



# **STATE OF NORTH CAROLINA**

**FINANCIAL STATEMENT AUDIT REPORT OF**

**THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL**

**CHAPEL HILL, NORTH CAROLINA**

**FOR THE YEAR ENDED JUNE 30, 2004**

**OFFICE OF THE STATE AUDITOR**

**LESLIE W. MERRITT, JR., CPA, CFP**

**STATE AUDITOR**

**FINANCIAL STATEMENT AUDIT REPORT OF**  
**THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL**  
**CHAPEL HILL, NORTH CAROLINA**  
**FOR THE YEAR ENDED JUNE 30, 2004**

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**AUDITOR'S TRANSMITTAL**

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

This report presents the results of our financial statement audit of The University of North Carolina at Chapel Hill, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, for the year ended June 30, 2004. Our audit was made by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

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

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

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

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

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

## AUDITOR'S TRANSMITTAL (CONCLUDED)

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

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

### **Finding**

Noncompliance with the Daily Deposit and Reporting Law

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

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

**Results** - Our tests disclosed no significant deficiencies in internal control over compliance and no instances of noncompliance which require disclosure herein under *OMB Circular A-133*.

*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.

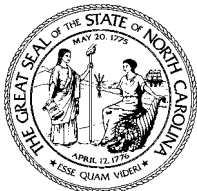


Leslie W. Merritt, Jr., CPA, CFP.  
State Auditor

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**INDEPENDENT AUDITOR'S REPORT**

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

We have audited the accompanying financial statements of The University of North Carolina at Chapel Hill, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component units, as of and for the year ended June 30, 2004, which collectively comprise The University of North Carolina at Chapel Hill's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., which represent 100% of the University's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for those entities, is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., were not audited in accordance with *Government Auditing Standards*. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provides a reasonable basis for our opinions.

## INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of The University of North Carolina at Chapel Hill and its discretely presented component units, as of June 30, 2004, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 17 to the financial statements, the University implemented Governmental Accounting Standards Board Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, during the year ended June 30, 2004.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 12, 2004, on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis, 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 required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise The University of North Carolina at Chapel Hill's basic financial statements. Schedule 1 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



Leslie W. Merritt, Jr., CPA, CFP  
State Auditor

November 12, 2004

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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### Introduction

Management's discussion and analysis provides an introduction and overview of the financial position and activities of The University of North Carolina at Chapel Hill (the "University") for the fiscal year ended June 30, 2004, with comparative information for the fiscal year ended June 30, 2003. Certain prior year amounts have been reclassified to conform to current year presentations. Management has prepared the discussion and analysis to be read in conjunction with the financial statements and accompanying note disclosures.

The University is a constituent institution of the sixteen-campus University of North Carolina System (UNC System), a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report*. Established in 1789, the University was the first State University to open its doors and the only public university in America to award degrees to students in the 18th Century. Through its teaching, research, and public service, the University is an educational and economic beacon for the people of North Carolina and beyond. Now in its third century, Carolina offers bachelor's, master's, doctoral, and professional degrees in academic areas critical to North Carolina's future: business, dentistry, education, law, medicine, nursing, pharmacy, public health, and social work, among others. The health sciences are well integrated with the liberal arts, basic sciences, and high-tech programs. Patient outreach programs affiliated with Carolina and the UNC Health Care System serve citizens in all 100 North Carolina counties.

For the fiscal year ended June 30, 2004, the University implemented Governmental Accounting Standards Board (GASB) Statement No. 39, *Determining Whether Certain Organizations are Component Units*. This Statement amends GASB Statement No. 14, *The Financial Reporting Entity*, to provide additional guidance to determine whether certain organizations for which the University is not financially accountable should be reported as component units based on the nature and significance of their relationship to the University. Note 1A of the financial statements describes the Financial Reporting Entity, which is comprised of the University and its component units.

The Financial Reporting Entity for the financial statements is comprised of the University and ten component units. Although legally separate, The University of North Carolina at Chapel Hill Foundation Investment Fund, Inc., UNC Investment Fund, LLC, UNC Management Company, Inc., The University of North Carolina at Chapel Hill Foundation, Inc., The Kenan-Flagler Business School Foundation, The School of Social Work Foundation Inc., and UNC Law Foundation, Inc., are reported as if they were part of the University.

Separate financial statements for three other component units are reported based on GASB Statement No. 39. The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc. are legally separate, nonprofit, tax-exempt organizations that are reported as discretely presented component units based on the nature and significance of their relationship to the University.



## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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Management's Discussion and Analysis includes a separate section regarding the three component units that are discretely reported in the financial statements. The rest of Management's Discussion and Analysis pertains to the University and the seven component units reported as part of the University.

### Financial Highlights

The University's financial position at June 30, 2004, remained solid with total assets of \$3.6 billion. Net assets, which represent the residual interest in the University's assets after deducting liabilities, were \$2.2 billion at June 30, 2004. The University's net assets increased by \$216 million in fiscal year 2003-2004, when operating, nonoperating, and other changes are included. Changes in net assets and total assets are summarized below:

	<u>2004</u>	<u>2003</u>	<u>% Change</u>
Net Assets - July 1	\$ 2,025,185,600	\$ 1,964,418,046	3.1
Increase in Net Assets	<u>216,013,557</u>	<u>60,767,554</u>	255.5
Net Assets - June 30	2,241,199,157	2,025,185,600	10.7
Total Liabilities	<u>1,357,712,327</u>	<u>1,112,017,605</u>	22.1
Total Assets	<u>\$ 3,598,911,484</u>	<u>\$ 3,137,203,205</u>	14.7

The significant increase in net assets included a modest increase in State appropriations. State appropriations continue to provide essential resources to support the University's mission. Continued capital funding through the North Carolina Higher Education Bond Referendum of 2000, controlled enrollment growth, a robust research program, the continuing success of the Carolina First fund-raising campaign, and the successful investments made through the management program were among the other factors resulting in the noteworthy financial results for the fiscal year.

### Using the Financial Statements

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

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

These financial statements have been prepared in accordance with Governmental Accounting Standards Board (GASB) statements. The GASB sets standards for external financial reporting for public colleges and universities and requires that financial statements be presented on a consolidated basis to focus on the entire University.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

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Other important characteristics of the financial statements include the following:

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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

### Condensed Statement of Net Assets

The Statement of Net Assets presents the financial position of the University at the end of the fiscal year, includes all assets and liabilities of the University and segregates the assets and liabilities into current and noncurrent components. Net assets represent the difference between total assets and total liabilities, and are one indicator of the University's current financial condition. The following table summarizes the University's assets, liabilities, and net assets at June 30, 2004, and 2003.

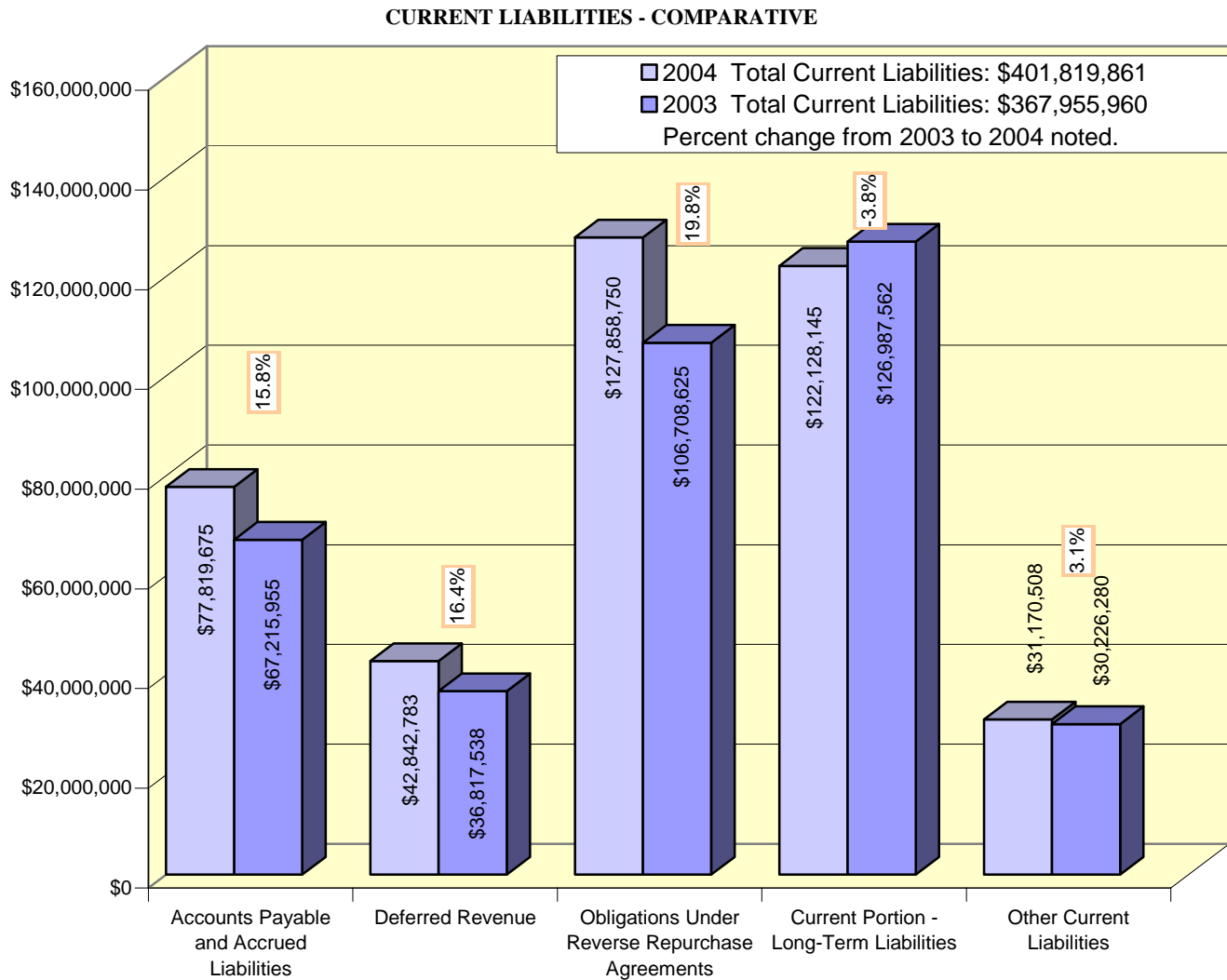
	2004	2003	% Change
<b>Assets:</b>			
Current Assets	\$ 810,667,402	\$ 735,583,502	10.2
Noncurrent Assets:			
Endowment Investments	848,469,859	754,623,099	12.4
Other Long-Term Investments	505,076,807	377,744,985	33.7
Capital Assets, Net	1,276,669,341	1,134,221,485	12.6
Other Noncurrent Assets	<u>158,028,075</u>	<u>135,030,134</u>	17.0
<b>Total Assets</b>	<u>3,598,911,484</u>	<u>3,137,203,205</u>	14.7
<b>Liabilities:</b>			
Current Liabilities	401,819,861	367,955,960	9.2
Noncurrent Liabilities:			
Funds Held in Trust for Pool Participants	440,811,149	345,883,384	27.4
Long-Term Liabilities	482,557,455	366,628,262	31.6
Other Noncurrent Liabilities	<u>32,523,862</u>	<u>31,549,999</u>	3.1
<b>Total Liabilities</b>	<u>1,357,712,327</u>	<u>1,112,017,605</u>	22.1
<b>Net Assets:</b>			
Invested in Capital Assets, Net of Related Debt	855,739,608	771,280,637	11.0
Restricted:			
Nonexpendable	328,735,341	323,961,205	1.5
Expendable	648,019,434	559,127,937	15.9
Unrestricted	<u>408,704,774</u>	<u>370,815,821</u>	10.2
<b>Total Net Assets</b>	<u>\$ 2,241,199,157</u>	<u>\$ 2,025,185,600</u>	10.7

### Current Assets and Liabilities

The Statement of Net Assets shows the University had total assets of \$3.6 billion at June 30, 2004, an increase of 14.7% over the prior year. Working capital, which is current assets less current liabilities, was \$408.8 million at June 30, 2004, an increase of 11.2% over the previous year. Factors causing the working capital increase include a decline in the liability for temporary financing for capital construction through the commercial paper program and an increase in-patient accounts receivables resulting from adjustments for uncollectible billings.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

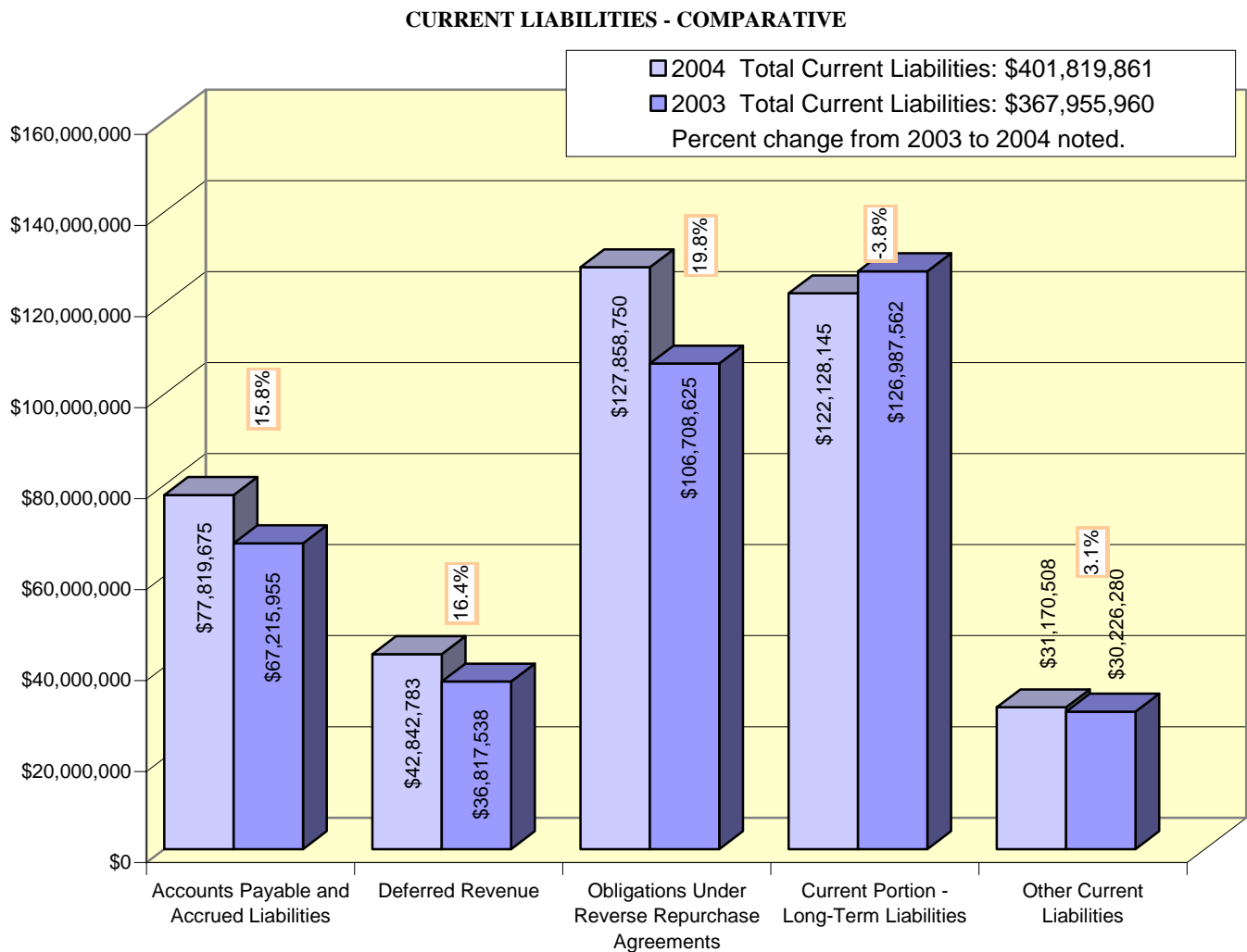
Current assets are represented graphically below:



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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Current liabilities are represented graphically below:



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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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

### **Endowment and Other Long-Term Investments**

Endowment investments were \$848.5 million at June 30, 2004, and include permanent endowments, funds internally designated as endowments, and similar funds such as gift annuities and charitable trusts. Net assets of endowment and similar funds were \$801.3 million at June 30, 2004.

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

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

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

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

The investment objective is to earn an average real total return of at least 5.5% per year, net of all fees, over rolling five and ten year periods. The earnings distribution policy is to provide a stable source of spending support that is sustainable over the long term while preserving the purchasing power of the endowment. The earnings distribution rate was established at 5% of

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

the previous year's market value, with annual increases based on inflationary factors. Each year's distribution is subject to a 4% floor and a 7% cap based on estimated fiscal year-end market value.

Other long-term investments of \$505.1 million include funds of \$422.6 million of affiliated entities that are not part of the University's financial reporting entity but do invest through the System Fund, and bond reserves and related funds of \$82.5 million.

