# University of California,
# Irvine Medical Center

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

# University of California, Irvine 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 14 through 34 present fairly, in all material respects, the financial position of the University of California, Irvine 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 13 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, Irvine Medical Center's financial position and operating activities for the year 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, Irvine Medical Center (the "Medical Center") serves as the principal clinical teaching site for the University of California, Irvine School of Medicine. In 1976, Orange County agreed to give the formerly known as Orange County Hospital to the University of California, now called, University of California, Irvine Medical Center. It is the 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 in Orange, California, and is licensed to operate 453 beds. The Medical Center serves as a major tertiary referral center for Orange County and is also the county's only Level I Trauma Center and Regional Burn Center. Currently, construction of a new, state-of-the-art hospital building is under way starting in February 2005 and is expected to be completed in early 2009. The new 480,000-square-foot hospital will have 191 private rooms and 13 surgical suites in the new main hospital building, in addition to the existing 102 beds in the medical center's tower and the 84-bed Neuropsychiatric center.

Outpatient services are provided by the Medical Center, which has a clinical practice group of over 450 faculty physicians and surgeons, primarily at the main campus pavilion buildings, Chao Cancer Center, Gottschalk Medical Plaza on the Irvine Campus, and Family Health Centers at Anaheim, Santa Ana, and Westminster clinics. The two Family Health Centers in Santa Ana and Anaheim are the only designated Federally Qualified Health Centers in Orange County.

These sites enable the Medical Center to provide a full scope of high quality patient care services and attract the volume and diversity of patients required to support the education and research programs of the School of Medicine. Together, these sites provide increased patient volumes, expanded market share, better serve the community, attract favorable payor mix, and generate a stable financial environment.

The Medical Center continues to be selected as one of the best hospitals in the United States by *U.S. News & World Report* for the seventh consecutive year. The Medical Center ranks among the best in the following specialties: urology and geriatrics.

During 2007, the Medical Center remained financially sound with a stable cash position and profitable operations.

For the year ended June 30, 2007, the Medical Center reported net income of $45.2 million and generated a margin of 9.2 percent. Total operating revenue increased by 2.4 percent. Total operating expenses increased by 7.6 percent due to increased staffing costs, inflationary increases in pharmaceuticals and medical supplies, and increased depreciation on facilities and equipment. The year ended with a cash position of 100.8 million.

These significant events and the impact of each on the Medical Center's operating results are summarized below.

- *Termination of full-risk managed care contracts*
  The Medical Center continued its strategy to improve net patient service revenue through termination of all capitated contracts, including the at-risk subcontract with Garden Grove Hospital, effective December 31, 2006.

- *Increase in labor costs*
  Labor costs continue to be adversely affected by the nationwide nursing shortage, compliance with legislation covering nurse staffing ratios, and increased premiums for employee healthcare. These combined factors had a significant impact on both the salary costs of hospital-employed nurses as well as the rates charged for nurses employed from nurse registry agencies. Overall, labor costs for hospital-paid employees increased by 9.3 percent over 2006.

- *New Hospital Financing*
  The construction of the new hospital was budgeted to be $371 million. This project will be funded through a combination of hospital reserves, philanthropy, and bonds issuance. The Regents had issued $62.9 million of the Medical Center Pooled Revenue Bonds 2007 Series A in January 2007. During 2007, the Medical Center spent $13.5 million on the new hospital construction fund.

### Operating Statistics

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

| Statistics | 2007 | 2006 | 2005 |
|---|---|---|---|
| Discharges | 16,793 | 17,179 | 17,529 |
| Average length of stay | 6.1 | 6.0 | 6.1 |
| Patient days: | | | |
| Medicare (non-risk) | 26,137 | 27,524 | 26,611 |
| Medi-Cal (non-risk) | 35,141 | 32,081 | 32,902 |
| CalOptima | 1,888 | 4,769 | 7,444 |
| Commercial | 892 | 865 | 1,262 |
| Contracts (discounted/per diem) | 27,312 | 25,904 | 25,505 |
| County/uninsured | 11,543 | 12,761 | 13,025 |
| Total patient days | 102,913 | 103,904 | 106,749 |
| Ambulatory/emergency room visits | 527,358 | 557,847 | 595,662 |

Discharges and patient days (excluding newborns) decreased by 2.2 percent and 1.0 percent, respectively, in 2007 due to the termination of all full-risk capitated contracts.

