



STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA SCHOOL OF THE ARTS

WINSTON-SALEM, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2004

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA SCHOOL OF THE ARTS

WINSTON-SALEM, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2004

BOARD OF GOVERNORS

THE UNIVERSITY OF NORTH CAROLINA

MOLLY CORBETT BROAD, PRESIDENT

BOARD OF TRUSTEES

STEPHEN P. KARR, CHAIRMAN

D. SAMUEL NEILL, VICE CHAIRMAN

**MARY BRAXTON-JOSEPH
PEGGY CORBITT
DONALD E. FLOW
DAVID R. HAYWORTH
RODNEY E. HOOD**

**CHARLES C. LUCAS, III
MICHAEL MARSICANO
CHRISTINE MCARDLE MCGUIRE
MICHAEL PULITZER, JR.
RALPH WOMBLE**

ADMINISTRATIVE OFFICERS

WADE HOBGOOD, CHANCELLOR

JOSEPH L. DICKSON, VICE CHANCELLOR FOR FINANCE AND ADMINISTRATION



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

STATE OF NORTH CAROLINA
Office of the State Auditor

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

AUDITOR'S TRANSMITTAL

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

This report presents the results of our financial statement audit of North Carolina School of the Arts, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, for the year ended June 30, 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 School are an integral part of the State's reporting entity represented in the State's *Comprehensive Annual Financial Report (CAFR)* and the State's *Single Audit Report*. In those reports, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor also presents the audit results on the State's internal controls and on the State's compliance with laws, regulations, contracts, and grants applicable to the State's financial statements and to its federal financial assistance programs.

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

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

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

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

AUDITOR'S TRANSMITTAL (CONCLUDED)

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

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

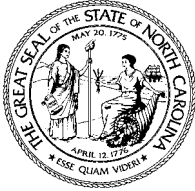
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.



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

TABLE OF CONTENTS

	PAGE
INDEPENDENT AUDITOR’S REPORT	1
MANAGEMENT’S DISCUSSION AND ANALYSIS	3
BASIC FINANCIAL STATEMENTS	
Exhibits	
A-1 Statement of Net Assets	12
A-2 Statement of Revenues, Expenses, and Changes in Net Assets	14
A-3 Statement of Cash Flows	15
B-1 Statement of Financial Position	17
B-2 Statement of Activities	18
Notes to the Financial Statement	19
SUPPLEMENTARY INFORMATION	
Schedule	
1 Schedule of General Obligation Bond Project Authorizations, Budgets, and Expenditures	39
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 <i>GOVERNMENT AUDITING STANDARDS</i>	41
DISTRIBUTION OF AUDIT REPORT	43



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

STATE OF NORTH CAROLINA
Office of the State Auditor

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

INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of North Carolina School of the Arts, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component units, as of and for the year ended June 30, 2004, which collectively comprise the North Carolina School of the Arts' basic financial statements as listed in the table of contents. These financial statements are the responsibility of the School'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 North Carolina School of the Arts Foundation, Inc., and the NCSA Housing Corporation, which represents 100% of the School'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 North Carolina School of the Arts Foundation, Inc., and the NCSA Housing Corporation were not audited in accordance with *Government Auditing Standards*. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

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 North Carolina School of the Arts 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.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

As discussed in Note 15 to the financial statements, the School 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 May 31, 2005, on our consideration of the School's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and 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 North Carolina School of the Arts' 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

May 31, 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS



Introduction

This section of the North Carolina School of the Arts financial report provides an overview of the financial position and activities for the year ended June 30, 2004. This discussion has been prepared by management along with the financial statements and related notes to the financial statements and should be read in conjunction with the financial statements and the notes thereto, which follow this section. This discussion and analysis is designed to focus on current activities, resulting change, and current known facts.

Using the Financial Statements

This annual report consists of a series of financial statements, prepared in accordance with the Governmental Accounting Standards Board Statement No. 35, *Basic Financial Statements - and Management's Discussion and Analysis - for Public Colleges and Universities*. These financial statements contain comparative information from the prior fiscal year and focus on the financial condition of the School, the results of operations, and cash flows of the School as a whole. There are three financial statements presented: the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and, the Statement of Cash Flows.

Statement of Net Assets

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

From the data presented, readers of the Statement of Net Assets are able to determine the assets available to continue the operations of the Institution. They are also able to determine how much the Institution owes vendors, investors and lending institutions. Finally, the Statement of Net Assets provides a picture of the net assets (assets minus liabilities) and their availability for expenditure by the Institution.

Net assets are divided into three major categories. The first category, invested in capital assets, net of related debt, provides the Institution's equity in property, plant and equipment owned by the Institution. The next net assets category is restricted net assets, which is divided into two categories, nonexpendable and expendable. Nonexpendable restricted net assets include endowment investments,

which are only available for investment purposes, and student loan funds. Expendable restricted net assets are available for expenditure by the Institution but must be spent for purposes as determined by

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

donors and/or external entities that have placed certain restrictions on the use of the assets. This category includes restricted funds for endowment investments, capital projects, and a reserve for debt service. The final category is unrestricted net assets, which are available to the Institution for any lawful purpose of the Institution. The School uses available resources to acquire and improve all areas of the Institution to better serve the instructional and public service missions of the Institution. Please refer to the financial statements and notes for more detail.

Statement of Net Assets

	Year Ended June 30,	
	2004	2003
Assets		
Current Assets	\$ 5,586,835	\$ 6,025,128
Capital Assets, Net	85,068,046	77,421,858
Other Noncurrent Assets	5,024,468	4,654,975
Total Assets	95,679,349	88,101,961
Liabilities		
Current Liabilities	3,564,719	4,322,129
Noncurrent Liabilities	6,580,369	7,141,531
Total Liabilities	10,145,088	11,463,660
Net Assets		
Invested in Capital Assets, Net of Related Debt	79,742,828	71,935,101
Restricted:		
Nonexpendable	3,090,696	2,519,616
Expendable	812,882	894,424
Unrestricted	1,887,855	1,289,160
Total Net Assets	\$ 85,534,261	\$ 76,638,301

The total assets of the School increased by \$7,577,388 for the year (\$438,293 decrease in current assets and \$8,015,681 increase in noncurrent assets). This overall increase was primarily due to a \$9,655,889 increase in capital assets, net of accumulated depreciation of \$2,009,307, bringing the net capital assets increase to \$7,646,582. The largest capital assets increase was in construction in progress, with an \$8,496,920 increase primarily attributable to increased expenditures in the general obligation bond projects during the 2003-2004 fiscal year. There were also \$9,684,377 of adjustments out of the construction in progress account into the appropriate capital asset accounts due to completion of construction. The \$9,684,377 in adjustments were to the following capital asset accounts: \$154,489 to land, \$8,142,433 to buildings, \$72,291 to machinery and equipment, and \$1,315,164 to general infrastructure.

