UNIVERSITY OF KENTUCKY

2011

UK HealthCare Hospital System Financial Statements

UK HealthCare Hospital System
An Organizational Unit of the University of Kentucky
Financial Statements
Years Ended June 30, 2011 and 2010

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Independent Accountants' Report on Financial Statements and Supplementary Information

Board of Trustees
University of Kentucky
UK HealthCare Hospital System
Lexington, Kentucky

We have audited the accompanying statements of net assets of the UK HealthCare Hospital System (System), an organizational unit of the University of Kentucky, a component unit of the Commonwealth of Kentucky, as of June 30, 2011 and 2010, and the related statements of revenues, expenses and changes in net assets and cash flows for the years 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 audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the System as of June 30, 2011 and 2010, and the changes in its financial position and its cash flows for the years 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 supplementary information and express no opinion on it.

BKD, LLP

September 29, 2011

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, 2011 and 2010. 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, Chandler cares for the most critically injured and ill patients in the region.

More than 630 faculty physicians and dentists, 600 resident physicians and a staff of 5,520 provide care in the 791 licensed beds at 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 $1.18 billion and liabilities of $557.9 million. Net assets, which represent the System’s residual interest in assets after liabilities are deducted, were $625.1 million or 52.8 percent of total assets. For the fiscal year ended June 30, 2011, the System reported net income before other changes in net assets of $63.7 million, generating a margin of 8.0 percent.

- Financial results for fiscal year 2011 exceeded prior year revenues with net inpatient revenues, excluding the provision for doubtful accounts, increasing approximately $15.1 million or 2.8 percent over the prior fiscal year and net outpatient revenues, excluding the provision for doubtful accounts, increasing $28.0 million or 10.0 percent over the previous fiscal year. The change in net patient service revenue is primarily the result of increases in rates, an overall increase in the case mix index and increased discharges.
- Total assets increased $20.1 million or 1.7 percent. This increase is primarily due to increases in capital assets, net, of $104.6 million; estimated third-party receivables, $12.2 million; and long-term investments $24.6 million. This was offset by decreases in cash and cash equivalents of $97.8 million; accounts receivable, net, $10.0 million; and other long-term assets of $12.6 million, which includes amounts on deposit with trustee, primarily invested in U.S. government agencies.
- Total liabilities decreased $21.2 million or 3.7 percent, as a result of decreases of $10.7 million in capital leases, $3.7 million in accounts payable and accrued expenses, and $6.0 million in deferred revenue.
- Total net assets increased $41.3 million or 7.1 percent, primarily due to the current year net income.
- Operating revenues increased $11.6 million or 1.5 percent.
- Operating expenses increased $22.6 million or 3.0 percent due primarily to increases in personnel costs, supplies and other expenses. This was offset by reduced purchased services.

- The net nonoperating revenues increase of $12.0 million resulted from a $14.5 million increase in investment income, a $3.3 million increase in gifts, offset by a $5.7 million increase in interest expense.

Operating Statistics

The following table presents utilization statistics for the System for fiscal years ended 2011, 2010 and 2009:

	2011	2010	2009
Discharges:			
Medicare	10,065	9,478	9,370
Medicaid	9,277	9,146	9,032
Commercial/Blue Cross	9,453	9,955	9,868
Patient/charity	3,762	3,776	3,498
Total discharges	32,557	32,355	31,768
Average daily census	530	508	495
Average length of stay	5.94	5.74	5.69
Outpatient visits:			
Hospital clinics	339,839	319,297	312,208
Emergency visits	77,205	69,671	68,299
Total visits	417,044	388,968	380,507

2011. Total discharges increased by 202 or 0.6 percent compared to the prior fiscal year. The increase occurred primarily due to an increase in Medicare discharges of 587. Medicaid discharges also increased 131. These increases were offset by a reduction in Commercial/Blue Cross discharges of 502.

Overall the Diagnosis-Related Group (DRG) case mix index increased to 1.7516 from 1.7285 and the average length of stay increased by 0.2 days to 5.94 days. The case mix for Chandler was at 1.8800 while Good Samaritan was at 1.3550.

Total outpatient visits increased by 28,076 or 7.2 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 System-wide basis.

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 the System include Kentucky Healthcare Enterprise, Inc.

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, 2011, with comparative information as of June 30, 2010. 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, 2011, 2010 and 2009 follows:

Condensed Statements of Net Assets (in thousands)

	2011	2010	2009
ASSETS			
Current assets	$ 152,641	$ 253,039	$ 286,800
Capital asset, net of depreciation	772,163	667,580	488,596
Other noncurrent assets	258,176	242,283	222,790
Total Assets	1,182,980	1,162,902	998,186
LIABILITIES			
Current liabilities	119,686	114,689	89,091
Noncurrent liabilities	438,184	464,393	364,709
Total Liabilities	557,870	579,082	453,800
NET ASSETS			
Invested in capital assets, net of related debt	324,438	208,407	124,643
Nonexpendable other	118	116	115
Restricted expendable	13,086	15,218	25,801
Unrestricted	287,468	360,079	393,827
Total Net Assets	$ 625,110	$ 583,820	$ 544,386

Assets. As of June 30, 2011, the System's total assets amounted to approximately $1.18 billion. Capital assets, net of depreciation, of $772.2 million or 65.3 percent represented the System's largest asset. Long-term investments of $210.3 million or 17.8 percent of total assets were the System's second largest asset. Accounts receivable, primarily patient-related, of $95.1 million or 8.0 percent represents another significant asset of the System. Cash and cash equivalents totaled $31.1 million or 2.6 percent of total assets.

Total assets increased by $20.1 million during the year ended June 30, 2011. The increase was the result of several factors: capital assets, net, increased $104.6 million due to the continuing construction of the new patient care facility, long-term investments increased $24.6 million due to a posted gain of 18.7% in endowments. Accounts receivable, net, decreased $10.0 million while unrestricted and restricted cash and cash equivalents decreased $97.8 million due to the expenditure of cash on the new patient care facility.

