

***Santa Barbara Regional
Health Authority***

*Financial Statements and Additional Information
for the Years Ended June 30, 2003 and 2002
and Independent Auditors' Report*

SANTA BARBARA REGIONAL HEALTH AUTHORITY

TABLE OF CONTENTS

	Page
MANAGEMENT’S DISCUSSION AND ANALYSIS	1–7
INDEPENDENT AUDITORS’ REPORT	8
FINANCIAL STATEMENTS:	
Balance Sheets	9
Statements of Revenues, Expenses and Changes in Net Assets	10
Statements of Cash Flows	11
Notes to Financial Statements	12–18
ADDITIONAL INFORMATION:	
Schedule 1—Schedule of Revenues and Expenses Per Member Per Month	19
Schedule 2—Schedule of Medical Related Expense—Actual and Budget	20
Schedule 3—Schedule of General and Administrative Expenses—Actual and Budget	21

MANAGEMENT'S DISCUSSION AND ANALYSIS

Santa Barbara Regional Health Authority ("SBRHA" or the "Authority") is an independent public agency organized by the County of Santa Barbara to operate a capitated, or prepaid, health care system for residents of Santa Barbara County who are covered under the State of California Medi-Cal program ("SBHI"). SBRHA receives approximately 98% of its revenue from this program. In addition to the Medi-Cal program, the Authority is contracted with the California Major Risk Medical Insurance Board to administer health care for pregnant women and their newborns (known as the "Prenatal Plus 2 program" or "PP2") and for children up to age 18 (known as the "Healthy Families program" or "HFP") in Santa Barbara County.

This section of the Authority's annual financial report presents Management's analysis of the Authority's financial performance during the fiscal year ended June 30, 2003.

FINANCIAL HIGHLIGHTS

The following represents fluctuations from June 30, 2002 to June 30, 2003:

- The Authority's net assets increased by \$8.2 million or 62.1%.
- Operating revenues increased 7.3% from \$136.6 million to \$146.5 million.
- Operating expenses decreased 1.5% from \$140.9 million to \$138.8 million. Within this amount, medical related expenses decreased 1.6% from \$130.1 million to \$128.0 million, while general and administrative expenses stayed consistent at \$10.8 million.
- The Authority's membership count as of June 30 increased 7.2% from 50,255 members to 53,857 members. For the Medi-Cal program, membership went from 48,443 to 51,746, an increase of 6.8%. For the Health Families program, membership went from 1,587 to 1,871, an increase of 17.9%. For the Prenatal Plus 2 program, membership went from 225 to 240, an increase of 6.7%.
- The Authority's available cash and cash equivalents increased 37.1% from \$18.6 million to \$25.5 million.

OVERVIEW OF THE FINANCIAL STATEMENTS

This annual report consists of three parts: management's discussion and analysis, financial statements and additional information. The financial statements include notes that explain in more detail some of the information presented in the financial statements.

REQUIRED FINANCIAL STATEMENTS

The financial statements of the Authority report financial information about the Authority using accounting methods in accordance with accounting principles generally accepted in the United States of America (GAAP) and governmental accounting and financial reporting standards.

The balance sheets include the Authority's assets and liabilities, and provide information about the nature and amounts of investments in resources (assets) and the obligations to the Authority's creditors (liabilities). It also provides the basis for evaluating the capital structure and assessing the liquidity and financial flexibility of the Authority.

Revenues and expenses are accounted for in the statement of revenues, expenses and changes in net assets. This statement measures the success of the Authority's operations over the past year and can be used to determine whether the Authority has successfully recovered all its costs through its capitation from the State of California and the investment of funds.

The final required financial statement is the statement of cash flows. The primary purpose of this statement is to provide information about the Authority's cash receipts and cash payments during the reporting period. The statement reports cash receipts, cash payments and net changes in cash resulting from operations and investing activities, and provides answers to such questions as where did the cash come from, what was cash used for, and what was the change in the cash balance during the year.

FINANCIAL ANALYSIS OF THE AUTHORITY

The balance sheets and the statement of revenues, expenses and changes in net assets report information about the Authority's financial results due to current year's activities. These two statements report the net assets of the Authority and changes in them, which presents information related to the Authority's financial health or financial position. Over time, increases or decreases in the Authority's net assets are one indicator of whether its financial health is improving or deteriorating. However, other nonfinancial factors, such as changes in economic conditions, population growth, and new or changed government legislation, should also be considered for such analysis.

NET ASSETS

To begin our analysis, a summary of the Authority's balance sheets is presented in Table A-1.

TABLE A-1
Condensed Balance Sheets
(In millions)

	FY 2003	FY 2002	Dollar Change	Percent Change
Current and other assets	\$ 44.4	\$ 41.2	\$ 3.2	7.8 %
Capital assets	<u>0.8</u>	<u>1.1</u>	<u>(0.3)</u>	(27.3)%
Total assets	45.2	42.3	2.9	6.9 %
Medical claims payable	20.2	26.1	(5.9)	(22.6)%
Other liabilities	<u>3.6</u>	<u>3.0</u>	<u>0.6</u>	20.0 %
Total liabilities	23.8	29.1	(5.3)	(18.2)%
Net assets:				
Invested in capital assets—net of related debt	0.8	1.1	(0.3)	(27.3)%
Unrestricted	20.3	11.8	8.5	72.0 %
Restricted	<u>0.3</u>	<u>0.3</u>	<u>0.0</u>	0.0 %
Total net assets	<u>21.4</u>	<u>13.2</u>	<u>8.2</u>	62.1 %
TOTAL LIABILITIES AND NET ASSETS	<u><u>\$ 45.2</u></u>	<u><u>\$ 42.3</u></u>	<u><u>\$ 2.9</u></u>	6.9 %

As can be seen from the table above, net assets increased by \$8.2 million in fiscal year 2003, primarily from the \$8.5 million increase in unrestricted net assets. The increase means the expenses necessary to finance the Authority's operations during the year were less than revenues generated on those operations. Medical claims payable decreased by \$5.9 million due to fiscal year 2002, including approximately \$2 million of retroactive increases in contracted rates which did not occur in 2003. Additionally, there were downward revisions to the fiscal year 2002 estimates due to claims paid at amounts less than expected by \$4.2 million. These amounts are offset by increased reserves for the current fiscal year due to increases in membership. Included within the unrestricted net assets are funds designated by the Board of Directors totaling \$1.6 million and \$1.2 million for fiscal years 2003 and 2002, respectively. These designated amounts are equal to the unfunded actuarial accrued pension liability for the Authority's employees covered under the California Public Employees Retirement System ("CalPERS").