Most of the University's endowment assets are managed within the System Fund, a pooled investment fund vehicle. The System Fund is designed to provide long-term, stable rates of return on the invested assets through the use of a highly diversified portfolio strategy. The nominal return on the endowment assets invested in the System Fund for fiscal year 2003-2004 was 16%, with a real return of 12.8% after inflation. The System Fund return of 16% was above the Strategic Investment Policy Portfolio ("SIPP") return of 15.4% and above the 70% S&P 500/30% Lehman Brothers Bond Index ("70/30") return of 13.3% for the year. The strong performance follows on the heels of superior performance over prior periods. For the three-year period ended June 30, 2004, the System Fund returned 6.3% versus the SIPP return of 3.3% and the 70/30 return of 1.7%. For the five-year period ended June 30, 2004, the System Fund returned 8.1% versus the SIPP return of 4% and the 70/30 return of 0.8%.

The noted returns were achieved while assuming less overall risk than the benchmark indexes. The volatility of performance metric, as measured by the standard deviation of returns, is a useful measure (lower volatility is better). For the fiscal year 2003-2004, the System's Fund's monthly volatility was 1.0% versus the S&P's volatility of 2.3% and the 70/30 index volatility of 1.7%. For the three-year period ended June 30, 2003, the System Fund's volatility was 1.3% versus the S&P's volatility of 4.8% and the 70/30 volatility of 3.3%. For the five-year period ended June 30, 2003, the System Fund's volatility was 2.3% versus the S&P's volatility of 4.8% and the 70/30 volatility of 3.4%. The System Fund is very well positioned in the current environment, and remains invested according to the approved investment policy that provides excellent diversification in both bull and bear markets.

### Capital Assets and Debt Management

Capital assets, net of accumulated depreciation, at June 30, 2004, and June 30, 2003, were as follows:

	2004	2003	% Change
<b>Capital Assets:</b>			
Construction in Progress	\$ 219,339,291	\$ 226,958,080	(3.4)
Land and Other Nondepreciable Assets	85,103,216	81,080,269	5.0
Buildings	703,546,321	546,453,143	28.7
General Infrastructure	187,589,810	198,911,507	(5.7)
Machinery and Equipment	81,090,703	80,818,486	0.3
<b>Total</b>	<b>\$ 1,276,669,341</b>	<b>\$ 1,134,221,485</b>	<b>12.6</b>

A summary of changes in capital assets is disclosed in Note 5.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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The University's method of capital planning is a long-term process that is continuously reevaluated. The University Board of Trustees approved the Campus Master Plan in March 2001, to guide the University's physical development in the 21st century. The Master Plan meshes the critical pieces needed for smart growth in the 21<sup>st</sup> century – transportation, parking, housing, utilities and environmental sustainability – with the program needs of a growing campus. The Master Plan combines the practical requirements of a research university with the beauty that inspired its founders. The University will grow dramatically in the coming years. With the Master Plan, that growth will improve the way campus works and extend the University's historic legacy of beautiful buildings and grounds to every corner of campus.

The University is engaged in a \$1.3 billion capital construction program that began in 2000, and will continue through the next four years. This program includes major capital renewal of existing buildings and infrastructure to address both deferred maintenance and programmatic needs. Additionally, expansion of campus facilities will allow the University to accommodate the enrollment growth projected over the next decade.

Major projects completed in fiscal year 2003-2004, include:

New Construction

Frank Porter Graham Student Union Addition	\$	14,153,300
Administrative Office Building		10,500,000
Sonja Haynes Stone Black Cultural Center		9,000,000

Major Renovations of Academic Buildings

Knapp Building - School of Government	\$	21,151,200
Peabody Hall		8,509,800
Original School of Dentistry Building		8,400,000

Completed projects represent 24% of the \$1.3 billion capital construction program, 28% of the projects are under construction, and 48% are in the design phase.

The Higher Education Bond Referendum, overwhelmingly approved in 2000 by North Carolina's voters, is providing nearly \$510 million for this program. The University is investing in its capital construction program using a variety of other funding sources including University bonds, cost reimbursements from research grants, internal reserves, and private gifts. Previous changes in State legislation allowed the University to pledge a broader stream of revenues as security for its debt obligations, and general revenue bonds were initially issued in fiscal year 2000-2001. In December 2003, the University issued \$108 million in fixed-rate bonds to finance certain capital construction projects. The general revenue pledge results in a stronger, more flexible security that captures the strengths of not only the University's auxiliary and student-related revenues, but also its research programs.



## **MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

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The University continues to use its commercial paper program that provides low-cost bridge financing for capital projects until gifts are received or in anticipation of an external bond issue. Commercial paper debt was \$8.8 million at June 30, 2004. The commercial paper program and the general revenue bonds allow the University to use a central bank concept for funding capital projects. The University issues fixed and variable rate debt externally, and blends the average borrowing rate to allocate debt costs to individual capital projects and campus divisions. This concept provides a stable and flexible debt-funding source for capital projects.

The interest rate on the commercial paper program for fiscal year 2003-2004, was 0.98%. Interest rates on the University's variable rate, long-term bonds were 1% for fiscal year 2003-2004. Interest rates on fixed rate, long-term bonds are disclosed in Note 8B of the financial statements.

The University's financial strength allowed it to achieve ratings of AA+/Aa1 by the national rating agencies. The University debt burden ratio, a measure of an entity's dependence on borrowed funds, was only 2.7% at June 30, 2004, and 2.1% for the prior year.

### **Other Noncurrent Assets**

Other noncurrent assets were \$158 million at June 30, 2004, a 17% increase over the prior year. Included in this category are restricted cash and cash equivalents of \$70.8 million, receivables for pledged gifts of \$29.5 million, notes receivable for student loans of \$29.3 million, investment in a joint venture of \$8.3 million, and restricted resources due from the primary government of \$20.1 million.

The increase over the prior year resulted from several factors. Restricted resources due from the primary government increased 27.1% and represent receivables for designated capital construction projects funded from proceeds from statewide higher education bonds. Notes receivable for student loans increased 16.1% based on additional loan advances under federal loan programs and a decrease in borrowers in repayment status. Pledged gifts increased 7.7% as the fundraising program continues. The investment in a joint venture represents the construction of the Southern Astrophysical Research Telescope (SOAR), situated in Cerro Pachon, Chile in South America, as part of an international consortium including UNC-Chapel Hill.

### **Noncurrent Liabilities**

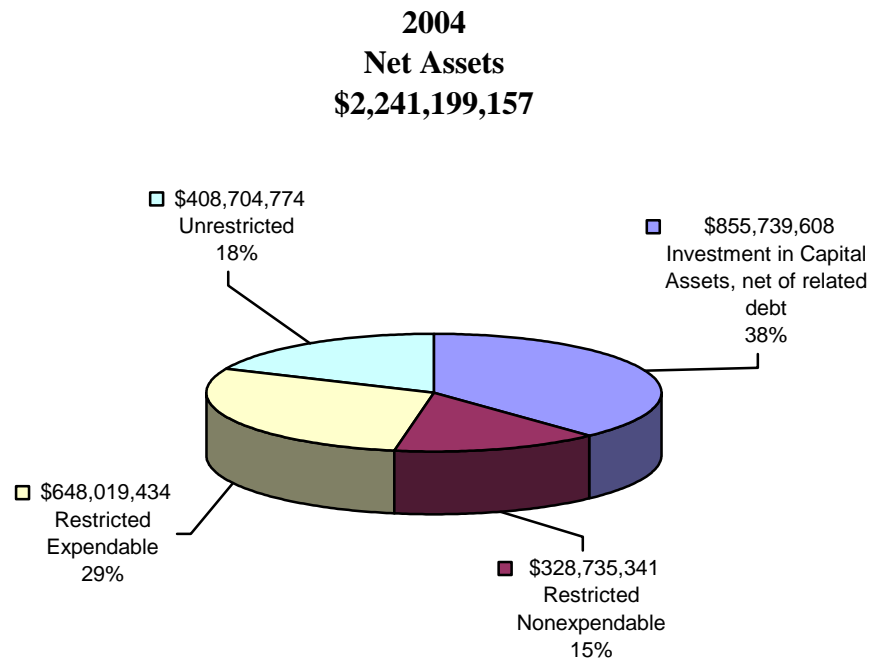
Noncurrent liabilities were \$955.9 million at June 30, 2004, and include funds of \$440.8 million held for the University's affiliated foundations and other campuses in the UNC System and their affiliates. These entities are not part of the University's financial reporting entity but do invest through the System Fund. The increase in 27.4% over the prior year resulted from improved investment performance, participant contributions, and the addition of additional, qualifying entities. Other noncurrent liabilities of \$32.5 million are refundable U.S. government grants that provide resources for student loan programs.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Long-term liabilities of \$482.6 million are the noncurrent portion of bonds payable, notes payable, capital leases payable, compensated absences, and annuities payable. The increase of 31.6% over the prior year resulted from University's issuance of \$108 million in fixed-rate general revenue bonds to finance certain capital construction projects. A second factor was the increase of \$16.1 million in noncurrent compensated absences as State of North Carolina employees were awarded two weeks of bonus leave for the second consecutive fiscal year. The reader may refer to Note 8 for summary of changes in long-term liabilities.

### Net Assets

Net assets represent the value of the University's assets after liabilities are deducted. The University's net assets at June 30, 2004, were \$2.2 billion and are presented graphically below:



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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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

The Statement of Revenues, Expenses, and Changes in Net Assets presents the University's results of operations. The statement for the fiscal year ended June 30, 2004, and the prior year is summarized as follows:

	2004	2003	% Change
<b>Operating Revenues:</b>			
Student Tuition and Fees, Net	\$ 153,943,215	\$ 146,961,417	4.8
Grants and Contracts	499,798,678	455,680,436	9.7
Sales and Services, Net	443,227,663	393,361,966	12.7
Other	5,667,765	7,563,970	(25.1)
<b>Total Operating Revenues</b>	<b>1,102,637,321</b>	<b>1,003,567,789</b>	<b>9.9</b>
<b>Operating Expenses:</b>			
Salaries and Benefits	917,840,235	876,265,477	4.7
Supplies and Materials	151,196,308	146,986,272	2.9
Services	380,125,640	377,855,970	0.6
Scholarships and Fellowships	47,427,018	45,618,092	4.0
Utilities	46,207,389	43,914,948	5.2
Depreciation	60,589,122	53,075,830	14.2
<b>Total Operating Expenses</b>	<b>1,603,385,712</b>	<b>1,543,716,589</b>	<b>3.9</b>
<b>Operating Loss</b>	<b>(500,748,391)</b>	<b>(540,148,800)</b>	<b>(7.3)</b>
<b>Nonoperating Revenues (Expenses):</b>			
State Appropriations	380,446,327	368,024,036	3.4
Noncapital Grants	53,153,741	40,994,829	29.7
Noncapital Gifts, Net	68,517,192	60,887,596	12.5
Investment Income, Net	135,369,198	47,398,174	185.6
Interest and Fees on Capital Asset-Related Debt	(18,339,114)	(15,680,788)	17.0
Other Nonoperating Revenues (Expenses)	(8,132,036)	(1,899,072)	328.2
<b>Income (Loss) Before Other Changes</b>	<b>110,266,917</b>	<b>(40,424,025)</b>	<b>372.8</b>
Capital Grants	74,392,000	72,486,349	2.6
Capital Appropriations	897,387		
Capital Gifts, Net	6,358,879	7,552,718	(15.8)
Additions to Permanent Endowments	24,098,374	21,152,512	13.9
<b>Increase in Net Assets</b>	<b>216,013,557</b>	<b>60,767,554</b>	<b>255.5</b>
<b>Net Assets - July 1</b>	<b>2,025,185,600</b>	<b>1,964,418,046</b>	<b>3.1</b>
<b>Net Assets - June 30</b>	<b>\$ 2,241,199,157</b>	<b>\$ 2,025,185,600</b>	<b>10.7</b>

### Operating Revenues

The operating revenues represent resources generated by the University in fulfilling its instruction, research, and public service missions. Student tuition and fees are reported net of the scholarship discount, which was \$33.3 million for fiscal year 2003-2004, and \$31.5 million for the prior year. Total revenues from student tuition and fees increased 4.8% over the prior year. Factors increasing revenues from tuition and fees were an inflationary rate increase of 5.0% for undergraduate students and for resident graduate students, an inflationary rate increase of 3.4% for nonresident graduate students, and an additional rate increase for one of the professional schools. The revenue growth from the rate increases was offset by a shift in residency status among graduate students from non-resident to resident.

Revenues from contracts and grants increased 9.7% over the prior year. Discussion of contracts and grants in terms of awards also provides a useful perspective. The University remains among the nation's leading public research universities, with a diversified portfolio of research that attracted more than \$577 million in sponsored program funding during fiscal year 2003-2004, a 7.5% increase over the previous year. During the same period, funding from the Department of Health and Human Services increased more than 8% to \$324 million. During the federal fiscal year 2003 (the latest available numbers), the University placed 20th nationally in overall funding from the National Institutes of Health (NIH). The University continues to rank in the top 20 educational institutions nationally in federal support for science and technology.

Substantial improvements to the physical infrastructure supporting research were made during fiscal year 2003-2004. The Administrative Office Building, which opened in January 2004, greatly improved the University's ability to provide the services that will help sustain the research enterprise. Several key research facilities were renovated, including the entire Health Sciences Library, the 11th floor of Mary Ellen Jones, and the Dental Building. Renovations were begun in Beard Hall, Molecular Biology, Burnett Womack, and the Medical Research Building. The School of Nursing addition, the new School of Public Health Teaching and Research Center, and the Carolina Physical Science Complex are well under way. The new Kerr Hall (School of Pharmacy) the Medical Biomolecular Building, the Neurosciences Research Building, and the Bioinformatics Building are fully occupied, equipped, and on line for research.

A central factor in the University's efforts to support research is the ability to recover facilities and administrative (F&A) costs associated with sponsored research. Two innovations will help ensure recovery of F&A costs. First, new space-survey software has been developed to more accurately identify the space used for research in campus facilities. Second, a year-long study has begun of library use, to more fully understand and document how the library organization supports research.

Sales and services revenues of \$443.2 million for fiscal year 2003-2004, represent an increase of 12.7% over the prior year and include the revenues of campus auxiliary or similar operations such as student housing, student stores, student health services, the utilities system, parking and transportation, the professional health-care clinics, and others. Sales and services

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

revenues are from the operations of the University's auxiliary enterprises and from operations of the patient health care clinics. Auxiliary enterprise revenues increased 3.2%. The revenues generated by the health clinic increased 31.7%, driven in large part by a reduction in the allowance for uncollectible patient accounts based on historical collection rates. Other revenues of \$5.7 million for fiscal year 2003-2004, represent operating resources not separately identified and include, as examples, an assessment to the Investment Fund to support administrative services, library fines, and interest income from student loans.

