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UNIVERSITY OF  
**KENTUCKY**<sup>®</sup>  
 2013 Financial Statements  
*UK Healthcare  
 Hospital System*

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**UK HealthCare Hospital System**  
**An Organizational Unit of the University of Kentucky**  
**Financial Statements**  
**Years Ended June 30, 2013 and 2012**

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## Independent Auditor's Report

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

We have audited the accompanying financial statement of the UK HealthCare Hospital System (System), an organizational unit of the University of Kentucky (University), a component unit of the Commonwealth of Kentucky, which comprise the statements of net position as of June 30, 2013 and 2012, and the related statements of revenues, expenses and changes in net position and cash flows for the years then ended, and the related notes to the financial statements.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the System's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## **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, 2013 and 2012, and the changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

## **Required Supplementary Information**

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis listed in the table of contents be presented to supplement the basic financial statements. Such information, although not part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

*BKD, LLP*

Louisville, Kentucky  
October 1, 2013

# 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, 2013 and 2012. 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 System operates three hospital units under one Joint Commission Accreditation and two licenses in addition to multiple ambulatory services. The major service units include Albert B. Chandler Hospital, Kentucky Children's Hospital, Good Samaritan Hospital, Markey Cancer Center, Gill Heart Institute and the Kentucky Clinic. The System has a combined total of 825 licensed beds. The System leases 44 beds to Select Specialty Hospitals for use as a long-term acute care hospital, and operates 718 beds at an average daily census of 577 patients. On a monthly basis, the System provides over: 1,147 inpatient surgeries, 1,240 outpatient surgeries, 27,915 radiology procedures, 7,396 emergency department visits and 30,685 hospital based outpatient clinic visits.

UK HealthCare, including the System, has grown dramatically in recent years to meet the health needs of the Commonwealth of Kentucky and has been recognized numerous times for top quality medical care by organizations such as US News and World Report, Pathway to Excellence and Best Doctors in America. A comprehensive listing of quality awards, recognitions, certifications, accreditations and other notable achievements can be found at <http://ukhealthcare.uky.edu/quality/awards/>.

In July 2013, UK HealthCare was designated as a National Cancer Institute (NCI) Cancer Center, a significant achievement for both the medical center and the state of Kentucky, strengthening our reputation as a frontrunner in cancer treatment and research. As the only designated program in the state and one of only 68 programs nationwide, NCI designated centers offer advanced treatment options, broader access to groundbreaking clinical trials and realize significantly improved survival rates over non-designated peers. With the NCI designation, UK HealthCare also joined an elite group of only 22 medical centers in the United States with a federally funded Center on Aging, Clinical and Translational Science Awards grant (CTSA) and NCI programs.

UK Healthcare and the Kentucky Cabinet for Health and Family Services (CHFS) recently entered into a contract under which the System will operate and manage Eastern State Hospital when it opens to patients in September 2013. The new \$129 million, 300,000 square-foot facility will be located on the University of Kentucky's Coldstream Research Campus, providing a modern setting for both acute and long-term inpatient psychiatric treatment for adults living within Fayette County and the 50 surrounding counties.

## Financial Highlights

The System's overall financial position remains strong with assets of \$1.26 billion and liabilities of \$560.0 million. Net position, which represents the System's residual interest in assets after liabilities are deducted, was \$702.0 million or 55.6% of total assets. For the fiscal year ended June 30, 2013, the System reported net income before other changes in net position of \$79.5 million, generating a margin of 8.4%.

- Financial results for fiscal year 2013 exceeded prior year revenues with net inpatient revenues, including the provision for doubtful accounts, increasing approximately \$21.2 million or 3.6% over the prior fiscal year and net outpatient revenues, including the provision for doubtful accounts, increasing \$16.9 million or 5.6% 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, improvements in payer mix and increased patient activity.

- Total assets increased \$16.3 million or 1.3%. This increase is primarily due to increases in cash and cash equivalents of \$37.8 million, long-term investments of \$24.8 million, accounts receivable, \$3.1 million, inventories of \$1.5 million and notes receivable of \$683 thousand. This was offset by decreases in estimated third-party receivables of \$30.1 million, capital assets, net, of \$19.0 million and other assets of \$2.5 million.
- Total liabilities decreased \$47.5 million or 7.8%, as a result of decreases of \$54.4 million in accounts payable and accrued expenses, and \$7.1 million in long-term liabilities due to \$10.4 million in payments on outstanding debt offset by a \$3.3 million net increase in the amount due to the University of Kentucky. These decreases were offset by increases in capital lease obligations of \$5.3 million and \$345 thousand in unearned revenue.
- Total net position increased \$63.8 million or 10.0%, primarily due to the current year net income.
- Operating revenues increased \$38.6 million or 4.2%.
- Operating expenses increased \$15.8 million or 1.8% due primarily to increases in supplies, personnel costs and depreciation offset by a decrease in other expenses.
- The net nonoperating revenues increase of \$26.0 million resulted from a \$26.2 million increase in investment income, a \$1.9 million increase in gifts, and a \$112 thousand decrease in interest expense offset by a \$2.2 million decrease in gain on disposal of capital assets.

### Operating Statistics

The following table presents utilization statistics for the System for fiscal years ended 2013, 2012 and 2011:

	2013	2012	2011
Discharges:			
Medicare	11,322	10,857	10,065
Medicaid	9,911	9,670	9,277
Commercial/Blue Cross	10,278	9,718	9,453
Patient/Charity	4,000	4,208	3,762
Total discharges	<u>35,511</u>	<u>34,453</u>	<u>32,557</u>
Average daily census	577	560	530
Average length of stay	5.93	5.95	5.94
Outpatient visits:			
Hospital clinics	368,223	359,011	339,839
Emergency visits	88,752	89,662	77,315
Total visits	<u>456,975</u>	<u>448,673</u>	<u>417,154</u>

**2013.** Total discharges increased by 1,058 or 3.1% compared to the prior fiscal year. The increase occurred primarily due to an increase in Commercial/Blue Cross discharges of 560. Medicare also increased 465 as well as Medicaid 241. Patient/Charity decreased 208.

Overall the Diagnosis-Related Group (DRG) case mix index increased to 1.8363 from 1.7822 and the average length of stay decreased by 0.02 days to 5.93 days. The case mix for Chandler was at 2.0000 while Good Samaritan was at 1.2732.

Total outpatient visits increased by 8,302 or 1.9% 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 Position, a Statement of Revenues, Expenses and Changes in Net Position, 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 System is an organizational unit of the University of Kentucky (the University), which is a component unit of the Commonwealth of Kentucky (the Commonwealth) and is included in the basic financial statements of the Commonwealth. The financial statements of the System include Kentucky Healthcare Enterprise, Inc. (KHE), a wholly owned for-profit subsidiary. The System provides inpatient, outpatient and emergency care services for residents of the Commonwealth of Kentucky.

