February 26, 2003
ILR 2003-A

Senator Lyle W. Hillyard
Utah State Senate
319 State Capitol Bldg
Salt Lake City UT 84114

Subject: University Hospital Fund Balances

Senator Hillyard,

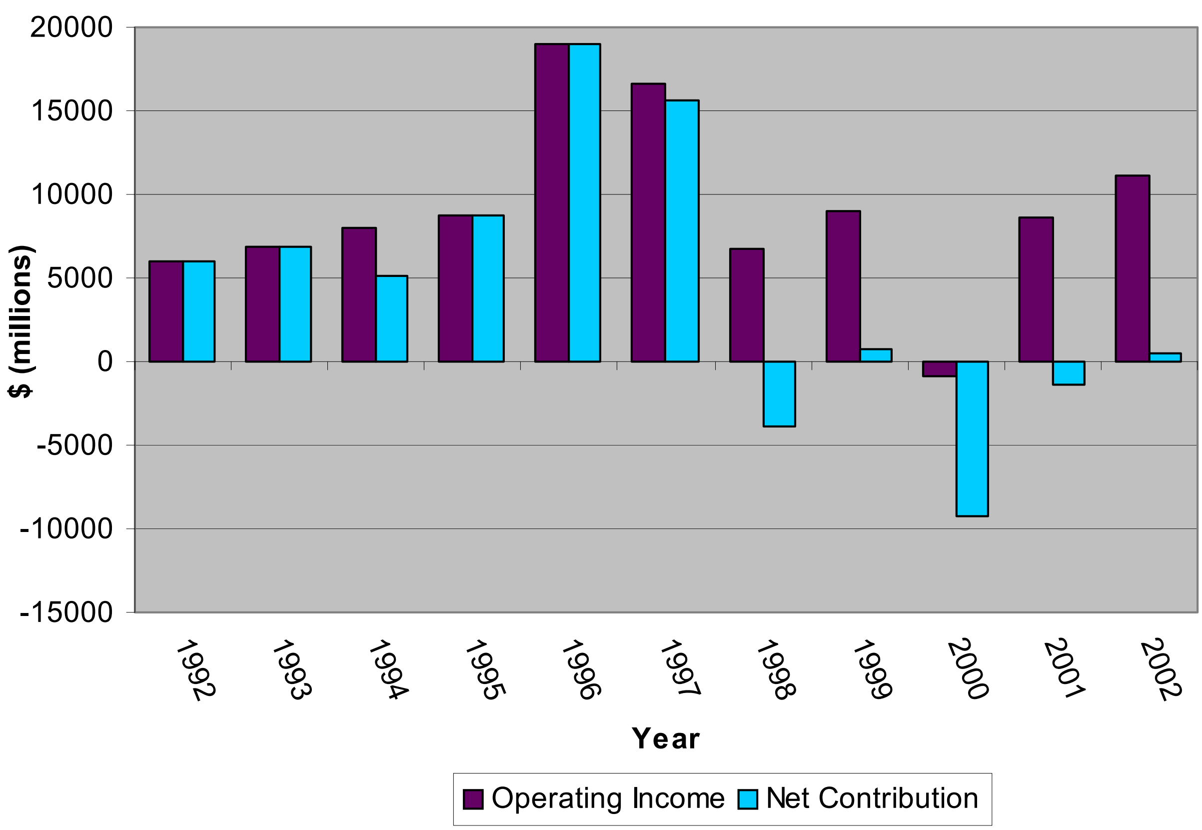
We have completed our survey of University Hospital (the hospital) operating surpluses. We gathered information on the deficits and surpluses the hospital has experienced over the past ten years (fiscal years 1992 to 2002). During this time period, the hospital's net income has been positive in all years but one (fiscal year 2000). The hospital operates on a relatively close margin, averaging about 3.1% annually and ranging as high as 7%. There are a number of influencing factors on this operating margin, including: transfers to other departments, acquisitions, escalating costs, and a changing long-term debt structure. In total these factors have significantly altered the hospital's reported income over the last few years. Further study of these factors, particularly inter-department transfers, may be warranted to gain a fuller understanding of overall hospital efficiency.

