**COUNTY OF MODOC**
**MODOC MEDICAL CENTER**
(An Enterprise Fund of the
County of Modoc, California)

Independent Auditors' Reports, Basic Financial Statements and
Required Supplementary Information,

For the Year Ended June 30, 2008

**COUNTY OF MODOC**
**MODOC MEDICAL CENTER**

**FOR THE YEAR ENDED JUNE 30, 2008**

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# INDEPENDENT AUDITORS' REPORT

The Honorable Board of Supervisors
County of Modoc, California

We have audited the accompanying financial statements of the Modoc Medical Center (the Medical Center), an enterprise fund of the County of Modoc, California (the County), as of and for the year ended June 30, 2008, 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 audit.

Except as discussed in the following paragraph, we conducted our audit 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. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Medical Center's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not observe the taking of the physical supplies inventories at June 30, 2008 (stated at $172,601), since this date was prior to the time we were initially engaged as auditors for the Medical Center. We were unable to satisfy ourselves about inventory quantities by means of other auditing procedures.

The Medical Center has classified its negative equity position with the County's Treasury Pool as negative cash and cash equivalents in the accompanying statement of net assets because management of the County of Modoc cannot determine which funds have loaned the amounts to the Medical Center. In our opinion, the negative cash and investments reported in the statement of net assets should be classified as a current liability to conform to accounting principles generally accepted in the United States of America. If the financial statements were corrected for that departure from U.S. generally accepted accounting principles, total liabilities would be increased by $11,107,188, and total assets would be increased by $11,107,188, as of June 30, 2008.

As discussed in Note 1, the financial statements of the Medical Center are intended to present the financial position and the changes in financial position and, where applicable, cash flows of only that portion of the business-type activities of the County that is attributable to the transactions of the Medical Center. They do not purport to, and do not, present fairly the financial position of the County as of June 30, 2008, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, except for the effects of classifying the negative cash and cash equivalents as a liability and the effects of such adjustments, if any, as might have been determined to be necessary had we been able to observe the physical supplies inventories taken as of June 30, 2008, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Medical Center as of June 30, 2008, 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.

The accompanying financial statements have been prepared assuming that the Medical Center will continue as a going concern. As discussed in Note 2 to the financial statements, the Medical Center's significant operating losses and accumulated net deficit raise substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As described in Note 1 to the financial statements, the Medical Center adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra–Entity Transfers*, and Governmental Accounting Standards Board (GASB) Statement No. 50, *Pension Disclosures—an amendment of GASB Statements No. 25 and No. 27*, in 2008.

In accordance with *Government Auditing Standards*, we have also issued our report dated __________, 2011 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 audits.

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.

Rancho Cucamonga, California
__________, 2011

**COUNTY OF MODOC**
**MODOC MEDICAL CENTER**

**STATEMENT OF NET ASSETS**

**JUNE 30, 2008**

| | |
|---|---|
| ASSETS | |
| Current Assets: | |
| Cash and cash equivalents | $ (11,107,188) |
| Patient accounts receivable, net of estimated uncollectibles of $2,315,159 | 2,258,718 |
| Due from third-party payors | 368,648 |
| Receivable from other governments | 116,691 |
| Contributions receivable | 500,000 |
| Supplies inventories | 172,601 |
| Prepaid expenses and other assets | 79,975 |
| Total Current Assets | (7,610,555) |
| Noncurrent Assets: | |
| Restricted cash and investments | 47,354 |
| Capital assets, net of accumulated depreciation of $4,276,994 | 2,198,654 |
| Total Noncurrent Assets | 2,246,008 |
| Total Assets | (5,364,547) |
| LIABILITIES | |
| Current Liabilities: | |
| Accounts payable | 711,259 |
| Accrued salaries and benefits | 241,320 |
| Accrued compensated absences | 26,080 |
| Other accrued liabilities | 5,520 |
| Capital lease obligations | 303,432 |
| Total Current Liabilities | 1,287,611 |
| Noncurrent Liabilities: | |
| Long-term compensated absences | 234,721 |
| Capital lease obligations, less current installments | 283,184 |
| Total Noncurrent Liabilities | 517,905 |
| Total Liabilities | 1,805,516 |
| NET ASSETS | |
| Invested in capital assets, net of related debt | 1,612,038 |
| Restricted for capital acquisitions | 547,354 |
| Unrestricted | (9,329,455) |
| Total Net Assets | $ (7,170,063) |

See accompanying notes to basic financial statements.

**COUNTY OF MODOC**
**MODOC MEDICAL CENTER**

**STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS**

**FISCAL YEAR ENDED JUNE 30, 2008**



| | |
|---|---|
| OPERATING REVENUES | |
| Net patient service revenue | $ 9,465,267 |
| Other | 61,765 |
| Total Operating Revenues | 9,527,032 |
| OPERATING EXPENSES | |
| Salaries and benefits | 5,989,653 |
| Supplies | 1,038,291 |
| Professional services | 3,019,401 |
| Purchased services | 853,925 |
| Insurance | 200,221 |
| Repairs and maintenance | 147,586 |
| Utilities | 261,615 |
| Depreciation | 263,838 |
| Rent | 117,520 |
| Other | 332,091 |
| Total Operating Expenses | 12,224,141 |
| Operating Loss | (2,697,109) |
| NONOPERATING REVENUES (EXPENSES) | |
| Investment income | 8,686 |
| Interest expense on debt | (294,105) |
| Other revenues (expenses) | (47,138) |
| Noncapital grants and contributions | 143,250 |
| Total Nonoperating Revenues (Expenses), Net | (189,307) |
| Excess (deficiency) of revenues over expenses before capital contributions | (2,886,416) |
| Capital contributions | 713,812 |
| Changes in Net Assets | (2,172,604) |
| Net Assets, Beginning of Year, as restated | (4,997,459) |
| Net Assets, End of Year | $ (7,170,063) |

See accompanying notes to basic financial statements.

**COUNTY OF MODOC**
**MODOC MEDICAL CENTER**

**STATEMENT OF CASH FLOWS**

**FISCAL YEAR ENDED JUNE 30, 2008**



| | |
|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | |
| Receipts from and on behalf of patients | $ 8,694,526 |
| Payments to suppliers and contractors | (5,741,936) |
| Payments to employees | (5,875,469) |
| Other receipts and payments, net | 61,765 |
| Net Cash Used in Operating Activities | (2,861,114) |
| CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES | |
| Interest paid loan from the County | (287,542) |
| Other nonoperating income (expense) | 96,112 |
| Net Cash Provided by Noncapital Financing Activities | (191,430) |
| CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES | |
| Purchase of capital assets | (297,007) |
| Capital and grant contributions | 210,312 |
| Principal payments on capital lease obligations | (180,847) |
| Interest paid on debt | (6,563) |
| Net Cash Used in Capital and Related Financing Activities | (274,105) |
| CASH FLOWS FROM INVESTING ACTIVITIES | |
| Interest on investments | 8,686 |
| Investment activity, net | 206,310 |
| Net Cash Provided by Investing Activities | 214,996 |
| Increase (Decrease) in Cash and Cash Equivalents | (3,111,653) |
| Cash and Cash Equivalents, Beginning of Year | (7,995,535) |
| Cash and Cash Equivalents, End of Year | $ (11,107,188) |

See accompanying notes to basic financial statements.

