STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

UNIVERSITY OF NORTH CAROLINA HOSPITALS

CHAPEL HILL, NORTH CAROLINA

FOR THE YEARS ENDED JUNE 30, 2003 AND 2002

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

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STATE OF NORTH CAROLINA
Office of the State Auditor

Ralph Campbell, Jr.
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AUDITOR'S TRANSMITTAL

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

This report presents the results of our financial statement audits of the University of North Carolina Hospitals, which is a part of The University of North Carolina Health Care System, which is a part of The University of North Carolina System, a component unit of the State of North Carolina, for the years ended June 30, 2003 and 2002. Our audits were made by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

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

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

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

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

   Results - The accompanying financial statements present fairly, in all material respects, the amounts and disclosures made in accordance with accounting principles generally accepted in the United States of America. These matters are more fully described in the Independent Auditor's Report on the Financial Statements.

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

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

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

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying basic financial statements of the University of North Carolina Hospitals, which is a part of The University of North Carolina Health Care System, which is a part of The University of North Carolina System, a component unit of the State of North Carolina, as of and for the years ended June 30, 2003 and 2002, as listed in the table of contents. These financial statements are the responsibility of the Hospitals' management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note 1, the financial statements present only the University of North Carolina Hospitals and are not intended to present fairly the financial position of The University of North Carolina Health Care System and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of North Carolina Hospitals as of June 30, 2003 and 2002, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 15 to the Financial Statements, the Hospitals implemented Governmental Accounting Standards Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statements of Net Assets,* during the year ended June 30, 2003. The Hospitals also changed its method of classifying restricted cash and cash equivalents on the Statement of Cash Flows for the fiscal year ended June 30, 2003.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

In accordance with *Government Auditing Standards*, we have also issued our report dated December 11, 2003 on our consideration of the Hospitals' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

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.

Ralph Campbell, Jr.
State Auditor

December 11, 2003

Introduction

The following discussion and analysis is provided by the University of North Carolina Hospitals' financial management as an overview to assist the reader in interpreting and understanding the accompanying basic financial statements. It includes comparative financial analysis with discussion of significant changes from the prior year, as well as, pertinent facts, decisions, and conditions.

Using the Financial Statements

The financial statements of the Hospitals provide information regarding its financial position and results of operations as of the report date. The Statements of Net Assets; the Statements of Revenues, Expenses, and Changes in Net Assets; and the Statements of Cash Flows comprise the basic financial statements required by the Governmental Accounting Standards Board (GASB). In accordance with the GASB, the financial statements are presented and follow reporting concepts consistent with those required of a private business enterprise. The financial statement balances reported are presented in a classified format to aid the reader in understanding the nature of the financial statement balance. The Note Disclosures accompanying the financial statements should be read in conjunction with the financial statements. These new statements were effective beginning with the Hospitals' fiscal year ending June 30, 2002.

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

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

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

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

Comparison of Two-Year Data

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

Analysis of Overall Financial Position and Results of Operations

Statements of Net Assets

Current assets decreased by $11.9 million or 5.4% from the prior year. In contrast, noncurrent assets increased by $38.5 million or 5.1%. Current cash and investments decreased by $26.6 million due to construction or acquisition of noncurrent capital assets such as the new administrative office building in Meadowmont, the Wellness Center, ongoing relocation and renovation of space vacated with the opening of the Women's and Children's Hospitals as well as normal capital replacement. Current patient accounts receivable – net increased by $9.6 million as a result of a rate increase implemented during the fiscal year and additional patient activity. Estimated third party settlements also increased by $3.3 million for a receivable related to the Champus program for Federal employees.

Both current and noncurrent liabilities decreased from the prior year as debts to vendors and bondholders were paid down. There was an increase in liabilities related to employee salaries and accumulated leave balances. This increase was the result of salary increases, an increase in the overall number of paid full time employee equivalents and an increase in the number of leave hours accumulated.

Statements of Revenues, Expenses, and Changes in Net Assets

The Statements of Revenues, Expenses, and Changes in Net Assets reflect an operating loss before net nonoperating revenues. While there was a $1.3 million reduction from the prior year level of State appropriation, investment activity net of all debt-related interest and fees continues to offset the loss from operations. Interest expenses rose for the current year, because $4.6 million of interest payments were capitalized as a part of the construction project in the prior year. It is expected that the interest expense for FY04 will decline as a result of the refunding of a portion of the Series 1996 bonds. See Footnote 6 for additional information on the refunding. In October 2002, the Hospitals liquidated its Long-Term Investment Fund that was managed by the State Treasurer and converted these funds to cash and cash equivalents. This action was taken to capture the unrealized gain that had accumulated over the past few years.

Net patient service revenue continues to be strong as evidenced by its 5.8% increase over the prior year. During the past year, the Hospitals implemented an average rate increase of 5.3% to gross charges and inpatient days increased by approximately 5% with an overall occupancy percentage of 83.2%. Outpatient volume remained constant with over a million visits.

Total operating expenses increased by 8.3%. Salaries and benefits comprised 58% of the total operating expenses for FY03 and increased by 9.1% over the prior year. The factors driving this increase were a performance-based increase of 4% and the Hospitals' dependence on contract staffing to supplement medical professionals where there was a shortage in the labor market. The second largest component of operating expenses, medical and surgical supplies, represented 17% of the total operating expenses and experienced an increase of 2.3% over the prior year due to growth in patient service volume and inflation. Medical malpractice costs showed the largest percentage increase over the prior year and depreciation increased due to a full year's depreciation for the Women's and Children's Hospitals.

Statements of Cash Flows

The Statements of Cash Flows provide information about the major sources and uses of the Hospitals' cash. For this past year, there was approximately $51 million spent on the acquisition or construction of capital assets. The statements also reflect payments for debt service on bonds and other debt. The increase in interest income as a result of the liquidation of long-term investments was offset by the reduction in noncash distributions.

Analysis of Net Asset Balances

Net assets invested in capital assets, net of related debt, totaled $183,525,184 representing the gross value of plant assets ($559,954,857) plus bond issuance costs ($1,693,958) less accumulated depreciation ($197,838,722) and related debt ($180,284,909). Restricted expendable net assets totaled $59,734,267 representing amounts subject to externally imposed restrictions. Unrestricted net assets totaled $382,837,654 representing amounts not subject to externally imposed stipulations but internally designated for various activities and initiatives, as well as future construction projects.

Discussion of Capital Asset and Long-Term Debt Activity

Capital Assets

With the issuance of the Series 2003 Revenue Refunding Bonds and the proceeds remaining from the issuance of the Series 2001 Revenue Bonds, the Hospitals has strengthened its position to continue to improve and modernize its facilities. Current projects include the renovation of the central Administrative Office Building, the renovation of Seventh Floor Rehabilitation space, the replacement of the Patient Kitchen and additional renovation of inpatient care space vacated with the opening of the Women's and Children's Hospitals. As of June 30, 2003, the Hospitals had $29,373,469 remaining in the 2001 Construction Fund for these and other projects.

Additionally, the Hospitals opened its Wellness Center at Meadowmont in November 2002, with funding provided from its accumulated reserves.

The Hospitals expended $51,450,218 during the year for the construction of new buildings/infrastructure, the renovation or repair of its facilities, and the purchase of new or replacement equipment.

At June 30, 2003, outstanding commitments on construction contracts were $9,593,198.

Long-Term Debt Activities

The Hospitals' 2003 Revenue Bonds received a rating of A1/VMIGI from Moody's Investors Service, Inc. and a rating of AA/A-1+ (Series 2003A) and AA/A-1 (Series 2003B) from Standard and Poor's Ratings Services. No additional bonds have been issued since the 2003 Bonds. For the current reporting period, there was no change in the ratings assigned by these agencies.