### Statement of Net Position

The Statement of Net Position is the System’s balance sheet. It reflects the total assets, deferred outflows of resources, liabilities, deferred inflows of resources and net position (equity) of the System as of June 30, 2013, with comparative information as of June 30, 2012. 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 Position, the difference between total assets, deferred outflows of resources, total liabilities, and deferred inflows of resources, is an important indicator of the System’s current financial condition, while the change in net position is an indicator of whether the overall financial position has improved or worsened during the year. Generally, assets, deferred outflows of resources, liabilities, and deferred inflows of resources 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, deferred outflows of resources, liabilities, deferred inflows of resources, and net position at June 30, 2013, 2012 and 2011 follows:

#### **Condensed Statements of Net Position (in thousands)**

	2013	2012	2011
<b>ASSETS</b>			
Current assets	\$ 197,525	\$ 184,845	\$ 152,641
Capital asset, net	793,329	812,369	772,163
Other noncurrent assets	271,134	248,492	254,388
Total Assets	1,261,988	1,245,706	1,179,192
<b>LIABILITIES</b>			
Current liabilities	131,052	173,094	119,686
Noncurrent liabilities	428,948	434,388	434,396
Total Liabilities	560,000	607,482	554,082
<b>NET POSITION</b>			
Net investment in capital assets	363,729	377,552	324,438
Nonexpendable other	117	118	118
Restricted expendable	14,965	14,529	13,086
Unrestricted	323,177	246,025	287,468
Total Net Position	\$ 701,988	\$ 638,224	\$ 625,110

**Assets.** As of June 30, 2013, the System's total assets amounted to approximately \$1.26 billion. Capital assets, net of depreciation, of \$793.3 million or 62.9% represented the System's largest asset. Long-term investments of \$232.9 million or 18.5% of total assets were the System's second largest asset. Accounts receivable, primarily patient-related, of \$119.9 million or 9.5% represents another significant asset of the System. Cash and cash equivalents totaled \$55.1 million or 4.4% of total assets.

Total assets increased by \$16.3 million during the year ended June 30, 2013. The increase was the result of several factors: unrestricted and restricted cash increased \$37.8 million from reduced spending on capital and related financing activities, long-term investments increased \$24.8 million due to the endowment posting a gain of 11.5%, accounts receivable, net, increased \$3.1 million, and inventories increased \$1.5 million. These increases were offset by decreases in estimated third-party payer settlements receivable of \$30.1 million, in capital assets, net, of \$19.0 million, and in other assets of \$2.5 million.

**Liabilities.** At June 30, 2013, the System's liabilities totaled approximately \$560.0 million. Long-term debt and long-term liabilities, which consists of general receipts project notes and note payable to the University, comprised the largest liability of \$364.2 million or 65.0% of total liabilities. Capital lease obligations totaled \$93.5 million or 16.7% of liabilities. Current accounts payable and accrued expenses represented approximately \$80.8 million or 14.4% of liabilities. Noncurrent accounts payable and accrued expenses, primarily unamortized bond premium, totaled \$6.2 million or 1.1% of liabilities. Total liabilities decreased \$47.5 million primarily due to paying off the noncapital loan to the University of \$47.9 million.

**Net Position.** Net position at June 30, 2013 totaled approximately \$702.0 million, or 55.6% of total assets. Net investment in capital assets totaled \$363.7 million or 51.8% of total net position. Restricted net position totaled approximately \$15.1 million or 2.1% of total net position. Unrestricted net position accounted for \$323.2 million or 46.0% of total net position. Total net position increased \$63.8 million or 10.0%.

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

**2012 Versus 2011** When comparing the fiscal year ended June 30, 2012 to the year ended June 30, 2011:

- Total assets increased by \$66.5 million, primarily due to an increase in capital assets net of \$40.2 million, a \$21.7 million increase in accounts receivable, and a \$17.8 million increase in estimated third-party payer settlements receivable offset by a \$13.8 million decrease in cash and a \$5.9 million decrease in other assets.
- Total liabilities increased \$53.4 million, primarily due to an increase of \$47.9 million in accounts payable and accrued expenses, \$13.9 million in long-term liabilities, offset by a \$8.4 million decrease in capital lease obligations.
- Total net position increased \$13.1 million, primarily due to a net gain for the year related to net income from continuing operations.

### **Statement of Revenues, Expenses and Changes in Net Position**

The Statement of Revenues, Expenses and Changes in Net Position is the System's income statement. It details how net position has fluctuated during the year ended June 30, 2013, with comparative information for the year ended June 30, 2012. 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 position must appear on the Statement of Revenues, Expenses and Changes in Net Position 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 Position**  
**(in thousands)**

	<u>2013</u>	<u>2012</u>	<u>2011</u>
<b>OPERATING REVENUES</b>			
Net patient service revenues	\$ 926,811	\$ 888,714	\$ 776,388
Sales and services	24,639	24,112	21,065
Total operating revenues	<u>951,450</u>	<u>912,826</u>	<u>797,453</u>
<b>OPERATING EXPENSES</b>			
Salaries and wages	279,001	274,979	250,756
Fringe benefits	79,803	77,973	68,414
Supplies	210,363	200,800	182,702
Purchased services	166,597	164,720	132,770
Other expenses	99,183	106,323	94,939
Depreciation	51,261	45,643	35,500
Total operating expenses	<u>886,208</u>	<u>870,438</u>	<u>765,081</u>
<b>OPERATING INCOME-continuing operations</b>	<u>65,242</u>	<u>42,388</u>	<u>32,372</u>
<b>NONOPERATING REVENUES (EXPENSES)</b>			
State appropriations	1,053	1,053	1,053
Permanent additions to endowments	1	1	2
Gifts and non-exchange grants	6,652	4,796	6,854
Investment income (loss)	25,839	(336)	35,619
Interest expense	(19,779)	(19,891)	(11,215)
Gain (loss) on disposal of capital assets	-	2,161	(412)
Other	454	448	(588)
Total nonoperating income (expenses)	<u>14,220</u>	<u>(11,768)</u>	<u>31,313</u>
Net income (loss) before other revenues, expenses, gains or losses	79,462	30,620	63,685
Transfer (to) from the University of Kentucky-noncapital	(17,373)	(17,277)	(22,611)
Transfer (to) from the University of Kentucky-capital	1,675	(213)	233
<b>DISCONTINUED OPERATIONS</b>			
Net loss from discontinued operations	<u>-</u>	<u>(16)</u>	<u>(17)</u>
Total increase in net position	63,764	13,114	41,290
Net position, beginning of year	<u>638,224</u>	<u>625,110</u>	<u>583,820</u>
Net position, end of year	<u>\$ 701,988</u>	<u>\$ 638,224</u>	<u>\$ 625,110</u>

## Operating Revenues:

Total operating revenues were approximately \$951.5 million for the year ended June 30, 2013, an increase of \$38.6 million or 4.2% over fiscal year 2012. The most significant source of operating revenue for the System was net patient service revenues of \$926.8 million, an increase of \$38.1 million or 4.3% in fiscal year 2013 over 2012.

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 2013 as a result of current economic conditions. Consequently, the provision for doubtful accounts increased \$10.7 million or 7.9% during the period.

