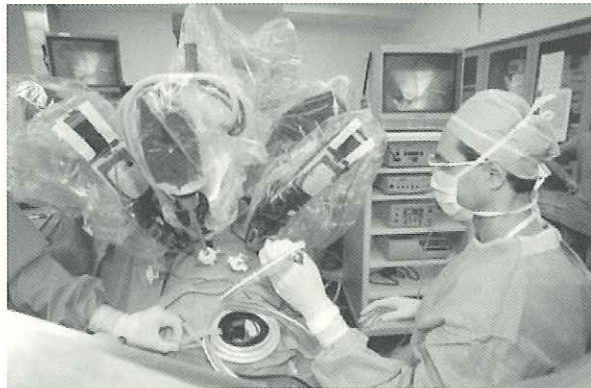
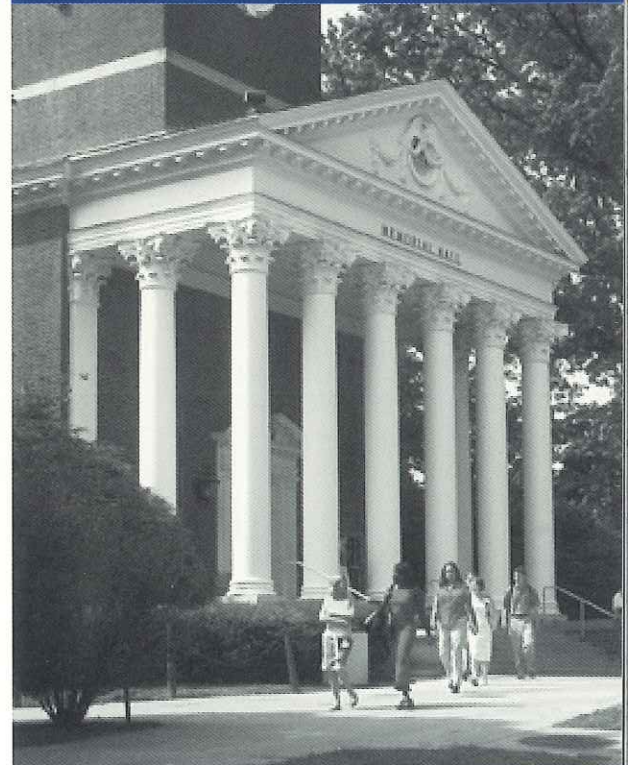
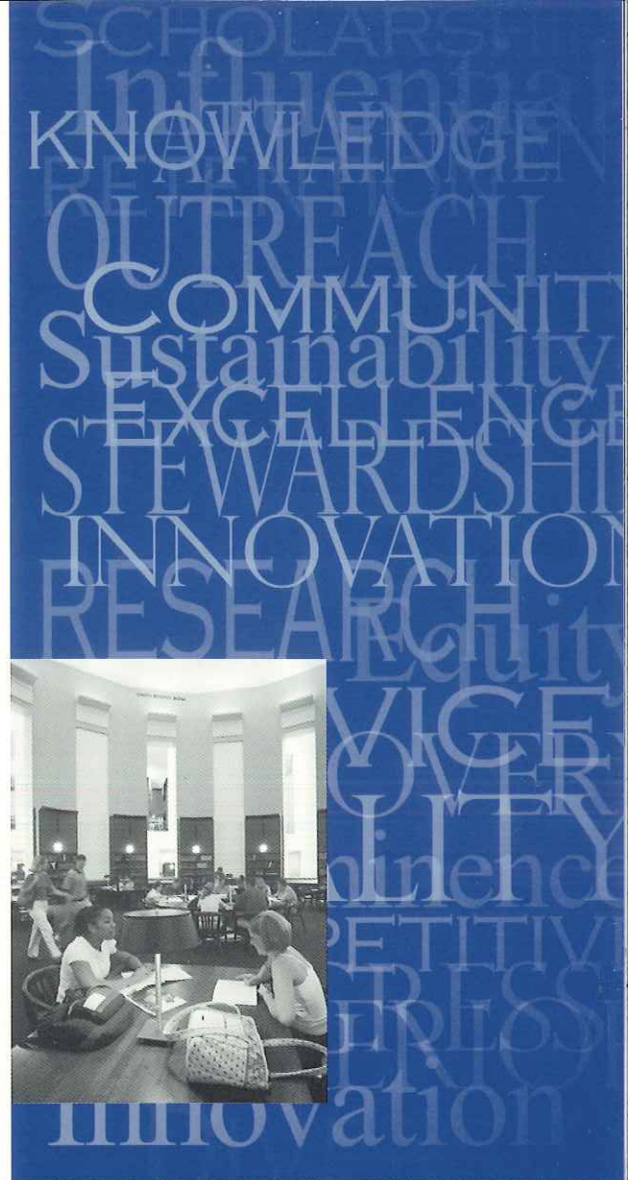


*University of Kentucky
2004 Consolidated
Financial Statements*



UK UNIVERSITY OF KENTUCKY



University of Kentucky
Consolidated Financial Statements
Year Ended June 30, 2004

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MESSAGE FROM THE PRESIDENT

When I became President of my beloved alma mater in 2001, our mission was set. Buoyed by the Postsecondary Education Improvement Act, which was passed by the Kentucky General Assembly in 1997, my goal was to make sure the University of Kentucky became one of the nation's 20 best public research universities by 2020.

Three years have passed and the mission remains the same. Our challenges, however, continue to grow.

Since my first day on campus, UK's share of state funds has been cut \$72.9 million. Those cuts would hurt any postsecondary institution at any time, but considering our current top-20 mission, the budget cuts have been particularly crippling.

Despite the setbacks, the University of Kentucky continues to press ahead. We will not let our current financial shortcomings deter our goal of becoming a top-20 university. In fact, I would rather not dwell on the negative issues facing the university, considering how many positive, exciting things are happening here in Lexington and around the state.

Last year in this space, we highlighted the university's 2003-2006 strategic plan, *The Dream & the Challenge*. It was our first step in providing a foundation for improving UK through a comprehensive, consolidated list of measurable results. In essence, we now have our first road map for UK to follow in its quest to become one of the nation's top-20 public research institutes.

The university has been making great strides toward achieving our top-20 status as identified in the six goals of *The Dream & the Challenge*. Here is a brief update of our successes:

Goal I – Reach for National Prominence

One of our major objectives is to enhance the excellence and sustainability of our clinical enterprise. We have taken great strides to improve and update UK's clinical abilities. We recently opened the Linda and Jack Gill Heart Institute, aimed at improving heart health for the entire state. In spring 2004, the UK Board of Trustees unanimously voted to create a College of Public Health. The college's curriculum and research will be geared to help Kentucky



University of Kentucky President Lee T. Todd Jr. with students – Fall 2003

eliminate the state's severe health disparities. Another goal was to increase the university's endowment to \$500 million by 2006. As of June 30, 2004, the market value of endowment net assets was \$491 million, up from \$414 million on June 30, 2003, when the strategic plan took effect.

Goal II – Attract and Graduate Outstanding Students

I am pleased to report we are flourishing in this area. Despite increasing tuition rates, more students want to come to UK than ever before. UK had a record number of freshmen apply for admission with over 10,000 applications, a 12.5 percent increase from last year. The 2004 freshman class promises to be the most selective in UK history.

One of our key indicators was to improve our six-year graduation rate to 60 percent by 2006. We are already there. Our six-year graduation rate for students who enrolled in fall 1997 was 60.8 percent. Our 2003-04 graduation rate was the highest of any public institution in the state, according to the Council on Postsecondary Education.

Another key indicator outlined in *The Dream & the Challenge* called for the opening of a new undergraduate residence hall, designed as a 21st century living/learning community. That new living complex, which includes four state-of-the-art residence halls, is scheduled to open in fall 2005.

Goal III – Attract, Develop and Retain a Distinguished Faculty

We added three more endowed chairs and eight endowed professorships in 2003-04. UK now has 80 endowed chairs and 193 endowed professorships.

Keeping our best faculty in Lexington remains a top priority, and we have taken several steps to make sure that happens. We have made improvements in the university's benefit system, which has allowed us to limit the cost of health care premiums for our employees. The Provost has worked to establish some funding that will assist in retention efforts. The Biological/Biomedical Science Research Building will greatly improve our capacity to offer quality laboratory and facility space.

Goal IV – Discover, Share and Apply Knowledge

Our first key objective in accomplishing this goal was to increase our federal research expenditures, as reported in the National Science Foundation Survey of Research and Development Expenditures at Universities and Colleges. UK's federal research expenditures for FY 2003 totaled \$120 million, up 20 percent from the previous year. Our goal was to raise \$140 million by 2006. We are well on our way.

We are also making impressive strides in the competitive arena of research grants and contracts. UK faculty and staff brought in a school-record \$238.3 million in new sponsored projects for FY 2004.

As of fall 2003, UK had already achieved another of its key indicators, increasing our enrollment of postdoctoral scholar students from 232 to more than 275.

Goal V – Nurture Diversity of Thought, Culture, Gender and Ethnicity

The university continues to recruit students and faculty from all walks of life in our never-ending quest to improve on-campus diversity. Moving our new multicultural initiatives forward will be

Bill Turner, who was hired this summer as Vice President for University Initiatives/Associate Provost for Multicultural Affairs.

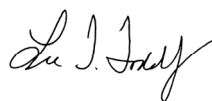
Over the past few years, we have made a concerted effort to recruit African-American students to campus. It appears those efforts are paying dividends. African-American applications for entrance into the fall 2004 class surged by 30 percent over 2003 figures.

Goal VI – Elevate the Quality of Life for Kentuckians

We continue to support and initiate programs that will improve the economic, medical and social conditions throughout the Commonwealth. We helped deliver \$1.28 million to northeastern Kentucky in an effort to revitalize that region's tobacco-dependent economy through entrepreneurship. In May, we received a \$5 million earmark, secured by Senator Mitch McConnell, which will focus on environmental research and site cleanup of the Paducah Gaseous Diffusion Plant. We also received a \$1 million federal grant to fight lethal cancers in Eastern Kentucky, thanks to a federal grant secured by Congressman Hal Rogers.

Clearly, the University of Kentucky is progressing toward its top-20 aspirations. We continue to do this both through the framework of the strategic plan, and through the individual empowerment of our students, faculty and staff.

Regardless of the financial obstacles that stand in our way, we will continue to do what is right and just for the university and the Commonwealth of Kentucky.



Lee T. Todd, Jr.
President, University of Kentucky
September 2004

Management's Discussion and Analysis

The following Management's Discussion and Analysis, or MD&A, provides an overview of the financial position and activities of the University of Kentucky (the University) and its affiliated corporations for the year ended June 30, 2004. Management has prepared this discussion and we encourage you to read it in conjunction with the consolidated financial statements and the notes appearing in this report.

About the University of Kentucky

The University of Kentucky is a public, research-extensive, land-grant university dedicated to enriching people's lives through excellence in teaching, research, and service. The University, as the flagship institution, plays a critical leadership role for the Commonwealth of Kentucky by promoting human and economic development that improves lives within Kentucky's borders and beyond. The University models a diverse community characterized by fairness and social justice. Founded in 1865 as the Agricultural and Mechanical College, the University has grown over the years into a comprehensive public institution of higher learning, with 93 undergraduate programs, master's degrees in 99 fields, and doctoral degrees in 66 programs and 4 first professional programs.

The University of Kentucky Chandler Medical Center, encompassing six colleges, the University Hospital, the UK Children's Hospital, Kentucky Clinics, and several Centers of Excellence, consistently receives national rankings for excellence in teaching, research and patient care. The Medical Center primarily serves patients from central and eastern Kentucky with approximately 19,700 inpatient discharges and 620,000 outpatient visits annually.

