Attachment Q

Board of Regents
State of Iowa

11260 Aurora Avenue Urbandale, Iowa 50322-7905

Gregory S. Nichols
Executive Director

Telephone: (515) 281-3934 Fax: (515) 281-6420
Website: www.state.ia.us/educate/regents

Members

Owen J. Newlin, President, *Des Moines*
Neala R. Arnold, *Bettendorf*
David J. Fisher, *West Des Moines*
Clarkson L. Kelly, Jr. M.D., *Charles City*
David G. Neil, *La Porte City*
Deborah A. Turner, M.D., *Des Moines*
Amir I. Arbisser, M.D., *Davenport*
Mary Ellen Becker, Ph.D., *Oskaloosa*
Sue Erickson Nieland, *Sioux City*

MEMORANDUM

To: Mary Shipman

From: Gregory S. Nichols GSN

Subject: Financial Audit of UIHC Health System

Date: August 14, 2002

In response to your e-mail request of August 1, attached is the financial audit of the University of Iowa Health System for the years ended December 2000 and December 2001.

Please let me know if you require further information.

jaf\H:\BF\Legislative\2003 Session\Responses\Shipman - UIHC audit 081302.doc
Enclosure
cc: Legislative Liaisons
Legislative Log

KPMG

UNIVERSITY OF IOWA HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Financial Statements

December 31, 2001 and 2000

(With Independent Auditors' Report Thereon)

KPMG

2500 Ruan Center
666 Grand Avenue
Des Moines, IA 50309

Independent Auditors' Report

To the Board of Directors
University of Iowa Health System:

We have audited the accompanying consolidated balance sheets of University of Iowa Health System and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the University of Iowa Health System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of University of Iowa Health System and subsidiaries as of December 31, 2001 and 2000, and the results of their activities and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

April 12, 2002

KPMG LLP. KPMG LLP, a U.S. limited liability partnership, is a member of KPMG International, a Swiss association.

UNIVERSITY OF IOWA HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2001 and 2000

Assets	2001	2000
Current assets:		
Cash and cash equivalents	$ 4,144,104	3,301,174
Restricted cash (note 10)	750,761	—
Patient accounts receivable, less estimated uncollectibles of $201,644 in 2001 and $295,732 in 2000 (note 5)	3,237,094	3,005,640
Due from affiliates (note 10)	105,189	334,670
Other receivables	420,909	108,738
Inventory	251,689	222,232
Prepaid expenses	206,137	202,430
Current portion of note receivable from affiliate (note 10)	107,990	87,617
Total current assets	9,223,873	7,262,501
Note receivable from affiliate (note 10)	238,797	331,818
Investment in Wellmark Health Plan of Iowa, Inc.	2,400,000	2,400,000
Investments in other health care joint ventures (note 3)	1,404,747	1,344,199
Property and equipment, net (notes 6 and 7)	998,574	1,389,682
Goodwill and other intangibles, net of amortization of $521,953 in 2001 and $278,365 in 2000	1,274,403	1,021,136
	$ 15,540,394	13,749,336
Liabilities and Net Assets		
Current liabilities:		
Current installments of notes payable (note 7)	$ 26,849	10,461
Due to affiliates (note 10)	1,922,834	833,012
Accounts payable	706,051	447,887
Other liabilities and accrued expenses	754,616	463,605
Cash held in trust (note 10)	750,761	—
Total current liabilities	4,161,111	1,754,965
Notes payable (note 7)	82,561	31,333
Other liability (note 6)	455,564	—
Total liabilities	4,699,236	1,786,298
Net assets – unrestricted	10,841,158	11,963,038
Commitments and contingencies (notes 11 and 12)		
	$ 15,540,394	13,749,336

See accompanying notes to consolidated financial statements.

UNIVERSITY OF IOWA HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Statements of Activities

