University of California,
San Diego Medical Center

Report on Audits of Financial Statements
For the Years Ended June 30, 2006 and 2005

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PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
350 South Grand Avenue
Los Angeles CA 90071
Telephone (213) 356 6000
Facsimile (813) 637 4444

Report of Independent Auditors

The Regents of the University of California
Oakland, California

In our opinion, the accompanying financial statements, as shown on pages 17 through 37, present fairly, in all material respects, the financial position of the University of California, San Diego Medical Center (the "Medical Center"), a division of the University of California ("University"), at June 30, 2006 and 2005, and changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Medical Center's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. These 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of the Medical Center are intended to present the financial position, and the changes in financial position and cash flows of only that portion of the University that is attributable to the transactions of the Medical Center. They do not purport to, and do not, present fairly the financial position of the University as of June 30, 2006 and 2005, and its changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2 through 16 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consist 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.

PricewaterhouseCoopers LLP

September 22, 2006

Introduction

The objective of the Management's Discussion and Analysis is to help readers better understand the University of California, San Diego Medical Center's financial position and operating activities for the years ended June 30, 2006, with selected comparative information for the years ended June 30, 2005 and 2004. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes to the financial statements. Unless otherwise indicated, years (2004, 2005, 2006, 2007, etc.) in this discussion refer to the fiscal years ended June 30.

Overview

The University of California, San Diego Medical Center (the "Medical Center") serves as the principal clinical teaching site for the University of California, San Diego ("UCSD") School of Medicine, established by The Regents of the University of California ("The Regents") in 1962. It is San Diego County's only academic medical center encompassing hospital-based and ambulatory patient care services, teaching, and clinical research.

The Medical Center is licensed to provide acute care hospital services at two sites, Hillcrest and La Jolla, and provides psychiatric services for children and adolescents at the 35 bed child and adolescent psychiatric unit located at Alvarado Hospital. The Hillcrest site, located in central San Diego, is licensed to operate 386 beds. As the Medical Center's principal teaching hospital, it is the focal point for UCSD's education and community services missions, and serves as a major tertiary referral center for San Diego and Imperial Counties. It is one of two of the county's Level I Trauma Centers and the only Regional Burn Center.

John M. and Sally B. Thornton Hospital ("Thornton Hospital"), which opened in July 1993, is licensed to operate 119 beds and is located in La Jolla on the UCSD campus. It is a general medical/surgical facility and is also the principal location of the Medical Center's cancer services.

Outpatient services are provided by the UCSD Medical Group, which has a clinical practice of over 340 faculty physicians, primarily at the UCSD Ambulatory Care Center and Lewis Street Center in Hillcrest and at the Perlman Ambulatory Care Center in La Jolla.

Completion of construction of the 158,000 square foot Rebecca and John Moore's UCSD Cancer Center ("Cancer Center") in March 2005 resulted in consolidation of nearly all outpatient clinical and research activities of the oncology programs of the University of California, San Diego. Outpatient clinical care encompassing prevention, diagnosis, prognosis, treatment, education, rehabilitation and after-care are now integrated in one convenient location on the East Campus in La Jolla.

Together, these sites enable the Medical Center to provide the full spectrum of services and attract the volume and diversity of patients necessary to meet its educational, clinical research, and community service missions.

For the fiscal year ended June 30, 2006, the Medical Center reported net income of $83.8 million and generated a total margin of 13.6 percent. Total operating revenues increased by 14.7 percent over the prior year due to increased outpatient volumes, improved collections, and release of a prior year $15.9 million Medi-Cal DSH reserve.

Operating expenses increased by 10.7 percent due to increased staffing costs, inflationary increases in pharmaceuticals, medical and other supplies, and increased depreciation on facilities and equipment. The Medical Center's cash position remained strong while cash used for capital expenditures to renovate, expand, and replace existing facilities and invest in new technology exceeded depreciation expense by 45.0 percent.

The Medical Center's operating revenues reflect increased utilization of services and continued focus on maximizing collections through contracting and pricing strategies. Labor costs continue to be adversely impacted by the nursing shortage, compliance with legislation covering nurse staffing ratios, and increased premiums for employee healthcare. Medical and other supply costs reflect the impact of new technologies, inflation and utilization of higher cost drugs.

As part of its overall strategic plan, management continues to focus on its financial goal of optimizing financial performance to enable continuous reinvestment in people, programs, facilities and technologies by optimizing reimbursement, improving efficiency, managing resources and costs, and increasing philanthropic donations in support of facilities renovation and expansion needs. Growth of patient volumes and expansion of targeted service lines, including oncology and cardiovascular services, are also key elements of the overall strategic plan.

- *Optimizing net patient service revenue*
  During 2006, the Medical Center continued its strategy to improve net patient service revenue through pricing strategies and contracting, aggressively pursuing coverage options for uninsured patients, maximization of collections through enhanced charge capture strategies, and efforts to sustain external funds to support the Medical Center's safety net role in the community.

  Pricing strategies ensure that the Medical Center's prices are aligned with the market while contracting efforts focused on obtaining short length of stay or surgical per diems, increases in general per diem rates, and increases to maximum payments for outpatient services. Throughout 2006 the Medical Center continued to receive increased payments from payers such as Medicare that reimburse on the basis of a patient's diagnosis as a result of the initiative that began in 2004 to facilitate complete documentation of clinical conditions to more accurately reflect the complexity of its inpatients and the care provided.

  As part of the Medical Center's strategy to sustain external funds to support its safety net role in the community, management worked with the University to shape the direction of Medicaid reform to stabilize and ensure future growth of Medi-Cal and indigent care funding for the University's Medical Centers. During 2005, the Medical Center received $27.3 million of previously unpaid amounts due under the SB1255 program for fiscal years 2003 through 2005.

As the volume of patient care services provided in an outpatient setting continues to increase, management will be implementing new strategies in 2007 to increase outpatient revenue collections and reduce days outstanding in patient accounts receivable. Other ongoing strategies to maximize net patient service revenue include educating both patients and staff on their respective responsibilities to pay and collect co-payments at time of appointment or discharge, improved management reporting and review of late charges to reduce the number of accounts that must be re-billed due to late charges, enhanced charge capture strategies, and pursuing payments for services to uninsured patients. Due to the large number of uninsured patients served by the Medical Center, an outside agency reviews all accounts of patients with no funding to determine if the patient is eligible for any type of public assistance.

- *Managing resources and costs*
  Managing labor productivity to national benchmark standards and adhering to the nurse to patient staffing ratio requirements of State Assembly Bill ("AB") 394 continues to be a priority for the Medical Center. AB394 established licensed nurse to patient staffing ratio requirements for all routine medical/surgical, step-down, telemetry, and intensive care hospital units and also set licensed nurse to patient staffing ratio requirements for the emergency room and during patient transports among hospital units. To fully comply with AB394, the Medical Center increased its staffing in 2004 by approximately 70 full time equivalent registered nurses, a portion of which are employed by the Medical Center with the remainder obtained through nurse registry agencies.

  During 2006, the Medical Center focused on its strategy of recruitment, retention, and support for new nurses by employing dedicated nurses, nurse recruiters, and support staff to recruit, orient, and provide bedside assistance to new hires. As a result of these efforts, the Medical Center experienced a decrease in double time pay for both registry and hospital-employed nurses of approximately 37 percent and increased the level of nurse travelers under contract by approximately 15 percent.

  Management's continued commitment to strategies implemented in earlier years to monitor staffing productivity for all departments in the Medical Center resulted in a decrease in the ratio of staff to adjusted occupied beds during 2006. Total salaries paid to hospital employees in 2006 increased by 11.4 percent over 2005 due to market pressures on wages. In addition, premiums paid for employee healthcare increased by approximately 14.7 percent over 2005.

  Managing medical and other supply costs is also a priority for Medical Center management. The Medical Center implemented several initiatives during 2006 including improvements to the process for evaluation of proposed purchases of new medical technologies. Every new device must now go through a rigorous examination process before it is approved for purchase. A committee structure that includes the Medical Center's Technology Assessment Committee, Surgical Committee, and Standards Committee is charged with oversight of this process. Other initiatives include enhanced benchmarking of supply cost data with other university based hospitals, planning for a new supply chain information system, and enhanced educational programs for Medical Center buyers that focus on improving contract and negotiation skills. All these programs were designed to improve productivity and increase the percent of on-contract purchases.

During the upcoming year a new supply chain information system will be implemented which will allow for the planned move towards centralized receiving in strategic areas and improved centralized management of high cost clinical inventories in certain departments.