The following table shows net patient revenue by funding source for fiscal years ended June 30, 2013, 2012 and 2011 (in thousands):

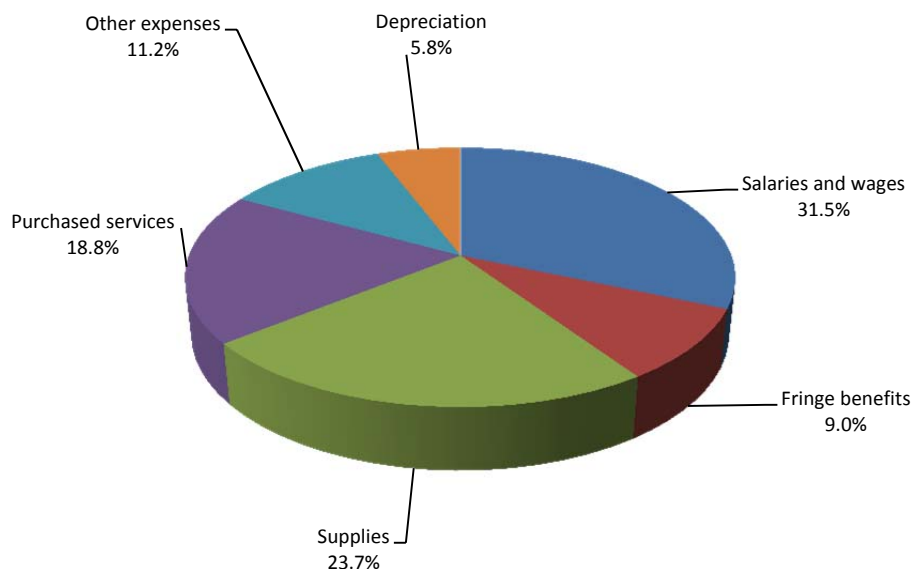
Payer	2013	2012	2011
Medicare	\$ 260,470	\$ 259,310	\$ 215,078
Medicaid	247,313	240,351	204,991
Commercial/Blue Cross	468,165	418,509	362,792
Patient/charity	96,071	105,080	80,829
Bad debt	(145,208)	(134,536)	(87,302)
Total	\$ 926,811	\$ 888,714	\$ 776,388

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. The System's 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 from Disproportionate Share System funds.

## TOTAL OPERATING EXPENSES



### Operating Expenses:

Total operating expenses, including \$51.3 million of depreciation were \$886.2 million, an increase of \$15.8 million or 1.8% over the prior year.

Salaries and wages increased by \$4.0 million over the prior fiscal. The increase in salary and wage was driven by a FTE increase of 59.44, a 1.1% increase over prior year. This was compounded by an increase in rate per FTE as a result of various market adjustments for specific clinical personnel groups such as registered nurses, nursing techs and respiratory techs.

Supplies expenses increased by \$9.6 million or 4.8% primarily due to increases in overall patient activity.

These increases were offset by a decrease in other expenses which was primarily the result of a service contract entered into with an external vendor for the maintenance and repair of clinical equipment. In addition, professional liability insurance was down almost \$2.0 million year over year due to a decrease in settlements. Additionally, rental and leases were down \$621 thousand and job orders decreased by \$575 thousand.

### Nonoperating Revenues (Expenses):

Total nonoperating revenues, net of expenses, were \$14.2 million in fiscal year 2013 compared to net nonoperating expenses of \$11.8 million during the prior fiscal year. This increase is primarily due to a net investment gain of \$25.8 million in fiscal year 2013 compared to a net investment loss of (\$336) thousand in the prior year. The endowment pool posted a total gain of 11.6% for fiscal 2013 versus a total loss of 0.8% in the prior year.

**2012 Versus 2011** Total operating revenues were \$912.8 million for the fiscal year ended June 30, 2012, an increase of \$115.4 million over the year ended June 30, 2011. Essentially all of the increase in operating revenues was due to increased patient revenues.

Operating expenses totaled \$870.4 million, an increase of \$105.4 million over 2011. The increase was caused by higher costs for personnel, medical supplies, purchased services and transplant costs.

Nonoperating expenses, net of revenues, amounted to \$11.8 million in fiscal year 2012 compared to net nonoperating revenues of \$31.3 million in the prior year. The decrease was primarily due to a loss on investments of \$336.0 thousand in 2012 compared to a gain of \$35.6 million in 2011 and an increase in interest expense of \$8.7 million during the same time period.

### **Statement of Cash Flows**

The Statement of Cash Flows details how cash has increased or decreased during the year ended June 30, 2013, with comparative financial information for the year ended June 30, 2012. 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 position 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)**

	<b>2013</b>	<b>2012</b>	<b>2011</b>
<b>CASH PROVIDED (USED) BY:</b>			
Operating activities	\$ 144,657	\$ 54,570	\$ 73,928
Noncapital financing activities	(55,791)	38,902	(16,821)
Capital and related financing activities	(54,696)	(109,193)	(179,903)
Investing activities	3,666	1,882	25,009
Net increase (decrease) in cash and cash equivalents	37,836	(13,839)	(97,787)
<b>Cash and cash equivalents, beginning of year</b>	17,310	31,149	128,936
<b>Cash and cash equivalents, end of year</b>	\$ 55,146	\$ 17,310	\$ 31,149

**2013.** The major source of cash included in operating activities was patient service revenues of \$963.4 million. The largest cash payments for operating activities were \$478.4 million to suppliers and \$359.9 million to employees for salaries, wages and fringe benefits.

Cash used by noncapital financing includes repayment of a \$47.9 million loan from the University and transfers of \$17.4 million. The cash provided consisted primarily of gifts and state appropriations of \$6.3 million and \$1.1 million, respectively.

Capital and related financing activities included \$25.0 million cash provided by capital leases. Cash of \$49.9 million was expended for principal and interest payments on capital leases and long term debt and \$31.0 million was expended for construction and acquisition of capital assets.

Investing activities included proceeds from sales and maturities of investments of \$195.5 million and interest and dividends of \$5.2 million. Cash of \$197.1 million was used to purchase investments.

**2012 Versus 2011** Cash balances decreased when comparing fiscal year 2012 versus fiscal year 2011 with a net decrease in cash of approximately \$13.8 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 2013, 2012, and 2011:

	<u>2013</u>	<u>2012</u>	<u>2011</u>
Days cash on hand	24	8	16
Days of revenue in accounts receivable	47	48	45
Debt service coverage (times)	2.7	1.6	1.7

Days cash on hand increased to 24 days in fiscal year 2013 from 8 days in fiscal year 2012 due to the increase in cash balance of \$37.8 million which resulted primarily from the reduction in capital spending. Days cash on hand measures the average number of days' expenses the System maintains in cash. Mitigating factors include access to working capital from the University and quasi-endowment investments of \$232.9 million.

The days of revenue in accounts receivable measures the average number of days it takes to collect accounts receivable. In fiscal year 2013, days in accounts receivable were 47 compared to 48 days in fiscal year 2012.

