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University of Illinois

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**Annual Financial Report  
Health Services Facilities System**

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**Year Ended June 30, 2005 with  
Comparative Totals for 2004**

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## UNIVERSITY OF ILLINOIS

Chicago • Springfield • Urbana-Champaign

Office of Vice President for Administration, Comptroller  
349 Henry Administration Building  
506 South Wright Street  
Urbana, IL 61801

September 28, 2005

Holders of University of Illinois  
Health Services Facilities System Revenue Bonds  
and  
The Board of Trustees  
University of Illinois

I am pleased to transmit the Annual Financial Report of the University of Illinois Health Services Facilities System for the fiscal year ended June 30, 2005. This report supplements the financial statements of the University of Illinois presented in the Annual Financial Report.

The 2005 financial statements and accompanying notes appearing on pages 4 through 17 have been audited by Clifton Gunderson LLP, Independent Certified Public Accountants, as special assistants to the Auditor General of the State of Illinois, whose report on the financial statements and applicable notes appears on page 3.

Clifton Gunderson LLP will also prepare a report for the year ended June 30, 2005, containing special data requested by the Auditor General and another report covering their audit of the compliance of the University with applicable state and federal laws and regulations for the year ended June 30, 2005. These reports, which include some data related to the Health Services Facilities System, are not contained herein and are primarily for the use of the Auditor General and state and federal agencies.

Respectfully submitted,



Stephen K. Rugg  
Vice President for  
Administration,  
Comptroller

## Independent Auditor's Report

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The Honorable William G. Holland  
Auditor General  
State of Illinois  
and  
The Board of Trustees  
University of Illinois

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statement of net assets of the University of Illinois (University) Health Services Facilities System (System) as of June 30, 2005, and the related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year partial comparative information has been derived from the System's 2004 financial statements and, in our report dated October 15, 2004 we expressed an unqualified opinion on those financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those 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. We believe that our audit provides a reasonable basis for our opinion.

The accompanying financial statements were prepared for the purpose of complying with the requirements of the indenture for the System's Series 1997A and 1997B Revenue Bonds, as described in Note 1, and are not intended to be a complete presentation of the University's assets, liabilities, revenues and expenses.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the System as of June 30, 2005, and its changes in financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In connection with our audit, nothing came to our attention that caused us to believe that the System failed to comply with the terms, covenants, provisions or conditions of the Resolution of the Board of Trustees of the University of Illinois which provided for the issuance of the University of Illinois Health Services Facilities System Revenue Bonds, Series 1997A and 1997B, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 28, 2005, on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

This report is intended solely for the information and use of the Auditor General of the State of Illinois, the General Assembly, the Legislative Audit Commission, the Governor, the Board of Trustees and management of the University of Illinois, and the bondholders and is not intended to be and should not be used by anyone other than these specified parties.

*Clifton Gunderson LLP*

Peoria, Illinois  
September 28, 2005

**Statement of Net Assets as of June 30, 2005  
with Comparative Totals for 2004**

	<u>2005</u>	<u>2004</u>
<b>Current assets:</b>		
Claim on cash and on pooled investments	\$ 36,962,576	\$ 23,263,144
Restricted cash, required for current liabilities	663,774	652,273
Patient receivables, less allowance for doubtful accounts of \$198,922,284	72,227,136	65,401,034
Other receivables	7,563,034	5,756,457
Inventories	5,068,326	4,771,182
Prepaid expenses and other deposits	7,234,321	9,244,952
<b>Total current assets</b>	<b>129,719,167</b>	<b>109,089,042</b>
<b>Noncurrent assets:</b>		
Restricted cash and investments, less amount required for current liabilities of \$663,774	2,454,523	1,246,820
Capital assets	171,075,391	176,424,080
Prepaid expenses	665,190	698,419
<b>Total noncurrent assets</b>	<b>174,195,104</b>	<b>178,369,319</b>
<b>Total assets</b>	<b>\$ 303,914,271</b>	<b>\$ 287,458,361</b>
<b>Current liabilities:</b>		
Accounts payable	\$ 16,122,044	\$ 14,032,852
Accrued expenses	7,958,956	6,853,496
Accrued interest payable	663,774	652,273
Estimated third party settlements	22,770,444	15,131,310
Current maturities of long term liabilities	5,101,856	5,268,123
Current portion of compensated absences	1,004,000	781,776
<b>Total current liabilities</b>	<b>53,621,074</b>	<b>42,719,830</b>
<b>Noncurrent liabilities:</b>		
Long term debt, net of current maturities	76,544,950	79,354,735
Accrued compensated absences, net of current portion	17,982,242	19,704,613
<b>Total noncurrent liabilities</b>	<b>94,527,192</b>	<b>99,059,348</b>
<b>Total liabilities</b>	<b>148,148,266</b>	<b>141,779,178</b>
<b>Net Assets:</b>		
Invested in capital assets, net of related debt	94,216,757	99,645,226
Restricted -		
Expendable for capital projects	2,432,585	1,220,378
Expendable for debt service	21,938	26,442
Unrestricted	59,094,725	44,787,137
<b>Total net assets</b>	<b>155,766,005</b>	<b>145,679,183</b>
<b>Total liabilities and net assets</b>	<b>\$ 303,914,271</b>	<b>\$ 287,458,361</b>

See accompanying notes to financial statements.

