STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

CHAPEL HILL, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2003

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT OF

THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

CHAPEL HILL, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2003

STATE OF NORTH CAROLINA
Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet http://www.ncauditor.net

Ralph Campbell, Jr.
State Auditor

AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Board of Trustees, The University of North Carolina at Chapel Hill

This report presents the results of our financial statement audit of The University of North Carolina at Chapel Hill, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, for the year ended June 30, 2003. Our audit was made by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

The accounts and operations of the University 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 University 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 at Chapel Hill. The audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States.

The purpose of this report is to present the results of our audit on the accompanying financial statements that relate solely to The University of North Carolina at Chapel Hill. 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 at Chapel Hill.

   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.

2. **Objective –** To present significant deficiencies, if any, in internal control over financial reporting which could adversely affect the University's ability to record, process, summarize, and report financial data in the financial statements and present instances of noncompliance, if any, with laws, regulations, contracts, or grants.

   Results – The following significant deficiency in internal control over financial reporting and instance of noncompliance was noted as a result of our audit:

   Finding

   1. Inadequate Controls in the Department of Radiology

   This matter is described in the Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting and the Audit Findings and Recommendations section of this report.

3. **Objective –** To present significant deficiencies, if any, in internal control over compliance that could adversely affect the University's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants and present instances of noncompliance with federal laws, regulations, contracts, or grants, the effects of which have a material effect in relation to a type of compliance requirement or audit objective identified in OMB Circular A-133 Compliance Supplement.

   Results – The following instance of noncompliance was noted as a result of our audit:

   Finding

   2. Tracking of Subrecipient Audit Reports – Research and Development Cluster

   This matter is described in the Audit Findings and Recommendations section of this report.

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.

Ralph Campbell, Jr.
State Auditor

TABLE OF CONTENTS

STATE OF NORTH CAROLINA

Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet http://www.ncauditor.net

Ralph Campbell, Jr.
State Auditor

INDEPENDENT AUDITOR'S REPORT

Board of Trustees
The University of North Carolina at Chapel Hill
Chapel Hill, North Carolina

We have audited the accompanying basic financial statements of The University of North Carolina at Chapel Hill, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, as of and for the year ended June 30, 2003, as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, 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 at Chapel Hill as of June 30, 2003, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 17 to the financial statements, the University implemented Governmental Standards Board Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, during the year ended June 30, 2003.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 18, 2004 on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

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

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedule 1 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, based on our audit, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

March 18, 2004

Introduction

This discussion and analysis provides an introduction and overview of the financial position and activities of The University of North Carolina at Chapel Hill (the "University") for the fiscal year ended June 30, 2003, with comparative information for the fiscal year ended June 30, 2002. Certain prior year amounts have been reclassified to conform to current year presentations. Management has prepared the discussion and analysis to be read in conjunction with the financial statements and accompanying note disclosures.

The University is a constituent institution of the sixteen-campus University of North Carolina System (UNC System), a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report.* The University of North Carolina at Chapel Hill has been built by the people of the State and has existed for more than two centuries as the nation's first State University. Through its excellent undergraduate, graduate, and professional programs it has provided higher education to generations of students, many of whom have become leaders of the State and the nation.

Financial Highlights

The University's financial position remained strong at June 30, 2003 with total assets of $3.1 billion. Net assets, which represent the residual interest in the University's assets after deducting liabilities, were $2 billion at June 30, 2003. Overall, the University's net assets increased by $60.8 million in fiscal year 2002-2003 when private gifts, grants and endowment additions are included. Changes in net assets and total assets are summarized below:

	2003	2002	% Change
Net Assets - July 1	$ 1,964,418,046	$ 1,919,024,460	2.4
Increase in Net Assets	60,767,554	45,393,586	33.9
Net Assets - June 30	2,025,185,600	1,964,418,046	3.1
Total Liabilities	1,112,017,605	925,114,193	20.2
Total Assets	$ 3,137,203,205	$ 2,889,532,239	8.6

The increase in net assets was achieved despite a slight decrease in State appropriations due to statewide budget reductions and revenue shortfalls. State appropriations continue to provide essential resources in support of the University's mission. Capital funding resulting from the North Carolina higher education bond referendum, controlled enrollment growth, a robust research program, the continuing success of the Carolina First fund-raising campaign, and the sound investment management program were among the other factors resulting in positive financial results for the fiscal year.

Using the Financial Statements

The University's Comprehensive Annual Financial Report includes the following three financial statements.

- Statement of Net Assets
- Statement of Revenues, Expenses, and Changes in Net Assets
- Statement of Cash Flows

These financial statements have been prepared in accordance with Governmental Accounting Standards Board (GASB) statements. The GASB sets standards for external financial reporting for public colleges and universities and requires that financial statements be presented on a consolidated basis to focus on the University as a whole. 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 GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, were effective for fiscal year 2001-2002 and later years. Prior to these standards, the financial statements focused on the accountability of individual fund groups rather than reporting the University's financial information in a single-column format. Other important characteristics of the financial statements include the following:

- Net assets represent the excess of total assets over total liabilities. There are three classes of net assets – unrestricted, restricted (nonexpendable and expendable), and invested in capital assets, net of related debt.
- Assets and liabilities are categorized as either current or noncurrent. Current liabilities are due within one year, and current assets are those assets available to pay current liabilities.
- Revenues and expenses are categorized as either operating or nonoperating, and a net income or loss from operations is displayed. State appropriations, noncapital gifts and grants, and investment income are nonoperating revenues, which results in a net loss from operations.
- Tuition and fees revenues are reported net of scholarships and fellowships that are applied to student accounts. The "scholarship discounts" reduce the tuition and fees revenues and the scholarship and fellowship expenses by equal amounts. Scholarships and fellowships paid directly to students continue to be reported as expenses.
- Expenses are reported in the financial statements by natural classification such as salaries and benefits, supplies and materials, and other categories. Presentation by program classification such as instruction, research, and public service are disclosed in the notes to the financial statements.
- Purchases of capital assets are expensed over the asset's useful life by the recognition of depreciation expense on the capital assets.

- A Statement of Cash Flows using the direct method is reported.

Condensed Statement of Net Assets

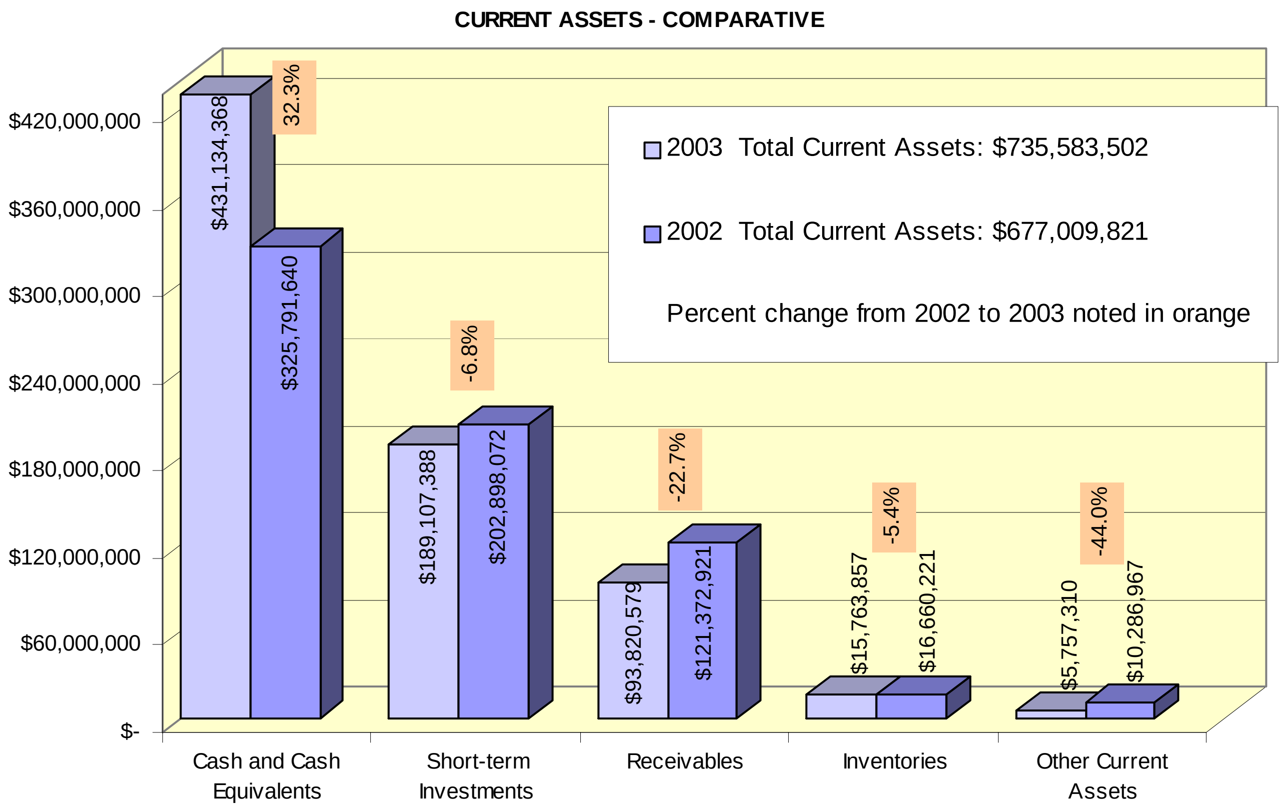
The Statement of Net Assets presents the financial position of the University at the end of the fiscal year, includes all assets and liabilities of the University, and segregates the assets and liabilities into current and noncurrent components. Net assets represent the difference between total assets and total liabilities, and are one indicator of the University's current financial condition. The following table summarizes the University's assets, liabilities and net assets at June 30, 2003 and 2002.

	2003	2002	% Change
Assets:			
Current Assets	$ 735,583,502	$ 677,009,821	8.7
Noncurrent Assets:			
Endowment Investments	754,623,099	758,987,497	-0.6
Other Long-Term Investments	377,744,985	300,226,736	25.8
Capital Assets, Net	1,134,221,485	1,027,884,988	10.4
Other Noncurrent Assets	135,030,134	125,423,197	7.7
Total Assets	3,137,203,205	2,889,532,239	8.6
Liabilities:			
Current Liabilities	367,955,960	280,246,736	31.3
Noncurrent Liabilities:			
Funds Held in Trust for Pool Participants	345,883,384	291,899,328	18.5
Long-Term Liabilities	366,628,262	321,843,654	13.9
Other Noncurrent Liabilities	31,549,999	31,124,475	1.4
Total Liabilities	1,112,017,605	925,114,193	20.2
Net Assets			
Invested in Capital Assets, Net of Related Debt	771,280,637	668,385,897	15.4
Restricted:			
Nonexpendable	323,961,205	304,096,632	6.5
Expendable	559,127,937	645,389,715	-13.4
Unrestricted	370,815,821	346,545,802	7.0
Total Net Assets	$ 2,025,185,600	$ 1,964,418,046	3.1

Current Assets and Liabilities

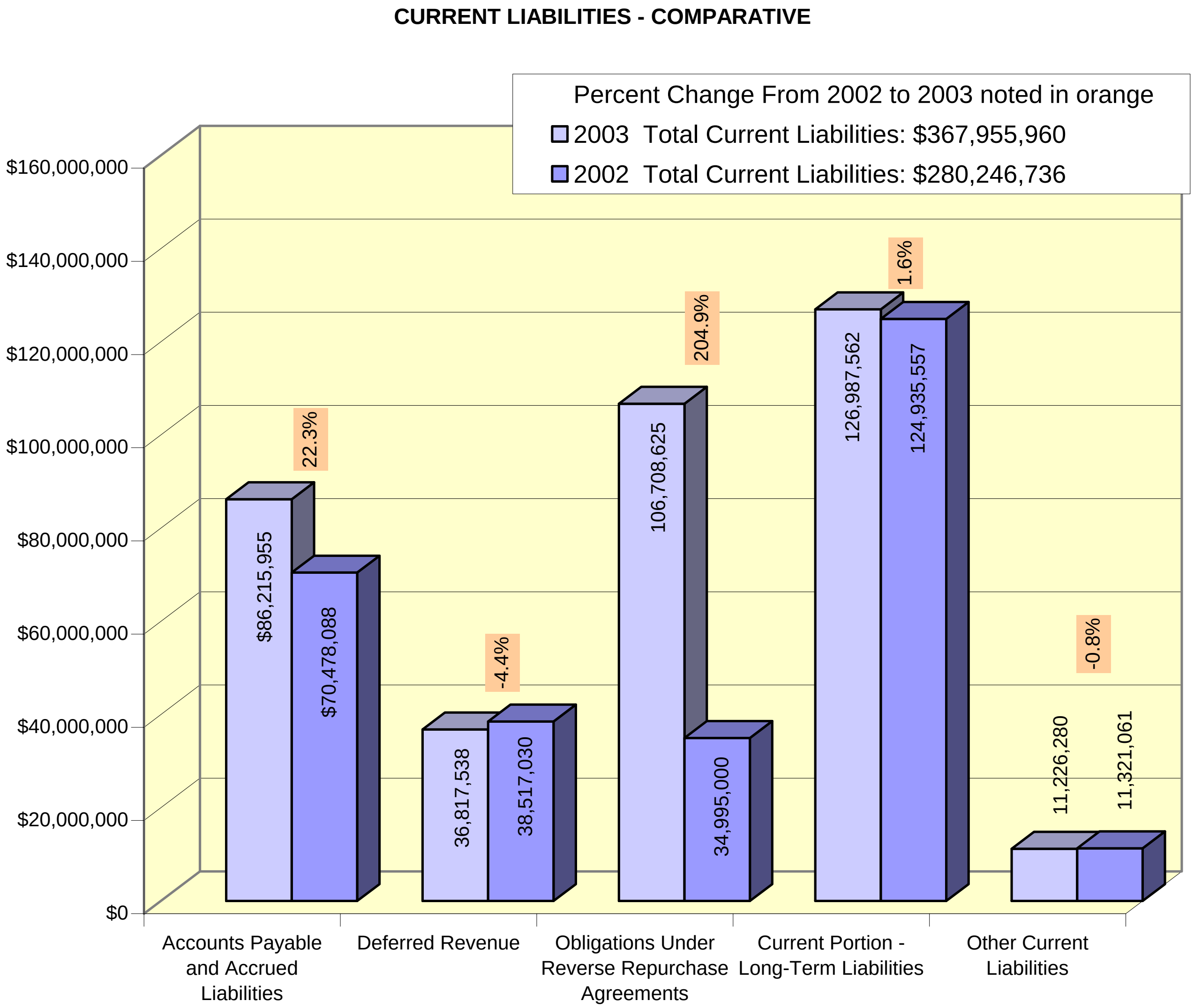
The Statement of Net Assets shows the University had total assets of $3.1 billion at June 30, 2003, an increase of 8.6% over the prior year. Working capital, which is current assets less current liabilities, was $367.6 million, a decrease of 7.3% from the prior year. Factors causing the working capital decrease include temporary financing for capital construction through the commercial paper program, a decrease in patient accounts receivables resulting from adjustments for uncollectible billings, continued use of the long-term investment pool for a limited portion of working capital to maximize investment returns, and authorization of two weeks of bonus leave to faculty and staff.

Current assets are represented graphically below:



- Cash and cash equivalents include cash in bank accounts, cash with fiscal agents, and cash invested through the State Treasurer of North Carolina.
- Short-term investments include funds invested through an investment pool administered by the University.
- Receivables include amounts due from students of the University, patients of the professional health-care clinics, governmental and private entities for contract and grant awards, donors for pledges of gifts as well as accrued investment earnings.
- Inventories represent goods for resale by auxiliary operations of the University.
- Other current assets include student loans and amounts due from the State of North Carolina or its component units.

Current liabilities are represented graphically below:



- Accounts payable and accrued liabilities include payables to vendors, accrued payroll costs, retainage on construction contracts, and commercial paper.
- Deferred revenue is primarily gifts through the planned giving program and represents the calculated remainder after annuity obligations to beneficiaries are determined based on the terms of the gift annuity, charitable trust, or other planned giving arrangement.
- Obligations under reverse repurchase agreements are liabilities incurred as part of the University's investment management program.
- The current portion of long-term liabilities includes bonds payable, notes payable, capital leases payable, and compensated absences (accrued vacation leave).

- Other current liabilities include amounts due to the State of North Carolina or its component units, deposits and interest payable, and funds held for others.

Endowment and Other Long-Term Investments

Endowment investments were $754.6 million at June 30, 2003 and include permanent endowments, funds internally designated as endowments, and similar funds such as gift annuities and charitable trusts. Net assets of endowment and similar funds were $710.1 million at June 30, 2003.

The endowment assets are invested with The University of North Carolina at Chapel Hill Foundation Investment Fund, Inc. (the "Investment Fund"), which is reported as a governmental external investment pool in the financial statements. The Investment Fund is a 501(c)(3) nonprofit corporation established to support the University by operating an investment pool for charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support the University.

Effective January 1, 2003, the assets of the Investment Fund were contributed to the UNC Investment Fund, LLC ("System Fund"), a North Carolina limited liability company organized and operated to invest assets contributed to it from time to time by the Investment Fund and by The University of North Carolina and its constituent institutions and their related endowments and tax-exempt foundations. All or substantially all of the assets of the Investment Fund are expected to be invested in the System Fund. Separate, audited financial statements for the Investment Fund and System Fund are available. The investment returns noted below refer to the pooled investment fund in existence for that time period.

The net assets of the endowment are categorized as restricted nonexpendable, restricted expendable, or unrestricted.

- Restricted nonexpendable net assets include permanent endowments for which the donor has stipulated that the principal shall remain inviolate and be invested in perpetuity to generate earnings that can be expended consistent with the purposes specified in the gift instrument.
- Restricted expendable net assets include internally designated endowments established by the University with restricted gifts and the undistributed earnings of permanent endowments.
- Unrestricted net assets include internally designated endowments established by the University with unrestricted funds.

The investment objective is to earn an average real total return of at least 5.5% per year, net of all fees, over rolling five and ten year periods. The earnings distribution policy is to provide a stable source of spending support that is sustainable over the long term while preserving the purchasing power of the endowment. The earnings distribution rate was established at 5% of the previous year's market value, with annual increases based on inflationary factors. Each year's distribution is subject to a 4% floor and a 7% cap based on estimated fiscal year-end market value.

