# POTOMAC HEALTH FOUNDATION

# FINANCIAL STATEMENTS

# YEAR ENDED OCTOBER 31, 2011

**POTOMAC HEALTH FOUNDATION**
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**YEAR ENDED OCTOBER 31, 2011**

CliftonLarsonAllen

CliftonLarsonAllen LLP
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# INDEPENDENT AUDITORS' REPORT

Board of Directors
Potomac Health Foundation
Woodbridge, Virginia

We have audited the accompanying statement of financial position of the Potomac Health Foundation (Foundation) as of October 31, 2011, and the related statement of activities, functional expenses and cash flows for the year then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Potomac Health Foundation as of October 31, 2011, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 8 to the financial statements, settlement receivable, contingent gain, accrued interest, and related party due to/from were not recorded correctly in the prior period. Accordingly, the beginning balances as of November 1, 2010 have been restated to reflect these adjustments.

CliftonLarsonAllen LLP

**CliftonLarsonAllen LLP**

Arlington, Virginia
March 7, 2012

# POTOMAC HEALTH FOUNDATION
# STATEMENT OF FINANCIAL POSITION
# OCTOBER 31, 2011

## ASSETS

| | | |
|---|---|---|
| **CURRENT ASSETS** | | |
| Cash and Cash Equivalents | $ | 200,204 |
| Interest Receivable | | 97,434 |
| Settlement Receivable - Current | | 82,314 |
| Prepaid Expenses | | 5,495 |
| Total Current Assets | | 385,447 |
| **NON-CURRENT ASSETS** | | |
| Settlement Receivable | | 612,277 |
| Investments | | 89,713,995 |
| Property and Equipment, Net of Accumulated Depreciation of $3,310 | | 19,786 |
| Total Non-Current Assets | | 90,346,058 |
| Total Assets | $ | 90,731,505 |

## LIABILITIES AND NET ASSETS

| | | |
|---|---|---|
| **CURRENT LIABILITIES** | | |
| Accounts Payable | $ | 146,472 |
| Due to Related Parties | | 16,261 |
| Grants Payable | | 468,564 |
| Federal Excise Tax Payable | | 87,930 |
| Total Current Liabilities | | 719,227 |
| **OTHER LIABILITIES** | | |
| Deferred Federal Excise Taxes | | 49,193 |
| Total Liabilities | | 768,420 |
| **NET ASSETS** | | |
| Unrestricted Net Assets | | 89,963,085 |
| Total Liabilities and Net Assets | $ | 90,731,505 |

*See accompanying Notes to Financial Statements.*

# POTOMAC HEALTH FOUNDATION
# STATEMENT OF ACTIVITIES
# YEAR ENDED OCTOBER 31, 2011

| | |
|---|---|
| **REVENUE AND SUPPORT** | |
| Investment Income, Net | $ 3,762,609 |
| Public Support | 580 |
| Total Revenue and Support | 3,763,189 |
| **EXPENSES** | |
| Program Expense | 4,789,110 |
| Management and Administrative | 307,904 |
| Total Expenses | 5,097,014 |
| **CHANGE IN NET ASSETS** | (1,333,825) |
| Net Assets - Beginning of Year (Restated - See Note 8) | 91,296,910 |
| **NET ASSETS - END OF YEAR** | $ 89,963,085 |

*See accompanying Notes to Financial Statements.*

**POTOMAC HEALTH FOUNDATION**
**STATEMENT OF FUNCTIONAL EXPENSES**
**YEAR ENDED OCTOBER 31, 2011**

| | Program | Administrative and Management | Total |
|---|---|---|---|
| Payroll | $ 52,339 | $ 153,274 | $ 205,613 |
| Payroll - Benefits | 6,936 | 14,646 | 21,582 |
| Professional Fees | 7,964 | 23,322 | 31,286 |
| Taxes and Fees | 18,420 | 53,942 | 72,362 |
| Professional Development | 2,057 | 4,532 | 6,589 |
| Occupancy | 8,114 | 23,762 | 31,876 |
| Travel | 1,313 | 5,755 | 7,068 |
| Meetings | 386 | 11,529 | 11,915 |
| Technology | 1,716 | 3,725 | 5,441 |
| Grants and Scholarships | 4,685,637 | - | 4,685,637 |
| Other Expense | 831 | 3,469 | 4,300 |
| Insurance | 2,554 | 7,481 | 10,035 |
| Depreciation | 843 | 2,467 | 3,310 |
| | $ 4,789,110 | $ 307,904 | $ 5,097,014 |

