



STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA SCHOOL OF THE ARTS

WINSTON-SALEM, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2002

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA SCHOOL OF THE ARTS

WINSTON-SALEM, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2002

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Ralph Campbell, Jr.
State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Board of Trustees, North Carolina School of the Arts

This report presents the results of our financial statement audit of North Carolina School of the Arts, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, for the year ended June 30, 2002. Our audit was made by authority of Article 5A of Chapter 147 of the General Statutes.

The accounts and operations of the School 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 School were subjected 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 that relate solely to North Carolina School of the Arts. 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 audit on the accompanying financial statements that relate solely to North Carolina School of the Arts. A summary of our reporting objectives and audit results is:

- 1. Objective** – To express an opinion on the accompanying financial statements that relate solely to North Carolina School of the Arts.

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. These matters are more fully described in the Independent Auditor's Report on the Financial Statements.

AUDITOR'S TRANSMITTAL (CONCLUDED)

2. **Objective** – To present significant deficiencies, if any, in internal control over financial reporting which could adversely affect the School'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 over financial reporting and no instances of noncompliance which require disclosure herein under *Government Auditing Standards*. These matters are more fully described in the Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting.

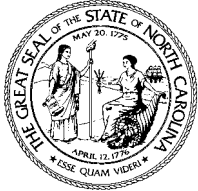
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.



Ralph Campbell, Jr.
State Auditor

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State Auditor

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INDEPENDENT AUDITOR'S REPORT

Board of Trustees
North Carolina School of the Arts
Winston-Salem, North Carolina

We have audited the accompanying basic financial statements of North Carolina School of the Arts, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, as of and for the year ended June 30, 2002, as listed in the table of contents. These financial statements are the responsibility of the School's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of North Carolina School of the Arts as of June 30, 2002, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 17 to the financial statements, the School implemented Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures* during the year ended June 30, 2002.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

In accordance with *Government Auditing Standards*, we have also issued our report dated March 26, 2003 on our consideration of the School's 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 this report in considering the results of our audit.

The Management's Discussion and Analysis (MD&A) on pages 3 to 15 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedule 1 is presented for purposes of additional analysis and is 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
March 26, 2003

MANAGEMENT'S DISCUSSION AND ANALYSIS



INTRODUCTION

This section of the North Carolina School of the Arts financial report provides an overview of the financial position and activities for the year ended June 30, 2002. This discussion has been prepared by management along with the financial statements and related footnote disclosures and should be read in conjunction with the financial statements and the notes thereto, which follow this section. Since this is a transition year for this format, only one year of financial data is presented. The discussion and analysis is designed to focus on current activities, resulting changes, and current known facts.

USING THE FINANCIAL STATEMENTS

This annual report consists of a series of financial statements, prepared in accordance with the Governmental Accounting Standards Board Statement No. 35, *Basic Financial Statements - and Management's Discussion and Analysis - for Public Colleges and Universities*. These financial statements differ significantly, in both the form and the accounting principals utilized, from prior financial statements presented. The financial statements in prior years focused on the accountability of funds, while these statements focus on the financial condition of the School, the results of operations, and cash flows of the School as a whole. The emphasis of discussions about these statements will be on current year data. A statewide decision was made to not present comparative totals in Management's Discussion and Analysis in the first year of implementation. However, comparative totals must be presented in future years. There are three financial statements presented: the Statement of Net Assets; the Statement Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows.

FINANCIAL HIGHLIGHTS

The School's financial position remained strong at June 30, 2002, with assets of \$74.9 million and liabilities of \$9.0 million. Net assets, which represent the residual interest in the School's assets after liabilities are deducted, are valued at approximately \$65.9 million. Changes in net assets represent the operating activity of the School, which results from revenues, expenses, and gains and losses for the year. The Statement of Revenues, Expenses, and Changes in Net Assets reflects a positive year with an increase in the net assets at the end of the year.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

One of the School's greatest strengths is the diverse revenue streams which supplement its student tuition and fees, including voluntary private from individuals, foundations, and corporations, along with other sponsored programs, State appropriations, and investment income. The School has in the past and will continue to seek funding from all possible sources consistent with its mission, to supplement student tuition, and to prudently manage the financial resources realized from these efforts to fund its operating activities.

Some highlights contained in the following financial statements include a donation of a film studio to the School, an endowment gift to create an opera institute, and University bond proceeds to enable the School to construct and renovate buildings and continue to actively acquire property adjacent to the campus for future enrollment growth and other program expansion needs.

Property Acquisition

The former Our Lady of Mercy Catholic School and offices were acquired near the end of the 2001-2002 fiscal year. These spaces, adjacent to the campus, were acquired for use as classrooms for NCSA students and offices for Development and Public Relations.

Former Our Lady of Mercy School and Offices



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

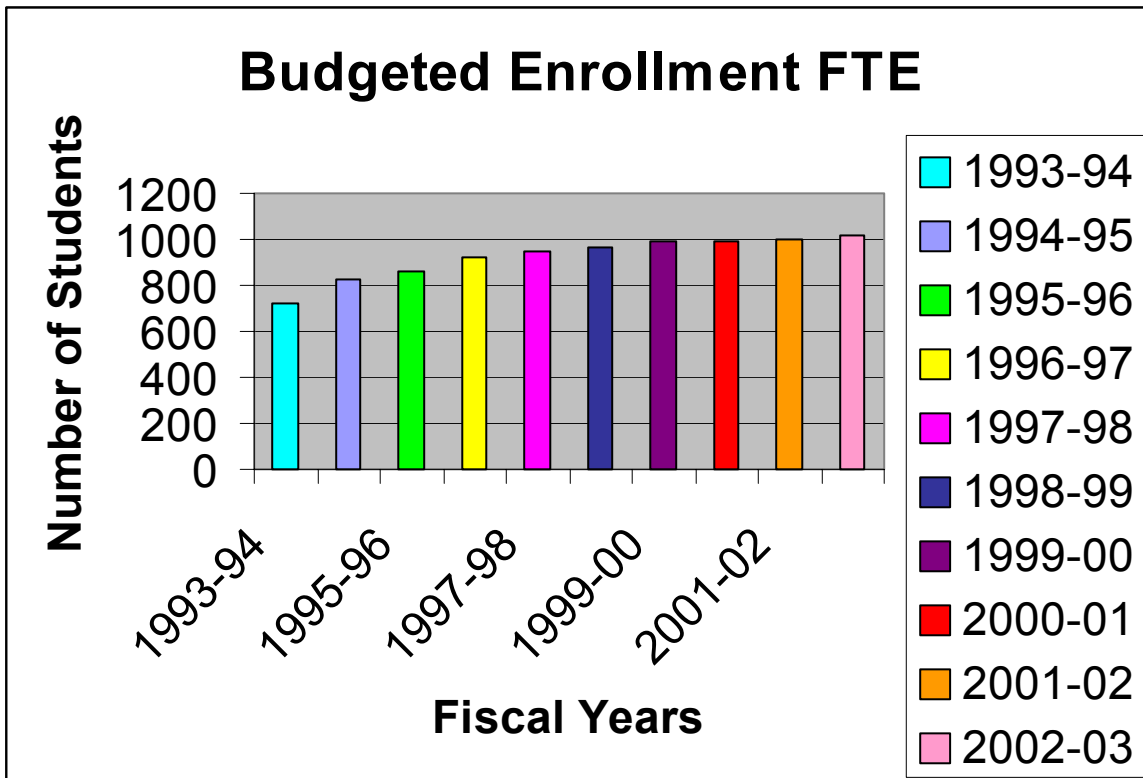
Property Donation

The former Carolina Atlantic Studios were donated in 2001-2002 to the North Carolina School of the Arts. This property is located about 20 minutes from campus and can be used as an additional film shooting stage and production facility.