Other long-term investments of $377.7 million include funds of $326.0 million of affiliated entities that are not part of the University's financial reporting entity but do invest through the System Fund, and bond reserves and related funds of $51.7 million.

Most of the University's endowment assets are managed within the System Fund, a pooled investment fund vehicle. The System Fund is designed to provide long-term, stable rates of return on the invested assets through the use of a highly diversified portfolio strategy. The return on the endowment assets invested in the System Fund for the fiscal year was a positive 3.3%. The System Fund return was marginally below the 70/30 S&P 500/Lehman Brothers Government/Corporate Bond Index return of 3.7% for the year, however the System Fund materially outperformed the index over the three-year and five-year periods, -0.1% vs. -4.9% and 6.1% vs. 1.5% respectively. Over the longer term, the System Fund has performed quite well, in both absolute and relative terms, increasing 9.9% for 10 years and 11.6% for 20 years versus the long term-benchmark of inflation plus 5.5% return of 8.6% and 8.8% respectively. Overall, the System Fund is very well positioned in the current environment, given the broad diversification, strong manager roster and conservative structure.

Capital Assets and Debt Management

Capital assets, net of accumulated depreciation, at June 30, 2003 and June 30, 2002 were as follows:

	2003	2002	% Change
Capital Assets:			
Construction in Progress	$ 226,958,080	$ 225,022,791	0.9
Land and Other Nondepreciable Assets	81,080,269	75,465,273	7.4
Buildings	546,453,143	491,322,542	11.2
General Infrastructure	198,911,507	162,460,694	22.4
Machinery and Equipment	80,818,486	73,613,688	9.8
Total	$ 1,134,221,485	$ 1,027,884,988	10.4

The University's method of capital planning is a long-term process that is continuously reevaluated. The University previously adopted a Facilities Profile and 10-Year Capital Plan, recognizing the need for additional academic and student life facilities to keep pace with programmatic expansion. This capital construction program includes major capital renewal of existing buildings and infrastructure to address both deferred maintenance and programmatic needs. Additionally, expansion of campus facilities will allow the University to accommodate the enrollment growth projections over the next decade. One of the critical factors for the University in fulfilling its mission of instruction, research, and public service and for providing a satisfying residential life for its students is investment in its facilities.

Maintenance and renewal of its facilities and infrastructure is an important priority for the University, as evidenced by its $1.3 billion capital construction program.

Major projects completed in fiscal year 2002-2003 include:

New Construction		
Medical Biomolecular Research Building	$	64,763,500
Bioinformatics Building		33,677,000
Banks D. Kerr Hall (School of Pharmacy) Addition		22,139,800
Major Renovations of Academic Buildings		
Murphey Hall Renovation		6,723,500
Hanes Hall Renovation to Second Floor		2,150,200
Infrastructure Improvements		
Replacement of Boiler		15,000,000
Cogeneration Facility Repairs to Coal Silos		12,000,000
Hot Water Heating System Upgrade		8,387,700
Steam Distribution System Replacement		6,000,000
Expansion of Commuter Parking Lot		1,890,000

Completed projects represent 16% of the $1.3 billion capital construction program, 27% of the projects are under construction, and 57% are in the design phase.

The Higher Education Bond Referendum, overwhelmingly approved in 2000 by North Carolina's voters, is providing nearly $510 million for this program. The University is investing in its capital construction program using a variety of other funding sources including University-issued bonds, cost reimbursements from research grants, internal reserves, and private gifts. Previous changes in State legislation allowed the University to pledge a broader stream of revenues as security for its debt obligations, and general revenue bonds were initially issued in fiscal year 2000-2001. The general revenue pledge results in a stronger, more flexible security that captures the strengths of not only the University's auxiliary and student-related revenues, but also its research programs.

The University launched a commercial paper program during the prior fiscal year that provides low-cost bridge financing for capital projects until gifts are received or in anticipation of an external bond issue. Commercial paper debt was $19,000,000 at June 30, 2003. The commercial paper program and the general revenue bonds allow the University to use a central bank concept for funding capital projects. The University issues fixed and variable rate debt externally, and blends the average borrowing rate to allocate debt costs to individual capital projects and campus divisions. This concept provides a stable and flexible debt-funding source for capital projects. The interest rate on the commercial paper program since its inception has averaged 1.29%. Interest rates on the University's variable rate, long-term bonds were less than one percent for fiscal year 2002-2003. Interest rates on fixed rate, long-term bonds are disclosed in Note 8B of the financial statements.

The University's financial strength allowed it to achieve ratings of AA+/Aa1 by the national rating agencies. The University debt burden ratio, a measure of an entity's dependence on borrowed funds, was only 2.1% at June 30, 2003 and 2.4% for the prior year.

Other Noncurrent Assets

Other noncurrent assets were $135.0 million at June 30, 2003, a 7.7% increase over the prior year. Included in this category are restricted cash and cash equivalents of $66.6 million, receivables for pledged gifts of $27.4 million, notes receivable for student loans of $25.2 million, and restricted resources due from the primary government of $15.8 million from statewide higher education bond referendum proceeds.

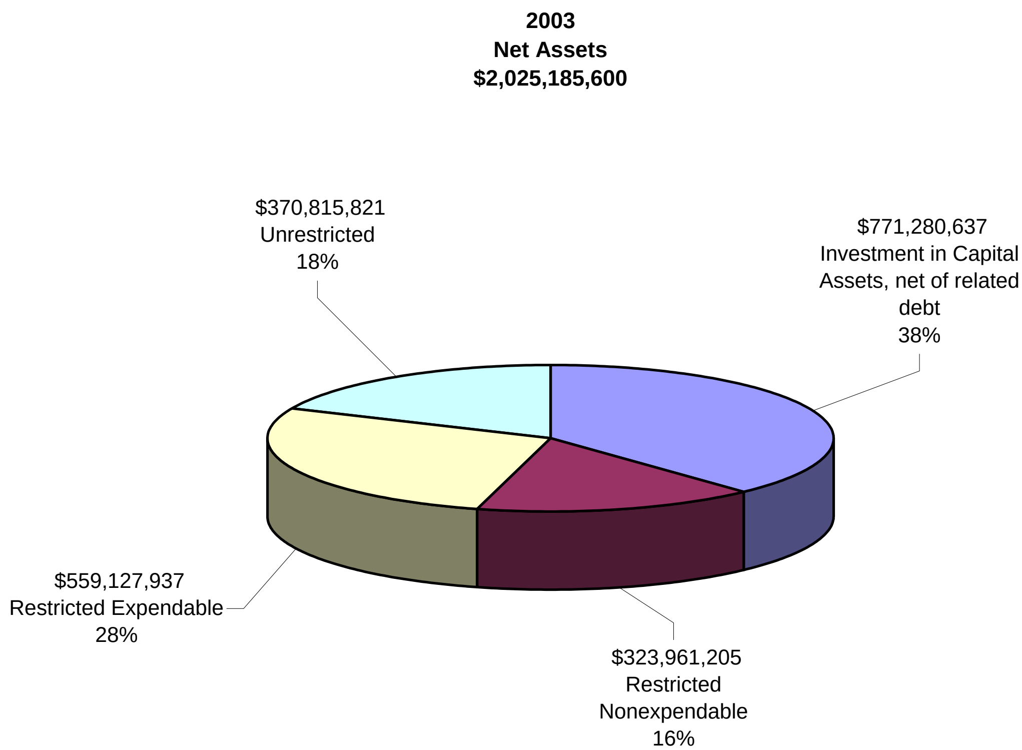
The increase over the prior year resulted from an increase in noncurrent, restricted cash and cash equivalents. An affiliated foundation, blended as part of the University financial reporting entity, obtained financing in the amount of $35.0 million to fund the costs of acquisition, construction, and equipping of a student family housing facility. This project, part of the University's master plan, involves building 306 apartments to house University students and their families. The two-bedroom units will replace the existing student family housing, known as Odum Village. The foundation will sell the facility to the University. The University will finance the approved purchase with self-liquidating debt-funded by housing revenues.

Noncurrent Liabilities

Noncurrent liabilities were $744.1 million at June 30, 2003 and include funds of $345.9 million held for the University's affiliated foundations and other campuses in the UNC System and their affiliates. These entities are not part of UNC-Chapel Hill's financial reporting entity but do invest through the System Fund. Other noncurrent liabilities of $31.5 million are refundable U.S. government grants that provide resources for student loan programs. Long-term liabilities of $366.6 million are the noncurrent portion of bonds payable, notes payable, capital leases payable, compensated absences, and annuities payable.

Net Assets

Net assets represent the value of the University's assets after liabilities are deducted. The University's net assets at June 30, 2003 were $2.0 billion and are presented graphically below:



The invested in capital assets, net of related debt category represents the University's land, buildings, general infrastructure, equipment, and other capital assets net of accumulated depreciation and net of the outstanding bonds and other indebtedness on the facilities. The restricted nonexpendable category includes the University's permanent endowments funds. The restricted expendable category primarily includes restricted internally designated endowments, gifts, contract and grant awards, and distributed endowment earnings. The unrestricted category includes unrestricted internally designated endowments, gifts, auxiliary operations, facilities and administrative funds (overhead receipts), and other unrestricted funds. While there are no externally imposed restrictions on unrestricted funds, the funds are generally designated by the University for specific academic programs or capital needs.

Condensed Statement of Revenues, Expenses, and Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Net Assets presents the University's results of operations. The statement for the fiscal year ended June 30, 2003 and the prior year is summarized as follows:

	2003	2002	% Change
Operating Revenues:			
Student Tuition and Fees, Net	$ 146,961,417	$ 124,661,145	17.9
Grants and Contracts	455,680,436	444,451,049	2.5
Sales and Services, Net	393,361,966	383,603,214	2.5
Other	7,563,970	14,749,606	-48.7
Total Operating Revenues	1,003,567,789	967,465,014	3.7
Operating Expenses:			
Salaries and Benefits	876,265,477	829,473,249	5.6
Supplies and Materials	146,986,272	148,324,265	-0.9
Services	364,456,573	364,831,514	-0.1
Scholarships and Fellowships	45,618,092	40,414,555	12.9
Utilities	57,314,345	45,452,167	26.1
Depreciation	53,075,830	48,517,249	9.4
	1,543,716,589	1,477,012,999	4.5
Operating Loss	(540,148,800)	(509,547,985)	-6.0
Nonoperating Revenues (Expenses):			
State Appropriations	368,024,036	368,504,553	-0.1
Noncapital Grants	40,994,829	34,768,925	17.9
Noncapital Gifts, Net	60,887,596	62,403,802	-2.4
Investment Income, Net	47,398,174	52,956,614	-10.5
Interest and Fees on Capital Asset-Related Debt	(15,680,788)	(15,031,104)	-4.3
Other Nonoperating Revenues (Expenses)	(1,899,072)	(7,661,489)	-75.2
Loss Before Other Changes	(40,424,025)	(13,606,684)	-197.1
Capital Grants	72,486,349	27,479,400	163.8
Capital Gifts, Net	7,552,718	8,238,379	-8.3
Additions to Permanent Endowments	21,152,512	23,282,491	-9.2
Increase in Net Assets	60,767,554	45,393,586	33.9
Net Assets - July 1	1,964,418,046	1,919,024,460	2.4
Net Assets - June 30	$ 2,025,185,600	$ 1,964,418,046	3.1

Operating Revenues

The operating revenues represent resources generated by the University in fulfilling its instruction, research, and public service missions. Student tuition and fees are reported net of the scholarship discount, which was $31.5 million for fiscal year 2002-2003 and $25.9 million for the prior year. Total revenues from student tuition and fees increased 17.9% over the prior year. An approved rate increase of $300 per student, inflationary rate increases of 4% for resident students and 12% for nonresident students, additional rate increases for the professional schools, and controlled enrollment growth contributed to the increase in revenues from tuition and fees in fiscal year 2002-2003.

Revenues from contracts and grants (including nonoperating grants) increased 3.6% over the prior year. Discussion of contracts and grants in terms of awards also provides a useful perspective. Research grant funding from the National Institutes of Health (NIH) increased 14.0%. The University is among the nation's leading public research universities, with a diversified portfolio of research that attracted more than $537 million in sponsored program awards during fiscal year 2002-2003, a 10.0% increase over the prior year. During the same period, NIH funding increased more than 13.0% to $308 million. During the federal fiscal year 2001-2002 (the latest available information), the University placed 13th nationally in overall NIH research support. The University continues to rank in the top 20 institutions nationally in federal support for science and technology.

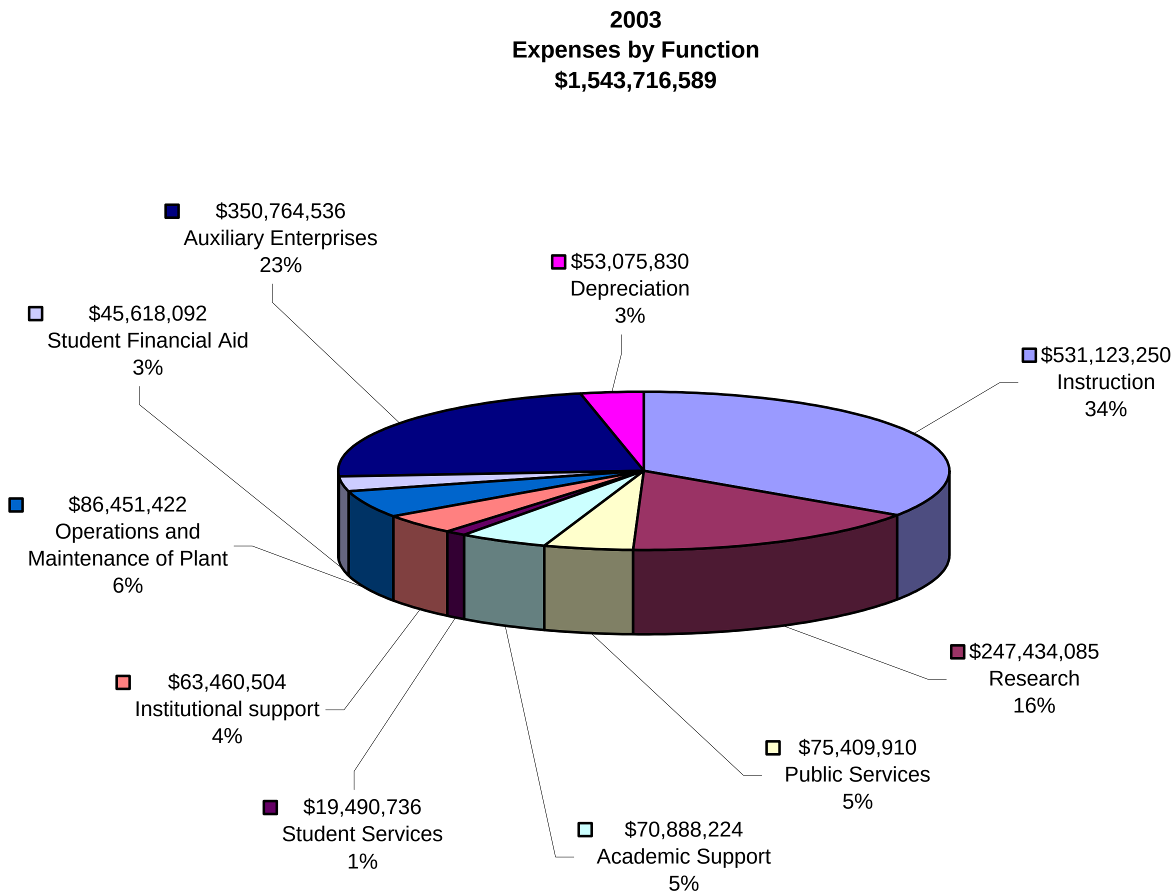
The University's standing among the nation's top research universities depends upon the excellence of the faculty and the reputation of the University. During the fiscal year, these strengths have continued to come under pressure as State funding has decreased. The key challenge remains for the administration to preserve or enhance the University's competitive position in the marketplace, not only to sustain external grant funding but also to retain and attract top faculty and students. To meet these challenges, a five-year strategic plan for research services was developed, and elements of the plan have been included in a newly approved academic plan. A new federal-relations position established in the prior year has allowed expansion of the influence of our faculty in the national policy arena and improves the University's ability to leverage federal funds.

Sales and services revenues of $393.4 million represent an increase of 2.5% over the prior year and include the revenues of campus auxiliary or similar operations such as student housing, student stores, student health services, the utilities system, parking and transportation, the professional health-care clinics, and others. Other revenues of $7.6 million represent operating resources not separately identified and include, as examples, an assessment to the Investment Fund to support administrative services, library fines, and interest income from student loans.

