

**KENTUCKY MEDICAL
SERVICES FOUNDATION, INC.**
Financial Statements

*Years Ended June 30, 2018 and 2017
with Report of Independent Auditors*

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Report of Independent Auditors

To the Board of Directors of
Kentucky Medical Services Foundation, Inc.
Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of Kentucky Medical Services Foundation, Inc. (KMSF) which comprise the balance sheets as of June 30, 2018 and 2017, and the related statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky Medical Services Foundation, Inc. as of June 30, 2018 and 2017, and the results of its changes in net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Dean Dorton Allen Ford, PLLC

September 21, 2018
Lexington, Kentucky

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KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Balance Sheets

June 30, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Assets		
Current assets:		
Investments and interest bearing deposits, current portion	\$ 18,398,814	\$ 6,793,534
Patient accounts receivable, less allowance for uncollectibles of \$8,594,272 and \$6,921,123 and allowances for contractual adjustments of \$78,238,257 and \$71,532,545 in 2018 and 2017, respectively	42,940,248	34,891,655
Accounts receivable - Physician Supplemental Payment (PSP) revenue	8,560,140	10,277,742
Other receivables, current portion	3,299,996	2,917,226
Other current assets	<u>1,160,399</u>	<u>526,747</u>
Total current assets	74,359,597	55,406,904
Assets limited as to use:		
Dean's academic enrichment funds - limited by agreement	5,543,805	31,843
Investments and interest bearing deposits, less current portion	44,858,065	42,763,685
Other receivables, less current portion	706,167	771,667
Property and equipment:		
Land and improvements	2,786,029	2,732,340
Buildings	46,753,015	45,157,965
Furniture and equipment	9,282,006	9,274,400
Capitalized software	16,986,574	16,986,574
Buildings under capital lease obligations	69,489,638	53,773,435
Equipment under capital lease obligations	<u>1,395,359</u>	<u>1,420,351</u>
	146,692,621	129,345,065
Less accumulated depreciation	<u>35,929,014</u>	<u>31,555,097</u>
Net property and equipment	<u>110,763,607</u>	<u>97,789,968</u>
Total assets	<u>\$ 236,231,241</u>	<u>\$ 196,764,067</u>

	<u>2018</u>	<u>2017</u>
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 8,177,932	\$ 8,134,572
Long-term debt, current portion	752,628	730,378
Capital leases, current portion	3,712,735	2,647,154
Settlements due to third party payors	569,474	1,092,207
Patient refunds	2,793,459	2,152,142
Due to the University of Kentucky	33,379,597	19,284,962
Due to the University of Kentucky - malpractice fund	21,914,077	19,940,008
Due to the College of Medicine departments under departmental plan agreements	<u>58,633,095</u>	<u>48,370,208</u>
Total current liabilities	129,932,997	102,351,631
Long-term debt, net of current portion	18,068,628	18,821,258
Capital leases, net of current portion	<u>51,839,009</u>	<u>41,409,685</u>
Total long-term liabilities	<u>69,907,637</u>	<u>60,230,943</u>
Total liabilities	199,840,634	162,582,574
Unrestricted net assets:		
Board designated - property (net of long-term debt and capital leases) and equipment	<u>36,390,607</u>	<u>34,181,493</u>
Total liabilities and net assets	<u>\$ 236,231,241</u>	<u>\$ 196,764,067</u>

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Operations and Changes in Net Assets

Years ended June 30, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Revenues and gains:		
Net professional clinical service fee revenue	\$ 253,808,897	\$ 239,714,246
Capitation revenue	27,303,892	27,120,431
Provision for bad debts	<u>(32,582,555)</u>	<u>(37,403,759)</u>
Net professional clinical service fee revenue less provision for bad debts	248,530,234	229,430,918
Lease income	5,915,444	5,077,919
Investment income, net	455,056	238,420
PSP revenue	60,762,761	75,383,038
Other income, net	<u>22,421,679</u>	<u>21,257,229</u>
Total revenues and gains	338,085,174	331,387,524
Expenses:		
Departmental expenses	279,232,781	274,259,777
Operating expenses - business office	24,556,521	25,812,896
UKHMO capitation expenses	6,242,537	6,019,266
Reimbursement to the University of Kentucky for malpractice insurance and expenses attendant to the production of clinical income	5,112,386	4,877,825
Dean's academic enrichment funds	10,000,000	10,983,333
Physicians' fringe benefits	3,529,891	3,713,738
Depreciation expense	4,408,884	3,721,034
Interest expense	<u>2,793,060</u>	<u>3,914,425</u>
Total expenses	<u>335,876,060</u>	<u>333,302,294</u>
Increase (decrease) in net assets	2,209,114	(1,914,770)
Net assets, beginning of year	<u>34,181,493</u>	<u>36,096,263</u>
Net assets, end of year	<u>\$ 36,390,607</u>	<u>\$ 34,181,493</u>

