



see blue.



UNIVERSITY OF
KENTUCKY[®]

*UK HealthCare
Hospital System*

2008 Financial Statements

**UK HealthCare Hospital System
University of Kentucky
Financial Statements
Year Ended June 30, 2008**

CONTENTS	PAGE
Independent Accountants' Report	1
Management's Discussion and Analysis	2
Financial Statements	
Statements of Net Assets	12
Statements of Revenues, Expenses and Changes in Net Assets	13
Statements of Cash Flows	14
Notes to Financial Statements	15



Independent Accountants' Report on Financial Statements and Supplementary Information

Board of Trustees
University of Kentucky
Lexington, Kentucky

We have audited the accompanying statement of net assets of the UK HealthCare Hospital System (System), an organizational unit of the University of Kentucky, as of June 30, 2008, and the related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the System as of and for the year ended June 30, 2007, were audited by other accountants whose report dated October 19, 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 System as of June 30, 2008, 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.

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 following Management's Discussion and Analysis, or MD&A, provides an overview of the financial position and activities of the UK HealthCare Hospital System for the years ended June 30, 2008 and 2007. UK HealthCare Hospital System includes Albert B. Chandler University Hospital, including Kentucky Children's Hospital (collectively Chandler); UK HealthCare Good Samaritan Hospital (Good Samaritan); and Kentucky Healthcare Enterprise, Inc. (KHE), a wholly owned for-profit subsidiary (collectively, the System). Management has prepared this discussion, and we encourage you to read it in conjunction with the financial statements and the notes appearing in this report.

About UK HealthCare System

The UK Chandler Medical Center, opened in 1960, stands among the nation's finest academic medical centers. Its faculty, students and staff take pride in achieving excellence in education, patient care, research, and community service. One of two Level 1 Trauma Centers in Kentucky, UK cares for the most critically injured and ill patients in the region.

On July 1, 2007, the System purchased Good Samaritan Hospital, a 302-bed community hospital located in Lexington, Kentucky. The purchase price was approximately \$12.8 million. This acquisition greatly expands the patient care opportunities available for the System to serve the Commonwealth. As of June 30, 2008 the Good Samaritan Hospital had 132 beds available and was operating at 56.1% occupancy. Good Samaritan started in 1888 with a commitment to caring for the health of Central Kentucky. Their long tradition of quality service is now strengthened and enhanced as a result of becoming part of the UK HealthCare Hospital System.

More than 600 faculty physicians and dentists, 500 resident physicians and a staff of 3,600 health professionals provide care in the 473-bed UK Chandler Hospital, Kentucky Children's Hospital and UK HealthCare Good Samaritan Hospital.

The System's mission is to help the people of the Commonwealth and beyond gain and retain good health through creative leadership and quality initiatives in patient care, education and research. The System serves patients primarily from central and eastern Kentucky and offers a full spectrum of routine and specialty services appropriate for a major regional quaternary care center.

Financial Highlights

The System's overall financial position remains strong with assets of \$1.03 billion and liabilities of \$437.1 million. Net assets, which represent the System's residual interest in assets after liabilities are deducted, were \$592.1 million or 57.5 percent of total assets. For the fiscal year ended June 30, 2008, the System reported net income before other changes in net assets of \$39.2 million, generating a margin of 5.8 percent.

- Financial results for fiscal year 2008 exceeded revenue expectations with net inpatient revenue, excluding the provision for doubtful accounts, increasing approximately \$82.1 million or 20.8 percent over the prior fiscal year and net outpatient revenues, excluding the provision for doubtful accounts, increasing \$42.2 million or 23.5 percent over the previous fiscal year. This net patient service revenue is primarily the result of increases in patient activity, rate increases in selected services and the addition of Good Samaritan Hospital.
- Total assets increased \$227.0 million or 28.3 percent. This increase is primarily due to the increase in capital assets, net, of \$97.8 million and restricted cash of \$94.0 million.
- Total liabilities increased \$207.6 million or 90.5 percent, primarily due to an increase of \$158.2 million in long-term liabilities which was the result of new project notes being issued during the year.
- Total net assets increased \$19.3 million or 3.4 percent, primarily due to current year net income.
- Operating revenues increased \$132.9 million or 24.7 percent.
- Operating expenses increased \$101.5 million or 19.5 percent due primarily to increases in personnel costs and supplies related to the addition of Good Samaritan Hospital.

- Net nonoperating revenues decreased \$48.7 million due to a decrease in current year investment income of \$46.5 million.

Operating Statistics

The following table presents utilization statistics for the System for fiscal years ended 2008, 2007 and 2006:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Discharges:			
Medicare	9,383	7,093	6,225
Medicaid	8,956	7,828	7,005
Commercial/Blue Cross	10,884	9,074	8,827
Patient/charity	3,706	3,297	2,703
Total discharges	<u>32,929</u>	<u>27,292</u>	<u>24,760</u>
Average daily census	487	406	369
Average length of stay	5.41	5.43	5.43
Outpatient visits:			
Hospital clinics	340,867	290,910	275,608
Emergency visits	65,962	45,655	44,646
Total visits	<u>406,829</u>	<u>336,565</u>	<u>320,254</u>

Total discharges increased by 5,637 or 20.7 percent compared to the prior fiscal year.

Overall the case mix index decreased to 1.6098 from 1.6677 and the average length of stay remained fairly constant. The case mix for Chandler was at 1.7148 while Good Samaritan was at 1.1821.

Total outpatient visits increased by 70,264 or 20.9 percent over the prior year.

Using the Financial Statements

The System presents its financial reports in a “business type activity” format, in accordance with Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments* and GASB Statement No. 35, *Basic Financial Statements – and Management’s Discussion and Analysis – for Public Colleges and Universities – an amendment of GASB Statement No. 34*. In addition to this MD&A section, the financial report includes a Statement of Net Assets, a Statement of Revenues, Expenses and Changes in Net Assets, a Statement of Cash Flows and Notes to the Financial Statements. GASB requires that statements be presented on a basis to focus on the System as a whole.

Reporting Entity

The UK HealthCare Hospital System is an organizational unit of the University of Kentucky (the University), which is a component unit of the Commonwealth of Kentucky and is included in the basic financial statements of the Commonwealth. The financial statements of UK HealthCare Hospital System include Albert B. Chandler University Hospital, Kentucky Children's Hospital, UK HealthCare Good Samaritan Hospital and Kentucky Healthcare Enterprise, Inc. (KHE), a wholly owned for-profit subsidiary (collectively, the System).

The System provides inpatient, outpatient and emergency care services for residents of the Commonwealth of Kentucky.

Statement of Net Assets

The Statement of Net Assets is the System's balance sheet. It reflects the total assets, liabilities and net assets (equity) of the System as of June 30, 2008, with comparative information as of June 30, 2007. Liabilities due within one year, and assets available to pay those liabilities, are classified as current. Other assets and liabilities are classified as non-current. Net assets, the difference between total assets and total liabilities, are an important indicator of the System's current financial condition, while the change in net assets is an indicator of whether the overall financial position has improved or worsened during the year. Generally, assets and liabilities are reported using current values. A major exception is capital assets, which are stated at historical cost, less accumulated depreciation. A summarized comparison of the System's assets, liabilities and net assets at June 30, 2008, 2007 and 2006 is as follows:

Condensed Statements of Net Assets (in thousands)

	2008	2007	2006
ASSETS			
Current assets	\$ 272,386	\$ 238,677	\$ 260,494
Capital asset, net of depreciation	350,241	252,440	156,412
Other noncurrent assets	406,604	311,146	270,336
Total Assets	1,029,231	802,263	687,242
LIABILITIES			
Current liabilities	74,665	51,032	39,136
Noncurrent liabilities	362,433	178,441	122,522
Total Liabilities	437,098	229,473	161,658
NET ASSETS			
Invested in capital assets, net of related debt	135,130	128,207	131,137
Nonexpendable other	14	14	-
Restricted expendable	17,118	8,412	2,855
Unrestricted	439,871	436,157	391,592
Total Net Assets	\$ 592,133	\$ 572,790	\$ 525,584

Assets. As of June 30, 2008, the System's total assets amounted to approximately \$1.03 billion. Capital assets, net of depreciation, totaling \$350.2 million or 34.0 percent represented the System's largest asset. Cash and cash equivalents totaling \$281.7 million or 27.3 percent of total assets were the System's next largest asset. Long-term investments totaling \$225.6 million or 21.9 percent of total assets represent another significant asset of the System. The System had accounts receivable, primarily patient-related, totaling \$94.6 million or 9.2 percent of total assets at year end.