Liabilities. At June 30, 2011, the System's liabilities totaled approximately $557.9 million. Long-term debt and long-term liabilities, which consists of general receipts project notes and note payable to the University of Kentucky, comprised the largest liability of $361.1 million or 64.7 percent of total liabilities. Capital lease obligations totaled $96.6 million or 17.3 percent of liabilities. Accrued expenses, primarily payroll, vacation and other employee benefits, totaled $48.4 million or 8.7 percent of liabilities. Accounts payable represented approximately $45.1 million or 8.1 percent of liabilities. Total liabilities decreased $21.2 million primarily due to decreases in capital leases, accounts payables and deferred revenue.

Net Assets. Net assets at June 30, 2011 totaled approximately $625.1 million, or 52.8 percent of total assets. Net assets invested in capital assets, net of related debt, totaled $324.4 million or 51.9 percent of total net assets. Restricted net assets totaled approximately $13.2 million or 2.1 percent of total net assets. Unrestricted net assets accounted for $287.5 million or 46.0 percent of total net assets. Total net assets increased $41.3 million or 7.1 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.

2010 Versus 2009 When comparing the fiscal year ended June 30, 2010 to the year ended June 30, 2009:

- Total assets increased by $164.7 million, primarily due to an increase in capital assets net of $179.0 million and a $19.5 million increase in other noncurrent assets, offset by a $33.8 million decrease in current assets, mainly due to the use of cash for the Patient Care Facility construction project.

- Total liabilities increased $125.3 million, primarily due to the increase of $96.2 million in long-term liabilities, $17.2 million in accounts payable and accrued expenses, and $10.9 million in capital lease obligations.

- Total net assets increased $39.4 million, primarily due to a net gain for the year related to the market impact on investment income.

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 fluctuated during the year ended June 30, 2011, with comparative information for the year ended June 30, 2010. 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)

	2011	2010	2009
OPERATING REVENUES			
Net patient service revenues	$ 776,388	$ 766,437	$ 686,604
Sales and services	21,065	19,431	18,308
Total operating revenues	797,453	785,868	704,912
OPERATING EXPENSES			
Salaries and wages	250,756	224,516	220,194
Fringe benefits	68,414	62,158	58,661
Supplies	182,702	178,577	172,710
Purchased services	132,770	155,291	142,909
Other expenses	94,939	90,220	75,678
Depreciation	35,500	31,694	28,027
Total operating expenses	765,081	742,456	698,179
OPERATING INCOME-continuing operations	32,372	43,412	6,733
NONOPERATING REVENUES (EXPENSES)			
State appropriations	1,053	1,053	1,053
Permanent additions to endowments	2	1	1
Gifts	6,854	3,505	8,238
Investment income (loss)	35,619	21,146	(42,393)
Interest expense	(11,215)	(5,534)	(3,666)
Loss on disposal of capital assets	(412)	(559)	(535)
Other	(588)	(273)	746
Total nonoperating income	31,313	19,339	(36,556)
Net income (loss) before other revenues, expenses, gains or losses	63,685	62,751	(29,823)
Transfer (to) the University of Kentucky-noncapital	(22,611)	(22,463)	(11,255)
Transfer (to) the University of Kentucky-capital	233	(840)	(6,652)
DISCONTINUED OPERATIONS			
Net loss from discontinued operations	(17)	(14)	(17)
Total increase (decrease) in net assets	41,290	39,434	(47,747)
Net assets, beginning of year	583,820	544,386	592,133
Net assets, end of year	$ 625,110	$ 583,820	$ 544,386

Operating Revenues:

Total operating revenues were approximately $797.5 million for the year ended June 30, 2011, an increase of $11.6 million or 1.5 percent over fiscal year 2010. The most significant source of operating revenue for the System was net patient service revenues of $776.4 million, an increase of $10.0 million or 1.3 percent in fiscal year 2011 over 2010.

The majority of the net patient service revenues increase was the result of increases in rates, the overall case mix and patient discharges. Patient service revenues are presented net of estimated allowances from contractual arrangements with Medicare, Medicaid and other third-party payers and have been estimated based on the terms of reimbursement and contracts currently in effect. A provision for doubtful accounts is also included.

The System has experienced an increased number of write-offs during fiscal year 2011 as a result of current economic conditions. Consequently, the provision for doubtful accounts increased $33.1 million or 61.0 percent during the period.

The following table shows net patient revenue by funding source for fiscal years ended June 30, 2011, 2010 and 2009 (in thousands):

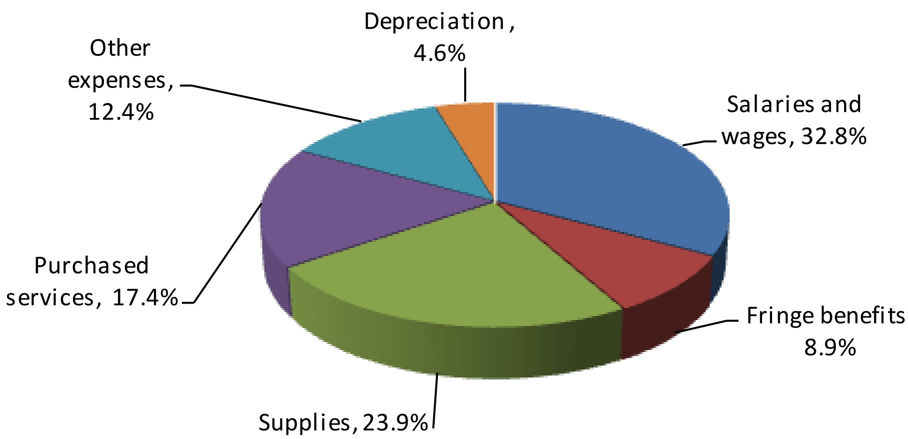
Payer	2011	2010	2009
Medicare	$ 215,078	$ 198,549	$ 199,207
Medicaid	204,991	192,892	162,711
Commercial/Blue Cross	362,792	352,078	325,585
Patient/charity	80,829	77,143	49,858
Bad debt	(87,302)	(54,225)	(50,757)
Total	$ 776,388	$ 766,437	$ 686,604

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 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 $35.5 million of depreciation were $765.1 million, an increase of $22.6 million or 3.0 percent over the prior year.

