

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

*Years Ended June 30, 2016 and 2015  
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, 2016 and 2015, 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.

To the Board of Directors of  
Kentucky Medical Services Foundation, Inc.  
Report of Independent Auditors, continued

**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, 2016 and 2015, 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 Dotson Allen Ford, PLLC*

September 20, 2016  
Lexington, Kentucky

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KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Balance Sheets

June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
<b>Assets</b>		
Current assets:		
Investments and interest bearing deposits, current	\$ 16,976,658	\$ 21,702,649
Patient accounts receivable, less allowance for uncollectibles of \$6,884,129 and \$4,003,021 and allowances for contractual adjustments of \$66,923,764 and \$49,168,484 in 2016 and 2015, respectively	35,129,615	28,417,769
Accounts receivable - PSP revenue	9,883,547	11,381,187
Other receivables, current portion	3,163,441	1,413,064
Other current assets	<u>370,076</u>	<u>176,764</u>
Total current assets	65,523,337	63,091,433
Assets limited as to use:		
Dean's academic enrichment funds - limited by agreement	252,461	561,193
Investments and interest bearing deposits, noncurrent	48,029,144	54,927,373
Other receivables, less current portion	813,333	801,900
Property and equipment:		
Land and improvements	2,729,890	2,636,277
Buildings	44,828,237	44,274,023
Furniture and equipment	9,115,214	9,788,990
Capitalized software	16,986,574	10,958,682
Buildings under capital lease obligations	34,868,223	27,235,355
Equipment under capital lease obligations	<u>1,380,386</u>	<u>1,260,140</u>
	109,908,524	96,153,467
Less accumulated depreciation	<u>27,853,767</u>	<u>20,408,672</u>
Net property and equipment	<u>82,054,757</u>	<u>75,744,795</u>
Total assets	<u>\$ 196,673,032</u>	<u>\$ 195,126,694</u>

	<u>2016</u>	<u>2015</u>
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 10,144,919	\$ 7,338,372
Long-term debt, current portion	18,928,997	600,169
Capital leases, current portion	2,992,805	2,465,360
Settlement due to third party payors	2,117,997	4,302,173
Patient refunds	1,515,997	505,664
Due to the University of Kentucky	21,873,134	18,590,039
Due to the University of Kentucky - malpractice fund	17,580,432	18,096,357
Due to the College of Medicine departments under departmental plan agreements	<u>61,377,521</u>	<u>70,492,986</u>
Total current liabilities	136,531,802	122,391,120
Long-term debt, net of current portion	-	18,928,969
Capital leases, net of current portion	<u>24,044,967</u>	<u>20,297,159</u>
Total long-term liabilities	<u>24,044,967</u>	<u>39,226,128</u>
Total liabilities	160,576,769	161,617,248
Unrestricted net assets:		
Board designated - property (net of long-term debt and capital leases) and equipment	<u>36,096,263</u>	<u>33,509,446</u>
Total liabilities and net assets	<u>\$ 196,673,032</u>	<u>\$ 195,126,694</u>

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Operations and Changes in Net Assets

Years ended June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Revenues and gains:		
Net professional clinical service fee revenue	\$ 223,704,971	\$ 208,338,766
Capitation revenue	27,462,335	27,115,653
Provision for bad debts	<u>(17,577,687)</u>	<u>(10,573,587)</u>
Net professional clinical service fee revenue less provision for bad debts	233,589,619	224,880,832
Lease income	4,782,483	3,109,167
Investment income, net	162,440	101,658
PSP revenue	68,954,583	71,996,809
Other income, net	<u>10,513,421</u>	<u>4,078,929</u>
Total revenues and gains	318,002,546	304,167,395
Expenses:		
Departmental expenses	251,064,431	246,019,511
Operating expenses - business office	35,428,216	22,966,855
UKHMO capitation expenses	6,009,813	5,634,868
Reimbursement to the University of Kentucky for malpractice insurance and expenses attendant to the production of clinical income	9,096,333	8,540,983
Dean's academic enrichment funds	10,561,545	6,290,322
Physicians' fringe benefits	<u>3,255,391</u>	<u>3,724,355</u>
Total expenses	<u>315,415,729</u>	<u>293,176,894</u>
Increase in net assets	2,586,817	10,990,501
Net assets, beginning of year	<u>33,509,446</u>	<u>22,518,945</u>
Net assets, end of year	<u>\$ 36,096,263</u>	<u>\$ 33,509,446</u>

See accompanying notes.



