



**UNIVERSITY OF WISCONSIN
HOSPITALS AND CLINICS AUTHORITY**

Basic Financial Statements

June 30, 2003 and 2002

(With Independent Auditors' Report Thereon)

**UNIVERSITY OF WISCONSIN
HOSPITALS AND CLINICS AUTHORITY**

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Management's Discussion and Analysis

Years ended June 30, 2003 and 2002

The University of Wisconsin Hospitals and Clinics Authority (the Hospital) is implementing Governmental Accounting Standards Board's (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, for the annual financial report year ended June 30, 2003. This section of the Hospital's annual financial report presents management's analysis of the Hospital's performance during the fiscal year that ended on June 30, 2003 and is designed to focus on the current fiscal year activity, resulting changes, and currently known facts; therefore, please read it in conjunction with the Hospital's financial statements.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Hospital's financial statements, and the notes to the financial statements.

The balance sheets and the statements of revenue, expenses, and changes in net assets, and cash flows, reported on the accrual basis, provide an indication of the Hospital's financial health. The balance sheets includes all of the Hospital's assets and liabilities, as well as an indication about which assets can be utilized for general purposes and which are restricted by external donors or for other purposes. The statements of revenue, expenses, and changes in net assets report all of the revenue and expenses during the period indicated. The statements of cash flows report the cash provided and used by operating activities, as well as other cash sources such as investment income and other cash uses, such as repayment of bonds and capital additions. Notes to financial statements provide additional information that is essential to a full understanding of the data provided in the financial statements.

Financial Highlights – Fiscal Year 2003

- The Hospital's net assets increased by approximately \$25 million
- Net patient service revenue increased by \$60 million, or 12.6%. Total operating revenues increased by \$61.0 million, or 12.5%, and total operating expenses increased by \$62.0 million, or 13.4%.
- Operating income for the year was \$20.1 million.
- Total nonoperating revenue/expense increased by \$7.0 million or > 300%. The excess of revenues over expenses before capital grants, gifts, and donations, additions to permanent endowments, and other payments increased \$5.8 million or 30.8%.

Hospital Highlights

- Completed renovation and opened an eight bed neurological intensive care unit in August 2002.
- Completed construction and occupied Phase I of the new ambulatory services building in the fall of 2002.
- The Hospital issued \$68.5 million in bonds to finance the construction of a new emergency department, finalizing construction, build out and equipping of the ambulatory services building, and relocation of the medflight helicopter landing area to the roof of the hospital facility. In addition, a portion of the proceeds of the Series 2002 Bonds will be used to remodel and expand various areas of the main hospital facility, including inpatient rooms, cancer center, cardiology clinics, radiotherapy treatment areas, and the admissions

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and clinics lobby areas. Lastly, a portion of the proceeds of the Series 2002 Bonds will be used to build out the lower level of the east clinic to accept a linear accelerator and remodel the research park clinic to accommodate program growth of existing and related services.

- In March 2003, American Family Mutual Insurance Company made an irrevocable charitable pledge to the Hospital to create a fund known as "The American Family Children's Hospital Building Fund". American Family Mutual Insurance Company will transfer the total sum of \$10 million, in cash or marketable securities to the Hospital, in four equal installments beginning in fiscal 2004.

FINANCIAL ANALYSIS AND RESULTS OF OPERATIONS

Due to this being the first year the current financial reporting model has been used, comparisons with the previous year are limited. More comprehensive analysis will be included in subsequent years. Changes to net assets over time may serve as a useful indicator of the Hospital's financial position. At June 30, 2003, the Hospital's assets exceeded liabilities by \$308.2 million, which is an increase in total net assets of \$25.0 million, or 8.8% from the prior fiscal year end. The Hospital classifies net assets as either invested in capital assets, restricted, or unrestricted. Table 1 summarizes assets, liabilities, and net assets at June 30:

TABLE 1

Net Assets

(In thousands)

	<u>June 30 2003</u>	<u>June 30 2002</u>	<u>Dollar change</u>	<u>Percent change</u>
Current and other assets	\$ 339,372	270,110	69,262	25.6%
Capital assets	229,243	199,822	29,421	14.7
Total assets	<u>\$ 568,615</u>	<u>469,932</u>	<u>98,683</u>	21.0
Long-term debt	\$ 198,555	132,272	66,283	50.1
Other liabilities	61,897	54,502	7,395	13.6
Total liabilities	<u>260,452</u>	<u>186,774</u>	<u>73,678</u>	39.4
Net assets:				
Invested in capital assets, net of related debt	85,230	67,550	17,680	26.2
Restricted	4,519	3,963	556	14.0
Unrestricted	218,414	211,645	6,769	3.2
Total net assets	<u>308,163</u>	<u>283,158</u>	<u>25,005</u>	8.8
Total liabilities and net assets	<u>\$ 568,615</u>	<u>469,932</u>	<u>98,683</u>	21.0

At June 30, 2003, the Hospital's cash and investments increased \$62.6 million or 35% compared to June 30, 2002. The majority of the increase in cash is attributable to the proceeds of the 2002 debt issue, operating activities, and investment income, offset by purchases of capital assets.

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Table 2 compares 2003 revenues and expenses to 2002, and shows the increase in net assets.

TABLE 2
Condensed Schedule of Revenues, Expenses, and Changes in Net Assets
(In thousands)

	June 30 2003	June 30 2002	Dollar change	Percent change
Operating revenues:				
Net patient service revenues	\$ 536,985	477,040	59,945	12.6%
Other operating revenues	10,329	9,359	970	10.4
Total operating revenues	547,314	486,399	60,915	12.5
Operating expenses:				
Salaries and benefits	282,108	247,932	34,176	13.8
Medical materials and supplies	111,879	100,683	11,196	11.1
Purchased services and agency costs	68,661	60,951	7,710	12.6
Depreciation and amortization	22,613	19,049	3,564	18.7
Other	41,954	36,502	5,452	14.9
Total operating expenses	527,215	465,117	62,098	13.4
Operating income	20,099	21,282	(1,183)	(5.6)
Nonoperating revenues (expenses):				
Nonoperating revenue	9,601	501	9,100	1,816.4
Nonoperating expenses	(5,443)	(2,669)	(2,774)	103.9
Other	572	(133)	705	530.1
Total nonoperating revenues (expenses)	4,730	(2,301)	7,031	305.6

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	<u>June 30 2003</u>	<u>June 30 2002</u>	<u>Dollar change</u>	<u>Percent change</u>
Excess of revenue over expenses before capital grants, gifts, donations, additions to permanent endowments, and other payments	24,829	18,981	5,848	30.8
Capital and permanent endowment contributions	676	1,999	(1,323)	(66.2)
Payments to the Medical School for capital expenditure support	(500)	(275)	(225)	81.8
Increase in net assets	25,005	20,705	4,300	20.8
Net assets beginning of year, as restated	283,158	262,453	20,705	7.9
Net assets end of year	\$ 308,163	283,158	25,005	8.8

To conform with Statement No. 34, the net assets as of June 30, 2001 have been restated. In accordance with GASB Statement No. 16, the Hospital recorded an additional vacation accrual for payroll taxes and retirement benefits for hours worked but not paid as of June 30, 2001. This restatement resulted in a decrease to net assets as of June 30, 2001 of \$600,000. The Hospital previously recorded the interest rate swap at its approximate fair value in other assets with the change in fair value reflected as investment income. Under the GASB statements, the Hospital does not record the fair value of the swap. This restatement resulted in a decrease to net assets as of June 30, 2001 of \$1.0 million and a decrease to investment income in 2002 of \$1.8 million from what was previously reported.

