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Kentucky Tobacco Research and Development Center

2008 Financial Statements

Kentucky Tobacco Research and Development Center

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BKD LLP

Independent Accountants' Report on Financial Statements and Supplementary Information

Board of Directors
Kentucky Tobacco Research
and Development Center
Lexington, Kentucky

We have audited the accompanying basic financial statements of the Kentucky Tobacco Research and Development Center (Center), an organizational unit of the University of Kentucky as of and for the year ended June 30, 2008, as listed in the table of contents. These financial statements are the responsibility of the Center's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Center as of and for the year ended June 30, 2007, were audited by other accountants whose report dated November 30, 2007, 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 2008 financial statements referred to above present fairly, in all material respects, the financial position of the Center as of June 30, 2008, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis as listed in the table of contents is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

BKD, LLP

September 29, 2008

Management's Discussion and Analysis

The Kentucky Tobacco Research and Development Center's (the Center) Management Discussion and Analysis (MD&A) of its financial condition provides an overview of the financial performance of the Center for the years ended June 30, 2008 and 2007. Management has prepared this discussion, which provides summary financial information, along with the financial statements and related footnotes. MD&A should be read in conjunction with the accompanying financial statements.

Financial Highlights

- The financial statements for FY 2007-2008 report a strong financial condition at June 30, 2008. Financial operations were in accordance with the revenue expectations and the approved budget plan.
- The Center's only asset was cash, which increased approximately $247,000 or 11.4%.
- Total net assets increased approximately $227,000 or 10.5% primarily due to state cigarette tax revenue in excess of operating expenses and grants to the University of Kentucky.
- Net assets represented 98.6% of total assets.

Using the Annual Report

This financial report consists of three financial statements: the Statement of Net Assets; the Statement of Revenues, Expenses and Changes in Net Assets; and the Statement of Cash Flows. These financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities.*

One of the most important questions asked about the Center's finances is whether the Center is better off as a result of the year's activities. One key to answering this question is the financial statements of the Center. The Statement of Net Assets; Statement of Revenues, Expenses and Changes in Net Assets; and the Statement of Cash Flows present financial information on the Center in a format similar to that used by corporations and present a long-term view of the Center's finances. The Center's net assets (the difference between assets and liabilities) are one sign of the Center's financial health. Over time, increases or decreases in net assets indicate the improvement or erosion of the Center's financial health.

The Statement of Net Assets includes all assets and liabilities. It is prepared on the accrual basis of accounting, whereby revenues and assets are recognized when the service is provided and expenses and liabilities are recognized when others provide the service, regardless of when cash is exchanged.

The Statement of Revenues, Expenses and Changes in Net Assets presents the revenues earned and expenses incurred during the year. Activities are reported as either operating or nonoperating. GASB 35 requires state cigarette taxes to be classified as nonoperating revenues. Accordingly, the Center generates a net operating loss prior to the addition of nonoperating revenues.

Another important factor to consider when evaluating financial viability is the Center's ability to meet financial obligations as they become due. The Statement of Cash Flows presents information related to cash inflows and outflows, summarized by operating, capital, financing and investing activities.

Reporting Entity

The Kentucky Tobacco Research and Development Center is an organizational unit within the University of Kentucky (the University). The Center was created by the General Assembly of the Commonwealth of Kentucky to undertake research not only into tobacco but also other research having related or complementary interests, including but not limited to commercialization potential of tobacco and plant research, plant natural products research and research into development of new crops based on tobacco and other plants. Its accounts are contained as departmental records within the records of the University.

Condensed Financial Information

Statements of Net Assets

	2008	2007	2006
ASSETS			
Current assets	$ 2,423,957	$ 2,176,782	$ 1,653,170
Total assets	2,423,957	2,176,782	1,653,170
LIABILITIES			
Current liabilities	33,349	13,348	13,768
Total liabilities	33,349	13,348	13,768
NET ASSETS			
Restricted			
Expendable	2,390,608	2,163,434	1,639,402
Total net assets	$ 2,390,608	$ 2,163,434	$ 1,639,402

Assets. As of June 30, 2008, the Center's total assets amounted to approximately $2.4 million. Cash and cash equivalents were the Center's only asset, which increased approximately $247,000 or 11.4%. The increase was primarily due to state cigarette tax revenue in excess of operating expenses and grants to the University.

