

**KENTUCKY MEDICAL
SERVICES FOUNDATION, INC.**
Financial Statements

*Years Ended June 30, 2014 and 2013
with Report of Independent Auditors*

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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, 2014 and 2013, and the related statements of operations and changes in net assets 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, 2014 and 2013, and the results of its changes in net assets 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

September 22, 2014
Lexington, Kentucky

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Balance Sheets

June 30, 2014 and 2013

| | <u>2014</u> | <u>2013</u> |
|--|-----------------------|-----------------------|
| Assets | | |
| Current assets: | | |
| Investments and interest bearing deposits, current | \$ 26,452,132 | \$ 6,943,720 |
| Patient accounts receivable, less allowance for uncollectibles of \$6,364,679 and \$5,676,295 and allowances for contractual adjustments of \$43,449,773 and \$33,350,010 in 2014 and 2013, respectively | 23,380,807 | 22,600,956 |
| Other receivables, current portion | 1,781,597 | 3,756,210 |
| Other current assets | <u>52,670</u> | <u>65,440</u> |
| Total current assets | 51,667,206 | 33,366,326 |
| Assets limited as to use: | | |
| Dean's academic enrichment funds - limited by agreement | 253,069 | 1,488,485 |
| Investments and interest bearing deposits, noncurrent | 44,469,880 | 41,197,572 |
| Other receivables, less current portion | 801,233 | 839,233 |
| Property and equipment: | | |
| Land and improvements | 2,322,552 | 2,322,552 |
| Buildings | 39,123,590 | 39,066,100 |
| Furniture and equipment | 12,245,474 | 10,185,780 |
| Equipment under capital lease obligations | <u>1,704,672</u> | <u>1,009,022</u> |
| | 55,396,288 | 52,583,454 |
| Less accumulated depreciation | <u>17,696,588</u> | <u>16,107,440</u> |
| Net property and equipment | <u>37,699,700</u> | <u>36,476,014</u> |
| Total assets | <u>\$ 134,891,088</u> | <u>\$ 113,367,630</u> |

| | <u>2014</u> | <u>2013</u> |
|--|-----------------------|-----------------------|
| Liabilities and Net Assets | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 5,753,632 | \$ 3,510,138 |
| Long-term debt, current portion | 1,373,324 | 1,265,332 |
| Settlement due to third party payor | 2,362,610 | 2,346,718 |
| Patient refunds | 428,750 | 169,646 |
| Due to the University of Kentucky | 12,738,091 | 12,462,528 |
| Due to the University of Kentucky - malpractice fund | 17,626,070 | 14,325,432 |
| Due to the College of Medicine departments under departmental plan agreements | <u>56,646,029</u> | <u>42,360,616</u> |
| Total current liabilities | 96,928,506 | 76,440,410 |
| Long-term debt, net of current portion | <u>20,266,760</u> | <u>20,963,770</u> |
| Total liabilities | 117,195,266 | 97,404,180 |
| Unrestricted net assets: | | |
| Board designated - property (net of debt) and equipment | <u>17,695,822</u> | <u>15,963,450</u> |
| Total net assets | <u>17,695,822</u> | <u>15,963,450</u> |
| | | |
| Total liabilities and net assets | <u>\$ 134,891,088</u> | <u>\$ 113,367,630</u> |

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Operations and Changes in Net Assets