Enrollment Growth

The following chart reflects the amount of growth in budgeted enrollment. The institution had a budgeted enrollment in fiscal year 1993-94 of 720 full-time students. The budgeted enrollment for 2002-03 is 1,020. This reflects a 42% growth in the student population over the last 10 years.



Statement of Net Assets

The Statement of Net Assets presents the assets, liabilities, and net assets of the School as of the end of the fiscal year. The Statement of Net Assets is a point of time financial statement. The purpose of the Statement of Net Assets is to present to the readers of the financial statements a fiscal snapshot of the North Carolina School of the Arts. The Statement of Net Assets presents end-of-year data concerning Assets (current and noncurrent), Liabilities (current and noncurrent), and Net Assets (Assets minus Liabilities).

From the data presented, readers of the Statement of Net Assets are able to determine the assets available to continue the operations of the institution. They are also able to determine how much the institution owes vendors, investors, and lending institutions. Finally, the Statement of Net Assets provides a picture of the net assets (assets minus liabilities) and their availability for expenditure by the institution. The difference between total assets and total liabilities (net assets) is one indicator of the current financial condition of the School, while the change in net assets is an indicator of whether the financial condition has improved or worsened during the year.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Net assets are divided into three major categories. The first category, invested in capital assets, net of related debt, provides the institution's equity in property, plant and equipment owned by the institution. The next asset category is restricted net assets, which is divided into two categories, nonexpendable and expendable. Nonexpendable restricted assets include endowment investments, which are only available for investment purposes, and student loan funds. Expendable restricted net assets are available for expenditure by the institution but must be spent for purposes as determined by donors and/or external entities that have placed certain restrictions on the use of the assets. This category includes restricted funds for capital projects and a reserve for debt service. The final category is unrestricted net assets, which are available to the institution for any lawful purpose of the institution. The School uses available resources to acquire and improve all areas of the institution to better serve the instructional and public service missions of the institution. Please refer to the financial statements and footnotes for more detail.

Statement of Net Assets

	<u>Amount</u>
Assets	
Current Assets	\$ 5,599,565
Capital Assets, Net	62,507,159
Other Noncurrent Assets	<u>6,825,638</u>
 Total Assets	 <u>74,932,362</u>
 Liabilities	
Current Liabilities	3,134,286
Noncurrent Liabilities	<u>5,841,947</u>
 Total Liabilities	 <u>8,976,233</u>
 Net Assets	
Invested in Capital Assets, Net of Related Debt	57,690,401
Restricted:	
Nonexpendable	2,093,669
Expendable	4,473,678
Unrestricted	<u>1,698,381</u>
 Total Net Assets	 <u>\$ 65,956,129</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Revenues, Expenses and Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Net Assets presents the School's results of operation for the fiscal year. Changes in total net assets presented on the Statement of Net Assets are based on the activity presented in the Statement of Revenues, Expenses, and Changes in Net Assets. The purpose of this statement is to present the revenues received by the institution, both operating and nonoperating, and the expenses paid by the institution, operating and nonoperating, and any other revenues, expenses, gains, and losses received or spent by the institution.

Generally speaking, operating revenues are received for providing instruction, goods, or services to the various customers and of the institution. Operating expenses are those expenses paid to acquire or produce the goods and services provided in return for the operating revenues, and to carry out the mission of the institution. Nonoperating revenues are revenues received for which goods and services are not provided. For example, the State appropriations are nonoperating because they are provided by the State legislature and the State legislature receives no goods or services in return for those revenues.

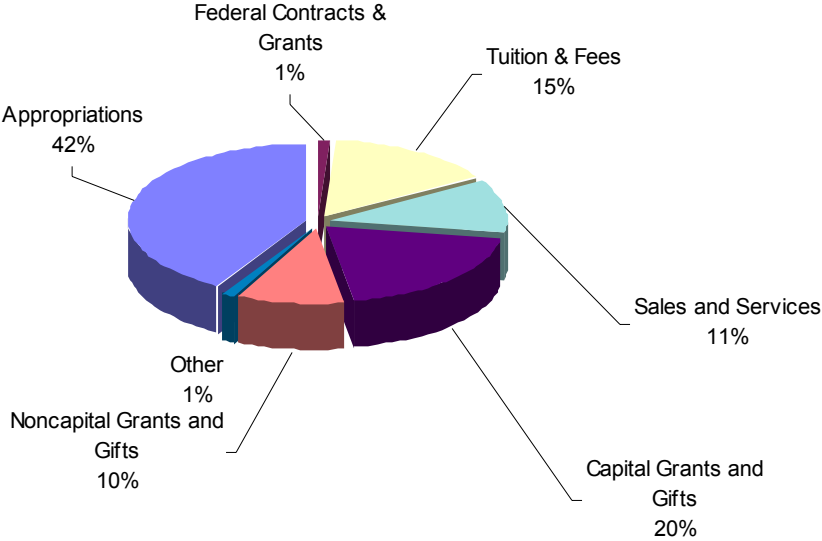
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Revenues, Expenses, and Changes in Net Assets

	<u>2002</u>
Operating Revenues	
Student Tuition and Fees, Net	\$ 5,928,903
Federal Grants and Contracts	432,496
Sales and Services, Net	4,384,777
Interest Earnings on Loans	1,565
Other Operating Revenues	<u>377,627</u>
Total Operating Revenues	<u>11,125,368</u>
Total Operating Expenses	<u>32,757,822</u>
Operating Income/(Loss)	<u>(21,632,454)</u>
Nonoperating Revenues	
State Appropriations	16,121,714
Noncapital Grants	130,861
Noncapital Gifts	2,949,602
Investment Income (Loss)	(32,108)
Interest and Fees on Capital Asset-Related Debt	(234,863)
Other Nonoperating Revenues	<u>402</u>
Net Nonoperating Revenues	<u>18,935,608</u>
Income Before Other Revenues, Expenses, Gains, or Losses	(2,696,846)
Capital Grants	4,616,400
Capital Gifts	3,041,670
Additions to Permanent Endowments	<u>767,000</u>
Total Other Revenue	<u>8,425,070</u>
Change in Net Assets	5,728,224
Beginning Net Assets	<u>60,227,905</u>
Ending Net Assets	<u><u>\$ 65,956,129</u></u>

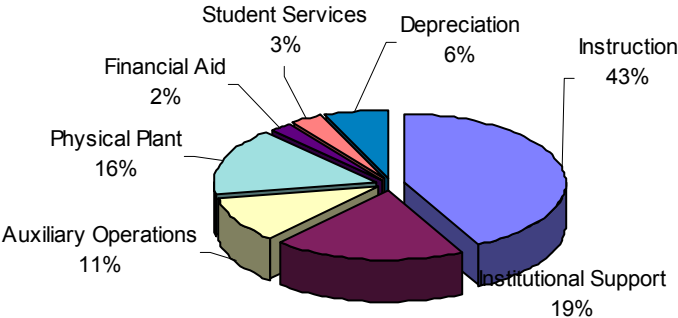
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Revenue by Source

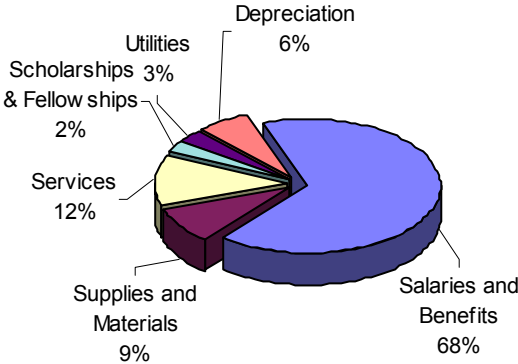


MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Operating Expenditures by Purpose



Operating Expenditures by Classification



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Cash Flows

The final statement presented is the Statement of Cash Flows. The Statement of Cash Flows presents detailed information about the cash activity of the institution during the year. The statement is divided into five parts. The first part deals with operating cash flows and shows net cash used by the operating activities of the institution. The second section reflects cash flows from noncapital financing activities. This section reflects cash received and spent for nonoperating, noninvesting, and noncapital financing purposes. The third section deals with cash flows from capital and related financing activities. This section deals with cash used for the acquisition and construction of capital and related items. The fourth section reflects the cash flows from investing activities and shows the purchases, proceeds, and interest received from investing activities. The fifth section reconciles the net cash used to the operating income or loss reflected on the Statement of Revenues, Expenses, and Changes in Net Assets.

