University of California,
San Diego Medical Center

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

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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 18 through 38, 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, 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 17 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, San Diego 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, 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. In addition, the UCSD Cancer Center on the East Campus serves as the primary site for outpatient clinical oncology care encompassing prevention, diagnosis, prognosis, treatment, education, rehabilitation and after-care.

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, 2007, the Medical Center reported net income of $67.2 million and generated a total margin of 10.5 percent. Total operating revenues increased by 4.6 percent over the prior year due to increased patient volumes and improved collections while operating expenses increased by 8.7 percent due to increased patient volumes, wage increases, inflationary increases in pharmaceuticals, medical and other supplies, and increased expenditures to improve and renovate the Medical Center's facilities.

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 51.9 percent.

The Medical Center's operating revenues reflect growth in admissions in nearly every major service line, increased utilization of outpatient services in key ancillary areas including surgery, radiation oncology, imaging and infusion, and continued focus on maximizing collections through contracting and pricing strategies. Labor costs continue to reflect increases in wages for nurses, other healthcare professionals and technical employees, 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, and expansion of the Medical Center's facilities to create capacity and support growth are also key elements of the overall strategic plan.

- *Optimizing net patient service revenue*

  During 2007, the Medical Center continued its strategy to improve net patient service revenue through pricing strategies and contracting, maximization of collections, aggressively pursuing coverage options for uninsured patients and sustaining 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. During 2007 the Medical Center participated with other University medical centers in coordinated efforts that led to successful contract negotiations with several major payors.

  Strategies to maximize collections include: enhancements to the authorization management and patient registration processes; enhanced charge capture; improved collection of co-payments at point of service; reduction in days outstanding in accounts receivable through expansion of the number of payors on electronic billing and remittance processing; 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.

Throughout 2007 management continued to work with the University to stabilize and ensure future growth of Medi-Cal and indigent care funding for the University's Medical Centers. Funds made available to the Medical Center in 2007 under the new federal Medicaid hospital financing waiver increased by approximately 10.0 percent over 2006.

- *Managing resources and costs*

During 2007, 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 of approximately 15% in both the nurse vacancy and nurse turnover rate. This resulted in a 12.5 percent decrease in nurse registry and traveler expense in 2007 and a 37.6 percent decrease in double time pay for hospital-employed nurses.

Managing medical and other supply costs is also a priority for Medical Center management. The Medical Center continued to focus on several initiatives implemented during 2006 including improvements to the process for evaluation of proposed purchases of new medical technologies that require a rigorous examination process before any new supply or device can be used at the Medical Center. Other ongoing initiatives include enhanced educational programs for Medical Center buyers that focus on improving contract and negotiation skills and benchmarking of supply costs.

During 2007 a new vendor visitation policy was created and approved to control visits by vendor representatives to ensure compliance with medical center purchasing policies. The Medical Center also began participation in group purchasing opportunities with the other University medical centers, which resulted in cost savings on suture and endosurgical products.

A new supply chain information system is currently being implemented and will allow for the planned move towards centralized receiving in strategic areas and improved centralized management of high cost clinical inventories in certain departments. Management expects this system to be fully implemented in the winter of 2007.

- *Facilities planning*

At the May 15, 2007 meeting of the University of California Board of Regents Building and Grounds Committee, the Medical Center received approval to proceed with preliminary plans for the UCSD Medical Center East Campus Bed Tower. This proposed project would build a new bed tower containing approximately 125-150 inpatient beds as an extension of the Thornton Hospital on the East Campus in La Jolla.

The project will support improvements and seismic retrofitting of the Hillcrest hospital by creating additional inpatient capacity within the Medical Center's two-hospital system and would allow the Medical Center to operate all of its total licensed bed capacity of 505 acute care beds. Only 460 of the Medical Center's licensed beds can be operated today due to facility limitations.

The Medical Center will also soon enter the construction phase of the Sulpizio Family Cardiovascular Center and Thornton Expansion project. This project, which was approved to proceed with construction at the January 19, 2006 meeting of the University of California Board of Regents, includes 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 on the main building is expected to begin in the spring of 2008 with completion in December 2009. This project will be funded through a combination of hospital cash reserves, philanthropy, and debt.