**COUNTY OF MODOC**
**MODOC MEDICAL CENTER**

**STATEMENT OF CASH FLOWS, Continued**

**FISCAL YEAR ENDED JUNE 30, 2008**



| | |
|---|---|
| RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES | |
| Operating Loss | $ (2,697,109) |
| Adjustments to reconcile operating loss to net cash used in operating activities: | |
| Depreciation and amortization | 263,838 |
| Decrease (Increase) in: | |
| Patient accounts receivable | (651,702) |
| Due from third-party payors | (10,835) |
| Receivables from other governments | (108,204) |
| Supplies inventories | (19,901) |
| Prepaid expenses and other assets | 40,742 |
| Increase (Decrease) in: | |
| Accounts payable and other accrued expenses | 207,873 |
| Accrued salaries and benefits | 88,104 |
| Accrued compensated absences | 26,080 |
| Net Cash Used in Operating Activities | $ (2,861,114) |

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES:

The Medical entered into capital lease obligations of $766,437 for new equipment in 2008.

See accompanying notes to basic financial statements.

## *NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES*

A. General

Modoc Medical Center (the Medical Center) is a component unit of Modoc County (the County), California, created in the early 1900's for the purpose of providing health care services to the County's residents. The Medical Center is an 87 bed facility which provides acute care, skilled nursing care, 24 hour emergency care and other inpatient and outpatient healthcare services.

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 imply 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.

The Medical Center's statement of revenues, expenses and changes in net assets distinguishes between operating and nonoperating revenues and expenses. Operating revenues result from exchange transactions associated with providing health care services - the Medical Center's principal activity. Nonexchange revenues, including grants and contributions received for purposes other than capital asset acquisition, are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide health care services, other than financing costs.

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.

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.

*NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)*

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.

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. Cash and Cash Equivalents

For purposes of the Statement of Cash Flows, the Medical Center considered all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Medical Center maintains the majority of its cash on deposit with the County Treasurer.

H. Restricted Cash and Investments

Restricted cash and investments represent funds held by the hospital that are either legally restricted or restricted through donor agreements.

I. Grants and Contributions

From time to time, the Medical Center receives federal grants as well as contributions from individuals and private organizations. Revenues from grants and contributions (including contributions of capital assets) are recognized when all eligibility requirements, including time requirements are met. Grants and contributions may be restricted for either specific operating purposes or for capital purposes. Amounts that are unrestricted or that are restricted to a specific operating purpose are reported as nonoperating revenues. Amounts restricted to capital acquisitions are reported after nonoperating revenues and expenses.

J. Supplies Inventories

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

*NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)*

K. 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 |

L. Compensated absences

The Medical Center's employees earn vacation benefits at varying rates depending on years of service. Employees also earn sick leave benefits based on varying rates depending on years of service. Both benefits call accumulate up to specified maximum levels. Employees are not paid for accumulated sick leave benefits if they leave either upon termination or before retirement. However, accumulated vacation benefits are paid to an employee upon either termination or retirement.

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. When the Medical Center has both restricted and unrestricted resources available to finance a particular program, it is the Medical Center's policy to use restricted resources before unrestricted resources.

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. Prepaid Items

Certain payments to vendors reflect costs applicable to future accounting periods and are recorded as prepaid items in both government-wide and fund financial statements. The consumption method is used by the Medical Center to report prepaids.

P. Implementation of Governmental Accounting Standards Board Statements

The Governmental Accounting Standards Board (GASB) releases new accounting and financial reporting standards which may have a significant impact on the Medical Center's financial reporting process. The following pronouncements were implement for the year ended June 30, 2008:

*Government Accounting Standards Board Statement No. 48*

For the fiscal year ended June 30, 2008, the Medical Center implemented GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenue and Intra-Entity Transfers of Assets*.

GASB Statement No. 48 establishes accounting and financial reporting standards for transactions in which a government receives, or is entitled to, resources in exchange for future cash flows generated by collecting specific future revenues. It also contains provisions that apply to certain situations in which a government does not receive resources but, nevertheless, pledges or commits future cash flows generated by collecting specific future revenues. In addition, this Statement establishes accounting and financial reporting standards that apply to all intra-entity transfers of assets and future revenues. This Statement does not apply to a government's pledge of its "full faith and credit" as security for its own debt of a component unit. The requirements of this Statement apply to the financial statements of all state and local governments. This statement does not have a material impact in the Medical Center's financial statements.

*Government Accounting Standards Board Statement No. 50*

For the fiscal year ended June 30, 2008, the Medical Center implemented GASB Statement No. 50, *Pension Disclosures-an amendment of GASB statements No. 25 and No. 27.*

GASB Statement No. 50 amends GASB Statement No. 27 to require employers participating in a cost sharing plan to include the following in the note disclosure: the required contribution rates of the employer in dollars and the percentage of that amount contributed for the current year and each of the two preceding years, and how the contractually required contribution rate is determined (for example, by statute or by contract, or on an actuarially determined basis) or that the cost sharing plan is financed on a pay-as-you-go basis. As discussed at Note 12 the Medical Center participates in the County of Modoc's pension plans, this standard will not have a direct and material effect on the financial statements.

*NOTE #1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)*

P. Implementation of Governmental Accounting Standards Board Statements, (Continued)

*Governmental Accounting Standard No. 55*

In March 2008, The GASB issued Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The objective of this Statement is to incorporate the hierarchy of general accepted accounting principles (GAAP) for state and local governments into the Governmental Accounting Standards Board's (GASB) authoritative literature. The implementation had no effect on the financial statements.

*Governmental Accounting Standard No. 56*

In March 2008, The GASB issued Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*. The objective of this Statement is to incorporate into the Governmental Accounting Standards Board's (GASB) authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statements on Auditing Standards. The implementation had no effect on the financial statements.

*NOTE #2 – GOING CONCERN*

As indicated in the accompanying financial statements, the Medical Center incurred a decrease in net assets of $2,172,604 during the year ended June 30, 2008. As of that date, the Medical Center's current liabilities exceeded its current assets by $8,898,166 and its total liabilities exceeded its total assets by $7,170,063. As of June 30, 2008, the Medical Center has a cash overdraft of $11,112,408 due to the County. Those factors, as well as the uncertain conditions that the Medical Center faces regarding its cash deficit position (as discussed in Note 10), create an uncertainty about the Medical Center's ability to continue as a going concern. Management of the Medical Center is developing a plan to reduce its liabilities through the increase of patient services, improved billing and collection efforts, and short period financing. A new healthcare district was formed on August 31, 2010. See Note 16. The ability of the Medical Center to continue as a going concern is dependent on acceptance of a plan by the County of Modoc Board of Supervisors, and the plan's success. The financial statements do not include any adjustments that might be necessary if the Medical Center is unable to continue as a going concern.

*NOTE #3 – PRIOR PERIOD ADJUSTMENT*

During the current year, it was determined that certain prior year revenues totaling $226,895 were not accrued as of June 30, 2007 and were incorrectly recorded as revenue for the year ended June 30, 2008. To correct this error, current year net patient revenues have been decreased, and the beginning net deficit of $5,224,354, as originally reported, has been decreased to $4,997,459.