The University enrolls over 25,000 students and awards approximately 5,200 degrees annually. Additionally, thousands more people are educated through continuing education programs. Approximately 1,900 full-time faculty and 9,000 full-time staff are employed by the University.

Research Challenge Trust Fund

The Commonwealth of Kentucky initiated the Research Challenge Trust Fund (RCTF), an endowment match program, in 1998. Since that time, the Commonwealth has appropriated over \$350 million to the public universities to be matched with private donations primarily to support chairs and professorships, fellowships and scholarships, and the research and graduate missions of the institutions. To date, the University of Kentucky has been allocated \$202.2 million in RCTF funding.

Financial Highlights

Despite reductions in budgeted State appropriations to the University of \$5.9 million (2 percent) in fiscal year 2004 and \$8.7 million (3 percent) in fiscal year 2003, the University's overall financial position remains strong with assets of \$2.31 billion and liabilities of \$569.0 million. Net assets, which represent the University's residual interest in assets after liabilities are deducted, were \$1.74 billion or 75 percent of total assets.

- In fiscal year 2004, the University adopted the provisions of Governmental Accounting Standards Board Statement No. 39, "Determining Whether Certain Organizations Are Component Units." As a result of implementing this new standard, Kentucky Medical Services Foundation, Inc. (KMSF) is now considered to be a component unit of the University. Accordingly, the net assets, revenues and expenses of KMSF are included in the accompanying consolidated financial statements of the University. Beginning net assets as of June 30, 2003 and 2002 have been restated by \$62.2 million and \$65.4 million, respectively.

- Total assets increased \$195.7 million, or 9 percent, primarily due to increases in endowment investments and capital assets.
- Total liabilities increased \$95.4 million, or 20 percent, primarily due to the issuance of new bonds offset by payments of current year principal maturities on bonds and capital lease obligations.
- Total net assets increased \$100.3 million, or 6 percent, due to an increase in net capital assets of \$57.1 million; an increase in restricted net assets of \$53.7 million, primarily due to realized and unrealized gains on endowment investments offset by the expenditure of net assets restricted for capital projects; and a decrease of \$10.4 million in unrestricted net assets, primarily due to the expenditure of funds for capital assets.
- Operating revenues were \$1.06 billion and operating expenses were \$1.38 billion, resulting in a loss from operations of \$322.3 million. Nonoperating revenues, including \$302.5 million in state appropriations, net of nonoperating expenses, were \$422.6 million, which, when combined with the loss from operations, resulted in an overall increase in net assets of \$100.3 million.

Using the Consolidated Financial Statements

The Consolidated Financial Statements consist of three financial statements: the Statement of Net Assets; the Statement of Revenues, Expenses and Changes in Net Assets; and the Statement of Cash Flows. These financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 35, *Basic Financial Statements – and Management’s Discussion and Analysis – for Public Colleges and Universities*. GASB requires that statements be presented on a consolidated basis to focus on the University as a whole.

Reporting Entity

The University of Kentucky is a component unit of the Commonwealth of Kentucky. The consolidated financial statements of the University include the operations of the University and the following entities:

- University of Kentucky Research Foundation, and its for-profit subsidiary, Kentucky Technology, Inc.
- University of Kentucky Athletic Association
- The Fund for Advancement of Education and Research in the University of Kentucky Medical Center
- University of Kentucky Business Partnership Foundation, Inc.
- University of Kentucky Center on Aging Foundation, Inc.
- University of Kentucky Gluck Equine Research Foundation, Inc.
- University of Kentucky Humanities Foundation, Inc.
- University of Kentucky Mining Engineering Foundation, Inc.
- Health Care Collection Service, Inc.
- Kentucky Medical Services Foundation, Inc.
- Kentucky Healthcare Enterprises, Inc., a for-profit subsidiary.

Consolidated Statement of Net Assets

The Consolidated Statement of Net Assets presents the financial position of the University at the end of the fiscal year and includes all assets and liabilities. Net assets, the difference between total assets and total liabilities, are an important indicator of the current financial condition, while the change in net assets is an indicator of whether the overall financial position has improved or worsened during the year. Generally, assets and liabilities are reported using current values. A major exception is capital assets, which are stated at historical cost, less accumulated depreciation. A summarized comparison of the University’s assets, liabilities and net assets at June 30, 2004, 2003 and 2002 is as follows:

Condensed Consolidated Statement of Net Assets (in thousands)

	<u>2004</u>	<u>2003</u>	<u>2002</u>
ASSETS			
Current assets	\$ 480,985	\$ 481,649	\$ 443,396
Capital assets, net of depreciation	982,366	900,856	845,824
Other noncurrent assets	844,098	729,235	763,771
Total Assets	<u>2,307,449</u>	<u>2,111,740</u>	<u>2,052,991</u>
LIABILITIES			
Current liabilities	204,913	199,810	178,779
Noncurrent liabilities	364,059	273,774	301,379
Total Liabilities	<u>568,972</u>	<u>473,584</u>	<u>480,158</u>
NET ASSETS			
Invested in capital assets, net of related debt	737,140	680,056	617,397
Restricted			
Nonexpendable	365,536	337,497	307,732
Expendable	195,112	169,472	205,147
Unrestricted	440,689	451,131	442,557
Total Net Assets, as restated	<u>\$ 1,738,477</u>	<u>\$ 1,638,156</u>	<u>\$ 1,572,833</u>

Assets. As of June 30, 2004, total assets amounted to \$2.31 billion. Of this amount, investment in capital assets (net of depreciation) of \$982.4 million, or 43 percent of total assets, represented the largest asset class. Endowment assets amounted to \$511.9 million or 22 percent of total assets and cash and cash equivalents amounted to \$401.1 million or 17 percent of total assets. During the year, total assets increased by \$195.7 million primarily due to increases in endowment and capital assets.

Liabilities. As of June 30, 2004, total liabilities amounted to \$569.0 million. Bonds payable and capital leases for educational buildings, the housing and dining system, the University hospital and the W.T. Young library amounted to \$326.5 million, or 57 percent of total liabilities. During the year total liabilities increased by \$95.4 million primarily due to the issuance of new bonds net of principal payments on bonds and capital lease obligations.

Net Assets. The equity of the University of \$1.74 billion as of June 30, 2004 is reported on the Statement of Net Assets in four net asset categories: invested in capital assets, net of related debt, \$737.1 million (43 percent), restricted-nonexpendable, \$365.5 million (21 percent), restricted-expendable, \$195.1 million (11 percent), and unrestricted, \$440.7 million (25 percent).

Restricted net assets are subject to externally imposed restrictions governing their use. Although unrestricted net assets are not subject to externally imposed stipulations, substantially all of the unrestricted net assets have been internally designated for support of academic and research programs and initiatives, capital projects and working capital requirements.

Total net assets increased by \$100.3 million during the year ended June 30, 2004. Invested in capital assets, net of related debt, increased by \$57.1 million, primarily due to net additions to capital assets of \$152.4 million, offset by current year depreciation expense of \$70.9 million. Restricted net assets increased by \$53.7 million, due to an increase in permanent endowments of \$28.0 million, and an increase in expendable restricted net assets of \$25.6 million, primarily due to an increase in realized and unrealized gains on endowment investments offset by the expenditure of net assets restricted for capital projects. Unrestricted net assets decreased \$10.4 million, primarily due to the expenditure of funds for capital assets.

2003 Versus 2002. During the year ended June 30, 2003:

- Total assets increased by \$58.7 million or 2.9 percent primarily due to increases in capital assets.
- Liabilities decreased by \$6.6 million or 1.4 percent primarily due to principal payments on bonds and capital lease obligations.
- Total net assets increased by \$65.3 million. Invested in capital, net of related debt, increased by \$62.7 million, primarily due to net additions to capital assets of \$123.3 million offset by current year depreciation expense of \$68.3 million. Restricted net assets decreased by \$5.9 million, due to an increase in permanent endowments of \$29.8 million, and a decrease in expendable restricted net assets of \$35.7 million, primarily due to the expenditure of net assets restricted for capital projects. Unrestricted net assets increased \$8.6 million, primarily due to University Hospital operating revenues in excess of expenses.

Consolidated Statement of Revenues, Expenses and Changes in Net Assets

The Consolidated Statement of Revenues, Expenses and Changes in Net Assets is prepared on the accrual basis of accounting, whereby revenues and assets are recognized when the service is provided and expenses and liabilities are recognized when others provide the service, regardless of when cash is exchanged. All items that increase or decrease net assets must appear on the Consolidated Statement of Revenues, Expenses and Changes in Net Assets as revenues, expenses, gains or losses.

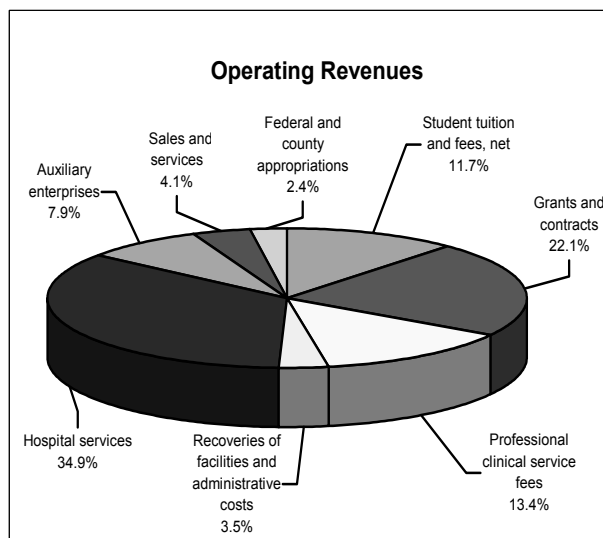
Financial activities are reported as either operating or nonoperating. GASB Statement No. 35 requires state appropriations, gifts, and investment and endowment income to be classified as nonoperating revenues. Accordingly, the University reports a net operating loss for the year prior to the addition of nonoperating revenues. The utilization of long-lived capital assets is reflected in the financial statements as depreciation, which amortizes the cost of an asset over its expected useful life. Tuition revenue is reduced by gift scholarships and institutional aid, and is reported net of scholarship allowances in the financial statements. A summarized comparison of the University's revenues, expenses and changes in net assets for the years ended June 30, 2004, 2003 and 2002 is as follows:

Condensed Consolidated Statement of Revenues, Expenses and Changes in Net Assets
(in thousands)