Expenditures for other projects and necessary renovations are also underway. During 2007 the Medical Center completed expansion and renovation of angiography suites at both hospital sites. In addition to ongoing infrastructure improvements, other projects currently underway at the Hillcrest site include an expansion and renovation of the NICU and Labor and Delivery and renovation of space to accommodate an inpatient MRI to replace an existing mobile unit.

During 2007, the Medical Center spent $23.4 million on facilities renovation and improvement projects, which included $23.0 million funded with hospital cash reserves and an additional $0.4 million funded with appropriations from the state of California for infrastructure improvements at the Hillcrest site. An additional $17.3 million was spent for equipment, information systems and new technology, which included $10.8 million funded with hospital cash reserves and $6.5 million acquired under capital lease obligations.

At June 30, 2007, the Medical Center's financial statements include capital assets of $319.2 million.

- *Information Technology Initiatives*

Adopting new technologies to support operational, clinical and research excellence is also a strategic priority for the Medical Center.

Major clinical systems already deployed at the Medical Center include Computerized Physician Order Entry, which has been fully implemented and in use in both Medical Center hospital sites, radiology PACS (Picture/Image Archiving and Communication System), and lab, cardiology imaging, and pharmacy information systems. A bar code assisted Medication Administration system was deployed during 2007 and implementation of ambulatory electronic medical records (EMR) across all hospital-based and physician clinics continued. At the end of 2007 ambulatory EMR had been implemented in approximately 50% of the primary care, internal medicine and specialty care clinic sites. Full implementation is expected by the end of 2008.

Over the next several years a next generation electronic medical record for inpatient and ICU will be integrated with our ambulatory system, allowing the Medical Center to achieve a paperless medical record system.

During 2008 two new major business systems, a new workforce management system and a new supply chain management system, will also be implemented.

Operating Statistics

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

Statistics	2007	2006	2005
Discharges	21,635	20,995	21,334
Average length of stay	6.1	6.3	6.1
Patient days:			
Medicare (non-risk)	31,526	30,704	30,828
Medi-Cal (non-risk)	39,356	36,226	36,016
Contracts – Commercial	46,015	44,339	44,136
County/Uninsured	15,622	17,657	16,325
Total patient days	132,519	128,926	127,305
Ambulatory visits:			
Clinic visits	464,804	479,649	465,178
Emergency room visits	60,023	60,769	57,855
Total ambulatory visits	524,827	540,418	523,033

Discharges increased by approximately 3.0 percent in 2007 compared to 2006 due primarily to an increase in cases in the medical and surgical service lines. Total patient days increased by 2.8 percent from 2006 due to 3.8 percent increase in admissions, which was partially offset by the decrease in length of stay in 2007 from 2006. Discharges in 2006 decreased by 1.6 percent over 2005 due primarily to an increase in the conversion of one-day/observation cases from inpatient to outpatient. Despite the decrease in discharges, total patient days increased in 2006 by 1.3 percent from 2005 due to an increase in average length of stay.

The increase in patient days for Medicare is due primarily to an increase in admissions, which is offset in part by a decrease in length of stay resulting from a decrease in the severity of cases, as reflected by the 5.5 percent decrease in Medicare case mix index in 2007 compared to 2006. The increase in patient days for Medi-Cal and Contracts – Commercial is due to increases in both admissions and length of stay. The decrease in patient days for County/Uninsured is due to decreases in both admissions and length of stay.

Ambulatory clinic visits decreased by 3.1 percent from 2006 due primarily to the transfer of primary care pediatric clinic activity to another hospital. Emergency room visits decreased by 1.2 percent from 2006 due primarily to a slight decrease in emergent visits at the Hillcrest Hospital. Ambulatory clinic visits for 2006 increased by 3.1 percent from 2005 while emergency room visits for 2006 increased by 5.0 percent from 2005.

