COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

FINANCIAL STATEMENTS

WITH AUDITORS' REPORT

JUNE 30, 2006 AND 2005

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

JUNE 30, 2006 AND 2005

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Vavrinek, Trine, Day & Co., LLP
Certified Public Accountants & Consultants

VALUE THE DIFFERENCE

INDEPENDENT AUDITORS' REPORT

The Honorable Board of Supervisors
County of San Bernardino, California:

We have audited the accompanying financial statements of the Arrowhead Regional Medical Center (the Medical Center), a fund of the County of San Bernardino (the County), as of and for the years ended June 30, 2006 and 2005, as listed in the accompanying table of contents. These financial statements are the responsibility of the Medical Center'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 standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States of America. 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 opinions.

As discussed in Note 1 of the notes to the financial statements, the financial statements present only the Medical Center and do not purport to, and do not, present fairly the financial position of the County as of June 30, 2006 and 2005, and the changes in its financial position and cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Medical Center as of June 30, 2006 and 2005, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 29, 2006 on our consideration of the Medical Center's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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The Medical Center has not presented management's discussion and analysis that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the basic financial statements.

Vavrinek, Trine, Day & Co., LLP

Rancho Cucamonga, California
September 29, 2006

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

STATEMENTS OF NET ASSETS

JUNE 30, 2006 AND 2005

(In Thousands)

	2006	2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 9,267	$ 14,997
Assets whose use is limited		135
Patient accounts receivable, net of estimated uncollectibles of $ 262,871 in 2006 and $184,610 in 2005	36,043	26,373
Due from third-party payors	7,592	3,839
Receivable from other governments	10,602	17,568
Due from County	2,222	2,184
Supplies inventories	1,401	1,471
Prepaid expenses and other assets	3,209	2,120
Total Current Assets	70,336	68,687
Noncurrent Assets		
Assets whose use is limited, investments	59,028	60,913
Assets whose use is limited, interest receivable	705	769
Capital assets, net of accumulated depreciation of $168,540 in 2006 and $150,353 in 2005	443,096	458,637
Deferred issuance costs	8,460	9,089
Total Noncurrent Assets	511,289	529,408
Total Assets	581,625	598,095
LIABILITIES		
Current Liabilities		
Accounts payable	12,176	12,480
Accrued salaries and benefits	18,732	16,149
Other accrued liabilities	446	371
Capital lease obligations	844	366
Certificates of participation	25,735	24,350
Interest payable	12,584	13,140
Arbitrage payable	191	165
Due to County	3,430	10,843
Total Current Liabilities	74,138	77,864
Noncurrent Liabilities		
Capital lease obligations, less current installments	1,594	940
Certificates of participation, less current installments (net of deferred amount of refunding and discount)	515,317	538,810
Total Noncurrent Liabilities	516,911	539,750
Total Liabilities	591,049	617,614
NET ASSETS (LIABILITIES)		
Invested in capital assets, net of related debt	(91,934)	(96,740)
Restricted for debt service	46,444	47,908
Unrestricted	36,066	29,313
Total Net Liabilities	$ (9,424)	$ (19,519)

See accompanying notes to basic financial statements.

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

YEARS ENDED JUNE 30, 2006 AND 2005

(In Thousands)

	2006	2005
OPERATING REVENUES		
Net patient service revenue	$ 345,923	$ 427,102
Premium revenue - managed care	8,650	8,732
Other	4,497	4,711
Total Operating Revenues	359,070	440,545
OPERATING EXPENSES		
Salaries and benefits	175,325	154,101
Medi-Cal matching fund expense	24,509	124,643
Medical claims expense	1,822	2,288
Supplies	63,717	56,630
Professional services	36,697	32,945
Purchased services	26,124	25,261
Insurance	8,839	5,176
Provision for bad debts	31,175	33,781
Utilities	6,806	6,442
Depreciation and amortization	18,241	18,368
Rent	3,758	2,904
Amortization related to debt	2,871	2,871
Other	4,035	2,990
Total Operating Expenses	403,919	468,400
Operating Loss	(44,849)	(27,855)
NONOPERATING REVENUES (EXPENSES)		
State debt service funding	21,521	20,259
State realignment funding	39,283	19,629
Tobacco tax	495	1,464
Investment income	333	5,486
Interest expense on debt	(30,313)	(31,907)
Other nonoperating expenses	(740)	(859)
Total Nonoperating Revenues, Net	30,579	14,072
Loss Before Transfers	(14,270)	(13,783)
Transfers from the County, Net	24,365	21,008
Changes in Net Assets	10,095	7,225
Net Liabilities, Beginning of Year	(19,519)	(26,744)
Net Liabilities, End of Year	$ (9,424)	$ (19,519)

See accompanying notes to basic financial statements.