**Statement of Revenues, Expenses, and Changes in Net Assets**  
**Year Ended June 30, 2005 with Comparative Totals for 2004**

	<b>2005</b>	<b>2004</b>
<b>Operating revenues:</b>		
Net patient service revenues	\$ 366,123,823	\$ 326,502,545
Payments on behalf of the System - hospital and other medical activities	84,580,648	185,364,889
Fee for services - state appropriation	46,117,046	47,868,867
Other revenues	13,816,808	10,088,211
<b>Total operating revenues</b>	<b>510,638,325</b>	<b>569,824,512</b>
<b>Operating expenses:</b>		
Salaries and wages	204,689,794	191,600,422
Fringe benefits	63,425,690	173,739,515
Supplies and general expenses	167,432,325	145,859,946
Provision for bad debts	32,874,973	25,362,374
Administrative services	10,750,000	11,750,824
Depreciation and amortization	17,828,817	14,047,990
<b>Total operating expenses</b>	<b>497,001,599</b>	<b>562,361,071</b>
<b>Operating income</b>	<b>13,636,726</b>	<b>7,463,441</b>
<b>Nonoperating revenue (expenses)</b>		
Interest payments on capital debt	(3,930,738)	(3,145,537)
Investment income	842,310	320,341
Loss on disposal of plant assets	(100,479)	(137,505)
Other nonoperating expense	(360,997)	(238,111)
<b>Net other nonoperating expense</b>	<b>(3,549,904)</b>	<b>(3,200,812)</b>
<b>Increase in net assets</b>	<b>10,086,822</b>	<b>4,262,629</b>
Net assets beginning of the year	145,679,183	141,416,554
<b>Net assets end of the year</b>	<b>\$ 155,766,005</b>	<b>\$ 145,679,183</b>

See accompanying notes to financial statements.

**Statement of Cash Flows**  
**Year Ended June 30, 2005 with Comparative Totals for 2004**

	<u>2005</u>	<u>2004</u>
<b>Cash flows from operating activities:</b>		
Patient services	\$ 326,422,746	\$ 297,566,726
Payments on behalf of the system	84,580,648	71,403,498
Payments to suppliers	(165,640,277)	(144,525,966)
Payments for administrative services	(10,750,000)	(11,750,824)
Payments to employees	(203,584,334)	(198,292,961)
Payments for benefits	(64,925,836)	(61,028,477)
Fee for services - state appropriations	47,096,021	47,554,342
Other receipts	17,497,065	12,402,667
<b>Net cash provided by operating activities</b>	<u>30,696,033</u>	<u>13,329,005</u>
<b>Cash flows from capital and related financing activities:</b>		
Purchases of capital assets	(7,655,642)	(11,113,461)
Principal paid on capital debt and leases	(5,235,889)	(3,690,729)
Interest paid on capital debt and leases	(3,889,559)	(3,126,908)
<b>Net cash used in capital and related financing activities</b>	<u>(16,781,090)</u>	<u>(17,931,098)</u>
<b>Cash flows from investing activities:</b>		
Interest on investments	1,003,693	269,190
<b>Net cash provided by investing activities</b>	<u>1,003,693</u>	<u>269,190</u>
<b>Net increase (decrease) in cash and cash equivalents</b>	<u>14,918,636</u>	<u>(4,332,903)</u>
<b>Cash and cash equivalents at beginning of year</b>	<u>25,162,237</u>	<u>29,495,140</u>
<b>Cash and cash equivalents at end of year</b>	<u>\$ 40,080,873</u>	<u>\$ 25,162,237</u>



**Statement of Cash Flows**  
**Year Ended June 30, 2005 with Comparative Totals for 2004 (continued)**

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**Reconciliation of operating income to net cash provided by operating activities:**

Operating income	13,636,726	7,463,441
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization expense	17,828,817	14,047,990
Bad debt expense	32,874,973	25,362,374
Changes in assets and liabilities		
Patient receivables	(39,701,075)	(28,935,819)
Other receivables	(1,967,961)	(561,883)
Inventories	(297,144)	437,705
Prepaid expenses	(1,011,942)	(1,093,417)
Accounts payable and accrued expenses	3,194,652	(5,796,264)
Estimated third party settlements	7,639,134	3,655,230
Compensated absences	(1,500,147)	(1,250,352)
<b>Net cash provided by operating activities:</b>	<b>\$ 30,696,033</b>	<b>\$ 13,329,005</b>

Noncash investing, capital, and financing activities:

Capital assets transferred from the University	-	445,619
Capital asset acquired through capital leases	5,425,991	5,906,453
Capital assets transferred to other State and University sources	534,287	308,113
Other deposits acquired through leasehold obligations	-	7,112,296
Other obligations transferred to the University	(116,577)	-
Capital leases cancelled	(56,682)	-

See accompanying notes to financial statements

## **Notes to Financial Statements**

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### **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

#### **Organizational Background and Basis of Presentation**

The University of Illinois Health Services Facilities System (System) is comprised of the University of Illinois Hospital (Hospital) and associated clinical facilities providing patient care at, but not limited to, the University of Illinois at Chicago Medical Center. The System is a tertiary care facility located primarily in Chicago, Illinois offering a full range of clinical services. Management of the System is the responsibility of the University of Illinois (University).