At June 30, 2003, the Hospitals had outstanding bond indebtedness in the amount of $298,690,000 of which $5,545,000 is due within the next year.

Discussion of Conditions that may have a Significant Effect on Net Assets or Revenues, Expenses, and Changes in Net Assets

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

The State's economy has been in a decline for several years and has resulted in continued reduced appropriated funding across State government. U. S. Department of Labor statistics for the Raleigh-Durham-Chapel Hill area showed an unemployment rate of 4.9% at the end of December 2002 and 5.1% at the end of June 2003.

As the economy slowed and unemployment rose, the Hospitals experienced an increase in its contractual adjustments for indigency and bad debt expense. Their combined increase totaled $18.0 million over the prior year and the combined adjustments represented 8.5% of gross patient charges for fiscal year 2003. Contractual adjustments for Medicare, Medicaid and Managed Care patients have also increased as third party payors continued to reduce their reimbursements. Further information regarding net patient service revenue is included in Note 8 to the Financial Statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

Summary of Condensed Financial Statements Totals — Table 1

	FY03	FY02	Change
STATEMENTS OF NET ASSETS			
Current Assets	$ 208,370,558	$ 220,223,468	$ (11,852,910)
Capital Assets, Net	362,116,135	341,009,244	21,106,891
Other Noncurrent Assets	426,134,220	408,773,498	17,360,722
TOTAL ASSETS	**996,620,913**	**970,006,210**	**26,614,703**
Current Liabilities	64,108,105	71,500,093	(7,391,988)
Noncurrent Liabilities	306,415,703	308,799,258	(2,383,555)
TOTAL LIABILITIES	**370,523,808**	**380,299,351**	**(9,775,543)**
Invested in Capital Assets, Net of Related Debt	183,525,184	179,481,715	4,043,469
Restricted for Expendable Uses	59,734,267	54,629,969	5,104,298
Unrestricted	382,837,654	355,595,175	27,242,479
TOTAL NET ASSETS	**626,097,105**	**589,706,859**	**36,390,246**
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS			
Net Patient Service Revenue	482,299,891	455,857,171	26,442,720
Other Operating Revenues	16,259,958	10,165,933	6,094,025
TOTAL OPERATING REVENUES	**498,559,849**	**466,023,104**	**32,536,745**
Salaries and Benefits	314,876,516	288,629,005	26,247,511
Medical and Surgical Supplies	90,594,373	88,582,472	2,011,901
Other Operating Expenses	133,144,091	120,169,848	12,974,243
TOTAL OPERATING EXPENSES	**538,614,980**	**497,381,325**	**41,233,655**
OPERATING LOSS	**(40,055,131)**	**(31,358,221)**	**(8,696,910)**
State Appropriations	37,770,647	39,092,359	(1,321,712)
Investment Activity	49,052,577	39,803,697	9,248,880
Other Nonoperating Revenues	2,158,521	1,654,989	503,532
Nonoperating Expenses	12,536,368	10,151,810	2,384,558
NET NONOPERATING REVENUES	**76,445,377**	**70,399,235**	**6,046,142**
INCREASE IN NET ASSETS	**36,390,246**	**39,041,014**	**(2,650,768)**
NET ASSETS - BEGINNING OF YEAR	**589,706,859**	**550,665,845**	**39,041,014**
NET ASSETS - END OF YEAR	**626,097,105**	**589,706,859**	**36,390,246**
STATEMENTS OF CASH FLOWS			
Cash Flows from Operating Activities	(22,868,564)	(5,418,863)	(17,449,701)
Cash Flows from Noncapital Financing Activities	38,017,395	38,749,144	(731,749)
Cash Flows from Capital and Related Financing Activities	(68,334,925)	(64,486,420)	(3,848,505)
Cash Flows from Investing Activities	449,558,465	25,673,930	423,884,535
NET INCREASE (DECREASE) IN CASH	**$ 396,372,371**	**$ (5,482,209)**	**$ 401,854,580**

University of North Carolina Hospitals
Statements of Net Assets
June 30, 2003 and 2002 **Exhibit A**

		2003		2002
ASSETS				
Current Assets:				
Cash and Cash Equivalents (Note 2)	$	64,356,943	$	25,084,240
Restricted Cash and Cash Equivalents (Note 2)		3,104,394		6,064,904
Short-Term Investments (Note 2)				62,898,290
Patient Accounts Receivable, Net (Note 3)		103,223,492		93,578,008
Accrued Interest Receivable		1,356,552		81,928
Restricted Accrued Interest Receivable		123,337		245,654
Estimated Third Party Settlements (Note 4)		4,269,966		923,631
Inventories		13,608,836		13,174,063
Notes Receivable		127,000		277,000
Other Accounts Receivable		17,367,471		16,031,640
Prepaid Expenses		832,567		1,864,110
Total Current Assets		208,370,558		220,223,468
Noncurrent Assets:				
Cash and Cash Equivalents (Note 2)		319,736,429		878,459
Restricted Cash and Cash Equivalents (Note 2)		97,149,755		55,947,547
Short-Term Investments (Note 2)				289,592,020
Restricted Short-Term Investments (Note 2)				50,837,344
Advance Deposits with Liability Insurance Trust Fund		100,000		3,409,869
Patient Accounts Receivable, Net (Note 3)		316,935		981,790
Bond Issuance Costs, Net		2,037,106		2,251,654
Start-Up Costs, Net		613,627		631,488
Notes Receivable				127,000
Investments in Affiliates (Note 14)		6,180,368		4,116,327
Capital Assets - Nondepreciable (Note 5)		40,422,792		55,076,569
Capital Assets - Depreciable, Net (Note 5)		321,693,343		285,932,675
Total Noncurrent Assets		788,250,355		749,782,742
Total Assets		996,620,913		970,006,210

University of North Carolina Hospitals
Statements of Net Assets — ***Exhibit A***
June 30, 2003 and 2002 — ***Page 2***

	2003	2002
LIABILITIES		
Current Liabilities:		
Accounts and Other Payables - Operating	14,389,211	24,571,790
Accounts and Other Payables - Capital	6,382,439	6,142,433
Accrued Salaries and Benefits	17,692,171	14,219,703
Estimated Third Party Settlements (Note 4)	8,694,659	10,310,000
Bond Interest Payable	1,902,973	3,632,239
Bonds Payable (Note 6)	5,545,000	4,840,000
Due to Patients or Third Parties	5,649,349	4,232,502
Compensated Absences	3,461,029	3,090,613
Funds Held for Others	391,274	460,813
Total Current Liabilities	64,108,105	71,500,093
Noncurrent Liabilities:		
Accounts and Other Payables - Capital	2,486,655	2,480,865
Bonds Payable, Net (Note 6)	274,929,048	280,083,429
Arbitrage Rebate Payable	3,215,797	2,236,169
Compensated Absences	12,169,329	10,868,795
Estimated Third Party Settlements (Note 4)	13,614,874	13,130,000
Total Noncurrent Liabilities	306,415,703	308,799,258
Total Liabilities	370,523,808	380,299,351
NET ASSETS		
Invested in Capital Assets, Net of Related Debt	183,525,184	179,481,715
Restricted for:		
Expendable:		
Bond Covenants	59,247,775	50,837,344
Liability Insurance Trust Fund	100,000	3,409,869
Trust Fund Donations	386,492	382,756
Unrestricted	382,837,654	355,595,175
Total Net Assets	$ 626,097,105	$ 589,706,859