Total assets increased by \$227.0 million during the year ended June 30, 2008. This increase was driven by an increase in capital assets, net, of \$97.8 million, primarily due to the construction of a new patient care facility, and a \$94.0 million increase in restricted cash.

Liabilities. At June 30, 2008, the System's liabilities totaled approximately \$437.1 million. Long-term debt, which consists of System project notes, represented the largest liability of \$265.7 million or 60.8 percent of total liabilities. Capital lease obligations totaled \$86.0 million or 19.7 percent of liabilities. Accrued expenses, primarily payroll, vacation and other employee benefits, totaled \$39.1 million or 8.9 percent of liabilities. Accounts payable represent approximately \$31.8 million or 7.3 percent of liabilities.

Net Assets. Net assets at June 30, 2008 totaled approximately \$592.1 million, or 57.5 percent of total assets. Net assets invested in capital assets, net of related debt, totaled \$135.1 million or 22.8 percent of total net assets. Restricted net assets totaled approximately \$17.1 million or 2.9 percent of total net assets. Unrestricted net assets accounted for \$439.9 million or 74.3 percent of total net assets. Total net assets increased \$19.3 million or 3.4 percent.

Restricted net assets are subject to externally imposed restrictions governing their use. Although unrestricted net assets are not subject to externally imposed stipulations, substantially all of the unrestricted net assets have been internally designated for capital projects and working capital requirements.

2007 Versus 2006 During the year ended June 30, 2007:

- Total assets increased by \$115.0 million, primarily due to an increase in capital assets, net, of \$96.0 million from the construction of a new patient care facility and the acquisition of land and buildings related to the purchase of Good Samaritan Hospital.
- Total liabilities increased \$67.8 million, primarily due to the increase in capital lease obligations of \$59.9 million.
- Total net assets increased \$47.2 million. Unrestricted net assets increased \$44.6 million due primarily to the net income of \$47.2 million for the year.

Statement of Revenues, Expenses and Changes in Net Assets

The Statement of Revenues, Expenses and Changes in Net Assets is the System's income statement. It details how net assets have increased during the year ended June 30, 2008, with comparative information for the year ended June 30, 2007. This statement 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. All items that increase or decrease net assets must appear on the Statement of Revenues, Expenses and Changes in Net Assets as revenues, expenses, gains or losses.

Financial activities are reported as either operating or nonoperating. GASB Statement No. 35 requires state appropriations, gifts and investment income to be classified as nonoperating revenues. The utilization of long-lived capital assets is reflected in the financial statements as depreciation, which amortizes the cost of an asset over its expected useful life.

Condensed Statements of Revenues, Expenses and Changes in Net Assets
(in thousands)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
OPERATING REVENUES			
Net patient service revenues	\$ 653,092	\$ 530,128	\$ 464,651
Sales and services	17,225	7,303	5,375
Total operating revenues	<u>670,317</u>	<u>537,431</u>	<u>470,026</u>
OPERATING EXPENSES			
Salaries and wages	202,596	167,078	150,247
Fringe benefits	52,559	42,965	39,236
Supplies	153,663	128,356	105,832
Purchased services	119,596	109,281	80,908
Other expenses	67,857	50,952	44,019
Depreciation	25,569	21,692	19,210
Total operating expenses	<u>621,840</u>	<u>520,324</u>	<u>439,452</u>
OPERATING INCOME-continuing operations	<u>48,477</u>	<u>17,107</u>	<u>30,574</u>
NONOPERATING REVENUES (EXPENSES)			
State appropriations	1,053	1,053	1,053
Permanent additions to endowments	1	1	-
Gifts	4,607	1,355	1,149
Investment income	(13,597)	32,951	6,098
Interest expense	(1,017)	(131)	(117)
Gain (loss) on disposal of capital assets	(246)	(66)	344
Other	(104)	(799)	645
Gain on sale of investment	-	5,049	28,836
Equity in income (loss) of unconsolidated investees	-	-	11,524
Income before other revenues, expenses, gains or losses	<u>39,174</u>	<u>56,520</u>	<u>80,106</u>
Transfer (to) the University of Kentucky-noncapital	(19,795)	(8,558)	(10,833)
Transfer (to) the University of Kentucky-capital	(16)	(761)	(323)
DISCONTINUED OPERATIONS			
Net income (loss) from discontinued operations	<u>(20)</u>	<u>5</u>	<u>(43)</u>
Total increase in net assets	19,343	47,206	68,907
Net assets, beginning of year	572,790	525,584	456,677
Net assets, end of year	<u>\$ 592,133</u>	<u>\$ 572,790</u>	<u>\$ 525,584</u>

Operating Revenues:

Total operating revenues were approximately \$670.3 million for the year ended June 30, 2008, an increase of \$132.9 million or 24.7 percent over 2007. The most significant source of operating revenue for the System was net patient service revenue of \$653.1 million. Net patient revenues increased \$123.0 million or 23.2 percent in fiscal year 2008 over 2007.

The majority of the net patient service revenue increase was the result of an increase in patient activity due to growth from strategic initiatives in select product lines, an enhanced outreach network and the addition of Good Samaritan Hospital. Patient service revenues are presented net of estimated allowances from contractual arrangements with Medicare, Medicaid and other third-party payors and have been estimated based on the terms of reimbursement and contracts currently in effect and include a provision for doubtful accounts.

The provision for doubtful accounts increased by \$1.4 million or 3.1 percent primarily due to the addition of Good Samaritan Hospital accounts receivable.

The following table shows net patient revenue by funding source for fiscal years ended June 30, 2008, 2007 and 2006 (in thousands):

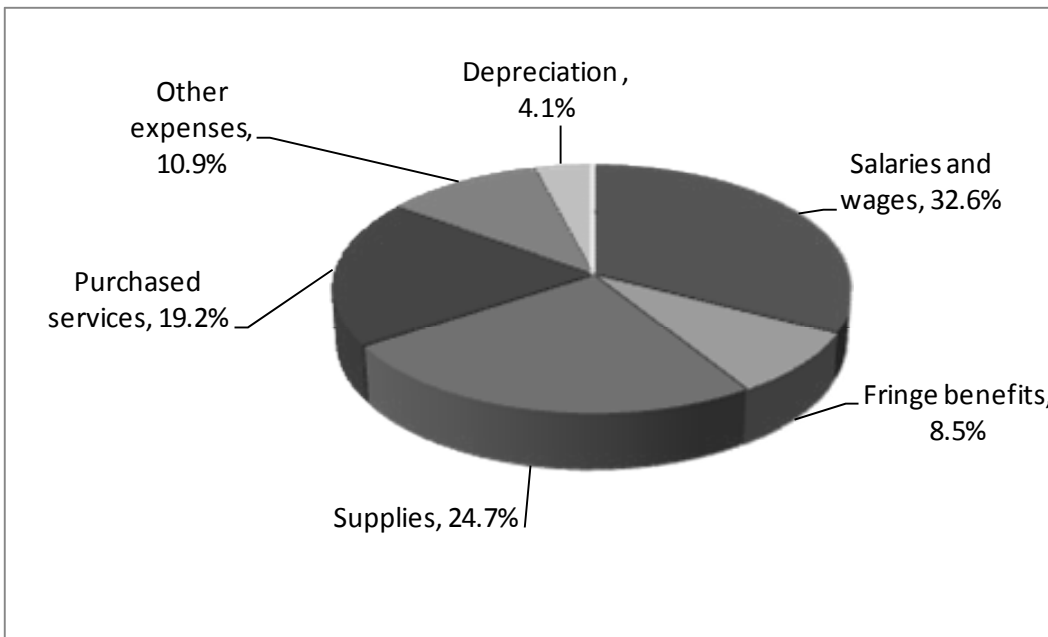
Payor	2008	2007	2006
Medicare	\$ 195,494	\$ 147,569	\$ 133,772
Medicaid	145,983	125,607	112,925
Commercial/Blue Cross	310,130	247,456	226,350
Patient/charity	47,629	54,269	43,242
Bad Debt	(46,144)	(44,773)	(51,638)
Total	<u>\$ 653,092</u>	<u>\$ 530,128</u>	<u>\$ 464,651</u>

Net revenues for Medicare represent payments for services provided to patients under Title XVIII of the Social Security Act. Payments for inpatient services provided to Medicare beneficiaries are paid on a per-discharge basis at rates set at the national level with adjustments for prevailing area labor costs. The System also receives additional payments for direct and indirect costs for graduate medical education, disproportionate share of indigent patients, capital reimbursement, and outlier payments on cases with unusually high costs of care. System outpatient care is reimbursed under a prospective payment system. Medicare reimburses the System for allowable costs at a tentative rate with final settlement of such items determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. Settlements with the Medicare program for prior years' cost reports are recognized in the year the settlement is resolved.