*NOTE #4 – 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 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 County Treasury pool did not include any derivative securities in 2008.

Investment policies and related credit, custodial credit, concentration of credit, and interest rate 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 investments as of June 30, 2008 consisted of the following:

| | |
|---|---|
| Cash with County Treasurer | $ (11,112,408) |
| Cash and cash equivalents | 4,345 |
| Petty cash | 875 |
| Total Cash and Investments | $ (11,107,188) |

The Medical Center's restricted cash and investments as of June 30, 2008 consisted of the following:

| | |
|---|---|
| Capital Improvement - Warnerview | $ 33,855 |
| Hospital Restricted Funds - Auxiliary | 8,947 |
| Employee FSA Account | 720 |
| Patient Trust Account | 3,832 |
| Total Restricted Cash and Investments | $ 47,354 |

**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 financial institutions in excess of federal depository insurance limits held in uncollateralized accounts at June 30, 2008.

*NOTE # 5 – ACCOUNTS RECEIVABLE AND PAYABLE*

Patient accounts receivable and accounts payable (including accrued expenses) reported as current assets and liabilities by the Medical Center at June 30, 2008 consisted of these amounts:

Patient Accounts Receivable

| | | |
|---|---|---|
| Receivable from patients and their insurance carriers | $ | 1,519,273 |
| Receivable from Medicare | | 1,930,979 |
| Receivable from Medi-Cal | | 1,123,625 |
| Total patient accounts receivable | | 4,573,877 |
| Less allowance for uncollectibles amounts | | (2,315,159) |
| Patient accounts receivable, net | $ | 2,258,718 |

Accounts Payable and Accrued Expenses

| | | |
|---|---|---|
| Payable to employees (including payroll taxes) | $ | 241,320 |
| Payable to suppliers | | 711,259 |
| Other | | 5,520 |
| Total accounts payable and accrued expenses | $ | 958,099 |

*NOTE #6 – NET PATIENT SERVICE REVENUE*

The Medical Center provides services to eligible patients under Medi-Cal and Medicare programs. For the fiscal year ended June 30, 2008, the Medi-Cal program represented approximately 40 percent, and the Medicare program represented approximately 33 percent 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, 2008 for Medicare and June 30, 2008, for Medi-Cal. Adjustments as a result of such audits are recorded in the year the amounts can be determined.

*NOTE #6 – NET PATIENT SERVICE REVENUE, (CONTINUED)*

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 $287,529 in AB-915 funds for the year ended June 30, 2008. 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.

*NOTE #7 – CHARITY CARE*

The amount of charges foregone for services and supplies furnished under the Medical Center's charity care policy aggregated approximately $23,800 for the year ended June 30, 2008.

*NOTE #8 – CAPITAL ASSETS*

A summary of capital assets activity for the year ended June 30, 2008 is as follows:

| | Beginning Balance | Additions | Deletions | Ending Balance |
|---|---|---|---|---|
| Capital assets not being depreciated: | | | | |
| Land and improvements | $ 99,528 | | | $ 99,528 |
| Construction-in-progress | 5,000 | $ 10,494 | $ (5,000) | 10,494 |
| Total capital assets not being depreciated | 104,528 | 10,494 | (5,000) | 110,022 |
| Capital assets being depreciated: | | | | |
| Equipment | 1,916,845 | 1,014,121 | $ (11,087) | 2,919,879 |
| Buildings and improvements | 3,398,289 | 47,458 | | 3,445,747 |
| Total capital assets being depreciated | 5,315,134 | 1,061,579 | (11,087) | 6,365,626 |
| Less Accumulated Depreciation: | | | | |
| Buildings and improvements | (2,394,695) | (109,492) | | (2,504,187) |
| Equipment | (1,629,418) | (154,346) | 10,957 | (1,772,807) |
| Total Accumulated Depreciation | (4,024,113) | (263,838) | 10,957 | (4,276,994) |
| Capital Assets, Net | $ 1,395,549 | $ 808,235 | $ (5,130) | $ 2,198,654 |

Depreciation expense included in depreciation on the statement of revenues, expenses and changes in net assets for the year ended June 30, 2008 is $263,838.

*NOTE #9 – CAPITAL CONTRIBUTIONS*

On April 15, 2008, the Medical Center received from the Mark and Jessie Milano Foundation a pledged contribution of $500,000 for the acquisition of a Computed Tomography (CT) Scanner and Ultrasound equipment. The Medical Center's board accepted the donation on April 15, 2008. The proceeds of the donation were subsequently received on July 1, 2008 and March 26, 2009, in the amounts of $250,000 and $250,000, respectively. The contribution has been recorded as Contribution Receivable in the Statement of Net Assets in the amount of $500,000.

*NOTE #10 – TRANSACTIONS WITH THE COUNTY*

The Medical Center uses the treasury function of the County and currently has a cash overdraft with the County which is being repaid only through collection of receivables. There is currently no official borrowing agreement between the County and the Medical Center that provides for formal repayment of the inter-fund borrowing. As a result, the County cannot identify which funds were used to advance cash to the Medical Center. As of June 30, 2008, the Medical Center has a cash overdraft of $11,112,408 due to the County. This balance is classified as negative cash on the Statement of Net Assets, which is a departure from generally accepted accounting principles (GAAP).

The Hospital has suffered considerable operating losses and a deficiency in cash flow to meet current obligations and has an accumulated net deficit of $7,170,063. The Hospital has been subsidized by the County to meet financial obligations and the current amount due to the County is $11,112,408 at June 30, 2008. See Note #2.

*NOTE #11 – LONG-TERM OBLIGATIONS*

The following is a summary of changes in long-term obligations for the fiscal year ended June 30, 2008:

| | June 30, 2008 | | | | |
|---|---|---|---|---|---|
| | Beginning Balance | Additions | Reductions | Ending Balance | Due within One Year |
| Compensated absences | $ 214,912 | $ 45,889 | | $ 260,801 | $ 26,080 |
| Capital lease obligations | 1,026 | 766,437 | $ (180,847) | 586,616 | 303,432 |
| Total | $ 215,938 | $ 812,326 | $ (180,847) | $ 847,417 | $ 329,512 |

*NOTE #11 – LONG-TERM OBLIGATIONS, (CONTINUED)*

A. Capital Lease Obligations

The Medical Center has various lease agreements with financial institutions and medical equipment manufacturers expiring at various dates through April 2013, 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, 2008, are as follows:

| Fiscal Year | | |
|---|---|---|
| 2009 | $ | 315,333 |
| 2010 | | 78,573 |
| 2011 | | 78,573 |
| 2012 | | 78,573 |
| 2013 | | 71,652 |
| Total minimum lease payments | | 622,704 |
| Less Amount Representing Interest | | 36,088 |
| Present value of net minimum lease payments | | 586,616 |
| Less Current Portion of Capital Lease Obligations | | 303,432 |
| Capital lease obligations, excluding current portion | $ | 283,184 |

The net book value of equipment acquired under capitalized leases at June 30, 2008 was $709,182, net of accumulated amortization of $65,699.