The System was established by a Bond Resolution (Resolution) of the Board of Trustees (Board) of the University of Illinois adopted on January 22, 1997. These financial statements have been prepared to satisfy the requirements of the 1997A and 1997B bond indentures. The financial balances and activities of the System, included in these financial statements, are included in the University's financial statements. The financial statements of the System are prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The System is not a separate legal entity and therefore has not presented management's discussion and analysis.

During fiscal year 2005, the University adopted GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, which requires certain reporting changes for the disclosure of deposits and investment risk.

The System's resources are classified into net asset categories and reported in the Statement of Net Assets. These categories are defined as (a) Invested in capital assets, net of related debt - capital assets net of accumulated depreciation and outstanding debt balances (b) Restricted nonexpendable - assets restricted by externally imposed stipulations (c) Restricted expendable - assets subject to externally imposed restrictions that can be fulfilled by actions of the entity pursuant to those stipulations or that expire by the passage of time and (d) Unrestricted - assets not subject to externally imposed stipulations but may be designated for specific purposes by action of management or the Board of Trustees.

The financial statements include prior year comparative information, which has been derived from the System's 2004 financial statements. Such information does not include all of the information required to constitute a presentation in conformity with accounting principles generally accepted in the United States of America. Accordingly, such information should be read in conjunction with the System's financial statements for the year ended June 30, 2004.

Certain items in the June 30, 2004 financial statements have been reclassified to correspond to the June 30, 2005 presentation.

#### **Significant Accounting Policies**

The System prepared its financial statements as a Business Type Activity, as defined by GASB Statement No. 35, using the economic resources measurement focus and the accrual basis of accounting. Business Type Activities are those financed in whole or in part by fees charged to external parties for goods and services.

The Statement of Revenues, Expenses, and Changes in Net Assets classifies the Facility's fiscal year activity as operating and nonoperating. Operating revenues generally result from exchange transactions such as payments received for providing goods and services.

Certain revenue sources that the System relies on for operations, including investment income, are defined by GASB Statement No. 35 as nonoperating. In addition, transactions related to capital and financing activities are components of nonoperating revenues.

A portion of the University's appropriations made from the State of Illinois General Revenue Fund for the benefit of the System are recognized as operating revenues to the extent expended, limited to available appropriations.

Net patient service revenue is reported at the estimated net realizable amounts due from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Approximately 92% of the Hospital's net patient

service revenues were derived from Medicare, Medicaid, Blue Cross and managed care programs for the year ended June 30, 2005.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 2005 net patient revenue increased approximately \$4,646,194 due to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations.

The System provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its establish rates. Because the system does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

The System has agreements with various Health Maintenance Organizations (HMO's) to provide medical services to subscribing participants. Under these agreements, the System receives monthly capitation payments based on the number of each HMO's participants, regardless of services actually performed by the System. In addition, the HMO's make fee-for-service payments to the System for certain covered services based upon discounted fee schedules.

The System grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at June 30, 2005 was as follows:

Medicare	24 %
Medicaid	34
Blue Cross	1
Other third-party payors	34
Patients	7
	<u>100 %</u>

In accordance with GASB No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, the System reported payments made by the State on behalf of the System for contributions to State group insurance and retirement programs for System employees, and payments made by the University on behalf of the System for operations, maintenance and utility costs. These expenditures represent the cost of providing medical services, regardless of where the funding originates. The expenditures are factored into the State's cost-based inpatient reimbursement methodologies and considered to be a part of an exchange transaction. Therefore, these costs are reflected in operating revenues as payments on behalf of the System and as expenses in the appropriate expense category as follows:

Salaries and wages	\$ 9,106,000
Fringe benefits	60,635,572
Self insurance	9,866,000
Supplies and general expenses	4,973,076
TOTAL	<u>\$ 84,580,648</u>

The System first applies restricted net assets when an expense or outlay is incurred for purposes for which both restricted and unrestricted net assets are available.

Accrued compensated absences for System personnel are charged to operations based on earned but unused vacation and sick leave days including the System's share of Social Security and Medicare taxes. The estimated outstanding liability at June 30, 2005 was \$18,986,242. Of that liability, it is estimated that at June 30, 2005, \$277,915 of the accrued compensated absences liability will be paid out of State of Illinois General Revenue Fund appropriations to the System in years subsequent to June 30, 2005, rather than from current resources available at June 30, 2005.

