



# **STATE OF NORTH CAROLINA**

**FINANCIAL STATEMENT AUDIT REPORT OF**

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

**CHAPEL HILL, NORTH CAROLINA**

**FOR THE YEAR ENDED JUNE 30, 2005**

**OFFICE OF THE STATE AUDITOR**

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

**STATE AUDITOR**

**FINANCIAL STATEMENT AUDIT REPORT OF**  
**THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL**  
**CHAPEL HILL, NORTH CAROLINA**  
**FOR THE YEAR ENDED JUNE 30, 2005**

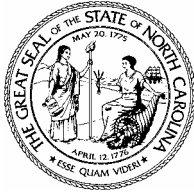
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STATE OF NORTH CAROLINA  
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**AUDITOR'S TRANSMITTAL**

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

We have completed a financial statement audit of The University of North Carolina at Chapel Hill for the year ended June 30, 2005, and our audit results are included in this report. You will note from the independent auditor's report that we determined that the financial statements are presented fairly in all material respects.

Our consideration of internal control over financial reporting and compliance and other matters based on an audit of the financial statements resulted in no audit findings.

*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.*

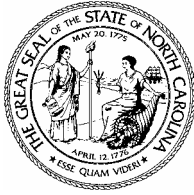
Leslie W. Merritt, Jr., CPA, CFP  
State Auditor

February 23, 2006

## TABLE OF CONTENTS

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	PAGE
INDEPENDENT AUDITOR’S REPORT .....	1
MANAGEMENT’S DISCUSSION AND ANALYSIS .....	3
BASIC FINANCIAL STATEMENTS	
University Exhibits	
A-1 Statement of Net Assets .....	28
A-2 Statement of Revenues, Expenses, and Changes in Net Assets .....	30
A-3 Statement of Cash Flows .....	31
Component Unit Exhibits	
B-1 Statement of Financial Position .....	33
B-2 Statement of Activities .....	34
Notes to the Financial Statements .....	35
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</i> <i>AUDITING STANDARDS</i> .....	83
DISTRIBUTION OF AUDIT REPORT .....	85



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**INDEPENDENT AUDITOR'S REPORT**

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

We have audited the accompanying financial statements of The University of North Carolina at Chapel Hill, a constituent institution of the 16-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, 2005, which collectively comprise The University of North Carolina at Chapel Hill's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., which represent 100% of the University's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for those entities, is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., were not audited in accordance with *Government Auditing Standards*. An audit includes 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 the 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 The University of North Carolina at Chapel Hill and its discretely presented component units

## INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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as of June 30, 2005, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 17 to the financial statements, the University implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures*, during the year ended June 30, 2005.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 30, 2005, on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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



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

November 30, 2005

## THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL MANAGEMENT'S DISCUSSION AND ANALYSIS

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### Introduction

Management's Discussion and Analysis provides an overview of the financial position and activities of The University of North Carolina at Chapel Hill (the "University") for the fiscal year ended June 30, 2005, with comparative information for the fiscal year ended June 30, 2004. Management has prepared the discussion and analysis to be read in conjunction with the financial statements and accompanying note disclosures.

The University is a constituent institution of the 16-campus University of North Carolina System (UNC System), a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report*. The Financial Reporting Entity for the financial statements is comprised of the University and 10 component units. Although legally separate, The University of North Carolina at Chapel Hill Foundation Investment Fund, Inc., UNC Investment Fund, LLC, UNC Management Company, Inc., The University of North Carolina at Chapel Hill Foundation, Inc., The Kenan-Flagler Business School Foundation, The School of Social Work Foundation, Inc., and UNC Law Foundation, Inc., are reported as if they were part of the University. The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., are legally separate, nonprofit, tax-exempt organizations that are reported as discretely presented component units based on the nature and significance of their relationship to the University.

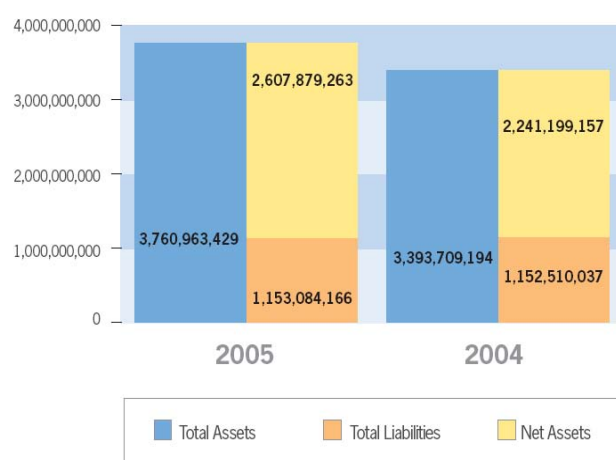
Management's Discussion and Analysis includes a separate section regarding the three component units that are discretely reported in the financial statements. The remainder of the management's discussion and analysis pertains to the University and the seven component units reported as part of the University.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

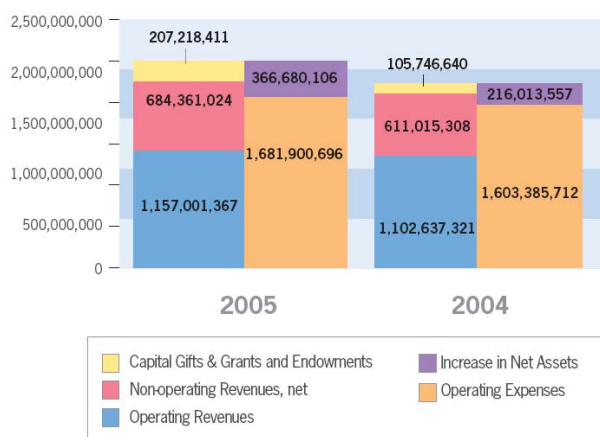
### Financial Highlights

The University's financial position at June 30, 2005, remained strong with total assets of \$3.8 billion. Net assets, which represent the residual interest in the University's assets after deducting liabilities, were \$2.6 billion at June 30, 2005. The University's net assets increased by \$367 million in fiscal year 2004-2005, when operating, nonoperating, and other changes are included. A comparison of the total assets, liabilities, and net assets at June 30, 2005, and 2004, and a comparison of the major components of the changes in net assets for the two fiscal years is presented below:

#### Statement of Net Assets



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





## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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Net assets increased 16.4% at June 30, 2005, over the prior year. Total assets increased 10.8% and total liabilities increased less than 1% for the same period. Operating revenues increased at the same rate as operating expenses in 2004-2005 over the prior year, 4.9 %. Net nonoperating revenues and expenses increased 12.0% in 2004-2005 over the prior year. The State appropriations growth of 6.9% was significant, given the previous, lesser rates of increase. Investment income growth remained strong with a 14.4% increase in 2004-2005 over the prior year. Research funding, fund raising for operational and capital needs and construction funding through the North Carolina Higher Education Bond Referendum of 2000 continued to be positive factors in the improved financial well-being of the University.

### Using the Financial Statements

The financial statements have been prepared in accordance with Governmental Accounting Standards Board (GASB) principles. Beginning with the fiscal year ended June 30, 2002, the financial statements have been based on the provisions of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities*. The full scope of the University's activities is considered to be a single business-type activity and accordingly, is reported within a single column in the basic financial statements.

Effective for the fiscal year ended June 30, 2005, the University implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures* – an amendment of GASB Statement No. 3. The statement provides disclosures that inform readers about deposit and investment risks that could impact the entity's ability to provide services and meet its financial obligation. Among the issues addressed are common deposit and investment risks related to credit risk, concentration of credit risk, custodial credit risk, interest rate risk, and foreign currency risk.

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

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

Management's Discussion and Analysis provides information regarding each of these financial statements.

Other important characteristics of the financial statements include the following:

- Net assets represent the excess of total assets over total liabilities. There are three classes of net assets – unrestricted, restricted (nonexpendable and expendable), and invested in capital assets net of related debt.

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

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

### **Condensed Statement of Net Assets**

The Statement of Net Assets presents the financial position of the University at the end of the fiscal year, includes all assets and liabilities of the University and segregates the assets and liabilities into current and noncurrent components. Net assets represent the difference between total assets and total liabilities and are one indicator of the University's current financial condition. The following table summarizes the University's assets, liabilities, and net assets at June 30, 2005 and 2004.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

	<u>2005</u>	<u>2004 (Restated)</u>	<u>% Change</u>
<b>Assets:</b>			
Current Assets	\$ 856,015,143	\$ 810,667,402	5.6
Noncurrent Assets:			
Endowment Investments	972,461,495	848,469,859	14.6
Other Long-Term Investments	283,640,904	299,874,517	(5.4)
Capital Assets, Net	1,550,201,138	1,276,669,341	21.4
Other Noncurrent Assets	98,644,749	158,028,075	(37.6)
<b>Total Assets</b>	<u>3,760,963,429</u>	<u>3,393,709,194</u>	10.8
<b>Liabilities:</b>			
Current Liabilities	420,350,366	401,819,861	4.6
Noncurrent Liabilities:			
Funds Held in Trust for Pool Participants	260,960,010	235,608,859	10.8
Long-Term Liabilities	440,422,863	482,557,455	(8.7)
Other Noncurrent Liabilities	31,350,927	32,523,862	(3.6)
<b>Total Liabilities</b>	<u>1,153,084,166</u>	<u>1,152,510,037</u>	
<b>Net Assets:</b>			
Invested in Capital Assets, Net of Related Debt	1,017,382,707	855,739,608	18.9
Restricted:			
Nonexpendable	378,234,148	328,735,341	15.1
Expendable	736,631,596	648,019,434	13.7
Unrestricted	475,630,812	408,704,774	16.4
<b>Total Net Assets</b>	<u>\$ 2,607,879,263</u>	<u>\$ 2,241,199,157</u>	16.4

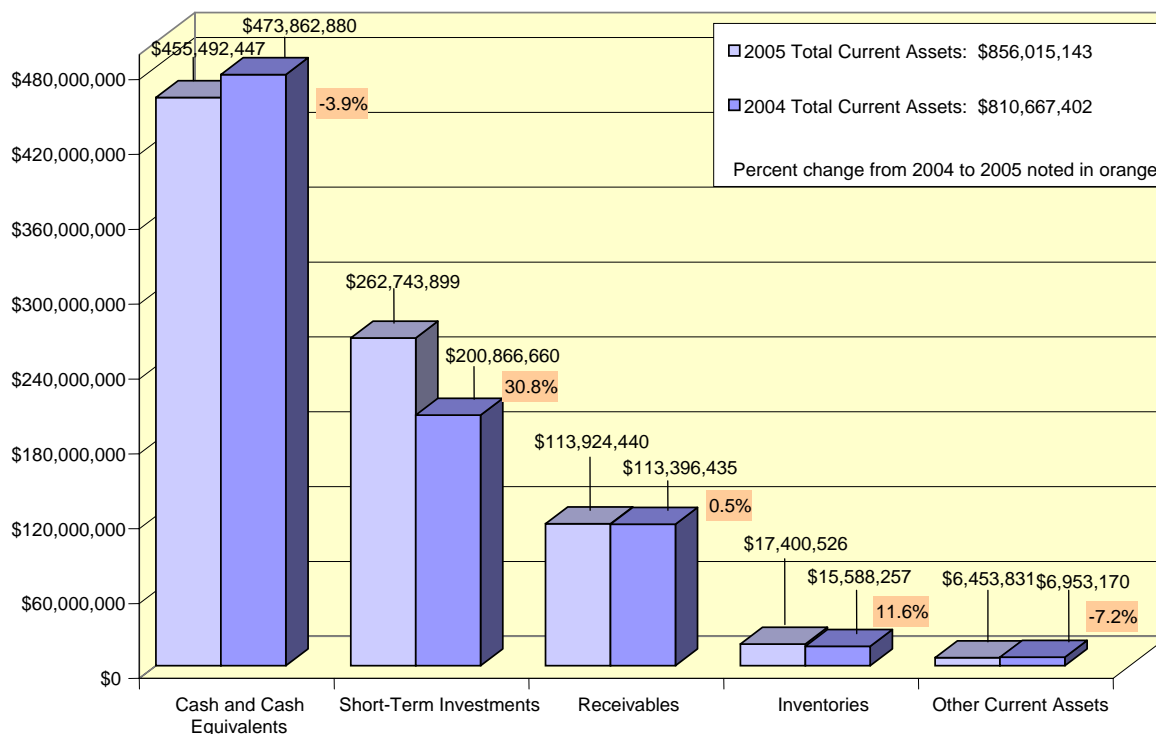
### Current Assets and Liabilities

The Statement of Net Assets shows the University had total assets of \$3.8 billion at June 30, 2005, an increase of 10.8% over the prior year. Working capital, which is current assets less current liabilities, was \$435.7 million at June 30, 2005, an increase of 6.6% over the previous year. One significant factor causing the working capital improvement was the increase in short-term investments resulting from increased expendable resources and investment returns.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Current assets are represented graphically below:

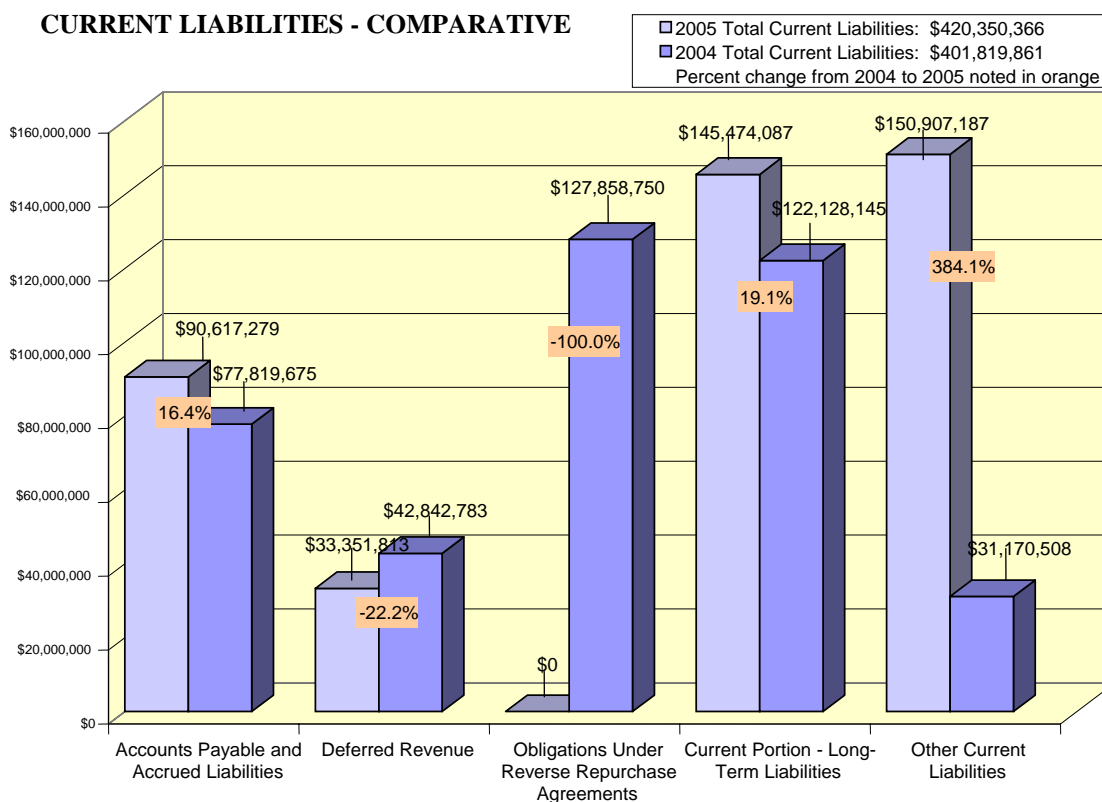
**CURRENT ASSETS - COMPARATIVE**



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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Current liabilities are represented graphically below:



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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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### Endowment and Other Long-Term Investments

Endowment investments increased 14.6% during 2004-2005, and were \$972.5 million at June 30, 2005, and \$848.5 million at June 30, 2004, and include permanent endowments, funds internally designated as endowments and similar funds such as gift annuities and charitable trusts. Net assets of endowment and similar funds were \$930.6 million at June 30, 2005, and \$801.3 million for the prior year.