*NOTE #12 – DEFINED BENEFIT PENSION PLANS*

CalPERS Pension Plan

The Medical Center participates in the County of Modoc’s defined benefit pension plan administered by the State of California Public Employees' Retirement System (PERS), an agent multiple-employer public employee retirement system that acts as a common investment and administrative agent for California cities and governmental jurisdictions, which participate in this retirement plan.

Rates for the County's contributions are set by the State based upon annual experience of County members and on periodic actuarial valuations. The contribution rate for the Medical Center is established by the County of Modoc.

The Medical Center pays 6.25 percent of the employees’ required 7 percent member contribution. In addition, the County contributes 9.96% of the member’s contribution. The rates are set by statute and therefore remain unchanged from year to year.

*NOTE #12 – DEFINED BENEFIT PENSION PLANS*

CalPERS Pension Plan, (Continued)

For the fiscal year ended June 30, 2008, the Medical Center was required to contribute $523,046 to the County of Modoc for the plan.

Information is not available separately for the Medical Center as to the funding policy, annual pension cost, and required supplementary information related to funding progress and trend information. Refer to the County's basic financial statements for further information.

LIUNA Pension Plan

*Plan Description* - The Medical Center participates in the County of Modoc's contribution to the Laborers' International Union of North America Pension Fund (LIUNA). The plan is managed by LIUNA as a cost-sharing employer plan. LIUNA is a joint labor-management trust maintained in accordance with the Labor Management Relations ("Taft-Harley") Act and is subject to the provisions of the Internal Revenue Code. LIUNA is administered by a Board of Trustees.

Requests for additional plan provisions and financial reports may be obtained from Laborers' National (Industrial) Pension Fund located at 905 16th Street N.W., Washington DC 20006-1765.

LIUNA provides regular pension, early retirement, deferred and disability benefits. Medical Center employees are eligible for regular pension benefits from LIUNA upon having attained age 62, earned at least five years of pension credit, and earned at least one year of pension credit during the period that his or her employer is contributing to LIUNA.

The benefits paid to eligible members are determined by the highest contribution rate at which he or she earned pension credit (years). The contribution rate is negotiated by the County and each bargaining unit (General, Safety, Medical Center, etc) as documented in a Memorandum of Understanding (MOU).

*Funding Policy* **–** Per the MOUs the County is required to contribute $58, $108 and $10 per month per General, Safety and Medical Center employee, respectively. Employee contributions are not required or accepted by LIUNA. The rates are established by LIUNA in accordance with the Rules and Regulations of the pension fund. The County's contribution rate and the corresponding benefits to County employees are determined by the bargaining process.

The County's annual pension cost was equal to the County's contractually required contributions.

Information is not available separately for the Medical Center as to the funding policy, annual pension cost, and required supplementary information related to funding progress and trend information. Refer to the County's financial statements for further information.

*NOTE 13 – RETIREE MEDICAL PLAN - OTHER POSTEMPLOYMENT BENEFITS*

In addition to the pension benefits described in Note 12, the County provides postemployment health care benefits, on behalf of the Medical Center, in accordance with the health care regulations of the Public Employees Retirement System, to Confidential Management Employees who retire from the Medical Center on or after attaining age 55 with at least five years vested.

*NOTE #14 – SELF-INSURANCE*

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

The Medical Center purchases commercial malpractice liability insurance on an occurrence basis. The policy coverage is $3,000,000 per occurrence for acute hospital services and $1,000,000 per occurrence for the skilled nursing facility, with a $10,000 deductible for both. There is an aggregate limitation of $10,000,000 for acute hospital services and $3,000,000 for the skilled nursing facility. The Medical Center accrues the deductible for all open claims.

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 year ended June 30, 2008 was $200,221.

*NOTE #15 – COMMITMENTS AND CONTINGENCIES*

<u>Litigation</u>

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.

<u>Grants</u>

The Medical center recognizes as revenue or contributions, grant monies received as reimbursement for costs incurred in certain Federal and State programs it administers. Amounts received or receivable from grantor agencies are subject to audit and adjustment by grantor agencies, principally the Federal government. Any disallowed claims, including amounts already collected, may constitute a liability. The amount, if any, of expenditures which may be disallowed by the grantor cannot be determined at this time although the Medical Center expects such amounts, if any, to be immaterial.

*NOTE #15 – COMMITMENTS AND CONTINGENCIES, (CONTINUED)*

Current Economic Conditions

Current economic conditions, including the rising unemployment rate, have made it difficult for a certain number of patients to pay for services rendered. As employers make adjustments to health insurance plans or more patients become unemployed, services provided to self-pay and other payers may significantly impact net patient service revenue, which could have an adverse impact on the Medical Center's future operating results. Further, the effect of economic conditions on the state may have an adverse effect on cash flows related to the Medi-Cal program.

Given the volatility of current economic conditions, the values of assets and liabilities recorded in the financial statements could change in the future, resulting in future adjustments in investment values and allowances for accounts and contributions receivable that could negatively impact the Medical Center.

*NOTE #16 – NEW ACCOUNTING PRONOUNCEMENTS*

The Governmental Accounting Standards Board (GASB) releases new accounting and financial reporting standards which may have a significant impact on the Medical Center's financial reporting process. Future new standards which may impact the Medical Center include the following:

*Governmental Accounting Standard No. 45*

In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This statement addresses how state and local governments should account for and report costs and obligations related to postemployment healthcare and other nonpension benefits. Annual OPEB cost for most employers will be based on actuarially determined amounts that, if paid on an ongoing basis, generally would provide sufficient resources to pay benefits as they come due. This statement's provisions may be applied prospectively and do not require governments to fund their OPEB plans. This statement also establishes disclosure requirements for information about the plans in which an employer participates, the funding policy followed, the actuarial valuation process and assumptions, and, for certain employers, the extent to which the plan has been funded over time. The requirements of this Statement are effective for financial statements for periods beginning after June 30, 2008 (June 30, 2009). The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 49*

In November 2006 the GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations.* This Statement addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of *existing* pollution by participating in pollution remediation activities such as site assessments and cleanups. The requirements of this Statement are effective for financial statements for periods ending June 30, 2009. The Medical Center has not determined its effect, if any, on the financial statements.

*NOTE #16 – NEW ACCOUNTING PRONOUNCEMENTS, (CONTINUED)*

*Governmental Accounting Standard No. 51*

In June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets.* This Statement requires that all intangible assets not specifically excluded by its scope provisions be classified as capital assets. This Statement requires that an intangible asset be recognized in the statement of net assets only if it is considered identifiable. This Statement also establishes guidance specific to intangible assets related to amortization. This Statement provides guidance on determining the useful life of intangible assets when the length of their life is limited by contractual or legal provisions. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2008. The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 52*

In November 2007, The GASB issued Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. This Statement establishes consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported at fair value. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2008 (June 30, 2009). The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 53*

In June 2007, The GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.* This Statement is intended to improve how state and local governments report information about derivative instruments—financial arrangements used by governments to manage specific risks or make investments—in their financial statements. The Statement specifically requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting. The guidance in this Statement also addresses hedge accounting requirements. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2008, with earlier application encouraged. The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 54*

In March 2009, the GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions.* The objective of this Statement is to enhance the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2010. Early implementation is encouraged. The Medical Center has not determined its effect, if any, on the financial statements.