The statement of revenues, expenses and changes in net assets provides answers as to the nature and scope of these changes. Table A-2 indicates the increase in net assets during 2003 is attributable to revenues exceeding expenses by \$8.2 million. The Authority's revenues increased by \$9.6 million, while expenses decreased by \$2.1 million. This small decrease in operating expenses exceeded the Authority's goal based on the implementation of its cost cutting strategies during the fiscal year 2003. The significant factors in operating expenses, being lower than 2002, is the \$2.1 million in additional medical cost recoveries, the lowering of pharmaceutical reimbursement from Average Wholesale Price ("AWP") less 5% to AWP less 10%, the lowering of physician reimbursement from 165% of Medi-Cal to 120% of Medi-Cal, and a lower than anticipated utilization of hospital services by Authority members during the fiscal year. The increase in revenues is mainly attributable to capitation revenue, which was greater in aggregate dollars due to total member months increasing 7.2% during the fiscal year. The decrease of \$2.1 million in total expenses was accomplished even though the Authority's membership in member months increased 7.2%.

TABLE A-2
Condensed Statements of Revenues,
Expenses and Changes in Net Assets
(In millions)

	FY 2003	FY 2002	Dollar Change	Percent Change
Capitation revenues	\$ 146.0	\$ 136.2	\$ 9.8	7 %
Other revenue	0.5	0.4	0.1	25 %
Interest revenue	<u>0.5</u>	<u>0.8</u>	<u>(0.3)</u>	(38)%
Total revenues	147.0	137.4	9.6	7 %
Medical related expenses	128.0	130.1	(2.1)	(2)%
General and administrative	<u>10.8</u>	<u>10.8</u>	<u>0.0</u>	0 %
Total expenses	138.8	140.9	(2.1)	(2)%
REVENUES LESS THAN EXPENSES	8.2	(3.5)	11.7	(334)%
BEGINNING NET ASSETS	<u>13.2</u>	<u>16.7</u>	<u>(3.5)</u>	(21)%
ENDING NET ASSETS	<u>\$ 21.4</u>	<u>\$ 13.2</u>	<u>\$ 8.2</u>	62 %

TABLE A-3
Program Revenue and Expense
(Per Member Per Month)
Fiscal Year 2002-03

	SBHI	HFP	PP2	SBRHA Consolidated
Capitation revenue	\$ 238.93	\$ 56.45	\$ 333.35	\$ 233.04
Medical related	210.22	30.50	294.85	204.39
Administrative	<u>17.06</u>	<u>2.51</u>	<u>0.29</u>	<u>17.16</u>
Total program expenses	227.28	33.01	295.14	221.55
Revenue greater than program expenses	<u>\$ 11.65</u>	<u>\$ 23.44</u>	<u>\$ 38.21</u>	<u>\$ 11.49</u>
Member months	602,090	21,604	2,688	626,382

TABLE A-3.1
Program Revenue and Expense
(Per Member Per Month)
Fiscal Year 2001-02

	SBHI	HFP	PP2	SBRHA Consolidated
Capitation revenue	\$ 239.08	\$ 65.18	\$ 290.01	\$ 233.97
Medical related	229.35	35.20	251.21	223.48
Administrative	<u>18.48</u>	<u>3.54</u>	<u>1.81</u>	<u>18.54</u>
Total program expenses	247.83	38.74	253.02	242.02
Revenue greater than program expenses	<u>\$ (8.75)</u>	<u>\$ 26.44</u>	<u>\$ 36.99</u>	<u>\$ (8.05)</u>
Member months	561,582	17,887	2,650	582,119

Each of the Authority's three health care programs contributed toward the positive results for 2002-03. Table A-3 shows that overall, the capitation revenue exceeded total consolidated expenses by \$11.49 per member per month ("PMPM"). Consolidated capitation revenue of \$233.04 PMPM for 2003 is approximately the same as it was for 2002 at \$233.97 PMPM. Total consolidated expenses for 2003 is \$221.55 PMPM compared to \$242.02 PMPM for 2002, a decrease of 8.5%, primarily due to factors discussed previously. As can be seen, the Medi-Cal program (SBHI) represents about 96% of the Authority's total member months and its financial results are therefore dependent almost entirely on the results of this program. The contract with the State of California for the Medi-Cal program has been extended through December 31, 2004. It is anticipated the Authority's financial health will be dependent and closely mirror the actual operating results of this program in the foreseeable future. The Authority's strategic goals are to begin developing and offering commercial type health insurance in the near future as a means to decrease its reliance on the Medi-Cal program and/or state/federal government funding.

SUMMARY OF CASH FLOW ACTIVITIES

Table A-4 below shows a summary of the major sources and uses of cash and cash equivalents for the current and prior fiscal year. Cash and cash equivalents are considered highly liquid investments.

