



STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA STATE UNIVERSITY

RALEIGH, 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

NORTH CAROLINA STATE UNIVERSITY

RALEIGH, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2005

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AUDITOR'S TRANSMITTAL

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

We have completed a financial statement audit of North Carolina State University 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.

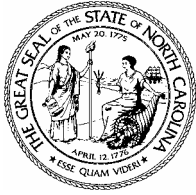
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

Leslie W. Merritt, Jr.

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

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INDEPENDENT AUDITOR'S REPORT

Board of Trustees
North Carolina State University
Raleigh, North Carolina

We have audited the accompanying financial statements of North Carolina State University, 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 as listed in the table of contents. These financial statements are the responsibility of the North Carolina State 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 North Carolina State University Foundation, Inc. or the NCSU Student Aid Association, 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 North Carolina State University Foundation, Inc., and the NCSU Student Aid Association, 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 North Carolina State University and its discretely presented component units 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.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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 18, 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 18, 2005

NORTH CAROLINA STATE UNIVERSITY MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

Management's Discussion and Analysis of the financial report provides an overview of the accompanying basic financial statements. It includes comparative financial analysis with discussion of significant changes from the prior year. The overview also includes information on currently known facts, decisions, or conditions affecting the financial affairs of the University.

Financial Highlights

NC State University's net assets increased by 13.6% to \$1.0 billion in fiscal year 2005. Net assets represent the University's equity, the assets less the liabilities. A major part of this net assets increase was the result of increases of \$107.6 million in capital assets net of related debt. The University's endowment funds also increased by \$7.0 million, to a total of \$139.7 million.

Revenues increased by 6.4% to \$902.8 million in fiscal year 2005. Revenues represent amounts received or accrued that are either operating or nonoperating on the accompanying financial statements. A major part of the revenues increase was the result of increased tuition and fees (operating) and state appropriations (nonoperating). Tuition and fees increased by 8.3% to \$121.7 million. State appropriations increased by 7.3% to \$366.6 million.

During fiscal year 2005, NC State University continued to see increased demand for research services. Federal, State and nongovernmental contracts and grants increased 4.9% to \$185.0 million. Also, the advancement activities of NC State's various foundations continued to promote the quality of the University's programs and contributions to public service. Foundation noncapital gifts increased by 12.1% to \$32.4 million.

Operating expenses increased by 5.8% to \$888.0 million in fiscal year 2005. Operating expenses represent amounts paid or accrued for operating purposes. A major part of the expense increase was the result of increases in Instruction, Research, Auxiliary Enterprises, and Operations and Maintenance expenses. These expenses increased as a result of increases in salaries, benefits, and service costs.

Using the Financial Statements

The University's financial statements are used to evaluate financial position as of June 30th and the results of operations for the fiscal year then ended. The *Statement of Net Assets* provides information relative to the evaluation of financial position. The *Statement of Revenues, Expenses, and Changes in Net Assets* provides information relative to the evaluation of the results of operations. Its ending net assets agree to the total net assets on the *Statement of Net Assets*.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The financial statements also include a *Statement of Cash Flows*. This statement is used to identify the University's sources and uses of cash. The ending cash on the *Statement of Cash Flows* agrees to the total cash reported on the *Statement of Net Assets*. Also, this statement reconciles the net operating loss reported in the *Statement of Revenues, Expenses, and Changes in Net Assets* to the net cash used by operating activities.

In using the financial statements, the *Notes to the Financial Statements* accompanying the financial statements should be read in conjunction with the financial statements. The notes provide information regarding the significant accounting principles applied in the financial statements, authority for and associated risk of deposits and investments, detailed information on long-term liabilities, detailed information on accounts receivable, accounts payable, revenues and expenses, required information on pension plans and other post employment benefits, insurance against losses, commitments and contingencies, and accounting changes. If necessary, the disclosures include a discussion of adjustments to prior periods and events subsequent to the University's financial statement period. Overall, these disclosures provide information to better understand details, risk, and uncertainty associated with amounts reported in the financial statements.

Effective June 30, 2005, the University implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures*. This statement modifies deposit and investment disclosure requirements. The University must disclose information related to investment risks, including credit risk, interest rate risk and foreign currency risk. The University must also disclose information about deposit risks, including custodial credit risk and foreign currency risk. Note 2 to the financial statements provides the new deposit and investment risk disclosures.

Comparative Condensed Financial Statement Information

Statement of Net Assets

The *Statement of Net Assets* provides information regarding the University's assets, liabilities, and net assets as of June 30, 2005. Asset and liability balances are classified as either current or noncurrent. Assets classified as current are those that are available to pay for current liabilities or current year expenditures. Liabilities classified as current are those that are due and payable in the next fiscal year. The net asset balances are classified as either invested in capital assets (net of related debt), restricted or unrestricted. In addition, net assets classified as restricted are classified as either nonexpendable or expendable. Overall, the *Statement of Net Assets* provides information to evaluate the financial strength of the University and its ability to meet current and long-term obligations.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

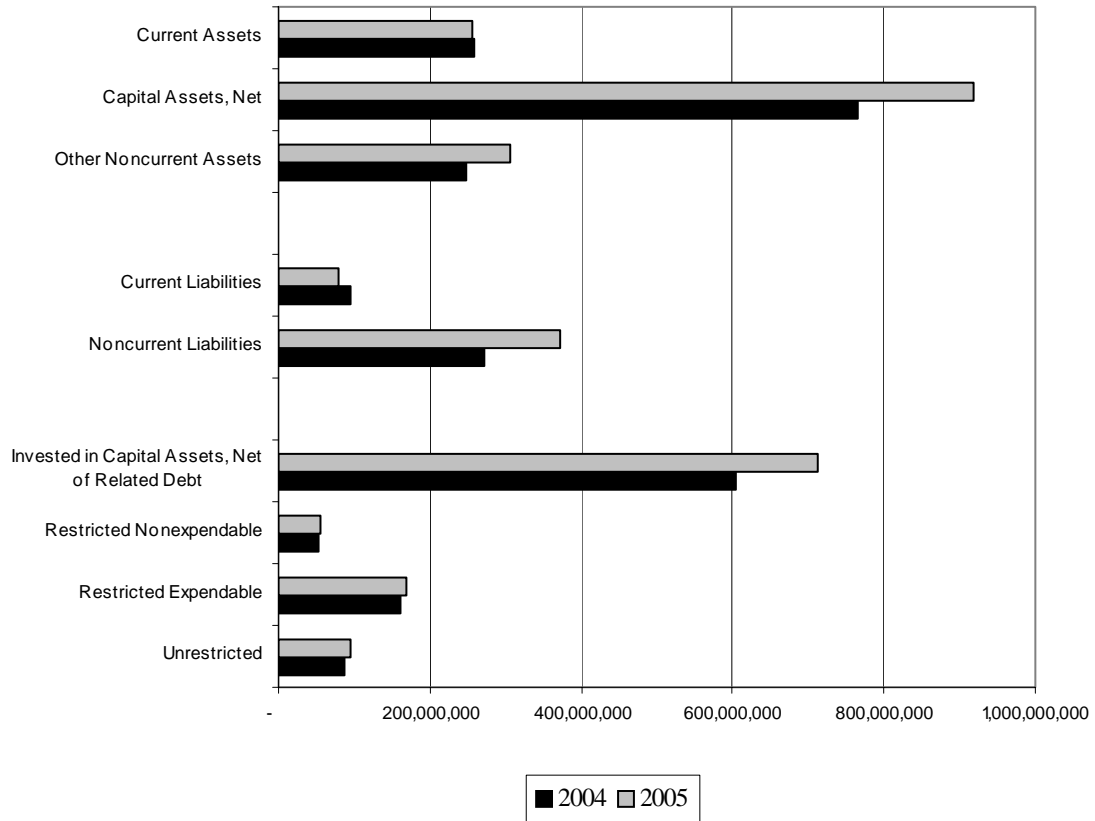
Following is a comparative analysis on the condensed balances reported in the *Statement of Net Assets* as of June 30, 2005, and 2004.

	<u>2005</u>	<u>2004 (1)</u>	<u>Increase/ (Decrease)</u>
Assets			
Current Assets	\$ 256,646,594	\$ 258,249,931	\$ (1,603,337)
Capital Assets, Net	918,993,804	766,108,970	152,884,834
Other Noncurrent Assets	<u>305,552,428</u>	<u>247,906,811</u>	<u>57,645,617</u>
Total Assets	<u>1,481,192,826</u>	<u>1,272,265,712</u>	<u>208,927,114</u>
Liabilities			
Current Liabilities	79,595,009	95,564,453	(15,969,444)
Noncurrent Liabilities	<u>373,333,728</u>	<u>271,533,464</u>	<u>101,800,264</u>
Total Liabilities	<u>452,928,737</u>	<u>367,097,917</u>	<u>85,830,820</u>
Net Assets			
Invested in Capital Assets, Net of Related Debt	712,183,236	604,572,196	107,611,040
Restricted			
Nonexpendable	54,518,640	52,821,358	1,697,282
Expendable	167,621,179	159,962,731	7,658,448
Unrestricted	<u>93,941,034</u>	<u>87,811,510</u>	<u>6,129,524</u>
Total Net Assets	<u>\$ 1,028,264,089</u>	<u>\$ 905,167,795</u>	<u>\$ 123,096,294</u>

(1) The 2004 balances were restated to be consistent with the current year presentation by (a) excluding component unit investments and the related liability and (b) distributing the compensated absences liability between restricted and unrestricted net assets.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The following graph illustrates the assets, liabilities and net assets of the University as of June 30, 2005, as compared to June 30, 2004.



Assets totaled \$1.5 billion, an increase of \$208.9 million over the prior year. The increase in assets includes capital asset growth of \$152.9 million, an increase in other noncurrent assets of \$57.6 million, and a decrease in current assets of \$1.6 million.

The capital asset growth is due primarily to \$102.4 million in capital grants, including the State's higher education bond program. Another major factor is some \$39.0 million from bond financing and available funds.

Key factors in the change in other noncurrent assets are an increase of approximately \$27.0 million in other long-term investments (mostly held for NC State's foundations) and an increase of some \$22.7 million in restricted cash. The growth in long-term investment balances is the result of increased external participation in the NC State Investment Fund. Restricted cash rose due to new bond financing proceeds.

The net reduction in current assets is caused by a \$9.7 million decrease in restricted cash, as less was necessary to cover current liabilities. This decrease is partially offset by increases in

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

receivables, mainly in due from private agencies and an increase in due from State of North Carolina component units (The Golden LEAF, Inc.).

Liabilities totaled \$452.9 million, an increase of \$85.8 million over the prior year. The increase in liabilities is attributable to an increase in noncurrent liabilities of \$101.8 million and a decrease in current liabilities of \$16.0 million.

The most significant factor in the noncurrent liabilities increase is the \$73.8 million rise in long-term liabilities, primarily the new construction financing. The current liability decrease is caused by a \$13.0 million reduction in commercial paper short-term debt, and a \$7.9 million decrease in accounts payable and accrued liabilities (primarily in retainage and earlier paid employee benefit liabilities). These decreases were partially offset by increases in other current liability line items.

Net assets totaled \$1.0 billion, an increase of \$123.1 million over the prior year. The higher net assets are attributable to increases of \$107.6 million in capital assets, net of related debt, \$9.4 million in restricted balances, and \$6.1 million in unrestricted balances.

The University's current assets are more than sufficient to cover current liabilities with a ratio of 3.2x, as compared to 2.7x in the prior year. The University's total assets excluding capital assets, net of depreciation, are more than sufficient to cover total liabilities with a ratio of 1.2x, as compared to 1.4x in the prior year. The University's total assets are significantly more than the University's liabilities with a ratio of 3.3x, as compared to 3.5x in the prior year. These financial ratios are indicators of NC State's financial strength and its ability to meet current and long-term obligations.

Statement of Revenues, Expenses, and Changes in Net Assets

The *Statement of Revenues, Expenses, and Changes in Net Assets* provides information regarding the University's activities for the year ending June 30, 2005. The activity balances are classified as operating, nonoperating, or other. Activities classified as operating include all revenues of the University except those considered nonoperating or those associated with funds received to enhance capital assets or permanent endowments, and all expenses except those related to interest expense on financing activities, loss on disposal of capital assets, and investment expenses (shown as net against investment income). Activities classified as nonoperating include State appropriations, noncapital gifts and grants revenue, investment income (net of investment expenses), and gains or losses on disposal of capital assets. Activities classified as other include capital gifts or grants and additions to permanent endowments. Overall, the *Statement of Revenues, Expenses, and Changes in Net Assets* provides information to evaluate the University's management of operations and maintenance of financial strength.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Following is a comparative analysis on the condensed balances reported in the *Statement of Revenues, Expenses, and Changes in Net Assets* for the fiscal years ended June 30, 2005, and 2004.