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

University of North Carolina Hospitals
Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Years Ended June 30, 2003 and 2002

Exhibit B

	2003	2002
REVENUES		
Operating Revenues:		
Net Patient Service Revenue (Note 8)	$ 482,299,891	$ 455,857,171
Other Operating Revenue	10,146,999	8,644,070
Prior Year Third Party Settlements	6,112,959	1,521,863
Total Operating Revenues	498,559,849	466,023,104
EXPENSES		
Operating Expenses:		
Salaries and Benefits	314,876,516	288,629,005
Medical and Surgical Supplies	90,594,373	88,582,472
Contracted Services	52,765,103	47,197,987
Other Supplies and Services	31,982,414	33,745,988
Communications, Utilities and Travel	13,375,047	14,611,763
Medical Malpractice Costs	5,543,292	1,754,408
Depreciation and Amortization	29,478,235	22,859,702
Total Operating Expenses	538,614,980	497,381,325
Operating Loss	(40,055,131)	(31,358,221)
NONOPERATING REVENUES (EXPENSES)		
State Appropriations	37,770,647	39,092,359
Investment Activity:		
Investment Income	23,835,063	32,724,336
Net Increase in Fair Value of Investments	24,214,142	8,260,539
Gain (Loss) on Investments in Affiliates	1,003,372	(1,181,178)
Interest and Fees on Capital Asset-Related Debt	(10,445,878)	(6,047,648)
Interest and Fees on Other Debt	(993,689)	(1,318,204)
Noncapital Unrestricted Gifts and Grants	2,056,685	1,602,705
Restricted Interest Income	15,201	16,784
Noncapital Restricted Gifts and Grants	86,635	35,500
Loss on Disposal of Capital Assets	(1,096,801)	(2,785,958)
Net Nonoperating Revenues	76,445,377	70,399,235
Increase in Net Assets	36,390,246	39,041,014
NET ASSETS		
Net Assets - Beginning of Year	589,706,859	550,665,845
Net Assets - End of Year	$ 626,097,105	$ 589,706,859

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

University of North Carolina Hospitals
Statement of Cash Flows
For the Fiscal Years Ended June 30, 2003 and 2002 — ***Exhibit C***

	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Received from Patients and Third Parties	$ 476,302,727	$ 454,400,520
Payments to Employees and Fringe Benefits	(309,733,098)	(285,385,821)
Payments to Vendors and Suppliers	(191,557,235)	(181,844,820)
Payments for Medical Malpractice	(1,336,289)	
Other Receipts	3,455,331	7,411,258
Net Cash Used by Operating Activities	(22,868,564)	(5,418,863)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State Appropriations	37,770,647	39,092,359
Interest Paid on Revenue Bonds	(1,216,572)	(1,318,204)
Principal Paid on Revenue Bond Maturities	(680,000)	(680,000)
Noncapital Gifts and Grants	2,143,320	1,654,989
Net Cash Provided by Noncapital Financing Activities	38,017,395	38,749,144
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES		
Proceeds from Sale of Capital Assets	422,471	65,836
Interest Paid on Capital Debt	(11,230,313)	(10,508,073)
Principal Paid on Revenue Bond Maturities	(4,160,000)	(4,000,000)
Principal Paid on Capital Lease and Notes Payable	(1,965,103)	(1,601,055)
Proceeds from Refunding Bonds for Issuance Costs	282,247	
Acquisition and Construction of Capital Assets	(51,450,218)	(48,443,128)
Issuance Costs Paid	(234,009)	
Net Cash Used by Capital Financing and Related Financing Activities	(68,334,925)	(64,486,420)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest Income	15,358,924	5,010,178
Proceeds from Sales of Investments with State Treasurer's Pool	435,860,457	20,000,000
Investments In and Loans to Affiliated Enterprises:		
Cash Received	5,632,837	1,734,248
Cash Payments	(7,293,753)	(1,070,496)
Net Cash Provided by Investing Activities	449,558,465	25,673,930
Net Increase (Decrease) in Cash and Cash Equivalents	396,372,371	(5,482,209)
Cash and Cash Equivalents, Beginning	87,975,150	93,457,359
Cash and Cash Equivalents, Ending	$ 484,347,521	$ 87,975,150

University of North Carolina Hospitals
Statement of Cash Flows ***Exhibit C***
For the Fiscal Years Ended June 30, 2003 and 2002 ***Page 2***

	2003	2002
RECONCILIATION OF NET OPERATING REVENUES (EXPENSES) TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating Loss	$ (40,055,131)	$ (31,358,221)
Adjustments to Reconcile Operating (Loss) to Net Cash Provided (Used) by Operating Activities:		
Depreciation and Amortization Expense	29,478,235	22,859,702
Changes in Assets and Liabilities:		
Patient Accounts Receivable	(8,980,629)	(2,848,180)
Other Accounts Receivable	(6,691,668)	(2,203,379)
Estimated Third Party Settlements	(3,346,335)	916,925
Inventories	(434,773)	(1,297,608)
Prepaid Expenses	1,031,543	936,695
Advance Deposits with Liability Insurance Trust Fund	4,207,003	1,754,408
Accrued Salaries and Benefits	3,472,468	1,534,936
Accounts and Other Payables	(3,437,068)	2,654,303
Due to Patients or Third Parties	286,380	(62,341)
Funds Held for Others	(69,539)	(14,351)
Compensated Absences	1,670,950	1,708,248
Net Cash Used by Operating Activities	$ (22,868,564)	$ (5,418,863)
RECONCILIATION OF CASH AND CASH EQUIVALENTS		
Current Assets:		
Cash and Cash Equivalents	$ 64,356,943	$ 25,084,240
Restricted Cash and Cash Equivalents	3,104,394	6,064,904
Noncurrent Assets:		
Cash and Cash Equivalents	319,736,429	878,459
Restricted Cash and Cash Equivalents	97,149,755	55,947,547
Total Cash and Cash Equivalents - End of Year	$ 484,347,521	$ 87,975,150
NONCASH INVESTING, CAPITAL AND FINANCING ACTIVITIES		
Change in Fair Value of Investments	$ 0	$ 8,316,041
Reinvested Distributions		29,178,736
Investments in Affiliated Enterprises:		
Current Gain from Discontinued Affiliated Operations	2,192,839	431,908
Current Loss from Equity Method Adjustments	(1,189,467)	(1,613,086)
Assets Acquired through the Assumption of a Liability	2,944,527	
Bonds Issued to Partially Refund Series 1996 Bonds	98,015,000	
Payment to Refunded Bond Escrow Agent	97,496,593	

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

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NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES:

A. Organization - The University of North Carolina Hospitals (the Hospitals) is the only State-owned teaching hospital in North Carolina. With a licensed base of 688 beds, this facility serves as an acute care teaching hospital for The University of North Carolina at Chapel Hill. The Hospitals consists of North Carolina Memorial Hospital, North Carolina Children's Hospital, North Carolina Neurosciences Hospital, and North Carolina Women's Hospital. As a State agency, the Hospitals is required to conform to financial requirements established by various statutory and constitutional provisions. While the Hospitals is exempt from both federal and State income taxes, a small portion of its revenue is subject to the unrelated business income tax.

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

The accompanying financial statements present all funds belonging to the Hospitals for which the UNC Health Care System Board of Directors is responsible. This includes Health System Properties, LLC (the LLC) which was established to purchase, develop and/or lease real property. Although a legally separate entity, the LLC is reported as part of the Hospitals because UNC Health Care System is the sole member manager of the LLC and is governed by the same Board that directs the Hospitals' operations. Additionally, the only property owned to date by the LLC in the Meadowmont Complex is for the sole use and benefit of the Hospitals.