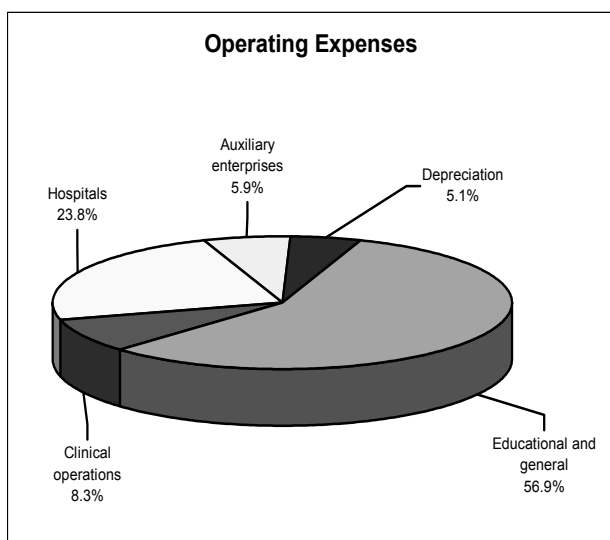
	<u>2004</u>	<u>2003</u>	<u>2002</u>
OPERATING REVENUES			
Student tuition and fees, net of scholarship allowances	\$ 124,034	\$ 107,485	\$ 103,770
Grants and contracts	234,092	212,920	182,583
Hospital services	370,628	343,393	316,345
Professional clinical service fees	141,989	131,451	120,161
Auxiliary enterprises, net of scholarship allowances	84,447	73,860	73,189
Sales and services	43,095	39,210	43,148
Recoveries of facilities and administrative costs	37,122	34,364	30,406
Federal and county appropriations	25,707	23,867	23,051
Other operating revenue	303	324	565
Total operating revenues	<u>1,061,417</u>	<u>966,874</u>	<u>893,218</u>
OPERATING EXPENSES			
Educational and general, excluding depreciation	787,780	751,083	718,412
Clinical operations, excluding depreciation	115,279	105,208	77,189
Hospital, excluding depreciation	329,142	296,375	283,600
Auxiliary enterprises, excluding depreciation	80,334	76,118	69,279
Depreciation	70,888	68,323	65,261
Other	276	223	475
Total operating expenses	<u>1,383,699</u>	<u>1,297,330</u>	<u>1,214,216</u>
OPERATING LOSS	<u>(322,282)</u>	<u>(330,456)</u>	<u>(320,998)</u>
NONOPERATING REVENUES (EXPENSES)			
State appropriations	302,539	304,735	303,639
Capital appropriations	2,070	1,660	49,002
Capital grants and gifts	15,275	20,005	11,343
Gifts and grants	22,477	19,721	28,132
Investment income	78,102	34,245	3,501
Interest on capital asset - related debt	(11,970)	(11,487)	(12,575)
Additions to permanent endowments	21,036	24,708	25,565
Other, net	(6,926)	2,192	11,252
Total nonoperating revenues (expenses)	<u>422,603</u>	<u>395,779</u>	<u>419,859</u>
Total increase in net assets	<u>100,321</u>	<u>65,323</u>	<u>98,861</u>
Net assets, beginning of year, as restated	1,638,156	1,572,833	1,473,972
Net assets, end of year, as restated	<u>\$ 1,738,477</u>	<u>\$ 1,638,156</u>	<u>\$ 1,572,833</u>

Total operating revenues were \$1.06 billion for the year ended June 30, 2004, an increase of \$94.5 million (10 percent). The primary components were student tuition and fees of \$124.0 million; grants, contracts and recoveries of facilities and administrative costs of \$271.2 million; hospital services of \$370.6 million; and professional clinical fee income of \$142.0 million.

The major increases were in hospital services of \$27.2 million due to rate increases required to cover rising costs; in grants, contracts and recoveries of facilities and administrative costs of \$23.9 million due to the continued expansion of the research mission of the University; and in tuition and fees of \$16.5 million due to tuition increases of approximately 15 percent.



Operating expenses totaled \$1.38 billion, an increase of \$86.4 million (7 percent). Of this amount, \$787.8 million was expended for educational and general programs, including the functions of instruction, research and service. Hospital expenses, excluding depreciation, amounted to \$329.1 million and clinical operations expenses, excluding depreciation, were \$115.3 million. Depreciation expense for the year amounted to \$70.9 million.



The most significant increase was in the hospital of \$32.8 million (11 percent) due to higher costs for medical supplies and personnel. The largest increase in educational and general expenses related to research of \$21.0 million (11 percent) due to the increased grant and contract activity mentioned above. Other educational and general expenses increased only \$17.0 million, or less than 3 percent, primarily due to fiscal constraints implemented by the University as a result of the reduction in state appropriations.

The net loss from operations for the year amounted to \$322.3 million. Nonoperating revenues, net of expenses, amounted to \$422.6 million, resulting in an increase in net assets of \$100.3 million for the year. Nonoperating revenues include state appropriations of \$302.5 million.

2003 Versus 2002. Total operating revenues were \$966.9 million for the year ended June 30, 2003, including student tuition and fees of \$107.5 million (11 percent), grants, contracts and recoveries of facilities and administrative costs of \$247.3 million (26 percent), professional clinical services fees of \$131.5 million (14 percent) and hospital services of \$343.4 million (36 percent). Operating revenues for fiscal 2003 increased by \$73.7 million or 8 percent over fiscal 2002, primarily due to increases in grants and contract revenue of approximately \$30.3 million and in hospital services revenue of \$27.0 million.

Operating expenses totaled \$1.30 billion. Of this amount, \$751.1 million, or 58 percent, was expended for educational and general programs, including the functions of instruction, research and public service. Hospital expenses, excluding depreciation, amounted to \$296.4 million, or 23 percent of the total expenses and clinical operations expenses were \$105.2 million, or 8 percent. Depreciation amounted to \$68.3 million, or 5 percent. Operating expenses for fiscal 2003 increased by \$83.1 million or 7 percent over fiscal 2002 primarily due to increases in educational and general expenses of \$32.7 million, in clinical operations of \$28.0 million and in hospital expenses of \$12.8 million.

The net loss from operations for the year amounted to \$330.5 million. Nonoperating revenues, net of expenses, amounted to \$395.8 million, resulting in an increase in net assets of \$65.3 million for the year. This compares with an increase in net assets for fiscal 2002 of \$98.9 million. The most significant differences between fiscal 2002 and 2003 were a decrease in capital appropriations of \$47.3 million and an increase in investment income of \$30.7 million.

Consolidated Statement of Cash Flows

The Consolidated Statement of Cash Flows presents information related to the University's cash inflows and outflows summarized by operating, capital, financing and investing activities. The primary purpose of the Consolidated Statement of Cash Flows is to provide information about the cash receipts and cash payments made by the University during the year that will allow financial statement readers to assess the institutions:

- Ability to generate future net cash flows,
- Ability to meet obligations as they become due, and
- The possible need for external financing.

A comparative summary of the University's consolidated statement of cash flows for the years ended June 30, 2004, 2003 and 2002 is as follows:

Condensed Consolidated Statement of Cash Flows (in thousands)

	2004	2003	2002
Cash provided (used by):			
Operating activities	\$ (228,300)	\$ (248,155)	\$ (235,615)
Noncapital financing activities	347,990	350,853	355,686
Capital and related financing activities	(79,170)	(132,164)	(110,302)
Investing activities	(6,490)	30,432	10,437
Net increase in cash	34,030	966	20,206
Cash and cash equivalents, beginning of year	367,060	366,094	345,888
Cash and cash equivalents, end of year	\$ 401,090	\$ 367,060	\$ 366,094

Major sources of cash received from operating activities are student tuition and fees of \$123.8 million, hospital services of \$376.2 million, and grants, contracts and recoveries of facilities and administrative costs of \$271.8 million. Major uses of cash for operating activities were payments to employees for salaries and benefits of \$777.6 million and to vendors and contractors of \$496.5 million.

Noncapital financing activities includes state appropriations from the Commonwealth of Kentucky of \$302.5 million.

Capital and related financing activities include proceeds of capital debt of \$185.7 million and capital grants and gifts of \$7.3 million. Cash of \$149.6 million was expended for construction and acquisition of capital assets, \$34.9 million was expended for principal and interest payments on debt and \$86.7 million was paid to refunding bond agents.

Investing activities include proceeds from sales and maturities of investments of \$1.67 billion and interest and dividends on investments of \$22.3 million. Cash of \$1.69 billion was used to purchase investments.

2003 Versus 2002. Cash remained relatively stable when comparing fiscal 2003 versus fiscal 2002 with a net increase in cash of approximately \$966,000. The net increase in cash declined by \$19.2 million, primarily due to increased capital and financing related expenditures of \$21.9 million and increased use of operating cash of \$12.5 million offset by increases in cash from investing activities of \$20.0 million.

Capital Asset and Debt Administration

Capital Assets

Capital assets, net of accumulated depreciation, totaled \$982.4 million at June 30, 2004, an increase of \$81.5 million. Capital assets as of June 30, 2004 and significant changes in capital assets during the years ended June 30, 2004 and 2003 are as follows (in millions):

	Balance June 30, 2002	Net Additions FY 02-03	Balance June 30, 2003	Net Additions FY 03-04	Balance June 30, 2004
Land and land improvements	\$ 78	\$ 11	\$ 89	\$ 3	\$ 92
Buildings, fixed equipment and infrastructure	907	150	1,057	60	1,117
Equipment, vehicles and capitalized software	335	12	347	30	377
Library materials and art	108	8	116	6	122
Construction in progress	144	(81)	63	26	89
Accumulated depreciation	<u>(726)</u>	<u>(45)</u>	<u>(771)</u>	<u>(44)</u>	<u>(815)</u>
Total	<u>\$ 846</u>	<u>\$ 55</u>	<u>\$ 901</u>	<u>\$ 81</u>	<u>\$ 982</u>

At June 30, 2004, the University has capital construction projects in progress totaling approximately \$213 million in scope. Major projects include: the Biomedical/Biological Sciences Research Building, Student Housing Facilities and the Main Building reconstruction.

Debt

At June 30, 2004, capital debt amounted to \$326.5 million, summarized below by trust indenture and type as follows (in millions):

	2004	2003	2002
Consolidated Educational Buildings Revenue Bonds	\$ 154.3	\$ 114.1	\$ 126.4
Consolidated Housing and Dining System Revenue Bonds	79.3	28.6	31.0
Hospital Revenue Bonds	3.8	3.8	9.3
Commonwealth Library Project (W.T. Young Library) Bonds	42.5	43.6	44.6
Capital Lease Obligations	43.1	45.0	48.8
Notes Payable	3.5	4.0	1.9
Total	<u>\$ 326.5</u>	<u>\$ 239.1</u>	<u>\$ 262.0</u>

Debt increased \$87.4 million during the year due to the issuance of Consolidated Educational Buildings Revenue Bonds and Consolidated Housing and Dining System Revenue Bonds offset by the payment of current year maturities.

Economic Factors That Will Affect the Future

Executive management believes that the University is well-positioned to maintain its strong financial condition and to continue providing excellent service to students, patients, the community and the Commonwealth of Kentucky. The University's strong financial condition, as evidenced by the receipt of a credit rating of Aa3 from Moody's Investors Service, will provide a high degree of flexibility in obtaining funds on competitive terms. This flexibility, along with ongoing efforts toward revenue diversification and cost containment, will enable the University to obtain the necessary resources to sustain excellence. The following are known facts and circumstances that will affect future financial results:

- The General Assembly of the Commonwealth of Kentucky has not adopted a budget for the 2004-06 biennium. Governor Ernie Fletcher implemented, by executive order, his Public Services Continuation Plan, an emergency spending plan for the first quarter of fiscal year 2005. The Public Services Continuation Plan, if implemented for the entire fiscal year, would reduce the University's general fund state appropriations by approximately \$16 million from the 2003-04 funding amount. The Board of Trustees has approved an operating budget for fiscal year 2005.
- As a result of a declining economy, budgeted state appropriations for fiscal year 2004-2005 will decline for the fourth consecutive year. One of the consequences of this decrease is an average increase in tuition rates for fiscal year 2005 of approximately 13.6 percent for resident undergraduate students. The tuition rate increases combined with increased enrollment are expected to generate additional operating revenues of approximately \$24.0 million.
- As state appropriations continue to decrease, the University must rely to a greater extent on the support of donors to maintain and enhance its core academic programs. However, economic pressures may influence the future level of support that the University receives from corporate and individual giving.
- As of June 30, 2004, grants and contracts of approximately \$164 million had been awarded to the University, but not expended. These contracts will provide grant revenue to future periods. Research grants and contracts awarded to the University in fiscal year 2004 were a record high of \$238.3 million.
- The University is conducting its Campaign for the University of Kentucky, a capital campaign with an expanded goal of \$1 billion. Nearly \$688 million of gifts have been received or pledged toward this goal.
- The University will continue its long-term endowment investment strategy to maximize total returns, at an appropriate level of risk, while utilizing a spending rate policy to insulate programs funded by the endowment from temporary market volatility.
- The University does not record a liability for post-employment retiree health benefits. Governmental Accounting Standards require that this liability be recognized in the financial statements beginning June 30, 2008. The University has not yet evaluated the impact that the adoption of this statement will have on its financial statements, but it is likely to be significant.