Total ambulatory and emergency visits decreased by 30,489, or 5.5 percent, over the prior year, primarily in clinic visits.

## 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 | $ 467,882 | $ 455,140 | $ 433,446 |
| Other operating revenue | 20,922 | 22,114 | 21,353 |
| Total operating revenue | 488,804 | 477,254 | 454,799 |
| Total operating expenses | 447,693 | 415,932 | 391,068 |
| Income from operations | 41,111 | 61,322 | 63,731 |
| Total non-operating revenue | 4,085 | 3,092 | 126 |
| Income before other changes in net assets | $ 45,196 | $ 64,414 | $ 63,857 |
| Margin | 9.2 percent | 13.5 percent | 14.0 percent |
| Other changes in net assets | 41,763 | 18,524 | 20,058 |
| Net assets – beginning of year | 354,963 | 272,025 | 188,110 |
| Net assets – end of year | $ 441,922 | $ 354,963 | $ 272,025 |

**Revenues**
Total operating revenues for the year ended June 30, 2007 were $488.8 million, an increase of $11.6 million, or 2.4 percent, over 2006. Operating revenues for 2006 were $477.3 million, an increase of $22.5 million, or 4.9 percent, over 2005.

Net patient service revenue for 2007 increased by $12.7 million, or 2.8 percent, over the prior year. Net patient service revenue in 2006 increased by $21.7 million, or 5 percent, over 2005. The increase in 2007 was due to changes in a more favorable patient mix and improvements in charge capture. Patient service revenues are net of estimated allowances from contractual arrangements with Medicare, Medi-Cal, the County of Orange, and other third-party payors which have been estimated based on the principles of reimbursements and terms of the contracts currently in effect.

Other operating revenue consists primarily of State Clinical Teaching Support funds and other non-patient services such as referral lab, cafeteria and parking operations. Other operating revenue decreased by $1.2 million, or 5.4 percent, over 2006 due primarily to the decrease in miscellaneous county funding and various non-patient revenues.

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

| Payor | 2007 | 2006 | 2005 |
|---|---|---|---|
| Medicare (non-risk) | $ 108,006 | $ 106,619 | $ 97,920 |
| Medi-Cal (non-risk) | 123,765 | 132,757 | 136,836 |
| CalOptima | 3,780 | 13,905 | 22,220 |
| Commercial | 16,308 | 15,993 | 19,250 |
| Contracts (discounted/per diem) | 178,722 | 151,245 | 130,397 |
| County/uninsured | 37,301 | 34,621 | 26,823 |
| Total | $ 467,882 | $ 455,140 | $ 433,446 |

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. Managed Medicare payments are paid on a per-diem or per-discharge basis. The Medical Center also receives additional payments from Medicare for direct or indirect medical education. Net revenue for Medicare patients including managed care patients, increased by $1.4 million from 2006 due primarily to a three-percent increase in Medicare reimbursement rate.

Payments for Medi-Cal patients are made on a per-diem basis for inpatient services and paid based on a fixed-fee schedule for outpatient services. Managed Medi-Cal patients are paid on a per-diem basis. Net revenue for Medi-Cal also includes supplemental funding in recognition of the Medical Center's indigent care and teaching activities.

Net Medi-Cal revenue decreased by $9 million over 2006 due to the decrease in supplemental funding primarily, Medi-Cal hospital waiver DSH payments. For the years ended June 30, 2007, the Medical Center recorded additional revenue of $78.9 million from the Medi-Cal hospital waiver DSH payments and under Senate Bill 1100. In addition, the Medical Center recognized $22 thousand of retrospective payments under Senate Bill 855 for prior years.

CalOptima net patient revenue continued to decrease by $10.1 million in 2007 due to the termination of the full risk capitated CalOptima contract and the adjudication of subsequent claims from prior years.

Net revenue for contracts continued to increase by $27.5 million from 2006 due to the Medical Center's continued efforts in contract negotiations and improved pricing strategies.

County/uninsured patient service revenues includes payments from the County of Orange 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 public health patients. Net revenue for County/uninsured patient services increased from the prior year by $2.7 million, or 7.7 percent. This category fluctuates from year to year depending on the volume and type of patients.

**Operating Expenses**
During 2007, total operating expenses of $447.7 million increased by $31.8 million, or 7.6 percent, over the prior year due to several factors – but primarily to an increase in labor costs, inflationary increases in medical supplies, and increase in facility costs. Total operating expenses for 2006 increased by $24.9 million, or 6.4 percent, over 2005 also due to increases in similar areas.