The total liabilities of the School decreased by \$1,318,572 for the year (\$757,410 decrease in current liabilities and \$561,162 decrease in noncurrent liabilities). The decrease in current liabilities was primarily attributable to a \$791,801 decrease in accounts payable and contract retainage. The decrease in noncurrent liabilities was primarily attributable to \$635,000 in principal payments made during the year on bonds and notes payable.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Revenues, Expenses, and Changes in Net Assets

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Revenues, Expenses, and Changes in Net Assets

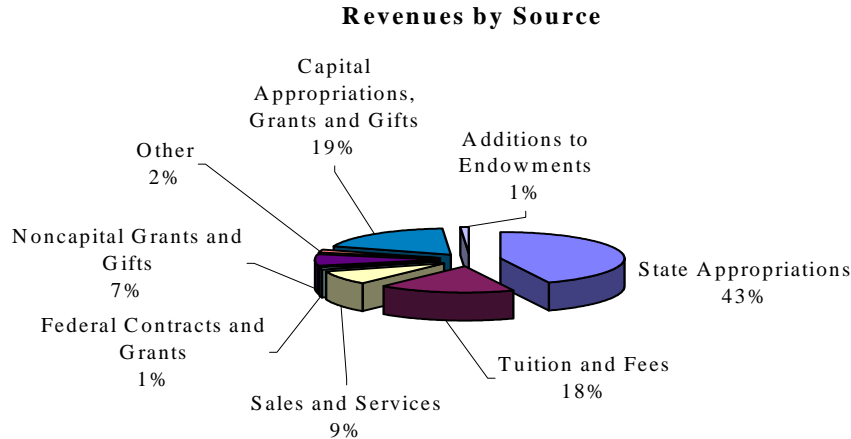
	Year Ended June 30,	
	2004	2003
Operating Revenues		
Student Tuition and Fees, Net	\$ 8,040,040	\$ 7,952,020
Federal Grants and Contracts	612,561	530,020
Sales and Services, Net	3,954,211	4,105,768
Interest Earnings on Loans	630	1,275
Other Operating Revenues	557,978	414,452
Total Operating Revenues	13,165,420	13,003,535
Total Operating Expenses	36,194,899	34,971,549
Operating Loss	(23,029,479)	(21,968,014)
Nonoperating Revenues (Expenses)		
State Appropriations	19,756,863	15,917,599
Noncapital Grants	17,540	31,320
Noncapital Gifts	3,127,727	3,754,355
Investment Income (Net of Investment Expense)	287,629	145,360
Interest and Fees on Capital Asset-Related Debt	(250,378)	(236,392)
Other Nonoperating Revenues (Expenses)	2,752	(138,012)
Net Nonoperating Revenues	22,942,133	19,474,230
Loss Before Other Revenues	(87,346)	(2,493,784)
Capital Appropriations	95,900	
Capital Grants	8,335,906	12,675,956
Capital Gifts	51,500	
Additions to Permanent Endowments	500,000	500,000
Total Other Revenues	8,983,306	13,175,956
Change in Net Assets	8,895,960	10,682,172
Beginning Net Assets	76,638,301	65,956,129
Ending Net Assets	\$ 85,534,261	\$ 76,638,301

The Statement of Revenues, Expenses, and Changes in Net Assets reflects an increase in the net assets at the end of the year. Total net revenues were \$45,090,859 for 2004 and \$45,653,721 for 2003. The decrease in total net revenues, \$562,862, is due primarily to the change in State appropriations, increase of \$3,839,264; and change in capital grants, decrease of \$4,340,050. Additional highlights of the information presented on the Statement of Revenues, Expenses, and Changes in Net Assets are as follows:

- Student tuition and fees reflects a slight increase primarily due to an increase in fees;
- Other operating revenues increased due to increased rentals of facilities, costumes, sets, and films;

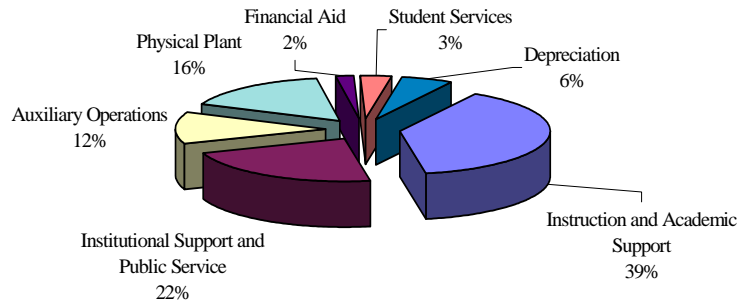
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

- State appropriations increased dramatically due to an increase for operating funds for new facilities constructed and purchased;
- Noncapital grants reflects a reduction in North Carolina Information Highway grants;
- Noncapital Gifts is lower in 2004 because 2003 reflected a large gift from the Kenan Arts Institute. This gift was in conjunction with the School managing the accounting for the Institute. The Institute makes grants to arts agencies and the grants are recorded under noncapital grants;
- Investment income increased this year due to improved earnings on endowment investments;
- Other nonoperating revenues include the disposal of capital assets. Disposals in 2004 were much lower than 2003;
- Capital appropriations increased due to the allotment of repair and renovation funds received in the 2004 fiscal year;
- Capital grants decreased dramatically due to a reduction in construction projects funded under the UNC bond projects;
- The statements reflect an increase in capital gifts for 2004. Capital gifts for 2004 included donations of furniture, musical instruments, lighting equipment, and an irrigation system.

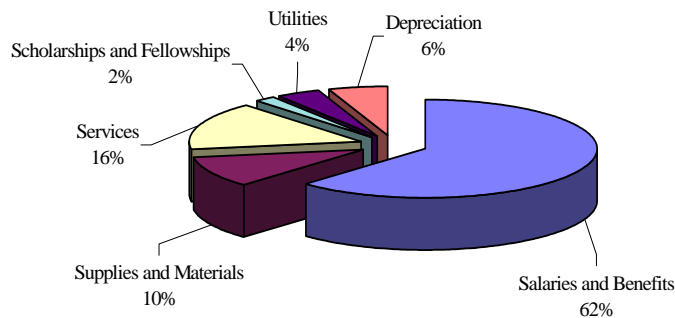


MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Operating Expenditures By Purpose



Operating Expenditures by Classification



Statement of Cash Flows

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

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Cash Flows

	Year Ended June 30,	
	2004	2003
Cash Provided (Used) by:		
Operating Activities	\$ (21,362,979)	\$ (19,598,339)
Noncapital Financing Activities	23,331,472	20,167,907
Capital and Related Financing Activities	(2,245,814)	(972,585)
Investing Activities	99,976	37,234
Net Change in Cash	(177,345)	(365,783)
Cash, Beginning of Year	6,521,571	6,887,354
Cash, End of Year	\$ 6,344,226	\$ 6,521,571

Capital Asset and Debt Administration

The School took out a \$1,500,000 loan in 2003. The Student Commons Renovation Loan was used for the completion of renovations and additions to the Student Commons project. The project included an entire new fitness center as well as an addition and renovations to the existing Student Commons Building, which encompasses the dining hall, snack bar, student life, student activities, health services, campus store, and campus mail center. Housing and Dining System revenues, as well as other available funds, have been pledged for the retirement of this debt. No new debt was issued in 2004.

Economic Outlook

The School faced several budget reductions in 2004 and will face additional reductions for 2005; however, the School has also received additional funding in 2005 for higher enrollment projections. The School has been very active working on plans to meet the budget reductions and also working on plans to allocate the new appropriation of funds as well as existing resources in ways necessary to deliver a high standard of classroom instruction and a high quality of student life.

The School is proceeding with remaining construction, renovation, and property acquisition projects (Phase I) relating to a \$2.5 billion University-wide bond issue in 1999-2000. The North Carolina School of the Arts received \$42.5 million of this bond issue to construct new buildings, renovate existing structures, and purchase land and additional buildings. The School is currently working on updating plans for Phase II of the bond projects.

