STATE OF
NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA SCHOOL OF THE ARTS

WINSTON-SALEM, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2005

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

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Office of the State Auditor

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

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AUDITOR'S TRANSMITTAL

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

We have completed a financial statement audit of North Carolina School of the Arts 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

November 29, 2005

TABLE OF CONTENTS

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of the North Carolina School of the Arts, 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 School's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the North Carolina School of the Arts' management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the North Carolina School of the Arts Foundation, Inc., and the NCSA Housing Corporation, which represent 100% of the School's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for those entities, is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the North Carolina School of the Arts Foundation, Inc., and the NCSA Housing Corporation were not audited in accordance with *Government Auditing Standards*. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and 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 School of the Arts 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.

As discussed in Note 15 to the financial statements, the School 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 October 31, 2005, on our consideration of the School's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

Leslie W. Merritt, Jr.

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

October 31, 2005

Introduction

This section of the North Carolina School of the Arts financial report provides an overview of the financial position and activities for the year ended June 30, 2005. This discussion has been prepared by management along with the financial statements and related notes to the financial statements and should be read in conjunction with the financial statements and the notes thereto, which follow this section. This discussion and analysis is designed to focus on current activities, resulting change, and current known facts.

Using the Financial Statements

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

Statement of Net Assets

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

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

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

Nonexpendable restricted net assets include endowment investments, which are only available for investment purposes, and student loan funds. Expendable restricted net assets are available for expenditure by the School but must be spent for purposes as determined by donors and/or external entities that have placed certain restrictions on the use of the assets. This category includes restricted funds for endowment investments, capital projects, and a reserve for debt service. The final category is unrestricted net assets, which are available to the School for any lawful purpose of the School. The School uses available resources to acquire and improve all areas of the School to better serve the instructional and public service missions of the School. Please refer to the financial statements and notes for more detail.

Statement of Net Assets

	Year Ended June 30,	
	2005	**2004**
Assets		
Current Assets	$ 7,044,967.10	$ 5,586,834.56
Capital Assets, Net	90,014,611.06	85,068,046.23
Other Noncurrent Assets	7,399,752.43	5,024,468.68
Total Assets	104,459,330.59	95,679,349.47
Liabilities		
Current Liabilities	3,946,868.93	3,564,718.80
Noncurrent Liabilities	5,880,278.49	6,580,369.32
Total Liabilities	9,827,147.42	10,145,088.12
Net Assets		
Invested in Capital Assets, Net of Related Debt	85,129,611.06	79,742,828.35
Restricted:		
Nonexpendable	4,857,324.73	3,090,695.71
Expendable	1,996,128.94	812,881.81
Unrestricted	2,649,118.44	1,887,855.48
Total Net Assets	$ 94,632,183.17	$ 85,534,261.35

The total assets of the School increased by $8,779,981.12 for the year, which includes an increase of $1,458,132.54 in current assets and an increase of $7,321,848.58 in noncurrent assets. This overall increase was primarily due to a $7,387,060.92 increase in capital assets, net of accumulated depreciation of $2,440,496.09, bringing the net capital assets increase to $4,946,564.83. The largest capital assets increase was in construction in progress, with a $6,982,269.18 increase primarily attributable to increased expenditures in the general obligation bond projects during the 2004-2005 fiscal year. There was also $26,098,015.01 of adjustments out of the construction in progress account into the appropriate capital asset accounts due to the completion of construction. The $26,098,015.01 in adjustments were to the following capital asset accounts: $23,750,468.53 to buildings, $6,485.00 to machinery and equipment, $2,266,774.79 to general infrastructure, and $74,286.69 to land. In addition to the capital assets increase, the School received endowment gifts of $1,749,427.38 for the establishment of three new endowments and additional gifts to existing endowments; thereby increasing the noncurrent restricted cash and cash equivalents account.

The total liabilities of the School decreased by $317,940.70 for the year, which includes an increase of $382,150.13 in current liabilities and a decrease of $700,090.83 in noncurrent liabilities. The increase in total current liabilities was primarily attributable to a $215,674.71 increase in accounts payable, payroll, and contracts retained. The decrease in noncurrent liabilities was primarily attributable to a $560,000.00 net decrease in bonds and notes payable during the year. The net decrease resulted from the addition of a new bond issue for $1,900,000.00 and from reductions due to debt retirements and bond defeasances totaling $2,460,000.00.