Net revenues for Medicaid represent payments for services provided to Medicaid beneficiaries. Payments for inpatient services are paid on a per discharge basis and include Intensity Operating Allowance revenues, which are intergovernmental transfer payments available for public institutions to assure access to medical care for Medicaid participants. Outpatient services are reimbursed based upon a combination of fee schedule, per case and retrospective cost settlement basis.

Net revenues for patient/charity include reimbursement for uncompensated care by the Commonwealth of Kentucky from Disproportionate Share System funds.

TOTAL OPERATING EXPENSES



Operating Expenses:

Total operating expenses, including \$25.6 million of depreciation and amortization, were \$621.8 million, an increase of \$101.5 million or 19.5 percent over the prior year.

Salaries and employee benefit expenses increased by \$45.1 million over the prior fiscal year due to increased staffing required for increased patient activity and merit increases.

Supplies expenses increased by \$25.3 million or 19.7 percent mainly due to increases in overall patient activity and higher costs.

Purchased services increased \$10.3 million or 9.4 percent from fiscal year 2007. The System had an increase in outsourced services, including agency nurses, of \$5.1 million primarily associated with the addition of Good Samaritan Hospital. Another \$4.3 million of the increase was due to higher volume of purchased services associated with the University health insurance plan managed by the System.

Other expenses rose by \$16.9 million or 33.2 percent in fiscal year 2008. Maintenance and repair along with equipment service contracts accounted for the largest dollar increase of \$5.4 million. Other factors contributing to the increase were higher utility costs of \$ 3.4 million and insurance costs of \$1.2 million.

Nonoperating Revenues (Expenses):

Total nonoperating expenses, net of revenues, were \$9.3 million for fiscal year 2008 compared to nonoperating revenues over expenses of \$39.4 million for the prior fiscal year. This decrease is primarily due to the fact that 2008 included a net investment loss of \$13.6 million while 2007 had an investment gain of \$33.0 million. The endowment pool posted a total loss of 8.2% for fiscal 2008 versus a total return of 16.8% in the prior year. Also, 2007 had a gain of \$5.0 million on the sale of CHA.

2007 Versus 2006 Total operating revenues were \$537.4 million for the year ended June 30, 2007, an increase of \$67.4 million over 2006. Essentially all of the increase in operating revenues was due to increased patient activity.

Operating expenses totaled \$520.3 million, an increase of \$80.9 million over 2006. The increase was primarily caused by higher costs for personnel, purchased services and medical supplies.

Nonoperating revenues, net of expenses, amounted to \$39.4 million. The decrease of \$10.1 million over the previous year was primarily due to the gain in 2006 on the sale of CHA of \$28.8 million and an increase in the equity in income of unconsolidated investees of \$10.3 million.

Statement of Cash Flows

The Statement of Cash Flows details how cash has increased (or decreased) during the year ended June 30, 2008, with comparative financial information for the year ended June 30, 2007. It breaks out the sources and uses of cash into the following categories:

- Operating activities
- Noncapital financing activities
- Capital and related financing activities
- Investing activities

Cash flows associated with the System's expendable net assets appear in the operating and noncapital financing categories. Capital financing activities include payments for capital assets, proceeds from long-term debt and debt repayments. Purchases and sales of investments are reflected in investing activities.

The primary purpose of the Statement of Cash Flows is to provide information about the cash receipts and cash payments made by the System during the year that will allow financial statement readers to assess the System's:

- Ability to generate future net cash flows,
- Ability to meet obligations as they become due, and
- The possible need for external financing.

Condensed Statements of Cash Flows (in thousands)

Cash provided (used) by:	2008	2007	2006
Operating activities	\$ 45,696	\$ 27,425	\$ 41,446
Noncapital financing activities	(13,489)	(7,481)	(16,885)
Capital and related financing activities	60,816	(75,957)	60,011
Investing activities	(8,226)	(29,790)	(72,423)
Net increase (decrease) in cash and cash equivalents	84,797	(85,803)	12,149
Cash and cash equivalents, beginning of year	<u>196,900</u>	<u>282,703</u>	<u>270,554</u>
Cash and cash equivalents, end of year	<u>\$ 281,697</u>	<u>\$ 196,900</u>	<u>\$ 282,703</u>

The major source of cash included in operating activities was patient service revenues of \$612.8 million. The largest cash payments for operating activities were \$339.5 million to suppliers and \$251.7 million to employees for salaries, wages and fringe benefits.

Cash used by noncapital financing activities consisted primarily of transfers to the University for noncapital purposes.

The major sources of cash from capital and related financing activities related to proceeds from capital debt of \$164.8 million. The largest use of cash is due to the purchase of capital assets of \$118.0 million.

Investing activities included proceeds from sales and maturities of investments of \$406.9 million and interest and dividends of \$14.0 million. Cash of \$429.1 million was used to purchase investments.

2007 Versus 2006 Cash balances decreased when comparing fiscal 2007 versus fiscal 2006 with a net decrease in cash of approximately \$85.8 million. The major outlay of cash was for capital and related financing activities.

Key Ratios

The following table shows key liquidity and capital ratios for fiscal years 2008, 2007 and 2006:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Days cash on hand	87	102	153
Days of revenue in accounts receivable	53	47	41
Debt service coverage (times)	3.5	11.0	16.2

Days cash on hand decreased to 87 days in fiscal year 2008 from 102 days in fiscal year 2007 due to the planned outflow of cash on capital and related financing activities. Days cash on hand measures the average number of days' expenses the System maintains in cash.

The days of revenue in accounts receivable measures the average number of days it takes to collect patient accounts receivable. Fiscal year 2008 days in accounts receivable rose to 53 days versus 47 days in 2007 due to the integration of Good Samaritan billing activities. Under Governmental Accounting Standards, net patient revenue is reduced by the provision for doubtful accounts while nongovernmental hospitals report the

provision for bad debts as an expense. This presentation change results in 3 days increase in the days in accounts receivable for each fiscal year.

Debt service coverage ratio measures the amount of funds available to cover the principal and interest on long-term debt. The System's ratio for fiscal year 2008 is 3.5 versus 11.0 in fiscal year 2007 due to the sale of additional project notes for the new patient care facility and the new equipment leases to modernize the Good Samaritan facility.

Capital Asset and Debt Administration

Capital Assets

Capital assets, net of accumulated depreciation, totaled approximately \$350.2 million at June 30, 2008, a net increase of \$97.8 million over the prior year end. Significant changes in capital assets during fiscal 2007-2008 included (in millions):

• Land, buildings and structures, net additions	\$ 39.3
• Equipment and vehicles, net additions	\$ 13.9
• Capitalized software additions	\$ 3.3
• Construction in process, net additions	\$ 55.9
• Increase in accumulated depreciation, net	\$ (14.7)

Debt

At year-end, the System had \$265.7 million in System project notes outstanding. In November 2007 the University took delivery of University of Kentucky General Receipts Project Notes, 2007 Series A and Series B for \$77,905,000 and \$80,245,000, respectively.

Economic Factors Impacting Future Periods

The following are known facts and circumstances that will affect future financial results:

- Net operating revenue for FY 2008-09 is budgeted to increase approximately \$24.0 million due to an annual rate increase effective July 1, 2008 and a projected increase in discharges due to growth. Growth includes the impact of strategic initiatives in Cardiology, Hematology/Oncology, Orthopedics, Neurosurgery, Digestive Health and Pediatrics.
- State appropriations continue to remain constant at \$1.1 million.
- The first phase of construction for the new Hospital is underway. Ground was broken on the new one-million square-foot UK Chandler Hospital, which is the cornerstone of a 20-year, \$2.5 billion plan for the south side of campus to construct an academic medical campus of the future that will further accelerate growth in research and health education.