One of the projects underway is a dorm connector building that will address additional space needs for high school students to congregate as well as some additional space needed to handle future growth of the high school population.

The Student Services Support Building will assist in accommodating the needs of the overall growing student population. Some of the departments to be housed in this new facility will include Registrar, Financial Aid, Admissions, Student Accounts, and Cashier, as well as some

MANAGEMENT’S DISCUSSION AND ANALYSIS (CONTINUED)

other associated departments. This facility will provide a “One-Stop Shop” environment addressing general population students’ needs.

The Film Archives Building will house a collection of approximately 27,000 films. This new facility will address all of the special film needs and serve as a world-class film history research center. This will afford students and individuals the opportunity to view films for researching scripts, commercials, billboards or any other type of film research data.

The Basic Performance and Education Complex includes the Chamber Music Hall. The Music Hall has two recital halls, supporting practice space, and office space.

Construction is underway for a comprehensive modernization/renovation to the various costume shops, recital halls, laboratories and special performance facilities. In addition, funds were authorized to address land acquisition and technology infrastructure needs. Some photos of the current bond construction and renovation projects are listed on the next page.

Bond Construction/Renovation Projects

School of Music Complex



Student Services Building



Design & Production Costume Shops



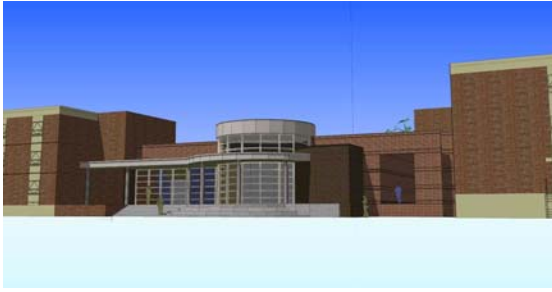
(Completed Projection)



(Current Construction)

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

Residence Hall Connector



(Completed Projection)



(Current Construction)

Film Archives



North Carolina School of the Arts
Statement of Net Assets
June 30, 2004

Exhibit A-1

ASSETS

Current Assets:

Cash and Cash Equivalents	\$ 4,260,117.61
Restricted Cash and Cash Equivalents	510,851.09
Receivables, Net (Note 4)	563,304.67
Due from University Component Units	17,105.75
Inventories	186,806.92
Notes Receivable, Net (Note 4)	48,648.52
	<hr/>
Total Current Assets	5,586,834.56
	<hr/>

Noncurrent Assets:

Restricted Cash and Cash Equivalents	1,573,257.27
Restricted Due from Primary Government	1,230,168.02
Endowment Investments	1,724,538.61
Other Long-Term Investments	99,909.75
Notes Receivable, Net (Note 4)	396,595.03
Capital Assets - Nondepreciable (Note 5)	29,154,378.49
Capital Assets - Depreciable, Net (Note 5)	55,913,667.74
	<hr/>
Total Noncurrent Assets	90,092,514.91
	<hr/>
Total Assets	95,679,349.47
	<hr/>

LIABILITIES

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)	1,668,651.01
Due to Primary Government	14,567.92
Deferred Revenue	1,026,035.61
Interest Payable	57,109.72
Long-Term Liabilities - Current Portion (Note 7)	798,354.54
	<hr/>
Total Current Liabilities	3,564,718.80
	<hr/>

Noncurrent Liabilities:

Deposits Payable	39,700.00
Funds Held for Others	13,300.27
U. S. Government Grants Refundable	435,573.89
Long-Term Liabilities (Note 7)	6,091,795.16
	<hr/>
Total Noncurrent Liabilities	6,580,369.32
	<hr/>
Total Liabilities	10,145,088.12
	<hr/>

***North Carolina School of the Arts
Statement of Net Assets
June 30, 2004***

***Exhibit A-1
Page 2***

NET ASSETS

Invested in Capital Assets, Net of Related Debt	79,742,828.35
Restricted for:	
Nonexpendable:	
Endowed Professorships	1,762,804.23
Departmental Uses	1,267,000.00
Loans	60,891.48
Expendable:	
Scholarships and Fellowships	87,931.61
Endowed Professorships	232,885.53
Departmental Uses	191,641.14
Capital Projects	200,513.78
Debt Service	99,909.75
Unrestricted	<u>1,887,855.48</u>
Total Net Assets	<u><u>\$ 85,534,261.35</u></u>

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

***North Carolina School of the Arts
Statement of Revenues, Expenses, and
Changes in Net Assets
For the Fiscal Year Ended June 30, 2004***

Exhibit A-2

REVENUES

Operating Revenues:	
Student Tuition and Fees, Net (Note 9)	\$ 8,040,040.19
Federal Grants and Contracts	612,560.62
Sales and Services, Net (Note 9)	3,954,210.73
Interest Earnings on Loans	629.59
Other Operating Revenues	557,978.49
	<hr/>
Total Operating Revenues	13,165,419.62
	<hr/>

EXPENSES

Operating Expenses:	
Salaries and Benefits	22,540,724.11
Supplies and Materials	3,740,829.66
Services	5,677,840.96
Scholarships and Fellowships	724,529.29
Utilities	1,501,667.81
Depreciation	2,009,306.88
	<hr/>
Total Operating Expenses	36,194,898.71
	<hr/>
Operating Loss	(23,029,479.09)
	<hr/>

NONOPERATING REVENUES (EXPENSES)

State Appropriations	19,756,862.97
Noncapital Grants	17,540.00
Noncapital Gifts	3,127,726.85
Investment Income (Net of Investment Expense of \$12,684.59)	287,629.53
Interest and Fees on Capital Asset-Related Debt	(250,377.84)
Other Nonoperating Revenues	2,751.75
	<hr/>
Net Nonoperating Revenues	22,942,133.26
	<hr/>
Loss Before Other Revenues	(87,345.83)
	<hr/>
Capital Appropriations	95,900.00
Capital Grants	8,335,906.00
Capital Gifts	51,500.00
Additions to Endowments	500,000.00
	<hr/>
Increase in Net Assets	8,895,960.17

NET ASSETS

Net Assets - July 1, 2003	<hr/> 76,638,301.18
Net Assets - June 30, 2004	<hr/> <hr/> \$ 85,534,261.35

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

***North Carolina School of the Arts
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2004***

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$ 12,988,115.44
Payments to Employees and Fringe Benefits	(22,606,940.16)
Payments to Vendors and Suppliers	(11,012,705.65)
Payments for Scholarships and Fellowships	(724,529.29)
Loans Issued	(149,169.60)
Collection of Loans	140,864.15
Interest Earned on Loans	946.81
US Government Grants Refundable Receipts	5,739.36
Student Deposits Received	39,700.00
Student Deposits Returned	(45,000.00)
	<hr/>
Net Cash Used by Operating Activities	(21,362,978.94)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations	19,756,862.97
Noncapital Grants	17,540.00
Noncapital Gifts	3,053,891.88
Additions to Permanent and Term Endowments	500,000.00
William D. Ford Direct Lending Receipts	3,863,161.00
William D. Ford Direct Lending Disbursements	(3,863,161.00)
Related Activity Agency Receipts	3,177.79
	<hr/>
Net Cash Provided by Noncapital Financing Activities	23,331,472.64

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

State Capital Appropriations	95,900.00
Capital Grants	8,749,439.13
Proceeds from Sale of Capital Assets	2,751.75
Acquisition and Construction of Capital Assets	(10,202,783.78)
Principal Paid on Capital Debt	(635,000.00)
Interest and Fees Paid on Capital Debt	(256,121.28)
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(2,245,814.18)