Salaries and employee benefit expenses increased by $32.5 million over the prior fiscal year due to additional staffing required for increased patient activity. The increase included a 10.2% increase in FTEs for Chandler and a 5.1% increase in FTEs for Samaritan as well as a 3.0% merit pool increase.

Supplies expenses increased by $4.1 million or 2.3 percent primarily due to increases in overall patient activity.

Purchased services and agreements with the College of Medicine decreased $22.5 million or 14.5 percent from fiscal year 2010. This was primarily due to the $14.6 million decrease in purchased services provided by the University of Kentucky College of Medicine and a $10.4 million decrease in University of Kentucky Health Maintenance Organization Regional Service Area costs due to the fact that the program is now managed and recorded at the University level.

Other expenses rose by $4.7 million or 5.2 percent in fiscal year 2011. There were increases in minor equipment purchased for the new patient care facility of $4.3 million, job order charges for maintenance $2.2 million, service contracts on equipment $1.6 million, computer and software maintenance contracts $1.4 million, and electricity and chilled water services $1.0 million. These increases were offset by a $7 million reduction in medical malpractice expense during the year.

Nonoperating Revenues (Expenses):

Total nonoperating revenues, net of expenses, were $31.3 million in fiscal year 2011 compared to net nonoperating revenues of $19.3 million during the prior fiscal year. This increase is primarily due to net investment income of $35.6 million in fiscal year 2011 compared to investment income of $21.1 million in the prior year. The endowment pool posted a total gain of 18.7% for fiscal 2011 versus a total gain of 13.1% in the prior year.

2010 Versus 2009 Total operating revenues were $785.9 million for the fiscal year ended June 30, 2010, an increase of $81.0 million over the year ended June 30, 2009. Essentially all of the increase in operating revenues was due to increased patient activity.

Operating expenses totaled $742.5 million, an increase of $44.3 million over 2009. The increase was primarily caused by higher costs for professional liability insurance, personnel, purchased services, maintenance and repairs, minor equipment, and medical supplies.

Nonoperating revenues, net of expenses, amounted to a $19.3 million net gain in fiscal year 2010 compared to $36.6 million net loss in the prior year. The increase was primarily due to a gain on investments of $21.1 million in 2010 compared to a loss of $42.4 million in 2009.

Statement of Cash Flows

The Statement of Cash Flows details how cash has increased or decreased during the year ended June 30, 2011, with comparative financial information for the year ended June 30, 2010. It classifies 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
- Possible need for external financing

Condensed Statements of Cash Flows (in thousands)

Cash provided/(used by) (in thousands):	**2011**	**2010**	**2009**
Operating activities	$ 73,928	$ 83,820	$ 37,722
Noncapital financing activities	(16,821)	(23,580)	(3,033)
Capital and related financing activities	(179,903)	(103,468)	(159,274)
Investing activities	25,009	(1,362)	16,414
Net increase in cash	(97,787)	(44,590)	(108,171)
Cash and cash equivalents, beginning of year	128,936	173,526	281,697
Cash and cash equivalents, end of year	$ 31,149	$ 128,936	$ 173,526

2011. The major source of cash included in operating activities was patient service revenues of $767.7 million. The largest cash payments for operating activities were $391.9 million to suppliers and $323.7 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, offset by gift income.

Capital and related financing activities included $14.3 million cash provided by bond proceeds and capital leases. Cash of $146.3 million was expended for construction and acquisition of capital assets and $50.8 million was expended for principal and interest payments on capital leases and long term debt.

Investing activities included proceeds from sales and maturities of investments of $228.5 million and interest and dividends of $4.7 million. Cash of $208.2 million was used to purchase investments.

2010 Versus 2009 Cash balances decreased when comparing fiscal year 2010 versus fiscal year 2009 with a net decrease in cash of approximately $44.6 million, primarily due to capital and related financing activities related to the construction of the patient care facility.

Key Ratios

The following table shows key liquidity and capital ratios for fiscal years 2011, 2010 and 2009:

	2011	**2010**	**2009**
Days cash on hand	16	66	89
Days of revenue in accounts receivable	45	50	51
Debt service coverage (times)	1.7	2.1	(0.8)

Days cash on hand decreased to 16 days in fiscal year 2011 from 66 days in fiscal year 2010 due to the decrease in cash balance of $97.8 million which resulted primarily from the use of cash reserves, in excess of debt proceeds, for the funding of the patient care facility. Days cash on hand measures the average number of days' expenses the System maintains in cash. The System's liquidity remains strong. Mitigating factors include access to working capital from the University and endowment investments of $210.3 million.

The days of revenue in accounts receivable measures the average number of days it takes to collect accounts receivable. In fiscal year 2011, days in accounts receivable decreased to 45 versus 50 days in 2010 due to higher cash collections at year end. 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.

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 2011 is 1.7 versus 2.1 in fiscal year 2010 due to lower capitalized interest.

