KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Financial Statements

Years Ended June 30, 2012 and 2011
with Independent Auditors' Report Thereon

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Independent Auditors' Report

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

We have audited the accompanying balance sheets of Kentucky Medical Services Foundation, Inc. (KMSF) as of June 30, 2012 and 2011, and the related statements of operations and changes in net assets and cash flows for the years 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 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, 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, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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September 26, 2012
Lexington, Kentucky

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KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Balance Sheets

June 30, 2012 and 2011

	2012	2011
Assets		
Current assets:		
Investments and interest bearing deposits, current	**$ 8,056,928**	$ 10,988,883
Patient accounts receivable, less allowance for uncollectibles of $5,131,357 and $3,498,887 and allowances for contractual adjustments of $31,874,245 and $22,260,811 in 2012 and 2011, respectively	**23,827,898**	19,124,849
Other receivables, current portion	**3,283,665**	2,526,927
Other current assets	**55,987**	51,797
Total current assets	**35,224,478**	32,692,456
Assets limited as to use:		
Dean's academic enrichment funds - limited by agreement	**1,483,415**	3,091,271
Investments and interest bearing deposits, noncurrent	**43,363,092**	35,356,484
Other receivables, less current portion	**892,434**	1,036,067
Property and equipment:		
Land and improvements	**2,308,952**	2,308,952
Buildings	**38,699,374**	38,777,834
Furniture and equipment	**5,688,626**	4,766,831
Equipment under capital lease obligations	**4,809,687**	4,812,756
	51,506,639	50,666,373
Less accumulated depreciation	**14,160,187**	12,812,795
Net property and equipment	**37,346,452**	37,853,578
Intangibles, net	**170,285**	340,571
Total assets	**$ 118,480,156**	$ 110,370,427

	2012	2011
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued liabilities	**$ 3,805,118**	$ 3,611,486
Long-term debt, current portion	**2,104,851**	2,482,619
Settlement due to third party payor	**3,075,757**	-
Patient refunds	**326,965**	386,370
Due to the University of Kentucky	**9,164,564**	1,719,996
Due to the University of Kentucky - malpractice fund	**15,930,079**	15,910,277
Due to the College of Medicine departments under departmental plan agreements	**46,470,619**	47,601,990
Total current liabilities	**80,877,953**	71,712,738
Long-term debt, net of current portion	**21,085,287**	21,830,498
Total liabilities	**101,963,240**	93,543,236
Unrestricted net assets:		
Board designated - property (net of debt), equipment and goodwill	**16,516,916**	16,827,191
Total net assets	**16,516,916**	16,827,191
Total liabilities and net assets	**$ 118,480,156**	$ 110,370,427

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Operations and Changes in Net Assets

Years ended June 30, 2012 and 2011

	2012	2011
Net professional clinical service fee revenue	**$ 223,688,135**	$ 207,025,579
Other operating revenues and gains:		
Lease income	**2,960,831**	2,800,760
Investment income, net	**100,072**	87,969
Other income and gains	**1,612,552**	528,782
Total other operating revenues and gains	**4,673,455**	3,417,511
Total revenues and gains	**228,361,590**	210,443,090
Expenses:		
Departmental expenses	**165,326,445**	154,622,806
Provision for bad debts	**25,220,713**	18,243,449
Operating expenses - business office	**19,672,364**	18,823,173
UKHMO capitation expenses	**5,839,974**	5,592,109
Reimbursement to the University of Kentucky for malpractice insurance and expenses attendant to the production of clinical income	**1,649,460**	6,238,799
Kentucky Clinic central expenses	**2,164,935**	2,146,216
Dean's academic enrichment funds	**5,451,488**	4,023,280
Physicians' fringe benefits	**2,307,208**	2,404,765
Dean's Fund scholarships	**868,992**	741,046
Total expenses	**228,501,579**	212,835,643
Impairment loss	**(170,286)**	(170,286)
Decrease in net assets	**(310,275)**	(2,562,839)
Net assets, beginning of year	**16,827,191**	19,390,030
Net assets, end of year	**$ 16,516,916**	$ 16,827,191