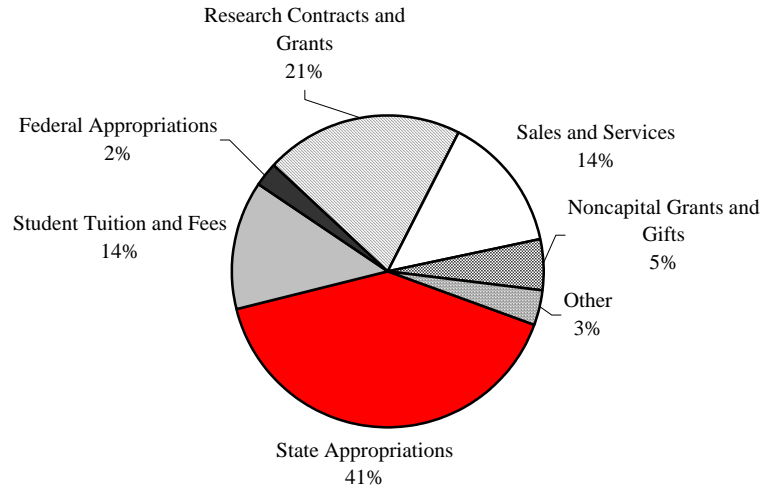
	<u>2005</u>	<u>2004</u>	<u>Increase/ (Decrease)</u>
Operating Activities			
Operating Revenues	\$ 463,383,809	\$ 446,556,945	\$ 16,826,864
Operating Expenses	<u>888,039,866</u>	<u>839,378,166</u>	<u>48,661,700</u>
Net Operating Loss	<u>(424,656,057)</u>	<u>(392,821,221)</u>	<u>(31,834,836)</u>
Nonoperating Activities			
Nonoperating Revenues	439,368,289	402,061,246	37,307,043
Nonoperating Expenses	<u>6,601,969</u>	<u>6,377,699</u>	<u>224,270</u>
Net Nonoperating Revenues	<u>432,766,320</u>	<u>395,683,547</u>	<u>37,082,773</u>
Other Activities			
Capital Grants and Gifts	113,909,198	137,225,496	(23,316,298)
Additions to Permanent Endowments	<u>1,076,833</u>	<u>2,465,815</u>	<u>(1,388,982)</u>
Total Other Activity Increases	<u>114,986,031</u>	<u>139,691,311</u>	<u>(24,705,280)</u>
Increase in Net Assets	<u>\$ 123,096,294</u>	<u>\$ 142,553,637</u>	<u>\$ (19,457,343)</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

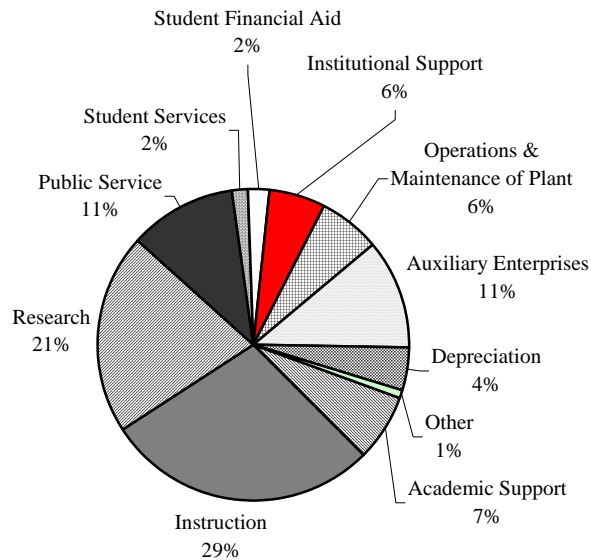
Operating and Nonoperating Activities

The following graph illustrates the relationships of operating and nonoperating revenue sources and expense functions to total revenue/expenses for the fiscal year 2005.

Operating and Nonoperating Revenues



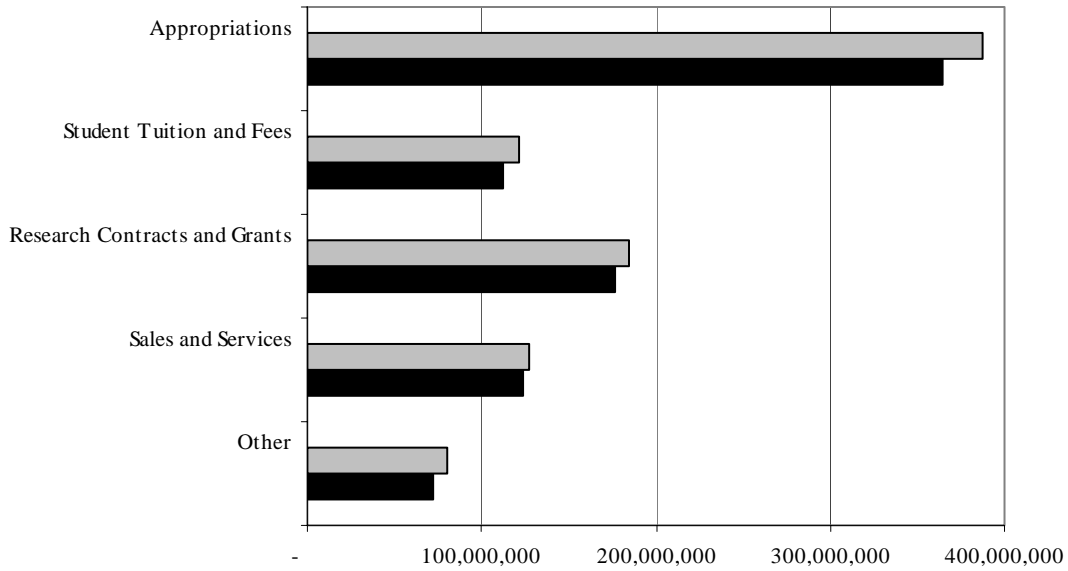
Operating and Nonoperating Expenses



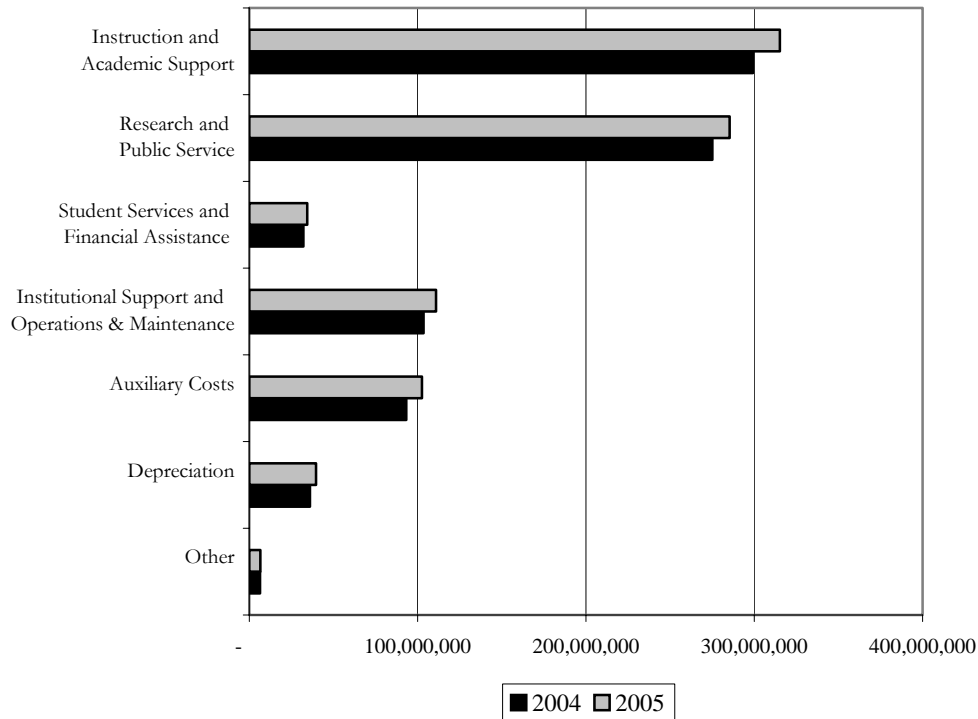
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The following graph illustrates the University's operating and nonoperating revenues/expenses by source/function.

Operating and Nonoperating Revenues



Operating and Nonoperating Expenses



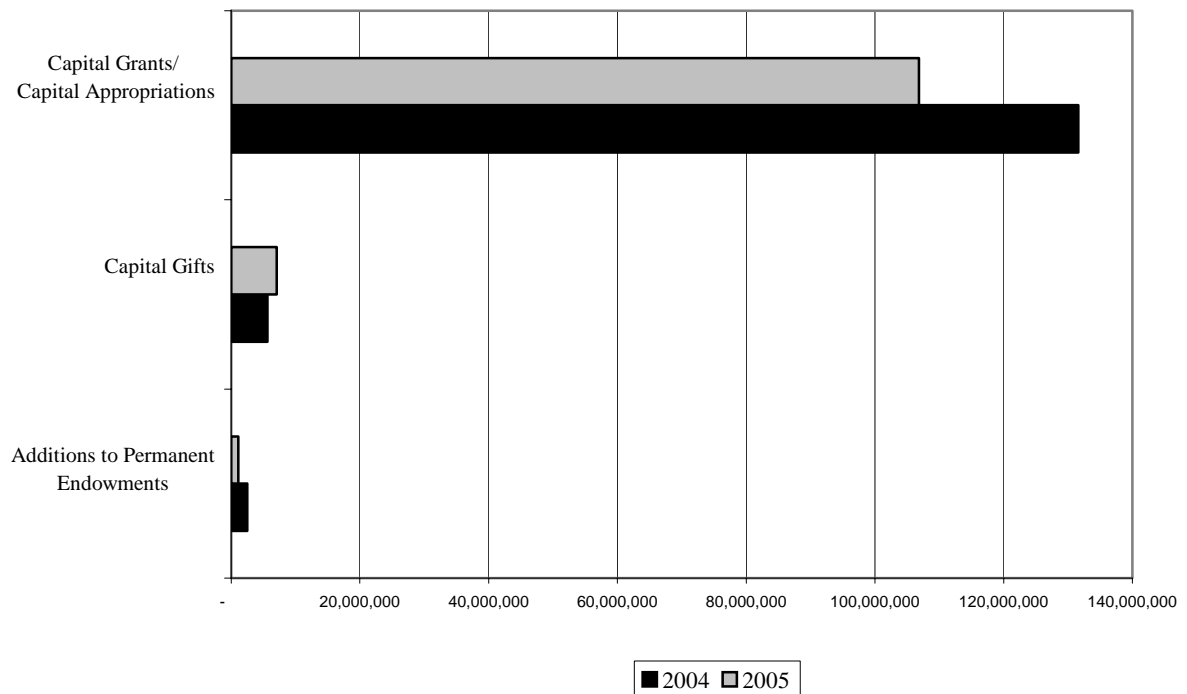
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Total revenues (operating and nonoperating) increased \$54.1 million or 6.4% over the prior year. Appropriations (State and Federal Land Grant Institution) increased by \$23.1 million or 6.3% over the prior year as a result of increased enrollments and legislative salary increases. Student tuition and fees increased by \$9.3 million or 8.3% over the prior year because of enrollment growth and approved tuition and fee rate increases. Research contracts and grants increased by \$8.7 million or 4.9% over the prior year due to additional demand for services. Sales and services increased by \$4.2 million or 3.4% over the prior year. This increase resulted from auxiliary growth, primarily in Veterinary School revenues, housing, and the bookstore. Other revenues (including operating and nonoperating sources) had a net increase of \$8.8 million or 12.2% over the prior year, primarily as a result of gain on a real estate transaction.

Total expenses (operating and nonoperating) increased \$48.9 million or 5.8% over the prior year, primarily as a result of increases in salaries and benefits of \$24.2 million and services of \$14.0 million. The salaries and benefits increase is due primarily to a 2.5% salary increase and an increase in retirement contributions. The services increase is the result of increased spending on subcontracting, repairs, maintenance and rent.

Other Activity

The following graph illustrates the University's other activities by source.



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Other activity totaled \$115.0 million, down \$24.7 from the prior year. This decrease is caused by the \$33.5 million Golden LEAF capital grant in 2004. The other activity total includes \$106.9 million in capital grants and appropriations (primarily in State bond proceeds), \$7.0 million in capital gifts and \$1.1 million in permanent endowments.

Statement of Cash Flows

The *Statement of Cash Flows* provides information about the University's cash activities for the year. The sources and uses of cash are classified as operating activities, noncapital financing activities, capital financing activities, and investing activities.

Following is a comparative analysis on the condensed balances reported in the *Statement of Cash Flows* for the fiscal years ended June 30, 2005 and 2004.

	<u>2005</u>	<u>2004</u>	<u>Increase/ (Decrease)</u>
Operating Activities			
Sources	\$ 463,189,348	\$ 445,609,967	\$ 17,579,381
Uses	<u>853,173,948</u>	<u>795,276,217</u>	<u>57,897,731</u>
Cash Used by Operating Activities	<u>(389,984,600)</u>	<u>(349,666,250)</u>	<u>(40,318,350)</u>
Noncapital Financing Activities			
Sources	515,053,334	451,809,357	63,243,977
Uses	<u>72,636,196</u>	<u>69,048,290</u>	<u>3,587,906</u>
Cash Provided by Noncapital Financing Activities	<u>442,417,138</u>	<u>382,761,067</u>	<u>59,656,071</u>
Capital Financing Activities			
Sources	241,032,753	113,270,602	127,762,151
Uses	<u>255,289,620</u>	<u>189,517,384</u>	<u>65,772,236</u>
Cash Provided (Used) by Capital Financial Activities	<u>(14,256,867)</u>	<u>(76,246,782)</u>	<u>61,989,915</u>
Investing Activities			
Sources	634,151,846	526,468,584	107,683,262
Uses	<u>659,103,511</u>	<u>520,682,926</u>	<u>138,420,585</u>
Cash Provided (Used) by Investing Activities	<u>(24,951,665)</u>	<u>5,785,658</u>	<u>(30,737,323)</u>
Net Increase (Decrease) in Cash	<u>\$ 13,224,006</u>	<u>\$ (37,366,307)</u>	<u>\$ 50,590,313</u>

Cash increased by \$13.2 million during fiscal year 2005, compared to a decrease of \$37.4 million in the prior year. One major factor in this increase was the \$81.6 million General Revenue Bonds issued in 2005.