The Statement of Cash Flows details the change in the cash and cash equivalents balance for the fiscal year. Cash and all liquid investments with original maturities of ninety days or less are defined as cash and cash equivalents.

Inventories of pharmaceutical and other supplies are stated at the lower of cost or market, determined using the first-in, first-out method.

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The System provides allowances for uncollectible accounts receivable based upon management's best estimate of uncollectible accounts, considering type, age, collection history, and any other factors as considered appropriate.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported revenues and expenditures during the reporting period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for doubtful accounts and contractual adjustments.

The System has cash and certain investments which are pooled with other University funds for the purpose of securing a greater return on investment and providing an equitable distribution of investment return. Pooled investments, which consist principally of U. S. Government and government agency securities and time deposits, are stated at fair market value, as determined by quoted market prices. Income is distributed based upon average quarterly balances invested in the pool. It is not feasible to separately categorize the System's claim on cash and on pooled investments by level of risk assumed. Claim on cash and pooled investments are classified as cash and cash equivalents.

In accordance with GASB Statement 20, *Accounting and Financial Reporting for Proprietary Funds and Other Government Entities That Use Proprietary Fund Accounting*, the System follows all applicable GASB pronouncements. In addition, the System applies all applicable Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989 unless those pronouncements conflict with or contradict GASB pronouncements. The System has elected not to apply FASB pronouncements issued after November 30, 1989.

## **NOTE 2 - DEPOSITS AND INVESTMENTS**

Illinois Statutes and Board Policy authorize the University to invest in obligations of the U.S. Treasury, agencies and instrumentalities (U.S. Government securities); bank and savings and loan time deposits; corporate bonds, stock and commercial paper; repurchase agreements; and mutual funds. These investments are stated at fair value, as determined by quoted market prices. Investment income and the change in fair value of investments is recognized in the fund which owned such investments. Illinois Statutes require a third party custodian to perfect the University's security interest under repurchase agreements. The University follows industry standards and requires that securities underlying repurchase agreements must have a fair value of at least 102% of the cost of the repurchase agreement. At June 30, 2005, the System had no repurchase agreements.

Nearly all of the University's investments are managed by external professional investment managers. Many of these investments are made through commingled investment vehicles such as common trust funds and mutual funds. A number of the investment managers utilize derivatives in the execution of their investment strategies. In general, managers utilize derivatives to reduce or eliminate undesirable risks, to increase portfolio liquidity and flexibility or to increase investment return within the level of risk defined in the manager's investment guidelines. Examples of authorized derivative transactions would be the hedging of foreign currency exposure through the use of currency forwards, owning mortgage securities with embedded prepayment options or utilizing treasury futures to change the duration of a fixed income portfolio. The System did not engage in any derivative transactions during 2005.

The University, by the authorization of the Board, increases its investment income by lending the University's securities, through its custodian, to independent third parties. Such loans are secured by collateral consisting of cash, cash equivalents or U.S. Government securities and irrevocable bank letters of credit in an amount not less than 102% of the fair value of the securities loaned. Any collateral securities cannot be pledged or sold by the University unless the borrower defaults. The University receives interest and dividends during the loan period as well as a fee from the custodian. At June 30, 2005, the University has no credit risk exposure to borrowers because the amounts the University owes the borrowers exceed the amounts the borrowers owe the University. As of June 30, 2005, approximately \$247,049,000 of the investments reported on the University's Statement of Net Assets were on loan, secured by collateral with a fair value of approximately \$252,339,000. The System does not participate in security lending transactions.

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At June 30, 2005, the carrying amount and bank balance of the System's deposits with financial institutions was \$3,051,411. All deposits are fully insured by the Federal Depository Insurance Corporation or collateralized with securities held by the System's agent in the System's name.

The Board develops University policy on investments and delegates the execution of those policies to its administrative agents. The University follows the State of Illinois Uniform Management of Institutional Funds Act when investing its endowment and operating funds. The State of Illinois Public Funds Investment Act provides the context and framework for plant fund investments.

*Interest Rate Risk:* Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The University employs multiple investment managers, of which each has specific maturity assignments related to the operating funds. The funds are structured with different layers of liquidity. Funds expected to be used within one year are invested in money market instruments. Core operating funds are invested in longer maturity investments. Core operating funds investment manager's performance benchmarks are Lehman Brother 1-3 year Government Credit Bond Index and the Lehman Brothers Intermediate Aggregate Bond Index. The University's manager guidelines provide that the average weighted duration of the portfolio, including options positions, not vary from that of their respective performance benchmarks by more than +/-20 percent. At June 30, 2005, the University's operating funds pool portfolio had an effective duration of 1.7 years.