TABLE A-4
Summary of Cash Flow Activities

	FY 2003	FY 2002	Change
Cash flow from operating activities	\$ 6,858,159	\$ 11,526,472	\$ (4,668,313)
Cash flow from capital and related financing activities	(514,902)	(416,959)	(97,943)
Cash flow from investing activities	<u>549,546</u>	<u>817,559</u>	<u>(268,013)</u>
Net increase in cash and cash equivalents	6,892,803	11,927,072	(5,034,269)
Cash and cash equivalents:			
Beginning of year	<u>18,649,135</u>	<u>6,722,063</u>	<u>11,927,072</u>
End of year	<u>\$25,541,938</u>	<u>\$18,649,135</u>	<u>\$ 6,892,803</u>

Cash and cash equivalents increased by \$6.9 million during 2002-03. This is due to the receipt of capitation due the Authority related to a capitation rate increase retroactive to January 1, 2002 that occurred early in the fiscal year, as well as the combination of greater aggregate capitation dollars corresponding to increased membership along with the decrease in operating expenses. Overall, a cash and cash equivalent balance of \$25.5 million at year-end 2003 represents more than 60 days cash on hand to finance ongoing operations. The Authority's excess cash funds (the amount above which is required to meet immediate operational needs) are invested in the State of California's Local Agency Investment Fund (LAIF), which offers competitive market interest rate returns with minimal risk. A protracted delay in the Authority receiving its capitation payments from the State of California (the "State"), due to a State budget impasse or other legislative delays in the appropriation of funds, would likely subject the Authority to short-term cash requirements which may need remedies, such as obtaining a line of credit.

SUPPLEMENTARY INFORMATION—BUDGETARY COMPARISON

Below in Table A-5, the Authority’s adopted budget is compared to its actual results for 2003:

**TABLE A-5
Santa Barbara Regional Health Authority
Budgetary Comparison Schedule
For the Year Ended June 30, 2003**

	<u>Final Adopted Budget</u>		Actual	Over (Under)
	Fixed	Flexible	Results	Variance with Flex Budget
REVENUES:				
Capitation—SBHI	\$ 136,402,181	\$ 143,891,419	\$ 143,859,278	\$ (32,141)
Capitation—HFP	1,071,623	1,220,851	1,219,462	(1,389)
Capitation—PP2	943,708	896,047	896,047	
Interest income	875,000	875,000	549,546	(325,454)
Other	<u>960,500</u>	<u>960,500</u>	<u>519,664</u>	<u>(440,836)</u>
	<u>\$ 140,253,012</u>	<u>\$ 147,843,817</u>	<u>\$ 147,043,997</u>	<u>\$ (799,820)</u>
MEDICAL RELATED EXPENSES:				
Physician capitation	4,016,919	4,161,053	4,249,350	88,297
Physician fee-for-service	15,009,413	15,543,768	16,802,638	1,258,870
Pharmaceuticals	38,488,618	40,361,979	43,093,859	2,731,880
Hospital services	33,562,935	34,418,932	28,275,725	(6,143,207)
Long-term care services	32,888,844	33,999,421	32,359,400	(1,640,021)
Other medical care	8,890,975	9,279,987	7,827,709	(1,452,278)
Health programs	603,560	595,931	501,579	(94,352)
Medical cost recoveries	<u>(1,873,990)</u>	<u>(1,950,771)</u>	<u>(5,082,122)</u>	<u>(3,131,351)</u>
	<u>\$ 131,587,274</u>	<u>\$ 136,410,300</u>	<u>\$ 128,028,138</u>	<u>\$ (8,382,162)</u>
GENERAL AND ADMINISTRATIVE EXPENSES:				
Salaries and fringe benefits	7,205,227		7,175,102	(30,125)
Contract services	1,103,190		956,632	(146,558)
Travel and transportation	162,382		105,357	(57,025)
Occupancy	835,058		795,242	(39,816)
Office supplies and equipment	421,277		311,584	(109,693)
Depreciation and amortization	770,000		761,532	(8,468)
Insurance	185,485		190,783	5,298
Other expenses	<u>517,666</u>		<u>454,022</u>	<u>(63,644)</u>
	<u>\$ 11,200,285</u>		<u>\$ 10,750,254</u>	<u>\$ (450,031)</u>

The Authority’s capitation revenue, and medical related expense budgets are developed on a PMPM basis and as such, is dependent on actual member enrollment. Administrative costs, interest income and other revenue are compared to fixed budgets. In Table A-5, we present both the adopted budget based on our initial estimates of enrollment for the budget year (fixed budget), as well as the budgeted amounts based on actual enrollment multiplied by budgeted PMPM amounts per expense category (flexible budget). The Authority’s Board of Directors adopted the 2002-03 operating budget in June 2002.

The Authority's interest income ended the year under budget. The lowering of key interest rates by the Federal Reserve board during the year resulted in lower than expected rates of return on the Authority's short-term investments. Other revenue also came in under budget, due to the deferral of such revenues in accordance with the licensing and maintenance agreements on the Authority's health information system. Physician costs were over budget as a result of greater billings for injectibles as well as an error in the development of the budget amount. Pharmaceuticals were over budget, not due to inflation in drug costs (in fact our ingredient cost growth was under 10%), but rather a larger growth in drug utilization among Authority members than was anticipated. Hospital services were well below budget with a significant decline in inpatient services, particularly from out-of-county providers. Long-term care and other medical care services were under budget, generally reflecting a lower utilization rate of services than was anticipated. Medical cost recoveries exceeded expectations. Total administrative expenses came in under budget due to the Authority's close scrutiny of expenditures.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET AND RATES