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows

Years ended June 30, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Increase (decrease) in net assets	\$ 2,209,114	\$ (1,914,770)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by (used in) operating activities:		
Depreciation	4,408,884	3,721,034
Loss on disposal of assets	12,287	2,361
Provision for bad debts	32,582,555	37,403,759
Increase (decrease) in cash due to changes in:		
Patient accounts receivable	(40,631,148)	(37,165,799)
Accounts receivable - PSP revenue	1,717,602	(394,195)
Other receivables	(317,270)	287,881
Other current assets	(633,652)	(156,671)
Accounts payable and accrued liabilities	43,360	(1,750,866)
Settlements due to third party payors	(522,733)	(1,025,790)
Patient refunds	641,317	636,145
Due to the University of Kentucky	14,094,635	(2,847,653)
Due to the University of Kentucky - malpractice fund	1,974,069	2,359,576
Due to the College of Medicine departments under departmental plan agreements	<u>10,262,887</u>	<u>(13,007,313)</u>
Net cash provided by (used in) operating activities	25,841,907	(13,852,301)
Cash flows from investing activities:		
Capital expenditures	(2,869,328)	(1,830,373)
(Increase) decrease in investments and interest-bearing deposits, net	(13,699,660)	15,448,583
(Increase) decrease in assets limited as to use, net	<u>(5,511,962)</u>	<u>220,618</u>
Net cash (used in) provided by investing activities	(22,080,950)	13,838,828
Cash flows from financing activities:		
Issuance of long-term debt	-	19,750,000
Repayments on long-term debt	(730,380)	(19,127,361)
Payments on capital leases	<u>(3,030,577)</u>	<u>(609,166)</u>
Net cash (used in) provided by financing activities	<u>(3,760,957)</u>	<u>13,473</u>
Net change in cash	<u>\$ -</u>	<u>\$ -</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows, continued

Years ended June 30, 2018 and 2017

Supplemental cash flow disclosures:	<u>2018</u>		<u>2017</u>
Cash paid for interest	\$ 2,793,060	\$	3,914,425
Noncash investing and financing transactions:			
Capital lease obligations for purchase of buildings and equipment	\$ 14,525,482	\$	17,628,233

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements

1. Description of the Organization

Kentucky Medical Services Foundation, Inc. (KMSF) is a non-profit, non-stock corporation. KMSF has been assigned the responsibility to bill, collect and administer all clinical income generated by the physicians of the University of Kentucky (UK) College of Medicine (the College) in accordance with an annual agreement (the Agreement) between KMSF and UK regarding the operation of KMSF. The Agreement was last renewed on July 1, 2018.

Although included in UK's audited financial statements according to *Governmental Accounting Standards*, KMSF is not considered to be an affiliate of UK by Kentucky Revised Statute.

2. Summary of Significant Accounting Policies

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) which required management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates. The Financial Accounting Standards Board (FASB) promulgates its Accounting Standards Codification as the only source of authoritative accounting principles recognized by the FASB to be applied to nongovernmental entities in the preparation of financial statements in conformity with GAAP. The following is a summary of the significant accounting policies consistently followed by KMSF in the preparation of its financial statements:

Basis of Accounting

The accompanying financial statements have been prepared on the accrual basis. Under the terms of the various departmental plans and the Agreement with UK, all income from operations of KMSF, exclusive of changes in the net book value of property and equipment, debt acquired for purchase of property and equipment and changes in amounts designated by the Board of Directors for specific purposes, are payable to the participating departments. Accordingly, such amounts have been included as departmental expenses in the accompanying statements of operations and changes in net assets.