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30, 2006 AND 2005

(In Thousands)

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers	$ 321,400	$ 424,978
Payments to suppliers	(184,944)	(278,091)
Payments to employees	(172,742)	(152,138)
Net Cash Used in Operating Activities	(36,286)	(5,251)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State realignment funding received	39,283	19,629
Tobacco tax received	495	1,464
Transfers from the County	24,365	21,008
Other nonoperating income (expense)	(740)	(859)
Net Cash Provided by Noncapital Financing Activities	63,403	41,242
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
State debt service funding	21,521	20,259
Purchase of capital assets	(2,700)	(2,737)
Proceeds from capital lease obligations	1,678	
Principal payments on capital lease obligations	(544)	(354)
Principal payments on certificates of participation	(24,350)	(23,060)
Interest paid on debt	(30,869)	(32,420)
Net Cash Used in Capital and Related Financing Activities	(35,264)	(38,312)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest on investments	333	5,486
Investment activity, net	2,084	(2,640)
Net Cash Provided by Investing Activities	2,417	2,846
Increase in Cash and Cash Equivalents	(5,730)	525
Cash and Cash Equivalents, Beginning of Year	14,997	14,472
Cash and Cash Equivalents, End of Year	$ 9,267	$ 14,997

See accompanying notes to basic financial statements.

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

STATEMENTS OF CASH FLOWS, Continued

YEARS ENDED JUNE 30, 2006 AND 2005

(In Thousands)

	2006	2005
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES		
Operating Loss	$ (44,849)	$ (27,855)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation and amortization	18,241	18,368
Amortization related to debt	2,871	2,871
Provision for bad debts	31,175	33,781
Decrease (Increase) in:		
Patient accounts receivable	(40,845)	(38,470)
Due from third-party payors	(3,753)	501
Receivables from other governments	6,966	23,467
Due from County	(38)	(1,065)
Supplies inventories	70	(122)
Prepaid expenses and other assets	(1,089)	(1,743)
Increase (Decrease) in:		
Accounts payable	(306)	874
Accrued salaries and benefits	2,583	1,963
Other accrued liabilities	75	103
Arbitrage payable	26	140
Due to County	(7,413)	(18,064)
Net Cash Used in Operating Activities	$ (36,286)	$ (5,251)

See accompanying notes to basic financial statements.

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006 AND 2005

(Dollar Amounts in Thousands)

NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. General

The County of San Bernardino (County) Arrowhead Regional Medical Center (Medical Center) is classified as a level II trauma center with eight trauma bays and four additional "swing" trauma rooms that can be used during an emergency. In addition, the Medical Center provides 373 patient beds and has 24 private treatment rooms for diagnosis and treatment of urgent care patients. During fiscal year 2000, the Medical Center assumed the inpatient operations, consisting of 90 beds, from the previously separate Department of Behavioral Health.

The Medical Center is owned by the County, which is a legal subdivision of the state of California charged with governmental powers, and is reflected in the County's comprehensive annual financial report as an enterprise fund. The County's powers are exercised through the Board of Supervisors, which, as the governing body of the County, is responsible for the legislative and executive control of the County.

These financial statements present only the Medical Center and do not purport to, and do not, present fairly the financial position of the County and the changes in its financial position and cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America.

B. Basis of Accounting

The basic financial statements of the Medical Center are presented using the economic resources measurement focus and the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America. Revenues are recognized in the period in which they are earned and become measurable. Expenses are recognized in the period in which they are incurred.

Operating revenues include those generated from direct patient care and related support services. Operating expenses include the cost of providing patient care, administrative expenses, and depreciation on capital assets. Revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

C. Accounting Standards

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 Medical Center has elected not to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB) issued after November 30, 1989. The Medical Center applies all applicable GASB pronouncements, as well as statements and interpretations of FASB, the Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure, issued on or before November 30, 1989, unless those pronouncements conflict or contradict GASB pronouncements.

NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

D. Income Taxes

The Medical Center is owned and operated by the County and is exempt from federal and state income tax pursuant to IRC Section 115 and similar provisions of the California Franchise Tax Code and is also exempt from federal and state income tax filing requirements.

E. Charity Care

The Medical Center provides care to patients who meet certain criteria under its charity care policy without charge or at an amount less than its established rates. Because the Medical Center does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. However, the Medical Center monitors the level of charity care provided. See Note # 5.

F. Net Patient Service Revenue

Net patient service revenue is recorded at established rates less contractual allowances from third-party payors, 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.

G. Premium Revenue - Managed Care

The Medical Center has agreements with Inland Empire Health Plan (IEHP) and Foundation Health to provide medical services to subscribing participants. Under these agreements, the Medical Center receives monthly capitation payments based on the number of participants, regardless of services actually performed by the Medical Center.

Premium revenue is recognized in the period in which participants are entitled to health care services.

H. Cash

The Medical Center maintains a certain portion of its cash on deposit with the County Treasurer.

I. Assets Whose Use is Limited

Assets whose use is limited represent funds held by a trustee which are legally restricted for bond reserve accounts. Assets whose use is limited that are required for obligations classified as current liabilities are reported as current assets.

NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

J. Capital Assets

Buildings, improvements, and equipment with a historical cost over $5,000 are capitalized. Contributed capital assets are reported at their estimated fair value at the date of donation. Depreciation expense is provided using the straight-line method over the estimated useful lives of the respective classes of capital assets. Equipment under capitalized leases is amortized using the straight-line method over the lesser of minimum lease terms or estimated useful lives. The estimated useful lives for computing depreciation expense are as follows:

Buildings	40 Years
Improvements	3 to 25 Years
Equipment	5 to 20 years

K. Capitalized Interest

The Medical Center capitalizes net interest expense as a cost of property constructed. No amounts were capitalized for the years ended June 30, 2006 and 2005.

L. Supplies Inventories

Supplies inventories are recorded at the lower of average cost or market.