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 are included in other expenses. The total paid for salaries and employee benefits in 2007 increased by $21.4 million, or 9.3 percent, over the prior year due to union negotiated and inflationary increases in wages and in related employee benefits. Salary and employee benefit costs for 2006 increased by $16 million, or 7.5 percent, over 2005.

Payments for professional services, decreased by $674 thousand, or 43.0 percent, over 2006 due to decrease in contracted medical director expenses. In 2006, professional services decreased slightly by $11.9 thousand, or 0.8 percent, over 2005.

Medical supply expense for 2007 increased by $5.2 million, or 7.7 percent, over the prior year due to a combination of inflationary increases and higher drug costs. Furthermore, medical supply expense increased by $5.2 million, or 8.2 percent, in 2006 over 2005 due to similar increases in patient utilization and inflation.

Other supplies and purchased services expenses include nursing registry, residents, and the cost of medical and non-medical purchased services. The overall other expenses increased by $3.7 million, or 3.8 percent, over 2006 due primarily to a $2.3 million increase in facility costs.

Depreciation and amortization expense increased by $2.2 million over the prior year due to increased capital expenditures and the construction costs of the replacement hospital. In 2006, depreciation and amortization increased by $522 thousand over 2005 due to increased capital expenditures.

Insurance expense of $1.8 million was primarily the Medical Center's contribution to the University of California self-insured malpractice fund. This expense decreased by $69 thousand, or 3.7 percent, over the prior year.

**Non-operating Revenues (Expenses)**
Non-operating revenues, which include interest earned on invested cash balances and losses from disposal or retirement of capital assets, increased by $1 million over 2006 due to an increase in STIP interest income. Non-operating revenues increased by $3.0 million in 2006 over 2005, due to a similar increase in STIP income.

**Income (Loss) before Other Changes in Net Assets**
The Medical Center reported income before other changes in net assets of $45.2 million in 2007 as compared to $64.4 million in 2006 and $63.9 million in 2005. The Medical Center's net income decreased by $19.2 million in 2007 over the prior year primarily due to the continuous escalating labor costs, medical and non-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 are the following:

- Health system support represents transfers primarily to the School of Medicine for academic and clinical support including the Primary Care Network. The Medical Center transferred $37.7 million this year.

- Transfers from the University included $76 million from the state and federal appropriations and $3.7 million from donated assets.

In total, the net assets increased for the year by $87 million to $441.9 million. The majority of this increase is the result of the excess of revenues over expenses of $45.2 million, the receipt of state capital appropriations for infrastructure projects of $75.9 million, the receipt from gift funds of $3.7 million, and the health system support of $37.7 million transferred out to the University.

### Statement 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 | $ 100,823 | $ 117,378 | $ 100,700 |
| Patient accounts receivable (net) | 61,818 | 61,541 | 59,661 |
| Other current assets | 29,218 | 28,407 | 17,269 |
| Total current assets | 191,859 | 207,326 | 177,630 |
| Capital assets | 381,163 | 237,446 | 180,814 |
| Other assets | 29,703 | – | – |
| Total assets | 602,725 | 444,772 | 358,444 |
| Current liabilities | 76,680 | 75,205 | 66,709 |
| Long-term debt | 84,123 | 14,604 | 19,710 |
| Total liabilities | 160,803 | 89,809 | 86,419 |
| Net assets: | | | |
| Invested in capital assets (net) | 317,778 | 215,626 | 153,456 |
| Unrestricted | 124,144 | 139,337 | 118,569 |
| Total net assets | $ 441,922 | $ 354,963 | $ 272,025 |

Total current assets decreased by $15.5 million, or 7.5 percent, compared to the prior year due to the decrease in cash and cash equivalents. Total assets at June 30, 2007 were $158 million higher than the previous year.

Cash decreased by $16.6 million, or 14.1 percent, in 2007 due primarily to an increased investment in capital assets, an increase in health system support transferred out to the University, and decreased net income of the Medical Center.

Net patient accounts receivable, net of estimated uncollectibles, increased slightly by 0.5 percent from the prior year due to the increase in net patient service revenue. The methodology deployed in calculating the allowance for doubtful accounts is based on historical collection experience, and current economic factors.