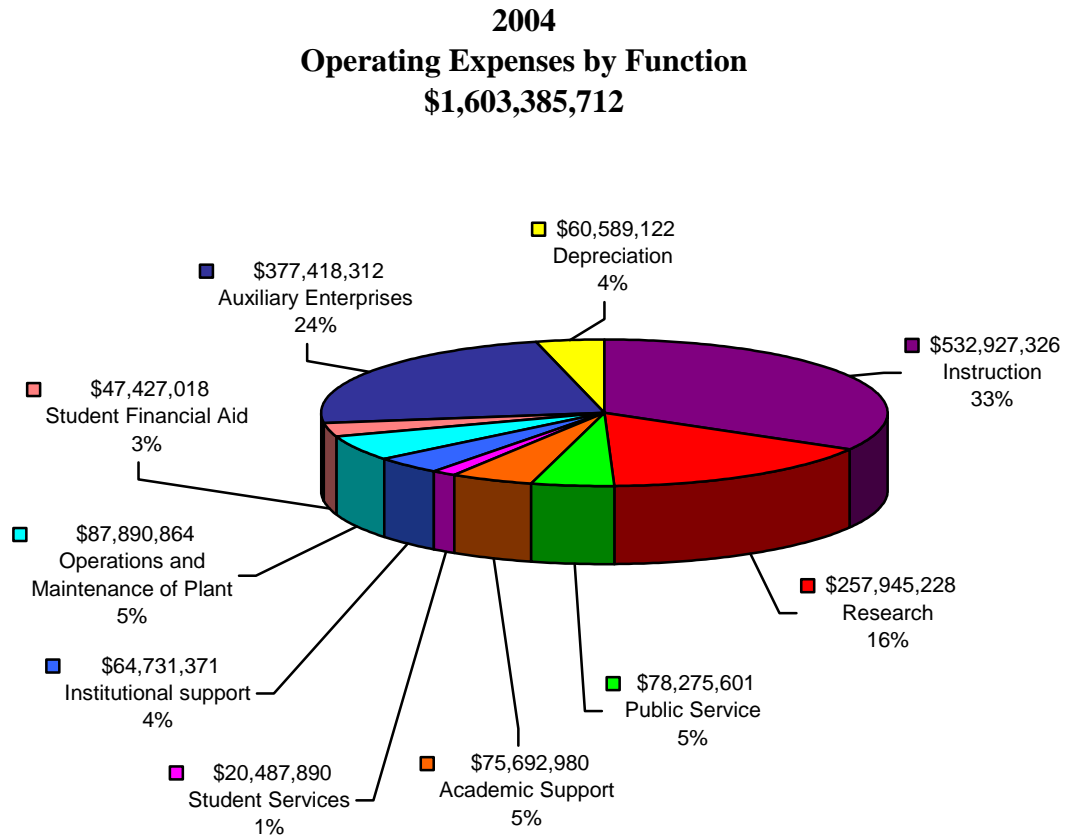
### Operating Expenses

The University's operating expenses were \$1.6 billion for the fiscal year ended June 30, 2004, an increase of 3.9% over the prior year. The operating expenses are reported by natural classification in the financial statements and by functional classification in the note disclosures (Note 11). The following table illustrates the University's operating expenses by the functional classification:

	2004	2003	% Change
<b>Operating Expenses by Function:</b>			
Instruction	\$ 532,927,326	\$ 531,123,250	0.3
Research	257,945,228	247,434,085	4.2
Public Service	78,275,601	75,409,910	3.8
Academic Support	75,692,980	70,888,224	6.8
Student Services	20,487,890	19,490,736	5.1
Institutional Support	64,731,371	63,460,504	2.0
Operations and Maintenance of Plant	87,890,864	86,451,422	1.7
Student Financial Aid	47,427,018	45,618,092	4.0
Auxiliary Enterprises	377,418,312	350,764,536	7.6
Depreciation	60,589,122	53,075,830	14.2
<b>Total Operating Expenses by Function</b>	<b>\$ 1,603,385,712</b>	<b>\$ 1,543,716,589</b>	<b>3.9</b>

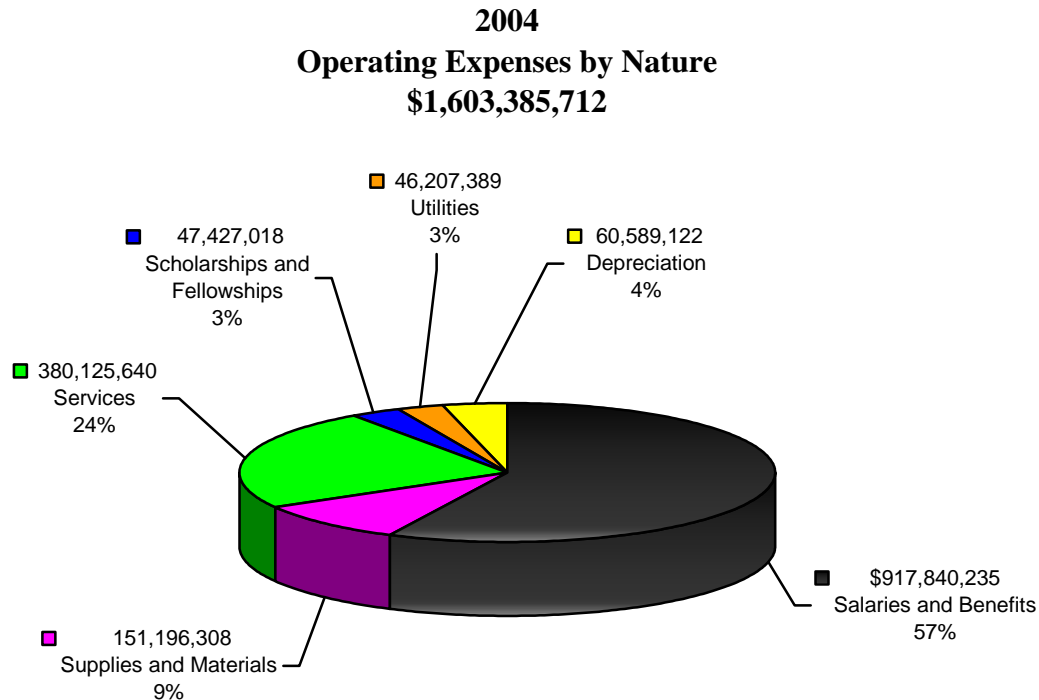
## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The following graph illustrates the University's operating expenses by function.



## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The following graph illustrates the University's operating expenses by the natural classification.



Operating expense categories reported by natural classification generally increased at a comparable rate to total operating expenses. The one outlier was depreciation expense. Depreciation increased 14.2% over the prior year. The increase was anticipated based on the ongoing, major capital construction program.

### Nonoperating Revenues and Expenses

State appropriations of \$380.4 million, noncapital grants of \$53.2 million, noncapital gifts of \$68.5 million, investment income of \$135.4 million, interest and fees on capital asset-related debt of (\$18.3) million, fixed asset writedowns of (\$4.9 million), and other revenues and expenses of (\$3.2) million comprise nonoperating revenues and expenses. These revenues are considered nonoperating because they were not generated by the University's principal, ongoing operations. For example, State appropriations were not generated by the University but were provided to help fund operating expenses.

The University's initial budget for State appropriations was \$396 million for fiscal year 2003-2004. Budget increases of \$5.5 million to fund a salary bonus of \$550 per employee and enrollment increases including distance learning and other program

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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enhancements as well as reductions in budgeted State appropriations of (\$13.9) million resulted in an operating budget for State appropriations of \$387.6 million. During the fiscal year 2003-2004, the University was required to reserve \$7.2 million in appropriations for reversion at the end of the year. There was no mid-year reduction for fiscal year 2003-2004, and the State allowed the carry forward of advance tuition and other deferred revenues at end of fiscal year 2003-2004. For the prior year, mid-year reductions and limitations on the carry forward of receipts reduced appropriations.

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

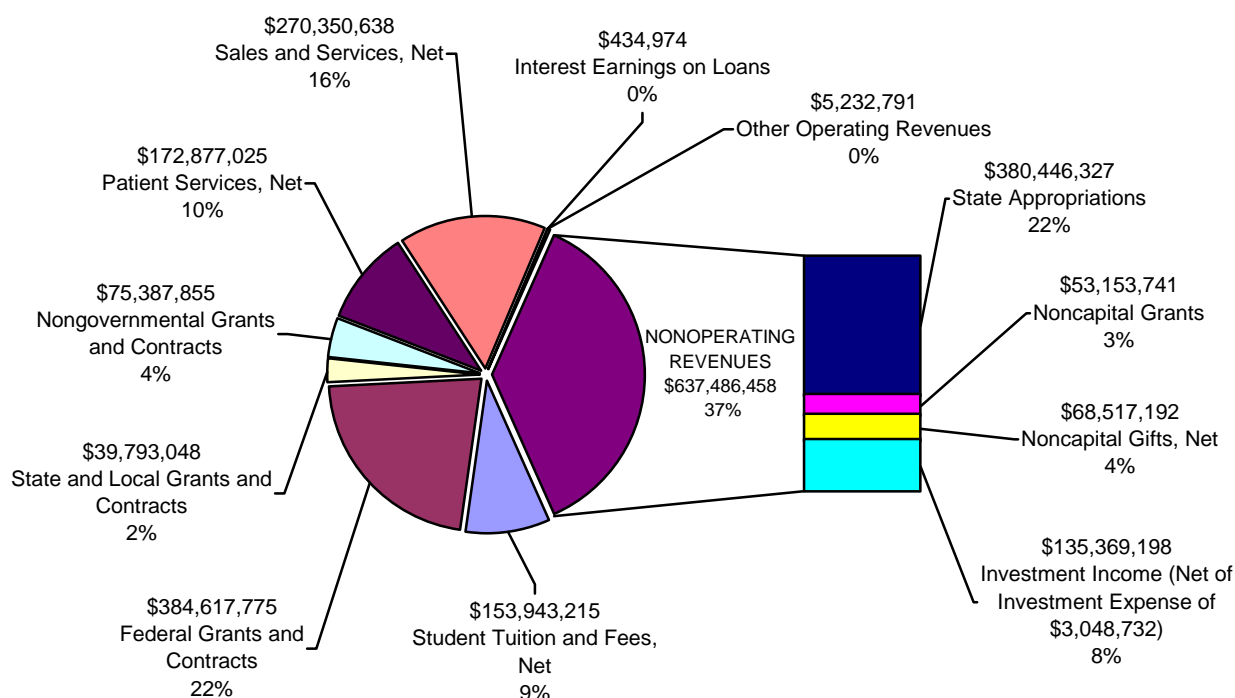
Noncapital grants increased by 29.7% to \$53.2 million in fiscal year 2003-2004, and represent federal awards that are not considered to be exchange transactions. Net noncapital gifts of \$68.5 million represent expendable gifts received and pledges made and are net of an allowance for uncollectible pledges. Net investment income of \$135.4 million includes income and realized and unrealized gains and is net of realized and unrealized losses and investment management fees. For detail discussion the reader may refer to Endowment and Other Long-term Investments section of Management's Discussion and Analysis. Interest and fees on capital asset-related debt were (\$18.3) million. Other nonoperating expenses total (\$8.1) million and include capital asset disposals. The increase in fiscal year 2003-2004, over the prior year resulted in part from increased disposals due to technology and other capital equipment upgrades.

### **Total Operating and Nonoperating Revenues**

Operating and nonoperating revenues such as State appropriations, noncapital grants, noncapital gifts, and investment income are used to fund University operations. The following chart illustrates the University's operating and nonoperating revenues which total \$1.8 billion for fiscal year 2003-2004.



**2004**  
**TOTAL REVENUES BY SOURCE**  
**\$1,740,123,779**



**Other Changes in Net Assets**

Capital grants of \$74.4 million came from Statewide higher education bond proceeds for capital construction projects. Capital appropriation of \$0.9 million received from the State for repairs and replacements. Net capital gifts of \$6.4 million also provided funding for construction projects. Nonexpendable gifts and funds from the State's program to match gifts for distinguished professorship endowments resulted in additions to permanent endowments of \$24.1 million during fiscal year 2003-2004.

**Condensed Statement of Cash Flows**

The Statement of Cash Flows provides additional information about the University's financial results by reporting the major sources and uses of cash. Cash increased by \$46.9 million during the fiscal year 2003-2004, compared with an increase of \$115.5 million during fiscal year 2002-2003. One factor which caused \$90 million of the increase in the cash position at June 30, 2003, was the additional use of the State Treasurer's short-term investment fund, which is classified as a cash equivalent, for the University's temporary investment pool. The

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

statements for the fiscal year ended June 30, 2004, and the prior year are summarized as follows:

	2004	2003	% Change
<b>Cash Flows Provided (Used)</b>			
Operating Activities	\$ (348,742,031)	\$ (382,265,470)	8.8
Noncapital Financing Activities	530,971,166	488,584,930	8.7
Capital and Related Financing Activities	(107,595,259)	(55,707,534)	93.1
Investing Activities	(27,684,390)	64,860,649	(142.7)
<b>Net Increase (Decrease) in Cash</b>	46,949,486	115,472,575	(59.3)
<b>Cash - July 1</b>	497,738,480	382,265,905	30.2
<b>Cash - June 30</b>	\$ 544,687,966	\$ 497,738,480	9.4

- Cash flows from operating activities include, as examples, cash received for tuition and fees or research grants and salaries paid to faculty or payments of invoices to vendors. Since State appropriations, gifts, and certain other revenues are not considered operating revenue, operating activities had a net cash outflow for both fiscal years.
- Noncapital financing activities include State appropriations received for operations and noncapital gifts, and had a net cash inflow for both fiscal years.
- The cash flows from capital and related financing activities include the proceeds received from short-term and long-term debt obligations, the repayment of debt, and the acquisition and construction of capital assets.
- The net cash inflows from investing activities include purchases and sales of equity securities and other investments as well as interest and dividends received. The significant change in the cash flows from investing activities resulted from additional investment purchases due to increased levels of gifts and other funds available for investment.

### Component Units Reported using Discrete Presentation

Potential component units of the University, primarily the affiliated fundraising foundations, are evaluated to determine if the financial statements of the potential component unit should be:

- a) combined with those of the University in the Comprehensive Annual Financial Report (CAFR),
- b) reported separately (that is, discretely) along with the University's financial statements in the CAFR, or
- c) not reported in the CAFR.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Three affiliated foundations were categorized as component units using discrete presentation. Discrete presentation provides readers with complete information regarding the financial activities of the component units. The reader may refer to Notes 1A and 17 for additional information regarding the three affiliated foundations.

Summary information regarding the financial activities of the three affiliated foundations follows:

	<u>2004</u>
Total Assets	\$ 389,576,735
Total Liabilities	<u>2,387,485</u>
Total Net Assets	<u>\$ 387,189,250</u>
<b>Net Assets Composition:</b>	
Unrestricted	\$ 17,723,823
Temporarily Restricted	209,029,695
Permanently Restricted	<u>160,435,732</u>
<b>Total Net Assets</b>	<u><u>\$ 387,189,250</u></u>

Unrestricted net assets are expendable and do not have external restrictions regarding use of the resources, temporarily restricted net assets are expendable but are subject to restrictions regarding allowable uses and the timing for availability, and permanently restricted net assets are not expendable and the related earnings are subject to restrictions regarding allowable uses.

	<u>2004</u>
Total Revenues	\$ 73,909,097
Total Expenses	<u>25,359,735</u>
Increase in Net Assets	48,549,362
<b>Net Assets - July 1</b>	<u>338,639,888</u>
<b>Net Assets - June 30</b>	<u><u>\$ 387,189,250</u></u>

Expenses included \$20.5 million provided to the University.

### Economic Outlook

Management's view is that the University is well positioned to continue demonstrating excellence in teaching, discovery, and public service. Management believes that, although national and State economic conditions have affected resources in prior years, fiscal year 2003-2004, demonstrated an improved financial condition. The University will maintain

## **MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

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its solid financial foundation and enhance its financial outlook. The University's strong debt credit rating allows it to obtain competitive financing for capital construction. The University's comparatively low tuition levels enhance its appeal to prospective students and provide a possible source of additional resources, should tuition increases be enacted.

Tuition rates increased for fiscal year 2004-2005, by 8.5% for undergraduate residents, 10.1% for undergraduate nonresidents, 7.9% for graduate residents, and 9.9% for graduate nonresidents. There were also limited tuition increases for the professional schools. The University's academic standing allows it to continuously attract top students. Student application levels, enrollment levels of students including cross admits, applicants' exam scores and other admission criteria, and other factors illustrate the substantial appeal of the University to prospective students. Carolina's tuition levels remain low compared with its national peer group of institutions. The University has launched the Carolina Covenant, which provides qualified students from low-income families with a Carolina education debt-free. Carolina Covenant Scholars agree to work on campus 10 to 12 hours weekly in a federal work-study job, and the University meets the rest of their needs through a combination of federal, State, university and other privately funded grants and scholarships. Carolina became the first major public U.S. University to announce plans for such a program. Since then, several universities, including Virginia, Maryland, Nebraska, Harvard, and Brown have created or announced plans for similar programs.

The University's relationship with the State of North Carolina continues to be a vital success factor. Given the many needs of the State and the recent economic challenges it has faced, the Governor and the General Assembly have continued to demonstrate strong financial support for higher education in North Carolina. The budgeted funding level for State appropriations for 2004-2005, totals \$408.5 million, which represents an increase of 7.4% over fiscal year 2003-2004, actual State appropriations. This level of funding includes base salary increases for all employees for the first time in over three years. It also includes a 1.5% permanent budget reduction, the smallest level of reduction in recent years. While additional budget reductions or reversions are not anticipated for fiscal year 2004-2005, it is not certain.

The North Carolina economy is back on track to outperform the national average as it usually has over the past 50 years. In July 2004, the unemployment rate in North Carolina was 5%, well below the national average of 5.5% on a seasonally adjusted basis. On September 28, 2004, the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce released revised personal income data for all States from the first quarter of 2001 through the first quarter of 2004. These data showed that total personal income in North Carolina in the second quarter of 2004, was \$249.1 billion at a seasonally adjusted annual rate, up 5.8% from the second quarter of 2003. The national average increase was 5.2%, so North Carolina was back in its normal position of outperforming the national average.

The University must continue to address competitive pressures related to recruiting and retaining faculty and staff. The University's programs for health, retirement, and other benefits have cost and coverage issues that are of concern and require resolution, working in conjunction with UNC System and State officials. The University is progressing on these benefits issues by pursuing additional flexibility in allowing benefits and other enhancements

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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to the benefits programs. However, the University's diverse revenue base, its strategic planning processes, and its proactive approach in addressing budgetary issues help alleviate the significance of the impacts.

Research efforts will continue to provide impetus to the financial condition of the University and the State. The University has created a new Renaissance Computing Institute based in Chapel Hill in partnership with Duke and North Carolina State universities. The University has taken steps to develop new research opportunities by forming a seed-funding program to support interdisciplinary activities and by successfully competing for three of only 21 planning grants awarded across the country as part of a new National Institutes of Health "Roadmap for Medical Research" initiative. The University also established an ongoing mechanism to continue competing successfully for NIH "Roadmap" funding opportunities.

As research activity grows, so do the challenges of complying with State and federal regulations. During the year, the University took major steps to ensure a strong campus-wide program of compliance including the reorganization of all institutional review boards under one office — the Office of Human Research Ethics. This move will help ensure uniform standards of compliance in research with human subjects. During the fiscal year 2003-2004, the University addressed a second undercover investigation by People for the Ethical Treatment of Animals (PETA) in a facility housing laboratory animals. After careful internal and external reviews, which found only minor violations in an otherwise well-managed program of animal care, the University's lab-animal program retained its national accreditation and demonstrated its ability to comply with federal standards.