*See accompanying Notes to Financial Statements.*

## POTOMAC HEALTH FOUNDATION
## STATEMENT OF CASH FLOWS
## YEAR ENDED OCTOBER 31, 2011

| | |
|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | |
| Change in Net Assets | $ (1,333,825) |
| Adjustments to Reconcile Change in Net Assets to Net Cash Used by Operating Activities: | |
| Depreciation | 3,310 |
| Decrease in Settlement Receivable - Noncash | 82,314 |
| Realized Gains on Investments | (1,713,411) |
| Unrealized Losses on Investments | 779,324 |
| Provision for Deferred Federal Excise Tax | (15,568) |
| Changes in Assets and Liabilities: | |
| Interest Receivable | 19,929 |
| Prepaid Expenses | (3,929) |
| Due from Related Parties | 120,095 |
| Accounts Payable | 34,033 |
| Due to Related Parties | (127,499) |
| Grants Payable | 468,564 |
| Federal Excise Tax Payable | 68,267 |
| Net Cash Used by Operating Activities | (1,618,396) |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | |
| Proceeds from Sales of Investments | 52,307,333 |
| Purchases of Investments | (50,838,072) |
| Net Cash Provided by Investing Activities | 1,469,261 |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | |
| Purchases of Property and Equipment | (23,096) |
| Net Cash Used by Financing Activities | (23,096) |
| **DECREASE IN CASH AND CASH EQUIVALENTS** | (172,231) |
| Cash and Cash Equivalents - Beginning of Year | 372,435 |
| **CASH AND CASH EQUIVALENTS - END OF YEAR** | $ 200,204 |

*See accompanying Notes to Financial Statements.*

## NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Organization

Potomac Health Foundation (the Foundation) was established as a result of the proceeds from the sale of Potomac Hospital Corporation to Sentara Healthcare, Inc. on December 1, 2009. The Foundation issues grants to institutions and organizations in the Foundation's community which qualify under IRS regulations as tax exempt and which are not private foundations as defined by the Internal Revenue Code.

### Basis of Accounting

The financial statements of the Foundation have been prepared on the accrual basis of accounting, in compliance with U.S. generally accepted accounting principles.

### Income Taxes

The Foundation is exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code. The Foundation has been classified by the Internal Revenue Service as a private foundation and pays Federal excise taxes on taxable investment income.

The Foundation evaluated its tax positions and determined that its positions are more-likely-than-not to be sustained on examination. The Foundation's tax returns are subject to review and examination by federal, state, and local authorities. The tax return for the fiscal year ended 2010 is open to examination by federal, state, and local authorities.

### Cash Equivalents

The Foundation considers all highly liquid investments, which are to be used for current operations and which have a maturity of three months or less when purchased, to be cash equivalents. All other highly liquid instruments, which are to be used for the long-term purchases of the Foundation, are classified as investments.

### Accounts Receivable

Accounts receivable are recorded at net realizable value. Management determined there was no allowance necessary for doubtful accounts at October 31, 2011.

### Investments

Investments consist of equity mutual funds, bond mutual funds, and shares of partnerships. These investments are recorded in the accompanying financial statements at fair value. Interest, dividends and realized gains or losses are recorded when earned, based upon settlement date. Fluctuations in the fair value of the portfolio are recorded as unrealized gains or losses.

The Foundation has various investment vehicles where the carrying value fluctuates with the financial markets. As a result, the value of such investments as of the date of this report may be materially different than year-end values.

## NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Fair Value of Financial Instruments

#### *Fair Value Measurements*

The Foundation accounts for a significant portion of its financial instruments at fair value or considers fair value in their measurement. The Foundation accounts for certain financial assets and liabilities at fair value under various accounting literature.

#### *Fair Value Hierarchy*

The Foundation has categorized its financial instruments, based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

Financial assets and liabilities recorded on the statement of financial position are categorized based on the inputs to the valuation techniques as follows:

*Level 1* – Financial assets and liabilities whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market that the Foundation has the ability to access.

*Level 2* – Financial assets and liabilities whose values are based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the asset or liability. Level 2 inputs include among others, quoted prices for similar assets or liabilities in active market or non-active market.

*Level 3* – Financial assets and liabilities whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the asset or liability.

### Property and Equipment

Property and equipment are stated at cost. The cost and related accumulated depreciation of assets retired or otherwise disposed of or sold are removed from the accounts and any resulting gain or loss is recognized in the accompanying statement of activities. Acquisitions of property and equipment over $1,000 with a useful life of greater than one year are capitalized. Repairs and maintenance are charged to expenses as incurred.

The straight-line method is used to depreciate the cost of furniture, fixtures and equipment over their estimated useful lives ranging from three to five years. Office improvements are being amortized on a straight-line basis over the shorter of the period of the lease or the useful life of the improvements.

## NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Net Assets

Net assets are classified as unrestricted, temporarily restricted or permanently restricted based on the existence or absence of donor-imposed restrictions. The purpose of each net asset group and fund within the net asset group is as follows:

Unrestricted - Resources over which the Foundation has discretionary control. Designated amounts represent those revenues, which the Foundation has set aside for a particular purpose.

Temporarily Restricted - Those resources subject to donor-imposed restrictions, which will be satisfied by actions of the Foundation or passage of time. The items of this nature recorded in the Foundation's financial statements are related to funds collected by the Foundation to be used per the donors' requirements. The earnings on the temporarily restricted net assets are temporarily restricted for the purpose specified by the donor.

### Functional Allocation of Expenses

The costs of providing the various programs and supporting services of the Foundation have been summarized on a functional basis in the statement of activities. Accordingly, certain costs have been allocated among the programs and supporting services benefited based on the estimated staff time devoted to each area.

### 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Subsequent Events

In preparing these financial statements, the Foundation has evaluated events and transactions for potential recognition or disclosure through March 7, 2012, the date the financial statements were available to be issued.

## NOTE 2 CONCENTRATION OF RISK

**Credit Risk**

Financial instruments that subject the Foundation to a concentration of credit risk consist of demand deposits placed with financial institutions which may, at times, exceed federally insured limits.

**Fair Value Risk**

The Foundation invests in a variety of investments. These investments are exposed to various risks, such as fluctuations in market value and credit risk. It is at least reasonably possible that changes in risks in the near term could materially affect investment balances and the amounts reported in the financial statements.

## NOTE 3 INVESTMENTS

Investments are recorded at fair value. Money market funds are stated at cost which approximates fair value and are considered cash equivalents. The estimated fair value is based on quoted market prices, except for alternative investments, for which quoted market prices are not available. The estimated fair value of certain alternative investments, such as interests in hedge funds and limited partnerships, is based on valuations provided by the external investment managers. The Foundation believes the carrying amount of these financial instruments is reasonable; however, because the alternative investments are not readily marketable, their estimated value is subject to uncertainly and may differ from the value used had a ready market for such investments existed. Such differences could be material.

Investments consist of the following at October 31, 2011:

| | Cost | Market |
|---|---|---|
| Mutual Funds- Domestic Equities | $ 25,496,470 | $ 27,176,199 |
| Mutual Funds- Bonds | 36,931,087 | 37,797,988 |
| Mutual Funds- International Equities | 11,926,821 | 11,867,898 |
| Alternative Investments | 12,900,000 | 12,871,910 |
| | $ 87,254,378 | $ 89,713,995 |

Investment income for the year ending October 31, 2011 consists of:

| | |
|---|---|
| Interest and Dividends | $ 3,162,695 |
| Realized Gains | 1,713,411 |
| Unrealized Losses | (779,324) |
| Management Fees | (334,173) |
| Total | $ 3,762,609 |

Interest accrued on investments as of October 31, 2011, is $97,434.

## NOTE 4 FAIR VALUE MEASUREMENTS

In September 2009 guidance was issued under the ASC Topic - Fair Value Measurements and Disclosures which clarified the fair value level classification for entities that calculate net asset value per share or its equivalent. The guidance states that "if a reporting entity has the ability to redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date, the fair value measurement of the investment shall be categorized as a Level 2 fair value measurement." In accordance with this guidance the following table presents the Foundation's fair value hierarchy for those assets measured at fair value on a recurring basis as of October 31, 2011:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Mutual Funds- Domestic Equities | $ 27,176,199 | $ - | $ - | $ 27,176,199 |
| Mutual Funds- Bonds | 37,797,988 | - | - | 37,797,988 |
| Mutual Funds- International Equities | 11,867,898 | - | - | 11,867,898 |
| Alternative Investments | - | 12,871,910 | - | 12,871,910 |
| Total | $ 76,842,085 | $ 12,871,910 | $ - | $ 89,713,995 |

Fair Value Measurements of Investments in Certain Entities that Calculate Net Asset Value per Share (or its Equivalent) for the year ended October 31, 2011:

| | Net Asset Value | Redemption Frequency (If Currently Eligible) | Redemption Notice Period |
|---|---|---|---|
| Limited Partnerships | $ 4,601,443 | Quarterly | 90 days |
| Hedge Funds | 8,270,467 | Quarterly | 30-90 days |
| | $ 12,871,910 | | |

The fair value of the limited liability partnerships and hedge funds in this category has been estimated using the net asset value per share of the investments.

