KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Financial Statements

Years Ended June 30, 2011 and 2010
with Independent Auditors' Report Thereon

CONTENTS

Independent Auditors' Report

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

We have audited the accompanying balance sheet of Kentucky Medical Services Foundation, Inc. (KMSF) as of June 30, 2011, and the related statements of operations and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of KMSF's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of KMSF as of and for the year ended June 30, 2010, were audited by Dean Dorton Ford, PSC, whose report dated September 27, 2010, expressed an unqualified opinion on those statements.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky Medical Services Foundation, Inc. as of June 30, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Dean Dorton Allen Ford, PLLC

September 27, 2011
Lexington, Kentucky

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KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Balance Sheets

June 30, 2011 and 2010

	2011	2010
Assets		
Current assets:		
Investments and interest bearing deposits, current	$ 10,988,883	$ 6,403,909
Patient accounts receivable, less allowance for uncollectibles of $3,498,887 and $3,311,285 and allowances for contractual adjustments of $22,260,811 and $24,909,201 in 2011 and 2010, respectively	19,124,849	22,160,113
Other receivables, current portion	2,526,927	5,658,647
Other current assets	51,797	47,165
Total current assets	32,692,456	34,269,834
Assets limited as to use:		
Dean's academic enrichment funds - limited by agreement	3,091,271	2,864,708
Investments and interest bearing deposits, noncurrent	35,356,484	28,168,767
Other receivables, less current portion	1,036,067	631,434
Property and equipment:		
Land and improvements	2,308,952	4,379,038
Buildings	38,777,834	38,086,017
Furniture and equipment	4,766,831	4,440,872
Equipment under capital lease obligations	4,812,756	4,040,453
	50,666,373	50,946,380
Less accumulated depreciation	12,812,795	10,423,889
Net property and equipment	37,853,578	40,522,491
Intangibles, net	340,571	510,857
Total assets	$ 110,370,427	$ 106,968,091

	2011	2010
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued liabilities	$ 3,611,486	$ 4,867,306
Long-term debt, current portion	2,482,619	4,983,821
Patient refunds	386,370	557,358
Due to the University of Kentucky	1,719,996	7,147,633
Due to the University of Kentucky - malpractice fund	15,910,277	15,081,650
Due to the College of Medicine departments under departmental plan agreements	47,601,990	32,911,054
Total current liabilities	71,712,738	65,548,822
Long-term debt, net of current portion	21,830,498	22,029,239
Total liabilities	93,543,236	87,578,061
Unrestricted net assets:		
Board designated - property (net of debt), equipment and goodwill	16,827,191	19,390,030
Total net assets	16,827,191	19,390,030
Total liabilities and net assets	$ 110,370,427	$ 106,968,091

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Operations and Changes in Net Assets

Years ended June 30, 2011 and 2010

	2011	2010
Net professional clinical service fee revenue	$ 207,025,579	$ 196,753,704
Other operating revenues and gains:		
Lease income	2,800,760	3,989,155
Investment income, net	87,969	145,702
Other income and gains	528,782	2,515,629
Total other operating revenues and gains	3,417,511	6,650,486
Total revenues and gains	210,443,090	203,404,190
Expenses:		
Departmental expenses	154,622,806	149,772,197
Provision for bad debts	18,243,449	18,363,014
Operating expenses - business office	18,823,173	18,733,572
UKHMO capitation expenses	5,592,109	6,513,295
Reimbursement to the University of Kentucky for malpractice insurance and expenses attendant to the production of clinical income	6,238,799	6,528,904
Kentucky Clinic central expenses	2,146,216	2,831,842
Dean's academic enrichment funds	4,023,280	2,418,368
Physicians' fringe benefits	2,404,765	2,123,476
Dean's Fund scholarships	741,046	687,697
Total expenses	212,835,643	207,972,365
Impairment loss	(170,286)	(85,143)
Decrease in net assets	(2,562,839)	(4,653,318)
Net assets, beginning of year	19,390,030	24,043,348
Net assets, end of year	$ 16,827,191	$ 19,390,030

