University of California, Davis Medical Center

Report on Audits of Financial Statements
For the Years Ended June 30, 2007 and 2006

University of California, Davis Medical Center
Report on Audits of Financial Statements

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Report of Independent Auditors

The Regents of the University of California
Oakland, California

In our opinion, the accompanying financial statements, as shown on pages 13 through 36, present fairly, in all material respects, the financial position of the University of California, Davis Medical Center (the "Medical Center"), a division of the University of California ("University"), at June 30, 2007 and 2006, 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, 2007 and 2006, 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 12 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

October 10, 2007

Introduction

The objective of the Management's Discussion and Analysis is to help readers better understand the University of California, Davis Medical Center's financial position and operating activities for the years ended June 30, 2007, with selected comparative information for the years ended June 30, 2006 and 2005. 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 (2005, 2006, 2007, 2008, etc.) in this discussion refer to the fiscal years ended June 30.

Overview

The University of California, Davis Medical Center (the "Medical Center") has served as the principal clinical teaching site for the UC Davis School of Medicine since the school was founded in 1966. Initially the school used the Sacramento County hospital for clinical training, but in 1973 the University acquired the hospital outright and began operating it as the UC Davis Medical Center.

Licensed as a 577-bed general acute care hospital with 25 operating rooms, the Medical Center provides a full range of inpatient general acute and intensive care, and a full complement of ancillary, support and ambulatory services. These services are housed in about 3 million gross square feet of facilities, most of which are sited on the 140-acre campus in the City of Sacramento. Ambulatory care is provided at the hospital-based clinics and at the 17 Primary Care Network ("PCN") satellite clinics in the surrounding communities of Auburn, Carmichael, Colusa, Davis, Elk Grove, Folsom, Rancho Cordova, Rocklin, Roseville, and Sacramento.

The Medical Center serves as a tertiary care referral hospital for a 33-county 65,000-square-mile service area with a population of six million. Its range of services includes heart and vascular surgery, transplant, and neurological surgery, and it is a designated Children's Hospital within a Hospital. It is the only provider of several tertiary/quaternary services between San Francisco and Portland, including Level 1 Adult & Pediatric Trauma care, National Institutes of Health designated Cancer Center, and adult burn care.

The Medical Center participates in a variety of cooperative outreach activities with regional health care providers, such as the development and operation of two cancer centers in cooperation with community-based providers in Marysville and Merced. In addition, the Medical Center operates a nationally recognized clinical telemedicine, distance education and rural affiliation program, and has affiliations with the VA and Lawrence Livermore National Laboratory and Shriners.

Inpatient and outpatient medical services are provided by the UC Davis Medical Group, with approximately 710 faculty and contract physicians, 630 residents and fellows, and 110 PCN physicians.

For the year ended June 30, 2007, 33,825 patients were admitted to the Medical Center, of which approximately 51 percent were admitted through the emergency room, and overall occupancy was approximately 83 percent. During the same period, there were over 924,000 outpatient visits, of which approximately 827,000 were visits to the Clinics and the PCN Sites and approximately 53,000 were emergency room visits.

Operating Statistics

The following table presents utilization statistics for the Medical Center for 2007, 2006 and 2005:

Statistics	2007	2006	2005
Admissions	33,825	33,341	32,886
Average daily census	471	442	425
Average length of stay	5.1	4.8	4.7
Case mix index	1.56	1.55	1.54
Patient days:			
Medicare (non-risk)	39,949	37,499	34,085
Medi-Cal (non-risk)	45,462	39,457	40,990
Commercial	104	206	299
County	15,758	14,641	14,488
Contracts (discounted/per diem)	48,678	46,197	41,908
Contracts (capitated)*	20,051	20,678	21,527
Non-sponsored/self-pay	1,852	2,787	1,728
Total patient days	171,854	161,465	155,025
Outpatient visits:			
Hospital clinics	368,253	373,661	355,806
Primary care network	423,372	419,319	418,665
Home health/hospice	44,020	52,595	53,456
Emergency visits	52,937	47,906	46,196
PCN outreach	35,617	39,536	35,467
Total visits	924,199	933,017	909,590

* Includes Medicare (risk)
Medi-Cal (risk)

In 2007, admissions increased by 484 or 1.5 percent over 2006. The average length of stay increased from 4.8 to 5.1 days due to a slightly higher case mix index and several discharges with length of stays of greater than 300 days. Hospital clinic visits decreased by 1.4 percent. PCN visits increased by 1.0 percent in 2007 and PCN outreach visits decreased by 9.9 percent primarily due to staffing changes. Emergency visits increased by 10.5 percent in 2007 primarily due to the Fast Track program expansion. Home Health visits decreased by 16.3 percent due to high staff turnover.

Statements of Revenues, Expenses and Changes in Net Assets

This statement shows the revenue, expenses and changes in net assets for the Medical Center for 2007 compared to the prior two years.

The following table summarizes the operating results for the Medical Center for fiscal years 2007, 2006 and 2005 (dollars in thousands):

	2007	2006	2005
Net patient service revenue	$ 928,896	$ 850,041	$ 805,443
Other operating revenue	14,736	13,674	14,349
Total operating revenue	943,632	863,715	819,792
Total operating expenses	881,503	799,047	763,194
Income from operations	62,129	64,668	56,598
Total non-operating expenses	(4,915)	(6,791)	(13,211)
Income before other changes in net assets	$ 57,214	$ 57,877	$ 43,387
Margin	6.1 percent	6.7 percent	5.3 percent
Other changes in net assets	11,531	(13,766)	(5,886)
Net assets – beginning of year	611,555	567,444	529,943
Net assets – end of year	$ 680,300	$ 611,555	$ 567,444

Revenues

Total operating revenues for the year ended June 30, 2007 were $943.6 million, an increase of $79.9 million, or 9.3 percent, over 2006. Operating revenues for 2006 of $863.7 million increased by $43.9 million, or 5.4 percent, over 2005.