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	642,751.10
Investment Income	85,075.32
Purchase of Investments and Related Fees	(627,850.71)
	<hr/>
Net Cash Provided by Investing Activities	99,975.71

Net Decrease in Cash and Cash Equivalents	(177,344.77)
Cash and Cash Equivalents - July 1, 2003	6,521,570.74
	<hr/>
Cash and Cash Equivalents - June 30, 2004	\$ 6,344,225.97

***North Carolina School of the Arts
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 USED BY OPERATING ACTIVITIES**

Operating Loss	\$ (23,029,479.09)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:	
Depreciation Expense	2,009,306.88
Allowances, Write-Offs, and Amortizations	(34,205.48)
Changes in Assets and Liabilities:	
Receivables (Net)	(132,416.62)
Due from University Component Units	(17,105.75)
Inventories	(27,732.86)
Accounts Payable and Accrued Liabilities	(235,626.17)
US Government Grants Refundable	5,739.36
Due to Primary Government	9,645.92
Deferred Revenue	4,352.31
Compensated Absences	98,148.01
Deposits Payable	(5,300.00)
Student Loans Issued	(149,169.60)
Student Loans Principal Repayments	140,864.15
	<u>140,864.15</u>
Net Cash Used by Operating Activities	<u>\$ (21,362,978.94)</u>

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:	
Cash and Cash Equivalents	\$ 4,260,117.61
Restricted Cash and Cash Equivalents	510,851.09
Noncurrent Assets:	
Restricted Cash and Cash Equivalents	1,573,257.27
	<u>1,573,257.27</u>
Total Cash and Cash Equivalents - June 30, 2004	<u>\$ 6,344,225.97</u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through a Gift	\$ 51,500.00
Change in Fair Value of Investments	171,725.40
Reinvested Distributions	14,510.42
Gain on Disposal of Capital Assets	2,357.43

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

***North Carolina School of the Arts
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2004***

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$ 12,988,115.44
Payments to Employees and Fringe Benefits	(22,606,940.16)
Payments to Vendors and Suppliers	(11,012,705.65)
Payments for Scholarships and Fellowships	(724,529.29)
Loans Issued	(149,169.60)
Collection of Loans	140,864.15
Interest Earned on Loans	946.81
US Government Grants Refundable Receipts	5,739.36
Student Deposits Received	39,700.00
Student Deposits Returned	(45,000.00)
	<hr/>
Net Cash Used by Operating Activities	(21,362,978.94)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations	19,756,862.97
Noncapital Grants	17,540.00
Noncapital Gifts	3,053,891.88
Additions to Permanent and Term Endowments	500,000.00
William D. Ford Direct Lending Receipts	3,863,161.00
William D. Ford Direct Lending Disbursements	(3,863,161.00)
Related Activity Agency Receipts	3,177.79
	<hr/>
Net Cash Provided by Noncapital Financing Activities	23,331,472.64

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

State Capital Appropriations	95,900.00
Capital Grants	8,749,439.13
Proceeds from Sale of Capital Assets	2,751.75
Acquisition and Construction of Capital Assets	(10,202,783.78)
Principal Paid on Capital Debt	(635,000.00)
Interest and Fees Paid on Capital Debt	(256,121.28)
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(2,245,814.18)

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	642,751.10
Investment Income	85,075.32
Purchase of Investments and Related Fees	(627,850.71)
	<hr/>
Net Cash Provided by Investing Activities	99,975.71

Net Decrease in Cash and Cash Equivalents	(177,344.77)
Cash and Cash Equivalents - July 1, 2003	6,521,570.74
	<hr/>
Cash and Cash Equivalents - June 30, 2004	\$ 6,344,225.97

***North Carolina School of the Arts
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 USED BY OPERATING ACTIVITIES**

Operating Loss	\$ (23,029,479.09)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:	
Depreciation Expense	2,009,306.88
Allowances, Write-Offs, and Amortizations	(34,205.48)
Changes in Assets and Liabilities:	
Receivables (Net)	(132,416.62)
Due from University Component Units	(17,105.75)
Inventories	(27,732.86)
Accounts Payable and Accrued Liabilities	(235,626.17)
US Government Grants Refundable	5,739.36
Due to Primary Government	9,645.92
Deferred Revenue	4,352.31
Compensated Absences	98,148.01
Deposits Payable	(5,300.00)
Student Loans Issued	(149,169.60)
Student Loans Principal Repayments	140,864.15
	<u>140,864.15</u>
Net Cash Used by Operating Activities	<u>\$ (21,362,978.94)</u>

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:	
Cash and Cash Equivalents	\$ 4,260,117.61
Restricted Cash and Cash Equivalents	510,851.09
Noncurrent Assets:	
Restricted Cash and Cash Equivalents	1,573,257.27
	<u>1,573,257.27</u>
Total Cash and Cash Equivalents - June 30, 2004	<u>\$ 6,344,225.97</u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through a Gift	\$ 51,500.00
Change in Fair Value of Investments	171,725.40
Reinvested Distributions	14,510.42
Gain on Disposal of Capital Assets	2,357.43

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

North Carolina School of the Arts Foundations
Statement of Financial Position
June 30, 2004

Exhibit B-1

	North Carolina School of the Arts Foundation, Inc.				NCSA Housing Corporation
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	
ASSETS					
Cash and Cash Equivalents	\$ 226,941	\$ 1,594,227	\$ 784,862	\$ 2,606,030	\$ 110,679
Investments		1,991,228	12,333,996	14,325,224	
Annuity Investments			1,062,302	1,062,302	
Beneficial Interest in Perpetual Trusts			723,424	723,424	
Beneficial Interest in Charitable Remainder Trusts			103,137	103,137	
Pledges Receivable, Net of Allowance and Discount of \$611,679	24,825	1,018,550	2,432,325	3,475,700	
Accounts Receivable	9,986	6,473		16,459	
Rent Receivable					950
Due From Related Parties	285,794	62,880		348,674	
Due From (To) Other Funds	201,299	(201,299)			
Pepaid Expenses	4,384	25,485		29,869	
Staff, Faculty and Student Loans Receivable	9,174	8,317		17,491	
Property and Equipment, Net	1,023,642	68,622		1,092,264	6,032,811
Total Assets	1,786,045	4,574,483	17,440,046	23,800,574	6,144,440
LIABILITIES					
Accounts Payable and Accrued Expenses	49,579	79,858		129,437	1,225
Unearned Rent					2,850
Accrued Interest					972
Loan from North Carolina School of the Arts Program					
Support Corporation					21,600
Security Deposits					43,378
Returnable Advances			833,334	833,334	
Annuity Payment Liability			800,897	800,897	
Notes Payable		96,029		96,029	
Long-Term Debt					6,400,000
Total Liabilities	49,579	175,887	1,634,231	1,859,697	6,470,025
NET ASSETS					
Unrestricted	1,736,466			1,736,466	(325,585)
Temporarily Restricted		4,398,596		4,398,596	
Permanently Restricted			15,805,815	15,805,815	
Total Net Assets	\$ 1,736,466	\$ 4,398,596	\$ 15,805,815	\$ 21,940,877	\$ (325,585)