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows

Years ended June 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Decrease in net assets	**$ (310,275)**	$ (2,562,839)
Adjustments to reconcile decrease in net assets to net cash provided by operating activities:		
Depreciation	**1,816,649**	2,411,466
Impairment loss	**170,286**	170,286
(Gain) loss on disposal of assets	**(114,358)**	134,107
Provision for bad debts	**25,220,713**	18,243,449
Increase (decrease) in cash due to changes in:		
Patient accounts receivable	**(29,923,762)**	(15,208,185)
Other receivables	**(613,105)**	2,727,087
Other current assets	**(4,190)**	(4,632)
Accounts payable and accrued liabilities	**193,632**	(1,255,820)
Settlement due to third party payor	**3,075,757**	-
Patient refunds	**(59,405)**	(170,988)
Due to the University of Kentucky	**7,444,568**	(5,427,637)
Due to the University of Kentucky - malpractice fund	**19,802**	828,627
Due to the College of Medicine departments under departmental plan agreements	**(1,131,371)**	14,690,936
Net cash provided by operating activities	**5,784,941**	14,575,857
Cash flows from investing activities:		
Capital expenditures	**(1,658,399)**	(1,157,102)
Increase in investments and interest-bearing deposits, net	**(5,074,653)**	(11,772,691)
Decrease (increase) in assets limited as to use, net	**1,607,856**	(226,563)
Proceeds on sale of property and equipment	**514,000**	2,052,745
Net cash used in investing activities	**(4,611,196)**	(11,103,611)
Cash flows from financing activities:		
Repayments on long-term debt	**(1,173,745)**	(3,472,246)
Net cash used in financing activities	**(1,173,745)**	(3,472,246)
Net change in cash	**$ -**	$ -

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows, continued

Years ended June 30, 2012 and 2011

Supplemental cash flow disclosures:		**2012**		2011
Cash paid for interest	**$**	**1,205,186**	$	1,634,322
Noncash investing and financing transactions:				
Capital lease obligation for purchase of equipment		**38,616**		772,303
Note payable for purchase of equipment		**12,150**		-

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, 2012.

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, if any, 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.

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 2012 and 2011, 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, 2012 follow:

	Carrying Amount	Accumulated Impairment Loss
Balance as of June 30, 2011	$ 340,571	$ 255,429
Impairment loss	(170,286)	170,286
Balance as of June 30, 2012	$ 170,285	$ 425,715

2. Summary of Significant Accounting Policies, continued

Intangibles, continued

In September 2011, an accounting amendment was issued that permits an entity to make a qualitative assessment as to whether it is more likely than not that a reporting unit's fair value is less than it's carrying value amount before applying the two-step goodwill impairment test. If an entity concludes that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, it does not need to perform the two-step impairment test. Management evaluated the accounting amendment and determined that a qualitative assessment would not have changed the impairment loss recorded.

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 (generally 2011 - 2009).

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.

Effective November 1, 2011, Medicaid has contracted with three managed care organizations (MCOs) that are to create networks of providers around Kentucky to provide Medicaid services to approximately 560,000 Kentuckians. The MCOs are to provide Medicaid covered benefits for Medicaid recipients for a fixed per member, per month premium via rates based on age, gender, disability, etc.

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 $21,599,278 and $23,890,458 in 2012 and 2011, respectively. Management has estimated its cost incurred to provide charity care to be approximately $7,110,240 and $6,798,945 as of June 30, 2012 and 2011, 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.

2. Summary of Significant Accounting Policies, continued

Investments and Investment Income, continued

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 accounting and disclosure requirements through September 25, 2012, the date that the financial statements were available to be issued.

New Accounting Pronouncements

Accounting Standards Update (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 $1,502,472 and $1,646,336 as of June 30, 2012 and 2011, respectively.

4. Academic Enrichment Funds

In accordance with the Agreement with UK, KMSF paid UK 4% in 2012 and 3% in 2011, $5,451,488 and $4,023,280, 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 4% in 2012 and 5% in 2011. 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 2012 and 2011, $6,027,212 and $4,741,185, respectively, of such funds were expended and are included in departmental expenses.

4. Academic Enrichment Funds, continued

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, 2012 and 2011, respectively. The balance due to the Dean's Fund from KMSF was $766,328 and $1,649,427 as of June 30, 2012 and 2011. The balance in the Dean's Fund's investments was $1,483,415 and $3,091,271 as of June 30, 2012 and 2011, respectively.

During 2012, pursuant to a joint development agreement and in furtherance of its charitable mission, KMSF spent approximately $2,200,000 of the academic enrichment funds to assist in funding the construction of a child development center for UK. These funds are not required to be repaid to the Dean's Fund. This center makes child care significantly more available to UK faculty.