Years ended June 30, 2014 and 2013

| | <u>2014</u> | <u>2013</u> |
|---|----------------------|----------------------|
| Revenues and gains: | | |
| Net professional clinical service fee revenue | \$ 233,645,352 | \$ 227,205,006 |
| Provision for bad debts | <u>(25,911,890)</u> | <u>(25,500,758)</u> |
| Net professional clinical service fee revenue less provision for bad debts | 207,733,462 | 201,704,248 |
| Lease income | 3,746,757 | 3,643,993 |
| Investment income, net | 86,801 | 118,961 |
| Other income, net | <u>18,721,854</u> | <u>1,632,062</u> |
| Total revenues and gains | 230,288,874 | 207,099,264 |
| Expenses: | | |
| Departmental expenses | 184,368,334 | 167,296,080 |
| Operating expenses - business office | 19,487,965 | 21,030,886 |
| UKHMO capitation expenses | 5,710,007 | 6,232,012 |
| Reimbursement to the University of Kentucky for malpractice insurance and expenses attendant to the production of clinical income | 3,698,491 | 1,278,101 |
| Kentucky Clinic central expenses | 2,972,831 | 1,568,890 |
| Dean's academic enrichment funds | 9,192,336 | 6,872,846 |
| Physicians' fringe benefits | 2,177,813 | 2,295,941 |
| Dean's Fund scholarships | <u>948,725</u> | <u>907,689</u> |
| Total expenses | 228,556,502 | 207,482,445 |
| Impairment loss | <u>-</u> | <u>(170,285)</u> |
| Increase (decrease) in net assets | 1,732,372 | (553,466) |
| Net assets, beginning of year | <u>15,963,450</u> | <u>16,516,916</u> |
| Net assets, end of year | <u>\$ 17,695,822</u> | <u>\$ 15,963,450</u> |

See accompanying notes.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows

Years ended June 30, 2014 and 2013

| | <u>2014</u> | <u>2013</u> |
|--|--------------------|--------------------|
| Cash flows from operating activities: | | |
| Increase (decrease) in net assets | \$ 1,732,372 | \$ (553,466) |
| Adjustments to reconcile increase (decrease) in net assets to net cash provided by (used in) operating activities: | | |
| Depreciation | 2,021,251 | 1,994,830 |
| Impairment loss | - | 170,285 |
| Donated furniture and equipment | (60,386) | - |
| Loss on disposal of assets | 470 | 7,641 |
| Provision for bad debts | 25,911,890 | 25,500,758 |
| Increase (decrease) in cash due to changes in: | | |
| Patient accounts receivable | (26,691,741) | (24,506,033) |
| Other receivables | 2,012,613 | (187,127) |
| Other current assets | 12,770 | (9,453) |
| Accounts payable and accrued liabilities | 2,243,494 | (294,980) |
| Settlement due to third party payor | 15,892 | (729,039) |
| Patient refunds | 259,104 | (157,319) |
| Due to the University of Kentucky | 275,563 | 3,297,964 |
| Due to the University of Kentucky - malpractice fund | 3,300,638 | (1,604,647) |
| Due to the College of Medicine departments under departmental plan agreements | <u>14,285,413</u> | <u>(4,110,003)</u> |
| Net cash provided by (used in) operating activities | 25,319,343 | (1,180,589) |
| Cash flows from investing activities: | | |
| Capital expenditures | (2,488,443) | (944,999) |
| Net change in investments and interest-bearing deposits | (22,780,720) | 3,278,728 |
| Net change in assets limited as to use | <u>1,235,416</u> | <u>(5,070)</u> |
| Net cash (used in) provided by investing activities | (24,033,747) | 2,328,659 |
| Cash flows from financing activities: | | |
| Repayments on long-term debt | <u>(1,285,596)</u> | <u>(1,148,070)</u> |
| Net cash used in financing activities | <u>(1,285,596)</u> | <u>(1,148,070)</u> |
| Net change in cash | <u>\$ -</u> | <u>\$ -</u> |

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Statements of Cash Flows, continued

Years ended June 30, 2014 and 2013

| Supplemental cash flow disclosures: | <u>2014</u> | <u>2013</u> |
|--|--------------------|--------------------|
| Cash paid for interest | \$ 915,817 | \$ 949,833 |
| Noncash investing and financing transactions: | | |
| Capital lease obligation for purchase of equipment | \$ 696,578 | \$ 94,995 |
| Note payable for purchase of equipment | - | 92,039 |

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, 2014.