See Note 1 in the Notes to the Financial Statements

**North Carolina School of the Arts Foundations
Statement of Activities
For the Fiscal Year Ended June 30, 2004**

Exhibit B-2

	North Carolina School of the Arts Foundation, Inc.				NCSA Housing Corporation
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	
REVENUES					
Gifts and Grants	\$ 603,944	\$ 2,299,863	\$ 980,213	\$ 3,884,020	\$ 0
Production Income	151,898			151,898	
Interest and Dividend Income	165,815	282,070		447,885	32
Realized and Unrealized Gains	57,096	925,450		982,546	
Change in Fair Value of Split-Interest Agreements			72,012	72,012	
Change in Fair Value of Beneficial Interest in Perpetual Trusts		30,575	50,337	80,912	
Rent Income					606,134
Other Income	114,969	111,542		226,511	
Net Assets Released from Restrictions	2,833,967	(2,833,967)			
Total Revenues	3,927,689	815,533	1,102,562	5,845,784	606,166
EXPENSES					
Program Services:					
Scholarships and Awards	948,298			948,298	
School Programs	1,961,738			1,961,738	
Production Expenditures	152,990			152,990	
Utilities and Other Monthly Rental Costs					146,161
Depreciation Expense					267,352
Property Taxes					42,610
Maintenance					27,327
Insurance					24,781
Security					21,550
Total Program Services	3,063,026			3,063,026	529,781
Supporting Services:					
Administrative Costs	205,602			205,602	
Investment Management Fees	83,484			83,484	
Development Costs	403,356			403,356	
Depreciation Expense	22,683			22,683	
Miscellaneous Expense	31,411			31,411	
Total Supporting Services	746,536			746,536	
General and Administrative Services:					
Interest					167,048
Depreciation Expense					712
Miscellaneous Expense					15,160
Total General and Administrative Services					182,920
Total Expenses	3,809,562			3,809,562	712,701
Change in Net Assets	118,127	815,533	1,102,562	2,036,222	(106,535)
NET ASSETS					
Net Assets - Beginning of Year	1,618,339	3,583,063	14,703,253	19,904,655	(219,050)
Net Assets - End of Year	\$ 1,736,466	\$ 4,398,596	\$ 15,805,815	\$ 21,940,877	\$ (325,585)

See Note 1 in the Notes to the Financial Statements

**NORTH CAROLINA SCHOOL OF THE ARTS
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2004**

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

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

The accompanying financial statements present all funds belonging to the School 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 School's funds. The School's component units are discretely presented in the School's financial statements. Discretely presented component units' financial data are reported in separate financial statements because of their use of different GAAP reporting models and to emphasize their legal separateness.

Discretely Presented Component Units – The North Carolina School of the Arts Foundation, Inc., and the NCSA Housing Corporation are legally separate not-for-profit corporations and are reported as discretely presented component units based on the nature and significance of their relationship to the School.

The North Carolina School of the Arts Foundation, Inc. (Foundation), is a legally separate, tax-exempt component unit of the School. The Foundation acts primarily as a fund-raising organization to supplement the resources that are available to the School in support of its programs. The Foundation board consists of 30 members. Although the School does not control the timing or amount of receipts from the Foundation, the majority of resources, or income thereon, that the Foundation holds and invests are restricted to the activities of the School by the donors. Because these restricted resources held by the Foundation can only be used by, or for the benefit of the School, the Foundation is considered a component unit of the School and is reported in separate financial statements because of the difference in its reporting model, as described below.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The North Carolina School of the Arts Foundation, Inc., is a private not-for-profit organization that reports its financial results under Financial Accounting Standards Board (FASB) Statements. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications have been made to the Foundation's financial information in the School's financial reporting entity for these differences.

During the year ended June 30, 2004, the Foundation distributed \$1,942,792.61 to the School for both restricted and unrestricted purposes. Complete financial statements for the Foundation can be obtained from the North Carolina School of the Arts Foundation, Inc., PO Box 12189, Winston-Salem, NC 27107.

The NCSA Housing Corporation (Corporation) is a legally separate, tax-exempt component unit of the School. The Corporation is owner of the Center Stage apartments located at 900 Center Stage Court, Winston-Salem, NC 27127. The Corporation board consists of five members. Although the School does not control the timing or amount of receipts from the Corporation, any excess resources not required by the Corporation accrue to the School. Because these excess resources held by the Corporation accrue to the benefit of the School, the Corporation is considered a component unit of the School and is reported in separate financial statements because of the difference in its reporting model, as described below.

The NCSA Housing Corporation is a private not-for-profit organization that reports its financial results under Financial Accounting Standards Board (FASB) Statements. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications have been made to the Corporation's financial information in the School's financial reporting entity for these differences.

Complete financial statements for the Corporation can be obtained from the NCSA Housing Corporation, PO Box 12189, Winston-Salem, NC 27107.

- 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*

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Financial Statements – and Management’s Discussion and Analysis – for Public Colleges and Universities, the full scope of the School’s activities is considered to be a single business-type activity (BTA) and accordingly, is reported within a single column in the basic financial statements.

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

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

Nonexchange transactions, in which the School 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, money market accounts, cash on deposit with fiscal agents, and deposits held by the State Treasurer in the short-term investment portfolio. The short-term investment portfolio maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty.

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

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

- F. Receivables** – Receivables consist of tuition and fees charges to students, charges for auxiliary enterprises’ sales and services, and student loans. Receivables also include amounts due from the federal and State

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

governments, and from private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants. Student and note receivables are recorded net of estimated uncollectible amounts. All other receivables are shown at book value with no provision for uncollectible amounts considered necessary.

- G. Inventories** – Inventories, consisting of expendable supplies and postage, are valued at cost using the last invoice cost. Merchandise for resale is valued using the retail inventory method.
- H. Capital Assets** – Capital assets are stated at cost at date of acquisition or fair value at date of donation in the case of gifts. The value of assets constructed includes all material direct and indirect construction costs.

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

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

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

- I. Restricted Assets** – Unexpended capital contributions are classified as restricted assets because their use is limited by applicable donor/grantor agreements. Certain other assets are classified as restricted because their use is limited by external parties or statute.
- J. Noncurrent Long-Term Liabilities** – Noncurrent long-term liabilities include principal amounts of bonds payable, notes payable, and compensated absences that will not be paid within the next fiscal year. Premiums, discounts, and issuance costs are expenses for bonds and notes payable.
- K. Compensated Absences** - The School's policy is to record the cost of vacation leave when earned. The policy provides for a maximum accumulation of unused vacation leave of 30 days which can be carried forward each January 1st or for which an employee can be paid upon termination of employment. Also, any accumulated vacation leave in excess of 30 days at year-end is converted to sick leave. Under this policy, the accumulated vacation leave for each employee at June 30th

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 School 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.

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

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

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

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

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

Restricted and unrestricted resources are tracked using a fund accounting system and are spent in accordance with established fund authorities. Fund authorities provide rules for the fund activity and are separately established for restricted and unrestricted activities. When both restricted and unrestricted funds are available for expenditure, the decision for

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

funding is transactional based within the departmental management system in place at the School. For projects funded by tax-exempt debt proceeds and other sources, the debt proceeds are always used first.

M. Scholarship Discounts – Student tuition and fees revenues and certain other revenues from School charges are reported net of scholarship discounts in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. The scholarship discount is the difference between the actual charge for goods and services provided by the School and the amount that is paid by students or by third parties on the students' behalf. Student financial assistance grants, such as Pell grants, and other federal, State, or nongovernmental programs, are recorded as either operating or nonoperating revenues in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. To the extent that revenues from these programs are used to satisfy tuition, fees, and other charges, the School has recorded a scholarship discount.