The Statement of Cash Flows is divided into four types of activities that generate and use cash. The first section deals with cash flows from operating activities, and includes sources such as tuition and fees and contracts and grants. Major operating uses of cash include

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

salaries and payments to vendors. Because appropriations, gifts, and some grants are not considered operating activities, generally the University has a net outflow of cash in operating activities. Fiscal years 2004 and 2005 both show cash used by operating activities.

Cash provided by noncapital financing activities includes sources such as appropriations, Federal Family Education Loan receipts, foundations' deposits for investment, and noncapital gifts and grants. Noncapital financing uses include Federal Family Education Loan disbursements and other payments.

Cash provided by capital financing activities includes sources such as proceeds from capital debt and capital appropriations, grants and gifts. Major capital financing uses include purchases of capital assets and payment of principal and interest on capital debt. The cash flows from capital financing showed net cash used of \$14.3 million. Cash used exceeded cash provided because the \$200.2 million cash used for acquisition and construction of capital assets included financing proceeds available from prior years.

Cash flows from investing activities include sources such as proceeds from investment transactions and dividend and interest income. In the investing activities section, the major use of cash is the purchase of investments. The cash flows from investing activities showed net cash used of \$24.9 million. Cash used exceeded cash provided because the purchases of investments (cash use) is included in investing activities, while the external participation in the Investment Fund (cash provided) is included in noncapital financing activities.

Capital Assets and Long-Term Debt Activities

Capital Assets

The University capitalizes assets that have a value or cost equal to or greater than \$5,000 at the date of acquisition and an expected useful life of more than one year. Repairs and renovations that do not extend the life of the building beyond the expected useful life at acquisition, nor increase the future service potential of the building are expensed and not capitalized.

Machinery and equipment are depreciated over their estimated useful lives, generally 3 to 15 years beginning in the year of acquisition. Buildings and general infrastructure are depreciated over their estimated useful lives, generally 10 to 50 years for buildings and 15 to 75 years for general infrastructure beginning in the year that the construction is completed or, if purchased after construction, when acquired. Land and construction in progress are nondepreciable capital assets. When a construction project is completed, the capital project costs are moved from the construction in progress account to either buildings or general infrastructure as appropriate.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

As shown in the following table, the University increased its net capital assets by \$152.9 million during fiscal year 2005.

	<u>2005</u>	<u>2004</u>	<u>Increase/ (Decrease)</u>
Land	\$ 22,951,966	\$ 13,059,625	\$ 9,892,341
Construction in Progress	170,116,963	224,744,215	(54,627,252)
Buildings	828,493,888	622,818,100	205,675,788
Machinery and Equipment	224,020,918	223,436,199	584,719
General Infrastructure	<u>96,923,003</u>	<u>78,546,485</u>	<u>18,376,518</u>
Total Capital Assets	1,342,506,738	1,162,604,624	179,902,114
Accumulated Depreciation	<u>423,512,934</u>	<u>396,495,654</u>	<u>27,017,280</u>
Net Capital Assets	<u>\$ 918,993,804</u>	<u>\$ 766,108,970</u>	<u>\$ 152,884,834</u>

In addition to costs incurred, the University had \$52.8 million in outstanding commitments for construction projects as of June 30, 2005.

The major change in capital assets during the year was related to the improvement and modernization of buildings and general infrastructure. These improvements were provided primarily by funds from the State of North Carolina Higher Education Improvement Bond Referendum (State Bond Program) and University debt financing. As of June 30, 2005, and for purposes of financing construction projects, the University had \$188.7 million in outstanding funding commitments from the State Bond Program, \$4.7 million outstanding from the State of North Carolina Certificate of Participation Program, \$33.2 million outstanding from The Golden LEAF, Inc., and \$28.9 million in unexpended University General Revenue Bond proceeds. In addition, the University has available Commercial Paper Program financing for short-term credit up to \$60.0 million to finance capital construction projects.

Following are some of the major construction projects completed or in progress as of June 30, 2005:

Construction of the Wolf Village Apartments was completed during fiscal year 2005. The Wolf Village Apartments consist of eight buildings and will house 1,200 students in fully furnished apartments and is located on central campus.

Construction of the new College of Engineering Complex – Phase 1 was completed during fiscal year 2005 and Phase 2 was near completion as of June 30, 2005. The College of Engineering Complex will provide Computer Science and Electrical and Computer Engineering with laboratories, offices and classrooms and is located on centennial campus.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Renovations to the David Clark Laboratory Building were near completion as of June 30, 2005. Originally built in 1939, the David Clark Laboratory Building provides space for the study of zoology and the Biological Sciences Program and is located on north campus.

Renovations to the Schaub Food Science Building were near completion at June 30, 2005. Originally built in 1968, the Schaub Food Science Building provides laboratory, office, classroom, conference and pilot plant space for the study of food science and is located on central campus.

Construction of the Chilled Water Central Plants - North Campus and the Cates Avenue Plant Expansion - Central Campus have begun and are planned for completion in fiscal year 2006. These Chilled Water Plants will provide chilled water production and distribution for the north and central campuses.

Construction of the Partners III Building was completed during fiscal year 2005. This 80,000 square foot facility will provide office and lab space for Physical and Mathematical Sciences and the College of Agricultural and Life Sciences and is located on Centennial Campus.

Renovation of Berry, Becton and Bagwell Residence Halls was started during fiscal year 2005 and is planned for completion by fiscal year 2006. The project will upgrade space and systems within them, including new HVAC systems, fire protection and suppression systems, electrical service, plumbing systems and elevators.

Construction of the College of Veterinary Medicine Research Building was completed during fiscal year 2005. This is the first building on the Centennial Biomedical Campus and will provide for research laboratories, offices and conference rooms. The building is located adjacent to the NCSU College of Veterinary Medicine Campus. The Centennial Biomedical Campus is an extension of the original NCSU Centennial Campus concept. The Centennial Biomedical Campus will emphasize partnerships between the University, government and industry in biomedical research and product development.

More information about the University's long-range capital plan is located at <http://www.ncsu.edu/facilities/univ-arch/masterplan.htm>.

Long-Term Debt Activities

The University incurs long-term debt to finance construction projects, to purchase equipment using lease arrangements and to provide for accumulated unused vacation benefits for employees. As shown in the following chart, the University increased its long-term debt by \$75.4 million during fiscal year 2005.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

	<u>2005</u>	<u>2004</u>	<u>Increase/ (Decrease)</u>
Bonds Payable	\$ 222,068,796	\$ 147,916,458	\$ 74,152,338
Capital Leases Payable	99,263	170,755	(71,492)
Compensated Absences	<u>43,546,662</u>	<u>42,179,635</u>	<u>1,367,027</u>
Total Long-Term Liabilities	<u>\$ 265,714,721</u>	<u>\$ 190,266,848</u>	<u>\$ 75,447,873</u>

The major change in long-term debt occurred as the result of issuing the Series 2005A University General Revenue Bonds. In addition to providing funding for various construction projects and costs of bond issuance, the Series 2005A bond issue was utilized to repay \$34.0 million of short-term debt and to refund \$7.1 million of outstanding 1997B bonds payable. The refunding reduced the University's debt service requirements by \$0.3 million over the next 13 years and provided an economic gain of \$0.4 million.

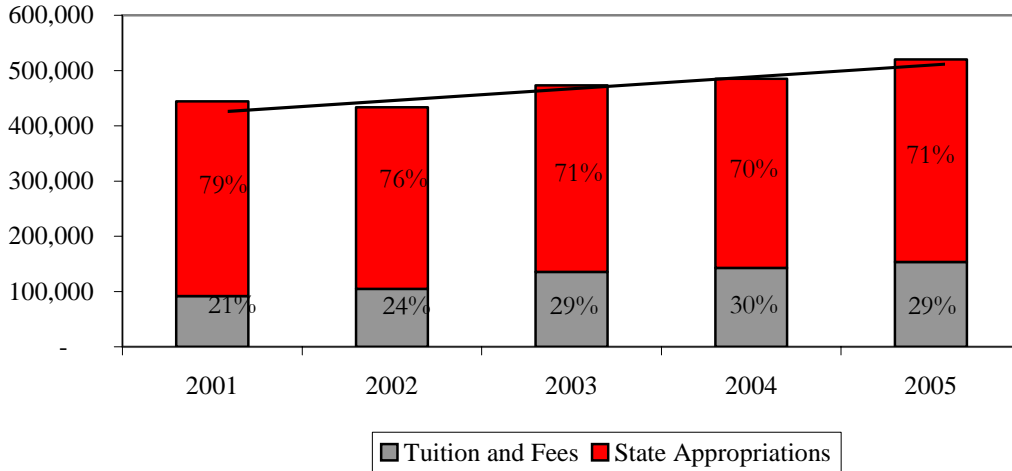
The University's bond rating on the Series 2005A issue was Aa3 by Moody's Investors Services and AA by Standard and Poor's.

Economic Factors That Will Affect the Future

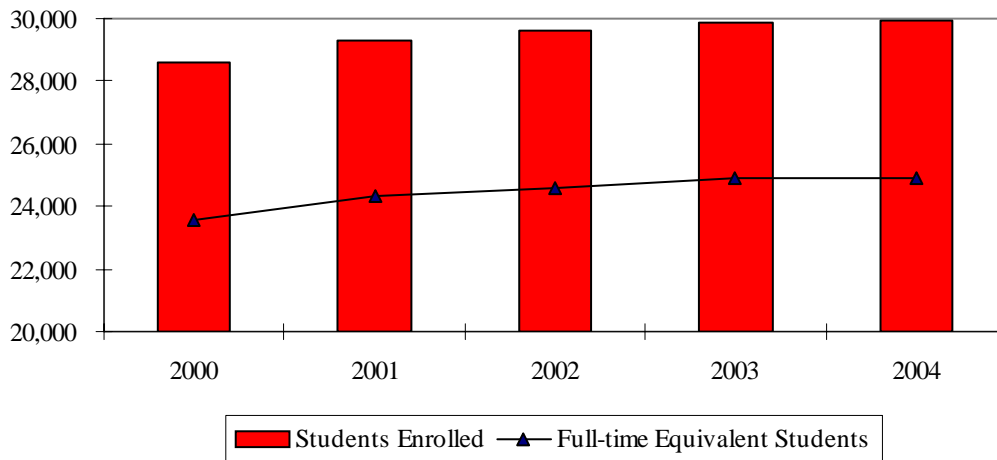
Throughout its history, NC State has been dedicated to excellence in scholarship, extension, and research. The outlook for the future is bright. The North Carolina economy is improving, and the State has continued to demonstrate strong support for higher education. State appropriations to NC State increased 7.3% in fiscal year 2005 and are budgeted to increase in fiscal year 2006. NC State's student enrollment is 30,147 for Fall 2005 and growing. Tuition and fee revenues increased by 8.3% in 2005. However, the approved tuition and fee rate increases for fiscal year 2006 are small – from \$71 for in-State undergraduates to \$371 for out-of-State and graduate students. With these moderate increases, the University retains a relatively low tuition rate in comparison to similar universities. Following are trend analyses of the appropriation and tuition and fee amounts realized for the past five years, student enrollment figures for the past five years, as well as a chart comparing peer institutions' tuition and fees amounts.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Tuition & Fees (gross) / State Appropriations
(in thousands)