- *Facilities planning*
  At the January 19, 2006 meeting of the University of California Board of Regents, the Medical Center received approval to proceed with construction of the Sulpizio Family Cardiovascular Center and expansion of patient care services at the Thornton Hospital. Planning approval for this project was previously received on May 19, 2004. This project will include additional ICU and step-down beds, cardiac catheterization rooms, operating rooms, patient exam rooms, physician offices, additional emergency department treatment stations and an expanded emergency department waiting area. Construction is expected to begin in December 2007 with completion in December 2009. This project will be funded through a combination of hospital cash reserves, philanthropy, and debt.

  The Medical Center also introduced its long-range facility master plan and vision for aligning the health system to best support evolving trends in health care delivery, teaching and research at the meeting of the University of California Board of Regents on March 16, 2005.

  While planning for construction of the Thornton Expansion/Cardiovascular Center project and the long-term facility vision continues, expenditures for other projects and necessary renovations are underway. During 2006, the Medical Center spent $24.4 million on facilities renovation and improvement projects which included $21.0 million funded with hospital cash reserves and an additional $3.4 million funded with appropriations from the State of California for infrastructure improvements at the Hillcrest site. An additional $14.1 million was spent for equipment, information systems and new technology, which included $9.6 million funded with hospital cash reserves and $4.5 million acquired under capital lease obligations.

  Construction of the Cancer Center was completed in March 2005 with select departments commencing operations in May and June 2005. The remaining departments relocated to the Cancer Center in July 2005. The Medical Center is financially responsible for funding and operating the clinical portion of this facility, which represents approximately 18 percent of the total assignable square feet. Construction financing for the clinical portion of the facility in the amount of $19.0 million was through standby financing from the University's commercial paper program. Long-term external financing is expected to be arranged through the Office of the Treasurer of the University by the end of 2007.

  At June 30, 2006, the Medical Center's financial statements include capital assets of $28.9 million for building and equipment costs and a short-term liability to the University of $19.0 million related to the Cancer Center. Interest expense on the stand-by financing has been charged to expense since March 2005.

Operating Statistics

The following table presents utilization statistics for the Medical Center for 2006, 2005 and 2004:

Statistics	2006	2005	2004
Discharges	20,995	21,334	21,790
Average Length of Stay	6.3	6.1	5.7
Patient days:			
Medicare (non-risk)	30,704	30,828	29,044
Medi-Cal (non-risk)	36,226	36,016	35,064
Contracts – Commercial	44,339	44,136	45,032
County/Uninsured	17,657	16,325	15,983
Total patient days	128,926	127,305	125,123
Ambulatory visits:			
Clinic visits	479,649	465,178	466,056
Emergency room visits	60,769	57,855	58,686
Total ambulatory visits	540,418	523,033	524,742

Discharges decreased by approximately 1.6 percent in 2006 compared to 2005 due primarily to an increase in the conversion of one-day/observation cases from inpatient to outpatient. Total patient days increased by 1.3 percent from 2005 due to an increase in average length of stay. The increase in length of stay in 2006 over 2005 was experienced in most programs. Discharges in 2005 decreased by 2.1 percent over 2004 due in part to an increase in observation days and a related decrease in trauma one-day stays. Despite the decrease in discharges, total patient days increased in 2005 by 1.7 percent from 2004 due to an increase in average length of stay.

The decrease in patient days for Medicare is due primarily to a decrease in admissions, which is offset in part by an increase in length of stay resulting from an increase in the severity of cases, as reflected by the 3.2 percent increase in Medicare case mix index in 2006 compared to 2005. The increase in patient days for Medi-Cal and Contracts – Commercial is due primarily to an increase in length of stay. The increase in patient days for County/Uninsured is due to an increase in both admissions and length of stay.

Ambulatory clinic visits increased by 3.1 percent over 2005 due primarily to an increase in oncology visits. Emergency room visits increased by 5.0 percent from 2005 due primarily to an increase in both urgent and emergent visits at the Thornton Hospital in La Jolla. Ambulatory clinic visits for 2005 decreased by 0.1 percent from 2004 while emergency room visits for 2005 decreased by 1.4 percent from 2004.

Statements of Revenues, Expenses and Changes in Net Assets

The following table presents the operating results for the Medical Center for fiscal years 2006, 2005 and 2004 (dollars in thousands):

	2006	2005	2004
Net patient service revenue	$ 600,405	$ 521,837	$ 461,777
Other operating revenue	14,270	13,965	12,879
Total operating revenue	614,675	535,802	474,656
Operating expenses:			
Salaries and employee benefits	266,162	244,071	224,364
Professional services	19,132	17,052	16,128
Medical supplies	124,580	108,999	100,647
Other expense	94,632	87,381	72,878
Depreciation and amortization	24,866	20,892	19,700
Total operating expenses	529,372	478,395	433,717
Income from operations	85,303	57,407	40,939
Total non-operating expenses	(1,508)	(2,467)	(3,132)
Income before other changes in net assets	$ 83,795	$ 54,940	$ 37,807
Margin	13.6 percent	10.3 percent	8.0 percent
Other changes in net assets	(17,387)	(14,321)	(12,717)
Net assets – beginning of year	325,604	284,985	259,895
Net assets – end of year	$ 392,012	$ 325,604	$ 284,985

Revenues

Total operating revenue for the year ended June 30, 2006 was $614.7 million, an increase of $78.9 million, or 14.7 percent, over 2005. Total operating revenue for 2005 of $535.8 million increased by $61.1 million, or 12.9 percent, over 2004.

Net patient service revenue for 2006 increased by $78.6 million, or 15.1 percent, over 2005. Net patient service revenue in 2005 increased by $ 60.1 million, or 13.0 percent, over 2004. The increase in 2006 was due to increased outpatient volumes, improved collections, and release of a $15.9 million prior year Medi-Cal DSH reserve. The increase in 2005 over 2004 was due to similar volume increases and contracting strategies combined with receipt of $27.3 million of additional SB1255 payments for fiscal years 2003 through 2005.

Net patient service revenue is reported net of estimated allowances under contractual arrangements with Medicare, Medi-Cal, the County of San Diego, and other third-party payors and has been estimated based on the principles of reimbursements and terms of the contracts currently in effect.

Other operating revenue consists primarily of Clinical Teaching Support funds, joint venture income accounted for under the equity method, and other non-patient services such as cafeteria and gift shop operations. The increase in other operating revenue over 2005 was due to an increase in non-patient service revenue.

The following table summarizes net patient service revenue for 2006, 2005 and 2004 (dollars in thousands):

Payor	2006	2005	2004
Medicare (non-risk)	$ 121,047	$ 105,104	$ 97,298
Medi-Cal (non-risk)	162,831	151,149	112,825
Contracts – commercial	289,296	240,284	229,989
County/Uninsured	27,231	25,300	21,665
Total	$ 600,405	$ 521,837	$ 461,777

Net revenues for Medicare represent payments for services provided to patients under Title XVIII of the Social Security Act. Payments for inpatient services provided to Medicare beneficiaries are paid on a per discharge basis at rates set at the national level with adjustments for prevailing area labor costs. The Medical Center also receives additional payments for direct and indirect costs for graduate medical education, disproportionate share of indigent patients, capital reimbursement, and outlier payments on cases with unusually high costs of care. Hospital outpatient care is reimbursed under a prospective payment system.

Net revenue for Medicare patients increased by $15.9 million from 2005 due primarily to an increase in case mix index and increased outpatient activity. Inpatient net revenue for 2006 increased by $8.4 million over 2005 due to a 5.4 percent increase in case mix index, an increase in outlier reimbursement and a 4.7 percent increase in the base payment rate per discharge reflecting the annual PPS update factor and wage index adjustment. These increases were partially offset by a 4.9% reduction in discharges. Outpatient net revenue increased by $7.5 million over 2005 due primarily to an increase in outpatient activity and a slight increase in APC payment rates. Net revenue also includes reimbursement for prior year settlements and other adjustments of $6.9 million in 2006 compared to ($1.0) million in 2005 and $1.7 million in 2004.

For 2004 and 2005, payments for Medi-Cal patients were made on a per diem basis for inpatient services and paid based on a fixed fee schedule for outpatient services. The Medical Center also received supplemental funds in recognition of its indigent care and teaching programs through the SB 855, SB 1255, and Medi-Cal medical education programs. In 2006, the State implemented a new Medicaid fee-for-service inpatient payment system. Under SB1100, the legislation enacting the new federal Medicaid hospital financing waiver in California, payments for inpatient services include a combination of fee-for-service payments, Disproportionate Share (DSH) payments and Safety Net Care Pool (SNCP) payments.

Total Medi-Cal net revenue increased by $11.7 million from 2005. Inpatient net revenue increased by $13.9 million over 2005 and includes $15.9 million related to the reversal of a reserve which had been established as the result of a report issued by the federal Department of Health and Human Services, Office of Inspector General ("OIG") in 2002 ("Audit of California's Medicaid Inpatient Disproportionate Share Hospital Payments for University of California, San Diego Medical Center, State Fiscal Year 1998"). The OIG had concluded, after applying a different methodology than the approved methodology set forth in California's Medicaid State Plan, that disproportionate share hospital ("DSH") payments were paid to the Medical Center in excess of the hospital-specific limits required under Section 1923(g) of the Social Security Act ("OBRA 1993 limits").