*Credit Risk:* Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The University's policy requires that operating funds be invested in fixed income securities and money market instruments. Fixed income securities shall be rated investment grade or better by one or more nationally recognized statistical rating organizations. Securities not covered by the investment grade standard are allowed if, in the manager's judgment, those instruments are of comparable credit quality. Securities which fall below the stated minimum credit requirements subsequent to initial purchase may be held at the manager's discretion. It is expected that the average credit quality of the operating funds will not fall below Standard & Poor's AA- or equivalent. The System's investments are not exposed to credit risk.

*Custodial Credit Risk:* Custodial credit risk is the risk that, in the event of the failure of the counterparty, the University will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. Exposure to custodial credit risk relates to investment securities that are held by someone other than the University and are not registered in the University's name. The University has no formal policy in regard to custodial credit risk. The System's share of University investments are comprised of mutual funds and money market investments which are not classifiable by custodial credit risk category. At June 30, 2005, the System's investments and deposits have no custodial credit risk exposure.

*Concentration of Credit Risk:* Concentration of credit risk is the risk of loss attributed to the magnitude of the University's investment in a single issuer. The University's policy provides that the total operating funds portfolio will be broadly diversified across securities in a manner that is consistent with fiduciary standards of diversification. This diversification is achieved by employing multiple investment managers and imposing maximum position limits for each manager. The University's manager guidelines for operating investments provide that non-U.S. government obligations may not exceed 10% per issuer and private mortgage-backed and asset-backed securities may not exceed 10% per issuer (unless collateral is credit independent of the issuer and the security's credit enhancement is generated internally, in which case the limit is 25% per issuer). Obligations with other issuers, other than the U.S. government, U.S. agencies, or U.S. government sponsored corporations and agencies, may not exceed 5%. As of June 30, 2005, not more than 5% of the System's total investments were invested in securities of any one issuer, excluding securities issued or guaranteed by the U.S. government, mutual funds, and external investment pools or other pooled investments.

*Foreign Currency Risk:* Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or deposit. The University's operating fund investments generally are not exposed to foreign currency risk. Under the manager's guidelines, the portfolio's foreign currency exposure may be unhedged or hedged back into U.S. dollars. Cross hedging is not permitted. The manager may invest up to 20% of the portfolio in emerging market securities. As of June 30, 2005 the System was not exposed to foreign currency risk.

### NOTE 3 - CAPITAL ASSETS

Capital assets are recorded at cost. University policy requires the System to capitalize all land and collection purchases, equipment at \$5,000, buildings and improvements at \$100,000, and infrastructure at \$1,000,000. Depreciation of buildings and equipment and software is calculated on a straight line basis over the estimated useful lives (three to fifty years) of the respective assets. The buildings are located on land primarily owned by the University and for which there is no charge to the System other than for maintenance.

Capital asset activity for the year ended June 30, 2005 is summarized as follows:

Capital Assets for the System				
	Beginning Balance	Additions	Retirements	Ending Balance
Nondepreciable Capital Assets:				
Land	\$ 770,917	\$	\$	\$ 770,917
Depreciable Capital Assets:				
Buildings	171,598,316	588,092	-	172,186,408
Construction in process	-	1,527,996	-	1,527,996
Equipment	118,664,782	10,874,326	(991,031)	128,548,077
Software	10,215,260	79,672		10,294,932
Subtotal	300,478,358	13,070,086	(991,031)	312,557,413
Less accumulated depreciation	124,825,195	17,795,558	(367,814)	142,252,939
Total net depreciable capital assets	175,653,163	(4,725,472)	(623,217)	170,304,474
Total Capital Assets	\$ 176,424,080	\$ (4,725,472)	\$ (623,217)	\$ 171,075,391

### NOTE 4 - LONG TERM OBLIGATIONS

During fiscal year 1997, Health Services Facilities System Bonds Series 1997A and 1997B (Series 1997A and 1997B Bonds) were issued for \$47,210,000 and \$25,000,000, respectively. Series 1997A Bonds are current interest fixed rate bonds with semiannual payments. Series 1997 B Bonds are variable rate bonds which bear interest at a rate determined weekly and paid monthly. The System capitalized all costs incurred to issue the bonds. The bond issuance costs are being amortized over the life of the bonds. Amortization was \$33,254 for the year ended June 30, 2005.

At June 30, 2005 Health Services Facilities System long term obligations are as follows:

Long term Obligations							
Series	Yield on Outstanding Debt	Maturity Dates	Beginning Balance	Additions	Deductions	Ending Balance	Current Portion
<b>Bonds Payable</b>							
1997A	4.8% - 5.875%	2001-2026	\$ 43,795,000	\$	\$ 995,000	\$ 42,800,000	\$ 1,070,000
1997B	Variable - 2.625%	2001-2026	22,700,000		600,000	22,100,000	600,000
<b>Total Principal Payable</b>			<b>66,495,000</b>		<b>1,595,000</b>	<b>64,900,000</b>	<b>1,670,000</b>
<b>Unamortized Debt Discount</b>			<b>(652,901)</b>	<b>29,677</b>		<b>(623,224)</b>	<b>(29,677)</b>
<b>Total Bonds Payable</b>			<b>65,842,099</b>	<b>29,677</b>	<b>1,595,000</b>	<b>64,276,776</b>	<b>1,640,323</b>
<b>Other obligations</b>			<b>12,164,212</b>	<b>2,403,419</b>	<b>2,440,584</b>	<b>12,127,047</b>	<b>2,149,172</b>
<b>Internal Financing Payable</b>			<b>6,616,547</b>	<b>(116,577)</b>	<b>1,256,987</b>	<b>5,242,983</b>	<b>1,312,361</b>
<b>Total long term debt</b>			<b>84,622,858</b>	<b>2,316,519</b>	<b>5,292,571</b>	<b>81,646,806</b>	<b>5,101,856</b>
<b>Compensated Absences</b>			<b>20,486,389</b>		<b>1,500,147</b>	<b>18,986,242</b>	<b>1,004,000</b>
<b>TOTAL</b>			<b>\$ 105,109,247</b>	<b>\$ 2,316,519</b>	<b>\$ 6,792,718</b>	<b>\$ 100,633,048</b>	<b>\$ 6,105,856</b>

The bonds do not constitute obligations of the State of Illinois. Bond principal and interest payments are funded from revenues pledged from (a) Net system revenues, principally consisting of all charges, income and revenues received from the continued use and operation of the System, excluding depreciation charges and transfers, (b) Medical Service Plan (MSP) revenues net of bad debt expense, and (c) College of Medicine tuition revenue. These revenues for the year ended June 30, 2005 are as follows in thousands:

System net revenues	\$ 20,683
Adjusted MSP revenues	<u>134,686</u>
College of Medicine student tuition	<u>29,520</u>
TOTAL	<u>\$ 184,889</u>

The resolution authorizing the University of Illinois Health Services Facilities System Revenue Bonds provides for the establishment of separate funds as follows: Revenue Fund, Project Fund, Repair and Replacement Reserve, Equipment Reserve, Bond and Interest Sinking Fund, and Development Reserve. All income and revenues received from the continued use and operation of the System, as provided for by the Bond Resolution, are to be deposited in the Revenue Fund and used to pay necessary operation and maintenance expenses of the System. The Bond Resolution also requires transfers to funds as follows:

**Project Fund** - at the discretion of the University Comptroller, amounts not needed to complete construction and renovation projects specified in the Bond Resolution are required to be transferred either to the Repair and Replacement Reserve or to the Bond and Interest Sinking Fund.

**Repair and Replacement Reserve** - an amount calculated as specified in the Bond Resolution to provide for the cost of unusual maintenance and repairs.

**Equipment Reserve** - an amount approved by the Board for the acquisition of movable equipment to be installed in the facilities constituting the System. The reserve may not exceed 20% of the book value of the movable equipment of the System.

**Bond and Interest Sinking Fund** - amounts into the Bond and Interest Sinking Fund sufficient to pay principal and interest as it becomes due on the outstanding bonds.

**Development Reserve** - an amount approved by The Board of Trustees of the University of Illinois (Board) for System development. No transfers were authorized by the Board during the year ended June 30, 2005, and there were no balances in the reserve at June 30, 2005.

After fulfillment of the provisions described above, the surplus, if any, remaining in the Revenue Fund may be used at the Board's option (a) to redeem bonds of the System which are subject to early redemption, (b) to improve or add facilities to the System, or (c) for any other lawful purpose.

Assets restricted by bond resolution were held for the following purposes at June 30, 2005:

Restricted Assets:	
Cash	\$ 3,051,411
Investments	<u>66,886</u>
TOTAL	<u>\$ 3,118,297</u>
Purpose:	
Repair and replacement reserve	\$ 2,432,585
Bond and interest sinking fund	<u>685,712</u>
Total assets limited as to use	<u>3,118,297</u>
Less amounts required for current liabilities	<u>(663,774)</u>
TOTAL	<u>\$ 2,454,523</u>

## Debt Service Requirements

Future debt service requirements for the Series 1997A and 1997B Bonds are as follows:

	Principal	Interest
2006	\$ 1,670,000	\$ 2,931,509
2007	1,755,000	2,860,519
2008	1,835,000	2,785,038
2009	1,925,000	2,703,826
2010	2,020,000	2,619,062
2011-2015	11,745,000	11,577,415
2016-2020	15,125,000	8,479,810
2021-2025	19,505,000	4,415,268
2026-2030	9,320,000	348,744
<b>TOTAL</b>	<b>\$ 64,900,000</b>	<b>\$ 38,721,191</b>

The required debt service for the variable rate Series 1997B Bonds has been calculated using the current interest rate of 2.28 % over the life of the bonds.