Years ended December 31, 2001 and 2000

	2001	2000
Revenue:		
Net patient service revenue (notes 4 and 5)	$ 12,548,933	11,299,558
Other operating revenue (note 10)	3,485,809	1,776,987
Total revenue	16,034,742	13,076,545
Expenses (note 10):		
Physicians' salaries and benefits	4,103,552	4,248,022
Nonphysicians' salaries and benefits	6,778,818	5,305,750
Supplies and expenses	7,845,813	6,704,672
Medical equipment	538,466	252,844
Depreciation and amortization	648,533	621,491
Interest	8,176	13,959
Provision for uncollectible accounts	536,020	388,155
Total expenses	20,459,378	17,534,893
Operating loss	(4,424,636)	(4,458,348)
Interest income	160,819	267,376
Share in loss of health care joint ventures	(22,518)	(49,934)
Loss on disposal of property and equipment (note 6)	(200,040)	(213,587)
Excess of expenses over revenues before minority interests	(4,486,375)	(4,454,493)
Minority interests	3,495	5,996
Excess of expenses over revenues	(4,482,880)	(4,448,497)
Transfers from the University of Iowa College of Medicine	1,680,500	2,392,000
Transfers from the University of Iowa Hospitals and Clinics	1,680,500	2,392,000
(Decrease) increase in net assets	(1,121,880)	335,503
Net assets at beginning of year	11,963,038	11,627,535
Net assets at end of year	$ 10,841,158	11,963,038

See accompanying notes to consolidated financial statements.

UNIVERSITY OF IOWA HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2001 and 2000

	2001	2000
Cash flows from operating activities:		
(Decrease) increase in net assets	$ (1,121,880)	335,503
Adjustments to reconcile (decrease) increase in net assets to net cash used in operating activities:		
Transfers of net assets	(3,361,000)	(4,784,000)
Share of loss from health care joint ventures	22,518	49,934
Depreciation and amortization	648,533	621,491
Provision for uncollectible accounts	536,020	388,155
Loss on disposal of property and equipment	200,040	213,587
Change in:		
Receivables	(420,455)	(1,348,627)
Inventory	(29,457)	1,848
Prepaid expenses and other assets	5,343	13,963
Accounts payable, due to affiliates, and other liabilities and accrued expenses	2,003,652	320,000
Net cash used in operating activities	(1,516,686)	(4,188,146)
Cash flows from investing activities:		
Payments for investments in health care joint ventures	(75,000)	(210,000)
Proceeds from sale of equipment	(8,100)	—
Purchase of property and equipment	(176,083)	(79,845)
Cash paid for acquisition, net of cash acquired	(721,951)	—
Net cash used in investing activities	(981,134)	(289,845)
Cash flows from financing activities:		
Transfer from University of Iowa College of Medicine	1,680,500	2,392,000
Transfer from University of Iowa Hospitals and Clinics	1,680,500	2,392,000
Payments on notes payable	(110,279)	(790,382)
Proceeds from issuance of note payable	90,029	640,365
Net cash provided by financing activities	3,340,750	4,633,983
Net increase in cash and cash equivalents	842,930	155,992
Cash and cash equivalents at beginning of year	3,301,174	3,145,182
Cash and cash equivalents at end of year	$ 4,144,104	3,301,174
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 12,870	12,460
Supplemental disclosure of noncash investing and financing activities:		
Acquisition of business (note 2):		
Cash paid	$ 800,000	—
Liabilities assumed	170,709	—
	$ 970,709	—
Allocated to:		
Current assets	$ 444,160	—
Property and equipment	36,445	—
Goodwill	490,104	—
	$ 970,709	—

See accompanying notes to consolidated financial statements.

(1) Summary of Significant Accounting Policies and Related Matters

(a) Operations

University of Iowa Health System (UIHS) was incorporated under the provisions of the Iowa Nonprofit Corporation Act on December 2, 1994. UIHS was formed to support the clinical, academic, and research programs of the University of Iowa College of Medicine (UICOM) and the University of Iowa Hospitals and Clinics (UIHC).

UIHS does not have members with voting rights. Upon dissolution, any remaining assets will be transferred to the University of Iowa, or its successor, if in existence. Otherwise the assets may be transferred by the Board of Directors to various entities exclusively for public purposes in accordance with the articles of incorporation for UIHS.

UIHS has majority ownership in University of Iowa Affiliated Health Providers, L.C. (UIAHP), which owns a 10% interest in Wellmark Health Plan of Iowa, Inc.

UIHS has a for-profit wholly owned subsidiary, University of Iowa Community Medical Services, Inc. (UICMS), which was formed in 1995 and began operations in 1996. UICMS has a for-profit wholly owned subsidiary, University of Iowa Community Homecare, Inc. (UICH), which was also formed in 1995 and began operations in 1996.

UIHS has a wholly owned subsidiary, UI HealthWorks, L.L.C (UIHW), which was formed and began operations in 1998.

UIHS has a 90% ownership interest in ResourceLink of Iowa, LLC (ResourceLink), which is consolidated.