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

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

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

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

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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Other long-term investments of \$283.6 million at June 30, 2005 include funds of \$246.2 million of affiliated entities that are not part of the University's financial reporting entity but do invest through the System Fund, and bond reserves and related funds of \$37.4 million.

Most of the University's endowment assets are managed within the System Fund, a pooled investment fund vehicle. The System Fund is designed to provide long-term, stable rates of return on the invested assets through the use of a highly diversified portfolio strategy. The nominal return on the endowment assets invested in the System Fund for fiscal year 2004-2005 was 15.5%, with a real return of 13% after inflation. The respective returns for fiscal year 2003-2004 were 16% and 12.8%. The System Fund return of 15.5% for 2004-2005 exceeded the Strategic Investment Policy Portfolio ("SIPP") return of 13.8% by 1.7%. The System Fund's return also exceeded the 70% S&P 500 / 30% Lehman Brothers Bond Index ("70/30") return of 6.6% for the year.

The strong investment performance of the past two years has increased the three-year compound return to 11.5% at June 30, 2005. This three-year return measure compares well with the corresponding measure of 10.3% for the SIPP and 7.8% for the 70/30. The System Fund is very well positioned in the current environment and remains invested according to the approved investment policy that provides excellent diversification in both bull and bear markets.

### Capital Assets and Debt Management

A critical aspect for enhancing and maintaining the University's academic, research, and service programs and its residential life is the development and renewal of its capital assets. The University Board of Trustees approved the campus master plan to guide the University's physical development in the 21st Century. The master plan meshes the critical pieces needed for smart growth in the 21st Century – transportation, parking, housing, utilities, and environmental sustainability – with the program needs of a growing campus. The master plan combines the practical requirements of a research university with the beauty that inspired its founders. The University will grow dramatically in the coming years.

A summary of changes in capital assets is disclosed in Note 5. Capital assets, net of accumulated depreciation, at June 30, 2005 and June 30, 2004, were as follows:

	2005	2004	% Change
<b>Capital Assets:</b>			
Construction in Progress	\$ 377,522,418	\$ 219,339,291	72.1
Land and Other Nondepreciable Assets	86,347,452	85,103,216	1.5
Buildings	798,180,554	703,546,321	13.5
General Infrastructure	202,593,509	187,589,810	8.0
Machinery and Equipment	85,557,205	81,090,703	5.5
<b>Total</b>	<u>\$ 1,550,201,138</u>	<u>\$ 1,276,669,341</u>	21.4

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

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The University is engaged in a \$1.5 billion capital construction program that began in 2000 and will continue through the next four years. This program includes major capital renewal of existing buildings and infrastructure to address both deferred maintenance and programmatic needs.

Major projects completed in fiscal year 2004-2005 include the Rams Head Center, the Michael Hooker Research Center for the School of Public Health, the addition to and renovation of Memorial Hall, the Carrington Hall addition for the School of Nursing, the Health Sciences Library renovation, and the Kenan, McIver, and Alderman residence halls renovations. The Rams Head Center combines a major new facility for student life with a new 700-car parking deck. It includes a retail grocery store, new dining facility with six different venues, a new student recreation center with three court gymnasium, elevated running track, exercise room and cardio fitness center. The buildings constructed on top of the parking deck form a new open space and pedestrian bridges which connect this facility to student residences to the south and north campus. The new open space incorporates a sophisticated stormwater management system to capture and reuse storm water as irrigation for the landscape. The Michael Hooker Research Center, the addition to the School of Public Health provides new research laboratories and office space, lecture hall and seminar rooms and a new atrium to provide much-needed gathering space for the School of Public Health.

Memorial Hall was originally constructed in 1931 and is used extensively for student assemblies and performances, lectures, concerts, and traveling theatrical productions. The project provided air-conditioning and a larger stage with wing space as well as modernized stage equipment and production needs. The Carrington Hall addition provides teaching laboratories, faculty offices and lecture hall for the School of Nursing. The new addition also features a rooftop garden which incorporates a stormwater management system to capture and reuse storm water as irrigation for the garden. This addition will be the first LEED (Leadership in Energy and Environmental Design) certified building at Carolina.

The renovation of the Health Sciences Library provided a comprehensive renovation to this 1960's facility including new mechanical, electrical, and telecommunications system. New compact storage on the ground floor allowed for the addition of group study space and a new café. The renovations to the Kenan, McIver, and Alderman residence halls provided a comprehensive renovation including new heating and cooling systems, telecommunication wiring, and new elevators. The buildings are now completely accessible and the living rooms have been restored.

Major projects under construction at June 30, 2005, include Phase I of the Carolina Physical Science Complex, Student Family Housing, Phase II of the Residence College capital program, the Medical Sciences Research Building addition and renovation, and renovations to Burnett Womack Building. Major infrastructure improvements continue as part of the master plan for capital development.

Research facilities are a critical component of the construction program, and fiscal year 2004-2005, brought substantial improvements to the physical infrastructure supporting



## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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research. Several key research facilities were renovated, including the entire Health Sciences Library, the 11th floor of Mary Ellen Jones Building, the School of Dentistry building, and the historic 440 West Franklin Street building. Renovations were begun in Brauer Hall, Burnett Womack, and the Medical Research Building. The School of Nursing addition and the new School of Public Health's Hooker Center are fully occupied, equipped, and contributing to our research capacity.

The Science Complex will replace outdated, deteriorating buildings with state-of-the-art facilities. It will provide an innovative learning atmosphere for students and open doors for integrated collaboration among Carolina's scientists. The complex will house the University's departments of chemistry, computer science, marine sciences, mathematics, physics and astronomy, and a new Institute for Advanced Materials, Nanoscience and Technology. The Science Complex Phase 1 is under way and both Phase II and III are projected to bid this year.

The 36 completed projects total \$310 million, or 21% of the \$1.5 billion capital construction program. The 42 projects under construction total \$750 million or 50%, and the 64 projects under design represent \$440 million or 29%. Capital funds resulting from North Carolina Higher Education Bonds continues to provide essential resources for construction. The University is directly investing in its capital construction program using a variety of other funding sources including University bonds, cost reimbursements from research grants, internal reserves, and private gifts. Previous changes in State legislation allowed the University to pledge a broader stream of revenues as security for its debt obligations, and general revenue bonds are issued to finance capital construction. The general revenue pledge results in a stronger, more flexible security that captures the strengths of not only the University's auxiliary and student-related revenues, but also its research programs.

In December 2003, the University issued \$108 million in fixed-rate bonds to finance certain capital construction projects. The University continues to use its commercial paper program that provides low-cost bridge financing for capital projects until gifts are received or in anticipation of an external bond issue. Commercial paper debt was \$141.1 million at June 30, 2005, and \$8.8 million at June 30, 2004. The commercial paper program and the general revenue bonds allow the University to use a central bank concept for funding capital projects. The University issues fixed and variable rate debt externally, and blends the average borrowing rate to allocate debt costs to individual capital projects and campus divisions. This concept provides a stable and flexible debt-funding source for capital projects.

The University maintains a combination of variable and fixed rate debt, consistent with its debt management policy. The effective, combined interest rate for variable and fixed rate debt was 4.5 % for fiscal year 2004-2005, and 4.36% for 2003-2004. The interest rate on the commercial paper program for fiscal year 2004-2005 was 1.82% and for 2003-2004 was 0.98%. Interest rates on the University's variable rate, long-term bonds were 1.82 % for fiscal year 2004-2005, and one % for 2003-2004. Interest rates on fixed rate, long-term bonds are disclosed in Note 8B of the financial statements. The University's financial strength allowed it to achieve ratings of AA+/Aa1 by the national rating agencies. The University

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

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debt service to operations ratio, a measure of an entity's dependence on borrowed funds, was only 2.2% at June 30, 2005 and 2.1% for the prior year.

### **Other Noncurrent Assets**

Other noncurrent assets were \$98.6 million at June 30, 2005 and \$158 million at June 30, 2004, a 37.6% decrease. Included in this category at June 30, 2005, are restricted cash and cash equivalents of \$3.9 million, receivables for pledged gifts of \$30.3 million, notes receivable for student loans of \$29 million, restricted resources due from the primary government of \$27.1 million, and an investment in a joint venture of \$8.3 million.

The decrease in other noncurrent assets from the prior year resulted primarily from a \$67 million decline in cash and cash equivalents. The decline resulted from the expenditure of note proceeds invested as a cash equivalent for the Student Family Housing construction project and the discontinued use of reverse repurchase agreements which are sales of securities with a simultaneous agreement for repurchase.

Restricted resources due from the primary government represent receivables for designated capital construction projects funded from proceeds from statewide higher education bonds and other State resources. The investment in a joint venture represents the construction of the Southern Astrophysical Research Telescope (SOAR), situated in Cerro Pachon, Chile, in South America, as part of an international consortium including the University.

### **Noncurrent Liabilities**

Noncurrent liabilities were \$732.7 million at June 30, 2005, and \$750.7 million at June 30, 2004, and include funds held in trust for the University's affiliated foundations and other campuses in the UNC System and their affiliates of \$261 million and \$235.6 million, respectively. These entities are not part of the University's financial reporting entity but do invest through the System Fund. The increase in funds held in trust of 10.8% over the prior year resulted from strong investment performance and participant contributions.

Long-term liabilities of \$440.4 million at June 30, 2005, and \$482.6 million at June 30, 2004, are the noncurrent portion of bonds payable, notes payable, capital leases payable, compensated absences, and annuities payable. The decrease of 8.7% from the prior year resulted from principal payments on bonds. The reader may refer to Note 8 for summary of changes in long-term liabilities. Other noncurrent liabilities of \$31.4 million at June 30, 2005, and \$32.5 million at June 30, 2004, are refundable U.S. government grants that provide resources for student loan programs.

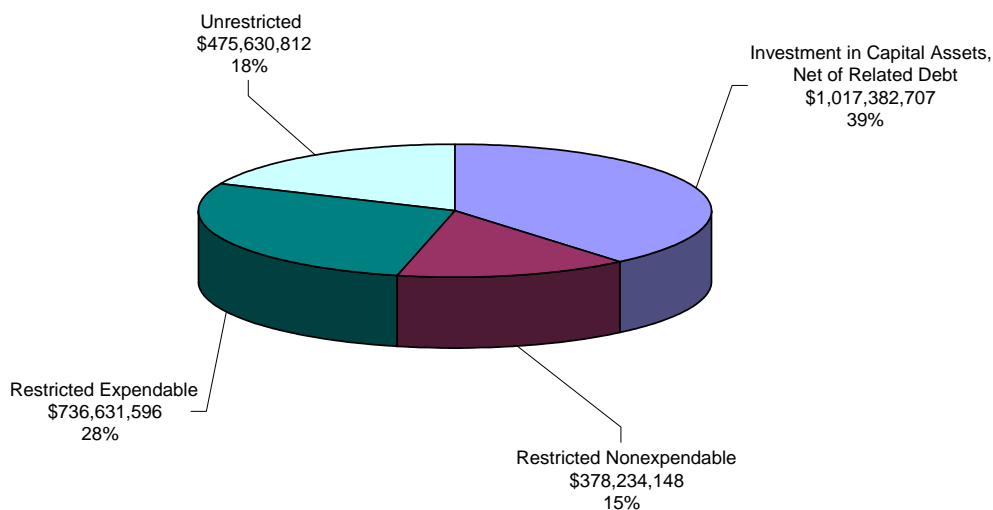
### **Net Assets**

Net assets represent the value of the University's assets after liabilities are deducted. The University's net assets were \$2.6 billion at June 30, 2005, an increase of \$367 million over the prior year.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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### 2005 NET ASSETS \$2,607,879,263



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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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

The Statements of Revenues, Expenses, and Changes in Net Assets present the University's results of operations. The statements for the fiscal year ended June 30, 2005, and the prior year are summarized as follows:

	2005	2004	% Change
<b>Operating Revenues:</b>			
Student Tuition and Fees, Net	\$ 164,456,925	\$ 153,943,215	6.8
Grants and Contracts	524,476,342	499,798,678	4.9
Sales and Services, Net	462,459,945	443,227,663	4.3
Other	5,608,155	5,667,765	(1.1)
<b>Total Operating Revenues</b>	<b>1,157,001,367</b>	<b>1,102,637,321</b>	<b>4.9</b>
<b>Operating Expenses:</b>			
Salaries and Benefits	966,629,252	917,840,235	5.3
Supplies and Materials	148,439,992	151,196,308	(1.8)
Services	407,689,396	380,125,640	7.3
Scholarships and Fellowships	51,169,976	47,427,018	7.9
Utilities	47,870,170	46,207,389	3.6
Depreciation	60,101,910	60,589,122	(0.8)
<b>Total Operating Expenses</b>	<b>1,681,900,696</b>	<b>1,603,385,712</b>	<b>4.9</b>
<b>Operating Loss</b>	<b>(524,899,329)</b>	<b>(500,748,391)</b>	<b>4.8</b>
<b>Nonoperating Revenues (Expenses):</b>			
State Appropriations	406,672,962	380,446,327	6.9
Noncapital Grants	62,544,341	53,153,741	17.7
Noncapital Gifts, Net	73,692,797	68,517,192	7.6
Investment Income, Net	154,899,571	135,369,198	14.4
Interest and Fees on Capital Asset-Related Debt	(21,822,928)	(18,339,114)	19.0
Other Nonoperating Revenues (Expenses)	8,374,281	(8,132,036)	203.0
<b>Income Before Other Changes</b>	<b>159,461,695</b>	<b>110,266,917</b>	<b>44.6</b>
Capital Grants	152,844,246	74,392,000	105.5
Capital Appropriations	5,165,922	897,387	475.7
Capital Gifts	11,520,297	6,358,879	81.2
Additions to Permanent Endowments	37,687,946	24,098,374	56.4
<b>Increase in Net Assets</b>	<b>366,680,106</b>	<b>216,013,557</b>	<b>69.7</b>
<b>Net Assets – July 1</b>	<b>2,241,199,157</b>	<b>2,025,185,600</b>	<b>10.7</b>
<b>Net Assets – June 30</b>	<b>\$ 2,607,879,263</b>	<b>\$ 2,241,199,157</b>	<b>16.4</b>

*Fiscal year 2004-2005 revenues and other changes and expenses total \$2,070,403,730 and \$1,703,723,624, respectively. Fiscal year 2003-2004 revenues and other changes and expenses total \$1,845,870,419 and \$1,629,856,862, respectively.*

### Operating Revenues

The operating revenues represent resources generated by the University in fulfilling its instruction, research, and public service missions. Student tuition and fees are reported net of the scholarship discount, which was \$37.9 million for fiscal year 2004-2005 and \$33.3 million for the prior year. Total revenues from student tuition and fees increased 6.8% over the prior year. The 2004-2005 tuition rates increased 8.5 % for undergraduate residents, 10.1% for undergraduate nonresidents, 7.9% for graduate residents, and 9.9% for graduate nonresidents. There were also limited tuition increases for the professional schools. The revenue growth from the rate increases was offset by a shift in residency status among graduate students from non-resident to resident.

