Board of Trustees, Audit Subcommittee
and Management
University of Kentucky
Lexington, Kentucky

As part of our audits of the financial statements of the organizations listed below, collectively the Organizations, as of and for the year ended June 30, 2008, we wish to communicate the following to you. Unless specifically identified, the following communications are applicable to all organizations listed below.

- University of Kentucky and Affiliates (University)
- University of Kentucky HealthCare Hospital System (System)
- University of Kentucky Research Foundation and Affiliates (UKRF)
- University of Kentucky Athletic Association (UKAA)
- Kentucky Tobacco Research and Development Center (KTRDC)
- The Fund for Advancement of Education and Research in the University of Kentucky Medical Center (Fund)
- Central Kentucky Management Services, Inc. (CKMS)
- University of Kentucky Mining Engineering Foundation, Inc. (UKMEF)
- University of Kentucky Business Partnership Foundation, Inc. (UKBPF)
- University of Kentucky Gluck Equine Research Foundation, Inc. (UKERF)
- University of Kentucky Humanities Foundation, Inc. (UKHF)
- University of Kentucky Center on Aging Foundation, Inc. (UKCOA)

Audit Scope and Results

Auditor’s Responsibility Under Auditing Standards Generally Accepted in the United States of America

An audit performed in accordance with auditing standards generally accepted in the United States of America is designed to obtain reasonable, rather than absolute, assurance about the financial statements. In performing auditing procedures, we establish scopes of audit tests in relation to the financial statements taken as a whole. Our engagement does not include a detailed audit of every transaction. Our engagement letter more specifically describes our responsibilities.
These standards require communication of significant matters related to the financial statement audit that are relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. Such matters are communicated in the remainder of this letter or have previously been communicated during other phases of the audit. The standards do not require the auditor to design procedures for the purpose of identifying other matters to be communicated with those charged with governance.

An audit of the financial statements does not relieve management or those charged with governance of their responsibilities. Our engagement letter more specifically describes your responsibilities.

Qualitative Aspects of Significant Accounting Policies and Practices

Significant Accounting Policies

The Organizations’ significant accounting policies are described in Note 1 of their respective audited financial statements. With respect to unusual accounting policies or accounting methods used by the Organizations for unusual transactions, we call your attention to the following topics:

- No matters are reportable

Alternative Accounting Treatments

We had discussions with management regarding alternative accounting treatments within accounting principles generally accepted in the United States of America for policies and practices for material items, including recognition, measurement and disclosure considerations related to the accounting for specific transactions as well as general accounting policies, as follows:

- No matters are reportable

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of financial statement preparation by management, based on its judgments. The following areas involve significant areas of such estimates for which we are prepared to discuss management’s estimation process and our procedures for testing the reasonableness of those estimates:

- Allowance for doubtful accounts and pledges receivable
- Self-insurance for medical malpractice, long-term disability, workers’ compensation and health insurance.
- Contractual allowances
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- Purchase accounting for Good Samaritan Hospital

Financial Statement Disclosures

The following areas involve particularly sensitive financial statement disclosures for which we are prepared to discuss the issues involved and related judgments made in formulating those disclosures:

- University - Governmental Accounting Standards Board (GASB) Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*
- University - Self-insurance for medical malpractice, long-term disability, workers' compensation and health insurance
- System - Revenue recognition

Audit Adjustments

During the course of any audit, an auditor may propose adjustments to financial statement amounts. Management evaluates our proposals and records those adjustments which, in its judgment, are required to prevent the financial statements from being materially misstated. Some adjustments proposed were not recorded because their aggregate effect is not currently material; however, they involve areas in which adjustments in the future could be material, individually or in the aggregate.

Areas in which adjustments were proposed include:

Proposed Audit Adjustments Recorded

- No matters are reportable

Proposed Audit Adjustments Not Recorded – University, System, UKRF and the Fund

- Accounts receivable and related revenues
- Accounts payable and related expenses

Attached are summaries of uncorrected misstatements for the University, the System, UKRF and the Fund that we aggregated during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the respective financial statements as a whole.
Auditor's Judgments About the Quality of the Organizations' Accounting Principles

During the course of the audit, we made the following observations regarding the Organizations' application of accounting principles:

- University - Implementation of GASB Statement 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions

Disagreements With Management

The following matters involved disagreements which if not satisfactorily resolved would have caused a modified auditor's opinion on the financial statements:

- No matters are reportable

Consultation With Other Accountants

During our audit we became aware that management had consulted with other accountants about the following auditing or accounting matters:

- No matters are reportable

Significant Issues Discussed With Management

Prior to Retention

During our discussion with management prior to our engagement, the following issues regarding application of accounting principles or auditing standards were discussed:

- No matters are reportable

During the Audit Process

During the audit process, the following issues were discussed or were the subject of correspondence with management:

- University and System - Purchase accounting for Good Samaritan Hospital acquisition and related lease
Difficulties Encountered in Performing the Audit

Our audit requires cooperative effort between management and the audit team. During our audit, we found significant difficulties in working effectively on the following matters:

- No matters are reportable

Other Material Written Communications

Listed below are other material written communications between management and BKD related to the audit:

- Management representation letter (attached)

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements of the Organizations as of and for the year ended June 30, 2008, in accordance with auditing standards generally accepted in the United States of America, we considered the Organizations’ internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organizations’ internal control. Accordingly, we do not express an opinion on the effectiveness of the Organizations’ internal control. As such, our consideration of internal controls would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements of the Organizations’ financial statements on a timely basis. A control deficiency in design exists when a control necessary to meet a control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, a control objective is not always met. A control deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Organizations’ ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Organizations’ financial statements that is more than inconsequential will not be prevented or detected by the Organizations’ internal controls.

A material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the Organizations’ financial statements will not be prevented or detected by the Organizations’ internal controls.
We observed the following matters that we consider to be control deficiencies, significant deficiencies or material weaknesses.

**Material Weaknesses**

No matters are reportable.

**Significant Deficiencies**

No matters are reportable.

**Other Control Deficiencies**

**Unrecorded Misstatements – University, System, UKRF and the Fund**

During the audit, BKD proposed passed adjustments related to unrecorded accounts payable and certain related accounts receivable as reflected on the attachments to this letter. The adjustments were not deemed to be material to the financial statements individually or taken in the aggregate and as a result, they were not recorded in the financial statements.

**Management Response**

While we understand that the auditors feel the obligation to bring this matter to our attention, we disagree with the classification of unrecorded misstatements as a control deficiency.

University financial management has very effective basic and supervisory internal controls to be certain that all material revenues and expenses and related accounts receivable and accounts payable are recorded in the appropriate period. Each April a year-end schedule of cut-off dates is distributed to the University community, in general and to college business officers, specifically. There is a continuing effort to educate the campus about the importance of adhering to accounting principles with regard to cut-off.

Given the distributed nature of responsibility and authority at an organization the size and complexity of the University, the staff in the Office of the Treasurer reviews all significant payments made subsequent to year end and record those material items relating to the prior period that have been overlooked by the campus in general.

In responding to an auditor suggestion, we like to be able to indicate how management will improve a process so that the auditor will feel like the suggestion has been taken to heart. In this case, we cannot identify any process improvement to make as a result of the comment. The items denoted in the audit represent amounts that were determined to be immaterial by management. Such items will exist every year.
Other Matters

Although not considered material weaknesses, significant deficiencies or other control deficiencies in internal control over financial reporting, we observed the following matters and offer these comments and suggestions with respect to matters which came to our attention during the course of the audit of the financial statements. Our audit procedures are designed primarily to enable us to form an opinion on the financial statements and, therefore, may not bring to light all weaknesses in policies and procedures that may exist. However, these matters are offered as constructive suggestions for the consideration of management as part of the ongoing process of modifying and improving accounting controls and the financial and administrative practices and procedures. We can discuss these matters further at your convenience and may provide implementation assistance for changes or improvements if you require.

Monitoring of Information Technology Process

Functional audits are being performed, but none are done within SAP. BKD recommends that information technology (IT) audits be expanded to include SAP.

Management Response

Internal audit (IA) agrees with BKD’s recommendation. IA had not included SAP reviews in its annual work plan due to previous application implementation. IA is aware of the importance of SAP reviews and consequently has been working towards this end over the last couple of years. This is evidenced by the IT Audit Universe initiative in fiscal year 2007. SAP is a top priority on IA’s Audit Universe as plans are being developed to complete top-down risk-based security and data integrity reviews. IA is currently engaged (although minimal) with SAP reviews (CORE and IT) being completed in different end-user departments.

Security

Tivol Storage System backs up just under 1GB daily and back up data is retained for eight weeks. This period of eight weeks might not be long enough to discover data corruption. BKD recommends retaining month end backups for one year at minimal extra cost.

Management Response

IT agrees with BKD’s recommendation. Additional tapes were ordered at a cost of $18,100. IT implemented a new practice in September 2008 to retain SAP R3 backups for 13 weeks. This change will allow the University to have three months of backup information in the case of data corruption.
Management's written responses to the control deficiencies and other matters identified in our audit have not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion on them.

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This communication is intended solely for the information and use of management, audit subcommittee, board of trustees and others within the Organizations and is not intended to be and should not be used by anyone other than these specified parties.

September 29, 2008