(b) Basis of Presentation

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of UIHS and its subsidiaries (the System). All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(c) Cash Equivalents

Cash equivalents consist of repurchase agreements primarily in cash management funds and government money market funds which totaled $2,673,756 and $2,591,933 at December 31, 2001 and 2000, respectively.

(Continued)

(d) Investments

Investments in health care joint ventures with 20 to 50% ownership are recorded using the equity method, with investments of less than 20% ownership recorded at cost, adjusted for impairment in value, if any.

UIAHP's 10% investment in Wellmark Health Plan of Iowa, Inc. is recorded at cost. The shareholder agreement allows the System to offer its investment in Wellmark Health Plan of Iowa, Inc. to shareholders other than Wellmark, Inc. If the other shareholders do not purchase the shares, Wellmark, Inc. must repurchase the shares at book value.

(e) Property and Equipment

Property and equipment are recorded at cost less accumulated depreciation. Depreciation is provided by accelerated methods over the assets' estimated useful lives.

(f) Inventory

Inventory consists of supplies and is stated at the lower of cost or market.

(g) Goodwill and Other Intangibles

Goodwill, which represents the excess of purchase price over fair value of net assets acquired, and other intangibles are amortized on a straight-line basis over three to fifteen years, the expected period to be benefited.

(h) System Funding

The Iowa State Board of Regents has authorized UIHC and UICOM to transfer $30,945,000, one-half from each unit, to UIHS to accomplish the purposes of UIHS.

During 2001 and 2000, UIHS received $1,680,500 and $2,392,000, respectively, in funds from both UIHC and UICOM, resulting in $24,161,200 of cumulative transfers at December 31, 2001.

(i) Net Patient Service Revenue

Net patient service revenue is recorded at the estimated net realizable amounts from patients, third-party payors, and others for services rendered or at capitated rates per covered life under certain insurance arrangements. UICMS, UICH, and ResourceLink are subject to payment limits imposed by Medicare and Medicaid. In addition, UICMS, UICH, UIHW, and ResourceLink have entered into payment agreements with certain commercial insurance companies, health maintenance organizations, and preferred provider organizations to provide care at rates that differ from established charges.

(j) Charity Care

The System has a policy of providing charity care to patients who are unable to pay. Such patients are identified based on financial information obtained from the patient and subsequent analysis. Since the System does not expect payment, estimated charges for charity care are not included in revenue.

(Continued)

(k) Income Taxes

UIHS, UICMS, and UICH are subject to federal and state income taxes and file their income tax returns on a consolidated basis. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and net operating loss carryforwards. Deferred taxes are measured using enacted rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effects of changes in tax rates are recognized in income in the period that includes the enactment date.

Income and losses of UIAHP, UIHW, and ResourceLink are included in the income tax returns of their members.

(2) Acquisition

On January 31, 2001, UICH purchased the operations and certain assets of two companies which provided home health care services for $800,000 and assumed liabilities of approximately $171,000. The purchase transaction resulted in goodwill of $490,104.

(3) Investments in Other Health Care Joint Ventures

The System's investments in health care joint ventures consist of investments in Deer Creek Health Center LLC (Deer Creek), Collaborative Laboratory Services LLC (Collaborative Labs), CareResources, LLC (CareResources), and Cancer Care of Iowa City LLC for which the System has ownership percentages of 40 or 50%. On an aggregate basis the health care joint ventures as of and for the year ended December 31, 2001 had total assets of $4,483,675, total equity of $3,223,395, and net income of $25,530.

(4) Charity Care

The System provides services to eligible patients at reduced or no cost based on the individual patient's financial situation. Records are kept to identify, approve, and monitor those charges that are forgone under the charity care policy. Charity care, determined at established rates, was $77,509 and $104,757 for 2001 and 2000, respectively.

(5) Third-party Reimbursement Programs

As a provider of health care services, the System generally grants credit to patients without requiring collateral or other securities; however, the System routinely obtains assignments of (or is otherwise entitled to receive) patients' benefits payable under their health insurance programs, plans, or policies, which are considered third-party payors. A major portion of the revenues of the System is derived from these third-party payors. Significant changes have been made and may be made in certain of these programs which could have a material adverse impact on the financial condition of the System. These changes include federal and state laws and regulations, particularly those pertaining to Medicare and Medicaid.

(Continued)

The System has agreements with certain of these third-party payors that provide for payment of services at amounts different from established rates. These third-party payors include: the Medicare and Medicaid programs, Blue Cross, various health maintenance and preferred provider organizations, commercial insurance companies, and other commercial enterprises. The basis for payment from these third-party payors varies by payor and includes established charges, contracted rates less than established charges, and periodic revenue at capitated rates per covered life. The System receives payment from these third-party payors for services at established rates less a usual, customary, and reasonable adjustment.