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 2013 is 2.7 versus 1.6 in fiscal year 2012 due to the increase in net position in fiscal year 2013 compared to fiscal year 2012.

### Capital Asset and Debt Administration

#### **Capital Assets**

Capital assets, net of accumulated depreciation, totaled approximately \$793.3 million at June 30, 2013, a net decrease of \$19.0 million over the prior year end. Significant changes in capital assets during fiscal 2012-2013 included (in millions):

• Land, buildings and structures, net additions	\$ 10.8
• Equipment and vehicles, net additions	4.1
• Capitalized software additions	8.8
• Artwork	0.1
• Construction in process, net additions	(0.4)
• Increase in accumulated depreciation, net	<u>(42.4)</u>
Total	<u><u>\$ (19.0)</u></u>

#### **Debt**

At year-end, the System had \$331.9 million in general receipts project notes outstanding and a \$32.3 million loan due to the University; \$13.9 million is included in current liabilities with the remainder long term. In addition, the System had \$93.5 million in capital leases.

## Economic Factors Impacting Future Periods

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

- 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. The long-term impact is largely unknown, as the long period between passage and its implementation lends to some level of uncertainty. The System will continue to develop and execute strategies in an effort to leverage available opportunities and mitigate negative impacts of this legislation as details unfold.
- The federal Health Information Technology for Economic and Clinical Health (HITECH) Act and Patient Protection and Affordable Care (PPAC) Act, enacted in 2009 and 2010, respectively, included an initiative for every American to realize the benefits of an “Electronic Health Record” (EHR) by 2014. The PPAC Act included financial incentives for eligible hospitals and physicians to demonstrate meaningful use of an EHR. The Act also included penalties of up to three percent in reductions to Medicare reimbursement if an EHR is not established by 2014. For the last decade, the System has utilized EHR and Computerized Physician Order Entry (CPOE) systems for inpatient care. However, in efforts to fully comply with the legislative requirements, maximize eligible financial incentives, and avoid reimbursement penalties, the System is in the process of implementing the Allscripts EHR solution for outpatient care across the System. Approximately 50% of UK HealthCare clinic sites are operational as of July 2013, with the project slated for completion in FY 2015.
- The US Department of Health and Human Services (HHS) has proposed the replacement of existing ICD-9-CM code sets used by medical coders and billers to report health care diagnoses and procedures with ICD-10 codes, with an effective date of October 1, 2014. ICD-10 implementation will radically change the way medical coding is performed and will require a significant effort to implement and train. The System has initiated an organized effort around this project to meet HHS requirements and the proposed deadline.
- 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. The System has successfully negotiated provider contracts with all of the MCO’s and their affiliates and has participated in the program since inception in November 2011.
- In January 2013, Governor Steve Beshear and UK President Dr. Eli Capilouto announced that the Kentucky Cabinet for Health and Family Services (CHFS) and the UK HealthCare signed a letter of intent under which the System will operate and manage the newly constructed Eastern State Hospital on UK’s Coldstream Campus in Lexington. The facility is expected to open to patients in September 2013.
- In March 2013, across-the-board Federal spending cuts known as sequestration went into effect resulting in disruptive effects across a spectrum of federal policy and procedure. Specific to healthcare, state Medicaid programs were exempted from sequestration; however, Medicare spending is slated for a two percent reduction in total annual spend each year through 2021. As the Medicare patient population represents a significant portion of the System’s overall payer mix, the System continues to monitor and plan around the anticipated impacts of sequestration on the health enterprise.
- In May 2013 Governor Beshear announced that Kentucky would accept Medicaid Expansion under President Barack Obama's healthcare reform law, a move expected to cut the state's uninsured population in half. The expansion will extend coverage to adults earning up to 133 percent of the federal poverty line, providing public health assistance to more than 300,000 people.
- In June 2013, the System received board approval to begin build-out on the 8th floor of Pavilion A. At an estimated cost of \$30.0 million dollars, the floor will be programmed for cardiovascular patients and will give the System incremental state of the art bed capacity for continued future growth, quality outcomes and patient satisfaction.

**UK HEALTHCARE HOSPITAL SYSTEM**  
**AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY**  
**STATEMENTS OF NET POSITION (in thousands)**  
**JUNE 30, 2013 AND 2012**

	<u>2013</u>	<u>2012</u>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 48,565	\$ 11,437
Accounts receivable (less allowance for doubtful accounts of \$35,493 in 2013 and \$35,684 in 2012)	119,857	116,778
Inventories and other assets	23,104	21,575
Accrued interest receivable	26	-
Estimated third-party payer settlements	-	30,136
Notes receivable	5,973	4,919
Total current assets	<u>197,525</u>	<u>184,845</u>
<b>Noncurrent Assets</b>		
Restricted cash and cash equivalents	6,581	5,873
Long-term investments	232,860	208,065
Capital assets, net	793,329	812,369
Notes receivable	14,929	15,300
Other assets	16,764	19,254
Total noncurrent assets	<u>1,064,463</u>	<u>1,060,861</u>
Total assets	<u>1,261,988</u>	<u>1,245,706</u>
<b>LIABILITIES</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued expenses	80,763	132,433
Unearned revenue	6,928	6,583
Estimated third-party payer settlements	8,367	-
Long-term debt - current portion	13,874	14,231
Capital lease obligations - current portion	21,120	19,847
Total current liabilities	<u>131,052</u>	<u>173,094</u>
<b>Noncurrent Liabilities</b>		
Accounts payable and accrued expenses	6,234	9,000
Long-term liabilities	350,301	357,047
Capital lease obligations	72,413	68,341
Total noncurrent liabilities	<u>428,948</u>	<u>434,388</u>
Total liabilities	<u>560,000</u>	<u>607,482</u>
<b>NET POSITION</b>		
<b>Net investment in capital assets</b>	<u>363,729</u>	<u>377,552</u>
<b>Restricted</b>		
Nonexpendable other	<u>117</u>	<u>118</u>
Expendable		
Capital projects	10,560	10,395
Other	4,405	4,134
Total restricted expendable	<u>14,965</u>	<u>14,529</u>
Total restricted	<u>15,082</u>	<u>14,647</u>
<b>Unrestricted</b>		
	<u>323,177</u>	<u>246,025</u>
Total net position	<u>\$ 701,988</u>	<u>\$ 638,224</u>

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 POSITION (in thousands)**  
**FOR THE YEARS ENDED JUNE 30, 2013 AND 2012**

