

University of Illinois

**Annual Financial Report
Health Services Facilities System**

Year Ended June 30, 2006

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From the Vice President for Administration, Comptroller

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

October 4, 2006

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, 2006. This report supplements the financial statements of the University of Illinois presented in the Annual Financial Report.

The 2006 financial statements and accompanying notes appearing on pages 4 through 18 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, 2006, 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, 2006. 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



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 Health Services Facilities System (System) as of June 30, 2006, 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.

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 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 of Illinois' assets, liabilities, revenues and expenses.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the System as of June 30, 2006, and the respective changes in its net assets 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*, a report on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters will be issued under separate cover. 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, upon issuance, 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 Comptroller, the Board of Trustees and the 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
October 4, 2006

Statement of Net Assets as of June 30, 2006

| | <u>2006</u> |
|---|-----------------------|
| Assets | |
| Current assets | |
| Cash and cash equivalents | \$ 43,696,164 |
| Cash and investments, required for current liabilities | <u>670,963</u> |
| Patient receivables, less allowance for doubtful accounts of \$220,706,045 | <u>69,463,999</u> |
| Other receivables | <u>11,399,154</u> |
| Inventories | <u>5,379,146</u> |
| Prepaid expenses and other deposits | <u>4,982,374</u> |
| Total current assets | <u>135,591,800</u> |
| Noncurrent assets | |
| Restricted cash and investments, less amount required for current liabilities of \$670,963 | <u>2,436,356</u> |
| Capital assets | <u>181,513,445</u> |
| Prepaid expenses | <u>631,930</u> |
| Total noncurrent assets | <u>184,581,731</u> |
| Total assets | <u>\$ 320,173,531</u> |
| Liabilities: | |
| Current liabilities | |
| Accounts payable | \$ 17,724,007 |
| Accrued expenses | <u>9,787,177</u> |
| Accrued interest payable | <u>670,963</u> |
| Estimated third party settlements | <u>27,621,400</u> |
| Current maturities of long term liabilities | <u>6,395,664</u> |
| Current portion of compensated absences | <u>1,086,075</u> |
| Total current liabilities | <u>63,285,286</u> |
| Noncurrent liabilities | |
| Long term debt, net of current maturities | <u>77,742,197</u> |
| Accrued compensated absences, net of current portion | <u>19,536,010</u> |
| Total noncurrent liabilities | <u>97,278,207</u> |
| Total liabilities | <u>160,563,493</u> |
| Net Assets: | |
| Invested in capital assets, net of related debt | <u>101,996,917</u> |
| Restricted - | |
| Expendable for capital projects | <u>2,422,547</u> |
| Expendable for debt service | <u>13,809</u> |
| Unrestricted | <u>55,176,765</u> |
| Total net assets | <u>159,610,038</u> |
| Total liabilities and net assets | <u>\$ 320,173,531</u> |

See accompanying notes to financial statements.

Statement of Revenues, Expenses, and Changes in Net Assets
Year Ended June 30, 2006

| | <u>2006</u> |
|---|-----------------------|
| Operating revenues: | |
| Net patient service revenues | \$ 393,100,217 |
| Payments on behalf of the System - hospital and other medical activities | 79,431,630 |
| Fee for services - state appropriation | 44,626,228 |
| Other revenues | 15,306,224 |
| Total operating revenues | <u>532,464,299</u> |
| Operating expenses: | |
| Salaries and wages | 230,119,951 |
| Fringe benefits | 64,956,318 |
| Supplies and general expenses | 171,636,865 |
| Provision for bad debts | 26,694,008 |
| Administrative services | 10,996,823 |
| Depreciation and amortization | 19,073,100 |
| Total operating expenses | <u>523,477,065</u> |
| Operating income | <u>8,987,234</u> |
| Nonoperating revenues (expenses) | |
| Interest payments on capital debt | (3,840,397) |
| Investment income | 1,137,818 |
| Loss on disposal of plant assets | (255,381) |
| Other nonoperating expense | (468,967) |
| Net nonoperating expense | <u>(3,426,927)</u> |
| Increase in net assets | 5,560,307 |
| Net assets beginning of the year, as restated | <u>154,049,731</u> |
| Net assets end of the year | <u>\$ 159,610,038</u> |

See accompanying notes to financial statements.