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 presents the operating results for the Medical Center for fiscal years 2007, 2006 and 2005 (dollars in thousands):

	2007	2006	2005
Net patient service revenue	$ 628,420	$ 600,405	$ 521,837
Other operating revenue	14,689	14,270	13,965
Total operating revenue	643,109	614,675	535,802
Operating expenses:			
Salaries and employee benefits	295,255	266,162	244,071
Professional services	23,581	19,132	17,052
Medical supplies	131,051	124,580	108,999
Other expense	99,507	94,632	87,381
Depreciation and amortization	26,148	24,866	20,892
Total operating expenses	575,542	529,372	478,395
Income from operations	67,567	85,303	57,407
Total non-operating expenses	(332)	(1,508)	(2,467)
Income before other changes in net assets	$ 67,235	$ 83,795	$ 54,940
Margin	10.5 percent	13.6 percent	10.3 percent
Other changes in net assets	(29,729)	(17,387)	(14,321)
Net assets – beginning of year	392,012	325,604	284,985
Net assets – end of year	$ 429,518	$ 392,012	$ 325,604

Revenues
Total operating revenues for the year ended June 30, 2007 were $643.1 million, an increase of $28.4 million, or 4.6 percent, over 2006. Total operating revenue for 2006 of $614.7 million increased by $78.9 million, or 14.7 percent, over 2005.

Net patient service revenue for 2007 increased by $28.0 million, or 4.7 percent, over 2006. Net patient service revenue in 2006 increased by $78.6 million, or 15.1 percent, over 2005. The increase in 2007 was due to increased inpatient volumes at both hospital sites, increased outpatient volumes in key ancillary areas including surgery, radiation oncology, imaging, and infusion, and improved collections. The increase in 2006 over 2005 was due to increased outpatient volumes, improved collections, and release of a $15.9 million prior year Medi-Cal DSH reserve.

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 2006 was due to an increase in non-patient service revenue.

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

Payor	2007	2006	2005
Medicare (non-risk)	$ 132,219	$ 121,047	$ 105,104
Medi-Cal (non-risk)	155,232	162,831	151,149
Contracts – commercial	314,027	289,296	240,284
County/Uninsured	26,942	27,231	25,300
Total	$ 628,420	$ 600,405	$ 521,837

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 $11.2 million from 2006 due to increased inpatient cases and increased outpatient activity. Inpatient net revenue for 2007 increased by $9.9 million or 11.5 percent over 2006 due primarily to an 8.1 percent increase in discharges and a 1.7 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 5.5 percent reduction in case mix index. Medicare outpatient net revenue for 2007 increased by $1.3 million over 2006 due primarily to an increase in patient activity. Net revenue also includes reimbursement for prior year settlements and other adjustments of $10.2 million in 2007 compared to $6.9 million in 2006 and ($1.0) million in 2005.

For 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 for 2007 decreased by $7.6 million from 2006 due primarily to the release in 2006 of a $15.9 million prior year DSH reserve. Excluding the impact of reversing this reserve in 2006, inpatient net revenue for 2007 increased by $6.0 million over 2006 due to increased funds available to the Medical Center under the new federal Medicaid hospital financing waiver.

Outpatient Medi-Cal net revenue decreased by $4.8 million from 2006 due primarily to recognition of $3.4 million less supplemental payments under Assembly Bill 915, *the Public Hospital Outpatient Services Supplemental Reimbursement Program*, in 2007 compared to 2006, and a reduction in Medi-Cal outpatient pharmacy revenue of $2.2 million due to a shift of some patients to the Medicare Part D program, which is reported in the contract-commercial payor group.

Total Medi-Cal net revenue for 2006 increased by $11.7 million over 2005 due primarily to the reversal of the reserve described above.

Net revenue for contracts – commercial increased by $24.7 million over 2006 due primarily to an increase in patient activity and the impact of the Medical Center's ongoing contracting efforts and pricing strategies. The $49.0 million increase in 2006 over 2005 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 decreased by $0.3 million from 2006 due primarily to a 13.0 percent decrease in patient days. The $1.9 million increase in 2006 over 2005 is due primarily to an 8.2 percent increase in patient days.

Operating Expenses

Total operating expenses for 2007 of $575.5 million increased by $46.2 million, or 8.7 percent, over 2006 due primarily to increased patient volumes, the impact of inflation, increased depreciation expense, and increased costs to improve and renovate the Medical Center's facilities. Total operating expenses for 2006 increased by $51.0 million, or 10.7 percent, over 2005 due primarily to increased labor and supply costs, increased depreciation expense, and increased outpatient activity.