N. Revenue and Expense Recognition – The School 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 School's principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as (1) student tuition and fees, (2) sales and services of auxiliary enterprises, (3) certain federal, State and local grants and contracts that are essentially contracts for services, and (4) interest earned on loans. Operating expenses are all expense transactions incurred other than those related to capital and noncapital financing or investing activities as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

Nonoperating revenues include activities that have the characteristics of nonexchange transactions. Revenues from nonexchange transactions and State appropriations that represent subsidies or gifts to the School, 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.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 2 - DEPOSITS AND INVESTMENTS

- A. **Deposits** – Unless specifically exempt, the School is required by General Statute 147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. In addition, the University of North Carolina Board of Governors, pursuant to General Statute 116-36.1, requires the School to deposit its institutional trust funds with the State Treasurer. Although specifically exempted, the School may voluntarily deposit endowment funds, special funds, revenue bond proceeds, and debt service funds with the State Treasurer. Special funds consist of moneys for agency funds held directly by the School.

Deposits include cash and cash equivalents totaling \$6,344,225.97. At year end, cash on hand was \$1,352,621.85. The School's portion of the State Treasurer's Investment Pool was \$3,011,295.82. It is the State Treasurer's policy and practice for deposits not covered by federal depository insurance to be covered by collateral held by the State of North Carolina's agent in the name of the State and for investments to be held by the State's agent in the State's name. The carrying amount of the School's deposits not with the State Treasurer was \$1,980,308.30 and the bank balance was \$1,986,520.65. Of the bank balance, \$178,275.06 was covered by federal depository insurance and \$1,808,245.59 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

B. Investments - The School 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 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.

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

Investments of the School's component units, the Foundation and Corporation, 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 School utilizes investment pools to manage investments and distribute investment income. The School utilizes the following investment pool:

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

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

School's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by a counterparty's trust department or agent but not in the School's name.

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

Long-Term Investment Pool

	Fair Value			Total
	Risk Category			
	1	2	3	
Categorized Investments:				
Corporate Stocks	\$ 0.00	\$ 719,994.51	\$ 0.00	\$ 719,994.51
International Stocks		20,668.00		20,668.00
Total Categorized Investments	\$ 0.00	\$ 740,662.51	\$ 0.00	740,662.51
Investments Not Categorized:				
Money Market Funds				36,673.73
Mutual Funds				204,709.47
Total Investments Not Categorized				241,383.20
Total Long-Term Investments				\$ 982,045.71

Non-Pooled Investments

	Fair Value
	Total
Investments Not Categorized:	
Money Market Funds	\$ 106,513.17
Mutual Funds	570,119.11
Equity-Based Common Trusts	165,770.37
Total Non-Pooled Investments	\$ 842,402.65

Total Investments

	Fair Value			Total
	Risk Category			
	1	2	3	
Total Categorized Investments	\$ 0.00	\$ 740,662.51	\$ 0.00	\$ 740,662.51
Total Investments Not Categorized				1,083,785.85
Total Investments				\$ 1,824,448.36

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 3 - ENDOWMENT INVESTMENTS

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

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

NOTE 4 - RECEIVABLES

Receivables at June 30, 2004, were as follows:

	<u>Gross Receivables</u>	<u>Less Allowance for Doubtful Accounts</u>	<u>Net Receivables</u>
Current Receivables:			
Students	\$ 178,362.86	\$ 15,141.19	\$ 163,221.67
Accounts	372,677.69		372,677.69
Interest on Loans	27,405.31		27,405.31
	<u>578,445.86</u>	<u>15,141.19</u>	<u>563,304.67</u>
Total Current Receivables	<u>\$ 578,445.86</u>	<u>\$ 15,141.19</u>	<u>\$ 563,304.67</u>
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	\$ 73,109.44	\$ 26,292.92	\$ 46,816.52
Institutional Student Loan Programs	8,271.20	6,439.20	1,832.00
	<u>81,380.64</u>	<u>32,732.12</u>	<u>48,648.52</u>
Total Notes Receivable - Current	<u>\$ 81,380.64</u>	<u>\$ 32,732.12</u>	<u>\$ 48,648.52</u>
Notes Receivable - Noncurrent:			
Federal Loan Programs	<u>\$ 542,950.46</u>	<u>\$ 146,355.43</u>	<u>\$ 396,595.03</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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	\$ 2,934,400.13	\$ 154,489.07	\$ 164,203.91	\$ 0.00	\$ 3,253,093.11
Art, Literature, and Artifacts	246,964.44		15,000.00		261,964.44
Construction in Progress	26,826,778.72	(9,684,377.37)	8,496,919.59		25,639,320.94
Total Capital Assets, Nondepreciable	30,008,143.29	(9,529,888.30)	8,676,123.50		29,154,378.49
Capital Assets, Depreciable:					
Buildings	58,578,257.58	8,142,433.06			66,720,690.64
Machinery and Equipment	8,485,238.44	72,291.19	947,805.91	72,836.54	9,432,499.00
General Infrastructure	1,288,211.66	1,315,164.05	31,960.00		2,635,335.71
Total Capital Assets, Depreciable	68,351,707.68	9,529,888.30	979,765.91	72,836.54	78,788,525.35
Less Accumulated Depreciation/Amortization for:					
Buildings	14,092,172.34		1,227,749.62		15,319,921.96
Machinery and Equipment	6,575,782.02		745,240.34	72,442.22	7,248,580.14
General Infrastructure	270,038.59		36,316.92		306,355.51
Total Accumulated Depreciation	20,937,992.95		2,009,306.88	72,442.22	22,874,857.61
Total Capital Assets, Depreciable, Net	47,413,714.73	9,529,888.30	(1,029,540.97)	394.32	55,913,667.74
Capital Assets, Net	\$ 77,421,858.02	\$ 0.00	\$ 7,646,582.53	\$ 394.32	\$ 85,068,046.23

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

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

	Amount
Accounts Payable	\$ 1,114,086.43
Accrued Payroll	223,383.78
Contract Retainage	331,180.80
Total Accounts Payable and Accrued Liabilities	\$ 1,668,651.01

NOTE 7 - 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	\$ 4,580,000.00	\$ 0.00	\$ 335,000.00	\$ 4,245,000.00	\$ 355,000.00
Notes Payable	1,500,000.00		300,000.00	1,200,000.00	300,000.00
Compensated Absences	1,347,001.69	980,055.70	881,907.69	1,445,149.70	143,354.54
Total Long-Term Liabilities	\$ 7,427,001.69	\$ 980,055.70	\$ 1,516,907.69	\$ 6,890,149.70	\$ 798,354.54

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2004	Principal Outstanding 06/30/2004
Housing and Dining System						
Refinancing of Dormitory and Dining Hall Series 1989	(A)	4.00%-5.00%	10/01/2009	\$ 1,080,000.00	\$ 380,000.00	\$ 700,000.00
Dormitory HVAC Renovations Project	(A)	3.25%-4.50%	10/01/2008	890,000.00	395,000.00	495,000.00
Technology Infrastructure Upgrades Project	(B)	5.00%-5.75%	10/01/2015	1,005,000.00	145,000.00	860,000.00
Total Housing and Dining System				2,975,000.00	920,000.00	2,055,000.00
Fitness and Student Center Project	(A)	3.25%-5.25%	10/01/2018	2,650,000.00	460,000.00	2,190,000.00
Total Bonds Payable				\$ 5,625,000.00	\$ 1,380,000.00	\$ 4,245,000.00

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

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

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

In addition, fund reservations required by the Bond Indenture have been established and recorded for the Series 2000 Bonds (B). On October 31, 2000, in accordance with the Bond Resolution, the School deposited \$99,975.00 in a Bond Reserve Fund. The balance in the Bond Reserve Fund was \$99,909.75 at June 30, 2004.