Student Enrollment
Fall Semester



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

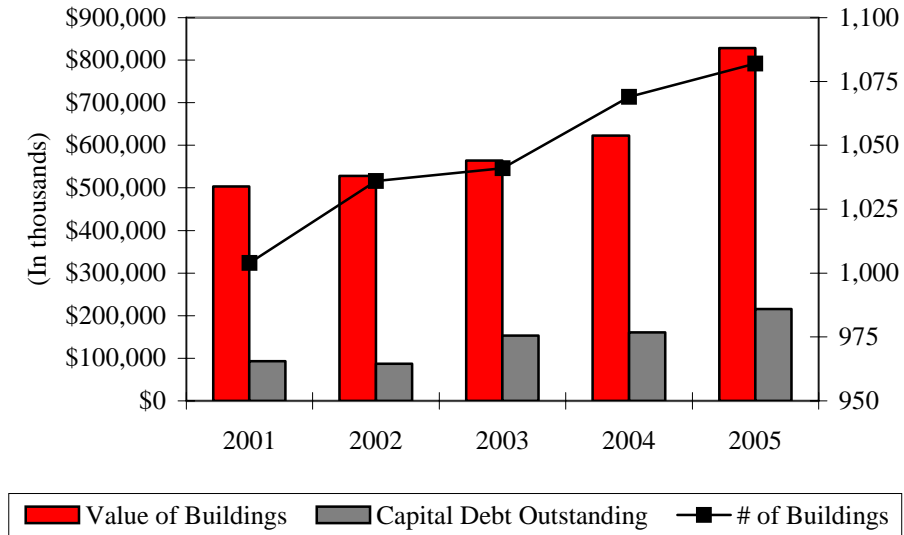
Tuition and Fees				
Public Peer Institutions				
Full-Time Students - 2004-05				
	Undergraduate		Graduate	
	In-State	Out-of-State	In-State	Out-of-State
Pennsylvania State Univ.	\$ 10,856	\$ 20,784	\$ 11,796	\$ 21,946
Rutgers University	8,564	15,599	10,839	15,345
Univ. of Illinois-Urbana	7,944	20,864	8,310	20,310
Univ. of California-Davis	6,936	23,892	8,407	23,346
Univ. of California-San Diego	6,224	23,180	7,867	22,806
Purdue University	6,092	18,700	6,092	18,700
Texas A&M University	5,955	13,695	6,058	12,250
University of Wisconsin	5,866	19,866	8,320	23,590
Virginia Polytechnic & State Univ.	5,838	16,581	7,512	11,682
Iowa State University	5,426	15,128	6,172	15,798
NC State University	4,282	16,180	4,501	16,549
Georgia Institute of Technology	4,278	17,558	4,954	17,850
University of Georgia	4,272	15,588	4,948	18,282

Source: University Planning and Analysis

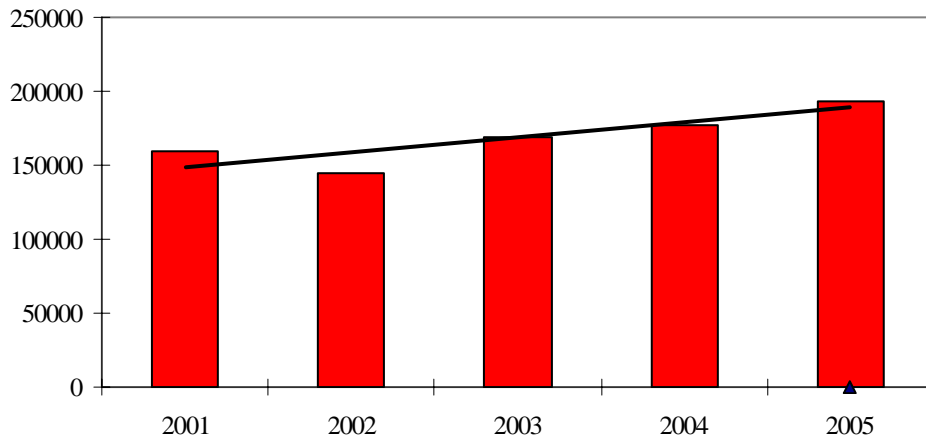
Net assets increased by 13.6%, demonstrating the University's financial growth. The continued expansion and improvement of facilities, increases in research contracts and grants, and the strong support of University-related foundations are other indicators of NC State's continuing strong financial position. Following are trend analysis of the number and value of buildings, revenue from contracts and grants, and gifts from the University-related foundations for the past five years.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

University Buildings (completed)
and Capital Debt

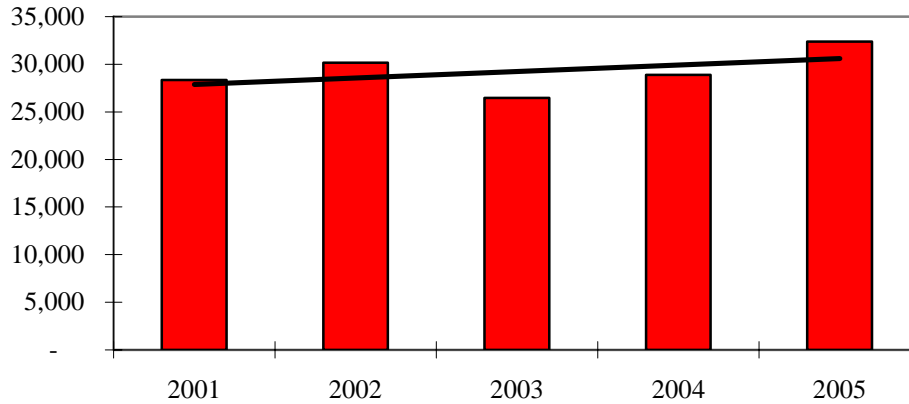


Research Contract and Grant Revenues
(in thousands)



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

University Foundation Support (noncapital)
(in thousands)



The current session of the NC State Legislature approved an Education Lottery for the State. As part of the Education Lottery Act, the University System will be beneficiary of 25% of the net revenues, to be allocated toward higher education scholarships. While organization and distribution requirements are pending, it is probable that this legislation will have a long-term benefit to public education in North Carolina and the constituent institutions of the University of North Carolina including NC State University.

NC State's economic strengths, the quality of the faculty and staff, the University's research and technology advancements, the technology transfers and partnerships between the University and industry, and the University's commitment and service to its students and the community demonstrate the University's value as a leader in scholarship, extension, and research.

North Carolina State University
Statement of Net Assets
June 30, 2005

Exhibit A-1

ASSETS

Current Assets:

Cash and Cash Equivalents	\$ 126,268,531
Restricted Cash and Cash Equivalents	38,518,083
Restricted Short-Term Investments	1,477,703
Receivables, Net (Note 4)	34,476,477
Due from Primary Government	11,209,581
Due from State of North Carolina Component Units	37,985,378
Due from University Component Units	1,568,157
Inventories	3,891,394
Notes Receivable, Net (Note 4)	1,251,290
	<hr/>
Total Current Assets	256,646,594

Noncurrent Assets:

Restricted Cash and Cash Equivalents	28,152,991
Restricted Due from Primary Government	17,017,892
Endowment Investments	139,727,604
Other Long-Term Investments	109,965,985
Notes Receivable, Net (Note 4)	10,687,956
Capital Assets - Nondepreciable (Note 5)	193,068,929
Capital Assets - Depreciable, Net (Note 5)	725,924,875
	<hr/>
Total Noncurrent Assets	1,224,546,232

Total Assets

1,481,192,826

LIABILITIES

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)	40,519,365
Due to Primary Government	365,766
Deferred Revenue	24,281,977
Interest Payable	2,201,306
Short-Term Debt (Note 7)	2,000,000
Long-Term Liabilities - Current Portion (Note 8)	10,226,595
	<hr/>
Total Current Liabilities	79,595,009

Noncurrent Liabilities:

Deposits Payable	67,736
Funds Held for Others	2,963,132
U. S. Government Grants Refundable	6,582,041
Funds Held in Trust for Pool Participants	108,232,693
Long-Term Liabilities (Note 8)	255,488,126
	<hr/>
Total Noncurrent Liabilities	373,333,728

Total Liabilities

452,928,737

North Carolina State University
Statement of Net Assets
June 30, 2005

Exhibit A-1
Page 2

NET ASSETS

Invested in Capital Assets, Net of Related Debt	712,183,236
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	9,307,602
Endowed Professorships	25,496,084
Departmental Uses	13,105,895
Loans	5,675,244
Other	933,815
Expendable:	
Scholarships and Fellowships	20,816,217
Research	16,503,237
Endowed Professorships	51,268,607
Departmental Uses	17,873,115
Loans	1,470,790
Capital Projects	49,134,107
Debt Service	4,226,271
Other	6,328,835
Unrestricted	93,941,034
Total Net Assets	<u>\$ 1,028,264,089</u>

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

North Carolina State University
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)	\$ 121,679,301
Federal Appropriations	21,059,195
Federal Grants and Contracts	103,219,655
State and Local Grants and Contracts	33,614,450
Nongovernmental Grants and Contracts	48,161,183
Sales and Services, Net (Note 10)	127,704,543
Interest Earnings on Loans	307,384
Other Operating Revenues, Net (Note 10)	7,638,098
	<hr/>
Total Operating Revenues	463,383,809

EXPENSES

Operating Expenses:	
Salaries and Benefits	554,010,039
Supplies and Materials	102,093,639
Services	149,448,441
Scholarships and Fellowships	17,252,741
Utilities	25,613,782
Depreciation	39,621,224
	<hr/>
Total Operating Expenses	888,039,866
	<hr/>
Operating Loss	(424,656,057)

NONOPERATING REVENUES (EXPENSES)

State Appropriations	366,632,546
Noncapital Grants	7,922,134
Noncapital Gifts	41,253,974
Investment Income (Net of Investment Expense of \$770,475)	13,446,362
Interest and Fees on Debt	(6,601,969)
Other Nonoperating Revenues	10,113,273
	<hr/>
Net Nonoperating Revenues	432,766,320
	<hr/>
Income Before Other Revenues, Expenses, Gains, or Losses	8,110,263
	<hr/>
Capital Appropriations	4,426,022
Capital Grants	102,440,986
Capital Gifts	7,042,190
Additions to Endowments	1,076,833
	<hr/>
Increase in Net Assets	123,096,294

NET ASSETS

Net Assets - July 1, 2004	905,167,795
	<hr/>
Net Assets - June 30, 2005	\$ 1,028,264,089

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

North Carolina State University
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2005

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$ 453,053,396
Payments to Employees and Fringe Benefits	(555,238,976)
Payments to Vendors and Suppliers	(277,618,310)
Payments for Scholarships and Fellowships	(17,252,741)
Loans Issued	(3,063,921)
Collection of Loans	2,221,288
Interest Earned on Loans	276,566
Other Receipts	7,638,098
	<hr/>
Net Cash Used by Operating Activities	(389,984,600)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations	366,632,546
Noncapital Grants	161,745
Noncapital Gifts	41,834,075
Additions to Endowments	1,076,833
Federal Family Education Loan Receipts	72,764,289
Federal Family Education Loan Disbursements	(72,636,196)
External Participation in Investment Fund	31,843,808
Other Receipts	740,038
	<hr/>
Net Cash Provided by Noncapital Financing Activities	442,417,138

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

Proceeds from Capital Debt	108,701,462
State Capital Appropriations	4,426,022
Capital Grants	104,708,995
Capital Gifts	6,854,852
Proceeds from Sale of Capital Assets	16,341,422
Acquisition and Construction of Capital Assets	(200,240,824)
Principal Paid on Capital Debt and Leases	(40,438,493)
Interest and Fees Paid on Capital Debt and Leases	(5,848,286)
Payment to Bond Escrow Agent	(7,465,405)
Other Payments	(1,296,612)
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(14,256,867)

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	623,800,648
Investment Income	10,351,198
Purchase of Investments and Related Fees	(659,103,511)
	<hr/>
Net Cash Used by Investing Activities	(24,951,665)
	<hr/>
Net Increase in Cash and Cash Equivalents	13,224,006
Cash and Cash Equivalents - July 1, 2004	179,715,599
	<hr/>
Cash and Cash Equivalents - June 30, 2005	\$ 192,939,605

North Carolina State University
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	\$ (424,656,057)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:	
Depreciation Expense	39,621,224
Allowances, Write-Offs, and Amortizations	337,331
Changes in Assets and Liabilities:	
Receivables (Net)	(6,010,485)
Inventories	400,852
Accounts Payable and Accrued Liabilities	(3,215,647)
Deferred Revenue	2,171,155
Compensated Absences	1,367,027
	<hr/>
Net Cash Used by Operating Activities	<u>\$ (389,984,600)</u>

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:	
Cash and Cash Equivalents	\$ 126,268,531
Restricted Cash and Cash Equivalents	38,518,083
Noncurrent Assets:	
Restricted Cash and Cash Equivalents	<hr/> 28,152,991
Total Cash and Cash Equivalents - June 30, 2005	<u>\$ 192,939,605</u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through a Gift	\$ 189,581
Change in Fair Value of Investments	4,357,902
Loss on Disposal of Capital Assets	(6,228,149)

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

North Carolina State University Foundations
Statement of Financial Position
June 30, 2005

Exhibit B-1

	North Carolina State University Foundation, Inc.	NCSU Student Aid Association, Inc.
ASSETS		
Cash and Cash Equivalents	\$ 507,633	\$ 21,817,434
Investments	66,524,667	17,942,230
Cash Surrender Value of Life Insurance	83,750	93,755
Real Estate Held for Resale	1,011,111	8,022,429
Receivables, Net	50,496	225,656
Pledges Receivable/Promises	6,572,558	44,101,431
Prepaid Expenses		23,100
Notes/Loans Receivable, Net		86,350
Property and Equipment, Net	194,281	55,707,684
	<hr/>	<hr/>
Total Assets	74,944,496	148,020,069
LIABILITIES		
Accounts Payable and Accrued Expenses	387,499	1,759,406
Due to University and Other Foundations		1,568,157
Deferred Revenue		4,188,495
Interest Payable		262,627
Deposits Payable		124,823
Funds Held for Others	358,629	
Interest Rate Swap Fair Value Liability		1,782,253
Split Interest Agreement Obligations	4,374,799	
Bonds Payable		84,385,000
	<hr/>	<hr/>
Total Liabilities	5,120,927	94,070,761
NET ASSETS		
Unrestricted	10,559,840	13,192,722
Temporarily Restricted	26,401,933	18,075,855
Permanently Restricted	32,861,796	22,680,731
	<hr/>	<hr/>
Total Net Assets	<u>\$ 69,823,569</u>	<u>\$ 53,949,308</u>