5. Investments and Interest Bearing Deposits

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

	2012	2011
Interest bearing deposits and government securities	**$ 35,876,677**	$ 30,651,619
Mutual funds primarily based in fixed income securities	**2,293,387**	2,773,742
Equity securities and equity security mutual funds	**12,964,893**	12,596,677
Guaranteed investment contracts	**285,063**	323,329
Total investment and interest bearing deposits	**$ 51,420,020**	$ 46,345,367

The components of investment income from investments and interest bearing deposits for 2012 and 2011 consist of $100,072 and $87,969, 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:

	2012	2011
Current investments	**$ 8,056,928**	$ 10,988,883
Non-current investments	**43,363,092**	35,356,484
Total investment and interest bearing deposits	**$ 51,420,020**	$ 46,345,367

6. Settlement Due to Third Party Payor

During 2012, KMSF received a demand letter from the Department for Medicaid Services (DMS) for approximately $4,100,000. Subsequent to June 30, 2012, KMSF and DMS have reached an agreement whereby KMSF will settle this liability for $1,500,000. This amount is attributed to disputed claims received from Medicaid from August 2008 through July 2011. A provision has been made in the financial statements as of June 30, 2012.

7. Long-Term Debt

As of June 30, 2012 and 2011, notes payable and capital lease obligations consisted of the following:

	2012	2011
Bank note payable, maturing June 2013 bearing interest at 1.97%, collateralized by a certificate of deposit, principal and interest payments of $41,308 due monthly.	**$ 1,393,095**	$ 1,793,392
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.	**185,064**	223,329
Bank note payable, refinanced March 2012.	**-**	21,366,958
Bank note payable, maturing March 2017, bearing interest at 4.25%, collateralized by property, principal and interest payments of $115,224 due monthly.	**20,999,821**	-
Bank note payable, maturing March 2017, bearing interest at 3.90%, collateralized by equipment and interest payments of $223 due monthly.	**11,966**	-
Capital lease obligations at varying rates of interest from 2.142% to 6.96%, collateralized by leased equipment with net book values of $717,334 at June 30, 2012.	**600,192**	929,438
Total long-term debt	**23,190,138**	24,313,117
Less current portion	**2,104,851**	2,482,619
Long-term debt, net of current portion	**$ 21,085,287**	$ 21,830,498

7. 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
2013	$ 1,923,152	$ 207,971
2014	553,932	207,971
2015	578,891	141,553
2016	602,703	86,407
2017	18,931,268	7,417
	$ 22,589,946	$ 651,319
Less amount representing interest under capital lease obligations		51,127
		$ 600,192

Interest expense was $1,205,186 and $1,634,322 for the years ended June 30, 2012 and 2011, respectively.

8. 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, 2012 and 2011 follows:

	2012	2011
Gross professional clinical service fee revenue	**$ 486,827,085**	$ 443,473,276
Less provision for contractual adjustments under third-party reimbursement programs and other adjustments	**(263,138,950)**	(236,447,697)
Net professional clinical service fee revenue	**$ 223,688,135**	$ 207,025,579

9. 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 $2,813,775 and $2,642,176 in lease income from UK and $147,056 and $158,584 from other non-related entities in 2012 and 2011, respectively.

10. Benefit Plan

KMSF provides a defined contribution plan covering substantially all full-time employees. The plan provides that KMSF make bi-weekly contributions of 10% of the employee's earnings. Contributions were $757,021 and $766,214 for 2012 and 2011, respectively.

11. 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.

12. 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 2012 and 2011 was $2,437,247 and $1,909,375, respectively.

The following is a schedule by year of future minimum lease payments under operating leases as of June 30, 2012, that have initial and remaining lease terms in excess of one year:

Year ending June 30,	
2013	$ 2,100,418
2014	1,260,437
2015	1,075,798
2016	990,685
2017	813,088
Thereafter	4,788,528
	$ 11,028,954

13. 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, 2012 and 2011, was as follows:

	2012	2011
Other third-party payors	**30 %**	33 %
Patients	**23**	27
Medicaid	**21**	11
Medicare	**17**	18
Blue Cross	**9**	11
	100 %	100 %

14. Healthcare Reform

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 year ended June 30, 2012, KMSF applied for and received $701,250 in Medicaid HIT funds. KMSF intends to apply for additional funds in the coming years. Both the 2012 funds and any funds from future applications are dependent on reaching certain metrics and various states of "meaningful use" as defined by the Recovery Act.