Operating Expenses

The University's operating expenses were $1.5 billion for the fiscal year ended June 30, 2003, an increase of 4.5% over the prior year. The operating expenses are reported by natural classification in the financial statements and by functional classification in the note disclosures. The following table illustrates the University's operating expenses by the functional classification:

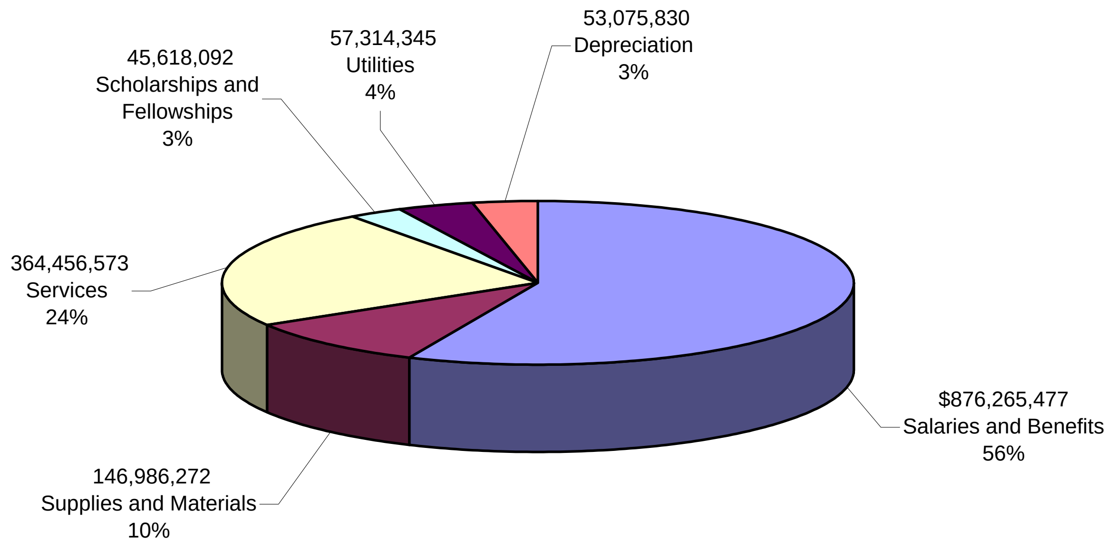
	2003	2002	% Change
Operating Expenses by Function:			
Instruction	$ 531,123,250	$ 497,770,880	6.7
Research	247,434,085	237,275,464	4.3
Public Service	75,409,910	76,896,238	-1.9
Academic Support	70,888,224	67,617,814	4.8
Student Services	19,490,736	18,224,875	6.9
Institutional Support	63,460,504	58,560,098	8.4
Operations and Maintenance of Plant	86,451,422	90,941,785	-4.9
Student Financial Aid	45,618,092	40,414,555	12.9
Auxiliary Enterprises	350,764,536	340,794,041	2.9
Depreciation	53,075,830	48,517,249	9.4
Total Operating Expenses by Function	$ 1,543,716,589	$ 1,477,012,999	4.5



Some operating expense categories increased at a higher rate than the total. Scholarships and fellowships increased 12.9% over the prior year. A portion of the revenues from tuition increases provide resources for need-based financial aid to enable students to pay the tuition increases. The University strengthened its commitment to merit-based aid as well. During fiscal year 2002-2003, about half of the student body received some form of financial assistance. Utilities expenses increased 26.1% over the prior year. The increase in utilities expenses resulted from growth in research and other facilities on campus due to the ongoing capital construction program, rate increases of both external providers of utilities and the campus utilities operation, and a change in billing protocol for chilled water operations. Depreciation expenses increased 9.4% over the prior year, an expected event given the ongoing, major capital construction activity.

The following charts illustrate the University's operating expenses by the natural classification.

2003
Expenses by Nature
$1,543,716,589



Nonoperating Revenues and Expenses

State appropriations of $368.0 million, noncapital grants of $41.0 million, noncapital gifts of $60.9 million, investment income of $47.4 million, interest and fees on capital asset-related debt of ($15.7) million, and other revenues and expenses of ($1.9) million comprise nonoperating revenues and expenses. Net nonoperating revenues and expenses were relatively unchanged for fiscal year 2002-2003 when compared to the prior year. These revenues are considered nonoperating because they were not generated by the University's principal, ongoing operations. For example, State appropriations were not generated by the University but were provided to help fund operating expenses.

The University's initial budget for State appropriations was $398.6 million for fiscal year 2002-2003. Budget increases of $4.4 million to fund enrollment increases including distance learning and other program enhancements as well as reductions in budgeted State appropriations of ($15.2) million resulted in an operating budget for State appropriations of $387.8 million. During the fiscal year 2002-2003, the University was required to reserve $17.2 million in appropriations for reversion at the end of the year. Additionally, the carry forward and use of certain revenues was not approved at the State level, which resulted in reversion of State appropriations of an additional $2.6 million.

National and State economic conditions have significantly affected the level of State appropriations. The University has proactively addressed this issue. Considering that enrollment growth funding was provided and therefore support for continuing operations declined more significantly, it is important to discuss actions taken by the University.

The University restructured the annual budget planning and hearing process with all deans and vice chancellors. The review process provides a framework to implement differential budget reductions, the across-the-board approach for budget reductions is not used. The approach in administering flat or declining State appropriations is to protect the classroom as much as possible, while streamlining administration and eliminating programs. The University has increased its reliance on alternative funding sources, such as clinical income, research awards, indirect cost reimbursements of facilities and administrative expenses, and gifts.

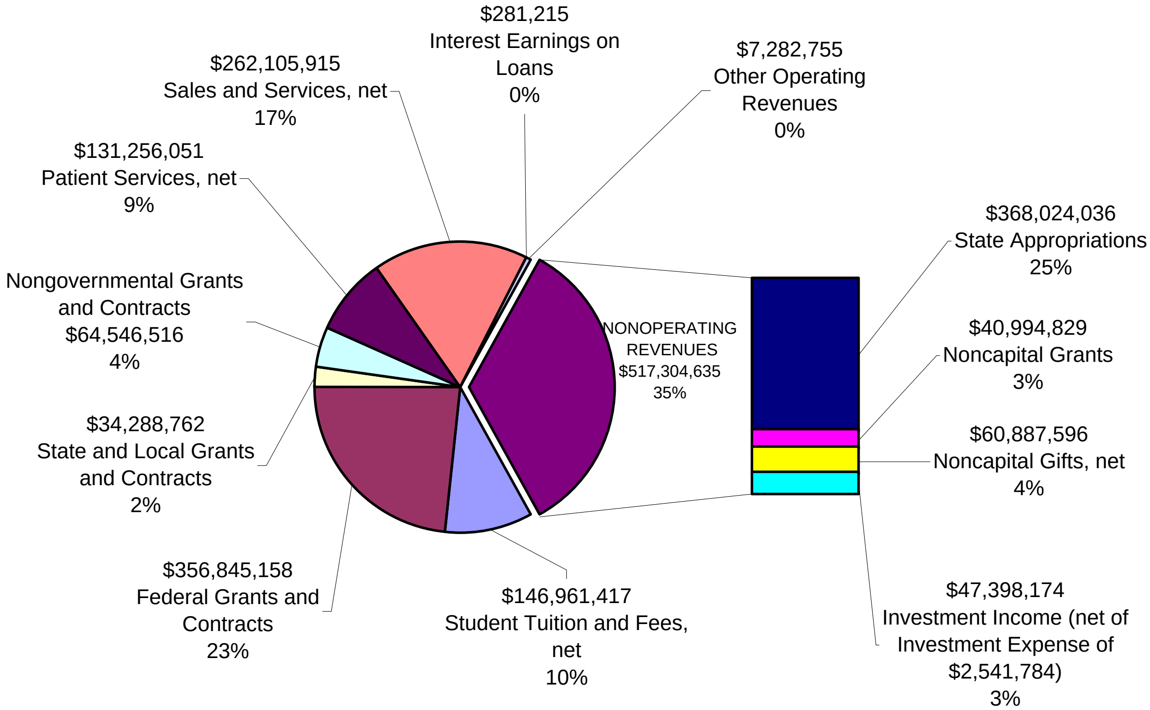
The management approach also includes protecting activities that are central to the University's mission, add value, or are required by law or for internal control purposes. Efficiency improvements are continuously sought in order to save resources. During fiscal year 2002-2003, specific programs as well as instructional and administrative positions were eliminated to address the reductions in State appropriations and to allow funding for enrollment growth to be used for the purposes allocated.

Noncapital grants increased by 17.9% to $40.9 million in fiscal year 2002-2003 and represent federal awards that are not considered to be exchange transactions. Net noncapital gifts of $60.9 million represent expendable gifts received and pledges made and are net of an allowance for uncollectible pledges. Net investment income of $47.4 million includes income and realized and unrealized gains and is net of realized and unrealized losses and investment management fees. Interest and fees on capital asset-related debt were ($15.7) million. Other nonoperating expenses total ($1.9) million and include capital asset disposals.

Total Operating and Nonoperating Revenues

Operating and nonoperating revenues such as State appropriations, noncapital grants, noncapital gifts, and investment income are used to fund University operations. The following chart illustrates the University's operating and nonoperating revenues which total $1.5 billion for fiscal year 2002-2003.

2003
TOTAL REVENUES BY SOURCE
$1,520,872,424



Other Changes in Net Assets

Capital grants of $72.5 million came from statewide higher education bond proceeds for capital construction projects. Net capital gifts of $7.6 million also provided funding for construction projects. Nonexpendable gifts and funds from the State's program to match gifts for distinguished professorship endowments resulted in additions to permanent endowments of $21.2 million during fiscal year 2002-2003.

Condensed Statement of Cash Flows

The Statement of Cash Flows provides additional information about the University's financial results by reporting the major sources and uses of cash. Cash increased by $115.5 million during the fiscal year 2002-2003. Many factors affect the changes in cash and the cash position of the University. One significant factor that resulted in a $90.0 million increase in the cash position at June 30, 2003 was the additional use of the State Treasurer's short-term investment fund, which is classified as a cash equivalent, for the University's temporary investment pool. The statements for the fiscal year ended June 30, 2003 and the prior year are summarized as follows:

	2003	2002
Cash Flows Provided (Used):		
Operating Activities	$ (382,265,470)	$ (440,098,807)
Noncapital Financing Activities	488,584,930	482,880,498
Capital and Related Financing Activities	(55,707,534)	(171,429,157)
Investing Activities	64,860,649	90,827,088
Net Increase (Decrease) in Cash	115,472,575	(37,820,378)
Cash - July 1	382,265,905	420,086,283
Cash - June 30	$ 497,738,480	$ 382,265,905

- Cash flows from operating activities include, as examples, cash received for tuition and fees or research grants and salaries paid to faculty or payments of invoices to vendors. Since State appropriations, gifts, and certain other revenues are not considered operating revenue, operating activities had a net cash outflow for both fiscal years.
- Noncapital financing activities include State appropriations received for operations and noncapital gifts, and had a net cash inflow for both fiscal years.
- The cash flows from capital and related financing activities include the proceeds received from short-term and long-term debt obligations, the repayment of debt, and the acquisition of capital assets. Due to the increase in the level of capital grants provided as part of the capital construction program and a decrease in debt principal payments, capital and related financing activities had a lower net cash outflow in fiscal year 2002-2003. The use of cash was significantly more in fiscal year 2001-2002 due to the issuance of general revenue bonds to defease $69.9 million of outstanding utility system revenue bonds.
- The net cash inflows from investing activities include purchases and sales of equity securities and other investments as well as interest and dividends received.

Economic Outlook

Management's view is that the University is well positioned to continue demonstrating excellence in teaching, discovery, and public service. Management believes that, although national and State economic conditions have affected resources, the University will maintain its solid financial foundation and enhance its financial outlook. The University's strong debt credit rating allows it to obtain competitive financing for capital construction. The University's comparatively low tuition levels enhance its appeal to prospective students and provide a possible source of additional resources, should tuition increase be enacted. The University's academic standing allows it to continuously attract top students. Student applications levels, enrollment levels of students including cross admits, applicants' exam scores and other admission criteria, and other factors illustrate the substantial appeal of the University to prospective students.

Tuition rates increased for fiscal year 2003-2004 by 5% with a $500 increase cap for nonresident graduate students. There were also limited tuition increases for professional schools. Consideration is being given at the federal level regarding use of price controls to control tuition increases of both private and public universities. Other changes related to affordability in higher education are also under consideration. Carolina's tuition levels remain low in comparison to its national peer group of institutions, and these very competitive tuition levels place the University in a stronger financial position as this national debate on rising educational costs for students continues.

Starting next fall, the University will launch the Carolina Covenant, a new initiative that will give children of low income families the opportunity to attend the University debt-free. This is the first program of its kind to be offered by a public university in the United States. The University will meet 100 percent of a qualified student's financial need through combination of federal, State, campus-based, privately funded grants and scholarships, as well as his or her participation in the federal work-study job program.

The University's relationship with the State of North Carolina is a critical success factor. Given the recent economic conditions, the State has continued to demonstrate strong financial support for higher education in North Carolina. The budgeted funding level for State appropriations for 2003-2004 totals $384.7 million, which represents an increase of 4.5% over fiscal year 2002-2003 actual State appropriations. Based on communications from State officials, 2.0% of the State appropriations budget is being held in reserve for possible reversion. Given the recent economic volatility and in the event budgeted State revenue targets are not realized this action was required by State officials. While additional reversions or budget reductions are not anticipated for fiscal year 2003-2004, it is not certain.

While the overall financial strength of the University remains solid both currently and prospectively, some appropriated support has stagnated. The cumulative impact of reduced State appropriations includes elimination of some academic and support programs, loss of faculty and staff positions, diminished classroom experience caused by an increase in class size and other factors, reduction in academic and administrative support services, impairment to the libraries, and organizational restructuring. The University must continue to address competitive pressures related to recruiting and retaining faculty and staff. The University's programs for health, retirement, and other benefits have cost and coverage issues that are of concern and require resolution, working in conjunction with UNC system and State officials. The University is progressing on these benefits issues by pursuing additional flexibility in allowing benefits and other enhancements to the benefits programs. However, the University's diverse revenue base, its strategic planning processes, and its proactive approach in addressing budgetary issues help alleviate the significance of the impacts. For example, completion of an academic plan to guide future investments over the next five years was a major step forward for the University.

Research efforts will continue to provide impetus to the financial condition of the University and the State. The research enterprise creates jobs for the North Carolina economy. The University continues its commitment to transfer new technologies developed by faculty to the market place, which translates into higher quality and better paying careers for the citizens of North Carolina. Planning for Carolina North, an approximately 900-acre tract of University-owned land proposed for mixed-use development is in its early stages. This living-learning community that is envisioned as a public-private partnership would significantly enhance the research, training, and public service mission of the University and benefit the people of North Carolina and beyond.

The University believes the investment performance of its Endowment Fund will continue to provide important resources for University operations. Although the investment performance record has been impressive, recent major changes are expected to strengthen investment management. The University' investment management operation was separately organized as the UNC Management Company, Inc. (UNC-MC), a nonprofit corporation organized and operated as a 501(c)(3) entity, to provide investment management services and administrative services to the University and to the other campuses of the UNC System and their affiliated, nonprofit foundations as appropriate. The UNC-MC was also organized to manage real estate, promote the dissemination and commercialization of technology development at the University, and to participate in joint ventures, limited partnerships, limited liability companies, and similar entities for the purpose of providing investment opportunities. Management believes this new structure will enhance the ability to attract and retain investment professionals and increase the number of entities that may invest in the pooled investment fund. It is anticipated that these factors will contribute to enhanced investment performance.

The $1.8 billion Carolina First fund-raising campaign continues to succeed, providing critical resources for the present and for future generations. The campaign began its quiet phase on July 1, 1999. As of September 30, 2003, gifts, pledges, and deferred commitments of $1.1 billion had been received. With 53% of the campaign's time period elapsed, 60% of the total goal has been reached through gifts and commitments. Of the $1.8 billion goal, $850 million will provide expendable resources, $700 million will be used to increase endowment assets, and $250 million will support the capital construction program. The campaign will conclude on June 30, 2007.

The capital planning process continues to benefit the University as the construction program has and will continue to improve the academic and administrative facilities of the University. The new and renovated facilities will enhance the teaching environment, improve research opportunities, and provide a better infrastructure. The operational planning process is a critical success factor as well. The current environment demanded that the University move away from a short-term, marginal focus to more strategic, mission-driven financial decision processes. Without the framework of an academic plan that considers mission-critical goals and resource needs, the University was not likely to achieve its full potential. An academic plan was developed, and a five-year financial planning process was undertaken. The purpose and desired outcomes of the Five-Year Financial Plan include the following:

- Serves as the 'enabling' means to implement long-range plans for programs, facilities, and other initiatives.
- Aligning resources optimally to accomplish the mission and the strategic goals of the University.
- Relying upon quantitative as well as qualitative analyses of critical issues that will affect the University's successful advancement and financial stability during the next five years.
- Providing ongoing mechanism for evaluating the extent that resources are being used to meet fundamental goals.
- Highlighting the links between the institutional values that drive our policies and ultimately determine the revenue and cost structures of the University.
- Enhancing flexibility to redirect or retain funds and strengthen the University's ability to react to change and cope with short- and long-term fiscal stress.

Management believes the improved academic and financial planning process will result in a more strategic use of resources.

The University's solid support from the State in difficult economic times, its widespread appeal to top prospective students, its diversified portfolio of research funding, its strong investment performance, its capital construction program, and its outstanding fundraising capabilities are among the factors indicating a positive and successful future for the University. The University's commitment to strategic and balanced operating budgets, protection and enhancement of its endowed and physical assets, and adherence to compliance and control standards all support a continuing strong financial position for the University.