	<u>2013</u>	<u>2012</u>
<b>OPERATING REVENUES</b>		
Net patient service revenues, less provision for doubtful accounts of \$145,208 in 2013 and \$134,536 in 2012	\$ 926,811	\$ 888,714
Sales and services	24,639	24,112
Total operating revenues	<u>951,450</u>	<u>912,826</u>
<b>OPERATING EXPENSES</b>		
Salaries and wages	279,001	274,979
Fringe benefits	79,803	77,973
Supplies	210,363	200,800
Purchased services	166,597	164,720
Other expenses	99,183	106,323
Depreciation	51,261	45,643
Total operating expenses	<u>886,208</u>	<u>870,438</u>
Net income from continuing operations	<u>65,242</u>	<u>42,388</u>
<b>NONOPERATING REVENUES (EXPENSES)</b>		
State appropriations	1,053	1,053
Permanent additions to endowments	1	1
Gifts and non-exchange grants	6,652	4,796
Investment income (loss)	25,839	(336)
Interest expense	(19,779)	(19,891)
Gain (loss) on disposal of capital assets	-	2,161
Other	454	448
Net nonoperating revenues (expenses)	<u>14,220</u>	<u>(11,768)</u>
Net income before other revenues, expenses, gains or losses	<u>79,462</u>	<u>30,620</u>
Transfers (to) the University of Kentucky for noncapital purposes	(17,373)	(17,277)
Transfers (to) from the University of Kentucky for capital purposes	1,675	(213)
Total other revenues (expenses)	<u>(15,698)</u>	<u>(17,490)</u>
Income (loss) from discontinued operations	<u>-</u>	<u>(16)</u>
<b>INCREASE IN NET POSITION</b>	63,764	13,114
<b>NET POSITION, beginning of year</b>	<u>638,224</u>	<u>625,110</u>
<b>NET POSITION, end of year</b>	<u>\$ 701,988</u>	<u>\$ 638,224</u>

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, 2013 AND 2012**

	2013	2012
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net patient service revenues	\$ 963,373	\$ 848,617
Sales and services	24,639	24,112
Payments to vendors and contractors	(478,370)	(476,508)
Salaries, wages and fringe benefits	(359,902)	(339,194)
Other receipts (payments)	(5,082)	(2,457)
Net cash provided by operating activities	144,657	54,570
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>		
State appropriations	1,053	1,053
Gifts	6,269	6,173
Additions to permanent endowments	1	1
Payments on loans to University of Kentucky departmental units	3,751	2,170
Loans to University of Kentucky departmental units	(1,583)	(1,127)
Loans from the University of Kentucky for noncapital purposes	-	47,909
Payments to the University of Kentucky for noncapital purposes	(47,909)	-
Transfers (to) the University of Kentucky for noncapital purposes	(17,373)	(17,277)
Net cash provided (used) by noncapital financing activities	(55,791)	38,902
<b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>		
Proceeds from sale of capital assets	368	4,100
Purchases of capital assets	(31,020)	(96,011)
Principal payments-capital leases and long-term obligations	(30,264)	(28,535)
Interest payments-capital leases and long-term obligations	(19,612)	(20,594)
Proceeds from capital leases	25,000	9,400
Loans from the University of Kentucky for capital purposes	339	22,578
Transfers from (to) the University of Kentucky for capital purposes	493	(131)
Net cash (used) by capital and related financing activities	(54,696)	(109,193)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from sales and maturities of investments	195,516	122,236
Purchase of investments	(197,080)	(124,841)
Interest and dividends on investments	5,230	4,487
Net cash provided (used) by investing activities	3,666	1,882
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>37,836</b>	<b>(13,839)</b>
<b>CASH AND CASH EQUIVALENTS, beginning of year</b>	<b>17,310</b>	<b>31,149</b>
<b>CASH AND CASH EQUIVALENTS, end of year</b>	<b>\$ 55,146</b>	<b>\$ 17,310</b>
<b>Reconciliation of net income from continuing operations to net cash provided by operating activities:</b>		
Net income from continuing operations	\$ 65,242	\$ 42,388
Income (loss) from discontinued operations	-	(16)
Adjustments to reconcile net income from continuing operations to net cash provided (used) by operating activities:		
Depreciation	51,261	45,643
Write off of principal note/lease receivable	901	901
Provision for doubtful accounts	(145,208)	(134,536)
Change in assets and liabilities:		
Accounts receivable	142,131	112,882
Inventories and other	(1,529)	(3,735)
Estimated third-party payer settlements receivable	38,503	(17,827)
Other assets	(686)	(1,204)
Accounts payable and accrued expenses	(6,302)	10,161
Deferred revenue	345	(87)
<b>Net cash provided by operating activities</b>	<b>\$ 144,657</b>	<b>\$ 54,570</b>
<b>NON CASH TRANSACTIONS:</b>		
Transfer of capital assets to (from) UK	\$ 1,182	\$ (82)
Capital lease additions	\$ 194	\$ 728
Capital asset additions in accounts payable	\$ 951	\$ 911
Capitalized interest, net of investment income	\$ 17	\$ 562
Amortized bond premium and cost of issues	\$ 318	\$ 318

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 (the Commonwealth) 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).

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

**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 position categories:

- Net investment in capital assets: 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 position subject to externally imposed stipulations that it be maintained permanently by the System.  
  
*Expendable* – Net position 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 position whose use by the System is not subject to externally imposed stipulations. Unrestricted net position 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, deferred outflows of resources, liabilities, deferred inflows of resources, net position, revenues, expenses, changes in net position and cash flows.

During the year ended June 30, 2013, the System adopted GASB No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position*.

The objective of GASB 63 is to provide guidance for reporting deferred outflows of resources, deferred inflows of resources and net position in a statement of financial position and related disclosures. GASB No. 63 has been applied retrospectively, by reclassifying certain 2012 financial statement line items to conform with the presentation requirements of the standard.

In addition to assets, GASB No. 63 requires the presentation of a separate financial statement element, deferred outflows of resources, which represents a consumption of net position that applies to a future period. The System has no items that qualify for reporting in this category.

In addition to liabilities, GASB No. 63 requires the presentation of a separate financial statement element, deferred inflows of resources, which represents an acquisition of net position that applies to a future period. The System has no items that qualify for reporting in this category.

## **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.

Pooled Endowment Funds. All endowments are managed in a consolidated investment pool, which consists of more than 2,000 named 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 unit 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 Kentucky Uniform Prudent Management of Institutional Funds Act (UPMIFA), as adopted by the Commonwealth 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. The University has made expenditure decisions in accordance with UPMIFA and donor gift agreements. UPMIFA prescribes guidelines for expenditure of a donor-restricted endowment fund (in the absence of overriding, explicit donor stipulations) and focuses on the entirety of a donor-restricted endowment fund, that is, both the original gift amount(s) and net appreciation. In accordance with the standard of prudence prescribed by UPMIFA and consistent with industry standards, the University has adopted a spending policy whose long-term objective is to maintain the purchasing power of each endowment and provide a predictable and sustainable level of income to support current operations.

For the years ended June 30, 2013 and 2012, the University's endowment standard spending rule provided for annual distributions of 4.25% of the 60 month moving average market value of fund units. In recognition of recent adverse market performance, reduced spending rules were established for certain endowments whose market value was less than the contributed value as of December 31st, which is the measurement date for calculating spending distributions for the following fiscal year. Additionally, for the years ended June 30, 2013 and 2012, the University's annual endowment management fee was 0.25%, however endowments whose market value was less than the contributed value as of December 31st were exempt from the management fee in the subsequent fiscal year.