Net patient service revenue for 2007 increased by $78.9 million, or 9.3 percent, over 2006. Net patient service revenue in 2006 increased by $44.6 million, or 5.5 percent, over 2005. The increase in 2007 was primarily due to increased inpatient volume and favorable payor mix. Patient service revenues are net of estimated allowances from contractual arrangements with Medicare, Medi-Cal and other third-party payors and have been estimated based on the terms of reimbursement and contracts currently in effect.

Other operating revenue consisted primarily of State Clinical Teaching Support Funds ("CTS") and other non-patient services such as cafeteria and campus revenues.

The following table summarizes net patient service revenue for 2007, 2006 and 2005 (dollars in thousands):

Payor	2007	2006	2005
Medicare (non-risk)	$ 178,598	$ 158,273	$ 137,503
Medi-Cal (non-risk)	108,683	119,728	129,655
Commercial	1,378	2,261	2,794
County	32,718	30,968	30,501
Contracts (discounted/per-diem)	461,842	406,917	373,614
Contracts (capitated)*	140,839	124,350	126,721
Non-sponsored/self-pay	4,838	7,544	4,655
Total	$ 928,896	$ 850,041	$ 805,443

* Includes Medicare and Medi-Cal risk

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. Medicare reimburses the Medical Center for allowable costs 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. Settlements with the Medicare program for prior years cost reports are recognized in the year the settlement is resolved. Excluding settlement adjustments, net patient revenue for Medicare increased by $18.7 million over the prior fiscal year.

Payments for Medi-Cal patients include a combination of Medi-Cal inpatient fee for service (FFS) payments, Medi-Cal Disproportionate Share ("DSH") payments, and Safety Net Care Pool ("SNCP"). The net patient revenue for Medi-Cal decreased by $11 million from 2006. This decrease is primarily due to a change in the allocation of the new Safety Net Care Pool.

Contracts net patient revenue (discounted/per-diem) increased by $54.9 million, or 13.5 percent primarily due to volume and contract rate increases.

The net patient service revenue for contracts that are full-risk capitation increased by $16.5 million, or 13.3 percent, due primarily to a slight decline in the enrollment and prior year revenue adjustments.

The non-sponsored/self-pay net revenue decreased from the prior year by $2.7 million, or 35.9 percent. This category fluctuates from year to year depending on the volume and type of patients.

Operating Expenses
During 2007, total operating expenses of $881.5 million increased by $82.5 million, or 10 percent, over 2006 and were primarily due to volume. Increases were primarily in salaries and benefits and medical supplies. In 2006, total operating expenses of $799.0 million increased by $35.9 million, or 4.7 percent, over 2005 primarily due to volume.

Salary and employee benefit expenses include wages paid to hospital employees, vacation, holiday and sick pay, payroll taxes, workers' compensation insurance premiums, health insurance and other employee benefits. Amounts paid for other contracted labor are included in purchased services. Salary increases accounted for $43.0 million, due mainly to wage increases. Increases in total benefits costs were $8.4 million. Health insurance benefits were higher by $4.2 million, but workers' compensation insurance expense was down by $1.6 million due to lower rates. In 2007, the refund of prior year workers' compensation premiums totaled $6.2 million while in 2006 the same refund totaled $9.6 million. Salary and employee benefit expenses increased by $51.4 million, or 11.1 percent, over 2006.

Payments for professional services increased by $1.6 million, or 2.6 percent, over 2006 due to increases in services and support provided by the UC Davis School of Medicine. In 2006, professional services decreased by $2.2 million, or 3.4 percent, over 2005 due to decreases in these same services and support.

Medical supplies expense for 2007 increased by $11.5 million, or 9 percent, over 2006 due to volume and inflation. The cost of pharmaceuticals increased by $2.2 million due to volume, inflation and increased usage of high cost drugs. In 2006, medical supplies expense increased by $6.9 million, or 5.7 percent, over 2005. The cost of pharmaceuticals increased by $6.3 million due to volume, inflation and increased usage of high cost drugs.

Other supplies and purchased services increased by $18.2 million, or 25.5 percent, over the prior year. Other supplies and purchased services decreased $2.4 million in 2006 over 2005.

Depreciation and amortization expense increased by $1.8 million over the prior year due to investment in capital assets.

Insurance expense of $6.5 million was primarily the Medical Center's contribution to the University of California's self-insured malpractice fund. This expense increased by $0.8 million, or 14.4 percent, over the prior year.

Non-operating Revenues (Expenses)
Total non-operating expenses were $4.9 million for 2007 compared to $6.8 million in the prior year. The decrease was primarily due to a decrease in interest expense of $1.3 million, an increase in interest income of $1.1 million and an increase in loss on disposal of assets of $0.6 million.

Income before Other Changes in Net Assets
The Medical Center's income before other changes in net assets was $57.2 million for 2007 compared to $57.9 million for 2006 and $43.4 million in 2005. The Medical Center had increased revenues from volume and improved payor mix, however, operating expenses increased in salaries, benefits and medical supplies.

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 for 2007 are the following:

- Contributions from the University for the building program of $16.1 million are related to the Surgery and Emergency Pavilion project and represent funding from the State Public Works Board Bonds.

- Health system support represents transfers primarily to the School of Medicine for academic and research support. The Medical Center transferred $14.1 million this year.

- Donated land totaled $8.2 million and is 14.4 acres located in Rocklin, California.

- Transfers from the University totaled $1.4 million and were primarily capital expenditures funded by the parking restricted fund.

In total, the net assets increased for the year ended June 30, 2007 by $68.7 million to $680 million. The majority of this increase is due to income before other changes in net assets.