A 2003 agreement between the State and CMS reaffirmed the State's authority to make DSH payments pursuant to the long-standing approved state plan subject to various conditions. In 2005, the DSH State plan was substantially amended to implement the terms and conditions of the new Section 1115 Medi-Cal Hospital/Uninsured Care Demonstration project. This State plan amendment was approved by CMS. It is the State's position that the 2005 changes ensure the issues raised in the Audit Report are certain not to occur in the future. It is also the State's position that the 2003 agreement with CMS has been fully satisfied. Accordingly, a retrospective recovery by CMS on the basis of the Audit Report is remote.

Outpatient Medi-Cal net revenue decreased by $2.2 million from 2005 due primarily to recognition of $11.2 million of supplemental payments under Assembly Bill 915, the Public Hospital Outpatient Services Supplemental Reimbursement Program, in 2006 compared to $12.7 million in 2005.

Total Medi-Cal net revenue for 2005 increased by $38.3 million over 2004 due in part to receipt of an additional $27.3 million of SB 1255 payments for fiscal year 2003 through 2005.

Net revenue for contracts – commercial increased by $49.0 million over 2005 due primarily to an increase in patient activity and the impact of the Medical Center's ongoing contracting efforts and pricing strategies. The $10.3 million increase in 2005 over 2004 is due to similar pricing and contracting strategies.

County/Uninsured patient service revenues includes payments from the County of San Diego under the Medical Center's contract to provide emergency medical services to the county's indigent population and emergency and non-emergency medical services to County custodial patients.

Net revenue for County/Uninsured increased by $1.9 million over 2005 due primarily to an 8.2 percent increase in patient days. The $3.6 million increase in 2005 over 2004 is due primarily to a 2.1 percent increase in patient days and the receipt of $0.6 million more than was anticipated from the County for 2004 services under the Medical Center's contract with the County to care for the County's indigents.

Operating Expenses

Total operating expenses for 2006 of $529.4 million increased by $51.0 million, or 10.7 percent, over 2005 due primarily to increased labor and nurse registry costs, inflationary increases in pharmaceuticals and medical supplies, increased depreciation expense, and increased outpatient activity. Total operating expenses for 2005 increased by $44.7 million, or 10.3 percent, over 2004 due primarily to increased labor and supply costs.

Salary and employee benefit expenses includes wages paid to hospital employees, holiday and sick pay, payroll taxes, workers' compensation insurance premiums, health and other employee benefits. Amounts paid for nurse registry and other contract labor is included in other expenses.

The total paid for salaries and employee benefits in 2006 increased by $22.1 million, or 9.1 percent, over 2005. Salaries and wages increased by $20.7 million due primarily to increases in wages for nurses and other healthcare professional and technical employees and a 6.3% increase in full time equivalent employees ("FTEs"). This increase in FTEs is due to increased outpatient activity and the provision of new services including the addition of approximately 21 FTEs in Imagining Services that were previously employed under a joint venture agreement that terminated June 30, 2005. Employee benefit expense increased by $1.4 million or 2.2% over 2005 due to the increase in FTEs and an increase in employee healthcare premiums. Employee benefit expense for 2006 also includes a $5.8 million retrospective rebate of workers compensation premiums from the University. Salary and employee benefit costs for 2005 increased by $19.7 million, or 8.8 percent, over 2004.

Payments for professional services increased by $2.1 million, or 12.2 percent, in 2006 compared to 2005 and $0.9 million, or 5.7 percent, in 2005 compared to 2004 due to the provision of new services.

Medical supply expense increased by $15.6 million, or 14.3 percent, over 2005 due to an increase in patient volumes, inflationary increases, and utilization of higher cost drugs. Implant costs increased by $4.7 million over 2005 due in part to a 5.2% increase in surgical cases. Pharmaceuticals increased by $4.1 million over 2005 and the remaining $6.8 million increase is in blood bank, surgical and other supply costs. Medical supply expense for 2005 increased by $8.4 million, or 8.3 percent, over 2004 with increases in pharmaceutical costs of $5.0 million and implants, surgical and all other supply costs of $3.4 million. These increases were the result of similar increases in utilization and the impact of inflation.

Other expenses increased by $7.3 million, or 8.3 percent, over 2005 due to increased expenditures for nurse registry and contract labor of $3.9 million, increased utility costs of $0.8 million due to increased natural gas rates and the opening of the Cancer Center, and $1.1 million of one-time expenditures resulting from a proposed nursing strike early in 2006. The remaining $1.5 million increase is due to increases in advertising, equipment rent, nutrition and food costs, and all other supplies and services.

Other expenses for 2005 increased by $14.5 million, or 19.9 percent, over 2004 due to similar increases in nurse registry and contract labor, one-time consulting costs in the areas of supply chain management and efficiency management in major ancillary departments, one-time expenditures for the Cancer Center, and increased facilities and equipment maintenance, and purchased services.

Depreciation and amortization increased by $4.0 million over 2005 due to increased capital expenditures and depreciation of the capital assets of the Cancer Center, which opened at the end of 2005. Depreciation and amortization for 2005 increased by $1.2 million over 2004 due to increased capital expenditures.

Insurance expense totaled $5.6 million in 2006, up from $5.6 and $4.9 million in 2005 and 2004, respectively. The Medical Center is insured through the University's malpractice and general liability programs.

Nonoperating Revenue and (Expense)
Non-operating expenses, which includes interest earned on invested cash balances, interest expense on debt, and losses from disposal or retirement of capital assets, decreased by $1.0 million from 2005. This decrease is due primarily to increased interest income resulting from an increase in average daily invested cash, an increase in the STIP earning rate, and a decrease in interest expense on intergovernmental transfers for the SB 855, SB 1255, and Medi-Cal Medical Education programs. Non-operating expenses for 2005 decreased by $0.7 million from 2004.

Income Before Other Changes in Net Assets
The Medical Center reported income before other changes in net assets of $83.8 million in 2006 compared to $54.9 million in 2005, and $37.8 million in 2004, an improvement of $28.9 million and $17.1 million, respectively.

Other Changes in Net Assets
The lower section of the Statement of Revenues, Expenses and Changes in Net Assets shows the other changes to net assets in addition to the income or loss. Net assets are the difference between the total assets and total liabilities. The other changes in net assets represent additional funds the Medical Center receives and cash outflow for support and transfers to other university entities.

Included in the other changes in net assets in 2006 are the following:

- Proceeds from state capital appropriations of $3.4 million.
- Health system support represents transfers primarily to the School of Medicine for academic and clinical support including support for the School of Medicine's primary care activities. The Medical Center transferred $22.8 million this year.
- Donated assets of $1.8 million.
- Transfers from the University of $0.2 million.

In total, the net assets increased for the year by $66.4 million to $392.0 million. The majority of this increase is due to the excess of revenues over expenses.

Statements of Net Assets

The following table is an abbreviated statement of net assets at June 30, 2006, 2005 and 2004 (dollars in thousands):

	2006	2005	2004
Current assets:			
Cash	$ 119,022	$ 124,455	$ 91,306
Patient accounts receivable (net)	92,091	67,217	62,205
Other current assets	35,847	29,688	34,418
Total current assets	246,960	221,360	187,929
Capital assets (net)	306,120	291,788	268,356
Other assets	2,856	5,859	6,774
Total assets	555,936	519,007	463,059
Current liabilities	86,205	112,204	78,331
Long-term debt	77,719	81,199	99,743
Total liabilities	163,924	193,403	178,074
Net assets			
Invested in capital assets (net)	203,746	186,354	164,692
Unrestricted	188,266	139,250	120,293
Total net assets	$ 392,012	$ 325,604	$ 284,985

Total current assets increased by $25.6 million in 2006 over 2005 due to an increase in both patient accounts receivable and other receivables, which was partially offset by a decrease in cash and cash equivalents. Total current assets at June 30, 2005 were $33.4 million higher than the previous year.

Cash and cash equivalents decreased by $5.4 million due primarily to an increase in days outstanding in accounts receivable and a decrease in days outstanding in accounts payable. Cash and cash equivalents in 2005 increased by $33.1 million over 2004 due primarily to receipt of $27.3 million additional SB 1255 supplement payments for 2003 through 2005, collection of the remaining $2.1 million due under the Medi-Cal outpatient lawsuit settlement, and a reduction in amounts due the Medical Center under the SB 855 program of $3.2 million.