In addition, under GASB statements, changes in fair value of investments are now recorded as nonoperating revenue instead of an increase or decrease to net assets. The impact of this adjustment is a decrease of \$8.6 million in excess of revenues over expenses before capital grants, gifts, and donations, additions to permanent endowments, and other payments, for the year ended June 30, 2002. As a result of the changes described above, excess of revenues over expenses before capital grants, gifts, and donations, additions to permanent endowments, and other payments, for fiscal year 2002 decreased to \$19.0 million from the \$29.3 million originally reported.

Net Patient Services Revenues

Net patient revenues increased \$60.0 million, or 12.6% from the prior year. The primary reasons for the growth in revenues are the increases in the number of patients cared for and a rate increase implemented on July 1, 2002. Inpatient volume, measured by patient days, increased approximately 5,900 days, or 5.0%, while outpatient volume, measured by visits, grew by approximately 28,000 visits, or 6.1%. The Hospital implemented a rate increase effective July 1, 2002 which averaged 6.3% in revenue from all payors. The Hospital's case mix index (CMI), which is a measure of patient acuity, was 1.79 in 2003 compared to 1.78 in 2002.

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Table 3 below depicts sources of net patient service revenue by payor category for fiscal years 2003 and 2002.

TABLE 3

Payor Mix

	Fiscal year 2003	Fiscal year 2002	Percent change
Medicare	25%	27	(2)
Medicaid	4	4	—
Indemnity	16	16	—
Managed care – capitated	9	8	1
Managed care – noncapitated	34	35	(1)
Private pay and other	12	10	2
	<u>100%</u>	<u>100</u>	

Other operating revenue, which includes non-patient revenue such as cafeteria sales and other auxiliary services, increased nearly \$1 million, or 10.4% from the prior year.

Operating Expenses

Operating expenses increased by \$62 million, or 13.4% from the prior year. The categories of expenses that caused the majority of the increases were salaries, wages and benefits, medical materials and supplies, and purchased services. Salaries, wages, and benefits expense and purchased service expense increased 13.6% from 2002 due to the increase in patient volume and the utilization of agency nurses to staff additional beds to address demand in excess of budget. Concurrent with the increase in contract labor utilization, the Hospital has hired additional nursing staff and other clinical personnel, thus increasing salary and benefit expenses. The increase in medical materials and supplies compared to the prior year was primarily in drugs, pharmaceuticals, and surgical appliances.

Nonoperating Revenues and Expenses

Nonoperating revenues and expenses consist primarily of income from the Hospital's cash and long-term investments, loss on disposal of capital assets, and the realized gain on cancellation of interest rate swap. Investment income, including change in fair value of investments, increased from \$501,000 in 2002 to \$5.6 million in 2003.

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The Hospital's investment income and net changes in fair value of investments for 2003 and 2002 are summarized in Table 4:

TABLE 4
Investment Earnings by Asset Category

	2003	2002
Interest and dividend income:		
Equity investments	\$ 1,966	1,888
Fixed income investments	7,192	7,168
Total investment income	9,158	9,056
Net change in fair value of equity instruments	(3,592)	(8,555)
Total	\$ 5,566	501

Nonoperating revenue in 2003 also includes a realized gain of \$4 million from the termination of an interest rate swap agreement. The loss on disposal of capital assets decreased from \$843,000 to \$306,000 in fiscal year 2003.

The increase in interest expense from \$2.7 million in 2002 to \$5.4 million in 2003 is due to the issuance of Series 2002 bonds and the termination of the swap agreement.

Capital Assets

At the end of 2003, the Hospital had \$229.2 million, net of accumulated depreciation and amortization, invested in capital assets. This amount represents a net increase, including additions and disposals, of \$29.4 million, or 14.7% from 2002. The majority of the increase is related to completion of construction projects and purchase of capital equipment.

Table 5 shows a summary of capital assets, net of accumulated depreciation and amortization, at June 30, 2003 and 2002.

TABLE 5
Capital Assets at Year End (Net of Accumulated Depreciation and amortization)
(In thousands)

	June 30	
	2003	2002
Land	\$ 2,466	2,466
Buildings	143,883	119,011
Equipment	62,885	49,744
Construction in progress	20,009	28,601
Total	\$ 229,243	199,822

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	June 30	
	2003	2002
Major additions by year (in thousands):		
Buildings and improvements:		
Phase 1 Ambulatory Services Building	\$ 20,000	—
Inpatient Room Remodeling	4,300	1,500
Neurosurgery Intensive Care Unit	1,300	—
Operating Room suites/Pediatric Intensive Care Unit	1,400	30,700
Research Park build-out for Open Bore MRI	400	600
West Clinic renovation for new clinics	—	1,000
University Station renovation for new clinics	400	800
Leasehold improvements	600	1,100
Equipment:		
Smart Infusion Pumps	3,100	—
Computed Radiology	1,000	700
CT Scanner	900	700
Gamma Camera	500	—
Single plane Cath Lab	—	800
Digital Mammography system	—	700
Brachytherapy system	—	600

Construction in progress at June 30, 2003 consist principally of costs incurred for the expansion of ambulatory services and remodeling of inpatient rooms at 600 Highland Avenue.

For more information about the Hospital's capital asset activity, please see note 6 to the financial statements. Ongoing capital requirements will be funded from the Series 2002 bond proceeds and from operations. The Hospital's total capital budget for fiscal 2003 was \$74.9 million, compared to the 2002 capital budget of \$77.6 million. The capital budget for 2004 is \$82.2 million.

Long-term Debt

At year end, the Hospital had \$198.6 million in long-term debt compared to \$132.2 million at the end of 2002 — an increase of 50.2%. As noted earlier, the increase in debt resulted from the issuance of \$68.5 million of the Series 2002 Revenue Bonds in October 2002.

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Management's Discussion and Analysis

Years ended June 30, 2003 and 2002

Table 6 below provides the detail of outstanding long-term debt, excluding current installment, as of June 30:

TABLE 6
Outstanding Long-Term Debt, at Year End
(In thousands)

	June 30	
	2003	2002
State of Wisconsin general obligation and refunding bonds	\$ 19,960	22,927
Authority Variable Rate Revenue Bonds, Series 1997	50,000	50,000
Authority Fixed Rate Revenue Bonds, Series 2000	56,500	56,500
Authority Short-term Adjustable Rate Revenue Bonds, Series 2002A	55,600	—
Authority Fixed Rate Revenue Bonds, Series 2002B	12,900	—
Premium on Series 2002B Bonds	628	—
Total	\$ 195,588	129,427

Series 1997 and Series 2002A Short-term Adjustable Rate bonds are insured by Financial Security Assurance, Inc. and Series 2000 bonds are insured by MBIA Insurance Corp. The Series 2002B bonds carry an A1 rating from Moody's and an A rating from Standard & Poor's.