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 2007 increased by $29.1 million, or 11.0 percent, over 2006. Salaries and wages increased by $23.5 million due primarily to increases in wages for nurses and other healthcare professional and technical employees and a 5.9 percent increase in full time equivalent employees ("FTEs"). This increase in FTEs is due to increased patient activity as the Medical Center's ratio of staff to adjusted occupied bed decreased by 0.1 in 2007 from 2006. Employee benefits expense increased by $5.6 million, or 8.7 percent, over 2006 due to the increase in FTEs and an increase in employee healthcare premiums. Employee benefit expense for 2007 and 2006 also include a retrospective rebate of workers compensation premiums from the University of $6.3 million and $5.9 million, respectively. Salary and employee benefit costs for 2006 increased by $22.1 million, or 9.1 percent, over 2005.

Payments for professional services increased by $4.4 million, or 23.3 percent, in 2007 compared to 2006 and $2.1 million, or 12.2 percent, in 2006 compared to 2005 due to the provision of new services.

Medical supply expense increased by $6.5 million, or 5.2 percent, over 2006 due to an increase in patient volumes and the impact of inflation. Surgical supplies and implant costs increased by $1.7 million over 2006 due in part to a 3.1 percent increase in surgical cases. Pharmaceuticals increased by $3.7 million over 2006 due to inflation and continued increase usage of high cost drugs. The remaining $1.1 million increase is in blood bank and other supply costs. Medical supply expense for 2006 increased by $15.6 million, or 14.3 percent, over 2005 with increases in pharmaceutical costs of $4.1 million and implants, surgical and all other supply costs of $11.5 million. These increases were the result of similar increases in utilization and the impact of inflation.

Other supplies and purchased services expense increased by $4.9 million, or 5.2 percent, over 2006 due primarily to increases in electricity, telecommunication costs, and expenditures for facilities and equipment maintenance and improvements.

Other supplies and purchased services expense for 2006 increased by $7.3 million, or 8.3 percent, over 2005 due primarily to increased expenditures for nurse registry and contract labor, increased natural gas costs, and one-time expenditures resulting from a proposed nursing strike early in 2006.

Depreciation and amortization increased by $1.3 million, or 5.2 percent, in 2007 compared to 2006 and by $4.0 million, or 19.0 percent, in 2006 compared to 2005 due to increased capital expenditures and depreciation of the capital assets of the Cancer Center, which opened at the end of 2005.

Insurance expense totaled $5.3 million in 2007, a decrease compared to $5.6 and $5.6 million in 2006 and 2005, respectively. The Medical Center is insured through the University's malpractice and general liability programs.

Non-operating Revenues 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 $1.2 million from 2006. This decrease is due primarily to increased interest income resulting from an increase in average daily invested cash and an increase in the STIP earning rate. Non-operating expenses for 2006 decreased by $1.0 million from 2005.

Income before Other Changes in Net Assets
The Medical Center reported income before other changes in net assets of $67.2 million in 2007 compared to $83.8 million in 2006, and $54.9 million in 2005.

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 2007 are the following:

- Proceeds from state capital appropriations of $0.4 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 $30.3 million this year.
- Transfers from the University of $0.2 million.

In total, the net assets increased for the year by $37.5 million to $429.5 million. The majority of this increase is due to the excess of revenues over expenses.

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

	2007	2006	2005
Current assets:			
Cash	$ 127,683	$ 119,022	$ 124,455
Patient accounts receivable (net)	107,874	92,091	67,217
Other current assets	41,477	35,847	29,688
Total current assets	277,034	246,960	221,360
Capital assets (net)	319,189	306,120	291,788
Other assets	4,057	2,856	5,859
Total assets	600,280	555,936	519,007
Current liabilities	75,488	86,205	112,204
Long-term debt	95,274	77,719	81,199
Total liabilities	170,762	163,924	193,403
Net assets:			
Invested in capital assets (net)	218,243	203,746	186,354
Unrestricted	211,275	188,266	139,250
Total net assets	$ 429,518	$ 392,012	$ 325,604

Total current assets increased by $30.1 million in 2007 over 2006. Total current assets at June 30, 2006 were $25.6 million higher than the previous year.

Cash increased by $8.7 million as cash from operations and investing exceeded cash used for capital investments and non-capital financing. Cash and cash equivalents in 2006 decreased by $5.4 million over 2005 due primarily to an increase in days outstanding in accounts receivable and a decrease in days outstanding in accounts payable.

Patient accounts receivable, net of estimated uncollectibles, increased by 17.1 percent over 2006 due to increased patient revenues and a 5-day increase in days outstanding in account receivable. The increase in days outstanding in accounts receivable in 2007 is due primarily to an increase in outpatient contract payor claims, which typically have a longer time elapsed from date of service to collection of payments. Days outstanding in patient accounts receivable increased by 7 days in 2006 compared to 2005 due to an increase in patient accounts balances not billed at June 30 and an increase in outpatient claims.