Condensed Statement of Cash Flows

	<u>2002</u>
Cash Provided (Used) by:	
Operating Activities	\$ (19,248,869)
Noncapital Financing Activities	20,072,584
Capital and Related Financing Activities	(1,301,531)
Investing Activities	<u>(419,525)</u>
Net Change in Cash	(897,341)
Cash, Beginning of Year	<u>7,784,695</u>
Cash, End of Year	<u><u>\$ 6,887,354</u></u>

ECONOMIC OUTLOOK

Looking toward the future, management believes that the School is well positioned to continue its strong financial condition and level of excellence in service and instruction to students, upkeep of performance facilities and equipment, the arts community, the City of Winston-Salem, and the State.

A crucial element to the School's future will continue to be our relationships with the University of North Carolina System and the North Carolina General Assembly, as we work to manage tuition rates to keep the School competitive while providing an outstanding education for our students. There is a direct relationship between the growth of the School

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

and the demand for State appropriation to operate the School. Two major areas that require additional state appropriation are additional enrollment and the addition of building space, either through construction, purchase, or donation.

A recent action by the North Carolina General Assembly had a major impact on the School and many North Carolina students. The passing of House Bill 1413, General Statute 116-143.6, in fiscal year 2001-2002, will afford all enrolled high school students from North Carolina the opportunity to attend the North Carolina School of the Arts high school program without paying tuition, fees, and room and board. This bill will increase the projected enrollment of high school students, thereby increasing facility needs for high school students in particular. State appropriations for space needs and inflationary factors are of major importance in relation to the high school initiative.

The School is currently in the midst of several construction, renovation, and property acquisition projects relating to a \$2.5 billion University-wide bond issue in 1999-2000. The North Carolina School of the Arts has been authorized to receive over a six-year period \$42.5 million of this bond issue to construct new buildings, renovate existing structures, and purchase land and additional buildings.

The Residence Hall Connector project will address additional space needed for high school students to congregate and some other spaces needed to handle the expansion of the high school population.

A Student Service Support building was also funded to assist in accommodating the needs of the overall growing student population. Some of the departments to be housed in this new facility will include Registrar, Financial Aid, Admissions, Student Accounts and Cashier as well as some other associated departments. This facility will provide a "One-Stop Shop" environment addressing general population student's needs.

Comprehensive renovation was funded for the Stevens Center. The Stevens Center located in downtown Winston-Salem was originally constructed in 1929 as a major theatre. It is used both as an instructional and performance facility for the school and community. Since the acquisition in 1985, there has not been any funding for renovation. For this reason, there are several upper floors that have not been available for use. However these floors will now be renovated and available for use.

The Film Archives department recently added a collection of approximately 27,000 films. This type of collection is required to be stored in a special climate controlled area to properly preserve the film. A new facility was funded to address all of the special film needs and to serve as a world-class film history research center. This would afford students and individuals the opportunity to view films for researching scripts, commercials, billboards, or any other type of film research data.

A Basic Performance/Education Complex was also funded via these general obligation bonds. The complex includes a new state of the art Chamber Music Hall with two recital halls,

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

supporting practice and office space. The complex also includes two rehearsal studios and supporting areas to the Performance Place facility.

Funding was also provided for comprehensive modernization/renovation to the various costume shops, recital halls, laboratories, and special performance facilities. In addition, funds were authorized to address land acquisition and technology infrastructure needs. Current bond construction and renovation projects follow:

BOND CONSTRUCTION/RENOVATION PROJECTS

BASIC EDUCATION COMPLEX PHASE I

School of Music Complex



- New Construction
- Project Duration: 12/7/00 – 6/26/03

Student Services Building



- New Construction
- Project Duration: 4/4/01 – 2/12/04

Performance Place



- Addition
- Project Duration: 12/7/00 – 6/26/03

Roger Stevens Center



- Renovation
- Project Duration: 11/15/00 – 5/21/03

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

Film Archives



- New Construction
- Project Duration: 3/21/01 – 11/5/03

Design & Production Costume Shops

- Renovation
- Project Duration: 10/4/01 – 10/12/04

Residence Hall Connector

- Addition
- Project Duration: 10/4/01 – 7/5/04

Other Projects

	Project Duration
Workplace Bld #2	3/11/02-5/30/05
Crawford Hall	3/11/02-5/28/05
Gray Classroom Bldg	3/11/02-3/05/05
Agnes deMille Theatre	3/11/02-3/07/05

***North Carolina School of the Arts
Statement of Net Assets
June 30, 2002***

Exhibit A

		<i>Exhibit A</i>
ASSETS		
Current Assets:		
Cash and Cash Equivalents	\$	4,217,311.42
Restricted Cash and Cash Equivalents		763,385.62
Receivables, Net (Note 5)		374,597.10
Inventories		166,386.54
Notes Receivable, Net (Note 5)		77,884.51
		<hr/>
Total Current Assets		5,599,565.19
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		1,906,656.83
Restricted Due from Primary Government		3,101,343.76
Endowment Investments		1,426,646.64
Other Long-Term Investments		102,242.71
Notes Receivable, Net (Note 5)		288,748.16
Capital Assets, Net (Note 6)		62,507,158.63
		<hr/>
Total Noncurrent Assets		69,332,796.73
		<hr/>
Total Assets		74,932,361.92
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities (Note 7)		1,267,134.53
Due to Primary Government		22.22
Deferred Revenue		1,407,171.77
Interest Payable		57,067.19
Long-Term Liabilities - Current Portion (Note 8)		402,889.73
		<hr/>
Total Current Liabilities		3,134,285.44
Noncurrent Liabilities:		
Deposits Payable		45,000.00
Funds Held for Others		2,826.49
U. S. Government Grants Refundable		373,885.88
Long-Term Liabilities (Note 8)		5,420,234.94
		<hr/>
Total Noncurrent Liabilities		5,841,947.31
		<hr/>
Total Liabilities		8,976,232.75

***North Carolina School of the Arts
Statement of Net Assets
June 30, 2002***

***Exhibit A
Page 2***

NET ASSETS		
Invested in Capital Assets, Net of Related Debt		57,690,401.25
Restricted for:		
Nonexpendable:		
Endowed Professorships		2,042,228.69
Loans		51,440.40
Expendable:		
Scholarships and Fellowships		88,670.20
Endowed Professorships		21,005.25
Departmental Uses		40,474.37
Capital Projects		4,223,552.90
Debt Service		99,975.00
Unrestricted		1,698,381.11
Total Net Assets		\$ 65,956,129.17
The accompanying notes to the financial statements are an integral part of this statement.		