See Note 1 in the Notes to the Financial Statements

***North Carolina State University Foundations
Statement of Activities
For the Fiscal Year Ended June 30, 2005***

Exhibit B-2

	North Carolina State University Foundation, Inc.	NCSU Student Aid Association, Inc.
CHANGES IN UNRESTRICTED NET ASSETS		
Revenues and Gains:		
Contributions	\$ 264,867	\$ 10,102,235
Donated Services and Noncash Contributions	156,900	2,404,292
Alumni Membership and Sales	984,396	268,390
Student Housing Rents		1,995,586
Income on Long-Term Investments	627,606	
Other Investment Income		1,007,778
Net Unrealized and Realized Gains on Long-Term Investments	877,965	
Unrealized Loss on Swap Contracts		(1,361,638)
Other	942,264	1,176,380
Total Unrestricted Revenues and Gains	3,853,998	15,593,023
Net Assets Released from Restrictions:		
Satisfaction of Program Restrictions	10,257,216	
Satisfaction of Equipment Acquisition Restrictions		3,727,819
Total Net Assets Released from Restrictions	10,257,216	3,727,819
Total Unrestricted Revenues, Gains, and Other Support	14,111,214	19,320,842
Expenses and Losses:		
University Support	11,552,648	7,788,790
University Facilities Support		3,727,819
Alumni Activities	597,909	
Student Housing		2,664,095
Management and General	247,236	640,170
Fund Raising	361,460	2,209,346
Total Expenses	12,759,253	17,030,220
Increase in Unrestricted Net Assets	1,351,961	2,290,622
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS		
Contributions	5,766,421	7,078,665
Alumni Membership and Sales	284,394	
Other		50,933
Income on Long-Term Investments	653,848	239,856
Net Unrealized and Realized Gains on Long-Term Investments	633,151	
Unrealized Loss on Swap Contracts		(449,777)
Net Assets Released from Restrictions:		
Satisfaction of Program Restrictions	(10,257,216)	
Satisfaction of Equipment Acquisition Restrictions		(3,727,819)
Increase (Decrease) in Temporarily Restricted Net Assets	(2,919,402)	3,191,858
CHANGES IN PERMANENTLY RESTRICTED NET ASSETS		
Contributions	2,115,905	6,762,552
Donated Services and Noncash Contributions		200,000
Income on Long-Term Investments	112,455	(330,658)
Change in Value of Split Interest Agreements	(205,603)	
Other		17,058
Net Unrealized and Realized Gains on Long-Term Investments	501,235	
Increase in Permanently Restricted Net Assets	2,523,992	6,648,952
Increase in Net Assets	956,551	12,131,432
Net Assets at Beginning of Year	68,867,018	41,817,876
Net Assets at End of Year	\$ 69,823,569	\$ 53,949,308

See Note 1 in the Notes to the Financial Statements

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**NORTH CAROLINA STATE UNIVERSITY
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2005**

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

- A. Financial Reporting Entity** - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements. North Carolina State 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 NC State Investment Fund, Inc. (Investment Fund) and the NC State University Partnership Corporation (Corporation), component units of the University, are reported as if they were part of the University.

The Investment Fund is governed by a Members Board consisting of six ex officio directors and five elected representatives. The Investment Fund's purpose is to support 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. The Investment Fund is a governmental external investment pool. Because the majority of the Members Board of the Investment Fund consist of University administrators and Board Members

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

and the Investment Fund's primary purpose is to benefit North Carolina State University, its financial statements have been blended with those of the University.

The Corporation is governed by a Board of Directors appointed by the Chancellor of the University. The Corporation's purpose is to support and benefit the University with the aims of creating new knowledge and improving the lives of the people of North Carolina. In addition, the Corporation formed NC State University Conference Center, LLC (LLC) on January 25, 2002, to develop, own, and operate a hotel, conference center, and public golf course on the Centennial Campus as outlined in the Campus Master Plan. Because the Corporation's Board is appointed by the Chancellor and its sole purpose is to support and benefit the University, both the Corporation and the LLC are considered part of the University for financial reporting purposes.

Separate financial statements for the Investment Fund may be obtained from Foundations Accounting and Investments Office, Campus Box 7207, Raleigh, NC 27695, or by calling (919) 513-7149. Financial information relative to the Corporation and the LLC may be obtained from the Corporation's Executive Director, Campus Box 7012, Raleigh, NC 27695, or by calling (919) 515-0388. Other related foundations and similar nonprofit corporations for which the University is not financially accountable are not part of the accompanying financial statements.

Discretely Presented Component Units – The North Carolina State University Foundation, Inc. (Foundation) and NCSU Student Aid Association, Inc. (Athletic Club) are legally separate not-for-profit corporations and are reported as discretely presented component units based on the nature and significance of their relationship to the University.

The Foundation and Athletic Club are legally separate, tax-exempt component units of the University. These entities act primarily as a fund-raising organization to supplement the resources that are available to the University in support of its programs. Separate Boards of Directors govern these entities independent of the University's Board of Trustees. Although the University does not control the timing or amount of receipts from these entities, the majority of resources, or income thereon, that these entities hold and invest are restricted to the activities of the University by the donors. Because these restricted resources held by these entities can only be used by, or for the benefit of the University, these entities are considered component units of the University and are reported in separate financial statements because of the difference in their reporting model, as described below.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The Foundation and Athletic Club are private not-for-profit 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 GASB revenue recognition criteria and presentation features. No modifications have been made to their financial information in the University's financial reporting entity for these differences.

During the year ended June 30, 2005, the Foundation distributed \$11,819,197 to the University for both restricted and unrestricted purposes. Complete financial statements for the Foundation can be obtained from the Foundations Accounting and Investments Office, Campus Box 7207, Raleigh, NC 27695, or by calling (919) 515-2110.

During the year ended June 30, 2005, the Athletic Club distributed \$7,212,782 to the University for both restricted and unrestricted purposes. Complete financial statements for the Athletic Club can be obtained from The NCSU Student Aid Association, Inc., PO Box 37100, Raleigh, NC 27627, or by calling (919) 865-1500.

- 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)

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

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

- D. Cash and Cash Equivalents** – This classification includes undeposited receipts, petty cash, cash on deposit with private bank accounts, cash on deposit with fiscal agents, and short-term investments with the State Treasurer’s Cash and Investment Pool (a governmental external investment pool). 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, foreign equity mutual funds, money market funds, real estate investment trusts, alternative investments, and other asset holdings by the University. Except for money market funds, real estate not held by a governmental external investment pool, and other asset holdings, investments are accounted for at fair value, as determined by quoted market prices, or an amount determined by management if quoted market prices are not available. The net increase (decrease) in the fair value of investments is recognized as a component of investment income.

Money market funds, 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.

- F. Receivables** – Receivables consist of tuition and fees charged to students and charges for auxiliary enterprises’ sales and services. Receivables also include amounts due from the federal government, State and local governments, private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants, 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. Receivables are recorded net of estimated uncollectible amounts.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

G. Inventories – Inventories, consisting of expendable supplies, and merchandise for resale, are valued at the lower of cost or market value using the first-in, first-out method. Exceptions are the bookstore, which uses the retail method, and physical plant, which uses the moving weighted average method.

H. Capital Assets – Capital assets are stated at cost at date of acquisition or fair value at date of donation in the case of gifts.

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

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 15 to 75 years for infrastructure, 10 to 50 years for buildings, and 3 to 15 years for equipment.

The University does not capitalize its collections. Collections not capitalized adhere to the University's policy to maintain for public exhibition, education or research; protect, keep unencumbered, care for and preserve; and requires proceeds from their sale to be used to acquire other collection items. Accounting principles generally accepted in the United States of America permit collections maintained in this manner to be charged to operations at time of purchase rather than be capitalized.

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

Bonds payable are reported net of unamortized premium or discount. The University amortizes bond premiums/discounts over the life of the bonds using the straight-line method. Losses on refundings and issuance costs

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

on bonds payable are not material to the accompanying financial statements and are expensed in the year incurred.

- L. 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 yearend 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.

- M. 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

- N. 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 operating 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.
- O. 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 (1) student tuition and fees, (2) sales and services of auxiliary enterprises, (3) certain federal, State and local grants and contracts that are essentially contracts for services, and (4) interest earned on loans. Operating expenses are all expense transactions incurred other than those related to capital and noncapital financing or investing activities as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

- P. 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 Central Stores, University Graphics, the Copy Center, the Creamery, Telecommunications, Physical Plant, and Motor Pool. 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.

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 \$192,577,106. 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 include in the State of North

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

Custodial credit risk is the risk that in the event of a bank failure, the University's deposits may not be returned to it. The University follows the Cash Management Plan (Plan) approved by the North Carolina Office of State Controller. As provided by the Plan, all funds belonging to the University are deposited with the State Treasurer pursuant to G.S. 147-77 and G.S. 147-69.1. As provided by the Plan, imprest checking accounts are established with outside banks when considered effective in meeting management objectives. All imprest checking accounts are authorized by the University Treasurer and are limited to the minimum amount needed for sanctioned purposes.

As of June 30, 2005, the carrying amount of the University's checking accounts not with the State Treasurer was \$338,473 and the bank balance was \$500,753. Of the bank balance amount, \$200,747 was exposed to custodial credit risk.

- 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, 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 discussed below.

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 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 Investment Fund, a University component unit, 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 University utilizes the following investment pools:

Long-Term Investment Pool - This is an internal investment pool that is utilized for the investment of the endowment funds. Pool ownership is measured using the unit value method. Under this method, each participating fund’s investment balance is determined on a market value basis. The investment strategy, including the selection of investment managers, is based on the directives of the University’s Endowment Board. This pool also participates in the Investment Fund.

Investment Fund – The Investment Fund began operations in April 1999 and is classified as a non-rated 2a7-like governmental external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC’s Rule 2a7 of the Investment Company Act of 1940. The Investment Fund is utilized as one of the investment managers for the Long-Term Investment Pool and for the North Carolina State University Foundation, Inc., a discretely presented component unit in the accompanying financial statements, (the Investment Fund’s internal participant). Other affiliated organizations not included in the University’s reporting entity represent the pool’s external participants. Fund ownership of the pool is measured using the dollar-day method. Under this method, each participating fund’s investment balance is determined based on an assigned weighted value for the time the funds are on deposit. The external portion of the pool is presented in the accompanying financial statements as “Funds Held in Trust for Pool Participants.”

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The Investment Fund is not subject to any formal oversight other than that provided by the Investment Fund Members Board or its Board of Directors. The Members Board is responsible for adopting investment objectives and policies and for monitoring policy implementation and investment performance. The Members Board has chosen not to make individual security selection decisions. The Board of Directors has the responsibility to oversee the allocation of the Investment Fund's portfolio among the asset classes, investment vehicles, and investment managers.

State Street Bank & Trust Company is the custodian for the Investment Fund and provides the University with quarterly statements defining income and fair value information, which is then allocated among the pool's participants. There are no involuntary participants in the pool. The University has not provided or obtained any legally binding guarantees during the period to support the value for the pool's investments. The annual financial report for the Investment Fund may be obtained from the Foundations Accounting and Investments Office, Campus Box 7207, Raleigh, NC 27695, or by calling (919) 513-7149.

The following table presents the fair value of the University's investments by type and investments subject to interest rate risk at June 30, 2005. Interest rate risk is defined by GASB Statement No. 40 as the risk a government may face should interest rate variances affect the fair value of investments. The University does not have a formal investment policy that addresses interest rate risk.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Long-Term Investment Pool (excludes amounts reported in the Investment Fund)

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	\$ 1,356,577	\$ 54,423	\$ 402,594	\$ 248,884	\$ 650,676
U.S. Treasury Strips	140,153	33,668	30,950		75,535
U.S. Agencies	1,561,473	103,786	98,974		1,123,016
Mortgage Pass Throughs	2,465,237			235,697	2,119,521
Collateralized Mortgage Obligations	799,787			249,728	550,059
State and Local Government	106,850		20,038	20,079	66,733
Asset-backed Securities	637,209		387,102	50,107	200,000
Mutual Bond Funds	5,323,986			5,323,986	
Money Market Funds	231,641	231,641			
Domestic Corporate Bonds	2,330,215	114,094	828,307	954,356	433,458
Foreign Corporate Bonds	101,150		15,265	43,325	42,560
Foreign Government Bonds	123,444		41,585	39,955	41,904
	<u>\$ 15,177,722</u>	<u>\$ 537,612</u>	<u>\$ 1,824,815</u>	<u>\$ 7,511,833</u>	<u>\$ 5,303,462</u>
Other Securities					
Pooled Investments	349,914				
Domestic Stocks	129				
Venture Capital	6,709,491				
	<u>6,709,491</u>				
Total Long-Term Investment Pool	<u><u>\$ 22,237,256</u></u>				

Investment Fund

Investment Type	Fair Value	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More than 10
Debt Securities					
Mutual Bond Funds	\$ 51,855,035	\$ 0	\$ 0	\$ 51,855,035	\$ 0
Money Market Funds	12,082,575	12,082,575			
	<u>\$ 63,937,610</u>	<u>\$ 12,082,575</u>	<u>\$ 0</u>	<u>\$ 51,855,035</u>	<u>\$ 0</u>
Other Securities					
Other Mutual Funds	32,808,661				
Real Estate Investment Trust	10,150,192				
Limited Partnerships	40,063,315				
Domestic Stocks	103,236,152				
Foreign Stocks	7,208,708				
	<u>7,208,708</u>				
Total Investment Fund	<u><u>\$ 257,404,638</u></u>				

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Non-Pooled Investments

Investment Type	Fair Value	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More than 10
Debt Securities					
Money Market Funds	\$ 3,224,114	\$ 3,224,114	\$ 0	\$ 0	\$ 0
Other Securities					
Investments in Real Estate	18,536,935				
Domestic Stocks	2,002,004				
Venture Capital	600,025				
Collections and Mineral Rights	69,879				
Total Non-Pooled Investments	<u>\$ 24,432,957</u>				

Total Investments

Investment Type	Fair Value	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More than 10
Total Debt Securities	\$ 82,339,446	<u>\$ 15,844,301</u>	<u>\$ 1,824,815</u>	<u>\$ 59,366,868</u>	<u>\$ 5,303,462</u>
Total Other Securities	221,735,405				
Total Investments	<u>\$ 304,074,851</u>				

Note: Total investments include \$52,903,559 held in the “Investment Fund” for a foundation that is presented in the accompanying component unit financial statements.

