

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, 2002 AND 2001

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT OF
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CHAPEL HILL, NORTH CAROLINA
FOR THE YEARS ENDED JUNE 30, 2002 AND 2001

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM

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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 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, 2002 and 2001. Our audits were made by authority of Article 5A of Chapter 147 of the General Statutes.

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 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 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 on the accompanying financial statements that relate solely to The University of North Carolina Hospitals. 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 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. 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 Hospitals' 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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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying basic 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 June 30, 2002 and 2001 and for the years ended June 30, 2002 and 2001, as listed in the table of contents. These financial statements are the responsibility of the Hospitals' 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.

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, based on our audit, 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, 2002 and 2001, and the changes in its financial position 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)

As discussed in Note 16 to the financial statements, the Hospitals 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 10, 2002 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 this report in considering the results of our audit.

The Management's Discussion and Analysis (MD&A) on pages 3 to 8 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.



Ralph Campbell, Jr.
State Auditor

December 10, 2002

**UNIVERSITY OF NORTH CAROLINA HOSPITALS
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDING JUNE 30, 2002 and 2001**

Overview of the Basic Financial Statements

Effective July 1, 2001, the Hospitals implemented new accounting and reporting standards required by the Governmental Accounting Standards Board (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* and as amended by GASB Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. The new reporting requirements include Management's Discussion and Analysis (MD&A), the Statements of Net Assets, the Statements of Revenues, Expenses, and Changes in Net Assets, the Statements of Cash Flows, and Financial Statement Disclosures.

This part of the financial report, Management's Discussion and Analysis, provides an introduction and overview to assist the reader in interpreting and understanding the basic financial statements. Currently known facts, decisions, or conditions are discussed in management's analysis of financial position and results of operations. Comparative analysis with the prior year financial report is also an important part to understanding the Hospitals' financial position and results of operations.

The Statements of Net Assets provide information relative to the Hospitals' assets, liabilities, and net assets as of the last day of the fiscal year. Assets and liabilities on this Statement are categorized as either current or noncurrent. Current assets are those that are available to pay for expenses in the next fiscal year and are anticipated to be used to pay for current liabilities. Current liabilities are those payable in the next fiscal year. Net assets on this Statement are categorized as invested in capital assets (net of related debt), restricted or unrestricted. Restricted net assets are categorized as expendable for the purposes noted. Overall, the Statements of Net Assets provide information relative to the financial strength of the Hospitals and its ability to meet current and long-term obligations.

The Statements of Revenues, Expenses, and Changes in Net Assets provide information relative to the results of the Hospitals' operations, nonoperating activities, and other activities affecting net assets, which occurred during the fiscal year. Nonoperating activities include primarily subsidies from the State in the form of appropriations, noncapital gifts and grants, interest expense on financing activities, investment income (net of investment expenses), and loss on disposition of capital assets. Other activities include change in fair value of investments and loss on affiliate activity. Overall the Statements of Revenues, Expenses, and Changes in Net Assets provide information relative to the Hospitals' management of its operations and its ability to maintain its financial strength.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The Statements of Cash Flows provide information relative to the Hospitals' sources and uses of cash funds for operating activities, noncapital financing activities, capital and related financing activities, and investing activities. This Statement provides a reconciliation of beginning cash balances to ending cash balances and is representative of the activity reported on the Statements of Revenues, Expenses, and Changes in Net Assets as adjusted for changes in the beginning and ending balances of noncash accounts on the Statements of Net Assets.

The Financial Statement Disclosures provide information relative to the significant accounting principles applied in the financial statements, authority for and associated risk of deposits and investments, detailed information on long-term liabilities, detailed information on accounts receivable, accounts payable, revenues and expenses, required information on pension plans and other postemployment benefits, insurance against losses, commitments and contingencies, accounting changes, and a discussion of adjustments to prior periods and events subsequent to the Hospitals' financial statement period. Overall, the Financial Statement Disclosures provide information to better understand details, risk, and uncertainty associated with amounts reported in the financial statements.

Comparison of Two-Year Data

Comparative financial data is summarized in Table 1. Additional comparative data can be found in the financial statements. Discussion of comparative data is included in the following section.

Analysis of Overall Financial Position and Results of Operations

The Statements of Net Assets reflect a decrease in current assets from the prior year. The acquisition of noncurrent capital assets with current assets caused the decrease. The completion of the Women's and Children's Hospitals accounted for the majority of the increase in noncurrent capital assets along with acquisitions through the Hospitals' normal capital equipment replacement cycle. Additionally, the noncurrent portion of short-term investments increased as a result of the reinvestment of earnings on the funds.

The increase in current liabilities reflects the higher accounts payable associated with operations and an increase in third party settlements. The decrease in noncurrent liabilities resulted mainly from the reclassification of bond payables and third party settlements to current liabilities as they become due.

The Statements of Revenues, Expenses, and Changes in Net Assets reflect a net operating loss resulting from the new GASB reporting requirement where State appropriation is recorded as a nonoperating revenue. Even though there was a reduction from the prior year level of support, the State appropriation continues to offset the loss from operations and covers the expenses associated with graduate medical education and the uncollected revenue from patients who are unable to pay. Net patient service revenue continues to be strong as evidenced by its 12% increase over the prior year. During the past year, the Hospitals implemented an average rate increase of 9.5% to gross charges and outpatient volume increased by approximately five percent. Patient day volume realized a small decline of less than one percent, but the overall occupancy percentage remains high at 75.8%.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Total operating expenses increased by 12%. The major components of operating expenses are reflected in the graph on page 8. Salaries and benefits comprise 58% of the total operating expenses for FY02 and increased by 14% over the prior year. The main factor driving this increase was the Hospitals' dependence on contract staffing to supplement medical professionals where there was a shortage in the labor market. The second largest component of operating expenses is medical and surgical supplies, which experienced an increase of approximately six percent over the prior year. Growth in patient service volume and inflation caused this increase. Depreciation expense showed the largest percentage increase (15.6%) over the prior year due to the opening of the Women's and Children's Hospitals.

The Statements of Cash Flows provide information about the major sources and uses of the Hospitals' cash. For both of the years presented, there was approximately \$48 million in funds spent on the acquisition or construction of capital assets. The Statement also reflects the amount of debt service for bonds and other debt. Investment income from interest and dividends showed a 12% increase related to the prior year investment of \$75 million into the State Treasurer's Pool. For both years, the change in cash balance was positive, and in both cases, the result of the liquidation of a portion of the Investments in the State Treasurer's Pool.

Analysis of Net Asset Balances

Net assets invested in capital assets, net of related debt, total \$179,481,715 and represent the gross value of plant assets (\$522,344,537) plus bond issuance costs (\$1,896,069) less accumulated depreciation (\$181,335,293) and related debt (\$163,423,598). Restricted expendable net assets of \$54,629,969 represent amounts subject to externally imposed restrictions. Unrestricted net assets of \$355,595,175 represent amounts not subject to externally imposed stipulations but are internally designated for various activities and initiatives, as well as future construction projects.