Although many economic challenges have faced the University in the past year and will continue to impact the future, university management believes that the University of Kentucky will be able to sustain its sound financial position and continue its progress to become one of America's 20 best public research institutions.

INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of the
University of Kentucky

and

the Secretary of Finance and
Administration Cabinet of the
Commonwealth of Kentucky

We have audited the accompanying consolidated statements of net assets of the University of Kentucky (the University) (an agency of the Commonwealth of Kentucky) and affiliated corporations as of June 30, 2004 and 2003, and the related consolidated statements of revenues, expenses and changes in net assets and of cash flows for the years then ended. These consolidated financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the University of Kentucky and affiliated corporations as of June 30, 2004 and 2003, and their changes in net assets and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, in 2004 the University implemented Governmental Accounting Standards Board ("GASB") Statement No. 39 *Determining Whether Certain Organizations Are Component Units* an amendment of GASB Statement 14 *The Financial Reporting Entity* as of and for the year ended June 30, 2004 and retroactively restated the June 30, 2003 financial statements for the change.

The Management's Discussion and Analysis (MD&A) on pages 1 through 9 is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the University's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 2, 2004, on our consideration of the University's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Deloitte & Touche LLP

September 2, 2004
Louisville, Kentucky

UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS
CONSOLIDATED STATEMENT OF NET ASSETS
JUNE 30, 2004 AND 2003

	<u>2004</u>	<u>2003</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 307,848,379	\$ 294,872,171
Notes, loans and accounts receivable, net	115,502,281	134,647,887
Investments	38,644,220	35,301,301
Inventories and other	18,990,178	16,827,389
Total current assets	<u>480,985,058</u>	<u>481,648,748</u>
Noncurrent Assets		
Restricted cash and cash equivalents	93,242,027	72,187,676
Endowment investments	511,928,739	432,405,612
Other long-term investments	208,484,085	200,049,145
Notes, loans and accounts receivable, net	30,443,232	24,592,526
Capital assets, net	982,365,781	900,856,127
Total noncurrent assets	<u>1,826,463,864</u>	<u>1,630,091,086</u>
Total assets	<u>2,307,448,922</u>	<u>2,111,739,834</u>
LIABILITIES		
Current Liabilities		
Accounts payable and accrued liabilities	115,314,338	115,336,398
Deferred revenue	46,950,552	43,029,339
Long-term liabilities - current portion	42,647,990	41,444,479
Total current liabilities	<u>204,912,880</u>	<u>199,810,216</u>
Noncurrent Liabilities		
Long-term liabilities	<u>364,059,493</u>	<u>273,773,864</u>
Total liabilities	<u>568,972,373</u>	<u>473,584,080</u>
NET ASSETS		
Invested in capital assets, net of related debt	<u>737,139,956</u>	<u>680,055,651</u>
Restricted		
Nonexpendable		
Scholarships and fellowships	69,557,085	64,044,365
Research	157,085,381	142,000,873
Instruction	56,635,431	54,059,533
Academic support	77,557,115	74,252,561
Other	4,700,992	3,140,103
Total restricted nonexpendable	<u>365,536,004</u>	<u>337,497,435</u>
Expendable (See note 10.)		
Scholarships and fellowships	47,010,108	38,178,527
Research	36,105,026	21,392,421
Instruction	40,150,819	30,818,475
Academic support	14,905,459	6,415,042
Loans	8,283,332	8,026,507
Capital projects	10,622,979	29,759,063
Debt service	6,570,210	10,175,572
Other	31,464,062	24,706,351
Total restricted expendable	<u>195,111,995</u>	<u>169,471,958</u>
Total restricted	<u>560,647,999</u>	<u>506,969,393</u>
Unrestricted (See note 11.)	<u>440,688,594</u>	<u>451,130,710</u>
Total net assets, as restated	<u>\$ 1,738,476,549</u>	<u>\$ 1,638,155,754</u>

UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS
CONSOLIDATED STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
OPERATING REVENUES		
Student tuition and fees, including pledged revenues	\$ 170,018,037	\$ 145,176,234
Less: Scholarship allowances	(45,983,729)	(37,691,166)
Net tuition and fees	124,034,308	107,485,068
Federal grants and contracts	134,207,554	126,281,668
State and local grants and contracts	70,043,579	58,308,131
Nongovernmental grants and contracts	29,840,995	28,330,343
Recoveries of facilities and administrative costs	37,122,226	34,364,247
Sales and services	43,095,272	39,210,281
Federal appropriations	15,622,978	14,065,904
County appropriations	10,083,679	9,800,456
Professional clinical service fees	141,988,915	131,451,326
Hospital services, including pledged revenues	370,627,540	343,393,345
Auxiliary enterprises:		
Housing and dining, including pledged revenues	36,224,731	32,300,052
Less: Scholarship allowances	(6,296,085)	(5,677,857)
Net housing and dining	29,928,646	26,622,195
Athletics	42,970,474	35,236,012
Other auxiliaries	11,548,258	12,001,641
Other operating revenues	302,761	323,803
Total operating revenues	1,061,417,185	966,874,420
OPERATING EXPENSES		
Educational and general:		
Instruction	247,011,317	244,538,479
Research	208,557,422	187,568,369
Public service	121,887,133	116,702,570
Libraries	13,609,420	12,009,480
Academic support	45,686,079	47,992,942
Student services	20,431,888	19,786,923
Institutional support	51,501,518	47,663,167
Operations and maintenance of plant	47,351,021	46,391,269
Student financial aid	31,743,647	28,430,916
Depreciation	50,273,283	48,992,899
Total educational and general	838,052,728	800,077,014
Clinical operations (including depreciation of \$718,796 in 2004 and \$674,585 in 2003)	115,998,394	105,882,535
Hospital and clinics (including depreciation of \$15,192,132 in 2004 and \$13,996,082 in 2003)	344,334,389	310,371,469
Auxiliary enterprises:		
Housing and Dining (including depreciation of \$2,148,480 in 2004 and \$2,109,639 in 2003)	34,369,705	30,925,358
Athletics (including depreciation of \$2,555,741 in 2004 and \$2,549,659 in 2003)	42,995,953	38,328,446
Other auxiliaries	7,672,281	11,521,955
Other operating expenses	276,185	223,386
Total operating expenses	1,383,699,635	1,297,330,163
Net loss from operations	(322,282,450)	(330,455,743)
NONOPERATING REVENUES (EXPENSES)		
State appropriations	302,538,956	304,734,856
Gifts and grants	22,476,900	19,720,658
Investment income	78,101,981	34,244,974
Interest on capital asset-related debt	(11,969,667)	(11,486,908)
Other nonoperating revenues and expenses, net	3,408,394	1,542,248
Net nonoperating revenues (expenses)	394,556,564	348,755,828
Net gain (loss) before other revenues, expenses, gains, or losses	72,274,114	18,300,085
Capital appropriations	2,070,472	1,659,523
Capital grants and gifts	15,275,331	20,004,678
Additions to permanent endowments, including Research Challenge		
Trust Funds of \$1,864,197 in 2004 and \$7,245,700 in 2003	21,035,538	24,708,418
Other, net	(10,334,660)	650,526
Total other revenues (expenses)	28,046,681	47,023,145
INCREASE IN NET ASSETS	100,320,795	65,323,230
NET ASSETS, beginning of year, as restated	1,638,155,754	1,572,832,524
NET ASSETS, end of year, as restated	\$ 1,738,476,549	\$ 1,638,155,754

See notes to consolidated financial statements.

**UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Student tuition and fees	\$ 123,841,597	\$ 108,388,929
Grants and contracts	234,600,486	204,665,201
Recoveries of facilities and administrative costs	37,167,131	32,824,951
Sales and services	43,048,326	39,875,966
Federal appropriations	15,527,585	13,780,753
County appropriations	10,292,606	9,595,694
Payments to vendors and contractors	(496,536,773)	(452,706,959)
Student financial aid	(31,707,371)	(28,424,974)
Salaries, wages and benefits	(777,649,684)	(742,699,153)
Professional clinic service fees	143,921,021	134,550,534
Hospital services	376,173,834	358,378,930
Auxiliary enterprise receipts:		
Housing and Dining	30,293,831	27,176,723
Athletics	42,282,589	36,572,243
Other auxiliaries	11,917,023	11,476,713
Loans issued to students	(11,756,427)	(8,591,245)
Collection of loans to students	9,940,975	7,917,958
Self insurance receipts	34,735,703	28,479,489
Self insurance payments	(30,128,712)	(30,297,265)
Other receipts (payments), net	5,735,798	880,556
Net cash provided (used) by operating activities	<u>(228,300,462)</u>	<u>(248,154,956)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations	302,538,956	304,734,856
Gifts and grants received for other than capital purposes:		
Gifts received for endowment purposes	21,035,538	24,748,418
Gifts received for other purposes	20,710,103	20,304,702
Agency and loan program receipts	95,604,960	88,111,872
Agency and loan program payments	(95,556,824)	(88,188,032)
Other nonoperating receipts (payments), net	3,658,247	1,141,067
Net cash provided (used) by noncapital financing activities	<u>347,990,980</u>	<u>350,852,883</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Capital appropriations	547,021	537,241
Capital grants and gifts	7,294,205	6,644,422
Purchases of capital assets	(149,595,685)	(106,615,032)
Proceeds from capital debt	185,689,095	12,146,099
Payments to refunding bond agents	(86,736,986)	(12,992,620)
Proceeds from sales of capital assets	238,749	3,975,507
Principal paid on capital debt and leases	(23,392,879)	(25,507,482)
Interest paid on capital debt and leases	(11,556,729)	(11,824,703)
Other capital and related financing receipts (payments), net	(1,656,327)	1,472,918
Net cash provided (used) by capital and related financing activities	<u>(79,169,536)</u>	<u>(132,163,650)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	1,665,952,773	1,072,318,666
Interest and dividends on investments	22,275,312	31,763,122
Purchase of investments	(1,694,718,508)	(1,073,649,769)
Net cash provided (used) by investing activities	<u>(6,490,423)</u>	<u>30,432,019</u>
NET INCREASE IN CASH	34,030,559	966,296
CASH AND CASH EQUIVALENTS, beginning of year	<u>367,059,847</u>	<u>366,093,551</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 401,090,406</u>	<u>\$ 367,059,847</u>
Reconciliation of net loss from operations to net cash used by operating activities:		
Operating loss	\$ (322,282,450)	\$ (330,455,743)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation expense	70,888,432	68,322,864
Change in assets and liabilities:		
Notes, loans and accounts receivable, net	5,992,813	7,016,905
Inventories and other assets	(2,064,424)	(1,782,652)
Accounts payable and accrued liabilities	7,859,203	6,677,779
Deferred revenue	5,444,662	1,527,424
Long term liabilities	5,861,302	538,467
Net cash used by operating activities	<u>\$ (228,300,462)</u>	<u>\$ (248,154,956)</u>

UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The University of Kentucky (the University) is a component unit of the Commonwealth of Kentucky and is included in the basic financial statements of the Commonwealth. The consolidated financial statements of the University include the operations of the University, its for-profit subsidiary (Kentucky Healthcare Enterprise, Inc.) and its affiliated non-profit corporations (entities for which the University is financially accountable as defined by Statement No. 14 and amended by Statement No. 39 of the Governmental Accounting Standards Board) as follows: The University of Kentucky Research Foundation and its for-profit subsidiary (Kentucky Technology, Inc.); The Fund for Advancement of Education and Research in the University of Kentucky Medical Center; University of Kentucky Athletic Association; Health Care Collection Service, Inc.; University of Kentucky Mining Engineering Foundation, Inc.; University of Kentucky Business Partnership Foundation, Inc.; University of Kentucky Gluck Equine Research Foundation, Inc.; University of Kentucky Humanities Foundation, Inc.; University of Kentucky Center on Aging Foundation, Inc.; and Kentucky Medical Services Foundation, Inc.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). GASB establishes standards for external financial reporting for public colleges and universities and requires that resources be classified for accounting and reporting purposes into the following net assets categories:

- Invested in capital assets, net of related debt: Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- Restricted:
 - Nonexpendable* – Net assets subject to externally imposed stipulations that they be maintained permanently by the University. Such assets include the principal of the University's permanent endowment funds.
 - Expendable* – Net assets whose use by the University is subject to externally imposed stipulations that can be fulfilled by actions of the University pursuant to those stipulations or that expire by the passage of time.
- Unrestricted: Net assets whose use by the University is not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Trustees or may otherwise be limited by contractual agreements with outside parties.