The percentage of patient service revenue at established rates by payor and patient accounts receivable by payor class at December 31, 2001 and 2000 were as follows:

	2001		2000	
	Patient revenue	Patient receivables	Patient revenue	Patient receivables
Medicare	32 %	19	32	24
Medicaid	10	17	10	18
Blue Cross	28	23	31	20
Commercial	27	26	25	24
Self-pay	3	15	2	14
	100 %	100	100	100

(6) Property and Equipment

Property and equipment at December 31, 2001 and 2000 are summarized as follows:

	2001	2000
Moveable equipment	$ 2,659,857	2,508,759
Leasehold improvements	196,922	376,449
Software	40,000	40,000
	2,896,779	2,925,208
Less accumulated depreciation and amortization	1,898,205	1,538,980
	998,574	1,386,228
Construction in progress	—	3,454
Net property and equipment	$ 998,574	1,389,682

(Continued)

UICMS closed two clinics in 2001. The net depreciated cost of leasehold improvements written off in 2001 related to clinic closings was $154,907. A liability was established at December 21, 2001 for remaining payments on the two noncancelable leases for the clinics that were closed during 2001, including $150,000 to terminate one of the leases effective May 2002. The lease obligations for both clinics in 2002 are included in accrued expenses at December 31, 2001. The long-term liability for one location is payable as follows:

Year ending December 31:	
2003	$ 80,600
2004	83,325
2005	83,325
2006	83,325
2007	83,325
Thereafter	41,664
	$ 455,564

UICMS closed a clinic in December 2000. The net depreciated cost of leasehold improvements written off was $208,863.

(7) **Notes Payable**

On January 31, 2001, UICH issued a variable rate note payable in monthly installments of $1,600, including interest, through January 31, 2007. The note is secured by UICH equipment. The interest rate is 0.50% over the Wall Street Journal Prime Rate and at December 31, 2001 was 5.25%, which was used to estimate the current and long-term obligations for disclosure purposes. The balance of the note at December 31, 2001 was $78,077.

ResourceLink has a note payable in monthly installments of principal and interest (8.25%) totaling $1,127 through maturity on July 6, 2004 and is secured by equipment. The balance of the note at December 31, 2001 and 2000 was $31,333 and $41,794, respectively.

The aggregate maturities of the notes for each of the five years subsequent to December 31, 2001 are as follows:

Year ending December 31:	
2002	$ 26,849
2003	28,634
2004	24,824
2005	18,103
2006	11,000

(Continued)

(8) Income Taxes

Income tax of zero differs from the expected tax benefit calculated by applying the United States federal corporate rate of 35% to excess of expenses over revenues before income taxes, primarily because a valuation allowance has been established for deferred tax assets relating to net operating loss carryforwards.

The tax effects of temporary differences between the financial statement bases and tax bases of assets and liabilities at December 31, 2001 and 2000 are as follows:

		2001	2000
Deferred tax assets:			
Net operating loss carryforwards	$	5,998,000	4,675,000
Goodwill amortization		41,600	—
Lease terminations		253,000	—
Other		70,600	125,400
Gross deferred tax assets		6,363,200	4,800,400
Valuation allowance		(6,363,200)	(4,800,400)
Net deferred tax assets	$	—	—

For federal income tax purposes, UIHS has a net operating loss carryforward of approximately $17.1 million at December 31, 2001, which is available to offset future taxable income of the consolidated group through 2021.

Management was unable to conclude it was more likely than not that UIHS would realize the benefits of the deferred tax assets. Accordingly, a valuation allowance has been recorded to offset the possible benefit available from temporary differences.

(9) Retirement Plans

The System has defined contribution employee benefit plans that cover substantially all full-time employees who meet certain eligibility requirements. The System makes a 100% matching contribution on the first 4% of the earnings that employees contribute. Employees must be employed by the System for one year to be eligible for matching contributions to the plans. For the years ended December 31, 2001 and 2000, the System had expenses of $212,134 and $203,258, respectively, related to the plans.

(10) Transactions With Affiliates

UICMS leases clinical space from employed physicians. Rent expense under this lease was $85,692 and $51,459 for the years ended December 31, 2001 and 2000, respectively (see note 12).