Statement of Revenues, Expenses, and Changes in Net Assets

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

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

Statement of Revenues, Expenses, and Changes in Net Assets

	Year Ended June 30, 2005	Year Ended June 30, 2004
Operating Revenues		
Student Tuition and Fees, Net	$ 8,167,556.61	$ 8,040,040.19
Federal Grants and Contracts	566,336.58	612,560.62
Sales and Services, Net	3,783,221.25	3,954,210.73
Interest Earnings on Loans	1,051.32	629.59
Other Operating Revenues	372,136.66	557,978.49
Total Operating Revenues	12,890,302.42	13,165,419.62
Total Operating Expenses	38,081,653.74	36,194,898.71
Operating Loss	(25,191,351.32)	(23,029,479.09)
Nonoperating Revenues (Expenses)		
State Appropriations	20,592,001.64	19,756,862.97
Noncapital Grants	21,181.42	17,540.00
Noncapital Gifts	3,331,246.18	3,127,726.85
Investment Income (Net of Investment Expense)	216,469.14	287,629.53
Interest and Fees on Capital Asset-Related Debt	(313,929.74)	(250,377.84)
Other Nonoperating Revenues	8,643.12	2,751.75
Net Nonoperating Revenues	23,855,611.76	22,942,133.26
Loss Before Other Revenues	(1,335,739.56)	(87,345.83)
Capital Appropriations	564,400.00	95,900.00
Capital Grants	8,108,434.00	8,335,906.00
Capital Gifts	11,400.00	51,500.00
Additions to Permanent Endowments	1,749,427.38	500,000.00
Total Other Revenues	10,433,661.38	8,983,306.00
Change in Net Assets	9,097,921.82	8,895,960.17
Beginning Net Assets	85,534,261.35	76,638,301.18
Ending Net Assets	$ 94,632,183.17	$ 85,534,261.35

The Statement of Revenues, Expenses, and Changes in Net Assets reflects an increase in the net assets at the end of the year. Total net revenues were $47,179,575.56 for 2005 and $45,090,858.88 for 2004. The increase in total net revenues, $2,088,716.68, is due primarily to the increase in State appropriations of $835,138.67, increase in capital appropriations of $468,500.00, and the increase in additions to permanent endowments of $1,249,427.38. Some highlights of the information presented on the Statement of Revenues, Expenses, and Changes in Net Assets are as follows:

- Student tuition and fees reflects a slight increase primarily due to a change in the enrollment mix of resident and non-resident students.

- Other operating revenues decreased due to the decline of rental income from the Stevens Center.
- State appropriations increased due to an increase for operating funds for new acquisitions and facilities constructed.
- Noncapital gifts increased due to additional gifts for the Kenan Arts Institute and A.J. Fletcher Opera Institute. These gifts were in conjunction with the School managing the accounting for the Institutes.
- Other nonoperating revenues show an increase due to increased surplus property sales.
- Capital grants continued to decrease due to a reduction in construction projects funded under the UNC bond projects.
- The School's endowments increased by $1,249,427.38 due to the establishment of three distinguished professorship endowments (Forsyth Dance Endowment, Forsyth Drama Endowment, and Forsyth Music Endowment) and additional gifts to the Nureyev Ballet and A.J. Fletcher Endowments.

Capital Asset and Debt Administration

The School refinanced two debt issues in the 2004-2005 fiscal year. The UNC System Pool Revenue Bonds, Series 2005B, for $1,900,000.00 was issued on April 14, 2005, and bond proceeds from this issue were used to refinance and defease $1,805,000.00 of outstanding UNC System Pool Revenue Bonds, Series 1998B (Refinancing of Dormitory and Dining Hall, Series 1989 for $595,000.00 and Dormitory HVAC Renovations Project for $405,000.00) and UNC System Pool Revenue Bonds, Series 2000 (Technology Infrastructure Upgrades Project for $405,000.00). The average interest rate decreased from 4.643% to 3.775%. Housing and Dining System revenues continue to be pledged for the retirement of this debt.