Current legislation limits the Hospital's total borrowing, exclusive of the amounts payable to the state, to \$175,000,000 with limited exceptions. For more information about the Hospital's outstanding debt, please see note 7 to the financial statements.

Economic Factors And Next Year's Budgets And Rates

The Hospital's senior leadership team considered many variables in developing the 2004 budgets and rates. Key principles in the budget process included (1) accommodating the demand for increased and technologically improved services, (2) achieving higher quality, safety and service standards, (3) becoming the employer of choice by paying adequate wages and providing benefits to recruit and retain qualified personnel, (4) mitigating the rising costs of health care to employers and consumers, (5) maintaining the mission to medical education, (6) keeping existing facilities and equipment up to date and safe, and (7) achieving fiscal margins and a financial condition that will provide for all of the above expectations.

The 2004 budget, as approved by the Hospital's board of directors, projects income from operations of \$23 million, resulting in an operating margin of 3.70%. Net income is budgeted at \$31.4 million with an excess margin of 5.00%. Achieving a 5.00% margin is accomplished by limiting the increase in the cost per unit of service to 5.01% offset by average payment increases of 5.50% across all payor categories. The 2004 budget calls for volume increases of 2.00% for inpatient admissions and 4.00% for inpatient days and 2.70% for outpatient clinic visits.

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Requests For Information

This financial report is designed to provide a general overview of University of Wisconsin Hospitals and Clinics Authority's financial results for all those with an interest in the Hospital's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to Chief Financial Officer, 600 Highland Avenue, Mail Drop# 8370, Madison, WI 53792.



777 East Wisconsin Avenue
Milwaukee, WI 53202

Independent Auditors' Report

The Board of Directors
University of Wisconsin
Hospitals and Clinics Authority:

We have audited the accompanying balance sheets of the University of Wisconsin Hospitals and Clinics Authority (the Hospital), a component unit of the State of Wisconsin, as of June 30, 2003 and 2002, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of Wisconsin Hospitals and Clinics Authority as of June 30, 2003 and 2002 and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 15 to the financial statements, effective July 1, 2001, the Hospital adopted the provisions of the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*; GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*; and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*.

Management's Discussion and Analysis on pages 1 through 9 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management, regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

August 6, 2003



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Balance Sheets

June 30, 2003 and 2002

(In thousands)

Assets	<u>2003</u>	<u>2002</u>
Current assets:		
Cash and cash equivalents	\$ 12,839	4,343
Patient accounts receivable, net of estimated uncollectible accounts of \$13,000 in 2003 and \$12,200 in 2002	73,465	66,143
Other receivables	8,604	11,261
Inventories of supplies	6,485	7,524
Prepaid expenses	2,333	2,753
Total current assets	<u>103,726</u>	<u>92,024</u>
Noncurrent cash and investments:		
Designated by board for capital replacement and debt retirement	136,221	124,522
Held by trustee for capital projects	54,543	11,236
Restricted by donors	3,704	3,190
Principal of permanent endowments	815	795
Other long-term investments	32,660	34,118
Total noncurrent cash and investments	<u>227,943</u>	<u>173,861</u>
Capital assets		
Non-depreciable	23,943	32,535
Depreciable, net	205,300	167,287
Total capital assets, net	<u>229,243</u>	<u>199,822</u>
Investments in joint ventures	1,861	878
Other assets	5,842	3,347
Total assets	<u>\$ 568,615</u>	<u>469,932</u>

See accompanying notes to financial statements.

Liabilities and Net Assets	<u>2003</u>	<u>2002</u>
Current liabilities:		
Current installments of long-term debt	\$ 2,967	2,845
Accounts payable	23,561	19,359
Accrued expenses	36,780	33,599
Estimated payables to Medicare and Medicaid	<u>1,556</u>	<u>1,544</u>
Total current liabilities	64,864	57,347
Long-term debt, less current installments	<u>195,588</u>	<u>129,427</u>
Total liabilities	<u>260,452</u>	<u>186,774</u>
Net assets:		
Invested in capital assets, net of related debt	85,005	78,786
Restricted expendable for donor specified purposes	3,704	3,168
Restricted nonexpendable	815	795
Unrestricted	<u>218,639</u>	<u>200,409</u>
Total net assets	<u>308,163</u>	<u>283,158</u>
Total liabilities and net assets	\$ <u><u>568,615</u></u>	<u><u>469,932</u></u>

**UNIVERSITY OF WISCONSIN
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Statements of Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2003 and 2002

(In thousands)

	2003	2002
Operating revenues:		
Net patient service revenue (net of provision for bad debts of \$11,994 in 2003 and \$13,429 in 2002)	\$ 536,985	477,040
Other operating revenue	10,329	9,359
Total operating revenues, net	547,314	486,399
Operating expenses:		
Salaries and wages	206,455	183,772
Employee benefits	75,653	64,160
Other expenses	29,457	25,552
Repairs, maintenance, and utilities	12,497	10,950
Purchased services and agency costs	68,661	60,951
Medical materials and supplies	111,879	100,683
Depreciation and amortization	22,613	19,049
Total operating expenses	527,215	465,117
Operating income	20,099	21,282
Nonoperating revenues (expenses):		
Investment income	9,158	9,056
Net decrease in fair value of investments	(3,592)	(8,555)
Gain on cancellation of swap	4,035	—
Interest expense	(5,443)	(2,669)
Equity interest in income of joint venture	478	296
Loss on disposal of capital assets	(306)	(843)
Noncapital grants and contributions	449	344
Other, net	(49)	70
Total nonoperating revenues (expenses)	4,730	(2,301)
Excess of revenues over expenses before capital grants, gifts, and donations, additions to permanent endowments, and other payments	24,829	18,981
Capital grants, gifts, and donations	656	1,968
Additions to permanent endowments	20	31
Payment to University of Wisconsin Medical School for capital expenditure support	(500)	(275)
Increase in net assets	25,005	20,705
Net assets beginning of the year, as restated	283,158	262,453
Net assets end of the year	\$ 308,163	283,158

See accompanying notes to financial statements.

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Statements of Cash Flows

Years ended June 30, 2003 and 2002

(In thousands)

	<u>2003</u>	<u>2002</u>
Cash flows from operating activities:		
Cash received from and on behalf of patients	\$ 529,663	470,354
Payments to suppliers	(203,852)	(189,156)
Payments to employees	(278,630)	(248,639)
Net cash provided by operating activities	<u>47,181</u>	<u>32,559</u>
Cash flows from noncapital financing activities:		
Noncapital grants and contributions	449	344
Additions to permanent endowment	20	31
Payment to University of Wisconsin Medical School for capital expenditure support	(500)	(275)
Net cash (used) provided by noncapital financing activities	<u>(31)</u>	<u>100</u>
Cash flows from capital and related financing activities:		
Capital grants, gifts and donations	656	1,968
Proceeds from long-term debt	69,170	336
Repayment of principal on long-term debt	(2,845)	(3,161)
Interest paid on long-term debt	(5,782)	(2,888)
Deferred financing costs	(2,634)	(18)
Purchases of capital assets	(52,324)	(61,391)
Proceeds from sale of capital assets	140	271
Net cash provided (used) by capital and related financing activities	<u>6,381</u>	<u>(64,883)</u>
Cash flows from investing activities:		
Proceeds from sales of investments	25,906	28,291
Purchases of investments	(81,436)	(19,315)
Receipt on termination of swap	4,035	—
Investment income	9,158	9,056
(Increase) decrease in investment in joint venture	(505)	273
Other, net	(49)	70
Net cash (used) provided by investing activities	<u>(42,891)</u>	<u>18,375</u>
Net increase (decrease) in cash and cash equivalents	<u>10,640</u>	<u>(13,849)</u>
Cash and cash equivalents at beginning of year	<u>6,913</u>	<u>20,762</u>
Cash and cash equivalents at end of year	<u>\$ 17,553</u>	<u>6,913</u>