Assets Limited as to Use

Assets limited as to use include cash and investments set aside by the Board of Directors for specific purposes over which the Board retains control and may, at its discretion, subsequently use for other purposes, if any, and cash and investments set aside in accordance with the Agreement between KMSF and UK (see Note 5.).

Property and Equipment

KMSF capitalizes all expenditures in excess of \$2,000 for property and equipment. Property and equipment purchased are recorded at cost at the date of acquisition. Depreciation is computed using the straight-line method over the estimated useful life of the depreciable assets which range from three to forty years. Donated property and equipment, if any, are recorded at estimated fair value at the date of donation.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Income Tax Exemption

KMSF is a non-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code (the Code) and is exempt from federal income taxes on related income.

Patient Accounts Receivable and Net Professional Clinical Service Fees

Patient accounts receivable and net professional clinical service fees are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including retroactive adjustments, if any, from third-party payors. A provision for uncollectible accounts is recorded based upon management's evaluation of current industry conditions, historical collection experience and other relevant factors which, in the opinion of management, require recognition in estimating the allowance for uncollectible accounts.

Retroactive settlements to third party payors are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. These final settlements occur in the normal course of business.

Charity Care

UK provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because UK does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. Charity care charges totaled \$9,039,961 and \$7,798,440 in 2018 and 2017, respectively. Management has estimated its cost incurred to provide charity care to be approximately \$3,200,000 and \$3,000,000 for the years ended June 30, 2018 and 2017, respectively.

Investments and Investment Income

KMSF has investments in certificates of deposit and other interest bearing deposits, government securities, guaranteed investment contracts and mutual funds as permitted by the Agreement with UK. These investments are stated at fair value or carrying amounts that approximate fair value.

Investment income (including realized and unrealized gains and losses on investments, interest and dividends) is considered by management to be essential to the ongoing operations of KMSF and is reported as other operating revenue.

Subsequent Events

Management has evaluated subsequent events for accounting and disclosure requirements through September 21, 2018, the date that the financial statements were available to be issued.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Reclassifications

Certain reclassifications have been made to the 2017 financial statement presentation to correspond to the current year's format. Net assets and increase (decrease) in net assets are unchanged due to these reclassifications.

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in GAAP when it becomes effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. Early adoption is not permitted before 2019. The updated standard becomes effective for KMSF in the year ending June 30, 2020. KMSF has not yet selected a transition method and is currently evaluating the effect that the updated standard will have on the financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, requiring all leases to be recognized on KMSF's balance sheet as a right-of-use asset and a lease liability, unless the lease is a short term lease (generally a lease with a term of twelve months or less). At the commencement date of the lease, KMSF will recognize: 1) a lease liability for KMSF's obligation to make payments under the lease agreement, measured on a discounted basis; and 2) a right-of-use asset that represents KMSF's right to use, or control the use of, the specified asset for the lease term. Upon adopting the ASU, KMSF will be required to recognize and measure its leases at the beginning of the earliest period presented using a modified retrospective approach. ASU 2016-02 will be effective for KMSF for the year ending June 30, 2021, with early adoption permitted. KMSF is currently evaluating the effect that the new standard will have on its financial statements.

In August 2016, the FASB issued ASU No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, that changes how a not-for-profit organization classifies its net assets, as well as the information it presents in the financial statements and notes about its liquidity, financial performance, and cash flows. The ASU includes a reduction in the number of net asset categories from three to two, conforming requirements on releases of capital restrictions, several new requirements related to expense presentation and disclosure (including investment expenses), and new required disclosures communicating information useful in assessing liquidity. The updated standard becomes effective for KMSF for the year ending June 30, 2019. Early adoption is permitted. KMSF is currently evaluating the effects adoption of this guidance will have on the financial statements.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

3. Patient Accounts Receivable

Patient accounts receivable consist of amounts due from government programs (e.g., Medicare and Medicaid) and non-government payors (e.g., self-pay and commercial payors). Management believes there are minimal credit risks associated with the receivables from government programs. Non-government receivables are from various payors that are subject to differing economic conditions. Management continually monitors and adjusts the allowance for uncollectible accounts associated with credit risk of patient accounts receivable.