Discussion of Capital Asset and Long-Term Debt Activity

Capital Assets

With the issuance of the Series 2001 Revenue Bonds, the Hospitals has strengthened its position to continue to improve and modernize its facilities. Current projects include the acquisition of a central Administrative Office Building, the renovation of space for the Rehabilitation Program and the replacement of the Patient Kitchen. As of June 30, 2002, the Hospitals had \$33,690,646 in bond funds remaining for these and other projects.

Additionally, the Hospitals opened its Women's and Children's Hospitals in March 2002. This construction was funded by the Series 1996 Revenue Bonds. The Wellness Center at Meadowmont opened in November 2002, with funding provided from the Hospitals' reserves.

The Hospitals expended \$48,443,128 during the year for the construction of new buildings/infrastructure, the renovation or repair of its facilities, and the purchase of new or replacement equipment.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

At June 30, 2002, outstanding commitments on construction contracts were \$14,934,094.

Long-Term Debt Activities

The Hospitals' 2001 Revenue Bonds received a rating of A1 from Moody's Investors Service, Inc. and a rating of AA from Standard and Poor's Ratings Services. No additional bonds have been issued since the 2001 Bonds. For the current reporting period, there was no change in the ratings assigned by these agencies.

At June 30, 2002, the Hospitals had outstanding bond indebtedness in the amount of \$293,840,000 of which \$4,840,000 is due within the next year.

Discussion of conditions that may have a significant effect on net assets or revenues, expenses, and changes in net assets.

The major source of funding for the Hospitals is the revenue it generates from patient care services. State appropriations from the State of North Carolina fund approximately eight percent of the Hospitals' operating expenses.

The State's economy has been in a decline since 2001 and has resulted in reduced appropriated funding for fiscal years 2002 and 2003 across State government. U. S. Department of Labor statistics for the Raleigh-Durham-Chapel Hill area show that the unemployment rate has increased from 2.5% for the quarter ending March 31, 2001 to 5.4% for the quarter ending June 30, 2002.

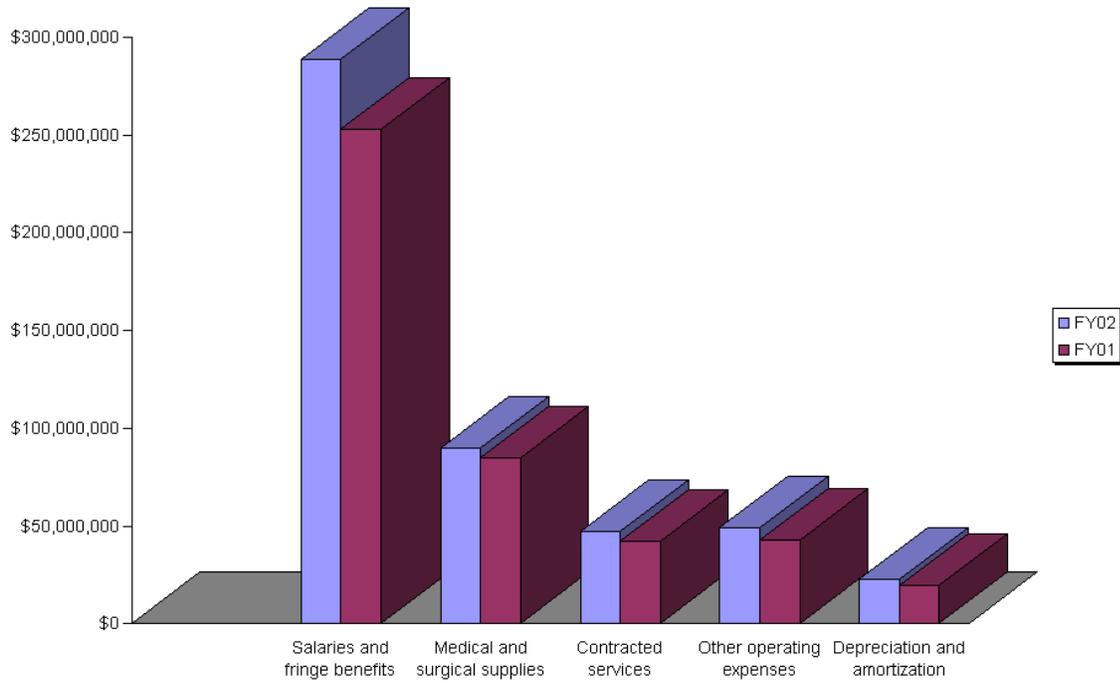
As the economy slowed and unemployment rose, the Hospitals has experienced an increase in its contractual adjustments for indigency and bad debt expense. Their combined increase is \$11.5 million over the prior year with both adjustments representing 7.2% of current year gross patient charges. Contractual adjustments for Medicare, Medicaid, and Managed Care patients have also increased as third party payors continue to reduce their reimbursements. Further information regarding net patient service revenue is included in Footnote 9 to the Financial Statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The University of North Carolina Hospitals				
Summary of Condensed Financial Statement Totals				Table 1
For the years ending June 30, 2002 and 2001				
		FY02	FY01	Change
Statements of Net Assets				
Total current assets	\$	220,223,468	\$ 224,610,962	\$ (4,387,494)
Total capital assets, net		341,009,244	313,459,463	27,549,781
Other noncurrent assets		408,773,498	389,526,445	19,247,053
TOTAL ASSETS		970,006,210	927,596,870	42,409,340
Total current liabilities		68,409,480	59,699,838	8,709,642
Total noncurrent liabilities		311,889,871	317,231,187	(5,341,316)
TOTAL LIABILITIES		380,299,351	376,931,025	3,368,326
Invested in capital assets, net of related debt		179,481,715	158,472,914	21,008,801
Restricted for expendable uses		54,629,969	48,494,108	6,135,861
Unrestricted		355,595,175	343,698,823	11,896,352
TOTAL NET ASSETS		589,706,859	550,665,845	39,041,014
Statements of Revenues, Expenses and Changes in Net Assets				
Total operating revenues		466,023,104	415,596,361	50,426,743
Net patient service revenue		455,857,171	407,895,133	47,962,038
Nonoperating revenues				
State appropriations		39,092,359	39,910,182	(817,823)
Investment activity (realized & unrealized)		40,984,875	37,268,745	3,716,130
Other nonoperating revenues		1,654,989	498,342	1,156,647
TOTAL REVENUES		547,755,327	493,273,630	54,481,697
Total operating expenses		497,381,325	442,207,423	55,173,902
Salaries and fringe benefits		288,629,005	252,741,432	35,887,573
Medical and surgical supplies		89,884,524	84,935,270	4,949,254
Contracted services		47,197,987	41,957,567	5,240,420
Other operating expenses		48,810,107	42,808,603	6,001,504
Depreciation & amortization		22,859,702	19,764,551	3,095,151
Nonoperating expenses				
Loss recognized on affiliate activity		1,181,178	9,090,406	(7,909,228)
Interest expense		7,365,852	6,051,586	1,314,266
Loss on disposal of capital assets		2,785,958	806,585	1,979,373
TOTAL EXPENSES		508,714,313	458,156,000	50,558,313
Increase in net assets		39,041,014	35,117,630	3,923,384
Beginning net assets		550,665,845	515,548,215	35,117,630
Ending net assets		589,706,859	550,665,845	39,041,014
Net operating loss		(31,358,221)	(26,611,062)	(4,747,159)
Statements of Cash Flows				
Cash flow from operations		(5,418,863)	6,149,398	(11,568,261)
Cash flow from noncapital financing		38,749,144	115,436,459	(76,687,315)
Cash flow from capital & related financing		(64,486,420)	(32,553,435)	(31,932,985)
Cash flow from investing		36,197,123	(87,741,112)	123,938,235
Increase in cash	\$	5,040,984	\$ 1,291,310	\$ 3,749,674