**North Carolina School of the Arts
Statement of Revenues, Expenses, and
Changes in Net Assets
For the Fiscal Year Ended June 30, 2002**

Exhibit B

REVENUES

Operating Revenues:

Student Tuition and Fees, Net (Note 10)	\$	5,928,903.69
Federal Grants and Contracts		432,495.63
Sales and Services, Net (Note 10)		4,384,776.64
Interest Earnings on Loans		1,564.59
Other Operating Revenues		377,627.16
Total Operating Revenues		11,125,367.71

EXPENSES

Operating Expenses:

Salaries and Benefits		21,836,494.04
Supplies and Materials		2,866,571.94
Services		4,069,681.64
Scholarships and Fellowships		798,534.77
Utilities		1,103,936.73
Depreciation		2,082,602.83
Total Operating Expenses		32,757,821.95
Operating Loss		(21,632,454.24)

NONOPERATING REVENUES (EXPENSES)

State Appropriations		16,121,714.36
Noncapital Grants		130,861.00
Noncapital Gifts		2,949,601.59
Investment Loss		(32,108.20)
Interest and Fees on Capital Asset-Related Debt		(234,862.51)
Other Nonoperating Revenues		401.54
Net Nonoperating Revenues		18,935,607.78
Loss Before Other Revenues, Expenses, Gains, or Losses		(2,696,846.46)
Capital Grants		4,616,400.00
Capital Gifts		3,041,670.20
Additions to Permanent Endowments		767,000.00
Increase in Net Assets		5,728,223.74

NET ASSETS

Net Assets - July 1, 2001, as Restated (Note 18)		60,227,905.43
Net Assets - June 30, 2002	\$	65,956,129.17

The accompanying notes to the financial statements are an integral part of this statement.

***North Carolina School of the Arts
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2002***

Exhibit C

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$ 11,355,430.51
Payments to Employees and Fringe Benefits	(21,592,320.98)
Payments to Vendors and Suppliers	(8,274,568.02)
Payments for Scholarships and Fellowships	(798,534.77)
Loans Issued	(98,636.00)
Collection of Loans	100,663.91
Interest Earned on Loans	986.58
US Government Grants Refundable Receipts (Net of Disbursements of \$73.78)	13,110.04
Student Deposits Received	45,000.00
Net Cash Used by Operating Activities	(19,248,868.73)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations	16,121,714.36
Grants for Other than Capital Purposes	130,861.00
Noncapital Gifts	3,068,159.68
Additions to Permanent and Term Endowments	767,000.00
William D. Ford Direct Lending Receipts	2,730,365.00
William D. Ford Direct Lending Disbursements	(2,730,365.00)
Related Activity Agency Disbursements (Net of Receipts)	(15,150.90)
Net Cash Provided by Noncapital Financing Activities	20,072,584.14

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

Capital Grants	5,899,989.80
Capital Gifts	400,000.00
Proceeds from Sale of Capital Assets	401.54
Acquisition and Construction of Capital Assets	(7,053,516.46)
Principal Paid on Capital Debt	(310,000.00)
Interest and Fees Paid on Capital Debt	(238,406.26)
Net Cash Used by Capital Financing and Related Financing Activities	(1,301,531.38)

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	243,307.45
Interest on Investments	152,569.71
Purchase of Investments and Related Fees	(815,402.56)
Net Cash Used by Investing Activities	(419,525.40)

Net Decrease in Cash and Cash Equivalents	(897,341.37)
Cash and Cash Equivalents - July 1, 2001	7,784,695.24
Cash and Cash Equivalents - June 30, 2002	\$ 6,887,353.87

**North Carolina School of the Arts
Statement of Cash Flows**

Exhibit C

For the Fiscal Year Ended June 30, 2002

Page 2

**RECONCILIATION OF NET OPERATING REVENUES (EXPENSES)
TO NET CASH USED BY OPERATING ACTIVITIES**

Operating Loss	\$	(21,632,454.24)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:		
Depreciation Expense		2,082,602.83
Allowances, Write-Offs, and Amortizations		(840.71)
Changes in Assets and Liabilities:		
Receivables (Net)		(25,747.08)
Inventories		(4,324.59)
Accounts Payable and Accrued Liabilities		(160,955.72)
Due to Federal Agencies		(0.21)
US Government Grants Refundable		13,110.04
Due to Primary Government		(8,150.64)
Deferred Revenue		260,851.44
Compensated Absences		180,012.24
Deposits Payable		45,000.00
Student Loans Issued		(98,636.00)
Student Loan Principal Repayments		100,663.91
Net Cash Used by Operating Activities	\$	<u>(19,248,868.73)</u>

**NONCASH INVESTING, CAPITAL, AND FINANCING
ACTIVITIES**

Assets Acquired through a Gift	\$	2,641,670.20
Change in Fair Value of Investments		(180,366.60)

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:		
Cash and Cash Equivalents	\$	4,217,311.42
Restricted Cash and Cash Equivalents		763,385.62
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		1,906,656.83
Total Cash and Cash Equivalents - June 30, 2002	\$	<u>6,887,353.87</u>

The accompanying notes to the financial statements are an integral part of this statement.

NORTH CAROLINA SCHOOL OF THE ARTS
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2002

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

- A. Financial Reporting Entity** - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements. North Carolina School of the Arts is a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report*.

The accompanying financial statements present all funds belonging to the School. While the Board of Governors of the University of North Carolina System has ultimate responsibility, the Chancellor, the Board of Trustees, and the Board of Trustees of the Endowment Fund have delegated responsibilities for financial accountability of the School's funds. Related foundations and similar non-profit corporations for which the School is not financially accountable are not part of the accompanying financial statements. These entities are not included because they are separately incorporated and there are neither common directors nor other evidence of common control.

- B. Basis of Presentation** - The accompanying financial statements are presented in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB).

Pursuant to the provisions of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities* effective for the School's year ended June 30, 2002, the full scope of the School's activities is considered to be a single Business-Type Activity (BTA) and accordingly, is reported within a single column in the basic financial statements.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- C. Basis of Accounting** - The financial statements of the School have been prepared using the economic resource measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned, and expenses are recorded when an obligation has been incurred.

In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the School does not apply Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989, for proprietary activities, unless the GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date.

- D. Cash and Cash Equivalents** – This classification appears on the Statement of Net Assets and the Statement of Cash Flows and includes undeposited receipts, petty cash, cash on deposit with private bank accounts, money market accounts, cash on deposit with fiscal agents, and short-term investments with the State Treasurer’s Cash and Investment Pool (a governmental external investment pool). The short-term investment portfolio maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty.

- E. Investments** - This classification includes equity investments, mutual funds, and money market fund holdings by the School. Except for money market funds, investments are accounted for at fair value, as determined by quoted market prices, or an amount determined by management, if quoted market prices are not available. The net increase (decrease) in the fair value of investments is recognized as a component of investment income.

Money market funds are reported at cost, if purchased, or at fair value or appraised value at date of gift, if donated.

- F. Receivables** – Receivables consist of tuition and fees charges to students, charges for sales and services, and student loans. Receivables also include amounts due from the federal and state governments, and from private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants. Students and Notes receivables are recorded net of estimated uncollectible amounts. All other receivables are shown at book value with no provision for uncollectible amounts considered necessary.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

G. Inventories – Inventories, consisting of expendable supplies, postage, textbooks, and merchandise for resale, are stated at the lower of cost or market value using the first-in, first-out method.