KMSF has recorded an allowance for uncollectible patient accounts receivable of approximately 7% and 6% of gross patient accounts receivable as of June 30, 2018 and 2017, respectively. A summary of the changes in the allowance for uncollectible patient accounts receivable is as follows:

Year ended June 30,	<u>2018</u>	<u>2017</u>
Balance, beginning of year	\$ 6,921,123	\$ 6,884,129
Provision for bad debts	32,582,555	37,403,759
Receivables charged off	<u>(30,909,406)</u>	<u>(37,366,765)</u>
Balance, end of year	<u>\$ 8,594,272</u>	<u>\$ 6,921,123</u>

4. Other Receivables

KMSF makes loans to physicians they anticipate will become employees of UK. A portion of these loans will be forgiven each year, up to the maximum amount of the loan, if certain conditions, such as serving as a full-time physician and faculty member of UK, are met by the borrower. If the conditions for forgiveness are not met, the entire principal balance is payable by the borrower, including accrued interest at the rate of 1% above prime. The total amount outstanding on such loans was \$1,395,600 and \$1,393,511 as of June 30, 2018 and 2017, respectively.

5. Academic Enrichment Funds

In accordance with the Agreement with UK effective July 1, 2017 and the Agreement with UK effective July 1, 2016, KMSF is required to maintain a separate bank account, which represents a specified percentage of cumulative clinical income collected, less cumulative disbursements by the Dean of the College of Medicine. The percentage of collections added to this account was 8% in both 2018 and 2017.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

5. Academic Enrichment Funds, continued

The funds in the account are for the use of the Dean of the College of Medicine for the enrichment of the program of the College or for related purposes at his/her sole discretion. The Dean's Fund supports the missions of UK and UK HealthCare by providing financial support of activities such as research, education, departmental and program development. In 2018 and 2017, the amount provided to UK for research and education was \$10,000,000 and \$10,983,333, respectively. In 2018 and 2017, \$1,604,858 and \$4,969,167, respectively, of such funds were expended in the Dean's operations for faculty and staff salaries, benefits and other operating expenses and are included in departmental expenses.

The cash balance in the dean's account as of June 30, 2018 and June 30, 2017 was \$5,543,805 and \$31,843 respectively, and is included as part of the liability payable under the Departmental Plan Agreements.

6. Investments and Interest Bearing Deposits

Investments and interest bearing deposits, including accrued interest, are as follows as of June 30:

	<u>2018</u>	<u>2017</u>
Interest bearing deposits and government securities	\$ 41,562,119	\$ 29,943,182
Fixed income securities	6,524,500	5,413,718
Equity securities and equity security mutual funds	<u>15,170,260</u>	<u>14,200,319</u>
Total investments and interest bearing deposits	<u>\$ 63,256,879</u>	<u>\$ 49,557,219</u>

The components of investment income from investments and interest bearing deposits for 2018 and 2017 consist of \$455,056 and \$238,420, respectively, of realized and unrealized gains and losses, dividends and interest.

Management has elected to follow Accounting Research Bulletin 43 in the presentation of current and non-current investments as follows:

	<u>2018</u>	<u>2017</u>
Current investments	\$ 18,398,814	\$ 6,793,534
Non-current investments	<u>44,858,065</u>	<u>42,763,685</u>
Total investment and interest bearing deposits	<u>\$ 63,256,879</u>	<u>\$ 49,557,219</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

7. Fair Value Measurements

KMSF classifies its investments based on a hierarchy consisting of: Level 1 (valued using quoted prices from active markets for identical assets), Level 2 (not traded on an active market but for which observable market inputs are readily available), and Level 3 (valued based on significant unobservable inputs). The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value on a recurring basis:

Interest bearing deposits and government securities: Valued at cost which approximates fair value.

Common stocks: Valued at the closing price reported on the active market on which the individual securities are traded.

Real estate investment partnership: Valued at cost, which approximates fair value.

Real estate investment trust: Valued at the closing price reported on the active market on which the individual securities are traded.

Mutual funds: Mutual funds based in equity securities are valued at the daily closing price as reported by the fund. These mutual funds held by KMSF are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value and to transact at that price. These mutual funds are deemed to be actively traded.

Fixed income securities: Valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing value on yields currently available on comparable securities of issuers with similar credit ratings.