Patient accounts receivable, net of estimated uncollectibles, increased by 37.0 percent over 2005 due primarily to a 7-day increase in days outstanding in account receivable. This increase in days outstanding in accounts receivable is primarily in Contracts – Commercial and Medi-Cal and is due to an increase in patient accounts balances not billed at June 30 and an increase in outpatient claims, which typically have a longer time elapsed from date of service to collection of payments. Days outstanding in accounts receivable increased by 5 days in 2005 compared to 2004 due primarily to an increase in time elapsed from the receipt of Medi-Cal electronic claims and payment of such claims and a temporary delay in payment of accounts with a certain charge code.

Other current assets, which include non-patient receivables, inventory, and prepaid expenses, increased by $6.1 million, or 20.7 percent, from 2005. Non-patient receivables increased by $5.0 million due primarily to an increase in the receivable for Medi-Cal supplemental funds. The total value of the Medical Center's pharmaceutical and supply inventories increased by $0.3 million from the prior year due to inflationary increases in supply costs. Prepaid expense increased by $0.8 million over the prior year due primarily to an increase in prepaid licenses and advance payments for implants to maximize pricing under bulk purchasing discounts. Other current assets decreased by $4.7 million in 2005 over 2004 due primarily to a decrease in non-patient receivables, offset by small increases in pharmaceutical and supply inventories and prepaid expenses.

Capital assets increased by 4.9 percent and 8.7 percent, respectively, during the past two fiscal years as expenditures for new capital expenditures exceeded asset depreciation. The Cancer Center, construction of which began in October 2002, was completed in May 2005. Included in the Medical Center's capital assets is $19.4 million for the clinical component of the building and $9.4 million of equipment at June 30, 2006 and $19.0 million for the clinical component of the building and $8.3 million of equipment at June 30, 2005.

Other assets decreased by $3.0 million from the prior year due primarily to a decrease in investments in joint ventures accounted for under the equity method. The UCSD Medical Center/Tenet Magnetic Resonance Institute joint venture agreement expired June 30, 2005. The joint venture is being liquidated under the terms of the agreement.

Current liabilities decreased by $26.0 million, or 23.2 percent, from 2005 due to the following: a $4.4 million decrease in accounts payable and accrued expenses due primarily to a decrease in days outstanding in accounts payable; a $3.1 million increase in accrued salaries and benefits due primarily to the timing of bi-weekly payroll payments; a $25.0 million decrease in third party payor settlements due primarily to release of a $15.9 million prior year Medi-Cal DSH reserve and final settlement of the 2002 Medicare cost report; and an increase in the current portion of long-term debt and capital leases of $0.3 million. Current liabilities increased by $33.9 million in 2005 over 2004 due primarily to the impact of inflation, timing of payroll payments, payments in tentative settlement of the 2004 Medicare cost report, and the reclassification of the liability for stand-by financing from the University's commercial paper program for the construction of the clinical component of the Cancer Center from long-term to current portion.

Long-term debt decreased by $3.5 million from the prior year as principal payments exceeded new borrowings. Long-term debt decreased by $18.5 million in 2005 from 2004 due primarily to reclassification of the standby financing from the University's commercial paper program for the clinical portion of the Cancer Center from long-term to current portion as management anticipated that intermediate or long-term financing would be arranged during 2006. Repayment of the standby financing was postponed while the University sought approval from the Regents for an Academic Medical Center Pooled Revenue Bond Indenture, proceeds of which will be used to repay the stand-by financing during 2007.

Net assets increased by $66.4 million over the prior year. The change in net assets includes the excess of revenues over expenses of $83.8 million, receipt of state capital appropriations for infrastructure projects of $3.4 million, donated assets of $1.8 million, and other transfers from the University of $.2 million reduced by the transfer of approximately $22.8 million of funds to the University as health system support. During fiscal years 2005 and 2004, the Medical Center transferred $22.7 million and $17.4 million of funds to the University as health system support, respectively.

Liquidity and Capital Resources

During 2006, the Medical Center generated $52.6 million of cash from operations and $6.6 million from investing activities. Capital expenditures for equipment, facilities, and information systems totaled $40.6 million, of which $3.4 million of capital was acquired with state funds and $4.5 million of capital was acquired under capital lease obligations. Construction of the Cancer Center was funded with stand-by financing from the University's commercial paper program. Permanent financing will be obtained by the end of fiscal year 2007, at which time the stand-by financing will be repaid to the University.

Cash used for debt repayments was $7.6 million. An additional $22.8 million of funds were transferred to the University as health system support to fund clinical program development and activities of the School of Medicine and other areas of health sciences.

The following table shows key capital and liquidity ratios for fiscal years 2006, 2005 and 2004:

	2006	2005	2004
Days cash on hand	85	98	80
Days in accounts receivable	64	57	52
Capital investments ($ in millions)	$40.6	$45.3	$38.8
Debt service coverage (times)	9.3	8.0	6.3

Days cash on hand decreased from 98 days at June 30, 2005 to 85 days at June 30, 2006 due primarily to an increase in days in patients accounts receivable and an increase in the receivable for Medi-Cal supplemental funds. The goal set by the University of California Office of the President is a minimum of 60 days.

The days of revenue in accounts receivable measures the average number of days it takes to collect patient accounts receivable. In 2006, net days in receivables increased 7 days to 64 due primarily to an increase in unbilled patient accounts at June 30, 2006 and an increase in Commercial-Contract outpatient activity. The increase in unbilled patient accounts is due to an increase in the number of patients not discharged at fiscal year-end with large balances. The increase in outpatient commercial activity has resulted in an increase in days of revenue in accounts receivable as collection of payments from commercial payors is typically longer than that of government payors including Medicare, Medi-Cal, and Champus. The Medical Center is currently taking actions to reduce days of revenue in account receivable below 60 days, which includes engaging an outside agency to assist with collections of outpatient accounts.

The debt service coverage ratio for 2006 was 9.3 times debt service compared to 8.0 times debt service in 2005. This increase in debt service coverage ratio for 2006 is due to the increase in net income. Total debt service payments were $12.1 million in 2006 and $10.0 million in 2005.

Looking Forward

The Hospital Facilities Seismic Safety Act (SB 1953)
During 2005, the Medical Center's capital program continued to address the requirements in the State of California Senate Bill 1953 (SB 1953). The projected cost for the Medical Center, which will be compliant with the requirements by January 1, 2013, is $48 million. The capital cost of compliance will be financed through the use of state lease revenue bond funds, Hospital Reserves, gift funds and debt. In 2006 and 2005, $0.4 million and $0.7 million was spent, respectively.

Regulatory Risk
Entities doing business with government payors, including Medicare and Medicaid (Medi-Cal in California), are subject to risks unique to the government-contracting environment that are difficult to anticipate and quantify. Revenues are subject to adjustment as a result of examination by government agencies or contractors. The audit process and the resolution of significant related matters (including disputes based on differing interpretations of the regulations) often are not finalized until several years after the services were rendered.

Medicaid Reform
In 2006, California implemented a new Medicaid fee-for-service (FFS) inpatient hospital payment system. The new payment system is the result of a new federal Medicaid hospital financing waiver that will govern Medicaid FFS inpatient hospital payments for the next five years. In September 2005, the state legislature enacted State of California Senate Bill 1100 (SB 1100) to implement the new waiver. SB 1100 is designed to protect baseline Medicaid funding for the University's medical centers over the next five years – at a minimum hospitals will receive the Medicaid inpatient hospital payments they received in 2005 adjusted for future utilization changes. SB 1100 also allows the University's medical centers to receive additional waiver growth funding subject to the availability of funds. Payments to the University's medical centers under SB 1100 include a combination of Medi-Cal inpatient FFS payments, Medi-Cal Disproportionate Share (DSH) payments and Safety Net Care Pool (SNCP) payments. The SNCP is a new federal allotment available under the waiver. The combination of these payments effectively replace the prior year Medi-Cal inpatient per diem payments, Medi-Cal DSH payments, Medi-Cal SB 1255 supplemental payments, and the Medi-Cal Medical Education supplemental payments. Although the new federal inpatient hospital financing waiver and SB 1100 are designed to ensure a predictable funding Medicaid supplemental payment funding level and provide growth funding, the full financial impact of these changes cannot be fully assessed at this time.

Children's Hospital Bond Act of 2004
During fiscal year 2005, California voters passed Proposition 61 that enables the State of California to issue $750 million in General Obligation bonds to fund capital improvement projects for children's hospitals. Each of the University medical centers is eligible for $30 million of grant funding from this pool of funds. Grant funds must be used for capital projects associated with the care of children and must be used prior to June 30, 2014.

University of California Retirement Plan
The University of California Retirement Plan ("UCRP") costs are funded by a combination of investment earnings, employee member and employer contributions. Since 1990, the Medical Center's contribution rate to the UCRP has been zero. In addition, since 1990, most of the required employee member contributions to the UCRP are being redirected to the separate defined contribution plan maintained by the University.