Other current assets, which include non-patient receivables, inventory, prepaid expenses and advances, increased slightly by $0.8 million, or 2.9 percent, in 2007. The increase was primarily due to a $1.1 million increase in pharmaceutical and supply inventories, a small increase of $0.1 million in advances, the current portion of the deferred bond issuance costs of $22 thousand, offset by a $0.4 million decrease in prepaid expenses.

Capital assets increased by $143.7 million, or 60.5 percent, from the prior year primarily due to the construction of the new replacement hospital.

Other assets included $28.7 million of unspent, restricted fund from the 2007 Series A Bonds for the replacement hospital and $1 million of the long-term portion of the deferred bond issuance costs.

Current liabilities increased by $1.5 million from the prior year mainly in the following areas: a $3 million increase in accrued salaries and benefits due to the timing of bi-weekly payroll payments, a $1.3 million increase in third party payor settlements due to pending open cost report settlements accounts payable, and a $1.5 million increase in the current portion of long-term debt due to the increase in capital leases, and a $0.4 million increase in other liabilities, offset by $4.7 million decrease in accounts payable.

Long-term debt includes the 2007 Series A Pooled Revenue Bonds and long-term capital leases. The long-term debt increased by $69.5 million from the prior year, mainly due to the issuance of the 2007 Revenue Bonds to raise $62.9 million to fund the new replacement hospital. The long-term capital leases increased by $6.4 million from the prior year as capital expenditures increased to invest and replace existing equipment.

Net assets increased by $87 million in 2007. The change in net assets includes the excess of revenues over expenses of $45.2 million, contributed capital assets of $79.6 million, reduced by transfers from the University of $0.1 million and the transfer of $37.7 million of funds to the School of Medicine as health system support.

## Liquidity and Capital Resources

During 2007, the Medical Center generated $57.9 million from operating activities.

Cash flows from non-capital financing activities show the Medical Center's cash was reduced by $37.7 million for transfers to the University as health system support.

Included in cash flows from capital and related financing activities are net transfers from the University of $75.8 million, proceeds from long-term borrowings and capital leases of $63.4 million and purchases of capital assets of $142.4 million. Principal payments on long-term debt and capital leases were $8.1 million and interest paid was about $0.9 million. The issuance cost of the 2007 Series A bond was $1 million.

Cash flows from investment activities show that $5.1 million was provided by interest income. Overall, cash flow decreased to $100.8 million from $117.4 million in 2006 due to the combined factors of lower operating income, increased transfer to the University as health system support, and increased capital expenditures.

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

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Days cash on hand | 85.4 | 106.5 | 97.5 |
| Days of revenue in accounts receivable | 56.3 | 63.2 | 57 |
| Debt service coverage ratio | 7.0 | 9.3 | 8.8 |

Days cash on hand decreased to 85.4 days in 2007 from 106.5 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, net days in receivables decreased by 6.9 days to 56.3. The decrease was the result of the success in improving billing and cash collection efforts.

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 7.0 versus 9.3 in 2006. The decrease in debt service coverage ratio was due to the increase in long-term debt, including the issuance of the new hospital revenue bonds and the related principal and interest repayments in 2007.

## Looking Forward

*The Hospital Facilities Seismic Safety Act ("SB 1953")*
During 2006, the UC Irvine 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, 2008, is $357.5 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, $21.3 million was spent from hospital reserve and gift funds.

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

| | 2007 | 2006 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash | $ 100,823 | $ 117,378 |
| Patient accounts receivable, net of estimated uncollectibles of $4,810 and $2,929, respectively | 61,818 | 61,541 |
| Other receivables | 11,599 | 11,523 |
| Inventory | 11,978 | 10,851 |
| Prepaid expenses and other assets | 5,641 | 6,033 |
| Total current assets | 191,859 | 207,326 |
| Restricted assets: | | |
| Cash restricted for replacement hospital | 28,677 | – |
| Capital assets, net | 381,163 | 237,446 |
| Deferred costs of issuance | 1,026 | – |
| Total assets | 602,725 | 444,772 |
| **Liabilities** | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | 16,006 | 20,685 |
| Accrued salaries and benefits | 26,719 | 23,751 |
| Third-party payor settlements | 24,823 | 23,514 |
| Current portion of long-term debt and capital leases | 8,732 | 7,216 |
| Other liabilities | 400 | 39 |
| Total current liabilities | 76,680 | 75,205 |
| Long-term debt and capital leases, net of current portion | 84,123 | 14,604 |
| Total liabilities | 160,803 | 89,809 |
| **Net Assets** | | |
| Invested in capital assets, net of related debt | 317,778 | 215,626 |
| Unrestricted | 124,144 | 139,337 |
| Total net assets | $ 441,922 | $ 354,963 |

