



# STATE OF NORTH CAROLINA

**FINANCIAL STATEMENT AUDIT REPORT OF  
THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
CHAPEL HILL, NORTH CAROLINA  
FOR THE YEARS ENDED JUNE 30, 2001 AND 2000**

**OFFICE OF THE STATE AUDITOR**

**RALPH CAMPBELL, JR.**

**STATE AUDITOR**

**FINANCIAL STATEMENT AUDIT REPORT OF  
THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
CHAPEL HILL, NORTH CAROLINA  
FOR THE YEARS ENDED JUNE 30, 2001 AND 2000**

**UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM**

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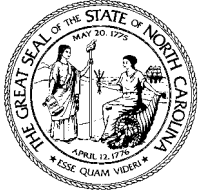
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Ralph Campbell, Jr.  
State Auditor

STATE OF NORTH CAROLINA  
Office of the State Auditor

2 S. Salisbury Street  
20601 Mail Service Center  
Raleigh, NC 27699-0601  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
Internet <http://www.osa.state.nc.us>

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**AUDITOR'S TRANSMITTAL**

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The Honorable Michael F. Easley, Governor  
The General Assembly of North Carolina  
Board of Directors, The University of North Carolina Health Care System

This report presents the results of our financial statement audits of The University of North Carolina Hospitals which is a part of The University of North Carolina Health Care System which is a part of The University of North Carolina System, a component unit of the State of North Carolina, for the years ended June 30, 2001 and 2000. Our audits were made by authority of Article 5A of G.S. §147.

The accounts and operations of the Hospitals are an integral part of the State's reporting entity represented in the State's *Comprehensive Annual Financial Report (CAFR)* and the State's *Single Audit Report*. In those reports, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor also presents the audit results on the State's internal controls and on the State's compliance with laws, regulations, contracts, and grants applicable to the State's financial statements and to its federal financial assistance programs.

As part of the audit work necessary for the CAFR and the *Single Audit Report*, the accounts and operations of the Hospitals were subject to audit procedures as we considered necessary. In addition, we performed auditing procedures that we considered necessary for us to report on the accompanying financial statements and supplementary information that relate solely to The University of North Carolina Hospitals. The audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States.

The purpose of this report is to present the results of our audits of the accompanying financial statements and supplementary information that relate solely to The University of North Carolina Hospitals. A summary of our reporting objectives and audit results are:

- 1. Objective** - Express an opinion on the accompanying financial statements and supplementary information that relate solely to The University of North Carolina Hospitals.

**Results** - The accompanying financial statements present fairly, in all material respects, the amounts and disclosures made in accordance with accounting principles generally accepted in the United States of America. The accompanying supplementary information presents information that is fairly stated in all material respects in relation to the basic financial statements taken as a whole. These matters are more fully described in the Independent Auditor's Report on the Financial Statements.

## AUDITOR'S TRANSMITTAL (CONCLUDED)

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2. **Objective** - Present significant deficiencies, if any, in internal controls which could adversely affect the Hospital's ability to record, process, summarize, and report financial data in the financial statements and present instances of noncompliance, if any, with laws, regulations, contracts or grants.

**Results** - Our tests disclosed no material weaknesses in internal control and no instances of noncompliance which require disclosure herein under *Government Auditing Standards*. These matters are described in the Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

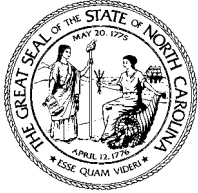


Ralph Campbell, Jr.  
State Auditor

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Ralph Campbell, Jr.  
State Auditor

STATE OF NORTH CAROLINA  
**Office of the State Auditor**

2 S. Salisbury Street  
20601 Mail Service Center  
Raleigh, NC 27699-0601  
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**INDEPENDENT AUDITOR'S REPORT**

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Board of Directors  
The University of North Carolina Health Care System  
Chapel Hill, North Carolina

We have audited the accompanying Balance Sheets of The University of North Carolina Hospitals, which is a part of The University of North Carolina Health Care System which is a part of The University of North Carolina System, a component unit of the State of North Carolina, as of June 30, 2001 and 2000, and the related Statements of Revenues, Expenditures, and Changes in Fund Balances and Statements of Cash Flows for the years then ended. These financial statements are the responsibility of the Hospitals' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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 present only The University of North Carolina Hospitals and are not intended to present fairly the financial position of The University of North Carolina Health Care System and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The University of North Carolina Hospitals as of June 30, 2001 and 2000, and the changes in fund balances and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

## INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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As discussed in Note 16 to the financial statements, the Hospitals changed its accounting for securities lending transactions allocated from the State Treasurer's Cash and Investment Pool during the year ended June 30, 2001. As also discussed in Note 16 to the financial statements, the Hospitals implemented Governmental Accounting Standard Board Statement 33 *Accounting and Reporting of Non-Exchange Transactions* during the year ended June 30, 2001.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 29, 2001 on our consideration of the Hospitals' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with the independent auditor's report in considering the results of our audits.

Schedules 1 and 2 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



Ralph Campbell, Jr.  
State Auditor

October 29, 2001

**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
BALANCE SHEETS**

**JUNE 30, 2001 AND 2000**

**EXHIBIT "A"**

		2001	2000
Current Assets	Cash and cash equivalents (Note 2)	\$ 19,996,275	\$ 18,753,080
	Investments with State Treasurer	76,179,381	4,099,987
	Assets whose use is limited or restricted (Note 5)	7,722,417	3,628,427
	Patient accounts receivable-net of allowances (Note 3)	91,045,684	92,765,860
	Other accounts receivable	13,068,445	14,966,355
	Notes receivable	210,334	-
	Accrued interest receivable	106,768	50,892
	Estimated third party settlements (Note 4)	855,638	8,048,672
	Inventories	11,876,455	11,681,387
	Prepaid expenses	2,800,805	227,817
	Total Current Assets	<u>223,862,202</u>	<u>154,222,477</u>
Noncurrent Assets	Assets whose use is limited or restricted (Note 5):		
	Assets whose use is limited	379,454,851	336,427,612
	Assets whose use is restricted	355,567	390,313
	Total assets whose use is limited or restricted	<u>379,810,418</u>	<u>336,817,925</u>
	Patient accounts receivable-net of allowances (Note 3)	665,934	507,911
	Notes receivable	254,000	-
	Investments in affiliates (Note 14)	6,550,057	8,557,334
	Bond issuance and start-up costs - net of amortization	2,994,796	2,539,252
	Property, plant and equipment-net of accumulated depreciation (Note 6)	314,526,979	273,491,721
	Total Noncurrent Assets	<u>704,802,184</u>	<u>621,914,143</u>
	Total Assets	<u>\$ 928,664,386</u>	<u>\$ 776,136,620</u>

See accompanying notes to financial statements.



**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
BALANCE SHEETS (continued)**

**JUNE 30, 2001 AND 2000**

**EXHIBIT "A"**

		2001	2000
Current Liabilities	Accrued salaries and benefits	\$ 12,684,767	\$ 10,781,991
	Accounts and other payables	26,889,757	18,201,091
	Bond interest payable	3,835,522	3,628,427
	Bonds payable - current portion (Note 9)	4,680,000	3,535,000
	Due to patients or third parties	4,294,843	5,692,625
	Funds held for others	475,164	425,058
	Estimated third party settlements (Note 4)	6,515,082	7,679,419
	Total Current Liabilities	<u>59,375,135</u>	<u>49,943,611</u>
Noncurrent Liabilities	Accumulated annual / holiday leave	12,251,160	12,067,806
	Bonds payable - net of discount (Note 9)	284,649,931	179,062,229
	Rebatable arbitrage payable	852,029	2,841,139
	Estimated third party settlements (Note 4)	15,940,000	14,268,581
	Total Noncurrent Liabilities	<u>313,693,120</u>	<u>208,239,755</u>
	Total Liabilities	<u>373,068,255</u>	<u>258,183,366</u>
Fund Balances	Unrestricted fund balances:		
	Operating	155,326,252	176,524,869
	Limited by:		
	Board designation	129,417,269	100,724,946
	Self insurance fund	4,061,501	2,017,383
	Bond indenture	266,437,121	238,173,124
	Capital improvement fund	-	122,619
	Restricted fund balances	353,988	390,313
	Total Fund Balances	<u>555,596,131</u>	<u>517,953,254</u>
	Total Liabilities and Fund Balances	<u>\$ 928,664,386</u>	<u>\$ 776,136,620</u>

See accompanying notes to financial statements.