M. Net Assets

Net assets of the Medical Center are classified in three components. *Net assets invested in capital assets net of related debt* consist of capital assets net of accumulated depreciation and reduced by the balances of any outstanding borrowings used to finance the purchase or construction of those assets. *Restricted net assets* are noncapital assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Medical Center. Restricted net assets are reduced by any liabilities payable from restricted 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.

N. 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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

O. Reclassification of Prior Year Amounts

Certain prior year amounts in these financial statements were reclassified to conform to the current year presentation.

P. New Accounting Pronouncements

Governmental Accounting Standards Board Statement No. 42

During fiscal year 2005-2006, the Medical Center adopted the provisions of Governmental Accounting Standards Board Statement No. 42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries. This statement establishes accounting and financial reporting standards for impairment of capital assets and also clarifies and establishes accounting requirements for insurance recoveries.

Governmental Accounting Standards Board Statement No. 46

During fiscal year 2005-2006, the Medical Center adopted the provisions of Governmental Accounting Standards Board Statement No. 46, Net Assets Restricted by Enabling Legislation—an amendment of GASB Statement No. 34. This Statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government—such as citizens, public interest groups, or the judiciary—can compel a government to honor. This Statement also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated. Finally, this Statement requires governments to disclose the portion of total net assets that is restricted by enabling legislation.

Governmental Accounting Standards Board Statement No. 47

During fiscal year 2005-2006, the Medical Center adopted the provisions of Governmental Accounting Standards Board Statement No. 47, *Accounting for Termination Benefits*. This Statement establishes accounting standards for termination benefits. This Statement supersedes accounting guidance in National Council on Governmental Accounting (NCGA) Interpretation 8, Certain Pension Matters, as amended, which addresses one form of voluntary termination benefits—special termination benefits, or those offered for a "short period of time."

NOTE #2 – CASH, CASH EQUIVALENTS, AND INVESTMENTS

The Medical Center maintains a certain portion of its cash with the County Treasury for investment purposes to maximize interest earnings. Interest on the pooled funds is allocated based on the Medical Center's average daily balance. The Medical Center's share of the investment activity in the pooled funds managed by the County is not material to the total held by the County. The equity in the County Treasury is carried at fair value based on the value of each participating dollar as provided by the County Treasurer. The fair value of the County Treasury pool was approximately $3,407,885 at June 30, 2006. The County Treasury pool did not include any derivative securities in 2006.

Investment policies and related credit, custodial credit, concentration of credit, interest rate and foreign currency risks applicable to the Medical Center's pooled funds are those of the County and are disclosed in the County's basic financial statements.

The Medical Center's cash and assets whose use is limited as of June 30, 2006, are classified in the accompanying financial statements as follows:

	2006	2005
Cash and cash equivalents	$ 9,267	$ 14,997
Assets whose use is limited	59,028	61,048
Total Cash and Investments	$ 68,295	$ 76,045

The Medical Center's cash and investments as of June 30, 2006, consisted of the following:

	2006	2005
Deposits with County Treasury	$ 9,267	$ 14,997
Deposits with Fiscal Agent		91
Investments	59,028	60,957
Total Cash and Investments	$ 68,295	$ 76,045

Investments Authorized by Debt Agreements

Investment of debt proceeds and reserves held by bond trustees are governed by provisions of the trust agreements created in connection with the issuance of debt (see Note #9), rather than the general provisions of the California Government Code. The Medical Center's bond reserves are held in money market mutual funds, U.S. Treasury Securities, and guaranteed investment contracts.

NOTE #2 – CASH, CASH EQUIVALENTS, AND INVESTMENTS, continued

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 rates. The Medical Center's investments held by bond trustees are monitored for interest rate risk by measuring the weighted average maturity.

Investment Type			Weighted Average Maturity (in years)
Held by bond trustee:			
Money market mutual funds	$	2,176	daily
Guaranteed investment contracts		34,507	12.04
U.S. Treasury Notes		22,345	16.39
Total	$	59,028	

Investments with Fair Values Highly Sensitive to Interest Rate Fluctuations

The Medical Center's investments held with bond trustees include the following investment that is highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided above):

Highly Sensitive Investments		Fair Value at Year End
Interest only Treasury strips. The fair value of these investments are closely associated with the present value of the expected stream of cash flows from interest payments made to maturity. Accordingly, the fair value of these securities are highly sensitive to change in market interest rates that might lead to dramatic changes in expected cash flows.	$	254

NOTE #2 – CASH, CASH EQUIVALENTS, AND INVESTMENTS, continued

Credit Risk

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. Presented below is the minimum rating (where applicable) required by the California Government Code, the Medical Center's investment policy, or debt agreements, and the actual rating for each investment type:

		Rating as of June 30, 2006		
Investment Type		Aaa	Aa2	A1+
Held by bond trustee:				
Money market mutual funds	$ 2,176	$ 2,176		
Guaranteed investment contracts	34,507		$ 34,507	
U.S. Treasury Bonds	22,345			$ 22,345
Total	$ 59,028	$ 2,176	$ 34,507	$ 22,345

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of investment in a single issuer. Investments in any one issuer that represent five percent or more of the Medical Center's total investments are shown below:

Issuer	Investment Type	Fair Value at Year End
FSA Capital Management	Guaranteed Investment Contract	$ 12,690
CDC Funding Corp.	Guaranteed Investment Contract	12,110
MBIA Investment Management Corp.	Guaranteed Investment Contract	9,707
		$ 34,507

NOTE #2 – CASH, CASH EQUIVALENTS, AND INVESTMENTS, continued

Custodial Credit Risk

Custodial credit risk for *deposits* is the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover its deposits or will not be able to recover collateral securities that are in the possession of an outside party. The California Government Code and the County Treasurer's investment policy do not contain legal or policy requirements that would limit the exposure to custodial credit risk for deposits or investments, other than the following provision for deposits: The California Government Code requires that a financial institution secure deposits made by state or local governmental units by pledging securities in an undivided collateral pool held by a depository regulated under state law. The market value of the pledged securities in the collateral pool must equal at least 110 percent of the total amount deposited by the public agencies. California law also allows financial institutions to secure deposits by pledging first trust deed mortgage notes having a value of 150 percent of the secured public deposits.

GASB Statement No. 40 requires that disclosure be made with respect to custodial credit risks relating to deposits. The Medical Center did not have any cash with fiscal agent in excess of federal depository insurance limits held in uncollateralized accounts at June 30, 2006.

NOTE #3 – STATE REALIGNMENT FUNDING

The State of California provides support to the Medical Center through a realignment fund. This realignment funding is provided from vehicle license fees and sales tax collected at the state level and allocated to California's counties. The realignment fund replaces state support previously given for specific purposes such as aid to local municipalities affected by decreased levels of tax support, aid to counties which provide services to medically indigent adults, and aid for unreimbursed medical costs of legalized indigent aliens. The amount to be received by the counties is dependent upon the actual change in sales tax and vehicle license fees. The Medical Center's share of these revenues for the years ended June 30, 2006 and 2005 was $39,283 and $19,629, respectively. Because the revenues received are not based upon services provided to patients, they have been classified as nonoperating revenue in the accompanying statements of revenues, expenses, and changes in net assets.

NOTE #4 -- NET PATIENT SERVICE REVENUE

The Medical Center provides services to eligible patients under Medi-Cal and Medicare programs. For the fiscal years ended June 30, 2006 and 2005, the Medi-Cal program represented approximately 38 percent and 47 percent, respectively, and the Medicare program represented approximately 18 percent and 10 percent, respectively, of the Medical Center's net patient service revenue. Medi-Cal inpatient services are reimbursed at contractually agreed-upon per diem rates and outpatient services are reimbursed under a schedule of maximum allowances. Medicare inpatient services are reimbursed based upon pre-established rates for diagnostic-related groups. Effective August 1, 2000, outpatient services went from a cost reimbursement payment methodology to prospectively determined payments per procedure under a system called Ambulatory Payment Classifications. Certain defined capital and medical education costs related to Medicare beneficiaries continue to be paid based on a cost-reimbursement methodology. The Medical Center is reimbursed for cost-reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports by the Medical Center and audits thereof by the fiscal intermediary. The Medical Center's classification of patients under these programs and the appropriateness of their admissions are subject to an independent review by a peer review organization under contract with the Medical Center. Reports on the results of such audits have been received through June 30, 2002 for Medicare and June 30, 2003, for Medi-Cal. Adjustments as a result of such audits are recorded in the year the amounts can be determined.

Senate Bill 855 - California's Senate Bill 855 (SB-855) was passed by the State Legislature and signed into law in 1991. The bill provided for supplemental Medi-Cal payments to hospitals that serve a disproportionately high percentage of Medi-Cal and other low-income patients. SB-855 provided additional funds through a reimbursement rate increase at the Medical Center for each Medi-Cal patient day provided, up to a maximum number of days. The Medical Center received $77,367 and $122,906 in SB-855 funds for the years ended June 30, 2006 and 2005, respectively. Because the revenues generated are based upon services provided to patients, they have been classified as net patient service revenue in the accompanying statements of revenues, expenses, and changes in net assets. The program required the Medical Center to contribute matching funds of $24,509 and $85,643 for the years ended June 30, 2006 and 2005, respectively, which were recorded as operating expense in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center recorded receivables of $6,733 and $15,782 at June 30, 2006 and 2005, respectively, which were included in receivables from other governments.

Senate Bill 1255 - California's Senate Bill 1255 (SB-1255) was passed by the California Legislature and signed into law in 1989. This bill provides a funding mechanism to assist disproportionate share hospitals to fund budget shortfalls. SB-1255 allows disproportionate share hospitals to make voluntary donations to the state. The state then matches the money received with federal funds and redistributes the funds to the eligible hospitals in the subsequent fiscal year. The Medical Center received $22,969 and $72,800 in SB-1255 funds for the years ended June 30, 2006 and 2005, respectively. Because the revenues generated are based upon services provided to patients, they have been classified as net patient service revenue in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center contributed matching funds of $-0- and $39,000 for the years ended June 30, 2006 and 2005, respectively, which were recorded as operating expense in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center had no related receivables at June 30, 2006 and 2005, respectively.

NOTE #4 – NET PATIENT SERVICE REVENUE, Continued

New Medi-Cal Waiver - In September 2005, the State of California significantly modified its Medi-Cal program under a new waiver with the Centers for Medicare and Medicaid Services (CMS). In connection with the new waiver, the State legislature passed the Medi-Cal/Hospital Uninsured Demonstration Project Act, or SB 1100. Under the new waiver, the State financing of the SB-855 and SB-1255 programs were altered.