## NOTE 5 - LEASES AND OTHER OBLIGATIONS

Other obligations consist of third party financing arrangements which have maturity dates from 2007 through 2012 and interest rates ranging from 3.03% to 9.00%. As of June 30, 2005, future minimum payments under other obligations are as follows:

	Principal	Interest
2006	\$ 2,149,172	\$ 400,813
2007	2,204,786	333,030
2008	2,277,054	259,863
2009	1,896,603	184,263
2010	1,864,876	120,450
2011-2015	1,734,556	59,140
<b>Total minimum payments</b>	<b>\$ 12,127,047</b>	<b>\$ 1,357,559</b>

As of June 30, 2005 the System had outstanding debt to the University of Illinois relating to certain building renovation projects completed during the past fiscal years. The agreement between the System and the University of Illinois requires annual payments of \$1,560,089 including interest at 4.50% through June 30, 2009. Aggregate annual maturities as of June 30, 2005 are as follows:

	Principal	Interest
2006	\$ 1,312,361	\$ 235,934
2007	1,371,417	176,878
2008	1,433,131	115,164
2009	1,126,074	50,673
<b>TOTAL</b>	<b>\$ 5,242,983</b>	<b>\$ 578,649</b>



The System leases various buildings and equipment under operating lease agreements, including leases renewed on an annual basis. Total rental expense under these agreements was approximately \$161,059 for the year ended June 30, 2005. In future years, the System expects to incur annual rental expense in amounts similar to 2005. The future minimum lease payments under operating leases (excluding those leases renewed on an annual basis) are as follows:

2006	<u>\$ 258,805</u>
2007	<u>255,521</u>
2008	<u>252,434</u>
2009	<u>251,354</u>
2010	<u>62,838</u>
TOTAL MINIMUM LEASE PAYMENTS	<u><u>\$ 1,080,952</u></u>

#### NOTE 6 - NET PATIENT SERVICE REVENUE

The Hospital has agreements with third-party payors that provide for payments to the Hospital at established program rates or costs, as defined, for rendering services to program beneficiaries. The Hospital provides contractual allowances on a current basis for the differences between charges for services rendered and the expected payments under these programs. The patient revenues from third-party payor programs for fiscal year 2005 are as follows:

Gross revenue	
Medicaid	<u>\$ 322,658,262</u>
Medicare	<u>255,640,114</u>
HMO / PPO	<u>341,208,724</u>
Commercial	<u>32,745,439</u>
Self-pay & other	<u>29,840,628</u>
Total gross revenue	982,093,167
Less: Contractual allowance	<u>(615,969,344)</u>
NET PATIENT REVENUE	<u><u>\$ 366,123,823</u></u>

A summary of the payment arrangements with major third-party payors follows:

**Medicare** - Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient skilled nursing services are paid at prospectively determined rates that are based on the patients' acuity. Other inpatient nonacute services, and defined medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. The Hospital is reimbursed for certain services at tentative rates with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare fiscal intermediary. Substantially all outpatient services are subject to a prospective payment system. Under this system, payments to the Hospital are based on a predetermined package rate based on services provided to patients. The System is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicare fiscal intermediary. At June 30, 2005 all Medicare settlements for 2005, 2004, and 2003 are subject to audit and retroactive adjustment.

**Medicaid** - Inpatient services rendered to Medicaid program beneficiaries are reimbursed at prospectively determined rates-per-discharge. Outpatient services rendered to program beneficiaries are reimbursed at prospectively determined rates.

**Blue Cross** - Inpatient and outpatient services rendered to Blue Cross subscribers are reimbursed under a cost reimbursement methodology. The System is reimbursed at a tentative rate with final settlement determined after submission of annual cost

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reports by the System and audits thereof by Blue Cross. At June 30, 2005, the Blue Cross settlements for 2005 and 2004 are subject to audit and retroactive adjustment.

The System also has payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment under these agreements include prospectively determined rates-per-discharge, discounts from established charges, prospectively determined daily rates, and capitated per member per month rates.

## **NOTE 7 - RETIREMENT AND POSTEMPLOYMENT BENEFITS**

Substantially all employees of the System participate in the State Universities Retirement System of Illinois (SURS), a cost-sharing multiple-employer defined-benefit pension plan. The University contributes to the plan with a special funding situation whereby the State of Illinois makes substantially all actuarially determined required contributions on behalf of the participating employers. The University contributions include payments for System employees covered under the plan.

SURS was established July 21, 1941 to provide retirement annuities and other benefits for staff members and employees of the State universities, certain affiliated organizations, and certain other State educational and scientific agencies and for survivors, dependents, and other beneficiaries of such employees. SURS is considered a component unit of the State of Illinois' financial reporting entity and is included in the State's financial reports as a pension trust fund. SURS is governed by Section 5/15, Chapter 40, of the *Illinois Compiled Statutes*. SURS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to SURS, 1901 Fox Drive, Champaign, IL 61820 or by calling 1-800-275-7877.

Eligible employees must participate upon initial employment. Employees are ineligible to participate if (a) employed after having attained age 68; (b) employed less than 50 percent of full-time; or (c) employed less than full-time and attending classes with an employer. Of those University employees ineligible to participate, the majority are students at the University.