**KENTUCKY MEDICAL SERVICES FOUNDATION, INC.**

Statements of Cash Flows

Years ended June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
<b>Cash flows from operating activities:</b>		
Increase in net assets	\$ 2,586,817	\$ 10,990,501
Adjustments to reconcile increase in net assets to net cash (used in) provided by operating activities:		
Depreciation	8,389,462	2,494,689
Loss (gain) on disposal of assets	2,295	(38,872)
Provision for bad debts	17,577,687	10,573,587
Increase (decrease) in cash due to changes in:		
Patient accounts receivable	(24,289,533)	(15,610,549)
Accounts receivable - PSP revenue	1,497,640	(11,381,187)
Other receivables	(1,761,810)	367,866
Other current assets	(193,312)	(124,094)
Accounts payable and accrued liabilities	2,806,547	(688,691)
Settlement due to third party payors	(2,184,176)	1,939,563
Patient refunds	1,010,333	76,914
Due to the University of Kentucky	3,283,095	5,851,948
Due to the University of Kentucky - malpractice fund	(515,925)	470,287
Due to the College of Medicine departments under departmental plan agreements	<u>(9,115,465)</u>	<u>16,120,388</u>
Net cash (used in) provided by operating activities	(906,345)	21,042,350
<b>Cash flows from investing activities:</b>		
Capital expenditures	(7,957,735)	(11,984,817)
Decrease (increase) in investments and interest-bearing deposits, net	11,624,220	(5,708,010)
Decrease (increase) in assets limited as to use, net	308,732	(308,124)
Proceeds on sale of property and equipment	<u>-</u>	<u>149,408</u>
Net cash provided by (used in) investing activities	3,975,217	(17,851,543)
<b>Cash flows from financing activities:</b>		
Repayments on long-term debt	(600,141)	(1,135,384)
Payments on capital leases	<u>(2,468,731)</u>	<u>(2,055,423)</u>
Net cash used in financing activities	<u>(3,068,872)</u>	<u>(3,190,807)</u>
Net change in cash	<u>\$ -</u>	<u>\$ -</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows, continued

Years ended June 30, 2016 and 2015

<b>Supplemental cash flow disclosures:</b>	<u>2016</u>	<u>2015</u>
Cash paid for interest	\$ 1,003,751	\$ 936,820
Noncash investing and financing transactions:		
Capital lease obligation for purchase of buildings and equipment	\$ 6,743,984	\$ 23,842,380

*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, 2016.

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 \$5,512,649 and \$1,340,926 in 2016 and 2015, respectively. Management has estimated its cost incurred to provide charity care to be approximately \$2,200,000 and \$510,000 for the years ended June 30, 2016 and 2015, 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 20, 2016, 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 2015 financial statement presentation to correspond to the current year's format. Net assets and increase in net assets are unchanged due to these reclassifications.

##### New Accounting Pronouncements

In May 2014, the 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 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.

#### 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.

## KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

### Notes to the Financial Statements, continued

#### 3. Patient Accounts Receivable, continued

KMSF has recorded an allowance for uncollectible patient accounts receivable of approximately 6% and 5% of gross patient accounts receivable as of June 30, 2016 and 2015, respectively. A summary of the changes in the allowance for uncollectible patient accounts receivable is as follows:

Year ended June 30,	<u>2016</u>	<u>2015</u>
Balance, beginning of year	\$ 4,003,021	\$ 6,364,679
Provision for bad debts	17,577,687	10,573,587
Receivables charged off	<u>(14,696,579)</u>	<u>(12,935,245)</u>
Balance, end of year	<u>\$ 6,884,129</u>	<u>\$ 4,003,021</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 \$1,549,400 and \$1,334,292 as of June 30, 2016 and 2015, respectively.

#### 5. Academic Enrichment Funds

In accordance with the Agreement with UK effective July 1, 2015 and the Agreement with UK effective July 1, 2014, KMSF reimbursed UK for actual expenses incurred by UK which are attendant to the production of clinical income, as defined. In 2016 and 2015, the amount reimbursed was \$10,561,545 and \$6,290,322, respectively.