Separate financial information for the LLC is maintained within the Hospitals' accounting system. Financial information may be obtained from the Chief Financial Officer, University of North Carolina Hospitals, 6011 East Wing, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-1727.

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

Pursuant to the provisions of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities and as amended by GASB Statement No. 37, Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, the full scope of the Hospitals' activities 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 Hospitals has elected to apply the provisions of all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs).

D. **Basis of Accounting** - The financial statements of the Hospitals 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 Hospitals receives (or gives) value without directly giving (or receiving) 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, if probable of collection.

E. **Cash and Cash Equivalents -** This classification includes petty cash, security deposits, cash on deposit in private bank accounts, 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.

F. **Investments -** The Hospitals' investments at June 30, 2002 were held by the State Treasurer in the long-term investment portfolio. During the current fiscal year, all investments were liquidated. Previously, investments were accounted for at fair value, as determined by quoted market prices, or an amount determined by management if quoted market prices are not available. The net increase in the fair value of investments is recognized as a component of investment activity.

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

H. **Other Receivables -** In addition to patient accounts receivable, the Hospitals recognizes other receivables related to its operations. These items include the sales tax refund due from the North Carolina Department of Revenue, amounts due from affiliates and other State agencies, and billings to outside companies for ancillary testing.

I. **Inventories -** Inventories consist of medical and surgical supplies, pharmaceuticals, prosthetics, and other supplies that are used to provide patient care or by service departments within the Hospitals. Inventories are stated at FIFO (first-in, first-out) cost.

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

The Hospitals capitalizes assets having a cost or fair value of at least $5,000 at the date of acquisition and an estimated useful life of three years or more. Useful life estimates are assigned based upon the American Hospital Association publication *Estimated Useful Lives of Depreciable Hospital Assets*.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 3 to 20 years for equipment, 10 to 50 years for buildings and fixed equipment, and 5 to 25 years for general infrastructure.

K. **Restricted Assets -** 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. Certain other assets are classified as restricted because their use is limited by external parties or statute.

L. **Bonds Payable -** Bonds payable are reported net of unamortized discount and deferred losses on refundings. The Hospitals amortizes bond discounts over the life of the bonds using the effective interest method. The deferred losses on refundings are amortized over the life of the old debt (new debt and old debt payoff at the same time) using the straight-line method. Bond issuance costs are amortized using the straight-line method over the life of the bonds.

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

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

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

Liability Calculation - The liability for accumulated annual leave, holiday leave, and PTO leave is calculated for each employee at year-end by taking the leave carried forward at the previous December 31 plus the leave earned, less the leave taken between January 1 and June 30. The liability is equal to the accumulated hours multiplied by the employee's current hourly rate plus benefits for social security and State retirement. The Hospitals has the policy of recording the cost of sick leave when taken and paid rather than when the leave is earned. Employees are not paid for accumulated sick leave upon termination; however, additional service credit for pension benefits is given for accumulated sick leave upon retirement.

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

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

Invested in Capital Assets, Net of Related Debt - This represents the Hospitals' total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

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

Unrestricted Net Assets - Unrestricted net assets include resources derived from patient care and ancillary services, unrestricted gifts and investment income.

Restricted and unrestricted resources are tracked using a fund accounting system and are spent in accordance with established fund authorities. Fund authorities provide rules for the fund activity and are separately established for restricted and unrestricted activities. When both restricted and unrestricted funds are available for expenditure, the decision for funding is transactional based and determined by Hospitals' departmental managers. For projects funded by tax-exempt debt proceeds and other sources, the debt proceeds are always used first.

O. Revenue and Expense Recognition - The Hospitals classifies its revenues and expenses as operating or nonoperating in the accompanying Statements 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 Hospitals' principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as charges for inpatient and outpatient services as well as external customers who purchase medical services. 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 and State appropriations that represent subsidies or gifts to the Hospitals, as well as investment income, are considered nonoperating since these are either investing, capital or noncapital financing activities.

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

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

Q. Medical Malpractice Costs - Medical malpractice costs represent the actuarially determined contribution to the Liability Insurance Trust Fund. See Note 11 for further discussion of the Liability Insurance Trust Fund.

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

NOTE 2 - DEPOSITS AND INVESTMENTS

A. Deposits - Unless specifically exempt, the Hospitals 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. In addition, the University of North Carolina Board of Governors, pursuant to General Statute 116-36.1, requires the Hospitals 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 Hospitals may voluntarily deposit endowment funds, special funds, revenue bond proceeds, debt service funds, and funds received for services rendered by health care professionals with the State Treasurer. Special funds consist of moneys for agency funds held directly by the Hospitals. Bond proceeds and debt service funds are invested in accordance with the bond resolutions in obligations which will by their terms mature on or before the date funds are expected to be required for expenditure or withdrawal.

At June 30, 2003, deposits include cash and cash equivalents of $484,329,831. Cash on hand was $17,690. The Hospitals' portion of the State Treasurer's Investment Pool was $484,084,121. It is the State Treasurer's policy and practice for deposits not covered by federal depository insurance to be covered by collateral held by the State of North Carolina's agent in the name of the State and for investments to be held by the State's agent in the State's name. The carrying amount of the Hospitals' deposits not with the State Treasurer was $245,710 and the bank balance was $234,245. Of the bank balance, $233,939 was covered by federal depository insurance and $306 was uninsured and uncollateralized.

At June 30, 2002, deposits include cash and cash equivalents of $87,956,801. Cash on hand was $18,349. The Hospitals' portion of the State Treasurer's Investment Pool was $87,879,021. It is the State Treasurer's policy and practice for deposits not covered by federal depository insurance to be covered by collateral held by the State of North Carolina's agent in the name of the State and for investments to be held by the State's agent in the State's name. The carrying amount of the Hospitals' deposits not with the State Treasurer was $77,780 and the bank balance was $75,508. Bank balances in excess of $100,000 are not covered by federal depository insurance. At June 30, 2002, no bank balance was in excess of $100,000.

North Carolina General Statutes 147-69.1(c), applicable to the State's General Fund and 147-69.2, applicable to institutional trust funds, authorize the State Treasurer to invest in the following: obligations of or fully guaranteed by the United States, obligations of certain federal agencies, repurchase agreements, obligations of the State of North Carolina, time deposits of specified institutions, prime quality commercial paper, and asset-backed securities with specified ratings. Also, General Statute 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified ratings. General Statute 147-69.2 authorizes the following: general obligations of other states, general obligations of North Carolina local governments, and obligations of certain entities with specified ratings.

The financial statements and disclosures for the State Treasurer's 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 - Investments consist of amounts held in the Long-Term Portfolio of the State Treasurer's Investment Pool. Total investments for 2003 and 2002 were $0 and $403,327,654, respectively. Since the Hospitals does not own specific identifiable securities, investments are not categorized as to the level of risk assumed by the entity at year-end.

NOTE 3 - PATIENT ACCOUNTS RECEIVABLE - NET

A. Current - Net patient accounts receivable consist of amounts due from patients and third parties at estimated realizable value. Included in gross receivables are amounts receivable at established billing rates less payments received through June 30. Allowances for uncollectible accounts and contractual adjustments are estimated using historical collection statistics and projections of reimbursement. The components of current net Patient Accounts Receivable reflected in the accompanying Statements of Net Assets are as follows at June 30, 2003 and 2002:

	2003	2002
In House Patients	$ 25,176,313	$ 20,122,843
Discharged (not final billed) Patients	19,604,933	24,674,681
Total Unbilled	44,781,246	44,797,524
Discharged Patients	132,125,400	120,353,988
Payment Arrangements	414,473	569,333
Indigent Care Provided	(16,778,749)	(17,727,151)
Current - Gross	160,542,370	147,993,694
Allowance for Bad Debts	(17,435,665)	(13,494,898)
Contractual Allowances	(39,883,213)	(40,920,788)
Total Allowances	(57,318,878)	(54,415,686)
Current - Net	$ 103,223,492	$ 93,578,008

B. Noncurrent - Net Patient Accounts Receivable consisted of $316,935 and $981,790 as of June 30, 2003 and 2002. Noncurrent amounts represent payment arrangements that extend beyond one year and are based on signed contractual agreements for a specific monthly payment amount.