In 2006, the Regents updated the funding policy for UCRP to provide for a targeted funding level of 100 percent over the long term, and for University and UCRP member contributions at rates necessary to maintain that level within a range of 95 percent to 110 percent. The University will implement a multi-year contribution strategy under which shared employer and employee contribution rates will increase gradually over time to 16 percent of covered compensation, based upon UCRP's current normal cost. The Regents have authorized the initial resumption of shared employer and employee contributions beginning July 1, 2007 gradually increasing over future years toward the normal cost, subject to funding and completion of the budget process.

Pooled Financing for the University's Academic Medical Centers
The Regents of the University of California have authorized University management to establish an Academic Medical Center Pooled Revenue Bond Indenture (AMC Indenture) that will allow the operating revenues of the five University medical centers, including the UCSD Medical Center, to be pooled and pledged for debt repayment, regardless of which medical center uses the proceeds of the financing. Currently, the operating revenues of each medical center are pledged for the financing of their specific capital projects.

Under generally accepted accounting principles, each medical center will include on its statement of net assets only the debt specifically used by each medical center. The contingent liability for each medical center associated with the pooling of its operating revenues under the AMC Indenture will be disclosed in the financial statements.

The University anticipates beginning the implementation of the AMC Indenture during fiscal 2006-07.

Cautionary Note Regarding Forward-Looking Statements

Certain information provided by the Medical Center, including written as outlined above or oral statements made by its representatives, may contain forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, which address activities, events or developments that the Medical Center expects or anticipates will or may occur in the future contain forward-looking information.

In reviewing such information it should be kept in mind that actual results may differ materially from those projected or suggested in such forward-looking information. This forward-looking information is based upon various factors and was derived using various assumptions. The Medical Center does not undertake to update forward-looking information contained in this report or elsewhere to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking information.

University of California, San Diego Medical Center
Statements of Net Assets
At June 30, 2006 and 2005
(Dollars in thousands)

Assets	**2006**	**2005**
Current assets:		
Cash	$ 119,022	$ 124,455
Patient accounts receivable, net of estimated uncollectibles of $5,111 and $3,010, respectively	92,091	67,217
Third-party payor settlements	27	
Other receivables, net of estimated uncollectibles of $249 and $346, respectively	19,856	14,885
Inventory	8,743	8,388
Prepaid expenses and other assets	7,221	6,415
Total current assets	246,960	221,360
Capital assets, net	306,120	291,788
Investments in joint ventures	886	3,981
Other plant assets	1,332	1,431
Prepaid expenses and other assets, net of current portion	638	447
Total assets	555,936	519,007
Liabilities		
Current liabilities:		
Accounts payable and accrued expenses	$ 33,570	$ 37,950
Accrued salaries and benefits	26,648	23,594
Third-party payor settlements	-	24,994
Current portion of long-term debt and capital leases	25,987	25,666
Total current liabilities	86,205	112,204
Long-term debt and capital leases, net of current portion	77,719	81,199
Total liabilities	163,924	193,403
Net Assets		
Invested in capital assets, net of related debt	203,746	186,354
Unrestricted	188,266	139,250
Total net assets	$ 392,012	$ 325,604

The accompanying notes are an integral part of these financial statements.

University of California, San Diego Medical Center
Statements of Revenues, Expenses and Changes in Net Assets
For the Years Ended June 30, 2006 and 2005
(Dollars in thousands)

	2006	2005
Net patient service revenue, net of provision for doubtful accounts of $9,208 and $8,142, respectively	$ 600,405	$ 521,837
Other operating revenue:		
Clinical teaching support	8,074	7,960
Other	6,196	6,005
Total other operating revenue	14,270	13,965
Total operating revenue	614,675	535,802
Operating expenses:		
Salaries and employee benefits	266,162	244,071
Professional services	19,132	17,052
Medical supplies	124,580	108,999
Other supplies and purchased services	89,013	81,830
Depreciation and amortization	24,866	20,892
Insurance	5,619	5,551
Total operating expenses	529,372	478,395
Income from operations	85,303	57,407
Nonoperating revenue (expenses):		
Interest income	3,474	2,456
Interest expense	(4,598)	(4,388)
Loss on disposal of capital assets	(384)	(535)
Total nonoperating revenues (expenses)	(1,508)	(2,467)
Income before other changes in net assets	83,795	54,940
Other changes in net assets:		
State capital appropriations	3,403	8,894
Donated assets	1,842	-
Health system support	(22,824)	(22,684)
Transfers from (to) University, net	215	(531)
Other	(23)	-
Total other changes in net assets	(17,387)	(14,321)
Increase in net assets	66,408	40,619
Net assets - beginning of year	325,604	284,985
Net assets - end of year	$ 392,012	$ 325,604

The accompanying notes are an integral part of these financial statements.

University of California, San Diego Medical Center
Statements of Cash Flows
For the Years Ended June 30, 2006 and 2005
(Dollars in thousands)

	2006	2005
Cash flows from operating activities:		
Receipts from patients and third-party payors	$ 545,363	$ 527,444
Payments to employees	(226,971)	(203,854)
Payments to suppliers	(254,135)	(219,778)
Payments for benefits	(52,033)	(52,300)
Other receipts	40,401	40,493
Net cash provided by operating activities	52,625	92,005
Cash flows from noncapital financing activities:		
Health system support	(22,824)	(22,684)
Net cash used by noncapital financing activities	(22,824)	(22,684)
Cash flows from capital and related financing activities:		
State capital appropriations	3,403	8,894
Transfers from (to) the University	215	(531)
Proceeds from debt issuance	-	1,699
Proceeds from sale of capital assets	983	106
Purchases of capital assets	(36,047)	(39,645)
Principal paid on long-term debt and capital leases	(7,613)	(5,599)
Interest paid on long-term debt and capital leases	(4,586)	(4,375)
Gifts and donated funds	1,842	-
Net cash used by capital and related financing activities	(41,803)	(39,451)
Cash flows from investing activities:		
Interest income received	3,474	2,456
Investments in joint venture	3,095	823
Net cash provided by investing activities	6,569	3,279
Net (decrease) increase in cash	(5,433)	33,149
Cash - beginning of year	124,455	91,306
Cash - end of year	$ 119,022	$ 124,455

The accompanying notes are an integral part of these financial statements.

University of California, San Diego Medical Center
Statements of Cash Flows (Continued)
For the Years Ended June 30, 2006 and 2005
(Dollars in thousands)

	2006	2005
Reconciliation of income from operations to net cash provided by operating activities:		
Income from operations	$ 85,303	$ 57,407
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation and amortization expense	24,866	20,892
Asset impairment	-	337
Provision for doubtful accounts	9,208	8,142
Changes in operating assets and liabilities:		
Patient accounts receivable	(34,082)	(13,098)
Other receivables	(4,971)	5,113
Inventory	(355)	(186)
Prepaid expenses and other assets	(997)	(261)
Accounts payable and accrued expenses	(4,380)	4,191
Accrued salaries and benefits	3,054	2,532
Third-party payor settlements	(25,021)	6,936
Net cash provided by operating activities	$ 52,625	$ 92,005
Supplemental noncash activities information:		
Capital assets acquired through capital lease obligations	$ 4,541	$ 5,657
Amortization of deferred financing costs	$ 99	$ 99
Amortization of deferred bond premium	$ 87	$ 87

The accompanying notes are an integral part of these financial statements.

1. Organization

The University of California, San Diego Medical Center (the "Medical Center") is a part of the University of California (the "University"), a California public corporation established under Article IX, Section 9 of the California Constitution. The University is administered by The Regents of the University of California ("The Regents"), an independent board composed of 26 members. The Medical Center's activities are monitored by The Regents' Committee on Health Services, with direct management authority being delegated to the Medical Center Director by the Chancellor of the San Diego campus. The Medical Center operates licensed bed facilities as follows: the 386 bed UCSD Medical Center in Hillcrest, near downtown San Diego, the 119 bed John M. and Sally B. Thornton Hospital ("Thornton Hospital") located in La Jolla, and the 35 bed child and adolescent programs at Alvarado Hospital.

2. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of the Medical Center have been prepared in accordance with accounting principles generally accepted in the United States of America, including all applicable statements of the Governmental Accounting Standards Board ("GASB"), and all statements of the Financial Accounting Standards Board through November 30, 1989. The proprietary fund method of accounting is followed and uses the economic resources measurement focus and the accrual basis of accounting. In addition, these statements follow generally accepted accounting principles applicable to the health care industry, which are included in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Health Care Organizations* to the extent that these principles do not contradict GASB.

