



2017 Financial Statements

 University of
Kentucky[®]

**UK HealthCare
Hospital System**

UK HealthCare Hospital System
An Organizational Unit of the University of Kentucky
Financial Statements
Years Ended June 30, 2017 and 2016

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Independent Auditor's Report

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

We have audited the accompanying financial statements of the UK HealthCare Hospital System (System), an organizational unit of the University of Kentucky (University), as of and for the years ended June 30, 2017 and 2016, and the related notes to the financial statements, which collectively comprise the System's basic financial statements as listed in the table of contents.

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 entity'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 entity'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 that 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, 2017 and 2016, 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.

Emphasis of Matters

As discussed in Note 19 to the financial statements, the 2016 financial statements have been restated to correct a misstatement. Our opinion is not modified with respect to this matter.

As discussed in Note 1, the financial statements of the System are intended to present the financial position, the changes in financial position and cash flows of only that portion of the business-type activities that is attributable to the transactions of the System. They do not purport to, and do not, present fairly the financial position of the University as of June 30, 2017 and 2016, the changes in its financial position or its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matter

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis as listed in the table of contents be presented to supplement the basic financial statements. Such information, although not a 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 19, 2017

**UK HEALTHCARE HOSPITAL SYSTEM
AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2017 AND 2016**

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, 2017 and 2016. 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

UK HealthCare, the University's advanced academic medical center and clinical care network, is uniquely equipped to provide advanced subspecialty care to the people of Kentucky. The academic medical center and health system provides patient care on par – in terms of both volume and complexity – with the nation's top 25 percent of academic medical centers. In August 2017, UK HealthCare was listed number one in Kentucky in the latest U.S. News Best Hospitals ranking for the second consecutive year. To be recognized as a best Hospital, UK HealthCare had to rank high nationally on a stringent data-driven ratings system that gauges performance. The analysis include multiple clinical specialties, procedures and conditions. Scores are based on a variety of patient outcome and care-related factors such as mortality and patient safety, as well as reputation. This and other notable achievements are listed at <http://ukhealthcare.uky.edu/quality/awards/>.

The System operates two hospital units under one Joint Commission Accreditation and two licenses in addition to ambulatory services. The major service units include Albert B. Chandler Hospital, Good Samaritan Hospital and the Kentucky Clinic. The System has a combined total of 945 licensed beds with an average daily census of 722 patients. On a monthly basis, the system provides over 1,281 inpatient surgeries, 1,442 outpatient surgeries, 33,974 radiology procedures, 9,327 emergency department visits, and 133,532 hospital based outpatient clinic visits.

Under a management contract entered into with the Kentucky Cabinet for Health and Family Services, the System also operates and manages Eastern State Hospital, a 300,000 square-foot facility located on the University's Coldstream Research Campus. The new psychiatric facility, opened in September 2013, provides a modern setting for both acute and long-term inpatient psychiatric treatment for adults living within Fayette County and the 50 surrounding counties.

UK HealthCare's Markey Cancer Center remains the state's only cancer center designated by the National Cancer Institute (NCI), which reflects the University's position as a frontrunner in cancer treatment and research. UK HealthCare is one of an elite group of only 22 medical centers in the United States that have NCI designation, a federally funded Center on Aging, and a highly prized Clinical and Translational Science Award grant.

UK HealthCare's dramatic growth within the last decade is in large part the result of a commitment to support the state's overall system of care by working hand-in-hand with local community providers to bring specialty care closer to the patient. These relationships take on different dimensions in each locality (management agreements, affiliate networks, outreach, etc.) and support keeping less acute care in the local community and smoothing the process for more complex, serious cases to be treated in UK HealthCare's Lexington facilities. The goal is better care at all points of the continuum.

Financial Highlights

The System's overall financial position remains strong with assets of \$1.87 billion and liabilities of \$669.3 million. Net position, which represents the System's residual interest in assets after liabilities are deducted, was \$1.21 billion or 64.7% of total assets. For the fiscal year ended June 30, 2017, the System reported net income before other revenues, expenses, gains and losses of \$206.0 million, generating a margin of 13.7%.

Financial results for fiscal year 2017 exceeded prior year revenues with net inpatient revenues, including the provision for doubtful accounts, increasing approximately \$36.0 million or 4.4% over the prior fiscal year and net outpatient revenues, including the provision for doubtful accounts, increasing \$33.8 million or 6.5% 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 outpatient activity.

- Total assets increased \$96.5 million or 5.4%. This increase is due to increases in capital assets, net of \$104.2 million, accounts receivable of \$23.0 million, long-term investments of \$22.4 million and inventories of \$636,000. This increase was offset by decreases in cash and cash equivalents of \$51.9 million, other assets of \$1.4 million, and notes receivable of \$498,000.
- Deferred outflows of resources decreased \$1.4 million, which represents the unamortized difference between the reacquisition price and the net carrying amount of the refunded debt.
- Total liabilities decreased \$19.0 million or 2.8%, as a result of decreases of \$15.3 million in long-term debt, \$10.7 million in capital lease obligations, \$11.9 million in accounts payable and accrued liabilities, and \$3.7 million in other long-term liabilities. The decrease in long-term debt and capital lease obligations was due to \$11.9 million in payments on outstanding debt and a \$3.0 million net decrease in the amount due to the University of Kentucky. These decreases were offset by increase of \$13.1 million in estimated third-party settlements and \$9.5 million in unearned revenue.
- Total net position increased \$114.1 million or 10.4%, primarily due to the current year net income.
- Operating revenues increased \$77.1 million or 5.4%, primarily due to an increase in net patient revenue of \$69.8 million.
- Operating expenses increased \$74.2 million or 6.0%. The largest increases came from personnel costs of \$95.0 million, and supplies of \$22.5 million. This was offset by a decrease in purchased services of \$44.9 million due to transferring medical directors and graduate medical education (GME) staff to hospital payroll instead of reimbursing through Enterprise Investment Requests.
- The net nonoperating revenues increase of \$40.8 million primarily resulted from a \$30.4 million increase in investment income. An additional increase was caused by a \$7.2 million decrease in loss on disposal of capital assets due to the 2016 change in the equipment capitalization policy which resulted in a loss of \$7.4 million for 2016.

Operating Statistics

The following table presents utilization statistics for the System for fiscal years ended 2017, 2016 and 2015:

Discharges:	2017	2016	2015
Medicare	13,463	12,700	12,591
Medicaid	14,789	14,756	14,286
Commercial/Blue Cross	9,791	9,655	9,519
Patient/Charity	663	678	647
Total discharges	38,706	37,789	37,043
Average daily census	722.02	709.46	698
Average length of stay	6.81	6.87	6.78
Outpatient visits:			
Hospital clinics	538,256	501,943	479,782
Emergency visits	111,920	108,417	101,395
Total visits	650,176	610,360	581,177

2017. Total discharges increased by 917 or 2.4% compared to the prior fiscal year. The increase occurred primarily due to increases in Medicare discharges of 763, Commercial/Blue Cross of 136 and Medicaid of 33. Overall the Diagnosis-Related Group (DRG) case mix index increased to 2.0128 from 2.0005 and the average length of stay decreased by 0.06 days to 6.81 days. The case mix for Chandler was at 2.1749 while Good Samaritan was at 1.3943. Total outpatient visits increased by 39,816 or 6.5% 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 (GASB) 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.