Statements of Net Assets

The following table is an abbreviated statement of net assets at June 30, 2007, 2006 and 2005 (dollars in thousands):

	2007	2006	2005
Current assets:			
Cash	$ 153,305	$ 142,852	$ 153,105
Restricted assets, held by trustee	1,819	8,622	8,551
Patient accounts receivable (net)	153,362	135,599	134,640
Other current assets	34,869	47,863	31,183
Total current assets	343,355	334,936	327,479
Restricted assets – Cash for capital projects	64,967	–	–
Capital assets (net)	818,576	737,738	709,223
Other assets	20,479	17,528	15,961
Total assets	1,247,377	1,090,202	1,052,663
Current liabilities	161,445	134,219	129,971
Long-term debt	405,632	344,428	355,248
Total liabilities	567,077	478,647	485,219
Net assets:			
Invested in capital assets (net)	441,727	375,358	342,183
Restricted – expendable for debt service	1,819	8,622	8,551
Unrestricted	236,754	227,575	216,710
Total net assets	$ 680,300	$ 611,555	$ 567,444

Total current assets increased by $8.4 million, or 2.5 percent, from 2006 to 2007 primarily due to an increase in cash of $10.5 million. Total current assets for 2006 increased by $7.5 million over 2005.

Cash increased by $10.5 million in 2007. The increase was primarily due to the timing of current liabilities.

Restricted assets, held by trustee decreased by $6.8 million from the prior year because the 1996 Hospital Revenue Bonds were paid in full in 2007.

Net patient accounts receivable increased by $17.8 million from the prior year due to increased volume.

Other current assets, including non-patient receivables, inventory and prepaid expenses, decreased by $13 million over the prior fiscal year. The decrease was primarily related to $15.2 million of payments for the new Safety Net Care Pool in non-patient receivables.

Net capital assets increased by $80.8 million from 2006 to 2007 primarily due to construction of the Surgery and Emergency Services Pavilion and the Electronic Medical Records (EMR). The increase of $28.5 million from 2005 to 2006 was primarily due to construction of the Surgery and Emergency Services Pavilion and equipment.

Restricted assets – cash, for the Pavilion capital project, increased from 2006 to 2007 by $65 million from the proceeds of the new pooled revenue bonds.

Current liabilities increased by $27.2 million from 2006 to 2007 primarily due to an increase of $14.9 million in construction contracts payable, $6.1 million in third party payor settlements and $6.1 million in accrued payroll.

Long term debt increased by $61.2 million from 2006 to 2007 due to $65 million of new pooled revenue bonds. Long-term debt decreased by $10.8 million from 2005 to 2006.

Net assets increased by $68.7 million from 2006 to 2007. This increase reflects $57.2 million from income before other changes in net assets, $16.1 million from contributions from the University for building program, $8.2 million of donated land less $14.1 million of Health System capital and operational support for the research and the teaching missions of the Health System.

Liquidity and Capital Resources

During 2007, the Medical Center generated $113.2 million from operating activities.

Cash flows from non-capital financing activities show the Medical Center's cash was reduced by $12.7 million primarily for transfers to the University for health system support.

Included in cash flows from capital and related financing activities were contributions from the University for funding from the State Public Works Board Bonds of $16.1 million, proceeds from financing loans of $15.2 million, purchases of capital assets of $106 million, principal payments on long-term debt and capital leases of $17.4 million and interest paid of $11.4 million.

Cash flows from investing activities show that $6.8 million was provided by interest income, $6.8 million was provided by decreased restricted assets held by trustee and $65.0 million was restricted for capital projects. Overall cash increased to $153.3 million in 2007 from $142.9 million in 2006.

The following table shows key liquidity and capital ratios for 2007, 2006 and 2005:

	2007	2006	2005
Days cash on hand	65	71	81
Days of revenue in accounts receivable	47	55	58
Debt service coverage ratio	3.5	4.2	3.9

Days cash on hand decreased to 65 days in 2007 from 71 days in 2006. Days cash on hand measures the average number of days' expenses the Medical Center maintains in cash. The goal set by the University of California Office of the President is 60 days.

The days of revenue in accounts receivable measures the average number of days it takes to collect patient accounts receivable. In 2007, days in accounts receivable decreased by 8 days to 47. The main reason for this decrease was the result of increased collections.

Debt service coverage ratio measures the amount of funds available to cover the principal and interest on long-term debt. The Medical Center's ratio for 2007 is 3.5 versus 4.2 in 2006. The decrease was due to the new $65 million of Pooled Revenue Bonds. This ratio is higher than the 1.2 required by the Bond Indenture.

Looking Forward

The Hospital Facilities Seismic Safety Act (SB 1953)
During 2007, the UC Davis 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 statutory requirements by January 1, 2013, is $227.3 million. The capital cost of compliance will be financed through the use of state lease revenue bond funds, Medical Center reserves and gift funds. In 2007, $31.9 million was spent on these requirements.

Payments from Federal and State Health Care Programs
Entities doing business with governmental 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 as well as auditors, contractors, and intermediaries retained by the federal, state, or local governments (collectively "Government Agents"). Resolution of such audits or reviews often extends (and in some cases does not even commence until) several years beyond the year in which services were rendered and/or fees received.

Moreover, different Government Agents frequently interpret government regulations and other requirements differently. For example, Government Agents might disagree on a patient's principal medical diagnosis, the appropriate code for a clinical procedure, or many other matters. Such disagreements might have a significant effect on the ultimate payout due from the government to fully recoup sums already paid. Governmental agencies may make changes in program interpretations, requirements, or "conditions of participation," some of which may have implications for amounts previously estimated. In addition to varying interpretation and evolving codification of the regulations, standards of supporting documentation and required data are subject to wide variation.

In accordance with generally accepted accounting principles, to account for the uncertainty around Medicare and Medicaid revenues, the Medical Center estimates the amount of revenue that will ultimately be received under the Medicare and Medi-Cal programs. Amounts ultimately received or paid may vary significantly from these estimates.

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 ("waiver") that will govern Medicaid FFS inpatient hospital payments through fiscal year 2010. In September 2005, the California state legislature enacted 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 from 2006 through 2010 – at a minimum medical centers will receive the Medicaid inpatient hospital payments they received in 2005 adjusted for yearly changes in costs. 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 replaces the Medi-Cal inpatient per diem payments, Medi-Cal DSH payments, Medi-Cal SB 1255 supplemental payments, and the Medi-Cal Medical Education supplemental payments, which were in effect in 2005. Although the new federal inpatient hospital financing waiver and SB 1100 are designed to ensure a predictable 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

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, 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 not yet authorized the initial resumption of shared employer and employee contributions.