H. Capital Assets – Capital assets are stated at cost at date of acquisition or fair value at date of donation in the case of gifts. The School capitalizes assets that have a value or cost in excess of \$5,000 at the date of acquisition and an expected useful life of one or more years. Library books are expensed.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 15 to 50 years for general infrastructure, 50 years for buildings, and 3 to 15 years for equipment.

The Regis Film collection is capitalized at cost or fair value at the date of donation. This collection is considered inexhaustible and is therefore not depreciated.

I. Restricted Assets – Restricted assets represent assets whose use is restricted by external parties or by law through constitutional provisions or enabling legislation.

J. Noncurrent Long-Term Liabilities – Noncurrent long-term liabilities include principal amounts of bonds payable and compensated absences that will not be paid within the next fiscal year. Premiums, discounts, and issuance costs are expensed for bonds payable.

K. Compensated Absences - The School's policy is to record the cost of vacation leave when earned. The policy provides for a maximum accumulation of unused vacation leave of 30 days which can be carried forward each January 1st or for which an employee can be paid upon termination of employment. Also, any accumulated vacation leave in excess of 30 days at year-end is converted to sick leave. Under this policy, the accumulated vacation leave for each employee at June 30th equals the leave carried forward at the previous December 31st plus the leave earned, less the leave taken between January 1st and June 30th.

When classifying compensated absences into current and noncurrent, leave is considered taken using a last-in, first-out method.

L. Net Assets – The School's net assets are classified as follows:

Invested in Capital Assets, Net of Related Debt – This represents the School's total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

Restricted Net Assets – Nonexpendable – Nonexpendable restricted net assets include endowments and similar type assets whose use is limited by donors or other outside sources, and, as a condition of the gift, the principal is to be maintained in perpetuity.

Restricted Net Assets – Expendable – Expendable restricted net assets include resources for which the School is legally or contractually obligated to spend in accordance with restrictions imposed by external parties.

Unrestricted Net Assets – Unrestricted net assets include resources derived from student tuition and fees, sales and services, unrestricted gifts, royalties, and interest income.

Restricted and unrestricted resources are tracked using a fund accounting system and are spent in accordance with established fund authorities. Fund authorities provide rules for the fund activity and are separately established for restricted and unrestricted activities. When both restricted and unrestricted funds are available for expenditure, the decision for funding is transactional based within the departmental management system in place at the School.

- M. Scholarship Discounts** – Student tuition and fees revenues and certain other revenues from School charges are reported net of scholarship discounts in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. The scholarship discount is the difference between the actual charge for goods and services provided by the School and the amount that is paid by students or by third parties on the students' behalf. Student financial assistance grants, such as Pell grants and other federal, State, or nongovernmental programs, are recorded as either operating or nonoperating revenues in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. To the extent that revenues from these programs are used to satisfy tuition, fees, and other charges, the School has recorded a scholarship discount.
- N. Revenue and Expense Recognition** – The School presents its revenues and expenses as operating or nonoperating based on recognition definitions from GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. Operating activities are those activities that are necessary and essential to the mission of the School. Operating revenues include all charges to customers, grants received for

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

student financial assistance, and interest earned on loans. Grants received for student financial assistance are considered operating revenues because they provide resources for student charges, and such programs are necessary and essential to the mission of the School. Revenues from nonexchange transactions and State appropriations that represent subsidies or gifts to the School, as well as investment income, are considered nonoperating since these are either capital or noncapital financing or investing activities. Operating expenses are all expense transactions incurred other than those related to capital or noncapital financing or investing activities. Revenues received for capital financing activities, as well as related expenses, are considered neither operating nor nonoperating activities and are presented after nonoperating activities on the accompanying Statement of Revenues, Expenses, and Changes in Net Assets.

- O. Internal Sales Activities** – The School has miscellaneous sales and service units that operated either on a reimbursement or charge basis. All internal sales activities to School departments from sales and service units have been eliminated in the accompanying financial statements. These eliminations are recorded by removing the revenue and expense in the sales and service units and, if significant, allocating any residual balances to those departments receiving the goods and services during the year.

NOTE 2 - BUDGETING AND BUDGETARY CONTROL

The State of North Carolina operates on a biennial budget cycle with separate annual departmental and institutional certified budgets adopted by the General Assembly.

Chapter 116, Article 1, Part 2A of the North Carolina General Statutes authorizes the universities within the sixteen-campus University of North Carolina System to apply for special responsibility status, which sets the legal level of budgetary control at the institution's budget code level. A budget code is a convention used in the State's accounting system to distinguish the type of fund and the responsible department or institution. Budget codes are also used to segregate certain purposes within departments or institutions. Institutions with special responsibility status must still have certain budget revisions, primarily those associated with unanticipated revenues, approved by the Office of State Budget and Management. Additionally, universities must maintain programs and services in accordance with the guidelines established by the Board of Governors of the consolidated University of North Carolina System. North Carolina School of the Arts has applied for and received special responsibility status.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

After the budget is approved by the General Assembly and adopted by the Board of Governors, the School follows an established system of budgetary controls. Periodic interim budget statements to department heads guide them in managing budget allocations. Monthly financial reports, which include budget and actual data, are provided for each fund to individual managers responsible for the fund. When actual conditions require changes to the budget, revisions are prepared and communicated to those affected. Changes to the budget are reviewed and approved at the School or State level as required. The School maintains an encumbrance accounting system as another method to ensure that imposed expenditure constraints are observed. The State budgetary control is maintained on a cash basis of accounting.

NOTE 3 - DEPOSITS AND INVESTMENTS

A. Deposits - The School is required by General Statute 147-77 to deposit its budget code cash, as defined in Note 2, and by the University of North Carolina Board of Governors pursuant to General Statute 116-36.1 to deposit its institutional trust funds in the State Treasurer's Cash and Investment Pool. In addition, the School may voluntarily deposit endowment funds, special funds, revenue bond proceeds, and debt service funds with the State Treasurer's Cash and Investment Pool. Special funds consist of moneys for agency funds held directly by the School.

Deposits include cash and cash equivalents totaling \$6,887,353.87. At year-end, cash on hand was \$1,627,513.38. The School's portion of the State Treasurer's Cash and Investment Pool was \$4,625,470.36. It is the State Treasurer's policy and practice for 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 investments to be held by the State's agent in the State's name. The carrying amount of the School's deposits not with the State Treasurer was \$634,370.13 and the bank balance was \$812,106.97. Of the bank balance, \$364,063.44 was covered by federal depository insurance and \$448,043.53 was uninsured and uncollateralized.

North Carolina General Statutes 147-69.1(c), applicable to the State's General Fund, and 147-69.2, applicable to institutional trust funds, 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; time deposits of specified institutions; prime quality commercial paper, and asset-backed securities with specified ratings. Also, General Statute 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

ratings. General Statute 147-69.2 authorizes the following: general obligations of other States; general obligations of North Carolina local governments; and obligations of certain entities with specified ratings.

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.

- B. Investments** - The School is authorized by The University of North Carolina Board of Governors pursuant to General Statute 116-36.2 to invest its special funds in the same manner as the State Treasurer is required to invest, as previously discussed.

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

General Statute 116-36(e) provides that the trustees of the Endowment Fund shall be responsible for the prudent investment of the Fund in the exercise of their sound discretion, without regard to any statute or rule of law relating to the investment of funds by fiduciaries but in compliance with any lawful condition placed by the donor upon that part of the Endowment Fund to be invested.

Investments of various funds may be pooled unless prohibited by statute or by terms of the gift or contract. The School utilizes investment pools to manage investments and distribute investment income. The School utilizes the following investment pool:

Long-Term Investment Pool - This is an internal investment pool that is utilized for the investment of the endowment funds. Fund ownership and allocation of investment income are based on the equity interest that each fund holds in the internal investment pool. The investment strategy, including the selection of investment managers, is based on the directives of the School's Endowment Board.