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

# University of California, Irvine 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 $6,242 and $5,777, respectively | $ 467,882 | $ 455,140 |
| Other operating revenue: | | |
| Clinical teaching support | 8,168 | 8,195 |
| Other | 12,754 | 13,919 |
| Total other operating revenue | 20,922 | 22,114 |
| Total operating revenue | 488,804 | 477,254 |
| Operating expenses: | | |
| Salaries and employee benefits | 252,831 | 231,402 |
| Professional services | 893 | 1,567 |
| Medical supplies | 73,348 | 68,099 |
| Other supplies and purchased services | 100,941 | 97,275 |
| Depreciation and amortization | 17,884 | 15,724 |
| Insurance | 1,796 | 1,865 |
| Total operating expenses | 447,693 | 415,932 |
| Income from operations | 41,111 | 61,322 |
| Non-operating revenues (expenses): | | |
| Interest income | 5,062 | 4,201 |
| Interest expense | (862) | (971) |
| Loss on disposal of capital assets | (115) | (138) |
| Total non-operating revenues | 4,085 | 3,092 |
| Income before other changes in net assets | 45,196 | 64,414 |
| Other changes in net assets: | | |
| Health system support | (37,731) | (32,994) |
| Transfers from University, net | 79,494 | 51,518 |
| Total other changes in net assets | 41,763 | 18,524 |
| Increase in net assets | 86,959 | 82,938 |
| Net assets – beginning of year | 354,963 | 272,025 |
| Net assets – end of year | $ 441,922 | $ 354,963 |

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

# University of California, Irvine 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 | $ 468,915 | $ 459,443 |
| Payments to employees | (200,081) | (183,501) |
| Payments to suppliers | (180,734) | (167,660) |
| Payments for benefits | (49,782) | (47,080) |
| Other receipts, net | 19,548 | 11,754 |
| Net cash provided by operating activities | 57,866 | 72,956 |
| Cash flows from noncapital financing activities: | | |
| Health system support | (37,731) | (32,994) |
| Transfers from University | – | 157 |
| Net cash used by noncapital financing activities | (37,731) | (32,837) |
| Cash flows from capital and related financing activities: | | |
| Transfers from University | 75,817 | 51,361 |
| Proceeds from debt issuance | 63,441 | 2,286 |
| Proceeds from sale of capital assets | – | 4 |
| Bond issuance costs | (1,048) | – |
| Purchases of capital assets | (142,366) | (72,497) |
| Principal paid on long-term debt and capital leases | (8,064) | (7,825) |
| Interest paid on long-term debt and capital leases | (855) | (971) |
| Net cash used by capital and related financing activities | (13,075) | (27,642) |
| Cash flows from investing activities: | | |
| Interest income received | 5,062 | 4,201 |
| Change in restricted assets | (28,677) | – |
| Net cash (used) provided by investing activities | (23,615) | 4,201 |
| Net (decrease) increase in cash | (16,555) | 16,678 |
| Cash – beginning of year | 117,378 | 100,700 |
| Cash – end of year | $ 100,823 | $ 117,378 |

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

# University of California, Irvine 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 | $ 41,111 | $ 61,322 |
| Adjustments to reconcile income from operations to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 17,884 | 15,724 |
| Provision for doubtful accounts | 6,242 | 5,777 |
| Changes in operating assets and liabilities: | | |
| Patient accounts receivable | (6,519) | (7,657) |
| Other receivables | (76) | (8,406) |
| Inventory | (1,127) | (770) |
| Prepaid expenses and other assets | 392 | (1,962) |
| Accounts payable and accrued expenses | (4,679) | 2,014 |
| Accrued salaries and benefits | 2,968 | 820 |
| Third-party payor settlements | 1,309 | 6,183 |
| Other liabilities | 361 | (89) |
| Net cash provided by operating activities | $ 57,866 | $ 72,956 |
| Supplemental noncash activities information: | | |
| Gifts of capital assets | $ 3,677 | $ 7,668 |
| Transfer of capital assets to the University | $ 115 | $ 33 |
| Amortization of bond premium | $ 15 | $ – |
| Capital assets acquired through capital lease obligations | $ 15,673 | $ 2,287 |
| Amortization of deferred costs of issuance | $ 22 | $ – |

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

## 1. Organization

The University of California, Irvine 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 Irvine campus. The Medical Center has 453 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 supplementary 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 their 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)**

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 $100,823 and $117,378, 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.