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, Davis Medical Center
Statements of Net Assets
June 30, 2007 and 2006
(Dollars in thousands)

	2007	2006
Assets		
Current assets:		
Cash	$ 153,305	$ 142,852
Restricted assets, held by trustee	1,819	8,622
Patient accounts receivable, net of estimated uncollectibles of $27,033 and $19,572, respectively	153,362	135,599
Other receivables, net of estimated uncollectibles of $0 and $1, respectively	13,398	32,105
Inventory	12,213	6,285
Prepaid expenses and other assets	9,258	9,473
Total current assets	343,355	334,936
Restricted assets:		
Cash restricted for capital projects	64,967	–
Capital assets, net	818,576	737,738
Investments in joint ventures	14,311	11,987
Deferred costs of issuance	6,168	5,541
Total assets	1,247,377	1,090,202
Liabilities		
Current liabilities:		
Accounts payable and accrued expenses	44,620	24,854
Accrued salaries and benefits	51,103	44,795
Third-party payor settlements	34,863	28,727
Current portion of long-term debt and capital leases	19,509	15,573
Other liabilities	11,350	20,270
Total current liabilities	161,445	134,219
Long-term debt and capital leases, net of current portion	405,632	344,428
Total liabilities	567,077	478,647
Net Assets		
Invested in capital assets, net of related debt	441,727	375,358
Restricted:		
Expendable:		
Debt service	1,819	8,622
Unrestricted	236,754	227,575
Total net assets	$ 680,300	$ 611,555

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

University of California, Davis Medical Center
Statements of Revenues, Expenses and Changes in Net Assets
For the Years Ended June 30, 2007 and 2006
(Dollars in thousands)

	2007	2006
Net patient service revenue, net of provision for doubtful accounts of $37,994 and $39,610, respectively	$ 928,896	$ 850,041
Other operating revenue:		
Clinical teaching support	7,789	7,789
Other	6,947	5,885
Total other operating revenue	14,736	13,674
Total operating revenue	943,632	863,715
Operating expenses:		
Salaries and employee benefits	516,291	464,847
Professional services	63,871	62,262
Medical supplies	139,585	128,053
Other supplies and purchased services	89,893	71,652
Depreciation and amortization	55,377	53,560
Insurance	6,461	5,650
Other	10,025	13,023
Total operating expenses	881,503	799,047
Income from operations	62,129	64,668
Non-operating revenues (expenses):		
Interest income	6,829	5,719
Interest expense	(13,447)	(14,777)
Loss on disposal of capital assets	(577)	(12)
Other	2,280	2,279
Total non-operating expenses	(4,915)	(6,791)
Income before other changes in net assets	57,214	57,877
Other changes in net assets:		
Contributions from University for building program	16,073	424
Donated assets	8,200	–
Health system support	(14,137)	(16,173)
Transfers from University	1,395	1,983
Total other changes in net assets	11,531	(13,766)
Increase in net assets	68,745	44,111
Net assets – beginning of year	611,555	567,444
Net assets – end of year	$ 680,300	$ 611,555

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

University of California, Davis Medical Center
Statements of Cash Flows
For the Years Ended June 30, 2007 and 2006
(Dollars in thousands)

	2007	2006
Cash flows from operating activities:		
Receipts from patients and third-party payors	$ 935,977	$ 835,807
Payments to employees	(418,821)	(387,311)
Payments to suppliers	(321,085)	(279,095)
Payments for benefits	(94,469)	(86,045)
Other receipts, net	11,582	11,396
Net cash provided by operating activities	113,184	94,752
Cash flows from noncapital financing activities:		
Health system support	(14,137)	(16,173)
Transfers from University	1,395	1,983
Net cash used by noncapital financing activities	(12,742)	(14,190)
Cash flows from capital and related financing activities:		
Proceeds from contributions by University for building program	16,073	424
Proceeds from debt issuance	65,543	–
Proceeds from financing loan	15,170	5,522
Proceeds from sale of capital assets	193	236
Bond issuance costs	(911)	–
Purchases of capital assets	(105,986)	(74,403)
Principal paid on long-term debt and capital leases	(17,356)	(15,966)
Interest paid on long-term debt and capital leases	(11,380)	(12,713)
Net cash used by capital and related financing activities	(38,654)	(96,900)
Cash flows from investing activities:		
Interest income received	6,829	5,719
Distributions from investments in joint ventures, net	–	437
Change in restricted assets	(58,164)	(71)
Net cash (used) provided by investing activities	(51,335)	6,085
Net increase (decrease) in cash	10,453	(10,253)
Cash – beginning of year	142,852	153,105
Cash – end of year	$ 153,305	$ 142,852

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

University of California, Davis Medical Center
Statements of Cash Flows (Continued)
For the Years Ended June 30, 2007 and 2006
(Dollars in thousands)

	2007	2006
Reconciliation of income from operations to net cash provided by operating activities:		
Income from operations	$ 62,129	$ 64,668
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation and amortization expense	55,377	53,560
Provision for doubtful accounts	37,994	39,610
Changes in operating assets and liabilities:		
Patient accounts receivable	(55,757)	(40,569)
Other receivables	18,707	(14,276)
Inventory	(5,928)	(511)
Prepaid expenses and other assets	215	(1,893)
Accounts payable and accrued expenses	(3,077)	(3,695)
Accrued salaries and benefits	6,308	(5,137)
Third-party payor settlements	6,136	1,001
Other liabilities	(8,920)	1,994
Net cash provided by operating activities	$ 113,184	$ 94,752

	2007	2006
Supplemental noncash activities information:		
Amortization of deferred financing costs and bond premium	$ 1,783	$ 2,064
Amortization of issuance cost	$ 284	$ –
Donated land	$ 8,200	$ –
Payables for property and equipment	$ 22,843	$ 7,920

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

1. Organization

The University of California, Davis 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 Davis campus. The Medical Center has 577 licensed beds.