Capital Asset and Debt Administration

Capital Assets

Capital assets, net of accumulated depreciation, totaled approximately $772.2 million at June 30, 2011, a net increase of $104.6 million over the prior year end. Significant changes in capital assets during fiscal 2010-2011 included (in millions):

• Land, buildings and structures, net additions	$ 484.8
• Equipment and vehicles, net additions	16.9
• Capitalized software additions	7.3
• Artwork	0.8
• Construction in process, net additions	(384.0)
• Increase in accumulated depreciation, net	(21.2)
Total	$ 104.6

Debt

At year-end, the System had $352.3 million in general receipts project notes outstanding and an 8.8 million loan from the University of Kentucky; $13.8 million is included in current liabilities with the remainder long term. In addition, the System had $96.6 million in capital leases.

Economic Factors Impacting Future Periods

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

- Net patient revenue for fiscal year 2012 is budgeted to increase approximately $78.6 million before bad debt. This is due to an increase in gross inpatient charges of 15 percent consisting of a nine percent increase in overall rate/price, two percent increase in utilization per case and a four percent increase in volume. Gross outpatient charges are budgeted to increase 12 percent in the coming year. This increase stems from an eight percent increase in overall rate/price, one percent increase in utilization per case and a three percent increase in volume.
- In May of 2011, 128 beds, including 48 intensive care beds and 80 acute care beds, were opened for use in the new patient care facility. In addition, the atrium lobby, a 305 seat auditorium, chapel, surgical waiting rooms, gift shop and coffee shop were opened.
- The construction of the new one-million square-foot UK Chandler Hospital is ongoing with eight additional operating rooms and one hybrid operating room expected to open this winter. The new facility 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. After completion, the new complex will have space for 512 private patient rooms for patients and families.
- In November 2010, UK HealthCare and Norton Healthcare officials signed a Memorandum of Agreement and joined forces to improve health care for all Kentuckians.
- Healthcare reform has initiated significant changes to the United States healthcare system, including potential material changes to the delivery of healthcare services and the reimbursement paid for such services by the government or other third-party payers. UK HealthCare Hospital System will develop and execute strategies in an effort to mitigate the negative impacts and to leverage opportunities.
- On July 7, 2011, Governor Steve Beshear announced that the state had enacted contracts with three new Managed Care Organizations (MCO's) to provide services to Medicaid recipients across the state, except for recipients receiving long-term care and waiver services. UK HealthCare is in the midst of negotiating provider contracts with the new MCO's.

UK HEALTHCARE HOSPITAL SYSTEM
AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY
STATEMENTS OF NET ASSETS (in thousands)
JUNE 30, 2011 AND 2010

	2011	2010
ASSETS		
Current Assets		
Cash and cash equivalents	$ 23,994	$ 126,353
Accounts receivable (less allowance for doubtful accounts of $23,779 and $21,797)	95,124	105,140
Inventories and other assets	17,840	18,050
Accrued interest receivable	23	183
Estimated third-party payer settlements receivable	12,310	87
Notes receivable	3,350	3,226
Total current assets	152,641	253,039
Noncurrent Assets		
Restricted cash and cash equivalents	7,155	2,583
Long-term investments	210,263	185,673
Capital assets, net	772,163	667,580
Notes receivable	16,661	17,308
Other assets	24,097	36,719
Total noncurrent assets	1,030,339	909,863
Total assets	1,182,980	1,162,902
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	81,196	81,770
Deferred revenue	6,670	6,323
Long-term debt - current portion	13,811	9,605
Capital lease obligations - current portion	18,009	16,991
Total current liabilities	119,686	114,689
Noncurrent Liabilities		
Accounts payable and accrued expenses	12,316	15,421
Deferred revenue	-	6,387
Long-term liabilities	347,278	352,295
Capital lease obligations	78,590	90,290
Total noncurrent liabilities	438,184	464,393
Total liabilities	557,870	579,082
NET ASSETS		
Invested in capital assets, net of related debt	324,438	208,407
Restricted		
Nonexpendable other	118	116
Expendable		
Debt service	2,336	2,721
Capital projects	6,505	8,700
Other	4,245	3,797
Total restricted expendable	13,086	15,218
Total restricted	13,204	15,334
Unrestricted	287,468	360,079
Total net assets	$ 625,110	$ 583,820

See notes to financial statements.

UK HEALTHCARE HOSPITAL SYSTEM
AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS (in thousands)
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

	2011	2010
OPERATING REVENUES		
Net patient service revenues, less provision for doubtful accounts of $ 87,302 and $ 54,225	$ 776,388	$ 766,437
Sales and services	21,065	19,431
Total operating revenues	797,453	785,868
OPERATING EXPENSES		
Salaries and wages	250,756	224,516
Fringe benefits	68,414	62,158
Supplies	182,702	178,577
Purchased services	132,770	155,291
Other expenses	94,939	90,220
Depreciation	35,500	31,694
Total operating expenses	765,081	742,456
Net income from continuing operations	32,372	43,412
NONOPERATING REVENUES (EXPENSES)		
State appropriations	1,053	1,053
Permanent additions to endowments	2	1
Gifts and non-exchange grants	6,854	3,505
Investment income (loss)	35,619	21,146
Interest expense	(11,215)	(5,534)
Loss on disposal of capital assets	(412)	(559)
Other	(588)	(273)
Net nonoperating revenues (expenses)	31,313	19,339
Net income before other revenues, expenses, gains or losses	63,685	62,751
Transfers (to) the University of Kentucky for noncapital purposes	(22,611)	(22,463)
Transfers (to) the University of Kentucky for capital purposes	233	(840)
Total other revenues (expenses)	(22,378)	(23,303)
Income (loss) from discontinued operations	(17)	(14)
INCREASE IN NET ASSETS	41,290	39,434
NET ASSETS, beginning of year	583,820	544,386
NET ASSETS, end of year	$ 625,110	$ 583,820

See notes to financial statements.