Plan members are required to contribute 8.0% of their annual covered salary and substantially all employer contributions are made by the State of Illinois on behalf of the individual employers at an actuarially determined rate. The current rate is 11.12% of annual covered payroll. The contribution requirements of plan members and employers are established and may be amended by the Illinois General Assembly. The University's contributions to SURS for the years ended June 30, 2005, 2004 and 2003, were \$ 145,752,000, \$755,398,000, and \$139,955,000, respectively, equal to the required contributions for each year. The 2004 contribution includes an annual calculated contribution of \$158,153,000 and additional funding from the State of Illinois of \$597,245,000.

In addition to providing pension benefits, the State provides certain health, dental and life insurance benefits to annuitants who are former State employees. This includes annuitants of the System. Substantially all State employees, including the employees of the System, may become eligible for postemployment benefits if they eventually become annuitants. Health and dental benefits include basic benefits for annuitants under the State's self-insurance plan and insurance contracts currently in force. Life insurance benefits for annuitants under age 60 are equal to their annual salary at the time of retirement; life insurance benefits for annuitants age 60 and older are limited to \$5,000 per annuitant.

## **NOTE 8 - RELATED PARTY TRANSACTIONS**

The University charged the System for administrative and other services totaling \$10,750,000 in 2005, based upon the gross expenditures and debt service transfers of various operations of the System. These charges represent a portion of the estimated administrative and other service costs incurred by the University in support of the System. An additional \$23,945,076 was paid by the University on behalf of the System for salaries, utility costs, and medical malpractice insurance for the year ended June 30, 2005, and are reported as Payments on behalf of the System.

Most health care services rendered by physicians at the University are charged, billed and collected through the Medical Service Plan (MSP). For ambulatory care services, there is a charge for both a professional and technical component. The System bills and collects on behalf of the MSP for the professional component of ambulatory care services. Based on the underlying

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agreements between the MSP and the University, the System remits funds collected to the MSP. Total MSP remittances from the System for the year ended June 30, 2005 relating to the billing and collection of physician fees and the delivery of ambulatory care were \$10,385,943.

During 2005, various departments within the College of Medicine agreed to reimburse the System for a portion of the expenses related to the resident and fellowship training program. This reimbursement, which totaled approximately \$1,505,404, has been reflected in the financial statements as a reduction of the related expenses.

## **NOTE 9 - COMMITMENTS AND CONTINGENCIES**

### **Commitments**

At June 30, 2005, the System had commitments outstanding for the perpetual right and license to use any or all of the Cerner licensed software. The fixed technology fee commitment totals \$5,600,000 payable in annual amounts of \$1,400,000 through the year ending June 30, 2009.

### **Accrued Self-Insurance and Legal Actions**

The University (including the System) is a defendant in a number of legal actions primarily related to medical malpractice. These legal actions have been considered in estimating the University's accrued self-insurance liability which covers hospital and clinical patient liability; hospital and medical professional liability; estimated general and contract liability; and workers' compensation liability. At June 30, 2005 the University's total accrued self-insurance liability, discounted at a rate of 6%, was \$130,976,000.

The University's accrued self-insurance includes \$91,263,000 at June 30, 2005, for the most probable and reasonably estimable ultimate cost of uninsured medical malpractice liabilities. Ultimate cost consists of amounts estimated by the University's risk management division and actuaries for asserted claims, unasserted claims arising from reported incidents, expected litigation expenses and amounts determined by actuaries using relevant industry data and Hospital specific data to cover projected losses for claims incurred but not yet reported. The System contributes to the University's self insurance reserve through annual assessments for claim exposure. Therefore, no liability related to medical malpractice claims is included in these financial statements but is reflected in the University's financial statements.

The University has contracted with several commercial carriers to provide varying levels and upper limits of excess indemnity coverage. These coverages have been considered in determining the required accrued self-insurance liability.

Amounts of accrued self-insurance liability related to the activities of the System are calculated based upon estimates made by the University's actuaries and the University's Risk Management Division. For the year ended June 30, 2005, the System's calculated required contribution for its portion of the University's self-insurance liability was \$20,182,268. Of that amount, \$9,866,000 was contributed by the University on behalf of the System. The University is responsible for the payment of claim judgements and settlements actually incurred, and therefore no accrued self-insurance liability has been recorded by the System. These amounts are reported as supplies and general expenses in the Statement of Revenues, Expenses, and Changes in Net Assets.

Because the amounts accrued by the University are estimates, the aggregate claims actually incurred could differ significantly from the accrued self-insurance liability at June 30, 2005. Changes in these estimates for claims related to the activities of the System will be charged by the University to the System and reflected by the System in the Statement of Revenues, Expenses, and Changes in Net Assets in the periods when additional information is available.

The total of amounts claimed under legal actions, including potential settlements and amounts relating to losses incurred but not reported, could exceed the amount of the self-insurance liability. In the opinion of the University's administrative officers, the University's self-insurance liability, including the System's portion, and limited excess indemnity insurance coverage from commercial carriers are adequate to cover the ultimate liability of these legal actions, in all material respects.

This information is an integral part of the accompanying financial statements.