The University of North Carolina at Chapel Hill
Statement of Net Assets
June 30, 2003 ***Exhibit A***

ASSETS		
Current Assets:		
Cash and Cash Equivalents	$	214,800,699
Restricted Cash and Cash Equivalents		216,333,669
Short-Term Investments		122,067,058
Restricted Short-Term Investments		67,040,330
Receivables, Net (Note 4)		93,820,579
Due from State of North Carolina Component Units		1,861,427
Inventories		15,763,857
Notes Receivable, Net (Note 4)		3,895,883
Total Current Assets		735,583,502
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		66,604,112
Receivables, Net (Note 4)		27,427,006
Restricted Due from Primary Government		15,787,019
Endowment Investments		754,623,099
Other Long-Term Investments		377,744,985
Notes Receivable, Net (Note 4)		25,211,997
Capital Assets - Nondepreciable (Note 5)		308,038,349
Capital Assets - Depreciable, Net (Note 5)		826,183,136
Total Noncurrent Assets		2,401,619,703
Total Assets		3,137,203,205
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities (Note 6)		86,215,955
Due to Primary Government		82,676
Due to State of North Carolina Component Units		1,033,245
Deposits Payable		2,160,444
Funds Held for Others		6,081,682
Deferred Revenue		36,817,538
Interest Payable		1,868,233
Obligations Under Reverse Repurchase Agreements		106,708,625
Long-Term Liabilities - Current Portion (Note 8)		126,987,562
Total Current Liabilities		367,955,960
Noncurrent Liabilities:		
U. S. Government Grants Refundable		31,549,999
Funds Held in Trust for Pool Participants		345,883,384
Long-Term Liabilities (Note 8)		366,628,262
Total Noncurrent Liabilities		744,061,645
Total Liabilities		1,112,017,605

The University of North Carolina at Chapel Hill
Statement of Net Assets — Exhibit A
June 30, 2003 — Page 2

NET ASSETS		
Invested in Capital Assets, Net of Related Debt		771,280,637
Restricted for:		
Nonexpendable:		
Scholarships and Fellowships		79,955,407
Research		10,035,203
Endowed Professorships		120,856,256
Departmental Uses		49,543,457
Loans		13,533,012
Library Acquisitions		20,017,539
Other		30,020,331
Expendable:		
Scholarships and Fellowships		110,132,665
Research		17,153,443
Endowed Professorships		188,740,918
Departmental Uses		165,334,114
Plant Improvements		13,361,072
Capital Projects		21,517,527
Debt Service		10,170,450
Library Acquisitions		16,278,810
Instruction and Educational Service Agreements		16,438,938
Unrestricted		370,815,821
Total Net Assets	$	2,025,185,600

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

The University of North Carolina at Chapel Hill
Statement of Revenues, Expenses, and
Changes in Net Assets
For the Fiscal Year Ended June 30, 2003 ***Exhibit B***

REVENUES		
Operating Revenues:		
Student Tuition and Fees, Net (Note 10)	$	146,961,417
Federal Grants and Contracts		356,845,158
State and Local Grants and Contracts		34,288,762
Nongovernmental Grants and Contracts		64,546,516
Patient Services, Net (Note 10)		131,256,051
Sales and Services, Net (Note 10)		262,105,915
Interest Earnings on Loans		281,215
Other Operating Revenues		7,282,755
Total Operating Revenues		1,003,567,789
EXPENSES		
Operating Expenses:		
Salaries and Benefits		876,265,477
Supplies and Materials		146,986,272
Services		364,456,573
Scholarships and Fellowships		45,618,092
Utilities		57,314,345
Depreciation		53,075,830
Total Operating Expenses		1,543,716,589
Operating Loss		(540,148,800)
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		368,024,036
Noncapital Grants		40,994,829
Noncapital Gifts, Net (Note 10)		60,887,596
Investment Income (Net of Investment Expense of $2,541,784)		47,398,174
Interest and Fees on Capital Asset-Related Debt		(15,680,788)
Other Nonoperating Expenses		(1,899,072)
Net Nonoperating Revenues		499,724,775
Loss Before Other Revenues, Expenses, Gains, or Losses		(40,424,025)
Capital Grants		72,486,349
Capital Gifts, Net (Note 10)		7,552,718
Additions to Endowments		21,152,512
Increase in Net Assets		60,767,554
NET ASSETS		
Net Assets - July 1, 2002		1,964,418,046
Net Assets - June 30, 2003	$	2,025,185,600

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

The University of North Carolina at Chapel Hill
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2003

Exhibit C

CASH FLOWS FROM OPERATING ACTIVITIES		
Received from Customers	$	1,017,533,913
Payments to Employees and Fringe Benefits		(854,699,876)
Payments to Vendors and Suppliers		(569,581,149)
Payments for Scholarships and Fellowships		(45,618,092)
Loans Issued		(5,879,203)
Collection of Loans		6,680,902
Other Receipts		69,298,035
Net Cash Used by Operating Activities		(382,265,470)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State Appropriations		368,024,036
Grants for Other than Capital Purposes		45,785,818
Noncapital Gifts		53,165,391
Additions to Permanent and Term Endowments		21,152,512
Related Activity Agency Receipts		2,405,224
Related Activity Agency Disbursements		(1,948,051)
Net Cash Provided by Noncapital Financing Activities		488,584,930
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from Capital Debt		53,532,276
Capital Grants		74,148,014
Capital Gifts		10,384,493
Acquisition and Construction of Capital Assets		(161,425,139)
Principal Paid on Capital Debt and Leases		(14,044,252)
Interest and Fees Paid on Capital Debt and Leases		(18,302,926)
Net Cash Used by Capital and Related Financing Activities		(55,707,534)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from Sales and Maturities of Investments		481,404,506
Interest on Investments		35,354,598
Obligations under Reverse Repurchase Agreements		71,713,626
Purchase of Investments and Related Fees		(523,612,081)
Net Cash Provided by Investing Activities		64,860,649
Net Increase in Cash and Cash Equivalents		115,472,575
Cash and Cash Equivalents - July 1, 2002		382,265,905
Cash and Cash Equivalents - June 30, 2003	$	497,738,480

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

Operating Loss	$	(540,148,800)
Adjustments to Reconcile Operating Loss to Net Cash Used		
by Operating Activities:		
Depreciation Expense		53,075,830
Allowances, Write-Offs, and Amortizations		340,915
Nonoperating Other Income		330,235
Changes in Assets and Liabilities:		
Receivables (Net)		29,607,181
Notes Receivable (Net)		(574,076)
Inventories		896,365
Accounts Payable and Accrued Liabilities		(493,025)
Due to Primary Government		(115,508)
Deferred Revenue		(879,063)
Compensated Absences		20,112,895
U.S. Government Grants Refundable		425,524
Funds Held for Others		55,156,057
Net Cash Used by Operating Activities	$	(382,265,470)

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:		
Cash and Cash Equivalents	$	214,800,699
Restricted Cash and Cash Equivalents		216,333,669
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		66,604,112
Total Cash and Cash Equivalents - June 30, 2003	$	497,738,480

NONCASH INVESTING, CAPITAL AND FINANCING ACTIVITIES

Assets Acquired through a Gift	$	765,916
Change in Fair Value of Investments		(9,564,883)
Increase in Receivable Related to Nonoperating Income		4,124,514

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

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

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

The accompanying financial statements present all funds belonging to the University and its component units. While the Board of Governors of the University of North Carolina System has ultimate responsibility, the Chancellor, the Board of Trustees, and the Board of Trustees of the Endowment Fund have both delegated and statutory responsibilities for financial accountability of the University's funds. Although legally separate, The University of North Carolina at Chapel Hill Foundation Investment Fund, Inc. (Investment Fund), UNC Investment Fund, LLC (System Fund), UNC Management Company, Inc. (Management Company), The University of North Carolina at Chapel Hill Foundation, Inc. (UNC-CH Foundation), The Kenan-Flagler Business School Foundation (Business School Foundation), The School of Social Work Foundation, Inc. (Social Work Foundation), and UNC Law Foundation, Inc. (Law Foundation), are reported as if they were part of the University.

The Investment Fund is governed by a board consisting of 11 ex officio directors and one or two elected directors. Ex officio directors include all of the members of the Board of Trustees of the Endowment Fund of The University of North Carolina at Chapel Hill, the Vice Chancellor for Finance and Administration, and the Vice Chancellor for University Advancement. The UNC-CH Foundation Board may, in its discretion, elect one or two of its at-large members to the Investment Fund Board. The Investment Fund supports the University by operating an investment fund for charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support the University. Because the members of the Board of Directors of the Investment Fund are officials or appointed by officials of the University and the Investment Fund's primary purpose is to benefit UNC-Chapel Hill and other organizations operated primarily to support the University, its financial statements have been blended with those of the University.

In December, 2002 the System Fund was organized to allow the University, University of North Carolina and its constituent institutions (UNC System), affiliated foundations, associations, trusts and endowments that support the University and the UNC System, to pool their resources and invest collectively in investment opportunities identified, structured and arranged by the Management Company (formerly University Investment Office). The Membership Interests are offered only to government entities or tax-exempt organizations that are controlled by or support the UNC System. The Investment Fund contributed and assigned all of its assets to the System Fund effective January 1, 2003 in exchange for its Membership Interest in the System Fund. Upon such contribution and assignment, and in consideration thereof, the System Fund has assumed all liabilities and obligations of the Investment Fund in respect of such contributed assets. At June 30, 2003 the Investment Fund Membership Interest was approximately 97% of the System Fund total membership interests. Because the Investment Fund is the predominant member of the System Fund, the financial statements of the System Fund have been blended with those of the University.

The Management Company is a North Carolina nonprofit corporation organized and operated exclusively to support the educational mission of the University. The Management Company will also provide investment management services to the University, UNC System, and institutions and affiliated tax-exempt organizations, and perform other functions for and generally carry out the purposes of the University. The Management Company is governed by five ex officio directors and one or two additional directors as fixed or changed from time to time by the Board, elected by the ex officio directors. The ex officio directors consist of the Chancellor of the University, the Vice Chancellor for Finance and Administration of the University, the Chairman of the University's Board of Trustees, the Chairman of the Board of Directors of the Investment Fund, and the President of the Management Company. Because members of the Board of Directors of the Management Company are officials or appointed by officials of the University, and the Management Company's primary purpose is to benefit UNC-Chapel Hill and other organizations operated primarily to support the University, its financial statements have been blended with those of the University. Effective January 1, 2003 the Management Company entered into an investment services agreement with the System Fund pursuant to which it will provide investment management and administrative services to the System Fund.

The UNC-CH Foundation is governed by a 17-member board consisting of nine ex officio directors and eight elected directors. Ex officio directors include the Chairman of the UNC-Chapel Hill Board of Trustees, the Chancellor, the Vice Chancellor for Finance and Administration, and the Vice Chancellor for University Advancement (nonvoting). In addition, the Board of Trustees elects two ex officio directors from among its own members as well as three ex officio directors from the membership of the Board of Trustees of the Endowment Fund who have not otherwise been selected. The eight remaining directors are elected as members of UNC-CH Foundation Board of Directors by action of the ex officio directors. The UNC-CH Foundation aids, supports, and promotes teaching, research and service in the various educational, scientific, scholarly, professional, artistic and creative endeavors of the University. Because members of the Board of Directors of the UNC-CH Foundation are officials or appointed by officials of the University and the UNC-CH Foundation's sole purpose is to benefit UNC-Chapel Hill, its financial statements have been blended with those of the University.

The Business School Foundation is governed by a board consisting of four ex officio directors and four or more elected directors. Ex officio directors include the Dean of the Kenan-Flagler Business School (Business School), as well as the school's Chief Financial Officer, Associate Dean of Academic Affairs, and Associate Dean for MBA Programs. The remaining directors are elected to the Business School Foundation Board of Directors by action of the ex officio directors. The Business School Foundation aids, promotes and supports the Kenan-Flager Business School at UNC-Chapel Hill. Because members of the Board of Directors of the Business School Foundation are officials or appointed by officials of the University, the financial statements of the Business School Foundation have been blended with those of the University.

The Social Work Foundation is governed by a board consisting of three ex officio directors and 10 elected directors. Ex officio directors include the Dean of the School of Social Work as well as the school's Chairman of the Board of Advisors and the Assistant Dean for External Affairs. The remaining 10 directors are elected to the Social Work Foundation Board of Directors by action of the ex officio directors. The Social Work Foundation fosters and promotes the growth, progress and general welfare of social work practice and research at the School of Social Work of UNC-Chapel Hill. Because members of the Board of Directors of the Social Work Foundation are officials or appointed by officials of the

University, the financial statements of the Social Work Foundation have been blended with those of the University.

The Law Foundation is governed by a board consisting of one ex officio director, six appointed directors and six elected directors. The ex officio director is the Dean of the School of Law of UNC-Chapel Hill. The ex officio director appoints six directors and the Board of Directors of the Law Alumni Association of the UNC, Inc. elects the other six directors. The Law Foundation provides support, fosters, and encourages the study and teaching of law at the UNC-Chapel Hill Law School. Because a majority of the members of the Board of Directors of the Law Foundation are officials or appointed by officials of the University, the financial statements of the Law Foundation have been blended with those of the University.

Separate financial statements for the Investment Fund, System Fund, the Management Company and blended foundations may be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370. Other related foundations and similar nonprofit corporations for which the University is not financially accountable are not part of the accompanying financial statements except for their participation in the Investment Fund and Temporary Pool as presented in the accompanying financial statements as Funds Held in Trust for Pool Participants. The University's financial statements include the financial activities of the clinical patient care programs. These clinical patient care programs established or maintained by the School of Medicine of The University of North Carolina at Chapel Hill are a component unit of the University of North Carolina Health Care System, which is a component unit of the University of North Carolina System.

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

Pursuant to the provisions of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities*, effective for the University's year ended June 30, 2003, the full scope of the University's activities is considered to be a single business-type activity (BTA) and accordingly, is reported within a single column in the basic financial statements.

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

C. **Basis of Accounting** - The financial statements of the University 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.

Nonexchange transactions, in which the University receives value without directly giving equal value in exchange includes State appropriations, certain grants, and donations. Revenues are recognized, net of estimated uncollectible amounts, as soon as all eligibility requirements imposed by the provider have been met, and collection is probable.

D. **Cash and Cash Equivalents –** This classification includes cash on deposit with private bank accounts, petty cash, undeposited receipts, savings accounts, cash on deposit with fiscal agents, and deposits held by the State Treasurer in the short-term investment portfolio. The short-term investment portfolio maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty.

E. **Investments** - This classification includes long-term fixed income investments, repurchase agreements, equity investments, mutual funds, money market funds, certificates of deposit, limited partnerships, real estate investment trusts, real estate, and other asset holdings by the University. Except for money market funds, certificates of deposit, real estate not held by a governmental external investment pool, and other asset holdings, these investments are reported at fair value for year-end financial reporting purposes. Fair value is the amount at which an investment could be exchanged between two willing parties. Fair value for financial reporting purposes is based on quoted market prices. The net increase (decrease) in the fair value of investments is recognized as a component of investment income.

Money market funds, certificates of deposit, real estate not held by a governmental external investment pool, and other asset holdings are reported at cost, if purchased, or at fair value or appraised value at date of gift, if donated.

Short-term investments include marketable securities representing the investment of cash that is available for current operations. A majority of this available cash is invested in the University's Temporary Pool, a governmental external investment pool.

F. Receivables – The receivables consist of tuition and fees charges to students, and charges to patients for services provided by the UNC Physicians & Associates and the Dental Faculty Practices. Receivables also include amounts due from the federal government, State and local governments, private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants, pledges that are verifiable, measurable, and expected to be collected and available for expenditures for which the resource provider's conditions have been satisfied, and notes receivable from loans to students. Patients, pledges and notes receivables are recorded net of the allowance for doubtful accounts. The accounts and other receivables are shown at book value with no provision for doubtful accounts considered necessary.

G. Inventories – Inventories held by the University are priced at cost or average cost except for the Student Stores inventory, which is valued at the lower of cost or market. The inventories consist of expendable supplies, postage, fuel held for consumption, textbooks, and other merchandise for resale.

H. Capital Assets – Capital assets are stated at cost at date of acquisition or fair value at date of donation in the case of gifts. The value of assets constructed includes all material direct and indirect construction costs. Interest costs incurred are capitalized during the period of construction.

The University capitalizes assets that have a value or cost in excess of $5,000 at the date of acquisition and an expected useful life of more than one year. Library books are generally not considered to have a useful life of more than one year unless part of a collection and are expensed in the year of acquisition.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 10 to 40 years for general infrastructure, 10 to 50 years for buildings, and 2 to 10 years for equipment.

The University's historic property, artworks, and literary collections are capitalized at cost or fair value at the date of donation. These property and collections are considered inexhaustible and are therefore not depreciated.

I. Restricted Assets – Restricted assets represent assets whose use is restricted by external parties or by law through constitutional provisions or enabling legislation. Unexpended proceeds of revenue bonds and unexpended capital contributions are classified as restricted assets because their use is limited by applicable bond covenants or donor/grantor agreements.

J. Funds Held in Trust for Pool Participants – Funds held in trust for pool participants represent the external portion of the University's governmental external investment pool more fully described in Note 2.

K. Funds Held in Trust by Others – Funds held in trust by others are resources neither in the possession nor the control of the University, but held and administered by an outside organization, with the University deriving income from such funds. Such funds established under irrevocable trusts where the University has legally enforceable rights or claims have not been recorded on the accompanying financial statements. The value of these assets at June 30, 2003 is approximately $31,726,073.

L. Noncurrent Long-Term Liabilities – Noncurrent long-term liabilities include principal amounts of bonds payable, notes payable, capital lease obligations, annuity payable, and compensated absences that will not be paid within the next fiscal year.

Bonds payable are reported net of unamortized premiums or discounts and deferred losses on refundings. The University amortizes bond premiums/discounts over the life of the bonds using the straight-line method. The deferred losses on refundings are amortized over the life of the old debt or new debt (whichever is shorter) using the straight-line method. Issuance costs paid from the debt proceeds are expensed.

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

In addition to the vacation leave described above, compensated absences includes the accumulated unused portion of the special annual leave bonus awarded by the North Carolina General Assembly to all full-time permanent employees as of September 30, 2002. The unused portion of this leave remains available until used, notwithstanding the limitation on annual leave carried forward described above.

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

There is no liability for unpaid accumulated sick leave because the University has no obligation to pay sick leave upon termination or retirement. However, additional service credit for retirement pension benefits is given for accumulated sick leave upon retirement.

N. **Net Assets –** The University's net assets are classified as follows:

Invested in Capital Assets, Net of Related Debt – This represents the University's 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 – Nonexpendable – Nonexpendable restricted net assets include endowments and similar type assets whose use is limited by donors or other outside sources, and, as a condition of the gift, the principal is to be maintained in perpetuity.

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

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

Restricted and unrestricted resources are recorded 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 University would generally first apply restricted funds, although individual departments have authority to use either restricted or unrestricted funds as appropriate.

O. **Scholarship Discounts –** Student tuition and fees revenues and certain other revenues from University charges are reported net of scholarship discounts in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. The scholarship discount is the difference between the actual charge for goods and services provided by the

University and the amount that is paid by students or by third parties on the students' behalf. Student financial assistance grants, such as Pell grants, and other federal, State, or nongovernmental programs, are recorded as either operating or nonoperating revenues in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. To the extent that revenues from these programs are used to satisfy tuition, fees, and other charges, the University has recorded a scholarship discount.

P. Revenue and Expense Recognition – The University classifies its revenues and expenses as operating or nonoperating in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the University's principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as student tuition and fees, sales and services of auxiliary enterprises, certain federal, State and local grants and contracts that are essentially contracts for services, and interest earned on loans. Operating expenses are all expense transactions incurred other than those related to capital and noncapital financing or investing activities as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting.*

Nonoperating revenues include activities that have the characteristics of nonexchange transactions. Revenues from nonexchange transactions such as State appropriations that represent subsidies, gifts to the University and certain grants, as well as investment income, are considered nonoperating since these are either investing, capital or noncapital financing activities. Capital contributions and additions to permanent endowments are presented separately after nonoperating revenues and expenses.

Q. Internal Sales Activities – Certain institutional auxiliary operations provide goods and services to University departments, as well as to its customers. These institutional auxiliary operations include activities such as utility services, telecommunications, central stores, printing and copy centers, postal services, repairs and maintenance services. In addition, the University has other miscellaneous sales and service units that operated either on a reimbursement or charge basis. All internal sales activities to University departments from auxiliary operations and sales and service units have been eliminated in the accompanying financial statements. These eliminations are recorded by removing the revenue and expense in the auxiliary operations and sales and service units and, if significant, allocating any residual balances to those departments receiving the goods and services during the year.