The University's research enterprise creates jobs for the State's economy. Expenses resulting from research funding at the University, cycle through the State and local economies, transforming federal funds into revenue for North Carolina residents and businesses. The University is the largest employer in the State with 20,637 employees, and about 6,200 of these employees conduct or support research. Using a U.S. government multiplier of 1.7, Carolina's \$577 million in research funding generated an estimated \$982 million in economic impact. The University continues its commitment to transfer new technologies developed by our faculty to the marketplace. Planning continued for Carolina North, a nearly 1,000-acre tract of land envisioned for mixed-use development that will support the research, teaching, and public service missions of the University. A master plan for Carolina North was developed and presented to the local community in an extensive series of meetings. Resulting feedback is helping shape a revised plan for proposed development.

Two new activities will enhance our ability to stimulate economic activity. During the year, the University became one of eight campuses nationally to receive funding under the Kauffman Entrepreneurial Initiative, which will promote entrepreneurship on the campus. The Office of Economic and Business Development was formed to coordinate efforts on campus and to enable all to work more effectively with external entities.

Management believes the investment performance of its endowment fund will continue to earn attractive returns and provide important resources for University operations. The organizational changes implemented in fiscal year 2002-2003, will continue to strengthen

## **MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)**

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investment management. The University's investment management operation was separately organized as the UNC Management Company, Inc. (UNC-MC), a nonprofit corporation organized and operated as a 501(c)(3) entity, to provide investment management services and administrative services to the University and to the other campuses of the UNC System and their affiliated nonprofit foundations as appropriate. Management believes this structure will continue to enhance the ability to attract and retain investment professionals and increase the pool of funds and resulting investment returns.

The University's fund-raising efforts continue to achieve a high level of success, and provide critical resources for the present and for future generations. Initially announced on October 11, 2002, the \$1.8 billion Carolina First Campaign began its quiet phase on July 1, 1999. Of the \$1.8 billion goal, \$850 million will provide expendable resources, \$700 million will be used to increase endowment assets, and \$250 million will support the capital construction program.

As of June 30, 2004, gifts, pledges and deferred commitments of \$1.3 billion had been recorded. The commitments represent more than 70% of the goal. Gift receipts were \$847 million of that total. Of the \$1.8 billion goal, over half is targeted directly for the University and for the business school, social work, law and UNC-CH foundations, with the remainder for the other University affiliated foundations. As of June 30, 2004, endowment commitments totaled \$524 million toward the overall endowment goal of \$700 million. With 63% of the campaign time period elapsed, the fund-raising drive has reached 75% of the endowment goal. The campaign will conclude on June 30, 2007, and management anticipates the goal will be attained.

The capital planning process continues to benefit the University as the construction program has and will continue to improve academic and administrative facilities. The new and renovated facilities have and will continue to enhance the teaching environment, improve research opportunities, and provide a better infrastructure. The operational planning process is a critical success factor as well. The strategic, mission-driven financial decision processes combined with the framework of the academic plan that considers mission-critical goals and resource needs ensures sound resource development and allocation decisions. Management believes the academic and financial planning processes result in a strategic use of resources.

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

**The University of North Carolina at Chapel Hill****Statement of Net Assets****June 30, 2004****Exhibit A-1****ASSETS**

## Current Assets:

Cash and Cash Equivalents	\$	229,145,462
Restricted Cash and Cash Equivalents		244,717,418
Short-Term Investments		124,311,551
Restricted Short-Term Investments		76,555,109
Receivables, Net (Note 4)		113,396,435
Due from Primary Government		1,073,935
Due from State of North Carolina Component Units		1,622,498
Inventories		15,588,257
Notes Receivable, Net (Note 4)		4,256,737
Total Current Assets		810,667,402

## Noncurrent Assets:

Restricted Cash and Cash Equivalents		70,825,086
Receivables, Net (Note 4)		29,543,833
Restricted Due from Primary Government		20,072,186
Endowment Investments		848,469,859
Other Long-Term Investments		505,076,807
Investment in Joint Venture		8,318,917
Notes Receivable, Net (Note 4)		29,268,053
Capital Assets - Nondepreciable (Note 5)		304,442,507
Capital Assets - Depreciable, Net (Note 5)		972,226,834
Total Noncurrent Assets		2,788,244,082
Total Assets		3,598,911,484

**LIABILITIES**

## Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)		77,819,675
Due to Primary Government		91,968
Due to State of North Carolina Component Units		4,156,524
Deposits Payable		5,051,920
Funds Held for Others		10,928,432
Deferred Revenue		42,842,783
Interest Payable		2,100,664
Obligations Under Reverse Repurchase Agreements		127,858,750
Short-Term Debt		8,841,000
Long-Term Liabilities - Current Portion (Note 8)		122,128,145
Total Current Liabilities		401,819,861

## Noncurrent Liabilities:

U. S. Government Grants Refundable		32,523,862
Funds Held in Trust for Pool Participants		440,811,149
Long-Term Liabilities (Note 8)		482,557,455
Total Noncurrent Liabilities		955,892,466
Total Liabilities		1,357,712,327

**The University of North Carolina at Chapel Hill****Statement of Net Assets****June 30, 2004****Exhibit A-1****Page 2****NET ASSETS**

Invested in Capital Assets, Net of Related Debt	855,739,608
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	81,210,043
Research	10,689,000
Endowed Professorships	121,273,813
Departmental Uses	50,278,694
Loans	14,005,878
Library Acquisitions	21,265,812
Other	30,012,101
Expendable:	
Scholarships and Fellowships	120,737,336
Research	11,403,638
Endowed Professorships	202,055,745
Departmental Uses	214,057,017
Plant Improvements	11,814,358
Capital Projects	27,910,308
Debt Service	8,905,000
Library Acquisitions	32,922,567
Instructional and Educational Service Agreements	18,213,465
Unrestricted	408,704,774
Total Net Assets	<u>\$ 2,241,199,157</u>

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



***The University of North Carolina at Chapel Hill***  
***Statement of Revenues, Expenses, and***  
***Changes in Net Assets***  
***For the Fiscal Year Ended June 30, 2004***

***Exhibit A-2***

**REVENUES**

Operating Revenues:

Student Tuition and Fees, Net (Note 10)	\$ 153,943,215
Patient Services, Net (Note 10)	172,877,025
Federal Grants and Contracts	384,617,775
State and Local Grants and Contracts	39,793,048
Nongovernmental Grants and Contracts	75,387,855
Sales and Services, Net (Note 10)	270,350,638
Interest Earnings on Loans	434,974
Other Operating Revenues	5,232,791

Total Operating Revenues	1,102,637,321
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**EXPENSES**

Operating Expenses:

Salaries and Benefits	917,840,235
Supplies and Materials	151,196,308
Services	380,125,640
Scholarships and Fellowships	47,427,018
Utilities	46,207,389
Depreciation	60,589,122

Total Operating Expenses	1,603,385,712
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Operating Loss	(500,748,391)
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**NONOPERATING REVENUES (EXPENSES)**

State Appropriations	380,446,327
Noncapital Grants	53,153,741
Noncapital Gifts, Net (Note 10)	68,517,192
Investment Income (Net of Investment Expense of \$3,048,732)	135,369,198
Interest and Fees on Capital Asset-Related Debt	(18,339,114)
Other Nonoperating Expenses	(8,132,036)

Net Nonoperating Revenues	611,015,308
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Income Before Other Revenues	110,266,917
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Capital Appropriations	897,387
Capital Grants	74,392,000
Capital Gifts, Net (Note 10)	6,358,879
Additions to Endowments	24,098,374

Increase in Net Assets	216,013,557
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**NET ASSETS**

Net Assets - July 1, 2003	2,025,185,600
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Net Assets - June 30, 2004	\$ 2,241,199,157
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The accompanying notes to the financial statements are an integral part of this statement.

***The University of North Carolina at Chapel Hill***  
***Statement of Cash Flows***  
***For the Fiscal Year Ended June 30, 2004***

***Exhibit A-3***

**CASH FLOWS FROM OPERATING ACTIVITIES**

Received from Customers	\$ 1,084,815,352
Payments to Employees and Fringe Benefits	(898,444,861)
Payments to Vendors and Suppliers	(582,211,541)
Payments for Scholarships and Fellowships	(47,427,017)
Loans Issued	(6,086,478)
Collection of Loans	2,957,144
Other Receipts	97,655,370
Net Cash Used by Operating Activities	(348,742,031)

**CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES**

State Appropriations	380,446,327
Noncapital Grants	53,345,290
Noncapital Gifts	67,528,414
Additions to Permanent and Term Endowments	24,098,374
Related Activity Agency Receipts	5,552,761
Net Cash Provided by Noncapital Financing Activities	530,971,166

**CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES**

Proceeds from Capital Debt	138,165,874
Capital Grants	69,032,898
Capital Appropriation	897,387
Capital Gifts	6,358,879
Acquisition and Construction of Capital Assets	(243,602,829)
Principal Paid on Capital Debt and Leases	(21,900,068)
Redemption of Short-Term Debt	(36,109,000)
Interest and Fees Paid on Capital Debt and Leases	(20,438,400)
Net Cash Used by Capital Financing and Related Financing Activities	(107,595,259)

**CASH FLOWS FROM INVESTING ACTIVITIES**

Proceeds from Sales and Maturities of Investments	426,565,826
Investment Income	42,094,867
Purchase of Investments and Related Fees	(517,495,208)
Obligations under reverse purchase agreements	21,150,125
Net Cash Used by Investing Activities	(27,684,390)

Net Increase in Cash and Cash Equivalents	46,949,486
Cash and Cash Equivalents - July 1, 2003	497,738,480
Cash and Cash Equivalents - June 30, 2004	\$ 544,687,966

***The University of North Carolina at Chapel Hill***  
***Statement of Cash Flows***  
***For the Fiscal Year Ended June 30, 2004***

***Exhibit A-3***

***Page 2***

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

Operating Loss	\$	(500,748,391)
Adjustments to Reconcile Operating Loss to Net Cash Provided Used by Operating Activities:		
Depreciation Expense		60,589,122
Allowances, Write-Offs, and Amortizations		(379,196)
Changes in Assets and Liabilities:		
Receivables (Net)		(22,816,576)
Notes Receivable (Net)		(4,037,714)
Inventories		175,600
Accounts Payable and Accrued Liabilities		(2,518,676)
Due to Primary Government		9,292
Deferred Revenue		(81,495)
Compensated Absences		17,426,149
US government grants refundable		973,863
Funds held for others		102,665,991
Net Cash Used by Operating Activities	\$	<u>(348,742,031)</u>

**RECONCILIATION OF CASH AND CASH EQUIVALENTS**

Current Assets:		
Cash and Cash Equivalents	\$	229,145,462
Restricted Cash and Cash Equivalents		244,717,418
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		<u>70,825,086</u>
Total Cash and Cash Equivalents - June 30, 2004	\$	<u>544,687,966</u>

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

Assets Acquired through the Assumption of a Liability	\$	(691,207)
Assets Acquired through a Gift		3,848,657
Change in Fair Value of Investments		84,092,546

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

**The University of North Carolina at Chapel Hill Foundations**  
**Statement of Financial Position**  
**June 30, 2004**

**Exhibit B-1**

	UNC-CH Arts and Sciences Foundation, Inc.	The Educational Foundation Scholarship Endowment Trust	The Medical Foundation of North Carolina, Inc.
<b>ASSETS</b>			
Current Assets:			
Cash and Cash Equivalents	\$ 8,304,966	\$ 6,564,214	\$ 30,168,986
Investments		104,679,158	84,761,433
Unconditional promises to give	5,825,902	7,282,354	1,839,697
Contributions receivable from remainder trusts		2,720,113	
Accounts Receivable	160,602		
Funds Held in Trust	346,674		
Accrued Income Receivable	17,463		268,062
Prepaid Expenses			11,080
Miscellaneous Receivables			179,768
Total Current Assets	14,655,607	121,245,839	117,229,026
Property and Equipment:			
Building			436,340
Furniture and Equipment	88,464		415,139
	88,464		851,479
Less: Allowance for Depreciation	(55,908)		(440,133)
Total Property and Equipment	32,556		411,346
Other Assets:			
Investments	70,876,111		38,865,939
Unconditional Promises to Give, Net	11,704,086		9,395,933
Restricted Cash	2,230,638		484,947
Partnership Interests Held for Investment	86,661		
Real Estate Interests Held for Investment	49,500		
Student Loans Receivable			45,120
Cash Surrender Value of Life Insurance		1,932,343	331,083
Total Other Assets	84,946,996	1,932,343	49,123,022
Total Assets	\$ 99,635,159	\$ 123,178,182	\$ 166,763,394
<b>LIABILITIES</b>			
Current Liabilities:			
Accounts Payable	\$ 8,776	\$ 0	\$ 258,791
Annuities Payable		206,672	
Accrued Expenses	152,534		1,265,369
Deferred Revenue			240,000
Total Current Liabilities	161,310	206,672	1,764,160
Long Term Debt	255,343		
Total Liabilities	416,653	206,672	1,764,160
<b>NET ASSETS</b>			
Unrestricted	8,028,817		9,695,006
Temporarily Restricted	39,296,131	53,295,275	116,438,289
Permanently Restricted	51,893,558	69,676,235	38,865,939
Total Net Assets	99,218,506	122,971,510	164,999,234
Total Liabilities and Net Assets	\$ 99,635,159	\$ 123,178,182	\$ 166,763,394
See Note 1 in the Notes to the Financial Statements			

<b>The University of North Carolina at Chapel Hill Foundations</b>								
<b>Statement of Activities</b>								
<b>For the Fiscal Year Ended June 30, 2004</b>								<b>Exhibit B-2</b>
					<b>UNC-CH Arts and Sciences Foundation, Inc.</b>	<b>The Educational Foundation Scholarship Endowment Trust</b>	<b>The Medical Foundation of North Carolina, Inc.</b>	
<b>REVENUES</b>								
Support:								
Contributions					\$ 13,018,807	\$ 7,139,394	\$ 9,033,597	
Developed Assessment Fee					1,063,668			
Donated Facilities					40,000			
Actuarial Adjustment of Annuities Payable						10,620		
Endowment Investment Return Designated for Current Operations						5,105,729		
Total Support					14,122,475	12,255,743	9,033,597	
Revenue:								
Interest and Dividend Income							3,605,019	
Net Unrealized and Realized Gains (Losses) on Investments					8,413,241		15,052,242	
Investment Income					1,752,603			
Loss on Sale of Real Estate Investments							(72,610)	
Loss on Sale of Property and Equipment							(4,995)	
Other Income							445,743	
Total Revenues					10,165,844		19,025,399	
Total Support and Revenue					24,288,319	12,255,743	28,058,996	
<b>EXPENSES</b>								
Program Services:								
Grants to the College of Arts and Sciences					5,292,123		10,160,058	
Scholarship Expense Distribution						5,096,553		
Annuity Payments						9,176		
Administrative Expenses						69,244		
Other Expenses						258,412		
Total Program Services					5,292,123	5,433,385	10,160,058	
Supporting Services:								
Fundraising Expenses					1,983,664		1,017,694	
Management and General					676,201		796,610	
Total Supporting Services					2,659,865		1,814,304	
Total Expenses					7,951,988	5,433,385	11,974,362	
<b>TRANSFERS</b>								
Transfers to UNC					(49,835)			
Transfers from UNC					101,555			
Net Transfers					51,720			
Change in Net Assets From Operations					16,388,051	6,822,358	16,084,634	
<b>OTHER CHANGES:</b>								
Investment Return in Excess of Amounts Designated for Current Operations						9,254,319		
Change in Net Assets					16,388,051	16,076,677	16,084,634	
<b>NET ASSETS</b>								
Net Assets - Beginning of Year					82,830,455	106,894,833	148,914,600	
Net Assets - End of Year					\$ 99,218,506	\$ 122,971,510	\$ 164,999,234	
See Note 1 in the Notes to the Financial Statements								

**THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2004**

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES**

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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to benefit The University and other organizations operated primarily to support the University, its financial statements have been blended with those of the University.

In December 2002, the System Fund was organized by the Investment Fund to allow the University, the University of North Carolina and its other constituent institutions (UNC System), affiliated foundations, associations, trusts and endowments that support the University and the UNC System, to pool their resources and invest collectively in investment opportunities identified, structured and arranged by the Management Company (formerly University Investment Office). The Membership Interests are offered only to government entities or tax-exempt organizations that are controlled by or support the University or UNC System. The Investment Fund contributed and assigned all of its assets to the System Fund effective January 1, 2003, in exchange for its membership interest in the System Fund. Upon such contribution and assignment, and in consideration thereof, the System Fund has assumed all liabilities and obligations of the Investment Fund in respect of such contributed assets. At June 30, 2004, the Investment Fund membership interest was approximately 92% of the System Fund total membership interests. Because the Investment Fund is the organizer and a predominant member of the System Fund, the financial statements of the System Fund have been blended with those of the University.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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University. Effective January 1, 2004, the Management Company entered into an investment services agreement with the System Fund pursuant to which it will provide investment management and administrative services to the UNC-CH Foundation.