GASB Statement No. 47, *Accounting for Termination Benefits*, was adopted during the year ended June 30, 2006. Statement No. 47 requires benefits such as early retirement incentives or severance to employees who are involuntarily terminated to be recognized in the period the Medical Center becomes obligated to provide the benefits. Benefits provided to employees who voluntarily terminate must be recognized when the termination offer is accepted. The effect of the implementation of GASB Statement No. 47 was not significant to the Medical Center's net assets or changes in net assets for the year ended June 30, 2006.

2. Summary of Significant Accounting Policies (Continued)

Cash

All University operating entities maximize the returns on their cash balances by investing in a short-term investment pool ("STIP") managed by the Treasurer of The Regents. The Regents are responsible for managing the University's STIP and establishing investment policy, which is carried out by the Treasurer of The Regents.

Substantially all of the Medical Center's cash is deposited into the STIP. All Medical Center deposits into the STIP are considered demand deposits. Unrealized gains and losses associated with the fluctuation in the fair value of the investments included in the STIP (and predominately held to maturity) are not recorded by each operating entity but are absorbed by the University, as the manager of the pool.

The Medical Center's cash at June 30, 2006 and 2005 was $119,022 and $124,455, respectively. None of these amounts are insured by the Federal Deposit Insurance Corporation.

Interest income is reported as non-operating revenue in the statements of revenues, expenses and changes in net assets.

Additional information on cash and investments can be obtained from the 2005-2006 annual report of the University.

Inventory

The Medical Center's inventory consists primarily of pharmaceuticals and medical supplies which is stated on a first-in, first-out basis at the lower of cost or market.

Prepaid Expenses and Other Assets

The Medical Center's prepaid expenses and other assets are primarily for pharmaceuticals and medical supplies, rent, equipment and maintenance contracts.

Capital Assets

The Medical Center's capital assets are reported at cost. Depreciation is recorded on a straight-line basis over the estimated useful lives of the assets. Equipment under capital leases is amortized over the shorter period of the lease term or the estimated useful life of the equipment. Lease amortization is included in depreciation and amortization expense. The range of the estimated useful lives for buildings and land improvements is 20 to 40 years and for equipment is 3 to 20 years. Interest on borrowings to finance facilities is capitalized during construction. University guidelines mandate that land purchased with Medical Center funds be recorded as an asset of the Medical Center. Land utilized by the Medical Center but purchased with other sources of funds is recorded as an asset of the University.

2. Summary of Significant Accounting Policies (Continued)

Net Assets
Net assets are required to be classified for accounting and reporting purposes in the following categories:

- Invested in capital assets, net of related debt – Capital assets, net of accumulated depreciation, reduced by outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted – The Medical Center classifies net assets resulting from transactions with purpose restrictions as restricted net assets until the resources are used for the specific purpose or for as long as the provider requires the resources to remain intact.

  - Nonexpendable – Net assets subject to externally imposed restrictions that must be retained in perpetuity by the Medical Center.

  - Expendable – Net assets whose use by the Medical Center is subject to externally imposed restrictions that can be fulfilled by actions of the Medical Center pursuant to those restrictions or that expire by the passage of time.

- Unrestricted – Net assets that are neither restricted nor invested in capital assets, net of related debt. Unrestricted net assets may be designated for specific purposes by management or The Regents. Substantially all unrestricted net assets are allocated for operating initiatives or programs, or for capital programs.

Revenues and Expenses
Revenues received in conducting the programs and services of the Medical Center are presented in the financial statements as operating revenue.

Operating revenue includes net patient service revenue reported at the estimated net realizable amounts from patients, third-party payors including Medicare and Medi-Cal, and others for services rendered, including estimated retroactive audit 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. Laws and regulations governing the Medicare and Medi-Cal 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.

Substantially all of the Medical Center's operating expenses are directly or indirectly related to patient care activities.

Non-operating revenue and expense includes interest income and expense, and the gain or loss on the disposal of capital assets.

2. Summary of Significant Accounting Policies (Continued)

Revenues and Expenses (Continued)

State capital appropriations, health system support, donated assets and other transactions with the University are classified as other changes in net assets.

Charity Care

The Medical Center provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are not reported as net patient service revenue. The Medical Center also provides services to other indigent patients under publicly sponsored programs, which may reimburse at amounts less than the cost of the services provided to the recipients. The difference between the cost of services provided to these indigent persons and the expected reimbursement is included in the estimated cost of charity care.

Transactions with the University and University Affiliates

The Medical Center has various transactions with the University and University affiliates. The University, as the primary reporting entity, has at its discretion the ability to transfer cash from the Medical Center at will (subject to certain restrictive covenants or bond indentures) and use that cash at its discretion. The Medical Center records expense transactions where direct and incremental economic benefits are received by the Medical Center. Those payments, which constitute subsidies or payments for which the Medical Center does not receive direct and incremental economic benefit, are recorded as health system support in the statements of revenues, expenses and changes in net assets.

Certain expenses are allocated from the University to the Medical Center. Allocated expenses reported as operating expenses in the statements of revenues, expenses, and changes in net assets are management's best estimates of the Medical Center's arms-length payment of such amounts for its market specific circumstances. To the extent that payments to the University exceed an arms-length estimated amount relative to the benefit received by the Medical Center, they are recorded as health system support.

Compensated Absences

The Medical Center accrues annual leave for employees at rates based upon length of service and job classification and compensatory time based upon job classification and hours worked.

Tax Exemption

The Regents of the University of California is a California public corporation qualified as a tax-exempt organization under the provisions of Section 501(c)(3) of the Internal Revenue Code and is exempt from federal and state income taxes on related income.

2. Summary of Significant Accounting Policies (Continued)

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures during the reporting period. Although management believes these estimates and assumptions are reasonable, they are based upon information available at the time the estimate or judgment is made and actual amounts could differ from those estimates.

Comparative Information

Certain revisions in classification have been made in the June 30, 2005 financial statements. The provision for doubtful accounts is now recorded as an offset to net patient service revenue rather than an operating expense. The effect on the 2005 presentation was to reduce both operating revenue and operating expense by $8,142.

While the effect on prior period financial statements was not material, management elected to make the revisions to the 2005 presentation to conform with the 2006 presentation. The revisions in classifications to the Medical Center's 2005 financial statements had no effect on previously reported total assets, liabilities and net assets, or increase or decrease in net assets, or net increase or decrease in cash.

New Accounting Pronouncements

In August 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, effective for the Medical Center's fiscal year beginning July 1, 2007. Statement No. 45 requires accrual-based measurement, recognition and disclosure of other postemployment benefit (OPEB) expense, such as retiree medical and dental costs, over the employees' years of service, along with the related liability, net of any plan assets. The Medical Center is currently evaluating the effect, if any, that Statement No. 45 will have on its financial statements.

3. Net Patient Service Revenue

The Medical Center has agreements with third-party payors that provide for payments at amounts different from the Medical Center's established rates. A summary of the payment arrangements with major third-party payors follows:

- ***Medicare*** – Medicare patient revenues include traditional reimbursement under Title XVIII of the Social Security Act (non-risk).

  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 non-acute services, certain outpatient services and medical education costs related to Medicare beneficiaries are paid based, in part, on a cost reimbursement methodology. Medicare reimburses hospitals for covered outpatient services rendered to its beneficiaries by way of an outpatient prospective payment system based on ambulatory payment classifications. The Medical Center does not believe that there are significant credit risks associated with this government agency.

  The Medical Center is reimbursed for cost reimbursable items at a tentative rate with final settlement of such items determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The Medical Center's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization. The Medical Center's Medicare cost reports have been audited by the Medicare fiscal intermediary through June 30, 2002.

- ***Medi-Cal*** – The federal Medicaid program is referred to as Medi-Cal in California. Effective July 1, 2005 Medi-Cal fee-for-service (FFS) inpatient hospital payments are made in accordance with the federal Medicaid hospital financing waiver and State of California Senate Bill 1100 (SB 1100). Medi-Cal Outpatient FFS services are reimbursed based on a fee schedule. SB 1100 is designed to protect baseline Medicaid funding for the Medical Center over the next five years – at a minimum the Medical Center will receive the Medicaid inpatient hospital payments they received in 2004-05 adjusted for future utilization changes. SB 1100 also allows the Medical Center to receive additional waiver growth funding subject to the availability of funds. The total payments made to the Medical Center under SB 1100 will include a combination of Medi-Cal inpatient FFS payments, Medi-Cal Disproportionate Share (DSH) payments, and Safety Net Care Pool (SNCP). The SNCP is a new federal allotment available under the waiver. For the year ended June 30, 2006, the Medical Center recorded total Medi-Cal revenue of $162,831.