R. **Related Parties –** Related parties are nonprofit organizations established to assist and provide support to University programs by funding scholarships, fellowships, professorships and other needs of specific schools as well as the University's overall academic endeavors. The University's financial statements do not include the assets, liabilities, net assets or operational transactions of these organizations except for support from each organization to the University.

NOTE 2 - DEPOSITS AND INVESTMENTS

A. **Deposits –** Unless specifically exempt, the University is required by General Statute 147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. General Statute 116-36.1 requires the University to deposit its institutional trust funds, except for funds received for services rendered by health care professionals, with the State Treasurer. Although specifically exempted, the University 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. Special funds consist of moneys for intercollegiate athletics and agency funds held directly by the University.

Deposits include cash and cash equivalents and certificates of deposit totaling $498,534,216. At year-end, cash on hand was $204,263. The University's portion of the State Treasurer's Investment Pool was $453,461,438. 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 University's deposits not with the State Treasurer was $44,277,042 and the bank balance was $7,097,583. Of the bank balance, $2,173,739 was covered by federal depository insurance or by collateral held by the University's agent in the University's name, and $4,923,844 was uninsured and uncollateralized.

North Carolina General Statutes 147-69.1(c), applicable to the State's General Fund, and 147-69.2, applicable to institutional trust funds, authorize the State Treasurer to invest in the following: obligations of or fully guaranteed by the United States; obligations of certain federal agencies; repurchase agreements; obligations of the State of North Carolina; time deposits of specified institutions; prime quality commercial paper, and asset-backed securities with specified ratings. General Statute 147-69.1(c) also authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified ratings. General Statute 147-69.2 also 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 Investment Pool are included in the State of North Carolina's *Comprehensive Annual Financial Report.* An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page http://www.osc.state.nc.us/ and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

B. **Investments** - The University is authorized by The University of North Carolina Board of Governors pursuant to General Statute 116-36.2 to invest its special funds and funds received for services rendered by health care professionals pursuant to General Statute 116-36.1(h) in the same manner as the State Treasurer is required to invest, as previously discussed.

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

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

Investments of the University's component units, the UNC-CH Foundation, the Investment Fund, the System Fund, the Management Company, the Business School Foundation, the Social Work Foundation and the Law Foundation are subject to General Statute 36B "Uniform Management of Institutional Funds Act" (UMIFA) and any requirements placed on them by contract or donor agreements.

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

Temporary Investment Pool (Temporary Pool) - This is a fixed income portfolio managed by UNC Management Co., Inc. (Management Company) and Tanglewood Asset Management LLC. It operates in conjunction with the University's Bank of America disbursing account for all special funds, funds received for services rendered by health care professionals and endowment revenue funds (internal portion) and funds of affiliated foundations (external portion). Because of the participation in the Temporary Pool by affiliated foundations, it is considered a governmental external investment pool. The external portion of the Temporary Pool is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants. The Temporary Pool is not registered with the SEC and the University has not provided legally binding guarantees during the period to support the value of the pool's investments. There are no involuntary participants in the Temporary Pool.

The Northern Trust Company is the custodian for the Temporary Pool and provides the University's Director of Accounting Services with monthly statements defining income and market value information. Investments of the Temporary Pool are highly liquid and generally include U.S. government securities, collateralized mortgage obligations, corporate bonds, mutual funds, and money market funds. The University has elected to invest a portion of the Temporary Pool assets in the University's Investment Fund.

Through written request to accounting services, participants may purchase and sell shares in the Temporary Pool at a fixed value of $1 per share. Generally, the purchase and sale of participation shares occur only at the beginning of the month. Income distribution is determined each quarter by multiplying the distribution rate by the average of the invested fund balance. Statements are sent to each participating account or group of accounts on a quarterly basis reflecting the participants' balance and income distribution. The rate earned by an account is dependent upon its account classification and investable fund balance. The rates are set in coordination between the Management Company and the Vice Chancellor for Finance and Administration.

UNC-CH Foundation Investment Fund Inc. (Investment Fund) - This is a North Carolina nonprofit corporation exempt from income tax pursuant to Section 501(c)3. It began operations in January 1997 by the University and is classified as a governmental external investment pool. The pool is utilized to manage the investments for charitable, nonprofit foundations, associations, trusts, endowments, and funds that are organized and operated primarily to support the University. The University's Endowment, the UNC-CH Foundation, the Business School Foundation, the Social Work Foundation, and the Law Foundation are participants in the Investment Fund and are included in the University's reporting entity (internal portion). Other affiliated organizations (external portion) in the Investment Fund are not included in the University's reporting entity. Fund ownership of the University's Investment Fund is measured using the unit value method. Under this method, each participant's investment balance is determined on a market value basis. The external portion of the Investment Fund is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants.

The Investment Fund is not registered with the SEC and is not subject to any formal oversight other than that provided by the Investment Fund Board of Directors (See Note 1 A).

The Northern Trust Company is the custodian for the Investment Fund and provides the University with monthly statements defining income and market value information. The Investment Fund uses a unit basis to determine each participant's market value and to distribute the Fund's earnings according to the Fund's spending policy. There are no involuntary participants in the Investment Fund pool. The University has not provided or obtained any legally binding guarantees during the period to support the value for the pool's investments. The audited financial statements for the Investment Fund pool may be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

UNC Investment Fund, LLC (System Fund) - This is a limited liability company organized under the laws of the State of North Carolina. It was established in December 2002 by the University and is classified as a governmental external investment pool. The pool is utilized to manage the investments for The University of North Carolina, its constituent institutions, and affiliates of the constituent institutions. This includes charitable, nonprofit foundations, associations, trusts, endowments, and funds that are organized and operated primarily to support these institutions. The Investment Fund, with an approximately 97% membership interest as of June 30, 2003, is a predominant member of the System Fund. The University's reporting entity portion of the Investment Fund is characterized as the internal portion. Other affiliated organizations in the Investment Fund in addition to other members of the System Fund not included in the University's reporting entity are characterized as the external portion. The external portion of the System Fund is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants. Membership interests of the System Fund are measured using the unit value method. Under this method, each member's investment balance is determined on a market value basis.

The System Fund is not registered with the SEC and is not subject to any formal oversight other than that provided by the Members and the Management Company (See Note 1 A). Effective January 1, 2003, the Management Company entered into an investment management services agreement with the System Fund and will provide investment management and administrative services.

The Northern Trust Company is the custodian for the System Fund and provides the University with monthly statements defining income and market value information. The System Fund uses a unit basis to determine each member's market value and to distribute the Fund's earnings. There are no involuntary participants in the System Fund pool. The University has not provided or obtained any legally binding guarantees during the period to support the value for the pool's investments. The audited financial statements for the System Fund pool may be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

Credit Risk Categories - The University's investments (pooled and non-pooled) are categorized below to give an indication of the level of risk assumed by the entity at year-end. The credit risk categories are concerned with custodial credit risk, which is the risk that a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party if the counterparty to the investment transaction fails. There are three categories of credit risk. Category 1 includes investments that are insured or registered or for which the securities are held by the University or its agent in the University's name. Category 2 includes uninsured and unregistered investments for which the securities are held by a counterparty's trust department or agent in the University's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by a counterparty's trust department or agent but not in the University's name.

A summary of the University's investments at June 30, 2003 is presented below:

Temporary Pool Investments

	Fair Value						
	Risk Category						
	1		2		3		Total
Categorized Investments:							
U.S. Government Securities	$	41,562,034	$ 0		$ 0	$	41,562,034
Collateralized Mortgage Obligations		53,172,386					53,172,386
State and Municipal Securities		4,330,691					4,330,691
Corporate Bonds		23,836,009					23,836,009
Corporate Stock		30,000					30,000
Total Categorized Investments	$	122,931,120	$ 0		$ 0	$	122,931,120
Investments Not Categorized:							
Investments Held by Broker-Dealers							
Under Reverse Repurchase Agreements:							
U.S. Government Securities							84,126,559
Certificates of Deposit							1,000,000
Money Market Funds							7,422,071
Mutual Funds							20,827,220
Total Investments Not Categorized							113,375,850
Total Temporary Pool Investments (a)						$	236,306,970

(a) The Temporary Pool also has $29,983,646 of equity in the Investment Fund categorized below.

Investment Fund Pool Investments - The Investment Fund consists of an approximately 97% membership interest in the System Fund categorized below:

System Fund Pool Investments

	Fair Value			
	Risk Category			
	1	2	3	Total
Categorized Investments:				
U.S. Government Securities	$ 2,173,104	$ 0	$ 0	$ 2,173,104
Collateralized Mortgage Obligations	4,497,979			4,497,979
Corporate Bonds	12,137,915			12,137,915
Corporate Stocks	33,651,924			33,651,924
International Bonds - Corporate	5,000,000			5,000,000
International Stocks	2,884,439			2,884,439
Total Categorized Investments	$ 60,345,361	$ 0	$ 0	60,345,361
Investments Not Categorized:				
Investments Held by Broker-Dealers				
Under Reverse Repurchase Agreements:				
U.S. Government Securities				24,326,240
Money Market Funds				3,668,659
Mutual Funds				394,394,266
Limited Partnerships				474,402,803
Total Investments Not Categorized				896,791,968
Total System Fund Pool Investments				$ 957,137,329

Non-Pooled Investments

	Fair Value Risk Category 1	2	3	Total
Categorized Investments:				
U.S. Government Securities	$ 3,723,478	$ 768,911	$ 0	$ 4,492,389
Collateralized Mortgage Obligations	141,612			141,612
State and Municipal Securities	163,999			163,999
Corporate Bonds	7,621,474			7,621,474
Corporate Stocks	13,058,815	722,273		13,781,088
Total Categorized Investments	$ 24,709,378	$ 1,491,184	$ 0	26,200,562
Investments Not Categorized:				
Money Market Funds				35,235,582
Mutual Funds				43,287,131
Real Estate				15,956,225
Other Investments				7,351,672
Total Investments Not Categorized				101,830,610
Total Non-Pooled Investments				$ 128,031,172

Total Investments

	Fair Value Risk Category 1	2	3	Total
Total Categorized Investments	$ 207,985,859	$ 1,491,184	$ 0	$ 209,477,043
Total Investments Not Categorized				1,111,998,429
Total Investments				$ 1,321,475,472

Since a separate annual financial report on the Temporary Investment pool has not and is not planned to be issued, the following additional disclosures are being provided in the University's financial statements.

The Temporary Investment pool's Statement of Net Assets and Statement of Operations and Changes in Net Assets as of and for the period ended June 30, 2003 are as follows:

Statement of Net Assets
June 30, 2003

		Amount
Assets:		
State Treasurer Investment Fund	$	112,000,000
Accrued Investment Income		2,200,631
Investment Fund Equity		29,983,646
Investments		236,306,970
Total Assets	$	380,491,247
Liabilities:		
Obligations Under Reverse Repurchase Agreements	$	82,285,000
Deferred Income		1,441,185
Total Liabilities		83,726,185
Net Assets:		
Internal Portion		159,036,397
External Portion		137,728,665
Total Net Assets		296,765,062
Total Liabilities and Net Assets	$	380,491,247

Statement of Operations and Changes in Net Assets
For the Fiscal Year Ended June 30, 2003

	Amount
Increase in Net Assets from Operations:	
Revenues:	
Investment Income	$ 17,709,598
Expenses:	
Investment Management	338,216
Net Increase in Net Assets Resulting from Operations	17,371,382
Distributions to Participants:	
Distributions Paid and Payable	17,731,382
Share Transactions:	
Net Share Purchases	35,235,074
Total Increase in Net Assets	35,235,074
Net Assets:	
Beginning of Year	261,529,988
End of Year	$ 296,765,062

The major investment classifications of the Temporary Pool had the following attributes at June 30, 2003:

Investment Classification	Fair Value	Principal Amount	Yield to Maturity	Range of Maturities
U.S. Government Securities	$ 41,562,034	$ 39,572,905	1.2% - 7.0%	2005 - 2030
Collateralized Mortgage Obligations	53,172,386	52,806,965	1.4% - 19.0%	2005 - 2033
State and Municipal Securities	4,330,691	3,918,505	2.3%	2009
Corporate Bonds	23,836,009	22,994,878	1.7% - 5.5%	2004 - 2026
Corporate Stocks	30,000	30,000	N/A	N/A
Certificate of Deposit	1,000,000	1,000,000	3.5%	2004
Mutual Funds	20,827,220	19,195,083	N/A	N/A
Money Market Funds	7,422,071	7,422,071	0.9%	1 day
Reverse Repurchase Agreements	84,126,559	81,835,972	1.2% - 1.4%	1 - 15 days
Total Temporary Pool Investments	$ 236,306,970	$ 228,776,379		

C. **Reverse Repurchase Agreements** - Under the University's authority to purchase and sell securities, it has entered into fixed coupon reverse repurchase (reverse repurchase) agreements; that is, a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The fair value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in fair value of the securities. If the dealers default on their obligations to resell these securities to the University or provide securities or cash of equal value, the University would suffer an economic loss equal to the difference between the fair value plus accrued interest of the underlying securities and the agreement obligation, including accrued interest. This credit exposure at year-end was $2,747,646.

At June 30, 2003 reverse repurchase agreements are both fixed term and open (on-demand) agreements. The amount and interest rate of the open agreements may be changed daily and either party may terminate the transaction at any time. In investing the proceeds of reverse repurchase agreements, the University's practice is for the term to maturity of the investment to be the same as the term of the reverse repurchase agreement. The University's investments in the underlying securities and the securities purchased with proceeds from the reverse repurchase agreements are in accordance with the statutory requirements as noted. The interest earnings and interest cost arising from reverse repurchase agreement transactions are reported at gross amounts on the accompanying financial statements.

D. **Derivative and Similar Transactions** - A derivative is a financial instrument created from, or whose value depends on (is derived from), the value of one or more underlying assets, reference rates, or indexes of asset values. These instruments may include forwards, futures, currency and interest rate swaps, options, floaters/inverse floaters, and caps/floors/collars. Investment transactions similar to a derivative may include securitized assets, such as mortgage-backed securities and other asset-backed securities. As required by accounting principles generally accepted in the United States of America, the nature of derivative or similar transactions entered into by the University, and the reasons for entering into those transactions follow:

Mortgage-Backed Securities - The University invests in mortgage-backed securities issued by the Government National Mortgage Association (GNMA), an agency of the United States government, government sponsored enterprises including the Federal Home Loan Mortgage Corporation (FHLMC) or the Federal National Mortgage Association (FNMA), and private trusts or corporations. The University invests in these securities to increase the yield and return on its investment portfolio given the available alternative investment opportunities.

The values of mortgage-backed securities are generally based on the cash flows from principal and interest receipts on the underlying mortgage pools. These securities may include mortgage pass-through securities and collateralized mortgage obligations (CMOs). Mortgage pass-through securities pay the holder of the security the principal and interest amounts received from the underlying pool of mortgages as these amounts are collected from the mortgage holders. In a CMO, the cash flows from principal and interest payments from one or more mortgage pass-through securities or a pool of mortgages may be reallocated to multiple security classes with different priority claims and payment streams (commonly referred to as tranches.) A holder of the CMO security thus chooses the class of security that best meet its risk and return objectives. Both pass-through securities and CMOs are subject to significant market risk due to fluctuations in interest rates, prepayment rates and various liquidity factors related to their specific markets.

The mortgage pass-through securities issued by GNMA, FNMA, and FHLMC are classified by the University as U.S. government securities. The mortgage pools underlying the GNMA pass-through securities are backed by the full faith and credit of the U.S. government by the Federal Housing Administration (FHA), Veterans Administration (VA), and the Farmers Home Administration (FHA). The FNMA and FHLMC securities are collateralized by underlying pools of mortgages primarily issued by GNMA, FNMA, or FHLMC which guarantee full and timely payment of principal and interest.

The CMOs held by the University include mortgage-backed securities issued by FNMA, FHLMC, certain trusts, and private corporations (including Real Estate Mortgage Investment Conduit issuers). In addition, nontraditional mortgage pass-through securities, such “interest-only strips” and “principal-only strips”, if held by the University, are classified as CMOs. The University held nontraditional pass-through securities during the year.

As of June 30, 2003, the University was holding $136,441,395 in mortgage-backed securities valued at fair value representing approximately 10.3% of its total investments. Of this amount $57,811,977 represent investments in CMOs.

Other Asset-Backed Securities - The University invests in various asset-backed securities such as automobile loan securitizations, credit card securitizations, and home equity loans. The University invests in the various asset-backed securities to increase the yield and return on its investment portfolio given the available alternative investment opportunities.

The values of these other asset-backed securities are generally based on the cash flows to be received from the underlying pools of assets. Accordingly, these securities are subject to market risk due to fluctuations in interest rates, prepayment rates, and various liquidity factors related to their specific markets. The market risk is reduced by the University's preference to invest in the shorter average life securities.

These security holdings are subject to credit-related losses in the event of nonperformance by the issuers or counterparties to these instruments. However, the University does not expect any issuers or counterparties to fail to meet their obligation given their high credit ratings. The assets that collateralize these securities, which could be liquidated at market values at the time of nonperformance, reduce the credit risk.

As of June 30, 2003, the University was holding $11,220,025 in asset-backed securities valued at fair value representing approximately 0.9% of its total investments.

Futures - The University purchases and sells equity index futures and futures on domestic and foreign securities and currencies. The University uses the futures market to securitize excess cash holdings, to gain exposure to non-U.S. markets, to exploit foreign interest rate yield opportunities, to diversify its overall investment portfolio, to lower its transaction costs and to improve its liquidity.

Futures contracts are traded on margin on various futures and options exchanges. Since there is no direct cost in establishing any given futures position, the book value of these securities is recorded at $0. The margin amounts remitted by the University to the brokerage houses are reflected in the University's cash and cash equivalent or government securities holdings. Gains or losses from trading the futures are recognized in income when the futures positions are closed or liquidated. Unlike most securities investments, the losses on futures contracts can exceed their cost (of $0).

The market value of a futures contract is dependent on the value of its underlying cash market security or securities. Accordingly, the futures contracts held by the University are sensitive to changes in their respective foreign currency rates or security values. They are also sensitive to changes in the level of interest rates. The University trades futures on organized exchanges, which mitigates its credit risk of default by a counterparty.