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, and net position (equity) of the System as of June 30, 2017, with comparative information as of June 30, 2016. 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, and total liabilities, 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, and liabilities, are reported using current values. A major exception is capital assets, which are stated at historical cost, less accumulated depreciation. A summarized comparison of the System’s assets, deferred outflows of resources, liabilities, and net position at June 30, 2017, 2016 and 2015 follows:

Condensed Statements of Net Position (in thousands)

	2017	2016	2015
ASSETS AND DEFERRED OUTFLOWS OF RESOURCES			
Current assets	\$ 551,057	\$ 515,953	\$ 445,260
Capital asset, net	982,543	878,391	826,805
Other noncurrent assets	338,036	380,829	438,558
Deferred outflows of resources	9,524	10,946	12,368
Total assets and deferred outflows of resources	1,881,160	1,786,119	1,722,991
LIABILITIES			
Current liabilities	201,155	190,494	180,618
Noncurrent liabilities	468,188	497,860	528,623
Total liabilities	669,343	688,354	709,241
NET POSITION			
Net investment in capital assets	521,040	455,374	437,489
Nonexpendable other	751	195	119
Restricted expendable	11,662	11,902	10,538
Unrestricted	678,364	630,294	565,604
Total net position	\$ 1,211,817	\$ 1,097,765	\$ 1,013,750

Assets. As of June 30, 2017, the System's total assets amounted to approximately \$1.87 billion. Capital assets, net of depreciation, of \$982.5 million, or 52.5% of total assets, represented the System's largest asset. Cash and cash equivalents of \$393.0 million, or 21.0% of total assets, is the second largest asset, and long-term investments of \$291.1 million or 15.6% of total assets were the System's third largest asset. Accounts receivable, primarily patient-related, of \$163.3 million or 8.7% represents another significant asset of the System.

Total assets increased by \$96.5 million during the year ended June 30, 2017. The increase was the result of several factors: capital assets, net, increased \$104.2 million primarily due to construction projects, purchases of capital equipment and software development. In addition, accounts receivable, net, increased \$23.0 million, long-term investments increased \$22.4 million and inventories increased \$636,000. These increases were offset by decreases in cash and cash equivalents of \$51.9 million, primarily from less cash provided by operating activities, and more cash used in noncapital financing activities and in capital and related financing activities.

Deferred Outflows of Resources. Deferred outflows of resources decreased \$1.4 million, which represents the unamortized difference between the reacquisition price and the net carrying amount of the refunded debt. The System refunded General Receipts 2005 Notes Series A, and General Receipts 2007 Notes Series A and B during the fiscal year 2015.

Liabilities. As of June 30, 2017, the System's liabilities totaled approximately \$669.3 million. Long-term debt (current and non-current), which consists of general receipts project notes and note payable to the University, comprised the largest liability of \$430.6 million or 64.3% of total liabilities. Capital lease obligations totaled \$34.0 million or 5.1% of liabilities while accounts payable and accrued expenses represented approximately \$123.1 million or 18.4% of liabilities. Long-term liabilities, other, totaled \$29.2 million or 4.4% of liabilities and consisted primarily of unamortized bond premium. Estimated third-party payer settlements were \$36.0 million or 5.4% while unearned revenue accounted for \$16.5 million or 2.5%.

Total liabilities decreased \$19.0 million primarily due to \$15.3 million principal payments on long-term debt and \$10.7 million principal payments on capital lease obligations. In addition, accounts payable and accrued expenses decreased \$11.9 million. Long-term liabilities, other decreased \$3.7 million, primarily due to the \$4.0 amortization of bond premium. These were offset by increases in estimated third-party settlements of \$13.1 million and unearned revenue of \$9.5 million.

Net Position. Net position at June 30, 2017 totaled approximately \$1.21 billion, or 64.7% of total assets. Net investment in capital assets totaled \$521.0 million or 43.0% of total net position. Restricted net position totaled approximately \$12.4 million or 1.0% of total net position. Unrestricted net position accounted for \$678.4 million or 56.0% of total net position. Total net position increased \$114.1 million or 10.4%.

Restricted net position is subject to externally imposed restrictions governing its 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.

2016 Versus 2015. When comparing the fiscal year ended June 30, 2016 to the year ended June 30, 2015:

- Total assets increased by \$64.6 million during the year ended June 30, 2016. The increase was the result of several factors: unrestricted and restricted cash increased \$13.2 million from cash provided by operating activities of \$184.8 million and investing activities of \$876,000, offset by cash used by noncapital financial activities of \$6.5 million and capital and related financing activities of \$166.0 million. Capital assets, net increased \$51.6 million primarily due to construction projects, purchases of capital equipment, and software development. In addition, accounts receivable, net, increased \$2.4 million, and inventories increased \$1.6 million. These increases were offset by decreases in long-term investments of \$3.0 million, other assets of \$945,000 and notes receivable of \$353,000.
- Deferred outflows of resources decreased \$1.4 million, which represents the unamortized difference between the reacquisition price and the net carrying amount of the refunded debt. The System refunded General Receipts 2005 Notes Series A, and General Receipts 2007 Notes Series A and B during the fiscal year 2015.
- Total liabilities decreased \$20.9 million primarily due to \$15.0 million in principal payments on long-term debt and \$12.1 million in principal payments on capital lease obligations. These were offset by

decreases in unearned revenue of \$3.6 million and long-term liabilities, and other liabilities of \$5.1 million.

- Total net position increased \$84.0 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, 2017, with comparative information for the year ended June 30, 2016. 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.

Statements of Revenues, Expenses and Changes in Net Position **(in thousands)**

	2017	2016 Restated	2015 Restated
OPERATING REVENUES			
Net patient service revenues	\$ 1,402,539	\$ 1,332,714	\$ 1,238,392
Sales and services	54,822	48,307	51,476
Management contract revenue	43,420	42,674	39,265
Total operating revenues	<u>1,500,781</u>	<u>1,423,695</u>	<u>1,329,133</u>
OPERATING EXPENSES			
Salaries and wages	462,465	385,834	343,872
Fringe benefits	129,682	111,343	98,101
Supplies	350,284	327,766	287,184
Purchased services	108,071	152,980	125,669
Other expenses	163,853	166,267	129,015
Depreciation	56,682	53,603	53,167
Management contract expenses	40,305	39,336	35,910
Total operating expenses	<u>1,311,342</u>	<u>1,237,129</u>	<u>1,072,918</u>
NET INCOME FROM CONTINUING OPERATIONS	<u>189,439</u>	<u>186,566</u>	<u>256,215</u>
NONOPERATING REVENUES (EXPENSES)			
State appropriations	1,053	1,053	1,053
Gifts and non-exchange grants	3,383	5,440	4,128
Investment income (loss)	28,227	(2,164)	4,837
Interest expense	(18,621)	(19,496)	(17,099)
Gain (loss) on disposal of capital assets	(164)	(7,364)	497
Other	2,695	(1,678)	721
Net nonoperating revenues (expenses)	<u>16,573</u>	<u>(24,209)</u>	<u>(5,863)</u>
Net income before other revenues, expenses, gains or losses	<u>206,012</u>	<u>162,357</u>	<u>250,352</u>
Transfers (to) the University of Kentucky for noncapital purposes	(96,855)	(75,924)	(60,129)
Transfers (to) the University of Kentucky for capital purposes	4,895	(2,418)	1,810
Total nonoperating and other revenues (expenses)	<u>(91,960)</u>	<u>(78,342)</u>	<u>(58,319)</u>
Total increase in net position	114,052	84,015	192,033
Net position, beginning of year	<u>1,097,765</u>	<u>1,013,750</u>	<u>821,717</u>
Net position, end of year	<u>\$ 1,211,817</u>	<u>\$ 1,097,765</u>	<u>\$ 1,013,750</u>