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

UNIVERSITY OF NORTH CAROLINA HOSPITALS
Operating Expenses by Category



**UNIVERSITY OF NORTH CAROLINA HOSPITALS
STATEMENTS OF NET ASSETS
JUNE 30, 2002 AND 2001**

EXHIBIT "A"

	<u>2002</u>	<u>2001</u>
ASSETS		
Current assets		
Cash and cash equivalents (Note 3)	\$ 25,084,240	\$ 20,088,214
Restricted cash and cash equivalents (Note 3)	6,064,904	8,077,985
Short term investments	62,898,290	76,179,381
Patient accounts receivable - net (Note 4)	93,578,008	91,045,684
Accrued interest receivable	81,928	110,236
Restricted accrued interest receivable	245,654	297,785
Estimated third party settlements (Note 5)	923,631	855,638
Inventories	13,174,063	11,876,455
Notes receivable	277,000	210,334
Other accounts receivable	16,031,640	13,068,445
Prepaid expenses	1,864,110	2,800,805
	<u>220,223,468</u>	<u>224,610,962</u>
Total current assets		
Noncurrent assets		
Cash and cash equivalents (Note 3)	878,459	833,501
Restricted cash and cash equivalents (Note 3)	55,947,547	64,457,659
Short term investments	289,592,020	265,630,378
Restricted short term investments	50,837,344	44,078,619
Advance deposits with Liability Insurance Trust Fund	3,409,869	4,061,501
Patient accounts receivable - net (Note 4)	981,790	665,934
Bond issuance costs - net	2,251,654	2,345,445
Start-up costs - net	631,488	649,351
Notes receivable	127,000	254,000
Investments in affiliates (Note 15)	4,116,327	6,550,057
Capital assets - net (Note 6)	341,009,244	313,459,463
	<u>749,782,742</u>	<u>702,985,908</u>
Total noncurrent assets		
	<u>970,006,210</u>	<u>927,596,870</u>
Total assets		

See accompanying notes to financial statements.

**UNIVERSITY OF NORTH CAROLINA HOSPITALS
STATEMENTS OF NET ASSETS (continued)
JUNE 30, 2002 AND 2001**

EXHIBIT "A"

	<u>2002</u>	<u>2001</u>
LIABILITIES		
Current liabilities		
Accounts and other payables - operating	24,571,790	20,528,174
Accounts and other payables - capital	6,142,433	6,686,286
Accrued salaries and benefits	14,219,703	12,684,767
Estimated third party settlements (Note 5)	10,310,000	6,515,082
Bond interest payable	3,632,239	3,835,522
Bonds payable (Note 7)	4,840,000	4,680,000
Due to patients or third parties	4,232,502	4,294,843
Funds held for others	460,813	475,164
Total current liabilities	<u>68,409,480</u>	<u>59,699,838</u>
Noncurrent liabilities (Note 7)		
Accounts and other payables - capital	2,480,865	3,538,067
Bonds payable - net of discount	280,083,429	284,649,931
Rebatable arbitrage payable	2,236,169	852,029
Compensated absences	13,959,408	12,251,160
Estimated third party settlements (Note 5)	13,130,000	15,940,000
Total noncurrent liabilities	<u>311,889,871</u>	<u>317,231,187</u>
Total liabilities	<u>380,299,351</u>	<u>376,931,025</u>
NET ASSETS		
Invested in capital assets, net of related debt	179,481,715	158,472,914
Restricted for expendable uses for:		
Bond covenants	50,837,344	44,078,619
Liability Insurance Trust Fund	3,409,869	4,061,501
Trust fund donations	382,756	353,988
Unrestricted	355,595,175	343,698,823
Total net assets	<u>\$ 589,706,859</u>	<u>\$ 550,665,845</u>

See accompanying notes to financial statements.

**UNIVERSITY OF NORTH CAROLINA HOSPITALS
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2002 AND 2001**

EXHIBIT "B"

	<u>2002</u>	<u>2001</u>
OPERATING REVENUES		
Net patient service revenue (Note 9)	\$ 455,857,171	\$ 407,895,133
Other operating revenue	8,644,070	8,867,697
Prior year third party settlements	1,521,863	(1,166,469)
	<u>466,023,104</u>	<u>415,596,361</u>
OPERATING EXPENSES		
Salaries and fringe benefits	288,629,005	252,741,432
Medical and surgical supplies	89,884,524	84,935,270
Contracted services	47,197,987	41,957,567
Other supplies and services	32,443,936	30,380,451
Communications, utilities, and travel	14,611,763	12,098,226
Medical malpractice costs	1,754,408	329,926
Depreciation and amortization	22,859,702	19,764,551
	<u>497,381,325</u>	<u>442,207,423</u>
Total operating expenses	<u>497,381,325</u>	<u>442,207,423</u>
Net operating loss	<u>(31,358,221)</u>	<u>(26,611,062)</u>
NONOPERATING REVENUE (EXPENSES)		
State appropriations	39,092,359	39,910,182
Investment activity		
Investment income	32,724,336	27,671,944
Net increase in fair value of investments	8,260,539	9,596,801
Loss on investments in affiliates (Note 15)	(1,181,178)	(9,090,406)
Interest and fees on capital asset related debt	(6,047,648)	(6,051,586)
Interest and fees on other debt	(1,318,204)	
Noncapital unrestricted gifts and grants	1,602,705	476,171
Restricted interest income	16,784	21,311
Noncapital restricted gifts and grants	35,500	860
Loss on disposal of capital assets	(2,785,958)	(806,585)
	<u>70,399,235</u>	<u>61,728,692</u>
Net nonoperating revenue	<u>70,399,235</u>	<u>61,728,692</u>
Increase in net assets	39,041,014	35,117,630
NET ASSETS		
Net assets - beginning of year	550,665,845	517,953,254
Restatement (Note 17)		(2,405,039)
Net assets - end of year	<u>\$ 589,706,859</u>	<u>\$ 550,665,845</u>

See accompanying notes to financial statements.