Other current assets, which include non-patient receivables, inventory, and prepaid expenses, increased by $5.6 million, or 15.7 percent, from 2006. Non-patient receivables increased by $1.1 million while the total value of the Medical Center's pharmaceutical and supply inventories increased by $4.1 million from the prior year. The increase in inventory was due primarily to recording of $3.2 million of inventory values in the interventional radiology, electrophysiology, and cardiac catheterization departments. The remaining $0.9 million increase is due to inflationary increases in pharmaceuticals and medical supplies. Prepaid expense increased by $0.4 million over the prior year due primarily to a deposit made in June for a large furniture order. Other current assets increased by $6.1 million in 2006 over 2005 due primarily to an increase in non-patient receivables.

Capital assets increased by 4.3 percent and 4.9 percent, respectively, during the past two fiscal years as expenditures for new capital expenditures exceeded asset depreciation.

Other assets increased by $1.2 million from the prior year due primarily to a $0.9 million increase in the investment in the joint venture for bone marrow transplantation services and recording of $0.4 million cost of issuance related to the Medical Center Pooled Revenue Bonds issued in January 2007 to refinance a portion of the UCSD Cancer Center construction costs.

Current liabilities decreased by $10.7 million, or 12.4 percent, from 2006 due to the following: a $4.9 million increase in accounts payable and accrued expenses due primarily to an increase in outstanding vendor checks due to timing issues; a $2.1 million increase in accrued salaries and benefits due primarily to the timing of bi-weekly payroll payments; a $0.9 million increase in third party liabilities, and an $18.6 million decrease in the current portion of long-term debt and capital leases due to repayment of the standby financing from the University for a portion of the construction costs of the UCSD Cancer Center with proceeds from the Medical Center Pooled Revenue Bonds. Current liabilities decreased by $26.0 million, or 23.2 percent, in 2006 over 2005 due primarily to 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.

Long-term debt increased by $17.6 million from the prior year due primarily to issuance of the Medical Center Pooled Revenue Bonds, proceeds of which were used to repay the standby financing from the University for a portion of the construction costs of the UCSD Cancer Center. Long-term debt decreased by $3.5 million in 2006 from 2005 as principal payments exceeded new borrowings.

Net assets increased by $37.5 million over the prior year. The change in net assets is due primarily to the excess of revenues over expenses of $67.2 million reduced by the transfer of approximately $30.3 million of funds to the University as health system support. During fiscal years 2006 and 2005, the Medical Center transferred $22.8 million and $22.7 million of funds to the University as health system support, respectively.

Liquidity and Capital Resources

During 2007, the Medical Center generated $80.2 million of cash from operations and $3.8 million from investing activities. Capital expenditures for equipment, facilities, and information systems totaled $39.7 million, of which $0.4 million of capital was acquired with state funds and $6.5 million of capital was acquired under capital lease obligations.

Cash used for debt repayments was $7.4 million. An additional $30.3 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 liquidity and capital ratios for fiscal years 2007, 2006 and 2005:

	2007	2006	2005
Days cash on hand	84	85	98
Days of revenue in accounts receivable	69	64	57
Capital investments ($ in millions)	$39.7	$40.6	$45.3
Debt service coverage ratio	8.2	9.3	8.0

Days cash on hand decreased from 85 days at June 30, 2006 to 84 days at June 30, 2007. 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 2007, net days in receivables increased 5 days to 69 due primarily to an increase in Commercial-Contract outpatient activity. 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 debt service coverage ratio for 2007 was 8.2 times debt service compared to 9.3 times debt service in 2006. This decrease in debt service coverage ratio for 2007 is due to the decrease in net income. Total debt service payments were $12.0 million in 2007 and $12.1 million in 2006.

Looking Forward

The Hospital Facilities Seismic Safety Act ("SB 1953")
During 2005, the UC San Diego 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 2007 and 2006, $0.7 million and $0.4 million was spent, respectively.