When revenue transfers (i.e., transfers or reductions from net income occurring after net income has been computed) are considered, the hospital has had a deficit in three of the ten years reviewed (fiscal years 1998, 2000, and 2001). In all three cases, these deficits were covered by the hospital's unrestricted fund balance. The surpluses generated in the other years were contributed to the hospital's unrestricted fund balance. During this period the hospital has acted as a stand-alone entity, neither requesting funding in time of deficit nor turning over funds to the state in times of surplus.

Revenue Transfers Have Significantly Altered Net Income

Hospital officials believe that the federal Balance Budget Act has significantly altered medical educational funding. As a result, in fiscal year 1998, revenue transfers from hospital funds increased. Since 1998, revenue transfers ranging from $8.2 to $10.6 million have occurred each year and have taken about $48 million from hospital operations. Before 1998, these revenue transfers occurred only twice in our review period — once in fiscal year 1994 for $2.8 million and once in fiscal year 1997 for $1 million. To review the effect revenue transfers have had on the contribution to the fund balance, see Figure 1. For more detail, see the Appendix.

Figure 1. Effects of Fund Transfers on Net Contribution — FY 1992 to 2002



Hospital officials believe that many of the financial changes beginning in fiscal year 1998 are attributable to the federal Balance Budget Act. Federal funding prior to 1998 supported medical education directly and is now being addressed through hospital inter-departmental transfers. Hospital officials also believe that the University School of Medicine state support received in fiscal year 2002 will act as seed money for federal funding which should reduce inter-departmental transfers in the future. Additionally, some other items were treated as expenses or did not exist prior to 1998. As a result, fiscal years 1998 through 2002 include revenue transfers that alter the hospital's reported net income. Hospital officials were able to provide detail as to the make-up of the fiscal year 2001 and 2002 revenue transfers. This information is provided in Figure 2.

Figure 2. Hospital Support of Departmental Services — Fiscal Years 2001 and 2002.

Department	2001	2002
Anesthesia (Program Support)	$ 50,697	$ 150,000
ARUP (Educational Component)	941,381	650,000
Dermatology (Program Support)	156,525	0
Dean's Office (CME Support)	0	35,069
Emergency Physicians (Program Support)	1,681,986	870,000
Health Network & Imaging	0	1,595,352
Internal Medicine (Memorandum)	1,453,893	1,828,327
Medicine (New Provider)	1,816,258	1,331,121
Neurology	59,444	15,000
Nursing (Program Support)	0	237,792
OB/GYN (New Provider)	513,866	173,437
Ophthalmology (Memorandum)	1,191,161	0
Pathology (New Provider, Program Support)	1,078,128	500,000
Pediatrics (New Provider, Program Support)	151,494	78,795
Psychiatry	269,725	215,780
Radiology (Memorandum)	259,385	966,074
Surgery (New Provider)	74,716	770,274
University Programs (Olympics)	0	596,482
VP Health Sciences (Administrative Support)	328,404	644,202
Total	**$10,027,063**	**$10,657,705**