Liabilities. At June 30, 2008, the Center's liabilities, consisting of accounts payable to vendors and contractors and accrued payroll, totaled approximately $33,000.

Net Assets. Net assets at June 30, 2008 totaled approximately $2.4 million, or 98.6% of total assets, all of which are restricted net assets.

Total net assets increased approximately $227,000 or 10.5%, primarily due to state cigarette tax revenue in excess of operating expense and grants to the University as mentioned above.

2007 Versus 2006. Total net assets increased by approximately $524,000 or 32.0%, when comparing fiscal 2007 versus fiscal 2006. This was primarily due to state cigarette tax revenue in excess of operating expenses.

Statements of Revenues, Expenses and Changes in Net Assets

	2008	2007	2006
OPERATING REVENUES			
Sales and services	$ 41,846	$ 288,278	$ 319,184
Total operating revenues	41,846	288,278	319,184
OPERATING EXPENSES			
Educational and general	2,249,452	2,483,035	3,457,607
Total operating expenses	2,249,452	2,483,035	3,457,607
OPERATING LOSS	(2,207,606)	(2,194,757)	(3,138,423)
NONOPERATING REVENUES (EXPENSES)			
State cigarette tax	2,760,523	2,730,877	2,658,441
State grants	-	-	493,315
Grants to the University of Kentucky	(325,743)	(12,088)	(224,731)
Total nonoperating revenues (expenses)	2,434,780	2,718,789	2,927,025
Total increase (decrease) in net assets	227,174	524,032	(211,398)
Net assets, beginning of year	2,163,434	1,639,402	1,850,800
Net assets, end of year	$2,390,608	$2,163,434	$1,639,402

The Center's operating revenues were primarily generated by rental income and revenue from a shared maintenance agreement.

Operating expenses were primarily related to research and totaled $2.2 million, a decrease of approximately $234,000. This was in accordance with the budget plan.

The net operating loss for the year amounted to $2.2 million while nonoperating revenues, net of grants to the University, amounted to $2.4 million. A decrease of $284,000 in net nonoperating revenues was caused by an increase in grants of research equipment to the University.

2007 Versus 2006. The net operating loss decreased $944,000 when comparing 2007 with 2006 primarily due to a decrease in operating expenses. Nonoperating revenues, net of grants to the University, amounted to $2.7 million. State cigarette taxes of $2.7 million included in this category increased $72,000 from the previous year because of an increase in cigarette sales.

Statements of Cash Flows

Another way to assess the financial health of an organization is to look at the Statement of Cash Flows. The primary purpose of the Statement of Cash Flows is to provide information about the cash receipts and cash payments made by the Center during the period. The Statement of Cash Flows also helps financial statement readers assess:

- the Center's ability to generate future net cash flows,
- the Center's ability to meet obligations as they become due, and
- the Center's need for external financing.

	2008	2007	2006
CASH PROVIDED (USED) BY:			
Operating activities	$ (2,187,605)	$ (2,139,896)	$ (3,296,812)
Noncapital financing activities	2,750,977	2,730,877	3,151,756
Capital and related financing activities	(316,197)	(12,088)	(224,731)
Net increase (decrease) in cash and cash equivalents	247,175	578,893	(369,787)
Cash and cash equivalents, beginning of year	2,176,782	1,597,889	1,967,676
Cash and cash equivalents, end of year	$ 2,423,957	$ 2,176,782	$ 1,597,889

Cash payments for operating activities of $932,000 were made to vendors and contractors and to University employees for salaries and benefits of approximately $1.3 million.

The cash receipts in the noncapital financing activities group related to the state tax revenues collected on cigarette sales of approximately $2.8 million.

Cash used by capital and related financing activities of approximately $316,000 related to grants of research equipment to the University.

2007 Versus 2006. Cash flows fluctuated significantly in the areas of operating and capital and related financing activities when comparing fiscal 2007 versus fiscal 2006. There was a decrease of $1.2 million in cash used in operating activities and a decrease of $213,000 in cash used to provide grants to the University for renovating and equipping research labs.

Capital Asset and Debt Administration

Capital Assets. Capital assets purchased by the Center are granted to the University of Kentucky at the time of acquisition.

Debt. The Center has had no debt at or during the year ended June 30, 2008.

Factors Impacting Future Periods

There are no known facts and circumstance that will impact future periods.