UK HEALTHCARE HOSPITAL SYSTEM
AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY
STATEMENTS OF CASH FLOWS (in thousands)
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Net patient service revenues	$ 767,595	$ 763,218
Sales and services	21,065	19,431
Payments to vendors and contractors	(391,855)	(421,189)
Salaries, wages and fringe benefits	(323,719)	(277,704)
Other receipts (payments)	842	64
Net cash provided by operating activities	73,928	83,820
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations	1,053	1,053
Gifts	6,781	3,962
Additions to permanent endowments	2	1
Payments on loans to University of Kentucky departmental units	1,048	1,866
Loans to University of Kentucky departmental units	(3,094)	(8,000)
Transfers (to) the University of Kentucky for noncapital purposes	(22,611)	(22,462)
Net cash (used) by noncapital financing activities	(16,821)	(23,580)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from sale of capital assets	1,192	981
Purchases of capital assets	(146,310)	(193,591)
Principal payments-capital leases and long-term obligations	(29,392)	(18,531)
Interest payments-capital leases and long-term obligations	(21,455)	(15,772)
Proceeds from capital leases	5,500	25,000
Proceeds from capital debt	8,794	100,605
Payments to bond agents - cost of issuance	-	(1,178)
Transfers from (to) the University of Kentucky for capital purposes	1,768	(982)
Net cash (used) by capital and related financing activities	(179,903)	(103,468)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	228,506	275,948
Purchase of investments	(208,195)	(282,159)
Interest and dividends on investments	4,698	4,849
Net cash provided (used) by investing activities	25,009	(1,362)
NET (DECREASE) IN CASH AND CASH EQUIVALENTS	(97,787)	(44,590)
CASH AND CASH EQUIVALENTS, beginning of year	128,936	173,526
CASH AND CASH EQUIVALENTS, end of year	$ 31,149	$ 128,936
Reconciliation of net income from continuing operations to net cash provided by operating activities:		
Net income from continuing operations	32,372	$ 43,412
Income (loss) from discontinued operations	(17)	(14)
Adjustments to reconcile net income from continuing operations to net cash provided (used) by operating activities:		
Depreciation	35,500	31,694
Write off of principal note/lease receivable	474	1,384
Provision for doubtful accounts	(87,302)	(54,225)
Change in assets and liabilities:		
Accounts receivable	97,374	44,980
Inventories and other	210	2,368
Estimated third-party payer settlements receivable	(12,223)	4,919
Other assets	(382)	(1,018)
Accounts payable and accrued expenses	12,740	9,283
Deferred revenue	(4,818)	1,037
Net cash provided by operating activities	$ 73,928	$ 83,820
NON CASH TRANSACTIONS:		
Transfer of capital assets to (from) UK	$ (1,535)	$ 142
Capital lease additions	$ 3,605	$ -
Capital asset additions in accounts payable	$ 10,470	$ 26,403
Capitalized interest, net of investment income	$ 10,146	$ 12,975
Amortized bond premium and cost of issues	$ 318	$ 77

See notes to financial statements.

UK HEALTHCARE HOSPITAL SYSTEM
AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY
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 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 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 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 long-term 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 average cost or market.

Long-Term Investments. The System's endowment investments are administered as part of the University's pooled endowment funds. All contributing endowments participate in the income and appreciation of the pool on a per unit basis commensurate with their contribution to the pool. New endowments purchase units in the pool at the current value, which is calculated each month based on the fair value of the pool investments divided by the number of pool units outstanding. 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.

In accordance with the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), as adopted by the Commonwealth of Kentucky in July 2010, the University employs a total return method for establishing investment objectives and spending policies designed to achieve financial equilibrium for endowment funds over the long-term. Prior to the passage of UPMIFA, the University was subject to the Uniform Management of Institutional Funds Act ("UMIFA"), as adopted by the Commonwealth of Kentucky, which also allowed for total return management.

The University utilizes a spending policy designed to smooth spending distributions and protect endowed programs from market volatility by calculating distributions based on a percentage of the average market value of the endowment over a specified period of time. The University has made expenditure decisions in accordance with prevailing UPMIFA or UMIFA statutes and donor gift agreements. UPMIFA allows institutions to appropriate for expenditure the amount of an endowment fund the institution deems is prudent based on a review of various factors set forth in the Act, subject to terms set forth in a gift agreement. UMIFA allowed institutions to appropriate for expenditure a prudent amount of realized and unrealized gains over the historic dollar value of an endowment fund, also subject to terms set forth in a gift agreement.

For the year ended June 30, 2011 the University's endowment spending rule provided for annual distributions of 4.375 percent of the sixty month moving average market value of fund units. For the year ended June 30, 2010, the University's endowment spending rule provided for annual distributions of 4.5 percent of the thirty-six month moving average market value of fund units. Approximately $5.3 million and $5.4 million respectively, was transferred from endowment realized and unrealized gains to support current programs in accordance with the University's endowment spending rule. Additionally, for the year ended June 30, 2011, the University assessed eligible endowment accounts with a management fee of 0.375 percent of total asset value. For the year ended June 30, 2010, the University assessed eligible endowment accounts with a management fee of 0.5 percent of total asset value.

The Investment Committee of the University's Board of Trustees has approved a spending rate distribution of 4.25 percent of a sixty month moving average market value of fund units for the year ended June 30, 2012. Additionally, the Investment Committee has approved a management fee of 0.25 percent for the year ended June 30, 2012.

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. Institutional software costing more than $400,000 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, 5 – 20 years for equipment and vehicles, and 10 years for capitalized software.

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, 2011 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 financial statements. 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 payers and others for services rendered, including contractual allowances and estimated retroactive adjustments under reimbursement programs with third-party payers 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.

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.