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. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, was adopted during the year ended June 30, 2007. Statement No. 48 establishes criteria to ascertain whether certain transactions should be recorded as a sale or collateralized borrowing.

GASB Statement No. 50, *Pension Disclosures,* was also adopted during the year ended June 30, 2007. Statement No. 50 enhances information disclosed in notes to financial statements or presented as required supplemental information by employers who provide pension benefits.

The implementation of GASB Statement No. 48 and Statement No. 50 had no effect on the Medical Center's net assets or changes in net assets for the years ended June 30, 2007 or 2006.

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.

2. Summary of Significant Accounting Policies (Continued)

Cash (Continued)

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, 2007 and 2006 was $153,305 and $142,852, 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 2007 annual report of the University.

Restricted Assets, Held by Trustee

Indenture requirements of bond financing (see Note 8, "Long-term Debt and Capital Leases") provide for the establishment and maintenance of various accounts with a trustee. The indenture terms require that the trustee control the expenditure of bond proceeds as well as the payment of principal and interest to the bondholders. Assets held by trustee consist of short-term investments, recorded at cost, which approximates fair value.

Inventory

The Medical Center's inventory consists primarily of pharmaceuticals and medical supplies which are 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 prepayments for pharmaceuticals and medical supplies, rent, equipment and maintenance contracts.

2. Summary of Significant Accounting Policies (Continued)

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 lease 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 5 to 40 years and for equipment it 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. Incremental cost, including salaries and employee benefits, directly related to the acquisition, development and installation of major software projects are included in the cost of the capital assets.

Deferred Costs of Issuance
Costs incurred in the issuance of long-term debt, including legal fees, bank fees, and accounting and consulting costs that have been capitalized and are being amortized as interest expense on the straight-line basis over the term of the related long-term debt, which approximates the effective interest method.

Bond Premium
The premium received in the issuance of long-term debt is amortized as a reduction to interest expense over the term of the related long-term debt.

Deferred Financing Costs
Refinancing or defeasance of previously outstanding debt has resulted in deferred financing costs comprised of the difference between the reacquisition price and the net carrying amount of the old debt. This is reflected as unamortized deferred financing costs which are included as an offset to the current and noncurrent portion of long-term debt, as appropriate, in the Medical Center's statement of net assets. These costs are being amortized as interest expense over the remaining life of the defeased or refinanced bonds, whichever is shorter.

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.

2. Summary of Significant Accounting Policies (Continued)

Net Assets (Continued)

- 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.

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

2. Summary of Significant Accounting Policies (Continued)

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. 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.

Interest Rate Swap Agreements

The Medical Center has entered into interest rate swap agreements to limit the exposure of its variable rate debt to changes in market interest rates. Interest rate swap agreements involve the exchange with a counterparty of fixed and variable rate interest payments periodically over the life of the agreement without exchange of the underlying notional principal amounts. The difference to be paid or received is recognized over the life of the agreements as an adjustment to interest expense. The Medical Center's counterparties are major financial institutions.

In accordance with GASB standards, the fair value of the interest rate swap agreements is not recognized in the Medical Center's statements of net assets and changes in fair value are not recognized in the statements of revenues, expenses and changes in net assets.

2. Summary of Significant Accounting Policies (Continued)

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.

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 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 of the estimate or judgment is made and actual amounts could differ from those estimates.

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. The Medical Center's participation in the University's postemployment benefit program is effectively as a cost-sharing employer participating in a plan administered as a trust. As a result, the Medical Center will recognize as an expense in the statement of revenues, expenses and changes in net assets the amount associated with the University's common assessment rate on an accrual basis. Accordingly, implementation of Statement No. 45 will not have any significant effect on its financial statements other than to the extent the University may change the common assessment rate each year.

In November 2006, the GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, effective for the Medical Center's fiscal year beginning July 1, 2008. This Statement establishes criteria to ascertain whether certain events result in a requirement for the University to estimate the components of any expected pollution remediation costs and determine whether these costs should be accrued as a liability or, if appropriate, capitalized.

In June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, effective for the University's fiscal year beginning June 30, 2009. This statement requires capitalization of identifiable intangible assets in the statement of net assets and provides guidance for amortization of intangible assets unless they are considered to have an indefinite useful life.

The Medical Center is currently evaluating the effect, if any, that Statements No. 49 and 51 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) or Medicare capitated contract revenue (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. 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 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, 2007 and 2006, the Medical Center recorded total Medi-Cal revenue of $108,683 and $119,728, respectively.

3. Net Patient Service Revenue (Continued)

- ***Senate Bill 1732*** – State of California Senate Bill 1732 ("SB 1732") provides for supplemental Medi-Cal reimbursement to disproportionate share hospitals for costs (i.e., principal and interest) of qualified patient care capital construction. For the years ended June 30, 2007 and 2006, the Medical Center applied for and received additional revenue of $8,151 and $6,020, respectively. The amounts received are related to the reimbursement of costs for certain debt financed construction projects based on the Medical Center's Medi-Cal utilization rate.

- ***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, 2007 and 2006, the Medical Center recorded revenue of $5,037 and $6,600, 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.

    - Capitated contracts with health plans that reimburse the Medical Center on a per-member-per-month basis, regardless of whether services are actually rendered. The Medical Center assumes a certain financial risk as the contract requires patient treatment for all covered services. Expected losses on capitated agreements are accrued when probable and can be reasonably estimated.

    - Certain health plans that have established a shared-risk pool where the Medical Center shares in any surplus associated with health care utilization as defined in the related contracts. Additionally, the Medical Center may assume the risk of certain health care utilization costs, as determined in the related agreements. Differences between the final contract settlement and the amount estimated as receivable or payable relating to the shared-risk arrangements are recorded in the year of final settlement.

(Dollars in thousands)

3. Net Patient Service Revenue (Continued)

- ***Other (Continued)***
  - 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 37 percent and 33 percent of net patient accounts receivable at June 30, 2007 and 2006, respectively.