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

Fiscal Year	Annual Requirements			
	Bonds Payable		Notes Payable	
	Principal	Interest	Principal	Interest
2005	\$ 355,000.00	\$ 189,718.76	\$ 300,000.00	\$ 36,720.00
2006	370,000.00	173,131.26	300,000.00	27,540.00
2007	390,000.00	156,418.76	300,000.00	18,360.00
2008	405,000.00	139,618.76	300,000.00	9,180.00
2009	420,000.00	122,343.76		
2010-2014	1,215,000.00	409,071.89		
2015-2019	1,090,000.00	115,969.75		
Total Requirements	\$ 4,245,000.00	\$ 1,306,272.94	\$ 1,200,000.00	\$ 91,800.00

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

D. Notes Payable - The School was indebted for notes payable for the purpose shown in the following table:

Purpose	Financial Institution	Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2004	Principal Outstanding 06/30/2004
Student Commons Building Renovation	Wachovia Bank, N.A.	3.06%	04/17/2008	\$ 1,500,000.00	\$ 300,000.00	\$ 1,200,000.00

Designated revenue streams related to the housing and dining system, as well as other available funds, have been pledged for the payment of this note.

NOTE 8 - OPERATING LEASE OBLIGATIONS

The School entered into operating leases for copiers and land. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2004:

<u>Fiscal Year</u>	<u>Amount</u>
2005	\$ 33,802.56
2006	11,552.97
2007	6,000.00
2008	6,000.00
2009	6,000.00
2010-2012	15,000.00
Total Minimum Lease Payments	<u>\$ 78,355.53</u>

Rental expense for all operating leases during the year was \$34,699.32.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 9 - 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 Bad Debt Recoveries	Net Revenues	Revenues Pledged as Security for Debt
Operating Revenues:						
Student Tuition and Fees	\$ 9,921,825.95	\$ 0.00	\$ 1,876,939.27	\$ 4,846.49	\$ 8,040,040.19	\$ 236,188.40 (A)
Sales and Services:						
Sales and Services of Auxiliary Enterprises:						
Residential Life	\$ 2,196,855.56	\$ 0.00	\$ 436,213.52	\$ 0.00	\$ 1,760,642.04	\$ 1,760,642.04 (B)
Dining	1,769,273.84		346,694.71		1,422,579.13	1,422,579.13 (B)
Health and Recreation Services	156,159.39				156,159.39	
Bookstore	264,367.20				264,367.20	
Parking	46,653.95			534.90	46,119.05	
Other	38,972.48				38,972.48	
Sales and Services of Education and Related Activities	298,964.17	33,592.73			265,371.44	
Total Sales and Services	<u>\$ 4,771,246.59</u>	<u>\$ 33,592.73</u>	<u>\$ 782,908.23</u>	<u>\$ 534.90</u>	<u>\$ 3,954,210.73</u>	<u>\$ 3,183,221.17</u>

Revenue Bonds Secured by Pledged Revenues:

(A) Facility Debt Fee for the Fitness and Student Center Project

(B) Housing and Dining System

NOTE 10 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 9,552,785.57	\$ 847,495.69	\$ 639,950.62	\$ 0.00	\$ 0.00	\$ 0.00	\$ 11,040,231.88
Public Service	510,997.17	38,297.78	568,683.08		467.97		1,118,446.00
Academic Support	2,473,839.70	276,863.32	296,406.99				3,047,110.01
Student Services	755,606.16	122,434.10	350,473.98				1,228,514.24
Institutional Support	4,705,117.86	863,570.73	1,333,863.63		3,199.26		6,905,751.48
Operations and Maintenance of Plant	2,507,986.67	1,592,168.04	459,430.01		1,204,919.17		5,764,503.89
Student Financial Aid				724,529.29			724,529.29
Auxiliary Enterprises	2,034,390.98		2,029,032.65		293,081.41		4,356,505.04
Depreciation						2,009,306.88	2,009,306.88
Total Operating Expenses	<u>\$ 22,540,724.11</u>	<u>\$ 3,740,829.66</u>	<u>\$ 5,677,840.96</u>	<u>\$ 724,529.29</u>	<u>\$ 1,501,667.81</u>	<u>\$ 2,009,306.88</u>	<u>\$ 36,194,898.71</u>

NOTE 11 - 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 School had a total payroll of \$18,418,227.45, of which \$9,019,520.47 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$541,171.23 and \$19,842.95, respectively. The School made one hundred percent of its annual required contributions for the years ended June 30, 2004, 2003, and 2002, which were \$19,842.95, \$0.00, and \$188,674.51, 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 School may join the Program instead of the Teachers' and State Employees' Retirement System. The Board of Governors of The University of North Carolina is responsible for the administration of the Program and designates the companies authorized to offer investment products. The Board has authorized the following carriers: Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), Lincoln Life Insurance Company, Variable Annuity Life Insurance Company (VALIC), and Fidelity Investments. Participants may elect to allocate their contributions and the School contributions to the carrier of their choice. Each carrier offers a variety of investment funds, including both fixed and variable account investment options and mutual funds.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 School assumes no liability other than its contribution.

For the year ended June 30, 2004, the School had a total payroll of \$18,418,227.45, of which \$7,204,276.29 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$432,256.58 and \$492,772.50, 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 School. The voluntary contributions by employees amounted to \$75,004.69 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 School except for a 5% employer contribution for the School's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of School law enforcement officers for the year

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

ended June 30, 2004, were \$45,182.24. The voluntary contributions by employees amounted to \$114,883.00 for the year ended June 30, 2004.

IRC Section 403(b) and 403(b)(7) Plans - Eligible School employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to \$134,966.80 for the year ended June 30, 2004.

NOTE 12 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees -** The School 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 School 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 School's total contribution to the Plan was \$519,161.50. The School 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 School participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System 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 School was not required to contribute to the DIPNC for

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the fiscal year ended June 30, 2004. The School assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 13 - RISK MANAGEMENT

The School is exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled via a combination of methods, including participation in State-administered insurance programs, purchase of commercial insurance, and self-retention of certain risks. Except for a reduction in the public officers' and employees' liability insurance from \$11,000,000 to \$5,000,000, there have been no significant reductions in insurance coverage from the previous year and settled claims have not exceeded coverage in any of the past three fiscal years.

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

The School is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not supported by the State's General Fund are charged for the coverage. The School also purchased through the Fund extended coverage for fire, sprinkler leakage, business interruption, vandalism, theft, and "all risks" for buildings and contents. Losses covered by the Fund are subject to a \$500 per occurrence deductible except theft losses, which carry a \$1,000 per occurrence deductible.

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

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

occurrence with a \$50,000 deductible and a 10% participation in each loss above the deductible.

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

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

Term life insurance (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 14 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The School has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were \$4,488,643.27 and on other purchases were \$1,336,569.38 at June 30, 2004.