Statement of Cash Flows Year Ended June 30, 2006

| | <u>2006</u> |
|--|----------------------|
| Cash flows from operating activities: | |
| Patient services | \$ 369,169,345 |
| Payments on behalf of the system | 79,431,630 |
| Payments to suppliers | (170,345,723) |
| Payments for administrative services | (10,996,823) |
| Payments to employees | (228,291,729) |
| Payments for benefits | (63,320,476) |
| Fee for services - state appropriations | 44,626,228 |
| Other receipts | 16,786,180 |
| Net cash provided by operating activities | <u>37,058,632</u> |
| Cash flows from noncapital financing activities: | |
| Contributions | 142,089 |
| Net cash provided by noncapital financing activities | <u>142,089</u> |
| Cash flows from capital and related financing activities: | |
| Purchases of capital assets | (22,029,135) |
| Principal paid on capital debt and leases | (5,783,264) |
| Interest paid on capital debt and leases | (3,803,530) |
| Net cash used by capital and related financing activities | <u>(31,615,929)</u> |
| Cash flows from investing activities: | |
| Interest on investments | 1,137,818 |
| Net cash provided by investing activities | <u>1,137,818</u> |
| Net increase in cash and cash equivalents | <u>6,722,610</u> |
| Cash and cash equivalents, beginning of year | <u>40,080,873</u> |
| Cash and cash equivalents, end of year | <u>\$ 46,803,483</u> |

Statement of Cash Flows Year Ended June 30, 2006 (continued)

| | <u>2006</u> |
|--|-----------------------------|
| Reconciliation of operating income to net cash provided by operating activities: | |
| Operating income | <u>8,987,234</u> |
| Adjustments to reconcile operating income to net cash provided by operating activities: | |
| Depreciation and amortization expense | <u>19,073,100</u> |
| Bad debt expense | <u>26,694,008</u> |
| Changes in assets and liabilities: | |
| Patient receivables | <u>(23,930,871)</u> |
| Other receivables | <u>(3,836,120)</u> |
| Inventories | <u>(310,820)</u> |
| Prepaid expenses | <u>465,118</u> |
| Accounts payable and accrued expenses | <u>3,430,184</u> |
| Estimated third party settlements | <u>4,850,956</u> |
| Compensated absences | <u>1,635,843</u> |
| Net cash provided by operating activities: | <u><u>\$ 37,058,632</u></u> |
| Noncash investing, capital, and financing activities: | |
| Capital assets transferred from the University | <u>\$ 9,184</u> |
| Capital asset acquired through capital leases | <u>7,694,957</u> |
| Capital assets transferred to other State and University sources | <u>255,381</u> |
| Other obligations transferred from the University | <u>616,543</u> |
| Capital leases cancelled | <u>3,698</u> |

See accompanying notes to financial statements

Notes to Financial Statements

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.

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 System 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.

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 System's fiscal year activity as operating and nonoperating. Operating revenues generally result from exchange transactions such as payments received for providing goods and services. The majority of the System's expenses are exchange transactions which GASB defines as operating expenses for financial statement presentation.

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 net nonoperating revenues.

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, 2006.

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 2006 net patient revenue increased approximately \$3,900,000 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 established 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, 2006 was as follows:

| | |
|--------------|--------------|
| Medicare | 23 % |
| Medicaid | 31 |
| Other payors | 46 |
| | <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, and maintenance, utility, and insurance 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 operating expenses in the appropriate expense category as follows:

| | |
|-------------------------------|----------------------|
| Salaries and wages | \$ 9,470,000 |
| Fringe benefits | 61,220,662 |
| Supplies and general expenses | 8,740,968 |
| Total | <u>\$ 79,431,630</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, 2006 was \$20,622,085. Of that liability, it is estimated that at June 30, 2006, \$28,312 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, 2006, rather than from current resources available at June 30, 2006.

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.

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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and

expenses 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.

In accordance with GASB Statement 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the System follows all applicable GASB pronouncements. In addition, the System follows 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 - CASH AND CASH EQUIVALENTS

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 custodial credit risk assumed.

NOTE 3 - 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, 2006, 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 2006.

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, 2006, 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, 2006, approximately \$212,997,000 of the investments reported on the University's Statement of Net Assets were on loan, secured by collateral with a fair value of approximately \$216,478,000. The System does not participate in security lending transactions.

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, 2006, the University's operating funds pool portfolio had an effective duration of 1.8 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, 2006, 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, 2006, 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, 2006 the System was not exposed to foreign currency risk.

NOTE 4 - PRIOR PERIOD ADJUSTMENT

During fiscal year 2006, the System reevaluated its clinical software agreement with Cerner and the related accounting treatment. As a result, the System retroactively reclassified portions of previous payments and recorded a capital lease liability. The net effect of the change in accounting treatment was to decrease net assets at June 30, 2005 by \$1,716,274.

| | |
|--|-----------------------|
| Net assets beginning of year, as previously reported | <u>\$ 155,766,005</u> |
| Prior period adjustment | <u>(1,716,274)</u> |
| Net assets beginning of year, as restated | <u>\$ 154,049,731</u> |

