



Financial Statements

for

**KENTUCKY MEDICAL SERVICES
FOUNDATION, INC.**

Years Ended June 30, 2020 and 2019
with Report of Independent Auditors

CONTENTS

	<u>Pages</u>
Report of Independent Auditors.....	1 - 2
Financial Statements:	
Balance Sheets.....	3 - 4
Statements of Operations and Changes in Net Assets.....	5
Statements of Functional Expenses.....	6
Statements of Cash Flows.....	7 - 8
Notes to the Financial Statements.....	9 - 23

Report of Independent Auditors

To the Board of Directors of
Kentucky Medical Services Foundation, Inc.
Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of Kentucky Medical Services Foundation, Inc. (KMSF) which comprise the balance sheets as of June 30, 2020 and 2019, the related statements of operations and changes in net assets, functional expenses and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the 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.

To the Board of Directors of
Kentucky Medical Services Foundation, Inc.
Report of Independent Auditors, continued

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky Medical Services Foundation, Inc. as of June 30, 2020 and 2019, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Dean Dotson Allen Ford, PLLC

Lexington, Kentucky
September 22, 2020

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Balance Sheets

June 30, 2020 and 2019

	<u>2020</u>	<u>2019</u>
Assets		
Current assets:		
Investments and interest bearing deposits, current portion	\$ 16,118,797	\$ 4,107,554
Patient accounts receivable, less allowance for uncollectibles of \$9,900,935 and \$15,486,714 and allowances for contractual adjustments of \$66,316,651 and \$86,815,686 in 2020 and 2019, respectively	36,187,135	37,692,880
Accounts receivable - Physician Supplemental Payment (PSP)/Directed Payment revenue	22,263,883	8,436,869
Other receivables, current portion	2,543,420	2,396,537
Other current assets	<u>1,393,677</u>	<u>1,537,298</u>
Total current assets	78,506,912	54,171,138
Assets limited as to use:		
Dean's academic enrichment funds - limited by agreement	9,700,820	12,000,855
Investments and interest bearing deposits, less current portion	43,892,356	43,055,976
Other receivables, less current portion	607,883	595,167
Property and equipment:		
Land and improvements	3,058,102	2,786,029
Buildings	54,468,638	54,224,909
Furniture and equipment	9,484,367	9,497,494
Capitalized software	16,986,574	16,986,574
Buildings under capital lease obligations	71,165,295	65,768,259
Equipment under capital lease obligations	1,365,107	1,365,107
Construction in progress	<u>4,114,263</u>	<u>-</u>
	160,642,346	150,628,372
Less accumulated depreciation	<u>55,078,698</u>	<u>45,956,943</u>
Net property and equipment	<u>105,563,648</u>	<u>104,671,429</u>
Total assets	<u>\$238,271,619</u>	<u>\$214,494,565</u>

	<u>2020</u>	<u>2019</u>
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 13,872,010	\$ 11,058,590
Long-term debt, current portion	799,123	774,098
Capital leases, current portion	3,288,100	3,355,335
Settlements due to third party payors	625,219	569,474
Patient refunds	1,532,319	2,507,146
Due to the University of Kentucky	32,021,461	33,140,187
Due to the University of Kentucky - malpractice fund	23,656,283	22,819,902
Due to the College of Medicine departments under departmental plan agreements	<u>61,000,679</u>	<u>39,727,837</u>
Total current liabilities	136,795,194	113,952,569
Long-term debt, net of current portion	16,495,408	17,294,531
Capital leases, net of current portion	<u>58,812,964</u>	<u>55,188,318</u>
Total long-term liabilities	<u>75,308,372</u>	<u>72,482,849</u>
Total liabilities	212,103,566	186,435,418
Net assets without donor restrictions:		
Board designated - property (net of long-term debt and capital leases) and equipment	<u>26,168,053</u>	<u>28,059,147</u>
Total liabilities and net assets	<u>\$238,271,619</u>	<u>\$214,494,565</u>

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Operations and Changes in Net Assets