For each of the years ended June 30, 2013 and 2012, management elected to retain the spending distribution in the quasi endowment and the amounts available for spending in accordance with the University's endowment spending policy were \$4,888,300 and \$5,259,000, respectively.

For future years the University has established a "hybrid" spending policy, which includes both the market value of the endowment and the current level of inflation in determining spending each year. Annual spending will be calculated by taking a weighted average comprising 60% of the prior year's spending, adjusted for inflation, and 40% of the amount that results when the target annual spending rate of four percent is applied to the average market value of the Endowment over the preceding 36 months. The spending amount determined by the formula will be constrained so that the calculated rate is at least three percent, and not more than six percent, of the current Endowment market value. The hybrid spending policy will be phased in over two years. The year ended June 30, 2014 will serve as a transition year to the new policy and spending will be based on four percent of the average market value for the preceding 60 months. The hybrid policy will be fully implemented in the year ending June 30, 2015.

Additionally, for fiscal years ending June 30, 2014 and thereafter, spending and management fee withdrawals will be suspended on all endowments with a market value less than the contributed value by more than 20% at December 31st of the prior year. Endowments with a market value less than the contributed value by more than 10% will undergo a formal review to determine the appropriate level of spending in accordance with various factors set forth in UPMIFA.

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.

Unearned Revenue. Unearned revenue consists of amounts received from the federal government through the Commonwealth 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, 2013 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 position 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 24 percent and 23 percent, respectively, of the System's net patient service revenues before the provision for doubtful accounts for the year ended June 30, 2013 and approximately 25 percent and 23 percent, respectively for the year ended June 30, 2012. 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.

Electronic Health Records Incentive Program. The Electronic Health Records Incentive Program, enacted as part of *the American Recovery and Reinvestment Act of 2009*, provides for incentive payments under both the Medicare and Medicaid programs to eligible hospitals that demonstrate meaningful use of certified electronic health records technology (EHR). Payments under the Medicare program are generally made for up to four years based on a statutory formula. Payments under the Medicaid program are generally made for up to four years based upon a statutory formula, as determined by the state, which is approved by the Centers for Medicare and Medicaid Services. Payment under both programs is contingent on the System continuing to meet escalating meaningful use criteria and any other specific requirements that are applicable for the reporting period. The final amount for any payment year is determined based upon an audit by the fiscal intermediary. Events could occur that would cause the final amounts to differ materially from the initial payments under the program.

The System recognizes revenue when management is reasonably assured it will meet all of the meaningful use objectives and any other specific grant requirements applicable for the reporting period.

In fiscal year 2013, the System was in the second year under the Medicare programs but did not attest to completion of the second phase and recorded no revenue. In fiscal year 2012, the System recorded \$2.0 million which was included in net patient service revenue within operating revenues in the statement of revenues, expenses, and changes in net position.

In fiscal year 2013, the System completed the second-year requirements under the Medicaid program and recorded revenue of approximately \$2.2 million, which is included in net patient service revenue within operating revenues in the statement of revenues, expenses, and changes in net position. In fiscal year 2011, the System recorded \$2.9 million in revenue.

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 Position, 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. In April 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*. This statement clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. With the exception of prepaid insurance costs, costs related to the issuance of debt will no longer be recorded as a deferred charge and amortized over the life of the debt, but instead will be recognized as an expense in the period incurred. Accounting changes to comply with the standard will be applied retroactively by restating financial statements for all periods presented. The adoption of GASB 65 will require reclassification of certain items and a change in the recognition of items previously reported as assets and liabilities, beginning with the fiscal year ending June 30, 2014.

GASB has also issued certain statements which are applicable to the System for fiscal years ending after June 30, 2013. The System does not expect the adoption of GASB Statements No. 66-70 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, 2013 and 2012 follows (in thousands):

	2013	2012
Cash on deposit with the University of Kentucky	\$ 55,146	\$ 17,310
Investment in University of Kentucky pooled endowment funds	232,860	208,065
	\$ 288,006	\$ 225,375
Statement of Net Position classification:		
Cash and cash equivalents	\$ 48,565	\$ 11,437
Restricted cash and cash equivalents	6,581	5,873
Long-term investments	232,860	208,065
	\$ 288,006	\$ 225,375

At June 30, 2013, the University's pooled endowment fund consists of pooled equity funds (37.9%), private equity funds (8.3%), pooled real estate funds (6.7%), government agency fixed income funds (0.9%), corporate fixed income funds (2.3%), pooled fixed income funds (9.3%), pooled absolute return funds (20.2%), pooled real return funds (8.5%), common and preferred stock (4.3%), U.S. Treasury fixed income funds (0.8%), and cash equivalents (0.8%). At June 30, 2012, the University's pooled endowment fund consists of pooled equity funds

(37.5%), private equity funds (7.5%), pooled real estate funds (6.6%), government agency fixed income funds (1.0%), corporate fixed income funds (2.9%), pooled fixed income funds (10.5%), pooled absolute return funds (19.7%), pooled real return funds (9.5%), common and preferred stock (3.6%), U.S. Treasury fixed income funds (1.0%), and cash equivalents (0.2%).

**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, which the University invests in deposits and repurchase agreements with banks and the Commonwealth; and
- Short-term investments managed by the University are held in the University's name by the University's custodian.
- Endowment investments in the University's pooled endowment fund.

Cash on deposit with the University is managed by the University following the University's Operating Fund Investment Policy.

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 statements of net position.

**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 University is governed by policy that minimizes 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. The System's deposits are insured up to \$250,000 at each FDIC insured institution. Credit risk on repurchase agreements is mitigated by requiring 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 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.
- 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. 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 the University's 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 is invested in deposits and repurchase agreements, which are held in the University's name, and deposits and repurchase agreements with the Commonwealth, which are held in the Commonwealth's name.
- 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.** The System's 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.
- 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 25% 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 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%.
- Endowment investment managers are limited to a maximum investment in any one issuer of no more than five percent of total investments.

At June 30, 2013 and 2012, the System has no investments in any one issuer that represent five 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 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.



- 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, 2013 and 2012 are as follows (in thousands):

	<u>2013</u>	<u>2012</u>
Medicare, Medicaid and other third parties	\$ 110,568	\$ 108,202
Private pay	8,555	7,063
Pledges receivable	734	1,513
Total accounts receivable, net	<u>\$ 119,857</u>	<u>\$ 116,778</u>

Operating pledges totaling approximately \$793,000 are expected to be collected over the next eight years. In addition, capital pledges totaling approximately \$4.4 million are expected to be collected over the next five 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, 2013 and 2012, the System recorded the discounted value of operating and capital pledges using a rate of two percent and three percent, respectively. Accordingly, at June 30, 2013, and 2012, respectively, the System recorded the discounted value of operating and capital pledges receivable of approximately \$3.3 million and \$3.7 million, including \$2.6 million and \$2.2 million in noncurrent – other assets, and \$734,000 and \$1.5 million in accounts receivable, net.