The Authority's Board of Directors and management considered many factors when adopting the 2004 operating budget. A key factor was whether the State of California 2003-04 budget, once adopted, would contain monies for Medi-Cal managed care health plan rate increases. Subsequently, we learned that (1) the State's proposal to the Center for Medicare and Medicaid Services ("CMS") for an Intergovernmental Transfer arrangement, which would have provided us with a net rate increase for calendar year 2003, was denied by CMS; and (2) rather than including any rate increases, the final 2003-04 State Budget instead included a 5% rate *decrease* for Medi-Cal managed care plans, effective January 1, 2004. Therefore, the likelihood of any rate increases in the foreseeable future, and in fact perhaps for the next two years, appears remote. On the expense side, the Authority's 2004 budget continues to maintain very limited growth in administrative costs, and the growth in medical expenses is anticipated to remain in check with plans to implement a psychotropic drug carve-out under our State Medi-Cal contract, as well as further modifications in our drug formulary and additional reductions in the reimbursement levels to pharmacies (both aimed at the goal of achieving greater generic utilization and thus reducing total pharmacy expenditures). If our medical related expense assumptions are accurate, we do anticipate operating at a deficit for 2004, given the likelihood of no capitation rate increases. Regardless, the Authority does not foresee any financial hardship in the near term, as it has the available cash position and net assets to finance an operating deficit during 2003-04, although any rate decreases imposed by the State over the next year or two could certainly radically and quickly alter such a projection. The Board of Directors will also be exploring various means in which the Authority can diversify its revenue sources, with an eye toward reducing its current primary reliance of state/federal government funding.

INDEPENDENT AUDITORS' REPORT

Board of Directors
Santa Barbara Regional Health Authority
Goleta, California

We have audited the accompanying balance sheets of Santa Barbara Regional Health Authority ("SBRHA") as of June 30, 2003 and 2002 and the related statements of revenues, expenses and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of SBRHA'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. 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, such financial statements present fairly, in all material respects, the financial position of the Santa Barbara Regional Health Authority at June 30, 2003 and 2002 and the changes in net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's discussion and analysis on pages 1 through 7 is not a required part of the basic financial statements but is supplementary information required by GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This supplementary information is the responsibility of SBRHA's management. We have applied certain limited procedures, which consisted principally of inquires of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

The additional information included in Schedules 1 through 3 on pages 19 to 21 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. This additional information is the responsibility of SBRHA's management. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

September 15, 2003

SANTA BARBARA REGIONAL HEALTH AUTHORITY

BALANCE SHEETS JUNE 30, 2003 AND 2002

ASSETS	2003	2002
CURRENT ASSETS:		
Cash and cash equivalents	<u>\$25,541,938</u>	<u>\$18,649,135</u>
Accounts receivable:		
State of California:		
Capitation	15,007,411	18,271,432
Reinsurance	2,297,988	2,497,199
Other—net of allowance for doubtful accounts of \$70,704 and \$92,884 in 2003 and 2002, respectively	<u>408,917</u>	<u>528,920</u>
Total accounts receivable	17,714,316	21,297,551
Advance payments to providers	545,386	694,501
Prepaid expenses and other assets	<u>273,735</u>	<u>189,942</u>
Total current assets	44,075,375	40,831,129
CAPITAL ASSETS—Net (Note 3)	835,284	1,081,992
RESTRICTED CERTIFICATE OF DEPOSIT (Note 8)	300,000	300,000
DEPOSITS	<u>37,048</u>	<u>37,048</u>
TOTAL	<u>\$45,247,707</u>	<u>\$42,250,169</u>
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	\$ 411,428	\$ 616,571
Accrued salaries and related benefits	1,094,393	774,831
Medical claims payable (Note 4)	20,237,448	26,079,960
Distributions payable (Note 5)	1,604,276	1,457,265
Deferred revenue	<u>475,682</u>	<u>162,667</u>
Total current liabilities	<u>23,823,227</u>	<u>29,091,294</u>
COMMITMENTS AND CONTINGENCIES (Notes 5, 6 and 7)		
NET ASSETS:		
Invested in capital assets—net of related debt	835,284	1,081,992
Restricted (Note 8)	300,000	300,000
Unrestricted (Notes 7 and 9)	<u>20,289,196</u>	<u>11,776,883</u>
Total net assets	<u>21,424,480</u>	<u>13,158,875</u>
TOTAL	<u>\$45,247,707</u>	<u>\$42,250,169</u>

See accompanying notes to financial statements.

SANTA BARBARA REGIONAL HEALTH AUTHORITY

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS YEARS ENDED JUNE 30, 2003 AND 2002

	2003	2002
OPERATING REVENUES:		
Capitation	\$ 145,974,787	\$ 136,198,384
Other	<u>519,664</u>	<u>352,582</u>
Total operating revenues	<u>146,494,451</u>	<u>136,550,966</u>
OPERATING EXPENSES:		
Medical related:		
Physician capitation	4,249,350	3,893,883
Physician fee-for-service	16,802,638	18,607,461
Pharmaceuticals	43,093,859	38,104,184
Hospital services	28,275,725	30,045,852
Long-term care services	32,359,400	33,747,409
Other medical care	7,827,709	8,303,226
Health programs	501,579	412,339
Medical cost recoveries (Note 2)	<u>(5,082,122)</u>	<u>(3,020,477)</u>
Total medical related	<u>128,028,138</u>	<u>130,093,877</u>
General and administrative:		
Salaries and fringe benefits	7,175,102	6,973,580
Contract services	956,632	1,086,035
Travel and transportation	105,357	106,251
Occupancy	795,242	792,995
Office supplies and equipment	311,584	334,187
Depreciation and amortization	761,532	904,355
Other	<u>644,805</u>	<u>593,589</u>
Total general and administrative	<u>10,750,254</u>	<u>10,790,992</u>
Total operating expenses	<u>138,778,392</u>	<u>140,884,869</u>
OPERATING INCOME (LOSS)	7,716,059	(4,333,903)
NON-OPERATING REVENUES—Interest income	<u>549,546</u>	<u>817,559</u>
TOTAL REVENUES GREATER THAN (LESS THAN) EXPENSES	8,265,605	(3,516,344)
NET ASSETS, BEGINNING OF YEAR	<u>13,158,875</u>	<u>16,675,219</u>
NET ASSETS, END OF YEAR	<u>\$ 21,424,480</u>	<u>\$ 13,158,875</u>

See accompanying notes to financial statements.