As of June 30, 2003 the futures contracts held by the University had expiration dates not exceeding September 2003.

Options - The University purchases and sells options on futures of U.S. and foreign securities. All options are traded through domestic and foreign exchanges.

The University uses the options to hedge certain of its futures positions, to gain exposure to non-U.S. markets, to exploit foreign interest rate yield opportunities, and to further diversify its overall investment portfolio.

The University records the book values of long and short call and put option contracts at the option premium paid (if the option is purchased) or collected (if the option is written.) The University records the book value of the options in an investment account at an amount equal to the quantity of contracts purchased (sold) at the respective option premium price paid (collected.) When the option contract expires, or is repurchased or is exercised, the University records any resulting gain or loss in related income accounts. Unlike purchased options and most securities investments, losses on written options can exceed their cost.

During the year ending June 30, 2003, the option contracts held by the University vary with changes in the market price of their underlying futures contracts and accordingly also fluctuate with changes in their respective foreign currency rates or security values. The University's option contracts are traded on organized exchanges which mitigate its credit risk of default by a counterparty.

As of June 30, 2003 the University had no outstanding option transactions.

Indirect Derivative Holdings - The University identifies various external investment funds (mutual funds, external investment pools, and limited partnerships) that meet asset allocation and investment management objectives. The University invests in these funds to increase the yield and return on its investment portfolio given the available alternative investment opportunities and to diversify its asset holdings. Fund investments generally include equity and bond funds. Certain funds expose the University to significant amounts of market risk by trading or holding derivative instruments and by leveraging the securities in the fund.

The University limits the amount of funds managed by any single asset manager and also limits the amount of funds to be invested in particular security classes. The asset classes of the System Fund that utilized derivative securities for the fiscal year ending June 30, 2003 are summarized in the chart below. The amounts shown in the chart represent the market value of the System Fund's investment in the various asset classes and the market value and percent of holdings held in derivatives in those classifications. The University's reporting entity comprises 71.01% of the System Fund.

The market values reported for each asset class do not include accrued income, reverse repurchase liabilities, investments in the State Treasurer's Investment Fund, cash with a fiscal agent, accounts receivable, or accounts payable.

The UNC Investment Fund, LLC (System Fund) Indirect Derivative Analysis for fiscal year ending June 30, 2003:

Asset Class	Total Market Value	% Invested Derivatives	Amount
Domestic Equity	$ 159,133,148	7.35%	$ 11,702,497
International Equity	141,705,565	4.74%	6,711,357
Global Equity	75,940,304	18.79%	14,267,461
Private Equity	157,935,300	0.57%	906,640
Absolute Return	100,896,577	4.24%	4,274,249
Fixed Income:			
Domestic Fixed Income	55,895,914	7.48%	4,183,268
Enhanced Fixed Income	152,716,894	1.31%	1,997,804
Real Estate	61,434,683	1.29%	795,560
Energy	50,640,848	30.90%	15,647,358
Total			$ 60,486,194
Total Market Value of Investments in the System Fund			$ 957,137,329
Total % of Market Value for Indirect Derivative Exposure		6.32%	

The market risk associated with these indirect derivative holdings by fund type follow:

Domestic Equity - From time-to-time domestic equity managers will utilize equity index futures, options on equity index futures, and specific stock options. These are used mainly to hedge their portfolio or to take advantage of an options mispricing on a security they own.

International Equity - International equity managers will utilize foreign equity index futures and options to hedge their exposure to their respective markets.

Global Equity – Global equity managers will utilize a wide range of currency, equity, and fixed income futures and options. These are used to gain exposure to specific markets in the most cost-effective and liquid manner possible.

Private Equity – By serving as substitutes for domestic and global common stocks, the role of these investments is to provide high real returns and control volatility. The private equity allocation is expected to be approximately one-half in traditional venture capital and one-half in buyout strategies.

Absolute Return - Absolute return managers utilize fixed income and equity futures both as a hedging tool and to gain exposure to specific markets.

Fixed Income - Fixed income funds utilize futures and options on global fixed income and currency markets. These vehicles are used purely to hedge exposure to a given market or to gain exposure to an illiquid market. Domestic and Enhanced are two subasset classes of this fund type. Domestic Fixed Income focuses upon U.S. Treasury securities, quasi-government securities and high-grade U.S. corporate bonds. Enhanced Fixed Income can include non-U.S. investments and non high-grade securities, and are generally intended to provide a higher total return than traditional fixed income.

Real Estate – Primarily serves as a hedge against high-unanticipated general price inflation, but is also a source of current income. Investments in this area include private portfolio investments, which focus on specific niche markets within the real estate sector or public Real Estate Investment Trust (REIT) investments, which provide a more liquid means of gaining exposure to the asset class.

Energy – Principally included to hedge against unanticipated inflation. These strategies include direct energy investments, energy security investments, commodity-linked notes and direct investments in commodity indices or the futures markets. The principal attraction of these investments is the lack of correlation with the balance of the portfolio.

The System Fund’s holdings in indirect derivatives (i.e., derivatives held by external investment managers) are primarily used to decrease risk. This is because the indirect derivatives are used by the fund’s hedge fund managers primarily to hedge underlying positions, or to gain exposure to specific markets in an efficient, inexpensive, liquid, and diversified manner. In the former case, risk is actually reduced by the use of derivatives because the derivative is directly offsetting market exposure. In the latter case, the derivatives are merely substituting for what would otherwise be a more traditional (individual security) array. Hence there would be no greater risk and often less risk than the traditional array that would exist in place of such derivatives. In limited cases, select managers are allowed to use derivatives to lever specific holdings or market positions. In aggregate, the Fund's 6.32% exposure to indirect derivative holdings reflects a smaller degree of risk than there would be without such derivatives in the portfolio. The University considers the risk associated with these holdings to be prudent and within acceptable bounds.

NOTE 3 - ENDOWMENT INVESTMENTS

Substantially all of the investments of the University's endowment funds are pooled in the Investment Fund. Investment return of the University's pooled endowment funds is predicated on the total return concept (yield plus appreciation). Annual distributions from the Investment Fund to the University's pooled endowment funds are based on an adopted spending policy. Under this policy, the prior year distribution is increased by the rate of inflation as measured by the Consumer Price Index (CPI). Each year's distribution, however, is subject to a minimum of 4% and a maximum of 7% of the pooled endowment fund's average market value for the previous year.

To the extent that the total return for the current year exceeds the distribution, the excess is added to principal. If current year earnings do not meet the distribution requirements, the University uses accumulated income and appreciation to make up the difference. At June 30, 2003, accumulated income and appreciation of $274,403,227 was available in the University's pooled endowment funds of which $243,771,348 was restricted to specific purposes.

NOTE 4 - RECEIVABLES

Receivables at June 30, 2003 were as follows:

	Gross Receivables	Less Allowance for Doubtful Accounts	Net Receivables
Current Receivables:			
Students	$ 2,532,008	$ 0	$ 2,532,008
Patients	69,359,847	(62,737,770)	6,622,077
Accounts	31,163,058		31,163,058
Intergovernmental	33,210,870		33,210,870
Pledges	15,949,393	(239,241)	15,710,152
Investment Earnings	3,910,475		3,910,475
Interest on Loans	671,939		671,939
Total Current Receivables	$ 156,797,590	$ (62,977,011)	$ 93,820,579
Noncurrent Receivables:			
Pledges	$ 27,844,676	$ (417,670)	$ 27,427,006
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	$ 2,515,106	$ (254,202)	$ 2,260,904
Institutional Student Loan Programs	485,604	(10,625)	474,979
Other Notes Receivable	1,160,000		1,160,000
Total Notes Receivable - Current	$ 4,160,710	$ (264,827)	$ 3,895,883
Notes Receivable - Noncurrent:			
Federal Loan Programs	$ 23,197,541	$ (2,355,707)	$ 20,841,834
Institutional Student Loan Programs	4,470,682	(100,519)	4,370,163
Total Notes Receivable - Noncurrent	$ 27,668,223	$ (2,456,226)	$ 25,211,997

Pledges are receivable over varying time periods ranging from 1 to 10 years, and have been discounted based on a projected interest rate of 3.58% for the outstanding periods, and allowances are provided for the amounts estimated to be uncollectible.

Scheduled receipts, the discounted amount under these pledge commitments, and allowances for uncollectible pledges are as follows:

Fiscal Year	Amount
2004	$ 15,975,771
2005	12,059,174
2006	10,449,751
2007	4,035,848
2008	1,865,829
2009-2012	2,502,317
Total Pledge Receipts Expected	46,888,690
Discount Amount Representing Interest (3.58% Rate of Interest)	(3,094,621)
Present Value of Pledge Receipts Expected	43,794,069
Less Allowance for Uncollectible	(656,911)
Pledges Receivable	$ 43,137,158

NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2003, is presented as follows:

	Balance July 1, 2002	Adjustments	Increases	Decreases	Balance June 30, 2003
Capital Assets, Nondepreciable:					
Land	$ 22,093,860	$ 2,372,320	$ 1,145,785	$ 0	$ 25,611,965
Art, Literature, and Artifacts	52,371,413		2,097,314	423	54,468,304
Construction in Progress	225,022,791	(89,847,692)	93,807,851	2,024,870	226,958,080
Intangible assets	1,000,000				1,000,000
Total Capital Assets, Nondepreciable	300,488,064	(87,475,372)	97,050,950	2,025,293	308,038,349
Capital Assets, Depreciable:					
Buildings	823,740,406	52,191,980	27,613,285		903,545,671
Machinery and Equipment	193,199,053		25,091,725	12,779,657	205,511,121
General Infrastructure	285,337,256	35,283,392	13,910,544		334,531,192
Total Capital Assets, Depreciable	1,302,276,715	87,475,372	66,615,554	12,779,657	1,443,587,984
Less Accumulated Depreciation/Amortization for:					
Buildings	332,417,864		24,674,664		357,092,528
Machinery and Equipment	119,585,365		15,658,043	10,550,773	124,692,635
General Infrastructure	122,876,562		12,743,123		135,619,685
Total Accumulated Depreciation	574,879,791		53,075,830	10,550,773	617,404,848
Total Capital Assets, Depreciable, Net	727,396,924	87,475,372	13,539,724	2,228,884	826,183,136
Capital Assets, Net	$ 1,027,884,988	$ 0	$ 110,590,674	$ 4,254,177	$ 1,134,221,485

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2003 were as follows:

	Totals
Accounts Payable	$ 41,338,853
Accrued Payroll	19,181,776
Contract Retainage	6,425,301
Commercial Paper (Note 7)	19,000,000
Other	270,025
Total Accounts Payable and Accrued Liabilities	$ 86,215,955

NOTE 7 - SHORT-TERM DEBT

Short-term debt activity for the year ended June 30, 2003 was as follows:

	Balance July 1, 2002	Issued	Redeemed	Balance June 30, 2003
Commercial Paper	$ 1,000,000	$ 18,000,000	$ 0	$ 19,000,000

The July 1, 2002 balance of $1,000,000 issued from the University of North Carolina General Revenue Bonds, Series 2002A had a maturity date of November 12, 2002 and has been extended to November 2003. The $18,000,000 issued during the fiscal year also matures in November 2003. These new proceeds were used to provide interim financing for the construction of capital projects.

NOTE 8 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2003 is presented as follows:

	Balance July 1, 2002	Additions	Reductions	Balance June 30, 2003	Current Portion
Notes Payable	$ 3,800,229	$ 35,532,276	$ 0	$ 39,332,505	$ 4,326,788
Bonds Payable	442,430,000		13,570,000	428,860,000	117,201,497
Add/Deduct Premium/Discount	(55,218,108)	4,028,023	1,190,835	(52,380,920)	
Deduct Deferred Charge on Refunding	(3,257,254)		(325,725)	(2,931,529)	
Total Bonds Payable	383,954,638	4,028,023	14,435,110	373,547,551	117,201,497
Capital Leases Payable	605,700	795,180	474,252	926,628	424,537
Compensated Absences	52,475,420	59,006,480	38,893,586	72,588,314	4,268,038
Annuity Payable	5,943,224	2,405,224	1,127,622	7,220,826	766,702
Total Long-Term Liabilities	$ 446,779,211	$ 101,767,183	$ 54,930,570	$ 493,615,824	$ 126,987,562

Additional information regarding capital lease obligations is included in Note 9.

The July 1, 2002 balance of $3,800,229 for the promissory note with Wachovia Bank had a maturity date of January 7, 2003 and has been extended to December 9, 2003.

On December 20, 2002, the UNC-CH Foundation (which is part of the University's financial reporting entity) signed a promissory note with Wachovia Bank in the amount of $318,960. On January 8, 2003, a second advance was received in the amount of $213,316 for a total note amount of $532,276. The final maturity date is December 31, 2003. The proceeds were used to acquire property. The University plans to repay the note maturing on December 31, 2003 after the State purchases the property using the State general obligation bond funding.

On April 7, 2003, the UNC-CH Foundation (which is part of the University's financial reporting entity) entered into a loan agreement with Bank of America in the amount of $35,000,000. The final maturity date is April 1, 2005. The proceeds will be used to finance the costs of acquisition, construction and equipping a student housing facility for students and their families. The student housing facility will be purchased by the University upon completion at which time the UNC-CH Foundation will repay the loan. The University plans to finance the purchase with other long term University financing.

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue Plus Capital Appreciation	Principal Paid Through 06/30/2003	Discount on Capital Appreciation Bonds	Principal Outstanding 06/30/2003
Housing System							
	1997A	4.500%- 5.100%	11/01/2017	$ 9,170,000	$ 1,315,000	$ 0	$ 7,855,000
	1997B	4.000%-5.000%	11/01/2017	7,210,000	810,000		6,400,000
Total Housing System				16,380,000	2,125,000		14,255,000
Utility System							
	1997	5.250%-5.500%	08/01/2021	84,135,000		(43,009,098)	41,125,902
	1992	3.000%-6.000%	08/01/2007	3,490,000	3,490,000		
Total Utility System				87,625,000	3,490,000	(43,009,098)	41,125,902
Parking System							
	1997A	4.350%-5.700%	05/15/2027	11,750,000	840,000		10,910,000
	1997B	3.900%-5.150%	05/15/2009	8,245,000	3,495,000		4,750,000
Total Parking System				19,995,000	4,335,000		15,660,000
General Revenue 2001							
	2001A	2.900%-5.125%	12/01/2025	89,930,000	3,585,000		86,345,000
	2001B	Variable	12/01/2025	54,970,000	3,015,000		51,955,000
	2001C	Variable	12/01/2025	54,970,000	3,015,000		51,955,000
Total General Revenue 2001				199,870,000	9,615,000		190,255,000
General Revenue 2002 Series	2002B	3.500%-5.000%	12/01/2011	66,555,000	1,595,000		64,960,000
Student Union	2000	4.550%-5.659%	06/01/2022	12,465,000	690,000		11,775,000
Student Recreation Center	1997	3.900%-5.000%	06/01/2011	3,545,000	765,000		2,780,000
U.S. EPA Project, Series 1991	1991	8.250%-9.050%	02/15/2015	58,125,000	13,990,000	(14,064,847)	30,070,153
U.S. EPA Project, Series 1996	1996	6.72%	02/15/2006	2,400,000	1,495,000		905,000
Total Bonds Payable (principal only)				$ 466,960,000	$ 38,100,000	$ (57,073,945)	371,786,055
Less: Unamortized Loss on Refunding							(2,931,529)
Plus: Unamortized Premium							4,693,025
Total Bonds Payable							$ 373,547,551

C. Demand Bonds - Included in bonds payable are two variable rate demand bond issues. Demand bonds are securities that contain a “put” feature that allows bondholders to demand payment before the maturity of the debt upon proper notice of the University’s remarketing or paying agents.

Regarding the following demand bonds, the University has not entered into legal agreements, which would convert the demand bonds not successfully remarketed into another form of long-term debt.

General Revenue, Series 2001B and 2001C:

In 2001 the University issued two series of variable rate demand bonds in the amount of $54,970,000 (2001B) and $54,970,000 (2001C) that each have a final maturity date of December 1, 2025, and are repaid from available funds. Available funds are defined as any unrestricted net assets remaining after satisfying obligations of the University under trust indentures, trust agreements or bond resolutions (specific revenue bonds), but excluding State appropriations, tuition, restricted gifts, and certain special facilities revenues. The bonds are subject to mandatory sinking fund redemption that began on December 1, 2001. The proceeds of these issuances were used to provide funds to refund in advance of their maturity the following issues: Ambulatory Care Clinic, Series 1990; Athletic Facilities, Series 1998; Carolina Inn, Series 1994; School of Dentistry, Series 1995; Housing System, Series 2000; Kenan Stadium, Series 1996; and Parking System, Series 1997C. While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the University's remarketing agents, Lehman Brothers, Inc (2001B) and UBS Financial Services, Inc (2001C).

Under an irrevocable line of credit issued by The Toronto-Dominion Bank and JP Morgan Chase Bank, the University is entitled to draw up to $54,970,000 from each bank or a maximum aggregate of $109,940,000 which the University would apply to meet its obligation to pay the principal, and, while the bonds are bearing interest at the daily or weekly rate, accrued interest on bonds delivered for purchase. The University is required to pay a quarterly commitment fee for the line of credit of .08% per annum of the amount of bonds then currently outstanding.

Under the letter of credit agreement, the University has promised to repay loans that represent purchase drawings in equal semi-annual payments after termination of the letter of credit. Interest at the rate of prime plus 1.0% (prime plus 2.0% after 60 days) is payable quarterly and upon draw repayment. At June 30, 2003, no purchase drawings had been made under the letter of credit.

The letter of credit terminates on February 4, 2004.

In order to protect against the risk of interest rate changes, effective October 3, 2000, the University entered into an interest rate swap contract agreement with Lehman Brothers Special Financing, Inc. (Lehman Brothers) related to $22,000,000 of The University of North Carolina at Chapel Hill Variable Rate Housing System Revenue Bonds, Series 2000. This series of bonds was refunded in its entirety by the issuance of The University's Variable Rate General Revenue Bonds, Series 2001B, and the interest swap agreement was amended to reflect the refunding.