UK HEALTHCARE HOSPITAL SYSTEM
STATEMENTS OF NET ASSETS (in thousands)
JUNE 30, 2008 AND 2007

	<u>2008</u>	<u>2007</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 142,587	\$ 151,795
Accounts receivable (less allowance for doubtful accounts of \$21,271 and \$18,416)	94,641	67,673
Inventories and other	20,020	12,747
Accrued interest receivable	65	352
Estimated third-party payor settlements receivable	13,181	4,028
Notes receivable	1,892	2,082
Total current assets	<u>272,386</u>	<u>238,677</u>
Noncurrent Assets		
Restricted cash and cash equivalents	139,110	45,105
Long-term investments	225,550	227,172
Capital assets, net	350,241	252,440
Notes receivable	12,888	14,788
Other assets	29,056	24,081
Total noncurrent assets	<u>756,845</u>	<u>563,586</u>
Total assets	<u>1,029,231</u>	<u>802,263</u>
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	57,649	40,567
Deferred revenue	5,538	5,145
Due to University of Kentucky	3,000	-
Capital lease obligations - current portion	8,478	5,320
Total current liabilities	<u>74,665</u>	<u>51,032</u>
Noncurrent Liabilities		
Accrued expenses	13,288	7,035
Deferred revenue	5,974	5,701
Long-term liabilities	265,690	107,540
Capital lease obligations	77,481	58,165
Total noncurrent liabilities	<u>362,433</u>	<u>178,441</u>
Total liabilities	<u>437,098</u>	<u>229,473</u>
NET ASSETS		
Invested in capital assets, net of related debt	<u>135,130</u>	<u>128,207</u>
Restricted		
Nonexpendable other	<u>14</u>	<u>14</u>
Expendable		
Debt service	2,134	110
Capital projects	13,011	6,193
Other	1,973	2,109
Total restricted expendable	<u>17,118</u>	<u>8,412</u>
Total restricted	<u>17,132</u>	<u>8,426</u>
Unrestricted	<u>439,871</u>	<u>436,157</u>
Total net assets	<u>\$ 592,133</u>	<u>\$ 572,790</u>

See notes to financial statements.

UK HEALTHCARE HOSPITAL SYSTEM
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS (in thousands)
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007

	<u>2008</u>	<u>2007</u>
OPERATING REVENUES		
Net patient service revenues, less provision for doubtful accounts of \$ 46,144 and \$ 44,773	\$ 653,092	\$ 530,128
Sales and services	17,225	7,303
Total operating revenues	<u>670,317</u>	<u>537,431</u>
OPERATING EXPENSES		
Salaries and wages	202,596	167,078
Fringe benefits	52,559	42,965
Supplies	153,663	128,356
Purchased services	119,596	109,281
Other expenses	67,857	50,952
Depreciation	25,569	21,692
Total operating expenses	<u>621,840</u>	<u>520,324</u>
Net income from continuing operations	<u>48,477</u>	<u>17,107</u>
NONOPERATING REVENUES (EXPENSES)		
State appropriations	1,053	1,053
Permanent additions to endowments	1	1
Gifts	4,607	1,355
Investment income	(13,597)	32,951
Interest expense	(1,017)	(131)
(Loss) on disposal of capital assets	(246)	(66)
Other	(104)	(799)
Gain on sale of investment	-	5,049
Net nonoperating revenues (expenses)	<u>(9,303)</u>	<u>39,413</u>
Net income before other revenues, expenses, gains or losses	<u>39,174</u>	<u>56,520</u>
Transfers (to) the University of Kentucky for noncapital purposes	(19,795)	(8,558)
Transfers (to) the University of Kentucky for capital purposes	(16)	(761)
Total other revenues (expenses)	<u>(19,811)</u>	<u>(9,319)</u>
Income (loss) from discontinued operations	<u>(20)</u>	<u>5</u>
INCREASE IN NET ASSETS	19,343	47,206
NET ASSETS, beginning of year	<u>572,790</u>	<u>525,584</u>
NET ASSETS, end of year	<u>\$ 592,133</u>	<u>\$ 572,790</u>

See notes to financial statements.

UK HEALTHCARE HOSPITAL SYSTEM
STATEMENTS OF CASH FLOWS (in thousands)
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net patient service revenues	\$ 612,801	\$ 516,925
Sales and services	23,205	7,539
Payments to vendors and contractors	(339,471)	(285,244)
Salaries, wages and fringe benefits	(251,655)	(208,912)
Other receipts (payments)	816	(2,883)
Net cash provided by operating activities	<u>45,696</u>	<u>27,425</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations	1,053	1,053
Gifts	2,026	1,282
Additions to permanent endowments	1	1
Payments on lease receivable	98	-
Loan to University of Kentucky departmental units	-	(2,484)
Payments on loans to University of Kentucky departmental units	3,128	1,225
Transfers (to) the University of Kentucky for noncapital purposes	(19,795)	(8,558)
Net cash (used) by noncapital financing activities	<u>(13,489)</u>	<u>(7,481)</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from sale of capital assets	120	127
Purchases of capital assets	(117,981)	(68,379)
Reduction of (payment) for deposits/Good Samaritan CON	6,476	(18,085)
Principal payments-capital leases and long-term obligations	(6,365)	(1,358)
Interest payments-capital leases and long-term obligations	(8,702)	(4,939)
Proceeds from capital leases	32,126	12,500
Proceeds from capital debt	164,846	-
Proceeds from sales and maturities of investments - funds on deposit with trustee	7,964	6,976
Purchase of investments - funds on deposit with trustee	(16,496)	(2,447)
Payments to bond agents - cost of issuance	(1,133)	(68)
Transfers (to) the University of Kentucky for capital purposes	(39)	(284)
Net cash provided (used) by capital and related financing activities	<u>60,816</u>	<u>(75,957)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	406,915	381,848
Purchase of investments	(429,130)	(431,442)
Interest and dividends on investments	13,989	19,804
Net cash (used) by investing activities	<u>(8,226)</u>	<u>(29,790)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>84,797</u>	<u>(85,803)</u>
CASH AND CASH EQUIVALENTS, beginning of year	<u>196,900</u>	<u>282,703</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 281,697</u>	<u>\$ 196,900</u>
Reconciliation of net income from continuing operations to net cash provided by operating activities:		
Net income from continuing operations	\$ 48,477	\$ 17,107
Income (loss) from discontinued operations	(20)	5
Adjustments to reconcile net income from continuing operations to net cash provided (used) by operating activities:		
Depreciation	25,569	21,692
Write off of principal - note receivable	263	198
Provision for doubtful accounts	46,144	44,773
Change in assets and liabilities:		
Accounts receivable	(73,113)	(52,981)
Inventories and other	(7,282)	(2,399)
Estimated third-party payor settlements receivable	(9,153)	(2,425)
Other assets	(361)	(2,883)
Accounts payable and accrued expenses	14,956	6,034
Deferred revenue	216	(1,696)
Net cash provided by operating activities	<u>\$ 45,696</u>	<u>\$ 27,425</u>
Non cash transactions:		
Transfer of capital assets to (from) UK	<u>\$ 23</u>	<u>\$ (477)</u>
Capital lease additions	<u>\$ 671</u>	<u>\$ 48,756</u>
Gifts of capital assets	<u>\$ -</u>	<u>\$ 73</u>
Capital asset additions in accounts payable	<u>\$ 11,688</u>	<u>\$ 4,953</u>
Capitalized interest, net of investment income	<u>\$ 5,772</u>	<u>\$ 97</u>
Amortized project notes cost of issuance	<u>\$ 89</u>	<u>\$ 50</u>
Adjustment of capital lease obligation	<u>\$ (3,958)</u>	<u>\$ -</u>

See notes to financial statements.

UK HEALTHCARE HOSPITAL SYSTEM NOTES TO FINANCIAL STATEMENTS

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The UK HealthCare Hospital System is an organizational unit of the University of Kentucky (the University) which is a component unit of the Commonwealth of Kentucky and is included in the basic financial statements of the Commonwealth. The financial statements of UK HealthCare Hospital System include Albert B. Chandler University Hospital including Kentucky Children's Hospital (collectively Chandler); UK HealthCare Good Samaritan Hospital (Good Samaritan); and Kentucky Healthcare Enterprise, Inc. (KHE), a wholly owned for-profit subsidiary (collectively, the System).

UK HealthCare Hospital System provides inpatient, outpatient and emergency care services for residents of the Commonwealth of Kentucky.

Basis of Presentation

The accompanying consolidated 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 System.
 - Expendable* – Net assets whose use by the System is subject to externally imposed stipulations that can be fulfilled by actions of the System pursuant to those stipulations or that expire by the passage of time.
- Unrestricted: Net assets whose use by the System is not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Trustees 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 System's assets, liabilities, net assets, revenues, expenses, changes in net assets and cash flows.

Pursuant to GASB Statement No. 20, the System has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB) that were issues 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 System 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 System considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Noncurrent cash and cash equivalents include the System's plant funds allocated for capital projects, with the exception of unrestricted renewal and replacement cash, which is included in current cash and cash equivalents, and endowment fund cash pending transfer to the custodian for investment. Cash and cash equivalents held by the University's endowment fund managers are included in endowment investments.