**UNIVERSITY OF NORTH CAROLINA HOSPITALS
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2002 AND 2001**

EXHIBIT "C"

	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from patients and third parties	\$ 454,400,520	\$ 416,280,889
Cash payments to employees for services	(285,385,821)	(250,655,302)
Cash payments to suppliers for goods and services	(181,844,820)	(168,224,132)
Cash payments for medical malpractice	-	(329,926)
Other cash receipts	7,411,258	9,077,869
Net cash provided (used) by operating activities	<u>(5,418,863)</u>	<u>6,149,398</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations received	39,092,359	39,910,182
Proceeds from sale of revenue bonds	-	75,000,000
Interest paid on revenue bonds	(1,318,204)	-
Principal paid on revenue bond maturities	(680,000)	-
Noncapital gifts and grants	1,654,989	526,277
Net cash provided by noncapital financing activities	<u>38,749,144</u>	<u>115,436,459</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from sale of equipment	65,836	56,503
Interest paid on capital debt	(10,508,073)	(10,917,308)
Principal paid on revenue bond maturities	(4,000,000)	(3,535,000)
Principal paid on capital lease and notes payable	(1,601,055)	(691,300)
Proceeds from sale of revenue bonds	-	35,000,000
Acquisition and construction of capital assets	(48,443,128)	(48,239,320)
Arbitrage paid on tax exempt financing	-	(3,678,183)
Issuance costs paid	-	(548,827)
Net cash used by capital and related financing activities	<u>(64,486,420)</u>	<u>(32,553,435)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest income	3,626,038	5,398,927
Investments with State Treasurer's Pool:		
Sales proceeds	31,907,333	4,000,000
Purchases	-	(89,592,576)
Investments in and loans to affiliated enterprises:		
Cash received	1,734,248	-
Cash payments	(1,070,496)	(7,547,463)
Net cash provided (used) by investing activities	<u>36,197,123</u>	<u>(87,741,112)</u>
Net change in cash and cash equivalents	5,040,984	1,291,310
Cash and cash equivalents, beginning	20,921,715	19,630,405
Cash and cash equivalents, ending	<u>\$ 25,962,699</u>	<u>\$ 20,921,715</u>

See accompanying notes to financial statements.

**UNIVERSITY OF NORTH CAROLINA HOSPITALS
STATEMENTS OF CASH FLOWS (continued)
FOR THE YEARS ENDED JUNE 30, 2002 AND 2001**

EXHIBIT "C"

	<u>2002</u>	<u>2001</u>
A RECONCILIATION OF NET OPERATING LOSS TO CASH PROVIDED (USED) BY OPERATIONS FOLLOWS:		
Net operating loss	\$ (31,358,221)	\$ (26,611,062)
ADJUSTMENTS TO RECONCILE OPERATING LOSS TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES:		
Depreciation and amortization	22,859,702	19,764,551
Change in assets and liabilities:		
Patient accounts receivable	(2,848,180)	1,562,153
Other accounts receivable	(2,203,379)	1,897,910
Estimated third party settlements	916,925	7,700,116
Inventories	(1,297,608)	(195,068)
Prepaid expenses	936,695	(2,572,988)
Advance deposits	1,754,408	
Accrued salaries and benefits	1,534,936	1,902,776
Accounts and other payables	2,654,303	3,915,438
Due to patients or third parties	(62,341)	(1,397,782)
Funds held for others	(14,351)	-
Compensated absences	1,708,248	183,354
	<u>\$ (5,418,863)</u>	<u>\$ 6,149,398</u>
NONCASH INVESTING ACTIVITIES:		
Unrealized gain on State Treasurer's Pool	\$ 8,316,041	\$ 9,464,934
Noncash distributions from State Treasurer's Long-Term Investment Portfolio	29,178,736	23,975,640
INVESTMENTS IN AFFILIATED ENTERPRISES:		
Current gain (loss) from discontinued affiliated operations	431,908	(8,173,444)
Current loss from equity method adjustments	(1,613,086)	(916,962)

See accompanying notes to financial statements.

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UNIVERSITY OF NORTH CAROLINA HOSPITALS
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2002 and 2001

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES:

- A. Organization: The University of North Carolina Hospitals (the Hospitals) is the only State-owned teaching hospital in North Carolina. With a licensed base of 688 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.
- B. 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 Capital Assets category 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 in Affiliates line to the Capital Assets line on the financial statements. These are both within the noncurrent asset category on the financial statements.

Separate financial information for the LLC is 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- C. 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* and as amended by GASB Statement No. 37, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments: Omnibus*, the full scope of the Hospitals’ activities for the year ended June 30, 2002, is considered to be a single business-type activity (BTA) and accordingly, is reported within a single column in the basic financial statements.

- D. Basis of Accounting: The accompanying financial statements 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 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).

- E. Cash and Cash Equivalents: This classification appears on the Statements of Net Assets and the Statements of Cash Flows and includes petty cash, security deposits, cash on deposit in private bank accounts, 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.

GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities that Use Proprietary Fund Accounting* permits the treatment of restricted funds as investments on Exhibit C, and consequently these amounts are not reported on the Statements of Cash Flows.

- F. Investments: The Hospitals’ investments are with the long-term portion of the State Treasurer’s Cash and Investment Pool. Investments are accounted for at fair value, as determined by quoted market prices, or an amount determined by management if quoted

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

market prices are not available. The net increase in the fair value of investments is recognized as a component of investment activity.

- G. Patient Accounts Receivable: The Hospitals has established flexible payment arrangements with selected payers to optimize collection of past-due accounts. Amounts due beyond 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 the section Net Patient Service Revenue later in the Significant Accounting Policies 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.
- H. Other Receivables: In addition to patient account receivables, the Hospitals recognizes other receivables related to its operations. These items include the sales tax refund due from the North Carolina Department of Revenue, amounts due from affiliates and other State agencies, and billings to outside companies for ancillary testing.
- I. Inventories: Inventories consist of medical and surgical supplies, pharmaceuticals, prosthetics, and other supplies that are used to provide patient care or by service departments within the Hospitals. Inventories are stated at first-in, first-out cost.
- J. 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 Hospitals capitalizes assets having a cost or fair value of at least \$5,000 at the date of acquisition and an estimated useful life of three years or more. Useful life estimates are assigned based upon the American Hospital Association publication *Estimated Useful Lives of Depreciable Hospital Assets*.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 3 to 20 years for equipment, 10 to 50 years for buildings and fixed equipment, and 5 to 25 years for general infrastructure. 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 month in which the item is placed into service or retired from service.