3. Net Patient Service Revenue (Continued)

The combination of the payments described above replaced the prior year Medi-Cal inpatient per diem payments, Medi-Cal DSH payments, Medi-Cal SB 1255 supplemental payments and the Medi-Cal Medical Education supplemental payments. For the year ended June 30, 2005, the Medical Center recorded total Medi-Cal revenue of $151,149.

Included in total Medi-Cal revenue for 2006 is $15.9 million related to the reversal of a reserve which had been established as the result of a report issued by the federal Department of Health and Human Services, Office of Inspector General ("OIG") in 2002 ("Audit of California's Medicaid Inpatient Disproportionate Share Hospital Payments for University of California, San Diego Medical Center, State Fiscal Year 1998").

- ***Assembly Bill 915*** – State of California Assembly Bill ("AB") 915, *Public Hospital Outpatient Services Supplemental Reimbursement Program*, provides for supplemental reimbursement equal to the federal share of unreimbursed facility costs incurred by public hospital outpatient departments. This supplemental payment covers only Medi-Cal fee-for-service outpatient services. The supplemental payment is based on each eligible hospital's certified public expenditures ("CPE"), which are matched with federal Medicaid funds. For the years ended June 30, 2006 and 2005, the Medical Center recorded revenue of $11,213 and $12,670, respectively.

- ***Other*** – The Medical Center has entered into agreements with numerous non-government third-party payors to provide patient care to beneficiaries under a variety of payment arrangements. These include arrangements with:

  - Commercial insurance companies that reimburse the Medical Center for reasonable and customary charges. Workers' compensation plans pay negotiated rates and are reported as contract (discounted or per-diem) revenue.

  - Managed care contracts such as those with HMO's and PPO's that reimburse the Medical Center at contracted or per-diem rates, which are usually less than full charges.

  - Counties in the state of California that reimburse the Medical Center for certain indigent patients covered under county contracts.

The most common payment arrangement for inpatient services is a prospectively determined per-diem rate. The most common payment arrangement for outpatient care is a prospective payment system that uses ambulatory payment classifications.

Amounts due from Medicare and Medi-Cal represent 19 percent and 23 percent of net patient accounts receivable at June 30, 2006 and 2005, respectively.

(Dollars in thousands)

3. Net Patient Service Revenue (Continued)

For the years ended June 30, 2006 and 2005, net patient service revenue included $6.9 million and $0.6 million, respectively, due to cost report settlements with Medicare, Medi-Cal and the County Medical Services Program.

Net patient service revenue by major payor for the years ended June 30 is as follows:

	2006	2005
Medicare (Non-Risk)	$ 121,047	$ 105,104
Medi-Cal (Non-Risk)	162,831	151,149
Commercial Insurance	7,443	7,978
Contract (Discounted or Per-Diem)	281,853	232,306
County	17,567	17,366
Non-sponsored/self-pay	9,664	7,934
Total	$ 600,405	$ 521,837

4. Charity Care

Information related to the Medical Center's charity care for the years ended June 30 is as follows:

	2006	2005
Charity care at established rates	$ 76,551	$ 55,817
Estimated cost of charity care	$ 25,245	$ 19,363

Estimated cost in excess of reimbursement for indigent patients under publicly sponsored programs was $11,351 and $9,082 for the years ended June 30, 2006 and 2005, respectively.

(Dollars in thousands)

5. Capital Assets

The Medical Center's capital asset activity for the years ended June 30 is as follows:

	2004	Additions	Disposals	2005	Additions	Disposals	2006
Original Cost							
Land	$ 4,550	$ –	$ –	$ 4,550	$ –	$ –	$ 4,550
Buildings and improvements	297,095	30,275	–	327,370	30,115	–	357,485
Equipment	100,396	21,839	(15,402)	106,833	15,047	(12,397)	109,483
Construction in progress	43,992	(7,149)	(40)	36,803	(4,597)	(52)	32,154
Capital assets, at cost	$ 446,033	$ 44,965	$ (15,442)	$ 475,556	$ 40,565	$ (12,449)	$ 503,672

	2004	Depreciation	Disposals	2005	Depreciation	Disposals	2006
Accumulated Depreciation and Amortization							
Buildings and improvements	$ 112,494	$ 10,522	$ –	$ 123,016	$ 12,826	$ –	$ 135,842
Equipment	65,183	10,370	(14,801)	60,752	12,040	(11,082)	61,710
Accumulated depreciation and amortization	$ 177,677	$ 20,892	$ (14,801)	$ 183,768	$ 24,866	$ (11,082)	$ 197,552
Capital assets, net	$ 268,356			$ 291,788			$ 306,120

Equipment under capital lease obligations and related accumulated amortization is $14,780 and $5,933 in 2006, respectively, and $10,431 and $3,777 in 2005, respectively.

The University has acquired certain facilities and equipment under a capital leases with the State of California Public Works Board. These facilities and equipment were contributed at cost by the University to the Medical Center to support the operations of the Medical Center. Principal and interest payments required under the leases are the obligations of the University and are not reflected in the financial statements of the Medical Center.

6. Investments in Joint Ventures

The Medical Center has entered into joint venture arrangements with two third party entities for the purpose of providing magnetic resonance diagnostic services and bone marrow transplantation services. Investments in these joint ventures are recorded using the equity method. On June 30, 2005, the UCSD Medical Center/Tenet Magnetic Resonance Institute joint venture was terminated and went into its liquidation phase in accordance with the agreement. No impairment has arisen from this event.

(Dollars in thousands)

7. Long-term Debt and Capital Leases

The Medical Center's outstanding debt at June 30 is as follows:

	2006	2005
The Regents of the University of California Hospital Revenue Bonds, Series 2000, collateralized by revenues of the Medical Center, interest rates from 4.125 percent to 10 percent, payable semi-annually, with annual principal payments through 2019	$ 57,335	$ 60,135
The Regents of the University of California General Revenue Bonds 2003, interest rates from 2.0 percent to 5.25 percent, payable semi-annually, with annual principal payments through 2023.	16,169	16,953
The Regents of the University of California Commercial Paper Program, interim financing for UCSD Cancer Center – a joint project with the School of Medicine, with interest capitalized during construction at the tax-exempt commercial paper rate	18,962	18,962
UCSD Energy Conservation Project tax-exempt private placement debt, interest rate of 5.75 percent interest payable semi-annually, annual principal payments through October 2006	818	1,590
Capital lease obligations, primarily for computer and medical equipment, with fixed interest rates of 3.28 percent to 7.79 percent payable through February 2010, collateralized by underlying equipment	9,259	7,975
Unamortized premium, The Regents of the University of California Hospital Revenue Bonds, Series 2000, San Diego Medical Center	1,163	1,250
Total debt and capital leases	103,706	106,865
Less: Current portion of debt and capital leases	(25,987)	(25,666)
Noncurrent portion of debt and capital leases	$ 77,719	$ 81,199

(Dollars in thousands)

7. Long-term Debt and Capital Leases (Continued)

The activity with respect to current and noncurrent debt for the years ended June 30 is as follows:

	Revenue Bonds	Capital Lease Obligations	Total
Year Ended June 30, 2006			
Current portion at June 30, 2005	$ 23,404	$ 2,262	$ 25,666
Reclassification from noncurrent	4,726	3,295	8,021
Amortization of bond premium	(87)	–	(87)
Principal payments	(4,356)	(3,257)	(7,613)
Current portion at June 30, 2006	$ 23,687	$ 2,300	$ 25,987
Noncurrent portion at June 30, 2005	$ 75,486	$ 5,713	$ 81,199
New obligations	–	4,541	4,541
Reclassification to current	(4,726)	(3,295)	(8,021)
Noncurrent portion at June 30, 2006	$ 70,760	$ 6,959	$ 77,719
Year Ended June 30, 2005			
Current portion at June 30, 2004	$ 4,123	$ 1,329	$ 5,452
Reclassification from noncurrent	23,404	2,496	25,900
Amortization of bond premium	(87)	–	(87)
Principal payments	(4,036)	(1,563)	(5,599)
Current portion at June 30, 2005	$ 23,404	$ 2,262	$ 25,666
Noncurrent portion at June 30, 2004	$ 97,191	$ 2,552	$ 99,743
New obligations	1,699	5,657	7,356
Reclassification to current	(23,404)	(2,496)	(25,900)
Noncurrent portion at June 30, 2005	$ 75,486	$ 5,713	$ 81,199

7. Long-term Debt and Capital Leases (Continued)

The Regents of the University of California Hospital Revenue Bonds, Series 2000 ("Series 2000 Bonds") are collateralized solely by revenues of the Medical Center. Under the bond indenture, the Medical Center is required to maintain a debt service coverage ratio of not less than 1.2 and between 1.2 and 2.0 depending upon various circumstances, and has limitations as to additional borrowings, the purchase or sale of business assets and the disposition of liquid assets.