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows

Years ended June 30, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Decrease in net assets	$ (2,562,839)	$ (4,653,318)
Adjustments to reconcile decrease in net assets to net cash provided by operating activities:		
Depreciation	2,411,466	2,201,317
Impairment loss	170,286	85,143
Loss on disposal of assets	134,107	145,347
Provision for bad debts	18,243,449	18,363,014
Increase (decrease) in cash due to changes in:		
Patient accounts receivable	(15,208,185)	(15,619,295)
Other receivables	2,727,087	(2,773,953)
Other current assets	(4,632)	(6,221)
Accounts payable and accrued liabilities	(1,255,820)	426,646
Patient refunds	(170,988)	33,747
Due to the University of Kentucky	(5,427,637)	(2,309,794)
Due to the University of Kentucky - malpractice fund	828,627	1,742,962
Due to the College of Medicine departments under departmental plan agreements	14,690,936	5,436,502
Net cash provided by operating activities	14,575,857	3,072,097
Cash flows from investing activities:		
Capital expenditures	(1,157,102)	(129,724)
(Increase) decrease in investments and interest-bearing deposits, net	(11,772,691)	1,221,835
Increase in assets limited as to use, net	(226,563)	(2,371,877)
Proceeds on sale of property and equipment	2,052,745	1,500
Net cash used in investing activities	(11,103,611)	(1,278,266)
Cash flows from financing activities:		
Repayments on long-term debt	(3,472,246)	(1,793,831)
Net cash used in financing activities	(3,472,246)	(1,793,831)
Net change in cash	$ -	$ -

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows, continued

Years ended June 30, 2011 and 2010

Supplemental cash flow disclosures:		2011		2010
Cash paid for interest	$	1,634,322	$	1,500,558
Noncash investing and financing transactions:				
Other receivable for reimbursement of clinic property and equipment	$	-	$	2,079,819
Capital lease obligation for purchase of equipment		772,303		551,209

See accompanying notes.

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, 2011.

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 Accounts Standards Codification (ASC) 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 the Company 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.

Management has elected to exclude the following disclosure required by GAAP: the identification of the investments' fair values by the levels of observable inputs are not disclosed. Management has examined the impact of this disclosure on the financial statements and believes the omittance of this disclosure does not have a material effect on a user's decisions regarding the financial statements.

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 and cash and investments set aside in accordance with the Agreement between KMSF and UK.

2. Summary of Significant Accounting Policies, continued

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. As a result of a change in strategy, during 2011, the Fountain Court property was sold with gross proceeds of $2,052,745 and a basis of $2,149,041. This transaction resulted in a net loss of $96,296.

Intangibles

Goodwill resulted from a 2006 acquisition of certain assets. The acquisition was recorded using the purchase method of accounting.

GAAP requires intangible assets to be valued at cost. Per GAAP, intangible assets that have indefinite useful lives, including goodwill, are not to be amortized but rather are to be tested at least annually for impairment. Any decrease in value of the asset would be recognized as impairment loss in the current year. If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. Intangible assets that have finite useful lives should be amortized over their useful lives.

KMSF periodically reviews the carrying value of its goodwill to determine whether an impairment exists. KMSF considers relevant cash flow and profitability information for the related assets acquired under the aforementioned purchase acquisition. In 2011 and 2010, KMSF determined an impairment of goodwill was necessary based on certain factors known about the underlying assets. The impairment loss is an estimate made by management based on the future years of positive cash flow expected. The changes in the carrying amount of goodwill and accumulated impairment loss for the year ended June 30, 2011 follow:

	Carrying Amount	Accumulated Impairment Loss
Balance as of June 30, 2010	$ 510,857	$ 85,143
Impairment loss	(170,286)	170,286
Balance as of June 30, 2011	$ 340,571	$ 255,429

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.