SANTA BARBARA REGIONAL HEALTH AUTHORITY

STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2003 AND 2002

	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from capitation arrangements	\$ 149,551,823	\$ 146,273,863
Cash receipts from other revenue arrangements	545,493	360,656
Cash paid for medical related expenses	(133,281,139)	(125,442,653)
Cash paid for selling, general and administrative expenses	<u>(9,958,018)</u>	<u>(9,665,394)</u>
Net cash provided by operating activities	<u>6,858,159</u>	<u>11,526,472</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of property and equipment	(514,902)	(421,959)
Proceeds from sale of property and equipment	<u>5,000</u>	<u>5,000</u>
Net cash used in capital and related financing activities	<u>(514,902)</u>	<u>(416,959)</u>
CASH FLOWS FROM INVESTING ACTIVITIES—Cash received for interest		
	<u>549,546</u>	<u>817,559</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	6,892,803	11,927,072
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<u>18,649,135</u>	<u>6,722,063</u>
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>\$ 25,541,938</u>	<u>\$ 18,649,135</u>
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income (loss)	\$ 7,716,059	\$ (4,333,903)
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	761,532	904,355
Loss on disposal of property and equipment	78	12,435
Changes in assets and liabilities:		
Accounts receivable—net	3,583,235	10,031,329
Advance payments to providers	149,115	(200,307)
Prepaid expenses and other assets	(83,793)	14,917
Accounts payable and accrued expenses	(205,143)	77,240
Accrued salaries and related benefits	319,562	116,651
Medical claims payable	(5,842,512)	4,602,398
Distributions payable	147,011	267,259
Deferred revenue	313,015	65,575
Funds designated for providers	<u>(31,477)</u>	<u>(31,477)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$ 6,858,159</u>	<u>\$ 11,526,472</u>

See accompanying notes to financial statements.

SANTA BARBARA REGIONAL HEALTH AUTHORITY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED JUNE 30, 2003 AND 2002

1. ORGANIZATION

Santa Barbara Regional Health Authority (“SBRHA” or the “Authority”) is an independent public agency organized by Santa Barbara County to operate a capitated, or prepaid, health care system for residents of Santa Barbara County who are covered under the State of California Medi-Cal program. SBRHA receives approximately 98% of its revenue from this program.

The prepaid system was authorized by legislation in March 1982, and SBRHA subsequently entered into a contract with the Department of Health Services of the State of California (the “State”) that was to expire on June 30, 1986. The contract with the State has been periodically extended with the current contract expiring on December 31, 2004.

During fiscal 1993, SBRHA entered into a contract with the California Major Risk Medical Insurance Board (“MRMIB”) for the administration of health care for pregnant women and their children (known as the “Prenatal PLUS 2 program”). SBRHA is paid a flat fee for each woman enrolled. This fee provides coverage from her enrollment date up to a maximum of 60 days following delivery. A monthly capitation payment is received for eligible children up to their second birthday.

In 1998, SBRHA entered into a contract with the California MRMIB to administer the Healthy Families Program in Santa Barbara County. This program, which began on July 1, 1998, offers low-cost health benefits to children whose working parents do not qualify for welfare and do not have medical insurance. SBRHA has contracted to manage this new program through June 30, 2004. SBRHA is paid a flat fee per month per subscriber. The program required SBRHA to obtain a Knox-Keene license, which it obtained on June 22, 2000.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting—SBRHA is a governmental health insuring organization and accordingly follows principles as prescribed by the Governmental Accounting Standards Board (“GASB”) and the provisions of the American Institute of Certified Public Accountants Audit and Accounting Guide, *Health Care Organizations*. SBRHA uses the accrual basis of accounting in accordance with provisions for proprietary fund types.

Net Assets—Net assets are classified into three components:

- *Invested in capital assets, net of related debt*—This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes or other borrowings that are attributable to the acquisition, construction or improvement of those assets.
- *Restricted*—This component of net assets consists of constraints placed on net asset use through external constraints imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

- *Unrestricted*—This component of net assets consists of net assets that do not meet the definition of “restricted” or “invested in capital assets, net of related debt.”

Accounting Standards—Pursuant to GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Authority has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issues after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

Cash and Cash Equivalents—Cash and cash equivalents consist of demand deposits, highly liquid securities and investments in the State Treasurer’s Local Agency Investment Fund (“LAIF”) and other short-term, highly liquid securities with original maturities of three months or less. The LAIF is a voluntary program created by statute as an investment alternative for California’s local governments and special districts. The cash and cash equivalents included in the LAIF are not individually identifiable and are not required to be categorized under GASB Statement No. 3. All other cash and cash equivalents are in Category 3, which includes investments that are uninsured and unregistered, and for which the securities underlying are held by the counterpart or by its trust department or agent, but not in SBRHA’s name. The carrying value of cash and cash equivalents approximates the fair value due to their short-term nature.

Capital Assets—Capital assets are recorded at historical cost less accumulated depreciation (see Note 3). Depreciation is computed on the straight-line method over the estimated useful lives of the various classes of assets or the lease term, whichever is less, as follows:

Office furniture and fixtures	5 years
Computer equipment and software	3 years
Leasehold improvements	5 years or lease term, if less

Revenue Recognition—Under the contracts with the State, Medi-Cal and Healthy Families revenues are recognized based on the estimated number of eligible enrollees per month, times the contracted monthly capitation rate. Revenue is recorded in the month in which eligible enrollees are entitled to health care services. Under the Prenatal PLUS 2 program, revenue is recorded ratably over the period in which services are expected to be provided. The portion of the case rate received by SBRHA for which the service period has not passed is included in deferred revenue.