The System has recorded an allowance for uncollectible patient accounts receivable equal to 24.2% and 25.2% of patient accounts receivable as of June 30, 2013 and 2012, respectively. A summary of the changes in the allowance for uncollectible patient accounts receivable is as follows:

	<u>2013</u>	<u>2012</u>
Balance, beginning of year	\$ 35,684	\$ 23,779
Provision for bad debts	145,208	134,536
Receivables charged off, net of recoveries	<u>(145,399)</u>	<u>(122,631)</u>
Balance, end of year	<u>\$ 35,493</u>	<u>\$ 35,684</u>

#### 4. CAPITAL ASSETS, NET

Capital assets as of June 30, 2013 and capital asset activity for the year ended June 30, 2013 are summarized as follows (in thousands):

	Beginning Balance	Additions	Deletions	Ending Balance
Land	\$ 23,577	\$ 1,761	\$ -	\$ 25,338
Non-depreciable land improvements	15,607	-	-	15,607
Depreciable land improvements	8,735	-	-	8,735
Buildings	721,610	7,429	-	729,039
Fixed equipment	18,737	1,467	-	20,204
Infrastructure	27,865	-	-	27,865
Equipment	230,936	13,485	9,346	235,075
Vehicles	934	-	-	934
Capitalized software	61,040	8,844	-	69,884
Artwork	1,601	72	-	1,673
Construction in process	4,398	3,139	3,493	4,044
	<u>1,115,040</u>	<u>36,197</u>	<u>12,839</u>	<u>1,138,398</u>
<u>Accumulated Depreciation:</u>				
Depreciable land improvements	3,860	330	-	4,190
Buildings	135,093	17,109	-	152,202
Fixed equipment	7,756	1,603	-	9,359
Infrastructure	2,750	1,115	-	3,865
Equipment	133,985	25,480	8,199	151,266
Vehicles	728	63	-	791
Capitalized software	18,499	4,897	-	23,396
	<u>302,671</u>	<u>50,597</u>	<u>8,199</u>	<u>345,069</u>
Capital assets, net	<u>\$ 812,369</u>	<u>\$ (14,400)</u>	<u>\$ 4,640</u>	<u>\$ 793,329</u>

Capital assets as of June 30, 2012 and capital asset activity for the year ended June 30, 2012 are summarized as follows (in thousands):

	Beginning Balance	Additions	Deletions	Ending Balance
Land	\$ 23,497	\$ 80	\$ -	\$ 23,577
Non-depreciable land improvements	15,607	-	-	15,607
Depreciable land improvements	8,559	186	10	8,735
Buildings	694,696	26,914	-	721,610
Fixed equipment	15,438	3,299	-	18,737
Infrastructure	27,865	-	-	27,865
Equipment	198,008	45,146	12,218	230,936
Vehicles	774	227	67	934
Capitalized software	40,069	20,971	-	61,040
Artwork	1,385	216	-	1,601
Construction in process	13,366	2,661	11,629	4,398
	<u>1,039,264</u>	<u>99,700</u>	<u>23,924</u>	<u>1,115,040</u>
<u>Accumulated Depreciation:</u>				
Depreciable land improvements	3,549	311	-	3,860
Buildings	118,852	16,241	-	135,093
Fixed equipment	6,272	1,484	-	7,756
Infrastructure	1,588	1,162	-	2,750
Equipment	119,755	24,384	10,154	133,985
Vehicles	751	44	67	728
Capitalized software	16,334	2,165	-	18,499
	<u>267,101</u>	<u>45,791</u>	<u>10,221</u>	<u>302,671</u>
Capital assets, net	<u>\$ 772,163</u>	<u>\$ 53,909</u>	<u>\$ 13,703</u>	<u>\$ 812,369</u>

At June 30, 2013, the System has construction projects in progress totaling approximately \$5.7 million in scope. The estimated cost to complete these projects is approximately \$1.9 million. Such construction is principally financed by System's cash reserves and loans from the University.

Interest costs incurred during construction, net of related investment income, are capitalized. Total interest capitalized was \$17,000 for 2013 and \$562,000 for 2012.

During 2013 and 2012, the System utilized capital leases to acquire various items of equipment. The net book value for capitalized leased land, buildings and equipment is \$69.5 million and \$57.9 million at June 30, 2013 and 2012, respectively.

## 5. NOTES RECEIVABLE

Notes receivable at June 30, 2013 and 2012 are as follows (in thousands):

	<u>2013</u>	<u>2012</u>
Non-interest bearing, unsecured receivable from UK Parking and Transportation, payable \$250,000 annually	\$ 500	\$ 750
Non-interest bearing, unsecured receivable from UK College of Pharmacy	6,723	6,723
Non-interest bearing, unsecured receivable from UK College of Pharmacy	6,500	7,000
Non-interest bearing, unsecured receivable from UK College of Pharmacy	2,817	2,817
Interest bearing, 1.29%, line of credit from Coldstream Laboratories, Inc. through a loan to University of Kentucky Research Foundation	2,710	1,127
Notes receivable - other	1,652	1,802
Total	<u>\$ 20,902</u>	<u>\$ 20,219</u>
Current portion	\$ 5,973	\$ 4,919
Noncurrent portion	<u>14,929</u>	<u>15,300</u>
Total	<u>\$ 20,902</u>	<u>\$ 20,219</u>

## 6. OTHER ASSETS

Other assets at June 30, 2013 and 2012 are as follows (in thousands):

	<u>2013</u>	<u>2012</u>
Unamortized bond cost of issuance - noncurrent portion	\$ 1,861	\$ 1,992
Amounts on deposit with trustee, primarily invested in U.S. government agencies	2	2,649
Noncurrent portion of prepaid expenses	702	797
Pledges receivable noncurrent	2,590	2,207
Good Samaritan Certificate of Need licensed beds	<u>11,609</u>	<u>11,609</u>
Total	<u>\$ 16,764</u>	<u>\$ 19,254</u>

## 7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities as of June 30, 2013 and 2012 are summarized as follows (in thousands):

	<u>2013</u>	<u>2012</u>
Payable to vendors and contractors	\$ 34,299	\$ 35,053
Due to the University of Kentucky	3,338	51,194
Accrued employee expenses, including vacation leave	<u>43,126</u>	<u>46,186</u>
Total	<u>\$ 80,763</u>	<u>\$ 132,433</u>

## 8. LONG-TERM DEBT

Long-term debt as of June 30, 2013 and 2012 are summarized as follows (in thousands):

	2013					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
General Receipts						
Project Notes	\$ 342,300	\$ -	\$ 10,415	\$ 331,885	\$ 10,875	\$ 321,010
Due to the University of Kentucky and affiliates	28,978	4,680	1,368	32,290	2,999	29,291
	<u>\$ 371,278</u>	<u>\$ 4,680</u>	<u>\$ 11,783</u>	<u>\$ 364,175</u>	<u>\$ 13,874</u>	<u>\$ 350,301</u>
	2012					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
General Receipts						
Project Notes	\$ 352,295	\$ -	\$ 9,995	\$ 342,300	\$ 10,415	\$ 331,885
Due to the University of Kentucky and affiliates	5,006	27,628	3,656	28,978	3,816	25,162
	<u>\$ 357,301</u>	<u>\$ 27,628</u>	<u>\$ 13,651</u>	<u>\$ 371,278</u>	<u>\$ 14,231</u>	<u>\$ 357,047</u>