Under this amended agreement, Lehman Brothers pays the University interest on the notational amount based on the Bond Market Association (BMA) Municipal Bond Index on a quarterly basis. For the fiscal year ended June 30, 2003, Lehman Brothers paid the University $285,962 under this agreement. On a semiannual basis, the University pays

Lehman Brothers interest at the fixed rate of 5.24%. For the fiscal year ended June 30, 2003, the University paid Lehman Brothers $1,147,167 under this agreement. The notional amount of the swap reduces annually; the reductions began in November 2002 and end in November 2025. The swap agreement matures November 1, 2025. As of June 30, 2003, rates were as follows:

	Terms	Rates
Fixed payment to Lehman	Fixed	5.24
Variable payment from Lehman	BMA	1.13
Net interest rate swap payments		4.11
Variable rate bond coupon payments		1.00
Synthetic interest rate on bonds		5.11

As of June 30, 2003, the swap had a negative fair value of $5,505,094. The fair value was developed by Lehman Brothers. Their method calculates the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for London Interbank Offered Rate (LIBOR) due on the date of each future net settlement on the swap.

As of June 30, 2003, the University was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the University would be exposed to credit risk in the amount of the derivative's positive fair value. Should the swap have a positive fair value of more than $1,000,000, at that point Lehman would be required to collateralize 103% of their exposure. Lehman Brothers Holdings, guarantor of Lehman Brothers Special Financing, Inc., was rated A2 by Moody's Investor's Service, A by Standard and Poor's Corporation, and A+ by Fitch Ratings.

The University receives the BMA Index from Lehman Brothers and pays a floating rate to its bondholders set by the remarketing agent. The University incurs basis risk when its bonds begin to trade at a yield above the BMA. Basis risk also exists since swap payments are made quarterly while bond payments are made monthly. With the alternative tax structure of the swap, a change in tax law would trigger the swap being converted from a BMA swap to a percentage of LIBOR swap. This would introduce basis risk. If the relationship of the University's bonds trade to a percentage of LIBOR greater than 65%, the University will experience an increase in debt service above the fixed rate on the swap.

The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. Termination could result in the University being required to make an unanticipated termination payment. The swap terminates if the University or Lehman Brothers fails to perform under terms of the contract.

As rates vary, variable rate bond interest payments and net swap payments will vary. Using rates as of June 30, 2003, debt service requirements of the variable rate debt and net swap payments, assuming current interest rates remain the same for their term, were as follows.

General Revenue Bonds Series 2001B

Fiscal Year Ending June 30	Principal	Interest	Interest Rate Swaps, Net*	Total
2004	$ 1,855,000	$ 510,275	$ 890,740	$ 3,256,015
2005	1,925,000	491,375	881,287	3,297,662
2006	2,060,000	471,450	871,423	3,402,873
2007	2,140,000	450,450	861,148	3,451,598
2008	2,175,000	428,875	850,359	3,454,234
2009-2013	12,590,000	1,789,600	4,064,687	18,444,287
2014-2018	11,635,000	1,168,875	3,368,556	16,172,431
2019-2023	10,710,000	599,150	2,086,338	13,395,488
2024-2026	6,865,000	105,125	375,758	7,345,883
Total	$ 51,955,000	$ 6,015,175	$ 14,250,296	$ 72,220,471

* Computed using (5.24% - 1.13%) x ($22,000,000 - annual reduction)

D. Capital Appreciation Bonds – The University's Series 1997 Utility System and the Series 1991 U. S. Environmental Protection Agency Project bond issues include capital appreciation bonds with an original issue amount of $30,379,142 and $3,828,921, respectively. These bonds are recorded in the amounts of $41,125,901 ($84,135,000 ultimate maturity less $43,009,099 discount), and $11,210,153 ($25,275,000 ultimate maturity less $14,064,847 discount), respectively, which are the accreted values at June 30, 2003. These bonds mature in the years from 2010 to 2021.

F. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2003 are as follows:

	Annual Requirements			
	Bonds Payable		Notes Payable	
Fiscal Year	Principal	Interest	Principal	Interest
2004	$ 17,080,000	$ 9,349,585	$ 4,332,505	$ 562,203
2005	17,930,000	8,841,269	35,000,000	394,110
2006	18,880,000	8,287,613		
2007	19,635,000	7,719,403		
2008	20,610,000	7,129,841		
2009-2013	113,695,000	27,679,907		
2014-2018	101,725,000	19,194,172		
2019-2023	85,465,000	10,363,010		
2024-2026	33,840,000	1,945,252		
Total Requirements	$ 428,860,000	$ 100,510,052	$ 39,332,505	$ 956,313

Interest on the variable rate General Revenue Bonds 2001B is calculated at 1.000% at June 30, 2003.
Interest on the variable rate General Revenue Bonds 2001C is calculated at 0.900% at June 30, 2003.
For UNC-CH General Revenue Bonds, Series 2001B and 2001C, interest rates change weekly.

F. Bond Defeasance - The University has extinguished long-term debt obligations by the issuance of new long-term debt instruments as follows:

Utilities System*:* On May 7, 2002, the University defeased $69,895,000 of outstanding Utility System Revenue Bonds, Series 1993. Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. The trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2003, the outstanding balance of the defeased Utility System Revenue Bonds was $64,445,000.

Dining System*:* On February 7, 2001 the University defeased $13,205,000 of outstanding Dining System Revenue Bonds, Series 1997. Securities were deposited into an irrevocable trust 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 University's Statement of Net Assets. At June 30, 2003 the outstanding balance of the defeased Dining System bonds was $11,595,000.

Dormitory System*:* On December 1, 1999, the University defeased $1,225,000 of outstanding Dormitory System Revenue Bonds, Series E, F, and G (1963). Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2003, the outstanding balance was $439,000 for the defeased outstanding Dormitory System Revenue Bonds, Series F and Series G (1963).

Student Apartments*:* On December 1, 1999, the University defeased $128,000 of outstanding Student Apartment Revenue Bonds, Series A (1961). Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2003, the outstanding balance was $0 for the defeased outstanding Student Apartment Revenue Bonds, Series A (1961).

Student Union*:* On December 1, 1999, the University defeased $620,000 of outstanding Student Union Revenue Bonds, Series 1967. Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2003, the outstanding balance was $405,000 for the defeased outstanding Student Union Revenue Bonds, Series 1967.

Utility System*:* On October 30, 1997 the University defeased $19,337,000 of outstanding Utility System Revenue Bonds, Series 1992. Securities were deposited into an irrevocable trust 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 University's Statement of Net Assets. At June 30, 2003 the outstanding balance of the defeased Utility System bonds was $0.

NOTE 9 - LEASE OBLIGATIONS

A. Capital Lease Obligations - Capital lease obligations relating to medical and research equipment are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2003:

Fiscal Year	Amount
2004	$ 465,649
2005	514,967
2006	10,038
Total Minimum Lease Payments	990,654
Amount Representing Interest (4.0% - 14.9% Rate of Interest)	64,026
Present Value of Future Lease Payments	$ 926,628

Machinery and equipment acquired under capital lease amounted to $2,072,142 at June 30, 2003.

B. Operating Lease Obligations – Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2003:

Fiscal Year	Amount
2004	$ 5,544,826
2005	4,596,029
2006	3,437,730
2007	1,363,553
2008	675,034
Total Minimum Lease Payments	$ 15,617,172

Rental expense for all operating leases during the year was $11,856,976.

C. Other Lease Obligations – The University of North Carolina at Chapel Hill Foundation, Inc. (UNC-CH Foundation) issued certificates of participation to provide for construction of Alumni facilities. The University constructed the facilities as an agent for the UNC-CH Foundation. In October 1989, the University entered into a 20-year lease agreement with the UNC-CH Foundation and simultaneously entered into a sublease agreement with the General Alumni Association, an affiliated organization, for the same time period for the use of the alumni facilities.

Payments under the terms of the lease are a limited obligation of the University, payable solely from and secured by the annual rental income derived from the sublease of the Alumni facilities. The University has no other obligations for repayment of the certificates of participation; therefore, the certificates are not reported as a liability in the accompanying financial statements. As of June 30, 2003, the aggregate principal amount of the certificates was $9,950,000.

If the University complies with all the terms of the lease agreement, title to the Alumni facilities will be conveyed to the University.

NOTE 10 - REVENUES

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

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Less Allowance for Uncollectibles	Less Indigent Care and Contractual Adjustments	Net Revenues	Revenues Pledged as Security for Debt	
Operating Revenues:								
Student Tuition and Fees	$ 178,483,678	$ 0	$ 31,522,261	$ 0	$ 0	$ 146,961,417	$ 0	
Patient Services	$ 336,493,199	$ 0	$ 0	$ 10,314,442	$ 194,922,706	$ 131,256,051	$ 0	
Sales and Services:								
Sales and Services of Auxiliary Enterprises:								
Residential Life	$ 24,252,104	$ 0	$ 4,314,574	$ 0	$ 0	$ 19,937,530	$ 18,464,277	(A)
Dining	16,813,899		238,307			16,575,592		
Student Union Services	2,067,743		406,238			1,661,505		
Health, Physical Education, and Recreation Services	14,050,244		2,809,535			11,240,709	11,240,709	(B)
Bookstore	32,075,507	6,072,533				26,002,974		
Parking	14,287,592					14,287,592	14,287,592	(C)
Athletic	33,187,532		454,184			32,733,348		
Utilities	72,725,243	55,258,490				17,466,753	17,466,753	(D)
Other Professional Income	69,027,595					69,027,595		
Other	136,560,842	83,388,525				53,172,317	4,734,172	(E)
Total Sales and Services	$ 415,048,301	$ 144,719,548	$ 8,222,838	$ 0	$ 0	$ 262,105,915	$ 66,193,503	
Nonoperating - Noncapital Gifts	$ 64,639,128	$ 0	$ 0	$ 3,751,532 *	$ 0	$ 60,887,596	$ 0	
Capital Gifts	$ 7,552,718	$ 0	$ 0	$ 0	$ 0	$ 7,552,718	$ 0	

Revenue Bonds Secured by Pledged Revenues:
(A) Housing System Revenue Bonds, Series 1997 A & B
(B) Student Fee Revenue Bonds, Series 1997 & 2000
(C) Parking System Revenue Bonds, Series 1997 A & B
(D) Utility System Revenue Bonds, Series 1992 & 1997
(E) US EPA Project, Series 1991 &1996

* Includes $3,094,621 PV discount on pledges receivable

NOTE 11 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	$ 398,172,611	$ 27,181,907	$ 105,734,309	$ 0	$ 34,423	$ 0	$ 531,123,250
Research	153,709,889	39,445,019	54,254,901		24,276		247,434,085
Public Service	27,232,590	1,454,851	46,689,814		32,655		75,409,910
Academic Support	45,488,859	13,059,982	12,339,383				70,888,224
Student Services	9,786,765	1,056,088	8,645,353		2,530		19,490,736
Institutional Support	41,330,738	4,473,044	17,595,079		61,643		63,460,504
Operations and Maintenance of Plant	27,529,762	7,581,750	11,661,547		39,678,363		86,451,422
Student Financial Aid				45,618,092			45,618,092
Auxiliary Enterprises	173,014,263	52,733,631	107,536,187		17,480,455		350,764,536
Depreciation						53,075,830	53,075,830
Total Operating Expenses	$ 876,265,477	$ 146,986,272	$ 364,456,573	$ 45,618,092	$ 57,314,345	$ 53,075,830	$ 1,543,716,589

NOTE 12 - PENSION PLANS

A. Retirement Plans - Each permanent full-time employee, as a condition of employment, is a member of either the Teachers' and State Employees' Retirement System or the Optional Retirement Program. Eligible employees can elect to participate in the Optional Retirement Program at the time of employment, otherwise they are automatically enrolled in the Teachers' and State Employees' Retirement System.

The Teachers' and State Employees' Retirement System is a cost sharing multiple-employer defined benefit pension plan established by the State to provide pension benefits for employees of the State, its component units and local boards of education. The plan is administered by the North Carolina State Treasurer.

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2003, the General Assembly required no contribution by employers and 6% of covered payroll for members.

For the year ended June 30, 2003, the University had a total payroll of $753,845,168, of which $325,527,079 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were $19,531,625 and $0, respectively. The University made one hundred percent of its annual required contributions for the years ended June 30, 2003, 2002, and 2001, which were $0, $6,175,101, and $16,111,000, respectively.

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

The Optional Retirement Program (Program) is a defined contribution retirement plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Administrators and eligible faculty of the University may join the Program instead of the Teachers' and State Employees' Retirement System. The Board of Governors of The University of North Carolina is responsible for the administration of the Program and designates the companies authorized to offer investment products. The Board has authorized the following carriers: Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), Lincoln Life Insurance Company, Variable Annuity Life Insurance Company (VALIC), and Fidelity Investments. Participants may elect to allocate their contributions and the University contributions to the carrier of their choice. Each carrier offers a variety of investment funds, including both fixed and variable account investment options and mutual funds.

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2003, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The University assumes no liability other than its contribution.

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

For the year ended June 30, 2003, the University had a total payroll of $753,845,168, of which $285,195,070 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were $17,111,704 and $19,507,343, respectively.

B. **Deferred Compensation and Supplemental Retirement Income Plans** - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (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 Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to $2,849,834 for the year ended June 30, 2003.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the University except for a 5% employer contribution for the University's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of University law enforcement officers for the year ended June 30, 2003 were $91,593. The voluntary contributions by employees amounted to $2,328,232 for the year ended June 30, 2003.

IRC Section 403(b) and 403(b)(7) Plans - Eligible University employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to $18,593,463 for the year ended June 30, 2003.

NOTE 13 - OTHER POSTEMPLOYMENT BENEFITS

A. **Health Care for Long-Term Disability Beneficiaries and Retirees** - The University participates in State-administered programs which provide postemployment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System or the Optional Retirement Program. These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The University contributed 2.35% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program for these health care benefits. For the fiscal year ended June 30, 2003, the University's total contribution to the Plan was $14,351,971. The University assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report.*

B. **Long-Term Disability** - The University 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 and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The University contributes .52% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the fiscal year ended June 30, 2003, the University's total contribution to the DIPNC was $3,175,755. The University assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 14 - RISK MANAGEMENT

The University 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 via a combination of methods, including participation in various 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.

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

Fire and Other Property Loss - The University 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 University also purchased through the Fund extended coverage and other property coverage such as sprinkler leakage, business interruption, vandalism, theft and all risk insurance for buildings and contents.

Automobile Liability Insurance - All State-owned vehicles are covered by liability insurance through a retrospective rated plan handled by the North Carolina Department of Insurance and a private insurance company. The liability limits for losses occurring in-State are $500,000 per claim and $5,000,000 per occurrence and out-of-State are $1,000,000 per claim and $5,000,000 per occurrence. The University is charged liability premiums in accordance with this retrospective rated plan as well as any optional physical damage coverages that may be purchased.

Employee and Computer Fraud - The University 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 with coverage of $5,000,000 per occurrence and a $50,000 deductible and a 10% participation in each loss above the deductible.

Other authorized coverage not handled by the North Carolina Department of Insurance is purchased through the State's insurance agent of record.

Comprehensive Major Medical Plan - University employees and retirees are provided comprehensive major medical care benefits. Coverage is funded by contributions to the State Health Plan (Plan), a pension and other employee benefit trust fund of the State of North Carolina. The Plan has contracted with third parties to process claims.

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 University's primary responsibility is to arrange for and provide the necessary treatment for work related injury. The University is responsible for paying medical benefits and compensation in accordance with the North Carolina Workers' Compensation Act. The University is self-insured for workers' compensation.

Liability Insurance Trust Fund – The University participates in the Liability Insurance Trust Fund (the Fund), a claims-servicing public entity risk pool for healthcare professional liability protection. The Fund services 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.

The Fund was created by Chapter 116, Article 26, of the General Statutes and The University of North Carolina Board of Governors Resolution of June 9, 1978 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 (University Physicians & Associates). 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 that has an affiliation agreement with the University of North Carolina, with a constituent institution of the University of North Carolina, or with the Hospitals. Only the University Physicians & Associates and the Hospitals have participated in the Fund to date. Participants provide management and administrative services to the Fund at no cost.

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 UNC System's Board of Governors.

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

The Fund provides occurrence coverage for participants as a corporate entity, as well as for the employees and professional staff of the participants. From July 1, 2002 through April 30, 2003 the trust Fund provided coverage on an occurrence basis of $7,000,000 for each and every claim and for the next $10,000,000 per claim/annual aggregate. As of July 1, 2002, the Fund purchased an excess policy on a claims made basis for $40,000,000 of coverage above the self-insured retention applicable to that policy year through April 30, 2003. As of May 1, 2003, the Fund had no excess of loss reinsurance coverage. As of May 1, 2003 the Fund provided coverage on an occurrence basis of $7,000,000 for each and every claim. 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 participants for the negligence of its employees. To assure that both existing and future claims will be paid, the UNC System Board of Governors is authorized by law to borrow up to $30,000,000 to replenish the 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, 2003, University assets in the Fund totaled $23,491,200 while University liabilities totaled $19,447,939 resulting in net assets of $4,043,261.

Additional disclosures relative to the funding status and obligations of the Trust Fund are set forth in the Audited Financial Statements of the Liability Insurance Trust Fund for the years ended June 30, 2003 and 2002. 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.

Term Life Insurance - The Death Benefit Plan is administered by the State Treasurer as part of the Teachers' and State Employees' Retirement System (TSERS) and funded with employer contributions. The employer contribution rate was .16% for the current fiscal year. The amount payable at death is approximately one times salary for eligible employees. The minimum benefit is $25,000 and the maximum is $50,000.

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

NOTE 15 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The University had commitments of $48,806,775 for various capital improvements projects that include construction and completion of new buildings, and renovations of existing buildings.

B. Pending Litigation and Claims – A $2.1 million claim related to the construction of the Frank Porter Graham Student Union project has been submitted to the State Construction Office by the contractor. No ruling has been made regarding this claim.

The University is undertaking environmental remediation efforts on the Old Sanitary Landfill. The amount of the liability associated with this site cannot reasonably be estimated at this time.

The University is a party to other litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of these matters, no provision for any liability has been made in the financial statements. University 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 University.