Revenues from grants and contracts increased 4.9% over the prior year as reflected in the financial statements. Discussion of grants and contracts in terms of awards provides another useful perspective. The University is among the nation's leading public research universities, with a diversified portfolio of research that attracted more than \$579 million in sponsored program awards during fiscal year 2004-2005, a 0.3% increase over the previous year. During the same period, awards from the Department of Health and Human Services increased more than 4% to \$338 million. During the federal fiscal year 2003-2004 (the latest available numbers), University faculty attracted \$289.7 million in National Institutes of Health (NIH) awards, up from \$271 million in 2003, ranking 15th overall among U.S. private and public universities. The University is the top public university in the South and one of only six Southern universities, public or private, cited in the NIH's top 20. All five of the University's health affairs schools – dentistry, medicine, nursing, pharmacy and public health – ranked within the top 20 of public and private institutions, according to the NIH. The University continues to rank in the top 20 educational institutions nationally in federal support for science and technology.

The NIH Roadmap committee and office established by the Office of the Vice Chancellor for Research and Economic Development has been instrumental in supporting a number of new research initiatives that are geared toward new funding opportunities at NIH. Last year, Carolina researchers received three of the 21 P-20 NIH Roadmap Awards offered nationally. The Citizen-Soldier Support Program coordinated by the University was initially funded through a \$1.8 million Congressional award. The program facilitates practical and emotional support for North Carolina National Guard and Reserve soldiers and their families preparing for, during and after return from deployments. This initiative gives communities more ways to support military men and women and their families and shows that Carolina and its program partners connect with the citizens of this State and their needs.

Sales and services and patient services revenues of \$462.5 million for fiscal year 2004-2005, represent an increase of 4.3% over the prior year and include the revenues of campus auxiliary operations such as student housing, student stores, student health services, the utilities system, and parking and transportation, as well as revenues from patient services provided by the professional health-care clinics. Net revenues generated by the health-care clinics decreased 0.5% in 2004-2005. Although gross revenues from patient services net of the allowance for uncollectible accounts increased by 4.2%, the \$17.7 million increase in

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

indigent care and contractual adjustments caused the slight decrease in net revenues from patient services. Other revenues of \$5.6 million for fiscal year 2004-2005 represent operating resources not separately identified and include, as examples, an assessment to the Investment Fund to support administrative services, library fines, and interest income from student loans.

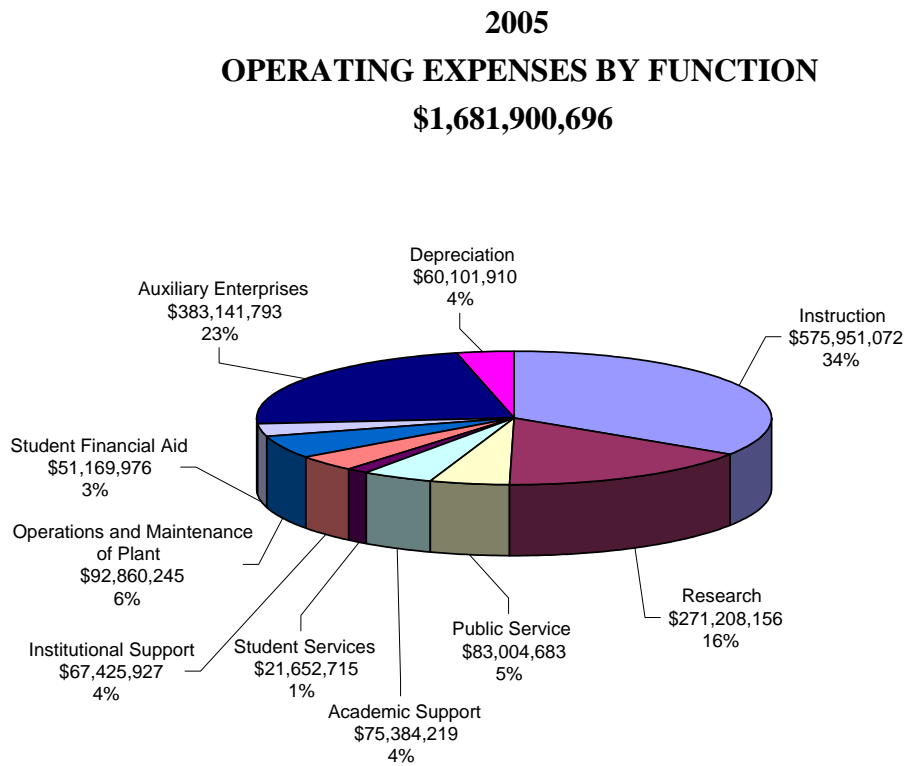
### Operating Expenses

The University's operating expenses were \$1.7 billion for the fiscal year ended June 30, 2005, an increase of 4.9% over the prior year. The operating expenses are reported by natural classification in the financial statements and by functional classification in the note disclosures (Note 11). The following table illustrates the University's operating expenses by the functional classification:

	2005	2004	% Change
<b>Operating Expenses by Function:</b>			
Instruction	\$ 575,951,072	\$ 532,927,326	8.1
Research	271,208,156	257,945,228	5.1
Public Service	83,004,683	78,275,601	6.0
Academic Support	75,384,219	75,692,980	(0.4)
Student Services	21,652,715	20,487,890	5.7
Institutional Support	67,425,927	64,731,371	4.2
Operations and Maintenance of Plant	92,860,245	87,890,864	5.7
Student Financial Aid	51,169,976	47,427,018	7.9
Auxiliary Enterprises	383,141,793	377,418,312	1.5
Depreciation	60,101,910	60,589,122	(0.8)
<b>Total Operating Expenses</b>	<b>\$ 1,681,900,696</b>	<b>\$ 1,603,385,712</b>	<b>4.9</b>

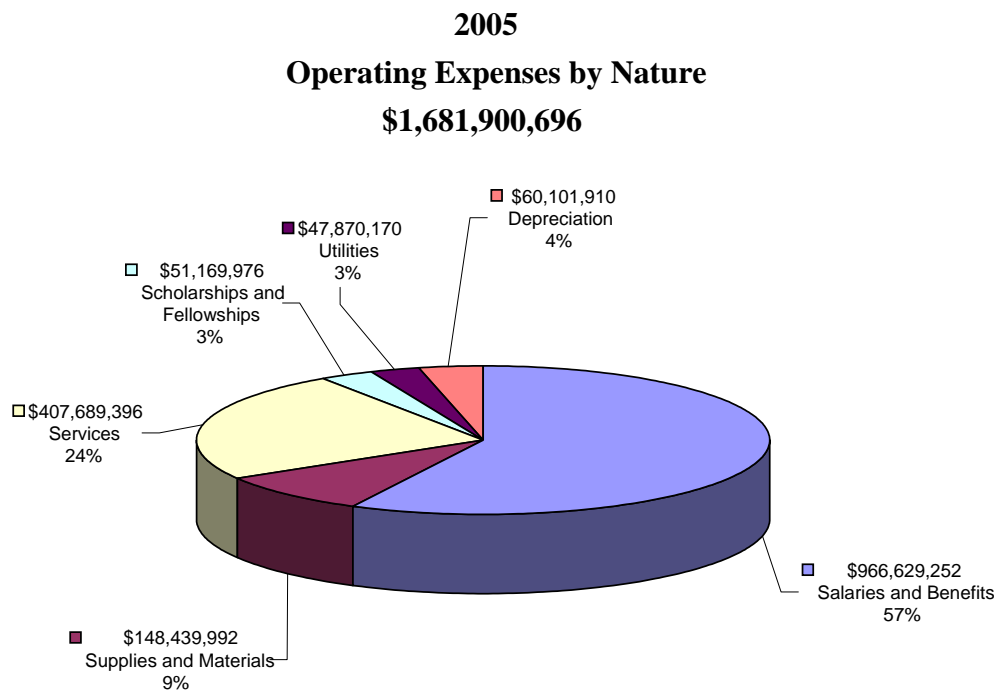
## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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



## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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



Operating expense categories reported by natural classification generally increased or decreased at a comparable rate to total operating expenses. Salaries and benefits increased 5.3% in 2004-2005 over the prior year, expenses for services increased 7.3%, scholarships and fellowships increased 7.9%, and utilities increased 3.6%. Supplies and materials decreased 1.8%, and depreciation decreased 0.8%.

### Nonoperating Revenues and Expenses

State appropriations of \$406.7 million, noncapital grants of \$62.5 million, noncapital gifts of \$73.7 million, investment income of \$154.9 million, interest and fees on capital asset-related debt of (\$21.8) million, and other revenues and expenses of \$8.4 million comprise net nonoperating revenues and expenses. These revenues are considered nonoperating because they were not generated by the University's principal, ongoing operations. For example, State appropriations were not generated by the University but were provided to help fund operating expenses.

The University's initial budget for State appropriations was \$400.7 million for fiscal year 2004-2005. Budget increases of \$17.5 million included funding of \$10.4 million for salary and benefit increases for faculty and staff, \$4.6 million for increased student enrollment including distance learning and other program enhancements, and \$2.5 million for other



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

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initiatives. Budget reductions in State appropriations were \$11.5 million. Included in the budget reductions was a \$1.1 million decrease based on legislation which exempted the University from paying sales and use taxes which resulted in lowering operating expenses by a like amount. A budget reduction of \$2.9 million was required in response to storm damage suffered throughout the State in August and September of 2004 resulting from hurricanes. The resulting appropriations of \$406.7 million represented a 6.9% increase over fiscal year 2003-2004. The University uses an annual budget planning and hearing process with all deans and vice chancellors. The review process provides a framework to implement differential budget reductions.

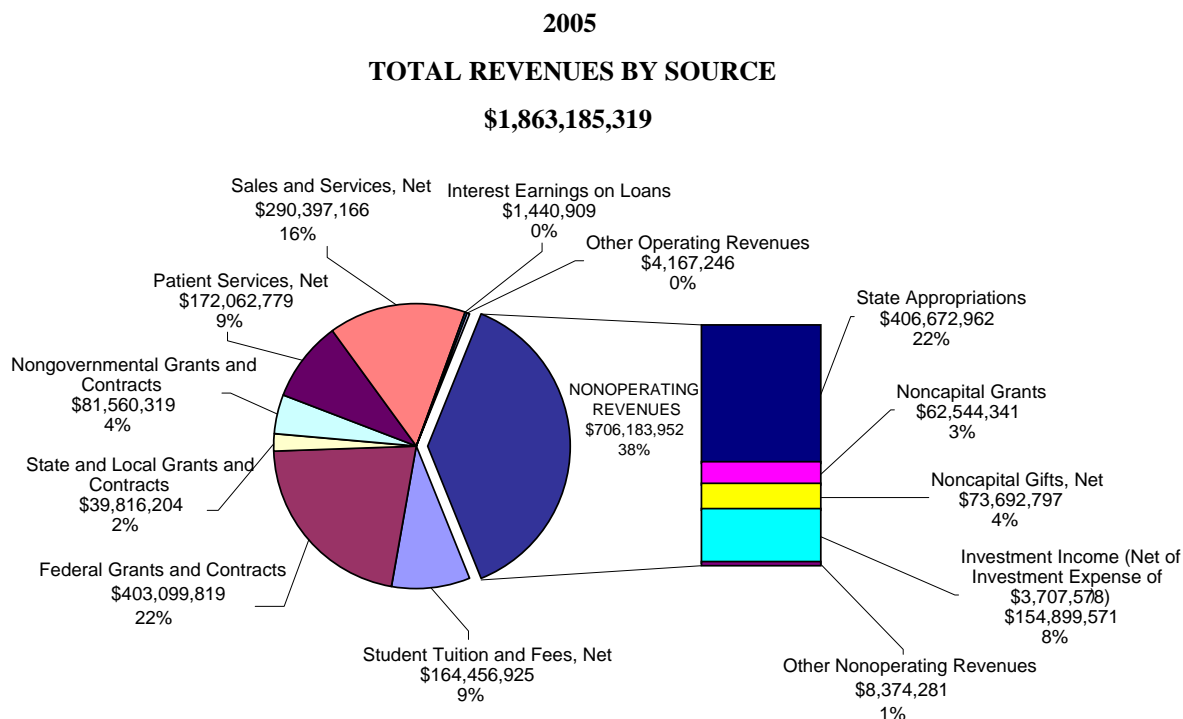
Noncapital grants increased by 17.7% to \$62.5 million in fiscal year 2004-2005 and represent federal awards that are not considered to be operating revenues. Net noncapital gifts increased by 7.6% to \$73.7 million and represent expendable gifts received and pledges made and are net of an allowance for uncollectible pledges. Net investment income of \$154.9 million, an increase of 14.4% over 2003-2004, includes income and realized and unrealized gains and is net of realized and unrealized losses and investment management fees. For detail discussion, the reader may refer to Endowment and Other Long-term Investments section of Management's Discussion and Analysis. Interest and fees on capital asset-related debt were (\$21.8) million, an increase of 19% over the prior year.

Other nonoperating revenues and expenses were \$8.4 million and include a \$6.6 million increase in the net assets of annuities and charitable remainder trusts. These annuities and charitable remainder trusts include split-interest agreements that have a liability component for the present value of projected future distributions to the annuitant or donor and liabilities to other organizations where the University reporting entity serves as trustee but not the beneficiary of the split-interest agreements. Changes in the actuarial calculations of the liabilities will increase or decrease the net assets of the annuities and charitable remainder trusts. The increase in fiscal year 2004-2005 over the prior year resulted in part from net asset increases in these annuities and trust.

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

Operating and nonoperating revenues such as State appropriations, noncapital grants, noncapital gifts, and investment income are used to fund University operations. The following chart illustrates the University's operating and nonoperating revenues which total \$1.9 billion for fiscal year 2004-2005.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)



### Other Changes in Net Assets

Capital grants of \$152.8 million for 2004-2005 and \$74.4 million for 2003-2004 are from Statewide higher education bond proceeds for capital construction projects. Capital appropriations of \$5.2 million for 2004-2005 and \$0.9 million for the prior year were received from the State for repairs and replacements. Net capital gifts of \$11.5 million for 2004-2005 and \$6.4 million for the prior year resulted from fund-raising efforts and also provided funding for construction projects. Nonexpendable gifts and funds from the State's program to match gifts for distinguished professorship endowments resulted in additions to permanent endowments of \$37.7 million during fiscal year 2004-2005 and \$24.1 million during fiscal year 2003-2004.

### Condensed Statement of Cash Flows

The Statement of Cash Flows provides additional information about the University's financial results by reporting the major sources and uses of cash. Cash decreased by \$85.3 million during the fiscal year 2004-2005, compared with an increase of \$46.9 million during fiscal year 2003-2004. The primary factor which caused the decrease in the cash position at June 30, 2005, was the decreased use of the State Treasurer's short-term investment fund (STIF), which is classified as a cash equivalent, for the University's temporary investment pool. The temporary investment pool's investment in STIF was \$120 million at

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

June 30, 2004, and zero at June 30, 2005. The statements for the fiscal year ended June 30, 2005, and the prior year are summarized as follows:

	<u>2005</u>	<u>Restated 2004</u>	<u>% Change</u>
<b>Cash Flows Provided (Used):</b>			
Operating Activities	\$ (460,045,805)	\$ (348,742,031)	31.9
Noncapital Financing Activities	589,302,508	325,768,875	80.9
Capital and Related Financing Activities	(67,227,484)	(107,595,259)	(37.5)
Investing Activities	(147,354,384)	177,517,901	(183.0)
<b>Net Increase (Decrease) in Cash</b>	(85,325,165)	46,949,486	(281.7)
<b>Cash – July 1</b>	544,687,966	497,738,480	9.4
<b>Cash – June 30</b>	<u>\$ 459,362,801</u>	<u>\$ 544,687,966</u>	(15.7)

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

### Component Units Reported using Discrete Presentation

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

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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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

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

	<u>2005</u>	<u>2004</u>	<u>% Change</u>
Total Assets	\$ 431,586,835	\$ 389,576,735	10.8
Total Liabilities	<u>2,165,737</u>	<u>2,387,485</u>	(9.3)
Total Net Assets	<u>\$ 429,421,098</u>	<u>\$ 387,189,250</u>	10.9
<b>Net Assets Composition:</b>			
Unrestricted	\$ 20,653,221	\$ 17,723,823	16.5
Temporarily Restricted	238,744,849	209,029,695	14.2
Permanently Restricted	<u>170,023,028</u>	<u>160,435,732</u>	6.0
<b>Total Net Assets</b>	<u>\$ 429,421,098</u>	<u>\$ 387,189,250</u>	10.9

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

<b>Changes in Net Assets</b>	<u>2005</u>	<u>2004</u>	<u>% Change</u>
Total Revenues	\$ 75,805,739	\$ 73,909,097	2.6
Total Expenses	<u>33,573,891</u>	<u>25,359,735</u>	32.4
Increase in Net Assets	42,231,848	48,549,362	(13.0)
Net Assets – July 1	<u>387,189,250</u>	<u>338,639,888</u>	14.3
Net Assets – June 30	<u>\$ 429,421,098</u>	<u>\$ 387,189,250</u>	10.9

The 32.4 % increase in expenses resulted primarily from additional grants to the University.