For the SB-855 program, the State continued to provide supplemental payments to hospitals for uncompensated care. However, the use of intergovernmental transfers (IGT's) by the State, as the non-federal match, was modified to a methodology consisting of certified public expenditures (CPE's) up to 100 percent of costs and IGT's between 100 and 175 percent of costs.

The new waiver replaced the SB-1255 program with the Safety Net Care Pool (SNCP). The SNCP will provide supplemental payments to public hospitals for the care to the uninsured. The methodology of financing the supplemental payments to public hospital is based on certified public expenditures rather than voluntary intergovernmental payments. The Medical Center recorded $22,969 in SNCP funds for the fiscal year ended June 30, 2006 and related receivable of $1,936.

Because the revenues and matching contributions, as applicable, for the SB-855 and SNCP programs are generated based upon services provided to patients, the amounts have been classified as net patient service revenue in the accompanying statement of revenues, expenses and changes in net assets.

Assembly Bill 915 - California's Assembly Bill 915 (SB-915) was passed by the State Legislature and signed into law in 2002. This bill provides for the payment of a supplemental reimbursement to acute care hospitals owned by certain public entities that provide outpatient services to Medi-Cal beneficiaries. The Medical Center recorded $6,256 and $15,562 in AB-915 funds for the years ended June 30, 2006 and 2005, respectively. Because the revenues generated are based upon services provided to patients, they have been classified as net patient service revenue in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center recorded receivables of $421 and $-0- for the years ended June 30, 2006 and 2005, respectively, which were included in receivable from other governments.

NOTE #5 – CHARITY CARE

The Medical Center maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges foregone for services and supplies furnished under its charity care policy. The following information measures the level of charity care provided during the fiscal years ended June 30:

	2006	2005
Charges foregone based on established rates	$ 337,522	$ 293,373

NOTE #6 – CAPITAL CONTRIBUTIONS

In 1991, the County Board of Supervisors approved the construction and financing plan of the Arrowhead Regional Medical Center project. The Inland Empire Public Facilities Corporation (Corporation) financed the project through the issuance of Certificates of Participation. The Corporation is a nonprofit public benefit corporation formed on May 30, 1986, to serve the County, including the Medical Center, by financing, refinancing, acquiring, constructing, improving, leasing, and selling buildings, building improvements, equipment, land, land improvements, and any other real or personal property for the benefit of the residents of the County. The Corporation is included in the County's reporting entity as a blended component unit. In fiscal year 1999, the Medical Center Project assets and liabilities were contributed to the Medical Center.

In accordance with the master lease agreement, the County is obligated to make aggregate lease payments each year as consideration for the use and occupancy of the Medical Center in an amount designated to be sufficient to pay the annual principal and interest due with respect to any construction debt outstanding. Senate Bill 1732 (SB-1732) was passed by the California Legislature and signed into law in October 1998. The law permits qualifying medical centers to receive reimbursement, in addition to their Medi-Cal contract reimbursement, for a portion of the debt service of qualified projects. Under SB-1732, the Medical Center estimates that it will receive proceeds equal to 50 percent of the total debt service costs. Amounts received by the Medical Center in SB-1732 funds during fiscal years 2006 and 2005 amounted to $21,521 and $20,259, respectively, which are included as nonoperating revenues in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center had no related receivables at June 30, 2006 and 2005.

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006 AND 2005

(Dollar Amounts in Thousands)

NOTE #7 – CAPITAL ASSETS

A summary of capital assets activity for the years ended June 30, 2006 and 2005, is as follows:

	Beginning Balance	Additions	Deletions	Transfers	Ending Balance
June 30, 2006					
Land and improvements	$ 22,292				$ 22,292
Buildings and improvements	491,002	$ 246			491,248
Equipment	95,079	2,707	$ 58		97,728
Construction-in-progress	617	297	546		368
Total Capital Assets, Gross	608,990	3,250	604	-	611,636
Accumulated Depreciation:					
Land and improvements	(39)	(16)			(55)
Buildings and improvements	(77,214)	(12,321)			(89,535)
Equipment	(73,100)	(5,904)	(54)		(78,950)
Total Accumulated Depreciation	(150,353)	(18,241)	(54)		(168,540)
Capital Assets, Net	$ 458,637	$ (14,991)	$ 550	$ -	$ 443,096
June 30, 2005					
Land and improvements	$ 22,292				$ 22,292
Buildings and improvements	490,599		$ 225	$ 628	491,002
Equipment	94,756	$ 1,498	1,367	192	95,079
Construction-in-progress	22	1,415		(820)	617
Total Capital Assets, Gross	607,669	2,913	1,592	-	608,990
Accumulated Depreciation:					
Land and improvements	(24)	(15)			(39)
Buildings and improvements	(65,134)	(12,305)	(225)		(77,214)
Equipment	(68,243)	(6,050)	(1,193)		(73,100)
Total Accumulated Depreciation	(133,401)	(18,370)	(1,418)	-	(150,353)
Capital Assets, Net	$ 474,268	$ (15,457)	$ 174	$ -	$ 458,637

NOTE #8 – TRANSACTIONS WITH THE COUNTY

The Medical Center uses the treasury function of the County and at times maintains a cash overdraft with the County which can be repaid only through collection of receivables. The Medical Center had no cash overdrafts as of June 30, 2006 and 2005.