Medical Related Expenses—SBRHA pays certain contracting health care providers, mostly primary care physicians, pursuant to capitation arrangements under which a provider agrees to supply all covered services for a monthly fixed fee. Capitation arrangements represent full payment for services and are not subject to retroactive adjustment of claims. For certain services not covered by the capitation fees, providers bill SBRHA as services are provided to enrollees pursuant to fee-for-service arrangements.

Fee-for-service arrangements result in claims by providers that are billed subsequent to services being rendered. Medical claims payable include the liability for claims received and unpaid and a provision for claims incurred but not reported. The provision for claims incurred but not reported is established using a historical analysis of the claims volume and the average time lag between the date the claim is incurred and the date that it is reported to SBRHA.

Medical cost recoveries consist of reinsurance recoveries and recoveries from third parties and Medicare. Reinsurance coverage for health care services is provided by the State, covering hospital inpatient medical costs in excess of \$75,000 per member per year based on Medi-Cal standard rates. Reinsurance recoveries are reported as reductions of medical related expenses.

Restricted Certificate of Deposit—A restricted certificate of deposit of \$300,000 at June 30, 2003 and 2002 was maintained under terms and conditions of SBRHA’s Knox-Keene license.

Income Taxes—Taxes on income are not required, as SBRHA is a special purpose organization created by an act of the California State Legislature.

Concentrations of Credit Risk—Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents and capitation receivable. All cash equivalents are invested in the State Treasurer’s LAIF. SBRHA contracts with the State of California to provide health care services to Medi-Cal eligible recipients under the Santa Barbara Health Initiative (“SBHI”). Revenues generated from the SBHI contract accounted for approximately 98% total revenues in the years ended June 30, 2003 and 2002.

Use of Estimates—The preparation of the 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 financial statements and the reported amounts of revenues and expenses during the reporting period. SBRHA’s principal areas of estimates include reinsurance, retroactive capitation receivables and claims incurred but not yet reported. Actual results could differ from those estimates.

Statements of Revenues, Expenses and Changes in Net Assets—All revenues and expenses directly related to the delivery of health care services are included in operating revenues and expenses in the statement of revenues, expenses and changes in net assets. Nonoperating revenues and expenses consist of those revenues and expenses that are related to financing and investing types of activities and result from nonexchange transactions or investment income.

Reclassifications—Certain amounts in the 2002 financial statements have been reclassified to conform to the 2003 presentation.

3. CAPITAL ASSETS

A summary of changes in capital assets during 2003 and 2002 is as follows:

	Beginning Balance 2003	Additions	Deletions	Ending Balance 2003
Office furniture and fixtures	\$ 953,933	\$ 1,438	\$ (2,127)	\$ 953,244
Computer equipment and software	5,504,738	509,385	(13,352)	6,000,771
Leasehold improvements	<u>404,383</u>	<u>4,079</u>	<u></u>	<u>408,462</u>
Total capital assets	6,863,054	514,902	(15,479)	7,362,477
Less accumulated depreciation and amortization	<u>5,781,062</u>	761,532	(15,401)	<u>6,527,193</u>
Net capital assets	<u>\$1,081,992</u>			<u>\$ 835,284</u>

	Beginning Balance 2002	Additions	Deletions	Ending Balance 2002
Office furniture and fixtures	\$ 957,217	\$ 11,656	\$ (14,940)	\$ 953,933
Computer equipment and software	5,209,693	393,377	(98,332)	5,504,738
Leasehold improvements	<u>387,457</u>	<u>16,926</u>	<u></u>	<u>404,383</u>
Total capital assets	6,554,367	421,959	(113,272)	6,863,054
Less accumulated depreciation and amortization	<u>4,972,544</u>	904,355	(95,837)	<u>5,781,062</u>
Net capital assets	<u>\$1,581,823</u>			<u>\$1,081,992</u>

4. MEDICAL CLAIMS PAYABLE

Medical claims payable comprise the following at June 30:

	2003	2002
Claims payable or pending approval	\$ 3,039,729	\$ 7,251,040
Provisions for claims incurred but not yet reported	<u>17,197,719</u>	<u>18,828,920</u>
	<u>\$20,237,448</u>	<u>\$26,079,960</u>

Management believes that the provision for medical claims payable is adequate to cover the net cost of claims incurred through June 30, 2003. However, such liability is, by necessity, estimated based on historical claim loss experience and other factors.

The cost of health care services is recognized in the period in which it is provided and includes an estimate of the cost of services that have been incurred but not yet reported. SBRHA estimates accrued claims payable based on historical claims payments and other relevant information. Estimates are continually monitored and reviewed, and as settlements are made or estimates adjusted, differences are reflected in current operations. Such estimates are subject to the impact of changes in the regulatory environment and economic conditions. Given the inherent variability of such estimates, the actual

liability could differ significantly from the amounts provided. While the ultimate amount of claims paid is dependent on future developments, management is of the opinion that the accrued claims payable is adequate.

The following is a reconciliation of accrued claims payable liability for the years ended June 30:

	2003	2002
Beginning balance	<u>\$ 26,079,960</u>	<u>\$ 21,477,562</u>
Incurred:		
Current	132,749,906	131,682,268
Prior	<u>(4,440,217)</u>	<u>(4,038,458)</u>
Total	<u>128,309,689</u>	<u>127,643,810</u>
Paid:		
Current	113,214,023	106,266,922
Prior	<u>20,938,178</u>	<u>16,774,490</u>
Total	<u>134,152,201</u>	<u>123,041,412</u>
Ending balance	<u><u>\$ 20,237,448</u></u>	<u><u>\$ 26,079,960</u></u>

5. DISTRIBUTIONS PAYABLE

SBRHA contracts with certain primary care physicians who agree to case manage all medical services provided to members assigned to them. For physicians thus contracted, SBRHA withholds 20% of the fixed monthly capitation payment otherwise due to the physicians. The 20% withheld plus other amounts included by SBRHA represent the physician's incentive pool, which is paid out to the physicians based on their ability to meet certain predetermined utilization and quality measures. In accordance with those physician agreements, SBRHA has accrued distributions payable of \$1,604,276 and \$1,457,265 as of June 30, 2003 and 2002, respectively.

