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Introductory Matters

The purpose of this report is to summarize various matters relating to our approach for the June 30, 2014, audit of the financial statements of the University of Kentucky (UK) and its subsidiaries.

Audits of Financial Statements

We will conduct our audits in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Audit Standards* issued by the Comptroller General of the United States and U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Our audits will be made for the purpose of rendering opinions on the following financial statements as of and for the year ended June 30, 2014:

✔ UK
✔ UK Healthcare Hospital System (Hospital)
✔ UK Department of Intercollegiate Athletics
✔ WUKY – FM Radio

Our engagement also includes audits of the financial statements of the following entities, which are communicated in separate pre-audit reports to the governance of those respective entities:

✔ UK Research Foundation
✔ The Fund for Advancement of Education and Research in the UK Medical Center
✓ Central Kentucky Management Services, Inc.
✓ UK Mining Engineering Foundation, Inc.
✓ UK Gluck Equine Research Foundation, Inc.
✓ UK Humanities Foundation, Inc.
✓ UK Center on Aging Foundation
✓ Kentucky Tobacco Research and Development Center

An audit of the financial statements does not relieve management or the audit and compliance subcommittee of their responsibilities.

Other Services

Other services we will provide include:

✓ Audit of the Schedule of Expenditures of Federal Awards
✓ Preparation of annual bond arbitrage calculations
✓ Agreed-upon procedures in accordance with the NCAA’s Financial Audit Guidelines

The actual terms of our engagement are more fully documented in an engagement letter dated December 23, 2013, and signed by you and BKD.

Our audit approach emphasizes the areas of higher risk, focusing on the unique characteristics of the operating environment, the effectiveness of your internal control and your financial statement amounts and disclosures.

Based on our understanding of UK and our assessment of your internal control, we plan our audit to achieve the appropriate level of assurance regarding material misstatements and material weaknesses in internal control over financial reporting.
We have preliminarily identified the following areas as significant risks of material misstatement due to error or fraud and propose to address these areas as described:

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<td>Risk of management override of controls</td>
<td>Review accounting estimates for bias, review of journal entries, evaluate business rationale for unusual transactions</td>
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<td>Self-insurance for medical malpractice, long-term disability, workers' compensation, health insurance and litigation reserves</td>
<td>Review management’s estimates for self-insurance and test of completeness of liabilities</td>
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<td>Valuation of alternative investments</td>
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<td>Adoption of GASB No. 65 -- <em>Items Previously Reported as Assets and Liabilities</em></td>
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<td>UK Healthcare Hospital System</td>
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<td>Recording of activity related to Eastern State Hospital</td>
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<td>Risk Area</td>
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<td>Contractual allowances and amounts due to/from third-party payers</td>
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We welcome any input you may have regarding the risk areas identified above, any other significant risk areas in your opinion or other matters you believe warrant particular attention during the audits.

We may identify additional significant risks as we complete risk assessment procedures.

We propose the following timeline:

✓ **Final Reports – October 3, 2014**

Final reports to the audit and compliance subcommittee will be issued prior to the Commonwealth of Kentucky’s reporting deadline of October 3, 2014, which is prior to the December 2014 scheduled meetings of the audit and compliance subcommittee and board of trustees.

✓ **Ongoing Communication**

Regular communication between the audit and compliance subcommittee and the auditors is critical to the success of the audit. Accordingly, the audit team may be available to the audit and compliance subcommittee and board of trustees at any time throughout the audit, not just the prescribed times identified above. In addition, there may be instances which require communication during the audit (prior to delivery of the financial statements) such as:

- Fraud involving senior management
- Illegal acts
- Significant deficiencies and/or material weaknesses
- Material instances of noncompliance for federal award programs
We understand the appropriate person in the governance structure with whom to communicate is Mr. Bill Britton.

If for any reason, any member of the audit and compliance subcommittee would need to contact us, please call Mary McKinley at 502.581.0435.