### **Economic Outlook**

The University's financial position and outlook are favorable. The University is well positioned to continue demonstrating excellence in teaching, discovery, and public service. Management believes that fiscal year 2004-2005 demonstrated an improvement on a solid financial foundation. The University's strong debt credit rating allows it to obtain

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

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competitive financing for capital construction. The University's comparatively low tuition levels enhance its appeal to prospective students and provide a possible source of additional resources, should tuition increases be enacted.

Tuition rates increased for fiscal year 2005-2006 by 4.3% for undergraduate nonresidents, 5.9% for graduate residents, and 5.7% for graduate nonresidents. There was no tuition rate increase for undergraduate residents. There were limited tuition increases for the professional schools. The University's academic standing allows it to continuously attract top students. Student application levels, enrollment levels of students including cross admits, applicants' exam scores, and other admission criteria, and other factors illustrate the substantial appeal of the University to prospective students. The University's ratio of accepted applications as a percentage of total applications was 35.8% for 2004-2005. The ratio of enrolled students as a percentage of accepted applications was 53.2% for 2004-2005. Carolina's tuition levels remain low compared with its national peer group of institutions.

The Carolina Covenant provides qualified students from low income families with a Carolina education debt-free. Carolina Covenant Scholars agree to work on campus 10 to 12 hours weekly in a federal work-study job, and the University meets the rest of their needs through a combination of federal, State, university and other privately funded grants and scholarships. Effective with the fall semester of 2005, the Carolina Covenant is expanding the program to include families with incomes up to 200% of the federal poverty level. This move will cover a family of four with an annual income of about \$37,000 or a single parent with a child who makes about \$24,000. These changes strengthen an already solid message about accessibility and the traditional commitment to opportunity in Chapel Hill for qualified students, regardless of their ability to pay.

The University's relationship with the State of North Carolina is an important success factor. The Governor and the General Assembly have continued to demonstrate strong financial support for higher education in North Carolina. The budgeted funding level for State appropriations for 2005-2006 totals \$439.2 million, which represents an increase of 8 % over fiscal year 2004-2005 actual State appropriations. This level of State appropriation funding includes faculty and staff pay and benefit increases of \$12.2 million. The fiscal year 2005-2006 pay increase of the greater of 2% or \$850 is the second consecutive year of base salary increases for all employees. Other budget increases included \$8.9 million for student enrollment increases, \$10.9 million for planned operating expenses for new construction, and \$5.9 million for the Renaissance Computing Institute based in Chapel Hill and created in partnership with Duke and North Carolina State universities. The 2005-2006 appropriations budget also included a base budget reduction of \$6.3 million. While additional budget reductions or reversions are not anticipated for fiscal year 2005-2006, it is not certain.

The University must continue to address competitive pressures related to recruiting and retaining faculty and staff. The University continues aggressive efforts to address competitive pressures on faculty and staff salaries and benefits. In particular, University staff continues to support UNC System efforts to provide an improved health insurance program for faculty and staff. In addition, the University is moving forward with a plan to develop below market

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

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housing for faculty and staff. The University's diverse revenue base, its strategic planning processes, and its proactive approach in addressing budgetary issues help alleviate the significance of the impacts.

A central factor in supporting research is our ability to recover facilities and administrative (F&A) costs associated with sponsored research. This year, two innovations helped to ensure that the University recovered its fair share of F&A. First, new space-survey software was developed to more accurately identify the space used for research in campus facilities. Second, a year-long study of library use was conducted to more fully understand and document how the library organization supports research. The library user survey has solidified the library component of the proposed rate that objectively recognizes the library organization's value to the research enterprise and will sustain overhead funding for library support to Carolina research at a competitive level compared to our public peers. These investments, efforts and initiatives are paying off as an unprecedented F&A recovery rate for Carolina has been proposed to the Federal Government. The University still has the federal review and negotiation process to go through, but is beginning that phase in a stronger position than ever before.

Carolina's research enterprise creates jobs for the State's economy. Expenditures resulting from research funding at UNC Chapel Hill cycle through the State and local economies, transforming federal funds into revenue for North Carolina residents and businesses. Using a U.S. government multiplier of 1.7, Carolina's \$579.6 million in research funding generated approximately \$985 million in economic impact. The University continues its commitment to transfer new technologies developed by our faculty to the marketplace. Planning continued for Carolina North, an approximately 1,000-acre tract of land that will support the research, teaching, and public service mission of the University. A master plan for Carolina North was developed and presented to the broad community in an extensive series of meetings. Based upon feedback at these meetings, a revised plan was developed and endorsed by the Board of Trustees. The site approvals for the first two buildings, an incubator building and the Frank Porter Graham Child Development First School, were approved by the Board of Trustees.

Management believes the investment performance of its endowment fund will continue to earn attractive returns and provide important resources for University operations. The University's investment management operation is separately organized as the UNC Management Company, Inc., a nonprofit corporation organized and operated as a 501(c)(3) entity, to provide investment management services and administrative services to the University and to the other campuses of the UNC System and their affiliated nonprofit foundations as appropriate. Management believes this structure will continue to enhance the ability to attract and retain investment professionals and increase the pool of funds and resulting investment returns.

The University's fund-raising efforts on behalf of the University and its affiliated foundations continue to achieve a high level of success, and provide critical resources for the present and for future generations. Initially announced on October 11, 2002, the \$1.8 billion Carolina

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

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First Campaign began its quiet phase on July 1, 1999. The campaign increased its goal to \$2 billion in October 2005.

As of June 30, 2005, gifts, pledges, and deferred commitments of \$1.5 billion had been recorded. Cash and other assets received represent 69% of the \$1.5 billion paid or pledged. Of the \$1.8 billion goal, over half is targeted directly for the University and for the business school, social work, law, and UNC Chapel Hill foundations, with the remainder for the other University affiliated foundations. As of June 30, 2005, endowment commitments totaled \$611 million toward the overall endowment goal of \$700 million. With 75% of the campaign period elapsed, the fund-raising drive has reached 87% of the endowment goal. The campaign will conclude on June 30, 2007, and management anticipates the goal will be attained. The fund-raising goal for the Carolina First Campaign was raised to \$2 billion on October 1, 2005. For the eighth time in the past 12 years, a national organization that supports educational advancement efforts has honored the University for its fund-raising success. Carolina received a 2005 CASE/ID Wealth Award for Educational Fund Raising for its overall performance from the Council for Advancement and Support of Education, which works with educational institutions to enhance their alumni-relations, communications and development efforts.

The University's priorities are to strengthen faculty recruitment, retention, and development; create the richest possible learning environment for undergraduate, graduate, and professional students; invest in centers of excellence in research and creativity; enhance Carolina's engagement with North Carolina and the world; successfully complete the campus development plan and begin Carolina North; determine strategies to direct resources to highest priorities; and define Carolina's role as a leader.

With increased support from the State, the ability to attract top prospective students, vibrant research funding, continued strength in investment performance, a dynamic capital construction program, and an exceptional fund-raising campaign all contribute to a positive outlook for the University. The University's commitment to sound financial and budgetary planning, protection and enhancement of its endowed and physical assets, and observance of compliance and control standards support a solid financial future for the University.

***The University of North Carolina at Chapel Hill***  
***Statement of Net Assets***  
***June 30, 2005***

***Exhibit A-1***

**ASSETS**

Current Assets:

Cash and Cash Equivalents	\$ 167,582,741
Restricted Cash and Cash Equivalents	287,909,706
Short-Term Investments	168,610,555
Restricted Short-Term Investments	94,133,344
Receivables, Net (Note 4)	113,924,440
Due from State of North Carolina Component Units	2,767,663
Inventories	17,400,526
Notes Receivable, Net (Note 4)	3,686,168
	<hr/>
Total Current Assets	856,015,143
	<hr/>

Noncurrent Assets:

Restricted Cash and Cash Equivalents	3,870,354
Receivables, Net (Note 4)	30,321,103
Restricted Due from Primary Government	27,089,076
Endowment Investments	972,461,495
Other Long-Term Investments	283,640,904
Investment in Joint Venture	8,318,917
Notes Receivable, Net (Note 4)	29,045,299
Capital Assets - Nondepreciable (Note 5)	463,869,870
Capital Assets - Depreciable, Net (Note 5)	1,086,331,268
	<hr/>
Total Noncurrent Assets	2,904,948,286
	<hr/>

Total Assets	3,760,963,429
	<hr/>

**LIABILITIES**

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)	90,617,279
Due to Primary Government	212,802
Due to State of North Carolina Component Units	1,409,355
Deposits Payable	1,919,543
Funds Held for Others	3,694,809
Deferred Revenue	33,351,813
Interest Payable	2,529,678
Short-Term Debt	141,141,000
Long-Term Liabilities - Current Portion (Note 8)	145,474,087
	<hr/>
Total Current Liabilities	420,350,366
	<hr/>

Noncurrent Liabilities:

U. S. Government Grants Refundable	31,350,927
Funds Held in Trust for Pool Participants	260,960,010
Long-Term Liabilities (Note 8)	440,422,863
	<hr/>
Total Noncurrent Liabilities	732,733,800
	<hr/>
Total Liabilities	1,153,084,166
	<hr/>



***The University of North Carolina at Chapel Hill***  
***Statement of Net Assets***  
***June 30, 2005***

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

**NET ASSETS**

Invested in Capital Assets, Net of Related Debt	1,017,382,707
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	85,350,731
Research	14,625,341
Library Acquisitions	23,096,771
Endowed Professorships	155,460,576
Departmental Uses	55,337,122
Loans	14,362,032
Other	30,001,575
Expendable:	
Scholarships and Fellowships	145,256,120
Research	16,752,163
Library Acquisitions	37,905,662
Instruction and Educational Agreements	12,930,841
Plant Improvements	14,409,834
Endowed Professorships	233,532,312
Departmental Uses	250,999,091
Capital Projects	15,913,073
Debt Service	8,932,500
Unrestricted	475,630,812
Total Net Assets	<u><u>\$ 2,607,879,263</u></u>

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

***The University of North Carolina at Chapel Hill  
Statement of Revenues, Expenses, and  
Changes in Net Assets  
For the Fiscal Year Ended June 30, 2005***

***Exhibit A-2***

**REVENUES**

Operating Revenues:

Student Tuition and Fees, Net (Note 10)	\$	164,456,925
Patient Services, Net (Note 10)		172,062,779
Federal Grants and Contracts		403,099,819
State and Local Grants and Contracts		39,816,204
Nongovernmental Grants and Contracts		81,560,319
Sales and Services, Net (Note 10)		290,397,166
Interest Earnings on Loans		1,440,909
Other Operating Revenues		4,167,246
Total Operating Revenues		<u>1,157,001,367</u>

**EXPENSES**

Operating Expenses:

Salaries and Benefits		966,629,252
Supplies and Materials		148,439,992
Services		407,689,396
Scholarships and Fellowships		51,169,976
Utilities		47,870,170
Depreciation		60,101,910
Total Operating Expenses		<u>1,681,900,696</u>
Operating Loss		<u>(524,899,329)</u>

**NONOPERATING REVENUES (EXPENSES)**

State Appropriations		406,672,962
Noncapital Grants		62,544,341
Noncapital Gifts, Net (Note 10)		73,692,797
Investment Income (Net of Investment Expense of \$3,707,578)		154,899,571
Interest and Fees on Capital Asset-Related Debt		(21,822,928)
Other Nonoperating Revenues		8,374,281
Net Nonoperating Revenues		<u>684,361,024</u>
Income Before Other Revenues		159,461,695
Capital Appropriations		5,165,922
Capital Grants		152,844,246
Capital Gifts		11,520,297
Additions to Endowments		37,687,946
Increase in Net Assets		<u>366,680,106</u>

**NET ASSETS**

Net Assets - July 1, 2004		<u>2,241,199,157</u>
Net Assets - June 30, 2005	\$	<u><u>2,607,879,263</u></u>

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

***The University of North Carolina at Chapel Hill***  
***Statement of Cash Flows***  
***For the Fiscal Year Ended June 30, 2005***

***Exhibit A-3***

**CASH FLOWS FROM OPERATING ACTIVITIES**

Received from Customers	\$ 1,151,504,503
Payments to Employees and Fringe Benefits	(966,176,894)
Payments to Vendors and Suppliers	(600,239,677)
Payments for Scholarships and Fellowships	(51,169,976)
Loans Issued	(6,482,788)
Collection of Loans	9,059,245
Other Receipts	3,459,782
	<hr/>
Net Cash Used by Operating Activities	(460,045,805)

**CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES**

State Appropriations	406,672,962
Noncapital Grants	67,026,288
Noncapital Gifts	62,930,161
Additions to Endowments	37,687,946
Related Activity Agency Receipts	14,985,151
	<hr/>
Cash Provided by Noncapital Financing Activities	589,302,508

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

Proceeds from Capital Debt	150,729,724
State Capital Appropriations	5,165,922
Capital Grants	146,901,291
Capital Gifts	10,958,365
Acquisition and Construction of Capital Assets	(318,730,947)
Principal Paid on Capital Debt and Leases	(39,607,649)
Interest and Fees Paid on Capital Debt and Leases	(22,644,190)
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(67,227,484)

**CASH FLOWS FROM INVESTING ACTIVITIES**

Proceeds from Sales and Maturities of Investments	935,151,022
Investment Income	32,698,725
Purchase of Investments and Related Fees	(987,345,381)
Obligations under reverse repurchase agreements	(127,858,750)
	<hr/>
Net Cash Used by Investing Activities	(147,354,384)
	<hr/>
Net Decrease in Cash and Cash Equivalents	(85,325,165)
Cash and Cash Equivalents - July 1, 2004	544,687,966
	<hr/>
Cash and Cash Equivalents - June 30, 2005	\$ 459,362,801

***The University of North Carolina at Chapel Hill***  
***Statement of Cash Flows***  
***For the Fiscal Year Ended June 30, 2005***

***Exhibit A-3***  
***Page 2***

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

Operating Loss	\$	(524,899,329)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:		
Depreciation Expense		60,101,910
Allowances, Write-Offs, and Amortizations		(754,326)
Changes in Assets and Liabilities:		
Receivables (Net)		(1,305,275)
Inventories		(1,812,269)
Notes receivable (Net)		1,055,097
Accounts Payable and Accrued Liabilities		7,528,586
Due to Primary Government		120,834
US government grants refundable		(1,172,935)
Deferred Revenue		2,317,786
Compensated Absences		(1,225,884)
Net Cash Used by Operating Activities	\$	<u>(460,045,805)</u>