The Medical Center is allocated a portion of the County's overhead costs. Such expenses totaled $2,877 and $2,111 for the years ended June 30, 2006 and 2005, respectively, and are included as operating expense in the accompanying statements of revenues, expenses, and changes in net assets.

The Medical Center is allocated a portion of the County's annual debt service requirement on the County's pension obligation revenue bonds. Such amounts totaled $4,513 and $27,372 for the years ended June 30, 2006 and 2005, respectively, and are included in transfers to the County in the accompanying statements of revenues, expenses, and changes in net assets.

The Medical Center also receives funds from the County of a fixed amount for care of the County's medically indigent patients.

NOTE #9 – LONG-TERM OBLIGATIONS

The following is a summary of changes in long-term obligations for the fiscal years ended June 30, 2006 and 2005:

	June 30, 2006				
	Beginning Balance	Additions	Reductions	Ending Balance	Due within One Year
Certificates of Participation					
Series 1994	$ 190,875		$ (4,470)	$ 186,405	$ 4,515
Series 1995	123,035		(5,875)	117,160	6,420
Series 1996	65,070			65,070	
Series 1997	60,820		(14,005)	46,815	14,800
Series 1998	176,510			176,510	
Total Certificates of Participation, Gross	616,310		(24,350)	591,960	25,735
Less:					
Deferred amount on refunding	(39,659)		1,808	(37,851)	
Discount on debt	(13,491)		435	(13,056)	
Total Certificates of Participation	563,160		(22,107)	541,053	25,735
Capital lease obligations	1,306	$ 1,648	(517)	2,438	844
Total	$ 564,466	$ 1,648	$ (22,624)	$ 543,491	$ 26,579

NOTE #9 – LONG-TERM OBLIGATIONS, Continued

	June 30, 2005				
	Beginning Balance	Additions	Reductions	Ending Balance	Due within One Year
Certificates of Participation					
Series 1994	$ 194,840		$ (3,965)	$ 190,875	$ 4,470
Series 1995	128,875		(5,840)	123,035	5,875
Series 1996	65,070			65,070	
Series 1997	74,075		(13,255)	60,820	14,005
Series 1998	176,510			176,510	
Total Certificates of Participation, Gross	639,370		(23,060)	616,310	24,350
Less:					
Deferred amount on refunding	(41,467)		1,808	(39,659)	
Discount on debt	(13,926)		435	(13,491)	
Total Certificates of Participation	583,977		(20,817)	563,160	24,350
Capital lease obligations	1,659		(354)	1,306	366
Total	$ 585,636	$ -	$ (21,171)	$ 564,466	$ 24,716

A. Certificates of Participation

The Medical Center's certificates of participation were issued by the Inland Empire Public Facilities Corporation (Corporation).

Certificates of participation at June 30, 2006 consist of the following:

Series 1994

The Medical Center Series 1994 Certificates of Participation were dated February 1, 1994, in the amount of $283,245, with interest rates from 4.60 percent to 7.00 percent.

The Series 1994 Certificates maturing on August 1, 2005, August 1, 2006, August 1, 2019, August 1, 2024, August 1, 2026, and August 1, 2028, are subject to optional redemption in whole or in part on any date in such order of maturity as the Corporation shall determine and by lot within a maturity, on or after August 1, 2004, at the following premiums, plus interest accrued to the redemption date:

Redemption Dates	Premium
August 1, 2005 to July 31, 2006	1%
August 1, 2006 and thereafter	-

NOTE #9 – LONG-TERM OBLIGATIONS, Continued

The Series 1994 Certificates maturing on August 1, 2009, August 1, 2017, August 1, 2020, and August 1, 2022, are not subject to optional redemption prior to maturity.

Series 1995

The Series 1995 Certificates of Participation were dated June 1, 1995, in the amount of $363,265, with interest rates from 4.80 percent to 7.00 percent.

The Series 1995 Certificates maturing on August 1, 2022, are subject to optional redemption, in whole or in part, on any date in such order of maturity as the Corporation shall determine and by lot within a maturity, on or after August 1, 2005, at the following premiums, plus interest accrued to the redemption date:

Redemption Dates	Premium
August 1, 2006 to July 31, 2007	1%
August 1, 2007 and thereafter	-

The Series 1995 Certificates maturing on and prior to August 1, 2010 and on August 1, 2017, are not subject to optional redemption prior to maturity.

Series 1996

The Series 1996 Certificates of Participation were dated January 1, 1996, in the amount of $65,070, with interest rates from 5.00 percent to 5.25 percent.

The Series 1996 Certificates are subject to optional redemption, in whole or in part, on any date in such order of maturity as the Corporation shall determine and by lot within a maturity, on or after August 1, 2006, at the following premiums, plus interest accrued to the redemption date:

Redemption Dates	Premium
August 1, 2007 to July 31, 2008	1%
August 1, 2008 and thereafter	-

Series 1997

The Series 1997 Certificates of Participation were dated September 1, 1997, in the amount of $121,095, with interest rates from 4.30 percent to 5.50 percent.

The Series 1997 Certificates are not subject to optional redemption prior to maturity.

