the District for the year ended June 30, 2003 were approximately $24,300. In addition, the Hospital Corporation paid the District's Directors' and Officers' liability insurance for the policy year ended March 25, 2003. The Hospital Corporation also provides office space for the District.

6. **Employee Benefit Plan**

On August 14, 2001, the Marin Healthcare District passed a resolution creating the Miscellaneous Plan of the Marin Healthcare District (Plan), a single-employer defined benefit plan providing retirement, disability, and death benefits to plan participants and beneficiaries. The Plan is administered by the California Public Employees' Retirement System (CalPERS) and is subject to all the provisions of the Public Employees' Retirement Law.

The contribution requirements of plan members and the District are established and may be amended by the state legislature. Plan members are required to contribute 7.0% on their annual reportable earnings. The District is required to contribute at an actuarially determined rate; currently determined to be 25.1% of annual reportable payroll.

The District's annual pension cost to CalPERS for the years ended June 30, 2003 and 2002 was $15,603 and $13,000, respectively. The net pension obligation was zero for both years.

The annual required contribution was determined as part of the April 1, 2001 actuarial valuation using the entry age normal cost method. The actuarial assumptions include an 8.25% investment rate of return (net of expense) and projected salary increases of 3.75% per year. Both the investment rate of return and the projected salary increase include an inflation component of 3.5%. The unfunded actuarial accrued liability is being amortized over a period ending 2015.

7. **Arbitration Settlement**

During the year ended June 30, 2000, the Hospital Corporation failed to provide the District with written notice of its election to pay minimum cash rent for the year by October 1, 1999, as required by the lease. Written notice of the election was received by the District on November 9, 1999. The District subsequently notified the Hospital Corporation that it was in default and was obligated to pay the entire $1,500,000 annual rent in cash.

Accordingly, the Hospital Corporation paid additional rent of approximately $638,000 under protest.

Continued

7. **Arbitration Settlement**, continued

Pursuant to the arbitration award dated July 18, 2000, the additional rent paid to the District was determined to be prepaid or deferred rent to be credited to amounts otherwise due and payable in the future. In addition, the Hospital Corporation was entitled to recover related attorney fees from the District. The deferred rent was completely amortized during the fiscal year ended 2003.

8. **Litigation Issues**

The District claimed that the lease should be void under Government Code §1090 and §1092, *Void–Contract,* due to conflict of interest issues. In August 1998, the Court dismissed the conflict of interest claim due to expiration of the statute of limitations. In October 1999, the District filed a Notice of Appeal with the California Court of Appeals in Sacramento, appealing the original dismissal of the claim. The court heard oral arguments in September 2002 and a decision was issued in November 2002, upholding the lower court's ruling. On December 23, 2002, the District filed a petition for review with the California Supreme Court. In early 2003, the California Supreme Court upheld the lower court's decision in favor of the Hospital Corporation.

In addition, the District was named jointly in a lawsuit with Marin General Hospital Corporation in November 2002. In the lawsuit, the plaintiff is suing the Hospital Corporation and the District for damages incurred to property resulting from a mudslide. The Hospital Corporation has agreed to defend the District in this matter, pursuant to the terms of the office lease. There have been no changes in the status of this suit during the current fiscal year.