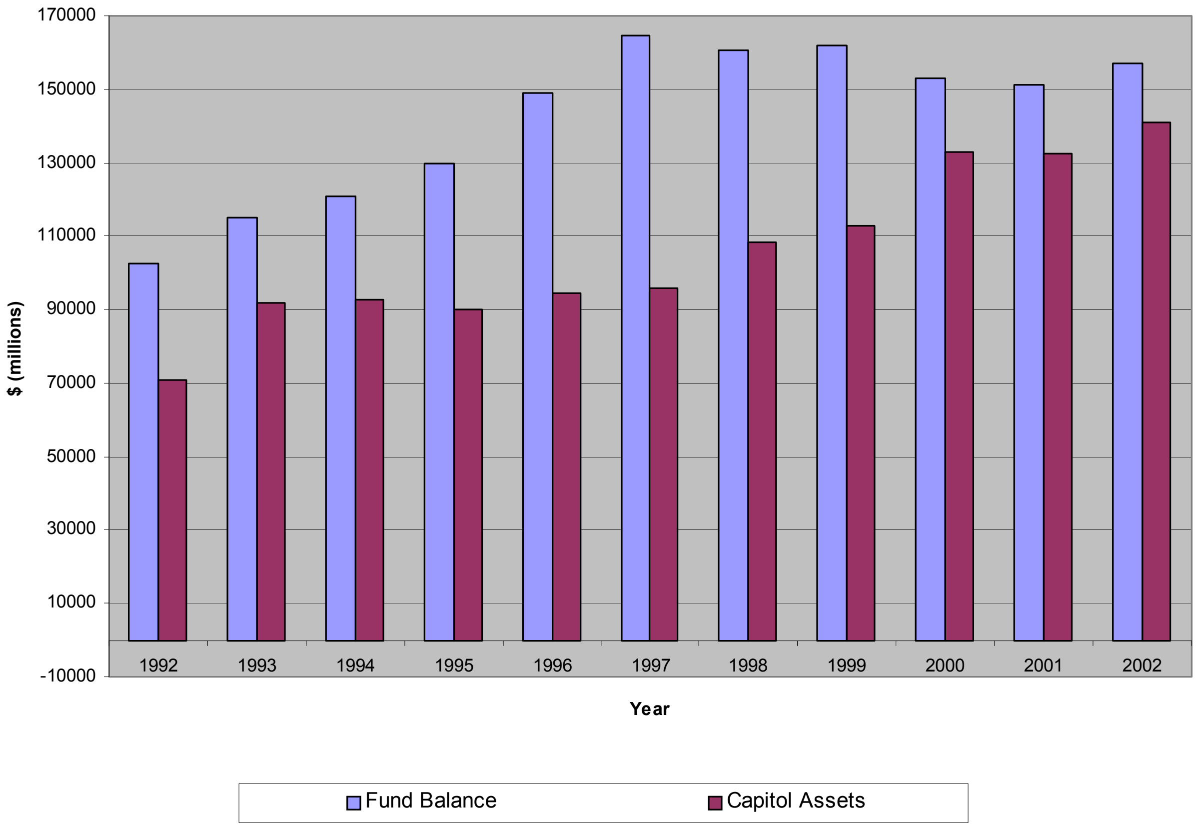
The hospital's Chief Financial Officer (CFO) indicated that three of these departmental revenue transfers (Internal Medicine, Radiology and Ophthalmology) are supported by memorandums of understanding that are based on the concept of profit sharing. For example, if Internal Medicine contributed $500,000 more then in previous years to the hospital's net income, then the hospital would share a portion of that additional $500,000 with Internal Medicine.

The CFO, who has only been in the position for six months, is in the process of determining first, the basis for each of these departmental revenue transfers, and second, whether each transfer is in the best interest of the hospital (i.e., positively contributes to the hospital's net income). The CFO will be presenting his analysis to the hospital's Board of Trustees in the near future.

Fund Balance Growth Has Slowed

The hospital's fund balance, while much higher now than in fiscal year 1992, has declined since fiscal year 1998. As an example, before fiscal year 1998, the hospital's contribution to the unrestricted fund balance averaged $11.1 million per year. After fiscal year 1998, the hospital's contribution to the unrestricted fund balance averaged -$2.7 million per year, indicating a loss of liquidity. To review the movement of the fund balance and its relationship with the hospital's capital assets since fiscal year 1992, see Figure 3.

Figure 3. University Hospital Fund Balance and Capitol Assets for Fiscal Years 1992 to 2002.