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Statements of Cash Flows

Years ended June 30, 2003 and 2002

(In thousands)

	2003	2002
Reconciliation of cash and cash equivalents to balance sheet:		
Cash and cash equivalents in current assets	\$ 12,839	4,343
Cash equivalents in noncurrent cash and investments	4,714	2,570
Total cash and cash equivalents	\$ 17,553	6,913
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 20,099	21,282
Adjustments to reconcile operating income to cash provided by operating activities:		
Provision for bad debts	11,994	13,429
Depreciation and amortization	22,613	19,049
Changes in assets and liabilities:		
Patient accounts receivable	(19,316)	(20,115)
Other receivables	2,657	(3,850)
Inventories of supplies	1,039	(413)
Prepaid expenses	420	(415)
Other assets	(17)	(418)
Accounts payable	4,202	4,385
Accrued expenses	3,478	(707)
Estimated payables to Medicare and Medicaid	12	332
Total adjustments	27,082	11,277
Net cash provided by operating activities	\$ 47,181	32,559

Noncash investing, capital and financing activities:

The Hospital held investments at June 30, 2003 and 2002 with a fair value of \$227,943 and \$173,861, respectively. During 2003 and 2002, the net decrease in the fair value of these investments was \$3,592 and \$8,555, respectively.

See accompanying notes to financial statements.

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Notes to Financial Statements

June 30, 2003 and 2002

(1) Summary of Organization and Significant Accounting Policies

The University of Wisconsin Hospitals and Clinics Authority (the Hospital) is an academic medical center operating an acute-care hospital with 470 available beds, numerous specialty clinics, and 4 ambulatory facilities providing comprehensive health care to patients, education programs, research, and community service primarily to residents of southern Wisconsin.

Prior to fiscal year 1997, the Hospital was a unit of the University of Wisconsin – Madison (the University). Beginning in fiscal year 1997, in accordance with legislation passed by the Wisconsin State Legislature, the Hospital restructured as a Public Authority, a public body corporate and politic created by Wisconsin Statutes. This legislation provided, among other things, for the Board of Regents of the University of Wisconsin System (Board of Regents) to execute various agreements with the Hospital. The State of Wisconsin (the State) appoints the majority of the Board of Directors of the Hospital. Based on statutorily mandated relationships with State governmental units, the Hospital is included as a discretely presented component unit in the basic financial statements of the State.

Under the terms of a Lease Agreement, the Hospital leases the facilities that were occupied by the Hospital as of June 29, 1996, for a nominal annual amount for an initial term of 30 years to be renewed annually with automatic extensions of one additional year on each July 1 until action is taken to stop the extensions. In addition, the Hospital is required to repay to the State outstanding debt obligations on the leased facilities. The leased facilities are included with the Hospital's capital assets (see note 6) and the debt obligations on the leased facilities are included with the Hospital's long-term debt (see note 7).

An Affiliation Agreement requires the Hospital to continue to support the educational, research, and clinical activities of the University, including the University of Wisconsin Medical School (the Medical School) and the University of Wisconsin Schools of Nursing and Pharmacy (see note 4). Subject to a Contractual Services Agreement and Operating and Service Agreement between the Board of Regents and the Hospital, the two parties have entered into contracts with each other for the continuation of the provision of services in support of programs and operations.

The significant accounting policies of the Hospital are as follows:

(a) Basis of Accounting

The accounting policies of the Hospital conform to accounting principles generally accepted in the United States of America as applicable to governmental entities. The accounts of the Hospital, which are reported similar to an enterprise fund, are used to account for the Hospital's activities that are financed and operated in a manner similar to a private business enterprise. Accordingly, the Hospital maintains its records on the accrual basis of accounting. Revenues from operations, investments, and other sources are recorded when earned. Expenses, including depreciation and amortization, are recorded when incurred.

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Non-exchange transactions, in which the Hospital receives value without directly giving equal value in return, include grants and contributions. Revenues from grants and contributions are recognized in the fiscal year in which all eligibility requirements have been satisfied. Eligibility requirements include timing requirements, which specify the year the resources are required to be used or the fiscal year use is first permitted, and expenditure requirements, in cases where the resources are provided to the Hospital on a reimbursement basis.

(b) Cash and Cash Equivalents

Cash and cash equivalents are defined as highly liquid investments purchased with an original maturity of three months or less.

(c) Inventories of Supplies

The inventories of supplies are stated at cost (first-in, first-out), which is not in excess of market.

(d) Investments and Investment Income

Investments in equity securities with readily determinable fair values, all investments in debt securities, and pooled investment funds on deposit with the University of Wisconsin Foundation – Endowment Fund are recorded at fair value based upon quoted market prices. The pooled investment funds on deposit with the University of Wisconsin Foundation – Restricted Fund and the repurchase agreement are recorded at cost plus accrued earnings to date, which approximates fair value. The University of Wisconsin Foundation assumes the market risk for the Hospital's investment in the University of Wisconsin Foundation – Restricted Fund.

Interest, dividends, and changes in the fair value of investments are included in non-operating revenue when earned.

Investments in joint ventures, where the Hospital has an equity interest and shares in the operating results of the joint venture, are recorded using the equity method of accounting.

(e) Capital Assets

Capital assets are stated at cost. Capital assets under capital leases are stated at the present value of minimum lease payments. Donated capital assets are recorded at fair market value at the date of donation, which then is treated as cost. Depreciation or amortization on capital assets is calculated on the straight-line method over the shorter of the estimated useful life or the period of the lease term. Gains (losses) on sales of capital assets are recorded as nonoperating revenues (expenses). Costs of repairs and maintenance are expensed as incurred. Capital assets are depreciated or amortized as follows:

Buildings and improvements	20 to 30 years
Equipment	5 to 10 years

Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the costs of acquiring those assets.

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(f) Costs of Borrowing

Costs incurred in connection with the issuance of long-term debt have been deferred and are being amortized over the term of the bonds.

(g) Contributions

From time to time, the Hospital receives contributions from individuals and private organizations. Revenues from contributions (including contributions of capital assets) are recognized when all eligibility requirements, including time requirements, are met. Contributions may be restricted for either specific operating purposes or for capital purposes. Amounts that are unrestricted or that are restricted for a specific operating purpose are reported as nonoperating revenues. Amounts restricted to capital acquisitions are reported as capital grants, gifts, and donations.