*NOTE #16 – NEW ACCOUNTING PRONOUNCEMENTS, (CONTINUED)*

*Governmental Accounting Standard No. 57*

In December 2009, the GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. This statement addresses issued related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plan. This statement is effective for periods beginning after June 15, 2011. The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 58*

In December 2009, the GASB issued Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*. This statement provides accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. This statement is effective for periods beginning after June 15, 2009. The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 59*

In June 2010, the GASB issued Statement No. 59, *Financial Instruments Omnibus*. This statement updates and improves existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. This is effective for periods beginning after June 15, 2010. The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 61*

In December 2010, the GASB issued Statement no. 61, *The Financial Reporting Entity: Omnibus*. This statement addresses the requirements of financial reporting entity financial statements being more relevant by improving guidance for including, presenting, and disclosing information about component units and equity interest transactions of a financial reporting entity. This statement is effective for period beginning after June 15, 2012. The Medical Center has not determined its effect, if any, on the financial statements.

*Governmental Accounting Standard No. 62*

In December 2010, the GASB issued Statement no. 61, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. This statement incorporates into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the following pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements:

1. Financial Accounting Standards Board (FASB) Statements and Interpretations
2. Accounting Principles Board Opinions
3. Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure.

*NOTE #16 – NEW ACCOUNTING PRONOUNCEMENTS, (CONTINUED)*

*Governmental Accounting Standard No. 62, Continued*

This Statement also supersedes Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* thereby eliminating the election provided in paragraph 7 of that Statement for enterprise funds and business-type activities to apply post-November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. However, those entities can continue to apply, as other accounting literature, post-November 30, 1989 FASB pronouncements that do not conflict with or contradict GASB pronouncements, including this Statement. This statement is effective for period beginning after December 15, 2011. The Medical Center has not determined its effect, if any, on the financial statements.

*NOTE #17 – SUBSEQUENT EVENTS*

Cost Report Settlements

Prior to the issuance of the financial statements, the Medical Center has received final settlements for its June 30, 2009 Medicare Cost Reports. The final settlement due to the Medicare program is $765,752. The Centers for Medicare and Medicaid approved a repayment plan for the Medical Center. The terms of the repayment plan allow the Medical Center to repay the settlements in 57 equal monthly installment totaling $16,731 commencing on April 5, 2010 at an interest rate of 10.875 percent. Total payments aggregate approximately $953,720.

The Medical Center also received final settlements for its June 30, 2010 Medicare Cost Reports. The final settlements due to the Medicare program are $1,025,634. The Centers for Medicare and Medicaid approved a repayment plan for the Medical Center to repay $455,026 at an interest rate of 11.250 percent in 55 equal monthly installments of $10,157 totaling $601,520 commencing on August 23, 2010. In addition, two other repayment plans were approved for $490,610 and $79,998. The terms of the repayment plan allow the Medical Center to repay the settlements in 55 equal monthly installment of $12,526 totaling $739,000 commencing on November 5, 2010 at an interest rate of 10.875 percent. Total payments aggregate approximately $1,340,520.

Capital Lease

On June 17, 2009, the Medical Center entered into a 36 month capital lease in the amount of $245,678, including interest and services charges, to finance the acquisition of surgery equipment. Delivery of equipment took place in July 2009, and repayment commences on July 31, 2009.

*NOTE #17 – SUBSEQUENT EVENT, (CONTINUED)*

Formation of Hospital District

On August 31, 2010, two measures were passed that 1) formed the Last Frontier Hospital District; and 2) created a special assessment of $195 per unique property owner within the newly formed district to fund operations of the Medical Center. The district formation includes all operations of the Medical Center. The District officially filed papers with the Board of Equalization and was considered a separate legal entity on October 12, 2010. The County and the District have an interim Operations Agreement in place, and are currently formalizing a Transfer Agreement that will terminate all County responsibility for operation of the hospital, and transfer responsibility formally to the District.

Seismic Requirement

In 1994, the California Legislature enacted SB 1953 as an unfunded mandate for all acute care medical facilities to meet strict structural requirements in order to remain open during a severe seismic event. The Medical Center's survey revealed that the main building required replacement, but at this time, the skilled nursing facility and the rural health clinic does not meet this requirement. Under SB 306, Health and Safety Code Section 130061.5 authorized the granting of extensions for city and county hospitals or for certain hospitals that meet strict financial hardship an extension until January 1, 2020. Facilities approved for the extension must comply with several criteria in order to maintain their eligibility. The Center was granted an extension and the extension was approved by the Office of Statewide Health Planning and Development (OSHPD) to transfer to the newly formed Last Frontier Healthcare District doing business as Modoc Medical Center.

The initial evaluation determined that it would be more costly to retro-fit than it would be to build a new facility. In addition, the Federal Emergency Management Agency (FEMA) has declared the existing site of the Medical Center to be in a flood zone. Accordingly, the Medical Center's intent is to build a new facility.

To assist in completing this project, the Modoc Frontier Healthcare Association (MFHA) was formed. Members include the City of Alturas, the County of Modoc, and Native American groups including Strong Family Health, Cedarville Rancheria, and Fort Bidwell Reservation. MFHA is in the process of a grant funded feasibility study to identify the needs of healthcare for the region. Also in process are site selection and negotiations to secure a land swap of the desired property when identified.

# OTHER REPORT

**INDEPENDENT AUDITORS' 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 Modoc, California

We have audited the financial statements of Modoc Medical Center (the Medical Center) an enterprise fund of the County of Modoc, California, as of and for the year ended June 30, 2008, and have issued our report thereon dated _______________. The report was qualified because the negative cash and investments presented in the statement of net assets should be classified as a current liability to conform to accounting principles generally accepted in the United States of America, and because we did not observe the physical supplies inventory at June 30, 2008. Our report contained explanatory paragraphs describing how the Medical Center's significant operating losses and accumulated net deficit raise substantial doubt about its ability to continue as a going concern, the Medical Center's adoption of the provisions of Governmental Accounting Standards Board (GASB) Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra–Entity Transfers*, and Governmental Accounting Standards Board (GASB) Statement No. 50, *Pension Disclosures—an amendment of GASB Statements No. 25 and No. 27*, in 2008 and the omission of management's discussion and analysis as required supplementary information. We conducted our audit 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Medical Center's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Medical Center's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings and questioned costs, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying schedule of findings and questioned costs as items 2008-01 and 2008-07 to be material weaknesses.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompany schedule of findings and questioned costs as items 2008-08 and 2008-09 to be significant deficiencies.



**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*.

We noted certain matters that we reported to management of the Medical Center, in a separate letter dated ______________.

The Medical Center's responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the Medical Center's response and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of management, Board of Supervisors, others within the entity, and the California State Controller's Office and is not intended to be and should not be used by anyone other than these specified parties

Rancho Cucamonga, California
_______________

**SCHEDULE OF FINDINGS AND RESPONSES**
**JUNE 30, 2008**



The following findings represent significant deficiencies, material weaknesses, and/or instances of noncompliance related to the financial statements that are required to be reported in accordance with *Government Audit Standards.*

**Finding 2008-01**

**FINANCIAL CONDITION OF THE MEDICAL CENTER – GOING CONCERN**

**Criteria or Specific Requirement:**

The Medical Center is responsible for the development; implementation and monitoring of the budget and internal control systems to protect the ongoing financial health of its operations.