The financial statement presentation is intended to provide a comprehensive, entity-wide perspective of the University's assets, liabilities, net assets, revenues, expenses, changes in net assets and cash flows.

Summary of Significant Accounting Policies

Accrual Basis. The consolidated financial statements have been prepared on the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when an obligation has been incurred. The University reports as a Business Type Activity (BTA) as defined by GASB Statement No. 35. BTA's are those activities that are financed in whole or part by fees charged to external parties for goods and services.

Cash and Cash Equivalents. Cash and cash equivalents consist of deposits with local banks and with the Commonwealth of Kentucky and investments in repurchase agreements. Deposits with local banks and investments in repurchase agreements are covered by federal depository insurance or collateralized by securities

held in the University's name by its agents. Deposits with the Commonwealth of Kentucky are covered by federal depository insurance or collateralized by securities held by the Commonwealth in the Commonwealth's name. The University considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Noncurrent cash and cash equivalents includes plant funds allocated for capital projects and endowment fund cash pending transfer to the custodian for investment. Cash and cash equivalents held by the University's endowment fund managers are included in endowment investments.

Inventories. Inventories are stated principally at the lower of average cost or market.

Pooled Endowment Funds. The University employs the total return concept of investment management for setting investment objectives and determining investment performance. This concept recognizes dividends and interest, plus or minus realized and unrealized gains or losses, in determining the total return earned during any particular period. The market value method of accounting for pooled endowment funds is employed to ensure proper distribution of market price changes, realized gain (loss) on sales, accrued income earned, and distribution of investment earnings for expenditure by participating funds.

The Uniform Management of Institutional Funds Act (UMIFA), as adopted by the Commonwealth of Kentucky, permits the University to appropriate an amount of the realized and unrealized endowment appreciation to support current programs. Accordingly, spendable return from the endowment is determined using the total return philosophy. This philosophy recognizes a prudent amount of realized and unrealized gains as spendable return in addition to traditional yield. Distribution of investment earnings for expenditure by participating funds is supported first by traditional yield earned and, if necessary, a transfer from the endowment of any prior years' accumulated earnings (unexpended traditional yield) or net realized or unrealized gains. The University's endowment spending rule provides for an annual distribution of 5 percent of the three-year moving average market value of fund units. For the years ended June 30, 2004 and 2003 approximately \$16,114,000 and \$13,892,000, respectively, was transferred from endowment realized and unrealized gains to support current programs in accordance with the University's endowment spending rule. Appreciation on endowments available to support future spending rule distributions amounted to approximately \$88,608,000 at June 30, 2004.

Investments. Investments in marketable securities are carried at fair value, as determined by the major securities markets. Changes in unrealized gain (loss) on the carrying value of investments are reported as a component of investment income in the statement of revenues, expenses and changes in net assets.

Capital Assets. Capital assets are stated at cost at date of acquisition or, in the case of gifts, at fair market value at date of gift.

Equipment with a unit cost of \$2,000 or more (\$1,000 for computers) and having an estimated useful life of greater than one year, is capitalized. Renovations to buildings, infrastructure and land improvements that significantly increase the value or extend the useful life of the structure are capitalized. Routine repairs and maintenance are charged to operating expense in the year in which the expense is incurred.

Depreciation of capital assets is computed on a straight-line basis over the estimated useful lives of the respective assets, generally 40 years for buildings, 10 – 25 years for land and building improvements and infrastructure, 10 years for library books and 5 – 20 years for equipment.

The University capitalizes, but does not depreciate, works of art and historical treasures that are held for exhibition, education, research and public service.

Deferred Revenue. Deferred revenue consists primarily of amounts received from grant and contract sponsors that have not yet been earned under the terms of the agreement. Deferred revenue also includes amounts received in advance of an event, such as advance athletic ticket sales relating to future fiscal years.

Student Tuition and Fees. Student tuition and fees are presented net of scholarship allowances applied to student accounts. Stipends and other payments made directly to students are presented as student financial aid expenses.

Hospital and Clinical Services Revenues. Hospital and clinical services revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including contractual allowances and estimated retroactive adjustments under reimbursement programs 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.

Income Taxes. The University is an agency and instrumentality of the Commonwealth of Kentucky, pursuant to Kentucky Revised Statutes sections 164.100 through 164.280. Accordingly, the University is excluded from Federal income taxes as an organization described in Section 170 (b)(1)(A)(ii) of the Internal Revenue Code of 1986. The majority of the University's affiliated non-profit organizations have been granted exemption from federal income taxation pursuant to the provisions of Internal Revenue Code section 501(c)(3).

Restricted Asset Spending Policy. The University's policy is that restrictions on assets cannot be fulfilled by the expenditure of unrestricted funds for similar purposes. The determination on whether restricted or unrestricted funds are expended for a particular purpose is made on a case-by-case basis. Restricted funds remain restricted until spent for the intended purpose.

Operating Activities. The University defines operating activities, as reported on the Statement of Revenues, Expenses and Changes in Net Assets, as those that generally result from exchange transactions, such as payments received for providing goods and services and payments made for goods and services received. Nearly all of the University's expenses are from exchange transactions. Certain significant revenues relied upon for operations, such as state appropriations, gifts and investment income, are recorded as non-operating revenues, in accordance with GASB Statement No. 35.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to use estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The accompanying financial statements include estimates for items such as bad debt and contractual allowances, self-insurance reserves, accrued expenses and other liability accounts.

Recent Accounting Pronouncements. In March 2003, the GASB issued Statement No. 40 "Deposit and Investment Risk Disclosures." This statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rate risk. The provisions of this statement are effective for financial statements for periods beginning after June 15, 2004. The University does not expect the adoption of this statement to have a material effect on its financial statements.

In November 2003, the GASB issued Statement No. 42, "Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries." This statement requires certain disclosures when the value of a capital asset has declined significantly and unexpectedly. This Statement also clarifies and establishes accounting requirements for insurance recoveries. The provisions of this statement are effective for financial statements for fiscal periods beginning after December 15, 2004. The University does not expect the adoption of this statement to have a material effect on its financial statements.

In June 2004, the GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions." This statement establishes standards for the measurement, recognition and display of other postemployment benefit expenses/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information in the financial reports of employers subject to governmental accounting standards. The provisions of this statement are effective for financial statements for fiscal periods beginning after December 15, 2006. The University has not yet evaluated the impact that the adoption of this statement will have on its financial statements, but it is likely to be significant.

2. RESTATEMENT OF PRIOR YEAR FINANCIAL STATEMENTS

In fiscal year 2003-04, the University adopted the provisions of GASB Statement No. 39, "Determining Whether Certain Organizations Are Component Units." This statement provided additional guidance to be used in determining whether certain organizations for which the University is not financially accountable should be reported as component units based on the nature and significance of their relationship with the University.

As a result of applying the guidance in GASB No. 39, Kentucky Medical Service Foundation, Inc. (KMSF) is now considered to be a component unit of the University and, accordingly, the net assets, revenues, and expenses of KMSF are included in the accompanying consolidated financial statements of the University. Beginning net assets as of June 30, 2003 and 2002 have been restated to reflect the application of the provisions of GASB No. 39, as follows (in thousands):

	<u>2003</u>	<u>2002</u>
Total net assets, June 30, as previously reported	\$ 1,576,001	\$ 1,507,426
Net assets added by the consolidation of KMSF as a component unit	<u>62,155</u>	<u>65,407</u>
Total net assets, June 30, as restated	<u>\$ 1,638,156</u>	<u>\$ 1,572,833</u>

3. RESEARCH CHALLENGE TRUST FUND

The Research Challenge Trust Fund (RCTF) was created by the Kentucky General Assembly with the passage of the Postsecondary Education Improvement Act of 1997 (House Bill 1). The objectives of the Trust Fund, as stated in the Bill, include support of efforts by the University of Kentucky to attain status as a top-20 public research university. The RCTF Endowment Match Program provides state funds on a dollar-for-dollar match basis. This program, also known as "Bucks for Brains", supports endowed chairs, professorships and graduate fellowships, and the research and graduate mission of the University.

The status of the RCTF endowed funds as of June 30, 2004, is summarized as follows (in thousands):

	<u>Kentucky General Assembly Funding</u>	<u>University of Kentucky Share of Funding</u>	<u>State Funds Received to Date</u>	<u>Matching Pledges Receivable</u>
1998 Biennium	\$ 100,000	\$ 66,667	\$ 66,667	\$ 80
2000 Biennium	100,000	68,857	68,857	18,246
2002 Biennium	<u>100,000</u>	<u>66,667</u>	<u>1,813</u>	<u>290</u>
Total	<u>\$ 300,000</u>	<u>\$ 202,191</u>	<u>\$ 137,337</u>	<u>\$ 18,616</u>

Interest income of approximately \$2.2 million earned on the state matching funds is included in the University's share of the 2000 Biennium funding.