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

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

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



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Social Work Foundation are officials or appointed by officials of the University, the financial statements of the Social Work Foundation have been blended with those of the University.

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

Separate financial statements for the Investment Fund, System Fund, the Management Company and blended foundations may be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

The Medical Foundation of North Carolina, Inc. (Medical Foundation), The Educational Foundation Scholarship Endowment Trust (Educational Foundation Trust), and The University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc. (Arts and Sciences Foundation), are legally separate, nonprofit, tax-exempt organizations and are reported as discretely presented component units based on the nature and significance of their relationship to the University.

The Medical Foundation is governed by an 83-member board of directors, elected annually by its members. Its purpose is to support educational and research efforts of the University's Medical School and UNC Hospitals. Historically, the University's Medical School has been the major recipient of financial support from the Medical Foundation compared to UNC Hospitals. Although the University does not control the timing or amount of receipts from the Medical Foundation, the majority of resources or income that the Medical Foundation holds and invests are restricted to the activities of the University by the donors. Because these restricted resources held by the Medical Foundation can only be used by, or for the benefit of the University, the Medical Foundation is considered a component unit of the University.

The Arts and Sciences Foundation is governed by a board consisting of three ex-officio directors, 24 elected directors and such number of emeritus directors determined from time to time by the Board of Directors. The 24 elected directors are elected for staggered terms, by the

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Board of Directors in office at the time of election. The purpose of the Arts and Sciences Foundation is to promote and support the University's College of Arts and Sciences. Although the University does not control the timing or amount of receipts from the Arts and Sciences Foundation, the majority of resources or income that the Arts and Sciences Foundation holds and invests are restricted to the activities of the University by the donors. Because these restricted resources held by the Arts and Sciences Foundation can only be used by, or for the benefit of the University, the Arts and Sciences Foundation is considered a component unit of the University.

The Educational Foundation Trust is governed by the Board of Trustees consisting of 10 trustees and the Chairman of the Executive Committee, who also serves as a Trustee during his or her term as Chairman. The Educational Foundation Trust operates solely to assist the University in providing financial assistance to students at the University. On an annual basis, the Board of Trustees of the Educational Foundation Trust appropriates a portion of the net appreciation on its assets to the Educational Foundation, Inc., in its capacity as agent for the Educational Foundation Trust. The distribution from the Educational Foundation Trust to the Educational Foundation, Inc., is then forwarded by the Educational Foundation, Inc., to the University to provide financial assistance to students at the University. Although the University does not control the timing or amount of receipts from the Educational Foundation Trust, the majority of resources or income that the Educational Foundation Trust holds and invests are restricted to the students of the University by the donors. Because these restricted resources held by the Educational Foundation Trust can only be used for the benefit of the students of the University, the Educational Foundation Trust is considered a component unit of the University.

The Medical Foundation, the Arts and Sciences Foundation, and the Educational Foundation Trust are private, nonprofit organizations that report their financial results under Financial Accounting Standards Board (FASB) Statements. As such, certain revenue recognition criteria and presentation features are different from Governmental Accounting Standards Board (GASB) revenue recognition criteria and presentation features. No modifications have been made to the financial information in the University's financial reporting entity for these differences.

During the year ended June 30, 2004, the Medical Foundation, Arts and Sciences Foundation, and the Educational Foundation Trust distributed in total \$20,497,014 to the University for both restricted and unrestricted purposes. Complete financial statements for the Medical Foundation, Arts and Sciences Foundation, and Educational Foundation Trust can be

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

Other related foundations and similar nonprofit corporations for which the University is not financially accountable are not part of the accompanying financial statements.

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

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

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

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

Nonexchange transactions, in which the University receives (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.

- D. Cash and Cash Equivalents** – This classification includes undeposited receipts, petty cash, cash on deposit with private bank accounts, savings accounts, cash on deposit with fiscal agents, and deposits held by the State Treasurer in the short-term investment portfolio. The short-term investment portfolio maintained by the State Treasurer has the general

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty.

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

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

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

- F. Receivables** – Receivables consist of tuition and fees charges to students and charges to patients for services provided by the UNC Physicians & Associates and the Dental Faculty Practices. Receivables also include amounts due from the federal government, State and local governments, private sources in connection with reimbursement of allowable expenses made pursuant to contracts and grants, and pledges that are verifiable, measurable, and expected to be collected and available for expenses for which the resource provider's conditions have been satisfied, and notes receivables from loans to students. Patients, pledges, and notes receivables are recorded net of the allowance for doubtful accounts. The accounts and other receivables are shown at book value with no provision for doubtful accounts considered necessary.
- G. Inventories** – Inventories held by the University are priced at cost or average cost except for the Student Stores inventory, which is valued at the lower of cost or market. The Inventories consist of expendable supplies, postage, fuel held for consumption, textbooks, and other merchandise for resale.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

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

- I. Restricted Assets** – 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.
- J. Funds Held in Trust for Pool Participants** – Funds held in trust for pool participants represent the external portion of the University's governmental external investment pool more fully described in Note 2.
- K. Funds Held in Trust by Others** – Funds held in trust by others are resources neither in the possession nor the control of the University, but held and administered by an outside organization, with the University deriving income from such funds. Such funds established under irrevocable trusts where the University has legally enforceable rights or claims have not been recorded on the accompanying financial statements. The value of these assets at June 30, 2004, is approximately \$30,696,886.
- L. Noncurrent Long-Term Liabilities** – Noncurrent long-term liabilities include principal amounts of bonds payable, notes payable, capital lease obligations, annuity payable, and compensated absences that will not be paid within the next fiscal year.

Bonds payable are reported net of unamortized premiums or discounts and deferred losses on refundings. The University amortizes bond

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

In addition to the vacation leave described above, compensated absences includes the accumulated unused portion of the special annual leave bonuses awarded by the North Carolina General Assembly to all full-time permanent employees as of September 30, 2002, and as of July 1, 2003. The unused portion of this leave remains available until used, notwithstanding the limitation on annual leave carried forward described above.

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

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

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

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

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

**Restricted Net Assets – Expendable** – Expendable restricted net assets include resources for which the University is legally or contractually

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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obligated to spend in accordance with restrictions imposed by external parties.

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

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

- O. Scholarship Discounts** – Student tuition and fees revenues and certain other revenues from University charges are reported net of scholarship discounts in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. The scholarship discount is the difference between the actual charge for goods and services provided by the University and the amount that is paid by students or by third parties on the students' behalf. Student financial assistance grants, such as Pell grants, and other federal, State, or nongovernmental programs, are recorded as either operating or nonoperating revenues in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. To the extent that revenues from these programs are used to satisfy tuition, fees, and other charges, the University has recorded a scholarship discount.
- P. Revenue and Expense Recognition** – The University classifies its revenues and expenses as operating or nonoperating in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the University's principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as student tuition and fees, sales and services of auxiliary enterprises, certain federal, State and local grants and contracts that are essentially contracts for services, and interest earned on loans. Operating expenses are all expense transactions incurred other than those related to capital and noncapital financing or investing activities as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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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 University, as well as investment income, are considered nonoperating since these are either investing, capital or noncapital financing activities. Capital contributions are presented separately after nonoperating revenues and expenses.

- Q. Internal Sales Activities** – Certain institutional auxiliary operations provide goods and services to University departments, as well as to its customers. These institutional auxiliary operations include activities such as utility services, telecommunications, central stores, printing and copy centers, postal services, repairs and maintenance services. In addition, the University has other miscellaneous sales and service units that operated either on a reimbursement or charge basis. All internal sales activities to University departments from auxiliary operations and sales and service units have been eliminated in the accompanying financial statements. These eliminations are recorded by removing the revenue and expense in the auxiliary operations and sales and service units and, if significant, allocating any residual balances to those departments receiving the goods and services during the year.
- R. Related Parties** – Related parties are nonprofit organizations established to assist and provide support to University programs by funding scholarships, fellowships, professorships and other needs of specific schools as well as the University's overall academic endeavors. Except as described in Note 1A, the University's financial statements do not include the assets, liabilities, net assets or operational transactions of these organizations except for support from each organization to the University.

### NOTE 2 - DEPOSITS AND INVESTMENTS

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



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Deposits include cash and cash equivalents and certificates of deposit totaling \$545,473,494. At year-end, cash on hand was \$214,472. The University's portion of the State Treasurer's Investment Pool was \$510,025,948. It is the State Treasurer's policy and practice for deposits not covered by federal depository insurance to be covered by collateral held by the State of North Carolina's agent in the name of the State and for investments to be held by the State's agent in the State's name. The carrying amount of the University's deposits not with the State Treasurer was \$34,662,018 and the bank balance was \$5,579,967. Of the bank balance, \$731,220 was covered by federal depository insurance and \$4,848,747 was uninsured and uncollateralized.

*North Carolina General Statutes* 147-69.1(c), applicable to the State's General Fund, and 147-69.2, applicable to institutional trust funds, authorize the State Treasurer to invest in the following: obligations of or fully guaranteed by the United States; obligations of certain federal agencies; repurchase agreements; obligations of the State of North Carolina; time deposits of specified institutions; prime quality commercial paper, and asset-backed securities with specified ratings. Also, General Statute 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified 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** - The University is authorized by The University of North Carolina Board of Governors pursuant to General Statute 116-36.2 and Section 600.2.4 of the Policy Manual of the University of North Carolina, to invest its special funds and funds received for services rendered by health care professionals in the same manner as the State Treasurer is required to invest, as previously discussed.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

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

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

Through written request to accounting services, participants may purchase and sell shares in the Temporary Pool at a fixed value of \$1 per share. Generally, the purchase and sale of participation shares occur only at the

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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beginning of the month. Income distribution is determined each quarter by multiplying the distribution rate by the average of the invested fund balance. Statements are sent to each participating account or group of accounts on a quarterly basis reflecting the participants' balance and income distribution. The rate earned by an account is dependent upon its account classification and investable fund balance. The rates are set in coordination between the Management Company and the Vice Chancellor for Finance and Administration.

**UNC-CH Foundation Investment Fund Inc. (Investment Fund)** - This is a North Carolina nonprofit corporation exempt from income tax pursuant to Section 501(c)(3). It began operations in January 1997, by the University and is classified as a governmental external investment pool. The pool is utilized to manage the investments for charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support the University. The University's Endowment, UNC-CH Foundation, Business School Foundation, Social Work Foundation, Law Foundation, Medical Foundation, Arts and Sciences Foundation, and Educational Foundation Trust are participants in the Investment Fund and are included in the University's reporting entity (internal portion) (See Note 1A.). Other affiliated organizations (external portion) in the Investment Fund are not included in the University's reporting entity. Fund ownership of the University's Investment Fund is measured using the unit value method. Under this method, each participant's investment balance is determined on a market value basis. The external portion of the Investment Fund is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants.

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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**UNC Investment Fund, LLC (System Fund)** - This is a limited liability company organized under the laws of the State of North Carolina. It was established in December 2002, by the Investment Fund and is classified as a governmental external investment pool. The pool is utilized to manage the investments for The University of North Carolina, its constituent institutions, and affiliates of the constituent institutions. This includes charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support these institutions. The Investment Fund, with an approximately 92% membership interest as of June 30, 2004, is the organizer and a predominant member of the System Fund. The University's reporting entity portion of the Investment Fund is characterized as the internal portion. Other affiliated organizations in the Investment Fund in addition to other members of the System Fund not included in the University's reporting entity are characterized as the external portion. The external portion of the System Fund is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants. Membership interests of the System Fund are measured using the unit value method. Under this method, each member's investment balance is determined on a market value basis.

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Category 1 includes investments that are insured or registered or for which the securities are held by the University or its agent in the University's name. Category 2 includes uninsured and unregistered investments for which the securities are held by a counterparty's trust department or agent in the University's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by a counterparty's trust department or agent but not in the University's name.

A summary of the University's investments at June 30, 2004, is presented below:

### *Temporary Pool Investments*

	Fair Value			
	Risk Category			
	1	2	3	Total
<b>Categorized Investments:</b>				
U.S. Government Securities	\$ 44,635,637	\$ 0	\$ 0	\$ 44,635,637
Collateralized Mortgage Obligations	46,925,563			46,925,563
State and Municipal Securities	3,532,086			3,532,086
Corporate Bonds	11,859,453			11,859,453
Corporate Stock	30,000			30,000
<b>Total Categorized Investments</b>	<u>\$ 106,982,739</u>	<u>\$ 0</u>	<u>\$ 0</u>	106,982,739
<b>Investments Not Categorized:</b>				
Investments Held by Broker-Dealers				
Under Reverse Repurchase Agreements:				
U.S. Government Securities				103,251,244
Certificates of Deposit				1,000,000
Money Market Funds				26,709,643
Mutual Funds				15,232,942
<b>Total Investments Not Categorized</b>				<u>146,193,829</u>
<b>Total Temporary Pool Investments (a)</b>				<u>\$ 253,176,568</u>

(a) The Temporary Pool also has \$32,839,710 of equity in the Investment Fund categorized below.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**Investment Fund Pool Investments** - The Investment Fund consists of an approximately 92% membership interest in the System Fund categorized below.

### *System Fund Pool Investments*

	Fair Value			
	Risk Category			
	1	2	3	Total
<b>Categorized Investments:</b>				
U.S. Government Securities	\$ 794,790	\$ 0	\$ 0	\$ 794,790
Collateralized Mortgage Obligations	2,233,109			2,233,109
Corporate Bonds	12,319,576			12,319,576
Corporate Stocks	50,402,573			50,402,573
International Corporate Bonds	4,705,551			4,705,551
International Stocks	4,525,984			4,525,984
<b>Total Categorized Investments</b>	<u>\$ 74,981,583</u>	<u>\$ 0</u>	<u>\$ 0</u>	74,981,583
<b>Investments Not Categorized:</b>				
Investments Held by Broker-Dealers				
Under Reverse Repurchase Agreements:				
U.S. Government Securities				24,309,934
Money Market Funds				5,777,098
Mutual Funds				433,606,203
Limited Partnerships				574,400,839
Other Investments				37,219,342
<b>Total Investments Not Categorized</b>				<u>1,075,313,416</u>
<b>Total System Fund Pool Investments</b>				\$ 1,150,294,999

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### *Non-Pooled Investments*

	Fair Value			
	Risk Category			Total
	1	2	3	
<b>Categorized Investments:</b>				
U.S. Government Securities	\$ 3,688,435	\$ 1,551,067	\$ 0	\$ 5,239,502
Collateralized Mortgage Obligations	315,560	57,428		372,988
State and Municipal Securities	152,102			152,102
Corporate Bonds	226,342	41,115		267,457
Corporate Stocks	4,667,663	779,460		5,447,123
International Stocks		8,039		8,039
<b>Total Categorized Investments</b>	<u>\$ 9,050,102</u>	<u>\$ 2,437,109</u>	<u>\$ 0</u>	11,487,211
<b>Investments Not Categorized:</b>				
Money Market Funds				58,158,625
Mutual Funds				61,395,148
Real Estate				15,057,965
Other Investments				4,842,810
<b>Total Investments Not Categorized</b>				<u>139,454,548</u>
<b>Total Non-Pooled Investments</b>				<u>\$ 150,941,759</u>

### *Total Investments*

	Fair Value			Total
	Risk Category			
	1	2	3	
Total Categorized Investments	\$ 191,014,424	\$ 2,437,109	\$ 0	\$ 193,451,533
Total Investments Not Categorized				1,360,961,793
Total Investments				\$ 1,554,413,326

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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The Temporary Investment Pool's Statement of Net Assets and Statement of Operations and Changes in Net Assets as of and for the period ended June 30, 2004, are as follows:

Statement of Net Assets  
June 30, 2004

	Amount
<b>Assets:</b>	
State Treasurer Investment Fund	\$ 120,000,000
Accrued Investment Income	1,139,459
Investment Fund Equity	32,839,710
Investments	253,176,568
<b>Total Assets</b>	<b>\$ 407,155,737</b>
<b>Liabilities:</b>	
Obligations Under Reverse Repurchase Agreements	\$ 103,186,250
Deferred Income	771,832
<b>Total Liabilities</b>	<b>103,958,082</b>
<b>Net Assets:</b>	
Internal Portion	175,036,006
External Portion	128,161,649
<b>Total Net Assets</b>	<b>303,197,655</b>
<b>Total Liabilities and Net Assets</b>	<b>\$ 407,155,737</b>



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### Statement of Operations and Changes in Net Assets For the Fiscal Year Ended June 30, 2004

	Amount
<b>Increase in Net Assets from Operations:</b>	
Revenues:	
Investment Income	\$ 19,233,988
Expenses:	
Investment Management	417,992
<b>Net Increase in Net Assets Resulting from Operations</b>	18,815,996
<b>Distributions to Participants:</b>	
Distributions Paid and Payable	18,815,996
<b>Share Transactions:</b>	
Net Share Purchases	6,432,593
<b>Total Increase in Net Assets</b>	6,432,593
<b>Net Assets:</b>	
Beginning of Year	296,765,062
End of Year	\$ 303,197,655

The major investment classifications of the Temporary Pool had the following attributes at June 30, 2004:

Investment Classification	Fair Value	Principal Amount	Yield to Maturity	Range of Maturities
U.S. Government Securities	\$ 44,635,637	\$ 45,081,630	1.8% - 7.6%	2005 - 2034
Collateralized Mortgage Obligations	46,925,563	48,245,420	1.9% - 9.2%	2005 - 2033
State and Municipal Securities	3,532,086	3,396,404	3.6%	2009
Corporate Bonds	11,859,453	11,810,369	1.4% - 5.9%	2006 - 2033
Corporate Stocks	30,000	30,000	N/A	N/A
Certificate of Deposit	1,000,000	1,000,000	3.5%	2004
Mutual Funds	15,232,942	15,665,392	N/A	N/A
Money Market Funds	26,709,643	26,709,643	0.9%	1 day
Reverse Repurchase Agreements	103,251,244	103,310,232	1.1% - 1.5%	1 - 15 days; open
Total Temporary Pool Investments	<u>\$ 253,176,568</u>	<u>\$ 255,249,090</u>		

**C. Reverse Repurchase Agreements** - Under the University's authority to purchase and sell securities, it has entered into fixed coupon reverse repurchase (reverse repurchase) agreements; that is, a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The fair value of the securities underlying reverse repurchase agreements normally exceeds the cash

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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received, providing the dealers a margin against a decline in fair value of the securities. If the dealers default on their obligations to resell these securities to the University or provide securities or cash of equal value, the University would suffer an economic loss equal to the difference between the fair value plus accrued interest of the underlying securities and the agreement obligation, including accrued interest. This credit exposure at year-end was \$372,489.