**Condition Found:**

*Material Weakness* - The Medical Center is currently in a severe financial crisis. As indicated in the accompanying financial statements, the Medical Center incurred a decrease in net assets of $2,172,604 during the year ended June 30, 2008. As of that date, the Medical Center's current liabilities exceeded its current assets by $8,898,166 and its total liabilities exceeded its total assets by $7,170,063. As of June 30, 2008, the Medical Center has a cash overdraft of $11,112,408 due to the County. Those factors, as well as the uncertain conditions that the Medical Center faces regarding its cash deficit position (as discussed in Note 10), create an uncertainty about the Medical Center's ability to continue as a going concern. Management of the Medical Center is developing a plan to reduce its liabilities through the increase of patient services, improved billing and collection efforts, and short period financing. A local citizen group is also campaigning for the creation of a healthcare district. See Subsequent Event footnote in the basic financial statements. The ability of the Medical Center to continue as a going concern is dependent on acceptance of a plan by the County of Modoc Board of Supervisors, and the plan's success. The financial statements do not include any adjustments that might be necessary if the Medical Center is unable to continue as a going concern.

**Context:**

The County does not have adequate resources to repay the funds which have been taken from the Investment Pool.

**Effect:**

The financial condition of the County has been severely impacted.

**Cause:**

The County has funded several years of deficit spending with resources that were taken from the Investment Pool. These resources were used to fund the continued operations of the County, primarily the Modoc Medical Center.

**Recommendation:**

The County must continue to develop and implement a recovery plan.

**Views of Responsible Officials and Planned Corrective Action:**

The hospital has taken several steps in efforts to reduce the burden to the County. The hospital was successful in attaining critical access status effective October 9, 2008. Doing so, changes the reimbursement structure from Medicare to be cost based, and therefore, more advantageous to financial operations. Also, in January 2009, the rate structure charged for services was reviewed and significantly raised to be more equitable with industry standards. While this action is not a dollar for dollar return, it does result in a more positive cash flow in terms of net revenue. Additionally, with the help of the Milano Foundation, diagnostic services have been expanded by acquiring a CT scanner in May 2008 and a digital ultra sound in April 2009. Outpatient surgeries started in August 2009, and respiratory therapy and wound care are now underway.

To reduce expenses, the hospital has changed its Group Purchasing Organization (GPO) to one that is more beneficial to our supply costs in November 2009. Furthermore, there have been great strides taken in reducing the amount of registry nurses and filling those positions with hired staff. Typically, registry rates are more costly than staff rates, plus the expense of housing registry is greatly diminished. Additionally, flex staffing has been implemented in certain areas, so staffing levels are correlated to current census of patients needing care. Also, Portions of the Patient Financial Services department have been outsourced in October 2009. Since then, collections have been improving evidenced by increased cash flow and reductions in the Days in Accounts Receivable.

In regards to cash flow, hospital management has been operating its funds in a cash positive manner for approximately the past twenty months. The balance of cash is monitored daily, and tracking of available funds begins over at the beginning of each month. Only if the cash account reflects a positive balance are warrants submitted to the County for payment. What's more, the hospital has been able to reimburse some of its past borrowings from the County that was used to maintain its operations prior to these changes.

A successful ballot measure on August 31, 2010 established a funded hospital district that anticipates sufficient tax revenue to sustain positive cash flows beginning in fiscal year ended June 30, 2011. Management considers separation from the County a positive alternative because funds are deposited into the Treasury, but may not be spent on hospital activity. See Subsequent Event footnote in the basic financial statements.

**Finding 2008-02**

**MONTHLY CASH RECONCILIATIONS**

**Criteria or Specific Requirement:**

A fundamental element of an effective system of internal controls is the proper segregation of duties.

Proper segregation of duties may provide a stronger system of internal control whereby the functions of each employee are subject to the review of by management.

**Condition Found:**

*Material Weakness* - As a result of our audit, we noted the Chief Financial Officer prepared the monthly cash reconciliation. However, we noted the Medical Center did not have a procedure in place to review the cash reconciliations prepared by the CFO.

**Context:**

The Hospital's daily cash collections are recorded in both the County's general ledger system and the Medical Center's separate general ledger. Monthly reconciliation is required to ensure both ledgers are in agreement.

**Effect:**

The Medical Center's internal control systems are weakened and proper safeguards are not in place to protect the assets of the Medical Center.

**Cause:**

The Medical Center experienced turnover during FY 2008 resulting in a lack of accounting staff.

**Recommendation:**

To strengthen control in this area, the Medical Center should implement procedures to ensure separate individuals have responsibility over preparing and reviewing the monthly cash reconciliation. This proper segregation of duties may provide a stronger system of internal control whereby the functions of each employee are subject to the review by other employees or management.

**Views of Responsible Officials and Planned Corrective Action:**

Not until recently has there been adequate staffing to implement satisfactory segregation of duties. In the interim, Management felt the CFO would be the likely person to perform the bank reconciliation as the remaining accounting staff's functions directly recorded daily activities into the general ledger system.

Currently, there is a sufficient structure in place for the CFO to monitor those activities rather than perform them. Accordingly, procedures have been implemented to segregate the preparation and review of activity, thereby strengthening internal controls. Accounting activities will be overseen by the Controller and monitored and reviewed by the CFO.

**Finding 2008-03**

**APPROVAL OF JOURNAL ENTRIES**

**Criteria or Specific Requirement:**

An element of effective internal controls is the proper segregation of duties. The basic premise of segregating duties is to prevent situations where an employee has the ability to perpetrate an error or irregularity and to conceal it as well. Proper segregation of duties provides for a system of checks and balances such that the functions by one employee are subject to review through the performance of the interrelated functions of another employee.

**Condition Found:**

*Material Weakness* - We noted a lack of segregation of duties in the preparation of journal entries (JE), whereby the same staff prepare, enter, and post journal entries to the general ledger. It is the Medical Center's policy to have staff entering the journal entries have a supervisor/manager or other authorized personnel independent of the preparation function review and approve the journal entry prior to posting to the general ledger.

**Context:**

Internal controls are designed to safeguard assets and assist in the prevention and/or detection of misstatements of the County's financial statements. A fundamental concept in the design of an effective system of internal control is the segregation of duties.

**Effect:**

The basic premise is that no one employee should have access to all phases of an accounting transaction.

**Cause:**

The Medical Center’s financial accounting system is currently not designed to prevent authorized staff from preparing, entering, and posting a JE to the general ledger.

**Recommendation:**

To strengthen control in this area, the Medical Center should implement procedures to ensure separate individuals have responsibility over preparing and reviewing journal entries. This proper segregation of duties may provide a stronger system of internal control whereby the functions of each employee are subject to the review by other employees or management.