Endowments are provided to the Hospital on a voluntary basis by individuals and private organizations. Permanent endowments require that the principal or corpus of the endowment be retained in perpetuity. If a donor has not provided specific instructions, the net appreciation of the investments of endowment funds are recorded with investment income in nonoperating revenue.

(h) Net Assets

Net assets of the Hospital are classified in four components:

Net assets invested in capital assets, net of related debt – which consists of capital assets, net of accumulated depreciation and amortization and reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets.

Restricted expendable net assets – which are noncapital net assets that must be used for a particular purpose, as specified by creditors or contributors external to the Hospital.

Restricted nonexpendable net assets – which equal the principal portion of permanent endowments.

Unrestricted net assets – which are remaining net assets that do not meet the definitions of invested in capital assets, net of related debt or restricted net assets.

When the Hospital has both restricted and unrestricted resources available to finance a particular program, it is the Hospital's policy to use the restricted resources before the unrestricted resources.

(i) Operating Revenues and Expenses

The Hospital's statements of revenues, expenses, and changes in net assets distinguishes between operating and nonoperating revenues and expenses. Operating revenues result from exchange transactions associated with providing health care services – the Hospital's principal activity. Nonexchange revenues, including contributions received for purposes other than capital asset acquisition, are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide health care services, other than interest expense.

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(j) *Net Patient Service Revenue*

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. Reimbursable amounts from third-party payors are estimated in the period the related services are rendered and adjusted in future periods, as final settlements are determined.

Net patient service revenue includes revenue derived from agreements with various managed care organizations to provide medical services to subscribing participants. Under certain of these agreements, the Hospital receives fixed monthly capitation payments (generally adjusted annually) based on the number of each managed care organizations' participants, regardless of services actually performed by the Hospital. The Hospital recognizes, in the year of contractual commitment, any losses on these contracts when it is probable that expected future medical and maintenance expense under a group of existing contracts would exceed anticipated future premiums and recoveries on these contracts. In other agreements, the managed care organizations make fee-for-service payments to the Hospital for certain covered services based upon discounted fee schedules.

(k) *Charity Care*

The Hospital has a policy of providing health care services, without charge or at amounts less than established rates, to those unable to pay all or a portion of their charges and who meet certain eligibility criteria established in the Hospital's charity care policy. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, they are not reported as patient service revenue.

(l) *Risk Management*

The Hospital is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The Hospital is self-insured for workers' compensation (see note 12). The estimated provision for self-insured workers' compensation includes the ultimate cost for both reported losses and losses incurred but not reported as of the respective balance sheet dates.

(m) *Compensated Absences*

The Hospital's employees earn vacation days at varying rates depending on years of service. Employees may accumulate vacation time up to a specified maximum. Employees are paid for accumulated vacation time if they terminate employment. Consistent with the compensated absences reporting standards of GASB Statement No. 16, *Accounting for Compensated Absences*, an accrual for certain salary-related payments associated with annual leave is included in the accrued expenses at June 30, 2003 and 2002.

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(n) Income Taxes

The Hospital qualifies as a Section 501(c)(3) not-for-profit institution of the Internal Revenue Code (the Code) and therefore, is exempt from Federal and state income taxes pursuant to Section 501(a) of the Code. The Hospital is, however, subject to Federal income taxes on any unrelated business income under the provisions of Section 511 of the Code.

(o) Accounting Standards

Based on Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, the Hospital has elected not to apply Financial Accounting Standards Board (FASB) or Accounting Practice Bulletins (APB), issued on or after November 30, 1989 to the financial statements of the Hospital.

(p) Use of Estimates

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.

(2) Restricted Net Assets and Endowments

Restricted expendable net assets are available for the following purposes:

	2003	2002
	(In thousands)	
Purchase of equipment	807	739
Research and general	2,897	2,429
Total expendable restricted net assets	\$ 3,704	3,168

Restricted nonexpendable net assets as of June 30, 2003 and 2002 represent the principal amounts of permanent endowments restricted to investment in perpetuity. Investment earnings for the Hospital's permanent endowments are expendable for purposes restricted by the donors.

(3) Designated Assets

Of the \$218,639,000 and \$200,409,000 of unrestricted net assets reported in 2003 and 2002, respectively, \$136,221,000 and \$124,522,000 in 2003 and 2002, respectively, has been designated by the Hospital's Board of Directors for capital replacement and debt retirement. Designated funds remain under the control of the Board of Directors, which may at its discretion later use the funds for other purposes.

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(4) Transactions with Related Parties

The Hospital receives certain administrative and other general services from the University and provides direct support for the educational, research, and clinical activities of the University through the Affiliation Agreement. Direct costs associated with these services and support approximated \$35,521,000 and \$33,164,000 in 2003 and 2002. The Hospital committed to support certain Medical School capital expenditures as incurred, up to a maximum of \$11,575,000, of which \$775,000 was paid through June 30, 2003 with the remaining \$10,800,000 to be paid by June 2005.

Wisconsin Therapies, Inc., a not-for-profit corporation controlled by the Hospital, was organized for the purpose of entering into a general partnership with Chartwell Midwest. The partnership is called Chartwell Wisconsin Enterprises, LLC, and is the sole member in Chartwell Midwest Wisconsin, LLC, and a single member limited liability company. The investment in joint venture is adjusted for equity in undistributed earnings of Chartwell Wisconsin Enterprises, LLC. Separate financial statements of the joint venture are available.

Wisconsin Dialysis, Inc. was organized in April 2002 and commenced operations in July 2003, as a not-for-profit corporation for the purpose of entering into a 45%, 45%, and 10% general partnership between the Hospital, Meriter Hospital Inc., and the University of Wisconsin Medical Foundation, respectively. During fiscal year 2003 and 2002, a capital contribution of \$710,000 and \$45,000, respectively, was made by the Hospital.

(5) Deposits and Investments

The Hospital's deposits and investments at June 30, 2003 and 2002 are categorized to give an indication of the level of custodial credit risk assumed by the Hospital.

(a) Bank Deposits

	2003	2002
	(In thousands)	
FDIC-Insured	\$ 200	200
Uninsured, uncollateralized, or collateralized by securities held by the pledging institution or by its trust department or agent in other than the Hospital's name	14,566	10,458
Petty cash	43	40
Total bank balances	\$ 14,809	10,698
Carrying amount	\$ 13,118	4,392

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(b) Investments

The Board of Directors has authorized management to invest in debt and equity securities through investment in the University of Wisconsin Foundation – Restricted Fund and the University of Wisconsin Foundation – Endowment Fund.