***Restricted Assets, Replacement Hospitals***
The proceeds from the Medical Center Pooled Revenue Bonds 2007 Series A, are held by the Treasurer of The Regents. Bond proceeds remain on deposit with the Treasurer until the project is constructed.

***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 10 to 40 years and for equipment is 5 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 costs 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 asset.

## 2. Summary of Significant Accounting Policies (Continued)

***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.

***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.

## 2. Summary of Significant Accounting Policies (Continued)

***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, 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. 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.

## 2. Summary of Significant Accounting Policies (Continued)

***Transactions with the University and University Affiliates (Continued)***

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 form 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 Medical Center 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.

## 2. Summary of Significant Accounting Policies (Continued)

***New Accounting Pronouncements (Continued)***
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 is 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.

**3. Net Patient Service Revenue (Continued)**

- ***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 $78,958 and $84,273, respectively, which includes revenue from prior years of $22 and $1,843, respectively.

- ***CalOptima*** – Orange County's HMO-model County Organized Health System for Medi-Cal Patients ("CalOptima") is a program that converted the reimbursement for a majority of the Medi-Cal patients in Orange County from fee-for-service (per-diem payments from the state) to a capitated system (set monthly payments per enrollee from CalOptima). Historically, the Medical Center has been a major provider of care to Medi-Cal patients in Orange County. Under CalOptima, there are a number of provider plans from which Medi-Cal beneficiaries may select. Each beneficiary has selected, or will select a primary care physician and related health plan, thus expanding the choice for Medi-Cal patients. The CalOptima capitated contract was terminated effective December 31, 2005.

  The Medical Center terminated the CalOptima sub-contract with Garden Grove Hospital for the Aged, Blind and Disabled (ABD) membership effective December 31, 2006.

- ***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 $1,201 and $2,133, respectively.

(Dollars in thousands)

### 3. Net Patient Service Revenue (Continued)

- ***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.

Amounts due from Medicare and Medi-Cal represent 12.1 percent and 20.2 percent of net patient accounts receivable for fiscal year at June 30, 2007. In 2006, the amount due from Medicare and Medi-Cal were 13.1 percent and 23.3 percent respectively.

For the years ended June 30, 2007 and 2006, net patient service revenue included favorable cost report settlements of $3,258 and $3,104, respectively, from Medicare, Medi-Cal and CalOptima Programs.

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

| | 2007 | 2006 |
|---|---|---|
| Medicare (non-risk) | $ 108,006 | $ 106,619 |
| Medi-Cal (non-risk) | 123,765 | 132,757 |
| CalOptima | 3,780 | 13,905 |
| Commercial | 16,308 | 15,993 |
| Contracts (discount/per diem) | 178,722 | 151,245 |
| County | 14,552 | 10,543 |
| Non-sponsored (uninsured) | 22,749 | 24,078 |
| Total | $ 467,882 | $ 455,140 |

(Dollars in thousands)

## 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 | $ 110,122 | $ 115,985 |
| Estimated cost of charity care | $ 27,519 | $ 26,757 |

Estimated cost in excess of reimbursement for indigent patients under publicly sponsored programs was $15,918 and $16,803 for the years ended June 30, 2007 and 2006, respectively.

## 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 | $ 7,394 | $ – | $ – | $ 7,394 | $ – | $ – | $ 7,394 |
| Buildings and improvements | 185,762 | 6,660 | – | 192,422 | 7,228 | – | 199,650 |
| Equipment | 102,382 | 7,727 | (7,614) | 102,495 | 21,337 | (3,811) | 120,021 |
| Construction in progress | 68,108 | 58,166 | – | 126,274 | 133,151 | – | 259,425 |
| Capital assets, at cost | $ 363,646 | $ 72,553 | $ (7,614) | $ 428,585 | $ 161,716 | $ (3,811) | $ 586,490 |

| | 2005 | Depreciation | Disposals | 2006 | Depreciation | Disposals | 2007 |
|---|---|---|---|---|---|---|---|
| **Accumulated Depreciation and Amortization** | | | | | | | |
| Buildings and improvements | $ 119,641 | $ 6,493 | $ – | $ 126,134 | $ 7,010 | $ – | $ 133,144 |
| Equipment | 63,191 | 9,285 | (7,471) | 65,005 | 10,874 | (3,696) | 72,183 |
| Accumulated depreciation and amortization | $ 182,832 | $ 15,778 | $ (7,471) | $ 191,139 | $ 17,884 | $ (3,696) | $ 205,327 |
| Capital assets, net | $ 180,814 | | | $ 237,446 | | | $ 381,163 |