- K. Restricted Assets: Restricted assets are those whose use is restricted by external parties or by law through constitutional provisions or enabling legislation.
- L. Bonds Payable: Bonds payable are reported net of unamortized discount and deferred loss on refunding. The Hospitals amortizes the bond discounts over the life of the bonds using the effective interest method. The deferred loss on refunding is amortized over the life of the old debt (new debt and old debt payoff at the same time) using the straight-line

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

method. Bond issuance costs are amortized using the straight-line method over the life of the bonds.

- M. Compensated Absences: The Hospitals' policy is to record the cost of annual leave when earned. Employees earn annual leave at varying rates depending upon years of service and the leave plan in which they participate.

Traditional Plan: The policy provides for a maximum accumulation of unused annual leave of 30 days that can be carried forward beyond the pay period that includes December 31. After the pay period that includes December 31, any excess accumulation over 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. Employees earn holiday leave at the rate of 11 or 12 days per year with an unlimited accumulation. The Hospitals' policy requires that employees use holiday hours in excess of 40 prior to using earned annual leave. At termination, employees are paid for any accumulated holiday leave. Employees earn sick leave at the rate of one day per month with an unlimited accumulation.

Paid Time Off (PTO) Plan: Effective May 1, 2002, the Hospitals implemented a PTO program that combines the various leave types that employees may earn into one earning rate that varies depending upon years of service. This new program is mandatory for all new employees, and existing employees will have the opportunity to convert to the PTO program over the next three years. This is a voluntary choice, but once they change, employees cannot return to the traditional program. The policy provides for a maximum accumulation of 280 hours of unused PTO time. Any excess accumulation over 280 hours is converted to catastrophic leave, which is treated similar to sick leave in the Traditional Plan. Upon termination of employment, employees are paid for their current balance in PTO based upon their years of service. Once an employee has more than five years of service, the entire accumulated balance is paid up to 280 hours. The PTO program also has an annual sell back feature that allows employees to sell back 50% of their accumulated hours over a minimum floor. This occurs in December each year.

Liability Calculation: The liability for accumulated annual leave, holiday leave, and PTO leave 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 by the employee's current hourly rate plus benefits for social security and State retirement. The Hospitals has the policy of recording the cost of sick leave when taken and paid rather than when the leave is earned. 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

When classifying compensated absences into current and noncurrent, leave is considered taken using a last-in, first-out method. For the Hospitals, the entire balance of compensated absences is classified as noncurrent, since the balance of accumulated hours increased for the fiscal year.

N. Net Assets: The Hospitals' net assets are classified as follows:

Invested in Capital Assets, Net of Related Debt: This represents the Hospitals' total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been 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 – Expendable: Expendable restricted net assets include resources for which the Hospitals is legally or contractually obligated to spend the resources in accordance with restrictions imposed by external parties.

Unrestricted Net Assets: Unrestricted net assets include resources derived from patient care services and ancillary services, unrestricted gifts and investment 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 and determined by Hospitals' departmental managers.

O. Revenue and Expense Recognition: The Hospitals 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 Hospitals' mission. Operating revenues include all charges to patients for inpatient and outpatient services as well as external customers who purchase medical services. Revenues from State appropriations that represent a subsidy to the Hospitals, as well as investment income, gifts and grants and loss on disposal of capital assets, are considered nonoperating since these are either investing, capital or noncapital financing activities. Operating expenses are all transactions incurred other than those related to investing, capital or noncapital financing activities.

P. 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

- Q. Medical Malpractice Costs: Medical malpractice costs represent the actuarially determined contribution to the Liability Insurance Trust Fund. See Note 12 for further discussion of the Liability Insurance Trust Fund.
- R. Amortization: Amortization expense for the start-up costs of affiliate activities is calculated using a straight-line method over a period of 40 years.
- S. 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 - BUDGETING AND BUDGETARY CONTROL:

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.

The Hospitals has Budget Code 16095, which tracks the level of State appropriation support for the institution. 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. In addition to Budget Code 16095, the Hospitals has Budget Code 56096 where it reports operating results as an enterprise fund.

The Hospitals' Board of Directors approves an annual operating budget in May each year in order to have a budget in place for the next fiscal year. After the General Assembly approves the appropriation budget in 16095, the budget in 56096 is revised to mirror the budget adopted by the Hospitals' Board of Directors. The Hospitals follows an established system of budgetary controls to track capital and operating expenses. Monthly financial reports, which include budget and actual data, are provided for each department manager. Additionally, monthly data is summarized in the State system and submitted for review by various agencies. When actual conditions require changes to the budget, revisions are prepared and communicated to those affected. Changes to the budget are reviewed and approved by senior management at the Hospitals and at the State level. The Hospitals requires the issuance of purchase orders for most departmental orders and capital equipment. State budget code 16095 is maintained on a cash basis of accounting while code 56096 is reported on an accrual basis.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 3 - DEPOSITS AND INVESTMENTS:

Deposits: The Hospitals is required by General Statute 147-77 to deposit its budget code cash, as defined in Note 2, and by General Statute 116-36.1 to deposit its institutional trust funds cash, in the State Treasurer's Cash and Investment Pool. In addition, the Hospitals may voluntarily deposit endowment funds, special funds, revenue bond proceeds, debt service funds, and funds received for services rendered by health care professionals with the State Treasurer's Cash and Investment Pool. Special funds consist of moneys for agency funds held directly by the Hospitals. 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.

At June 30, 2002, deposits include cash and cash equivalents of \$87,956,801. Cash on hand was \$18,349. The Hospitals' portion of the State Treasurer's Cash and Investment Pool was \$87,514,778. 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 Hospitals' deposits not with the State Treasurer was \$77,780 and the bank balances were \$75,508. Bank balances in excess of \$100,000 are not covered by federal depository insurance. At June 30, 2002, no bank balance was in excess of \$100,000.

At June 30, 2001, deposits include cash and cash equivalents of \$93,439,560. Cash on hand was \$17,799. The Hospitals' portion of the State Treasurer's Cash and Investment Pool was \$92,931,782. 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.

North Carolina General Statute 147-69.1(c), applicable to the State's General Fund and General Statute 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 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Investments: Investments consist of amounts held in the Long Term Portfolio of the State Treasurer's Cash and Investment Pool. Total investments for 2002 and 2001 were \$403,327,654 and \$385,888,378 respectively. 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.

NOTE 4 - 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 uncollectible 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, 2002 and 2001:

	2002	2001
In house patients	\$ 20,122,843	\$ 21,818,362
Discharged (not final billed) patients	24,674,681	16,787,974
Total unbilled	44,797,524	38,606,336
Discharged patients	120,353,988	111,499,519
Payment arrangements	569,333	401,877
Indigent care provided	(17,727,151)	(15,718,451)
Current – gross	147,993,694	134,789,281
Allowance for bad debts	(13,494,898)	(12,908,480)
Contractual allowances	(40,920,788)	(30,835,117)
Total allowances	(54,415,686)	(43,743,597)
Current – net	93,578,008	91,045,684
Payment arrangements	1,402,557	951,335
Allowance for bad debts	(420,767)	(285,401)
Noncurrent – net	981,790	665,934
Total net	\$ 94,559,798	\$ 91,711,618

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 5 - 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 \$12,526,179 and \$12,477,542 in passthrough payments for 2002 and 2001, including \$923,631 earned but not received as of June 30, 2002 and \$855,638 as of June 30, 2001.