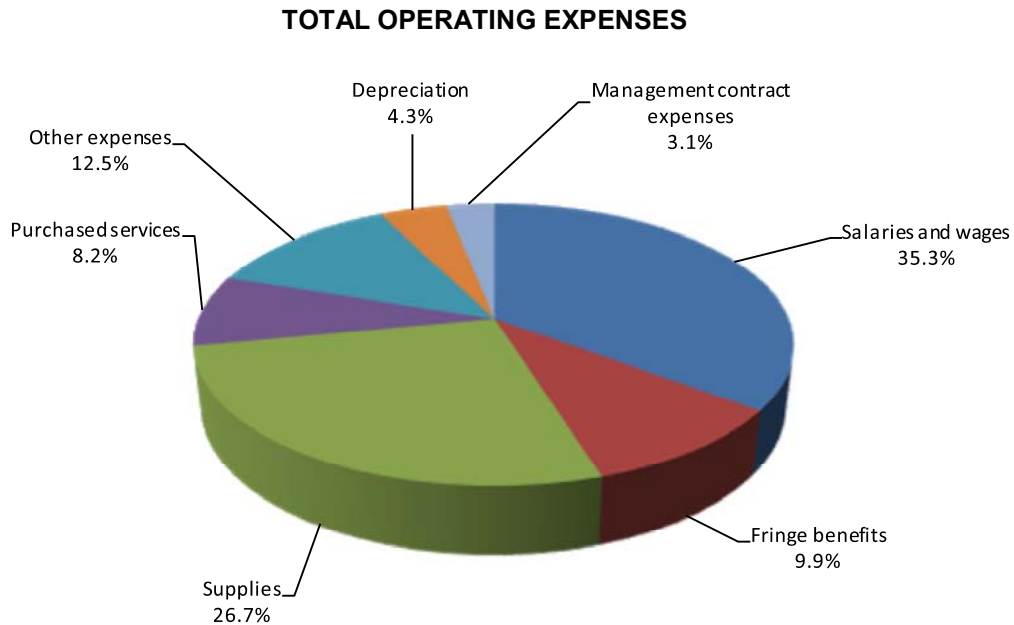
Operating Revenues:

Total operating revenues were approximately \$1.50 billion for the year ended June 30, 2017, an increase of \$77.1 million or 5.4% over fiscal year 2016. The most significant source of operating revenue for the System was net patient service revenues of \$1.40 billion, an increase of \$69.8 million or 5.2% in fiscal year 2017 over 2016.

Inpatient net revenue, including bad debt, increased \$36.0 million or 4.4% over prior year. Rate was the primary driver of the increase which can be partially attributed to a 0.6% increase in acuity, with case mix index closing the year at 2.0128. In addition, a favorable payer mix change driven by an increase of 763 Medicare cases, 136 commercial cases, and 33 Medicaid cases.

Outpatient net revenue, including bad debt, increased by \$33.8 million or 6.5% over prior year. Outpatient activity increased by 6.5% over prior year and an increase of 3,503 in emergency room visits.

Bad debt provision decreased by \$143,000 or 0.2% over prior year.



Operating Expenses:

Total operating expenses, including \$56.7 million of depreciation, were \$1.31 billion, an increase of \$74.2 million or 6.0% over the prior year.

Salaries and wages increased by \$76.6 million over the prior fiscal year. The increase in salary and wages was driven by an FTE increase of 1,004, a 13.4% increase over prior year. The majority of this increase, 679 FTEs (\$50.6 million) was the transition of Medical Directors and graduate medical education (GME) staff to hospital payroll instead of reimbursing through Enterprise Investment Requests with the College of Medicine. Fringe benefits increased \$18.3 million or 16.4%.

Supplies expenses increased by \$22.5 million or 6.9% primarily due to increases in drugs and antibiotics and variable hospital supplies, and an increase in the inpatient population. Purchased services decreased \$44.9 million or 29.3% primarily due to the \$50.6 million transfer of medical directors and GME staff to hospital payroll instead of reimbursing through Enterprise Investment Requests (EIR) transfers to the College of Medicine. This was offset by increases in lab services of \$2.3 million and contract labor of \$7.2 million. Other expenses decreased \$2.4 million or 1.4% primarily as a result in decreases in professional liability claims of \$5.5 million and minor equipment service contracts of \$3.4 million. This was offset by increases in job order charges of \$2.2 million, environment charges of \$1.2 million and computer maintenance and license fees of \$2.8 million.

Nonoperating Revenues (Expenses):

Total nonoperating revenues were \$16.6 million in fiscal year 2017 compared to nonoperating expenses of \$24.2 million during the prior fiscal year, an increase of \$40.8 million. This increase is primarily due to a \$30.4 million increase in investment gains and a \$7.2 million decrease in loss on disposal in fiscal year 2016 which stemmed from a change in capitalization policies. Gifts and non-exchange grants also decreased \$2.1 million.

Transfers to the University of Kentucky increased to \$92.0 million in 2017 compared to \$78.3 million in 2016 primarily because of an increase in noncapital transfers of \$20.9 million. This was mainly due to an increase in Enterprise Investment requests to the College of Medicine of \$31.5 million. This was offset by an increase in transfers from the University of Kentucky for capital purposes of \$7.3 million

2016 Versus 2015. Total operating revenues were \$1.42 billion for the fiscal year ended June 30, 2016, an increase of \$94.6 million over the year ended June 30, 2015. The increase in operating revenues was primarily due to increased net patient service revenues.

Operating expenses totaled \$1.24 billion, an increase of \$164.2 million over 2015. The increase was caused primarily by higher costs for personnel, supplies and other expenses.

Nonoperating expenses amounted to (\$24.2) million in fiscal year 2016 compared to net nonoperating revenues, net of expenses, of (\$5.9) million in the prior year. This decrease is primarily due to interest expense of \$19.5 million and a loss on disposal of capital net assets of \$7.4 million.

Statement of Cash Flows

The Statement of Cash Flows details how cash has increased or decreased during the year ended June 30, 2017, with comparative financial information for the year ended June 30, 2016. 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)

	2017	2016 Restated	2015 Restated
CASH PROVIDED (USED) BY:			
Operating activities	\$ 231,047	\$ 246,288	\$ 320,721
Noncapital financing activities	(90,616)	(67,937)	(42,011)
Capital and related financing activities	(198,145)	(165,993)	38,487
Investing activities	5,826	876	2,774
Net increase (decrease) in cash and cash equivalents	(51,888)	13,234	319,971
Cash and cash equivalents, beginning of year	444,873	431,639	111,668
Cash and cash equivalents, end of year	<u>\$ 392,985</u>	<u>\$ 444,873</u>	<u>\$ 431,639</u>

2017. The major sources of cash included in operating activities was patient service revenues of \$1.40 billion, sales and services of \$54.8 million and management contract services of \$42.2 million. Cash payments for operating activities were \$619.8 million to suppliers, \$604.0 million to employees for salaries, wages and fringe benefits, payments on management contract services of \$39.9 million and other receipts of \$425,000.

Cash used by noncapital financing consists of transfers to the University of Kentucky for noncapital purposes of \$96.9 million offset by an inflow of cash from gifts of \$4.7 million, state appropriations of \$1.1 million, and payments on loan from University departmental units of \$523,000.

Cash used by capital and related financing activities included purchases of capital assets of \$152.5 million, principal and interest payments on long-term obligations of \$47.1 million.

Investing activities included proceeds from sales and maturities of investments of \$198.4 million and interest and dividends of \$6.1 million. Cash of \$198.7 million was used to purchase investments.

2016 Versus 2015. Cash balances increased when comparing fiscal year 2016 versus fiscal year 2015 with a net increase in cash of approximately \$13.2 million. The net increase was the result of more cash provided by operating activities than the cash used by noncapital financing activities and capital and related financing activities.

Key Ratios

The following table shows key liquidity and capital ratios for fiscal years 2017, 2016, and 2015:

	2017	2016	2015
Days cash on hand	114	138	154
Days of revenue in accounts receivable	42	39	41
Debt service coverage (times)	4.0	3.2	5.4

Days cash on hand decreased to 115 days in fiscal year 2017 from 139 days in fiscal year 2016. Days cash on hand measures the average number of days' expenses the System maintains in cash. In addition, the System has access to working capital from the University and quasi-endowment investments of \$291.1 million.