6. COMMITMENTS AND CONTINGENCIES

Legal proceedings may arise from the normal conduct of business, but in the opinion of management and legal counsel, the ultimate dispositions of these matters will not have a materially adverse effect on the financial position or results of operations of SBRHA.

The following is a schedule of future minimum lease payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year at June 30, 2003:

2004	\$ 427,488
2005	59,565
2006	48,858
2007	21,662
Thereafter	<u> </u>
Total minimum lease payments	<u><u>\$ 557,573</u></u>

Rental expense (which includes office space and various equipment) for the years ended June 30, 2003 and 2002 was \$685,377 and \$682,020, respectively.

7. RETIREMENT PLANS

Defined Benefit Plan:

Plan Description—Effective January 1, 1997, SBRHA entered into a contract with the California Public Employee Retirement System (“CalPERS”), a multiple-employer public employee retirement system that acts as a common investment and administrative agent for participating public entities within the State of California. A menu of benefit provisions as well as other requirements is established by State statutes within California Public Employee Retirement Law. SBRHA selects optional benefit provisions from the benefit menu by contract with CalPERS and adopts those benefits through Board of Directors (the “Board”) authorization.

CalPERS issues a separate comprehensive annual financial report. Copies of the CalPERS annual financial report may be obtained from the CalPERS Executive Office at 400 P Street, Sacramento, California 95814.

All regular SBRHA employees with greater than 1,000 hours scheduled are eligible to participate in CalPERS. Benefits vest after five years of service. Employees who retire at or after age 50, with five years of credited service, are entitled to an annual retirement benefit, payable monthly for life, in an amount based on the average monthly pay rate during the highest consecutive 36 months of employment that varies from 1.09% at age 50 to a maximum of 2.42% at age 63 for each year of credited service. The system also provides for death and survivor’s benefits.

Funding Policy—Active plan members in the SBRHA defined benefits plan (the “Plan”) are required to contribute 7% of their annual covered salary. SBRHA is required to contribute the actuarially determined remaining amounts necessary to fund the benefits for its members. The actuarial methods and assumptions used are those adopted by the CalPERS Board of Administration. The required employer contribution rate for fiscal years 2003 and 2002 was 8.30% and 8.21%, respectively. The contribution requirements of Plan members are established by State statute, and the employer contribution rate is established and may be amended by CalPERS.

Annual Pension Cost—For the years ended June 30, 2003 and 2002, SBRHA’s annual pension cost was \$857,856 and \$844,160, respectively, of which \$466,595 and \$455,607, respectively, were contributed by SBRHA and the remainder was contributed by the employees. This represents 15.17% and 15.21% of SBRHA’s covered payroll for the respective years. The required contribution for the years ended June 30, 2003 and 2002 was determined as part of the actuarial valuation using the entry-age-normal-actuarial-cost method, with the contributions determined as percentage of pay. The actuarial assumptions included (a) 8.25% investment rate of return (net of administrative expenses); (b) projected salary increases of 3.75% to 14.20% a year compounded annually, depending on age, service, and type of employment, attributable to inflation, and (c) merit increases. Both (a) and (b) include an inflation component of 3.5%. The actuarial value of the Plan’s assets was determined using a technique that smoothes the effect of short-term volatility in the market value of investments over a two- to five-year period depending on the size of investment gains and/or losses. The Plan’s unfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on a closed basis. The remaining amortization period at June 30, 2002 was 15 years.

Three-Year Trended Information

Fiscal Year Ended June 30,	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
2001	782,483	100	-
2002	844,160	100	-
2003	857,856	100	-

Schedule of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability (AAL) - Entry Age	Unfunded AAL (UAAL)	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
June 30, 1999	1,956,321	3,161,406	1,205,085	62	4,696,007	26
June 30, 2000	3,006,301	4,166,934	1,160,633	72	4,818,027	24
June 30, 2001	3,912,835	5,534,428	1,621,593	71	5,302,337	61

The Board has elected to designate unrestricted net assets in an amount equal to the unfunded actuarial accrued liability.

Deferred Compensation Plan—SBRHA offers its employees a deferred compensation plan created in accordance with the Internal Revenue Code Section 457. The plan, available to employees at their option, permits participants to defer a portion of their salary until future years. The deferred compensation is not available to participants until termination, retirement, death or unforeseeable emergency. All amounts of compensation deferred under the plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property or rights are maintained (until paid or made available to the participant or beneficiary) in a trust account administered by State Street Bank and Trust. Participants have sole rights under the plan in an amount equal to the fair market value of the deferred account for each participant.

8. REGULATORY REQUIREMENTS

Under the California Knox-Keene Health Care Service Plan Act of 1975, as amended, SBRHA must comply with certain minimum capital or tangible net equity requirements. SBRHA's net worth exceeded the minimum requirement at June 30, 2003 and 2002. Additionally, SBRHA must maintain minimum investment amounts for the restricted use of the regulators, which totaled \$300,000 at June 30, 2003 and 2002.

9. BOARD-DESIGNATED FUNDS

The Board has elected to designate certain unrestricted net assets for the following:

	2003	2002
Unfunded pension costs	\$ 1,621,593	\$ 1,160,633

Unfunded pension costs designated by the Board correspond to the actuarial accrued liability associated with the SBRHA CalPERS plan, which is discussed in greater detail in Note 7.