Years ended June 30, 2020 and 2019

	<u>2020</u>	<u>2019</u>
Revenues and gains:		
Net professional clinical service fee revenue	\$277,431,690	\$275,025,652
Capitation revenue	27,032,886	27,810,492
Provision for bad debts	<u>(44,942,541)</u>	<u>(51,599,370)</u>
Net professional clinical service fee revenue less provision for bad debts	259,522,035	251,236,774
Lease income	6,791,929	6,399,680
Investment income, net	449,109	803,776
PSP/Directed Payment revenue	85,481,869	61,905,336
Cares Act revenue	2,363,742	-
Other income, net	<u>23,447,220</u>	<u>20,172,178</u>
Total revenues and gains	378,055,904	340,517,744
Expenses:		
Departmental expenses	327,068,498	278,249,815
Operating expenses - business office	6,601,740	24,942,975
UKHMO capitation expenses	6,332,193	6,142,590
Reimbursement to the University of Kentucky for malpractice insurance and expenses attendant to the production of clinical income	5,372,981	5,523,205
Dean's academic enrichment funds	16,689,285	13,775,000
Physicians' fringe benefits	3,785,127	3,553,135
Depreciation expense	9,133,897	13,262,523
Interest expense	<u>4,963,277</u>	<u>3,399,961</u>
Total expenses	379,946,998	<u>348,849,204</u>
Change in net assets	(1,891,094)	(8,331,460)
Net assets, beginning of year	<u>28,059,147</u>	<u>36,390,607</u>
Net assets, end of year	<u>\$ 26,168,053</u>	<u>\$ 28,059,147</u>

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Functional Expenses

Years ended June 30, 2020 and 2019

2020

	UK Healthcare Mission	UK HMO	Administrative	Total
Salaries and wages	\$ 214,152,882	\$ 415,258	\$ 2,386,056	\$ 216,954,196
Fringe benefits	41,706,178	102,037	725,364	42,533,579
Purchased services	5,352,600	6,332,193	1,071,616	12,756,409
Supplies	9,019,930	185	178,693	9,198,808
Malpractice expenses	5,372,981	-	-	5,372,981
Rent and lease expenses	1,874,285	-	-	1,874,285
Utilities	1,157,040	-	205,332	1,362,372
Maintenance and repairs	1,286,655	-	6,102	1,292,757
Interest expense	4,962,191	-	1,086	4,963,277
Depreciation	6,138,688	-	2,995,208	9,133,896
Other expenses	<u>74,334,521</u>	<u>169,917</u>	<u>-</u>	<u>74,504,438</u>
 Total expenses	 <u>\$ 365,357,951</u>	 <u>\$ 7,019,590</u>	 <u>\$ 7,569,457</u>	 <u>\$ 379,946,998</u>

2019

	UK Healthcare Mission	UK HMO	Administrative	Total
Salaries and wages	\$ 209,137,798	\$ 351,359	\$ 10,384,616	\$ 219,873,773
Fringe benefits	43,526,815	77,174	3,754,039	47,358,028
Purchased services	6,104,902	6,177,579	7,631,600	19,914,081
Supplies	7,725,960	639	237,199	7,963,798
Malpractice expenses	5,523,205	-	-	5,523,205
Rent and lease expenses	1,241,598	-	49,754	1,291,352
Utilities	1,371,390	-	2,188	1,373,578
Maintenance and repairs	991,806	-	72,900	1,064,706
Interest expense	3,399,961	-	-	3,399,961
Depreciation	12,046,360	-	1,216,163	13,262,523
Other expenses	<u>26,908,014</u>	<u>198,844</u>	<u>717,341</u>	<u>27,824,199</u>
 Total expenses	 <u>\$ 317,977,809</u>	 <u>\$ 6,805,595</u>	 <u>\$ 24,065,800</u>	 <u>\$ 348,849,204</u>