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.

At June 30, 2002, the Hospitals estimates a current liability of \$3,750,000 and \$6,560,000 for amounts due to Medicare and Medicaid, respectively. Cost settlements estimated as noncurrent are \$11,230,000 and \$1,900,000 for Medicare and Medicaid, respectively.

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

NOTE 6 - CAPITAL ASSETS - NET:

A summary of changes in capital assets for the year ended June 30, 2002 is presented below:

	Beginning Balance	Reclasses	Additions	Retirements	Ending Balance
Capital Assets, Non-Depreciable:					
Land	\$ 20,775,582	\$ 0	\$ 100	\$ 0	\$ 20,775,682
Construction in Progress	119,740,594	(98,077,943)	12,638,236		34,300,887
Total Capital Assets, Non-Depreciable	140,516,176	(98,077,943)	12,638,336		55,076,569
Capital Assets, Depreciable:					
Buildings	142,083,649	91,360,101		(5,894,715)	227,549,035
Equipment	215,552,659	6,717,842	39,470,810	(27,715,968)	234,025,343
General Infrastructure	4,793,152		915,320	(14,882)	5,693,590
Total Capital Assets, Depreciable	362,429,460	98,077,943	40,386,130	(33,625,565)	467,267,968
Less Accumulated Depreciation:					
Buildings	46,729,209		4,601,369	(10,987)	51,319,591
Equipment	140,658,140		17,760,724	(30,762,784)	127,656,080
General Infrastructure	2,098,824		260,798		2,359,622
Total Accumulated Depreciation	(189,486,173)		22,622,891	(30,773,771)	(181,335,293)
Total Capital Assets, Depreciable, Net	172,943,287	98,077,943	17,763,239	(2,851,794)	285,932,675
Capital Assets, Net	\$ 313,459,463	\$ 0	\$ 30,401,575	\$ (2,851,794)	\$ 341,009,244

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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. The Hospitals capitalizes the net interest expense into construction in progress (CIP) for the projects. The Hospitals' gross bond interest expense for 2002 was \$11,585,326 of which \$6,823,316 was on construction related projects and \$4,581,339 was capitalized. For 2001, the gross bond interest expense was \$11,321,198 of which \$6,910,923 was on construction related projects and \$5,499,219 was capitalized.

NOTE 7 - LONG-TERM LIABILITIES:

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

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Notes Payable	\$ 3,862,770	\$ 734,012	\$ (985,658)	\$ 3,611,124	\$ 1,532,633
Capital Lease Payable	827,304		(206,109)	621,195	218,821
Total Accounts and Other Payables - Capital	4,690,074	734,012	(1,191,767)	4,232,319	1,751,454
Bonds Payable	298,520,000		(4,680,000)	293,840,000	4,840,000
Less: Discount	(5,235,968)		101,574	(5,134,394)	
Less: Deferred Charge on Refunding	(3,954,101)		171,924	(3,782,177)	
Total Bonds Payable	289,329,931		(4,406,502)	284,923,429	4,840,000
Arbitrage Payable	852,029	1,384,140		2,236,169	
Compensated Absences	12,251,160	17,309,105	(15,600,857)	13,959,408	
Third Party Settlements	22,455,082	984,918		23,440,000	10,310,000
Total Long-Term Liabilities	\$ 329,578,276	\$ 20,412,175	\$ (21,199,126)	328,791,325	\$ 16,901,454
Less: Current Portion				(16,901,454)	
Net Long-Term Liabilities				\$ 311,889,871	

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- B. Notes Payable: The Hospitals uses installment purchase agreements with IBM Global Financing to finance its purchase of computer hardware and software. Additionally, the Hospitals entered into a financing agreement for the upfit costs associated with its dialysis unit located in Pittsboro. This agreement was paid off in July 2002.

Purpose	Financial Institution	Interest Rate/Range	Final Maturity Date	Original Note Amount	Principal Paid at 06/30/2002	Principal Remaining 06/30/2002
Purchase computer hardware and software	IBM Global	4.82% to 6.83%	04/01/2005	\$ 4,772,016	\$ 1,589,285	\$ 3,182,731
Dialysis unit upfit costs	Chatham Mills	9.50%	07/31/2002	<u>435,000</u>	<u>6,607</u>	<u>428,393</u>
Total				<u>\$ 5,207,016</u>	<u>\$ 1,595,892</u>	<u>\$ 3,611,124</u>

- C. Bonds Payable: The Hospitals was indebted for bonds payable for the following purposes:

Purpose	Series	Interest Rate Range	Final Maturity Date	Original Note Amount	Principal Paid at 06/30/2002	Principal Remaining 06/30/2002
Construction of Women's and Children's Hospitals	1996	4.20% to 5.375%	02/15/2029	\$ 133,870,000	\$ 4,410,000	\$ 129,460,000
Refund 1992 Revenue Bonds	1999	4.00% to 5.25%	02/15/2024	58,925,000	3,545,000	55,380,000
Rex Acquisition and Hospital Renovations	2001A 2001B	Variable	02/15/2031	<u>110,000,000</u>	<u>1,000,000</u>	<u>109,000,000</u>
Total				<u>\$ 302,795,000</u>	<u>\$ 8,955,000</u>	<u>\$ 293,840,000</u>

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. These bonds were subsequently defeased by the Series 1999 Revenue Bonds. During the current fiscal year, the final redemption occurred for the Series 1992 Revenue Bonds.

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.

On June 3, 1999 the Board of Governors of The University of North Carolina issued \$58,925,000 in revenue bonds to refund the Series 1992 Bonds.

On January 31, 2001 the Board of Governors of The University of North Carolina issued \$110,000,000 in revenue bonds for the acquisition of controlling interest in Rex Healthcare Inc. and for various construction and renovation projects of the University of

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

North Carolina Hospitals. For the past fiscal year, the interest rate on these variable rate bonds ranged from 0.80% to 3.30%.

- D. Demand Bonds: Included in bonds payable is the following demand bond issue. Demand bonds are securities that contain a “put” feature that allows bondholders to demand payment before the maturity of the debt upon proper notice to the Hospitals’ remarketing agents.

On January 31, 2001, the Board of Governors of The University of North Carolina issued Series 2001A and Series 2001B 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 began on February 15, 2002. A portion of the proceeds was used to reimburse the Hospitals for \$75,000,000 spent allowing the UNC Health Care System to acquire controlling interest in Rex Healthcare Inc. The remaining proceeds are to be used for the renovation of space vacated after the opening of the North Carolina Women’s Hospital, North Carolina Children’s Hospital, and associated support services. 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 0.22% 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 0.50% 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, 2002 and 2001, there were no Bank Bonds held by the Liquidity Facility.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

The current expiration date of the Agreements is July 29, 2003. 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.