NOTE 5 - CAPITAL ASSETS

Capital assets are carried at the System's cost or fair value at the date of a gift. 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, 2006 is summarized as follows:

| Capital Assets | | | | | |
|--------------------------------------|----------------------|---------------|--------------|-------------|----------------|
| | Beginning Balance | Additions | Retirements | Transfers | Ending Balance |
| Nondepreciable Capital Assets: | | | | | |
| Land | \$ 770,917 | | | | \$ 770,917 |
| Depreciable Capital Assets: | | | | | |
| Buildings | 172,186,408 | - | - | 1,092,279 | 173,278,687 |
| Construction in process | 1,527,996 | 6,646,719 | - | (4,667,502) | 3,507,213 |
| Leasehold improvements | | | | 3,575,223 | 3,575,223 |
| Equipment | 128,548,077 | 17,919,453 | (1,534,664) | | 144,932,866 |
| Software | 10,294,932 | 5,167,104 | | | 15,462,036 |
| Subtotal | 312,557,413 | 29,733,276 | (1,534,664) | - | 340,756,025 |
| Less accumulated depreciation | 142,252,939 | 19,039,841 | (1,279,283) | - | 160,013,497 |
| Total net depreciable capital assets | 170,304,474 | 10,693,435 | (255,381) | - | 180,742,528 |
| Total Capital Assets | \$ 171,075,391 | \$ 10,693,435 | \$ (255,381) | \$ - | \$ 181,513,445 |

NOTE 6 - 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. Costs associated with the issuance of the bonds have been recorded as prepaid expense and are being amortized over the life of the bonds. Amortization was \$33,259 for the year ended June 30, 2006.

Long term obligations activity for the year ended June 30, 2006 was as follows:

| Long Term Obligations | | | | | | | |
|----------------------------|------------------------------|-------------------|----------------------|---------------|--------------|-------------------|--------------------|
| Series | Yield on Outstanding Debt | Maturity Dates | Beginning Balance | Additions | Deductions | Ending Balance | Current Portion |
| Bonds Payable | | | | | | | |
| 1997A | 5.3% - 5.875% | 2007-2027 | \$ 42,800,000 | | \$ 1,070,000 | 41,730,000 | \$ 1,055,000 |
| 1997B | Variable | 2007-2027 | 22,100,000 | | 600,000 | 21,500,000 | 700,000 |
| | | | 64,900,000 | | 1,670,000 | 63,230,000 | 1,755,000 |
| Unamortized Debt Discount | | | (623,224) | 29,677 | | (593,547) | (29,677) |
| Total Bonds Payable | | | 64,276,776 | 29,677 | 1,670,000 | 62,636,453 | 1,725,323 |
| Other Obligations | | | 12,127,047 | 7,946,377 | 2,800,903 | 17,272,521 | 3,312,346 |
| Internal Financing Payable | | | 5,242,983 | 298,265 | 1,312,361 | 4,228,887 | 1,357,995 |
| Total long term debt | | | 81,646,806 | 8,274,319 | 5,783,264 | 84,137,861 | 6,395,664 |
| Compensated Absences | | | 18,986,242 | 2,886,975 | 1,251,132 | 20,622,085 | 1,086,075 |
| Total Long Term Obligation | | | \$ 100,633,048 | \$ 11,161,294 | \$ 7,034,396 | \$ 104,759,946 | \$ 7,481,739 |

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, 2006 are as follows:

| | |
|-------------------------------------|----------------------|
| System net revenues | \$ 23,678,505 |
| Adjusted MSP revenues | 136,434,856 |
| College of Medicine student tuition | 33,054,591 |
| Total | <u>\$193,167,952</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 for System development. No transfers were authorized by the Board during the year ended June 30, 2006, and there were no balances in the reserve at June 30, 2006.

The System made all required transfers for the year ended June 30, 2006.

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, 2006:

| | |
|---|---------------------|
| Restricted Assets: | |
| Cash | \$ 2,422,547 |
| Investments | 684,772 |
| Total | <u>\$ 3,107,319</u> |
| Purpose: | |
| Repair and replacement reserve | \$ 2,422,547 |
| Bond and interest sinking fund | 684,772 |
| Total assets limited as to use | 3,107,319 |
| Less amounts required for current liabilities | (670,963) |
| Total | <u>\$ 2,436,356</u> |

Debt Service Requirements

Future debt service requirements for the Series 1997A and 1997B Bonds at June 30, 2006 are as follows:

| | Principal | Interest |
|----------------------------|----------------------|----------------------|
| 2007 | \$ 1,755,000 | \$ 3,229,390 |
| 2008 | 1,835,000 | 3,135,775 |
| 2009 | 1,925,000 | 3,042,523 |
| 2010 | 2,020,000 | 2,944,715 |
| 2011 | 2,120,000 | 2,839,853 |
| 2012-2016 | 12,355,000 | 12,363,408 |
| 2017-2021 | 15,910,000 | 8,675,574 |
| 2022-2026 | 20,530,000 | 3,862,886 |
| 2027-2031 | 4,780,000 | 73,175 |
| Total Debt Service | \$ 63,230,000 | \$ 40,167,299 |
| Unamortized Debt Discount | (593,547) | |
| Total Bonds Payable | \$ 62,636,453 | |

The required debt service for the variable rate Series 1997B Bonds has been calculated using the current interest rate of 4 % over the remaining life of the bonds.