Economic Outlook

The School continued to face budget reductions in 2005 and will face additional reductions for 2006; however, the School has also received additional funding in 2006 for higher enrollment projections. The School has been very active working on plans to meet the budget reductions and also working on plans to allocate the new appropriation of funds as well as existing resources in ways necessary to deliver a high standard of classroom instruction and a high quality of student life.

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

One of the projects underway is the Dance Recital Hall that will give the School's dance department additional classroom space. Also included in the plans is a new dance costume design shop with more storage space for materials and sewing machines, with climate control to prevent the deterioration of costumes, and a large exhaust fan to use when dying costumes.

A new residence for the Chancellor is in the developing stages. This will provide the Chancellor with a newly constructed condominium that has 6,000 square feet. The condominium is located five minutes from campus and will provide more room to host fund raising dinners and receptions for the School.

The remaining projects are property acquisitions on Chapel Street, Main Street, and Sunnyside Avenue, which would help to expand the campus for future growth.

The North Carolina School of the Arts (NCSA) and Winston-Salem State University (WSSU) are planning a collaborative program to establish the Center for Design Innovation as an inter-institutional center of mutual interest and benefit that will further the instructional, creative, service and research objectives of NCSA and WSSU in a manner consistent with their status as non-profit educational and research institutions. The School will initially receive $2 million for capital expenditures related to advanced technology and equipment needed to establish the Center.

North Carolina School of the Arts
Statement of Net Assets
June 30, 2005 — *Exhibit A-1*

ASSETS		
Current Assets:		
Cash and Cash Equivalents	$	5,414,942.70
Restricted Cash and Cash Equivalents		1,143,772.76
Receivables, Net (Note 4)		181,147.26
Due from University Component Units		18,447.00
Inventories		175,706.42
Notes Receivable, Net (Note 4)		110,950.96
Total Current Assets		7,044,967.10
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		3,463,285.86
Restricted Due from Primary Government		1,813,331.99
Endowment Investments		1,667,476.36
Other Long-Term Investments		100,470.38
Notes Receivable, Net (Note 4)		355,187.84
Capital Assets - Nondepreciable (Note 5)		10,124,844.78
Capital Assets - Depreciable, Net (Note 5)		79,889,766.28
Total Noncurrent Assets		97,414,363.49
Total Assets		104,459,330.59
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities (Note 6)		1,884,325.72
Deferred Revenue		1,228,560.88
Interest Payable		45,511.00
Long-Term Liabilities - Current Portion (Note 7)		788,471.33
Total Current Liabilities		3,946,868.93
Noncurrent Liabilities:		
Deposits Payable		50,250.00
Funds Held for Others		12,437.95
U. S. Government Grants Refundable		476,359.53
Long-Term Liabilities (Note 7)		5,341,231.01
Total Noncurrent Liabilities		5,880,278.49
Total Liabilities		9,827,147.42

NET ASSETS		
Invested in Capital Assets, Net of Related Debt		85,129,611.06
Restricted for:		
Nonexpendable:		
Endowed Professorships		3,022,963.07
Departmental Uses		1,767,000.00
Loans		67,361.66
Expendable:		
Scholarships and Fellowships		86,594.11
Endowed Professorships		218,498.97
Departmental Uses		213,497.90
Capital Projects		1,377,562.96
Debt Service		99,975.00
Unrestricted		2,649,118.44
Total Net Assets	$	94,632,183.17

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

North Carolina School of the Arts
Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Year Ended June 30, 2005 — *Exhibit A-2*