**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND BALANCES**

**FOR THE YEARS ENDED JUNE 30, 2001 AND 2000**

**EXHIBIT "B"**

		2001	2000
Operating Revenue	Net patient service revenue (Note 10)	\$ 429,802,052	\$ 405,326,522
	Premium revenue	1,687,738	6,646,418
	State operating appropriations	39,910,182	36,616,815
	Other operating revenue	7,179,959	9,213,501
	Prior year third party settlements	(1,166,469)	1,085,724
	<b>Total Operating Revenue</b>	<b><u>477,413,462</u></b>	<b><u>458,888,980</u></b>
Operating Expenses	Salaries and fringe benefits	252,741,432	243,397,845
	Medical and surgical supplies	84,935,270	85,861,235
	Contracted services	42,648,867	50,690,849
	Other supplies and services	30,380,451	25,239,811
	Communications and utilities	12,098,226	12,100,145
	Medical malpractice costs	329,926	1,402,094
	Interest expense-not capitalized	5,892,886	6,512,249
	Provision for bad debts	21,906,919	17,654,917
	Depreciation and amortization	16,706,704	17,131,489
	<b>Total Operating Expenses</b>	<b><u>467,640,681</u></b>	<b><u>459,990,634</u></b>
	<b>Net Operating Income (Loss)</b>	<b><u>9,772,781</u></b>	<b><u>(1,101,654)</u></b>
Nonoperating Revenue and Expenses	Investment income:		
	Unrestricted interest income	27,671,944	31,341,175
	Net increase (decrease) in fair value of investments	9,596,801	(9,399,500)
	Gain (loss) on investments in affiliates (Note 14)	(9,090,406)	(12,433,502)
	Unrestricted gifts and grants	476,171	268,131
	<b>Total Nonoperating Revenue</b>	<b><u>28,654,510</u></b>	<b><u>9,776,304</u></b>
	<b>Net Income</b>	<b><u>\$ 38,427,291</u></b>	<b><u>\$ 8,674,650</u></b>

See accompanying notes to financial statements.

**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND BALANCES (continued)**

**FOR THE YEARS ENDED JUNE 30, 2001 AND 2000**

**EXHIBIT "B"**

		2001	2000
Other	Restricted interest income	21,311	21,831
Financing	Restricted gifts and grants	860	41,323
Sources	Loss on disposal of fixed assets	(806,585)	(3,055,506)
	Transfer to UNC Health Care System (Note 12)	-	(100,000,000)
	Total Other Financing Sources (Uses)	<u>(784,414)</u>	<u>(102,992,352)</u>
	Increase (Decrease) in fund balances	37,642,877	(94,317,702)
Fund	Fund balances - beginning of year	517,953,254	612,270,956
Balance			
Activity			
	Fund Balances - end of year	\$ <u>555,596,131</u>	\$ <u>517,953,254</u>

See accompanying notes to financial statements.

**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
STATEMENTS OF CASH FLOWS**

**FOR THE YEARS ENDED JUNE 30, 2001 AND 2000**

**EXHIBIT "C"**

		2001	2000
Cash Flows From Operating Activities	Cash received from patients and third parties	416,280,889	380,899,620
	Cash payments to employees for services	(250,655,302)	(241,208,966)
	Cash payments to suppliers for goods and services	(168,915,432)	(174,127,375)
	Cash payments for medical malpractice claims	(329,926)	(1,844,992)
	Other cash receipts	9,077,869	9,104,085
	<b>Net Cash Provided(Used) By Operating Activities</b>	<u>5,458,098</u>	<u>(27,177,628)</u>
Cash Flows From Noncapital Financing Activities	State operating appropriations:		
	Amount received	39,910,182	37,204,037
	Amount returned	-	(587,222)
	Gifts and grants	526,277	300,835
	Transfer to UNC Health Care System	-	(100,000,000)
	<b>Net Cash Provided(Used) By Noncapital Financing Activities</b>	<u>40,436,459</u>	<u>(63,082,350)</u>
Cash Flows From Capital and Related Financing Activities	Proceeds from sale of equipment	56,503	71,167
	Interest paid on capital debt	(10,917,308)	(9,156,093)
	Principal paid on revenue bond maturities	(3,535,000)	(740,000)
	Proceeds from sale of revenue bonds	110,000,000	-
	Arbitrage paid on tax exempt financing	(3,678,183)	-
	Issuance costs paid	(548,827)	-
	Acquisition and construction of fixed assets	(48,239,320)	(50,320,071)
	<b>Net Cash Provided(Used) By Capital and Related Financing Activities</b>	<u>\$ 43,137,865</u>	<u>\$ (60,144,997)</u>

See accompanying notes to financial statements.

**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS  
STATEMENTS OF CASH FLOWS (continued)**

**FOR THE YEARS ENDED JUNE 30, 2001 AND 2000**

**EXHIBIT "C"**

		2001	2000
Cash Flows From Investing Activities	Interest income	\$ 29,326,452	\$ 32,383,115
	Investments with State Treasurer's Pool:		
	Unrestricted assets	(73,477,705)	107,643,273
	Assets whose used is limited or restricted	(36,090,511)	8,515,386
	Investments in and Loans to Affiliated Enterprises:		
	Cash received	-	6,323,685
	Cash payments	(7,547,463)	(9,139,354)
	Net Cash Provided(Used) By Investing Activities	<u>(87,789,227)</u>	<u>145,726,105</u>
	Net Change in Cash and Cash Equivalents	1,243,195	(4,678,870)
	Cash and Cash Equivalents, Beginning	<u>18,753,080</u>	<u>23,431,950</u>
Ending Cash	Cash and Cash Equivalents, Ending	\$ <u>19,996,275</u>	\$ <u>18,753,080</u>

See accompanying notes to financial statements.

**UNIVERSITY OF NORTH CAROLINA HOSPITALS  
STATEMENTS OF CASH FLOWS (continued)**

**FOR THE YEARS ENDED JUNE 30, 2000 AND 1999**

**EXHIBIT "C"**

2001

2000

A reconciliation of net operating income (loss) to cash provided (used) by operations follows:

Net Operating Income (Loss)	\$ 9,772,781	\$ (1,101,654)
Adjustments to reconcile operating income to cash flows from operations:		
State operating appropriations	(39,910,182)	(36,616,815)
Provision for bad debts	21,906,919	17,654,917
Depreciation and Amortization	16,706,704	17,007,545
Interest Expense	5,892,886	6,512,249
Change in assets and liabilities:		
Patient accounts receivable	(20,344,766)	(29,485,002)
Other accounts receivable	1,897,910	(750,131)
Estimated third party settlements	7,700,116	(7,590,309)
Inventories	(195,068)	(1,196,600)
Prepaid Items	(2,572,988)	(92,357)
Accrued salaries and benefits	1,902,776	1,763,343
Accounts and other payables	3,915,438	4,916,267
Due to patients or third parties	(1,397,782)	1,339,005
Funds held for others	-	36,378
Accrued annual and holiday leave	183,354	425,536
	<hr/>	<hr/>
Net Cash Used By Operating Activities	\$ <u>5,458,098</u>	\$ <u>(27,177,628)</u>
Non-Cash Capital Financing Activities:		
New capital leases	-	1,250,700
Non-Cash Investing Activities:		
Unrealized gain (loss) on State Treasurer's Pool:		
Unrestricted assets	(1,530,178)	(5,503,267)
Assets whose used is limited or restricted	10,995,112	(7,020,945)
Investments in affiliated enterprises:		
Current loss from discontinuance of affiliated operations	(8,173,444)	(6,790,994)
Current loss from equity method adjustments	(916,962)	(5,642,508)

See accompanying notes to financial statements.

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**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2001 and 2000**

**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES:**

Organization: The University of North Carolina Hospitals (the Hospitals) is the only State-owned teaching hospital in North Carolina. With a licensed base of 684 beds, this facility serves as an acute care teaching hospital for The University of North Carolina at Chapel Hill. The Hospitals consists of North Carolina Memorial Hospital, North Carolina Children's Hospital, North Carolina Neurosciences Hospital, and North Carolina Women's Hospital. As a state agency, the Hospitals is required to conform to financial requirements established by various statutory and constitutional provisions. While the Hospitals is exempt from both federal and state income taxes, a small portion of its revenue is subject to the unrelated business income tax.

Financial Reporting Entity: The Hospitals is a part of the University of North Carolina (UNC) Health Care System which is a part of The University of North Carolina System. The University of North Carolina System is a component unit of the State of North Carolina and an integral part of the State of North Carolina's *Comprehensive Annual Financial Report*.

The accompanying financial statements present all funds belonging to the Hospitals for which the UNC Health Care System Board of Directors is responsible. This includes Health System Properties, LLC (the LLC) which was established to purchase, develop and/or lease real property. Although a legally separate entity, the LLC is reported as part of the Hospitals because UNC Health Care System is the sole member manager of the LLC and is governed by the same Board that directs the Hospitals' operations. Additionally, the only property currently being developed by the LLC is for the sole use and benefit of the Hospitals and the Hospitals has entered into a long term Ground Lease Agreement with the LLC for its use of the Meadowmont property. The construction costs for the Hospitals' new wellness center which is being constructed on the land owned by the LLC is included in the Property, Plant and Equipment account on the financial statements. Because of these relationships, the LLC's operations have been blended with those of the Hospitals. The major impact of this blending has been the reclassification of \$1,568,000 from the investment account to the Property, Plant and Equipment account on the financial statements. These are both within the noncurrent asset category on the financial statements.