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 (ASC) 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.

Management has elected to exclude the following disclosure required by GAAP: the identification of the investments' fair values by the levels of observable inputs are not disclosed. Management has examined the impact of this disclosure on the financial statements and believes the omission of this disclosure does not have a material effect on a user's decisions regarding the financial statements.

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 5).

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Property and Equipment

KMSF capitalizes all expenditures in excess of \$2,000 for property and equipment. 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 which range from three to forty years. Donated property and equipment, if any, are recorded at estimated fair value at the date of donation.

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.

KMSF has evaluated the tax positions taken on all income tax returns that remain open to examination by the respective taxing authorities. KMSF does not believe that there are any uncertain positions on those returns that require recognition or disclosure in the financial statements (generally 2011-2013).

Net Professional Clinical Service Fees

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.

Medicaid has contracted with three managed care organizations (MCOs) that are to create networks of providers around Kentucky to provide Medicaid services to approximately 560,000 Kentuckians. The MCOs provide Medicaid covered benefits for Medicaid recipients for a fixed per member, per month premium via rates based on age, gender, disability, etc. One of the MCO's, Kentucky Spirit, terminated their contract with Medicaid on July 5, 2013. Kentucky Spirit recipients were reassigned to one of the two remaining MCO's, CoventryCares or WellCare. At the time that Kentucky Spirit left the state, KMSF had an outstanding accounts receivable balance with them. During fiscal year 2014, the balance was settled between Kentucky Spirit and KMSF and what was not paid to KMSF was written off.

Under the Medicaid Expansion Program in fiscal year 2014, Anthem, Humana CareSource, and Passport Health Plan were added as new MCO's to expand Medicaid coverage in Kentucky. As a result of the Medicaid Expansion Program, a significant number of individuals are newly eligible for Medicaid coverage. This has led to a decline in patients qualifying for charity care.

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.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

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 totaled \$14,237,056 and \$23,289,042 in 2014 and 2013, respectively. Management has estimated its cost incurred to provide charity care to be approximately \$4,180,000 and \$7,590,000 as of June 30, 2014 and 2013, 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 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. Unrealized gains and losses on investments, if any, are excluded from the excess of revenues over expenses.

Subsequent Events

Management has evaluated subsequent events for accounting and disclosure requirements through September 22, 2014, the date that the financial statements were available to be issued.

Reclassifications

Certain reclassifications have been made to the 2013 financial statement presentation to correspond to the current year's format. Net assets and changes in net assets are unchanged due to these reclassifications.

3. 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

3. Patient Accounts Receivable, continued

KMSF has recorded an allowance for uncollectible patient accounts receivable of approximately 8.50% and 8.69% of gross patient accounts receivable as of June 30, 2014 and 2013, respectively. A summary of the changes in the allowance for uncollectible patient accounts receivable is as follows:

| Year ended June 30, | <u>2014</u> | <u>2013</u> |
|----------------------------|---------------------|---------------------|
| Balance, beginning of year | \$ 5,676,295 | \$ 5,131,357 |
| Provision for bad debts | 25,911,890 | 25,500,758 |
| Receivables charged off | <u>(25,223,506)</u> | <u>(24,955,820)</u> |
| Balance, end of year | <u>\$ 6,364,679</u> | <u>\$ 5,676,295</u> |

4. Other Receivables

During 2006, KMSF began making loans to physicians who 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 \$1,312,284 and \$1,440,645 as of June 30, 2014 and 2013, respectively.