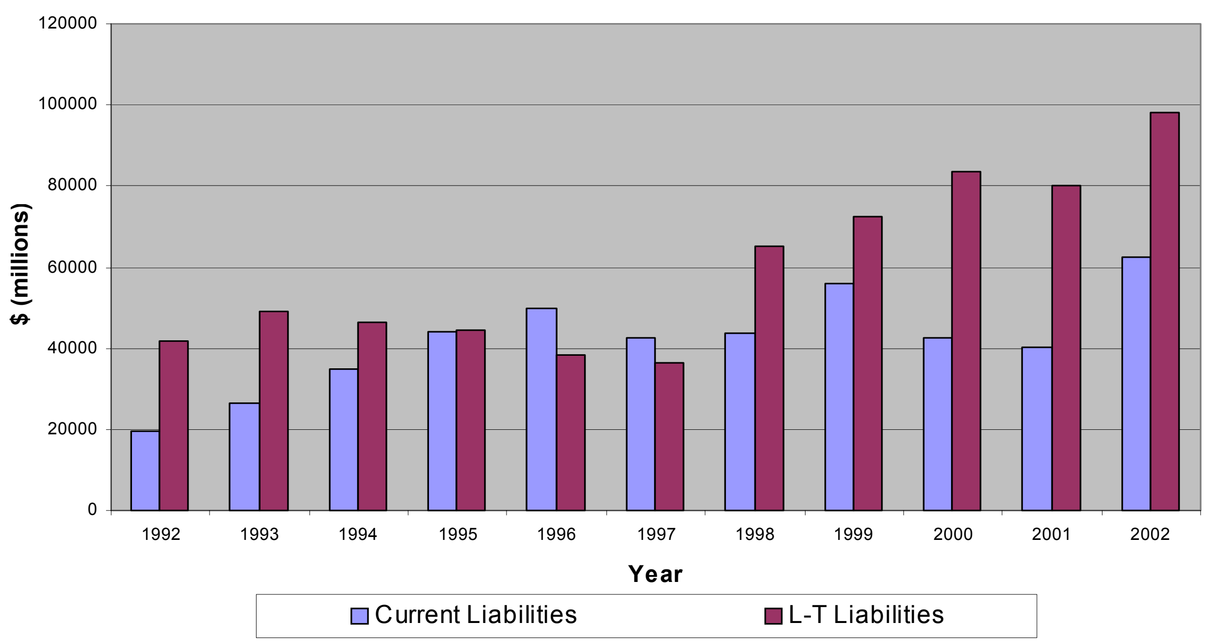
Two contributors to this fund balance decline appear to be an increase in revenue transfers (discussed previously) and an increase in current debt service. Both of these activities reduce net income which, in turn, directly impacts the unrestricted fund balance. Since 1997, the hospital has bonded three times to finance new equipment and expansion. Bonding has significantly changed the hospital's balance sheet. While the unrestricted fund balance was once double the balance sheet's liabilities in fiscal year 1997, by fiscal year 2002 the unrestricted fund balance was less than total liabilities. Additionally, the current year fund balance has a considerably larger restricted portion related to current construction. In effect, current hospital infrastructure growth is being paid for with bonding (future revenues) and a declining fund balance (past revenues).

Long-term Debt Is Reaching Its Limit

The long-term debt of the hospital has, with legislative approval, increased since fiscal year 1998. The current portion of the hospital's long-term debt before fiscal year 1998 averaged $6.1 million a year. However, since fiscal year 1998, this same current portion rose to an average of $9.6 million a year. The current portion of long-term debt is shown in the Appendix as Current Maturities.

This increase in current debt service is the result of an increase in the hospital's bonding activity. Before fiscal year 1998, the hospital's long-term debt averaged $39.3 million. Since fiscal year 1998, this long-term debt averaged $75.4 million. The hospital's long-term debt has increased in order to acquire new properties and to remodel or expand existing properties. This increase is reflected in current and long-term liabilities. The historical trends in both current and long-term liabilities are displayed in Figure 4.

Figure 4. University Hospital Liabilities - FY 1992 to 2002



The CFO told us that the hospital is close to its debt limit. Currently the hospital's debt to equity ratio is 62 percent. In fiscal year 1992, this same ratio was 39 percent. Further, it is possible that the hospital's Moody bond rating may be downgraded again, given the hospital's current liquidity. The hospital's bond rating was downgraded from an A2 to an A3 in fiscal year 2002. If the hospital is downgraded to a Baa, it would become difficult to sell their bonds at a reasonable interest rate.