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 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

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, San Diego Medical Center
Statements of Net Assets
At June 30, 2007 and 2006

(Dollars in thousands)

	2007	2006
Assets		
Current assets:		
Cash	$ 127,683	$ 119,022
Patient accounts receivable, net of estimated uncollectibles of $7,346 and $5,111, respectively	107,874	92,091
Third-party payor settlements	-	27
Other receivables, net of estimated uncollectibles of $293 and $249, respectively	20,948	19,856
Inventory	12,862	8,743
Prepaid expenses and other assets	7,667	7,221
Total current assets	277,034	246,960
Capital assets, net	319,189	306,120
Investments in joint ventures	1,743	886
Deferred costs of issuance	1,739	1,332
Prepaid expenses and other assets, net of current portion	575	638
Total assets	600,280	555,936
Liabilities		
Current liabilities:		
Accounts payable and accrued expenses	38,466	33,570
Accrued salaries and benefits	28,704	26,648
Third-party payor settlements	907	-
Current portion of long-term debt and capital leases	7,411	25,987
Total current liabilities	75,488	86,205
Long-term debt and capital leases, net of current portion	95,274	77,719
Total liabilities	170,762	163,924
Net Assets		
Invested in capital assets, net of related debt	218,243	203,746
Unrestricted	211,275	188,266
Total net assets	$ 429,518	$ 392,012

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, 2007 and 2006
(Dollars in thousands)

	2007	2006
Net patient service revenue, net of provision for doubtful accounts of $12,050 and $9,208, respectively	$ 628,420	$ 600,405
Other operating revenue:		
Clinical teaching support	8,261	8,074
Other	6,428	6,196
Total other operating revenue	14,689	14,270
Total operating revenue	643,109	614,675
Operating expenses:		
Salaries and employee benefits	295,255	266,162
Professional services	23,581	19,132
Medical supplies	131,051	124,580
Other supplies and purchased services	94,198	89,013
Depreciation and amortization	26,148	24,866
Insurance	5,309	5,619
Total operating expenses	575,542	529,372
Income from operations	67,567	85,303
Non-operating revenues (expenses):		
Interest income	4,655	3,474
Interest expense	(4,646)	(4,598)
Loss on disposal of capital assets	(341)	(384)
Total non-operating revenues (expenses)	(332)	(1,508)
Income before other changes in net assets	67,235	83,795
Other changes in net assets:		
State capital appropriations	387	3,403
Donated assets	37	1,842
Health system support	(30,308)	(22,824)
Transfers from University	159	215
Other	(4)	(23)
Total other changes in net assets	(29,729)	(17,387)
Increase in net assets	37,506	66,408
Net assets - beginning of year	392,012	325,604
Net assets - end of year	$ 429,518	$ 392,012

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, 2007 and 2006
(Dollars in thousands)

	2007	2006
Cash flows from operating activities:		
Receipts from patients and third-partypayors	$ 612,963	$ 545,363
Payments to employees	(254,256)	(226,971)
Payments to suppliers	(268,377)	(254,135)
Payments for benefits	(56,489)	(52,033)
Other receipts, net	46,383	40,401
Net cash provided by operating activities	80,224	52,625
Cash flows from noncapital financing activities:		
Health system support	(30,308)	(22,824)
Net cash used by noncapital financing activities	(30,308)	(22,824)
Cash flows from capital and related financing activities:		
State capital appropriations	387	3,403
Transfers from the University, net	864	215
Proceeds from debt issuance	19,473	-
Repayment of commercial paper borrowings	(18,962)	-
Proceeds from sale of capital assets	160	983
Bond issuance costs	(510)	-
Purchases of capital assets	(34,489)	(36,047)
Principal paid on long-term debt and capital leases	(7,381)	(7,613)
Interest paid on long-term debt and capital leases	(4,632)	(4,586)
Gifts and donated funds	37	1,842
Net cash used by capital and related financing activities	(45,053)	(41,803)
Cash flows from investing activities:		
Interest income received	4,655	3,474
Investments in joint venture	(857)	3,095
Net cash provided by investing activities	3,798	6,569
Net increase (decrease) in cash	8,661	(5,433)
Cash - beginning of year	119,022	124,455
Cash - end of year	$ 127,683	$ 119,022

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, 2007 and 2006
(Dollars in thousands)