REVENUES		
Operating Revenues:		
Student Tuition and Fees, Net (Note 9)	$	8,167,556.61
Federal Grants and Contracts		566,336.58
Sales and Services, Net (Note 9)		3,783,221.25
Interest Earnings on Loans		1,051.32
Other Operating Revenues		372,136.66
Total Operating Revenues		12,890,302.42
EXPENSES		
Operating Expenses:		
Salaries and Benefits		24,575,747.01
Supplies and Materials		3,122,268.27
Services		5,839,745.86
Scholarships and Fellowships		564,523.27
Utilities		1,538,873.24
Depreciation		2,440,496.09
Total Operating Expenses		38,081,653.74
Operating Loss		(25,191,351.32)
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		20,592,001.64
Noncapital Grants		21,181.42
Noncapital Gifts		3,331,246.18
Investment Income (Net of Investment Expense of $12,073.90)		216,469.14
Interest and Fees on Capital Asset-Related Debt		(313,929.74)
Other Nonoperating Revenues		8,643.12
Net Nonoperating Revenues		23,855,611.76
Loss Before Other Revenues		(1,335,739.56)
Capital Appropriations		564,400.00
Capital Grants		8,108,434.00
Capital Gifts		11,400.00
Additions to Endowments		1,749,427.38
Increase in Net Assets		9,097,921.82
NET ASSETS		
Net Assets - July 1, 2004		85,534,261.35
Net Assets - June 30, 2005	$	94,632,183.17

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

North Carolina School of the Arts
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2005 — *Exhibit A-3*

CASH FLOWS FROM OPERATING ACTIVITIES	
Received from Customers	$ 13,131,954.32
Payments to Employees and Fringe Benefits	(24,584,093.41)
Payments to Vendors and Suppliers	(10,240,718.40)
Payments for Scholarships and Fellowships	(564,523.27)
Loans Issued	(153,891.75)
Collection of Loans	188,976.19
Interest Earned on Loans	1,612.22
US Government Grants Refundable Receipts	8,977.83
Student Deposits Received	60,450.00
Student Deposits Returned	(49,900.00)
Net Cash Used by Operating Activities	(22,201,156.27)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State Appropriations	20,592,001.64
Noncapital Grants	21,181.42
Noncapital Gifts	3,647,151.55
Additions to Permanent and Term Endowments	1,749,427.38
William D. Ford Direct Lending Receipts	4,186,472.00
William D. Ford Direct Lending Disbursements	(4,186,472.00)
Related Activity Agency Disbursements	(862.32)
Net Cash Provided by Noncapital Financing Activities	26,008,899.67
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES	
Proceeds from Capital Debt	1,900,000.00
State Capital Appropriations	564,400.00
Capital Grants	7,525,270.03
Proceeds from Sale of Capital Assets	8,643.12
Acquisition and Construction of Capital Assets	(7,615,723.50)
Principal Paid on Capital Debt	(2,460,000.00)
Interest and Fees Paid on Capital Debt	(325,528.46)
Net Cash Used by Capital Financing and Related Financing Activities	(402,938.81)
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from Sales and Maturities of Investments	394,250.78
Investment Income	193,313.99
Purchase of Investments and Related Fees	(314,594.01)
Net Cash Provided by Investing Activities	272,970.76
Net Increase in Cash and Cash Equivalents	3,677,775.35
Cash and Cash Equivalents - July 1, 2004	6,344,225.97
Cash and Cash Equivalents - June 30, 2005	$ 10,022,001.32

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

Operating Loss	$	(25,191,351.32)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:		
Depreciation Expense		2,440,496.09
Allowances, Write-Offs, and Amortizations		47,001.33
Changes in Assets and Liabilities:		
Receivables (Net)		51,074.68
Due from University Component Units		(1,341.25)
Inventories		11,100.50
Accounts Payable and Accrued Liabilities		399,741.43
US Government Grants Refundable		8,977.83
Due to Primary Government		(14,567.92)
Deferred Revenue		202,525.27
Compensated Absences		(200,447.36)
Deposits Payable		10,550.00
Student Loans Issued		(153,891.75)
Student Loan Principal Repayments		188,976.20
Net Cash Used by Operating Activities	$	(22,201,156.27)

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:		
Cash and Cash Equivalents	$	5,414,942.70
Restricted Cash and Cash Equivalents		1,143,772.76
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		3,463,285.86
Total Cash and Cash Equivalents - June 30, 2005	$	10,022,001.32

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through a Gift	$	11,400.00
Change in Fair Value of Investments		22,987.08
Reinvested Distributions		24,569.84
Loss on Disposal of Capital Assets		(47,352.74)

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

North Carolina School of the Arts Foundations
Statement of Financial Position
June 30, 2005 *Exhibit B-1*