Principal maturities and interest on long-term debt for the next five years and in subsequent five-year periods as of June 30, 2013 are as follows (in thousands):

	Principal	Interest	Total
2014	\$ 13,874	\$ 14,704	\$ 28,578
2015	15,005	14,154	29,159
2016	15,018	13,561	28,579
2017	15,646	12,933	28,579
2018	19,245	12,265	31,510
2019-2023	107,922	49,607	157,529
2024-2028	115,050	25,524	140,574
2029-2033	22,700	9,501	32,201
2034-2038	27,295	4,904	32,199
2039-2040	12,420	465	12,885
Total	<u>\$ 364,175</u>	<u>\$ 157,618</u>	<u>\$ 521,793</u>

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, \$100.6 million 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 an annual cash subsidy from the U.S. Treasury equal to 35% of the interest payable on the bonds. This subsidy, which was approximately \$1.8 million during fiscal year 2013, is included in gifts and non-exchange grants in the statements of revenues, expenses and changes in net position.

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, 2013 and 2012 are summarized as follows (in thousands):

		2013					
		Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Leases		\$ 88,188	\$ 25,194	\$ 19,849	\$ 93,533	\$ 21,120	\$ 72,413

		2012					
		Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Leases		\$ 96,599	\$ 10,128	\$ 18,539	\$ 88,188	\$ 19,847	\$ 68,341

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

Years ended June 30		
	2014	\$ 23,766
	2015	18,704
	2016	13,484
	2017	11,392
	2018	8,300
	2019 and later years	32,411
	Total	108,057
	Less amount representing interest	(14,524)
	Present value of net minimum lease payments	\$ 93,533

Capital lease obligations are at varying rates of imputed interest of 0.95% to 4.45%.

## 10. OTHER NONCURRENT LIABILITIES

Other long-term liabilities as of June 30, 2013 and 2012 are summarized as follows (in thousands):

	2013			
	Beginning Balance	Additions	Reductions	Ending Balance
Refundable deposits	\$ 2,598	\$ 27	\$ 2,614	\$ 11
Unearned compensation	228	269	-	497
Noncurrent unamortized bond premium	6,174	-	448	5,726
Accounts payable and accrued expenses	<u>\$ 9,000</u>	<u>\$ 296</u>	<u>\$ 3,062</u>	<u>\$ 6,234</u>

	2012			
	Beginning Balance	Additions	Reductions	Ending Balance
Refundable deposits	\$ 5,693	\$ 34	\$ 3,129	\$ 2,598
Unearned compensation	-	232	4	228
Noncurrent unamortized bond premium	6,623	-	449	6,174
Accounts payable and accrued expenses	<u>\$ 12,316</u>	<u>\$ 266</u>	<u>\$ 3,582</u>	<u>\$ 9,000</u>

## 11. DESIGNATIONS OF UNRESTRICTED NET POSITION

Unrestricted net position is 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 position at June 30, 2013 and 2012 are as follows (in thousands):

	2013	2012
Working capital requirements	\$ 100,154	\$ 49,139
Future capital expenditures	223,023	196,886
Total	<u>\$ 323,177</u>	<u>\$ 246,025</u>

## 12. INVESTMENT INCOME (LOSS)

Components of investment income (loss) for the years ended June 30, 2013 and 2012 are as follows (in thousands):

	<u>2013</u>	<u>2012</u>
Interest and dividends earned on endowment investments	\$ 3,822	\$ 3,397
Realized and unrealized gains and (losses) on endowment investments	20,528	(4,781)
Interest and dividends on cash and non-endowment investments	1,759	44
Realized and unrealized gains and (losses) on non-endowment investments	<u>(270)</u>	<u>1,004</u>
Total	<u>\$ 25,839</u>	<u>\$ (336)</u>

## 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>2013</u>	<u>2012</u>
Revenue from the Commonwealth of Kentucky	\$ 27,170	\$ 23,780
2.5% tax paid by System on patient cash receipts	(11,755)	(11,755)
Matching contribution paid by the System	<u>(7,458)</u>	<u>(6,835)</u>
Net amount received, included in net patient service revenues	<u>\$ 7,957</u>	<u>\$ 5,190</u>

The amount of charges forgone for services and supplies furnished under the System's charity care policy aggregated to approximately \$187.3 million and \$162.1 million in 2013 and 2012, respectively.

## 14. PLEDGED REVENUES

The System has substantially pledged all of the unrestricted operating and nonoperating revenues to repay the General Receipts notes issued during 2005 to 2009. Proceeds from the notes provided funding for the construction of the new patient care facility. The notes are payable from unrestricted operating and nonoperating revenues and are payable through 2039. Annual principal and interest payments on notes are expected to require less than 3% of pledged revenue. The total principal and interest remaining to be paid on the notes is \$520,458,000 and \$547,539,000 in 2013 and 2012, respectively. Principal and interest paid for 2013 and 2012 were \$27,081,000 and \$27,083,000, respectively.

## 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 \$21.2 million and \$20.4 million for the years ended June 30, 2013 and 2012, respectively. Employees contributed \$10.6 million and \$10.2 million during 2013 and 2012, respectively. The payroll for employees covered by the retirement plans was \$211.9 million and \$204.2 million for 2013 and 2012, 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, 2013.

## **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 2012 to 2013. 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 three and a half percent. The malpractice liability at June 30, 2013, 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, 2013.

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, 2013.

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, 2013.

#### **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. The System paid approximately \$11.8 million in 2013 and 2012 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 2013 and 2012, the System received payments of approximately \$28.7 million and \$27.7 million respectively, from the University. In December 2011, the University of Kentucky Board of Trustees authorized the transfer of up to \$4.0 million, to UKRF to be used for investment in Coldstream Laboratories, Inc. (CLI) to fund operations and capital improvement. In addition, the System advanced \$3.0 million to UKRF to be used as a line of credit to CLI for working capital to be repaid over five years at a rate of 1.29%. As of June 30, 2013, \$2.7 million had been transferred to CLI on the line of credit and \$3.6 million had been transferred for operations and capital improvements. The System provided the funds to UKRF for the investment and line of credit and included in the net due to the University of Kentucky and affiliates.

#### **19. RECLASSIFICATIONS**

Certain reclassifications to fiscal year 2012 comparative amounts have been made to conform to the fiscal year 2013 financial statement classifications. Such reclassifications had no effect on the change in net position.

#### **20. SUBSEQUENT EVENTS**

The System and the Kentucky Cabinet for Health and Family Services signed a contract dated July 3, 2013 in which the System will operate and manage the Eastern State Hospital for the period August 15, 2013-June 30, 2014.



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 40506-0032, (859) 257-8927 or at [www.uky.edu/evpfa/eoo](http://www.uky.edu/evpfa/eoo).

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