Accounts Receivable. The System reports patient accounts receivable for services rendered at net realizable amounts from third-party payers and others. The System provides an allowance for doubtful accounts based upon a review of outstanding receivables, historical collection information and existing economic conditions.

Inventories. Inventories are stated principally at the lower of cost or market.

Long Term Investments. The System's endowment investments are administered as part of the University's pooled endowment funds. The University employs the total return concept of investment management for setting investment objectives and determining investment performance. This concept recognizes dividends and interest, plus or minus realized and unrealized gains or losses, in determining the total return earned during any particular period. The market value method of accounting for pooled endowment funds is employed to ensure proper distribution of market price changes, realized gains (losses) on sales, accrued income earned, and distribution of investment earnings for expenditure by participating funds.

The Uniform Management of Institutional Funds Act (UMIFA), as adopted by the Commonwealth of Kentucky, permits the University to appropriate an amount of the realized and unrealized endowment appreciation to support current programs. Accordingly, spendable return from the endowment is determined using the total return philosophy. This philosophy recognizes a prudent amount of realized and unrealized gains as spendable return in addition to traditional yield. Distribution of investment earnings for expenditure by participating funds is supported first by traditional yield earned and, if necessary, a transfer from the endowment of any prior years' accumulated earnings (unexpended traditional yield) or net realized or unrealized gains.

The University's endowment spending rule provides for annual distributions of 4.50 percent of the three-year moving average market value of fund units. For the years ended June 30, 2008 and 2007 approximately \$2.5 and \$5.9 million, respectively, was transferred from endowment realized and unrealized gains to support current programs in accordance with the University's endowment spending rule. Additionally, the University assesses eligible endowment accounts with a management fee of 0.5 percent of total asset value to support fundraising and endowment administration.

Capital Assets. Capital assets are stated at cost at date of acquisition or, in the case of gifts, at fair market value at date of gift.

The System capitalizes interest costs as a component of construction in progress, based on the interest cost of borrowing specifically for the project, net of interest earned on investments acquired with the proceeds of the borrowing.

Equipment with a unit cost of \$2,000 or more (\$1,000 for computers) and having an estimated useful life of greater than one year is capitalized. Renovations to buildings, infrastructure and land improvements that significantly increase the value or extend the useful life of the structure are capitalized. Routine repairs and maintenance are charged to operating expense in the year in which the expense is incurred.

Depreciation of capital assets is computed on a straight-line basis over the estimated useful lives of the respective assets, generally 40 years for buildings, 10 – 25 years for land and building improvements and infrastructure, 10 years for library books and 5 – 20 years for equipment and vehicles.

Title to all capital assets of the System belongs to the University. The financial information relating to capital assets represents assets that the System occupies and uses. Transfer of capital assets to/from the University represents changes in control of individual assets within divisions of the University from one period to another.

Deferred Revenue. Deferred revenue consists of amounts received from the federal government through the Commonwealth of Kentucky for Disproportionate Share System (DSH) funds and other unearned amounts. The DSH amounts are recognized as revenue over the term of the federal government fiscal year, October 1 – September 30.

Compensated Absences. The amount of vacation leave earned but not taken by employees at June 30, 2008 is recorded as a liability by the System. Temporary disability leave payable upon termination under the University's payout policy is also recorded as a liability on the University's books. Compensated absence liabilities are computed using the pay rates in effect at the statement of net assets date plus an additional amount for compensation-related payments such as social security and Medicare taxes computed using rates in effect at that date.

Net Patient Service Revenues. Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including contractual allowances and estimated retroactive adjustments under reimbursement programs with third-party payors and include a provision for doubtful accounts. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined.

Medicare. Inpatient acute care services and substantially all outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient skilled nursing services are paid at prospectively determined per diem rates that are based on the patients' acuity. Certain inpatient nonacute services and defined medical education costs are paid based on a cost reimbursement methodology. The System is reimbursed for certain services at tentative rates with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicare fiscal intermediary.

Medicaid. Inpatient and outpatient services rendered to Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology for certain services and at prospectively determined rates for all other services. The System is reimbursed for cost reimbursable services at tentative rates with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicaid fiscal intermediary.

Revenue from the Medicare and Medicaid programs accounted for approximately 30 percent and 22 percent, respectively, of the System's net patient service revenues for the year ended June 30, 2008 and approximately 28 percent and 24 percent, respectively for the year ended June 30, 2007. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

The System also entered into payment agreements with certain commercial insurance carriers, health maintenance organization and preferred provider organizations. The basis for payment to the System under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

Charity Care. The System provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Since the System does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

Income Taxes. The University, of which the System is an organizational unit, is an agency and instrumentality of the Commonwealth of Kentucky, pursuant to Kentucky Revised Statutes sections 164.100 through 164.280. Accordingly, the University is excluded from federal Income taxes as an organization described in Section 115 of the Internal Revenue Code of 1986, as amended.

Restricted Asset Spending Policy. The System'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 System 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. Nearly all of the System's revenues and expenses are from exchange transactions. Certain revenues relied upon for operations, such as state appropriations, gifts and investment income, are recorded as non-operating revenues, in accordance with GASB Statement No. 35.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The accompanying financial statements include estimates for items such as contractual allowances, allowances for doubtful accounts, estimated third-party payor settlements and estimated medical claims payable.

Recent Accounting Pronouncements. The GASB has issued certain statements which are applicable to the System for fiscal years ending after June 30, 2009. The System does not expect the adoption of these statements to have a material effect on its financial statements.

2. DEPOSITS AND INVESTMENTS

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

	2008	2007
Cash on deposit with the Commonwealth of Kentucky	\$ 281,697	\$ 196,900
United States government securities	10,140	10,011
Investment in University of Kentucky pooled endowment funds	215,410	217,161
	<u>\$ 507,247</u>	<u>\$ 424,072</u>
Statement of Net Assets classification		
Cash and cash equivalents	\$ 142,587	\$ 151,795
Restricted cash and cash equivalents	139,110	45,105
Long-term investments	225,550	227,172
	<u>\$ 507,247</u>	<u>\$ 424,072</u>

At June 30, 2008, the University's pooled endowment fund consists of pooled equity funds (66.0%), private equity funds (1.7%), pooled real estate funds (9.0%), government agency fixed income funds (5.8%), corporate fixed income funds (5.9%), pooled fixed income funds (10.8%) and cash equivalents (0.8%). At June 30, 2007, the University's pooled endowment fund consists of common and preferred stock funds (8.7%), pooled equity funds (61.4%), private equity funds (0.9%), pooled real estate funds (7.9%), U.S .Treasury fixed income funds (2.0%), government agency fixed income funds (4.2%), corporate fixed income funds (3.1%), pooled fixed income funds (10.0%) and cash equivalents (1.8%).

Deposit and investment policies. The University's Board of Trustees is responsible for establishing deposit and investment policies for the System. Once established, the Board has delegated day-to-day management to the Treasurer of the University. Deposit and investment policies are developed to insure compliance with state laws and regulations as well as to establish and maintain sound financial management practices.

The System follows Kentucky Revised Statutes (KRS 42.500) for the investment of public funds, which list allowable investment instruments to include: obligations of the United States or a United States government agency; obligations of any corporation of the United States Government; collateralized certificates of deposit; highly rated uncollateralized certificates of deposit, bankers acceptances and commercial paper; highly rated securities issued by a state or local government; and mutual funds comprised of any of the above allowable investments.

For purposes of investment management, the System's deposits and investments can be grouped into four significant categories, as follows:

- Cash on deposit with the University of Kentucky, which the University invests in deposits and repurchase agreements with local banks and the Commonwealth of Kentucky;
- Bond revenue fund investments held by the Treasurer of the Commonwealth of Kentucky as required by the University's general receipts trust indenture, and invested in pooled fixed income funds managed by the Commonwealth of Kentucky;

- Short-term investments managed by the University, including individual securities purchased and held by the University and short-term investments in pooled fixed income funds managed by the Commonwealth of Kentucky and,
- Endowment investments in the University's pooled endowment fund.

Cash on deposit with the University and short-term investments are managed by the University following the University's Statement of Investment Objectives and Policies for Short-Term Current Funds Investments established by the Investment Committee of the University's Board of Trustees.

The System's policy for the investment of bond revenue funds is governed by the University's General Receipts bond trust indenture.