At June 30, 2004, reverse repurchase agreements are both fixed term and open (on-demand) agreements. The amount and interest rate of the open agreements may be changed daily and either party may terminate the transaction at any time. In investing the proceeds of reverse repurchase agreements, the University's practice is for the term to maturity of the investment to be the same as the term of the reverse repurchase agreement. The University's investments in the underlying securities and the securities purchased with proceeds from the reverse repurchase agreements are in accordance with the statutory requirements as noted. The interest earnings and interest cost arising from reverse repurchase agreement transactions are reported at gross amounts on the accompanying financial statements.

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

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

The values of mortgage-backed securities are generally based on the cash flows from principal and interest receipts on the underlying mortgage pools. These securities may include mortgage pass-through securities and

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

As of June 30, 2004, the University was holding \$141,595,246 in mortgage-backed securities valued at fair value representing approximately 9.1% of its total investments. Of this amount, \$49,531,660 represents investments in CMOs.

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

The values of these other asset-backed securities are generally based on the cash flows to be received from the underlying pools of assets. Accordingly, these securities are subject to market risk due to fluctuations in interest rates, prepayment rates, and various liquidity factors related to

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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their specific markets. The market risk is reduced by the University's preference to invest in the shorter average life securities.

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

As of June 30, 2004, the University was holding \$7,399,041 in asset-backed securities valued at fair value representing approximately 0.5% of its total investments.

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

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

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

As of June 30, 2004, the futures contracts held by the University had expiration dates not exceeding September 2004.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

During the year ending June 30, 2004, the option contracts held by the University vary with changes in the market price of their underlying futures contracts and accordingly also fluctuate with changes in their respective foreign currency rates or security values. The University's option contracts are traded on organized exchanges which mitigate its credit risk of default by counterparty.

As of June 30, 2004, the option contracts held by the University had expiration dates not exceeding September 2004.

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

The University limits the amount of funds managed by any single asset manager and also limits the amount of funds to be invested in particular security classes. The asset classes of the System Fund that utilized derivative securities for the fiscal year ending June 30, 2004, are summarized in the chart below. The amounts shown in the chart represent the market value of the System Fund's investment in the various asset classes and the market value and percent of holdings held in derivatives in those classifications. The University's reporting entity, including the three discretely presented component units, comprises 84.26% of these totals.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

The UNC Investment Fund, LLC (System Fund) Indirect Derivative Analysis for fiscal year ending June 30, 2004:

Asset Class	Total Market Value	% Invested Derivatives	Amount
Domestic Equity	\$ 221,299,722	12.49%	\$ 27,646,740
International Equity	189,258,690	15.31%	28,981,246
Global Equity	116,448,467	16.87%	19,649,812
Private Equity	200,654,634	0.41%	826,298
Absolute Return	88,103,420	10.08%	8,882,272
Fixed Income:			
Domestic Fixed Income	48,200,250	4.84%	2,333,912
Enhanced Fixed Income	126,749,538	0.40%	503,421
Real Estate	72,041,092	1.60%	1,155,158
Energy	84,652,068	1.23%	1,041,478
Total			<u><u>\$ 91,020,337</u></u>
Total Market Value of Investments in the System Fund			<u><u>\$ 1,150,294,999</u></u>
Total % of Market Value for Indirect Derivative Exposure			7.91%

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

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

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

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

The System Fund's holdings in indirect derivatives (i.e., derivatives held by external investment managers) are primarily used to decrease risk. This is because the indirect derivatives are used by the fund's hedge fund managers primarily to hedge underlying positions, or to gain exposure to specific markets in an efficient, inexpensive, liquid, and diversified manner. In the former case, risk is actually reduced by the use of derivatives because the derivative is directly offsetting market exposure. In the latter case, the derivatives are merely substituting for what would otherwise be a more traditional (individual security) array. Hence there would be no greater risk and often less risk than the traditional array that would exist in place of such derivatives. In limited cases, select managers are allowed to use derivatives to lever specific holdings or market

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

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positions. In aggregate, the fund's 7.91% exposure to indirect derivative holdings reflects a smaller degree of risk than there would be without such derivatives in the portfolio. The University considers the risk associated with these holdings to be prudent and within acceptable bounds.

### **NOTE 3 - ENDOWMENT INVESTMENTS**

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

To the extent that the total return for the current year exceeds the distribution, the excess is added to principal. If current year earnings do not meet the distribution requirements, the University uses accumulated income and appreciation to make up the difference. At June 30, 2004, accumulated income and appreciation of \$337,829,022 was available in the University's pooled endowment funds of which \$302,110,699 was restricted to specific purposes.



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 4 - RECEIVABLES

Receivables at June 30, 2004, were as follows:

	Gross Receivables	Less Allowance for Doubtful Accounts	Net Receivables
<b>Current Receivables:</b>			
Students	\$ 2,095,068	\$ 0	\$ 2,095,068
Patients	69,199,973	44,835,457	24,364,516
Accounts	36,647,242		36,647,242
Intergovernmental	32,506,706		32,506,706
Pledges	14,956,001	373,900	14,582,101
Investment Earnings	2,501,970		2,501,970
Interest on Loans	698,832		698,832
<b>Total Current Receivables</b>	<u>\$ 158,605,792</u>	<u>\$ 45,209,357</u>	<u>\$ 113,396,435</u>
<b>Noncurrent Receivables:</b>			
Pledges	<u>\$ 30,301,367</u>	<u>\$ 757,534</u>	<u>\$ 29,543,833</u>
<b>Notes Receivable:</b>			
<b>Notes Receivable - Current:</b>			
Federal Loan Programs	\$ 2,706,567	\$ 198,517	\$ 2,508,050
Institutional Student Loan Programs	834,285	40,941	793,344
Other Notes Receivable	955,343		955,343
<b>Total Notes Receivable - Current</b>	<u>\$ 4,496,195</u>	<u>\$ 239,458</u>	<u>\$ 4,256,737</u>
<b>Notes Receivable - Noncurrent:</b>			
Federal Loan Programs	\$ 27,076,484	\$ 1,985,393	\$ 25,091,091
Institutional Student Loan Programs	4,293,969	117,007	4,176,962
<b>Total Notes Receivable - Noncurrent</b>	<u>\$ 31,370,453</u>	<u>\$ 2,102,400</u>	<u>\$ 29,268,053</u>

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

Fiscal Year	Amount
2005	\$ 14,956,001
2006	14,119,275
2007	7,911,315
2008	4,061,479
2009	2,549,536
2010-2014	<u>5,290,203</u>
Total Pledge Receipts Expected	48,887,809
Discount Amount Representing Interest (3.5% Rate of Interest)	<u>(3,630,441)</u>
Present Value of Pledge Receipts Expected	45,257,368
Less Allowance for Uncollectible	<u>(1,131,434)</u>
Pledges Receivable	<u><u>\$ 44,125,934</u></u>

### NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2004, is presented as follows:

	Balance July 1, 2003	Adjustments	Increases	Decreases	Balance June 30, 2004
Capital Assets, Nondepreciable:					
Land	\$ 25,611,965	\$ 0	\$ 1,405,675	\$ 678,559	\$ 26,339,081
Art, Literature, and Artifacts	54,468,304		3,328,382	32,551	57,764,135
Construction in Progress	226,958,080	(160,135,093)	152,678,489	162,185	219,339,291
Intangible Assets	<u>1,000,000</u>				<u>1,000,000</u>
<b>Total Capital Assets, Nondepreciable</b>	<u>308,038,349</u>	<u>(160,135,093)</u>	<u>157,412,546</u>	<u>873,295</u>	<u>304,442,507</u>
Capital Assets, Depreciable:					
Buildings	903,545,671	159,301,391	32,841,381	3,912,034	1,091,776,409
Machinery and Equipment	205,511,121		21,435,222	13,441,619	213,504,724
General Infrastructure	<u>334,531,192</u>	<u>833,702</u>	<u>1,030,070</u>		<u>336,394,964</u>
<b>Total Capital Assets, Depreciable</b>	<u>1,443,587,984</u>	<u>160,135,093</u>	<u>55,306,673</u>	<u>17,353,653</u>	<u>1,641,676,097</u>
Less Accumulated Depreciation/Amortization for:					
Buildings	357,092,528		31,190,228	52,668	388,230,088
Machinery and Equipment	124,692,635		16,213,426	8,492,040	132,414,021
General Infrastructure	<u>135,619,685</u>		<u>13,185,469</u>		<u>148,805,154</u>
<b>Total Accumulated Depreciation</b>	<u>617,404,848</u>		<u>60,589,123</u>	<u>8,544,708</u>	<u>669,449,263</u>
<b>Total Capital Assets, Depreciable, Net</b>	<u>826,183,136</u>	<u>160,135,093</u>	<u>(5,282,450)</u>	<u>8,808,945</u>	<u>972,226,834</u>
<b>Capital Assets, Net</b>	<u><u>\$ 1,134,221,485</u></u>	<u><u>\$ 0</u></u>	<u><u>\$ 152,130,096</u></u>	<u><u>\$ 9,682,240</u></u>	<u><u>\$ 1,276,669,341</u></u>

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2004, were as follows:

	Amount
Accounts Payable	\$ 51,339,205
Accrued Payroll	21,151,001
Contract Retainage	5,300,762
Other	28,707
<b>Total Accounts Payable and Accrued Liabilities</b>	<b>\$ 77,819,675</b>

### NOTE 7 - SHORT-TERM DEBT – COMMERCIAL PAPER

Short-term debt activity for the year ended June 30, 2004, was as follows:

	Balance July 1, 2003	Issued	Redeemed	Balance June 30, 2004
Commercial Paper	\$ 19,000,000	\$ 25,950,000	\$ 36,109,000	\$ 8,841,000

Commercial Paper was issued from the University of North Carolina General Revenue Bonds, Series 2002A, to provide interim financing for the construction of capital projects. Commercial Paper was redeemed with proceeds from the University of North Carolina General Revenue Bonds, Series 2003.

The UNC-CH Foundation entered into a line of credit agreement on June 30, 2004, issued by Bank of America, N.A., in the aggregate principal amount up to \$10,000,000 to finance the costs of projects benefiting the Foundation or the University. The line of credit has a maturity date of June 30, 2005, and may be extended by agreement between Bank of America and the UNC-CH Foundation. At June 30, 2004, no principal amounts have been advanced.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 8 - LONG-TERM LIABILITIES

#### A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2004, is presented as follows:

	Balance July 1, 2003	Additions	Reductions	Balance June 30, 2004	Current Portion
Bonds Payable	\$ 428,860,000	\$ 107,960,000	\$ 17,080,000	\$ 519,740,000	\$ 115,057,582
Add/Deduct Premium/Discount	(52,380,920)	4,017,452	(2,913,148)	(45,450,320)	
Deduct Deferred Charge on Refunding	(2,931,529)		(325,726)	(2,605,803)	
Total Bonds Payable	373,547,551	111,977,452	13,841,126	471,683,877	115,057,582
Notes Payable	39,332,505		4,332,505	35,000,000	
Capital Leases Payable	926,628	881,350	487,564	1,320,414	693,439
Compensated Absences	72,588,314	61,805,858	44,379,710	90,014,462	5,568,119
Annuity and Life Income Payable	7,220,826	582,866	1,136,845	6,666,847	809,005
Total Long-Term Liabilities	\$ 493,615,824	\$ 175,247,526	\$ 64,177,750	\$ 604,685,600	\$ 122,128,145

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

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2004	Accretion on Capital Appreciation Bonds	Principal Outstanding 06/30/2004
Housing System							
	1997A	4.500% - 5.100%	11/01/2017	\$ 9,170,000	\$ 1,680,000	\$ 0	\$ 7,490,000
	1997B	4.000% - 5.000%	11/01/2017	7,210,000	1,385,000		5,825,000
Total Housing System				16,380,000	3,065,000		13,315,000
Utilities System	1997	5.250% - 5.500%	08/01/2021	84,135,000		(40,752,639)	43,382,361
Parking System							
	1997A	4.350% - 5.700%	05/15/2027	11,750,000	1,075,000		10,675,000
	1997B	3.900% - 5.150%	05/15/2009	8,245,000	4,175,000		4,070,000
Total Parking System				19,995,000	5,250,000		14,745,000
General Revenue							
	2001A	2.900% - 5.125%	12/01/2025	89,930,000	5,675,000		84,255,000
	2001B	Variable	12/01/2025	54,970,000	4,870,000		50,100,000
	2001C	Variable	12/01/2025	54,970,000	4,870,000		50,100,000
	2002B	3.500% - 5.000%	12/01/2011	66,555,000	7,540,000		59,015,000
	2003	2.000% - 5.000%	12/01/2033	107,960,000			107,960,000
Total General Revenue				374,385,000	22,955,000		351,430,000
Student Union	2000	4.550% - 5.659%	06/01/2022	12,465,000	1,060,000		11,405,000
Student Recreation Center	1997	3.900% - 5.000%	06/01/2011	3,545,000	1,060,000		2,485,000
U.S. EPA Project	1991	8.250% - 9.050%	02/15/2015	58,125,000	16,495,000	(13,003,930)	28,626,070
U.S. EPA Project	1996	6.72%	02/15/2006	2,400,000	1,805,000		595,000
Total Bonds Payable (principal only)				\$ 571,430,000	\$ 51,690,000	\$ (53,756,569)	465,983,431
Less: Unamortized Loss on Refunding							(2,605,803)
Plus: Unamortized Premium							8,306,249
Total Bonds Payable							\$ 471,683,877

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

The line of credit issued by Toronto-Dominion Bank and Chase Manhattan Bank expired on February 4, 2004, and a new line of credit was issued by JP Morgan Chase Bank on February 4, 2004. Under the new line of credit agreement, the University is entitled to draw amounts sufficient to pay the principal, and, while the bonds are bearing interest at the daily or weekly rate, accrued interest on bonds delivered for purchase.

The University is required to pay a quarterly commitment fee for the line of credit of 0.13% per annum based on the unused portion of the line of credit commitment. If the University’s credit rating for unsecured debt were to drop below “Aa3” (or its equivalent) by Moody’s, “AA-” (or its equivalent) by S&P, or “AA-” (or its equivalent) by Fitch, the quarterly commitment fee would increase to 0.18%. If the University’s credit rating for unsecured debt were to drop below “A3” (or its equivalent) by Moody’s, “A-” (or its equivalent) by S&P, or “A-” (or its equivalent) by Fitch, the quarterly commitment fee would increase to 0.28%. Additionally, if the University were to terminate the line of credit prior to

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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February 2, 2005, then the University must pay a termination fee of \$50,000 less any unused commitment fees paid to date.

Under the line of credit agreement, the University has promised to repay loans that represent purchase drawings in equal semi-annual payments after termination of the line of credit. Interest at the rate of Prime plus 1.0% (Prime plus 2.0% after 60 days) is payable quarterly and upon draw repayment. At June 30, 2004, no purchase draws had been made under the letter of credit.

The new line of credit agreement expires on February 2, 2005. However, between November 3, 2004, and December 3, 2004, the University may request that the Bank extend the expiration date for another year. The Bank shall respond affirmatively or negatively within 30 days after receipt of such request.

In the event of termination of the line of credit, outstanding principal is to be repaid in semi-annual installments of principal on each February 1, and August 1, commencing on the first of such dates succeeding the termination date with the remaining principal amount payable on the second anniversary of the termination date. Further, accrued interest will continue to be due and payable on the first day of the calendar quarter and on the date any portion of principal is payable.