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows

Years ended June 30, 2020 and 2019

	<u>2020</u>	<u>2019</u>
Cash flows from operating activities:		
Change in net assets	\$ (1,891,094)	\$ (8,331,460)
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation	9,133,897	13,262,523
(Gain) loss on disposal of assets	(3,015)	47,353
Provision for bad debts	44,942,541	51,599,370
Amortization of loan fees	5,943	5,944
Increase (decrease) in cash due to changes in:		
Patient accounts receivable	(43,436,796)	(46,352,002)
Accounts receivable - PSP/Directed Payment revenue	(13,827,014)	123,271
Other receivables	(159,599)	1,014,459
Other current assets	143,621	(376,899)
Accounts payable and accrued liabilities	2,813,420	2,880,658
Settlements due to third party payors	55,745	-
Patient refunds	(974,827)	(286,313)
Due to the University of Kentucky	(1,118,726)	(239,410)
Due to the University of Kentucky - malpractice fund	836,381	905,825
Due to the College of Medicine departments under departmental plan agreements	<u>21,272,842</u>	<u>(18,905,258)</u>
Net cash provided by (used in) operating activities	17,793,319	(4,651,939)
Cash flows from investing activities:		
Capital expenditures	(4,630,065)	(850,185)
(Increase) decrease in investments and interest-bearing deposits, net	(12,847,623)	16,093,349
Decrease (increase) in assets limited as to use, net	2,300,035	(6,457,050)
Proceeds on sale of property and equipment	<u>4,000</u>	<u>-</u>
Net cash (used in) provided by investing activities	(15,173,653)	8,786,114
Cash flows from financing activities:		
Repayments on long-term debt	(780,041)	(758,571)
Payments on capital leases	<u>(1,839,625)</u>	<u>(3,375,604)</u>
Net cash used in financing activities	<u>(2,619,666)</u>	<u>(4,134,175)</u>
Net change in cash	<u>\$ -</u>	<u>\$ -</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows, continued

Years ended June 30, 2020 and 2019

	<u>2020</u>	<u>2019</u>
Supplemental cash flow disclosures:		
Cash paid for interest	\$ 4,963,277	\$ 3,399,961
Noncash investing and financing transactions:		
Capital lease obligations for purchase of buildings and equipment	\$ -	\$ 6,367,513
Capital lease obligation amendment	5,397,036	-

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements

1. Description of the Organization

Kentucky Medical Services Foundation, Inc. (KMSF) is a non-profit, non-stock corporation. KMSF has been assigned the responsibility to bill, collect and administer all clinical income generated by the physicians of the University of Kentucky (UK) College of Medicine (the College) in accordance with an annual agreement (the Agreement) between KMSF and UK regarding the operation of KMSF. The Agreement was last renewed on July 1, 2020.

Although included in UK's audited financial statements according to *Governmental Accounting Standards*, KMSF is not considered to be an affiliate of UK by Kentucky Revised Statute.

2. Summary of Significant Accounting Policies

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) which required management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates. The Financial Accounting Standards Board (FASB) promulgates its Accounting Standards Codification as the only source of authoritative accounting principles recognized by the FASB to be applied to nongovernmental entities in the preparation of financial statements in conformity with GAAP. The following is a summary of the significant accounting policies consistently followed by KMSF in the preparation of its financial statements:

Basis of Accounting

The accompanying financial statements have been prepared on the accrual basis. Under the terms of the various departmental plans and the Agreement with UK, all income from operations of KMSF, exclusive of changes in the net book value of property and equipment, debt acquired for purchase of property and equipment and changes in amounts designated by the Board of Directors for specific purposes, are payable to the participating departments. Accordingly, such amounts have been included as departmental expenses in the accompanying statements of operations and changes in net assets.

Assets Limited as to Use

Assets limited as to use include cash and investments set aside by the Board of Directors for specific purposes over which the Board retains control and may, at its discretion, subsequently use for other purposes, if any, and cash and investments set aside in accordance with the Agreement between KMSF and UK (see Note 6).

Property and Equipment

KMSF capitalizes all expenditures of \$5,000 or more for moveable equipment and of \$10,000 or more for buildings and building improvements, fixed equipment, infrastructure assets and land improvements. Property and equipment purchased are recorded at cost at the date of acquisition. Depreciation is computed using the straight-line method over the estimated useful life of the depreciable assets, or if leased, the shorter of estimated useful life or leased period, which range from three to forty years. Donated property and equipment, if any, are recorded at estimated fair value at the date of donation.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Income Tax Exemption

KMSF is a non-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code (the Code) and is exempt from federal income taxes on related income.

Patient Accounts Receivable and Net Professional Clinical Service Fees

Patient accounts receivable and net professional clinical service fees are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including retroactive adjustments, if any, from third-party payors. A provision for uncollectible accounts is recorded based upon management's evaluation of current industry conditions, historical collection experience and other relevant factors which, in the opinion of management, require recognition in estimating the allowance for uncollectible accounts.

Retroactive settlements to third party payors are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. These final settlements occur in the normal course of business.

Charity Care

UK provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because UK does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. Charity care charges totaled \$10,855,313 and \$9,860,402 in 2020 and 2019, respectively. Management has estimated its cost incurred to provide charity care to be approximately \$4,300,000 and \$3,700,000 for the years ended June 30, 2020 and 2019, respectively.