Investments in Limited Partnerships consists of funds placed with a core property fund seeking both current income and long-term capital appreciation and is organized to invest directly and indirectly in a diversified pool of private investment vehicles that invest in commercial real estate properties.

Hedge funds use a variety of strategies, including hedged equity, global trading, market neutral, long and short biased, event driven and global asset allocation. Hedge funds can invest in a wide variety of both public and private securities including equities, fixed income, commodities, private placements, currencies, real estate, loans, derivatives and special situation investments.

## NOTE 5 FEDERAL TAXES AND DISTRIBUTION REQUIREMENTS

**Federal Excise and Income Taxes**

The Foundation is subject to a 2% excise tax (reduced to 1% if certain requirements are met) on its net investment income. Net investment income principally includes income from investments and net realized capital gains (net capital losses, however, are not deductible). The Foundation was subject to the 2% rate in 2011. The federal excise and income tax return for the Foundation for 2011 is subject to examination by the Internal Revenue Service.

Deferred federal excise taxes based on the 2% rate are computed on the differences between the carrying value and tax basis of the Foundation's investments.

The composition of the federal excise tax provision is as follows:

| | | |
|---|---|---|
| Federal Excise Tax Payable | $ | 87,930 |
| Deferred Federal Excise Taxes | | 49,193 |
| | $ | 137,123 |

**Distribution Requirements**

The Foundation is subject to distribution requirements of the Internal Revenue Code. Accordingly, it must distribute, within one year after the end of each fiscal year, 5% of the fair market value of its investment assets. Qualifying distributions are determined on a cash basis and include grant payment and certain other expenses incurred by the Foundation.

## NOTE 6 SETTLEMENT RECEIVABLE

On December 1, 2009, Potomac Hospital Foundation (now doing business as Potomac Health Foundation), Sentara Healthcare, Inc. (Sentara) and Potomac Hospital Corporation (Hospital) entered into an affiliation agreement. The agreement stipulates that Sentara will provide to the Foundation office space and a clerical staff person free of charge for ten years starting on the date of the agreement. The October 31, 2010 net assets were restated for the value of the receivable (See Note 8). As of October 31, 2011, the balance of the receivable was $694,591, consisting of $286,884 in in-kind rent and $407,707 in donated services. During the year ended October 31, 2011, $82,314 was utilized by the Foundation and recognized as expense in the Statement of Activities. Long-term settlement receivables consist of the following in-kind pledges:

| | | |
|---|---|---|
| 2012 - 2016 | $ | 411,570 |
| Thereafter | | 283,021 |
| | | 694,591 |
| Less Current Portion | | 82,314 |
| | $ | 612,277 |

## NOTE 7 ESCROW

On December 1, 2009, the Foundation, Sentara, and the Hospital entered into an affiliation agreement. As a result, the assets of the Hospital were transferred to Sentara. Sentara subsequently transferred $86,500,000 to the Foundation. In addition, $5,500,000 was escrowed to be available for claims against the Hospital that originated prior to the date of the agreement. The Foundation is currently unable to determine the amount of the escrow that will remain for the Foundation's usage. Therefore, no contingent gain has been recorded on the accompanying financial statements.

## NOTE 8 RESTATEMENT

The Foundation restated the beginning balances as of November 1, 2010. The balance of the escrow was previously reported as an asset, but management believes that these funds represent a contingent gain and therefore the escrow should not be reported as an asset. The in-kind space and services from Sentara were not reflected in the beginning balances; therefore the beginning net assets are restated to capture the effect of this transaction in the period it occurred. Accrued interest on investments was not reported in the beginning balances and management decided to restate this balance to reflect the full amount of the receivable. The amount due to the Hospital was understated and the Foundation restated beginning balances to reflect the full amount of the liability. The effects of these restatements are as follows:

| | November 1, 2010 Balances Prior to Restatement | Restatement Adjustment | November 1, 2010 Balances After Restatement |
|---|---|---|---|
| Escrow | $ 5,508,811 | $ (5,508,811) | $ - |
| Prepaid Expenses | 19,616 | (18,050) | 1,566 |
| Accrued Interest | - | 117,363 | 117,363 |
| Settlement Receivable | - | 776,905 | 776,905 |
| Due to Related Party | (124,580) | (19,180) | (143,760) |
| Unrestricted Net Assets | (95,948,683) | 4,653,399 | (91,296,910) |

## NOTE 9 RELATED PARTY TRANSACTIONS

During year ended October 31, 2011, the Foundation incurred $77,571 of expense for employees leased from Sentara. As of October 31, 2011, $16,261 was due to Sentara from the Foundation.