In summary, the hospital is not required to return surplus funds to the state nor does it appear to be in a position to return surpluses if it were required to do so. The hospital's net income has been positive in all years but one (fiscal year 2000). However, when revenue transfers are considered, the hospital has had a deficit in three of the ten years reviewed (fiscal years 1998, 2000, and 2001). The CFO is in the process of analyzing these revenue transfers and determining if they are in the best interest of the hospital. Annual deficits have been covered by the hospital's unrestricted fund balance and surpluses have fed back into the hospital's unrestricted fund balance. Additionally, the hospital's current debt position does not appear too favorable and could limit future hospital plans. Dependant on the CFO's findings, further work may be advisable.

We hope that this information meets your needs. A response from the University Hospital is attached. If you have any further questions, please call Janice Coleman at 538-1033 ext. 107.

Sincerely,

Wayne L. Welsh
Auditor General

WLW:JTC/lm

Appendix

Apppendix

University Hospital

Balance Sheet 1992 to 2002 ($millions)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
ASSETS											
Cash & Equivalents	2,932	1,241	1,768	23,799	33,787	35,205	31,586	44,715	39,335	35,106	50,665
Funds in trust	15,076	4,253	7,681	8,304	4,183	814	23,378	14,815	14,538	9,523	20,792
Net Patient Accounts Recievable	53,695	63,057	82,037	71,434	75,417	84,534	81,735	85,750	62,571	59,718	68,361
Inventories & Other Assets	14,820	21,360	9,883	17,719	21,328	20,346	15,005	13,153	17,549	22,280	22,823
CURRENT ASSETS	86,523	89,911	101,369	121,256	134,715	140,899	151,704	158,433	133,993	126,627	162,641
Trusteed Investments (Limited Use)	5,208	5,125	4,809	4,673	5,919	6,063	8,014	7,231	7,078	6,895	11,861
Depreciable Property	124,223	151,638	158,722	165,232	177,893	188,842	211,510	237,609	260,091	272,747	282,446
Accumulated Depreciation	(53,303)	(59,896)	-66,185	-75,191	(83,326)	(93,151)	(102,973)	(114,790)	(127,205)	(140,193)	(141,637)
NET PP&E	70,920	91,742	92,537	90,041	94,567	95,691	108,537	122,819	132,887	132,554	140,809
Other Assets	1,287	3,835	3,296	2,361	1,659	1,249	1,475	1,440	4,901	5,624	2,118
TOTAL ASSETS	163,938	190,613	202,011	218,331	236,860	243,902	269,730	289,923	278,858	271,700	317,429
LIABILITIES & FUND BALANCE											
Current Maturities	2,268	4,481	8,449	7,334	8,389	7,716	7,261	8,340	10,805	11,207	10,668
Payables and Other Current Liabilities	17,431	22,037	26,259	36,882	41,477	35,013	36,480	47,446	31,706	29,086	51,699
CURRENT LIABILITIES	19,699	26,518	34,708	44,216	49,866	42,729	43,741	55,786	42,511	40,293	62,367
Long Term-Debt	40,115	47,120	44,266	41,396	34,884	32,112	60,407	68,408	79,986	75,997	92,231
Other LT Liabilities	1,573	1,924	2,183	3,024	3,290	4,483	4,753	3,895	3,453	3,976	5,936
TOTAL LIABILITIES	61,387	75,562	81,157	88,636	88,040	79,324	108,901	128,089	125,949	120,266	160,534
Fund Balance											
Unrestricted	102,275	114,627	119,798	128,593	147,574	163,187	159,292	160,050	150,762	149,357	149,851
Recstricted	276	424	1,056	1,102	1,246	1,391	1,537	1,784	2,147	2,077	7,044
TOTAL LIABILITIES & FUND BALANCE	163,938	190,613	202,011	218,331	236,860	243,902	269,730	289,923	278,858	271,700	317,429