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 25 percent and 24 percent, respectively, of the System's net patient service revenues before the provision for doubtful accounts for the year ended June 30, 2011 and approximately 24 percent and 24 percent, respectively for the year ended June 30, 2010. 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 organizations 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 of 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 payer 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, 2011. 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, 2011 and 2010 follows (in thousands):

	2011	2010
Cash on deposit with the University of Kentucky	$ 31,149	$ 128,936
United States government securities	-	10,142
Investment in University of Kentucky pooled endowment funds	210,263	175,531
	$ 241,412	$ 314,609
Statement of Net Assets classification:		
Cash and cash equivalents	$ 23,994	$ 126,353
Restricted cash and cash equivalents	7,155	2,583
Long-term investments	210,263	185,673
	$ 241,412	$ 314,609

At June 30, 2011, the University's pooled endowment fund consists of pooled equity funds (37.0%), private equity funds (4.7%), pooled real estate funds (5.5%), government agency fixed income funds (1.8%), corporate fixed income funds (2.2%), pooled fixed income funds (13.1%), pooled absolute return funds (19.1%), pooled real return funds (10.4%), common and preferred stock (5.3%), U.S. treasury fixed income funds (0.8%), and cash equivalents (0.1%). At June 30, 2010, the University's pooled endowment fund consists of pooled equity funds (48.2%), private equity funds (3.6%), pooled real estate funds (6.9%), government agency fixed income funds (2.0%), corporate fixed income funds (4.4%), pooled fixed income funds (12.1%), pooled absolute return funds (10.0%), pooled real return funds (7.1%), U.S. treasury fixed income funds (4.4%), and cash equivalents (1.3%).

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 Vice President for Financial Operations and 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 three significant categories, as follows:

- Cash on deposit with the University of Kentucky, which the University invests in deposits and repurchase agreements with 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 and,
- Endowment investments in the University's pooled endowment fund.

Cash on deposit with the University is 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. 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.

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 (the Commonwealth) is governed by policy that minimizes credit risk in several ways. Deposits are governed by state law, which requires full collateralization for balances exceeding amounts covered by the Federal Deposit Insurance Corporation. On November 9, 2010, the FDIC Board of Directors issued a final rule to implement Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act that provides temporary unlimited deposit insurance coverage for noninterest-bearing transaction accounts at all FDIC-insured depository institutions (the "Dodd-Frank Provision"). The separate coverage for noninterest-bearing transaction accounts became effective on December 31, 2010 and terminates on December 31, 2012. The System's deposits are non-interest bearing and are fully insured by FDIC coverage. Credit risk on repurchase agreements 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 managers are permitted to use derivative instruments to limit credit risk. Additionally, 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, 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 deposited or invested in one issuer. However, all such deposits 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, other than the requirement that the amount of money invested at any one time in commercial paper, bankers' acceptances and municipal obligations shall not exceed 20 percent.
- Endowment investment managers are limited to a maximum investment in any one issuer of no more than five (5) percent of total investments.

At June 30, 2011 and 2010, the System has no investments in any one issuer that represent five (5) percent or more of total investments other than U.S. treasury and agency obligations.

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.
- Endowment managers are permitted to use derivative instruments to limit interest rate risk. Additionally, endowment investments held by fixed income managers are limited to a duration that is within +/-25% of the duration of the Barclay's Aggregate Bond Index.

Foreign Currency Risk. Foreign currency risk is the risk that fluctuations 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 endowment investments of the University's pooled endowment fund. The University's investment policy allows fixed income managers to invest a portion of their portfolios in non-U.S. securities. Additionally, the investment policy allows various pooled fund managers to invest in accordance with the guidelines established in each individual fund's prospectus, which allows for investment in non-U.S. securities. The University's investments in the various pooled funds are denominated in U.S. dollars, with the exception of two private equity funds denominated in Euros. Endowment managers are permitted to use derivative instruments to limit foreign currency risk.

3. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net, as of June 30, 2011 and 2010 are as follows (in thousands):

	2011	2010
Medicare, Medicaid and other third parties	$ 86,527	$ 99,129
Private pay	6,312	4,869
Pledges receivable	2,229	1,142
Total accounts receivable, net	$ 95,068	$ 105,140

Operating pledges totaling approximately $1.2 million are expected to be collected over the next ten years. In addition, capital pledges totaling approximately $7.3 million are expected to be collected over the next six years. 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. For the years ended June 30, 2011 and 2010, the University recorded the discounted value of operating and capital pledges using a rate of four percent. Accordingly, at June 30, 2011, and 2010, respectively, the System recorded the discounted value of operating and capital pledges receivable of approximately $5.8 million and $4.6 million, including $3.6 million and $3.5 million in noncurrent – other assets.

4. CAPITAL ASSETS, NET

Capital assets as of June 30, 2011 and capital asset activity for the year ended June 30, 2011 are summarized as follows (in thousands):

	Beginning Balance	Additions	Deletions	Ending Balance
Land	$ 23,130	$ 367		$ 23,497
Non-depreciable land improvements	4,357	11,250		15,607
Depreciable land improvements	3,943	4,616		8,559
Buildings	245,488	449,208		694,696
Fixed equipment	10,635	4,803		15,438
Infrastructure	13,344	14,521		27,865
Equipment	181,175	33,755	$ 16,922	198,008
Vehicles	755	19	-	774
Capitalized software	32,731	7,338	-	40,069
Artwork	597	788	-	1,385
Construction in process	397,337	12,903	396,874	13,366
	913,492	539,568	413,796	1,039,264
Accumulated Depreciation:				
Depreciable land improvements	3,451	98	-	3,549
Buildings	108,486	10,366	-	118,852
Fixed equipment	5,411	861	-	6,272
Infrastructure	1,933	(345)	-	1,588
Equipment	111,724	21,399	13,368	119,755
Vehicles	648	103	-	751
Capitalized software	14,259	2,075	-	16,334
	245,912	34,557	13,368	267,101
Capital assets, net	$ 667,580	$ 505,011	$ 400,428	$ 772,163

Capital assets as of June 30, 2010 and capital asset activity for the year ended June 30, 2010 are summarized as follows (in thousands):