Investments and Investment Income

KMSF has investments in certificates of deposit and other interest bearing deposits, government securities, guaranteed investment contracts and mutual funds as permitted by the Agreement with UK. These investments are stated at fair value or carrying amounts that approximate fair value.

Investment income (including realized and unrealized gains and losses on investments, interest and dividends) is considered by management to be essential to the ongoing operations of KMSF and is reported as other operating revenue.

Subsequent Events

Management has evaluated subsequent events for accounting and disclosure requirements through September 22, 2020, the date that the financial statements were available to be issued.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The core principle of ASU 2014-09 is to recognize revenues when a customer obtains control of a good or service, in an amount that reflects the consideration to which an entity is expected to be entitled for those goods or services. Additionally, the ASU will require enhanced qualitative and quantitative disclosures regarding customer contracts. The updated standard will replace most existing revenue recognition guidance in GAAP when it becomes effective and permits the use of either a full retrospective or modified retrospective with cumulative effect transition method. In June 2020, the FASB issued ASU 2020-05, which deferred the effective date of ASU 2014-09. The updated standard will be effective for the year ending June 30, 2021. KMSF has not yet selected a transition method and is currently evaluating the effect that the new standard will have on its financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, requiring all leases to be recognized on KMSF's balance sheet as a right-of-use asset and a lease liability, unless the lease is a short term lease (generally a lease with a term of twelve months or less). At the commencement date of the lease, KMSF will recognize: 1) a lease liability for KMSF's obligation to make payments under the lease agreement, measured on a discounted basis; and 2) a right-of-use asset that represents KMSF's right to use, or control the use of, the specified asset for the lease term. The ASU originally required recognition and measurement of leases at the beginning of the earliest period presented using a modified retrospective transition method. In July 2018, the FASB issued ASU 2018-11, which provided an additional (and optional) transition method that permits application of the updated standard at the adoption date with recognition of a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. In June 2020, the FASB issued ASU 2020-05, which deferred the effective date of ASU 2016-02. The updated standard will be effective for the year ending June 30, 2022. KMSF has not yet selected a transition method and is currently evaluating the effect that the new standard will have on its financial statements.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

3. Liquidity and Availability

The following table reflects KMSF's current financial assets as of June 30, 2020 and 2019, reduced by amounts that are not available to meet general expenditures within one year of the statement of financial position date because of contractual restrictions or internal board designations. There were no net assets with donor restrictions at June 30, 2020 and 2019.

	<u>2020</u>	<u>2019</u>
Investments and interest bearing deposits, current portion	\$ 16,118,797	\$ 4,107,554
Patient accounts receivable, net	36,187,135	37,692,880
Accounts receivable - Physician Supplemental Payment (PSP) revenue	22,263,883	8,436,869
Other receivables, current portion	2,543,420	2,396,537
Other current assets	<u>1,393,677</u>	<u>1,537,298</u>
Financial assets available to meet cash needs for general expenditures within one year	<u>\$ 78,506,912</u>	<u>\$ 54,171,138</u>

KMSF has approximately \$20,000,000 in short-term certificates of deposit with maturity terms varying between one week and four months. These are classified under long-term investments; however, they are available to be redeemed if necessary to meet general expenditures within one year.

KMSF also maintains a designated investment portfolio for the malpractice fund. The market value of the portfolio as of June 30, 2020 and 2019 was \$23,656,283 and \$22,819,902, respectively. The portfolio is classified under long-term investments on the financial statements, however, it is available to meet the financial obligation due to the University of Kentucky for the Malpractice Fund, listed at an equal value within current liabilities.

4. Patient Accounts Receivable

Patient accounts receivable consist of amounts due from government programs (e.g., Medicare and Medicaid) and non-government payors (e.g., self-pay and commercial payors). Management believes there are minimal credit risks associated with the receivables from government programs. Non-government receivables are from various payors that are subject to differing economic conditions. Management continually monitors and adjusts the allowance for uncollectible accounts associated with credit risk of patient accounts receivable.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

4. Patient Accounts Receivable, continued

KMSF has recorded an allowance for uncollectible patient accounts receivable of approximately 9% and 11% of gross patient accounts receivable as of June 30, 2020 and 2019, respectively. A summary of the changes in the allowance for uncollectible patient accounts receivable is as follows:

Year ended June 30,	<u>2020</u>	<u>2019</u>
Balance, beginning of year	\$ 15,486,714	\$ 8,594,272
Provision for bad debts	44,942,541	51,599,370
Receivables charged off	<u>(50,528,320)</u>	<u>(44,706,928)</u>
Balance, end of year	\$ <u>9,900,935</u>	\$ <u>15,486,714</u>

5. Other Receivables

KMSF makes loans to physicians they anticipate will become employees of UK. A portion of these loans will be forgiven each year, up to the maximum amount of the loan, if certain conditions, such as serving as a full-time physician and faculty member of UK, are met by the borrower. If the conditions for forgiveness are not met, the entire principal balance is payable by the borrower, including accrued interest at the rate of 1% above prime. The total amount outstanding on such loans was \$1,077,824 and \$1,278,766 as of June 30, 2020 and 2019, respectively.

6. Academic Enrichment Funds

In accordance with the Agreement with UK effective July 1, 2019 and the Agreement with UK effective July 1, 2018, KMSF is required to maintain a separate bank account, which represents a specified percentage of cumulative clinical income collected, less cumulative disbursements by the Dean of the College of Medicine. The percentage of collections added to this account was 8% in both 2020 and 2019.

The funds in the account are for the use of the Dean of the College of Medicine for the enrichment of the program of the College or for related purposes at his/her sole discretion. The Dean's Fund supports the missions of UK and UK HealthCare by providing financial support of activities such as research, education, departmental and program development. In 2020 and 2019, the amount provided to UK for research and education was \$16,689,285 and \$13,775,000, respectively. In 2020 and 2019, \$955,167 and \$1,341,657, respectively, of such funds were expended in the Dean's operations for faculty and staff salaries, benefits and other operating expenses and are included in departmental expenses.

The cash balance in the dean's account as of June 30, 2020 and 2019 was \$9,700,820 and \$12,000,855 respectively, and is included as part of the liability payable under the Departmental Plan Agreements.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

7. Investments and Interest Bearing Deposits

Investments and interest bearing deposits, including accrued interest, are as follows as of June 30:

	<u>2020</u>	<u>2019</u>
Interest bearing deposits and government securities	\$ 36,453,732	\$ 24,560,759
Fixed income securities	6,843,733	7,217,836
Equity securities and equity security mutual funds	<u>16,713,688</u>	<u>15,384,935</u>
Total investments and interest bearing deposits	<u>\$ 60,011,153</u>	<u>\$ 47,163,530</u>

The components of investment income from investments and interest bearing deposits for 2020 and 2019 consist of \$449,109 and \$803,776, respectively, of realized and unrealized gains and losses, dividends and interest.

Management has elected to follow Accounting Research Bulletin 43 in the presentation of current and non-current investments as follows:

	<u>2020</u>	<u>2019</u>
Current investments	\$ 16,118,797	\$ 4,107,554
Non-current investments	<u>43,892,356</u>	<u>43,055,976</u>
Total investment and interest bearing deposits	<u>\$ 60,011,153</u>	<u>\$ 47,163,530</u>

8. Fair Value Measurements

KMSF classifies its investments based on a hierarchy consisting of: Level 1 (valued using quoted prices from active markets for identical assets), Level 2 (not traded on an active market but for which observable market inputs are readily available), and Level 3 (valued based on significant unobservable inputs). The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

8. Fair Value Measurements, continued

Following is a description of the valuation methodologies used for assets measured at fair value on a recurring basis:

Interest bearing deposits and government securities: Valued at cost which approximates fair value.

Common stocks: Valued at the closing price reported on the active market on which the individual securities are traded.

Real estate investment partnership: Valued at cost, which approximates fair value.

Real estate investment trust: Valued at the closing price reported on the active market on which the individual securities are traded.

Mutual funds: Mutual funds based in equity securities are valued at the daily closing price as reported by the fund. These mutual funds held by KMSF are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value and to transact at that price. These mutual funds are deemed to be actively traded.

Fixed income securities: Valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing value on yields currently available on comparable securities of issuers with similar credit ratings.