The days of revenue in accounts receivable measures the average number of days it takes to collect accounts receivable. In fiscal year 2017, days in accounts receivable were 42 compared to 39 days in fiscal year 2016.

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 2017 is 4.0 versus 3.2 in fiscal year 2016 due to the increase in net position in fiscal year 2017 compared to fiscal year 2016.

Capital Asset and Debt Administration

Capital Assets. Capital assets, net of accumulated depreciation, totaled approximately \$982.5 million at June 30, 2017, a net increase of \$104.2 million over the prior year end. Significant changes in capital assets during fiscal 2016-17 included (in millions):

Land, buildings and structures, net additions	\$ 48.0
Equipment and vehicles, net additions	28.6
Capitalized software additions	17.0
Artwork	0.1
Construction in process, net additions	57.7
Increase in accumulated depreciation, net	<u>(47.2)</u>
Total	<u><u>\$ 104.2</u></u>

Debt. At June 30, 2017, the System had \$411.3 million in general receipts project notes outstanding and a \$19.2 million loan due to the University; \$18.5 million is included in current liabilities with the remainder long term. In addition, the System had \$34.0 million in capital leases.

Economic Factors Impacting Future Periods

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

- Health care reform has initiated significant change for health care organizations across the United States. The Centers for Medicare and Medicaid Services continue to implement programs such as the Quality Payment Program and alternative payment models that include material changes to the delivery of health care services and reimbursement from Medicare. In addition, proposed changes at the federal level to the Affordable Care Act could significantly affect health care coverage rates across the U.S., but particularly in Kentucky. At the state level, in June 2016, Governor Matt Bevin applied for a federal waiver to undertake sweeping changes to the state's \$10 billion per year Medicaid program that covers about 1.3 million Kentuckians. The plan is aimed to empower individuals to improve their health and well-being while simultaneously ensuring Medicaid's long-term fiscal sustainability. The long-term impact is largely unknown as the long period between approval and implementation lends to some level of uncertainty. UK HealthCare continues to develop and execute strategies in an effort to leverage available opportunities and mitigate negative impacts of multiple federal and state changes as details unfold.
- Chandler Hospital remains No. 1 in Kentucky for the second consecutive year in the U.S. News & World Report's Best Hospitals rankings. Additionally, we are nationally ranked in four adult specialties. The Best Hospital designation is derived from a stringent data-driven ratings system that gauges performance in multiple clinical specialties, procedures and conditions. Scores are based on a variety of patient-outcome and care-related factors, such as mortality, patient safety and reputation. High performance in these national indicators is representative of our commitment to being an elite academic medical center dedicated to providing complex medical care in Kentucky and beyond.
- In May and June 2016 UK HealthCare opened both the 9th and 10th floor of Pavilion A. The new state-of-the art areas house medicine intensive care unit beds and universal beds for the medicine service line. This investment will create incremental bed capacity for continued future clinical growth and quality outcomes.

UK HEALTHCARE HOSPITAL SYSTEM
AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY
STATEMENTS OF NET POSITION (in thousands)
JUNE 30, 2017 AND 2016

	<u>2017</u>	<u>2016</u>
ASSETS AND DEFERRED OUTFLOWS OF RESOURCES		
Current Assets		
Cash and cash equivalents	\$ 350,452	\$ 338,804
Accounts receivable (less allowance for doubtful accounts of \$73,425 in 2017 and \$63,419 in 2016)	163,256	140,270
Inventories and other assets	34,715	34,079
Notes receivable	<u>2,634</u>	<u>2,800</u>
Total current assets	<u>551,057</u>	<u>515,953</u>
Noncurrent Assets		
Restricted cash and cash equivalents	42,533	106,069
Long-term investments	291,091	268,666
Capital assets, net	982,543	878,391
Notes receivable	3,607	3,939
Other assets	<u>805</u>	<u>2,155</u>
Total noncurrent assets	<u>1,320,579</u>	<u>1,259,220</u>
Total assets	<u>1,871,636</u>	<u>1,775,173</u>
Deferred Outflows of Resources	<u>9,524</u>	<u>10,946</u>
Total assets and deferred outflows of resources	<u>1,881,160</u>	<u>1,786,119</u>
LIABILITIES		
Current Liabilities		
Accounts payable and accrued liabilities	123,057	134,953
Unearned revenue	16,503	7,030
Estimated third-party payer settlements	35,954	22,818
Long-term debt - current portion	18,494	14,960
Capital lease obligations - current portion	<u>7,147</u>	<u>10,733</u>
Total current liabilities	<u>201,155</u>	<u>190,494</u>
Noncurrent Liabilities		
Long-term liabilities - other	29,224	32,911
Long-term liabilities - debt	412,062	430,925
Capital lease obligations	<u>26,902</u>	<u>34,024</u>
Total noncurrent liabilities	<u>468,188</u>	<u>497,860</u>
Total liabilities	<u>669,343</u>	<u>688,354</u>
NET POSITION		
Net investment in capital assets	<u>521,040</u>	<u>455,374</u>
Restricted		
Nonexpendable other	<u>751</u>	<u>195</u>
Expendable		
Debt Service	2,703	-
Capital projects	2,750	5,212
Other	<u>6,209</u>	<u>6,690</u>
Total restricted expendable	<u>11,662</u>	<u>11,902</u>
Total restricted	<u>12,413</u>	<u>12,097</u>
Unrestricted	<u>678,364</u>	<u>630,294</u>
Total net position	<u>\$ 1,211,817</u>	<u>\$ 1,097,765</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, 2017 AND 2016

	<u>2017</u>	<u>2016</u> (Restated - Note 19)
OPERATING REVENUES		
Net patient service revenues, less provision for doubtful accounts of \$74,715 in 2017 and \$74,858 in 2016	\$ 1,402,539	\$ 1,332,714
Sales and services	54,822	48,307
Management contract revenue	43,420	42,674
Total operating revenues	<u>1,500,781</u>	<u>1,423,695</u>
OPERATING EXPENSES		
Salaries and wages	462,465	385,834
Fringe benefits	129,682	111,343
Supplies	350,284	327,766
Purchased services	108,071	152,980
Other expenses	163,853	166,267
Depreciation	56,682	53,603
Management contract expenses	40,305	39,336
Total operating expenses	<u>1,311,342</u>	<u>1,237,129</u>
Net income from continuing operations	<u>189,439</u>	<u>186,566</u>
NONOPERATING REVENUES (EXPENSES)		
State appropriations	1,053	1,053
Gifts and non-exchange grants	3,383	5,440
Investment income (loss)	28,227	(2,164)
Interest expense	(18,621)	(19,496)
Loss on disposal of capital assets	(164)	(7,364)
Other	2,695	(1,678)
Net nonoperating revenues (expenses)	<u>16,573</u>	<u>(24,209)</u>
Net income before other revenues, expenses, gains or losses	<u>206,012</u>	<u>162,357</u>
Transfers (to) the University of Kentucky for noncapital purposes	(96,855)	(75,924)
Transfers (to) from the University of Kentucky for capital purposes	4,895	(2,418)
Total other revenues (expenses)	<u>(91,960)</u>	<u>(78,342)</u>
INCREASE IN NET POSITION	114,052	84,015
NET POSITION, beginning of year	<u>1,097,765</u>	<u>1,013,750</u>
NET POSITION, end of year	<u>\$ 1,211,817</u>	<u>\$ 1,097,765</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, 2017 AND 2016