In addition to the interest rate risk disclosed above, the Long-Term Investment Pool and the Investment Fund include investments with fair values highly sensitive to interest rate changes. The Long-Term Investment Pool invests in a fixed income mutual fund, and the Investment Fund invests in a fixed income mutual fund and several limited partnerships that contain securities that are highly sensitive to rate changes. The managers of these investments utilize various risk tools such as diversification, concentration limits, and position size to monitor and mitigate risk.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The following table presents debt securities by investment type and rating, by Moody's Investors Services or Standard and Poor's, as of June 30, 2005.

Long-Term Investment Pool (excludes amounts reported in the Investment Fund)

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	Unrated
Debt Securities Subject to Credit Risk Disclosure:							
U.S. Agencies	\$ 1,499,380	\$ 1,499,380	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Mortgage Pass Throughs	2,084,121	2,084,121					
Collateralized Mortgage Obligations	799,787	799,787					
State and Local Government	106,850	86,807	20,043				
Asset-backed Securities	637,209	637,209					
Mutual Bond Funds	5,323,986	4,339,048	53,240	468,511	425,919	37,268	
Money Market Funds	231,641	231,641					
Domestic Corporate Bonds	2,330,215	34,473	376,225	912,406	1,007,111		
Foreign Corporate Bonds	101,150		18,587	53,243	29,320		
Foreign Government Bonds	123,444		31,034	41,170	43,366		7,874
	<u>\$ 13,237,783</u>	<u>\$ 9,712,466</u>	<u>\$ 499,129</u>	<u>\$ 1,475,330</u>	<u>\$ 1,505,716</u>	<u>\$ 37,268</u>	<u>\$ 7,874</u>
Debt Securities Exempt From Credit Risk Disclosure:							
US Treasuries	1,356,577						
US Treasury Strips	140,153						
U.S. Agencies	62,093						
Mortgage Pass Throughs	381,116						
Total Long-Term Investment Pool - Debt Securities	<u>\$ 15,177,722</u>						

Investment Fund

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	Unrated
Debt Securities Subject to Credit Risk Disclosure:							
Mutual Bond Funds	\$ 51,855,035	\$ 32,150,122	\$ 1,555,651	\$ 15,556,511	\$ 2,074,201	\$ 518,550	\$ 0
Money Market Funds	12,082,575			12,082,575			
Total Investment Fund - Debt Securities	<u>\$ 63,937,610</u>	<u>\$ 32,150,122</u>	<u>\$ 1,555,651</u>	<u>\$ 27,639,086</u>	<u>\$ 2,074,201</u>	<u>\$ 518,550</u>	<u>\$ 0</u>

Non-Pooled Investments

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	Unrated
Debt Securities Subject to Credit Risk Disclosure:							
Money Market Funds	\$ 3,224,114	\$ 3,224,114	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Custodial Credit Risk: For an investment, 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. At June 30, 2005, the University did not have any investments requiring disclosure of custodial credit risk.

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

Foreign Currency Risk: Foreign currency risk is the possibility that changes in exchange rates between the U.S. dollar and foreign currencies will adversely affect the fair value of a deposit/investment. The University does not have a formal policy for foreign currency risk. As of June 30, 2005, the University's Investment Fund had investments in an International Mutual Fund with a fair value of \$32,808,661, a Global Macro Limited Partnership with a fair value of \$5,158,651, and an International Long Short Equity Limited Partnership with a fair value of \$5,201,317, that had foreign currency exposure with various foreign currency denominations.

NOTE 3 - ENDOWMENT INVESTMENTS

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

Investment return of the University's endowment funds is predicated on the total return concept (yield plus appreciation). Annual payouts from the University pooled endowment funds are determined by applying 4 percent (the Board approved spending rate) to the average market value of the Long-Term Investment Pool (for a 12 month period), divided by the number of investment units in the pool to determine the "average spending amount" per unit of investment. The individual endowment fund payout or spending budget is then determined by applying the "average spending amount" to the number of investment units held by the individual endowment fund. To the extent that the total return for the current year exceeds the payout, the excess is added to

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

principal. If current year earnings do not meet the payout requirements, the University uses accumulated income and appreciation from restricted, expendable net asset endowment balances to make up the difference. At June 30, 2005, net appreciation of \$100,054,817 was available to be spent, of which \$87,236,761 was restricted to specific purposes.

NOTE 4 - RECEIVABLES

Receivables at June 30, 2005, were as follows:

	<u>Gross Receivables</u>	<u>Less Allowance for Doubtful Accounts</u>	<u>Net Receivables</u>
Current Receivables:			
Students	\$ 2,984,560	\$ 1,338,204	\$ 1,646,356
Accounts	21,164,384	2,348,126	18,816,258
Intergovernmental	13,382,637		13,382,637
Interest on Loans	358,617	310,395	48,222
Other	583,004		583,004
Total Current Receivables	<u>\$ 38,473,202</u>	<u>\$ 3,996,725</u>	<u>\$ 34,476,477</u>
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	\$ 1,071,666	\$ 14,906	\$ 1,056,760
Institutional Student Loan Programs	200,135	5,605	194,530
Total Notes Receivable - Current	<u>\$ 1,271,801</u>	<u>\$ 20,511</u>	<u>\$ 1,251,290</u>
Notes Receivable - Noncurrent:			
Federal Loan Programs	\$ 11,057,716	\$ 762,285	\$ 10,295,431
Institutional Student Loan Programs	554,371	161,846	392,525
Total Notes Receivable - Noncurrent	<u>\$ 11,612,087</u>	<u>\$ 924,131</u>	<u>\$ 10,687,956</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 5 - CAPITAL ASSETS

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

	Balance July 1, 2004	Adjustments	Increases	Decreases	Balance June 30, 2005
Capital Assets, Nondepreciable:					
Land	\$ 13,059,625	\$ 0	\$ 9,892,341	\$ 0	\$ 22,951,966
Construction in Progress	224,744,215	(151,318,535)	96,691,283		170,116,963
Total Capital Assets, Nondepreciable	237,803,840	(151,318,535)	106,583,624		193,068,929
Capital Assets, Depreciable:					
Buildings	622,818,100	139,298,098	67,918,034	(1,540,344)	828,493,888
Machinery and Equipment	223,436,199		17,876,469	(17,291,750)	224,020,918
General Infrastructure	78,546,485	12,020,437	6,356,081		96,923,003
Total Capital Assets, Depreciable	924,800,784	151,318,535	92,150,584	(18,832,094)	1,149,437,809
Less Accumulated Depreciation/Amortization for:					
Buildings	238,136,273		16,983,274	(1,214,834)	253,904,713
Machinery and Equipment	140,581,690		20,572,234	(11,389,110)	149,764,814
General Infrastructure	17,777,691		2,065,716		19,843,407
Total Accumulated Depreciation	396,495,654		39,621,224	(12,603,944)	423,512,934
Total Capital Assets, Depreciable, Net	528,305,130	151,318,535	52,529,360	(6,228,150)	725,924,875
Capital Assets, Net	\$ 766,108,970	\$ 0	\$ 159,112,984	\$ (6,228,150)	\$ 918,993,804

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

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

	Amount
Accounts Payable	\$ 30,483,973
Accrued Payroll	3,982,450
Contract Retainage	5,263,241
Other	789,701
Total Accounts Payable and Accrued Liabilities	\$ 40,519,365

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 7 - SHORT-TERM DEBT – COMMERCIAL PAPER PROGRAM

The University has available Commercial Paper Program financing for short-term credit up to \$60,000,000 to finance capital construction projects. The University's available funds are pledged to the Commercial Paper Program financing with the anticipation of converting to general revenue bond financing in the future. As of June 30, 2005, \$2,000,000 in Tax-Exempt Commercial Paper was outstanding. Short-term debt activity for the year ended June 30, 2005, was as follows:

	Balance July 1, 2004	Draws	Repayments	Balance June 30, 2005
Commercial Paper Program	\$ 15,000,000	\$ 21,000,000	\$ (34,000,000)	\$ 2,000,000

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	\$ 145,637,000	\$ 81,615,000	\$ (13,457,000)	\$ 213,795,000	\$ 8,180,000
Add/Deduct Premium/Discount	2,279,458	6,086,461	(92,123)	8,273,796	
Total Bonds Payable	147,916,458	87,701,461	(13,549,123)	222,068,796	8,180,000
Capital Leases Payable	170,755		(71,492)	99,263	78,184
Compensated Absences	42,179,635	24,987,959	(23,620,932)	43,546,662	1,968,411
Total Long-Term Liabilities	\$ 190,266,848	\$ 112,689,420	\$ (37,241,547)	\$ 265,714,721	\$ 10,226,595

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	Principal Outstanding 06/30/2005
STUDENT HOUSING SYSTEM						
Dormitory Complex	(1) G	3.00%	09/01/2006	\$ 3,225,000	\$ 2,950,000	\$ 275,000
Refund Housing System Series H, J, & K	(1) N	5-5.8%	09/01/2009	4,110,000	2,725,000	1,385,000
Resident Hall Improvement Project	(1) (A)	3.25-5%	10/01/2010	15,770,000	6,835,000	8,935,000
Housing System Project	(1) (B)	5-5.5%	10/01/2010	<u>3,020,000</u>	<u>1,025,000</u>	<u>1,995,000</u>
Total Student Housing System				<u>26,125,000</u>	<u>13,535,000</u>	<u>12,590,000</u>
DINING HALL SYSTEM						
Dining Hall System Refunding Bonds	(2) 1996	4-5.3%	02/01/2012	<u>2,345,000</u>	<u>865,000</u>	<u>1,480,000</u>
STUDENT HEALTH SYSTEM						
Student Health Facility Project	(3) (A)	3.25-5.25%	10/01/2013	<u>5,615,000</u>	<u>1,810,000</u>	<u>3,805,000</u>
PARKING SYSTEM						
Parking System Refunding Bonds	(4) 1996	4-5.1%	06/01/2009	<u>6,530,000</u>	<u>3,605,000</u>	<u>2,925,000</u>
ATHLETIC SYSTEM						
Entertainment and Sports Arena Project	(5) (A)	3.25-5.25%	10/01/2018	<u>6,325,000</u>	<u>1,340,000</u>	<u>4,985,000</u>
CENTENNIAL CAMPUS SYSTEM						
Centennial Campus Projects	(6) 1997A	6.55-7.04%	12/15/2010	7,765,000	3,790,000	3,975,000
Centennial Campus Projects	(6) 1999A	Variable	12/15/2019	<u>13,500,000</u>	<u>500,000</u>	<u>13,000,000</u>
Total Centennial Campus System				<u>21,265,000</u>	<u>4,290,000</u>	<u>16,975,000</u>
STUDENT CENTER SYSTEM						
University Student Center	(7) 1996	4.5-5.1%	11/01/2009	<u>2,210,000</u>	<u>1,030,000</u>	<u>1,180,000</u>
CENTRAL STORES						
Stores Expansion Project	(8) (B)	5-5.75%	10/01/2020	<u>3,370,000</u>	<u>430,000</u>	<u>2,940,000</u>
GENERAL REVENUE						
Refund Housing System Series L & M	(9) 2002B	2-5%	10/01/2014	8,800,000	1,345,000	7,455,000
Centennial Campus Projects	(9) 2002C	2.75-6.45%	10/01/2013	7,160,000	1,415,000	5,745,000
Housing System Projects	(9) 2003A	2-5%	10/01/2018	26,735,000		26,735,000
Housing System Projects	(9) 2003B	Variable	10/01/2027	45,660,000	295,000	45,365,000
Various Construction Projects	(9) 2005A	3-5%	10/01/2025	<u>81,615,000</u>		<u>81,615,000</u>
Total General Revenue				<u>169,970,000</u>	<u>3,055,000</u>	<u>166,915,000</u>
Total Bonds Payable (principal only)				<u>\$ 243,755,000</u>	<u>\$ 29,960,000</u>	213,795,000
Less: Unamortized Discount						(130,589)
Plus: Unamortized Premium						<u>8,404,385</u>
Total Bonds Payable						<u>\$ 222,068,796</u>

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

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Designated student fees and revenue streams related to the systems financed above have been pledged for the payment of these bonds. In addition, fund reservations required by the Bond Indentures have been established and recorded as restricted net assets. The following revenues as summarized in Note 10 have been pledged or are security for the bonds.