	2007	2006
Reconciliation of income from operations to net cash provided by operating activities:		
Income from operations	$ 67,567	$ 85,303
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation and amortization expense	26,148	24,866
Provision for doubtful accounts	12,050	9,208
Changes in operating assets and liabilities:		
Patient accounts receivable	(27,833)	(34,082)
Other receivables	(1,092)	(4,971)
Inventory	(4,119)	(355)
Prepaid expenses and other assets	(383)	(997)
Accounts payable and accrued expenses	4,896	(4,380)
Accrued salaries and benefits	2,056	3,054
Third-party payor settlements	934	(21,821)
Net cash provided by operating activities	$ 80,224	$ 55,825
Supplemental noncash activities information:		
Capital assets acquired through capital lease obligations	$ 6,505	$ 4,541
Amortization of costs of issuance	$ 103	$ 99
Amortization of deferred bond premium	$ 89	$ 87
Payables for property and equipment	$ 2,097	$ -

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. 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 $127,683 and $119,022, 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.

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.

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.

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 rate method.

2. Summary of Significant Accounting Policies (Continued)

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.

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.

2. Summary of Significant Accounting Policies (Continued)

Revenues and Expenses (Continued)
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.

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 accounting principles generally accepted 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.

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).

  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 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, 2007 and 2006, the Medical Center recorded total Medi-Cal revenue of $155,232 and $162,831, respectively.

3. Net Patient Service Revenue (Continued)

- ***Medi-Cal (Continued)***
  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, 2007 and 2006, the Medical Center recorded revenue of $7,793 and $11,213, 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 20 percent and 19 percent of net patient accounts receivable at June 30, 2007 and 2006, respectively.

(Dollars in thousands)

3. Net Patient Service Revenue (Continued)

For the years ended June 30, 2007 and 2006, net patient service revenue included $8.5 million and $6.9 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:

	2007	2006
Medicare (non-risk)	$ 132,219	$ 121,047
Medi-Cal (non-risk)	155,232	162,831
Commercial	9,127	7,443
Contract (discounted or per diem)	304,900	281,853
County	17,635	17,567
Non-sponsored/self-pay	9,307	9,664
Total	$ 628,420	$ 600,405

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	$ 69,421	$ 76,551
Estimated cost of charity care	$ 23,289	$ 25,245

Estimated cost in excess of reimbursement for indigent patients under publicly sponsored programs was $12,947 and $11,351 for the years ended June 30, 2007 and 2006, respectively.

(Dollars in thousands)

5. 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	$ 4,550	$ –	$ –	$ 4,550	$ –	$ –	$ 4,550
Buildings and improvements	327,370	30,115	–	357,485	17,351	–	374,836
Equipment	106,833	15,047	(12,397)	109,483	17,106	(12,566)	114,023
Construction in progress	36,803	(4,597)	(52)	32,154	6,537	–	38,691
Capital assets, at cost	$ 475,556	$ 40,565	$ (12,449)	$ 503,672	$ 40,994	$ (12,566)	$ 532,100

	2005	Depreciation	Disposals	2006	Depreciation	Disposals	2007
Accumulated Depreciation and Amortization							
Buildings and improvements	$ 123,016	$ 12,826	$ –	$ 135,842	$ 13,806	$ –	$ 149,648
Equipment	60,752	12,040	(11,082)	61,710	12,342	(10,789)	63,263
Accumulated depreciation and amortization	$ 183,768	$ 24,866	$ (11,082)	$ 197,552	$ 26,148	$ (10,789)	$ 212,911
Capital assets, net	$ 291,788			$ 306,120			$ 319,189

Equipment under capital lease obligations and related accumulated amortization is $21,283 and $8,268 in 2007, respectively, and $14,780 and $5,933 in 2006, 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. Investment in Joint Venture

The Medical Center has entered into a joint venture arrangement with a third party entity for the purpose of providing bone marrow transplantation services. Investment in the joint venture is recorded using the equity method.