Credit Risk Categories - The School's investments (pooled and non-pooled) are categorized below to give an indication of the level of risk assumed by the entity at year-end. The credit risk categories are concerned with custodial credit risk, which is the risk that a government will not be able to recover the value of investment or collateral securities

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

that are in the possession of an outside party if the counterparty to the investment transaction fails. There are three categories of credit risk. Category 1 includes investments that are insured or registered or for which the securities are held by the School or its agent in the School's name. Category 2 includes uninsured and unregistered investments for which the securities are held by a counterparty's trust department or agent in the School's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by a counterparty's trust department or agent but not in the School's name.

A summary of the School's investments at June 30, 2002 is presented below:

Long-Term Investment Pool

	Fair Value			Total
	Risk Category			
	1	2	3	
Categorized Investments:				
Corporate Stocks	\$ 0.00	\$ 565,795.50	\$ 0.00	\$ 565,795.50
Investments Not Categorized:				
Mutual Funds				173,085.49
Total Long-Term Pool Investments				\$ 738,880.99

Non-Pooled Investments

	Fair Value
	Total
Investment Not Categorized:	
Money Market Funds	\$ 118,739.83
Mutual Funds	281,859.77
Equity-Based Common Trusts	389,408.76
Total Non-Pooled Investments	\$ 790,008.36

Total Investments

	Fair Value			Total
	Risk Category			
	1	2	3	
Total Categorized Investments	\$ 0.00	\$ 565,795.50	\$ 0.00	\$ 565,795.50
Total Investments Not Categorized				963,093.85
Total Investments				\$ 1,528,889.35

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 4 - ENDOWMENT INVESTMENTS

Investments of the School's endowment funds are separately invested or pooled, unless required to be separately invested by the donor. If a donor has not provided specific instructions, State law permits the Board of Trustees to authorize for expenditure the net appreciation, realized and unrealized, of the investments of the endowment funds.

Investment return of the School's endowment funds is predicated on the total return concept (yield plus appreciation). To the extent that the total return for the current year exceeds the payout, the excess is added to principal. If current year earnings do not meet the payout requirements, the Schools uses accumulated income and appreciation from the endowment balance to make up the difference.

NOTE 5 - RECEIVABLES

Receivables at June 30, 2002 were as follows:

	Gross Receivables	Allowance for Doubtful Accounts	Net Receivables
Current Receivables:			
Students	\$ 58,512.12	\$ 48,262.08	\$ 10,250.04
Accounts	325,076.96		325,076.96
Investment Earnings	9,437.12		9,437.12
Interest on Loans	29,832.98		29,832.98
Total Current Receivables	\$ 422,859.18	\$ 48,262.08	\$ 374,597.10
Notes Receivables:			
Notes Receivable - Current			
Federal Loan Programs	\$ 100,873.25	\$ 24,025.74	\$ 76,847.51
Institutional Student Loan Programs	7,326.20	6,289.20	1,037.00
Total Notes Receivable Current	\$ 108,199.45	\$ 30,314.94	\$ 77,884.51
Notes Receivable - Noncurrent:			
Federal Loan Programs	\$ 496,711.68	\$ 207,963.52	\$ 288,748.16

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 6 - CAPITAL ASSETS

A summary of changes in the capital assets is presented as follows:

	Balance July 1, 2001	Adjustments	Increases	Decreases	Balance June 30, 2002
Capital Assets, Non-Depreciable:					
Land	\$ 1,736,782.16	\$ 0.00	\$ 1,283,128.20	\$ 0.00	\$ 3,019,910.36
Art, Literature, and Artifacts	246,964.44				246,964.44
Construction in Progress	5,913,436.57	(28,295.10)	4,864,729.76		10,749,871.23
Total Capital Assets, Non-Depreciable	7,897,183.17	(28,295.10)	6,147,857.96		14,016,746.03
Capital Assets, Depreciable:					
Buildings	55,243,411.49		3,289,714.52	74,235.74	58,458,890.27
Machinery and Equipment	7,511,583.25		709,850.54	66,377.14	8,155,056.65
General Infrastructure	1,062,634.99	28,295.10		28,450.76	1,062,479.33
Totals	63,817,629.73	28,295.10	3,999,565.06	169,063.64	67,676,426.25
Less Accumulated Depreciation for:					
Buildings	11,881,865.53		1,112,914.88	74,235.74	12,920,544.67
Machinery and Equipment	5,141,088.26		944,104.66	66,377.14	6,018,815.78
General Infrastructure	249,520.67		25,583.29	28,450.76	246,653.20
Totals	17,272,474.46		2,082,602.83	169,063.64	19,186,013.65
Total Capital Assets, Depreciable, Net	46,545,155.27	28,295.10	1,916,962.23		48,490,412.60
Capital Assets, Net	\$ 54,442,338.44	\$ 0.00	\$ 8,064,820.19	\$ 0.00	\$ 62,507,158.63

NOTE 7 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2002 were as follows:

	Amount
Accounts Payable	\$ 924,203.62
Accrued Payroll	111,870.85
Contract Retainage	231,060.06
Total Accounts Payable and Accrued Liabilities	\$ 1,267,134.53

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 8 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities is presented as follows:

	Balance July 1, 2001	Additions	Reductions	Balance June 30, 2002	Current Portion
Bonds Payable	\$ 5,220,000.00	\$ 0.00	\$ 310,000.00	\$ 4,910,000.00	\$ 330,000.00
Compensated Absences	733,112.43	738,397.13	558,384.89	913,124.67	72,889.73
Total Long-Term Liabilities	<u>\$ 5,953,112.43</u>	<u>\$ 738,397.13</u>	<u>\$ 868,384.89</u>	<u>\$ 5,823,124.67</u>	<u>\$ 402,889.73</u>

B. Bonds Payable - The School was indebted for bonds payable for the purposes shown in the following table:

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2002	Principal Outstanding 06/30/2002
Housing and Dining System						
Refinancing of Dormitory and Dining Hall Series 1989	(A)	4.00% - 5.00%	10/01/2009	\$ 1,080,000.00	\$ 180,000.00	\$ 900,000.00
Dormitory HVAC Renovations Project	(A)	3.25% - 4.50%	10/01/2008	890,000.00	225,000.00	665,000.00
Technology Infrastructure Upgrades Project	(B)	5.00% - 5.75%	10/01/2015	1,005,000.00	45,000.00	960,000.00
Total Housing and Dining System				<u>2,975,000.00</u>	<u>450,000.00</u>	<u>2,525,000.00</u>
Fitness and Student Center Project	(A)	3.25% - 5.25%	10/01/2018	2,650,000.00	265,000.00	2,385,000.00
Total Bonds Payable				<u>\$ 5,625,000.00</u>	<u>\$ 715,000.00</u>	<u>\$ 4,910,000.00</u>

(A) The University of North Carolina System Pool Revenue Bonds, Series 1998B

(B) The University of North Carolina Sysstem Pool Revenue Bonds, Series 2000

Designated student fees and revenue streams related to the systems financed have been pledged for the payment of these bonds. Bond insurance was purchased by the School to guarantee the payment of principal and interest for the above Revenue Bonds.