	2017	2016 (Restated - Note 19)
CASH FLOWS FROM OPERATING ACTIVITIES		
Net patient service revenues	\$ 1,397,357	\$ 1,335,901
Sales and services	54,822	48,307
Management contract services	42,187	39,737
Payments to vendors and contractors	(619,775)	(645,746)
Salaries, wages and fringe benefits	(604,022)	(490,932)
Payments on management contract services	(39,947)	(39,440)
Other receipts (payments)	425	(1,539)
Net cash provided (used) by operating activities	<u>231,047</u>	<u>246,288</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations	1,053	1,053
Gifts	4,663	6,399
Payments on loans from University of Kentucky departmental units	523	535
Transfers from (to) the University of Kentucky for noncapital purposes	(96,855)	(75,924)
Net cash provided (used) by noncapital financing activities	<u>(90,616)</u>	<u>(67,937)</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchases of capital assets	(152,506)	(119,318)
Principal payments-capital leases and long-term obligations	(26,037)	(27,162)
Interest payments-capital leases and long-term obligations	(21,058)	(17,444)
Transfers from (to) the University of Kentucky for capital purposes	1,456	(2,069)
Net cash provided (used) by capital and related financing activities	<u>(198,145)</u>	<u>(165,993)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	198,422	111,008
Purchase of investments	(198,700)	(115,565)
Interest and dividends on investments	6,104	5,433
Net cash provided (used) by investing activities	<u>5,826</u>	<u>876</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>(51,888)</u>	<u>13,234</u>
CASH AND CASH EQUIVALENTS, beginning of year	<u>444,873</u>	<u>431,639</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 392,985</u>	<u>\$ 444,873</u>
Reconciliation of net income from continuing operations to net cash provided by operating activities:		
Net income from continuing operations	\$ 189,439	\$ 186,566
Adjustments to reconcile net income from continuing operations to net cash provided (used) by operating activities:		
Depreciation	56,682	53,603
Write off of principal note/lease receivable	(761)	(633)
Provision for doubtful accounts	(74,715)	(74,858)
Change in assets and liabilities:		
Accounts receivable	51,729	72,436
Inventories and other	(636)	(1,648)
Estimated third-party payer settlements receivable and payable	13,136	2,661
Other assets	783	434
Accounts payable and accrued liabilities	(14,083)	11,319
Unearned revenue	9,473	(3,592)
Net cash provided by operating activities	<u>\$ 231,047</u>	<u>\$ 246,288</u>
NON CASH TRANSACTIONS:		
Transfer of capital assets from (to) UK	\$ 3,439	\$ (349)
Capital asset changes in accounts payable	\$ 2,809	\$ 6,229
Capitalized interest, net of investment income	\$ 2,242	\$ 2,032
Amortized bond premium	\$ 4,116	\$ 4,116
Amortized difference between reacquisition price and net carrying amount of refunded debt	\$ 1,422	\$ 1,422

See notes to financial statements

**UK HEALTHCARE HOSPITAL SYSTEM
AN ORGANIZATIONAL UNIT OF THE UNIVERSITY OF KENTUCKY
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2017 AND 2016**

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The UK HealthCare Hospital System (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 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.

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, net position, revenues, expenses, changes in net position and cash flows.

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 endowments are managed in a consolidated investment pool which consists of more than 2,200 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 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. 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 makes 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.

The adopted spending policy is 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 University also utilized an endowment management fee to support internal management and fundraising costs related to the endowment. For the years ended June 30, 2017 and 2016 the University's annual endowment management fee was 0.50%.

To protect endowment funds from permanent impairment of value, spending and management fee withdrawals are suspended on endowments with a market value less than the contributed value by more than 20%. Additionally, endowments with a market value less than the contributed value by more than 10% undergo a formal review to determine the appropriate level of spending in accordance with various factors set forth in UPMIFA. All donor restrictions and stipulations prevail in decisions regarding preservation and spending of endowment funds.

For each of the years ended June 30, 2017 and 2016, 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 was \$9.7 million and \$9.1 million, respectively.

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 a currently active project, net of interest earned on investments acquired with the proceeds of the borrowing. The System also capitalizes interest costs as a component of construction in progress on projects funded by unrestricted funds based on the interest costs of borrowings no longer associated with a specific project. The calculation is based on a project's average expenditures times the weighted average interest rate borrowings.

Equipment with a unit cost of \$5,000 and having an estimated useful life of greater than one year is capitalized. Institutional software costing more than \$400,000 is capitalized. Renovations to buildings, infrastructure and land improvements that significantly increase the value or extend the useful life of the structure are capitalized. Routine repairs and maintenance are charged to operating expense in the year in which the expense is incurred.

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

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

Deferred Outflows of Resources. A deferred outflow of resources is a loss in net position by the System that is applicable to a future reporting period. Deferred outflows of resources are reported in the statement of net position, but are not recognized in the financial statements as expense until in the related period. Deferred outflows of resources of \$9.5 million as of June 30, 2017 and \$10.9 million as of June 30, 2016, consisted of the unamortized difference between the reacquisition price and the net carrying amount of the refunded debt. The System issued General Receipts 2014 Bonds Series D to refund General Receipts 2005 Notes Series A which was originally issued to fund the construction of the Patient Care Facility. General Receipts Notes 2007 Series A and B originally issued to fund construction of the Patient Care Facility were refunded by the General Receipts 2015 Bond Series B.

Unearned Revenue. Unearned revenue consists of funds generated from the Kentucky AIDS Drug Assistance Program (KADAP) to be used for allowable costs within the program, and other unearned amounts.

Compensated Absences. The amount of vacation leave earned but not taken by employees at June 30, 2017 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 25% and 31%, respectively, of the System's net patient service revenues before the provision for doubtful accounts for the year ended June 30, 2017 and approximately 24% and 31%, respectively for the year ended June 30, 2016. 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. With expanded Medicaid, more Kentuckians are becoming insured, resulting in a decrease in the

System's self-pay population. This has led to the System's inability to qualify for Disproportionate Share Hospital payments from Medicaid. The monies received from Medicaid which will be recouped are represented as third-party settlements and included in accrued liabilities on the Statement of Net Position totaling \$59.4 million and \$41.1 million for the years ended June 30, 2017 and 2016, respectively.

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.

Management Contract Revenue. The System entered into a contract with the Kentucky Cabinet for Health and Family Services (CHFS) to manage Eastern State Hospital (ESH) and Central Kentucky Recovery Center (CKRC). Under the contract the System is reimbursed 100% of the related operating expenses up to a limit of \$37.2 million, and \$1.9 million, for ESH and CKRC respectively. The System also receives an eight percent management fee. The initial contract term was August 13, 2013 to June 30, 2014 with the option to renew the contract for two additional one-year terms. Subsequent to year end, the contract was renewed for the period of July 1, 2017 to June 30, 2018 with substantially the same terms.

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. 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. The System received no revenue under the Medicare or Medicaid program in 2017 as the final payments were received in 2016 and 2014 respectively. In fiscal year 2016, the System was in the fifth and final year under the Medicare program and recorded \$550,000, which is included in net patient service revenue within operating revenues in the statement of revenues, expenses, and changes in net position.

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. The amount of charges forgone for services and supplies furnished under the System's charity care policy aggregated to approximately \$49.3 million and \$33.0 million in 2017 and 2016, respectively.

Income Taxes. The University, of which the System is an organizational unit, is an agency and instrumentality of the Commonwealth, 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. As of June 30, 2017, the GASB has issued the following applicable statements to the University but are not yet implemented.

- GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, issued June 2015. The provisions of this Statement are effective for fiscal years beginning after June 15, 2017, (fiscal year 2018). This statement establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expenses. This statement addresses employers whose employees are provided defined contribution other postemployment benefits. The University continues to work with an actuary to determine the impact of the pronouncement and estimates the liability of approximately \$267.3 million for the unfunded portion to be recorded on the University's financial statements. 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 unfunded portion.
- GASB Statement No. 81, *Irrevocable Split-Interest Agreements*, issued March 2016. The provisions of this Statement are effective for fiscal years beginning after December 15, 2016, (fiscal year 2018). This statement requires that a government that receives resources pursuant to an irrevocable split-interest agreement recognizes assets, liabilities, and deferred inflows of resources at the inception of the agreement. Furthermore, this Statement requires that a government recognize assets representing its beneficial interests in irrevocable split-interest agreements that are administered by a third party, if the government controls the present service capacity of the beneficial interests. This Statement requires that a government recognize revenue when the resources become applicable to the reporting period. The System currently has no such agreements and statement No. 81 will have no impact on its financial statements.
- GASB Statement No. 84, *Fiduciary Activities*, issued January 2017. The provisions of this Statement are effective for fiscal years beginning after December 15, 2018 (fiscal year 2020). This statement provides guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes; and will require the University to include fiduciary fund financial statements for material fiduciary activities before the notes to the financial statements. The University has determined statement No. 84 will have no material impact on its financial statements. As an organizational unit of the University, the System has no fiduciary activities and statement No. 84 will have no impact on its financial statements.
- GASB Statement No. 87, *Leases*, issued June 2017. The provisions of the Statement are effective for fiscal years beginning after December 15, 2019 (fiscal year 2021.) This Statement requires certain lease assets and liabilities for leases that previously were classified as operating leases to be recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. The Statement establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. The System has yet to determine the impact statement No. 87 will have on its financial statements.

2. DEPOSITS AND INVESTMENTS

The fair value of deposit and investment, by statement of net position classification, at June 30, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Statement of Net Position classification:		
Cash and cash equivalents	\$ 350,452	\$ 338,804
Restricted cash and cash equivalents	42,533	106,069
Total cash and cash equivalents	<u>392,985</u>	<u>444,873</u>
Long-term investments	<u>291,091</u>	<u>268,666</u>
Total Deposits and Investments	<u>\$ 684,076</u>	<u>\$ 713,539</u>

Fair Value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at a measurement date. The framework for measuring fair value established by generally accepted accounting principles provides a fair value hierarchy as follows:

Level 1	Quoted prices in active markets for identical assets or liabilities
Level 2	Observable inputs other than level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
Level 3	Unobservable inputs supported by little or no market activity and are significant to the fair value of the assets or liabilities

The University categorizes its fair value measurements within the fair value hierarchy. Certain investments are measured at fair value using net asset value per share (or its equivalent), practical expedient, amortized costs, or historical costs and therefore have not been classified in the fair value hierarchy. These investments have been included in the table below to permit reconciliation of the fair value hierarchy to the amounts presented in the Statement of Net Position.

The fair value of deposits and investments, by type, at June 30, 2017 and 2016 follows (in thousands):

	2017						
	Total Value	Fair Value Measurement Using				Total Measured at Fair Value	Amortized or Historical Cost
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)			
Cash and cash equivalents	\$ 392,985	\$ -	\$ -	\$ -	\$ -	\$ 392,985	
Guaranteed investment contracts	69	-	-	-	-	69	
Cash surrender value of life insurance policies	597	-	-	-	-	597	
Global equity - U.S.	262	262	-	-	262	-	
Global equity - international	86	86	-	-	86	-	
Real Assets - Public	49	49	-	-	49	-	
Endowed deposits and investments	290,028	-	-	290,028	290,028	-	
Total deposits and investments	\$ 684,076	\$ 397	\$ -	\$ 290,028	\$ 290,425	\$ 393,651	

	2016						
	Total Value	Fair Value Measurement Using				Total Measured at Fair Value	Amortized or Historical Cost
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)			
Cash and cash equivalents	\$ 444,873	\$ -	\$ -	\$ -	\$ -	\$ 444,873	
Guaranteed investment contracts	34	-	-	-	-	34	
Cash surrender value of life insurance policies	550	-	-	-	-	550	
Global equity - U.S.	116	116	-	-	116	-	
Global equity - international	37	37	-	-	37	-	
Real Assets - Public	24	24	-	-	24	-	
Endowed deposits and investments	267,905	-	-	267,905	267,905	-	
Total deposits and investments	\$ 713,539	\$ 177	\$ -	\$ 267,905	\$ 268,082	\$ 445,457	

Where quoted market prices are available in an active market, securities are classified within level 1 of the valuation hierarchy. If quoted prices are not available, then fair values are estimated by using quoted prices of securities with similar characteristics or independent asset pricing services and pricing models, the inputs of which are market-based or independently sourced market parameters, including, but not limited to, yield curves, interest rates, volatiles, prepayments, defaults, cumulative loss projections and cash flows. Such securities are classified in level 2 of the valuation hierarchy.

The investment in University pooled endowment fund is derived based on the per unit calculation as described in footnote 1, thus is deemed to be a level 3 investment. There have been no significant changes in the valuation techniques during the year ended June 30, 2017. For more information regarding the fair value measurements, refer to the University's financial statements, note 2.

The composition of the University's pooled endowment fund based upon fair value at June 30, 2017 and 2016 is as follows:

	2017	2016
Cash and cash equivalents	0.4%	0.7%
Diversifying strategies	18.8%	16.2%
Global equity - hedged fund	8.3%	13.5%
Global equity - international	13.8%	13.9%
Global equity - private	14.2%	14.2%
Global equity - U.S.	9.6%	13.7%
Global fixed income - high quality/rate sensitive	8.2%	3.7%
Global fixed income - private credit	3.0%	2.0%
Global fixed income - public credit	4.9%	4.1%
Real assets - private	9.6%	10.8%
Real assets - public	9.2%	7.2%
Total	100.0%	100.0%

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

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

- Cash on deposit with the University, which the University invests in deposits and money market funds with banks, the Commonwealth and other financial institutions.
- 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 established by the Treasurer of the University.

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

Deposit and Investment Risks. The System's deposits and investments are exposed to various risks including credit, interest rate and foreign currency risk. 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 (FDIC). The System's deposits are insured up to \$250,000 at each FDIC insured institution. Credit risk on deposits in excess of FDIC coverage with local banks is mitigated by the issuing financial institution's pledge of specific U.S. Treasury or agency securities, held in the name of the University by the Federal Reserve Bank. Money market fund portfolios consist of securities eligible for short-term investments.
- Endowment managers are permitted to use derivative instruments to limit credit risk.

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 University is invested in deposits and money market funds which are held in the University's name by various financial institutions. Deposits with the Commonwealth are held in the Commonwealth's name. The University maintains records evidencing the System's ownership interest of such balances.
- Endowment investments are held in the University's name by the University's custodian. The University maintains records evidencing the System's ownership interest of such balances.

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 deposit 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.
- The University's endowment fixed income managers are limited to a maximum investment in any one issuer of no more than five percent of total investments excluding sovereign debt of governments belonging to the Organization for Economic Cooperation and Development and U.S. agencies.

At June 30, 2017 and 2016, the System had no investments in any one issuer that represented 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 University 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 the University's core-plus fixed income managers are limited to a duration that is within two years of the duration of the Barclay's Aggregate Bond Index and new unconstrained fixed income strategies have been implemented to further protect against interest rate risk.

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. Endowment managers are permitted to use derivative instruments to limit foreign currency risk.

3. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net, as of June 30, 2017 and 2016 are as follows (in thousands):

	2017		
	Gross Receivable	Allowance	Net Receivable
Medicare, Medicaid and other third parties	\$ 236,048	\$ (73,077)	\$ 162,971
Private pay	173	(59)	114
Pledges receivable (less discount of \$12)	460	(289)	171
Total	\$ 236,681	\$ (73,425)	\$ 163,256

	2016		
	Gross Receivable	Allowance	Net Receivable
Medicare, Medicaid and other third parties	\$ 200,237	\$ (61,165)	\$ 139,072
Private pay	63	(18)	45
Pledges receivable (less discount of \$10)	3,389	(2,236)	1,153
Total	\$ 203,689	\$ (63,419)	\$ 140,270

The above pledges receivable are shown net of present value discount.

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, 2017 and 2016, the System recorded the discounted value of operating and capital pledges using a rate of two percent.