There have been no changes in the valuation methodologies used at June 30, 2020 and 2019.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while KMSF's management believes the valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

8. Fair Value Measurements, continued

The following tables set forth by level, within the fair value hierarchy, KMSF's assets and liabilities at fair value:

<u>June 30, 2020</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Interest bearing deposits and government securities	\$ 36,453,732	\$ -	\$ -	\$ 36,453,732
Common stocks and foreign equities	9,682,763	-	-	9,682,763
Real estate investment trust	1,364,694	-	-	1,364,694
Real estate investment partnership	-	840,109	-	840,109
Mutual funds :				
Taxable/fixed income	3,722,055	-	-	3,722,055
International	3,387,455	-	-	3,387,455
Mid cap	956,296	-	-	956,296
Small cap	<u>482,371</u>	<u>-</u>	<u>-</u>	<u>482,371</u>
Total mutual funds	8,548,177	-	-	8,548,177
Fixed income securities :				
Aaa credit rating	-	1,132,348	-	1,132,348
Aa2 credit rating	-	105,469	-	105,469
Aa3 credit rating	-	292,057	-	292,057
A1 credit rating	-	374,796	-	374,796
A2 credit rating	-	531,066	-	531,066
A3 credit rating	-	491,334	-	491,334
Baa1 credit rating	-	95,632	-	95,632
NR credit rating	<u>-</u>	<u>98,976</u>	<u>-</u>	<u>98,976</u>
Total fixed income securities	<u>-</u>	<u>3,121,678</u>	<u>-</u>	<u>3,121,678</u>
Total investments	<u>\$ 56,049,366</u>	<u>\$ 3,961,787</u>	<u>\$ -</u>	<u>\$ 60,011,153</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

8. Fair Value Measurements, continued

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>June 30, 2019</u>				
Interest bearing deposits and government securities	\$ 24,560,759	\$ -	\$ -	\$ 24,560,759
Common stocks and foreign equities	8,375,102	-	-	8,375,102
Real estate investment trust	1,179,638	-	-	1,179,638
Real estate investment partnership	-	490,109	-	490,109
Mutual funds :				
Taxable/fixed income	4,616,806	-	-	4,616,806
International	3,264,253	-	-	3,264,253
Mid cap	1,150,662	-	-	1,150,662
Small cap	<u>925,171</u>	<u>-</u>	<u>-</u>	<u>925,171</u>
Total mutual funds	9,956,892	-	-	9,956,892
Fixed income securities :				
Aaa credit rating	-	619,819	-	619,819
Aa2 credit rating	-	101,552	-	101,552
Aa3 credit rating	-	104,444	-	104,444
A1 credit rating	-	202,267	-	202,267
A2 credit rating	-	204,368	-	204,368
A3 credit rating	-	304,796	-	304,796
Baa1 credit rating	-	91,603	-	91,603
NR credit rating	<u>-</u>	<u>972,181</u>	<u>-</u>	<u>972,181</u>
Total fixed income securities	<u>-</u>	<u>2,601,030</u>	<u>-</u>	<u>2,601,030</u>
Total investments	<u>\$ 44,072,391</u>	<u>\$ 3,091,139</u>	<u>\$ -</u>	<u>\$ 47,163,530</u>

To assess the appropriate classification of assets and liabilities within the fair value hierarchy, the availability of market data is monitored. Changes in economic conditions or valuation techniques may require the transfer of assets and liabilities from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period. KMSF's management evaluates the significance of transfers between levels based upon the nature of the assets and liabilities and size of the transfer relative to total net assets. There were no transfers of assets or liabilities from one fair value level to another during the years ended June 30, 2020 and 2019.

9. Settlements Due to Third Party Payors

KMSF has accrued settlements due to third party payors of approximately \$625,000 and \$570,000 as of June 30, 2020 and 2019, respectively. This liability represents amounts due to the federal government and insurance companies for payments KMSF has received but which need to be refunded due to various reasons within the revenue cycle.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

10. Long-Term Debt and Capital Leases

As of June 30, 2020 and 2019, notes payable and capital lease obligations consisted of the following:

	<u>2020</u>	<u>2019</u>
Capital lease obligation, maturing August 2034, bearing interest at 5.0%, collateralized by property with a net book value of \$31,706,154, payments of \$256,007 per month (payment amounts increase annually as defined by the agreement).	\$ 33,352,194	\$ 34,698,108
Capital lease obligation, maturing March 2037, bearing interest at 4.75% for the base rent, and 7.5% for the tenant improvements portion, collateralized by property with a net book value of \$14,361,592, payments of \$111,181 per month (payment amounts per month increase every fifth year of the capital lease obligation).	15,892,289	16,312,832
County of Clark, Kentucky Healthcare Revenue Bonds, Series 2017, accruing interest at a rate equal to 2.94% as of June 30, 2020, due in monthly principal and interest payments of \$55,374 and maturing in April 2037.	8,785,700	9,181,148
County of Scott, Kentucky Healthcare Revenue Bonds, Series 2017, accruing interest at a rate equal to 2.94% as of June 30, 2020, due in monthly principal and interest payments of \$54,016 and maturing in April 2037.	8,609,376	8,993,969
Capital lease obligation, maturing June 2027, bearing interest at 4.25%, collateralized by property with a net book value of \$5,770,600, payments of \$90,022 per month (increasing by 2% every subsequent lease year).	6,912,745	1,035,100
Capital lease obligation, maturing June 2028, bearing interest at 4.25%, collateralized by property with a net book value of \$5,330,766, payments of \$65,851 per month (increasing by 2.75% every subsequent lease year). KMSF has the option to renew for three additional five year lease terms.	5,860,077	6,368,314

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

10. Long-term Debt and Capital Leases, continued

	<u>2020</u>	<u>2019</u>
Capital lease obligations at varying rates of interest from 0.35% to 5.50%, collateralized by leased equipment with a net book value of \$250,772 at June 30, 2020.	<u>83,759</u>	<u>129,299</u>
Total long-term debt	79,496,140	76,718,770
Less capitalized loan fees, net	<u>100,545</u>	<u>106,488</u>
	79,395,595	76,612,282
Less current portion	<u>4,087,223</u>	<u>4,129,433</u>
Long-term debt, net of current portion	<u>\$ 75,308,372</u>	<u>\$ 72,482,849</u>

Scheduled principal repayments on bonds and payments on capital lease obligations are as follows:

Year ending June 30,	<u>Bonds</u>	<u>Capital Lease Obligations</u>
2021	\$ 805,067	\$ 6,331,457
2022	829,395	6,412,030
2023	854,459	6,543,209
2024	879,101	6,620,845
2025	906,845	6,690,336
Thereafter	<u>13,120,209</u>	<u>54,537,218</u>
	<u>\$ 17,395,076</u>	87,135,095
Less amount representing interest under capital lease obligations		<u>25,034,031</u>
		<u>\$ 62,101,064</u>

Interest expense was \$4,963,277 and \$3,399,961 for the years ended June 30, 2020 and 2019, respectively.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

11. Net Professional Clinical Service Fees and Capitation Revenue

UK and KMSF have agreements with third-party payors that provide for payments at amounts different from their established rates. Contractual adjustments represent the difference between billing at established rates and amounts reimbursed by third-party payors.

A summary of gross and net professional clinical service fee revenue and capitation revenue for the years ended June 30, 2020 and 2019 follows:

	<u>2020</u>	<u>2019</u>
Gross professional clinical service fee revenue and capitation revenue	\$ 786,054,470	\$ 781,764,981
Less provision for contractual adjustments under third-party reimbursement programs and other adjustments	<u>(481,589,894)</u>	<u>(478,928,837)</u>
Net professional clinical service fee revenue and capitation revenue	<u>\$ 304,464,576</u>	<u>\$ 302,836,144</u>

12. PSP and Directed Payment Revenue

During 2020 and 2019, KMSF received \$85,481,869 and \$61,905,336, respectively, in PSP and directed payment revenue from the University of Kentucky. These funds are used to supplement KMSF's professional clinical service fees and to support the ongoing operations of KMSF.

13. Other Income

Other income consists of the following for the years ended June 30, 2020 and 2019:

	<u>2020</u>	<u>2019</u>
Medical & administrative services contractual income	\$ 19,672,032	\$ 17,404,635
EHR meaningful use	1,385,500	1,428,453
Prior years revenue adjustments	827,823	930,132
Shared Savings Payments	477,195	-
Royalty and Honoraria income	134,345	126,428
Payor quality incentives	391,234	94,246
Other income	<u>559,091</u>	<u>188,284</u>
Total other income	<u>\$ 23,447,220</u>	<u>\$ 20,172,178</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

14. Leasing Activities

KMSF leases office space to UK as well as other non-related entities. The lease contracts with UK vary with remaining terms ranging from one year to five years with optional extensions as provided by the various agreements. The lease contracts with the non-related entities vary with remaining terms ranging from less than one year to forty-eight years. KMSF received \$6,660,046 and \$6,267,259 in lease income from UK and \$131,883 and \$132,421 from other non-related entities in 2020 and 2019, respectively.