Payments are also made to UK for the purpose of providing a fund (the Dean's Fund) for academic enrichment for the College of Medicine. The Dean's Fund supports the missions of UK and UK HealthCare in support of activities such as research, education, departmental and program development. The Dean of the College of Medicine may expend these funds to support the College of Medicine or any related purpose. Also in accordance with these Agreements, KMSF is required to maintain a cash amount, 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 2016 and 2015. The funds in the account are for the use of the Dean and are included as part of the liability payable under the Departmental Plan Agreements. In 2016 and 2015, \$5,464,622 and \$5,590,595, respectively, of such funds were expended and are included in departmental expenses.

**KENTUCKY MEDICAL SERVICES FOUNDATION, INC.**

Notes to the Financial Statements, continued

**6. Investments and Interest Bearing Deposits**

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

	<u>2016</u>	<u>2015</u>
Interest bearing deposits and government securities	\$ 51,876,769	\$ 58,557,330
Fixed income securities	975,442	1,795,767
Equity securities and equity security mutual funds	12,145,316	16,220,617
Guaranteed investment contract	<u>8,275</u>	<u>56,308</u>
 Total investments and interest bearing deposits	 <u>\$ 65,005,802</u>	 <u>\$ 76,630,022</u>

The components of investment income from investments and interest bearing deposits for 2016 and 2015 consist of \$162,440 and \$101,658, 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>2016</u>	<u>2015</u>
Current investments	\$ 16,976,658	\$ 21,702,649
Non-current investments	<u>48,029,144</u>	<u>54,927,373</u>
 Total investment and interest bearing deposits	 <u>\$ 65,005,802</u>	 <u>\$ 76,630,022</u>

**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.



KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

**7. Fair Value Measurements, continued**

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 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 NAV 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, 2016 and 2015.

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>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>June 30, 2016</u>				
Interest bearing deposits and government securities	\$ 51,876,769	\$ -	\$ -	\$ 51,876,769
Common stocks and foreign equities	6,490,812	-	-	6,490,812
Real estate investment trust	1,070,070	-	-	1,070,070
Other	-	8,275	-	8,275
Mutual funds :				
Taxable/fixed income	1,804,362	-	-	1,804,362
International	1,731,015	-	-	1,731,015
Mid cap	506,640	-	-	506,640
Small cap	405,806	-	-	405,806
Other - equities	<u>136,611</u>	<u>-</u>	<u>-</u>	<u>136,611</u>
Total mutual funds	4,584,434	-	-	4,584,434
Fixed income securities :				
Aaa credit rating	-	325,138	-	325,138
Aa3 credit rating	-	79,320	-	79,320
A credit rating	-	94,552	-	94,552
A1 credit rating	-	47,145	-	47,145
A2 credit rating	-	241,608	-	241,608
A3 credit rating	-	147,603	-	147,603
Baa1 credit rating	<u>-</u>	<u>40,076</u>	<u>-</u>	<u>40,076</u>
Total fixed income securities	<u>-</u>	<u>975,442</u>	<u>-</u>	<u>975,442</u>
Total investments	<u>\$ 64,022,085</u>	<u>\$ 983,717</u>	<u>\$ -</u>	<u>\$ 65,005,802</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, 2015</u>				
Interest bearing deposits and government securities	\$ 58,557,330	\$ -	\$ -	\$ 58,557,330
Common stocks and foreign equities	8,067,066	-	-	8,067,066
Real estate investment trust	1,016,979	-	-	1,016,979
Other	-	56,308	-	56,308
Mutual funds :				
Taxable/fixed income	1,775,858	-	-	1,775,858
International	2,149,196	-	-	2,149,196
Mid cap	1,077,886	-	-	1,077,886
Small cap	727,502	-	-	727,502
Alternatives	841,905	-	-	841,905
Other - equities	<u>564,225</u>	<u>-</u>	<u>-</u>	<u>564,225</u>
Total mutual funds	7,136,572	-	-	7,136,572
Fixed income securities :				
Aaa credit rating	-	515,772	-	515,772
Aa2 credit rating	-	156,217	-	156,217
Aa3 credit rating	-	224,316	-	224,316
A1 credit rating	-	124,805	-	124,805
A2 credit rating	-	302,731	-	302,731
A3 credit rating	<u>-</u>	<u>471,926</u>	<u>-</u>	<u>471,926</u>
Total fixed income securities	<u>-</u>	<u>1,795,767</u>	<u>-</u>	<u>1,795,767</u>
Total investments	<u>\$ 74,777,947</u>	<u>\$ 1,852,075</u>	<u>\$ -</u>	<u>\$ 76,630,022</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.