5. Academic Enrichment Funds

In accordance with the Agreement with UK effective July 1, 2013 and the Agreement with UK effective July 1, 2012, KMSF reimbursed UK for actual expenses incurred by UK which are attendant to the production of clinical income, as defined. In 2014 and 2013, the amount reimbursed was \$9,192,336 and \$6,872,846, respectively. Payments are made to UK for the purpose of providing a fund (the Dean's Fund) for academic enrichment for the College. The Dean of the College may expend these funds to support the College or any related purpose. Also in accordance with these Agreements, KMSF is required to maintain a cash amount, which represents a specified percentage of cumulative clinical income collected, less cumulative disbursements by the Dean of the College. The percentage of collections added to this account was 8% in 2014 and 2013. The funds in the account are for the use of the Dean and are included as part of the liability payable under the Departmental Plan Agreements. In 2014 and 2013, \$4,604,374 and \$6,643,480, respectively, of such funds were expended and are included in departmental expenses.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

6. Investments and Interest Bearing Deposits

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

| | <u>2014</u> | <u>2013</u> |
|---|----------------------|----------------------|
| Interest bearing deposits and government securities | \$ 53,229,687 | \$ 33,973,634 |
| Mutual funds primarily based in fixed income securities | 1,904,895 | 1,590,190 |
| Equity securities and equity security mutual funds | 15,685,743 | 12,432,908 |
| Guaranteed investment contracts | <u>101,687</u> | <u>144,560</u> |
| Total investments and interest bearing deposits | <u>\$ 70,922,012</u> | <u>\$ 48,141,292</u> |

The components of investment income from investments and interest bearing deposits for 2014 and 2013 consist of \$86,801 and \$118,961, respectively, of dividends and interest.

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

| | <u>2014</u> | <u>2013</u> |
|--|----------------------|----------------------|
| Current investments | \$ 26,452,132 | \$ 6,943,720 |
| Non-current investments | <u>44,469,880</u> | <u>41,197,572</u> |
| Total investment and interest bearing deposits | <u>\$ 70,922,012</u> | <u>\$ 48,141,292</u> |

7. Settlement Due to Third Party Payor

During 2012, KMSF received a demand letter from the Department for Medicaid Services (DMS) for approximately \$4,100,000. Subsequent to June 30, 2012, KMSF and DMS reached an agreement whereby KMSF settled this liability for \$1,500,000. This amount is attributed to disputed claims received from Medicaid from August 2008 through July 2011. A provision was made in the financial statements as of June 30, 2012, and was subsequently paid in November 2012.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

8. Long-Term Debt

As of June 30, 2014 and 2013, notes payable and capital lease obligations consisted of the following:

| | <u>2014</u> | <u>2013</u> |
|---|----------------------|----------------------|
| Bank note payable, maturing June 2015 bearing interest at 1.707% collateralized by a certificate of deposit, principal and interest payments of \$41,358 due monthly. | \$ 491,688 | \$ 974,914 |
| Note payable to an individual, maturing August 2016, bearing interest at 5.7%, collateralized by an annuity security, principal and interest payments of \$4,168 due monthly. | 101,687 | 144,560 |
| Bank note payable, maturing March 2017, bearing interest at 4.25%, collateralized by property, principal and interest payments of \$115,224 due monthly. | 20,003,878 | 20,512,564 |
| Bank note payable, maturing May 2017, bearing interest at 3.90%, collateralized by equipment, principal and interest payments of \$223 due monthly. | 7,373 | 9,715 |
| Bank note payable, maturing August 2017, bearing interest at 3.13%, collateralized by equipment, principal and interest payments of \$1,655 due monthly. | 59,896 | 77,649 |
| Capital lease obligations at varying rates of interest from 1.55% to 6.96%, collateralized by leased equipment with a net book value of \$1,283,560 at June 30, 2014. | <u>975,562</u> | <u>509,700</u> |
| Total long-term debt | 21,640,084 | 22,229,102 |
| Less current portion | <u>1,373,324</u> | <u>1,265,332</u> |
| Long-term debt, net of current portion | <u>\$ 20,266,760</u> | <u>\$ 20,963,770</u> |

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

8. Long-term Debt, continued

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

| Year ending June 30, | <u>Notes Payable</u> | Capital Lease <u>Obligations</u> |
|--|----------------------|-------------------------------------|
| 2015 | \$ 1,088,875 | \$ 313,658 |
| 2016 | 621,560 | 258,638 |
| 2017 | 18,950,789 | 179,394 |
| 2018 | 3,298 | 168,316 |
| 2019 | <u>-</u> | <u>129,309</u> |
| | <u>\$ 20,664,522</u> | 1,049,315 |
| Less amount representing interest under capital lease obligations | | <u>73,753</u> |
| | | <u>\$ 975,562</u> |

Interest expense was \$915,817 and \$949,833 for the years ended June 30, 2014 and 2013, respectively.