NOTE 4 - ESTIMATED THIRD PARTY SETTLEMENTS

A. Medicare Passthrough Payments - Medicare makes interim payments to the Hospitals for certain portions of inpatient acute care costs that continue to be reimbursed at cost under the Prospective Payment System. The Hospitals earned $12,492,877 and $12,526,179 in passthrough payments for 2003 and 2002, including $958,322 earned but not received as of June 30, 2003 and $923,631 as of June 30, 2002.

B. **Tricare/Champus DRG-Based Payments:** Tricare/Champus is a federal insurance program for retired military personnel and their dependents. Tricare/Champus makes adjustments to its interim payments to the Hospitals for certain portions of direct medical education and capital costs. These amounts are computed upon completion of the Medicare Cost Report. The Hospitals estimated $3,311,644 in payments earned but not received as of June 30, 2003.

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

At June 30, 2003, the Hospitals estimated a current liability of $2,134,659 and $6,560,000 for amounts due to Medicare and Medicaid, respectively. Cost settlements estimated as noncurrent are $11,114,874 and $2,500,000 for Medicare and Medicaid, respectively.

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

NOTE 5 - CAPITAL ASSETS:

A summary of changes in 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	$ 20,775,682	$ 0	$ 1,603,054	$ 0	$ 22,378,736
Construction in Progress	34,300,887	(28,453,676)	12,854,490	(657,645)	18,044,056
Total Capital Assets, Nondepreciable	55,076,569	(28,453,676)	14,457,544	(657,645)	40,422,792
Capital Assets, Depreciable:					
Buildings	227,549,035	20,326,136		(31,913)	247,843,258
Equipment	234,025,343	8,127,540	37,532,109	(13,689,775)	265,995,217
General Infrastructure	5,693,590				5,693,590
Total Capital Assets, Depreciable	467,267,968	28,453,676	37,532,109	(13,721,688)	519,532,065
Less Accumulated Depreciation for:					
Buildings	51,319,591	214,457	7,001,325		58,535,373
Equipment	127,656,080	(204,753)	22,086,911	(12,860,061)	136,678,177
General Infrastructure	2,359,622	(9,704)	275,254		2,625,172
Total Accumulated Depreciation	181,335,293	0	29,363,490	(12,860,061)	197,838,722
Total Capital Assets, Depreciable, Net	285,932,675	28,453,676	8,168,619	(861,627)	321,693,343
Capital Assets, Net	$ 341,009,244	$ 0	$ 22,626,163	$ (1,519,272)	$ 362,116,135

NOTE 6 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of the 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	$ 3,611,124	$ 2,944,527	$ (1,746,283)	$ 4,809,368	$ 2,489,473
Capital Lease Payable	621,195		(218,821)	402,374	235,614
Total Accounts and Other Payables - Capital	$ 4,232,319	$ 2,944,527	$ (1,965,104)	$ 5,211,742	$ 2,725,087
Bonds Payable	$ 293,840,000	$ 98,015,000	$ (93,165,000)	$ 298,690,000	$ 5,545,000
Less: Discount	(5,134,394)		4,419,594	(714,800)	
Less: Deferred Charge on Refunding	(3,782,177)	(14,071,300)	352,325	(17,501,152)	
Total Bonds Payable	$ 284,923,429	$ 83,943,700	$ (88,393,081)	$ 280,474,048	$ 5,545,000
Arbitrage Rebate Payable	$ 2,236,169	$ 979,628	$ 0	$ 3,215,797	$ 0
Compensated Absences	$ 13,959,408	$ 23,206,124	$ (21,535,174)	$ 15,630,358	$ 3,461,029

Additional information regarding capital lease obligations is included in Note 7A.

B. Notes Payable - The Hospitals was indebted for notes payable for the purposes shown in the following table:

Purpose	Financial Institution	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2003	Principal Outstanding 06/30/2003
Purchase Computer Hardware and Software	IBM Global	4.82% to 6.83%	04/01/2005	$ 4,772,016	$ 2,907,175	$ 1,864,841
Patient Care Beds	Hill Rom	4.12%	12/15/2004	2,944,527		2,944,527
Dialysis Unit Upfit Costs	Chatham Mills	9.50%	07/31/2002	435,000	435,000	
Total Notes Payable				$ 8,151,543	$ 3,342,175	$ 4,809,368

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2003	Principal Outstanding 06/30/2003
Construction of Women's and Children's Hospitals	1996	4.20% to 5.375%	02/15/2005	$ 45,545,000	$ 6,755,000	$ 38,790,000
Refund 1992 Revenue Bonds	1999	4.00% to 5.25%	02/15/2024	58,925,000	5,040,000	53,885,000
Rex Acquisition and Hospital Renovations	2001A 2001B	Variable	02/15/2031	110,000,000	2,000,000	108,000,000
Refund portion of 1996 Revenue Bonds	2003A 2003B	Variable	02/01/2029	98,015,000	0	98,015,000
Total Bonds Payable (principal only)				$ 312,485,000	$ 13,795,000	298,690,000
Less: Unamortized Loss on Refunding						(17,501,152)
Less: Unamortized Discount						(714,800)
Total Bonds Payable						$ 280,474,048

D. Demand Bonds - Included in bonds payable are several 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 to the Hospitals’ remarketing agents.

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

University of North Carolina Hospitals at Chapel Hill Revenue Bonds-Series 2001A and Series 2001B: On January 31, 2001, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of $55,000,000 (2001A) and $55,000,000 (2001B) that have a final maturity date of February 15, 2031. The bonds are subject to mandatory sinking fund redemption that began on February 15, 2002. A portion of the proceeds was used to reimburse the Hospitals for $75,000,000 spent allowing the UNC Health Care System to acquire controlling interest in Rex Healthcare Inc. The remaining proceeds are to be used for the renovation of space vacated after the opening of the North Carolina Women’s Hospital, North Carolina Children’s Hospital, and associated support services. While initially bearing interest in a daily mode, the mode on these bonds may change to a weekly rate, a unit pricing rate, a term rate or a fixed rate.

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

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

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Formula Rate (Base Rate equal to the higher of the Prime Rate for such day or the sum of .50% plus the Federal Funds Rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is due quarterly (the first business day of January, April, July and October) for each period in which Bank Bonds are outstanding. At June 30, 2003 and 2002, there were no Bank Bonds held by the Liquidity Facility.

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

The current expiration date of the Agreements is July 27, 2004. The Hospitals may request additional extensions of up to 364 days. Extensions are at the discretion of Liquidity Provider.

University of North Carolina Hospitals at Chapel Hill Revenue Refunding Bonds-Series 2003A and Series 2003B: On February 13, 2003, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of $63,770,000 (2003A) and $34,245,000 (2003B) that have a final maturity date of February 1, 2029.

The bonds are subject to mandatory sinking fund redemption that begins on February 1, 2004. The proceeds were used to advance refund $88,325,000 of the Series 1996 Bonds. While initially bearing interest in a weekly mode, the mode on these bonds may change to a daily rate, a unit pricing rate, a term rate or a fixed rate.