KENTUCKY TOBACCO RESEARCH AND DEVELOPMENT CENTER
STATEMENTS OF NET ASSETS
JUNE 30, 2008 AND 2007

	2008	2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 2,423,957	$ 2,176,782
Total current assets	2,423,957	2,176,782
Total assets	2,423,957	2,176,782
LIABILITIES		
Current Liabilities		
Accounts payable and accrued liabilities	33,349	13,348
Total current liabilities	33,349	13,348
Total liabilities	33,349	13,348
NET ASSETS		
Restricted expendable	2,390,608	2,163,434
Total net assets	$ 2,390,608	$ 2,163,434

See notes to financial statements

KENTUCKY TOBACCO RESEARCH AND DEVELOPMENT CENTER
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007

	2008	2007
OPERATING REVENUES		
Sales and services	$ 41,846	$ 288,278
Total operating revenues	41,846	288,278
OPERATING EXPENSES		
Research	1,339,466	1,632,274
Administration	361,317	367,096
Operations and maintenance of plant	548,669	483,665
Total operating expenses	2,249,452	2,483,035
Net income (loss) from operations	(2,207,606)	(2,194,757)
NONOPERATING REVENUES		
State cigarette tax	2,760,523	2,730,877
Grants (to) from the University of Kentucky for noncapital purposes	(9,546)	-
Net nonoperating revenues	2,750,977	2,730,877
Net income before other revenues (expenses)	543,371	536,120
Grants (to) from the University of Kentucky for capital purposes	(316,197)	(12,088)
Total other revenues (expenses)	(316,197)	(12,088)
Increase (decrease) in net assets	227,174	524,032
NET ASSETS, beginning of year	2,163,434	1,639,402
NET ASSETS, end of year	$ 2,390,608	$ 2,163,434

See notes to financial statements

KENTUCKY TOBACCO RESEARCH AND DEVELOPMENT CENTER
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Sales and services	$ 41,846	$ 288,278
Payments to vendors and contractors	(931,777)	(912,978)
Salaries, wages and benefits	(1,297,674)	(1,515,196)
Net cash provided (used) by operating activities	(2,187,605)	(2,139,896)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State cigarette tax	2,760,523	2,730,877
Grants (to) from the University of Kentucky for noncapital purposes	(9,546)	-
Net cash provided (used) by noncapital financing activities	2,750,977	2,730,877
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Grants (to) from the University of Kentucky for capital purposes	(316,197)	(12,088)
Net cash provided (used) by capital and related financing activities	(316,197)	(12,088)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	247,175	578,893
CASH AND CASH EQUIVALENTS, beginning of year	2,176,782	1,597,889
CASH AND CASH EQUIVALENTS, end of year	$ 2,423,957	$ 2,176,782

Reconciliation of net income (loss) from operations to net cash provided (used) by operating activities:		
Net income (loss) from operations	$ (2,207,606)	$ (2,194,757)
Adjustments to reconcile operating income (loss) to net cash used by operating activities:		
Change in assets and liabilities:		
Inventories	-	55,281
Accounts payable and accrued liabilities	20,001	(420)
Net cash provided (used) by operating activities	$ (2,187,605)	$ (2,139,896)

See notes to financial statements

NOTES TO FINANCIAL STATEMENTS

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity
The Kentucky Tobacco Research and Development Center (the Center), is an organizational and component unit of the University of Kentucky (the University). The Center was created by the General Assembly of the Commonwealth of Kentucky (the Commonwealth) to undertake research not only into tobacco but also other research having related or complementary interests, including but not limited to commercialization potential of tobacco and plant research, plant natural products research and research into development of new crops based on tobacco and other plants. Its accounts are contained as departmental records within the records of the University.

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

- Invested in capital assets, net of related debt: Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted:
  Nonexpendable – Net assets subject to externally imposed stipulations that they be maintained permanently by the Center.

  Expendable – Net assets whose use by the Center is subject to externally imposed stipulations that can be fulfilled by actions of the Center pursuant to those stipulations or that expire by the passage of time.

- Unrestricted: Net assets whose use by the Center is not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

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

Pursuant to GASB Statement No. 20, the Center has elected to apply the provisions for all relevant pronouncements of the Financial Accounting Standards Board (FASB) that were issued on or before November 30, 1989 and do not conflict with or contradict GASB pronouncements.