	2003	2002
	(In thousands)	
Cash and investments with fiscal agents, uninsured, unregistered, and collateralized securities held by the counterparty's trust department or agent in the Hospital's name	\$ 54,317	11,236
Cash and investments with the University of Wisconsin Foundation, which are uncategorized	173,347	162,576
Total	\$ 227,664	173,812
Carrying amount	\$ 227,664	173,812

Cash and investments with the University of Wisconsin Foundation are uncategorized as ownership does not depend on control of individual securities. The carrying amounts of deposits and investments shown above are included in the Hospital's balance sheets as follows:

	2003	2002
	(In thousands)	
Deposits	\$ 13,118	4,392
Investments	227,664	173,812
	\$ 240,782	178,204

Included in the following balance sheet captions:

	2003	2002
	(In thousands)	
Cash and cash equivalents	\$ 12,839	4,343
Noncurrent cash and investments	227,943	173,861
Total cash, cash equivalents, and investments	\$ 240,782	178,204

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Noncurrent cash and investments are invested as follows:

	2003	2002
	(In thousands)	
Pooled investment funds on deposit with the University of Wisconsin Foundation:		
Pooled Restricted Fund	\$ 138,653	128,458
Pooled Endowment Fund	34,694	34,118
Funds held with trustee-repurchase agreement	54,317	11,236
Other	279	49
Total	\$ 227,943	173,861

At June 30, 2003, the funds held with trustee were invested in a collateralized flexible draw investment agreement maintained with a financial institution in accordance with the provisions of the bond indenture agreement, mature on June 15, 2005, and provide a fixed rate of return of 1.66%.

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(6) Capital Assets

Capital asset additions, retirements, and balances for the years ended June 30, 2003 and 2002 were as follows:

	Balance July 1, 2002	Additions and transfers	Retirements	Balance June 30, 2003
		(In thousands)		
Capital assets not being depreciated:				
Land	\$ 2,466	—	—	2,466
Land improvements	1,468	—	—	1,468
Construction in progress	28,601	(8,592)	—	20,009
Total	<u>32,535</u>	<u>(8,592)</u>	<u>—</u>	<u>23,943</u>
Capital assets being depreciated:				
Buildings and improvements	213,287	34,422	—	247,709
Equipment	138,258	26,013	(20,368)	143,903
Total	<u>351,545</u>	<u>60,435</u>	<u>(20,368)</u>	<u>391,612</u>
Less accumulated depreciation and amortization for:				
Buildings and improvements	95,744	9,550	—	105,294
Equipment	88,514	12,426	(19,922)	81,018
Total	<u>184,258</u>	<u>21,976</u>	<u>(19,922)</u>	<u>186,312</u>
Total capital assets being depreciated, net	<u>167,287</u>	<u>38,459</u>	<u>(446)</u>	<u>205,300</u>
Total capital assets	<u>\$ 199,822</u>	<u>29,867</u>	<u>(446)</u>	<u>229,243</u>

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	Balance July 1, 2001	Additions and transfers	Retirements	Balance June 30, 2002
		(In thousands)		
Capital assets not being depreciated:				
Land	\$ 2,466	—	—	2,466
Land improvements	1,468	—	—	1,468
Construction in progress	26,358	2,243	—	28,601
Total	30,292	2,243	—	32,535
Capital assets being depreciated:				
Buildings and improvements	173,818	39,469	—	213,287
Equipment	138,902	19,694	(20,338)	138,258
Total	312,720	59,163	(20,338)	351,545
Less accumulated depreciation and amortization for:				
Buildings and improvements	88,406	7,338	—	95,744
Equipment	96,416	11,307	(19,209)	88,514
Total	184,822	18,645	(19,209)	184,258
Total capital assets being depreciated, net	127,898	40,518	(1,129)	167,287
Total capital assets	\$ 158,190	42,761	(1,129)	199,822

Total capital assets approximating \$25,114,000 and \$29,741,000, net, were held under a Lease Agreement (see note 1) at June 30, 2003 and 2002.

Construction in progress at June 30, 2003 consisted principally of costs incurred for the expansion of ambulatory services and remodeling of inpatient rooms at 600 Highland Avenue. The construction project is being financed with debt proceeds (see note 7). During 2003 and 2002 interest expense of approximately \$731,000 and \$1,713,000, respectively, net of interest income of approximately \$598,000 and \$1,713,000, respectively, was capitalized.

Total remaining commitments on capital assets purchases and the renovation and construction projects approximated \$1,000,000 at June 30, 2003.

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(7) Long-term Debt

Changes in long-term debt for the years ended June 30, 2003 and 2002 were as follows:

	<u>Balance July 1, 2002</u>	<u>Additions</u>	<u>Payments and amortization</u> (In thousands)	<u>Balance June 30, 2003</u>	<u>Amounts due within one year</u>
Amounts payable to the State under capital lease agreements for:					
General Obligation Bonds	\$ 1,719	—	746	973	373
Refunding Bonds	24,053	—	2,099	21,954	2,594
Total payable to the State	<u>25,772</u>	<u>—</u>	<u>2,845</u>	<u>22,927</u>	<u>2,967</u>
Hospital Revenue Bonds:					
Series 1997	50,000	—	—	50,000	—
Series 2000	56,500	—	—	56,500	—
Series 2002A	—	55,600	—	55,600	—
Series 2002B	—	12,900	—	12,900	—
Total long- term debt	<u>132,272</u>	<u>68,500</u>	<u>2,845</u>	<u>197,927</u>	<u>2,967</u>
Premium on long-term debt	<u>—</u>	<u>670</u>	<u>42</u>	<u>628</u>	<u>—</u>
Long-term debt including premium	<u>\$ 132,272</u>	<u>69,170</u>	<u>2,887</u>	<u>198,555</u>	<u>2,967</u>

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	<u>Balance July 1, 2001</u>	<u>Additions</u>	<u>Payments and amortization</u> <small>(In thousands)</small>	<u>Balance June 30, 2002</u>	<u>Amounts due within one year</u>
Amounts payable to the State under capital lease agreements for:					
General Obligation Bonds	\$ 3,058	336	1,675	1,719	746
Refunding Bonds	25,539	—	1,486	24,053	2,099
Total payable to the State	<u>28,597</u>	<u>336</u>	<u>3,161</u>	<u>25,772</u>	<u>2,845</u>
Hospital Revenue Bonds:					
Series 1997	50,000	—	—	50,000	—
Series 2000	56,500	—	—	56,500	—
Total long-term debt	<u>\$ 135,097</u>	<u>336</u>	<u>3,161</u>	<u>132,272</u>	<u>2,845</u>

The amounts payable to the State under capital lease agreements represent portions of the respective obligations for which repayment has been assigned to the Hospital in connection with the financing of the Hospital's facilities and equipment (see note 1). In March 2002, the Hospital was notified that the State included the cost of the CSC Heat Recovery Chiller project in a new General Obligation Bond series and assigned \$336,000 of the series to the Hospital, which is included with amounts payable to the State. Interest rates range from 4.00% to 6.26%, with final maturities due in April 2022. Annual principal and semiannual interest payments are required on all amounts payable to the State.

In April 1997, the Hospital issued \$50,000,000 of Variable Rate Demand Hospital Revenue Bonds, Series 1997 (Series 1997 Bonds). Principal payments on the Series 1997 Bonds are due annually commencing in April 2010 through April 2026. The Series 1997 Bonds bear interest at a weekly rate determined by a remarketing agent. Interest is payable monthly. The effective annual interest rate was 1.3% in 2003 and 1.8% in 2002.

In March 2000, the Hospital issued \$56,500,000 of Hospital Revenue Bonds, Series 2000 (Series 2000 Bonds). Principal payments on the Series 2000 Bonds are due annually commencing in April 2007 through April 2029. Interest rates range from 5.35% to 6.20% and interest is payable semiannually on April 1 and October 1 of each year beginning October 1, 2000. The effective annual interest rate was 6.1% in 2003 and 6.1% in 2002.