The bonds are subject to purchase on demand with seven days' notice and delivery to the bond Tender Agent, Wachovia Bank, National Association. The Hospitals' remarketing agents, Banc of America Securities LLC (Series 2003A) or Wachovia Bank, National Association (Series 2003B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received.

Under separate Standby Bond Purchase Agreements for the Series 2003A and Series 2003B (Agreements) between the Hospitals and Bank of America, N.A. (Series 2003A) or Wachovia Bank, National Association (Series 2003B) a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require a facility fee equal to .20% for Series 2003A and .22% for Series 2003B of the available commitment, payable quarterly in advance, beginning on February 13, 2003, and on each February 1, May 1, August 1, and November 1 thereafter until the expiration date of the termination date of the Agreements.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Bank Bond Interest Rate (for Series 2003A, the rate equals LIBOR plus 2.50% for the first 90 days and then equals LIBOR plus 2.50%; for Series 2003B, the rate equals Prime Rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is on the first business day of each month for each period in which Bank Bonds are outstanding. At June 30, 2003, there were no Bank Bonds held by the Liquidity Facility.

The Hospitals is required to redeem (purchase) the Bank Bonds held by the Liquidity Facility for the Series 2003A on the first February 1, May 1, August 1 and November 1 that occurs at least 90 days after it originally becomes a bank bond. Alternatively, the purchase may be paid in twelve equal quarterly installments. For the Series 2003B, the purchase must occur on the date 90 days after the bond became a bank bond. Alternatively, the Bank can establish a loan to the Hospitals for the bank bonds with a repayment schedule of 36 monthly payments and an interest rate of Prime plus 1%.

The current expiration date of the Series 2003A Agreement is February 12, 2004 and February 13, 2005 for the Series 2003B Agreement. The Hospitals has requested and received an extension through June 30, 2005 on the Series 2003A Agreement. The Hospitals may request additional extensions which are approved at the discretion of the Liquidity Provider.

Interest Rate Swap Agreement

Objective: In order to protect against the risk of interest rate changes, the Hospitals entered into an interest rate swap contract agreement with Bank of America, N.A. (BOA) on February 13, 2003. The agreement covers the variable rate Revenue Refunding Bonds, Series 2003 A ($63,770,000) and Series 2003 B ($34,245,000). The 2003 series of bonds partially refunded fixed rate Revenue Bonds, Series 1996.

Terms, fair values, and credit risk: Under this agreement, BOA pays the Hospitals interest on the notional amount based on 67% of the arithmetic mean of the USD-LIBOR-BBA (with a designated maturity of one month) on a monthly basis. Also on a monthly basis, the Hospitals pays BOA interest at the fixed rate of 3.48%. No cash was paid or received by the Hospitals upon initiation of the agreement. The notional amount of the swap reduces annually; the reductions begin in February 2004 and end in February 2029. The swap agreement terminates February 1, 2029. As of June 30, 2003, rates were as follows:

	Terms	Rates
Fixed payment to BOA	Fixed	3.48
Variable payment from BOA	LIBOR(1)-BBA(2)	0.80
Net interest rate swap payments		2.68
Variable rate bond coupon payments		0.95
Synthetic interest rate on bonds		3.63

(1) London Inter-Bank Offered Rate
(2) British Bankers Association

Because rates have declined, the swap had a negative fair value of $5,972,285 as of June 30, 2003. BOA developed the fair value. Their method calculates the present value of 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 LIBOR due on the date of each future net settlement on the swap.

As of June 30, 2003, the Hospitals 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 Hospitals would be exposed to credit risk in the amount of the derivative's positive fair value. BOA is currently rated AA by Moody's Investor's Service, Aa1 by Standard and Poor's Corporation, and AA- by Fitch Ratings. At such time that their ratings fall below A3 for Moody's or below A- for S&P, BOA will be required to collateralize a portion of their exposure (up to 100%).

Basis risk: The Hospitals receives 67% of 1-month LIBOR-BBA Index from BOA and pays a floating rate to its bondholders set by the remarketing agent. The Hospitals incurs basis risk when its bonds trade at a yield above 67% of 1-month LIBOR-BBA Index. If the relationship of the Hospitals' bonds trade to a percentage of LIBOR greater than 67%, the Hospitals will experience an increase in debt service above the fixed rate on the swap.

Termination risk: The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The Hospitals or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If the swap is terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the Hospitals would be liable to the counterparty for that amount. Termination could result in the Hospitals being required to make an unanticipated termination payment.

Swap payments and associated debt: Using the rates as of June 30, 2003 for the 2003A and 2003B revenue bonds, debt service requirements of the variable rate debt and net swap payments, assuming current interest rates remain the same for their term, are as follows. As rates vary, variable rate bond interest payments and net swap payments will vary.

Fiscal Year	Principal	Interest	Interest Rate Swaps, Net	Total Payments
2004	$ 535,000	$ 938,218	$ 2,498,624	$ 3,971,842
2005	435,000	922,876	2,457,764	3,815,640
2006	455,000	920,163	2,450,539	3,825,702
2007	470,000	915,782	2,438,873	3,824,655
2008	490,000	912,709	2,430,687	3,833,396
2009-2013	2,725,000	4,480,513	11,932,314	19,137,827
2014-2018	17,095,000	4,158,639	11,075,113	32,328,752
2019-2023	30,665,000	2,920,984	7,779,041	41,365,025
2024-2028	36,910,000	1,325,972	3,531,271	41,767,243
2029	8,235,000	46,170	122,958	8,404,128
Total	$ 98,015,000	$ 17,542,026	$ 46,717,184	$ 162,274,210

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

	Bonds Payable	
Fiscal Year	Principal	Interest
2004	$ 5,545,000	$ 9,139,381
2005	5,615,000	8,895,619
2006	6,030,000	8,688,874
2007	6,245,000	8,461,465
2008	6,470,000	8,227,788
2009-2013	37,645,000	36,806,071
2014-2018	47,605,000	27,949,817
2019-2023	58,790,000	18,457,080
2024-2028	72,710,000	8,194,381
2029-2033	52,035,000	982,374
Total Requirements	$ 298,690,000	$ 135,802,850

Interest on the variable rate 2001A and 2001B revenue bonds is calculated at 1.00% based upon the daily rate at which the bonds were re-marketed on June 30, 2003. Interest on the variable rate 2003A and 2003B revenue bonds is calculated at .95% based upon the daily rate at which the bonds were re-marketed on June 30, 2003. In addition, the Hospitals has entered into an interest rate swap agreement to synthetically fix the rate on the 2003A and 2003B revenue bonds. See Note 6D for more information on the demand bonds and the interest rate swap agreement.

	Notes Payable	
Fiscal Year	Principal	Interest
2004	$ 2,489,473	$ 199,526
2005	2,319,895	81,126
Total Requirements	$ 4,809,368	$ 280,652

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

On February 13, 2003 the Hospitals defeased $88,325,000 of outstanding University of North Carolina Hospitals at Chapel Hill Revenue Bonds Series 1996 (original issue amount $133,870,000 of which $38,790,000 remains outstanding at June 30, 2003). 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 Hospitals' Statements of Net Assets. As a result, the Hospitals reduced its debt service requirements by an estimated $11,644,568 over the next 26 years and obtained an economic gain of $6,992,108. Since this is a synthetic fixed rate swap agreement, savings are estimated and will fluctuate dependent upon the basis risk associated with the bond issue. At June 30, 2003 the outstanding balance of the defeased University of North Carolina Hospitals at Chapel Hill Revenue Bonds Series 1996 was $88,325,000.