Equipment under capital lease obligations and related accumulated amortization was $45,060 and $19,684 in 2007, respectively, and $34,634 and $17,391 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)**

## 5. Capital Assets (Continued)

The Medical Center is currently making seismic improvements in order to be in compliance with Senate Bill 1953, the *Hospital Seismic Safety Act*. A portion of the improvements are financed under a lease-revenue bond with the State of California Public Works Board. These amounts totaling $183 and $177 for the years ended June 30, 2007 and 2006, respectively, are shown as contributions from the University for building program on the statement of revenues, expenses and changes in net assets.

## 6. 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 | $ 62,920 | $ – |
| University of California General Revenue Bonds, interest rates from 1.0 to 5.125 percent, payable semi-annually, with annual principal payments through 2017 | 3,816 | 4,112 |
| Capital lease obligations, primarily for computer and medical equipment, with fixed interest rates of 3.1 percent to 6.3 percent payable through 2010 | 25,613 | 17,708 |
| Unamortized bond premium | 506 | – |
| Total debt and capital leases | 92,855 | 21,820 |
| Less: Current portion of debt and capital leases | (8,732) | (7,216) |
| Noncurrent portion of debt and capital leases | $ 84,123 | $ 14,604 |

### (Dollars in thousands)

## 6. 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 | $ 296 | $ 6,920 | $ 7,216 |
| Reclassification from noncurrent | 309 | 9,286 | 9,595 |
| Principal payments | (296) | (7,768) | (8,064) |
| Amortization of bond premium | (15) | – | (15) |
| Current portion at June 30, 2007 | $ 294 | $ 8,438 | $ 8,732 |
| Noncurrent portion at June 30, 2006 | $ 3,816 | $ 10,788 | $ 14,604 |
| New obligations | 62,920 | 15,673 | 78,593 |
| Bond premium | 521 | – | 521 |
| Reclassification to current | (309) | (9,286) | (9,595) |
| Noncurrent portion at June 30, 2007 | $ 66,948 | $ 17,175 | $ 84,123 |
| **Year Ended June 30, 2006** | | | |
| Current portion at June 30, 2005 | $ 284 | $ 7,364 | $ 7,648 |
| Reclassification from noncurrent | 296 | 7,097 | 7,393 |
| Principal payments | (284) | (7,541) | (7,825) |
| Current portion at June 30, 2006 | $ 296 | $ 6,920 | $ 7,216 |
| Noncurrent portion at June 30, 2005 | $ 4,112 | $ 15,598 | $ 19,710 |
| New obligations | – | 2,287 | 2,287 |
| Reclassification to current | (296) | (7,097) | (7,393) |
| Noncurrent portion at June 30, 2006 | $ 3,816 | $ 10,788 | $ 14,604 |

Medical Center Pooled Revenue Bonds are issued to finance 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 $62,920 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.

**6. Long-term Debt and Capital Leases (Continued)**

The $62,920 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 $521, 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.

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 indenture for the Medical Center Pooled Revenue Bonds. The Medical Center's obligations under the terms of the General Revenue Bonds are subordinate to the Medical Center Pooled Revenue Bonds.

The University has an internal working capital program which allows the Medical Center to receive internal advances from the University 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.

(Dollars in thousands)