E. Summary: Bonds payable at June 30, 2002 and 2001 is as follows:

	2002	2001
4.20% - 5.25% serial 1996 bonds due 2001-2011	\$ 25,555,000	\$ 27,805,000
4.00% - 5.25% serial 1999 bonds due 2001-2017	31,070,000	32,500,000
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	109,000,000	110,000,000
Principal outstanding	293,840,000	298,520,000
Unamortized discount	(5,134,394)	(5,235,968)
Deferred charge due to advanced refunding	(3,782,177)	(3,954,101)
Bonds payable	284,923,429	289,329,931
Less: Current portion	(4,840,000)	(4,680,000)
Bonds payable – noncurrent	\$ 280,083,429	\$ 284,649,931

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

Bonds Payable:

Payments During Fiscal Year	Principal	Interest	Total Debt Service
2003	\$ 4,840,000	\$ 11,305,247	\$ 16,145,247
2004	5,010,000	11,279,133	16,289,133
2005	5,180,000	11,091,651	16,271,651
2006	5,575,000	10,878,848	16,453,848
2007	5,775,000	10,656,386	16,431,386
2008-2012	33,185,000	49,377,336	82,562,336
2013-2017	42,335,000	41,117,095	83,452,095
2018-2022	54,165,000	30,406,896	84,571,896
2023-2027	69,425,000	17,192,113	86,617,113
2028-2032	68,350,000	4,140,910	72,490,910
Total payments	<u>\$ 293,840,000</u>	<u>\$ 197,445,615</u>	<u>\$ 491,285,615</u>

Interest on the variable rate 2001A revenue bonds is calculated at 2.00% and at 1.85% for the 2001B revenue bonds based upon the daily rate at which the bonds were re-marketed on June 30, 2002.

Notes Payable:

Payments During Fiscal Year	Principal	Interest	Total Debt Service
2003	\$ 1,532,634	\$ 153,434	\$ 1,686,068
2004	1,166,044	88,670	1,254,714
2005	912,446	21,928	934,374
Total payments	<u>\$ 3,611,124</u>	<u>\$ 264,032</u>	<u>\$ 3,875,156</u>

- G. Bond Defeasance: 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' Statements of Net Assets. At June 30, 2002 and 2001, the outstanding

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

balance of the defeased University of North Carolina Hospitals 1992 Revenue Bonds was \$0 and \$53,515,000, respectively.

NOTE 8 - LEASE OBLIGATIONS:

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, 2002:

<u>For the year ending June 30,</u>	<u>Capital Leases</u>	<u>Operating Leases</u>
2003	\$ 250,140	\$ 827,422
2004	250,140	529,509
2005	166,760	245,862
2006		107,663
2007		108,913
Subsequent to 2007		<u>534,285</u>
Total minimum lease payments	667,040	<u>\$ 2,353,654</u>
Amount representing interest (6% Rate of Interest)	<u>45,845</u>	
Present value of net minimum payments	<u>\$ 621,195</u>	

Total minimum lease payments were \$6,217,214 at June 30, 2001. Additional details are provided in the prior year financial statements. Total rental expense in 2002 and 2001 for all operating leases was \$1,980,607 and \$1,966,054, respectively.

The value of capital leases included in Capital Assets – Net is \$758,527 at June 30, 2002.

NOTE 9 - NET PATIENT SERVICE REVENUE:

Medicare: The Hospitals is reimbursed for inpatient acute care services under the provisions of the Prospective Payment System (PPS). Under PPS, payment is made at predetermined rates for treating various diagnoses and performing 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 difference in the standard hospital charge and the prospective payment for such services is reflected as an adjustment from patient

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

service revenue. The DRG payments include adjustments for indirect medical education and disproportionate share.

Medicare reimburses inpatient capital-related costs based upon a predetermined amount per discharge. Beginning in 2002, the ten-year phase-in to the federal PPS rate ended and the Hospitals is now receiving one hundred percent of the federal PPS rate. Additionally, Medicare makes payments for Direct Graduate Medical Education (DGME) in support of the direct costs of residency training. These passthrough payments are discussed further in Note 5, Estimated Third Party Settlements.

The Balanced Budget Act of 1997 required the implementation of a prospective payment system for outpatient services. The system became effective August 1, 2000 and is based on ambulatory payment classifications. It applies to most hospital outpatient services other than ambulance, rehabilitation services, clinical diagnostic laboratory services, dialysis for end-stage renal disease, non-implantable durable medical equipment, prosthetic devices, and orthotics. Previously, payment for outpatient services varied by type of service: fee schedule, the lower of cost or charges, or a blend of the fee schedules and cost.

Medicaid: Medicaid reimburses inpatient services on an interim basis under a Prospective Payment System. Medicaid uses the Medicare DRG system with the addition of six neonatal DRGs. A settlement is made at year-end to adjust from the interim DRG reimbursement to a cost-based reimbursement basis.

Medicaid reimburses outpatient services on the basis of documented cost for all services except ambulance, hearing aids, durable medical equipment (DME), outpatient pharmacy, home health, dialysis, and 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 Program for a final determination of actual program costs.

Contracting Hospital Agreement (CHA): The Hospitals enters into a CHA each year with Blue Cross and Blue Shield of North Carolina (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 deductibles or co-payments applicable to specific terms of insurance policies. All patient charges (regardless of payor) conform to the approved rates in the CHA and are subject to change at the Hospitals' discretion.

Other Agreements: The Hospitals has also entered into reimbursement agreements with certain commercial insurance carriers and managed care organizations to accept patients on a discounted fee for service basis. The basis for reimbursement under these agreements includes case rates per discharge, discounts from established charges, fee schedules, and per diem rates.

In general, all payments for inpatient and outpatient services are subject to deductibles and co-payments that are the patient's responsibility. Additionally, insurance plans may

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

reimburse their subscribers or make direct payment to the Hospitals on an assignment of benefits basis.

A summary of net patient service revenue for the years ended June 30, 2002 and 2001 follows:

	2002	2001
Inpatient routine	\$ 167,272,879	\$ 156,156,635
Inpatient ancillary	356,062,599	319,215,139
Outpatient	266,634,851	202,459,473
Indigent care provided	(32,508,800)	(23,519,423)
Gross patient service revenue	757,461,529	654,311,824
Medicare contractual	(78,414,927)	(59,688,760)
Medicaid contractual	(63,997,120)	(47,374,163)
Managed care contractual	(108,287,491)	(101,135,377)
Other contractals	(26,445,081)	(16,311,472)
Bad debt	(24,459,739)	(21,906,919)
Contractual adjustments	(301,604,358)	(246,416,691)
Net patient service revenue	\$ 455,857,171	\$ 407,895,133
Percent of gross patient revenue	60.18%	62.34%

NOTE 10 - PENSION PLANS:

A. 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 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 Hospitals had a gross payroll of \$206,790,959 of which \$174,177,130 was covered under the System. Total employee and employer pension contributions for the year were \$10,450,642 and \$3,429,358, respectively. The Hospitals made one hundred percent of its employer required contributions to the System for the years ended June 30, 2002, 2001 and 2000, which were \$3,429,358, \$8,343,675, and \$12,248,140, respectively.