The University expects to fully realize all outstanding matching pledges, however, it may be obligated to return any state funds and accrued interest income related to pledges not received within five years of the initial pledge dates if unable to replace the unpaid pledges with other eligible gifts. A payment schedule of the outstanding pledges is shown below (in thousands):

	<u>1998 Biennium</u>	<u>2000 Biennium</u>	<u>2002 Biennium</u>
Pledges due in fiscal years 2004 or prior	\$ 80	\$ 2,613	
Pledges due in fiscal year 2005	-	8,344	\$ 28
Pledges due in fiscal year 2006	-	6,184	28
Pledges due in fiscal year 2007	-	948	117
Pledges due in fiscal year 2008	-	127	117
Pledges due in fiscal year 2009	<u>-</u>	<u>30</u>	<u>-</u>
Total	<u>\$ 80</u>	<u>\$ 18,246</u>	<u>\$ 290</u>

4. NOTES, LOANS AND ACCOUNTS RECEIVABLE

Notes, loans and accounts receivable as of June 30, 2004 and 2003, respectively, are as follows (in thousands):

	<u>2004</u>		
	<u>Gross Receivable</u>	<u>Allowance</u>	<u>Net Receivable</u>
Hospital patient accounts	\$ 62,185	\$ (14,269)	\$ 47,916
KMSF patient accounts	24,974	(9,665)	15,309
Student loans	27,571	(3,050)	24,521
Reimbursement receivable - grants and contracts	29,330	-	29,330
Pledges receivable	14,846	(5,856)	8,990
Accrued interest receivable	2,011	-	2,011
Other	21,958	(4,090)	17,868
Total	<u>\$ 182,875</u>	<u>\$ (36,930)</u>	<u>\$ 145,945</u>
Current portion			\$ 115,502
Non-current portion			<u>30,443</u>
Total			<u>\$ 145,945</u>
	<u>2003</u>		
	<u>Gross Receivable</u>	<u>Allowance</u>	<u>Net Receivable</u>
Hospital patient accounts	\$ 75,211	\$ (15,064)	\$ 60,147
KMSF patient accounts	27,133	(11,479)	15,654
Student loans	25,903	(3,185)	22,718
Reimbursement receivable - grants and contracts	28,991	-	28,991
Pledges receivable	6,885	(2,927)	3,958
Accrued interest receivable	8,737	-	8,737
Other	22,655	(3,619)	19,036
Total	<u>\$ 195,515</u>	<u>\$ (36,274)</u>	<u>\$ 159,241</u>
Current portion			\$ 134,648
Non-current portion			<u>24,593</u>
Total			<u>\$ 159,241</u>

University accounts for its investment in CHA by the equity method since, under the provisions of CHA's by-laws, the University cannot exercise control over the day-to-day operations of CHA. A summary of the University's investment in CHA is as follows (in thousands):

	June 30, 2002	FY2002-03	June 30, 2003	FY2003-04	June 30, 2004
Investment	\$ 38,180		\$ 38,180		\$ 38,180
Equity in income (losses) through December 31, 2002 and 2003 (CHA fiscal year end)	<u>(8,775)</u>	<u>\$ 5,841</u>	<u>(2,934)</u>	<u>\$ (6,177)</u>	<u>(9,111)</u>
	<u>\$ 29,405</u>	<u>\$ 5,841</u>	<u>\$ 35,246</u>	<u>\$ (6,177)</u>	<u>\$ 29,069</u>

The University's equity in the net income of CHA for the six months ended June 30, 2004, was approximately \$958,000 (unaudited). This income is not reflected in the University's consolidated financial statements as of June 30, 2004.

6. CAPITAL ASSETS, NET

Capital assets as of June 30, 2004, and capital asset activity for the year ended June 30, 2004, are summarized as follows (in thousands):

	June 30, 2003	Additions	Deletions	June 30, 2004
Land	\$ 38,896	\$ 1,286	\$ 924	\$ 39,258
Land improvements - nonexhaustible	7,172	876	-	8,048
Land improvements - exhaustible	43,596	779	-	44,375
Buildings	992,925	58,537	2,543	1,048,919
Fixed equipment - communications	30,066	2,887	-	32,953
Infrastructure	33,471	1,328	-	34,799
Equipment	322,017	50,025	26,189	345,853
Vehicles	16,201	1,124	776	16,549
Library materials	109,285	7,037	624	115,698
Capitalized software	8,573	5,681	-	14,254
Art	6,793	100	-	6,893
Construction in progress	62,409	59,564	32,411	89,562
	<u>1,671,404</u>	<u>189,224</u>	<u>63,467</u>	<u>1,797,161</u>
<u>Accumulated Depreciation</u>				
Land improvements - exhaustible	36,661	1,532	-	38,193
Buildings	410,882	26,654	707	436,829
Fixed equipment - communications	16,093	2,273	-	18,366
Infrastructure	5,378	1,364	-	6,742
Equipment	210,291	31,679	25,223	216,747
Vehicles	11,355	1,474	711	12,118
Library materials	79,888	5,680	-	85,568
Capitalized software	-	232	-	232
	<u>770,548</u>	<u>70,888</u>	<u>26,641</u>	<u>814,795</u>
Capital assets, net	<u>\$ 900,856</u>	<u>\$ 118,336</u>	<u>\$ 36,826</u>	<u>\$ 982,366</u>

Capital assets as of June 30, 2003, and capital asset activity for the year ended June 30, 2003, are summarized as follows (in thousands):

	June 30, 2002	Additions	Deletions	June 30, 2003
Land	\$ 32,771	\$ 6,364	\$ 239	\$ 38,896
Land improvements - nonexhaustible	2,426	4,746	-	7,172
Land improvements - exhaustible	43,126	470	-	43,596
Buildings	862,226	131,980	1,281	992,925
Fixed equipment - communications	25,359	4,707	-	30,066
Infrastructure	19,225	14,246	-	33,471
Equipment	313,482	32,024	23,489	322,017
Vehicles	15,837	2,212	1,848	16,201
Library materials	101,172	9,069	956	109,285
Capitalized software	5,681	2,892	-	8,573
Art	6,500	293	-	6,793
Construction in progress	143,772	40,528	121,891	62,409
	<u>1,571,577</u>	<u>249,531</u>	<u>149,704</u>	<u>1,671,404</u>
<u>Accumulated Depreciation</u>				
Land improvements - exhaustible	35,020	1,641	-	36,661
Buildings	386,196	25,004	318	410,882
Fixed equipment - communications	14,094	1,999	-	16,093
Infrastructure	4,324	1,054	-	5,378
Equipment	200,147	31,904	21,760	210,291
Vehicles	11,456	1,350	1,451	11,355
Library materials	74,517	5,371	-	79,888
	<u>725,754</u>	<u>68,323</u>	<u>23,529</u>	<u>770,548</u>
Capital assets, net	<u>\$ 845,823</u>	<u>\$ 181,208</u>	<u>\$ 126,175</u>	<u>\$ 900,856</u>

At June 30, 2004, the University has construction projects in process totaling approximately \$213 million in scope. The estimated cost to complete these projects is approximately \$114 million. Such construction is principally financed by appropriations from the Commonwealth of Kentucky and proceeds from bonds.

The University has utilized capital leases to acquire various items of equipment costing approximately \$18.6 million and lease agreements with the State Property and Buildings Commission to finance renovations to Commonwealth Stadium.

7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities as of June 30, 2004 and 2003, respectively, are as follows (in thousands):

	2004	2003
Payable to vendors and contractors	\$ 48,476	\$ 53,915
Accrued expenses, primarily vacation and sick leave	41,706	35,519
Employee withholdings and deposits payable to third parties	25,132	25,902
Total	<u>\$ 115,314</u>	<u>\$ 115,336</u>

8. DEFERRED REVENUE

Deferred revenue as of June 30, 2004 and 2003, respectively, is as follows (in thousands):

	<u>2004</u>	<u>2003</u>
Unearned summer school revenue	\$ 4,383	\$ 3,646
Unearned hospital revenue	8,501	3,895
Unearned grants and contracts revenue	20,836	20,241
Prepaid athletic ticket sales	9,058	10,000
Unearned state deferred maintenance pool funds	1,207	2,731
Other	<u>2,966</u>	<u>2,516</u>
Total	<u>\$ 46,951</u>	<u>\$ 43,029</u>

9. LONG-TERM LIABILITIES

Long-term liabilities as of June 30, 2004, and long-term liability activity for the year ended June 30, 2004, are summarized as follows (in thousands):

	<u>June 30, 2003</u>	<u>Additions</u>	<u>Reductions</u>	<u>June 30, 2004</u>	<u>Current Portion</u>	<u>Noncurrent Portion</u>
<u>Bonds, notes and capital leases</u>						
Educational buildings bonds	\$ 114,100	\$ 128,375	\$ 88,150	\$ 154,325	\$ 12,760	\$ 141,565
Housing and dining bonds	28,621	57,050	6,396	79,275	2,640	76,635
Hospital bonds	3,850	-	-	3,850	2,080	1,770
Library bonds	43,565	-	1,045	42,520	1,105	41,415
Capital leases	45,013	4,950	6,877	43,086	5,146	37,940
Notes payable	3,979	915	1,409	3,485	3,063	422
Total bonds, notes and capital leases	<u>239,128</u>	<u>191,290</u>	<u>103,877</u>	<u>326,541</u>	<u>26,794</u>	<u>299,747</u>
<u>Other liabilities</u>						
Medical malpractice	24,783	3,846	2,669	25,960	3,315	22,645
Long term disability	10,774	3,719	2,886	11,607	2,170	9,437
Annuities payable	5,298	980	632	5,646	686	4,960
Health insurance	3,821	22,259	20,625	5,455	5,455	-
Federal loan programs	20,767	647	-	21,414	-	21,414
Workers compensation	4,827	4,268	3,418	5,677	2,767	2,910
Mining and Minerals Trust	604	-	549	55	-	55
Compensated absences	2,500	250	-	2,750	417	2,333
Supplemental disability	367	446	205	608	328	280
Arbitrage rebate	1,862	-	1,584	278	-	278
Outstanding check liability	374	413	374	413	413	-
Unemployment compensation	113	953	763	303	303	-
Total other liabilities	<u>76,090</u>	<u>37,781</u>	<u>33,705</u>	<u>80,166</u>	<u>15,854</u>	<u>64,312</u>
Total	<u>\$ 315,218</u>	<u>\$ 229,071</u>	<u>\$ 137,582</u>	<u>\$ 406,707</u>	<u>\$ 42,648</u>	<u>\$ 364,059</u>

Long-term liabilities as of June 30, 2003, and long-term liability activity for the year ended June 30, 2003, are summarized as follows (in thousands):

	June 30, 2002	Additions	Reductions	June 30, 2003	Current Portion	Noncurrent Portion
<u>Bonds, notes and capital leases</u>						
Educational buildings bonds	\$ 126,380	\$ 5,115	\$ 17,395	\$ 114,100	\$ 10,235	\$ 103,865
Housing and dining bonds	31,021	-	2,400	28,621	2,490	26,131
Hospital bonds	9,320	3,850	9,320	3,850	-	3,850
Library bonds	44,545	-	980	43,565	1,045	42,520
Capital leases	48,806	3,178	6,971	45,013	11,441	33,572
Notes payable	1,910	3,494	1,425	3,979	1,409	2,570
Total bonds, notes and capital leases	<u>261,982</u>	<u>15,637</u>	<u>38,491</u>	<u>239,128</u>	<u>26,620</u>	<u>212,508</u>
<u>Other liabilities</u>						
Medical malpractice	27,149	346	2,712	24,783	3,512	21,271
Long term disability	10,672	2,760	2,658	10,774	1,916	8,858
Annuities payable	5,658	342	702	5,298	392	4,906
Health insurance	2,855	22,160	21,194	3,821	3,821	-
Federal loan programs	20,215	607	55	20,767	-	20,767
Workers compensation	3,316	4,477	2,966	4,827	3,284	1,543
Mining and Minerals Trust	1,126	-	522	604	-	604
Compensated absences	2,250	250	-	2,500	366	2,134
Supplemental disability	657	90	380	367	205	162
Arbitrage rebate	1,117	968	223	1,862	841	1,021
Outstanding check liability	472	374	472	374	374	-
Unemployment compensation	200	-	87	113	113	-
Total other liabilities	<u>75,687</u>	<u>32,374</u>	<u>31,971</u>	<u>76,090</u>	<u>14,824</u>	<u>61,266</u>
Total	<u>\$ 337,669</u>	<u>\$ 48,011</u>	<u>\$ 70,462</u>	<u>\$ 315,218</u>	<u>\$ 41,444</u>	<u>\$ 273,774</u>

Principal maturities and interest on bonds, notes and capital leases for the next five years and in subsequent five-year periods as of June 30, 2004, are as follows (in thousands):

	Principal	Interest	Total
2005	\$ 26,794	\$ 13,422	\$ 40,216
2006	22,523	12,322	34,845
2007	19,042	11,645	30,687
2008	16,812	11,044	27,856
2009	17,177	10,470	27,647
2010 - 2014	80,042	42,682	122,724
2015 - 2019	76,971	26,247	103,218
2020 - 2024	60,900	8,806	69,706
2025	6,280	157	6,437
Total	<u>\$ 326,541</u>	<u>\$ 136,795</u>	<u>\$ 463,336</u>

At June 30, 2004, assets with a fair market value of approximately \$100,443,000 have been placed on deposit with trustees to totally defease bonds with a par amount of \$95,011,000. The liability for these fully defeased bonds is not included in the financial statements.