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In September 2000, the Hospital entered into an interest rate swap in order to effectively change a portion of the Series 2000 Bonds fixed rate interest cash flows to variable rate interest cash flows. The notional amount of this swap agreement was \$46,460,000. The terms of the swap agreement are for the Hospital to pay to the counterparty a variable rate and to receive a fixed interest payment from the counterparty. The fair value of \$2,891,000 at June 30, 2002 is not reflected in the financial statements. The swap agreement was terminated in September 2002. The cancellation resulted in a gain to the Hospital of \$4,035,000 reflecting additional market value appreciation. The gain is included in the statements of revenue, expenses, and changes in net assets for 2003.

In October 2002, the Hospital issued \$68,500,000 of Hospital Revenue Bonds, Series 2002 (Series 2002 Bonds) consisting of \$55,600,000 Series 2002A Short-term Adjustable Securities and \$12,900,000 Series 2002B Fixed Interest Rate Bonds. The bond proceeds are designated to finance qualified capital projects. Principal payments on the Series 2002A Bonds range from \$500,000 to \$3,900,000 due annually commencing in April 2013 through 2032. The interest rates and the interest payment dates for the Series 2002A bonds vary depending on if the bonds are in auction mode, daily mode, weekly mode, or in flexible mode beginning November 29, 2002. Principal payments on the Series 2002B Bonds range from \$1,385,000 to \$1,900,000 due annually commencing in April 2006 through April 2013. Interest rates for the Series 2002B Bonds range from 5.25% to 5.50% and interest is payable semiannually on April 1 and October 1 of each year beginning April 1, 2003. The effective annual interest rate of the Series 2002 A Bonds was 1.19% in 2003. The effective annual interest rate of the Series 2002 B Bonds was 5.45% in 2003.

In October 2002, the Hospital entered into an interest rate swap in order to convert a portion of the Series 2002A Short-term Adjustable Rate Securities to fixed rates. The notional amount of this swap agreement was \$21,350,000 at June 30, 2003, which matures on April 1, 2022. The terms of the swap agreement are for the Hospital to pay the counterparty a fixed rate of 3.85% per annum, payable semiannually, and the Hospital to receive a floating rate of 70% of one-month LIBOR per annum, payable monthly. As of June 30, 2003, the interest rate received by the Hospital was 0.92%. The Hospital will be exposed to variable rates if the counterparty to the swap defaults or if the swap is terminated. The swap exposes the Hospital to basis risk should the relationship between LIBOR and auction rate converge, changing the synthetic rate on the bonds. The Hospital does not intend to terminate this agreement. The fair value of the swap of \$(1,850,000) at June 30, 2003 is not reflected in the financial statements. As of June 30, 2003, the Hospital was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the Hospital would be exposed to credit risk in the amount of the swap's fair value.

The Series 1997 Bonds, Series 2000 Bonds, and Series 2002 Bonds are collateralized by a security interest in substantially all of the Hospital's revenue. The borrowing agreements contain various covenants and restrictions including compliance with the terms and conditions of a Lease Agreement (see note 1) and provisions limiting the amount of additional indebtedness which may be incurred. The borrowing agreements also require the establishment and maintenance of certain funds under the control of a trustee (see note 5).

Current legislation (see note 1) limits the Hospital's total borrowings, exclusive of amounts payable to the State, to \$175,000,000, with limited exceptions.

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Scheduled principal and interest repayments on long-term debt, including the effect of the swap, are as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Interest rate swap, net</u>	<u>Total</u>
	(In thousands)			
Year ending June 30:				
2004	\$ 2,967	6,325	625	9,917
2005	2,792	6,165	625	9,582
2006	4,312	6,017	625	10,954
2007	4,364	5,802	625	10,791
2008	4,619	5,577	625	10,821
2009-2013	27,048	24,006	3,125	54,179
2014-2018	34,259	18,622	3,125	56,006
2019-2023	42,366	14,369	2,344	59,079
2024-2028	52,010	9,271	—	61,281
2029-2033	23,190	919	—	24,109
Premium on 2002B bonds	628	—	—	628
	<u>\$ 198,555</u>	<u>97,073</u>	<u>11,719</u>	<u>307,347</u>

(8) Net Patient Service Revenue

The Hospital has agreements with third-party payors that provide for reimbursement at amounts different from the Hospital's established rates. Contractual adjustments under third-party reimbursement programs represent the difference between the Hospital's established rates for services and amounts reimbursed by third-party payors. A summary of the basis of reimbursements with major third-party payors follows:

Medicare – Inpatient acute care services rendered to Medicare beneficiaries and defined capital costs 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 nonacute services, outpatient services provided before August 2000, medical education, and certain organ acquisition costs related to Medicare beneficiaries are paid based upon cost reimbursement methods, established fee screens, or a combination thereof. The Hospital is reimbursed for cost reimbursement items at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits by the Medicare fiscal intermediary. Effective August 1, 2000, the outpatient reimbursement system was changed to prospective rates. The Hospital's Medicare cost reports have been audited by the Medicare fiscal intermediary through June 30, 2000.

Medicaid – Inpatient services rendered to Medicaid beneficiaries are reimbursed similar to the method for Medicare inpatient acute care services. Differences from the Medicare method pertain to reimbursements for organ transplants, capital costs, and medical education costs. Medicaid outpatient services are paid on a predetermined rate per visit.

The percentage of net patient service revenue applicable to services provided to Medicare and Medicaid patients was approximately 29% and 31% in 2003 and 2002, respectively.

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Net patient service revenue for the years ended June 30, 2003 and 2002 included approximately \$3,386,000 and \$1,600,000, respectively, of favorable retrospectively determined settlements from third party payors and changes in estimates.

Other – The Hospital has also entered into reimbursement agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for reimbursements under these agreements includes capitation, prospectively determined rates per discharge, discounts from established rates, and prospectively determined per diem rates.

Capitation revenue with third-party payors comprised approximately 9% and 8% of net patient service revenue for the years ended June 30, 2003 and 2002, respectively.

The mix of net receivables from patients and third-party payors is summarized as follows:

	2003	2002
Medicare	20%	24%
Medicaid	6	5
Managed care	35	34
Other	39	37
Total	100%	100%

(9) Unreimbursed and Partially Reimbursed Care

The Hospital maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges foregone for services and supplies furnished under its charity care policy. The approximate level of charity care provided (based on charges) during the years ended June 30, 2003 and 2002 was \$11,279,000 and \$8,345,000, respectively.

(10) Pension Plan

Virtually all Hospital employees participate in the Wisconsin Retirement System (the System), a cost-sharing multiple-employer defined-benefit public employee retirement system governed by Chapter 40 of the Wisconsin Statutes. All permanent employees expected to work over 600 hours per year are eligible to participate in the System. Covered employees are required by statute to contribute 5% of their salary to the plan. However, the Hospital makes these contributions to the plan on behalf of the employees. The Hospital is required to contribute the remaining amounts necessary to pay the projected cost of defined future benefits.