- | | |
|---|--------------------------------|
| (1) Residential Life Revenues (Housing) | (6) Centennial Campus Revenues |
| (2) Dining Revenues | (7) Student Center Revenues |
| (3) Student Health Revenues | (8) Central Stores Revenues |
| (4) Parking Revenues | (9) Available Funds |
| (5) Athletic Revenues | |

Available funds, as defined in the General Indenture dated October 1, 2001, are any funds of NC State in each fiscal year remaining after satisfying debt obligations excluding (1) State appropriations, (2) tuition payments, (3) funds restricted by gift, grant, or payee, (4) revenues from special facilities, and (5) funds restricted by law. Available funds are not pledged to the trustee, but rather are the source from which principal and interest on the bonds will be paid.

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

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

The North Carolina State University at Raleigh Variable Rate Revenue Bonds (Centennial Campus Projects), Series 1999A: On September 22, 1999, the University issued tax-exempt variable rate demand bonds in the amount of \$13,500,000 that have a final maturity date of December 15, 2019. The bonds are subject to mandatory sinking fund redemption that begins on December 1, 2000. The University’s proceeds of this issuance were used to (i) discharge a portion of a loan from First Union National Bank, the proceeds from which were used for the construction and equipping of a building known as the Partners II Building located on the Centennial Campus of NC State, (ii) paying the cost of relocating utility easements on the Centennial Campus of NC State, and (iii) paying the costs incurred in connection with the issuance of the 1999A Bonds.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the paying agent, The Bank of New York. Upon notice from the paying agent, the remarketing agent, Lehman Brothers, Inc., has agreed to exercise its best efforts to remarket the bonds for which a notice of purchase has been received.

Under a Standby Bond Purchase Agreement (Agreement) between the Board of Governors of the University of North Carolina and First Union National Bank, a Liquidity Facility has been established for the Trustee (The Bank of New York) to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. This Agreement requires a commitment fee equal to 0.20% of the available commitment, payable quarterly in arrears, beginning on October 1, 1999, and on each January 1, April 1, and July 1 thereafter until the expiration date or the termination date of the Agreement.

Under the Agreement, any bonds purchased through the Liquidity Facility become Liquidity Provider Bonds and shall, from the date of such purchase and while they are Liquidity Provider Bonds, bear interest at the Liquidity Provider Rate (the greater of the Bank prime commercial lending rate and Federal Funds Rate plus 0.5%). Upon remarketing of Liquidity Provider Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Liquidity Provider Bonds. Payment of the interest on the Liquidity Provider Bonds is due the first business day of each month in which Liquidity Provider Bonds are outstanding. At June 30, 2005, there were no Liquidity Provider Bonds held by the Liquidity Facility. The original Liquidity Facility has been extended and is scheduled to expire on September 15, 2008, unless otherwise extended based on the terms of the agreement.

Upon expiration or termination of the Agreement, the University is required to redeem (purchase) the Liquidity Provider Bonds held by the Liquidity Facility in 20 quarterly installments, beginning the first business day that is at least 180 days following such expiration date or termination date along with accrued interest at the Liquidity Provider Rate. In the event the entire issue of \$13,000,000 of demand bonds was “put” and not resold, the University would be required to pay \$3,028,778 a year for 5 years under this agreement assuming a 6 percent interest rate.

Effective October 1, 1999, the University entered into an interest rate swap contractual agreement with Lehman Brothers, Inc., on \$9,000,000 of these demand bonds. Under this agreement, the University will pay interest at a fixed rate of 4.574%. On a monthly basis the difference

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

between 67% of the weighted average of the weekly LIBOR (London Interbank Offered Rates) rate and the fixed rate will be calculated. If the fixed rate is greater than the LIBOR calculated rate, the University will pay the difference to Lehman Brothers, Inc. If the LIBOR rate is greater, Lehman Brothers will refund the difference to the University. During the fiscal year, the University paid Lehman Brothers \$279,692 under this agreement.

The North Carolina State University at Raleigh Variable Rate General Revenue Bonds, Series 2003B: On June 20, 2003, the University issued tax-exempt variable rate revenue demand bonds in the amount of \$45,660,000 that have a final maturity date of October 1, 2027. The bonds are subject to mandatory sinking fund redemption that began on October 1, 2004. The University's proceeds of this issuance were used to pay a portion of the costs of certain improvements on the campus of the University, to refund certain debt previously incurred for that purpose, and to pay the costs incurred in connection with the issuance of the 2003B bonds.

While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the paying agent, The Bank of New York. Upon notice from the paying agent, the remarketing agent, UBS Financial Services Inc., has agreed to exercise its best efforts to remarket the bonds for which a notice of purchase has been received.

Under a Standby Bond Purchase Agreement (Agreement) between the Board of Governors of the University of North Carolina and Bayerische Landesbank, a Liquidity Facility has been established for the Trustee (The Bank of New York) to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. This Agreement requires a commitment fee equal to 0.20% of the available commitment, payable quarterly in arrears, beginning on July 1, 2003, and on each October 1, January 1, April 1, and July 1 thereafter until the expiration date or the termination date of the Agreement.

Under the Agreement, any bonds purchased through the Liquidity Facility become Liquidity Provider Bonds and shall, from the date of such purchase and while they are Liquidity Provider Bonds, bear interest at the Liquidity Provider Rate (the greater of the Bank prime commercial lending rate and Federal Funds Rate plus 0.5%). Upon remarketing of Liquidity Provider Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Liquidity Provider Bonds. Payment of the interest on the Liquidity Provider Bonds is due the first business day of each month in which Liquidity Provider

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Bonds are outstanding. At June 30, 2005, there were no Liquidity Provider Bonds held by the Liquidity Facility. The original Liquidity Facility expiration date has been extended and is scheduled to expire on November 30, 2015, unless otherwise extended based on the terms of the Agreement.

Upon expiration or termination of the Agreement, the University is required to redeem (purchase) the Liquidity Provider Bonds held by the Liquidity Facility in 20 quarterly installments, beginning the first business day of January, April, July, or October, whichever first occurs on or following the Purchase Date along with accrued interest at the Liquidity Provider Rate. In the event the entire issue of \$45,365,000 of demand bonds was "put" and not resold, the University would be required to pay \$10,569,271 a year for five years under this agreement assuming a 6 percent interest rate.

Effective June 20, 2003, the University entered into an interest rate swap contractual agreement with Bank of America, Inc., on \$24,655,000 of these demand bonds. Under this agreement the University will pay interest at a fixed rate of 3.54%. On a monthly basis the difference between the weighted average of the weekly BMA (the Bond Market Association Municipal Swap Index) rate and the fixed rate will be calculated. If the fixed rate is greater than the BMA calculated rate, the University will pay the difference to Bank of America, Inc. If the BMA rate is greater, Bank of America will refund the difference to the University. During the fiscal year the University paid Bank of America \$447,497 under this agreement.

Effective June 20, 2003, the University entered into an interest rate swap contractual agreement with Bank of America Inc., on \$21,005,000 of these demand bonds. Under this agreement the University will pay interest at a fixed rate of 1.19%. On a monthly basis the difference between the weighted average of the weekly BMA (the Bond Market Association Municipal Swap Index) rate and the fixed rate will be calculated. If the fixed rate is greater than the BMA calculated rate, the University will pay the difference to Bank of America, Inc. If the BMA rate is greater, Bank of America will refund the difference to the University. During the fiscal year the University received from Bank of America \$110,792 under this agreement. This swap terminates on July 1, 2005.

Interest Rate Swaps:

Objective: In order to protect against the potential of rising interest rates, the University entered into three separate pay-fixed, receive-variable

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

interest rate swaps at a cost anticipated to be less than what the University would have paid to issue fixed-rate debt.

Terms, fair values, and credit risk: The University's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled or anticipated reductions in the associated "bonds payable" category. The terms, fair values, and credit ratings of the outstanding swaps as of June 30, 2005, were as follows.

Associated Bond Issue	Notional Amount	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Counterparty Credit Rating
Centennial Campus 1999A	\$ 9,000,000	10/1/1999	4.574%	67% of LIBOR ¹	\$ (1,074,844)	12/1/2019	A1 / A+ / A+
General Revenue 2003B	24,655,000	6/20/2003	3.54%	BMA ^{2,3}	(572,074)	10/1/2027	Aa1 / AA / AA
General Revenue 2003B	<u>20,710,000</u>	6/20/2003	1.19%	BMA	<u> </u>	7/1/2005 ⁴	Aa1 / AA / AA
Total	<u>\$ 54,365,000</u>				<u>\$ (1,646,918)</u>		

¹ London Interbank Offered Rate

² The Bond Market Association Municipal Swap Index TM

³ Variable rate received is BMA Municipal Swap Index from 6/20/03 to 7/1/06, thereafter, the variable rate received will be 75% of LIBOR.

⁴ Counterparty had the option to extend the swap to July 1, 2007, which was not exercised.

Because rates have declined since the effective dates of the swaps, both the 1999A and 2003B swaps have a negative fair value as of June 30, 2005. The negative fair value may be countered by a reduction in total interest payments required under the variable-rate bonds, creating lower synthetic interest rates. Because the coupons on the University's variable-rate bonds adjust to changing interest rates, the bonds do not have corresponding fair value increases. The fair values are the market values as of June 30, 2005.

As of June 30, 2005, the University was not exposed to credit risk in the amount of the positive fair value on the swaps. The swap agreements require termination should the University's or the counterparty's credit rating fall below either Baa2 as issued by Moody's Investors Services or BBB as issued by Standard & Poor's or Fitch Ratings. Also, under the terms of the swap agreements, should one party become insolvent or otherwise default on its obligations, provisions permit the nondefaulting party to accelerate and terminate all outstanding transactions. Of the three agreements entered into by the University, two swaps, approximating 83% of the notional amount of the swaps outstanding, are held with one counterparty. All the counterparties are rated A1 or better.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Basis risk: The University is exposed to basis risk on the swaps when the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence, the expected cost savings may not be realized. As of June 30, 2005, the BMA rate was 2.28 percent, whereas 67% of LIBOR was 2.24 percent.

Termination risk: The University or the counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. If any of the swaps are terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the University would be liable to the counterparty for that amount.

Swap payments and associated debt: As rates vary, variable-rate debt and net swap payments will vary. 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.

<u>Fiscal Year</u>	<u>Bonds</u>			
	<u>Principal</u>	<u>Interest</u>	<u>Interest Rate Swaps, Net</u>	<u>Total</u>
2006	\$ 900,000	\$ 1,284,137	\$ 502,221	\$ 2,686,358
2007	915,000	1,263,333	492,877	2,671,210
2008	925,000	1,242,258	481,195	2,648,453
2009	1,040,000	1,219,734	469,515	2,729,249
2010	1,060,000	1,195,654	457,834	2,713,488
2011-2015	5,300,000	5,610,572	2,076,574	12,987,146
2016-2020	10,470,000	4,887,249	1,672,411	17,029,660
2021-2025	22,510,000	2,917,603	1,374,849	26,802,452
2026-2030	15,245,000	507,994	197,568	15,950,562
Total	<u>\$ 58,365,000</u>	<u>\$ 20,128,534</u>	<u>\$ 7,725,044</u>	<u>\$ 86,218,578</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

<u>Fiscal Year</u>	<u>Annual Requirements</u>	
	<u>Bonds Payable</u>	
	<u>Principal</u>	<u>Interest</u>
2006	\$ 8,180,000	\$ 9,122,055
2007	9,335,000	8,191,068
2008	9,625,000	7,779,405
2009	9,890,000	7,352,492
2010	9,340,000	6,902,867
2011-2015	49,900,000	28,002,350
2016-2020	49,885,000	16,444,129
2021-2025	46,860,000	7,223,209
2026-2030	20,780,000	635,300
Total Requirements	\$ 213,795,000	\$ 91,652,875

Interest on the variable rate 1999A is calculated at 2.35% and the 2003B revenue bonds is calculated at 2.18%, the rates in effect at June 30, 2005, for each series.

The variable rate is changed weekly every Wednesday by the Remarketing agent with a maximum rate of 12%. In addition, the University has entered into interest rate swaps to synthetically fix a portion of the 1999A and 2003B bonds. See note 8C for more information on the demand bonds and the interest rate swaps.

E. Bond Defeasance - The University has extinguished long-term debt obligations by the issuance of new long-term debt instruments or by advance cash payout as follows:

In fiscal year 2004 the University defeased \$935,000 of outstanding University of North Carolina System Pool Revenue Bonds, Series 1998B (original issue amount \$1,695,000). An irrevocable trust was established 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 University of North Carolina System Pool Revenue Bonds, Series 1998B, was \$720,000.