The System has recorded an allowance for uncollectible patient accounts receivable equal to 33.2% and 30.6% of patient accounts receivable as of June 30, 2017 and 2016, respectively. A summary of the changes in the allowance for uncollectible patient accounts receivable is as follows:

	2017	2016
Balance, beginning of year	\$ 63,419	\$ 43,015
Provision for bad debts	74,715	74,858
Receivables charged off, net of recoveries	(64,709)	(54,454)
Balance, end of year	\$ 73,425	\$ 63,419

4. CAPITAL ASSETS, NET

Capital assets as of June 30, 2017 and capital asset activity for the year ended June 30, 2017 are summarized as follows (in thousands):

	Beginning Balance	Additions	Deletions	Ending Balance
Land	\$ 25,488	\$ 5,123	\$ -	\$ 30,611
Non-depreciable land improvements	16,197	-	-	16,197
Depreciable land improvements	8,737	147	-	8,884
Buildings	834,679	34,446	91	869,034
Fixed equipment	30,296	4,598	-	34,894
Infrastructure	27,866	3,770	-	31,636
Equipment	262,085	38,972	10,331	290,726
Vehicles	1,220	436	461	1,195
Capitalized software	86,182	16,960	-	103,142
Artwork	2,268	139	-	2,407
Construction in process	20,782	58,621	954	78,449
Certificate of need	11,609	-	-	11,609
	<u>1,327,409</u>	<u>163,212</u>	<u>11,837</u>	<u>1,478,784</u>
<u>Accumulated Depreciation:</u>				
Depreciable land improvements	5,247	350	-	5,597
Buildings	205,761	20,783	15	226,529
Fixed equipment	15,154	2,558	-	17,712
Infrastructure	7,209	1,180	-	8,389
Equipment	172,588	24,565	8,982	188,171
Vehicles	997	168	462	703
Capitalized software	42,062	7,078	-	49,140
	<u>449,018</u>	<u>56,682</u>	<u>9,459</u>	<u>496,241</u>
Capital assets, net	<u>\$ 878,391</u>	<u>\$ 106,530</u>	<u>\$ 2,378</u>	<u>\$ 982,543</u>

Capital assets as of June 30, 2016 and capital asset activity for the year ended June 30, 2016 are summarized as follows (in thousands):

	Beginning Balance	Additions	Deletions	Ending Balance
Land	\$ 25,338	\$ 150	\$ -	\$ 25,488
Non-depreciable land improvements	15,607	590	-	16,197
Depreciable land improvements	8,737	-	-	8,737
Buildings	767,775	66,955	51	834,679
Fixed equipment	23,987	6,309	-	30,296
Infrastructure	27,866	-	-	27,866
Equipment	259,965	36,878	34,758	262,085
Vehicles	1,220	-	-	1,220
Capitalized software	79,565	6,617	-	86,182
Artwork	1,850	418	-	2,268
Construction in process	25,539	1,844	6,601	20,782
Certificate of need	11,609	-	-	11,609
	<u>1,249,058</u>	<u>119,761</u>	<u>41,410</u>	<u>1,327,409</u>
<u>Accumulated Depreciation:</u>				
Depreciable land improvements	4,896	351	-	5,247
Buildings	186,690	19,077	6	205,761
Fixed equipment	13,003	2,151	-	15,154
Infrastructure	6,094	1,115	-	7,209
Equipment	175,358	24,062	26,832	172,588
Vehicles	884	113	-	997
Capitalized software	35,328	6,734	-	42,062
	<u>422,253</u>	<u>53,603</u>	<u>26,838</u>	<u>449,018</u>
Capital assets, net	<u>\$ 826,805</u>	<u>\$ 66,158</u>	<u>\$ 14,572</u>	<u>\$ 878,391</u>

At June 30, 2017, the System has commitments in construction projects in progress totaling approximately \$335.4 million in scope. The estimated cost to complete these projects was approximately \$253.0 million. Such construction is principally financed by the System's cash reserves, loans from the University and proceeds from the System general receipts bonds.

Interest costs incurred during construction, net of related investment income, are capitalized. Total interest capitalized was \$2.2 million for 2017 and \$2.0 million for 2016.

During 2017 and 2016, the System utilized capital leases to acquire various items of equipment. The net book value for capitalized leased land, buildings and equipment is \$38.6 million and \$45.0 million at June 30, 2017 and 2016, respectively.

5. NOTES RECEIVABLE

Notes receivable at June 30, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Non-interest bearing, unsecured receivable from UK College of Pharmacy	\$ 4,500	\$ 5,000
Non-interest bearing, unsecured receivable from UK College of Nursing	1,741	1,739
Total	<u>\$ 6,241</u>	<u>\$ 6,739</u>
Current portion	\$ 2,634	\$ 2,800
Noncurrent portion	3,607	3,939
Total	<u>\$ 6,241</u>	<u>\$ 6,739</u>

6. OTHER ASSETS

Other assets at June 30, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Amounts on deposit with trustee	\$ 2	\$ 25
Noncurrent portion of prepaid expenses	240	287
Pledges receivable noncurrent, net	563	1,843
Total	<u>\$ 805</u>	<u>\$ 2,155</u>

The amounts on deposit with the trustee represent cash equivalents, measured as a level 1 on the fair value hierarchy as discussed in note 2.

7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities as of June 30, 2017 and 2016 are summarized as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Payable to vendors and contractors	\$ 63,952	\$ 57,647
Due to the University of Kentucky	4,878	3,617
Accrued expenses, including vacation leave	54,227	73,689
Total	<u>\$ 123,057</u>	<u>\$ 134,953</u>

8. LONG-TERM DEBT

Long-term debt as of June 30, 2017 and 2016 are summarized as follows (in thousands):

	2017					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
General Receipts						
Project Notes	\$ 423,250	\$ -	\$ 11,901	\$ 411,349	\$ 15,471	\$ 395,878
Due to the University of Kentucky	22,635	-	3,428	19,207	3,023	16,184
Total	<u>\$ 445,885</u>	<u>\$ -</u>	<u>\$ 15,329</u>	<u>\$ 430,556</u>	<u>\$ 18,494</u>	<u>\$ 412,062</u>
	2016					
	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
General Receipts						
Project Notes	\$ 435,245	\$ -	\$ 11,995	\$ 423,250	\$ 11,901	\$ 411,349
Due to the University of Kentucky	25,660	-	3,025	22,635	3,059	19,576
Total	<u>\$ 460,905</u>	<u>\$ -</u>	<u>\$ 15,020</u>	<u>\$ 445,885</u>	<u>\$ 14,960</u>	<u>\$ 430,925</u>

Principal maturities and interest on long-term debt for the next five years and in subsequent five-year periods as of June 30, 2017 are as follows (in thousands):

	Principal	Interest	Total
2018	\$ 18,494	\$ 19,390	\$ 37,884
2019	18,958	18,580	37,538
2020	19,433	17,727	37,160
2021	22,560	16,818	39,378
2022	23,579	15,757	39,336
2023-2027	118,692	61,931	180,623
2028-2032	65,750	38,556	104,306
2033-2037	58,905	26,108	85,013
2038-2042	57,310	11,742	69,052
2043-2045	26,875	2,178	29,053
Total	<u>\$ 430,556</u>	<u>\$ 228,787</u>	<u>\$ 659,343</u>

Bond premiums, which are included in current and noncurrent accrued liabilities, are amortized over the life of the bond using the effective interest method.

The general receipts project notes consist of bonds in the original amount of \$672.6 million dated November 8, 2007 through April 15, 2015, which bear interest at 2.24% to 4.66%. The bonds are payable in annual installments through June 30, 2045. 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 2009 Bonds Series B were issued at a net interest cost of 3.59%. These bonds were issued as Build America Bonds (BAB) 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 2017, is included in gifts and non-exchange grants in the statements of revenues, expenses and changes in net position. The subsidy payment is contingent on federal regulations and may be subject to change. On March 1, 2013, the President signed an executive order to reduce the budgetary authority in accounts subject to sequestration, As a result, the BAB subsidy was reduced to approximately 33% and 32% in 2017 and 2016, respectively.