For employees beginning participation on or after January 1, 1990 and no longer actively employed on or after April 24, 1998, creditable service in each of five years is required for eligibility for a retirement annuity. Participants employed prior to 1990 and on or after April 24, 1998 are immediately vested. Employees who retire at or after age 65 are entitled to receive an unreduced retirement benefit. The factors influencing the benefit are: (1) final average earnings, (2) years of creditable service, and (3) a formula factor.

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For the purposes of calculating benefits under the pension plan, final average earning is the average of the participant's three highest years' earnings. Creditable service is the creditable current and prior service expressed in years or decimal equivalents of partial years for which a participant receives earnings and makes contributions as required. The formula factor is a standard percentage based on employment category.

Employees may retire at age 55 and receive reduced benefits. Employees terminating covered employment before becoming eligible for a retirement benefit may withdraw their contributions and forfeit all rights to any subsequent benefits.

Required contribution as a percentage of covered payroll was 13% in 2003, 2002, and 2001, including a 3% administrative fee. Required and actual contributions including the 3% administrative fee were \$25,455,000, \$21,814,000, and \$19,603,000 for 2003, 2002, and 2001, respectively, included with employee benefits expense in the statements of revenues, expenses, and changes in net assets.

Copies of the separately issued financial report of the System that includes financial statements and required supplementary information may be obtained by writing to:

Department of Employee Trust Funds
801 West Badger Road
P O Box 7931
Madison, WI 53707-7931

During 2001, the Hospital received notice from the Wisconsin Department of Employee Trust Funds that it would be entitled to a \$2,800,000 employer pension credit as a result of 1999 Wisconsin Act 11. The State of Wisconsin Controller's Office has requested that these credits be paid to the State. The Hospital has been contesting this request, however, due to the uncertainty, until the matter is resolved, the amount has been recorded as a liability and as an operating expense in fiscal 2002.

(11) Malpractice Insurance

The Hospital has professional liability insurance with a private insurance carrier for its employees that covers the Hospital's liability for claims arising on or after July 1, 2002 (occurrence-based coverage). The Hospital also carries a separate tail coverage policy on the Hospital and resident liability for claims arising from activities prior to July 1, 2002. Losses in excess of the professional liability insurance are fully covered through the Hospital's mandatory participation in the Patients' Compensation Fund of the State of Wisconsin. The Patients Compensation Fund pays that portion of a medical malpractice claim which is in excess of the legal primary insurance limit prescribed under law, or the maximum liability limit for which the health provider is insured, whichever limit is greater. Most health care providers permanently practicing or operating in the State are required to pay Patients Health Compensation Fund operating fees. Risk of loss is retained by the fund.

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(12) Liabilities for Workers' Compensation Claims

A reconciliation of changes in the aggregate liabilities for workers' compensation claims for the years ended June 30, 2003, 2002, and 2001 is as follows:

	Amount of claims liabilities beginning of year	Incurred claims and changes in estimates	Payments on claims	Amount of claims liabilities end of year
2003	\$ 1,380,000	4,880,000	(3,721,000)	2,539,000
2002	367,000	2,017,000	(1,004,000)	1,380,000
2001	530,000	1,086,000	(1,249,000)	367,000

Workers' compensation claim expense is included with employee benefits expense in the statements of revenues, expenses, and changes in net assets and accrued expenses in the balance sheets.

(13) Commitments and Contingencies

(a) Leases

The Hospital leases buildings, equipment, and helicopter transport services under operating leases. Rental expense for cancelable and noncancelable operating leases was approximately \$5,273,000 and \$6,248,000 for 2003 and 2002, respectively, and is included in other expenses. Future minimum lease payments for the next five years under operating leases that have initial or remaining noncancelable lease terms in excess of one year, in thousands, as of June 30, 2003 are as follows:

2004	\$ 5,283
2005	5,176
2006	4,888
2007	4,441
2008	3,268
2009 – 2013	4,189
	<u>\$ 27,245</u>

(b) Regulatory Investigations

The U.S. Department of Justice and other Federal agencies are increasing resources dedicated to regulatory investigation and compliance audits of health care providers. The Hospital is subject to these regulatory efforts. Management is currently unaware of any regulatory matters which will have a material adverse effect on the Hospital's financial position or results of operations.

(c) Other

The Hospital is subject to various legal proceedings and claims which are incidental to its normal business activities. In the opinion of the Hospital, the amount of ultimately liability with respect to these actions will not materially affect the operations or net assets of the Hospital.

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(14) Pledge from American Family Mutual Insurance Company (American Family)

In March 2003, American Family made an irrevocable pledge to the Hospital to create a fund known as "The American Family Children's Hospital Building Fund." The pledge amount is restricted by American Family to be used exclusively for capital costs associated with the children's hospital project. American Family will pay the Hospital the total sum of \$10,000,000, in cash or marketable securities, in four equal annual installments beginning in fiscal 2004. The amounts will be recognized in the financial statements in the period of actual receipt from American Family.

(15) Accounting Changes and Restatement

During the year ended June 30, 2003, the Hospital adopted the provisions of GASB Statement No. 34, *Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments* and Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments: Omnibus*, retroactive to July 1, 2001. These Statements changed the format and content of the Hospital's financial statements including the presentation of net assets, the preparation of the statement of cash flows on the direct method, and the inclusion of management's discussion and analysis as required supplementary information and modification to certain note disclosures. The 2002 financial statements have been restated in accordance with GASB statements.

The Hospital previously reported its financial statements in accordance with FASB statements. The net assets previously reported as unrestricted, temporarily restricted, and permanently restricted are now reported as net assets – invested in capital assets, net of related debt; restricted expendable for donor specified purposes; restricted nonexpendable, and unrestricted. Further, the statements of operations and statements of changes in net assets as previously reported pursuant to FASB standards have been combined in the statements of revenues, expenses, and changes in net assets as required by GASB standards.

During the year ended June 30, 2003, the Hospital also adopted the provisions of GASB Statement No. 38, *Certain Financial Statement Note Disclosure*, retroactive to July 1, 2001. This Statement modifies, establishes, and rescinds certain financial statement note disclosures. The financial statements have been prepared in conformance with this Statement.

As a result of above restatement in accordance with GASB statements, the accompanying financial statements as of and for the year ended June 30, 2002 have been restated to reflect the changes as detailed below:

The Hospital previously recorded its interest rate swap at its approximate fair value in other assets with the change in fair value reflected in investment income. Under the GASB statements, the Hospital does not record the fair value of the interest rate swap or changes therein. This restatement resulted in a decrease to net assets as of June 30, 2001 of \$1,041,000 and a decrease to excess of revenues over expenses before capital grants, gifts, and donations, additions to permanent endowments, and other payments for the year ended June 30, 2002 by \$1,850,000 from what previously had been reported.

The Hospital also recorded an additional vacation accrual for salary related expenses under GASB Statement No. 16, *Accounting for Compensated Absences*. This restatement resulted in a decrease to net assets as of June 30, 2001 of \$600,000.

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A summary of the effects of the restatement as described above as of and for the year ended June 30, 2001, in thousands, is as follows:

Net assets , June 30, 2001, as previously reported	\$ 264,094
Fair value of swap	(1,041)
Additional vacation accrual for salary related expenses	<u>(600)</u>
Net assets, June 30, 2001, as restated	<u>\$ 262,453</u>