(Dollars in thousands)

7. 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 from 4.50 percent to 5.00 percent, payable semi-annually, with annual principle payments beginning in 2012 through 2047	$ 19,230	$ –
University of California Hospital Revenue Bonds, interest rates from 4.125 percent to 10 percent, payable semi-annually, with annual principal payments through 2019	54,325	57,335
University of California General Revenue Bonds, interest rates from 2.0 percent to 5.25 percent, payable semi-annually, with annual principal payments through 2023	15,359	16,169
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
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
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	12,455	9,259
Unamortized bond premium	1,316	1,163
Total debt and capital leases	102,685	103,706
Less: Current portion of debt and capital leases	(7,411)	(25,987)
Noncurrent portion of debt and capital leases	$ 95,274	$ 77,719

(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, 2007			
Current portion at June 30, 2006	$ 23,687	$ 2,300	$ 25,987
Reclassification from noncurrent	4,067	4,356	8,423
Repayment of long-term debt	(18,962)	(567)	(19,529)
Principal payments	(4,639)	(2,742)	(7,381)
Amortization of bond premium	(89)	–	(89)
Current portion at June 30, 2007	$ 4,064	$ 3,347	$ 7,411
Noncurrent portion at June 30, 2006	$ 70,760	$ 6,959	$ 77,719
New obligations	19,230	6,505	25,735
Bond premium	243	–	243
Reclassification to current	(4,067)	(4,356)	(8,423)
Noncurrent portion at June 30, 2007	$ 88,166	$ 9,108	$ 95,274
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

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

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 $19,230 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.

The $19,230 of Medical Center Pooled Revenue Bonds specifically for the Medical Center were issued in January 2007 to refinance a portion of the UCSD Cancer Center construction costs. Proceeds, including a bond premium of $243, were used to pay for issuance costs and repay interim commercial paper financing 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.

University of California Hospital Revenue Bonds, have also financed certain improvements at the Medical Center. The Hospital Revenue 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.

General Revenue Bonds, collateralized solely by general revenues of the University, finance 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.

Medical Center revenues are not pledged for any other purpose than under the indentures for the Medical Center Pooled Revenue Bonds 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.

(Dollars in thousands)

7. 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.

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	Capital Leases	Total Payments	Principal	Interest
2008	$ 8,186	$ 3,791	$ 11,977	$ 7,319	$ 4,658
2009	8,181	3,778	11,959	7,609	4,350
2010	8,179	3,312	11,491	7,460	4,031
2011	8,174	1,756	9,930	6,192	3,738
2012	8,372	805	9,177	5,705	3,472
2013 – 2017	40,549	–	40,549	27,154	13,395
2018 – 2022	28,788	–	28,788	22,512	6,276
2023 – 2027	6,742	–	6,742	3,168	3,574
2028 – 2032	5,487	–	5,487	2,480	3,007
2033 – 2037	5,477	–	5,477	3,095	2,382
2038 – 2042	5,480	–	5,480	3,860	1,620
2043 – 2047	5,484	–	5,484	4,815	669
Total future debt service	139,099	13,442	152,541	$ 101,369	$ 51,172
Less: Interest component of future payments	(50,185)	(987)	(51,172)		
Principal portion of future payments	88,914	12,455	101,369		
Adjusted by:					
Unamortized bond premium	1,316	–	1,316		
Total debt	$ 90,230	$ 12,455	$ 102,685		

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

(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, 2007 and 2006 was $3,763 and $3,299, respectively. The terms of the operating leases extend through the year 2012.

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	$ 3,026
2009	1,612
2010	747
2011	272
2012	77
Total	$ 5,734

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 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.

9. Retirement Plans (Continued)

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.

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.

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.

Workers' compensation premiums, included as salaries and employee benefits expense in the statement of revenues, expenses and changes in net assets, were $2,545 and $3,269 for the years ended June 30, 2007 and 2006, respectively. During 2007 and 2006, as a result of actuarial analysis, the Medical Center received a refund of premiums from the University of $6,344 and $5,851, respectively, 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 $5,309 and $5,726 for the years ended June 30, 2007 and 2006, 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:

	2007	2006
Salaries and employee benefits	$ 2,077	$ 1,461
Professional services	23,581	19,133
Medical supplies	(953)	(1,059)
Other supplies and purchased services	(8,361)	(6,616)
Interest income (net)	(3,876)	(2,677)
Insurance	5,309	5,619
Total	$ 17,777	$ 15,861

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 $48,085 and $38,685 in 2007 and 2006, respectively. Of these amounts, $17,777 and $15,861 are reported as operating expenses for the years ended June 30, 2007 and 2006, respectively, and $30,308 and $22,824 are reported as health system support for the years ended June 30, 2007 and 2006, 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 2007 and 2006, $387 and $3,403, 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. The Medical Center has received an extension to January 1, 2013 to complete the required renovations. 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, 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 $28.0 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 $190.0 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.