In addition, fund reservations required by the Bond Indentures have been established and recorded for the Series 2000 Bonds (B). On October 31, 2000, in accordance with the Bond Resolution, the School deposited \$99,975.00 in a Bond Reserve Fund. The balance in the Bond Reserve Fund was \$101,092.06 at June 30, 2002.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

C. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2002 are as follows:

<u>Fiscal Year</u>	Annual Requirements	
	Bonds Payable	
	Principal	Interest
2003	\$ 330,000.00	\$ 220,718.76
2004	335,000.00	205,506.26
2005	355,000.00	189,718.76
2006	370,000.00	173,131.26
2007	390,000.00	156,418.76
2008-2012	1,570,000.00	542,534.41
2013-2017	1,175,000.00	227,031.25
2018-2019	385,000.00	17,437.50
Total Requirements	\$ 4,910,000.00	1,732,496.96

NOTE 9 - OPERATING LEASE OBLIGATIONS

Future minimum lease payments under non-cancelable operating leases consist of the following at June 30, 2002:

<u>Fiscal Year</u>	<u>Amount</u>
2003	\$ 16,761.12
2004	6,896.76
2005	6,000.00
2006	6,000.00
2007	6,000.00
2008-2012	27,000.00
Total Minimum Lease Payments	\$ 68,657.88

Rental expense for all operating leases during the year was \$17,953.62.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 10 - REVENUES

A summary of eliminations and allowances by revenue classification and revenues pledged as security for revenue bonds is presented as follows:

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Allowance for Uncollectibles	Net Revenues	Net Revenues Pledged as Security for Debt	
Operating Revenues:							
Student Tuition and Fees	\$ 7,215,875.65	\$ 0.00	\$ 1,288,191.01	\$ 1,219.05	\$ 5,928,903.69	\$ 239,223.60	(A)
Sales and Services:							
Sales and Services of Auxiliary Enterprises:							
Residential Life	\$ 1,977,547.34	\$ 0.00	\$ 379,231.52	\$ 62.23	\$ 1,598,378.05	\$ 1,598,378.05	(B)
Dining	1,600,404.89		302,974.98	(278.98)	1,297,150.93	1,297,150.93	(B)
Health and Recreation Services	1,138,869.79		190,730.52	225.37	948,364.64		
Bookstore	233,251.37				233,251.37		
Parking	33,296.70			40.55	33,337.25		
Other	42,368.64				42,368.64		
Sales and Services of Educational and Related Activities	287,816.83	55,891.07			231,925.76		
Total Sales and Services	\$ 5,313,555.56	\$ 55,891.07	\$ 872,937.02	\$ 49.17	\$ 4,384,776.64	\$ 2,895,528.98	

Revenue bonds secured by pledged revenues:

- (A) Facility Debt Fee for the Fitness and Student Center Project
- (B) Housing and Dining System

NOTE 11 - OPERATING EXPENSES BY FUNCTION

The School's operating expenses by functional classification are presented as follows:

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 10,015,108.52	\$ 482,725.98	\$ 538,701.93	\$ 0.00	\$ 0.00	\$ 0.00	\$ 11,036,536.43
Public Service	387,697.73	36,507.96	492,624.43		729.77		917,559.89
Academic Support	2,386,660.53	216,745.27	258,183.73				2,861,589.53
Student Services	834,483.02	36,278.18	179,855.79				1,050,616.99
Institutional Support	4,305,792.78	270,216.65	846,126.77				5,422,136.20
Operations and Maintenance of Plant	2,151,561.25	1,860,937.20	252,027.04		852,686.15		5,117,211.64
Student Financial Aid				798,534.77			798,534.77
Auxiliary Enterprises	1,755,190.21	(36,839.30)	1,502,161.95		250,520.81		3,471,033.67
Depreciation						2,082,602.83	2,082,602.83
Total Operating Expenses	\$ 21,836,494.04	\$ 2,866,571.94	\$ 4,069,681.64	\$ 798,534.77	\$ 1,103,936.73	\$ 2,082,602.83	\$ 32,757,821.95

NOTE 12 - PENSION PLANS

A. Retirement Plans - Each permanent full-time employee, as a condition of employment, is a member of either the Teachers' and State Employees' Retirement System or the Optional Retirement Program. The Teachers' and State Employees' Retirement System (System) is a multiple-employer cost sharing defined benefit pension plan administered by the North Carolina State Treasurer.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

After five years of creditable service, members of the Teachers' and State Employees' Retirement System qualify for a vested deferred benefit. Employees who retire on or after age 65 and complete 5 years of membership service (age 55 and 5 years of creditable service for law enforcement officers), reach age 60 with 25 years of membership service, or complete 30 years of creditable service receive a retirement allowance of 1.81% of an average final compensation (based on the 4 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 20 years of creditable service or reach age 60 with 5 years of creditable service (age 50 with 15 years creditable service for law enforcement officers).

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by North Carolina General Statutes 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, 2002, these rates were set at 1.97% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2002, the School had a total payroll of \$17,702,263.99, of which \$9,577,386.20 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$574,643.17 and \$188,674.51, respectively. The School made one hundred percent of its annual required contributions for the years ended June 30, 2002, 2001, and 2000, which were \$188,674.51, \$488,586.34, and \$736,827.55, respectively.

The Teachers' and State Employees' Retirement 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.

The Optional Retirement Program (Program) is a defined contribution retirement plan, which provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Administrators and eligible faculty of the School may join the Program instead of the Teachers' and State Employees' Retirement System. The Board of Governors of The University of North Carolina is responsible

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

for the administration of the Program and designates the companies authorized to offer investment products. The Board has authorized the following carriers: Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), Lincoln Life Insurance Company, Variable Annuity Life Insurance Company (VALIC), and Fidelity Investments. Participants may elect to allocate their contributions and the School contributions to any one of the carriers or may direct their contributions to one carrier and the School contributions to another. Each carrier offers a variety of investment funds, including both fixed and variable account investment options and mutual funds.

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2002, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The School assumes no liability other than its contribution.

Participants in the Program are immediately vested in the value of employee contributions. The value of employer contributions is vested after five years of participation in the Program. Participants become eligible to receive distributions when they terminate employment or retire.

For the year ended June 30, 2002, the School had a total payroll of \$17,702,263.99, of which \$6,220,808.44 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$373,248.51 and \$425,503.30, respectively.

- B. 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

School. The voluntary contributions by employees amounted to \$54,240.62 for the year ended June 30, 2002.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program 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 School except for a 5% employer contribution for the School's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of School law enforcement officers for the year ended June 30, 2002 were \$38,964.85. The voluntary contributions by employees amounted to \$123,553.00 for the year ended June 30, 2002.

IRC Section 403(b) and 403(b)(7) Plans - Eligible School employees 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 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 School. The voluntary contributions by employees amounted to \$147,888.52 for the year ended June 30, 2002.

NOTE 13 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees -** The School participates in State-administered programs which provide postemployment 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 or the Optional Retirement Program. 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. The School contributed 2.35% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program for these health care benefits. For the fiscal year ended June 30, 2002, the School's total contribution to the Plan was \$371,257.58. The School assumes no liability for retiree health care

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.

- B. Long-Term Disability** - The School 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 or the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The School contributes .52% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the fiscal year ended June 30, 2002, the School's total contribution to the DIPNC was \$82,150.61. The School assumes no liability for long-term disability benefits under the plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 14 - RISK MANAGEMENT

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

Tort claims of up to \$500,000 are self-insured under the authority of the State Tort Claims Act. In addition, the State provides excess public officers' and employees' liability insurance up to \$11,000,000 via contract with a private insurance company. The School pays the premium, based on a composite rate, directly to the private insurer.

The School is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not supported by the State's General Fund are charged for the coverage. The School also purchased through the Fund extended coverage for sprinkler leakage, business interruption, vandalism, theft, and "all risks" for

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

buildings and contents. Losses covered by the Fund are subject to a \$500 per occurrence deductible except theft losses, which carry a \$1,000 per occurrence deductible.