* * * * *

SCHEDULE 1

SANTA BARBARA REGIONAL HEALTH AUTHORITY

**SCHEDULE OF REVENUES AND EXPENSES PER MEMBER PER MONTH
YEARS ENDED JUNE 30, 2003 AND 2002**

	2003		2002	
	Per Member Per Month*	As a Percentage of Capitation Revenue	Per Member Per Month**	As a Percentage of Capitation Revenue
REVENUES:				
Capitation	\$ 233.04	100.00 %	\$ 233.97	100.00 %
Interest income	0.88	0.38	1.40	0.60
Other	<u>0.83</u>	<u>0.36</u>	<u>0.61</u>	<u>0.26</u>
Total revenues	<u>234.75</u>	<u>100.74</u>	<u>235.98</u>	<u>100.86</u>
EXPENSES:				
Medical related:				
Physician case management—capitation	6.78	2.91	6.69	2.86
Physician fee-for-service	26.82	11.51	31.97	13.66
Prescription drugs and pharmaceuticals	68.80	29.52	65.46	27.98
Hospital inpatient services	34.57	14.83	40.51	17.31
Hospital outpatient services	10.57	4.54	11.10	4.75
Long-term care services	51.66	22.17	57.97	24.79
Home health care	1.73	0.74	2.03	0.87
Laboratory services	1.62	0.70	2.01	0.86
Medical supplies and equipment	2.77	1.19	3.15	1.34
Other	6.38	2.74	7.07	3.02
Health Programs	0.80	0.34	0.71	0.30
Medical cost recovery	<u>(8.11)</u>	<u>(3.48)</u>	<u>(5.19)</u>	<u>(2.22)</u>
Total medical related	<u>204.39</u>	<u>87.71</u>	<u>223.48</u>	<u>95.52</u>
General and administrative:				
Salaries and fringe benefits	11.44	4.91	11.99	5.12
Contract services	1.53	0.66	1.87	0.80
Travel and transportation	0.17	0.07	0.18	0.08
Occupancy	1.27	0.54	1.36	0.58
Office supplies and equipment	0.50	0.21	0.57	0.24
Depreciation and amortization	1.22	0.52	1.55	0.66
Other	<u>1.03</u>	<u>0.44</u>	<u>1.02</u>	<u>0.44</u>
Total general and administrative	<u>17.16</u>	<u>7.36</u>	<u>18.54</u>	<u>7.92</u>
Total expenses	<u>221.55</u>	<u>95.07</u>	<u>242.02</u>	<u>103.43</u>
REVENUES GREATER THAN (LESS THAN) EXPENSES	<u>\$ 13.20</u>	<u>5.66 %</u>	<u>\$ (6.04)</u>	<u>(2.58)%</u>

* 626,382 estimated member months

** 582,119 member months

SANTA BARBARA REGIONAL HEALTH AUTHORITY

SCHEDULE OF MEDICAL RELATED EXPENSES—ACTUAL AND BUDGET

YEAR ENDED JUNE 30, 2003

	Actual	Budgeted	Variance Over (Under) Budget
MEDICAL RELATED EXPENSES:			
Physician case mgmt—capitation	\$ 4,249,350	\$ 4,161,053	\$ 88,297
Physician fee-for-service	16,802,638	15,543,768	1,258,870
Pharmaceuticals	43,093,859	40,361,979	2,731,880
Hospital inpatient services	21,653,651	27,537,448	(5,883,797)
Hospital outpatient services	6,622,074	6,881,484	(259,410)
Skilled nursing facility	29,019,493	30,235,756	(1,216,263)
Intermediate care facility	3,339,907	3,763,665	(423,758)
Home health care	1,080,843	1,491,502	(410,659)
Laboratory services	1,013,572	1,346,993	(333,421)
Optometric services	796,740	1,038,605	(241,865)
Audiology services	365,500	401,049	(35,549)
Physical and speech therapies	211,960	317,403	(105,443)
Medical transportation	964,295	1,043,207	(78,912)
Medical supplies and equipment	1,735,853	1,868,987	(133,134)
Other health care	1,658,946	1,772,241	(113,295)
Health Program	501,579	595,931	(94,352)
Medical cost recovery	<u>(5,082,122)</u>	<u>(1,950,771)</u>	<u>(3,131,351)</u>
TOTAL MEDICAL RELATED EXPENSES	<u>\$ 128,028,138</u>	<u>\$ 136,410,300</u>	<u>\$(8,382,162)</u>

SANTA BARBARA REGIONAL HEALTH AUTHORITY

SCHEDULE OF GENERAL AND ADMINISTRATIVE EXPENSES—ACTUAL AND BUDGET
YEAR ENDED JUNE 30, 2003

	Actual	Budgeted	Variance Over (Under) Budget
GENERAL AND ADMINISTRATIVE EXPENSES:			
Salaries and wages	\$ 5,362,828	\$ 5,134,979	\$ 227,849
Fringe benefits	1,812,274	2,070,248	(257,974)
Outside services	858,731	985,690	(126,959)
Legal services	27,901	47,500	(19,599)
Auditing services	70,000	70,000	
Travel and transportation	105,357	162,382	(57,025)
Rent	634,190	660,948	(26,758)
Repairs and maintenance	72,129	69,585	2,544
Utilities	88,923	104,525	(15,602)
Equipment leases	62,131	54,355	7,776
Postage	101,971	186,830	(84,859)
Printing	55,383	58,374	(2,991)
Other office supplies and minor equipment	92,099	121,718	(29,619)
Depreciation and amortization	761,532	770,000	(8,468)
Insurance	190,783	185,485	5,298
Dues and subscriptions	35,172	43,421	(8,249)
Equipment/software maintenance	164,318	154,184	10,134
Other expenses	<u>254,532</u>	<u>320,061</u>	<u>(65,529)</u>
 TOTAL GENERAL AND ADMINISTRATIVE EXPENSES	 <u>\$ 10,750,254</u>	 <u>\$ 11,200,285</u>	 <u>\$ (450,031)</u>

(1270806)