Separate financial statements are not produced for the LLC, but financial information is separately maintained within the Hospitals' accounting system. Financial information may be obtained from the Chief Financial Officer, University of North Carolina Hospitals, 6011 East Wing, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-1727.

Basis of Accounting: The accompanying financial statements have been prepared on the accrual basis of accounting.



## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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Fund Structure: The accompanying financial statements have been prepared on an aggregated basis.

Accounting Standards: Pursuant to Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Hospitals has elected to apply the provisions of all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs).

Cash and Cash Equivalents: This classification includes cash on hand, cash in banks and short-term investments with the State Treasurer's Cash and Investment Pool. Cash and cash equivalents whose use is limited or restricted are reported separately as part of "Assets whose use is limited or restricted."

Investments: The Hospitals invests in long-term investments with the State Treasurer's Cash and Investment Pool. Investments whose use is limited or restricted are reported separately as part of "Assets whose use is limited or restricted." Investments are reported at fair value for financial reporting purposes. Fair value is the amount at which an investment could be exchanged between two willing parties. Fair value for financial reporting purposes is based on quoted market prices. The net change in the fair value of investments is recognized as a "Net increase (decrease) in fair value of investments."

Assets Whose Use is Limited or Restricted: Assets whose use is limited include: assets set aside by the Board as nonexpendable gifts over which the Board retains control and may at its discretion subsequently use for other purposes; assets held by a trustee under the self-insurance trust fund arrangement net of estimated malpractice costs; assets held by a trustee under the 1996, 1999 and 2001 Bond Indentures; reserves required by the Bond Indentures; capital improvement projects funded by state appropriation; and assets designated by the Board.

Assets whose use is restricted include assets restricted by donors and grantors for specific operating purposes. Restricted gifts and grants are recorded as additions to restricted fund balances when received and transfers to other operating revenue when expended.

Capital improvement funds are authorized by the General Assembly or Advisory Budget Commission to provide for new construction and major renovation projects for the Hospitals. Use of these funds is limited to the projects specified in the approved State applications. At the completion of a project, unused funds are reverted to the original source of funding for the project.

Assets whose use is limited or restricted that are required for current liabilities at the balance sheet date are reported as current assets. All other assets whose use is limited or restricted are reported as noncurrent assets.

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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Patient Accounts Receivable: The Hospitals has established flexible payment arrangements with selected payers to optimize collection of past-due accounts. Amounts due after one year under these arrangements are classified as noncurrent assets. As a part of its patient accounts receivable policy, the Hospitals makes a provision for contractual allowances and bad debt. See Net Patient Service Revenue for a further discussion of contractual allowances. The provision for bad debt represents services for which individuals have refused to make payment even though they have the financial ability to pay. These occur on accounts for uninsured (self-pay) patients and for the portions of the co-payments and deductibles that are the patient's liability under commercial indemnity insurance policies.

Inventories: Inventories are stated at FIFO (first-in, first-out) cost.

Property, Plant and Equipment: Property, plant and equipment are recorded at cost. Donated assets are recorded at fair value at the date of receipt, which is then treated as cost. The Hospitals capitalizes assets having a cost or fair value in excess of \$5,000. Upon disposal, the cost and accumulated depreciation are eliminated from the respective accounts, and the resulting gain or loss is recorded as an increase or decrease in fund balance.

Annual, Holiday and Sick Leave: The Hospitals' policy is to record the cost of annual leave when earned. Employees earn annual leave ranging from 0.98 to 2.15 days per month depending upon years of service. The policy provides for a maximum accumulation of unused annual leave of 30 days that can be carried forward each January 1. At December 31, any excess accumulation over the 30 days of annual leave is converted to sick leave. Upon termination of employment, employees are paid for the current balance of annual leave accumulated up to the maximum of 30 days. The accumulated annual leave amounts for 2001 and 2000 were \$11,052,442 and \$10,945,211.

Employees earn holiday leave at the rate of 11 days per year with an unlimited accumulation. Hospital policy requires employees to use holiday hours in excess of 40 prior to using earned annual leave. At termination, employees are paid for any accumulated holiday leave. The accumulated holiday leave amounts for 2001 and 2000 were \$1,198,718 and \$1,122,595.

The liability for accumulated annual and holiday leave shown is calculated for each employee at year-end by taking the leave carried forward at the previous December 31 plus the leave earned, less the leave taken between January 1 and June 30. The liability is equal to the accumulated hours multiplied times the employee's current hourly rate plus benefits for social security and state retirement.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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The Hospitals has the policy of recording the cost of sick leave when taken and paid rather than when the leave is earned. Employees earn sick leave at the rate of one day per month with an unlimited accumulation. Employees are not paid for accumulated sick leave upon termination; however, additional service credit for pension benefits is given for accumulated sick leave upon retirement.

Net Patient Service Revenue: Patient service revenue is recorded at the Hospitals' established rates. The difference between established rates and the estimated amount collectable is recognized as revenue deductions on an accrual basis and deducted from gross patient service revenue to report service revenue at net realizable value. Indigent care provided represents health care services that were provided free of charge to individuals who meet the criteria of the Hospitals' charity care policy. Indigent care provided is not considered to be revenue to the Hospitals.

Differences between the amounts paid for services under third-party reimbursement programs and established rates are accounted for as contractual adjustments. Final determinations of contractual adjustments arising under reimbursement agreements with third-party payers are subject to review by appropriate authorities. Retroactively calculated adjustments are recorded as prior year third-party settlements in the year in which the adjustments can be reasonably estimated.

Premium Revenue: The Hospitals has an agreement with Healthsource to provide medical services to subscribing participants. Under this agreement, the Hospitals receives monthly capitation payments based on the number of Healthsource participants, regardless of services actually performed by the Hospitals. In addition, Healthsource makes fee-for-service payments to the Hospitals for certain covered services based upon discounted fee schedules.

Medical Malpractice Costs: Medical malpractice costs consist of provisions for anticipated self insured medical malpractice claims and claims adjustment expenses incurred during the current year and any change in the provision for claims incurred in prior years. Claims alleging medical malpractice have been asserted against the Hospitals and are currently in various stages of litigation. It is the opinion of Hospitals' management that estimated malpractice costs accrued at year-end are adequate to provide for potential losses resulting from pending or threatened litigation. Actual paid losses and loss adjustment expenses may vary significantly from the estimated amount due to assumptions inherent in the determination of the discounted liability.

Depreciation and Amortization: For depreciable assets (other than buildings) one-half year depreciation is taken in the year of acquisition regardless of acquisition date and one-half year depreciation is taken upon disposition regardless of disposition date. Depreciation is taken on buildings based upon the date placed into service or the date retired from service.

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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Property, plant and equipment is depreciated using the straight-line method over the following estimated useful lives:

<u>Assets</u>	<u>Years</u>
Equipment	3-20
Buildings	10-50
Fixed equipment	10-50
Other structures and improvements	5-25

Construction in progress is transferred to depreciable assets only after the completion of construction and upon the assets being placed in service.

The interest cost incurred during the construction period for assets that were financed with the proceeds of tax-exempt debt is capitalized to the extent that interest cost exceeds interest earned on related interest-bearing investments acquired with the proceeds of the related tax-exempt borrowing.

Amortization expense is calculated for the bond issuance costs using the effective interest method over the life of the bonds and for the start-up costs of affiliate activities using a straight-line method over a period of 40 years.

Donated Services: No amounts have been included for donated services since no objective basis is available to measure the value of such services. However, a substantial number of volunteers donated significant amounts of their time to the Hospitals' operations.

### **NOTE 2 - DEPOSITS AND INVESTMENTS:**

Deposits: At June 30, 2001, deposits include cash and cash equivalents of \$19,978,476 and similar assets whose use is limited or restricted of \$73,369,144 for total deposits of \$93,347,621. Cash on hand was \$17,799. The Hospitals' portion of short-term investments with the State Treasurer's Cash and Investment Pool was \$92,931,782. It is the State Treasurer's policy and practice for the pool's uninvested cash deposits not covered by federal depository insurance to be covered by collateral held by the State of North Carolina's agent in the name of the State and for the pool's investments to be held by the State's agent in the State's name. The carrying amount of the Hospitals' deposits not with the State Treasurer was \$49,795 and the bank balances were \$48,706. Bank balances in excess of \$100,000 are not covered by federal depository insurance. At June 30, 2001, no bank balance was in excess of \$100,000.