C. University Improvement General Obligation Bonds – The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of $2.5 billion of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The funds authorized are to be used solely for capital facilities cost on the University of North Carolina campuses as specified in the legislation. The bond legislation specifies the amount of bond funding for each University campus and the level of bond funding intended for each project. The bonds are authorized to be issued over a six-year period beginning in 2001 at a level not to exceed amounts provided in the legislation. Using a cash flow financing approach, The University of North Carolina – Office of the President (UNC-OP), establishes annual amounts not to exceed for each approved project. The amounts not to exceed are subject to change due to actual cash availability and needs during the year. Subsequent to the bond sales and the availability of bond proceeds, UNC-OP notifies the Office of State Budget and Management (OSBM) of the amounts not to exceed for each approved project. Within these amounts, based on an official request of cash needs from the University, OSBM authorizes allotments. The University records the allotments as revenue on the accompanying financial statements. In addition, amounts not allotted but accrued as expended at year-end are recorded as revenue. The University's remaining authorization $386,815,928 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

D. Other Contingent Receivables – The University has received notification of other gifts and grants for which funds have not been disbursed by the resource provider and for which conditions attached to the gift or grant have not been satisfied or, in the case of permanent endowments, cannot begin to be satisfied. In accordance with accounting principles generally accepted in the United States of America, these amounts have not been recorded on the accompanying financial statements. The purpose and amount of other contingent receivables at year-end is as follows:

Purpose	Amount
Pledges to Permanent Endowments	$ 21,618,179

NOTE 16 - RELATED PARTIES

Foundations - There are 14 separately incorporated nonprofit organizations associated with the University. These organizations are The Botanical Garden Foundation, Inc., The Dental Alumni Association, Inc., The Dental Foundation of North Carolina, Inc., The Educational Foundation, Inc., The General Alumni Association, The Institute of Government Foundation, Inc., The Law Alumni Association of N.C., Inc., The Medical Foundation of North Carolina, Inc., The Pharmacy Foundation of North Carolina, Inc., The School of

Education Foundation, Inc., The School of Journalism and Mass Communication Foundation of North Carolina, Inc., The University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., The University of North Carolina at Chapel Hill Public Health Foundation, Inc., and The University of North Carolina at Chapel Hill School of Nursing Foundation, Inc. The support from these organizations to the University approximated $19,065,762 for the year ended June 30, 2003.

NOTE 17 - ACCOUNTING CHANGES

For the fiscal year ended June 30, 2003, the University implemented the GASB Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets.* GASB Technical Bulletin No. 2003-1 supercedes Technical Bulletin No. 94-1 and applies to derivatives that are not reported at fair value on the Statement of Net Assets. This standard provides an updated definition of derivatives and also requires disclosure of the government's objective for entering into the derivative and the derivative's terms, fair value, associated debt, and risk exposures.

NOTE 18 - SUBSEQUENT EVENT

In December 2003, the Board of Governors of the University of North Carolina issued The University of North Carolina at Chapel Hill General Revenue Bonds, Series 2003, in the amount of $107,960,000. The bonds will mature, subject to mandatory and optional redemption, from December 1, 2004 to December 1, 2033, with amounts varying from $990,000 due December 1, 2004 to $24,765,000 Term Bonds due December 1, 2033. Interest on the bonds is payable on each December 1 and June 1, commencing June 1, 2004. Interest rates range from 2.0% to 5.0% Term Bonds. The bonds are being issued primarily to finance or refinance the costs of certain capital projects at The University of North Carolina at Chapel Hill.

The University of North Carolina at Chapel Hill
Schedule of General Obligation Bond Project Authorizations, Budgets, and Expenditures
For Project-to-Date as of June 30, 2003

Schedule 1

Capital Improvement Projects	Projected Start Date	General Obligation Bonds Authorized	Other Sources	Total Project Budget	Amount Expended	Percent Completed	Expected Completion Date
Projects Started							
Medical Biomolecular Research Bldg	Dec 2000	$ 26,718,000	$ 38,847,748	$ 65,565,748	$ 63,019,323	96.12%	Aug 2003
RB House Library-Renovations	Jan 2001	9,898,700	10,182,700	20,081,400	19,073,029	94.98%	Jan 2003
Murphey Hall Classroom Bldg Comp Renovation	Jun 2001	6,826,500	300,000	7,126,500	6,470,688	90.80%	Dec 2003
Memorial Hall-Comp Renovation and Addition	Apr 2003	9,000,000	6,000,000	15,000,000	1,723,212	11.49%	Oct 2004
Memorial Hall-Comp Renovation and Addition	Apr 2003	200,000		200,000	200,000	100.00%	Oct 2004
Renovate Health Sciences Library	Oct 2002	11,000,000	1,036,358	12,036,358	6,025,886	50.06%	Oct 2004
Teaching Research Bldg-Sch of Public Health Proj Supp	Jul 2002	13,382,900	25,598,300	38,981,200	23,428,391	60.10%	Oct 2004
Sch of Dentistry Bldg Renovation & Conversion fr. Operatory	Aug 2002	8,397,100		8,397,100	5,389,780	64.19%	Aug 2004
Carrington Hall-Addn for Sch of Nursing Proj Supp	Nov 2002	10,082,100	7,904,000	17,986,100	6,756,109	37.56%	Mar 2004
Peabody Hall-Classroom Bldg Comp Renovation	May 2002	8,509,800	1,969,008	10,478,808	4,510,656	43.05%	Dec 2003
Inst Marine Sciences-Morehead City Comp Renovation	Dec 2002	1,833,300		1,833,300	1,681,114	91.70%	Oct 2003
Science Complex Phase I	Mar 2003	55,012,500		55,012,500	12,248,247	22.26%	Mar 2005
Burnett Womack Bldg Research Lab Comp Renovation	Jun 2001	24,848,000		24,848,000	2,723,504	10.96%	Nov 2004
Medical Research Bldg-Comp. Renov. of Classrooms	May 2003	22,875,997	500,000	23,375,997	3,340,820	14.29%	May 2004
Carolina Living & Learning Center	Nov 2001	1,154,275	1,364,275	2,518,550	2,472,485	98.17%	Sep 2002
Sch of Med-Bioinformatics Bldg-Supplement	Feb 2001	2,000,000	33,585,234	35,585,234	29,761,113	83.63%	May 2003
Campus Fiber Optics Network	May 2004	17,430,500		17,430,500	3,710,629	21.29%	Mar 2008
Steam Distribution System Replacement	Apr 2002	6,300,000		6,300,000	5,518,740	87.60%	Oct 2003
Phillips Hall-Comp Classroom & Lecture Renovation	Mar 2003	1,450,000		1,450,000	688,974	47.52%	Sep 2003
Hill & Davie Halls-Classroom & Lecture Renovation	Jul 2005	1,949,000		1,949,000	28,000	1.44%	Aug 2006
Infrastructure Improvements	Sep 2002	32,298,000	2,764,885	35,062,885	8,063,610	23.00%	Feb 2006
Storm Drainage Improvements	Oct 2002	10,500,000		10,500,000	1,956,069	18.63%	Jan 2007
Beard Hall & Lab Bldg Comp Renovation	Nov 2002	3,500,000	21,839,600	25,339,600	22,053,482	87.03%	Oct 2004
Berryhill Hall Lab Bldg Comp Renovation	Nov 2004	10,700,000		10,700,000	565,355	5.28%	Aug 2006
Arts & Sciences-Digital Multimedia Inst Ctr & Music Lib	Mar 2005	20,150,000		20,150,000	972,281	4.83%	Aug 2007
Land Acquisition	Sep 2001	8,000,000		8,000,000	8,872	0.11%	Feb 2006
Gerard Hall Classroom Bldg Comp Renovation	Mar 2005	1,350,000		1,350,000	1,156	0.09%	Jul 2005
Electrical Systems Improvement	Sep 2003	5,200,000		5,200,000	114,832	2.21%	Aug 2004
Technology Infrastructure Expansion	Feb 2005	9,165,000		9,165,000	301,627	3.29%	Jun 2006
Physical Plant Support Facilities	Oct 2002	11,075,000		11,075,000	829,802	7.49%	Apr 2004
Upgrade Campus Energy Mgt and Control System	Oct 2002	3,682,600		3,682,600	622,974	16.92%	Mar 2005
Saunders Hall Classroom Bldg- Comp Renovation	Aug 2003	4,194,100		4,194,100	351,050	8.37%	Sep 2004
440 W Franklin St. Renovation & Conversion for Info Tech	Jan 2004	9,170,000		9,170,000	334,007	3.64%	Jun 2005
Wollen & Fetzer Gyms Comp Renovation of Classrooms	Jun 2005	1,598,000		1,598,000	12,000	0.75%	Apr 2007
Brauer Hall Comp. Renovation of Dental Clinic	Jul 2004	13,415,400		13,415,400	459,143	3.42%	Jul 2006
Academic Facilities to Consolidate Int'l Educ. Programs	Jul 2004	20,000,000		20,000,000	908,292	4.54%	Jul 2006
Hanes & Manning Halls & Alumni Bldg-Renovation of Class	Dec 2004	2,233,000		2,233,000	6,686	0.30%	Oct 2005
Student Services Bldg-Consolid of Services	Apr 2005	27,000,000		27,000,000	232,060	0.86%	Sep 2006

The University of North Carolina at Chapel Hill
Schedule of General Obligation Bond Project Authorizations, Budgets, and Expenditures
For Project-to-Date as of June 30, 2003

Schedule 1

Capital Improvement Projects	Projected Start Date	General Obligation Bonds Authorized	Other Sources	Total Project Budget	Amount Expended	Percent Completed	Expected Completion Date
Projects Not Started - To Be Funded in Future Years							
Caldwell & Howell Hall Class and Lecture Halls Renovation	Jan 2002	1,732,000		1,732,000			Nov 2002
Community Health Bldg-Consolid of Programs	Aug 2002	8,359,003		8,359,003			Dec 2004
Coker & Mitchell Hall-Comp Renovation of Classrooms	Jan 2004	1,718,000		1,718,000			Nov 2009
Rosenau Hall Lab Bldg Comprehensive Renovation	Apr 2004	9,000,000		9,000,000			Jun 2005
Cogeneration Facility-Back Pressure Turbine Generator	Jul 2004	2,625,000		2,625,000			Jun 2005
New West Classroom Bldg-Comp Renovation	Aug 2004	4,500,000		4,500,000			Jan 2006
Steele Bldg-Comp Renovation & Conversion of Admin Office	Jul 2004	3,428,600		3,428,600			Sep 2007
Greenlaw Hall-Comp Renovation of Classrooms	May 2005	1,825,000		1,825,000			Oct 2008
Wilson Hall Lab-Comp Renovation	May 2005	8,920,000		8,920,000			Jun 2006
Smith Hall-Comp Renovation	Aug 2005	1,355,200		1,355,200			Jan 2007
Science Complex Phase II	Oct 2005	33,437,500		33,437,500			Jan 2009
Hamilton Hall-Comp Renovation of Classrooms	Jul 2006	1,539,000		1,539,000			Nov 2007
Total All Projects		$ 510,539,075	$ 151,892,108	$ 662,431,183	$ 236,563,998		

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

[This Page Left Blank Intentionally]

STATE OF NORTH CAROLINA
Office of the State Auditor

Ralph Campbell, Jr.
State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet http://www.ncauditor.net

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

Board of Trustees
The University of North Carolina at Chapel Hill
Chapel Hill, North Carolina

We have audited the financial statements of The University of North Carolina at Chapel Hill, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, as of and for the year ended June 30, 2003, and have issued our report thereon dated March 18, 2004.

As discussed in Note 17 to the financial statements, the University implemented Governmental Standards Board Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, during the year ended June 30, 2003.

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 University's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests, which are reported in the Audit Findings and Recommendations section of this report, disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Finding

1. Inadequate Controls in the Department of Radiology

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 University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the University's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions noted as a result of our audit are described in the Audit Findings and Recommendations section of this report.

Finding

1. Inadequate Controls in the Department of Radiology

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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

This report is intended solely for the information and use of the Audit Committee, the Board of Trustees and Board of Governors, management and staff of the University, 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.

Ralph Campbell, Jr.
State Auditor

March 18, 2004

AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Financial Reporting or Federal Compliance Objectives

The following findings and recommendations were identified during the current audit and describes conditions that represent significant deficiencies in internal control or noncompliance with laws, regulations, contracts, or grants.

1. INADEQUATE CONTROLS IN THE DEPARTMENT OF RADIOLOGY

On March 18, 2004, the University's internal auditors released a special review that reported failures of internal controls in the Department of Radiology. These failures led to inappropriate and excessive expenditures, possible conflicts of interest, and inadequate record keeping by the Department. The conditions, which existed over a four-year period including the period of our audit, included:

- Overpayments for services due to contracting with related parties.
- Inadequate reviews of transactions and financial reports by fiscal personnel.
- Inadequate records for tracking computers and related equipment.
- Other cases of unnecessary or questionable expenditures.

Recommendation: We recommend that the University continue to monitor the internal controls over the Department of Radiology and to take corrective actions as needed.

University Response: Management concurs with the condition of the finding. The University Internal Audit report of March 18, 2004 details the corrective actions that have occurred or are planned. Organizational, staffing, and policy and procedural changes within the Department of Radiology will restore sound business practices and ensure good stewardship of resources. Policy and procedural changes related to proper separation of duties, the use of outside services, and the processes used for purchasing will provide improvements in financial controls. The University's central review process will include additional documentation standards for purchases and automated monitoring of purchase commitments.

In addition to the improvements related to purchasing and other financial transaction processes, improvements in review of management information and control of equipment have been implemented. The Department of Radiology's review of financial reports is now in a current status, and management review of future reports will be performed timely. Also, an asset management system to ensure control and tracking of computer equipment and peripherals has been implemented. These corrective actions, along with others detailed in the Internal Audit report, will provide the needed improvements in the Department of Radiology.

2. TRACKING OF SUBRECIPIENT AUDIT REPORTS – RESEARCH AND DEVELOPMENT CLUSTER

The University did not have adequate controls to ensure the tracking and receipt of subrecipient audit reports for the Research and Development Cluster. This condition limits the University's ability to comply with Federal OMB Circular A-133, which states that the pass-through entity (the University) is responsible for ensuring that required subrecipient audits are performed and that the subrecipient takes prompt corrective action on any audit finding.

The University requires subrecipients to return a certification letter that states whether an audit has been performed, if there were findings, or if the subrecipient was not subject to the single audit provisions of A-133. OMB Circular A-133 requires grant recipients expending $300,000 or more in Federal funds in a fiscal year to obtain a single audit or program-specific audit for that year. Our audit of the tracking of subrecipient audit reports disclosed the following:

- The University had not received the required certification letter from thirteen of the thirty subrecipients tested.
- One certification letter contained erroneous information on the amount of funding received.
- While gaining an understanding of the subrecipient monitoring process, the auditor identified an instance in which the University had not performed follow-up procedures on a certification letter that indicated the subrecipient had audit findings.
- The University uses the US Office of Management and Budget (OMB) Federal Audit Clearinghouse website to monitor subrecipient audit reports. There was no documentation to support that review of the reports on the website was occurring.

Recommendation: The University should develop and implement a tracking system to ensure that all required subrecipient audit reports are reviewed in a timely manner. This tracking system should include documentation that the audit certification letters were received, the audit reports were reviewed, and a management decision is issued on any audit findings in subrecipient reports within six months.

University Response: Management concurs with the condition of the finding. The finding is a result of a significant increase in the number of subcontracts requiring subrecipient monitoring. From fiscal year 1999 to fiscal year 2003 the numbers increased from 466 to 842, nearly doubling. No additional staffing was added in 1987/88 when subrecipient monitoring became a compliance mandate under A-128 and now A-133, while the federal government continues to increase areas and complexity of compliance staffing has remained the same. The Office of Sponsored Research is in the midst of reorganization and is looking to add additional positions in the Post Award Services area as a means to strengthen compliance and to once again provide full monitoring of subrecipients. The increased staffing will allow us to support our tracking system to ensure that all required subrecipient audit reports are reviewed in a timely manner.

DISTRIBUTION OF AUDIT REPORT

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

EXECUTIVE BRANCH

The Honorable Michael F. Easley	Governor of North Carolina
The Honorable Beverly M. Perdue	Lieutenant Governor of North Carolina
The Honorable Richard H. Moore	State Treasurer
The Honorable Roy A. Cooper, III	Attorney General
Mr. David T. McCoy	State Budget Officer
Mr. Robert L. Powell	State Controller
Ms. Molly Corbett Broad	President, The University of North Carolina
Dr. James Moeser	Chancellor, The University of North Carolina at Chapel Hill
Ms. Nancy D. Suttenfield	Vice Chancellor for Finance and Administration The University of North Carolina at Chapel Hill
Mr. Richard T. Williams	Chairman, Board of Trustees The University of North Carolina at Chapel Hill

LEGISLATIVE BRANCH

Appointees to the Joint Legislative Commission on Governmental Operations

President Pro Tempore	Speaker of the House
Senator Marc Basnight, Co-Chair	Representative James B. Black, Co-Chair
Senator Charles W. Albertson	Representative Richard T. Morgan, Co-Chair
Senator Patrick J. Ballantine	Representative Martha B. Alexander
Senator Daniel G. Clodfelter	Representative Rex L. Baker
Senator Walter H. Dalton	Representative Bobby H. Barbee, Sr.
Senator Charlie S. Dannelly	Representative Harold J. Brubaker
Senator James Forrester	Representative Debbie A. Clary
Senator Linda Garrou	Representative E. Nelson Cole
Senator Wilbur P. Gulley	Representative James W. Crawford, Jr.
Senator Fletcher L. Hartsell, Jr.	Representative William T. Culpepper, III
Senator David W. Hoyle	Representative W. Pete Cunningham
Senator Ellie Kinnaird	Representative W. Robert Grady
Senator Jeanne H. Lucas	Representative Joe Hackney
Senator Stephen M. Metcalf	Representative Julia C. Howard
Senator Anthony E. Rand	Representative Joe L. Kiser
Senator Eric M. Reeves	Representative Edd Nye
Senator Robert A. Rucho	Representative William C. Owens, Jr.
Senator R. C. Soles, Jr.	Representative Wilma M. Sherrill
Senator Scott Thomas	Representative Thomas E. Wright

Other Legislative Officials

Mr. James D. Johnson	Director, Fiscal Research Division

May 27, 2004

ORDERING INFORMATION

Copies of this report may be obtained by contacting the:

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

Internet: http://www.ncauditor.net

Telephone: 919/807-7500

Facsimile: 919/807-7647