NOTE 7 - 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, 2006, future minimum payments under other obligations are as follows:

| | Principal | Interest |
|-------------------------------|----------------------|---------------------|
| 2007 | \$ 3,312,346 | \$ 427,881 |
| 2008 | 3,813,971 | 503,421 |
| 2009 | 3,225,038 | 384,478 |
| 2010 | 2,753,241 | 279,986 |
| 2011 | 2,598,506 | 153,080 |
| 2012-2016 | 1,569,419 | 122,738 |
| Total minimum payments | \$ 17,272,521 | \$ 1,871,584 |

As of June 30, 2006 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 including interest at 4.50% through June 30, 2009. Aggregate annual maturities as of June 30, 2006 are as follows:

| | Principal | Interest |
|--------------|---------------------|-------------------|
| 2007 | \$ 1,357,995 | \$ 190,300 |
| 2008 | 1,419,105 | 129,190 |
| 2009 | 1,249,503 | 65,330 |
| 2010 | 202,284 | 9,103 |
| Total | \$ 4,228,887 | \$ 393,923 |

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 \$279,031 for the year ended June 30, 2006. In future years, the System expects to incur annual rental expense in amounts similar to 2006. The future minimum lease payments under operating leases (excluding those leases renewed on an annual basis) are as follows:

| | |
|------------------------------|-------------------|
| 2007 | \$ 255,521 |
| 2008 | 252,434 |
| 2009 | 251,354 |
| 2010 | 62,838 |
| Total Minimum Lease Payments | <u>\$ 822,147</u> |

NOTE 8 - PATIENT ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE AND OTHER CURRENT LIABILITIES

Patient accounts receivable and accounts payable and other current liabilities reported as current assets and liabilities consisted of the following amounts:

| | |
|--|----------------------|
| Patient accounts receivable | |
| Patients and their insurance carriers | \$ 252,715,403 |
| Medicare | 16,248,038 |
| Medicaid | 21,206,603 |
| Total | 290,170,044 |
| Less allowance for uncollectible accounts | (220,706,045) |
| Total patient accounts receivable, net | <u>\$ 69,463,999</u> |
| Accounts payable and other current liabilities | |
| Payable to employees | \$ 9,787,177 |
| Payable to suppliers and service providers | 13,980,054 |
| Payable to health plans and for worker's compensation claims | 3,743,953 |
| Total accounts payable and other current liabilities | <u>\$ 27,511,184</u> |

NOTE 9 - 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 2006 are as follows:

| | |
|-----------------------------|-----------------------|
| Medicaid | \$ 360,409,902 |
| Medicare | 284,522,852 |
| HMO / PPO | 380,047,142 |
| Commercial | 36,795,036 |
| Self-pay & other | 37,937,696 |
| Total gross revenue | 1,099,712,628 |
| Less: Contractual allowance | (706,612,411) |
| Net Patient Revenue | <u>\$ 393,100,217</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, 2006 all Medicare settlements for 2006, 2005, and 2004 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 reports by the System and audits thereof by Blue Cross. At June 30, 2006, the Blue Cross settlements for 2006 and 2005 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 10 - 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 10.18% 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, 2006, 2005 and 2004, were \$ 101,570,000, \$145,752,000, and \$755,398,000, 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.

Currently the State does not segregate payments made to annuitants from those made to current employees for health, dental and life insurance benefits. The cost of health, dental and life insurance benefits is recognized by the State as incurred. These costs are funded by the State and are not an obligation of the System or the University.

NOTE 11 - RELATED PARTY TRANSACTIONS

The University charged the System for administrative and other services totaling \$10,996,823 in 2006, 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 \$18,210,968 was paid by the University on behalf of the System for salaries, utility costs, and medical malpractice insurance for the year ended June 30, 2006, 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 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, 2006 relating to the billing and collection of physician fees and the delivery of ambulatory care were \$9,823,604.

During 2006, 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 \$1,296,651, has been reflected in the financial statements as a reduction of the related expenses.

NOTE 12 - COMMITMENTS AND CONTINGENCIES

Commitments

At June 30, 2006, 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 \$4,200,000 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, 2006 the University's total accrued self-insurance liability, discounted at a rate of 5.5%, was \$142,214,064.

The University's accrued self-insurance includes \$99,805,944 at June 30, 2006, 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, 2006, the System's calculated required contribution for its portion of the University's self-insurance liability was \$16,356,466. Of that amount, \$2,903,000 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, 2006. 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.