For the years ended June 30, 2007 and 2006, net patient service revenue included $3.5 million and $1.3 million, respectively, due to favorable cost report settlements with Medicare, Medi-Cal and the County Medical Services Program. In addition, in 2007 and 2006, previously established liabilities in the amount of $2.5 million and $3.4 million, respectively, were released to income and are reflected in net patient service revenue.

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

	2007	2006
Medicare (non-risk)	$ 178,598	$ 158,273
Medicare (risk)	27,593	21,938
Medi-cal (non-risk)	108,683	119,728
Medi-cal (risk)	11,850	14,446
Commercial	1,378	2,261
Contract (discounted or per diem)	461,842	406,918
Contract (capitated)	101,396	87,965
County	32,718	30,968
Non-sponsored/self-pay	4,838	7,544
Total	$ 928,896	$ 850,041

4. Charity Care

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

	2007	2006
Charity care at established rates	$ 94,902	$ 73,733
Estimated cost of charity care	$ 20,598	$ 18,129

Estimated cost in excess of reimbursement for indigent patients under publicly sponsored programs was $97,995 and $83,962 for the years ended June 30, 2007 and 2006, respectively.

(Dollars in thousands)

5. Restricted Assets, Held by Trustee

Restricted assets held by trustee are for future payment of principal and interest in accordance with various indenture and other long-term debt requirements. Securities are held by the trustee in the name of the University. The trust agreement permits the trustee to invest in U.S. and state government or agency obligations, commercial paper, or other corporate obligations meeting certain credit rating requirements.

The composition of restricted assets at June 30 is as follows:

	2007	2006
Short-term, highly liquid investments	$ 1,819	$ 8,622

6. Capital Assets

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

	2005	Additions	Disposals	2006	Additions	Disposals	2007
Original Cost							
Land	$ 29,606	$ –	$ –	$ 29,606	$ 8,200	$ –	$ 37,806
Buildings and improvements	673,555	52,852	–	726,407	10,089	–	736,496
Equipment	263,053	26,164	(20,413)	268,804	43,330	(22,405)	289,729
Construction in progress	112,286	3,307	–	115,593	75,410	–	191,003
Capital assets, at cost	$ 1,078,500	$ 82,323	$ (20,413)	$ 1,140,410	$ 137,029	$ (22,405)	$ 1,255,034
	2005	**Depreciation**	**Disposals**	**2006**	**Depreciation**	**Disposals**	**2007**
Accumulated Depreciation and Amortization							
Buildings and improvements	$ 214,925	$ 24,579	$ –	$ 239,504	$ 25,167	$ –	$ 264,671
Equipment	154,352	28,981	(20,165)	163,168	30,210	(21,591)	171,787
Accumulated depreciation and amortization	$ 369,277	$ 53,560	$ (20,165)	$ 402,672	$ 55,377	$ (21,591)	$ 436,458
Capital assets, net	$ 709,223			$ 737,738			$ 818,576

Equipment under capital lease obligations and related accumulated amortization is $811 and $540 in 2007, respectively, and $811 and $270 in 2006, respectively.

The University has acquired certain facilities and equipment under 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.

(Dollars in thousands)

6. Capital Assets (Continued)

The Medical Center is currently making seismic improvements in order to be in compliance with Senate Bill 1953, the *Hospital Facilities Seismic Safety Act*. A portion of the improvements is financed under a lease-revenue bond with the State of California Public Works Board. These amounts totaling $16,073 and $424 for the years ended June 30, 2007 and 2006, respectively, are shown as contributions from University for building program on the statements of revenues, expenses and changes in net assets.

7. Investments in Joint Ventures

The Medical Center has entered into joint venture arrangements with various third party entities that include home health services, cancer center operations and a health maintenance organization. Investments in these joint ventures are recorded using the equity method.

8. Long-term Debt and Capital Leases

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

	2007	2006
University of California Medical Center Pooled Revenue Bonds, interest rates ranging from 4.5 percent to 5.0 percent, payable semi-annually, with annual principle payments beginning in 2012 through 2047	$ 65,000	$ –
University of California Hospital Revenue Bonds (University of California, Davis Medical Center, Series 1996), interest rate of 10 percent, payable semi-annually, with annual principal payments through 2006	–	7,695
University of California Refunding Hospital Revenue Bonds (University of California, Davis Medical Center, Series 2003) Series A-E, variable rate bonds, with annual principal payments through 2026	336,225	339,600
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	13,254	13,816
Financing obligations, primarily for computer and medical equipment, with fixed interest rates of 2.7 percent to 4.0 percent, payable through 2012	29,784	20,153
Capital lease obligations, for computer software, with a fixed interest rate of 3.0 percent, payable through 2010, collateralized by underlying computer software	589	774
Unamortized bond premium	537	–
Unamortized deferred financing costs	(20,248)	(22,037)
Total debt and capital leases	425,141	360,001
Less: Current portion of debt and capital leases	(19,509)	(15,573)
Noncurrent portion of debt and capital leases	$ 405,632	$ 344,428

(Dollars in thousands)

8. 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	Other Debt Obligations	Total
Year Ended June 30, 2007			
Current portion at June 30, 2006	$ 9,844	$ 5,729	$ 15,573
Reclassification from noncurrent	10,806	8,703	19,509
Principal payments	(11,632)	(5,724)	(17,356)
Amortization of bond premium	(6)	–	(6)
Amortization of deferred financing costs	1,789	–	1,789
Current portion at June 30, 2007	$ 10,801	$ 8,708	$ 19,509
Noncurrent portion at June 30, 2006	$ 329,230	$ 15,198	$ 344,428
New obligations	65,000	15,170	80,170
Bond premium	543	–	543
Reclassification to current	(10,806)	(8,703)	(19,509)
Noncurrent portion at June 30, 2007	$ 383,967	$ 21,665	$ 405,632
Year Ended June 30, 2006			
Current portion at June 30, 2005	$ 9,024	$ 4,384	$ 13,408
Reclassification from noncurrent	9,844	6,498	16,342
Principal payments	(10,813)	(5,153)	(15,966)
Amortization of deferred financing costs	1,789	–	1,789
Current portion at June 30, 2006	$ 9,844	$ 5,729	$ 15,573
Noncurrent portion at June 30, 2005	$ 339,074	$ 16,174	$ 355,248
New obligations	–	5,522	5,522
Reclassification to current	(9,844)	(6,498)	(16,342)
Noncurrent portion at June 30, 2006	$ 329,230	$ 15,198	$ 344,428