There have been no changes in the valuation methodologies used at June 30, 2018 and 2017.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while KMSF's management believes the valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

7. Fair Value Measurements, continued

The following tables set forth by level, within the fair value hierarchy, KMSF's assets and liabilities at fair value:

<u>June 30, 2018</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Interest bearing deposits and government securities	\$ 41,562,119	\$ -	\$ -	\$ 41,562,119
Common stocks and foreign equities	8,673,750	-	-	8,673,750
Real estate investment trust	468,664	-	-	468,664
Real estate investment partnership	-	468,318	-	468,318
Mutual funds :				
Taxable/fixed income	4,269,422	-	-	4,269,422
International	4,247,753	-	-	4,247,753
Mid cap	868,537	-	-	868,537
Small cap	<u>443,238</u>	<u>-</u>	<u>-</u>	<u>443,238</u>
Total mutual funds	9,828,950	-	-	9,828,950
Fixed income securities :				
Aaa credit rating	-	677,998	-	677,998
Aa2 credit rating	-	210,865	-	210,865
Aa3 credit rating	-	79,345	-	79,345
A1 credit rating	-	144,391	-	144,391
A2 credit rating	-	39,991	-	39,991
A3 credit rating	-	334,535	-	334,535
NR credit rating	<u>-</u>	<u>767,953</u>	<u>-</u>	<u>767,953</u>
Total fixed income securities	<u>-</u>	<u>2,255,078</u>	<u>-</u>	<u>2,255,078</u>
 Total investments	 <u>\$ 60,533,483</u>	 <u>\$ 2,723,396</u>	 <u>\$ -</u>	 <u>\$ 63,256,879</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

7. Fair Value Measurements, continued

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>June 30, 2017</u>				
Interest bearing deposits and government securities	\$ 29,943,182	\$ -	\$ -	\$ 29,943,182
Common stocks and foreign equities	7,714,223	-	-	7,714,223
Real estate investment partnership	-	468,120	-	468,120
Mutual funds :				
Taxable/fixed income	3,735,695	-	-	3,735,695
International	4,014,461	-	-	4,014,461
Mid cap	796,964	-	-	796,964
Small cap	208,623	-	-	208,623
Alternatives	<u>997,928</u>	<u>-</u>	<u>-</u>	<u>997,928</u>
Total mutual funds	9,753,671	-	-	9,753,671
Fixed income securities :				
Aaa credit rating	-	388,582	-	388,582
Aa2 credit rating	-	100,168	-	100,168
Aa3 credit rating	-	119,900	-	119,900
A1 credit rating	-	150,126	-	150,126
A2 credit rating	-	40,158	-	40,158
A3 credit rating	-	340,021	-	340,021
NR credit rating	<u>-</u>	<u>539,068</u>	<u>-</u>	<u>539,068</u>
Total fixed income securities	<u>-</u>	<u>1,678,023</u>	<u>-</u>	<u>1,678,023</u>
 Total investments	 <u>\$ 47,411,076</u>	 <u>\$ 2,146,143</u>	 <u>\$ -</u>	 <u>\$ 49,557,219</u>

To assess the appropriate classification of assets and liabilities within the fair value hierarchy, the availability of market data is monitored. Changes in economic conditions or valuation techniques may require the transfer of assets and liabilities from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period. KMSF's management evaluates the significance of transfers between levels based upon the nature of the assets and liabilities and size of the transfer relative to total net assets. There were no transfers of assets or liabilities from one fair value level to another during the years ended June 30, 2018 and 2017.

8. Settlements Due to Third Party Payors

KMSF has accrued settlements due to third party payors of approximately \$570,000 and \$1,090,000 as of June 30, 2018 and 2017, respectively. This liability represents amounts due to the federal government, insurance companies and individuals for payments KMSF has received but which need to be refunded due to various reasons within the revenue cycle.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

9. Long-Term Debt and Capital Leases

As of June 30, 2018 and 2017, notes payable and capital lease obligations consisted of the following:

	<u>2018</u>	<u>2017</u>
Capital lease obligations, maturing February 2030, bearing interest at 4.25%, collateralized by property with a net book value of \$37,319,804, payments of \$132,671 per month (increasing by 2% every subsequent lease year) for the first floor of the property, and payments of \$56,252 per month (increasing every fifth year, beginning July 1, 2021, by an amount that is equivalent to the percentage increase in the Consumer Price Index as defined by the agreement) for the second floor of the property.	\$ 22,560,026	\$ 23,818,196
Capital lease obligation, maturing March 2037, bearing interest at the prime rate plus 1% (currently 4.75%), for the base rent, and 7.5% for the tenant improvements portion, collateralized by property with a net book value of \$16,659,447, payments of \$111,181 per month (payment amounts per month increase every fifth year of the capital lease obligation).	16,709,942	17,084,990
County of Clark, Kentucky Healthcare Revenue Bonds, Series 2017, accruing interest at a rate equal to 2.94% as of June 30, 2018, due in varying monthly principal and interest payments and maturing in April 2037.	9,565,709	9,938,993
County of Scott, Kentucky Healthcare Revenue Bonds, Series 2017, accruing interest at a rate equal to 2.94% as of June 30, 2018, due in varying monthly principal and interest payments and maturing in April 2037.	9,367,979	9,731,019
Capital lease obligations, maturing February 2030, bearing interest at 4.25%, collateralized by property with a net book value of \$37,319,804, payments of \$61,724 per month (payment amounts per month increase every fifth year of the capital lease obligation).	7,306,737	-

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

9. Long-term Debt and Capital Leases, continued

	<u>2018</u>	<u>2017</u>
Capital lease obligation, maturing June 2028, bearing interest at 4.25%, collateralized by property with a net book value of \$7,068,356, payments of \$62,374 per month (increasing by 2.75% every subsequent lease year). KMSF has the option to renew for three additional five year lease terms.	6,835,322	-
Capital lease obligation, maturing June 2020, bearing interest at 4.25%, collateralized by property with a net book value of \$4,866,791, payments of \$86,526 per month (increasing by 2% every subsequent lease year).	2,006,908	2,918,451
Capital lease obligations at varying rates of interest from 0.35% to 5.50%, collateralized by leased equipment with a net book value of \$463,478 at June 30, 2018.	<u>132,809</u>	<u>235,202</u>
Total long-term debt	74,485,432	63,726,851
Less capitalized loan fees, net	<u>112,432</u>	<u>118,376</u>
	74,373,000	63,608,475
Less current portion	<u>4,465,363</u>	<u>3,377,532</u>
Long-term debt, net of current portion	<u>\$ 69,907,637</u>	<u>\$ 60,230,943</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

9. Long-term Debt and Capital Leases, continued

Scheduled principal repayments on bonds and payments on capital lease obligations are as follows:

Year ending June 30,	<u>Bonds</u>	<u>Capital Lease Obligations</u>
2019	\$ 758,572	\$ 6,209,317
2020	780,042	6,248,358
2021	805,067	5,239,313
2022	829,395	5,305,780
2023	854,459	5,417,922
Thereafter	<u>14,906,153</u>	<u>48,159,982</u>
	<u>\$ 18,933,688</u>	76,580,672
Less amount representing interest under capital lease obligations		<u>21,028,928</u>
		<u>\$ 55,551,744</u>

Interest expense was \$2,793,060 and \$3,914,425 for the years ended June 30, 2018 and 2017, respectively.

10. Net Professional Clinical Service Fees and Capitation Revenue

UK and KMSF have agreements with third-party payors that provide for payments at amounts different from their established rates. Contractual adjustments represent the difference between billing at established rates and amounts reimbursed by third-party payors.

A summary of gross and net professional clinical service fee revenue and capitation revenue for the years ended June 30, 2018 and 2017 follows:

	<u>2018</u>	<u>2017</u>
Gross professional clinical service fee revenue and capitation revenue	\$ 720,787,138	\$ 671,684,041
Less provision for contractual adjustments under third- party reimbursement programs and other adjustments	<u>(439,674,349)</u>	<u>(404,849,364)</u>
Net professional clinical service fee revenue and capitation revenue	<u>\$ 281,112,789</u>	<u>\$ 266,834,677</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

11. PSP Revenue

During 2018 and 2017, KMSF received \$60,762,761 and \$75,383,038, respectively, in PSP revenue from the University of Kentucky. These funds are used to supplement KMSF's professional clinical service fees and to support the ongoing operations of KMSF.