Endowment investments are managed by the University's Endowment Investment Policy as established by the Investment Committee of the University's Board of Trustees, which governs the University's pooled endowment fund.

Deposit and investment risks. The System'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 System to experience a loss of principal.

As a means of limiting its exposure to losses arising from credit risk, the University's investment policies limit the exposure of its various investment types, as follows:

- Cash on deposit with the Commonwealth of Kentucky is governed by policy that minimizes credit risk in several ways. Deposits are governed by state law which requires full collateralization. Credit risk on repurchase agreements with local banks is mitigated by the issuing financial institution's pledge of specific U.S. treasury or agency securities, held in the name of the University by the Federal Reserve Bank. Credit risk on repurchase agreements with the Commonwealth of Kentucky 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.
- Bond revenue funds held in the Commonwealth's investment pools can be invested in U.S. treasuries and agencies; commercial paper or asset backed securities rated in the highest category by a nationally recognized rating agency; certificates of deposit, bankers acceptances, state or local government securities and corporate, Yankee and Eurodollar securities rated in one of the three highest categories by a nationally recognized rating agency; shares of mutual funds (up to 10%); and state and local property tax certificates of delinquency secured by interests in real estate.
- Short-term investments managed by the University are limited to direct obligations of the U.S. Treasury, other appropriate securities issued by federal agencies, repurchase agreements of U.S. government obligations, and certificates of deposit collateralized by U.S. government obligations or general obligations of the University of Kentucky. Short-term investments held in the Commonwealth's investment pools are subject to the same credit quality requirements as denoted above for bond revenue fund investments.
- Endowment investments held by fixed income managers are generally limited to holdings of high quality fixed income securities. These managers may invest a portion of the portfolio in other below-investment grade bonds, non-U.S. dollar denominated bonds and emerging market bonds, provided the overall credit quality of the fixed income portfolios is not lower than A-.

Custodial Credit Risk. Custodial credit risk is the risk that, in the event of the failure of the counterparty, the System will not be able to recover the value of its investment or collateral securities that are in possession of an outside party.

As a means of limiting its exposure to losses arising from custodial credit risk, the University's investment policies limit the exposure of its various investment types, as follows:

- Cash on deposit with the Commonwealth of Kentucky is invested in deposits and repurchase agreements with local banks, which are held in the University's name, and deposits and repurchase agreements with the Commonwealth of Kentucky, which are held in the Commonwealth's name.

- Bond revenue fund investments and short-term investments held in the Commonwealth's investment pools are held in the Commonwealth's name by the Commonwealth's custodian.
- Short-term investments managed by the University are held in the University's name by the University's custodian.
- Endowment investments are held in the University's name by the University's custodian.

Concentrations of Credit Risk. System investments can be exposed to a concentration of credit risk if significant amounts are invested in any one issuer.

As a means of limiting its exposure to concentrations of credit risk, the University's investment policies limit concentrations in various investment types, as follows:

- Cash on deposit with the University 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.
- Bond revenue fund and short-term investments held in the Commonwealth's investment pools are limited as follows: U.S. dollar denominated corporate and Yankee securities issued by foreign and domestic issuers shall not exceed twenty-five (25) percent of an individual pool and \$25,000,000 per issuer, inclusive of commercial paper, bankers' acceptances and certificates of deposit; and U. S. dollar denominated sovereign debt shall not exceed five (5) percent of any individual portfolio and \$25,000,000 per issuer.
- There is no specific limit on the maximum amount of short-term investments managed by the University that may be invested in one issuer. However, such investments are limited to direct U.S. government obligations (U.S. Treasuries) and U.S. government agencies.
- Endowment investment managers are limited to a maximum investment in any one issuer of no more than 5 percent of total investments.

At June 30, 2008 and 2007, the System has no investments in any one issuer that represent 5 percent or more 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.

As a means of limiting its exposure to fair value losses arising from increasing interest rates, the University's investment policies limit the maturity of its various investment types, as follows:

- Cash on deposit with the Commonwealth of Kentucky has limited exposure to interest rate risk due to the short-term nature of the investment. The University requires that all deposits and repurchase agreements be available for use on the next business day.
- Bond revenue fund and short-term investments held in the Commonwealth's short-term investment pool are limited to a duration that does not exceed 90 days. Such investments in the Commonwealth's intermediate-term investment pool must maintain a modified duration of less than 3 years.
- Short-term investments managed by the University are limited to a maximum maturity of 24 months.
- Endowment investments held by fixed income managers are limited to a duration that is within +/-25% of the duration of the Lehman Aggregate Bond Index.

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 System's exposure to foreign currency risk derives from certain limited endowment investments, including pooled fixed income funds, a pooled global equity fund, and a pooled non-U.S. equity fund. The University's endowment investment policy allows fixed-income managers to invest a portion of their funds in non-U.S. securities and equity fund managers of co-mingled portfolios to invest in accordance with the guidelines established in the individual fund's prospectus.

The System invests in various securities. Investment securities are exposed to various interest rate, market and credit risks, discussed above. Due to the level of risk associated with certain investment securities, it is at least

reasonably possible that changes in the values of investment securities will occur in the near term and that such change could affect the investment amounts in the statement of net assets.

3. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net, as of June 30, 2008 and 2007 are as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Medicare, Medicaid and other third parties	\$ 86,639	\$ 57,057
Private pay	7,508	3,216
CHA escrow	-	7,400
Pledges receivable	494	-
Total accounts receivable, net	<u>\$ 94,641</u>	<u>\$ 67,673</u>

At June 30, 2008, pledges totaling approximately \$5.3 million are expected to be collected primarily over the next eleven years for operating and capital purposes. In accordance with GASB Statement No. 33, "Accounting and Financial Reporting for Nonexchange Transactions," the System is required to record operating and capital pledges as revenue when all eligibility requirements have been met. Accordingly, for the year ended June 30, 2008 the System recorded the discounted value of operating and capital pledges using a rate of 6 percent, net of the allowance for uncollectible pledges, of approximately \$3.1 million. The current portion is recorded above with accounts receivable while the noncurrent portion of approximately \$2.6 million is included with other assets.

4. CAPITAL ASSETS, NET

Capital assets as of June 30, 2008 and capital asset activity for the year ended June 30, 2008 are summarized as follows (in thousands):

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending Balance</u>
Land	\$ 19,508	\$ 3,101	\$ 1,076	\$ 21,533
Non-depreciable land improvements	40	3,589	-	3,629
Depreciable land improvements	3,171	528	-	3,699
Buildings	186,216	39,149	7,335	218,030
Fixed equipment	7,178	952	11	8,119
Infrastructure	64	447	2	509
Equipment	139,860	24,100	10,458	153,502
Vehicles	439	295	-	734
Capitalized software	16,311	3,307	-	19,618
Construction in process	68,738	94,563	38,659	124,642
	<u>441,525</u>	<u>170,031</u>	<u>57,541</u>	<u>554,015</u>
<u>Accumulated Depreciation:</u>				
Depreciable land improvements	2,918	392	-	3,310
Buildings	93,665	5,595	4,068	95,192
Fixed equipment	3,175	617	3	3,789
Infrastructure	9	1	-	10
Equipment	82,205	16,088	6,809	91,484
Vehicles	210	144	-	354
Capitalized software	6,903	2,732	-	9,635
	<u>189,085</u>	<u>25,569</u>	<u>10,880</u>	<u>203,774</u>
Capital assets, net	<u>\$ 252,440</u>	<u>\$ 144,462</u>	<u>\$ 46,661</u>	<u>\$ 350,241</u>

Capital assets as of June 30, 2007 and capital asset activity for the year ended June 30, 2007 are summarized as follows (in thousands):

	Beginning Balance	Additions	Deletions	Ending Balance
Land	\$ 7,974	\$ 11,534		\$ 19,508
Non-depreciable land improvements	40	-		40
Depreciable land improvements	3,171	-		3,171
Buildings	152,887	33,750	\$ 421	186,216
Fixed equipment	6,058	1,120	-	7,178
Infrastructure	64	-	-	64
Equipment	125,170	18,964	4,274	139,860
Vehicles	210	229	-	439
Capitalized software	13,898	2,413	-	16,311
Construction in process	18,305	50,957	524	68,738
	<u>327,777</u>	<u>118,967</u>	<u>5,219</u>	<u>441,525</u>
<u>Accumulated Depreciation:</u>				
Depreciable land improvements	2,763	155	-	2,918
Buildings	88,247	5,423	5	93,665
Fixed equipment	2,515	660	-	3,175
Infrastructure	6	3	-	9
Equipment	73,207	13,643	4,645	82,205
Vehicles	120	90	-	210
Capitalized software	4,507	2,396	-	6,903
	<u>171,365</u>	<u>22,370</u>	<u>4,650</u>	<u>189,085</u>
Capital assets, net	<u>\$ 156,412</u>	<u>\$ 96,597</u>	<u>\$ 569</u>	<u>\$ 252,440</u>

At June 30, 2008 the System has construction projects in process totaling approximately \$418.4 million in scope. The estimated cost to complete these projects is approximately \$309.8 million. Such construction is principally financed by proceeds from the University's general receipts bonds and System cash reserves.