On October 29, 2003, \$9,335,000 of Consolidated Educational Building Refunding Revenue Bonds (CEBRB) Series O (Second Series) were issued at a net interest cost of 3.37 percent, representing a full refunding of the original \$12,015,000 Series O dated August 1, 1995. The refunding defeased \$8,600,000 Series O bonds outstanding as of May 1, 2004. The refunding will decrease the University's total debt service payments over the next 12 years by \$577,698, representing an economic gain (difference between the present value of the debt service payments on the old and new debt) of \$490,814.

On October 30, 2003, \$4,235,000 of Housing and Dining Refunding Revenue Bonds Series M and O (Second Series) were issued at a net interest cost of 4.035 percent, representing a full refunding of the original \$2,866,000 Housing and Dining Series M, dated June 1, 1994, and a full refunding of the original \$2,205,000 Housing and Dining Series O, dated May 1, 1994. The refunding defeased \$2,401,000 Series M bonds and \$1,500,000 Series O bonds outstanding as of June 1, 2004. The refunding will decrease the University's total debt service payments over the next 20 years by \$286,435, representing an economic gain (difference between the present value of the debt service payments on the old and new debt) of \$206,225.

On January 27, 2004, \$19,520,000 of Consolidated Educational Building Refunding Revenue Bonds (CEBRB) Series E, J, L (Third Series) were issued at a net interest cost of 2.253 percent, representing a full refunding of the original \$38,970,000 CEHRB Series E, J, L (Second Series) dated January 1, 1994. The refunding defeased \$22,715,000 Series E, J, L (Second Series) bonds outstanding as of May 1, 2004. The refunding will decrease the University's total debt service payments of the next seven years by \$965,790, representing an economic gain (difference between the present value of the debt service payments on the old and new debt) of \$895,593.

On March 18, 2004, \$52,110,000 of Consolidated Educational Building Refunding Revenue Bonds (CEBRB) Series P, Q, R (Second Series) were issued at a net interest cost of 3.72 percent, representing a full refunding of the original \$6,200,000 Series P dated June 1, 1998, a full refunding of the original \$29,870,000 Series Q dated October 15, 2000, and a full refunding of the original \$20,510,000 Series R dated February 1, 2001. The refunding defeased \$5,165,000 Series P bonds, \$27,440,000 Series Q bonds, and \$19,135,000 Series R bonds outstanding as of May 1, 2004. The refunding will decrease the University's total debt service payments over the next 17 years by \$1,081,947, representing an economic gain (difference between the present value of the debt service payments on the old and new debt) of \$820,889.

10. COMPONENTS OF RESTRICTED EXPENDABLE NET ASSETS

Restricted expendable net assets are subject to externally imposed stipulations or conditions that must be followed and cannot be used for support of general operations of the University. At June 30, 2004 and 2003, respectively, restricted expendable net assets were composed of the following (in thousands):

	<u>2004</u>	<u>2003</u>
Appreciation on permanent endowments	\$ 53,282	\$ 12,756
Term endowments	5,718	5,001
Quasi-endowments initially funded with restricted assets	45,998	40,741
Funds restricted for capital purposes	17,193	39,935
Funds restricted for non-capital purposes	64,638	63,013
Loan funds (primarily University funds required for Federal match)	<u>8,283</u>	<u>8,026</u>
Total	<u>\$ 195,112</u>	<u>\$ 169,472</u>

11. DESIGNATIONS OF UNRESTRICTED NET ASSETS

Unrestricted net assets are designated for specific purposes by action of the Board of Trustees or management or may otherwise be limited by contractual agreements. Commitments for the use of unrestricted net assets at June 30, 2004 and 2003, respectively, are as follows (in thousands):

	<u>2004</u>	<u>2003</u>
Working capital requirements	\$ 40,317	\$ 46,705
Budget appropriations for future year fiscal operations	27,018	20,768
Designated for capital projects	49,589	64,671
Designated for renewal and replacement of capital assets	170,172	153,042
Hospital	92,892	103,321
Affiliated corporations	<u>60,701</u>	<u>62,624</u>
Total	<u>\$ 440,689</u>	<u>\$ 451,131</u>

12. PLEDGED REVENUES

Certain revenues reflected in the Statement of Revenues, Expenses and Changes in Net Assets as of June 30, 2004 and 2003, are pledged as security for the University's outstanding bonds, as follows (in thousands):

	<u>2004</u>	<u>2003</u>
Student tuition and fees, pledged as collateral for the University's Consolidated Educational Buildings Revenue Bonds	\$ 170,018	\$ 145,176
Housing and Dining system revenues, pledged as collateral for the University's Consolidated Housing and Dining System Revenue Bonds	\$ 24,329	\$ 22,194
Hospital patient services revenue, pledged as collateral for University's Hospital Revenue Bonds	\$ 371,982	\$ 345,143

13. INVESTMENT INCOME

Components of investment income for the years ended June 30, 2004 and 2003 are as follows (in thousands):

	<u>2004</u>	<u>2003</u>
Interest and dividends earned on endowment investments	\$ 7,105	\$ 9,101
Realized and unrealized gains and losses on endowment investments	67,103	(1,435)
Interest and dividends on cash and non-endowment investments	9,819	20,134
Realized and unrealized gains and losses on non-endowment investments	(6,693)	5,466
Investment income from external trusts	<u>768</u>	<u>979</u>
Total	<u>\$ 78,102</u>	<u>\$ 34,245</u>

14. FUNDS HELD IN TRUST BY OTHERS

The University is the income beneficiary of various trusts that are held and controlled by independent trustees. For the years ended June 30, 2004 and 2003, respectively, the University received income from these trusts of approximately \$768,000 and \$979,000. The University has no equity interest in the principal of the trusts that, accordingly, are recorded at a nominal value of \$1 each.

15. PLEDGES AND DEFERRED GIFTS

At June 30, 2004, pledges totaling approximately \$39,039,000 are expected to be collected primarily over the next five years, as follows (in thousands):

Operating purposes	\$ 6,478
Capital projects	10,898
Endowment principal	<u>21,663</u>
Total	<u>\$ 39,039</u>

In accordance with GASB Statement No. 33, "Accounting and Financial Reporting for Nonexchange Transactions," the University is required to record operating and capital pledges as revenue when all eligibility requirements have been met. Endowment pledges are not recognized as revenue until the gifts are actually received. Accordingly, for the years ended June 30, 2004 and 2003, the University recorded the discounted value of operating and capital pledges, net of the allowance for uncollectible pledges, of approximately \$8,990,000 and \$3,958,000, respectively.

Deferred gifts through insurance, known bequests and irrevocable trusts in which the University has a remainder interest are estimated to be approximately \$49,875,000 at June 30, 2004. The University records these amounts as revenue when the cash is received.

16. GRANTS AND CONTRACTS AWARDED

At June 30, 2004, grants and contracts of approximately \$164 million had been awarded to the University and the University of Kentucky Research Foundation but not expended. These amounts will be recognized in future periods.

17. PENSION PLANS

Regular full-time employees, including faculty, are participants in the University of Kentucky Retirement Plan, a defined contribution plan. The University of Kentucky Retirement Plan consists of five groups as follows:

Group I	Established July 1, 1964, for faculty and certain administrative officials.
Group II	Established July 1, 1971, for staff members in the clerical, technical and service categories.
Group III	Established July 1, 1972, for staff members in the managerial, professional and scientific categories.
Group IV	Established January 1, 1973, for staff members having U.S. Civil Service retirement entitlement.
Group V	Established July 1, 1987, for staff members covered under the Federal Employees Retirement System that replaced Civil Service (those whose employment began during the period from January 1, 1984 to March 31, 1987). Staff members whose employment began after March 31, 1987 are under one of the above University of Kentucky Retirement Plans.

Participation in the University of Kentucky Retirement Plan is mandatory for all regular full-time employees in groups I, II and III who are age 30 or older. Participation is voluntary for regular full-time employees under the age of 30 and for those employees in groups IV and V. Participants in groups I, II, III and IV contribute 5 percent and the University contributes 10 percent of the participant's eligible compensation to the retirement plan. Participants in group V contribute 1 percent and the University contributes 2 percent of the participant's eligible compensation to the retirement plan.

The University has authorized three retirement plan carriers, as follows:

Teachers Insurance and Annuity Association/College
Retirement Equities Fund (TIAA/CREF)
Fidelity Institutional Services Company
American Century Investments

Under the fully funded University of Kentucky Retirement Plan, the University and plan participants make contributions to provide fully vested retirement benefits to employees in individually owned contracts. The University's contributions and costs for 2004 and 2003 were approximately \$49,597,000 and \$46,691,000, respectively. Employees contributed approximately \$24,574,000 in 2004 and \$23,170,000 in 2003. The University's total payroll costs were approximately \$701,427,000 and \$677,945,000, respectively, for the years ended June 30, 2004 and 2003. The payroll for employees covered by the retirement plan was approximately \$495,973,000 and \$466,914,000 for 2004 and 2003, respectively.

In addition to retirement benefits provided from the group retirement plan, the University provides supplemental retirement income benefits to certain eligible employees in each of the retirement groups (see Note 18).

18. MINIMUM ANNUAL RETIREMENT BENEFITS AND SUPPLEMENTAL RETIREMENT INCOME

Employees in retirement groups I, II and III, referred to in Note 17, who were age 40 or older prior to the date of establishment of each group plan, and who were employed by the University prior to that date, qualify for the minimum annual retirement benefit provisions of the retirement plan. Benefits for these eligible employees are based upon a percentage, determined through years of service, of the participant's annual salary in the last year of employment prior to retirement. Retirement benefits as determined are funded by each individual retiree's accumulation in the group retirement plan, with the balance, if necessary, provided by the University as supplemental retirement income.

The Legislature of the Commonwealth of Kentucky has appropriated funds to the University for the payment of supplemental retirement income benefits since adoption of the group retirement plans, and is expected to continue this practice. However the Constitution of the Commonwealth of Kentucky prohibits the commitment of future revenues beyond the end of the current biennium. Accordingly, the University does not recognize the liability for supplemental retirement income benefits during the service life of covered employees, but recognizes its costs when funds are appropriated by the Legislature and payments are made. The University intends to continue paying supplemental retirement income benefits contingent upon the Legislature continuing to appropriate funds required to make these payments. Supplemental retirement benefit payments were approximately \$3,680,000 and \$3,767,000 for the years ended June 30, 2004 and 2003, respectively.

The latest actuarial valuation was prepared as of June 30, 2004, by TIAA. The actuarial present value of accumulated supplemental retirement income benefits as determined by this valuation, utilizing an assumed rate of return of 7 percent, was \$21,934,000.

19. HEALTH INSURANCE BENEFITS FOR RETIREES

The University provides a health care credit towards health insurance coverage to retirees who have a minimum of fifteen years service. The University recognizes the cost of providing this credit by expensing the credit in the year provided. These health care credits totaled approximately \$6,708,000 and \$6,041,000 for the years ended June 30, 2004 and 2003, respectively. At June 30, 2004, 2,251 retirees met the service requirement and were receiving the health care credit.

20. RISK MANAGEMENT

The University is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. These risks are covered by (1) the State Fire and Tornado Insurance Fund (the Fund), (2) Sovereign Immunity and the State Board of Claims or, (3) in the case of risks not covered by the Fund and Sovereign Immunity, commercial insurance, participation in insurance risk retention groups or self-insurance.