	Beginning Balance	Additions	Deletions	Ending Balance
Land	$ 22,318	$ 812		$ 23,130
Non-depreciable land improvements	4,308	49		4,357
Depreciable land improvements	3,836	107		3,943
Buildings	241,440	4,048		245,488
Fixed equipment	9,557	1,078		10,635
Infrastructure	13,343	1		13,344
Equipment	176,279	16,284	$ 11,388	181,175
Vehicles	754	1	-	755
Capitalized software	25,780	6,951	-	32,731
Artwork	256	341	-	597
Construction in process	215,373	184,316	2,352	397,337
	713,244	213,988	13,740	913,492
<u>Accumulated Depreciation:</u>				
Depreciable land improvements	3,267	196	12	3,451
Buildings	101,471	7,015	-	108,486
Fixed equipment	4,544	867	-	5,411
Infrastructure	653	1,280	-	1,933
Equipment	101,546	20,048	9,870	111,724
Vehicles	514	134	-	648
Capitalized software	12,653	1,606	-	14,259
	224,648	31,146	9,882	245,912
Capital assets, net	$ 488,596	$ 182,842	$ 3,858	$ 667,580

At June 30, 2011 the System has construction projects in progress totaling approximately $40.9 million in scope. The estimated cost to complete these projects is approximately $25.7 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 $10.1 million for 2011 and $13.0 million for 2010.

During 2011 and 2010, the System utilized capital leases to acquire various items of equipment. The net book value for capitalized leased land, buildings and equipment is $56.0 million and $57.7 million at June 30, 2011 and 2010, respectively.

5. NOTES RECEIVABLE

Notes receivable at June 30, 2011 and 2010 are as follows (in thousands):

	2011	2010
Non-interesting bearing, unsecured receivable from UK Parking and Transportation, payable $250,000 annually through 2013	$ 1,000	$ 1,250
Non-interesting bearing, unsecured receivable from UK Office of Associate Vice President-Research, payable $500,000 annually, 2003 through 2010	-	213
Non-interesting bearing, unsecured receivable from UK College of Pharmacy	6,723	6,795
Non-interesting bearing, unsecured receivable from UK College of Pharmacy	7,500	8,000
Non-interest bearing, unsecured receivable from UK College of Pharmacy	2,817	2,817
Notes receivable	1,971	1,459
Total	$ 20,011	$ 20,534
Current portion	$ 3,350	$ 3,226
Noncurrent portion	16,661	17,308
Total	$ 20,011	$ 20,534

6. OTHER ASSETS

Other assets at June 30, 2011 and 2010 are as follows (in thousands):

	2011	2010
Unamortized bond cost of issuance - noncurrent portion	$ 2,123	$ 2,253
Amounts on deposit with trustee, primarily invested in U.S. government agencies	2,643	17,686
Investment in Coldstream Laboratories Inc., through a loan to University of Kentucky Research Foundation	3,788	692
Noncurrent portion of prepaid expenses	351	968
Pledges receivable noncurrent	3,583	3,511
Good Samaritan Certificate of Need licensed beds	11,609	11,609
Total	$ 24,097	$ 36,719

7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities as of June 30, 2011 and 2010 are summarized as follows (in thousands):

	2011	2010
Payable to vendors and contractors	$ 45,094	$ 50,657
Due to the University of Kentucky	2,813	-
Accrued expenses, including vacation leave	33,289	31,113
Total	$ 81,196	$ 81,770

8. LONG-TERM DEBT

Long-term debt as of June 30, 2011 and 2010 are summarized as follows (in thousands):

	2011					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
General Receipts Project Notes	$ 361,900	$ -	$ 9,605	$ 352,295	$ 9,995	$ 342,300
Due to the University of Kentucky	-	8,794	-	8,794	3,816	4,978
	$ 361,900	$ 8,794	$ 9,605	$ 361,089	$ 13,811	$ 347,278

	2010					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
General Receipts Project Notes	$ 265,690	$ 100,605	$ 4,395	$ 361,900	$ 9,605	$ 352,295
	$ 265,690	$ 100,605	$ 4,395	$ 361,900	$ 9,605	$ 352,295

Principal maturities and interest on notes and amounts due to the University for the next five years and in subsequent five-year periods as of June 30, 2011 are as follows (in thousands):

	Principal	Interest	Total
2012	$ 13,811	$ 17,649	$ 31,460
2013	15,393	17,175	32,568
2014	10,875	16,205	27,080
2015	11,390	15,692	27,082
2016	11,945	15,136	27,081
2017-2021	81,150	65,596	146,746
2022-2026	104,815	43,510	148,325
2027-2031	62,415	19,097	81,512
2032-2036	25,345	10,544	35,889
2037-2040	23,950	2,794	26,744
Total	$ 361,089	$ 223,398	$ 584,487

Bond discounts and premiums, which are included in current and noncurrent accrued liabilities, 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 $366.3 million dated October 27, 2005 through November 24, 2009, which bear interest at 3.593% to 4.657%. The bonds are payable in annual installments through November 1, 2039. 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. On November 24, 2009, $100,605,000 of the University of Kentucky General Receipts Bonds Series 2009 B were issued at a net interest cost of 3.59%. These bonds were issued as Build America Bonds as authorized under the American Recovery and Reinvestment Act of 2009. The System will receive a cash subsidy from the U.S.treasury equal to 35% of the interest payable on the bonds. This subsidy is included in gifts and non-exchange grants in the statements of revenues, expenses and changes in net assets.

On July 30, 2010, the System entered into an unsecured internal loan agreement with the University to acquire funding for construction of a suite of operating rooms in the newly constructed patient care facility. Funds will be transferred to the construction project as needed and will be repaid over a ten year period. Interest shall be charged based on the historical performance of the two-year U.S. treasury note plus 100 basis points (1.0%). The annual interest rate will be determined March 1 and be effective for the following fiscal year.