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.

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 Hospitals. The voluntary contributions by employees amounted to \$138,458 in 2002 and \$129,481 in 2001.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

are incurred by the Hospitals except for a five-percent employer contribution for the Hospitals' law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of Hospitals' law enforcement officers were \$38,881 in 2002 and \$36,534 in 2001. Voluntary contributions by employees amounted to \$938,378 in 2002 and \$888,731 in 2001.

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 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 \$4,206,835 in 2002 and \$4,205,964 in 2001.

NOTE 11 - 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, 2002, the Hospitals contributed 2.35% of its covered payroll or \$4,090,858 to the plan. For the fiscal year ended June 30, 2001, contributions equaled \$2,003,734. 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. 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, 2002 and 2001 with total contributions to DIPNC of \$905,211 and \$814,017, 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*.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 12 - 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. 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.

The Hospitals 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. Losses covered by the Fund are subject to a \$500 per occurrence deductible. The Hospitals also purchased through the Fund "all risks" insurance for buildings and contents. No significant losses occurred during the year.

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 Hospitals pays premiums to the Department of Insurance for the coverage.

The Hospitals 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, 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 care 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 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)

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 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 Physicians and Associates (UNC P&A). 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 UNC P&A 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

The Fund provides occurrence coverage for entity participants as well as the employees and professional staff participants. For the year ending June 30, 2002, the Fund provided coverage of \$3,500,000 per occurrence and \$12,000,000 annual aggregate for the negligence of individual employees of the participants within the course and scope of their employment. For the year ending June 30, 2001, the Fund provided coverage of \$3,000,000 per occurrence and \$8,000,000 annual aggregate. 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, 2002 and 2001, the Hospitals had advance deposits with the Fund totaling \$3,409,869 and \$4,061,501, respectively.

Additional disclosures relative to the funding status and obligations of the Fund are set forth in the audited financial statements of the Liability Insurance Trust Fund for the years ended June 30, 2002 and 2001. 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.

NOTE 13 - COMMITMENTS AND CONTINGENCIES:

- A. Commitments: The Hospitals has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments at June 30, 2002 and 2001 on construction contracts were \$14,934,094 and \$13,776,427, respectively.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- B. 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.

NOTE 14 - RELATED PARTY TRANSACTIONS:

Medical Foundation of North Carolina - The Hospitals is a participant in the Medical Foundation of North Carolina, a non-profit 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. If the Foundation were to purchase any equipment for the Hospitals, then the amount would be recorded at the time of receipt 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 a controlling interest in the governance of Rex Healthcare Inc. and related entities. 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 an equity transfer. In addition, the agreement calls for future funding of Rex capital needs for the next ten years up to \$58 million. To date, there have been no calls under the agreement, because the capital needs have been funded by Rex's operating surplus.

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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 15 - INVESTMENTS IN AFFILIATES:

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were \$4,116,327 and \$6,550,057 at June 30, 2002 and 2001. The Hospitals' share of these affiliates and joint ventures is not significant individually. The summarized unaudited financial information below represents an aggregation of the affiliates and joint ventures:

	(unaudited) 2002	(unaudited) 2001
Total Affiliate Activity		
Current assets	\$ 11,130,750	\$ 9,511,042
Noncurrent assets	4,186,188	3,773,146
Current liabilities	6,742,224	5,237,541
Noncurrent liabilities	3,101	5,482
Shareholders equity	8,571,613	8,041,165
Revenue	21,222,908	18,869,880
Net loss	(1,814,695)	(2,623,136)
<hr/>		
Hospitals' Share of Activity		
Affiliate loss – ongoing operations	(1,613,086)	(916,962)
Affiliate gain (loss) – discontinued operations	431,908	(8,173,444)
Total loss realized from affiliate activities	<u>\$ (1,181,178)</u>	<u>\$ (9,090,406)</u>

NOTE 16 - ACCOUNTING CHANGES:

Effective July 1, 2001, the Hospitals 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* and as amended by GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*. The financial statement presentation required by these Statements is a single-column enterprise activity. Significant changes to the Hospitals' reporting include:

- Calculation of net patient service revenue now includes bad debt which was formerly shown as an operating expense

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

- Classification of State appropriation and interest expense as nonoperating
- Removal of the assets whose use is limited designation on the Statements of Net Assets
- New categories for net asset designations

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

NOTE 17 - NET ASSET RESTATEMENT:

In preparing the additional disclosures necessary for outstanding notes payable, additional notes were identified in the amount of \$4,473,004. This amount had been omitted from the 2001 Statement of Net Assets for both the Capital Assets and the Notes Payable. Prior payments on these notes had been treated as an operating expense for maintenance contracts rather than as a note payment. This treatment excluded the recognition of the depreciation expense on the capital assets. Additional depreciation was also identified for capital assets that were placed in service in a prior year. To correct these misclassifications, an adjustment of \$2,405,039 was made to the net asset balance for the beginning of the fiscal year ending June 30, 2001. Since comparative statements are shown for 2002 and 2001, an additional amount of \$2,525,247 was added to the expenses previously reported on the 2001 Statement of Revenues, Expenses, and Changes in Net Assets. The following table summarizes the changes:

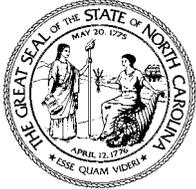
Statement of Revenues, Expenses, and Changes in Net Assets

	<u>2001</u>	<u>Prior to 2001</u>	<u>Total</u>
Contracted services	\$ (691,300)	\$ (121,332)	\$ (812,632)
Interest expense	158,700	43,697	202,397
Depreciation – notes	747,130	289,967	1,037,097
Depreciation – other	<u>2,310,717</u>	<u>2,192,707</u>	<u>4,503,424</u>
Total adjustment	<u>\$ 2,525,247</u>	<u>\$ 2,405,039</u>	<u>\$ 4,930,286</u>

NOTE 18 - SUBSEQUENT EVENTS:

In September 2002, the Hospitals entered into an agreement to purchase an office building in Chapel Hill, North Carolina for \$11,022,500. Closing occurred October 31, 2002.

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Ralph Campbell, Jr.
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 Directors
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 year ended June 30, 2002, and have issued our report thereon dated December 10, 2002.

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. As discussed in Note 16 to the financial statements, the Hospitals 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 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 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 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 Audit Committee, the Board of Directors of The University of North Carolina Health Care System, 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

December 10, 2002

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February 3, 2003

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