The University issued General Revenue Bonds, collateralized solely by general revenues of the University, to refinance certain Medical Center projects. The Medical Center is charged for its proportional share of total principal and interest payments made on the General Revenue Bonds pertaining to Medical Center projects.

Additional information on the revenue bonds can be obtained from the 2006 annual report of the University.

The University of California's commercial paper program provided construction financing for a portion of the UCSD Cancer Center construction costs. The Medical Center is financially responsible for the clinical portion of this facility, which is $19 million. The Cancer Center was completed in March 2005. It is expected that intermediate or long-term financing will be arranged by the Medical Center during fiscal year 2007 in order the replace the commercial paper financing.

The University has an internal working capital program which allows the Medical Center to receive internal advances up to 60 percent of the Medical Center's accounts receivable for any working capital needs. Interest on any such advance is based upon the earnings rate on the STIP. Repayment of any advances made to the Medical Center under the working capital program is not secured by a pledge of revenues. Currently, there are no advances to the Medical Center. The University may cancel or change the terms of the working capital program at its sole discretion. However, the University has historically provided working capital advances under informal or formal programs for the Medical Center.

(Dollars in thousands)

7. Long-term Debt and Capital Leases (Continued)

Future debt service payments for each of the five fiscal years subsequent to June 30, 2006 and thereafter are as follows:

Year Ending June 30,	Revenue Bonds	Capital Leases	Total Payments	Principal	Interest
2007	$ 27,197	$ 2,635	$ 29,832	$ 25,987	$ 3,845
2008	7,387	2,524	9,911	6,347	3,564
2009	7,382	2,525	9,907	6,603	3,304
2010	7,380	2,022	9,402	6,368	3,034
2011	7,375	324	7,699	4,904	2,795
2012-2016	35,836	–	35,836	25,422	10,414
2017-2021	29,267	–	29,267	25,736	3,531
2022-2023	2,522	–	2,522	2,339	183
Total future debt service	124,346	10,030	134,376	$ 103,706	$ 30,670
Less: Interest component of future payments	(29,899)	(771)	(30,670)		
Principal portion of future payments	$ 94,447	$ 9,259	$ 103,706		

(Dollars in thousands)

8. Operating Leases

The Medical Center leases buildings and equipment under agreements recorded as operating leases. Operating lease expense for the years ended June 30, 2006 and 2005 was $3,299 and $2,283, respectively. The terms of the operating leases extend through the year 2011.

Future minimum payments on operating leases with an initial or non-cancelable term in excess of one year are as follows:

Year Ending June 30	
2007	$ 2,632
2008	2,445
2009	1,052
2010	326
2011	85
Total	$ 6,540

9. Retirement Plans

Substantially all full-time employees of the Medical Center participate in the University of California Retirement System ("UCRS") that is administered by the University. The UCRS consists of The University of California Retirement Plan ("UCRP"), a single employer, defined benefit plan and the University of California Retirement Savings Program ("UCRSP") that includes three defined contribution plans with several investment portfolios generally funded with employee non-elective and elective contributions.

The UCRP provides lifetime retirement income, disability protection, and survivor benefits to eligible employees. Benefits are based on average highest three years compensation, age, and years of service and are subject to limited cost-of-living increases. Contributions to the UCRP may be made by the University and the employees. The University's policy is to provide for a targeted funding level of 100 percent over the long-term, and for the University and UCRP member contributions to be set at rates necessary to maintain that level within a range of 95 percent to 110 percent.

The actuarial value of UCRP assets and the actuarial accrued liability using the entry age normal cost method as of June 30, 2006 were $42 billion and $40.3 billion, respectively. The net assets held in trust for pension benefits on the UCRP Statement of Plan's Fiduciary Net Assets were $43.4 billion at June 30, 2006. For the years ended June 30, 2006 and 2005, there was no employer contribution, annual pension cost or net pension obligation for the University. The annual pension cost was equal to the actuarially determined contributions.

9. Retirement Plans (Continued)

The UCRSP plans (DC Plan, 403(b) Plan and 457(b) Plan) provide savings incentives and additional retirement security for all eligible employees. The DC Plan accepts both pre-tax and after-tax employee contributions. The 403(b) and 457(b) plans accept pre-tax employee contributions. The Medical Center may also make contributions on behalf of certain members of management. Benefits from the plans are based on participants' mandatory and voluntary contributions, plus earnings, and are immediately vested.

Information related to contributions made, plan assets and liabilities, as they relate to Medical Center employees, is not readily available. Additional information on the plans can be obtained from the 2006 annual report of the University.

10. University Self-Insurance

The Medical Center is insured through the University's malpractice, general liability, workers' compensation, and health and welfare self-insurance programs. All operating departments of the University are charged premiums to finance the workers' compensation and health and welfare programs. The University's medical centers are charged premiums to finance the malpractice insurance. All claims and related expenses are paid from the University's self-insurance funds. Such risks are subject to various per claim and aggregate limits, with excess liability coverage provided by an independent insurer. The Medical Center is contingently liable for the obligations under these self-insurance programs.

The Medical Center's self-insurance premiums were $8,995 and $15,844 for the years ended June 30, 2006 and 2005, respectively.

Workers' compensation premiums, included as salaries and employee benefits expense in the statement of revenues, expenses and changes in net assets, were $3,269 and $10,161 for the years ended June 30, 2006 and 2005, respectively. During 2006, as a result of the most recent actuarial analysis, the Medical Center received a refund of premium of $5,851 from the University that reduced the overall workers' compensation cost for the year.

Combined malpractice and general liability premiums, recorded as insurance expense in the statement revenues, expenses and changes in net assets, were $5,726 and $5,683 for the years ended June 30, 2006 and 2005, respectively.

(Dollars in thousands)

11. Transactions with Other University Entities

Services purchased from the University include office and medical supplies, building maintenance, repairs and maintenance, administrative, treasury, medical services, and insurance. Services provided to the University include physician office rentals, pharmaceuticals, billing services, medical supplies and cafeteria services. Such amounts are netted and included in the statements of revenues, expenses and changes in net assets for the years ended June 30 as follows:

	2006	2005
Salaries and employee benefits	$ 1,461	$ 1,404
Professional services	19,133	17,053
Medical supplies	(1,059)	(1,061)
Other supplies and purchased services	(6,616)	(6,525)
Interest income	(2,677)	(1,653)
Insurance	5,619	5,551
Total	$ 15,861	$ 14,769

Additionally, the Medical Center makes payments to the University of California, San Diego School of Medicine ("School of Medicine"). Services purchased from the School of Medicine include physician services that benefit the Medical Center, such as emergency room coverage, physicians providing medical direction to the Medical Center, and the Medical Center's allocation of malpractice insurance. Such expenses are reported as operating expenses in the statements of revenue, expenses and changes in net assets. Health system support includes amounts paid by the Medical Center to fund School of Medicine operating activities, payments to support clinical research, transfers to faculty practice plans, as well as other payments made to support various School of Medicine programs.

The total net amount of payments made by the Medical Center to the University were $38,685 and $37,453 in 2006 and 2005, respectively. Of these amounts, $15,861 and $14,769 are reported as operating expenses for the years ended June 30, 2006 and 2005, respectively, and $22,824 and $22,684 are reported as health system support for the years ended June 30, 2006 and 2005, respectively.

12. State Funds for Capital Acquisitions

The 2000 State Budget Act provided $50 million in state capital appropriations for non-seismic capital improvement (i.e., infrastructure) projects at the University's medical centers. The Medical Center was allocated $25 million of the $50 million state capital appropriation. During fiscal years 2006 and 2005, $3,403 and $8,894, respectively, was expended and received by the Medical Center and reflected as a state capital appropriation in the statements of revenues, expenses and changes in net assets.

13. Commitments and Contingencies

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations is subject to periodic government review, interpretation and audits, as well as regulatory actions unknown and unasserted at this time.

The University is contingently liable in connection with certain claims and contracts, including those currently in litigation, arising out of the normal course of its activities. Management and General Counsel are of the opinion that the outcome of such matters will not have a material effect on the financial statements.

State of California Senate Bill 1953, Hospital Facilities Seismic Safety Act, specifies certain requirements that must be met within a specified time in order to increase the probability that the hospital could maintain uninterrupted operations following major earthquakes. By January 1, 2008, all general acute care inpatient buildings must be life safe. By January 1, 2030, all general acute care inpatient buildings must be operational after an earthquake. Previously, the State of California's budget authorized the University to use $600 million in lease-revenue bond funds for earthquake safety renovations. The Regents have approved the allocation of the $600 million among the University's medical centers, of which $40 million was allocated to the Medical Center. The Medical Center spent $0 and $0 of its allocation during the years ended June 30, 2006 and 2005, respectively. As of June 30, 2006, any repayment the Medical Center may be obligated for, under these financing arrangements, is still being determined.