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

Under this amended agreement, Lehman Brothers pays the University interest on the notional amount based on the Bond Market Association (BMA) Municipal Bond Index on a quarterly basis. On a semiannual basis, the University pays Lehman Brothers interest at the fixed rate of 5.24%. The notional amount of the swap reduces annually; the reductions began in November 2002, and end in November 2025. The swap agreement matures November 1, 2025. As of June 30, 2004, rates were as follows:

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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	Terms	Rates
Fixed Payment to Lehman	Fixed	5.24
Variable Payment from Lehman	BMA	0.98
Net Interest Rate Swap Payments		4.26
Variable Rate Bond Coupon Payments		1.01
Synthetic Interest Rate on Bonds		5.27

As of June 30, 2004, the swap had a negative fair value of \$3,513,801. The fair value was developed by Lehman Brothers. Its method calculates the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for London Interbank Offered Rate (LIBOR) due on the date of each future net settlement on the swap.

As of June 30, 2004, the University was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the University would be exposed to credit risk in the amount of the derivative's positive fair value. Should the swap have a positive fair value of more than \$1,000,000, Lehman would be required to collateralize 103% of its exposure. Lehman Brothers Holdings, guarantor of Lehman Brothers Special Financing, Inc., was rated A1 by Moody's Investor's Service, A by Standard and Poor's Corporation, and A+ by Fitch Ratings.

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

As rates vary, variable rate bond interest payments and net swap payments will vary. Using rates as of June 30, 2004, debt service requirements of the variable rate debt and net swap payments, assuming current interest rates remain the same for the their term, are as follows.

Fiscal Year	General Revenue Bonds, Series 2001B			
	Principal	Interest	Interest Rate Swaps, Net*	Total
2005	\$ 1,925,000	\$ 496,289	\$ 913,451	\$ 3,334,740
2006	2,060,000	476,165	903,227	3,439,392
2007	2,140,000	454,955	892,577	3,487,532
2008	2,175,000	433,164	881,394	3,489,558
2009	2,285,000	410,641	869,786	3,565,427
2010-2014	12,560,000	1,680,489	4,117,610	18,358,099
2015-2019	11,975,000	1,061,333	3,283,182	16,319,515
2020-2024	10,295,000	499,066	1,810,074	12,604,140
2025-2029	4,685,000	47,849	175,832	4,908,681
Total	<u>\$ 50,100,000</u>	<u>\$ 5,559,951</u>	<u>\$ 13,847,133</u>	<u>\$ 69,507,084</u>

\*Computed using  $(5.24\% - 0.98\%) \times (\$22,000,000 - \text{annual reduction})$

**D. Capital Appreciation Bonds** – The University’s Series 1997 Utility System and the Series 1991 U. S. Environmental Protection Agency Project bond issues include capital appreciation bonds with an original issue amount of \$30,379,142 and \$3,828,921, respectively. These bonds are recorded in the amounts of \$43,382,361 (\$84,135,000 ultimate maturity less \$40,752,639 discount) and \$12,271,070 (\$25,275,000 ultimate maturity less \$13,003,930 discount), respectively, which are the accreted values at June 30, 2004. These bonds mature in the years from 2010 to 2021.

**E. Annual Requirements** - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2004, are as follows:



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Fiscal Year	Annual Requirements			
	Bonds Payable		Notes Payable	
	Principal	Interest	Principal	Interest
2005	\$ 18,920,000	\$ 17,587,809	\$ 0	\$ 619,500
2006	20,840,000	16,728,662	35,000,000	154,875
2007	21,635,000	15,783,717		
2008	22,645,000	14,788,536		
2009	23,920,000	13,706,786		
2010-2014	125,585,000	55,054,900		
2015-2019	113,580,000	40,837,693		
2020-2024	95,220,000	26,272,428		
2025-2029	47,140,000	11,678,158		
2030-2034	30,255,000	3,917,331		
Total Requirements	<u>\$ 519,740,000</u>	<u>\$ 216,356,020</u>	<u>\$ 35,000,000</u>	<u>\$ 774,375</u>

Interest on the variable rate General Revenue Bonds 2001B is calculated at 1.010% at June 30, 2004.  
Interest on the variable rate General Revenue Bonds 2001C is calculated at 1.000% at June 30, 2004.  
For General Revenue Bonds, Series 2001B and 2001C, interest rates change weekly.

This schedule also includes the debt service requirements for debt associated with interest rate swaps. More detailed information about interest rate swaps is presented in Note 8C.

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

**Utilities System:** On May 7, 2002, the University defeased \$69,895,000 of outstanding Utilities System Revenue Bonds, Series 1993. Securities were placed in an irrevocable trust with an escrow agent and provided payment in full for the defeased bonds on August 1, 2002. At June 30, 2004, the outstanding balance of the defeased Utilities System Revenue Bonds was \$0.

**Dining System:** On February 7, 2001, the University defeased \$13,205,000 of outstanding Dining System Revenue Bonds, Series 1997. Securities were deposited into an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. The trust assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2004, the outstanding balance of the defeased Dining System bonds was \$11,010,000.

**Dormitory System:** On December 1, 1999, the University defeased \$1,225,000 of outstanding Dormitory System Revenue Bonds, Series E, F, & G (1963). Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2004, the outstanding balance was \$202,000 for the defeased outstanding Dormitory System Revenue Bonds, Series F and Series G (1963).

**Student Union:** On December 1, 1999, the University defeased \$620,000 of outstanding Student Union Revenue Bonds, Series 1967. Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2004, the outstanding balance was \$330,000 for the defeased outstanding Student Union Revenue Bonds, Series 1967.

**G. Notes Payable** - The University 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 06/30/2004	Principal Outstanding 06/30/2004
Student Housing Facility	Bank of America	1.77%	04/01/2005	<u>\$ 35,000,000</u>	<u>\$ 0</u>	<u>\$ 35,000,000</u>

The loan agreement is between the UNC-CH Foundation, which is part of the University's financial reporting entity, and Bank of America in the amount of \$35,000,000 with a maturity date of April 1, 2005. Subsequently, the loan agreement was refinanced and the maturity date extended to October 1, 2005 (Refer to Note 18 – Subsequent Events). The University plans to refinance the note with other long-term financing.

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## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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### NOTE 9 - LEASE OBLIGATIONS

- A. Capital Lease Obligations** - Capital lease obligations relating to medical and research equipment are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2004:

<u>Fiscal Year</u>	<u>Amount</u>
2005	\$ 758,292
2006	248,077
2007	197,335
2008	145,632
2009	95,031
Total Minimum Lease Payments	1,444,367
Amount Representing Interest (4.0% - 14.9% Rate of Interest)	123,953
Present Value of Future Lease Payments	<u>\$ 1,320,414</u>

Machinery and equipment acquired under capital lease amounted to \$1,746,469 at June 30, 2004.

- B. Operating Lease Obligations** – Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2004:

<u>Fiscal Year</u>	<u>Amount</u>
2005	\$ 5,926,647
2006	4,246,450
2007	2,825,428
2008	1,052,697
2009	164,375
Total Minimum Lease Payments	<u>\$ 14,215,597</u>

Rental expense for all operating leases during the year was \$10,667,677.

- C. Other Lease Obligations** – The UNC-CH Foundation issued certificates of participation to provide for construction of Alumni facilities. The University constructed the facilities as an agent for the UNC-CH Foundation. In October 1989, the University entered into a 20-year lease agreement with the UNC-CH Foundation and simultaneously entered into

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

a sublease agreement with the General Alumni Association, an affiliated organization, for the same time period for the use of the Alumni facilities.

Payments under the terms of the lease are a limited obligation of the University, payable solely from and secured by the annual rental income derived from the sublease of the Alumni facilities. The University has no other obligations for repayment of the certificates of participation; therefore, the certificates are not reported as a liability in the accompanying financial statements. As of June 30, 2004, the aggregate principal amount of the certificates was \$9,950,000.

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

### NOTE 10 - REVENUES

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

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Less Allowance for Uncollectibles	Less Indigent Care and Contractual Adjustments	Net Revenues	Revenues Pledged as Security for Debt	
<b>Student Tuition and Fees</b>	<u>\$ 187,243,558</u>	<u>\$ 0</u>	<u>\$ 33,300,343</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 153,943,215</u>	<u>\$ 0</u>	
<b>Patient Services</b>	<u>\$ 380,322,481</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ (17,969,088)</u>	<u>\$ 225,414,544</u>	<u>\$ 172,877,025</u>	<u>\$ 0</u>	
<b>Sales and Services:</b>								
Sales and Services of Auxiliary Enterprises:								
Residential Life	\$ 26,834,809	\$ 0	\$ 4,990,012	\$ 0	\$ 0	\$ 21,844,797	\$ 21,004,736	(A)
Dining	18,649,175	72,758	244,431			18,331,986		
Student Union Services	2,141,134		425,019			1,716,115		
Health, Physical Education, and Recreation Services	15,112,580		3,180,178			11,932,402	11,932,402	(B)
Bookstore	33,454,712	5,075,010				28,379,702		
Parking	15,431,949					15,431,949	15,431,949	(C)
Athletic	33,671,572	20,574	471,558			33,179,440		
Utilities	72,193,037	56,335,143				15,857,894	15,857,894	(D)
Other Professional Income	68,147,187					68,147,187		
Other	143,866,637	88,337,471				55,529,166	4,527,555	(E)
<b>Total Sales and Services</b>	<u>\$ 429,502,792</u>	<u>\$ 149,840,956</u>	<u>\$ 9,311,198</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 270,350,638</u>	<u>\$ 68,754,536</u>	
<b>Nonoperating - Noncapital Gifts</b>	<u>\$ 73,279,067</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 4,761,875</u>	<u>\$ 0</u>	<u>\$ 68,517,192</u>	<u>\$ 0</u>	
<b>Capital Gifts</b>	<u>\$ 6,358,879</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 6,358,879</u>	<u>\$ 0</u>	

(A) Housing System Revenue Bonds, Series 1997 A & B

(B) Student Fee Revenue Bonds, Series 1997 & 2000

(C) Parking System Revenue Bonds, Series 1997 A & B

(D) Utility System Revenue Bonds, Series 1997

(E) US EPA Project, Series 1991 & 1996

\*Includes \$3,630,441 PV discount on pledges receivable

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 11 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 405,156,040	\$ 27,896,687	\$ 99,838,351	\$ 0	\$ 36,248	\$ 0	\$ 532,927,326
Research	168,172,666	38,991,238	50,732,175		49,149		257,945,228
Public Service	28,331,147	1,121,468	48,776,636		46,350		78,275,601
Academic Support	48,036,408	14,159,806	13,495,957		809		75,692,980
Student Services	10,266,755	765,904	9,453,893		1,338		20,487,890
Institutional Support	41,582,465	4,175,161	18,952,564		21,181		64,731,371
Operations and Maintenance of Plant	29,812,183	4,266,718	13,066,329		40,745,634		87,890,864
Student Financial Aid				47,427,018			47,427,018
Auxiliary Enterprises	186,482,571	59,819,326	125,809,735		5,306,680		377,418,312
Depreciation						60,589,122	60,589,122
Total Operating Expenses	<u>\$ 917,840,235</u>	<u>\$ 151,196,308</u>	<u>\$ 380,125,640</u>	<u>\$ 47,427,018</u>	<u>\$ 46,207,389</u>	<u>\$ 60,589,122</u>	<u>\$ 1,603,385,712</u>

### NOTE 12 - PENSION PLANS

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

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

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2004, these rates were set at .22% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2004, the University had a total payroll of \$800,874,408, of which \$344,434,804 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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contributions for pension benefits for the year were \$20,666,088 and \$757,757, respectively. The University made one hundred percent of its annual required contributions for the years ended June 30, 2004, 2003, and 2002, which were \$757,757, \$0, and \$6,175,101, respectively.

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

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

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

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2004, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The University assumes no liability other than its contribution.

For the year ended June 30, 2004, the University had a total payroll of \$800,874,408, of which \$300,100,834 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$18,006,050 and \$20,526,897, respectively.

**B. Deferred Compensation and Supplemental Retirement Income Plans** - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement, or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, *the North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to \$3,409,430 for the year ended June 30, 2004.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the University except for a 5% employer contribution for the University's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of University law enforcement officers for the year ended June 30, 2004, were \$95,346. The voluntary contributions by employees amounted to \$2,504,985 for the year ended June 30, 2004.

IRC Section 403(b) and 403(b)(7) Plans - Eligible University employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to \$20,049,594 for the year ended June 30, 2004.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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### NOTE 13 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees -** The University 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 or the Optional Retirement Program. These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The University contributed 3.2% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program for these health care benefits. For the fiscal year ended June 30, 2004, the University's total contribution to the Plan was \$20,625,140. The University assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.
- B. Long-Term Disability -** The University participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. Employer contributions are established in the Appropriations Bill by the General Assembly. The University was not required to contribute to the DIPNC for the fiscal year ended June 30, 2004. The University assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

### NOTE 14 - RISK MANAGEMENT

The University is exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled via a combination of methods, including participation in State-administered insurance programs, purchase of commercial insurance, and self-retention of certain risks. Except for a reduction in the public officers' and employees' liability insurance from \$11,000,000 to \$5,000,000, and additional limitation to



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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the State's property reinsurance, there have been no significant reductions in insurance coverage from the previous year and settled claims have not exceeded coverage in any of the past three fiscal years.

**Public Officers' and Employees' Liability Insurance** - Tort claims of up to \$500,000 are self-insured under the authority of the State Tort Claims Act. In addition, the State provides excess public officers' and employees' liability insurance up to \$5,000,000 via contract with a private insurance company. The University pays the premium, based on a composite rate, directly to the private insurer.

**Fire and Other Property Loss** - The University is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a \$500 per occurrence deductible. The University also purchased through the Fund extended coverage or all risk coverage with a \$500 per occurrence deductible for certain buildings and contents.

**Automobile Liability Insurance** - 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 University pays premiums to the North Carolina Department of Insurance for the coverage.

**Employee and Computer Fraud** - The University is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is handled by the North Carolina Department of Insurance. Universities are 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.

Other authorized coverage not handled by the North Carolina Department of Insurance is purchased through the State's insurance agent of record. Examples include, but are not limited to, fine arts, boiler and machinery, medical professional liability, athletic accident and revenues and study abroad health insurance.

**Comprehensive Major Medical Plan** - University employees and retirees are provided comprehensive major medical care benefits. Coverage is funded by contributions to the State Health Plan (Plan), a pension and other employee

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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benefit trust fund of the State of North Carolina. The Plan has contracted with third parties to process claims.

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

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

The Trust Fund was created by Chapter 116, Article 26, of the General Statutes and The University of North Carolina Board of Governors Resolution of June 9, 1978, to provide professional liability protection for program participants and individual health care practitioners working as employees, agents, or officers of The University of North Carolina Hospitals at Chapel Hill (the Hospitals) and The University of North Carolina at Chapel Hill Physicians and Associates (University Physicians and Associates). The Trust 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 Trust 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 UNC Hospitals. Only the UNC Physicians and Associates and the Hospitals have participated in the Trust Fund to date. Participants provide management and administrative services to the Trust Fund at no cost.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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The Trust 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 Trust Fund provides coverage for participants as a corporate entity, as well as for the employees and professional staff of the participants. From July 1, 2003, through June 30, 2004, the Trust Fund provided coverage on an occurrence basis of \$7,000,000 per individual for each and every claim, self-insured through the Trust Fund. During the period July 1, 2003 – June 30, 2004, the Trust Fund had no excess of loss reinsurance coverage. For fiscal year ending June 30, 2004, the Trust Fund purchased a direct insurance policy to cover the first \$1,000,000 per occurrence and \$3,000,000 in the aggregate for dental residents. The Trust Fund provides coverage of \$500,000 per occurrence in accordance with the limited waiver of sovereign immunity afforded by the State Tort Claims Act, for any recovery against the participants for the negligence of its employees. To assure that both existing and future claims will be paid, the UNC System Board of Governors is authorized by law to borrow up to \$30,000,000 to replenish the Trust Fund. No borrowings have been made under this line of credit to date. The Council believes adequate funds are on deposit in the Trust Fund to meet estimated losses based upon the results of the independent actuary's report.

The Trust 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 Trust Fund will be required to make future payments on these claims is considered remote.

The Council may choose to terminate the Trust 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, 2004, University assets in the Trust Fund totaled \$24,677,500 while University liabilities totaled \$23,581,211 resulting in net assets of \$1,096,289.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Additional disclosures relative to the funding status and obligations of the Trust Fund are set forth in the Audited Financial Statements of the Liability Insurance Trust Fund for the years ended June 30, 2004, and 2003. Copies of this report may be obtained from The University of North Carolina Liability Insurance Trust Fund, 6001 East Wing, University of North Carolina Hospitals, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-3041.

**Term Life Insurance** - 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. There were no employer contributions required for the current fiscal year.

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

### NOTE 15 - COMMITMENTS AND CONTINGENCIES

- A. **Commitments** - The University has commitments of \$67,258,187 for various capital improvements projects that include construction and completion of new buildings, and renovations of existing buildings.
- B. **Pending Litigation and Claims** - A \$2.1 million claim related to the construction of the Frank Porter Graham Student Union project has been submitted to the State Construction Office by the contractor. No ruling has been made regarding this claim.