At June 30, 2000, deposits included cash and cash equivalents of \$18,705,354 and similar assets whose use is limited or restricted of \$60,927,614 for total deposits of \$79,632,968. Cash on hand was \$17,824. Cash on deposit with the Office of State Controller for processing Worker's Compensation claims was \$29,902. The Hospitals' portion of short-term investments with the State Treasurer's Cash and Investment Pool was \$79,073,342. It is the State Treasurer's policy and practice for the pool's uninvested cash deposits not covered

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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by federal depository insurance to be covered by collateral held by the State of North Carolina's agent in the name of the State and for the pool's investments to be held by the State's agent in the State's name. The carrying amount of the Hospitals' deposits not with the State Treasurer was \$559,626 and the bank balances were \$590,782. Bank balances in excess of \$100,000 are not covered by federal depository insurance. At June 30, 2000, this amount was \$405,860.

North Carolina General Statutes 147-69.1(c) and 147-69.2 authorize the State Treasurer to invest in the following: Obligations of or fully guaranteed by the United States; obligations of certain federal agencies; repurchase agreements; obligations of the State of North Carolina; certificates of deposit of specified institutions; prime quality commercial paper; specified bills of exchange; asset-backed securities, corporate bonds and notes with specified ratings; general obligations of other states; general obligations of North Carolina local governments; certain venture capital limited partnerships; and the obligations or securities of the North Carolina Enterprise Corporation.

Investments: General Statute 147-77 and 116-36.1 requires the Hospitals to deposit its funds with the State Treasurer's Cash and Investment Pool.

Bond proceeds and debt service funds are invested in accordance with the bond resolutions in obligations which will by their terms mature on or before the date funds are expected to be required for expenditure or withdrawal.

Investments of the Hospitals' unrestricted operating reserves are reported as "Investments with the State Treasurer." Investments for restricted purposes or for those whose use is limited are reported separately as part of "Assets whose use is limited or restricted".

Since the Hospitals does not own specific identifiable securities, investments are not categorized as to the level of risk assumed by the entity at year-end.

The Hospitals' Investments with the State Treasurer's Cash and Investment Pool – Long Term Portfolio stated at fair market value were:

	<u>2001</u>	<u>2000</u>
Unrestricted Operating Reserves	76,179,381	4,099,987
Investments Whose Use is Limited or Restricted	<u>309,708,997</u>	<u>277,215,952</u>
Total Investments	<u><u>385,888,378</u></u>	<u><u>281,315,939</u></u>

The financial statements and disclosures for the State Treasurer's Cash and Investment Pool are included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page <http://www.osc.state.nc.us/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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### **NOTE 3 - PATIENT ACCOUNTS RECEIVABLE - NET:**

Net patient accounts receivable consist of amounts due from patients and third parties at estimated realizable value. Included in gross receivables are amounts receivable at established billing rates less payments received through June 30. Allowances for uncollectable accounts and contractual adjustments are estimated using historical collection statistics and projections of reimbursement. The components of net patient accounts receivable reflected in the balance sheet are as follows at June 30, 2001 and 2000:

	<u>2001</u>	<u>2000</u>
In house patients	21,818,362	15,237,125
Discharged (not final billed) patients	<u>10,050,065</u>	<u>11,676,203</u>
Total unbilled	<u>31,868,427</u>	<u>26,913,328</u>
Discharged patients	118,237,428	113,945,952
Payment arrangements	401,877	263,699
Indigent care provided	<u>(15,718,451)</u>	<u>(17,136,154)</u>
Current - gross	<u>134,789,281</u>	<u>123,986,825</u>
Allowance for bad debts	(12,908,480)	(9,472,300)
Contractual allowances	(30,835,117)	(21,748,665)
Total allowances	<u>(43,743,597)</u>	<u>(31,220,965)</u>
Current - net	<u>91,045,684</u>	<u>92,765,860</u>
Payment arrangements	951,335	725,587
Allowance for bad debts	(285,401)	<u>(217,676)</u>
Noncurrent - net	<u>665,934</u>	<u>507,911</u>
Total net	<u><u>91,711,618</u></u>	<u><u>93,273,771</u></u>

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

### **NOTE 4 - ESTIMATED THIRD PARTY SETTLEMENTS:**

Medicare Passthrough Payments: Medicare makes interim payments to the Hospitals for certain portions of inpatient acute care costs that continue to be reimbursed at cost under the Prospective Payment System. The Hospitals earned \$12,477,542 and \$12,526,658 in pass through payments for 2001 and 2000, including \$855,638 earned but not received as of June 30, 2001 and \$821,426 as of June 30, 2000.

Annual Audits and Tentative Cost Settlements: The Hospitals' cost reports for Medicare and Medicaid are subject to annual audits which may result in various adjustments and interim settlements relating to the cost-based portion of reimbursement.

As of June 30, 2001, the Hospitals estimates a current liability of \$1,585,082 and \$4,930,000 for amounts due to Medicare and Medicaid, respectively. Cost settlements estimated as noncurrent are \$13,010,000 and \$2,930,000 for Medicare and Medicaid, respectively.

As of June 30, 2000, the Hospitals estimated a current liability of \$2,111,419 and \$5,568,000 for amounts due to Medicare and Medicaid, respectively. Cost settlements estimated as noncurrent were \$11,668,581 and \$2,600,000 for Medicare and Medicaid, respectively.

### **NOTE 5 - ASSETS WHOSE USE IS LIMITED OR RESTRICTED:**

Assets whose use is limited or restricted at June 30, 2001 and 2000 includes the following:

	2001	2000
Advance Deposits with Liability Insurance Trust Fund	4,061,501	2,017,383
Advance Deposits – Other	91,940	
By bond indenture:		
Construction funds	64,742,708	51,593,416
Principal and interest funds	7,735,153	6,565,960
1996 maintenance reserve	138,665,555	138,665,555
1999 7.5% maintenance reserve	44,078,619	41,348,193
By board designation:		
Other reserves	16,725,810	
UNC health care system		1,273,806
Construction/renovation/equipment	111,075,982	97,991,396
Nonexpendable gift		477,711
Capital improvement funds		122,619
Restricted trust funds	355,567	390,313
Total assets whose use is limited or restricted	387,532,835	340,446,352
Less: amount required to meet current obligations	(7,722,417)	(3,628,427)
Total assets whose use is limited or restricted - noncurrent	379,810,418	336,817,925

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The composition of assets whose use is limited or restricted is set forth below. For Exhibit C, Assets whose use is limited or restricted are treated as investments as permitted by GASB 9.

	2001	2000
Cash and cash equivalents	73,369,144	60,927,614
Investments	309,708,997	277,215,952
Advance deposits with Liability Insurance Trust Fund	4,061,501	2,017,383
Advance deposits - Other	91,940	
Accrued interest	301,253	285,403
	387,532,835	340,446,352

### **NOTE 6 - PROPERTY, PLANT AND EQUIPMENT - NET:**

A summary of changes in property, plant and equipment for the year ended June 30, 2001 is presented below:

	Balance July 1, 2000	Additions/ Reclasses	Retirements	Balance June 30, 2001
Equipment	195,084,982	17,136,026	1,141,353)	211,079,655
Buildings	131,396,805	12,878,670	(2,191,826)	142,083,649
Land	977,256	19,798,326		20,775,582
Land improvements	3,240,978	1,692,052	(149,082)	4,783,948
Leasehold improvements	17,206		(8,002)	9,204
Total assets in service	330,717,227	51,505,074	(3,490,263)	378,732,038
Accumulated depreciation	(170,072,624)	(16,503,302)	2,630,273	(183,945,653)
Under construction	112,847,118	6,893,476		119,740,594
Net Property, Plant & Equipment	273,491,721	41,895,248	(859,990)	314,526,979

Amortization expense for bond issuance costs and start-up costs equals \$93,283 for 2001 and \$88,566 for 2000. These amounts are included with depreciation expense at June 30. Additional details for the year ended June 30, 2000 are provided in the prior year financial statements.



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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The Hospitals incurred interest expense related to the construction projects financed by tax-exempt revenue bonds. Bond interest expenses are offset by interest earnings on the related construction proceeds as required. The Hospitals capitalizes the net interest expense into construction in progress (CIP) for the projects. The Hospitals capitalized net interest expense 2001 and 2000 as follows:

	2001	2000
Interest expense incurred on CIP	6,910,923	6,939,478
Less: Interest earnings on related construction proceeds	<u>(1,411,704)</u>	<u>(3,545,349)</u>
Net interest expense capitalized	<u>5,499,219</u>	<u>3,394,129</u>

### **NOTE 7 - PENSION PLANS:**

Retirement Plans: Each permanent full-time employee, as a condition of employment, is a member of the North Carolina Teachers' and State Employees' Retirement System (the System). The System is a multiple-employer, cost sharing defined benefit pension plan administered by the North Carolina State Treasurer. Graduate medical residents, temporary employees and permanent part-time employees with appointments of less than 30 hours per week are not covered by the System.