NOTE #9 – LONG-TERM OBLIGATIONS, Continued

Series 1998

The Series 1998 Certificates of Participation were dated October 22, 1998, in the amount of $176,510. Interest with respect to the Certificates is payable at an adjustable weekly interest rate, which may be converted to a fixed interest rate at the option of the Corporation. The Corporation entered into an interest rate swap agreement with Merrill Lynch Capital Services, Inc., which provides that the Corporation will pay a fixed rate of 4.1895 percent to the Swap Provider on a notional amount equal to the principal amount of the Series 1998 Certificates, and the Swap Provider will pay interest to the Corporation at a variable rate of interest on such notional amount, such payments to be made on a net basis. See information below.

The Series 1998 Certificates are subject to optional redemption prior to their maturity at a redemption price equal to the principal amount thereof, plus accrued interest to the date of redemption as follows:

a) Prior to the Conversion Date, fixed interest rate, at a redemption price equal to the principal amount called for redemption without premium.

b) After the Conversion Date, at a redemption price of 100 percent of the principal amount plus a premium to be determined on or prior to the Conversion Date.

The proceeds from the Series 1998 Certificates of Participation (Certificates) were used for the advance refunding for $160,700 of previously issued Series 1995 Certificates of Participation. Government securities were purchased with the proceeds, and those securities were deposited in an irrevocable trust with an escrow agent to provide debt service until the remaining outstanding Certificates mature. The advance-refunding method met the requirements of an in-substance defeasance, and the remaining outstanding Certificates were removed as a liability of the Medical Center.

At both June 30, 2006 and 2005, the balance of defeased debt outstanding, but removed from the Medical Center's financial statements was $61,070 and $276,770, respectively.

Interest Rate Swap

Objective of the interest rate swap. As a means to lower financing costs, and to reduce the risks to the Corporation associated with the fluctuation in market interest rates, the Corporation entered into an interest rate swap in connection with the Medical Center Series 1998 Certificates of Participation (Series 1998 Certificates) in the amount of $176,510. The intention of the swap was to effectively change the variable interest rate on the bonds to a synthetic fixed-rate of 4.1895 percent.

NOTE #9 – LONG-TERM OBLIGATIONS, Continued

Terms. The Series 1998 Certificates and the related swap agreement mature on August 1, 2026, and the swap's notional amount of $176,510 matches the $176,510 variable-rate COPs. The swap was effective at the same time the Series 1998 Certificates were issued on October 22, 1998. Starting in fiscal year 2008-09, the notional value of the swap and the principal amount of the associated debt should decline. Under the swap agreement, through August 1, 2005, the Corporation pays Merrill Lynch a fixed rate of 4.1895 percent and Merrill Lynch pays the Corporation an amount equal to the variable rate interest payable on the outstanding Series 1998 Certificates. After August 1, 2005, the Corporation pays Merrill Lynch a fixed payment of 4.1895 percent and receives from Merrill Lynch a variable payment computed as 73 percent of the monthly London Interbank Offered Rate (LIBOR). Conversely, the Series 1998 Certificates variable-rate coupons have historically been similar to the Bond Market Association Municipal Swap Index (BMA).

Fair Value. Because interest rates have increased since execution of the swap, the swap had a positive fair value of $436 as of June 30, 2006. The swap's positive fair value may be countered by an increase in total anticipated future interest payments required under the variable-rate bonds, creating a higher synthetic interest rate. Because the coupons on the variable-rate Series 1998 Certificates adjust to changing interest rates, the Series 1998 Certificates do not have a corresponding fair value increase. The fair value was the quoted market price from Merrill Lynch at June 30, 2006.

Credit Risk. The swap counterparty was rated Aa3 by Moody's and A+ by Standard & Poor as of June 30, 2006. The swap agreement specifies that if the long-term senior unsecured debt rating of Merrill Lynch & Co. is withdrawn, suspended or falls below A- (Standard & Poor) or A3 (Moody's), a collateral agreement will be executed within 30 days or the swap agreement will terminate.

Basis Risk. The swap exposes the Corporation to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the Series 1998 Certificates. If a change occurs that results in the rates moving to convergence, the expected cost savings may not be realized. As of June 30, 2006, the BMA rate was 3.97 percent, the actual variable interest rate was 3.87 percent, and 73 percent of LIBOR was 3.89 percent.

Termination Risk. The Corporation or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. The swap may be terminated by the Corporation if Merrill Lynch's credit quality rating falls below A- as issued by Standard & Poor or A3 by Moody's. If the swap is terminated, the variable-rate Series 1998 Certificates would no longer carry a synthetic interest rate. Also, if at the time of termination the swap has a negative fair value, the Corporation would be liable to Merrill Lynch for a payment equal to the swap's fair value.

NOTE #9 – LONG-TERM OBLIGATIONS, Continued

Swap payments and associated debt. Using rates as of June 30, 2006, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same for their term, were as follows. As rates vary, variable rate Series 1998 Certificates interest payments and net swap payments will vary.