KMSF has evaluated the tax positions taken on all income tax returns that remain open to examination by the respective taxing authorities. KMSF does not believe that there are any uncertain positions on those returns that require recognition or disclosure in the financial statements.

Net Professional Clinical Service Fees

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.

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 totaled $3,583,147 and $4,094,197 in 2011 and 2010, 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 approximates fair value.

Investment income (including realized 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. Unrealized gains and losses on investments, if any, are excluded from the excess of revenues over expenses.

Subsequent Events

Management has evaluated subsequent events for items requiring recognition or disclosure in the financial statements through September 27, 2011, the date that the financial statements were issued. There were no events occurring during the evaluation period that would require recognition or disclosure in the financial statements.

2. Summary of Significant Accounting Policies, continued

New Accounting Pronouncements

The Financial Accounting Standards Board has issued Accounting Standards Update (ASU) No. 2010-23, 2010-24, and No. 2011-07 to ASC Topic 954,*Health Care Entities.*

ASU No. 2010-23, *Measuring Charity Care for Disclosure,* requires that a health care entity report the amount of charity care provided at the entity's estimated costs instead of at gross charges. For KMSF, the effective date for this ASU is year ending June 30, 2012.

ASU No. 2010-24, *Presentation of Insurance Claims and Related Insurance Recoveries,* requires that a health care entity no longer report its insurance claim liabilities net of insurance recoveries and instead report both the gross liability and gross insurance recovery receivable on the entity's balance sheet. For KMSF, the effective date for this ASU is year ending June 30, 2012.

ASU No. 2011-07, Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities, requires that certain health care entities change the presentation in their statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). Additionally, those health care entities are required to provide enhanced disclosure about their policies for recognizing revenue and assessing bad debts. The amendments also require disclosures of patient service revenue (net of contractual allowances and discounts) as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. For KMSF, the effective date for this ASU is the year ending June 30, 2013.

3. Other Receivables

During 2006, KMSF began making loans to physicians who 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 $1,646,336 and $1,047,867 as of June 30, 2011 and 2010, respectively.

4. Academic Enrichment Funds

In accordance with the Agreement with UK, KMSF paid UK 3% in 2011 and 2% in 2010, $4,023,280 and $2,418,368, respectively, of the clinical income collected by KMSF, as defined, for the purpose of providing a fund (the Dean's Fund) for academic enrichment for the College. The Dean of the College may expend these funds to support the College or any related purpose. Also in accordance with the Agreement, 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. The percentage of collections added to this account was 5% in 2011 and 6% in 2010. 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 2011 and 2010, $4,741,185 and $3,725,486, respectively, of such funds were expended and are included in departmental expenses.

In 2009, KMSF borrowed $4,362,928 from the Dean's Fund to help fund the down payment on the purchase of three buildings and two vacant lots (collectively, the Alumni Park Plaza properties). These funds are being repaid to the Dean's Fund on a monthly basis over a 5 year term and bear no interest. Because this is an intercompany transaction, the payable and receivable have been eliminated as of June 30, 2011 and 2010, respectively. The balance due to the Dean's Fund from KMSF was $1,649,427 and $2,522,012 as of June 30, 2011 and 2010. The balance in the Dean's Fund's investments was $3,091,271 and $2,864,708 as of June 30, 2011 and 2010, respectively.

5. Investments and Interest Bearing Deposits

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

	2011	2010
Interest bearing deposits and government securities	$ 30,651,619	$ 19,617,969
Mutual funds primarily based in fixed income securities	2,773,742	3,448,681
Equity securities and equity security mutual funds	12,596,677	10,996,546
Guaranteed investment contracts	323,329	509,480
Total investment and interest bearing deposits	$ 46,345,367	$ 34,572,676

The components of investment income from investments and interest bearing deposits for 2011 and 2010 consist of $87,969 and $145,702, respectively, of dividends and interest.