All State-owned vehicles are covered by liability insurance through a private insurance company and handled by the North Carolina Department of Insurance. The liability limits for losses occurring in state are \$500,000 per claim and \$5,000,000 per occurrence. The School pays premiums to the Department of Insurance for the coverage.

The School is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is handled by the North Carolina Department of Insurance. Coverage limit is \$5,000,000 per occurrence with a \$50,000 deductible.

Employees and retirees are provided health care coverage by the Comprehensive Major Medical Plan (Plan), a component unit of the State. The Plan is funded by employer and employee contributions and is administered by a third-party contractor. Effective for the October 1, 2001 through September 30, 2002 year, the Plan no longer offers health coverage through 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 School's primary responsibility is to arrange for and provide the necessary treatment for work related injury. The School is responsible for paying medical benefits and compensation in accordance with the North Carolina Workers' Compensation Act. The School is self-insured for workers' compensation.

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 and funded via employer contributions.

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

NOTE 15 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The School has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were \$11,724,447.19 and on other purchases were \$775,626.53 at June 30, 2002.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

B. University Improvement General Obligation Bonds – The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of two billion five hundred million dollars of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The funds authorized are to be used solely for capital facilities cost on the University of North Carolina campuses as specified in the legislation. The bond legislation specifies the amount of bond funding for each University campus and the level of bond funding intended for each project. The bonds are authorized to be issued over a six-year period beginning in 2001 at a level not to exceed amounts provided in the legislation. Using a cash flow financing approach, The University of North Carolina – General Administration (UNC-GA), establishes annual amounts not to exceed for each approved project. The amounts not to exceed are subject to change due to actual cash availability and needs during the year. Subsequent to the bond sales and the availability of bond proceeds, UNC-GA notifies the Office of State Budget and Management (OSBM) of the amounts not to exceed for each approved project. Within these amounts, based on an official request of cash needs from the School, OSBM authorizes allotments. The School records the allotments as revenue on the accompanying financial statements. The School's remaining authorization of \$33,431,100.00 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

NOTE 16 - NORTH CAROLINA SCHOOL OF THE ARTS FOUNDATION, INC.

There is a separately incorporated non-profit foundation associated with the School. This foundation is the North Carolina School of the Arts Foundation, Inc.

This organization serves as the primary fundraising arm of the School through which individuals, corporations, and other organizations support School programs by providing scholarships, fellowships, faculty salary supplements, and unrestricted funds to specific colleges and the School's overall academic environment. The School's financial statements do not include the assets, liabilities, net assets, or operational transactions of the foundation, except for support from the organization to the School. This support approximated \$2,508,001.56 for the year ended June 30, 2002.

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

NOTE 17 - ACCOUNTING CHANGES

Effective July 1, 2001, the School implemented GASB Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management’s Discussion and Analysis – for Public Colleges and Universities*. The financial statement presentation required by these Statements is a single-column enterprise activity rather than the fund-group perspective previously reported. Significant accounting changes in order to comply with the new requirements include adopting depreciation on capital assets, reporting revenues net of discounts and allowances, eliminating interfund activities, classifying activities as operating or nonoperating, classifying assets and liabilities as current or noncurrent, and prorating summer school activities to periods earned.

In addition, the School implemented GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. Changes in existing disclosures include more detailed information on debt service requirements, and obligations under leases, and disclosure of the major components of receivable and payable balances.

NOTE 18 - NET ASSET RESTATEMENT

As referred to in Note 17, the School implemented GASB Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management’s Discussion and Analysis – for Public Colleges and Universities*.

July 1, 2001 Fund Equity as previously reported	\$ 84,031,298.48
Implementation of GASB 34/35	<u>(23,803,393.05)</u>
July 1, 2001 Net Assets as Restated	<u>\$ 60,227,905.43</u>

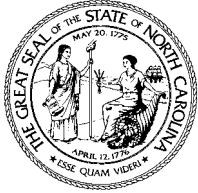
***North Carolina School of the Arts
Schedule of General Obligation Bond Project Authorizations,
Budgets, and Expenditures
For Project-to-Date as of June 30, 2002***

Schedule 1

Capital Improvement Projects	Projected Start Date	General Obligation Bonds Authorized	Other Sources	Total Project Budget	Amount Expended	Percent Completed	Expected Completion Date
<i>Projects Started</i>							
Basic Performance and Education Complex	Dec 2000	\$ 18,211,700.00	\$ 0.00	\$ 18,211,700.00	\$ 3,492,671.03	19.18%	Apr 2003
Stevens Center Renovations	Nov 2000	4,231,775.00		4,231,775.00	224,207.39	5.30%	May 2003
Film Archives Building	Mar 2001	2,142,000.00		2,142,000.00	126,344.97	5.90%	Nov 2003
Student Services Support Complex	Apr 2001	2,400,000.00		2,400,000.00	195,807.50	8.16%	Mar 2004
Dance Costume Shop - Comprehensive Renovation	Oct 2001	399,000.00		399,000.00	13,702.50	3.43%	Oct 2004
Workplace Building #2 - Comprehensive Renovation	Mar 2002	1,282,500.00		1,282,500.00			May 2005
Crawford Hall and the Recital Hall - Comprehensive Renovation	Mar 2002	474,905.00		474,905.00			May 2004
Residence Hall	Oct 2001	1,740,495.00		1,740,495.00	19,893.38	1.14%	Jul 2004
Gray Classroom Building - Partial Renovation	Mar 2002	1,698,315.00		1,698,315.00			Mar 2005
Technology Infrastructure Expansion	Feb 2001	1,772,300.00		1,772,300.00	676,201.30	38.15%	Mar 2004
Renovation of Demille Theatre	Mar 2002	2,213,785.00		2,213,785.00			Mar 2005
Land Acquisition	Feb 2001	4,000,000.00		4,000,000.00	1,896,578.79	47.41%	Dec 2004
Project Management	Dec 2000	1,980,725.00		1,980,725.00	178,844.89	9.03%	Jun 2007
Total All Projects		\$ 42,547,500.00	\$ 0.00	\$ 42,547,500.00	\$ 6,824,251.75		

Note: The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of two billion five hundred million dollars of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The projects listed on this schedule are those funded or to be funded by bond proceeds from the general obligation bonds authorized by Senate Bill 912.

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Ralph Campbell, Jr.
State Auditor

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Office of the State Auditor

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**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**

Board of Trustees
North Carolina School of the Arts
Winston-Salem, North Carolina

We have audited the financial statements of North Carolina School of the Arts, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, as of and for the year ended June 30, 2002, and have issued our report thereon dated March 26, 2003.

As discussed in Note 17 to the financial statements, the School implemented Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures* during the year ended June 30, 2002.

We conducted our audit 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 School's 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 audit 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)**

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the School's 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 Audit Committee, the Board of Trustees and Board of Governors, management and staff of the School, 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
March 26, 2003

DISTRIBUTION OF AUDIT REPORT

In accordance with General Statutes 147-64.5 and 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.

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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. Wade Hobgood	Chancellor, North Carolina School of the Arts
Mr. Joseph L. Dickson	Vice Chancellor for Finance and Administration North Carolina School of the Arts
Dr. Michael Marsicano	Chairman, Board of Trustees North Carolina School of the Arts

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Senator Patrick J. Ballantine	Minority Leader of the N. C. Senate
Representative N. Leo Daughtry	N. C. House of Representatives
Mr. James D. Johnson	Director, Fiscal Research Division

May 2, 2003

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