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 (1.0%). The total effective rate was 1.84% for interest payments in 2017 and 1.66% in 2016. The annual interest rate will be determined March 1 and be effective for the following fiscal year.

At June 30, 2017, assets with a fair market value of approximately \$109.6 million have been placed on deposit with trustees to totally defease bonds with a par amount of \$107.4 million. The liability for these fully defeased bonds is not included in the financial statements.

9. CAPITAL LEASE OBLIGATIONS

Capital lease obligations as of June 30, 2017 and 2016 are summarized as follows (in thousands):

2017					
Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
\$ 44,757	\$ -	\$ 10,708	\$ 34,049	\$ 7,147	\$ 26,902

2016					
Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
\$ 56,899	\$ -	\$ 12,142	\$ 44,757	\$ 10,733	\$ 34,024

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

Years ended June 30		
2018		\$ 8,325
2019		4,913
2020		4,917
2021		2,653
2022		2,655
2022 and later		17,273
Total		40,736
Less amount representing interest		(6,687)
Present value of net minimum lease payments		<u>\$ 34,049</u>

Capital lease obligations are at varying rates of imputed interest of 0.0% to 4.45%.

10. LONG-TERM LIABILITIES – OTHER

Other long-term liabilities as of June 30, 2017 and 2016 are summarized as follows (in thousands):

	2017			Ending Balance
	Beginning Balance	Additions	Reductions	
Refundable deposits	\$ 10	\$ -	\$ -	\$ 10
Unearned compensation	211	255	-	466
Workers compensation	60	96	-	156
Noncurrent construction retainage	30	-	30	-
Noncurrent unamortized bond premium	32,600	-	4,008	28,592
Long-term liabilities - other	<u>\$ 32,911</u>	<u>\$ 351</u>	<u>\$ 4,038</u>	<u>\$ 29,224</u>

	2016			Ending Balance
	Beginning Balance	Additions	Reductions	
Refundable deposits	\$ 10	\$ -	\$ -	\$ 10
Unearned compensation	1,081	-	870	211
Workers compensation	142	-	82	60
Noncurrent construction retainage	60	-	30	30
Noncurrent unamortized bond	36,716	-	4,116	32,600
Long-term liabilities - other	<u>\$ 38,009</u>	<u>\$ -</u>	<u>\$ 5,098</u>	<u>\$ 32,911</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, 2017 and 2016 are as follows (in thousands):

	2017	2016
Working capital requirements	\$ 332,348	\$ 311,171
Future capital expenditures	346,016	319,123
Total	<u>\$ 678,364</u>	<u>\$ 630,294</u>

12. INVESTMENT INCOME (LOSS)

Components of investment income (loss) for the years ended June 30, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Interest and dividends earned on endowment investments	\$ 4,001	\$ 3,112
Realized and unrealized gains and (losses) on endowment investments	22,123	(6,730)
Interest and dividends on cash and non-endowment investments	2,113	1,466
Realized and unrealized gains and (losses) on non-endowment investments	<u>(10)</u>	<u>(12)</u>
Total	<u>\$ 28,227</u>	<u>\$ (2,164)</u>

13. PLEDGED REVENUES

The University has substantially pledged all of the unrestricted operating and nonoperating revenues, including the System revenues, to repay the general receipts bonds and notes issued during 2005 to 2015. Only the General Receipts 2007 Notes Series A and B, General Receipts 2009 Bonds Series B, General Receipts Bonds 2014 Series D and General Receipts Bonds 2015 Series A and B are reflected as the System debt. Proceeds from the bonds and notes provided funding for the construction of the new patient care facility and the refunding of previously issued notes. The bonds and notes are payable from unrestricted operating and nonoperating revenues and are payable through 2045. Annual principal and interest payments on bonds and notes are expected to require less than three percent of pledged revenues. The total principal and interest remaining to be paid on the bonds and notes is \$638.6 million and \$670.1 million as of June 30, 2017 and 2016, respectively. Principal and interest paid for each of the years ended June 30, 2017 and 2016 was \$29.8 million and \$30.1 million, respectively.

14. RETIREMENT PLANS

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

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

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

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

- Teachers Insurance and Annuity Association (TIAA)
- 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 \$32.1 million and \$29.7 million for the years ended June 30, 2017 and 2016, respectively. Employees contributed \$16.1 million and \$14.9 million during 2017 and 2016, respectively. The payroll for employees covered by the retirement plans was \$321.2 million and \$297.3 million for 2017 and 2016, respectively.

15. HEALTH INSURANCE BENEFITS FOR RETIREES

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

The University provides a pre-65 credit of up to 90% of the "true retiree" cost of the least expensive pre-65 medical plan. For post-65 benefits, the University provides a credit equal to 90 percent of the "true retiree" cost of the post-65 medical plan. However, retirees must pay the greater of \$25 per month or 10% 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 No. 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, 2017.

16. 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 \$5,000 and \$1.0 million per occurrence. Losses in excess of \$1.0 million are insured by commercial carriers up to \$1.5 billion per occurrence. Buildings and contents are insured at replacement cost. 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 2016 to 2017. Settlements have not exceeded insurance coverage during the past five 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, 2017, 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, 2017. 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 No. 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, 2017.

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, 2017.

17. 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 \$14.5 million and \$14.6 million respectively in 2017 and 2016 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 2017 and 2016, the System received payments of approximately \$31.6 million and \$31.1 million, respectively, from the University for the capitation health plan. Noncapital transfers between the System and the University increased \$20.9 million over prior year which was mainly due to increased Enterprise Investment requests to the College of Medicine, of \$31.5 million, which was offset by an increase in capital transfers from the University of \$7.3 million.

18. RECLASSIFICATIONS

Certain reclassifications to fiscal year 2016 comparative amounts have been made to conform to the fiscal year 2017 financial statement classifications. Such reclassifications had no effect on the change in net position.

19. RESTATEMENT OF PRIOR YEAR'S FINANCIAL STATEMENTS

The System's audited financial statements for the year ended June 30, 2016 have been restated to reflect the reclassification of certain transactions between the System and the University, primarily with College of Medicine. The transactions previously were reported within purchased services in the statements of revenues, expenses, and changes in net position. The transactions were determined to be more appropriately considered a subsidy to the clinical enterprise and have been reclassified as transfers to the University noncapital in the non-operating activities section of the statements of revenues, expenses, and changes in net position. The restatement had no effect on the net increase in the net position. The restatement also impacted the statement of cash flows as shown below.

	As Restated	As Previously Reported	Effect of Change
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION			
Purchased services	\$ 152,980	\$ 214,458	\$ (61,478)
Total operating expenses	\$ 1,237,129	\$ 1,298,607	\$ (61,478)
Net income from continuing operations	\$ 186,566	\$ 125,088	\$ 61,478
Net income before other revenues, expenses, gains or losses	\$ 162,357	\$ 100,879	\$ 61,478
Transfers (to) the University of Kentucky for noncapital purposes	\$ (75,924)	\$ (14,446)	\$ (61,478)
Total other revenues (expenses)	\$ (78,342)	\$ (16,864)	\$ (61,478)
STATEMENTS OF CASH FLOWS			
Payments to vendors and contractors	\$ (645,746)	\$ (707,224)	\$ 61,478
Net cash provided (used) by operating activities	\$ 246,288	\$ 184,810	\$ 61,478
Payments to the University of Kentucky for noncapital purposes	\$ (75,924)	\$ (14,446)	\$ (61,478)
Net cash provided (used) by noncapital financing activities	\$ (67,937)	\$ (6,459)	\$ (61,478)



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