The following is a schedule of future minimum rentals under the noncancellable leases at June 30, 2020 for the next five years:

Year ending June 30,	
2021	\$ 6,382,759
2022	4,470,533
2023	3,229,685
2024	435,534
2025	47,281
Thereafter	<u>1,753,340</u>
	<u>\$ 16,319,132</u>

15. Medical Malpractice Insurance

KMSF is self-insured, along with UK, for malpractice claims. On an annual basis, the malpractice liability is actuarially determined at a consolidated basis using claims data from UK and KMSF. UK informs KMSF of their portion of the overall liability as well as their funding requirements to maintain appropriate funding levels. KMSF maintains their portion of the malpractice fund investments. Management believes the malpractice self-insurance fund is adequate to cover any losses.

16. Commitments and Contingencies

Litigation

KMSF is currently involved in litigation and/or regulatory investigations. KMSF's involvement typically arises either in the course of KMSF's business or in KMSF's role as a support organization for UK, and it is possible that the litigation and/or regulatory investigations could result in a material adverse effect on KMSF's future financial position or results from operations. Apart from matters where KMSF's involvement is part of such support role, management estimates these matters will be resolved without material adverse effect on KMSF's future financial position or results from operations.

Construction in Progress

As of June 30, 2020, KMSF expects to incur approximately \$4,200,000 of additional construction in progress costs related to the Turfland renovations.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

16. Commitments and Contingencies, continued

Operating Leases

KMSF leases various equipment and facilities under operating leases that are set to expire at various dates. Total rental expense in 2020 and 2019 was \$1,874,285 and \$1,291,352, respectively.

The following is a schedule by year of future minimum lease payments under operating leases as of June 30, 2020:

Year ending June 30,	
2021	\$ 2,027,648
2022	434,737
2023	173,093
2024	86,603
2025	86,683
Thereafter	<u>1,023,358</u>
	<u>\$ 3,832,122</u>

17. Concentrations of Credit Risk

UK and KMSF grant credit without collateral to their patients, most of whom are area residents and are insured under third-party payor arrangements. The mix of receivables from patients and third-party payors at June 30, 2020 and 2019, was as follows:

	<u>2020</u>	<u>2019</u>
Medicaid	26 %	29 %
Other third-party payors	26	26
Medicare	22	21
Blue Cross	16	13
Patients	<u>10</u>	<u>11</u>
	<u>100 %</u>	<u>100 %</u>

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

18. Healthcare Reform and Reimbursement Changes

The American Recovery and Reinvestment Act of 2009

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (the Recovery Act) was signed into law. A major component of the Recovery Act is its emphasis on improving health information technology (also known as HIT). The federal government believes the implementation of technology will ultimately increase the quality and reduce the cost of healthcare.

To accomplish the improvement of HIT, the Recovery Act includes payment incentives for qualifying professionals. Physicians and hospitals that are considered early adopters of electronic health records (EHR) can become eligible to receive a significant amount of money from Medicare or Medicaid.

During the years ended June 30, 2020 and 2019, KMSF applied for and received \$1,385,500 and \$1,428,000 in Medicaid HIT funds, respectively. KMSF intends to apply for additional funds in the coming years. Both the 2020 and 2019 funds and any funds from past or future applications are contingent on reaching certain metrics and various states of "meaningful use" as defined by the Recovery Act.

19. COVID-19

Business Disruption

During March 2020, the World Health Organization declared the coronavirus (COVID-19) outbreak to be a pandemic. COVID-19 continues to spread across the globe and is impacting worldwide economic activity and financial markets. As of June 30, 2020 and as of the date of the financial statements were issued, KMSF has not experienced significant disruption in its operations. The continued spread of the disease also represents a significant risk that KMSF's operations could be disrupted in the near future. The extent to which COVID-19 impacts KMSF will depend on future developments, which are highly uncertain and cannot be predicted.

Coronavirus Aid, Relief, and Economic Security (CARES) Act

In March 2020, the CARES Act was passed by legislation to assist businesses as a result of the economic impact caused by COVID-19. The CARES Act allocated aid to be provided to Medicare providers. KMSF received \$2,363,742 in aid from the CARES Act in April 2020.