The Fund covers losses to property from fire, wind, earthquake, flood and most other causes of loss between \$500 and \$500,000 per occurrence. Losses in excess of \$500,000 are insured by commercial carriers up to \$500 million per occurrence principally on an actual cash value basis. As a state agency, the University is vested with Sovereign Immunity and is subject to the provisions of the Board of Claims Act, under which the University's liability for certain negligence claims is limited to \$200,000 for any one person or \$350,000 for all persons damaged by a single act of negligence. Claims against educators' errors and omissions and wrongful acts are insured through a reciprocal risk retention group. There have been no significant reductions in insurance coverage from 2003 to 2004. Settlements have not exceeded insurance coverage during the past three years.

The University and its agents are insured against medical malpractice by a combination of Sovereign Immunity, self-insurance, commercial liability insurance, and an excess coverage fund established by the Commonwealth of Kentucky. The malpractice liability at June 30, 2004, is based on the requirements of GASB Statement No. 10, which requires that a liability for claims be recorded if it is probable that a liability has occurred and the amount of loss can be reasonably estimated. The liability includes an estimate for claims that have been incurred but not reported at June 30, 2004.

The University is self-insured for the long-term disability income program and has established a 501(c)(9) trust for purposes of paying claims and establishing necessary reserves. The estimated long-term disability payments for known claims at June 30, 2004 are reported at their present value assuming an investment yield of 6.0 percent.

The University also self-insures certain employee benefits, including health insurance, worker's compensation, unemployment claims, and a long-term disability supplemental reserve, to the extent not covered by insurance. The University has recorded an estimate for asserted claims at June 30, 2004.

Long-term liabilities related to self-insurance are detailed in Note 9, above.

21. CONTINGENCIES

The University is defendant in various lawsuits. However, University officials are of the opinion, based on advice of in-house legal counsel, that the effect of the ultimate outcome of all litigation will not be material to the future operations or financial position of the University.

22. NATURAL CLASSIFICATION

The University's operating expenses by natural classification were as follows for the years ended June 30, 2004 and 2003, respectively (in thousands):

	<u>2004</u>	<u>2003</u>
Salaries and wages	\$ 637,653	\$ 611,910
Employee benefits	156,718	144,813
Repairs and maintenance	68,471	64,478
Supplies	157,283	140,614
Depreciation	70,888	68,323
Student scholarships and financial aid	37,795	34,084
Utilities	47,363	46,558
Communications	17,753	17,661
Professional services	70,294	61,230
Travel	12,789	12,815
Resale	9,468	8,962
Other, various	97,225	85,882
Total	<u>\$ 1,383,700</u>	<u>\$ 1,297,330</u>

23. SUBSEQUENT EVENT - TRANSFER OF LEXINGTON COMMUNITY COLLEGE

The General Assembly of the Commonwealth of Kentucky during the 2004 Regular Session enacted House Joint Resolution 214. The resolution directed the University of Kentucky Board of Trustees to delegate the governance and management responsibilities for the Lexington Community College (LCC) to the Kentucky Community and Technical College System (KCTCS) on or before July 1, 2004. Effective on July 1, 2004, the transition was completed and memorandum of agreement for transfer was implemented. The following assets, liabilities, and net assets of LCC were transferred to KCTCS effective July 1, 2004 (in thousands).

Assets	\$ 6,116
Liabilities	\$ 1,148
Net Assets	\$ 4,968

These amounts are included in the University of Kentucky consolidated financial statements as of June 30, 2004.

24. RECLASSIFICATIONS

Certain reclassifications to fiscal 2003 comparative amounts have been made to conform with the 2004 classifications.

INDEPENDENT AUDITORS' REPORT ON ADDITIONAL INFORMATION

To the Board of Trustees of the
University of Kentucky

and

the Secretary of Finance and
Administration Cabinet of the
Commonwealth of Kentucky

Our audit was conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The additional consolidating information contained on pages 31 and 32 is presented for the purpose of additional analysis and is not a required part of the basic consolidated financial statements. This additional information is the responsibility of the University's management. Such information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects, in relation to the basic consolidated financial statements taken as a whole.

Deloitte & Touche LLP

September 2, 2004
Louisville, Kentucky

UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS
CONSOLIDATING SCHEDULE
STATEMENT OF NET ASSETS
JUNE 30, 2004
(in thousands)



	UK	UK Research Foundation	The Fund	Equine Research Foundation	UK Athletic Association	Humanities Foundation	Mining Engineering Foundation	Business Partnership Foundation	Center on Aging	Health Care Collection Service	Kentucky Medical Services Foundation	Total
ASSETS												
Current Assets												
Cash and cash equivalents	\$ 283,304	\$ 120	\$ 8,240	\$ 1,018	\$ 10,738	\$ 38	\$ 11	\$ 402	\$ 270	\$ 260	\$ 3,447	\$ 307,848
Notes, loans and accounts receivable, net	68,846	29,432	1,657		238	20		2			15,308	115,503
Investments	14,793	1,631	102		2,334					9	38,644	38,644
Inventories and other	366,943	31,183	9,999	1,018	13,310	58	11	404	270	269	121	18,990
Noncurrent Assets												
Restricted cash and cash equivalents	93,240											93,242
Endowment investments	483,662	3,932	209	8,245	291	1,214	1,720	12,656				511,929
Other long-term investments	191,685	322			3,175						13,302	208,484
Notes, loans and accounts receivable, net	30,348					66		29				30,443
Capital assets, net	910,104	4,455			53,367					279	14,161	982,366
Total noncurrent assets	1,709,039	8,709	209	8,245	56,833	1,280	1,722	12,685	-	279	27,463	1,826,464
Total assets	2,075,982	39,892	10,208	9,263	70,143	1,338	1,733	13,089	270	548	84,983	2,307,449
LIABILITIES												
Current Liabilities												
Accounts payable and accrued liabilities	100,411	6,084	254		2,321		1	4		269	5,970	115,314
Deferred revenue	16,569	21,324			9,058							46,951
Long-term liabilities - current portion	38,481				1,105						3,062	42,648
Total current liabilities	155,461	27,408	254	-	12,484	-	1	4	-	269	9,032	204,913
Noncurrent Liabilities												
Long-term liabilities	322,221				41,415						423	364,059
Total liabilities	477,682	27,408	254	-	53,899	-	1	4	-	269	9,455	568,972
INTERFUND BALANCES												
NET ASSETS	19,107	(1,800)	(589)	(99)	(180)						(16,439)	-
Invested in capital assets, net of related debt	707,707	4,455			14,023					279	10,676	737,140
Restricted												
Nonexpendable	351,053	1,131	37	4,676		640	565	7,434				365,536
Expendable	178,658	3,130	708	4,488	342	698	1,167	5,651	270			195,112
Total restricted	529,711	4,261	745	9,164	342	1,338	1,732	13,085	270	-	-	560,648
Unrestricted	379,989	1,968	8,620		1,699						48,413	440,889
Total net assets	\$ 1,617,407	\$ 10,684	\$ 9,365	\$ 9,164	\$ 16,064	\$ 1,338	\$ 1,732	\$ 13,085	\$ 270	\$ 279	\$ 59,089	\$ 1,738,477

UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS
CONSOLIDATING SCHEDULE FOR THE YEAR ENDED JUNE 30, 2004
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
(in thousands)

	UK	UK Research Foundation	The Fund	Equine Research Foundation	UK Athletic Association	Humanities Foundation	Mining Engineering Foundation	Business Partnership Foundation	Center on Aging	Health Care Collection Service	Kentucky Medical Services Foundation	Total
OPERATING REVENUES												
Student tuition and fees, net	\$ 124,034											\$ 124,034
Federal grants and contracts	19,825	\$ 114,382										\$ 134,207
State and local grants and contracts	28,136	41,756	\$ 152									70,044
Nongovernmental grants and contracts	5,088	22,969	1,784									29,841
Recoveries of facilities and administrative costs	337	36,785										37,122
Sales and services	29,414	599	9,517		\$	1	\$	1	\$	3,562		43,095
Federal appropriations	15,623											15,623
County appropriations	10,084											10,084
Professional clinical service fees										\$	141,989	141,989
Hospital patient services	370,628											370,628
Auxiliary enterprises:												
Housing and Dining, net	29,929				\$	42,970						29,929
Athletics	11,548											11,548
Other auxiliaries	244		18								41	303
Other operating revenues	644,890	216,491	11,471		42,970	1	1		1	3,562	142,030	1,061,417
Total operating revenues												
OPERATING EXPENSES												
Educational and general:												
Instruction	232,652	14,120	121			6	52	\$	60			247,011
Research	68,632	139,628	18	\$	1		52		60			208,568
Public service	87,500	33,995	381				11					121,887
Libraries	13,606		3									13,609
Academic support	41,231	1,730	2,432				293					45,686
Student services	20,310	33	83			6						20,432
Institutional support	47,320	420	206							3,556		51,502
Operations and maintenance of plant	47,351											47,351
Student financial aid	30,007	1,496	65			43						31,744
Depreciation	49,913	285								75		50,273
Total educational and general	638,922	191,707	3,309	1		55	115	546	167	3,631		838,053
Clinical operations (including depreciation of \$719)												
Hospital (including depreciation of \$15,192)	344,334										115,998	115,998
Auxiliary enterprises:												
Housing and Dining (including depreciation of \$2,148)	34,370											34,370
Athletics (including depreciation of \$2,556)	(238)				43,234							42,996
Other auxiliaries	7,672											7,672
Other expenses	276											276
Total operating expenses	1,024,936	191,707	3,309	1	43,234	55	115	546	167	3,631	115,998	1,383,699
Net income (loss) from operations	(380,046)	24,784	8,162	(1)	(264)	(54)	(114)	(546)	(166)	(69)	26,032	(322,282)
NONOPERATING REVENUES (EXPENSES)												
State appropriations	302,539											302,539
Gifts and grants	21,826	21	219	210		2	1	62	136			22,477
Investment income	70,994	627	153	1,305	333	185	313	1,965	5	3	2,219	78,102
Interest on capital asset-related debt	(9,850)				(2,120)							(11,970)
Grant to/from the University for non-capital purposes	52,862	(17,784)	(7,153)	(816)	2,716	(11)	(328)	(126)	(13)		(29,347)	-
Other nonoperating revenues and expenses	1,089	786			1,534							3,409
Net nonoperating revenues	439,460	(16,350)	(6,781)	699	2,463	176	(14)	1,901	128	3	(27,128)	394,557
Net income (loss) before other revenues, expenses, gains, or losses	59,414	8,434	1,381	698	2,199	122	(128)	1,355	(38)	(66)	(1,096)	72,275
Capital appropriations	2,070											2,070
Capital grants and gifts	11,985	5,110									(1,820)	15,275
Additions to permanent endowments	20,900											21,036
Grant to/from the University for capital purposes	(10,169)	(15,563)	(250)		(2,640)	5	3	(3)	(20)		(150)	(10,335)
Other	(10,169)				(16)							
Total other revenues	43,262	(10,453)	(250)		(16)	5	3	125	(20)		(150)	28,046
INCREASE (DECREASE) IN NET ASSETS	102,676	(2,019)	1,131	698	(457)	127	(125)	1,480	(58)	(66)	(3,066)	100,321
NET ASSETS, beginning of year, as restated	1,514,731	12,703	8,234	8,466	16,521	1,211	1,857	11,605	328	345	62,155	1,638,156
NET ASSETS, end of year	\$ 1,617,407	\$ 10,684	\$ 9,365	\$ 9,164	\$ 16,064	\$ 1,338	\$ 1,732	\$ 13,085	\$ 270	\$ 279	\$ 59,089	\$ 1,738,477

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