B. University Improvement General Obligation Bonds - The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of \$2.5 billion of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The funds authorized are to be used solely for capital facilities cost on the University of North Carolina campuses as specified in the legislation. The bond legislation specifies the amount of bond funding for each University campus and the level of bond funding intended for each project. The bonds are authorized to be issued over a six-year period beginning in 2001 at a level not to exceed amounts provided in the legislation. Using a cash flow financing approach, The University of

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

North Carolina – General Administration (UNC-GA), establishes annual amounts not to exceed for each approved project. The amounts not to exceed are subject to change due to actual cash availability and needs during the year. Subsequent to the bond sales and the availability of bond proceeds, UNC-GA notifies the Office of State Budget and Management (OSBM) of the amounts not to exceed for each approved project. Within these amounts, based on an official request of cash needs from the School, OSBM authorizes allotments. The School records the allotments as revenue on the accompanying financial statements. The School's remaining authorization of \$12,419,238.00 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

NOTE 15 - CHANGE IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2004, the School 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 School is not financially accountable should be reported as component units based on the nature and significance of their relationship to the School.

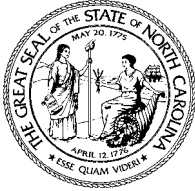
***North Carolina School of the Arts
Schedule of General Obligation Bond Project Authorizations,
Budgets, and Expenditures
For Project-to-Date as of June 30, 2004***

Schedule 1

Capital Improvement Projects	Original Projected Start Date	Revised/ Actual Start Date	General Obligation Bonds Authorized	Other Sources	Total Project Budget	Amount Expended	Percent Completed	Original Expected Completion Date	Revised/ Actual Completion Date
<i>Projects Started</i>									
Basic Performance and Education Complex	Dec 2000	Dec 2000	\$ 16,928,700.00	\$ 0.00	\$ 16,928,700.00	\$ 15,965,090.60	94.31%	Sep 2004	Aug 2005
Stevens Center Renovations	Nov 2000	Nov 2000	4,462,775.00		4,462,775.00	4,444,325.94	99.59%	May 2003	Jun 2005
Film Archives Building	Mar 2001	Mar 2001	2,054,000.00		2,054,000.00	1,911,687.77	93.07%	Mar 2003	May 2005
Student Services Support Complex	Apr 2001	Apr 2001	2,850,000.00		2,850,000.00	1,878,625.59	65.92%	Feb 2004	Jun 2005
Dance Costume Shop - Comprehensive Renovation	Sep 2001	Oct 2001	1,770,000.00		1,770,000.00	106,665.11	6.03%	Oct 2004	Jul 2005
Workplace Building #2 - Comprehensive Renovation	Nov 2001	Mar 2002	56,129.00		56,129.00	56,129.00	100.00%	May 2005	Oct 2002
Residence Hall	Nov 2001	Oct 2001	1,890,495.00	100,000.00	1,990,495.00	495,213.69	24.88%	Jul 2004	Jun 2005
Technology Infrastructure Expansion	Feb 2001	Feb 2001	1,772,300.00		1,772,300.00	1,318,724.26	74.41%	Mar 2004	May 2005
Renovation of DeMille Theatre	Nov 2001	Mar 2002	5,613,376.00		5,613,376.00	327,156.76	5.83%	Mar 2005	May 2006
Land Acquisition	Feb 2001	Feb 2001	3,475,000.00		3,475,000.00	2,602,771.86	74.90%	Dec 2004	Mar 2006
Project Management	Dec 2000	Dec 2000	1,674,725.00		1,674,725.00	1,216,868.52	72.66%	Jun 2007	Apr 2006
Total All Projects			\$ 42,547,500.00	\$ 100,000.00	\$ 42,647,500.00	\$ 30,323,259.10			

Note: The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of \$2.5 billion of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The projects listed on this schedule are those funded or to be funded by bond proceeds from the general obligation bonds authorized by Senate Bill 912.

[This Page Left Blank Intentionally]



STATE OF NORTH CAROLINA
Office of the State Auditor

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

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

**INDEPENDENT AUDITOR'S REPORT
ON 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**

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

We have audited the financial statements of North Carolina School of the Arts, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component units, as of and for the year ended June 30, 2004, which collectively comprise the School's basic financial statements and have issued our report thereon dated May 31, 2005. We did not audit the financial statements of the North Carolina School of the Arts Foundation, Inc., and the NCSA Housing Corporation, which represents 100% of the School'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 discretely presented component units, is based on the reports of the other auditors.

As discussed in Note 15 to the financial statements, the School 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 School's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the

**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)**

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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the School's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and 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 disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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

Leslie W. Merritt, Jr.

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

May 31, 2005

DISTRIBUTION OF AUDIT REPORT

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

EXECUTIVE BRANCH

The Honorable Michael F. Easley
The Honorable Beverly M. Perdue
The Honorable Richard H. Moore
The Honorable Roy A. Cooper, III
Mr. David T. McCoy
Mr. Robert L. Powell
Ms. Molly Corbett Broad
Mr. Wade Hobgood
Mr. Jon E. Yellin

Mr. Stephen P. Karr

Governor of North Carolina
Lieutenant Governor of North Carolina
State Treasurer
Attorney General
State Budget Officer
State Controller
President, The University of North Carolina
Chancellor, North Carolina School of the Arts
Vice Chancellor for Finance and Administration
North Carolina School of the Arts
Chairman, Board of Trustees
North Carolina School of the Arts

LEGISLATIVE BRANCH

Appointees to the Joint Legislative Commission on Governmental Operations

President Pro Tempore
Senator Marc Basnight, Co-Chair
Senator Charles W. Albertson
Senator Thomas M. Apodaca
Senator Daniel G. Clodfelter
Senator Walter H. Dalton
Senator Charlie S. Dannelly
Senator James Forrester
Senator Linda Garrou
Senator Kay R. Hagan
Senator Fletcher L. Hartsell, Jr.
Senator David W. Hoyle
Senator John H. Kerr, III
Senator Ellie Kinnaird
Senator Jeanne H. Lucas
Senator Anthony E. Rand
Senator R. C. Soles, Jr.
Senator Richard Y. Stevens
Senator A. B. Swindell, IV
Senator Scott Thomas

Speaker of the House
Representative James B. Black, Co-Chair
Representative Alma S. Adams
Representative Martha B. Alexander
Representative Harold J. Brubaker
Representative Lorene T. Coates
Representative E. Nelson Cole
Representative James W. Crawford, Jr.
Representative William T. Culpepper, III
Representative W. Pete Cunningham
Representative Beverly M. Earle
Representative Pryor A. Gibson, III
Representative Joe Hackney
Representative R. Phillip Haire
Representative Dewey L. Hill
Representative Lindsey H. Holliman
Representative Julia C. Howard
Representative Howard J. Hunter, Jr.
Representative Margaret M. Jeffus
Representative Daniel F. McComas
Representative Charles L. McLawhorn
Representative Henry M. Michaux, Jr.
Representative Richard T. Morgan
Representative Edd Nye
Representative William C. Owens, Jr.
Representative Deborah K. Ross
Representative Drew P. Saunders
Representative Wilma M. Sherrill
Representative Joe P. Tolson
Representative Edith D. Warren
Representative Thomas E. Wright
Representative Douglas Y. Yongue

Other Legislative Officials

Mr. James D. Johnson

Director, Fiscal Research Division

June 28, 2005

ORDERING INFORMATION

Copies of this report may be obtained by contacting the:

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

Internet: <http://www.ncauditor.net>

Telephone: 919/807-7500

Facsimile: 919/807-7647