9. CAPITAL LEASE OBLIGATIONS

Capital lease obligations as of June 30, 2011 and 2010 are summarized as follows (in thousands):

	2011					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Leases	$ 107,281	$ 9,105	$ 19,787	$ 96,599	$ 18,009	$ 78,590

	2010					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Leases	$ 96,417	$ 25,000	$ 14,136	$ 107,281	$ 16,991	$ 90,290

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

Years ending June 30	
2012	$ 21,449
2013	20,648
2014	17,222
2015	12,162
2016	7,047
2017 and later years	37,333
Total	115,861
Less amount representing interest	(19,262)
Present value of net minimum lease payments	$ 96,599

Capital lease obligations are at varying rates of imputed interest of 1.06% to 4.96%.

10. OTHER NONCURRENT LIABILITIES

Other long-term liabilities as of June 30, 2011 and 2010 are summarized as follows (in thousands):

	2011			
	Beginning Balance	Additions	Reductions	Ending Balance
Refundable deposits	$ 5,691	$ 82	$ 80	$ 5,693
Noncurrent unamortized bond premium	7,071	-	448	6,623
Payable to vendors and contractors	2,659	-	2,659	-
Accounts payable and accrued expenses	$ 15,421	$ 82	$ 3,187	$ 12,316

	Beginning Balance	Additions	Reductions	Ending Balance
Deferred revenue	$ 6,387	$ 45	$ 6,432	$ -

	2010			
	Beginning Balance	Additions	Reductions	Ending Balance
Refundable deposits	$ 5,618	$ 218	$ 145	$ 5,691
Noncurrent unamortized bond premium	7,519	-	448	7,071
Payable to vendors and contractors	-	2,659	-	2,659
Accounts payable and accrued expenses	$ 13,137	$ 2,877	$ 593	$ 15,421

	Beginning Balance	Additions	Reductions	Ending Balance
Deferred revenue	$ 6,306	$ 245	$ 164	$ 6,387

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, 2011 and 2010 are as follows (in thousands):

	2011	2010
Working capital requirements	$ 77,404	$ 171,370
Future capital expenditures	210,064	188,709
Total	$ 287,468	$ 360,079

12. INVESTMENT INCOME

Components of investment income (loss) for the years ended June 30, 2011 and 2010 are as follows (in thousands):

	2011	2010
Interest and dividends earned on endowment investments	$ 3,513	$ 4,142
Realized and unrealized gains and (losses) on endowment investments	29,875	16,319
Interest and dividends on cash and non-endowment investments	116	685
Realized and unrealized gains and (losses) on non-endowment investments	2,115	-
Total	$ 35,619	$ 21,146

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):

	2011	2010
Revenue from the Commonwealth of Kentucky	$ 26,925	$ 27,388
2.5% tax paid by System on patient cash receipts	(12,082)	(11,755)
Matching contribution paid by the System	(7,358)	(7,610)
Net amount received, included in net patient service revenues	$ 7,485	$ 8,023

The amount of charges forgone for services and supplies furnished under the System's charity care policy aggregated to approximately $151.7 million and $127.0 million in 2011 and 2010, 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 percent and each employee contributes 5 percent of eligible compensation. All payments are vested immediately for employees hired prior to January 1, 2010. For employees hired after January 1, 2010, employer contributions are vested after five years.

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

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

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

The total contributions charged to operations for the various retirement plans were approximately $18.7 million and $17.0 million for the years ended June 30, 2011 and 2010, respectively. Employees contributed $9.4 million and $8.5 million during 2011 and 2010, respectively. The payroll for employees covered by the retirement plans was $187.2 million and $170.1 million for 2011 and 2010, 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 percent 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 percent 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, 2011.

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 2010 to 2011. 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, 2011, 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, 2011. All assets and liabilities related to medical malpractice are recorded in the financial records of the University and, accordingly, no assets or liabilities related to medical malpractice are recorded on the System's financial statements. However, the System does fund its required share of the actuarially determined medical malpractice expense.

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, 2011.

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, 2011.

18. TRANSACTIONS WITH RELATED PARTIES

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 2011 and 2010, the System paid approximately $13.8 million and $10.1 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 2011 and 2010, the System received payments of approximately $21.2 million and $32.5 million respectively, from the University. For the fiscal year 2011, the System recorded other non-operating expenses of $446,000 related to certain expenses related to Coldstream Laboratories, Inc. (CLI), a for-profit subsidiary of the University of Kentucky Research Foundation, a component unit of the University.

19. CURRENT ECONOMIC CONDITIONS

On March 23, 2010, President Obama signed into law the healthcare reform bill, the Patient Protection and Affordable Care Act (PPACA). This legislation plus the Health Care and Education Reconciliation Act of 2010, makes sweeping changes to the US health care system. The actual implementation of these Acts will happen over many years but we will begin to see the impact of the potential changes in the near future. The majority of the measures are designed to change the care delivery system but it also includes changes to insurance markets and pricing transparency.

As employers make adjustments to health insurance plans in response to PPACA, we may experience an adverse impact on the System's future operating results. PPACA may influence some employers to drop or reduce employee benefits thereby increasing patient co-pays and deductibles, which in turn would influence the System's collection efforts. The System may also experience a change in payer mix if employers begin to drop coverage and more patients are covered by Medicaid plans.

Given the volatility of current economic conditions, the values of assets and liabilities recorded in the financial statements could change rapidly, resulting in material future adjustments in investment values, and allowances for accounts and contributions receivable and the valuation of intangibles that could negatively impact the System's ability to meet debt covenants or maintain sufficient liquidity. Due to the volatility of capital markets subsequent to year end, changes in investment values have been significant and may continue to affect investment amounts in the statements of net assets in the near term.

20. RECLASSIFICATIONS

Certain reclassifications have been made to the 2011 financial statements to conform to the 2010 financial statements presentation. These reclassifications had no effect on change in net assets.

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