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

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

- C. **University Improvement General Obligation Bonds** - The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of \$2,500,000,000 of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The funds authorized are to be used solely for capital facilities

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

cost on the University of North Carolina campuses as specified in the legislation. The bond legislation specifies the amount of bond funding for each University campus and the level of bond funding intended for each project. The bonds are authorized to be issued over a six-year period beginning in 2001, at a level not to exceed amounts provided in the legislation. Using a cash flow financing approach, The University of North Carolina – General Administration (UNC-GA), establishes annual amounts not to exceed for each approved project. The amounts not to exceed are subject to change due to actual cash availability and needs during the year. Subsequent to the bond sales and the availability of bond proceeds, UNC-GA notifies the Office of State Budget and Management (OSBM) of the amounts not to exceed for each approved project. Within these amounts, based on an official request of cash needs from the University, OSBM authorizes allotments. The University records the allotments as revenue on the accompanying financial statements. The University's remaining authorization of \$312,423,928 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

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

Purpose	Amount
Pledges to Permanent Endowments	\$ 29,070,767

### NOTE 16 - RELATED PARTIES

**Foundations** - There are 12 separately incorporated nonprofit foundations associated with the University. These foundations are the are The Botanical Garden Foundation, Inc., The Dental Alumni Association, Inc., The Dental Foundation of North Carolina, Inc., The Educational Foundation, Inc., The General Alumni Association, The Institute of Government Foundation, Inc., The Law Alumni Association of N.C., Inc., The Pharmacy Foundation of North Carolina, Inc., The School of Education Foundation, Inc., The School of Journalism and Mass Communication Foundation of North Carolina, Inc., The

## NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

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University of North Carolina at Chapel Hill Public Health Foundation, Inc., and The University of North Carolina at Chapel Hill School of Nursing Foundation, Inc. The support from these organizations to the University approximated \$13,422,394 for the year ended June 30, 2004.

### NOTE 17 - CHANGE IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2004, the University implemented Governmental Accounting Standards Board Statement No. 39, *Determining Whether Certain Organizations are Component Units*. This Statement amends GASB Statement No. 14, *The Financial Reporting Entity*, to provide additional guidance to determine whether certain organizations for which the University is not financially accountable should be reported as component units based on the nature and significance of their relationship to the University.

### NOTE 18 - SUBSEQUENT EVENTS

On September 22, 2004, the Kenan-Flagler Business School Foundation, part of the University reporting entity, closed a \$20 million unsecured line of credit with Wachovia Bank. This credit facility is to be used to fund the expansion of the Paul J. Rizzo Business Conference Center and will expire on September 22, 2006. Advances under the line of credit accrue interest at the variable rate of the LIBOR Market Index plus 1.20%. There is an availability fee due each year on the anniversary date of the line of credit and is calculated as 0.125% of the difference between the commitment amount and the average balance outstanding for the year leading up to the anniversary date.

On October 1, 2004, the UNC-CH Foundation, also part of the University reporting entity, refinanced its \$35,000,000 unsecured loan with Bank of America. The purpose of the refinance was to increase the commitment to \$47,300,000 to provide additional funding for a Student Family Housing Project, and the facility will mature on October 1, 2005. The outstanding balance under the credit facility accrues interest at the LIBOR Rate plus 0.40%.

**The University of North Carolina at Chapel Hill**

**Schedule of General Obligation Bond Project Authorizations, Budgets and Expenditures**

**For Project-to-Date as of June 30, 2004**

**Schedule 1**

	Original Projected	Revised/ Actual	Original General Obligation Bonds Authorized	Current General Obligation Bonds Authorized	Other Sources	Total Project Budget	Amount Expended	Percent Completed	Original Expected Completion Date	Revised/ Actual Completion Date
<b>Capital Improvement Project</b>	<b>Start Date</b>	<b>Start Date</b>	<b>Bonds Authorized</b>	<b>Bonds Authorized</b>	<b>Sources</b>	<b>Budget</b>	<b>Expended</b>	<b>Completed</b>	<b>Date</b>	<b>Date</b>
<b>Projects Started</b>										
Medical Biomolecular Research Bldg	Dec-00	Feb-01	\$ 26,718,000	\$ 26,718,000	\$ 38,847,748	\$ 65,565,748	\$ 64,416,356	98.25%	May-03	Mar-03
RB House Library-Renovations	Apr-01	Apr-01	9,898,700	9,898,700	10,182,700	20,081,400	19,935,409	99.27%	Aug-02	May-02
Murphey Hall Classroom Bldg Comp Renovation	Jun-01	Oct-01	6,926,500	6,926,500	400,000	7,326,500	7,180,302	98.00%	Nov-02	Dec-02
Memorial Hall-Comp Renovation and Addition	Jun-01	May-03	9,200,000	9,910,000	8,383,730	18,293,730	9,333,585	51.02%	Jul-03	Oct-04
Memorial Hall-Comp Renovation and Addition	Jun-01	May-03		200,000		200,000	200,000	100.00%	Jul-03	Oct-04
Renovate Health Sciences Library	Jun-01	Oct-02	11,000,000	11,000,000	1,125,375	12,125,375	8,426,262	69.49%	Jan-04	Aug-04
Teaching Research Bldg-Sch of Public Health Proj Supp	Jun-01	Jul-02	13,382,900	11,162,900	25,598,300	36,761,200	28,982,870	78.84%	Dec-04	Nov-04
Sch of Dentistry Bldg Renovaton & Conversion fr. Operatory	Jun-01	Aug-02	8,397,100	8,354,800		8,354,800	7,888,673	94.24%	Jul-03	Aug-04
Carrington Hall-Addn for Sch of Nursing Proj Supp	Jun-01	Nov-02	10,082,100	9,242,100	7,904,000	17,146,100	10,706,278	62.44%	Sep-03	Nov-04
Peabody Hall-Classroom Bldg Comp Renovation	Jun-01	May-02	8,509,800	6,688,535	1,969,008	8,657,543	6,193,536	71.54%	May-04	Dec-03
Inst Marine Sciences-Morehead City Comp Renovation	Jun-01	Jan-03	1,833,300	1,833,300		1,833,300	1,830,761	99.86%	Feb-04	Mar-04
Science Complex Phase I	Jun-01	Dec-02	55,012,500	52,753,695		52,753,695	29,970,549	56.81%	Nov-05	Aug-06
Burnett Womack Bldg Research Lab Comp Renovation	Jun-01	Nov-03	24,848,500	24,455,551		24,455,551	5,566,123	22.76%	Nov-04	Oct-05
Medical Research BLDG-Comp. Renov. of Classrooms	Jun-01	Aug-03	12,895,000	23,173,654	500,000	23,673,654	6,458,500	27.28%	Dec-04	Aug-05
Carolina Living & Learning Center	Jun-01	Jan-02	1,154,275	1,154,275	1,364,275	2,518,550	2,473,285	98.20%	Sep-02	Nov-02
Sch of Med-Bioinformatics Bldg-Supplement	Feb-01	Feb-01	2,000,000	2,000,000	33,585,234	35,585,234	31,991,998	89.90%	Dec-02	May-03
Campus Fiber Optics Network	Nov-01	Jun-04	17,533,500	17,072,926		17,072,926	4,925,674	28.85%	Feb-06	Dec-08
Steam Distribution System Replacement	Apr-02	Apr-02	6,300,000				6,262,152		Oct-03	Oct-03
Phillips Hall-Comp Classroom & Lecture Renovation	Jul-02	Feb-03	1,450,000	1,431,410		1,431,410	766,966	53.58%	Oct-05	Jan-05
Hill & Davie Halls-Classroom & Lecture Renovation	Aug-02	Jun-05	1,949,000	1,949,000		1,949,000	259,447	13.31%	Oct-06	Dec-05
Infrastructure Improvements	Sep-02	Oct-01	32,298,000	38,972,060	2,764,885	41,736,945	23,035,700	55.19%	Feb-06	Jun-06
Storm Drainage Improvements	Oct-02	Jun-05	10,500,000	7,436,208		7,436,208	6,333,325	85.17%	Jan-07	Oct-05
Beard Hall & Lab Bldg Comp Renovation	Nov-02	Nov-02	3,500,000	2,353,707	21,839,600	24,193,307	23,148,838	96.68%	Jun-04	Aug-05
Berryhill Hall Lab Bldg Comp Renovation	Apr-04	Oct-05	10,700,000	17,373,653		17,373,653	1,048,799	6.04%	Jul-05	Sep-06
Arts & Sciences-Digital Multimedia Inst Ctr & Music Lib	Mar-05	Feb-07	20,150,000	20,150,000		20,150,000	980,045	4.86%	Aug-07	Oct-08
Ramshead Parking Lot Development	Nov-02	Nov-02	11,120,000	11,120,000	59,036,000	70,156,000	39,415,863	56.18%	Oct-05	Oct-05
Renovations to Alexander, Connor and Winston Res Halls	Jun-02	Jul-02		339,000	14,028,273	14,367,273	12,613,353	87.79%	Aug-03	Aug-03
Parking Lot Repairs and Expansion	Jul-03	Jul-03		1,350,000	2,400,000	3,750,000	3,049,999	81.33%	Oct-04	Oct-04
Stone Center	Jun-02	Jun-02		50,000	9,828,800	9,878,800	8,970,639	90.81%	Aug-04	Aug-04
School of Pharmacy (Beard Hall Addition)	Nov-99	Nov-99		1,250,000	22,724,800	23,974,800	22,633,838	94.41%	Nov-02	Nov-02
Land Acquisition	Sep-01	Sep-01	8,000,000	8,000,000		8,000,000	1,339,502	16.74%	Feb-06	Feb-06
Caldwell & Howell Hall Class and Lecture Halls Renovation	Jan-02	Jun-06	1,732,000	1,732,000		1,732,000	362,860	20.95%	Nov-04	Nov-07
Gerard Hall Classroom Bldg Comp Renovation	Jul-02	Mar-05	1,350,000	1,350,000		1,350,000	11,821	0.88%	Nov-03	Jul-05
Electrical Systems Improvement	Sep-02	Nov-03	8,400,000	4,524,000		4,524,000	266,321	5.89%	Feb-04	Mar-06
Technology Infrastructure Expansion	Sep-02	May-05	9,165,000	9,731,627		9,731,627	1,267,864	13.03%	Feb-06	Oct-06
Physical Plant Support Facilities	Oct-02	Oct-04	7,875,000	11,075,000		11,075,000	1,528,744	13.80%	Apr-04	Dec-05
Upgrade Campus Energy Mgt and Control System	Oct-02	Feb-05	3,682,600	3,682,600		3,682,600	252,462	6.86%	Mar-05	Aug-05
Saunders Hall Classroom Bldg- Comp Renovation	Nov-02	Sep-03	4,194,100	4,284,334		4,284,334	2,707,476	63.19%	Dec-03	Jan-05
440 W Franklin St. Renovation & Conversion for Info Tech	May-03	Aug-04	9,170,000	9,170,000		9,170,000	680,596	7.42%	Mar-05	Sep-05
Wollen & Fetzer Gyms Comp Renovation of Classrooms	Jul-03	May-04	1,598,000	1,588,381		1,588,381	201,543	12.69%	Oct-07	May-05
Brauer Hall Comp. Renovation of Dental Clinic	Dec-03	Aug-04	13,415,400	13,415,400		13,415,400	906,106	6.75%	Nov-05	May-06
Coker & Mitchell Hall-Comp Renovation of Classrooms	Jan-04	Oct-05	1,718,000	1,718,000		1,718,000	22,479	1.31%	Nov-09	Nov-06
Rosenau Hall Lab Bldg Comprehensive Renovation	Mar-04	May-05	9,000,000	8,800,000		8,800,000	312,310	3.55%	Oct-05	Jun-06
Academic Facilities to Consolidate Int'l Educ. Programs	Mar-04	Oct-04	20,000,000	19,790,815		19,790,815	2,468,860	12.47%	Jul-06	Jan-06
Hanes & Manning Halls & Alumni Bldg-Renovation of Class	May-04	Aug-05	2,233,000	2,226,644		2,226,644	284,003	12.75%	Oct-05	Dec-05
Student Services Bldg-Consolid of Services	Jun-04	Jun-05	27,000,000	27,000,000		27,000,000	770,801	2.85%	Feb-06	Nov-06
Cogeneration Facility-Back Pressure Turbine Generator	Jul-04	Dec-04	2,625,000	2,625,000		2,625,000	1,150,024	43.81%	Dec-05	Aug-05
New West Classroom Bldg-Comp Renovation	Jul-04	Oct-04	4,500,000	4,500,000		4,500,000	243,423	5.41%	Nov-05	Feb-07
Greenlaw Hall-Comp Renovation of Classrooms	May-05	Sep-05	1,825,000	1,825,000		1,825,000	10,890	0.60%	Oct-08	Dec-06
Wilson Hall Lab-Comp Renovation	May-05	Oct-05	8,920,000	8,920,000		8,920,000	25,320	0.28%	Dec-06	May-06
Smith Hall-Comp Renovation	Aug-05	May-05	1,355,200	1,355,200		1,355,200	51,317	3.79%	Jan-07	Jul-08
Hamilton Hall-Comp Renovation of Classrooms	Jul-06	May-05	1,539,000	1,539,000		1,539,000	10,843	0.70%	Nov-07	Nov-07

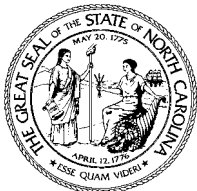
### Schedule 1

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Leslie W. Merritt, Jr., CPA, CFP  
State Auditor

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

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

We have audited the financial statements of The University of North Carolina at Chapel Hill, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component units, as of and for the year ended June 30, 2004, which collectively comprise the University's basic financial statements and have issued our report thereon dated November 12, 2004. We did not audit the financial statements of The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., which represent 100% of the University's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., is based on the reports of the other auditors.

As discussed in Note 17 to the financial statements, the University implemented Governmental Accounting Standards Board Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, during the year ended June 30, 2004.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. The financial statements of the discretely presented component units were not audited in accordance with *Government Auditing Standards*, and accordingly, this report does not extend to the discretely presented component units.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control

**INDEPENDENT AUDITOR'S REPORT  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING  
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GOVERNMENT AUDITING STANDARDS (CONTINUED)**

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over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the University's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition noted as a result of our audit is described in the Audit Finding and Recommendation section of this report.

**Finding**

Noncompliance with the Daily Deposit and Reporting Law

A material weakness is a reportable 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 caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we do not believe the reportable condition described above is a material weakness.

Compliance and Other Matters

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

**Finding**

Noncompliance with the Daily Deposit and Reporting Law

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

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

*Leslie W. Merritt, Jr.*

Leslie W. Merritt, Jr., CPA, CFP  
State Auditor

November 12, 2004

## AUDIT FINDING AND RECOMMENDATION

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### **Matter Related to Financial Reporting or Federal Compliance Objectives**

The following finding and recommendation was identified during the current audit and describes a condition that represents a significant deficiency in internal control and noncompliance with laws, regulations, contracts, grant agreements or other matters.

#### NONCOMPLIANCE WITH THE DAILY DEPOSIT AND REPORTING LAW

Departmental receipts were not deposited in accordance with the daily deposit requirements of General Statute 147-77. Departments did not have adequate controls over the receipting process to ensure that all receipts were deposited intact and deposited timely. In our test of thirty-nine departmental receipts, we identified seven that were deposited two days to three months after the receipt. Three of the seven departments did not have receipt or check log procedures. The other four departments used check logs or receipts, but these controls were not adequately implemented, and this failure resulted in late deposits. When deposits are delayed, revenues may be lost and inappropriate or fraudulent activity may go undetected.

*Recommendation:* We recommend that the University require all departments to implement adequate controls over the receipting process and comply with the daily deposit law. All departments should implement procedures such as check logs or sequential receipts to document that all items received have been deposited intact and deposited timely.

*University's Response:* University policy is consistent with the provisions of General Statute 147-77, which requires daily deposit of funds. Timely deposit of University funds is an important component of the cash management program. The communication and training provided to campus units regarding daily deposits will be increased. Issues related to appropriate control of receipts, proper recording of receipts, and timely depositing of funds will continue to be addressed in communication and training. Internal Audit performs surprise cash counts in campus departments and identifies issues requiring corrective actions including the need for timely deposits. Corrective action has been taken in the seven departments noted in the findings.

As part of the University's plan to address NACUBO's recommendations related to the Sarbanes-Oxley Act, a new financial controls manager position has been established. This person's primary role is to assist central offices and campus units in strengthening their internal controls.

One of the person's first assignments was to develop a questionnaire on internal controls, which includes a question on the timing, securing, and recording of deposits. The questionnaire serves as a self-assessment tool for campus units to evaluate their internal control environment and must be signed by the respondent and the dean, director or department chair. Based on the responses, the financial control manager provides support to

## **AUDIT FINDING AND RECOMMENDATION (CONCLUDED)**

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specific units where weaknesses exist, as well as general training sessions where common themes emerge across units. All campus departments will be required to fill out the questionnaire on a periodic basis.

This focused effort on financial controls will provide a more proactive and broader approach in identifying and resolving potential limitations on sound internal control through the self-assessment process, targeted campus training sessions, special reviews, improved documentation of internal controls, and timely and useful responses to questions from campus units.

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Director, Fiscal Research Division

April 15, 2005



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