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

	2011	2010
Current investments	$ 10,988,883	$ 6,403,909
Non-current investments	35,356,484	28,168,767
Total investment and interest bearing deposits	$ 46,345,367	$ 34,572,676

6. Long-Term Debt

As of June 30, 2011 and 2010, notes payable and capital lease obligations consisted of the following:

	2011	2010
Bank note payable, maturing June 2012 bearing interest at 1.97%, collateralized by a certificate of deposit, principal and interest payments of $41,308 due monthly.	$ **1,793,392**	$ 2,176,394
Bank note payable, matured December 2010.	**-**	1,777,101
Note payable to an individual, maturing August 2016, bearing interest at 5.7%, collateralized by an annuity security, principal and interest payments of $4,168 due monthly.	**223,329**	259,481
Bank note payable, maturing January 2014, bearing interest at 6.0%, collateralized by property, principal and interest payments of $133,688 due monthly.	**21,366,958**	21,643,318
Capital lease obligations at varying rates of interest from 2.142% to 6.96%, collateralized by leased equipment with net book values of $2,162,292 at June 30, 2011.	**929,438**	1,156,766
Total long-term debt	**24,313,117**	27,013,060
Less current portion	**2,482,619**	4,983,821
Long-term debt, net of current portion	$ **21,830,498**	$ 22,029,239

6. Long-term Debt, continued

Scheduled principal repayments on long-term debt and payments on capital lease obligations are as follows:

Year ending June 30,	Long-Term Debt	Capital Lease Obligations
2012	$ 2,143,629	$ 416,740
2013	344,799	210,561
2014	20,793,563	193,418
2015	45,380	123,483
2016	48,034	69,350
Thereafter	8,274	-
	$ 23,383,679	1,013,552
Less amount representing interest under capital lease obligations		84,114
		$ 929,438

Interest expense was $1,634,322 and $1,500,558 for the years ended June 30, 2011 and 2010, respectively.

7. Net Professional Clinical Service Fees

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 for the years ended June 30, 2011 and 2010 follows:

	2011	2010
Gross professional clinical service fee revenue	$ **443,473,276**	$ 425,129,827
Less provision for contractual adjustments under third-party reimbursement programs and other adjustments	**(236,447,697)**	(228,376,123)
Net professional clinical service fee revenue	$ **207,025,579**	$ 196,753,704

8. 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 until a contract can be executed between KMSF and UK. 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 $2,642,176 and $2,906,256 in lease income from UK and $158,584 and $1,082,899 from other non-related entities in 2011 and 2010, respectively.

The following is a schedule by years of future minimum rentals, excluding UK, under the noncancellable leases at June 30, 2011:

Year ending June 30,	
2012	$ 17,114

9. Benefit Plan

KMSF provides a defined contribution plan covering substantially all full-time employees. The plan provides that KMSF make monthly contributions of 10% of the employee's earnings. Contributions were $766,214 and $732,680 for 2011 and 2010, respectively.

10. 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.

11. 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.

11. 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 2011 and 2010 was $1,909,375 and $1,718,993, respectively.

The following is a schedule by year of future minimum lease payments under operating leases as of June 30, 2011, that have initial and remaining lease terms in excess of one year:

Year ending June 30,		
2012	$	1,573,967
2013		1,294,809
2014		919,171
2015		822,938
2016		726,706
Thereafter		6,390,507
	$	11,728,098

12. Concentrations of Credit Risk

KMSF, at times, may have a concentration of credit risk in that it maintains cash deposits in a single institution which may exceed federally insured limits and collateral agreements with the institutions. As of June 30, 2011 and 2010, KMSF had no cash deposits in excess of federally insured limits and collateral agreements.

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, 2011 and 2010, was as follows:

	2011	2010
Medicare	18 %	19 %
Medicaid	11	16
Blue Cross	11	10
Other third-party payors	33	30
Patients	27	25
	100 %	100 %