**Views of Responsible Officials and Planned Corrective Action:**

Not until recently has there been adequate staffing to implement satisfactory segregation of duties. In the interim, Management felt the CFO would be the likely person to perform the journal entries as the remaining accounting staff’s functions directly recorded daily activities into the general ledger system. The CFO and CEO would discuss financial reports prior to Finance Committee meetings.

Currently, there is a sufficient structure in place for the CFO to monitor those activities rather than perform them. Accordingly, procedures have been implemented to segregate the preparation and review of activity, thereby strengthening internal controls. Accounting activities will be overseen by the Controller and monitored and reviewed by the CFO.

**Finding 2008-04**

**THIRD PARTY SETTLEMENTS**

**Criteria or Specific Requirement:**

Health care entities need to estimate third party revenue and related receivable amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with generally accepted accounting principles. In addition, preparation of third-party cost reports should be reviewed for accuracy and completeness prior to filing to intermediary agencies.

**Condition Found:**

*Material Weakness* - As a result of our audit, we noted the Medical Center does not have policies or procedures in place to evaluate the completeness of its third party settlements. In FY 2008, we noted the Hospital filed an Assembly Bill (AB) 915 cost report to the State of California for supplemental MediCal outpatient services. The cost report for FY 2007 was not filed until March 2008. However, the Medical Center did not record the estimated net settlement in its June 30, 2007 financial statements. The net settlement for FY 2007 was recorded in FY 2008 when the reimbursement was received. We also noted the Medical Center did not record as of June 30, 2008 the estimated net settlement for its AB 915 cost report for FY 2008. As a result, beginning net assets were restated to reflect the FY 2007 AB cost report settlement revenue. Additionally, an adjustment was proposed to record the estimated net settlement for FY 2008.

We also noted that Medical Center has received settlement letters for its FY 2009 and FY 2010 Medicare reimbursements indicating the Medical Center was overpaid during these periods.

**Context:**

The Medical Center received $287,529 and $226,895 in AB 915 revenues for fiscal years ending June 30, 2008 and 2007, respectively. These amounts were not accrued in the proper accounting period.

**Effect:**

Beginning net assets were restated to reflect the FY 2007 AB cost report settlement revenue. Additionally, an adjustment was proposed to record the estimated net settlement for FY 2008. Subsequent event disclosures have been included to communicate the affect of the FY 2009 and FY 2010 cost report settlements.

**Cause:**

The Medical Center did not have a policy in place to estimate and record the AB 915 cost report settlement amounts and make the required disclosures in accordance with GAAP.

**Recommendation:**

We understand the Medical Center prepares the AB 915 cost report subsequent to each fiscal year. However, we recommend that the Medical Center establish and maintain internal controls that will enable management to estimate and record all third party settlements based on their estimated realizable amounts, in the proper period, in accordance with GAAP. We also recommend that the Medical Center implement policies and procedures to ensure amounts billed to Medicare are at the appropriate rate.

**Views of Responsible Officials and Planned Corrective Action:**

It is Management's view that AB 915 and cost reporting activity should be accrued to be in accordance with GAAP, and therefore concur with the auditor's finding. Items subsequent to fiscal year ended June 30, 2008 have been accrued and intend for these items to be accrued in future years as well. It is hospital policy to record general ledger transactions as activity is incurred in accordance with GAAP practices.

**Finding 2008-05**

**CAPITAL ASSET MANAGEMENT**

**Criteria or Specific Requirement:**

A fundamental element of an effective system of internal controls is proper controls over capital assets. Per the Medical Center's policy, every purchase of construction or major capital asset that have costs in excess of $5,000 required at least three bids.

**Condition Found:**

*Material Weakness* **-** As a result of our testwork, we noted that the Medical Center has an asset tagging system in place, but it is not properly implemented. We also noted that the Medical Center has not performed any type of physical inventory count to ensure all Medical Center's capital assets are safeguarded. In addition, VTD noted that no process is in place for the detection of fixed assets impairment. It was noted that department managers are responsible for notifying the Chief Financial Officer whenever fixed assets are acquired lost, destroyed, stolen or disposed of. However, we noted procedures are not performed to communicate the disposition of capital assets to the department of finance.

Per inquiry, we noted the County's policy requires every purchase of capital assets that have costs in excess of $5,000 to solicit at least three bids. Based on the testwork over the bid procedures, we noted, only one proposal was obtained for the acquisition of a Chemical Analyzer in the amount of $85,800 from Fisher Healthcare.

We also noted the Medical Center did not seek three competitive bids for the purchase of a Chemical Analyzer.

**Context:**

The condition noted above was identified during our testwork over capital assets. While we observed the existence of material capital assets recorded as of June 30, 2008, we noted weaknesses in the internal controls over existence and valuation of the Medical Center's capital assets.

**Effect:**

Without a properly implemented asset tagging system in place and performing periodic physical inventory counts, capital assets will not be fully safeguarded. An asset tagging system along with performing a physical inventory of fixed assets on an annual basis can assist in tracking all of the Medical Center's capital assets. Impaired fixed assets will not be detected without a proper process for detection of fixed assets impairment.

**Cause:**

The Medical Center's policies over capital assets were not properly designed and implemented during the fiscal year.

**Recommendation:**

We recommend that the Medical Center develop internal procedures to adequately track the additions and deletions of capital assets. These procedures should include reconciling the Medical Center's general ledger or subsidiary ledgers to physical capital asset records. We also recommend that the Medical Center initiate the process to perform periodic inventories of its capital assets. We also recommend that the Medical Center implement procedures to ensure capital asset procured are purchased through a competitive bidding process. In addition, procedures should be implemented for the detection of fixed asset impairment to improve the effectiveness and efficiency of detecting impaired assets.

**Views of Responsible Officials and Planned Corrective Action:**

Management is in the process of developing a tagging system between Accounting, Purchasing, and Maintenance to ensure tags are placed on equipment prior to being distributed from purchasing. The tag numbers will then be traceable to the general ledger system where reports can be generated by department, so physical inspection can occur on a periodic basis to evaluate the existence and valuation of the assets.

**Finding 2008-06**

**YEAR-END CUTOFF PROPOSED ADJUSTING JOURNAL ENTRIES**

**Criteria:**

The Medical Center should maintain procedures to ensure that year end closing procedures address all accounts.

**Condition Found:**

*Material weakness* - During our testing of year-end cutoff procedures, we proposed audit adjustments to properly state the year-end account balances of certain accounts in order to properly present the statements of net assets and the statements of revenue, expenses, and changes in net assets of the Medical Center. All adjustments that were proposed during the current year audit were presented to management and subsequently posted to the general ledger. The adjustment proposed this current fiscal year related to accounts payable, prepaid expenses, third-party settlements, capital assets, capital and non-capital contributions, accrued pension expense, and donated capital equipment.

**Context:**

The above condition was identified during our audit procedures over the Medical Center's year end account balances and cut-off procedures.

**Effect:**

Adjustments were proposed and posted to the Medical Center's general ledger for the year ended June 30, 2008.

**Cause:**

The Medical Center did not consistently apply its year-end closing procedures for cut-off.

**Recommendation:**

We recommend that the Medical Center strengthen its year-end closing procedures to ensure that all transactions related to fiscal year are properly captured and recorded in the general ledger to ensure the accuracy and complete of the financial statements.