**RECONCILIATION OF CASH AND CASH EQUIVALENTS**

Current Assets:		
Cash and Cash Equivalents	\$	167,582,741
Restricted Cash and Cash Equivalents		287,909,706
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		<u>3,870,354</u>
Total Cash and Cash Equivalents - June 30, 2005	\$	<u>459,362,801</u>

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

Assets Acquired through the Assumption of a Liability	\$	784,763
Assets Acquired through a Gift		561,932
Change in Fair Value of Investments		66,797,060

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

***The University of North Carolina at Chapel Hill Foundations***  
***Statement of Financial Position***  
***June 30, 2005***

***Exhibit B-1***

	<b>UNC-CH Arts and Sciences Foundation, Inc.</b>	<b>The Educational Foundation Scholarship Endowment Trust</b>	<b>The Medical Foundation of North Carolina, Inc.</b>
<b>ASSETS</b>			
Current Assets:			
Cash and Cash Equivalents	\$ 8,297,311	\$ 7,734,230	\$ 33,745,072
Investments		119,406,517	91,477,285
Unconditional Promises to Give, Net	5,628,109	7,581,475	2,413,671
Contributions Receivable from Split-Interest Agreements		3,332,944	
Accounts Receivable	135,602		
Funds Held in Trust	188,446		
Accrued Income Receivable	21,822		200,100
Prepaid Expenses			12,707
Miscellaneous Receivables			177,267
Total Current Assets	14,271,290	138,055,166	128,026,102
Property and Equipment:			
Building			436,340
Furniture and Equipment	88,464		341,016
	88,464		777,356
Less: Allowance for Depreciation	(66,940)		(411,543)
Total Property and Equipment	21,524		365,813
Other Assets:			
Investments	79,972,005		42,970,980
Unconditional Promises to Give, Net	11,354,784		10,688,891
Restricted Cash	2,766,272		231,725
Escrow Deposit	200,000		
Real Estate Interests Held for Investment	49,500		
Restricted Investments			259,133
Student Loans Receivable			39,095
Cash Surrender Value of Life Insurance		1,956,360	358,195
Total Other Assets	94,342,561	1,956,360	54,548,019
Total Assets	\$ 108,635,375	\$ 140,011,526	\$ 182,939,934
<b>LIABILITIES</b>			
Current Liabilities:			
Accounts Payable	\$ 8,745	\$ 0	\$ 204,214
Annuities Payable		202,736	
Accrued Expenses	123,922		1,123,329
Deferred Revenue			240,000
Total Current Liabilities	132,667	202,736	1,567,543
Long Term Debt	262,791		
Total Liabilities	395,458	202,736	1,567,543
<b>NET ASSETS</b>			
Unrestricted	10,093,745		10,559,476
Temporarily Restricted	46,906,276	63,996,638	127,841,935
Permanently Restricted	51,239,896	75,812,152	42,970,980
Total Net Assets	108,239,917	139,808,790	181,372,391
Total Liabilities and Net Assets	\$ 108,635,375	\$ 140,011,526	\$ 182,939,934

See Note 1 in the Notes to the Financial Statements

***The University of North Carolina at Chapel Hill Foundations***  
***Statement of Activities***  
***For the Fiscal Year Ended June 30, 2005***

***Exhibit B-2***

	<b>UNC-CH Arts and Sciences Foundation, Inc.</b>	<b>The Educational Foundation Scholarship Endowment Trust</b>	<b>The Medical Foundation of North Carolina, Inc.</b>
<b>REVENUES</b>			
Support:			
Contributions	\$ 7,809,276	\$ 6,793,061	\$ 15,369,525
Developed Assessment Fee	1,183,082		
Donated Facilities	40,000		
Actuarial Adjustment of Annuities Payable		3,936	
Endowment Investment Return Designated for Current Operations		5,400,697	
Total Support	9,032,358	12,197,694	15,369,525
Revenue:			
Interest and Dividend Income			3,860,562
Net Unrealized and Realized Gains (Losses) on Investments	8,989,292		12,633,447
Investment Income	2,464,674		
Loss on Sale of Real Estate Investments			(34,910)
Gain on Sale of Property and Equipment			9,404
Other Income			554,120
Total Revenues	11,453,966		17,022,623
Total Support and Revenue	20,486,324	12,197,694	32,392,148
<b>EXPENSES</b>			
Program Services:			
Grants	9,123,219		14,033,976
Scholarship Expense Distribution		5,391,034	
Annuity Payments		9,663	
Administrative Expenses		56,471	
Other Expenses		632,819	
Total Program Services	9,123,219	6,089,987	14,033,976
Supporting Services:			
Fundraising Expenses	1,659,748		1,000,319
Management and General	681,946		984,696
Total Supporting Services	2,341,694		1,985,015
Total Expenses	11,464,913	6,089,987	16,018,991
Change in Net Assets From Operations	9,021,411	6,107,707	16,373,157
<b>OTHER CHANGES:</b>			
Investment Reform in Excess of Amounts Designated for Current Operations		10,729,573	
Change in Net Assets	9,021,411	16,837,280	16,373,157
<b>NET ASSETS</b>			
Net Assets - Beginning of Year	99,218,506	122,971,510	164,999,234
Net Assets - End of Year	\$ 108,239,917	\$ 139,808,790	\$ 181,372,391

See Note 1 in the Notes to the Financial Statements

**THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2005**

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES**

- A. Financial Reporting Entity** - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements. The University of North Carolina at Chapel Hill (University) is a constituent institution of the 16-campus University of North Carolina System, which is a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report*.

The accompanying financial statements present all funds belonging to the University and its component units. While the Board of Governors of the University of North Carolina System has ultimate responsibility, the Chancellor, the Board of Trustees, and the Board of Trustees of the Endowment Fund have delegated responsibilities for financial accountability of the University's funds. The University's component units are either blended or discretely presented in the University's financial statements. The blended component units, although legally separate, are, in substance, part of the University's operations and therefore, are reported as if they were part of the University. 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.

**Blended Component Units** - Although legally separate, The University of North Carolina at Chapel Hill Foundation Investment Fund, Inc. (Investment Fund), UNC Investment Fund, LLC (System Fund), UNC Management Company, Inc. (Management Company), The University of North Carolina at Chapel Hill Foundation, Inc. (UNC-Chapel Hill Foundation), The Kenan-Flagler Business School Foundation (Business School Foundation), The School of Social Work Foundation Inc. (Social Work Foundation), and UNC Law Foundation Inc. (Law Foundation), are reported as if they were part of the University.

The Investment Fund is governed by a board consisting of 11 ex-officio directors and one or two elected directors. Ex-officio directors include all of the members of the Board of Trustees of the Endowment Fund of the

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

In December 2002, The System Fund was organized by the Investment Fund to allow the University, the University of North Carolina and its other constituent institutions (UNC System), affiliated foundations, associations, trusts and endowments that support the University and the UNC System, to pool their resources and invest collectively in investment opportunities identified, structured and arranged by the Management Company. The membership interests are offered only to government entities or tax-exempt organizations that are controlled by or support the University or UNC System. The Investment Fund contributed and assigned all of its assets to the System Fund effective January 1, 2003, in exchange for its membership interest in the System Fund. Upon such contribution and assignment, and in consideration thereof, the System Fund has assumed all liabilities and obligations of the Investment Fund in respect of such contributed assets. At June 30, 2005, the Investment Fund membership interest was approximately 93% of the System Fund total membership interests. Because the Investment Fund is the organizer and a predominant member of the System Fund, the financial statements of the System Fund have been blended with those of the University.

The Management Company is a North Carolina nonprofit corporation organized and operated exclusively to support the educational mission of the University. The Management Company will also provide investment management services to the University, UNC System, and institutions and affiliated tax-exempt organizations, and perform other functions for and generally carry out the purposes of the University. The Management Company is governed by five ex-officio directors and one or two additional directors as fixed or changed from time to time by the board, elected by the ex-officio directors. The ex-officio directors consist of the Chancellor of the University, the Vice Chancellor for Finance and Administration of the University, the Chairman of the University's Board of Trustees of the University, the Chairman of the Board of Directors of the Investment Fund, and the President of the Management Company.



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Because members of the Board of Directors of the Management Company are officials or appointed by officials of the University and the Management Company's primary purpose is to benefit the University and other organizations operated primarily to support the University, its financial statements have been blended with those of the University. Effective January 1, 2003, the Management Company entered into an investment services agreement with the System Fund pursuant to which it will provide investment management and administrative services to the System Fund and the University. Effective January 1, 2004, the Management Company entered into an investment services agreement with the System Fund pursuant to which it will provide investment management and administrative services to the UNC-Chapel Hill Foundation.

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Business School Foundation have been blended with those of the University.

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

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

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

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

The Medical Foundation is governed by an 83-member board of directors, elected annually by its members. Its purpose is to support educational and research efforts of the University's Medical School and UNC

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Hospitals. Historically, the University's Medical School has been the major recipient of financial support from the Medical Foundation compared to UNC Hospitals. Although the University does not control the timing or amount of receipts from the Medical Foundation, the majority of resources or income that the Medical Foundation holds and invests are restricted to the activities of the University by the donors. Because these restricted resources held by the Medical Foundation can only be used by, or for the benefit of the University, the Medical Foundation is considered a component unit of the University.

The Arts and Sciences Foundation is governed by a board consisting of three ex-officio directors, 24 elected directors and such number of emeritus directors determined from time to time by the Board of Directors. The 24 elected directors are elected for staggered terms, by the Board of Directors in office at the time of election. The purpose of the Arts and Sciences Foundation is to promote and support the University's College of Arts and Sciences. Although the University does not control the timing or amount of receipts from the Arts and Sciences Foundation, the majority of resources or income that the Arts and Sciences Foundation holds and invests are restricted to the activities of the University by the donors. Because these restricted resources held by the Arts and Sciences Foundation can only be used by, or for the benefit of the University, the Arts and Sciences Foundation is considered a component unit of the University.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

During the year ended June 30, 2005, the Medical Foundation, Arts and Sciences Foundation and the Educational Foundation Trust distributed in total \$28,548,229 to the University for both restricted and unrestricted purposes. Complete financial statements for the Medical Foundation, Arts and Sciences Foundation, and Educational Foundation Trust can be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

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

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

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

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

- C. Basis of Accounting** - The financial statements of the University have been prepared using the economic resource measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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recognized when earned, and expenses are recorded when an obligation has been incurred.

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

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

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

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

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

**F. Receivables** – Receivables consist of tuition and fees charged to students and charges to patients for services provided by the UNC Physicians & Associates and the Dental Faculty Practices. Receivables also include amounts due from the federal government, State and local governments,

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants, and pledges that are verifiable, measurable, and expected to be collected and available for expenditures for which the resource provider's conditions have been satisfied, and notes receivables from loans to students. Patients, pledges, and notes receivables are recorded net of the allowance for doubtful accounts. The accounts and other receivables are shown at book value with no provision for doubtful accounts considered necessary.

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

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

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

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

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

**I. Restricted Assets** – Unexpended proceeds of revenue bonds and unexpended capital contributions are classified as restricted assets because their use is limited by applicable bond covenants or donor/grantor agreements. Certain other assets are classified as restricted because their use is limited by external parties or statute.

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

**K. Funds Held in Trust by Others** – Funds held in trust by others are resources neither in the possession nor the control of the University, but

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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held and administered by an outside organization, with the University deriving income from such funds. Such funds established under irrevocable trusts where the University has legally enforceable rights or claims have not been recorded on the accompanying financial statements. The value of these assets at June 30, 2005, is approximately \$30,623,598.

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

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

- M. Compensated Absences** - The University's policy is to record the cost of vacation leave when earned. The policy provides for a maximum accumulation of unused vacation leave of 30 days which can be carried forward each January 1 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 30 equals the leave carried forward at the previous December 31 plus the leave earned, less the leave taken between January 1 and June 30.

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

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

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

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

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



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

**R. Related Parties** – Related parties are nonprofit organizations established to assist and provide support to University programs by funding scholarships, fellowships, professorships and other needs of specific schools as well as the University's overall academic endeavors. Except as described in Note 1A, the University's financial statements do not include the assets, liabilities, net assets or operational transactions of these organizations except for support from each organization to the University.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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### NOTE 2 - DEPOSITS AND INVESTMENTS

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

At June 30, 2005, the University's deposit with the State Treasurer's Short-Term Investment Fund totaled \$456,047,648. The Short-Term Investment Fund (a portfolio within the State Treasurer's Investment Pool, an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating) had a weighted average maturity of 1.41 years as of June 30, 2005. Assets and shares of the Short-Term Investment Fund are valued at amortized cost, which approximates fair value. Deposit and investment risks associated with the State Treasurer's Investment Pool (which includes the State Treasurer's Short-Term Investment Fund) 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.ncosc.net/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

The carrying amount of the University's deposits not with the State Treasurer, including certificates of deposit, was \$4,315,153 and the bank balance was \$7,167,899. Custodial credit risk is the risk that in the event of a bank failure, the University's deposits may not be returned to it. Pursuant to G.S. 116-36.1, funds received for health care services not deposited with State Treasurer shall be fully secured in the manner as prescribed by the State Treasurer for the security of public deposits. The University does not have a deposit policy for custodial credit risk. As of June 30, 2005, of the University's bank balance, \$6,079,538 was exposed to custodial credit risk as uninsured and uncollateralized.

- B. Investments** - The University is authorized by The University of North Carolina Board of Governors pursuant to G.S. 116-36.2 and Section 600.2.4 of the Policy Manual of the University of North Carolina,

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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to invest its special funds and funds received for services rendered by health care professionals in the same manner as the State Treasurer is required to invest, as previously discussed.

G.S. 147-69.1(c), applicable to the State's General Fund, and G.S. 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 the 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, G.S. 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified ratings. G.S. 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.

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.

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

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

The investments are subject to the following risks:

*Interest Rate Risk:* Interest rate risk is the risk an University may face should interest rate variances affect the fair value of investments. The

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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University does not have a formal investment policy that addresses interest rate risk.

*Credit Risk:* Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The University does not have a formal policy that addresses credit risk.

*Custodial Credit Risk:* Custodial credit risk is the risk that, in the event of the failure of the counterparty, the University will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The University does not have a formal policy for custodial credit risk. The University's investments were not exposed to custodial credit risk.

*Concentration of Credit Risk:* Concentration of credit risk is the risk of loss attributed to the magnitude of a University investment in a single issuer. While the University's does not have a formal investment policy limiting concentration exposure, risk of loss is mitigated by diversifications as to investments by asset class and within asset classes. As of June 30, 2005, the University did not have any single investments that exceed 5% of the total investments of the University.

*Foreign Currency Risk:* Foreign currency risk is the risk that changes in the exchange rates that could adversely affect the fair value of an investment. The University does not have a formal policy for foreign currency risk.

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

The Northern Trust Company is the custodian for the Temporary Pool and provides the University with monthly statements defining income and

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

market value information. Investments of the Temporary Pool are highly liquid and generally include U.S. government securities, collateralized mortgage obligations, corporate bonds, mutual funds and money market funds. The University has elected to invest a portion of the Temporary Pool assets in the University's Investment Fund.

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

The following table presents the fair value of the Temporary Pool investments by type and investments subject to interest rate risk at June 30, 2005.