On February 10, 2005, the University defeased \$7,090,000 of outstanding North Carolina State University at Raleigh Revenue Bonds (Centennial Campus Projects), Series 1997B (original issue amount \$7,090,000). 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

University's Statement of Net Assets. As a result, the University reduced its debt service requirements by \$307,435 over the next 13 years and obtained an economic gain of \$406,928. At June 30, 2005, the outstanding balance of the defeased North Carolina State University at Raleigh Revenue Bonds (Centennial Campus Projects), Series 1997B, was \$7,090,000.

NOTE 9 - LEASE OBLIGATIONS

- A. Capital Lease Obligations** - Capital lease obligations relating to 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	\$ 83,742
2007	17,733
2008	<u>4,485</u>
Total Minimum Lease Payments	105,960
Amount Representing Interest (8.74% Rate of Interest)	<u>6,697</u>
Present Value of Future Lease Payments	<u><u>\$ 99,263</u></u>

Machinery and equipment acquired under capital lease amounted to \$338,317 at June 30, 2005.

- B. Operating Lease Obligations** - The University entered into operating leases for equipment and property rental. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2005:

<u>Fiscal Year</u>	<u>Amount</u>
2006	\$ 4,482,814
2007	3,393,758
2008	1,632,394
2009	1,086,119
2010	360,647
2011-2015	<u>6,918</u>
Total Minimum Lease Payments	<u><u>\$ 10,962,650</u></u>

Rental expense for all operating leases during the year was \$3,501,438.

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 Allowance for Uncollectibles	Net Revenues	Revenues Pledged as Security for Debt
Operating Revenues:						
Student Tuition and Fees	\$ 153,297,460	\$ 0	\$ 31,604,185	\$ 13,974	\$ 121,679,301	\$ 17,918,491 (D,E,F,G)
Other Revenues	\$ 12,295,644	\$ 4,281,810	\$ 0	\$ 375,736	\$ 7,638,098	\$ 4,818,204 (A)
Sales and Services:						
Sales and Services of Auxiliary Enterprises:						
Residential Life	\$ 27,268,553	\$ 295,678	\$ 4,766,078	\$ 49,478	\$ 22,157,319	\$ 27,268,553 (B)
Dining	18,033,971	1,820,141	1,419,422	(6,195)	14,800,603	18,033,971 (C)
Bookstore	14,596,836	533,907			14,062,929	
Athletics	28,661,903	297,382		(51)	28,364,572	28,661,903 (D)
Parking	5,613,957	610,682		(146,729)	5,150,004	5,613,957 (E)
Student Center	592,503	151,502		(2,363)	443,364	592,503 (F)
Student Health	3,277,588	210,202	634,148	(11,484)	2,444,722	3,277,588 (G)
Other	12,659,744	8,187,243	1,388,118	(12,258)	3,096,641	1,338,933 (H)
Sales and Services of Education and Related Activities	61,053,310	24,090,624		(221,703)	37,184,389	
Total Sales and Services	\$ 171,758,365	\$ 36,197,361	\$ 8,207,766	\$ (351,305)	\$ 127,704,543	\$ 84,787,408

Revenue Bonds Secured by Pledged Revenues:

(A) Centennial Campus System	(E) Parking System
(B) Student Housing System	(F) Student Center System
(C) Dining System	(G) Student Health System
(D) Athletics System	(H) Other

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	\$ 211,128,935	\$ 19,728,006	\$ 23,410,317	\$ 0	\$ 3,481	\$ 0	\$ 254,270,739
Research	127,721,928	19,384,080	40,013,570		480,243		187,599,821
Public Service	69,245,125	7,061,110	21,206,069		245,486		97,757,790
Academic Support	34,042,814	12,704,894	14,155,064		8,721		60,911,493
Student Services	9,610,314	1,307,464	3,876,751		197		14,794,726
Institutional Support	43,748,128	2,642,499	7,159,800		3,981		53,554,408
Operations and Maintenance of Plant	20,730,784	9,607,275	6,122,209		20,919,781		57,380,049
Student Financial Aid	605,220	149,475	1,609,815	17,252,741			19,617,251
Auxiliary Enterprises	37,176,791	29,508,836	31,894,846		3,951,892		102,532,365
Depreciation						39,621,224	39,621,224
Total Operating Expenses	\$ 554,010,039	\$ 102,093,639	\$ 149,448,441	\$ 17,252,741	\$ 25,613,782	\$ 39,621,224	\$ 888,039,866

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 \$490,491,455, of which \$246,180,135 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$14,770,808 and \$5,342,109, respectively. The University made 100% of its annual required contributions for the years ended June 30, 2005, 2004, and 2003, which were \$5,342,109, \$528,928, 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)

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 \$490,491,455, of which \$149,936,887 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$8,996,213 and \$10,255,683, 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)

University. The voluntary contributions by employees amounted to \$1,697,990 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 percent 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 \$119,016. The voluntary contributions by employees amounted to \$3,063,605 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 \$8,943,034 for the year ended June 30, 2005.

- C. Federal Employment Retirement** - The Federal Retirement System is a multiple-employer retirement system and is composed of three retirement programs: the Civil Service Retirement System (CSRS) for participants employed prior to January 1, 1987, the Federal Employees Retirement System for Participants (FERS) employed after January 1, 1987, and the Civil Service Retirement Offset System for reemployed CSRS employees.

North Carolina Cooperative Extension employees with federal appointments prior to January 1, 1987, participate in the Civil Service Retirement System. Currently, 180 employees participate in CSRS. Participating employees are required by federal statute to contribute 7% of salary and the University 7% of salary to CSRS. In addition, the employees may contribute up to 10% of salary to the Thrift Savings Plan (a defined contribution plan managed by the Federal Retirement Thrift Investment Board). Total employee and employer contributions for CSRS for the year ended June 30, 2005, were \$859,308 and \$885,882

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

respectively. Employees covered under CSRS contributed \$56,467 to the Thrift Savings Plan.

Under the Federal Employees Retirement System (FERS), employees are required to contribute 0.8% of salary and the University 11.2%. Currently, 14 employees participate in FERS. The University is also required to contribute 1% of participant's salary to the Thrift Savings Plan, plus up to an additional 4% depending upon employee's contribution, which can range from 0% to 15% of their salary. Total employee and employer contributions for the year ended June 30, 2005, were \$8,276 and \$114,990 respectively. For employees covered under FERS the total employee and employer contributions to the Thrift Savings Plan for the year ended June 30, 2005, were \$109,572 and \$50,947 respectively.

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 \$12,675,745. The University assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.
- B. Long-Term Disability -** The University participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The University contributes .445% of covered payroll under the Teachers' and

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 \$1,762,721. 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, with the exception of one automobile liability claim settled in a previous fiscal year.

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.

The University is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a \$500 per occurrence deductible, except for the peril of theft with an applicable \$1,000 per occurrence deductible. University departments, as an individual business decision, may also purchase through the Fund primary extended coverage for buildings and contents. Coverage may also be purchased through the Fund for theft, vandalism, sprinkler leakage, or all-risk perils. University departments also have the option to purchase all-risk coverage for computers and "miscellaneous equipment" on a scheduled basis.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

and \$5,000,000 per occurrence. The University pays premiums to the North Carolina Department of Insurance for the coverage. While liability coverage is required by Statute for all University vehicles, departments may also individually opt to purchase collision and comprehensive physical damage coverage.

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 \$1,000,000 per occurrence with a \$25,000 deductible.

The University purchased other authorized coverage from private insurance companies through the North Carolina Department of Insurance and the State's Agent of Record. The types of insurance policies purchased include: Medical Professional Liability, Veterinary Professional Liability, Fine Arts Property, Master Crime, Inland Marine Property For Musical Instruments, Campers Accident and Sickness, Athletic Accident, Boiler and Machinery, Watercraft, Oceanographic Equipment, and Nuclear Energy Liability.

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.

Term life insurance (death benefits) of \$25,000 to \$50,000 is provided to eligible workers. This Death Benefit Plan is administered by the State Treasurer and funded via employer contributions. There were no employer contributions required for the current fiscal year.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 15 - COMMITMENTS AND CONTINGENCIES

- A. Commitments** - The University has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were \$52,833,583 at June 30, 2005.
- B. Pending Litigation and Claims** – As previously reported, the Environmental Protection Agency (EPA) filed a civil action against the University pursuant to the Comprehensive Environmental Response, Compensation and Liability Act. The complaint sought relief that would cause the University to enter into remediation of a hazardous waste site known as “Lot 86.” The University is involved in ongoing discussions and negotiations with the EPA concerning the appropriate means for addressing the remediation. A Consent Decree executed by North Carolina State University and the EPA has been approved by the Court. Remedial clean-up pursuant to the Consent Decree continues. The remediation costs paid by the University for the year ended June 30, 2005, totaled \$29,937.

As previously reported, the NC School Boards Association, et. al., filed a civil action against various State officials in their official capacity. The complaint sought 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. In part, this civil action includes a determination of whether monetary payments collected pursuant to statutory authority by the University for violations of parking 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. On July 1, 2005, the NC Supreme Court held in favor of the school boards with regard to parking fines and held in favor of the University with regard to library fines. The matter has been remanded back to the trial court for disposition in accordance with the Superior Court’s decision. Determination of the amount due from the University is pending. At issue are approximately \$6,834,787 in transportation fines since December 1995 to June 30, 2005, and \$700,000 annually.

On October 8, 2004, a lawsuit was filed by Cree, Inc. (Corporation) against the University for breach of contract. The lawsuit alleges that NC State, along with certain graduate students, were attempting to establish a new start-up technology company to compete against the Corporation and the corresponding “Option and License Agreements.” The University has spent approximately \$362,846 to date for outside

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

counsel fees and related litigation costs on the lawsuit, and costs could exceed \$1,000,000 before the case is settled.

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 \$188,721,328 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

NOTE 16 - RELATED PARTIES

Foundations - There are 11 separately incorporated nonprofit foundations associated with the University. These foundations are the North Carolina Agricultural Foundation, Inc., North Carolina State University Foundation, Inc., North Carolina Tobacco Foundation, Inc., Pulp and Paper Foundation, Inc., North Carolina State University Physical and Mathematical Sciences Foundation, Inc., North Carolina Engineering Foundation, Inc., North Carolina

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Veterinary Medical Foundation, Inc., The North Carolina Forestry Foundation, Inc., North Carolina Textile Foundation, Inc., NCSU Student Aid Association, Inc., and the North Carolina State Alumni Association, Inc. During fiscal year 2005 the North Carolina Dairy Foundation, Inc., merged as part of the North Carolina Agricultural Foundation, Inc.

These organizations serve 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. As described in Note 1 to the financial statements, The North Carolina State University Foundation, Inc., and the NCSU Student Aid Association, Inc., are considered component units of the University for reporting purposes and their financial statements are presented separately as part of the University's financial statements. 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 of the foundations, excluding amounts from the North Carolina State University Foundation, Inc., and the NCSU Student Aid Association, Inc., approximated \$20,230,075 for the year ended June 30, 2005, for noncapital purposes.

Non-Profit Corporation - The Centennial Authority (Authority) was created by the 1995 General Assembly (Senate Bill 606) for the purpose of studying, designing, planning, constructing, owning, promoting, financing and operating a regional facility on land owned by the State. Prior to this act, the General Assembly authorized the construction by the University of a facility to be known as the "Entertainment and Sports Arena" (ESA). This facility serves as a regional sports entertainment center and is available for cultural performances, sporting events and other activities of the University or of other entities (the centennial center project). With the 1995 legislation, the centennial center project was transferred to the Authority.

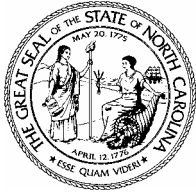
The Authority entered into a Ground Lease with the State of North Carolina to lease land for the ESA for a period of 99 years at an annual rent of \$1. The University entered into a Use Agreement with the Authority. Both parties agreed that the University shall be the primary and preferred user of all areas of the ESA. The University is required to pay the greater of 10% of gross ticket revenues or \$43,315 for each men's and \$18,944 for each women's basketball game to compensate the Authority for facility rental and operating expenses. Rent and expense payments for miscellaneous events will be negotiated on an event by event basis based on the availability of the ESA and the anticipated attendance.

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

In fiscal year 2003 a naming rights agreement was executed to change the name of the ESA to the “RBC Center.” As a result of this agreement, the University will receive \$13,184,000 over a ten-year period beginning in fiscal year 2003.

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, 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.



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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**

Board of Trustees
North Carolina State University
Raleigh, North Carolina

We have audited the financial statements of North Carolina State University, 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 18, 2005. We did not audit the financial statements of the North Carolina State University Foundation, Inc. and the NCSU Student Aid Association, Inc., which represent 100% of the University's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for the North Carolina State University Foundation, Inc., and the NCSU Student Aid Association, Inc., is based on the reports of the other auditors.

As discussed in Note 17 to the financial statements, the University implemented Governmental Accounting Standards Board Statement No. 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 discretely presented component units were not audited in accordance with *Government Auditing Standards*, and accordingly, this report does not extend to the discretely presented component units.

Internal Control Over Financial Reporting

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

**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)**

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 18, 2005

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Director, Fiscal Research Division

January 13, 2006

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