After five years of creditable service, members of the System qualify for a vested deferred benefit. Employees who retire on or after age 65 and complete five years of membership service (age 55 and five years of creditable service for law enforcement officers), reach age 60 with twenty-five years of membership service, or complete thirty years of creditable service receive a retirement allowance of 1.81% of an average final compensation (based on the four consecutive years that produce the highest average) multiplied by the number of years of creditable service. Employees may retire with reduced benefits if they reach age 50 with twenty years of creditable service (age 50 with fifteen years of creditable service for law enforcement officers) or reach age 60 with five years of creditable service.

Benefit and contribution provisions for the System are established by North Carolina General Statute 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2001, these rates were set at 5.33% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2001, the Hospitals had a total payroll of \$207,243,476 of which \$156,541,746 was covered under the System. Total employee and employer pension contributions for the year were \$9,392,505 and \$8,343,675, respectively. The Hospitals made one hundred percent of its employer required contributions to the System for the years ended June 30, 2001, 2000 and 1999, which were \$8,343,675, \$12,248,140 and \$10,519,996, respectively.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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In accordance with constitutional provisions requiring a balanced budget for the State of North Carolina, the Governor issued an executive order requiring the employers' share of retirement contributions for the months February 2001 through June 2001 to be transferred to a reserve account rather than paid to the System. A portion of those funds was ultimately used by the State of North Carolina for general fund purposes and not released to the System. The total amount of employer contributions paid by the Hospitals has been recognized as pension costs in the financial statements. The contributions which were not released to the System are considered immaterial to the Hospitals' financial statements taken as a whole. The Hospitals has no liability for pension costs beyond the contributions already made.

The System's financial information is included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page <http://www.osc.state.nc.us/> and clicking on "Financial Reports," or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

### Deferred Compensation and Supplemental Retirement Income Plans:

IRC Section 457 Plan: The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, the *North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the Hospitals. The voluntary contributions by employees amounted to \$129,481 in 2001 and \$135,242 in 2000.

IRC Section 401(k) Plan: All members of the Teachers' and State Employees' Retirement System are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the plan are the responsibility of the plan participants. No costs are incurred by the Hospitals except for a five percent employer contribution for the Hospitals' law enforcement officers which is mandated under General Statute 143-163.30 (e). Total employer contributions on behalf of Hospitals' law enforcement officers were \$36,534 in 2001 and \$40,008 in 2000. Voluntary contributions by employees amounted to \$888,731 in 2001 and \$730,958 in 2000.

IRC Section 403(b) and 403(b)(7) Plans: All Hospitals' employees who work can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and state income taxes until the annuity is received or the

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other non-profit institutions. All costs of administering and funding these plans are the responsibility of the plan participants. No costs are incurred by the Hospitals. Voluntary contributions by employees amounted to \$4,205,964 in 2001 and \$3,769,247 in 2000.

### **NOTE 8 - OTHER POSTEMPLOYMENT BENEFITS:**

Health Care for Long-Term Disability Beneficiaries and Retirees: The Hospitals participates in state administered programs that provide post-employment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System. These benefits were established by Chapter 135, Article 3, Part 3 of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. For the fiscal year ended June 30, 2001, the Hospitals contributed 1.28% of its covered payroll or \$2,003,734 to the plan. For the fiscal year ended June 30, 2000, contributions to the plan were not required. The Hospitals assumes no liability for retiree health care benefits provided by the programs other than its required contributions. Additional detailed information about these programs is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

Long-Term Disability: The Hospitals participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System. DIPNC provides disability income to eligible participants. Long-term disability benefits are advance funded on an actuarially determined basis using the one-year term cost method. The Hospitals contributed 0.52% of its payroll covered under the Teachers' and State Employees' Retirement System to the DIPNC for the fiscal year ended June 30, 2001 and 2000 with total contributions to DIPNC of \$814,017 and \$781,476, respectively. The Hospitals assumes no liability for long-term disability benefits under the plan other than its contribution. Additional detailed information about DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

### **NOTE 9 - BONDS PAYABLE:**

On January 22, 1992 the Board of Governors of The University of North Carolina issued \$59,990,000 in revenue bonds for the construction of a neurosciences hospital, an administrative office building, and the chiller plant expansion.

On March 20, 1996 the Board of Governors of The University of North Carolina issued \$133,870,000 in revenue bonds for the construction of the North Carolina Children's Hospital, North Carolina Women's Hospital, and support services.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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On June 3, 1999, the Board of Governors of The University of North Carolina issued \$58,925,000 in Revenue Refunding Bonds, Series 1999, to defease \$55,595,000 of outstanding 1992 Revenue Bonds. An irrevocable trust was established with an escrow agent to provide for all future debt service payments on the defeased bonds. The trust assets and the liability for the defeased bonds are not included in the Hospitals' balance sheet. At June 30, 2001 and 2000, the outstanding balance of the defeased University of North Carolina Hospitals 1992 Revenue Bonds was \$53,515,000 and \$54,580,000, respectively.

On January 31, 2001, the Board of Governors of The University of North Carolina issued Series 2001A and Series 2001 B Revenue Bonds on behalf of the Hospitals. These tax-exempt variable rate demand bonds with an initial interest rate mode of daily were issued in the amount of \$110,000,000 and have a final maturity date of February 15, 2031. The bonds are subject to mandatory sinking fund redemption that begins on February 15, 2002. The proceeds of this issuance are for certain amounts paid by the Hospitals that allowed the UNC Health Care System to acquire controlling interest in Rex Healthcare Inc. (\$75,000,000) and for the renovation of space vacated when the construction of the North Carolina Children's Hospital, North Carolina Women's Hospital, and support services is completed (\$35,000,000). While initially bearing interest in a daily mode, the mode on these bonds may change to a weekly rate, a unit pricing rate, a term rate or a fixed rate.

The bonds are subject to purchase on demand with seven days' notice and delivery to the bond Tender Agent, First Union National Bank. The Hospitals' remarketing agents, Merrill Lynch, Pierce, Fenner & Smith Incorporated (Series 2001A) or Banc of America Securities LLC (Series 2001B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received.

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and *Landesbank Hessen-Thüringen Girozentrale*, a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require a facility fee equal to .22% of the available commitment, payable quarterly in arrears, beginning on April 2, 2001, and on each July, October, January and April thereafter until the expiration date or the termination date of the Agreements.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Formula Rate (Base rate equal to the higher of the Prime Rate for such day or the sum of .50% plus the Federal Funds Rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is due quarterly (the first business day of January, April, July and October) for each period in which Bank Bonds are outstanding. At June 30, 2001, there were no Bank Bonds held by the Liquidity Facility.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The original expiration date of the Agreements is January 29, 2002 and the Hospitals has requested and received an extension through July 31, 2002. The Hospitals may request additional extensions of up to 364 days through the third anniversary date of the Agreements on January 31, 2004. Extensions are at the discretion of Liquidity Provider.

The Hospitals is required to redeem (purchase) the Bank Bonds held by the Liquidity Facility in equal quarterly installments on the first business day of January, April, July and October. The payments will commence with the first business day of any such month that is at least 90 days following the applicable Purchase Date of the Bank Bond and end no later than the fifth anniversary of such Purchase Date.

A summary of bonds payable at June 30, 2001 and 2000 follows:

	2001	2000
4.20% - 5.25% serial 1996 bonds due 2001-2011	27,805,000	29,965,000
4.00% - 5.25% serial 1999 bonds due 2001-2017	32,500,000	33,875,000
5.375% term 1996 bonds due 02-15-2015	15,580,000	15,580,000
5.25% term 1996 bonds due 02-15-2019	19,170,000	19,170,000
5.00% term 1999 bonds due 02-15-2021	12,870,000	12,870,000
5.00% term 1999 bonds due 02-15-2024	11,440,000	11,440,000
5.25% term 1996 bonds due 02-15-2026	44,625,000	44,625,000
5.00% term 1996 bonds due 02-15-2029	24,530,000	24,530,000
Variable rate 2001 bonds due 2002-2031	110,000,000	
Principal outstanding	298,520,000	192,055,000
Unamortized discount	(5,235,968)	(5,331,746)
Deferred charge due to advanced refunding	(3,954,101)	(4,126,025)
Bonds payable	289,329,931	182,597,229
Less: Current portion	(4,680,000)	(3,535,000)
 Bonds payable – noncurrent	 284,649,931	 179,062,229

Debt service payments to maturity are as follows:

Payments During			Total Debt
Fiscal Year	Principal	Interest	Service
2002	4,680,000	13,232,489	17,912,489
2003	4,840,000	12,934,035	17,774,035
2004	5,010,000	12,737,133	17,747,133
2005	5,180,000	12,540,108	17,720,108
2006	5,575,000	12,309,848	17,884,848
2007-2011	31,750,000	57,648,946	89,398,946
2012-2016	40,245,000	49,387,830	89,632,830
2017-2021	51,610,000	38,592,187	90,202,187
2022-2026	66,100,000	24,967,062	91,067,062
2027-2031	83,530,000	9,315,480	92,845,48
 Total payments	 298,520,000	 243,665,118	 542,185,118

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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### **NOTE 10 - NET PATIENT SERVICE REVENUE:**

Medicare: The Hospitals is reimbursed for Medicare inpatient acute care services under the provisions of the Medicare Prospective Payment System (PPS). Under PPS, payment is made at predetermined rates for treating or performing various diagnoses and procedures that have been grouped into defined diagnostic-related groups (DRGs) applicable to each patient discharge, rather than on the basis of the Hospitals' allowable charges. The charges from treating Medicare patients that exceed the prospective payment for such services are reflected as a deduction from patient service revenue.