NOTE 7 - LEASE OBLIGATIONS

A. Capital Lease Obligations - Capital lease obligations relating to medical 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	$ 250,140
2005	166,760
Total Minimum Lease Payments	416,900
Amount Representing Interest (6% Rate of Interest)	14,526
Present Value of Future Lease Payments	$ 402,374

Medical equipment acquired under capital lease amounted to $541,805 at June 30, 2003.

B. Operating Lease Obligations - The Hospitals entered into operating leases for space rental. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2003:

Fiscal Year	Amount
2004	$ 839,053
2005	563,779
2006	269,848
2007	212,340
2008	189,793
Subsequent to 2008	424,122
Total Minimum Lease Payments	$ 2,498,935

Rental expense for all operating leases during the year was $1,511,820.

NOTE 8 - NET PATIENT SERVICE REVENUE

Medicare: The Hospitals is reimbursed for inpatient acute care services under the provisions of the Prospective Payment System (PPS). Under PPS, payment is made at predetermined rates for treating various diagnoses and performing procedures that have been grouped into defined diagnostic-related groups (DRGs) applicable to each patient discharge, rather than on the basis of the Hospitals' allowable charges. The difference in the standard hospital charge and the prospective payment for such services is reflected as an adjustment from patient service revenue. The DRG payments include adjustments for indirect medical education and disproportionate share.

Medicare reimburses inpatient capital-related costs based upon a predetermined amount per discharge. Beginning in 2002, the ten-year phase-in to the federal PPS rate ended and the Hospitals is now receiving one hundred percent of the federal PPS rate. Additionally, Medicare makes payments for Direct Graduate Medical Education (DGME) in support of the direct costs of residency training. These passthrough payments are discussed further in Note 4, Estimated Third Party Settlements.

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

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

Medicaid reimburses outpatient services on the basis of documented cost for all services except ambulance, hearing aids, durable medical equipment (DME), outpatient pharmacy, home health, dialysis and diagnostic laboratory services. Payment is made based on a tentative reimbursement rate with final settlement determined after submission of annual cost reports by the Hospitals. Cost reports are subject to audit by the Medicaid Program for a final determination of actual program costs.

Contracting Hospital Agreement (CHA): The Hospitals enters into a CHA each year with Blue Cross and Blue Shield of North Carolina (BCBS) whereby both parties accept a schedule of charges for all inpatient and outpatient services delivered. BCBS reimburses the Hospitals on behalf of its subscribers based upon 100% of the charges approved in the contract, less any deductibles or co-payments applicable to specific terms of insurance policies. All patient charges (regardless of payor) conform to the approved rates in the CHA and are subject to change at the Hospitals' discretion.

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

In general, all payments for inpatient and outpatient services are subject to deductibles and co-payments that are the patient's responsibility. Additionally, insurance plans may reimburse their subscribers or make direct payment to the Hospitals on an assignment of benefits basis.

A summary of net patient service revenue for the years ended June 30, 2003 and 2002 follows:

	2003	2002
Inpatient Routine	$ 201,325,157	$ 167,272,879
Inpatient Ancillary	389,546,521	356,062,599
Outpatient	287,616,312	266,634,851
Indigent Care Provided	(40,677,245)	(32,508,800)
Gross Patient Service Revenue	837,810,745	757,461,529
Medicare Contractual	(90,516,691)	(78,414,927)
Medicaid Contractual	(75,156,135)	(63,997,120)
Managed Care Contractual	(126,265,755)	(108,287,491)
Other Contractuals	(29,303,636)	(26,445,081)
Bad Debt	(34,268,637)	(24,459,739)
Contractual Adjustments	(355,510,854)	(301,604,358)
Net Patient Service Revenue	$ 482,299,891	$ 455,857,171

NOTE 9 - PENSION PLANS

A. **Retirement Plans -** Each permanent full-time employee, as a condition of employment, is a member of the Teachers' and State Employees' Retirement System (the System). The 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. Graduate medical residents, temporary employees and permanent part-time employees with appointments of less than 30 hours per week are not covered by the plan.

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

For the year ended June 30, 2003, the Hospitals had a total payroll of $231,967,959 of which $193,726,678 was covered under the System. Total employee and employer pension contributions for the year were $11,626,406 and $0, respectively. The Hospitals made one hundred percent of its employer required contributions to the System for the years ended June 30, 2003, 2002, and 2001, which were $0, $3,429,358, and $8,343,675, respectively.

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

B. **Deferred Compensation and Supplemental Retirement Income Plans** - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, the *North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the Hospitals. The voluntary contributions by employees amounted to $227,066 in 2003 and $138,458 in 2002.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the plan are the responsibility of the plan participants. No costs are incurred by the Hospitals except for a 5% employer contribution for the Hospitals' law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of Hospitals' law enforcement officers were $44,871 in 2003 and $38,881 in 2002. Voluntary contributions by employees amounted to $1,102,699 in 2003 and $938,378 in 2002.

IRC Section 403(b) and 403(b)(7) Plans - Eligible 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 Hospitals. Voluntary contributions by employees amounted to $4,059,245 in 2003 and $4,206,835 in 2002.

NOTE 10 - OTHER POSTEMPLOYMENT BENEFITS

A. Health Care for Long-Term Disability Beneficiaries and Retirees - The Hospitals participates in State-administered programs that 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. 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 Hospitals contributed 2.35% of the covered payroll under the Teachers' and State Employees'

Retirement System for these health care benefits. For the fiscal years ending June 30, 2003 and 2002, the Hospitals' total contribution to the plan was $4,552,311 and $4,090,858, respectively. The Hospitals assumes no liability for retiree health care benefits provided by the programs other than its required contributions. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report.*

B. Long-Term Disability - The Hospitals participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The Hospitals contributed 0.52% of covered payroll under the Teachers' and State Employees' Retirement System to the DIPNC. For the fiscal years ending June 30, 2003 and 2002, the Hospitals' total contribution to the plan was $1,007,320 and $905,211, respectively. The Hospitals assumes no liability for long-term disability benefits under the plan other than its contribution. Additional detailed information about DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 11 - RISK MANAGEMENT

The Hospitals is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled by a combination of methods, including participation in State-administered insurance programs, purchase of commercial insurance and self-retention of certain risks. There have been no significant reductions in insurance coverage from the previous year and settled claims have not exceeded coverage in any of the past three fiscal years.

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

The Hospitals is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a $500 per occurrence deductible. The Hospitals also purchased through the Fund "all risks" replacement cost basis insurance for buildings and contents subject to a $25,000 per occurrence deductible. No significant losses occurred during the year.

All State-owned vehicles are covered by liability insurance through a private insurance company and handled by the North Carolina Department of Insurance. The liability limits for losses occurring in-State are $500,000 per claim and $5,000,000 per occurrence and out-of-State are $1,000,000 per claim and $5,000,000 per occurrence. The Hospitals pays premiums to the North Carolina Department of Insurance for the coverage.

The Hospitals is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is handled by the North Carolina Department of Insurance. The Hospitals is charged a premium by the private insurance company. Coverage limit is $5,000,000 per occurrence with a $50,000 deductible and a 10% participation in each loss above the deductible.