Medical Center Pooled Revenue Bonds are issued to provide financing to the University's medical centers and are collateralized by a joint and several pledge of the operating revenues, as defined in the Indenture, of all five of the University's medical centers. The Medical Center Pooled Revenue Bond indenture requires the medical centers to set rates, charges and fees each year sufficient for the medical center operating revenues to pay for the annual principal and interest on the bonds and certain other financial covenants. Total Medical Center Pooled Revenue Bonds outstanding at June 30, 2007 are $537,325 of which $65,000 are specifically for capital projects at the Medical Center. Combined operating revenues of the University's five medical centers for the years ended June 30, 2007 and 2006 were $4.6 and $4.3 billion, respectively.

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

The $65,000 of Medical Center Pooled Revenue Bonds specifically for the Medical Center were issued in January 2007 to finance certain improvements. Proceeds, including a bond premium of $543, are to be used to pay for project construction and issuance costs and repay interim financing incurred prior to the issuance of the bonds. The bonds require interest only payments through November 2011, mature at various dates through 2047 and have a weighted average interest rate of 4.55 percent.

Hospital Revenue Bonds Series 1996 were issued to finance the acquisition and construction of certain health care and related facilities. The Bonds have sinking fund requirements and optional redemption provisions. The Hospital Revenue Bonds are collateralized by gross revenues of the Medical Center. In addition, under the bond indentures, the Medical Center is required to maintain a debt service coverage ratio of 1.2 to 1.0 and has limitations as to additional borrowings and the purchase or sale of business assets. The final principal payment was made on this debt as of July 1, 2006.

Refunding Hospital Revenue Bonds Series 2003 with a variable interest rate were issued to advance refund and defease the majority of the previously outstanding bonds. The Medical Center also entered into interest rate swap agreements in connection with the financing. The defeasance resulted in unamortized deferred cost of financing. The Refunding Hospital Revenue Bonds Series 2003 are collateralized by the gross revenues of the Medical Center and have sinking fund requirements and optional redemption provisions. In addition, under the bond indentures, the Medical Center is required to maintain a debt coverage ratio of 1.1 to 1.0 and has limitations as to additional borrowings and the purchase or sale of business assets.

The University issued General Revenue Bonds Series 2003, collateralized solely by general revenues of the University, to refinance certain Medical Center projects. The Medical Center is charged for its proportionate share of total principal and interest payments made on the General Revenue Bonds pertaining to Medical Center Projects.

Medical Center revenues are not pledged for any other purpose than under the indentures for the Medical Center Pooled Revenue Bonds, interest rate swap agreements and specific Hospital Revenue Bonds. The pledge of medical center revenues under Medical Center Pooled Revenue Bonds is on a parity with interest rate swap agreements and subordinate to the Hospital Revenue Bonds. The Medical Center's obligations under the terms of the General Revenue Bonds are subordinate to the Medical Center Pooled Revenue Bonds.

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

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 collateralized 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.

Interest Rate Swap Agreements

As a means to lower the Medical Center's borrowing costs when compared against fixed-rate bonds at the time of issuance, the Medical Center entered into interest rate swaps with three financial institutions in connection with its Refunding Hospital Revenue Bonds. The intention of the swap transaction was to effectively change the variable interest rate on the bonds to a fixed rate of 3.1 percent.

The bonds and the related swap agreements mature on September 1, 2026. The swap agreements contain scheduled reductions to outstanding notional amounts that match scheduled reductions in the bonds. Under the swaps, the Medical Center pays the swap counterparties a fixed payment of 3.1385 percent and receives a variable payment computed as 67 percent of 30 day London Interbank Offered Rate ("LIBOR"). The Medical Center believes that over time the variable interest rates it pays on the bonds will approximate the variable payments it receives on the interest rate swaps, leaving the fixed interest rate payment on the swaps as the net payment obligation for the transaction.

Because swap interest rates have increased since execution of the swaps, the swaps have an estimated positive fair value of $16.5 million as of June 30, 2007. The fair value of the interest rate swap is the estimated amount the Medical Center would have paid if the swap agreement was terminated on June 30, 2007 and was estimated by financial institutions using quoted market prices when available or a forecast of expected discounted future net cash flows.

These swaps expose the Medical Center to basis risk whenever the interest rates on the bonds are reset. The interest rate on the bonds is a tax-exempt interest rate, while the basis of the variable receipt on the interest rate swaps is taxable. Tax-exempt interest rates can change without a corresponding change in the 30 day LIBOR rate due to factors affecting the tax exempt market which do not have a similar effect on the taxable market. For example, the swap exposes the Medical Center to risk if reductions in the federal personal income tax cause the relationship between the variable interest rate on the bonds to be greater than 67 percent of 30 day LIBOR.

(Dollars in thousands)

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

Interest Rate Swap Agreements (Continued)

Although the Medical Center has the interest rate swaps with creditworthy financial institutions, there is credit and termination risk to losses in the event of non-performance by counterparties or unfavorable interest rate movements. Swap contracts with positive fair values are exposed to credit risk. The Medical Center faces a maximum possible loss equivalent to the amount of the swap's fair value. Swap contracts with negative fair values are not exposed to credit risk. The swaps may be terminated if the insurer's credit quality rating falls below "A –" as issued by Fitch Ratings or Standard & Poor's, thereby canceling the synthetic interest rate and returning the interest rate payments to the variable interest rates on the bonds. At termination, the Medical Center may also owe a termination payment if there is a realized loss based on the fair value of the swap.