Capital related costs are reimbursed by Medicare based upon a ten-year phase-in of hospital-specific capital cost per discharge based on FY90 capital costs and a federally determined prospective rate per discharge. This phase-in began July 1, 1992 with the Hospitals being reimbursed at ten percent of the federal PPS rate and ninety percent of hospital specific capital related costs. A ten percent increase is scheduled for each year thereafter towards one hundred percent of the federal PPS rate in the fiscal year beginning July 1, 2001. Graduate medical education costs are reimbursed by Medicare based upon a prospectively determined amount per resident. Outpatient services are reimbursed at the lower of cost, charges or a blend of the Medicare fee schedule amounts and actual costs, subject to deductibles and co-payments.

Medicaid: The Hospitals was reimbursed for Medicaid inpatient acute care services based on an all-inclusive per diem rate through December 31, 1994. Effective January 1, 1995, Medicaid began reimbursing inpatient services under a Prospective Payment System. Medicaid is using the Medicare DRG system with the addition of six neonatal DRGs. A settlement is made at year-end to adjust from the per diem/DRG reimbursement to a cost-based reimbursement basis.

Medicaid reimburses the Hospitals on the basis of documented cost for all outpatient services except for diagnostic laboratory services. Payment is made based on a tentative reimbursement rate with final settlement determined after submission of annual cost reports by the Hospitals. Cost reports are subject to audit by the Medicaid fiscal intermediary for a final determination of actual program costs.

Blue Cross and Blue Shield of North Carolina (BCBS): The Hospitals enters into a contractual agreement each year with BCBS whereby both parties accept a schedule of charges for all inpatient and outpatient services delivered. BCBS reimburses the Hospitals on behalf of its subscribers based upon 100% of the charges approved in the contract, less any appropriate deductibles or co-payments applicable to specific terms of insurance policies. Commercial indemnity insurance plans reimburse their subscribers or make direct payments to the Hospitals on an assignment of benefits basis, whereby the patients must pay the difference, if any, between the insurance proceeds and the total charges incurred. All patient charges conform to the approved rates in the BCBS contract.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Other Agreements: The Hospitals has also entered into reimbursement agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations to accept patients on a discounted fee for service basis. The basis for reimbursement under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined per diem rates. The Hospitals entered into its first capitation contract with Healthsource on January 1, 1996.

A summary of net patient service revenue for the years ended June 30, 2001 and 2000 follows:

	2001	2000
	<u>                    </u>	<u>                    </u>
Inpatient routine	156,156,635	145,103,194
Inpatient ancillary	319,215,139	280,849,855
Outpatient	202,459,473	161,761,870
Indigent care provided	(23,519,423)	(14,073,108)
Gross patient service revenue	<u>654,311,824</u>	<u>573,641,811</u>
Medicare contractual	(59,688,760)	(38,981,911)
Medicaid contractual	(47,374,163)	(39,199,303)
Managed care contractual	(101,135,377)	(73,113,475)
Other contractals	(16,311,472)	(17,020,600)
Contractual adjustments	<u>(224,509,772)</u>	<u>(168,315,289)</u>
Net patient service revenue	<u><u>429,802,052</u></u>	<u><u>405,326,522</u></u>

### NOTE 11 - LEASES:

The following is a schedule by year of future minimum lease payments under capital and operating leases that have initial or remaining lease terms in excess of one year at June 30, 2001:

For the year ending June 30,	Capital Leases	Operating Leases
	<u>                    </u>	<u>                    </u>
2002	250,140	1,467,036
2003	250,140	1,180,728
2004	250,140	710,842
2005	166,760	391,428
2006		300,000
Subsequent to 2006		<u>1,250,000</u>
Total minimum lease payments	917,180	<u><u>5,300,034</u></u>
Amounts representing interest	<u>89,876</u>	
Present value of net minimum payments	<u><u>827,304</u></u>	

**NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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Total minimum lease payments were \$8,590,186 at June 30, 2000. Additional details are provided in the prior year financial statements.

Total rental expense in 2001 and 2000 for all operating leases was \$1,966,054 and \$1,807,838, respectively.

### **NOTE 12 - RELATED PARTY TRANSACTIONS:**

Medical Foundation of North Carolina: The Hospitals is a participant in the Medical Foundation of North Carolina, a nonprofit foundation for The University of North Carolina at Chapel Hill and the Hospitals, which solicits gifts and grants for both entities. The Board of Directors of the Medical Foundation administers the funds of the Foundation. Transactions are recorded only by the Foundation. Purchases of equipment for the Hospitals by the Foundation are included in donated equipment in the accompanying financial statements.

UNC Health Care System: On April 13, 2000, the UNC Health Care System (System) entered into a contractual agreement with Rex Healthcare, Inc. (Rex) and the John Rex Endowment (a private, non-profit corporation separate from the System) to gain 100% control over the assets and operations of Rex. At the signing of the agreement, the Hospitals transferred \$100 million on behalf of the System to the John Rex Endowment as a result of the contractual agreement. The transaction was recorded as a "Transfer to UNC Health Care System" on the accompanying financial statements. In addition, the agreement calls for future funding of Rex capital needs up to \$58 million. Under the agreement, the funding of the capital needs could be provided by Rex's operating surplus or from other sources available to the System, including the Hospitals' available reserves.

John Rex Endowment: The John Rex Endowment (Endowment) operates as a 501(c)(3) corporation and is independent of the Board of Directors of the UNC Health Care System. Its purpose is to advance the health and well-being of the residents of the greater Triangle area, with specific funds set aside for indigent care and to make grants to support health services, education, prevention and research. In discharging its purposes, priority consideration will be given to any funding requests from Rex, UNC Health Care System and their affiliates. The funding source for the Endowment is the \$100 million transfer that came from UNC Hospitals. The Endowment has committed \$25 million for capital projects at Rex Healthcare, Inc.

### **NOTE 13 - RISK MANAGEMENT:**

The Hospitals is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled by a combination of methods, including participation in state-administered insurance programs, purchase of commercial insurance and self-retention of certain risks.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Tort claims of up to \$500,000 are self-insured under the authority of the State Tort Claims Act.

The State Property Fire Insurance Fund (Fund), an internal service fund of the State, insures all State owned buildings and contents for fire losses up to \$2,500,000 per occurrence. The Fund purchases excess insurance from private insurers to cover losses over the amounts insured by the Fund. Coverage for fire losses for operations supported by the State's General Fund is provided at no cost to the Hospitals. Other operations not supported by the State's General Fund are charged for fire coverage. Coverage for fire losses is purchased through the Fund and premiums are based on the value of covered buildings and contents. Losses covered by the Fund are subject to a \$500 per occurrence deductible. There have been no significant reductions in insurance coverage from the previous year and settled claims have not exceeded coverage in any of the past three fiscal years.

The Hospitals did not purchase extended coverage for wind, explosion, smoke, sprinkler leakage, business interruption, vandalism, theft, flood, and "all risks" for buildings and contents and intends to cover losses from any such events from its reserves or, to the extent such losses may be covered, by general liability insurance purchased by the Hospitals. No significant losses occurred during the year.

All State-owned vehicles are covered by liability insurance handled by the North Carolina Department of Insurance. The State is self-insured for the first \$500,000 of any loss through a retrospective rating plan. Excess insurance coverage is purchased through a private insurer to cover losses greater than \$500,000. The liability limits for losses occurring in state are \$500,000 per claimant and \$5,000,000 per occurrence. The Hospitals is charged premiums to cover the cost of excess insurance and to pay for those losses falling under the self-insured retention.

The Hospitals is protected for losses from employee dishonesty and computer fraud for employees paid in whole or in part from State funds. The blanket honesty bond is with a private insurance company and is handled by the North Carolina Department of Insurance with coverage of \$5,000,000 per occurrence and a \$50,000 deductible.

Employees and retirees are provided health care coverage by the Comprehensive Major Medical Plan, a component unit of the State. The Plan is funded by employer and employee contributions and is administered by a third party contractor. Health care coverage is optionally available through contractual agreements with several HMO plans.

The North Carolina Workers' Compensation Program provides benefits to workers injured on the job. All employees of the State and its component units are included in the program. When an employee is injured, the Hospitals' primary responsibility is to arrange for and provide the necessary treatment for work related injury. The Hospitals is responsible for paying medical benefits and compensation in accordance with the North Carolina Workers' Compensation Act. The Hospitals is self-insured for workers' compensation.