Interest costs incurred during construction, net of related investment income, are capitalized. Total interest capitalized was \$5.8 million for 2008 and \$97 thousand for 2007.

During 2008 and 2007, respectively, the System has utilized capital leases to acquire various items of equipment and also utilized capital leases for the lease purchase of land and buildings associated with its purchase of Good Samaritan Hospital costing approximately \$671,000 and \$ 48,756,000 The net book value for capitalized leased land, buildings and equipment is \$48.7 million and \$50.6 million at June 30, 2008 and 2007, respectively.

5. NOTES RECEIVABLE

Notes receivable at June 30, 2008 and 2007 are as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Non-interest bearing, unsecured receivable from UK Parking and Transportation, payable \$250,000 annually through 2013	\$ 1,750	\$ 2,000
Non-interest bearing, unsecured receivable from UK Office of Associate Vice President-Research, payable \$500,000 annually, 2003 through 2010	1,213	1,500
Non-interest bearing, unsecured receivable from UK Office of Associate Vice President-Research payable \$475,000 annually, through 2009	475	950
Unsecured receivable, bearing interest at 4.34% from UK Biomedical Biological Sciences Research Building, payable \$27,856 monthly 2006 through 2012	-	1,000
Non-interest bearing, unsecured receivable from UK College of Pharmacy	6,795	6,819
Interest bearing, 7.0%, capital equipment lease receivable from Coldstream Laboratories Inc (CLI) payable \$18,224 monthly, through 2013	1,082	1,181
Non-interest bearing, unsecured receivable from UK College of Pharmacy	2,817	2,817
Notes receivable	648	603
Total	<u>\$ 14,780</u>	<u>\$ 16,870</u>
Current portion	\$ 1,892	\$ 2,082
Noncurrent portion	12,888	14,788
Total	<u>\$ 14,780</u>	<u>\$ 16,870</u>

6. OTHER ASSETS

Other assets at June 30, 2008 and 2007 are as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Unamortized bond cost of issuance	\$ 1,926	\$ 874
Amounts on deposit with trustee, primarily invested in U.S. government agencies	11,054	2,522
Investment in CLI through loan to University of Kentucky Research Foundation	825	1,900
Noncurrent portion of prepaid expenses	1,061	700
Pledges receivable	2,581	-
Escrow deposit and other prepaid costs-Good Samaritan acquisition	-	18,085
Good Samaritan Certificate of Need licensed beds	11,609	-
Total	<u>\$ 29,056</u>	<u>\$ 24,081</u>

7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities as of June 30, 2008 and 2007 are summarized as follows (in thousands):

	2008	2007
Payable to vendors and contractors	\$ 31,826	\$ 18,684
Accrued expenses, including vacation leave	25,823	21,883
Total	<u>\$ 57,649</u>	<u>\$ 40,567</u>

8. LONG-TERM LIABILITIES

Long-term liabilities as of June 30, 2008 and 2007 are summarized as follows (in thousands):

	Beginning Balance	Additions	2008		Current Portion	Noncurrent Portion
			Reductions	Ending Balance		
General Receipts						
Project Notes	<u>\$ 107,540</u>	<u>\$ 158,150</u>	<u>-</u>	<u>\$ 265,690</u>	<u>-</u>	<u>\$ 265,690</u>
	Beginning Balance	Additions	2007		Current Portion	Noncurrent Portion
General Receipts						
Project Notes	<u>\$ 107,540</u>	<u>-</u>	<u>-</u>	<u>\$ 107,540</u>	<u>-</u>	<u>\$ 107,540</u>

Principal maturities and interest on notes for the next five years and in subsequent five-year periods as of June 30, 2008 are as follows (in thousands):

	Principal	Interest	Total
2009	\$ -	\$ 12,404	\$ 12,404
2010	4,395	12,331	16,726
2011	9,605	12,074	21,679
2012	9,995	11,682	21,677
2013	10,415	11,260	21,675
2014-2018	59,875	48,504	108,379
2019-2023	75,395	32,990	108,385
2024-2028	96,010	12,371	108,381
Total	<u>\$ 265,690</u>	<u>\$ 153,616</u>	<u>\$ 419,306</u>

Bond discounts and premiums are amortized over the life of the bond using a method that approximates the effective interest method.

The General Receipts Project Notes consist of bonds in the original amount of \$265.7 million dated October 27, 2005 through November 8, 2007, which bear interest at 3.30% to 5.0%. The bonds are payable in annual installments through October 1, 2027. The System is required to make semi-annual deposits of varying amounts to the debt service funds held by the trustees. The bonds are secured by pledged revenues of the University, which include the net revenues of the System.

9. CAPITAL LEASE OBLIGATIONS

Capital lease obligations as of June 30, 2008 and 2007 are summarized as follows (in thousands):

	Beginning Balance	Additions	2008		Current Portion	Noncurrent Portion
			Reductions	Ending Balance		
Leases	<u>\$ 63,485</u>	<u>\$ 32,797</u>	<u>\$ 10,323</u>	<u>\$ 85,959</u>	<u>\$ 8,478</u>	<u>\$ 77,481</u>
	Beginning Balance	Additions	2007		Current Portion	Noncurrent Portion
			Reductions	Ending Balance		
Leases	<u>\$ 3,587</u>	<u>\$ 61,256</u>	<u>\$ 1,358</u>	<u>\$ 63,485</u>	<u>\$ 5,320</u>	<u>\$ 58,165</u>

Scheduled payments of capital lease obligations are as follows (in thousands):

Years ending June 30	
2009	\$ 10,477
2010	10,519
2011	9,976
2012	35,758
2013	5,838
2014-2018	<u>23,064</u>
Total	95,632
Less amount representing interest	<u>(9,672)</u>
Present value of net minimum lease payments	<u>\$ 85,959</u>

Capital lease obligations are at varying rates of imputed interest of 3.49% to 18.84%.

10. OTHER LONG-TERM LIABILITIES

Other long-term liabilities as of June 30, 2008 and 2007 are summarized as follows (in thousands):

	2008			Ending Balance
	Beginning Balance	Additions	Reductions	
Refundable deposits	\$ 5,079	\$ 6,426	\$ 6,184	\$ 5,321
Non-current unamortized bond premium	1,956	8,260	2,249	7,967
Accrued expenses	<u>\$ 7,035</u>	<u>\$ 14,686</u>	<u>\$ 8,433</u>	<u>\$ 13,288</u>
Deferred revenue	\$ 5,701	\$ 273	-	\$ 5,974
	<u>\$ 5,701</u>	<u>\$ 273</u>	<u>-</u>	<u>\$ 5,974</u>
	2007			Ending Balance
	Beginning Balance	Additions	Reductions	
Refundable deposits	\$ 4,811	\$ 5,819	\$ 5,551	\$ 5,079
Non-current unamortized bond premium	2,069	-	113	1,956
Accrued expenses	<u>\$ 6,880</u>	<u>\$ 5,819</u>	<u>\$ 5,664</u>	<u>\$ 7,035</u>
Deferred revenue	\$ 5,399	\$ 309	\$ 7	\$ 5,701
	<u>\$ 5,399</u>	<u>\$ 309</u>	<u>\$ 7</u>	<u>\$ 5,701</u>

11. DESIGNATIONS OF UNRESTRICTED NET ASSETS

Unrestricted net assets are designated for specific purposes by action of the University's Board of Trustees or management or may otherwise be limited by contractual obligations. Commitments for the use of unrestricted net assets at June 30, 2008 and 2007 are as follows (in thousands):

	2008	2007
Working capital requirements	\$ 198,879	\$ 185,372
Future capital expenditures	240,992	250,785
Total	<u>\$ 439,871</u>	<u>\$ 436,157</u>

12. INVESTMENT INCOME

Components of investment income for the years ended June 30, 2008 and 2007 are as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Interest and dividends earned on endowment investments	\$ 6,052	\$ 4,163
Realized and unrealized gains and losses on endowment investments	(23,837)	21,529
Interest and dividends on cash and non-endowment investments	4,183	7,187
Realized and unrealized gains and losses on non-endowment investments	5	72
Total	<u>\$ (13,597)</u>	<u>\$ 32,951</u>

During the year ended June 30, 2006, the System sold its investment in an affiliated entity. Certain purchase price adjustments during the year ended June 30, 2007 resulted in a gain on the sale of this investment of \$5.1 million.