As rates vary, variable rate bond interest payments and net swap payments will vary. Although not a prediction by the Medical Center of the future interest cost of the variable rate bonds or the impact of the interest rate swaps, using rates as of June 30, 2007, debt service requirements of the variable rate debt and net swap payments are as follows:

	Variable-Rate Bond			
Year Ending June 30,	Principal	Interest	Interest Rate Swap, Net	Total
2008	$ 11,950	$ 11,424	$ (1,394)	$ 21,980
2009	12,375	10,996	(1,342)	22,029
2010	12,800	10,553	(1,287)	22,066
2011	13,225	10,095	(1,232)	22,088
2012	13,700	9,621	(1,174)	22,147
2013 – 2017	75,850	40,405	(4,930)	111,325
2018 – 2022	89,875	25,853	(3,154)	112,574
2023 – 2027	106,450	8,612	(1,051)	114,011
Total	$ 336,225	$ 127,559	$ (15,564)	$ 448,220

(Dollars in thousands)

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

Future Debt Service

Future debt service payments for each of the five fiscal years subsequent to June 30, 2007 and thereafter are as follows:

Year Ending June 30,	Revenue Bonds	Other Debt	Total Payments	Principal	Interest
2008	$ 26,193	$ 9,670	$ 35,863	$ 21,238	$ 14,625
2009	26,242	9,620	35,862	21,933	13,929
2010	26,278	6,381	32,659	19,421	13,238
2011	26,300	3,658	29,958	17,331	12,627
2012	27,074	3,359	30,433	18,381	12,052
2013 – 2017	135,951	–	135,951	83,938	52,013
2018 – 2022	137,183	–	137,183	100,160	37,023
2023 – 2027	133,761	–	133,761	114,267	19,494
2028 – 2032	18,539	–	18,539	8,370	10,169
2033 – 2037	18,532	–	18,532	10,475	8,057
2038 – 2042	18,537	–	18,537	13,060	5,477
2043 – 2047	18,540	–	18,540	16,278	2,262
Total future debt service	613,130	32,688	645,818	$ 444,852	$ 200,966
Less: Interest component of future payments	(198,651)	(2,315)	(200,966)		
Principal portion of future payments	414,479	30,373	444,852		
Adjusted by:					
Unamortized deferred financing costs	(20,248)	–	(20,248)		
Unamortized bond premium	537	–	537		
Total debt	$ 394,768	$ 30,373	$ 425,141		

Additional information on the revenue bonds can be obtained from the 2007 annual report of the University.

9. Operating Leases

The Medical Center leases certain buildings and equipment under agreements recorded as operating leases. Operating lease expense for the years ended June 30, 2007 and 2006 was $11,749 and $10,821, respectively. The terms of the operating leases extend through the year 2016.

(Dollars in thousands)

9. Operating Leases (Continued)

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,	Minimum Annual Lease Payments
2008	$ 11,212
2009	8,440
2010	6,461
2011	6,020
2012	4,382
2013 – 2016	10,097
Total	$ 46,612

10. 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 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 rates for employer and employee contributions as a percentage of payroll are determined annually pursuant to The Regents' funding policy based upon recommendations of the consulting actuary. Employee contributions are subject to collective bargaining.

The actuarial value of UCRP assets and the actuarial accrued liability using the entry age normal cost method as of June 30, 2007 were $43.4 billion and $41.4 billion, respectively. The net assets held in trust for pension benefits on the UCRP Statement of Plan's Fiduciary Net assets were $48.1 billion at June 30, 2007. For the years ended June 30, 2007 and 2006, 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.

10. Retirement Plans (Continued)

The UCRSP plans (Defined Contribution 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 retirement plans can be obtained from the 2006-2007 annual reports of the University of California Retirement plan, the University of California Retirement Savings Plan and the University of California PERS-VERIP.

11. 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.

Workers' compensation premiums, included as salaries and employee benefits expense in the statement of revenues, expenses and changes in net assets, were $4,336 and $2,667 for the years ended June 30, 2007 and 2006, respectively. During 2007 and 2006, as a result of an actuarial analysis, the Medical Center received a refund of premiums from the University of $6,187 and $9,566, respectively, that reduced the overall workers' compensation cost for the year.

Combined malpractice and general liability premiums, recorded as insurance expense in the statement of revenues, expenses and changes in net assets, were $6,461 and $5,650 for the years ended June 30, 2007 and 2006, respectively.

(Dollars in thousands)

12. Transactions with Other University Entities

Services purchased from the University include repairs and maintenance, administrative and treasury services, and insurance. Services provided to the University include physician office rentals, building maintenance, billing services, 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:

	2007	2006
Salaries and employee benefits	$ 4,336	$ 2,667
Professional services	31,719	30,083
Other supplies and purchased services	3,249	3,092
Interest income (net)	(6,829)	(5,719)
Insurance	6,461	5,650
Total	$ 38,936	$ 35,773

Additionally, the Medical Center makes payments to the University of California, Davis 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 School of Medicine were $53,073 and $49,435 in 2007 and 2006, respectively. Of these amounts, $38,936 and $33,262 are reported as operating expenses for the years ended June 30, 2007 and 2006, respectively, and $14,137 and $16,173 are reported as health system support for the years ended June 30, 2007 and 2006, respectively.

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.

13. Commitments and Contingencies (Continued)

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, 2013, 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 $120 million was allocated to the Medical Center. The Medical Center spent $16,073 and $424 of its allocation during the years ended June 30, 2007 and 2006, respectively. As of June 30, 2007, any repayment the Medical Center may be obligated for under these financing arrangements is still being determined.

The Medical Center has entered into various construction contracts. The remaining cost of these Medical Center projects is estimated to be approximately $12.8 million, excluding interest, as of June 30, 2007.

Subsequent to June 30, 2007, one of the medical centers issued additional debt under the Medical Center Pooled Revenue Bonds totaling $197.0 million to refinance certain improvements. These bonds were not specifically for the Medical Center. The Medical Center's revenues, consistent with the original issuance, have been collectively pledged as collateral for this additional debt.