Summary of Significant Accounting Policies

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

Cash and Cash Equivalents. The Center considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

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

Operating Activities. The Center defines operating activities, as reported on the Statement of Revenues, Expenses and Changes in Net Assets, as those that generally result from exchange transactions, such as payments received for providing goods and services and payments made for goods and services received. Accordingly, the Center does not have significant operating revenues. Certain significant revenues relied upon for operations, such as state cigarette taxes, are recorded as nonoperating revenues.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to use estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

2. DEPOSITS AND INVESTMENTS

The fair value of deposits and investments, by type, at June 30, 2008 and 2007 is as follows:

	2008	2007
Cash on deposit with the Commonwealth of Kentucky	$ 2,423,957	$ 2,176,782

Deposit and investment policies. The Center was created by the General Assembly of the Commonwealth. Funding for the Center comes from taxes levied on the sale of cigarettes in the Commonwealth and other state funds. Such funds are held on deposit with the Commonwealth until needed for operations by the Center. Accordingly, deposit and investment policies for these funds are contained in the Kentucky Revised Statutes.

Deposit and investment risks. The Center's deposits and investments are exposed to various risks, including credit, interest rate and foreign currency risk, as discussed in more detail below:

Credit Risk. Credit risk is the risk that the issuer or other counterparty to an investment will not fulfill its obligation, causing the Center to experience a loss of principal. Cash on deposit with the Commonwealth is governed by state law which requires full collateralization. Credit risk on repurchase agreements with the Commonwealth is mitigated by the Commonwealth's requirement that providers of overnight repurchase agreements collateralize these investments at 102% of face value with U.S. treasury or agency securities, pledged in the name of the Commonwealth.

Custodial Credit Risk. Custodial credit risk is the risk that, in the event of the failure of the counterparty, the Center will not be able to recover the value of its investment or collateral securities that are in possession of an outside party. Cash on deposit with the Commonwealth is invested in deposits and repurchase agreements held in the Commonwealth's name.

Concentrations of Credit Risk. The Center's investments can be exposed to a concentration of credit risk if significant amounts are invested in any one issuer. Cash on deposit with the Commonwealth is not limited as to the maximum amount that may be invested in one issuer. However, all such investments in excess of Federal Depository Insurance are required to be fully collateralized by U.S. treasury and/or U.S. agency securities or other similar investments as provided by KRS 41.240.

At June 30, 2008, the Center had no underlying investments in any one issuer that represent more than 5% of total investments.

Interest Rate Risk. Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Cash on deposit with the Commonwealth has limited exposure to interest rate risk due to the short term nature of the investment. The Commonwealth requires that all deposits and repurchase agreements be available for use on the next business day.

Foreign Currency Risk. Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or deposit. The Center is not exposed to foreign currency risk.

3. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities as of June 30, 2008 and 2007 are as follows:

	2008	2007
Payable to vendors and contractors	$ 25,165	$ 7,324
Accrued payroll	8,184	6,024
Total	$ 33,349	$ 13,348

4. RISK MANAGEMENT

The Center is exposed to various risks of loss related to torts and errors and omissions. These risks are covered by extension of coverage by the University's participation in an insurance risk retention group and self-insurance. Claims against directors and officers for wrongful acts (errors and omissions) are insured through a risk retention group. There have been no significant reductions in insurance coverage from 2007 to 2008. Settlements have not exceeded insurance coverage during the past three years.

5. TRANSACTIONS WITH THE UNIVERSITY OF KENTUCKY

All salaries, wages and benefits, as reflected in the Statement of Cash Flows, represent charges for University employees. The Center utilizes buildings and equipment owned by the University. The historic cost of these assets as of June 30, 2008 and 2007 is as follows:

	2008	2007
Buildings	$ 4,616,967	$ 4,616,967
Equipment	$ 2,367,256	$ 2,396,760

In accordance with an agreement between the Center and the University all costs related to facilities for general support, maintenance, personnel and general overhead are reimbursed to the University. These reimbursements are included in operations and maintenance of plant on the statement of revenues, expenses and changes in net assets. During 2008 and 2007, the Center reimbursed the University $462,000 and $445,000, respectively. All equipment purchased by the center is considered grants to the University. During the fiscal years ended June 30, 2008 and 2007, the Center transferred $316,000 and $12,000, respectively, to the University for capital purposes.

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