UICMS and UICH incurred expenses of $270,504 and $983,627 in 2001 and 2000, respectively, for contracted physicians and general services, equipment, and supplies provided by UIHC and other units of the University of Iowa.

(Continued)

UIHW incurred expenses of $276,556 and $96,078 in 2001 and 2000, respectively, for medical and general services from the University of Iowa Clinical Outreach Services (UICOS) and other units of the University of Iowa, of which $38,376 and $37,348 was due to UICOS at December 31, 2001 and 2000, respectively, and $20,970 and $7,849 to other affiliates at December 31, 2001 and 2000, respectively.

UICMS purchases services from Collaborative Labs. Expenses incurred in 2001 and 2000 were $23,264 and $36,665, respectively. At December 31, 2001 and 2000, $928 and $2,118, respectively, was due to Collaborative Labs for these services.

UICH purchases management services from CareResources. Expenses incurred for these services in 2001 and 2000 were $243,306 and $99,252, respectively. At December 31, 2001 and 2000, UICH owed $70,138 and $1,150, respectively, to CareResources related to these services. UICH also incurred expenses of $8,006 in 2001 for various services and supplies provided to UICH by CareResources.

UICMS provides general administrative services and supplies, including leasing of physicians, to Deer Creek. During 2001 and 2000, $655,925 and $589,293, respectively, was recognized in revenue from Deer Creek. At December 31, 2001 and 2000, the System had $29,388 and $60,841, respectively, due from Deer Creek.

UICH has a subcontractor agreement with UIHC to obtain home infusion therapy products from the UIHC. Expenses under this agreement were $1,252,164 and $830,767 in 2001 and 2000, respectively. At December 31, 2001 and 2000, $1,754,378 and $747,214, respectively, was payable to UIHC under this agreement.

During 2000, UIAHP loaned $475,000 to CareResources. The note bears interest at a rate of 6% and is being repaid in monthly principal and interest payments through May 2005. The note is secured by computer equipment and requires principal repayments as follows: $107,990 in 2002, $98,759 in 2003, $104,850 in 2004, and $35,188 in 2005.

Effective November 2000, UICMS sold three clinics to UIHC. UICMS provides management, operating, and certain physician services for the clinics under an annually renewable contract. For 2001 and 2000, the service fee revenue amounted to $54,000 and $9,900, respectively. In addition, UICMS incurred operating and staffing expenses for the clinics which will be reimbursed by UIHC. At December 31, 2001 and 2000, UICMS had a receivable of $41,852 and $249,600, respectively, related to these services. At December 31, 2001, UICMS maintained cash and a corresponding liability in the amount of $738,546 related to these clinics.

At December 31, 2001, UIHW maintained cash and a corresponding liability in the amount of $12,215 for University of Iowa Behavioral Health.

Receivables from other affiliates were $33,949 and $24,229 at December 31, 2001 and 2000, respectively. Payables to other affiliates were $38,044 and $82,530 at December 31, 2001 and 2000, respectively.

(Continued)

(11) Liability Insurance

Professional liability insurance coverage is maintained on a claims-made basis of $1,000,000 per occurrence, $3,000,000 per year, with no deductibles. The amount of loss, if any, for claims which may be asserted and not covered by insurance cannot be reasonably estimated. The accompanying consolidated financial statements do not include any accrued liabilities for possible losses due to unasserted claims. Should the claims-made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during the policy term but reported subsequently would be uninsured.

(12) Commitments

Certain property, equipment, and office space is being leased under long-term noncancelable operating leases. Rent expense under operating leases was $949,891 for 2001 and $994,208 for 2000. Future minimum rental payments required under noncancelable operating leases that have initial or remaining noncancelable lease terms of one year or more (including $1,035,312 to employed physicians) as of December 31, 2001 are as follows:

Year ending December 31:	
2002	$ 1,061,193
2003	1,013,920
2004	945,818
2005	864,905
2006	699,238
Thereafter	1,626,069
	$ 6,211,143

UICMS has an agreement to sublease a portion of its clinical space to the Joint Office of Clinical Outreach Services of UICH/University of Iowa College of Medicine. Future minimum rental income at December 31, 2001 under this noncancelable sublease total $31,297.

UICMS is committed under noncancelable physician and mid-level provider employment contacts in the following amounts for years ending December 31, 2002, $2,428,063; 2003, $1,586,143; 2004, $304,160; and 2005, $70,000.

The System has agreements to lease physicians and/or physician assistants to Deer Creek and UIHC. Future minimum income at December 31, 2001 under these noncancelable leases totals $630,357.