13. PROGRAM FOR INDIGENT CARE AND CHARITY CARE

The System is reimbursed for uncompensated care, including indigent care, by the Commonwealth of Kentucky based upon available Disproportionate Share System funds. The amounts are included in net patient service revenues and summarized below (in thousands):

	<u>2008</u>	<u>2007</u>
Revenue from the Commonwealth of Kentucky	\$ 24,334	\$ 23,299
2.5% tax paid by System on patient cash receipts	(11,755)	(10,449)
Matching contribution paid by the System	(7,250)	(7,107)
Net amount received, included in net patient service revenues	<u>\$ 5,329</u>	<u>\$ 5,743</u>

The amount of charges forgone for services and supplies furnished under the System's charity care policy aggregated to approximately \$86,000 and \$63,000 in 2008 and 2007, respectively.

14. PLEDGED REVENUES

Substantially all operating and nonoperating revenues are pledged as collateral for the General Receipts Project Notes.

15. PENSION PLANS

Regular full-time employees of the System are participants in the University of Kentucky Retirement Plan, a defined contribution plan. System employees participate in one of the following three groups of the University of Kentucky Retirement Plan:

Group I	Established July 1, 1964, for faculty and certain administrative officials.
Group II	Established July 1, 1971, for staff members in the clerical, technical and service categories.
Group III	Established July 1, 1972, for staff members in the managerial, professional and scientific categories.

Participation in these groups of the University of Kentucky Retirement Plan is mandatory for all regular full-time employees age 30 and older. Participation is voluntary until age 30. The System contributes 10% and each employee contributes 5% of eligible compensation.

The University has authorized three retirement plan carriers, as follows:

Teachers Insurance and Annuity Association/College
Retirement Equities Fund (TIAA/CREF)
Fidelity Investments Institutional Services Company
American Century Investments

In addition to retirement benefits provided from the group retirement plan, the System provides supplemental retirement income benefits to certain eligible employees of the System.

The total contributions charged to operations for the various retirement plans were approximately \$15.2 million and \$12.0 million for the years ended June 30, 2008 and 2007, respectively. Employees contributed \$7.6 million and \$6.0 million during 2008 and 2007, respectively. The payroll for employees covered by the retirement plans was \$152.4 million and \$120.1 million for 2008 and 2007, respectively.

16. HEALTH INSURANCE BENEFITS FOR RETIREES

The University administers a single-employer defined-benefit healthcare plan including medical and prescription drug benefits. The plan provides lifetime healthcare insurance benefits for eligible retirees and their surviving spouses. Human Resources Policies and Procedures define retiree health benefits and can be amended by the President of the University as delegated by the University's Board of Trustees

The University provides a pre-65 credit of up to 90% of the "true retiree" cost of the least expensive pre-65 medical plan. For post-65 benefits, the University provides a credit equal to 90% of the "true retiree" cost of the post-65 medical plan. However, retirees must pay the greater of \$25 per month or 10 percent of total plan cost.

The University has established a trust fund to segregate plan assets, and currently plans to contribute amounts to the trust fund sufficient to fully fund the annual required contribution, an amount actuarially determined in accordance with the parameters of GASB Statement 45.

As an organizational unit of the University, the System has recognized its share of the contribution in employee benefit costs and has no additional liability for this benefit at June 30, 2008.

17. RISK MANAGEMENT

The University, of which the System is an organizational unit, is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. These risks are covered by (1) the State Fire and Tornado Insurance Fund (the Fund), (2) Sovereign Immunity and the State Board of Claims, or (3) in the case of risks not covered by the Fund and Sovereign Immunity, commercial insurance, participation in insurance risk retention groups or self-insurance.

The Fund covers losses to property from fire, wind, earthquake, flood and most other causes of loss between \$250,000 and \$500,000 per occurrence. Losses in excess of \$500,000 are insured by commercial carriers up to \$500 million per occurrence, buildings at replacement cost and contents on an actual cash value basis. As a state agency, the University is vested with Sovereign Immunity and is subject to the provisions of the Board of Claims Act, under which the University's liability for certain negligence claims is limited to \$200,000 for any one person or \$350,000 for all persons damaged by a single act of negligence. Claims against educators' errors and omissions and wrongful acts are insured through a reciprocal 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.

The University and its agents are insured against medical malpractice by a combination of Sovereign Immunity, self-insurance, commercial liability insurance, and an excess coverage fund established by the Commonwealth of Kentucky. An actuarial valuation is performed to determine the self insurance funding requirements and the

fund liability, which has been discounted using an interest rate of six percent. The malpractice liability at June 30, 2008, is based on the requirements of GASB Statement No. 10, which requires that a liability for claims be recorded if it is probable that a liability has occurred and the amount of loss can be reasonably estimated. The liability includes an estimate for claims that have been incurred but not reported at June 30, 2008. All assets and liabilities related to medical malpractice are recorded in the financial records of the University. However, the System does fund its required share of the actuarially determined medical malpractice expense and, accordingly, no assets or liabilities related to medical malpractice are recorded on the System's financial statements.

The University is self-insured for the long-term disability income program and has established a 501(c)(9) trust for purposes of paying claims and establishing necessary reserves. The University currently plans to contribute amounts to the trust fund sufficient to fully fund the annual required contribution of the employer, an amount actuarially determined in accordance with the parameters of GASB Statement 45. As an organizational unit of the University, the System has recognized its share of the contribution in employee benefit costs and has no additional liability for this benefit at June 30, 2008

The University also self-insures certain employee benefits, including health insurance, worker's compensation and unemployment claims. The University has recorded an estimate for asserted claims at June 30, 2008.

18. PURCHASE OF GOOD SAMARITAN

On July 1, 2007, the System purchased Good Samaritan Hospital, a 302-bed community hospital located in Lexington, Kentucky. The following summarizes the acquired assets and liabilities (in thousands):

Inventories	\$	1,946
Capital assets		100
Other assets (Certificate of Need License)		10,712
Total assets purchased	<u>\$</u>	<u>12,758</u>
 Vacation liability assumed	 <u>\$</u>	 <u>473</u>

Acquisition costs of approximately \$900,000 were also capitalized with the assets.

19. FUNCTIONAL EXPENSES

Below is a summary of functional expenses for the year ended June 30, 2008 and 2007 (in thousands):

	<u>2008</u>	<u>2007</u>
Operating Expenses:		
Health care services	\$ 555,600	\$ 468,477
General and administrative	66,240	51,847
Total operating expenses	<u>\$ 621,840</u>	<u>\$ 520,324</u>

20. TRANSACTIONS WITH THE UNIVERSITY OF KENTUCKY

Due to the nature of the relationship of the System with the University, the System has substantial transactions with the University, including purchases of various supplies and services. Additionally, the University and its affiliates provide certain administrative support functions to the System. During 2008 and 2007, the System paid approximately \$4.9 million and \$4.7 million, respectively, to the University as reimbursement for various educational and support functions. The System also recognized income from the University for providing medical services to employees under a capitation health plan. During 2008 and 2007, the System received payments of approximately \$34.1 million and \$27.9 million respectively. As of June 30, 2008, the System has an amount payable to the University of \$3 million for accrued physician incentive payments.

21. RECLASSIFICATIONS

Certain reclassifications to fiscal 2007 comparative amounts have been made to conform to the 2008 financial statement classifications. Certain transactions previously reported on a net basis in the Statement of Revenues, Expenses, and Changes in Net Assets are now being reported on a gross basis. Additionally, the provision for doubtful accounts has been recorded as a reduction to net patient service revenues rather than as bad debt expense.



www.uky.edu

The University of Kentucky is committed to a policy of providing opportunities to people regardless of economic or social status and will not discriminate on the basis of race, color, ethnic origin, creed, religion, political belief, sex, sexual orientation, marital status, age, veteran status, or physical or mental disability.

The University of Kentucky is an Equal Opportunity University.
Questions concerning compliance with regulations may be directed to the Equal Opportunity Office,
13 Main Building, University of Kentucky, Lexington, KY 40506-0333.
(859) 257-8927 or at www.uky.edu/evpfa/eoo.