**View of responsible official and planned corrective action:**

In the past, there was not a clear understanding of accrual basis accounting by fiscal staff, nor the affects of what other modules do when posted to the general ledger module. As a result, management has tried to align staff in "best fit" positions and continue to train those that work in the financial software package.

Management is in the process of strengthening year end closing procedures to include a checklist of activity that will capture related activity to specific periods.

**Finding 2008-07**

**SEGREGATION OF DUTIES - PAYROLL**

**Criteria or Specific Requirement:**

An element of effective internal controls is the proper segregation of duties. The basic premise of segregating duties is to prevent situations where an employee has the ability to perpetrate an error or irregularity and to conceal it as well. Proper segregation of duties provides for a system of checks and balances such that the functions by one employee are subject to review through the performance of the interrelated functions of another employee.

**Condition Found:**

*Material Weakness* - We noted the following control deficiencies as a result of our audit procedures over the payroll and human resource process:

- We noted there is currently not a monitoring procedure in place designed to ensure pay rates changed within the payroll system are reviewed.
- We noted all Accounting Department employees have access capability in the system to change pay rates in the system. We also noted a former department employee maintains access to the system. We also noted the Accounting Department employees have the ability to edit the employee master file.
- We noted the payroll clerk will enter hours into the payroll system for those employees that do not prepare a time sheet. This procedure is not subject to management review.
- We noted, per inquiry and inspection, employees do not always sign their time card. In such cases, the Medical Center is not requesting the employee to sign the time card prior to processing the payroll.
- There is no review or approval of the balances entered into the direct deposit bank account, aside from the reconciliation of reports run by the payroll clerk.

**Context:**

The above condition was identified during our audit procedures over the Medical Center's payroll process.

**Effect:**

These same individuals also have the ability to change payroll data, such as pay rates, as well as enter time into the payroll system.

**Cause:**

We note that the Medical Center currently does not generate and review a report on a periodic basis to detect any changes to the payroll system.

**Recommendation:**

To strengthen control in this area, the Medical Center should implement/improve controls by restricting the responsibility of adding new employees and updating pay rates to the Medical Center's personnel department. Also, upper management should periodically review changes to the payroll data and the employee master file. Lastly, the Medical Center should implement improved securities within its payroll system to ensure employees do not have access and ability to change or manipulate employee data, including pay rates. This proper segregation of duties may provide a stronger system of internal control whereby the functions of each employee are subject to the review of by management.

**View of responsible official and planned corrective action:**

Management will implement policies to strengthen controls by limiting employee setup accessibility to certain Accounting personnel, IT, and Human Resources. Management will print a pay rate report and periodically compare to the employee master file. For current processing, pay rates will be reflected on input reports for supervisor approval prior to processing. That report can be compared to final reports for consistency in gross pay amounts.

ADP has been contracted since September 2010 to calculate payroll and related reporting. Prior to timeclocks being implemented, management will be trained to monitor and approve employee hours worked.

**Finding 2008-08**

**SEGREGATION OF DUTIES - CHARGEMASTER**

**Criteria or Specific Requirement:**

An element of effective internal controls is the proper segregation of duties. The basic premise of segregating duties is to prevent situations where an employee has the ability to perpetrate an error or irregularity and to conceal it as well. Proper segregation of duties provides for a system of checks and balances such that the functions by one employee are subject to review through the performance of the interrelated functions of another employee.

Changes to the chargemaster must be authorized. Procedures should be established to control changes and updates to information included on the rate master file or listing of approved rates. Additionally, system configuration related to the chargemaster should be properly designed, implemented, functioning, maintained and subject to appropriate change control procedures.

**Condition Found:**

*Significant Deficiency* - As a result of our audit procedures over the Medical Center's patient accounting, we noted that the individual responsible for entering charges from charge sheets in the patient management system is also responsible for updating the chargemaster. In addition, we tested access to the chargemaster noting access does not appear to be properly controlled or limited. However, we noted the Medical Center does have an approval process for changing rates in the chargemaster.

**Context:**

The condition noted above was identified during our testwork over patient revenue system.

**Effect:**

Having segregation of duties between individuals responsible for coding charges to patient accounts and updating the chargemaster will minimize unauthorized changes to chargemaster for specific patients.

**Cause:**

The Medical Center does not have effective controls in place to segregate access and changes to the chargemaster.

**Recommendation:**

We recommend that an individual separate from the charge sheet processing have the responsibility of updating the chargemaster. Additionally, any changes to the chargemaster should be logged or reviewed on a monthly basis by management. A log will strengthen the control over identifying any unauthorized changes to the chargemaster.

**Views of Responsible Officials and Planned Corrective Action:**

The controls for access to the chargemaster have been inconsistent over the past years due to changes in staff positions or re-alignment of duties. Management agrees that controls over the chargemaster need to be strengthened.

To do so, all access to change the chargemaster will be eliminated except for the CFO, Controller, and the contracted Patient Financial Services Director. A change request form will be used to initiate any updates. Requested changes will occur only after authorization has been indicated on the form by the Health Information Manager, CFO or Controller.

In addition, a log to identify access will be generated on a monthly basis from the financial software and another ongoing log will identify changes made by date.

**Finding 2008-09**

**SUPERVISORY APPROVAL OF EMPLOYEE LABOR HOURS**

**Criteria:**

Employee hours processed through the payroll system should be approved by an employee’s supervisor. Evidence of the employee’s preparation of the timesheet and approval from the employee’s supervisor should be maintained.

**Condition Found:**

*Significant Deficiency* - Based on the testing over the payroll process internal controls, we noted the following exceptions.

- It was noted that 4 out of 40 employee time cards tested were missing a supervisor’s approval on manual timecards.
- We were unable recalculate the gross pay on a test basis to the gross pay per the payroll register for 2 of the employees selected.
- We noted per review of 40 personnel files, 25 were missing a signed I-9 form, one was a missing W-4 and one was missing a signed application.

**Context:**

The condition noted above was identified during our testing over the approval of payroll time processed and calculation of payroll expense.

**Effect:**

The Medical Center was not able to provide evidence of supervisor certification of employee's payroll time processed through the payroll system. In addition, the Medical Center could not reconcile the gross pay per the payroll register to supporting documentation. As such, the control environment is weakened.

**Cause:**

The Medical Center is not following its established policies and procedures to ensure that timesheets are prepared by the employee and approved by the employee's supervisor.

**Recommendation:**

We recommend that the Medical Center formalize policies and procedures to ensure that employee and supervisor certification of payroll time are maintained. In addition, the Medical Center should implement procedures to ensure employee personnel files are complete.

**View of responsible official and planned corrective action:**

Personnel files now have a checklist in place that help ensure completeness of required documentation. Also, all files were checked for current employees to make sure that I-9 forms were completed and available. In the past, certain forms were kept in a separate location and became inaccessible.

For payroll processing, additional training and oversight has been provided to payroll staff. Also, management will include in its policies to have department supervisors approve an input report prior to payroll processing.

**COUNTY OF MODOC**
**MODOC MEDICAL CENTER**

**SUMMARY STATUS OF PRIOR YEAR FINDINGS**

**JUNE 30, 2008**



None reported.