Fiscal Year	Variable Rate Bonds Principal	Variable Rate Bonds Interest	Interest Rate Swaps, Net	Total
2007		$ 6,831	$ 521	$ 7,352
2008		6,831	521	7,352
2009	$ 1,000	6,812	520	8,332
2010	1,100	6,771	517	8,388
2011	1,200	6,726	513	8,439
2012-2027	173,210	60,262	4,600	238,072
Totals	$ 176,510	$ 94,233	$ 7,192	$ 277,935

B. Debt Service Requirements

The total annual debt service requirements to maturity for the outstanding Certificates of Participation as of June 30, 2006 are summarized as follows:

Fiscal Year	Total Principal	Total Interest
2007	$ 25,735	$ 29,694
2008	27,180	28,247
2009	29,795	26,670
2010	14,610	25,355
2011	15,635	24,378
2012-16	91,910	108,420
2017-21	119,285	81,552
2022-26	154,835	46,360
2027-31	112,975	8,470
Totals	$ 591,960	$ 379,146

NOTE #9 – LONG-TERM OBLIGATIONS, Continued

C. Capital Lease Obligations

The Medical Center has various lease agreements with financial institutions and medical equipment manufacturers expiring at various dates through November 2009, providing for monthly payments at various interest rates. Equipment acquired under these agreements have been accounted for as capital leases.

Future minimum lease payments on capital leases as of June 30, 2006, are as follows:

Fiscal Year		
2007	$	1,004
2008		1,004
2009		650
Total minimum lease payments		2,658
Less Amount Representing Interest		(220)
Present value of net minimum lease payments		2,438
Less Current Portion of Capital Lease Obligations		(844)
Capital lease obligations, excluding current portion	$	1,594

The net book value of equipment acquired under capitalized leases at June 30, 2006 and 2005 was $2,514 and $1,208, net of accumulated amortization of $4,042 and $3,670, respectively.

NOTE #10 – ARBITRAGE PAYABLE

Interest earned in excess of interest expense related to tax-exempt debt issued for public purposes must be remitted to the federal government following the end of each period of five bond years of the Certificates of Participation. The amount of excess investment earnings calculated as of June 30, 2006 and 2005, totaled $191 and $165, respectively.

NOTE #11 – OPERATING LEASES

Rent expense for operating leases for the years ended June 30, 2006 and 2005, totaled $2,835 and $1,770, respectively.

NOTE #12 – RETIREMENT PLAN

Employees of the Medical Center participate in a cost-sharing multiple-employer defined benefit retirement plan (the Plan) administered by the San Bernardino County Employee's Retirement Association (SBCERA). The Plan is governed by the San Bernardino Board of Retirement under the California County Employees Retirement Act of 1937 (1937 Act). It provides retirement, death, and disability benefits to members. Employees become eligible for membership on their first day of regular employment and become fully vested after five years. SBCERA issues a stand-alone financial report, which may be obtained by contacting the Board of Retirement, 195 North Arrowhead Avenue, San Bernardino, California 92415-0014.

Participating members are required by statute (Sections 31621, 31621.2, and 31639.25 of the California Code) to contribute a percentage of covered salary based on certain actuarial assumptions and their age at entry into the Plan. Employee contribution rates vary according to age and classification (general or safety). Members are required to contribute 8.89 percent to 12.65 percent of their annual covered salary, of which the County pays approximately 7 percent. Employers are required to contribute 10.8 percent to 13.0 percent of the current year covered payroll. The Medical Center's pension cost for the fiscal years ended June 30, 2006 and 2005, was approximately $22,232 and $17,722, respectively. Employee contribution rates are established and may be amended pursuant to Articles 6.1 and 6.8 of the 1937 Act. Employer rates are determined pursuant to Section 31453 of the 1937 Act. The following table shows the County's required contributions and the percentage contributed for the current year and each of the two preceding years:

Year Ended June 30,	County's Annual Required Contributions	Percentage Contributed
2004	$ 590,661	100%
2005	141,450	100%
2006	166,614	100%

NOTE #13 – SELF-INSURANCE

The Medical Center participates in the County's self-insurance programs for general liability, unemployment insurance, employee dental insurance, medical malpractice, and workers' compensation claim-related risks.

The activities related to the self-insurance programs are accounted for in the County's Risk Management Funds, separate internal service funds of the County, except for unemployment insurance and employee dental insurance, which are accounted for in the General Fund of the County. The Medical Center participates in these plans through a premium based arrangement that consists of annual amounts not subject to adjustment for adverse claims. Insurance premium expense for the years ended June 30, 2006 and 2005 was $8,839 and $5,176, respectively.

NOTE #14 – LITIGATION

The Medical Center is the defendant in various lawsuits and other claims arising in the ordinary course of its operations. In the opinion of County Counsel and County officials, the ultimate outcome of these matters will have no significant effect on the financial condition or operations of the Medical Center.

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Vavrinek, Trine, Day & Co., LLP
Certified Public Accountants & Consultants

VALUE THE DIFFERENCE

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

The Honorable Board of Supervisors
County of San Bernardino, California:

We have audited the financial statements of the Arrowhead Regional Medical Center (Medical Center), a fund of the County of San Bernardino (County), as of and for the year ended June 30, 2006 and 2005, and have issued our report thereon dated September 29, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Medical Center's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessary disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving internal control over financial reporting that we have reported to management of the Medical Center in a separate letter dated September 29, 2006.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Medical Center's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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This report is intended solely for the information and use of the Board of Supervisors, management, Federal awarding agencies, pass-through entities and the Controller of the State of California and is not intended to be, and should not be, used by anyone other than these specified parties.

Vavrinek, Trine, Day & Co., LLP

Rancho Cucamonga, California
September 29, 2006