INFORMATION FROM KAUFMAN HALL CREDIT ANALYSIS

Appendix

University Hospital

Income Statements 1992 to 2002 ($millions)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Net Patient Service Revenue	192,951	221,973	232,845	247,990	256,287	273,421	287,931	314,165	318,552	352,514	423,740
Other Operating Revenue	7,406	7,614	8,056	9,345	10,466	10,577	10,091	9,100	8,260	11,045	37,299
OPERATING REVENUES	200,357	229,587	240,901	257,335	266,753	283,998	298,022	323,265	326,812	363,559	461,039
Investment Income	435	290	157	199	1,365	1,970	2,396	3,416	3,769	4,356	3,871
Other Income from Affiliates	1,413	915	1,417	826	1,326	914	562	184	1,755		
TOTAL REVENUES	202,205	230,792	242,475	258,360	269,444	286,882	300,980	326,865	332,336	367,915	464,910
Salaries and Benefits	94,578	107,746	119,948	127,218	126,818	136,751	141,233	147,047	149,773	158,135	200,801
Supplies, Services, and Other	83,619	95,035	93,093	96,696	95,368	103,705	118,360	136,429	148,026	162,387	212,739
Bad Debt	7,923	10,330	8,285	11,409	14,459	14,434	18,335	14,858	14,272	16,153	17,695
Depreciation	6,863	7,675	9,884	10,196	10,392	11,883	13,133	15,311	17,167	18,499	18,459
Interest	3,161	3,111	3,295	4,046	3,427	3,496	3214	4,205	3,912	4,119	4,064
TOTAL EXPENSES	196,144	223,897	234,505	249,565	250,464	270,269	294,275	317,849	333,150	359,293	453,758
OPERATING INCOME	6,061	6,895	7,970	8,795	18,980	16,613	6,705	9,016	(814)	8,622	11,152
Fund Balance Activity/Transfers	0	0	(2800)	0	0	(1000)	(10600)	(8257)	(8474)	(10027)	(10658)
Contribution of Property		5,457									
NET REVENUE	6,061	12,352	5,170	8,795	18,980	15,613	(3,895)	759	(9,288)	(1,405)	494

INFORMATION FROM KAUFMAN HALL CREDIT ANALYSIS

Agency Response

February 25, 2003

Wayne L. Welsh
Legislative Auditor General
130 State Capitol
Salt Lake City, Utah 84114

Dear Mr. Welsh:

We have reviewed your survey of the Hospital's current financial position and the related historical financial activity over the last 10 years. It is important to note that while our financial position is stable, we are not now prepared to address many of the future capital demands unless our working capital position improves. We are however, actively working on managing our expenses and enhancing our revenues in order to be in a better financial position and thus be able to replace our infrastructure including equipment as the need arises.

The Hospital is not independent from the School of Medicine and therefore our ability to upgrade infrastructure is critical to the education of medical students as well as the successful delivery of care to our patients. We must be able to ensure that our medical students have the proper equipment and facilities for their training experience.

Last year the Legislature provided some "seed" money as a source of matching for education related federal Medicaid funds. These monies will go directly to the School of Medicine. We believe that the new source of support will relieve some of the financial pressure we have felt as we have tried to support the School of Medicine in the past. We are confident that all of our efforts will lead to higher quality healthcare throughout the State of Utah.

Our primary financial focus for the next few years will be on increasing our liquidity, which will hopefully lead to an improved bond rating. We will never be able to reach the "AAA" level enjoyed by the State of Utah, but we hope to regain our previous level of"A_2" prior to our need to replace and/or expand the hospital buildings. In the short-term, we will use every opportunity to solicit donor support from our community and we will start to create a capital reserve through improved net income.

We appreciate the work of Janice Coleman and Tim Osterstock in evaluating our finances and hope that the information we have provided to them has been timely and beneficial in completing the survey. We will be happy to provide an update to Senator Hillyard each year as to the progress we are making in improving our financial position and we look forward to his continued involvement with this hospital as a key component to the future development of our State.

Sincerely,

Richard A. Fullmer
Executive Director

cc: Cecilia H. Foxley, Commissioner of Higher Education
J.Bernard Machen, President of the University of Utah