### *Temporary Pool Investments*

Investment Type	Fair Value	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More than 10
Debt Securities					
U.S. Treasuries	\$ 25,243,204	\$ 0	\$ 25,243,204	\$ 0	\$ 0
U.S. Agencies	27,329,296	4,905,745	13,625,110	8,307,881	490,560
Mortgage Pass Throughs	56,582,945	90,984	13,342,629	5,824,259	37,325,073
Collateralized Mortgage Obligations	91,465,162		1,727,159		89,738,003
State and Local Government	2,809,248		2,809,248		
Asset-Backed Securities	3,443,672		640,254	2,304,733	498,685
Mutual Bond Funds	14,229,168	543,250	805,800	3,646,168	9,233,950
Domestic Corporate Bonds	13,336,223	455,303	6,875,810	1,824,722	4,180,388
Foreign Corporate Bonds	5,000,000			5,000,000	
Money Market Funds	78,634,154	78,634,154			
	318,073,072	\$ 84,629,436	\$ 65,069,214	\$ 26,907,763	\$ 141,466,659
Other Securities					
Certificates of Deposit	1,000,000				
Domestic Stocks	30,000				
Total Temporary Pool Investments	\$ 319,103,072				

Certificates of deposit reported as investments are also a component of the deposit totals reported in the deposits section of this note.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

As of June 30, 2005, the investments subject to credit risk in the Temporary Pool were rated as follows:

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	Unrated
U.S. Agencies	\$ 24,265,502	\$ 17,251,170	\$ 3,218,922	\$ 0	\$ 0	\$ 0	\$ 3,795,410
Mortgage Pass Throughs	32,091,752						32,091,752
Collateralized Mortgage Obligations	91,465,162	44,969,848	11,129,290	29,085,252			6,280,772
State and Local Government	2,809,248	2,809,248					
Asset-Backed Securities	3,443,672	2,488,565		456,422	498,685		
Mutual Bond Funds	14,229,168	4,012,950	805,800	9,410,418			
Domestic Corporate Bonds	13,336,223	3,435,741		8,015,260		1,885,222	
Foreign Corporate Bonds	5,000,000		5,000,000				
Money Market Funds	78,634,154			78,634,154			
	<u>\$ 265,274,881</u>	<u>\$ 74,967,522</u>	<u>\$ 20,154,012</u>	<u>\$ 125,601,506</u>	<u>\$ 498,685</u>	<u>\$ 1,885,222</u>	<u>\$ 42,167,934</u>

Rating Agencies:

Moody's/Standard & Poor's

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

The Temporary Investment Pool's Statement of Net Assets and Statement of Operations and Changes in Net Assets as of and for the period ended June 30, 2005 are as follows:

### Statement of Net Assets June 30, 2005

	Amount
<b>Assets:</b>	
Accrued Investment Income	\$ 1,579,657
Investments Fund Equity	36,056,153
Investments	319,103,072
<b>Total Assets</b>	<u>\$ 356,738,882</u>
<b>Liabilities:</b>	
Deferred Income	\$ 867,678
<b>Total Liabilities</b>	<u>867,678</u>
<b>Net Assets:</b>	
Internal Portion	231,209,521
External Portion	124,661,683
<b>Total Net Assets</b>	<u>355,871,204</u>
<b>Total Liabilities and Net Assets</b>	<u>\$ 356,738,882</u>

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### Statement of Operations and Changes in Net Assets For the Fiscal Year Ended June 30, 2005

	Amount
<b>Increase in Net Assets from Operations:</b>	
Revenues:	
Investment Income	\$ 14,707,512
Expenditures:	
Investment Management	412,812
<b>Net Increase in Net Assets Resulting from Operations</b>	14,294,700
<b>Distributions to Participants:</b>	
Distributions Paid and Payable	14,294,700
<b>Share Transactions:</b>	
Net Share Purchases	52,673,549
<b>Total Increase in Net Assets</b>	52,673,549
<b>Net Assets:</b>	
Beginning of Year	303,197,655
End of Year	\$ 355,871,204

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

The Investment Fund consists of an approximately 93% membership in the System Fund categorized below.

**UNC Investment Fund, LLC (System Fund)** - This is a limited liability company organized under the laws of the State of North Carolina. It was established in December, 2002 by the Investment Fund and is classified as a governmental external investment pool. The pool is utilized to manage the investments for The University of North Carolina, its constituent institutions, and affiliates of the constituent institutions. This includes charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support these institutions. The Investment Fund, with an approximately 93% membership interest as of June 30, 2005, is the organizer and a predominant member of the System Fund. The University's reporting entity portion of the Investment Fund is characterized as the internal portion. Other affiliated organizations in the Investment Fund in addition to other members of the System Fund not included in the University's reporting entity are characterized as the external portion. The external portion of the System Fund is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants. Membership interests of the System Fund are measured using the unit value method. Under this method, each member's investment balance is determined on a market value basis.

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

The Northern Trust Company is the custodian for the System Fund and provides the University with monthly statements defining income and



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

The following table presents the fair value of the System Fund investments by type and investments subject to interest rate risk at June 30, 2005.

### *System Fund Pool Investments*

Investment Type	Fair Value	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More than 10
Debt Securities					
U.S. Treasuries	\$ 23,022,627	\$ 0	\$ 0	\$ 0	\$ 23,022,627
U.S. Agencies	1,473,045			146,003	1,327,042
Mortgage Pass Throughs	2,790,000			2,790,000	
Collateralized Mortgage Obligations	5,617,198				5,617,198
Mutual Bond Funds	13,489,063		917,980	9,424,742	3,146,341
Domestic Corporate Bonds	10,973,212			67,320	10,905,892
Foreign Corporate Bonds	4,391,417			4,391,417	
Money Market Funds	24,085,592	24,085,592			
	85,842,154	<u>\$ 24,085,592</u>	<u>\$ 917,980</u>	<u>\$ 16,819,482</u>	<u>\$ 44,019,100</u>
Other Securities					
Other Money Market Funds	7,077,361				
Other Mutual Funds	37,048,495				
Limited Partnerships	658,620,903				
Domestic Stocks	53,937,314				
Foreign Stocks	4,209,639				
Hedge Equities	455,140,674				
Total System Fund Pool Investments	<u>\$ 1,301,876,540</u>				

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

As of June 30, 2005, the investments subject to credit risk in the System Fund were rated as follows:

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	Unrated
U.S. Agencies	\$ 1,327,042	\$ 1,327,042	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Mortgage Pass Throughs	2,790,000	2,790,000					
Collateralized Mortgage Obligations	5,617,198	4,585,858	1,031,340				
Mutual Bond Funds	13,489,063	1,678,180	3,634,591		750,406		7,425,886
Domestic Corporate Bonds	10,973,212			5,240,960	5,664,932		67,320
Foreign Corporate Bonds	4,391,417					4,391,417	
Money Market Funds	24,085,592			24,085,592			
	<u>\$ 62,673,524</u>	<u>\$ 10,381,080</u>	<u>\$ 4,665,931</u>	<u>\$ 29,326,552</u>	<u>\$ 6,415,338</u>	<u>\$ 4,391,417</u>	<u>\$ 7,493,206</u>

Rating Agencies:

Moody's/Standard & Poor's

*Foreign Currency Risk:* As of June 30, 2005, the University's exposure to foreign currency risk for the System Fund Investments was as follows:

Investment	Currency	Fair Value (U.S. Dollars)
Limited Partnerships	Euro	\$ 15,952,284
Limited Partnerships	British Pound Sterling	3,612,231
Total		<u>\$ 19,564,515</u>

In addition to the foreign currency risk disclosed above, the System Fund includes investments with fair values highly sensitive to interest rate changes. The System Fund invests in a Hedge Fund that contains securities that are highly sensitive to rate changes.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**Non-Pooled Investments** - The following table presents the fair value of the Non-Pooled investments by type and investments subject to interest rate risk at June 30, 2005.

### *Non-Pooled Investments*

Investment Type	Fair Value	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More than 10
<b>Debt Securities</b>					
U.S. Treasuries	\$ 744,596	\$ 175,344	\$ 124,305	\$ 109,577	\$ 335,370
U.S. Treasury Strips	2,645,843		2,308,901	336,942	
U.S. Agencies	446,800		269,274	151,776	25,750
Mortgage Pass Throughs	1,298,948		19,446	22,505	1,256,997
Collateralized Mortgage Obligations	937,834		53,355		884,479
State and Local Government	154,985		31,839	39,459	83,687
Mutual Bond Funds	14,732,368		2,551,110	11,780,818	400,440
Domestic Corporate Bonds	265,463		196,296		69,167
	21,226,837	\$ 175,344	\$ 5,554,526	\$ 12,441,077	\$ 3,055,890
<b>Other Securities</b>					
Money Market Funds	31,784,547				
Other Mutual Funds	47,251,493				
Investments in Real Estate	15,057,965				
Domestic Stocks	13,021,313				
Foreign Stocks (ADR's)	6,658				
Other	4,980,637				
<b>Total Non-Pooled Investments</b>	<u>\$ 133,329,450</u>				

As of June 30, 2005, the University's Non-Pooled investments subject to credit risk were rated as follows:

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	B	Unrated
U.S. Agencies	\$ 404,880	\$ 372,518	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 32,362
Mortgage Pass Throughs	1,108,958							1,108,958
Collateralized Mortgage Obligations	937,834	406,579		377,113	103,814			50,328
State and Local Government	154,985	31,839						123,146
Mutual Bond Funds	14,732,368	1,387,407	953,432	325,090	801,011		296,842	10,968,586
Domestic Corporate Bonds	265,463		29,539	180,617		55,307		
	<u>\$ 17,604,488</u>	<u>\$ 2,198,343</u>	<u>\$ 982,971</u>	<u>\$ 882,820</u>	<u>\$ 904,825</u>	<u>\$ 55,307</u>	<u>\$ 296,842</u>	<u>\$ 12,283,380</u>

Rating Agencies:

Moody's/Standard & Poor's

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**Total Investments** – The following table presents the fair value of the total investments at June 30, 2005.

Investment Type	Fair Value
Debt Securities	
U.S. Treasuries	\$ 49,010,427
U.S. Treasury Strips	2,645,843
U.S. Agencies	29,249,141
Mortgage Pass Throughs	60,671,893
Collateralized Mortgage Obligations	98,020,194
State and Local Government	2,964,233
Asset-Backed Securities	3,443,672
Mutual Bond Funds	42,450,599
Domestic Corporate Bonds	24,574,898
Foreign Corporate Bonds	9,391,417
Money Market Funds	102,719,746
	<u>425,142,063</u>
Other Securities	
Certificates of Deposit	1,000,000
Other Money Market Funds	38,861,908
Other Mutual Funds	84,299,988
Investments in Real Estate	15,057,965
Limited Partnerships	658,620,903
Domestic Stocks	66,988,627
Foreign Stocks	4,216,297
Other	460,121,311
	<u>460,121,311</u>
Total Investments	<u>\$ 1,754,309,062</u>

Total investments include \$235,462,764 held in the System Fund for the component units that are discretely presented in the accompanying financial statements. The University's reporting entity, including the three discretely presented component units, comprises 85.03% of the System Fund.

### NOTE 3 - ENDOWMENT INVESTMENTS

Substantially all of the investments of the University's endowment funds are pooled in the Investment Fund. Investment return of the University's pooled endowment funds is predicated on the total return concept (yield plus appreciation). Annual distributions from the Investment Fund to the

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

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University's pooled endowment funds are based on an adopted distribution policy. Under this policy, the prior year distribution is increased by the rate of inflation as measured by the Consumer Price Index (CPI). Each year's distribution, however, is subject to a minimum of 4% and a maximum of 7% of the pooled endowment fund's average market value for the previous year.

To the extent that the total return for the current year exceeds the distribution, the excess is added to principal. If current year earnings do not meet the distribution requirements, the University uses accumulated income and appreciation to make up the difference. At June 30, 2005, accumulated income and appreciation of \$404,406,631 was available in the University's pooled endowment funds of which \$366,483,954 was restricted to specific purposes.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 4 - RECEIVABLES

Receivables at June 30, 2005, were as follows:

	Gross Receivables	Less Allowance for Doubtful Accounts	Net Receivables
<b>Current Receivables:</b>			
Students	\$ 2,144,213	\$ 0	\$ 2,144,213
Patients	70,863,703	44,086,413	26,777,290
Accounts	32,507,077		32,507,077
Intergovernmental	31,782,956		31,782,956
Pledges	17,696,035	442,401	17,253,634
Investment Earnings	2,840,889		2,840,889
Interest on Loans	608,032		608,032
Other	10,349		10,349
<b>Total Current Receivables</b>	<b>\$ 158,453,254</b>	<b>\$ 44,528,814</b>	<b>\$ 113,924,440</b>
<b>Noncurrent Receivables:</b>			
Pledges	\$ 31,098,568	\$ 777,465	\$ 30,321,103
<b>Notes Receivable:</b>			
<b>Notes Receivable - Current:</b>			
Federal Loan Programs	\$ 2,795,462	\$ 143,164	\$ 2,652,298
Institutional Student Loan Programs	757,004	35,925	721,079
Other Notes Receivable	312,791		312,791
<b>Total Notes Receivable - Current</b>	<b>\$ 3,865,257</b>	<b>\$ 179,089</b>	<b>\$ 3,686,168</b>
<b>Notes Receivable - Noncurrent:</b>			
Federal Loan Programs	\$ 25,998,673	\$ 1,288,480	\$ 24,710,193
Institutional Student Loan Programs	4,305,069	119,963	4,185,106
Other Notes Receivable	150,000		150,000
<b>Total Notes Receivable - Noncurrent</b>	<b>\$ 30,453,742</b>	<b>\$ 1,408,443</b>	<b>\$ 29,045,299</b>

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

Fiscal Year	Amount
2006	\$ 17,696,035
2007	13,733,006
2008	6,997,543
2009	4,757,578
2010	1,914,839
2011-2015	8,214,392
<b>Total Pledge Receipts Expected</b>	<b>53,313,393</b>
Discount Amount Representing Interest (3.58% Rate of Interest)	(4,518,791)
<b>Present Value of Pledge Receipts Expected</b>	<b>48,794,602</b>
Less Allowance for Uncollectible	(1,219,865)
<b>Pledges Receivable</b>	<b>\$ 47,574,737</b>

### NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2005, is presented as follows:

	Balance July 1, 2004	Adjustments	Increases	Decreases	Balance June 30, 2005
Capital Assets, Nondepreciable:					
Land	\$ 26,339,081	\$ 0	\$ 1,136,117	\$ 1,405,676	\$ 26,069,522
Art, Literature, and Artifacts	57,764,135		1,627,375	113,580	59,277,930
Construction in Progress	219,339,291	(103,189,790)	261,374,264	1,347	377,522,418
Intangible Assets	1,000,000				1,000,000
<b>Total Capital Assets, Nondepreciable</b>	<b>304,442,507</b>	<b>(103,189,790)</b>	<b>264,137,756</b>	<b>1,520,603</b>	<b>463,869,870</b>
Capital Assets, Depreciable:					
Buildings	1,091,776,409	85,274,705	44,655,253	872,886	1,220,833,481
Machinery and Equipment	213,504,724		17,960,961	9,201,510	222,264,175
General Infrastructure	336,394,964	17,915,085	10,999,980		365,310,029
<b>Total Capital Assets, Depreciable</b>	<b>1,641,676,097</b>	<b>103,189,790</b>	<b>73,616,194</b>	<b>10,074,396</b>	<b>1,808,407,685</b>
Less Accumulated Depreciation/Amortization for:					
Buildings	388,230,088		34,967,811	544,972	422,652,927
Machinery and Equipment	132,414,021		11,222,733	6,929,784	136,706,970
General Infrastructure	148,805,154		13,911,366		162,716,520
<b>Total Accumulated Depreciation</b>	<b>669,449,263</b>		<b>60,101,910</b>	<b>7,474,756</b>	<b>722,076,417</b>
<b>Total Capital Assets, Depreciable, Net</b>	<b>972,226,834</b>	<b>103,189,790</b>	<b>13,514,284</b>	<b>2,599,640</b>	<b>1,086,331,268</b>
<b>Capital Assets, Net</b>	<b>\$ 1,276,669,341</b>	<b>\$ 0</b>	<b>\$ 277,652,040</b>	<b>\$ 4,120,243</b>	<b>\$ 1,550,201,138</b>