8. Settlement Due to Third Party Payors

KMSF has accrued settlements due to third party payors of approximately \$2,100,000 and \$4,300,000 as of June 30, 2016 and 2015, 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, 2016 and 2015, notes payable and capital lease obligations consisted of the following:

	<u>2016</u>	<u>2015</u>
Bank note payable, maturing March 2017, bearing interest at 4.25%, collateralized by property, principal and interest payments of \$115,224 due monthly	\$ 18,920,722	\$ 19,472,830
Note payable to an individual, maturing August 2016, bearing interest at 5.7%, collateralized by an annuity security, principal and interest payments of \$4,167 due monthly	8,275	56,308
Capital lease obligations, maturing February 2030, bearing interest at 4.25%, collateralized by property with a net book value of \$28,802,444, payments of \$132,302 per month (increasing by 2% every subsequent lease year) for the first floor of the property, and payments of \$58,362 per month (increasing every five 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; KMSF has the option to rent more space if needed	23,326,334	18,131,313
Capital lease obligation, maturing June 2020, bearing interest at 4.25%, collateralized by property with a net book value of \$5,034,668, payments of \$81,536 per month (increasing by 2% every subsequent lease year)	3,410,960	4,311,239
Capital lease obligations at varying rates of interest from 0.35% to 5.50%, collateralized by leased equipment with a net book value of \$710,800 at June 30, 2016	<u>300,478</u>	<u>319,967</u>
Total long-term debt	45,966,769	42,291,657
Less current portion	<u>21,921,802</u>	<u>3,065,529</u>
Long-term debt, net of current portion	<u>\$ 24,044,967</u>	<u>\$ 39,226,128</u>

**KENTUCKY MEDICAL SERVICES FOUNDATION, INC.**

Notes to the Financial Statements, continued

**9. Long-term Debt and Capital Leases, continued**

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

Year ending June 30,	<u>Notes Payable</u>	<u>Capital Lease Obligations</u>
2017	\$ 18,928,997	\$ 3,324,062
2018	-	3,364,820
2019	-	3,377,596
2020	-	3,396,054
2021	-	2,365,860
Thereafter	<u>-</u>	<u>21,932,016</u>
	<u>\$ 18,928,997</u>	37,760,408
Less amount representing interest under capital lease obligations		<u>10,722,636</u>
		<u>\$ 27,037,772</u>

Interest expense was \$1,003,751 and \$936,820 for the years ended June 30, 2016 and 2015, 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, 2016 and 2015 follows:

	<u>2016</u>	<u>2015</u>
Gross professional clinical service fee revenue and capitation revenue	\$ 648,593,584	\$ 591,156,750
Less provision for contractual adjustments under third-party reimbursement programs and other adjustments	<u>(397,426,278)</u>	<u>(355,702,331)</u>
Net professional clinical service fee revenue and capitation revenue	<u>\$ 251,167,306</u>	<u>\$ 235,454,419</u>



## KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

### Notes to the Financial Statements, continued

#### 11. PSP Revenue

During 2016 and 2015, KMSF received \$68,954,583 and \$71,996,809, 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. 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 \$4,702,661 and \$3,047,023 in lease income from UK and \$79,822 and \$62,144 from other non-related entities in 2016 and 2015, respectively.

#### 13. 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.

#### 14. 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.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

14. Commitments and Contingencies, continued

Operating Leases

KMSF leases various equipment and facilities under operating leases that are set to expire at various dates. Total rental expense in 2016 and 2015 was \$1,912,335 and \$2,015,015, respectively.

The following is a schedule by year of future minimum lease payments under operating leases as of June 30, 2016:

Year ending June 30,	
2017	\$ 2,081,734
2018	1,284,162
2019	1,200,742
2020	1,185,328
2021	1,012,668
Thereafter	<u>5,157,111</u>
	\$ <u>11,921,745</u>

15. 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, 2016 and 2015, was as follows:

	<u>2016</u>	<u>2015</u>
Medicaid	34 %	30 %
Other third-party payors	24	29
Medicare	19	22
Blue Cross	10	13
Patients	<u>13</u>	<u>6</u>
	<u>100 %</u>	<u>100 %</u>

## KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

### Notes to the Financial Statements, continued

#### 16. 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, 2016 and 2015, KMSF applied for and received \$586,500 and \$365,500 in Medicaid HIT funds, respectively, and \$922,564 and \$1,325,866 in Medicare funds, respectively. KMSF intends to apply for additional funds in the coming years. Both the 2016 and 2015 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 will select 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.