The Hospitals purchased other authorized coverages from private insurance companies through the North Carolina Department of Insurance. These coverages include:

- Boiler and Machinery insurance up to $25,000,000 with a deductible of $5,000 per occurrence

- Directors and Officers Liability insurance up to $10,000,000 with a deductible of $200,000 per occurrence

- Master Crime insurance up to $500,000 with a deductible of $1,000

- Comprehensive General Liability insurance up to $2,000,000 with a deductible of $10,000 per occurrence

- Automobile Physical Damage (for vehicles costing greater than $75,000) insurance up to $5,000,000 per accident with a deductible of $500 per occurrence

- General Liability for Helipad on Premises insurance up to $20,000,000 with a deductible of $7,500 per occurrence

- General Liability for Non-owned Aircraft insurance up to $20,000,000 with no deductible

- Business Travel insurance for aircraft flight team up to $600,000 per accident with no deductible

- Computerized Business Equipment replacement cost insurance up to $1,246,204 with a deductible of $10,000 per occurrence

- Fine Arts Floater insurance up to $50,000 ($5,000 per item) with a deductible of $1,000 per occurrence

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

Term life insurance (death benefits) of $25,000 to $50,000 is provided to eligible workers. This Death Benefit Plan is administered by the State Treasurer and funded via employer contributions. The employer contribution rate was 0.16% for the fiscal years ending June 30, 2003 and 2002.

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

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

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

Participation in the Fund is open to the University of North Carolina, any constituent institution of the University of North Carolina, the Hospitals, and any health care institution, agency or entity 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 UNC P&A and the Hospitals have participated in the Fund to date. Participants provide management and administrative services to the Fund at no cost.

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

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

The Fund provides occurrence coverage for entity participants as well as the individual employees and professional staff participants within the course and scope of their employment. For the period July 1, 2002 through April 30, 2003, the Fund provides coverage on a claims made basis of $7,000,000 for each and every claim and for the next $10,000,000 per claim/annual aggregate. Effective May 1, 2003, the Fund provides coverage on a claims made basis of $7,000,000 for each and every claim. For the period July 1, 2002 through April 30, 2003, the Fund purchased an excess policy on a claims made basis for $40,000,000 of coverage above the self-insured retention. As of May 1, 2003, the Fund had no excess of loss reinsurance coverage. For the year ending June 30, 2002, the Fund provides coverage of $3,500,000 per occurrence and $12,000,000 annual aggregate. Commercial excess insurance of $25,000,000 per occurrence and $50,000,000 annual aggregate is provided above the self-insurance retention limits. The Fund provides coverage of $500,000 per occurrence, in accordance with the limited waiver of sovereign immunity afforded by the State Tort Claims Act, for any recovery against the entity participants for the negligence of its employees. To assure that both existing and future claims will be paid, the Board of Governors of the University of North Carolina is authorized by law to borrow up to $30 million to replenish the Trust Fund. No borrowings have been made under this line of credit to date. The Council believes adequate funds are on deposit in the Fund to meet estimated losses based upon the results of the independent actuary's report.

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

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

At June 30, 2003 and 2002, the Hospitals had advance deposits with the Fund totaling $100,000 and $3,409,869, respectively.

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

NOTE 12 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The Hospitals has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments at June 30, 2003 and 2002 on construction contracts were $9,593,198 and $14,934,094, respectively.

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

NOTE 13 - RELATED PARTY TRANSACTIONS

Medical Foundation of North Carolina - The Hospitals is a participant in the Medical Foundation of North Carolina, a nonprofit Foundation for the University of North Carolina at Chapel Hill and the Hospitals, which solicits gifts and grants for both entities. The Board of Directors of the Medical Foundation administers the funds of the Foundation. Transactions are recorded only by the Foundation. If the Foundation were to purchase any equipment for the Hospitals, then the amount would be recorded at the time of receipt in the accompanying financial statements.

UNC Health Care System - On April 13, 2000, the UNC Health Care System (System) entered into a contractual agreement with Rex Healthcare, Inc. (Rex) and the John Rex Endowment (a private, nonprofit corporation separate from the System) to gain a controlling interest in the governance of Rex Healthcare Inc. and related entities. At the signing of the agreement, the Hospitals transferred $100 million on behalf of the System to the John Rex Endowment as a result of the contractual agreement. The transaction was recorded as an equity transfer. In addition, the agreement calls for future funding of Rex capital needs for the next ten years up to $58 million. To date, there have been no calls under the agreement, because the capital needs have been funded by Rex's operating surplus.

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

Carolina Dialysis, LLC – On July 1, 2002, UNC Hospitals and Renal Research Institute (RRI) entered into a joint venture for the purpose of operating chronic outpatient dialysis facilities programs and improving the quality of care to end-stage renal disease patients. Carolina Dialysis LLC (a North Carolina limited liability company) was established to formalize the joint venture. UNC Hospitals contributed the assets of its dialysis facilities to the LLC and RRI purchased one-third ownership of the assets of the LLC from UNC Hospitals. The two partners in the joint venture share the revenues and expenses from operations on a one-third / two-third basis. A six-member board governs the LLC with two members from RRI, two members from UNC Hospitals and two members from University of North at Chapel Hill School of Medicine.

NOTE 14 - INVESTMENTS IN AFFILIATES

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were $6,180,368 and $4,116,327 at June 30, 2003 and 2002. The Hospitals' share of these affiliates and joint ventures is not significant individually. The summarized unaudited financial information below represents an aggregation of the affiliates and joint ventures:

	(unaudited) 2003	(unaudited) 2002
TOTAL AFFILIATE ACTIVITY		
Current Assets	$ 19,048,872	$ 11,130,750
Noncurrent Assets	11,685,463	4,186,188
Current Liabilities	8,227,087	6,742,224
Noncurrent Liabilities	631	3,101
Shareholders Equity	22,506,617	8,571,613
Revenue	30,204,749	21,222,908
Net Gain (Loss)	361,385	(1,814,695)
HOSPITALS' SHARE OF ACTIVITY		
Affiliate Loss - Ongoing Operations	(1,189,467)	(1,613,086)
Affiliate Gain - Discontinued Operations	2,192,839	431,908
Total Gain (Loss) Realized from Affiliate Activities	$ 1,003,372	$ (1,181,178)

NOTE 15 - ACCOUNTING CHANGES

For the fiscal year ended June 30, 2003, the Hospitals implemented GASB Technical Bulletin No. 2003-1 that 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 Hospitals' objective for entering into the derivative and the derivative's terms, fair value, associated debt, and risk exposures.

For the fiscal year ended June 30, 2003, the Hospitals changed its method of classifying restricted cash and cash equivalents on the Statement of Cash Flows. Restricted cash and cash equivalents is reported on the Statement of Cash Flows, whereas in prior years it was classified as investments and excluded. Cash and cash equivalents was restated for the prior year to reflect this change.

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

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

We have audited the financial statements of the University of North Carolina Hospitals, which is a part of The University of North Carolina Health Care System, which is a part of The University of North Carolina System, a component unit of the State of North Carolina, as of and for the years ended June 30, 2003 and 2002, and have issued our report thereon dated December 11, 2003.

As discussed in Note 1, the financial statements present only the University of North Carolina Hospitals and are not intended to present fairly the financial position of The University of North Carolina Health Care System and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America. As discussed in Note 15 to the financial statements, the Hospitals implemented Governmental Accounting Standards Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statements of Net Assets,* during the year ended June 30, 2003. The Hospitals also changed its method of classifying restricted cash and cash equivalents on the Statement of Cash Flows for the fiscal year ended June 30, 2003.

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

Compliance

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

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

Internal Control Over Financial Reporting

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

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

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

December 11, 2003

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

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The Honorable Richard H. Moore	State Treasurer
The Honorable Roy A. Cooper, III	Attorney General
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Mr. Eric B. Munson	President and Chief Executive Officer University of North Carolina Hospitals
Mr. Charles F. Ayscue	Senior Vice President and Chief Financial Officer University of North Carolina Hospitals
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February 20, 2004

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