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2005, were as follows:

	Amount
Accounts Payable	\$ 55,190,176
Accrued Payroll	22,663,985
Contract Retainage	12,569,153
Other	193,965
<b>Total Accounts Payable and Accrued Liabilities</b>	<b>\$ 90,617,279</b>

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

Short-term debt activity for the year ended June 30, 2005, was as follows:

	Balance July 1, 2004	Issued	Redeemed	Balance June 30, 2005
Commercial Paper Program	\$ 8,841,000	\$ 132,300,000	\$ 0	\$ 141,141,000

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

### NOTE 8 - LONG-TERM LIABILITIES

**A. Changes in Long-Term Liabilities** - A summary of changes in the long-term liabilities for the year ended June 30, 2005, is presented as follows:

	Balance July 1, 2004	Additions	Reductions	Balance June 30, 2005	Current Portion
Bonds Payable	\$ 519,740,000	\$ 0	\$ 18,920,000	\$ 500,820,000	\$ 112,857,582
Add/Deduct Premium/Discount	(45,450,320)		(3,003,454)	(42,446,866)	
Deduct Deferred Charge on Refunding	(2,605,803)		(325,725)	(2,280,078)	
<b>Total Bonds Payable</b>	<b>471,683,877</b>		<b>15,590,821</b>	<b>456,093,056</b>	<b>112,857,582</b>
Notes Payable	35,000,000	19,729,724	21,210,255	33,519,469	27,389,745
Capital Leases Payable	1,320,414	426,628	777,394	969,648	589,882
Compensated Absences	90,014,462	46,528,757	47,754,641	88,788,578	3,812,522
Annuity and Life Income Payable	6,666,847	278,876	419,524	6,526,199	824,356
<b>Total Long-Term Liabilities</b>	<b>\$ 604,685,600</b>	<b>\$ 66,963,985</b>	<b>\$ 85,752,635</b>	<b>\$ 585,896,950</b>	<b>\$ 145,474,087</b>

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



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2005	Accretion on Capital Appreciation Bonds	Principal Outstanding 06/30/2005
<b>Housing System</b>							
	1997A	4.500% - 5.100%	11/01/2017	\$ 9,170,000	\$ 2,060,000	\$ 0	\$ 7,110,000
	1997B	4.000% - 5.000%	11/01/2011	7,210,000	1,985,000		5,225,000
Total Housing System				16,380,000	4,045,000		12,335,000
<b>Utilities System</b>							
	1997	5.250% - 5.500%	08/01/2021	84,135,000		(38,372,357)	45,762,643
<b>Parking System</b>							
	1997A	4.350% - 5.700%	05/15/2027	11,750,000	1,320,000		10,430,000
	1997B	3.900% - 5.150%	05/15/2009	8,245,000	4,890,000		3,355,000
Total Parking System				19,995,000	6,210,000		13,785,000
<b>General Revenue</b>							
	2001A	2.900% - 5.125%	12/01/2025	89,930,000	7,875,000		82,055,000
	2001B	Variable	12/01/2025	54,970,000	6,795,000		48,175,000
	2001C	Variable	12/01/2025	54,970,000	6,795,000		48,175,000
	2002B	3.500% - 5.000%	12/01/2011	66,555,000	13,720,000		52,835,000
	2003	2.000% - 5.000%	12/01/2033	107,960,000	990,000		106,970,000
Total General Revenue				374,385,000	36,175,000		338,210,000
Student Union	2000	4.550% - 5.659%	06/01/2022	12,465,000	1,450,000		11,015,000
Student Recreation Center	1997	3.900% - 5.000%	06/01/2011	3,545,000	1,365,000		2,180,000
U.S. EPA Project	1991	8.250% - 9.050%	02/15/2015	58,125,000	19,225,000	(11,842,615)	27,057,385
U.S. EPA Project	1996	6.72%	02/15/2006	2,400,000	2,140,000		260,000
Total Bonds Payable (principal only)				\$ 571,430,000	\$ 70,610,000	\$ (50,214,972)	450,605,028
Less: Unamortized Loss on Refunding							(2,280,078)
Plus: Unamortized Premium							7,768,106
Total Bonds Payable							\$ 456,093,056

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

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

**General Revenue, Series 2001B and 2001C:** In 2001, the University issued two series of variable rate demand bonds in the amount of \$54,970,000 (2001B) and \$54,970,000 (2001C) that each have a final maturity date of December 1, 2025, and are repaid from available funds. Available funds are defined as any Unrestricted Net Assets remaining after satisfying obligations of the University under trust indentures, trust agreements or bond resolutions (specific revenue bonds), but excluding State appropriations, tuition, restricted gifts and certain facilities

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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revenues. The bonds are subject to mandatory sinking fund redemption on the interest payment date on or immediately preceding each December throughout the term of the bonds. The proceeds of these issuances were used to provide funds to refund in advance of their maturity the following issues: Ambulatory Care Clinic, Series 1990; Athletic Facilities, Series 1998; Carolina Inn, Series 1994; School of Dentistry, Series 1995; Kenan Stadium, Series 1996; and Parking System, Series 1997C. While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the University's remarketing agents, Lehman Brothers, Inc. (2001B), and UBS Financial Services, Inc. (2001C).

The University renewed its line of credit, in the amount of \$107,460,000, with JP Morgan Chase Bank effective February 2, 2005. Under the line of credit agreement, the University is entitled to draw amounts sufficient to pay the principal, and accrued interest on bonds delivered for purchase.

The University is required to pay a quarterly commitment fee for the line of credit of 0.13% per annum based on the unused portion of the line of credit commitment. If the University's credit rating for unsecured debt were to drop below "Aa3" (or its equivalent) by Moody's, "AA-" (or its equivalent) by S&P, or "AA-" (or its equivalent) by Fitch, the quarterly commitment fee would increase to 0.18%. If the University's credit rating for unsecured debt were to drop below "A3" (or its equivalent) by Moody's, "A-" (or its equivalent) by S&P, or "A-" (or its equivalent) by Fitch, the quarterly commitment fee would increase to 0.28%. Additionally, if the University were to terminate the line of credit prior to February 1, 2006, then the University must pay a termination fee of \$50,000 less any unused commitment fees paid to date.

Under the line of credit agreement, the University has promised to repay loans that represent purchase drawings in equal semi-annual payments after termination of the line of credit. Interest at the rate of Prime plus 1.0% (Prime plus 2.0% after 60 days) is payable quarterly and upon draw repayment. At June 30, 2005, no purchase draws had been made under the letter of credit.

The line of credit agreement expires on February 1, 2006. However, between November 3, 2005, and December 3, 2005, the University may request that the Bank extend the expiration date for another year. The Bank shall respond affirmatively or negatively within 30 days after receipt of such request.

In the event of termination of the line of credit, outstanding principal is to be repaid in semi-annual installments of principal on each February 1, and

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

August 1, commencing on the first of such dates succeeding the termination date with the remaining principal amount payable on the second anniversary of the termination date. Further, accrued interest will continue to be due and payable on the first day of the calendar quarter and on the date any portion of principal is payable.

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

Under this amended agreement, Lehman Brothers pays the University interest on the notional amount based on the Bond Market Association (BMA) Municipal Bond Index on a quarterly basis. On a semiannual basis, the University pays Lehman Brothers interest at the fixed rate of 5.24%. The notional amount of the swap reduces annually in conjunction with the 2001B Bonds; the reductions began in November 2002, and end in November 2025. The swap agreement matures November 1, 2025. As of June 30, 2005, rates were as follows:

	Terms	Rates
Fixed Payment to Lehman	Fixed	5.24
Variable Payment from Lehman	BMA	2.13
Net Interest Rate Swap Payments		3.11
Variable Rate Bond Coupon Payments		2.43
Synthetic Interest Rate on Bonds		5.54

As of June 30, 2005, the swap had a negative fair value of \$4,604,713. The fair value was developed by Lehman Brothers. Their method calculates the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for London Interbank Offered Rate (LIBOR) due on the date of each future net settlement on the swap.

As of June 30, 2005, the University was not exposed to credit risk because the swap had a negative fair value. However, should interest

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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rates change and the fair value of the swap becomes positive, the University would be exposed to credit risk in the amount of the derivative's positive fair value. Should the swap have a positive fair value of more than \$1,000,000, at that point Lehman would be required to collateralize 103% of their exposure. Lehman Brothers Holdings, guarantor of Lehman Brothers Special Financing, Inc., was rated A1 by Moody's Investor's Service, A by Standard and Poor's Corporation, and A+ by Fitch Ratings.

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

As rates vary, variable rate bond interest payments and net swap payments will vary. Using rates as of June 30, 2005, debt service requirements of the University's variable-rate debt and net swap payments, assuming current interest rates remain the same, for their terms were as follows.

Fiscal Year	General Revenue Bonds, Series 2001B			
	Principal	Interest	Interest Rate Swaps, Net*	Total
2006	\$ 2,060,000	\$ 1,145,624	\$ 659,398	\$ 3,865,022
2007	2,140,000	1,094,594	651,623	3,886,217
2008	2,175,000	1,042,166	643,459	3,860,625
2009	2,285,000	987,977	634,984	3,907,961
2010	2,405,000	930,994	626,199	3,962,193
2011-2015	12,480,000	3,738,920	2,918,813	19,137,733
2016-2020	11,800,000	2,264,639	2,224,972	16,289,611
2021-2025	10,435,000	948,854	1,050,247	12,434,101
2026	2,395,000	29,099	32,500	2,456,599
Total	<u>\$ 48,175,000</u>	<u>\$ 12,182,867</u>	<u>\$ 9,442,195</u>	<u>\$ 69,800,062</u>

\*Computed using  $(5.24\% - 2.13\%) \times (\$22,000,000 - \text{annual swap reduction})$

**D. Capital Appreciation Bonds** – The University's Series 1997 Utility System and the Series 1991 U.S. Environmental Protection Agency Project bond issues include capital appreciation bonds with an original issue amount of \$30,379,142 and \$3,828,921, respectively. These bonds are recorded in the amounts of \$45,762,643 (\$84,135,000 ultimate maturity less \$38,372,357 discount) and \$13,432,385 (\$25,275,000 ultimate maturity less \$11,842,615 discount), respectively, which is the accreted value at June 30, 2005. These bonds mature in the years from 2010 to 2021.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**E. Annual Requirements** - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2005, are as follows:

Fiscal Year	Annual Requirements			
	Bonds Payable		Notes Payable	
	Principal	Interest	Principal	Interest
2006	\$ 20,840,000	\$ 17,705,888	\$ 27,389,745	\$ 529,606
2007	21,635,000	16,709,429	6,129,724	85,129
2008	22,645,000	15,661,387		
2009	23,920,000	14,525,014		
2010	24,345,000	13,306,686		
2011-2015	126,450,000	54,649,767		
2016-2020	110,535,000	39,675,444		
2021-2025	88,365,000	23,762,069		
2026-2030	37,320,000	9,713,946		
2031-2034	24,765,000	2,552,125		
Total Requirements	<u>\$ 500,820,000</u>	<u>\$ 208,261,755</u>	<u>\$ 33,519,469</u>	<u>\$ 614,735</u>

Interest on the variable rate General Revenue Bonds 2001B is calculated at 2.43% at June 30, 2005.  
Interest on the variable rate General Revenue Bonds 2001C is calculated at 2.17% at June 30, 2005.  
For General Revenue Bonds, Series 2001 B and 2001C, interest rates change weekly.

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

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

**Dining System:** On February 7, 2001, the University defeased \$13,205,000 of outstanding Dining System Revenue Bonds, Series 1997. Securities were deposited into an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. The trust assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2005, the outstanding balance of the defeased Dining System Bonds was \$10,395,000.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Statement of Net Assets. At June 30, 2005, the outstanding balance was \$77,000 for the defeased outstanding Dormitory System Revenue Bonds, Series G (1963).

**Student Union:** On December 1, 1999, the University defeased \$620,000 of outstanding Student Union Revenue Bonds, Series 1967. Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2005, the outstanding balance was \$250,000 for the defeased outstanding Student Union Revenue Bonds, Series 1967.

**G. Notes Payable** - The University was indebted for notes payable for the purposes shown in the following table:

Purpose	Financial Institution	Interest Rate/Ranges	Final Maturity Date	Beginning Balance 7/1/2004	Draws Made Through 6/30/2005	Principal Paid Through 06/30/2005	Principal Outstanding 06/30/2005
Student Family Housing	Bank of America	3.74%	10/01/2005	\$ 35,000,000	\$ 12,300,000	\$ 19,910,255	\$ 27,389,745
Rizzo Center	Wachovia Bank	4.54%	09/22/2006		5,532,556		5,532,556
Real Property Purchases	Bank of America	3.74%	06/30/2007		1,897,168	1,300,000	597,168
Total Notes Payable				<u>\$ 35,000,000</u>	<u>\$ 19,729,724</u>	<u>\$ 21,210,255</u>	<u>\$ 33,519,469</u>

The UNC-Chapel Hill Foundation, part of the University's reporting entity, has a loan agreement for a Student Family Housing Project with Bank of America, originally in the amount of \$35,000,000. The unsecured loan was refinanced on October 1, 2004, and the commitment was increased to \$47,300,000 to provide additional funding with the maturity date extended to October 1, 2005. The outstanding balance under the credit facility accrues interest at the LIBOR Rate plus 0.40%. The University plans to refinance the note with other long-term financing.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The UNC-Chapel Hill Foundation, part of the University's reporting entity, has a line of credit agreement issued by Bank of America, originally in the aggregate principal amount up to \$10,000,000 to finance the costs of projects benefiting the Foundation or the University. The line of credit had a maturity date of June 30, 2005, and was extended until June 30, 2007, and the aggregate principal amount was reduced to \$6,000,000. Advances under the line of credit accrue interest at the variable rate of the LIBOR Market Index plus 0.40%. There is an unused commitment fee due each quarter calculated as 0.25% of the difference between the commitment amount and the average balance outstanding for the quarter through June 30, 2005, and 0.225% thereafter. The University repays draws on the note with capital improvement funds designated for land acquisition.

### NOTE 9 - LEASE OBLIGATIONS

- A. Capital Lease Obligations** - Capital lease obligations relating to medical and research equipment are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2005:

<u>Fiscal Year</u>	<u>Amount</u>
2006	\$ 626,324
2007	190,567
2008	126,784
2009	82,587
Total Minimum Lease Payments	1,026,262
Amount Representing Interest (2.5% - 7.3% Rate of Interest)	56,614
Present Value of Future Lease Payments	<u>\$ 969,648</u>

Machinery and equipment acquired under capital lease amounted to \$1,276,501 at June 30, 2005.



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

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- B. Operating Lease Obligations** – Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2005:

<u>Fiscal Year</u>	<u>Amount</u>
2006	\$ 6,277,638
2007	4,246,287
2008	1,824,434
2009	516,052
2010	370,771
2011-2015	144,124
Total Minimum Lease Payments	<u><u>\$ 13,379,306</u></u>

Rental expense for all operating leases during the year was \$11,170,323.