We wish to communicate the following significant matters related to the financial statement audit to you that are, in our judgment, relevant to your responsibilities in overseeing the financial reporting process:

**Critical Accounting Policies and Practices**

✓ No matters are reportable.

**Alternative Treatments of GAAP**

✓ No matters are reportable.

**New Audit Techniques to be Applied**

✓ No matters are reportable.

**Critical Audit Areas**

✓ No matters are reportable.

**Locations to be Visited and Scope of Audit Work at These Locations**

✓ UK, UK Hospital and affiliates’ accounting departments.

**Unusual Accounting Matters**

✓ No matters are reportable.

**New Accounting Pronouncements**

✓ GASB No. 65, *Items Previously Reported as Assets and Liabilities*
Reliance on Internal Audit

✓ We will review internal audit’s work plan and all internal audit reports issued during the year ending June 30, 2014, to assist us in identifying risk areas, and to possibly place reliance upon internal audit’s work to reduce our detailed testing procedures. We will not utilize internal audit staff to provide direct staffing assistance to us during our auditing procedures.

One of the most common questions we receive from boards of trustees is, “How do you address fraud in a financial statement audit?” Our responsibility, as it relates to fraud, in an audit of financial statements is addressed in auditing standards generally accepted in the United States of America.

Our audit approach includes such procedures as:

✓ Engagement Team Brainstorming

• Discussions include how and where they believe UK’s financial statements might be susceptible to material misstatement due to errors or fraud, how management could perpetrate and conceal fraudulent financial reporting and how assets of UK could be misappropriated

• An emphasis is placed on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to errors or fraud

✓ Inquiries of Management and Others

• Personnel interviewed include the audit and compliance subcommittee chair, president, treasurer, provost, controller and others

• Inquiries are directed towards the risks of errors or fraud and whether personnel have knowledge of any fraud or suspected fraud affecting UK
✓ Reviewing Accounting Estimates for Bias
✓ Evaluating Business Rationale for Significant Unusual Transactions
✓ Incorporating an Element of Unpredictability Into the Audit Each Year

At this time, we would certainly welcome any additional questions that the audit and compliance subcommittee or board of trustees may have. As always, you may also contact Mary McKinley at 502.581.0435 at any time.

Our clients deserve and to the best of our ability receive unmatched client service. We welcome the opportunity for you to experience the same as we deliver the services outlined above.

Our goal is to deliver results with integrity: results that are unquestionably ethical while also practical, timely and affordable.
EFFECT OF RECENT GASB PRONOUNCEMENTS

April 1, 2014

CPAs & ADVISORS

Experience perspective

[Image of a cityscape]

[Red vertical stripe]
DISCUSSION

// GASB No. 60 – Accounting and Financial Reporting for Service Concession Arrangements
(Effective for fiscal year ended June 30, 2013)

// GASB No. 65 – Items Previously Reported as Assets and Liabilities
(Effective for fiscal year ending June 30, 2014)

// GASB No. 68 – Accounting and Financial Reporting for Pensions—an amendment of GASB
Statement No. 27 (Effective for fiscal year ending June 30, 2015)

// GASB No. 71 – Pension Transition for Contributions Made Subsequent to the Measurement
Date—an amendment of GASB Statement No. 68 (Effective for fiscal year ending June 30, 2015)

// GASB No. 69 – Government Combinations and Disposals of Government Operations
(Effective for fiscal year ending June 30, 2015)

// GASB No. 70 – Accounting and Financial Reporting for Nonexchange Financial Guarantees
(Effective for fiscal year ending June 30, 2014)
GASB 60 – ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS

Decision tree/flowchart – all yes = service concession arrangement
1. Right/obligation to provide service in exchange for consideration?
2. Public asset used?
3. Operator compensated by service recipients?
4. Transferor exercises control over services, recipients and rates?
5. Transferor retains significant residual interest in asset?
GASB 60 – ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS

// Education Realty Trust (EdR) Contract Phase I

// Agreement overview

// Dorms opened in August 2013

// Initial 50-year term for lease of land to EdR

// 1st renewal – 10 years – UK required to purchase dorms at fair market value, unless
// 2nd renewal option exercised

// 2nd renewal option – 15 years – UK required to purchase dorms for $10

// Considered for GASB 60 accounting treatment; however, as title to the halls does not transfer to UK at the end of the initial lease term, GASB No. 60 is not applicable

// In FY ’13 -’14, UK began recording ground lease revenues from EdR under an operating lease arrangement
GASB 60 – ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS

// Education Realty Trust (EdR) Contract Phase II

// Agreement overview

// Multiple projects – 1st dorm to open in August 2014
// 75-year term for lease of land to EdR
// UK to immediately take title to dorm buildings upon construction completion

// GASB 60 accounting treatment is applicable

// In FY '14 - '15, UK will record

// The cost of the buildings and furnishings as an asset (approximately $133 million)
// Accrued liabilities for insurance on the assets (approximately $5 million)
// Deferred inflows for service concession arrangements (approximately $128 million)

// In FY '14 - '15 and in future years, UK will record depreciation on the building and furnishings (75 years); and will record amortization on the service concession amount (75 years)

// Furnishings will be continually replaced over 75 year term
// Depreciation expense (debit to financial statements) will = amortization of service concession "income" (credit to financial statements)
GASB NO. 65 – ITEMS PREVIOUSLY REPORTED AS ASSETS AND LIABILITIES

// Effective for June 30, 2014 financial statements
// Retroactive application required – Restated financial statements
// Debt issuance costs previously recorded as assets, will be written off to expense (approximately $3.7 million at July 1, 2012)
// Deferred losses on debt defeasances reclassified from debt line item to deferred outflow line item
// Advance-funded grants containing only time restrictions, will be recorded as deferred inflows
GASB NO. 68 – ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS—AN AMENDMENT OF GASB STATEMENT NO. 27

// Effective for June 30, 2015 financial statements
// Retroactive application required – Restated financial statements
// Primarily affects multi-employer defined benefit plans (e.g., KTRS, KERS)
  // Pension expense reported as employees earn benefits by providing services
  // If unfunded amount, statements report a net pension liability
// UK has defined contribution pension plan
// Regional universities, state government, others will record significant liabilities upon adoption
GASB NO. 71 – PENSION TRANSITION FOR CONTRIBUTIONS MADE SUBSEQUENT TO THE MEASUREMENT DATE

// Required to be applied simultaneously with the provisions of Statement 68
// Amends paragraph 137 of Statement 68 – At the beginning of the period in which the provisions of 68 are adopted, there may be circumstances in which it is not practical for a government to determine the amounts of ALL applicable deferred inflows of resources and deferred outflows of resources related to pensions. In such circumstances, the government should recognize a beginning deferred outflow of resources only for its pension contributions, if any, made subsequent to the measurement date of the beginning net pension liability but before the start of the government’s fiscal year.
GASB NO. 69, GOVERNMENT COMBINATIONS & DISPOSALS OF GOVERNMENT OPERATIONS

// Effective for June 30, 2015 financial statements

// Acquisitions

// Record at acquisition values
// Consideration > assets/liabilities = deferred outflow
// Net position > consideration
  // Reduce acquisition values of noncurrent assets acquired or contributed
  // Remaining excess recognized as a special items
GASB 70 – ACCOUNTING AND FINANCIAL REPORTING FOR NONEXCHANGE FINANCIAL GUARANTEE TRANSACTIONS

// Effective for June 30, 2014 financial statements
// Requires a government that extends (or receives) a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not the government will be required to make a payment on the guarantee.

// A Nonexchange Financial Guarantee is a guarantee of an obligation of a legally separate entity or individual, including a blended or discretely presented component unit, which requires the guarantor to indemnify a third-party obligation holder under specified conditions.