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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Term life insurance of \$25,000 to \$50,000 is provided to eligible workers. This self-insured death benefit program is administered by the State Treasurer's Office and funded via employer contributions.

Additional details on the State-administered risk management programs are disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*, issued by the Office of the State Controller.

Liability Insurance Trust Fund: The Hospitals participates in the Liability Insurance Trust Fund (the Fund), a claims-servicing public entity risk pool for professional liability protection. The Fund acts as a servicer of professional liability claims, managing separate accounts for each participant from which the losses of that participant are paid. Although participant assessments are determined on an actuarial basis, ultimate liability for claims remains with the participants and, accordingly, the insurance risks are not transferred to the Fund.

Chapter 116, Article 26, of the North Carolina General Statutes and The University of North Carolina Board of Governors' Resolution of June 9, 1978 created the Fund to provide professional liability protection for program participants and individual health care practitioners working as employees, agents, or officers of The University of North Carolina Hospitals at Chapel Hill (the Hospitals) and The University of North Carolina at Chapel Hill School of Medicine. The Fund is exempt from federal and state income taxes, and is not subject to regulation by the North Carolina Department of Insurance.

Participation in the Fund is open to The University of North Carolina, any constituent institution of The University of North Carolina, the Hospitals, and any health care institution, agency or entity which has an affiliation agreement with The University of North Carolina, with a constituent institution of The University of North Carolina, or with the Hospitals. Only the School of Medicine of The University of North Carolina at Chapel Hill and the Hospitals have participated in the Fund to date. Management and administrative services are provided to the Fund at no cost by participants.

The Fund is governed by the Liability Insurance Trust Fund Council (the Council). The Council consists of thirteen members as follows: one member each appointed by the State Attorney General, the State Auditor, the State Insurance Commissioner, the Director of the Office of State Budget and Management, the State Treasurer, (each serving at the pleasure of the appointer); and eight members appointed to three year terms (with no limit on the number of terms) by the Board of Governors of The University of North Carolina.

The Fund establishes claim liabilities based on estimates of the ultimate cost of claims (including future expenses and claim adjustment expenses) that have been reported but not settled and of claims incurred but not reported. Claim liabilities are recomputed annually based on an independent actuary's study to produce current estimates that reflect recent settlements, claims frequency, inflation and other factors. Participant assessments are determined at a level to fund claim liabilities, discounted for future investment earnings. Each participant is required by statute to maintain a fund balance of \$100,000 at all times. Participants are subject to additional premium assessments in the event of deficiencies.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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The Fund provides occurrence coverage for entity participants as well as the employees and professional staff participants. The Fund provides coverage of \$3,000,000 per occurrence and \$8,000,000 annual aggregate for the negligence of individual employees of the participants within the course and scope of their employment. Commercial excess insurance of \$25,000,000 per occurrence and \$50,000,000 annual aggregate is provided above the self-insurance retention limits. The Fund provides coverage of \$500,000 per occurrence, in accordance with the limited waiver of sovereign immunity afforded by the State Tort Claims Act, for any recovery against the entity participants for the negligence of its employees. To assure that both existing and future claims will be paid, the Board of Governors of The University of North Carolina is authorized by law to borrow up to \$30 million to replenish the Trust Fund. No borrowings have been made under this line of credit to date. The Council believes adequate funds are on deposit in the Fund to meet estimated losses based upon the results of the independent actuary's report.

The Fund has purchased annuity contracts to settle claims for which the claimant has signed an agreement releasing the Fund from further obligation. The related claim liabilities have been removed from estimated malpractice costs. The likelihood that the Fund will be required to make future payments on these claims is considered remote.

The Council may choose to terminate the Fund, or the respective participants may choose to terminate their participation. In the event of such termination by either the Council or a participant, an updated actuarial study will be performed to determine amounts due to or from the participants based on loss experience up to the date of termination.

At June 30, 2001 and 2000, the Hospitals had advance deposits with the Fund totaling \$4,061,501 and \$2,017,383, respectively.

Additional disclosures relative to the funding status and obligations of the Trust Fund are set forth in the Audited Financial Statements of the Liability Insurance Trust Fund for the years ended June 30, 2001 and 2000. Copies of this report may be obtained from The University of North Carolina Liability Insurance Trust Fund, 6001 East Wing, University of North Carolina Hospitals, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-3041.

## **NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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### **NOTE 14 - INVESTMENTS IN AFFILIATES:**

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were \$6,550,057 and \$8,557,334 at June 30, 2001 and 2000. The Hospitals' share of these affiliates and joint ventures is not significant individually. The summarized unaudited financial information below represents an aggregation of the Hospitals' affiliates and joint ventures:

	(unaudited) 2001	(unaudited) 2000
Current assets	9,511,042	16,097,958
Noncurrent assets	3,773,146	7,522,998
Current liabilities	5,237,541	10,836,462
Noncurrent liabilities	5,482	275,493
Shareholders equity	8,041,165	12,509,001
<hr/>		
Revenue	18,869,880	33,434,696
Net loss	(2,623,136)	(9,187,174)
<hr/>		
Affiliate loss – ongoing operations	(916,962)	(5,642,508)
Affiliate loss – discontinued operations	(8,173,444)	(6,790,994)
<hr/>		
Total loss realized from affiliate activities	<u>(9,090,406)</u>	<u>(12,433,502)</u>

### **NOTE 15 – COMMITMENTS AND CONTINGENCIES:**

Commitments: The Hospitals has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments at June 30, 2001 and 2000 on construction contracts were \$18,998,647 and \$24,138,891, respectively.

Pending Litigation and Other Contingencies: The Hospitals is party to other litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of those matters, no provision for any liability has been made in the accompanying financial statements. Hospitals management is of the opinion that the liability, if any, for any of these matters will not have a material adverse effect on the financial position of the Hospitals.

## **NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)**

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### **NOTE 16 – ACCOUNTING CHANGES:**

Securities Lending Transactions: The Hospitals deposits certain funds with the State Treasurer's Cash and Investment Pool, which participates in securities lending activities. In prior years, it was the State's policy to allocate the risk associated with these transactions to each component unit. For the year ending June 30, 2001, the State changed its policy, as a result of discussions with the GASB technical staff, to report the associated risk as part of the State of North Carolina's fiduciary funds rather than to allocate the risk to component units. The effect of this change removes the assets and liabilities associated with the State Treasurer's security lending program from the Hospitals' financial statements. This change does not affect the Hospitals' beginning fund equities and for comparative purposes, the 2000 balance sheet was adjusted to remove the current asset and current liability in the amount of \$99,733,309.

Governmental Accounting Standard Board, Statement #33 - Accounting and Reporting of Non-Exchange Transactions: Effective July 1, 2000, the Hospitals implemented the new accounting and reporting standards required in GASB #33. This standard provides accounting rules over non-exchange transactions and changes the Hospitals' standards for the recognition of revenues and the reporting of funds received but not earned in the Hospitals' restricted fund. In prior years, the Hospitals reported funds received but not expended in its restricted fund as an addition to fund equity. Based on this new standard, revenues are recognized when earned and when the resource provider's conditions have been satisfied. Amounts received not meeting the recognition requirements are now reported as deferred revenue. In addition, the new standard requires promises to give (pledges) that are expected to be collected and available for expenditure, and that are verifiable and measurable, be recorded as a receivable and revenue, upon satisfying the resource provider's conditions. Prior to this year, pledges were not recorded as a receivable unless there was a legally enforceable right. The implementation of this standard had no effect on the beginning fund equity of the Hospitals; and there was no increase to deferred revenue of the funds.