9. Net Professional Clinical Service Fees

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 for the years ended June 30, 2014 and 2013 follows:

| | <u>2014</u> | <u>2013</u> |
|---|-----------------------|-----------------------|
| Gross professional clinical service fee revenue | \$ 548,328,060 | \$ 492,052,995 |
| Less provision for contractual adjustments under third- party reimbursement programs and other adjustments | <u>(314,682,708)</u> | <u>(264,847,989)</u> |
| Net professional clinical service fee revenue | <u>\$ 233,645,352</u> | <u>\$ 227,205,006</u> |

10. Physician Supplemental Payments

During 2014, KMSF received approximately \$14,750,000 in physician supplemental payments 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. This amount is included in "other income, net" on the statements of operations and changes in net assets.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

11. Leasing Activities

KMSF leases office space to UK as well as other non-related entities. The lease contract with UK is currently month-to-month. The lease contracts with the non-related entities vary with remaining terms ranging from less than one year to less than two years. KMSF received \$3,636,598 and \$3,533,834 in lease income from UK and \$110,159 from other non-related entities in 2014 and 2013, respectively.

12. Benefit Plan

KMSF provides a defined contribution plan covering substantially all full-time employees. The plan provides that KMSF make bi-weekly contributions of 10% of the employee's earnings. Contributions were \$675,044 and \$799,961 for 2014 and 2013, respectively.

13. 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.

14. 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.

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

14. 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 2014 and 2013 was \$3,286,018 and \$3,415,205, respectively.

During 2014, KMSF entered into a lease agreement for a property that is currently under construction. Lease payments begin in February 2015. KMSF has accounted for the lease as an operating lease and has included the future minimum payments in the schedule below. This lease provides KMSF the option, until the second anniversary of KMSF's occupancy of the premises, to require the landlord to purchase a building and property owned by KMSF with a net book value of \$2,192,273 as of June 30, 2014.

The following is a schedule by year of future minimum lease payments under operating leases as of June 30, 2014, that have initial and remaining lease terms in excess of one year:

| | |
|----------------------|----------------------|
| Year ending June 30, | |
| 2015 | \$ 3,913,427 |
| 2016 | 4,218,116 |
| 2017 | 4,157,503 |
| 2018 | 4,026,915 |
| 2019 | 3,909,949 |
| Thereafter | <u>26,999,338</u> |
| | <u>\$ 47,225,248</u> |

KENTUCKY MEDICAL SERVICES FOUNDATION, INC.

Notes to the Financial Statements, continued

15. 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, 2014 and 2013, was as follows:

| | <u>2014</u> | <u>2013</u> |
|--------------------------|--------------|--------------|
| Other third-party payors | 32 % | 30 % |
| Patients | 10 | 23 |
| Medicaid | 25 | 21 |
| Medicare | 22 | 17 |
| Blue Cross | <u>11</u> | <u>9</u> |
| | <u>100 %</u> | <u>100 %</u> |

16. Healthcare Reform

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, 2014 and 2013, KMSF applied for and received \$269,167 and \$1,905,417 in Medicaid HIT funds, respectively, and \$1,017,344 and \$124,049 in Medicare funds, respectively. KMSF intends to apply for additional funds in the coming years. Both the 2014 and 2013 funds and any funds from future applications are dependent on reaching certain metrics and various states of "meaningful use" as defined by the Recovery Act.