## 6. 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 | Capital Leases | Total Payments | Principal | Interest |
|---|---|---|---|---|---|
| 2008 | $ 3,395 | $ 9,190 | $ 12,585 | $ 8,732 | $ 3,853 |
| 2009 | 3,394 | 6,819 | 10,213 | 6,635 | 3,578 |
| 2010 | 3,393 | 5,234 | 8,627 | 5,264 | 3,363 |
| 2011 | 3,393 | 3,720 | 7,113 | 3,916 | 3,197 |
| 2012 | 4,081 | 2,431 | 6,512 | 3,450 | 3,062 |
| 2013 – 2017 | 20,403 | – | 20,403 | 6,137 | 14,266 |
| 2018 – 2022 | 17,948 | – | 17,948 | 5,120 | 12,828 |
| 2023 – 2027 | 17,942 | – | 17,942 | 6,450 | 11,492 |
| 2028 – 2032 | 17,950 | – | 17,950 | 8,105 | 9,845 |
| 2033 – 2037 | 17,944 | – | 17,944 | 10,145 | 7,799 |
| 2038 – 2042 | 17,943 | – | 17,943 | 12,640 | 5,303 |
| 2043 – 2047 | 17,944 | – | 17,944 | 15,755 | 2,189 |
| Total future debt service | 145,730 | 27,394 | 173,124 | $ 92,349 | $ 80,775 |
| Less: Interest component of future payments | (78,994) | (1,781) | (80,775) | | |
| Principal portion of future payments | 66,736 | 25,613 | 92,349 | | |
| Adjusted by: Unamortized bond premium | 506 | – | 506 | | |
| Total debt | $ 67,242 | $ 25,613 | $ 92,855 | | |

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

**(Dollars in thousands)**

## 7. 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 $3,774 and $3,091, respectively. The terms of the operating leases extend through the year of 2011.

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

| Year Ending June 30, | Minimum Annual Lease Payments |
|---|---|
| 2008 | $ 3,706 |
| 2009 | 3,307 |
| 2010 | 1,230 |
| 2011 | 732 |
| Total | $ 8,975 |

## 8. 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.

## 8. 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.

## 9. 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 $5,915 and $5,940 for the years ended June 30, 2007 and 2006, respectively. During 2007 and 2006, as a result of actuarial analysis, the Medical Center reviewed a refund of premiums of $1,721 and $496, respectively, from the University that reduced the overall workers' compensation cost for the year.

Combined malpractice and general liability premiums, recorded as insurance expense in the statement revenues, expenses and changes in net assets, were $1,796 and $1,865 for the years ended June 30, 2007 and 2006, respectively.

**(Dollars in thousands)**

## 10. 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 health care services to the Medical Group's capitated members, 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 |
|---|---|---|
| Professional services | $ 893 | $ 1,567 |
| Other supplies and purchased services | 20,212 | 20,531 |
| Interest income (net) | (4,861) | (2,925) |
| Insurance | 1,796 | 1,865 |
| Administrative costs | (4,406) | (4,570) |
| Total | $ 13,634 | $ 16,468 |

Additionally, the Medical Center makes payments to the University of California, Irvine 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 amounts of payments made by the Medical Center to the School of Medicine were $51,365 and $49,462 in 2007 and 2006, respectively. Of these amounts, $13,634 and $16,468 are reported as operating expenses for the years ended June 30, 2007 and 2006, respectively, and $37,731 and $32,994 are reported as health system support for the years ended June 30, 2007 and 2006, respectively.

## 11. 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.

**(Dollars in thousands)**

### 11. 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, 2008, all general acute care inpatient buildings must be life safe. By January 1, 2030, all general acute care inpatient buildings must be operational after an earthquake. Previously, the state of California's budget authorized the University to use $600 million in lease-revenue bond funds for earthquake safety renovations. The Regents have approved the allocation of the $600 million among the University's medical centers, of which $235 million was allocated to the Medical Center. The Medical Center spent $90 million and $32 million 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 is in the process of construction to build a new replacement hospital. The total cost of this Medical Center project is currently estimated to be $ 357.5 million, excluding interest. The replacement hospital financing sources are estimated as follows:

| | |
|---|---|
| Gift funds | $ 47.5 |
| State lease revenue bonds | 235.0 |
| External financing | 65.0 |
| Hospital reserves | 10.0 |
| Total | $ 357.5 |

At June 30, 2007, the Medical Center had outstanding commitments for capital expenditures in connection with the construction of approximately $125 million. The Medical Center expects to fund these costs principally through the proceeds of financing sources noted above. Accordingly, no liability has been recorded in the accompanying financial statements.

Gift funds used for construction in progress totaling $3.6 million in 2007 and $4.1 million in 2006 are reflected in the statements of revenues, expenses and changes in net assets. Additional gift funds and pledges received but not used as of June 30, 2007 are not reflected on the financial statements of the Medical Center. These funds are reflected on the financial statements of the University and transferred to the Medical Center when used.

Subsequent to June 30, 2007, one of the medical centers issued additional debt under the Medical Center Pooled Revenue Bonds totaling $197 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.