**BALANCE SHEETS**  
**JUNE 30, 2001**

Schedule 1

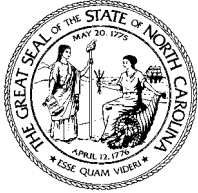
	Revenue Fund	Operating Reserve Fund	Maintenance Reserve Fund	Construction Fund	Principal and Interest Fund	Total Bond Funds
Cash and cash equivalents	\$ -	\$ 11,367,190	\$ -	\$ -	\$ -	\$ 11,367,190
Investments with State Treasurer	-	76,179,381	-	-	-	76,179,381
Interfund receivable / (payable)	(20,041)	20,041	-	-	-	-
Accrued interest receivable	20,041	86,728	-	-	-	106,769
Assets whose use is limited:						
Cash and cash equivalents	-	-	833,501	64,457,659	7,722,417	73,013,577
Investments with State Treasurer	-	-	309,708,997	-	-	309,708,997
Accrued interest receivable	-	-	3,468	285,049	12,736	301,253
Capitalized interest	-	-	-	-	11,215,086	11,215,086
Bond issuance costs-net	-	-	-	-	2,345,445	2,345,445
<b>Total Assets</b>	<b>\$ -</b>	<b>\$ 87,653,340</b>	<b>\$ 310,545,966</b>	<b>\$ 64,742,708</b>	<b>\$ 21,295,684</b>	<b>\$ 484,237,698</b>
Bond interest payable	\$ -	\$ -	\$ -	\$ -	\$ 3,835,522	\$ 3,835,522
Bonds payable-current portion	-	-	-	-	4,680,000	4,680,000
Rebatable arbitrage payable	-	-	-	852,029	-	852,029
Bonds payable	-	-	-	-	293,840,000	293,840,000
Discount on bonds payable	-	-	-	-	(5,235,968)	(5,235,968)
Deferred charge due to advanced refunding	-	-	-	-	(3,954,101)	(3,954,101)
<b>Total Liabilities</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>852,029</b>	<b>293,165,453</b>	<b>294,017,482</b>
<b>Fund Balances</b>	<b>-</b>	<b>87,653,340</b>	<b>310,545,966</b>	<b>63,890,679</b>	<b>(271,869,769)</b>	<b>190,220,216</b>
<b>Total Liabilities and Fund Balances</b>	<b>\$ -</b>	<b>\$ 87,653,340</b>	<b>\$ 310,545,966</b>	<b>\$ 64,742,708</b>	<b>\$ 21,295,684</b>	<b>\$ 484,237,698</b>

**THE UNIVERSITY OF NORTH CAROLINA HOSPITALS**  
**BOND FUNDS**  
**STATEMENTS OF CHANGES IN FUND BALANCE**  
**FOR THE YEAR ENDED JUNE 30, 2001**

Schedule 2

	Revenue Fund	Operating Reserve Fund	Maintenance Reserve Fund	Construction Fund	Principal and Interest Fund	Total Bond Funds
Operating receipts	\$ 483,925,511	\$ -	\$ -	\$ -	\$ -	\$ 483,925,511
Trust fund receipts	2,398,996	-	-	-	-	2,398,996
Investment income	311,669	3,461,781	21,545,710	1,636,242	338,485	27,293,887
Realized gain(loss) on investments	-	131,867	-	-	-	131,867
Unrealized gain(loss) on investments	-	(1,530,178)	10,995,112	-	-	9,464,934
<b>Total Additions</b>	<b>486,636,176</b>	<b>2,063,470</b>	<b>32,540,822</b>	<b>1,636,242</b>	<b>338,485</b>	<b>523,215,195</b>
Interest expense	-	-	-	-	11,321,197	11,321,197
Interest expense capitalized	-	-	-	-	(5,499,219)	(5,499,219)
Interest expense not capitalized	-	-	-	-	5,821,978	5,821,978
Amortization of bond issuance costs	-	-	-	-	75,421	75,421
Contracted services	-	-	-	-	65,743	65,743
Transfer to (from) operating fund	-	463,415,350	-	-	(635,452)	462,779,898
Transfer to capital improvement funds	-	-	-	17,930,005	-	17,930,005
Transfer to trust funds	2,398,996	14,533,704	-	-	-	16,932,700
<b>Total Deductions</b>	<b>2,398,996</b>	<b>477,949,054</b>	<b>-</b>	<b>17,930,005</b>	<b>5,327,690</b>	<b>503,605,745</b>
<b>Excess of Additions over(under) Deductions</b>	<b>484,237,180</b>	<b>(475,885,584)</b>	<b>32,540,822</b>	<b>(16,293,763)</b>	<b>(4,989,205)</b>	<b>19,609,450</b>
Transfer to operating reserve fund	(472,104,081)	547,432,309	-	(75,328,228)	-	-
Transfer to principal & interest fund	(12,133,099)	-	-	-	12,133,099	-
Transfer to construction fund	-	-	-	106,760,392	(106,760,392)	-
<b>Total Interfund Transfers</b>	<b>(484,237,180)</b>	<b>547,432,309</b>	<b>-</b>	<b>31,432,164</b>	<b>(94,627,293)</b>	<b>-</b>
Change in Fund Balance	-	71,546,725	32,540,822	15,138,401	(99,616,498)	19,609,450
Fund Balance - Beginning	-	16,106,615	278,005,144	48,752,278	(172,253,271)	170,610,766
<b>Fund Balance - Ending</b>	<b>\$ -</b>	<b>\$ 87,653,340</b>	<b>\$ 310,545,966</b>	<b>\$ 63,890,679</b>	<b>\$ (271,869,769)</b>	<b>\$ 190,220,216</b>





Ralph Campbell, Jr.  
State Auditor

STATE OF NORTH CAROLINA  
**Office of the State Auditor**

2 S. Salisbury Street  
20601 Mail Service Center  
Raleigh, NC 27699-0601  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
Internet <http://www.osa.state.nc.us>

**INDEPENDENT AUDITOR'S REPORT  
ON COMPLIANCE AND ON INTERNAL CONTROL  
OVER FINANCIAL REPORTING BASED ON AN AUDIT OF  
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH  
GOVERNMENT AUDITING STANDARDS**

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Board of Directors  
The University of North Carolina Health Care System  
Chapel Hill, North Carolina

We have audited the financial statements of The University of North Carolina Hospitals, which is a part of The University of North Carolina Health Care System which is a part of The University of North Carolina System, a component unit of the State of North Carolina, as of and for the years ended June 30, 2001 and 2000, and have issued our report thereon dated October 29, 2001.

As discussed in Note 1, the financial statements present only The University of North Carolina Hospitals and are not intended to present fairly the financial position of The University of North Carolina Health Care System which is a part of The University of North Carolina System, a component unit of the State of North Carolina, and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America. As discussed in Note 16 to the financial statements, the Hospitals changed its accounting for securities lending transactions allocated from the State Treasurer's Cash and Investment Pool during the year ended June 30, 2001. As also discussed in Note 16 to the financial statements, the Hospitals implemented Governmental Accounting Standard Board Statement 33 *Accounting and Reporting of Non-Exchange Transactions* during the year ended June 30, 2001.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Hospitals' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audits and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

**INDEPENDENT AUDITOR'S REPORT  
ON COMPLIANCE AND ON INTERNAL CONTROL  
OVER FINANCIAL REPORTING BASED ON AN AUDIT OF  
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH  
GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

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Internal Control Over Financial Reporting

In planning and performing our audits, we considered the Hospitals' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Board of Directors and Board of Governors, management and staff of the Hospitals, the Governor, the State Controller, the General Assembly, and federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties.



Ralph Campbell, Jr.  
State Auditor

October 29, 2001

## DISTRIBUTION OF AUDIT REPORT

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In accordance with G.S. § 147-64.5 and G.S. § 147-64.6(c)(14), copies of this report have been distributed to the public officials listed below. Additional copies are provided to other legislators, state officials, the press, and the general public upon request.

### EXECUTIVE BRANCH

The Honorable Michael F. Easley	Governor of North Carolina
The Honorable Beverly M. Perdue	Lieutenant Governor of North Carolina
The Honorable Richard H. Moore	State Treasurer
The Honorable Roy A. Cooper, III	Attorney General
Mr. David T. McCoy	State Budget Officer
Mr. Robert L. Powell	State Controller
Ms. Molly Corbett Broad	President, The University of North Carolina
Mr. Eric B. Munson	President and Chief Executive Officer The University of North Carolina Hospitals
Mr. Charles F. Ayscue	Senior Vice President and Chief Financial Officer The University of North Carolina Hospitals
Mr. John S. Stevens	Chair of Board of Directors The University of North Carolina Health Care System

### LEGISLATIVE BRANCH

#### Appointees to the Joint Legislative Commission on Governmental Operations

Senator Marc Basnight, Co-Chairman	Representative James B. Black, Co-Chairman
Senator Charlie Albertson	Representative Martha B. Alexander
Senator Frank W. Ballance, Jr.	Representative Flossie Boyd-McIntyre
Senator Charles Carter	Representative E. Nelson Cole
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Senator Allen H. Wellons	Representative Douglas Y. Yongue

## **DISTRIBUTION OF AUDIT REPORT (CONCLUDED)**

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### **Other Legislative Officials**

Representative Philip A. Baddour, Jr.  
Senator Anthony E. Rand  
Senator Patrick J. Ballantine  
Representative N. Leo Daughtry  
Representative Joe Hackney  
Mr. James D. Johnson

Majority Leader of the N.C. House of Representatives  
Majority Leader of the N.C. Senate  
Minority Leader of the N.C. Senate  
Minority Leader of the N.C. House of Representatives  
N. C. House Speaker Pro-Tem  
Director, Fiscal Research Division

January 17, 2002

## ORDERING INFORMATION

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Copies of this report may be obtained by contacting the:

Office of the State Auditor  
State of North Carolina  
2 South Salisbury Street  
20601 Mail Service Center  
Raleigh, North Carolina 27699-0601

Internet: <http://www.ncauditor.net>

Telephone: 919/807-7500

Facsimile: 919/807-7647