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

Payments under the terms of the lease are a limited obligation of the University, payable solely from and secured by the annual rental income derived from the sublease of the alumni facilities. The University has no other obligations for repayment of the certificates of participation; therefore, the certificates are not reported as a liability in the accompanying financial statements. As of June 30, 2005, the aggregate principal amount of the certificates was \$9,950,000. If the University complies with all the terms of the lease agreement, title to the alumni facilities will be conveyed to the University.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 10 - REVENUES

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

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Less Change in Allowance for Uncollectibles	Less Indigent Care and Contractual Adjustments	Net Revenues	Revenues Pledged as Security for Debt
<b>Operating Revenues:</b>							
Student Tuition and Fees	\$ 202,361,925	\$ 0	\$ 37,905,000	\$ 0.00	\$ 0	\$ 164,456,925	\$ 0
Patient Services	\$ 414,396,346	\$ 0	\$ 0	\$ (747,766.00)	\$ 243,081,333	\$ 172,062,779	\$ 0
<b>Sales and Services:</b>							
Sales and Services of Auxiliary Enterprises:							
Residential Life	\$ 29,588,016	\$ 0	\$ 5,460,309	\$ 0	\$ 0	\$ 24,127,707	\$ 23,399,623 (A)
Dining	20,172,899	73,595	372,438			19,726,866	
Student Union Services	2,336,654		466,757			1,869,897	
Health, Physical Education, and Recreation Services	15,355,964		3,665,191			11,690,773	11,690,773 (B)
Bookstore	32,026,077	4,953,411	153,378			26,919,288	
Parking	15,732,201					15,732,201	15,732,201 (C)
Athletic	37,449,537	22,788	500,230			36,926,519	
Utilities	73,796,128	55,654,424				18,141,704	18,141,704 (D)
Other Professional Income	75,461,969	515				75,461,454	
Other	155,137,342	95,336,585				59,800,757	5,017,374 (E)
<b>Total Sales and Services</b>	<b>\$ 457,056,787</b>	<b>\$ 156,041,318</b>	<b>\$ 10,618,303</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 290,397,166</b>	<b>\$ 73,981,675</b>
<b>Nonoperating - Noncapital Gifts</b>	<b>\$ 73,781,228</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 88,431</b>	<b>\$ 0</b>	<b>\$ 73,692,797</b>	<b>\$ 0</b>

Revenue Bonds Secured by Pledged Revenues:

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

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

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

(D) Utility System Revenue Bonds, Series 1997

(E) US EPA Project, Series 1991 & 1996

### NOTE 11 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 432,210,248	\$ 27,014,411	\$ 116,691,390	\$ 0	\$ 35,023	\$ 0	\$ 575,951,072
Research	174,936,422	39,202,525	57,017,134		52,075		271,208,156
Public Service	29,707,783	1,487,165	51,743,889		65,846		83,004,683
Academic Support	50,896,198	10,981,672	13,505,543		806		75,384,219
Student Services	10,484,335	738,132	10,430,121		127		21,652,715
Institutional Support	45,009,823	5,187,601	17,195,753		32,750		67,425,927
Operations and Maintenance of Plant	31,880,071	5,635,343	14,540,820		40,804,011		92,860,245
Student Financial Aid				51,169,976			51,169,976
Auxiliary Enterprises	191,504,372	58,193,143	126,564,746		6,879,532		383,141,793
Depreciation						60,101,910	60,101,910
<b>Total Operating Expenses</b>	<b>\$ 966,629,252</b>	<b>\$ 148,439,992</b>	<b>\$ 407,689,396</b>	<b>\$ 51,169,976</b>	<b>\$ 47,870,170</b>	<b>\$ 60,101,910</b>	<b>\$ 1,681,900,696</b>

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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### NOTE 12 - PENSION PLANS

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

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

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2005, these rates were set at 2.17% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2005, the University had a total payroll of \$846,607,921, of which \$351,795,628 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$21,107,738 and \$7,633,965, respectively. The University made 100% of its annual required contributions for the years ended June 30, 2005, 2004, and 2003, which were \$7,633,965, \$757,757, and \$0, respectively.

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

The Optional Retirement Program (Program) is a defined contribution retirement plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Administrators and eligible faculty of the University may join the Program instead of the Teachers' and State Employees' Retirement

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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System. The Board of Governors of The University of North Carolina is responsible for the administration of the Program and designates the companies authorized to offer investment products. The Board has authorized the following carriers: Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), Lincoln Life Insurance Company, Variable Annuity Life Insurance Company (VALIC), and Fidelity Investments. Participants may elect to allocate their contributions and the University contributions to the carrier of their choice. Each carrier offers a variety of investment funds, including both fixed and variable account investment options and mutual funds.

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

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2005, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The University assumes no liability other than its contribution.

For the year ended June 30, 2005, the University had a total payroll of \$846,607,921, of which \$328,301,666 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$19,698,100 and \$22,455,834, 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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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University. The voluntary contributions by employees amounted to \$4,484,869 for the year ended June 30, 2005.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the University except for a 5% employer contribution for the University's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of University law enforcement officers for the year ended June 30, 2005, were \$98,798. The voluntary contributions by employees amounted to \$2,849,161 for the year ended June 30, 2005.

IRC Section 403(b) and 403(b)(7) Plans - Eligible University employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to \$21,956,103 for the year ended June 30, 2005.

### **NOTE 13 - OTHER POSTEMPLOYMENT BENEFITS**

- A. Health Care for Long-Term Disability Beneficiaries and Retirees -** The University participates in State-administered programs that provide postemployment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System or the Optional Retirement Program. These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The University contributed 3.2% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program for these health care benefits. For the fiscal year ended June 30, 2005, the University's total contribution to the Plan was \$21,763,113. The University assumes no liability for retiree health care

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.

- B. Long-Term Disability** - The University participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The University contributes .445% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the year ended June 30, 2005, the University's total contribution to the DIPNC was \$3,026,433. The University assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

### NOTE 14 - RISK MANAGEMENT

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

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

**Fire and Other Property Loss** - The University is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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a \$500 per occurrence deductible. The University also purchased through the Fund extended coverage or all risk coverage with a \$500 per occurrence deductible for certain buildings and contents.

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

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

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

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

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

**Liability Insurance Trust Fund** - The University participates in the Liability Insurance Trust Fund (Trust Fund), a claims-servicing public entity risk pool for healthcare professional liability protection. The Trust Fund services professional liability claims, managing separate accounts for each participant from which the losses of that participant are paid. Although participant assessments are determined on an actuarial basis, ultimate liability for claims

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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remains with the participants and, accordingly, the insurance risks are not transferred to the Trust Fund.

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

Participation in the Trust Fund is open to the University of North Carolina, any constituent institution of the University of North Carolina, the UNC Hospitals, and any health-care institution, agency or entity that has an affiliation agreement with the University of North Carolina, with a constituent institution of the University of North Carolina, or with the UNC Hospitals. Only the UNC P&A and the UNC Hospitals have participated in the Trust Fund to date. Participants provide management and administrative services to the Trust Fund at no cost.

The Trust Fund is governed by the Liability Insurance Trust Fund Council (the Council). The Council consists of 13 members as follows: one member each appointed by the State Attorney General, the State Auditor, the State Insurance Commissioner, the Director of the Office of State Budget and Management, the State Treasurer, (each serving at the pleasure of the appointer); and eight members appointed to three year terms (with no limit on the number of terms) by the UNC System's Board of Governors.

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

The Trust Fund provides coverage for participants as a corporate entity, as well as for the employees and professional staff of the participants. From July 1, 2004, through June 30, 2005, the Trust Fund provided coverage on an occurrence basis of \$3,000,000 per individual and \$7,000,000 in the aggregate



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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per claim. Effective July 1, 2004, through June 30, 2005, the Trust Fund entered into an excess of loss agreement with an unaffiliated reinsurer. Reinsurance coverage under this policy carries a \$10,000,000 aggregate limit in excess of a self-insured aggregate of \$30,000,000 subject to a \$7,000,000 per occurrence limit (sub-limit of \$3,000,000 per individual) with a \$300,000 continuing underlying amount per claim. For fiscal year ending June 30, 2005, the Trust Fund purchased a direct insurance policy to cover the first \$1,000,000 per occurrence and \$3,000,000 in the aggregate for dental residents. The Trust Fund provides coverage of \$500,000 per occurrence in accordance with the limited waiver of sovereign immunity afforded by the State Tort Claims Act, for any recovery against the participants for the negligence of its employees. To assure that both existing and future claims will be paid, the UNC System Board of Governors is authorized by law to borrow up to \$30,000,000 to replenish the Trust Fund. No borrowings have been made under this line of credit to date. The Council believes adequate funds are on deposit in the Trust Fund to meet estimated losses based upon the results of the independent actuary's report.

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

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

At June 30, 2005, University assets in the Trust Fund totaled \$32,811,589 while University liabilities totaled \$26,585,628 resulting in net assets of \$6,225,961.

Additional disclosures relative to the funding status and obligations of the Trust Fund are set forth in the Audited Financial Statements of the Liability Insurance Trust Fund for the years ended June 30, 2005, and 2004. Copies of this report may be obtained from the University of North Carolina Liability Insurance Trust Fund, 6001 East Wing, University of North Carolina Hospitals, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-3041.

**Term Life Insurance** - Term life insurance (death benefits) of \$25,000 to \$50,000 is provided to eligible workers. This Death Benefit Plan is

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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administered by the State Treasurer and funded via employer contributions. There were no employer contributions required for the current fiscal year.

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

### NOTE 15 - COMMITMENTS AND CONTINGENCIES

- A. **Commitments** - The University has commitments of \$65,771,751 for various capital improvements projects that include construction and completion of new buildings, and renovations of existing buildings.
- B. **Pending Litigation and Claims** – A \$2.1 million claim related to the construction of the Frank Porter Graham Student Union project has been submitted to the State Construction Office by the contractor. No ruling has been made regarding this claim.

The Supreme Court of North Carolina issued a ruling on July 1, 2005, regarding litigation between North Carolina School Boards Association, et. al. v. Richard H. Moore, State Treasurer, et. al. which involves various State officials in their official capacity seeking a judicial determination as to whether the State constitution requires certain monetary payments collected by State agencies to be paid to the local county school funds rather than statutorily designated recipients. The complaint alleged in part that the monetary payments collected pursuant to statutory authority by the University for violations of parking and traffic regulations and library fines are “civil penalties” which the State Constitution requires to be paid to the School fund in the county where they are collected. The lawsuit sought declaratory judgment that the State Civil Penalty and Forfeiture Fund, the State School Technology Fund, and the Public Settlement Reserve Fund are unconstitutional. On December 14, 2001, the Wake County Superior Court ruled in favor of the Plaintiffs but has stayed enforcement of the ruling, pending appeal. The Defendants did appeal this judgment. The Court of Appeals affirmed in part and reversed in part the order of summary judgment by the Superior Court. The Supreme Court affirmed the Court of Appeals ruling that library fines are not civil penalties. The Supreme Court reversed the ruling that fines for parking and traffic regulations are not civil penalties. The Supreme Court ruling is under review to determine the financial impact on parking and traffic operations. At issue is the effective date of the ruling. The amount of \$11,101,663 representing fines from the Public Safety department has been collected from 1994-95 through 2004-05, and of that amount 20% may be retained by the University to fund related operating expenses.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Therefore, \$8,881,330 may be payable by the University. The amount of \$3,907,525 has been held in reserve to fund the required payment. Annual fines are approximately \$1,000,000. It is not expected that the effective date of the ruling will be prior to fiscal year 1994-95.

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

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

- C. University Improvement General Obligation Bonds** – The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of \$2.5 billion of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The funds authorized are to be used solely for capital facilities cost on the University of North Carolina campuses as specified in the legislation. The bond legislation specifies the amount of bond funding for each University campus and the level of bond funding intended for each project. The bonds are authorized to be issued over a six-year period beginning in 2001 at a level not to exceed amounts provided in the legislation. Using a cash flow financing approach, The University of North Carolina – General Administration (UNC-GA), establishes annual amounts not to exceed for each approved project. The amounts not to exceed are subject to change due to actual cash availability and needs during the year. Subsequent to the bond sales and the availability of bond proceeds, UNC-GA notifies the Office of State Budget and Management (OSBM) of the amounts not to exceed for each approved project. Within these amounts, based on an official request of cash needs from the University, OSBM authorizes allotments. The University records the allotments as revenue on the accompanying financial statements. The University's remaining authorization of \$164,052,183 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.
- D. Other Contingent Receivables** – The University has received notification of other gifts and grants for which funds have not been disbursed by the resource provider and for which conditions attached to

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the gift or grant have not been satisfied or, in the case of permanent endowments, cannot begin to be satisfied. In accordance with accounting principles generally accepted in the United States of America, these amounts have not been recorded on the accompanying financial statements. The purpose and amount of other contingent receivables at year-end is as follows:

Purpose	Amount
Pledges to Permanent Endowments	\$ 44,144,921

### NOTE 16 - RELATED PARTIES

**Foundations** – Separately incorporated nonprofit foundations associated with the University are The Botanical Garden Foundation, Inc., The Dental Alumni Association, Inc., The Dental Foundation of North Carolina, Inc., The Educational Foundation, Inc., The General Alumni Association, The Institute of Government Foundation, Inc., The Law Alumni Association of N.C., Inc., The Morehead Scholarship Foundation, Inc., The Pharmacy Foundation of North Carolina, Inc., The School of Education Foundation, Inc., The School of Journalism and Mass Communication Foundation of North Carolina, Inc., The University of North Carolina at Chapel Hill Public Health Foundation, Inc., and The University of North Carolina at Chapel Hill School of Nursing Foundation, Inc.

These organizations serve, in conjunction with the University's component units (See Note 1A), as the primary fundraising arm of the University through which individuals, corporations, and other organizations support University programs by providing scholarships, fellowships, faculty salary supplements, and unrestricted funds to specific colleges and the University's overall academic environment. The alumni associations provide educational opportunities or other services to alumni. The University's financial statements do not include the assets, liabilities, net assets, or operational transactions of the foundations, except for support from each organization to the University. This support totaled approximately \$10,598,810 for the year ended June 30, 2005.

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

For the fiscal year ended June 30, 2005, the University implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures*. This Statement establishes and modifies disclosure requirements related to investment risks: credit risk (including

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

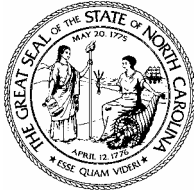
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custodial credit risk and concentration of credit risk), interest rate risk, and foreign currency risk. This statement also establishes and modifies disclosure requirements for deposit risks: custodial credit risk and foreign currency risk.

### **NOTE 18 - SUBSEQUENT EVENTS**

On August 30, 2005, the University issued \$404,960,000 of University of North Carolina at Chapel Hill General Revenue and Revenue Refunding Bonds, Series 2005A. The 2005A Bonds were issued to provide funds (1) to finance or refinance the costs of certain capital projects at the University, (2) to advance refund certain revenue bonds issued for the benefit of the University, (3) to pay capitalized interest on a portion of the 2005A Bonds and (4) to pay the costs incurred in connection with the issuance of the 2005A Bonds. The bonds will mature, subject to mandatory and optional redemption, from December 1, 2005, to December 1, 2034, with amounts varying from \$480,000 due December 1, 2005, to \$305,680,000 Term Bonds due December 1, 2034. The 2005A bonds have an interest rate range of 3.0% to 5.0%.

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STATE OF NORTH CAROLINA  
**Office of the State Auditor**

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

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

We have audited the financial statements of The University of North Carolina at Chapel Hill, a constituent institution of the 16-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, 2005, which collectively comprise the University's basic financial statements and have issued our report thereon dated November 30, 2005. We did not audit the financial statements of The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., which represent 100% of the University's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for those entities, is based on the reports of the other auditors.

As discussed in Note 17 to the financial statements, the University implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures*, during the year ended June 30, 2005.

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 Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., were not audited in accordance with *Government Auditing Standards*, and accordingly, this report does not extend to those entities.

**Internal Control Over Financial Reporting**

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

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

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over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. 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 University's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests 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 Governors, the Board of Trustees, management of the University, the Governor, the State Controller, the General Assembly, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

*Leslie W. Merritt, Jr.*

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

November 30, 2005



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

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Director, Fiscal Research Division

February 23, 2006

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