12. Other Income

Other income consists of the following for the years ended June 30, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Medical & administrative services contractual income	\$ 17,892,474	\$ 16,350,747
EHR meaningful use	2,964,190	3,030,106
Prior years revenue adjustments	546,785	917,205
Payor quality incentives	442,946	88,106
Royalty income	222,977	294,483
Other income	<u>352,307</u>	<u>576,582</u>
Total other income	<u>\$ 22,421,679</u>	<u>\$ 21,257,229</u>

13. Leasing Activities

KMSF leases office space to UK as well as other non-related entities. The lease contract with UK is currently month-to-month. The lease contracts with the non-related entities vary with remaining terms ranging from less than one year to less than two years. KMSF received \$5,802,712 and \$4,967,975 in lease income from UK and \$112,732 and \$109,944 from other non-related entities in 2018 and 2017, respectively.

14. Medical Malpractice Insurance

KMSF is self-insured, along with UK, for malpractice claims. On an annual basis, the malpractice liability is actuarially determined at a consolidated basis using claims data from UK and KMSF. UK informs KMSF of their portion of the overall liability as well as their funding requirements to maintain appropriate funding levels. KMSF maintains their portion of the malpractice fund investments. Management believes the malpractice self-insurance fund is adequate to cover any losses.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

15. Commitments and Contingencies

Litigation

KMSF is currently involved in litigation and/or regulatory investigations. KMSF's involvement typically arises either in the course of KMSF's business or in KMSF's role as a support organization for UK, and it is possible that the litigation and/or regulatory investigations could result in a material adverse effect on KMSF's future financial position or results from operations. Apart from matters where KMSF's involvement is part of such support role, management estimates these matters will be resolved without material adverse effect on KMSF's future financial position or results from operations.

Operating Leases

KMSF leases various equipment and facilities under operating leases that are set to expire at various dates. Total rental expense in 2018 and 2017 was \$1,325,515 and \$1,899,299, respectively.

The following is a schedule by year of future minimum lease payments under operating leases as of June 30, 2018:

Year ending June 30,	
2019	\$ 1,475,356
2020	581,560
2021	384,625
2022	229,650
2023	50,880
Thereafter	<u>905,644</u>
	<u>\$ 3,627,715</u>

16. Concentrations of Credit Risk

UK and KMSF grant credit without collateral to their patients, most of whom are area residents and are insured under third-party payor arrangements. The mix of receivables from patients and third-party payors at June 30, 2018 and 2017, was as follows:

	<u>2018</u>	<u>2017</u>
Medicaid	35 %	32 %
Other third-party payors	22	20
Medicare	21	19
Patients	12	18
Blue Cross	<u>10</u>	<u>11</u>
	<u>100 %</u>	<u>100 %</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

17. Healthcare Reform and Reimbursement Changes

The American Recovery and Reinvestment Act of 2009

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (the Recovery Act) was signed into law. A major component of the Recovery Act is its emphasis on improving health information technology (also known as HIT). The federal government believes the implementation of technology will ultimately increase the quality and reduce the cost of healthcare.

To accomplish the improvement of HIT, the Recovery Act includes payment incentives for qualifying professionals. Physicians and hospitals that are considered early adopters of electronic health records (EHR) can become eligible to receive a significant amount of money from Medicare or Medicaid.

During the years ended June 30, 2018 and 2017, KMSF applied for and received \$2,936,750 and \$2,562,750 in Medicaid HIT funds, respectively, and \$27,440 and \$467,356 in Medicare funds, respectively. KMSF intends to apply for additional funds in the coming years. Both the 2018 and 2017 funds and any funds from past or future applications are contingent on reaching certain metrics and various states of "meaningful use" as defined by the Recovery Act.

Medicare Access and CHIP Reauthorization Act

In April 2015, The Medicare Access and CHIP Reauthorization Act (MACRA) was signed in to law. MACRA replaces the sustainable growth rate (SGR) formula with a framework that rewards providers for providing higher quality care through the creation of two reimbursement pathways:

- Merit-based incentive Payment System (MIPS), and
- Alternative Payment Models (APMs).

Additionally, the proposed rules collapse three existing quality reporting programs (PQRS, Value-based Payment Modifier, and Meaningful Use) into the newly created MIPS pathway. Most physicians that bill Medicare Part B claims will be impacted. Providers selected a reimbursement pathway in December 2016, pending final approval. Provider reimbursements will begin being adjusted in 2019, pending final approval. KMSF is currently evaluating the impact this will have on its reimbursement from Medicare.