	North Carolina School of the Arts Foundation, Inc.				
	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**	**Total**	**NCSA Housing Corporation**
ASSETS					
Cash and Cash Equivalents	$ 366,671	$ 659,975	$ 347,468	$ 1,374,114	$ 62,160
Investments		3,552,447	13,109,030	16,661,477	
Annuity Investments			1,077,862	1,077,862	
Beneficial Interest in Perpetual Trusts			744,874	744,874	
Beneficial Interest in Charitable Remainder Trusts			109,377	109,377	
Pledges Receivable, Net of Allowance and Discount of $663,784	18,458	832,790	2,352,640	3,203,888	
Accounts Receivable	7,521	2,245		9,766	
Rent Receivable					7,993
Due From (To) Other Funds	224,132	(224,132)			
Pepaid Expenses	9,398	25,485		34,883	5,273
Staff, Faculty and Student Loans Receivable	12,271	11,995		24,266	
Property and Equipment, Net	865,027	62,654		927,681	5,759,130
Total Assets	1,503,478	4,923,459	17,741,251	24,168,188	5,834,556
LIABILITIES					
Accounts Payable and Accrued Expenses	4,051	62,768		66,819	4,756
Returnable Advances			833,334	833,334	
Annuity Payment Liability			732,964	732,964	
Notes Payable		67,279		67,279	
Long-Term Debt					6,400,000
Total Liabilities	4,051	130,047	1,566,298	1,700,396	6,404,756
NET ASSETS					
Unrestricted	1,499,427			1,499,427	(570,200)
Temporarily Restricted		4,793,412		4,793,412	
Permanently Restricted			16,174,953	16,174,953	
Total Net Assets	$ 1,499,427	$ 4,793,412	$ 16,174,953	$ 22,467,792	$ (570,200)

See Note 1 in the Notes to the Financial Statements

North Carolina School of the Arts Foundations
Statement of Activities
For the Fiscal Year Ended June 30, 2005 — *Exhibit B-2*

	North Carolina School of the Arts Foundation, Inc.				
	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**	**Total**	**NCSA Housing Corporation**
REVENUES					
Gifts and Grants	$ 252,989	$ 1,512,967	$ 457,272	$ 2,223,228	$ 0
Production Income	54,989			54,989	
Interest and Dividend Income	37,860	323,281		361,141	190
Realized and Unrealized Gains		1,028,346		1,028,346	
Change in Fair Value of Split-Interest Agreements			140,516	140,516	
Change in Fair Value of Beneficial Interest in Perpetual Trusts		20,750	21,350	42,100	
Rent Income					624,456
Other Income	81,930	20,810		102,740	
Net Assets Released from Restrictions	2,511,338	(2,511,338)			
Total Revenues	2,939,106	394,816	619,138	3,953,060	624,646
EXPENSES					
Program Services:					
Scholarships and Awards	943,969			943,969	
School Programs	1,552,781			1,552,781	
Production Expenditures	54,989			54,989	
Utilities and Other Monthly Rental Costs					152,985
Depreciation Expense					276,394
Property Taxes					155
Maintenance					24,231
Insurance					26,792
Security					22,610
Total Program Services	2,551,739			2,551,739	503,167
Supporting Services:					
Administrative Costs	256,913			256,913	
Investment Management Fees	34,089			34,089	
Development Costs	318,821			318,821	
Depreciation Expense	14,583			14,583	
Total Supporting Services	624,406			624,406	
General and Administrative Services:					
Interest					281,235
Depreciation Expense					712
Professional Fees					60,299
Bad Debts					11,989
Miscellaneous Expense					11,859
Total General and Administrative Services					366,094
Total Expenses	3,176,145			3,176,145	869,261
Change in Net Assets Before Transfer	(237,039)	394,816	619,138	776,915	(244,615)
Transfer of Endowment Funds to the School			(250,000)	(250,000)	
Change in Net Assets	(237,039)	394,816	369,138	526,915	(244,615)
NET ASSETS					
Net Assets - Beginning of Year	1,736,466	4,398,596	15,805,815	21,940,877	(325,585)
Net Assets - End of Year	$ 1,499,427	$ 4,793,412	$ 16,174,953	$ 22,467,792	$ (570,200)

See Note 1 in the Notes to the Financial Statements

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NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

A. Financial Reporting Entity - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements. North Carolina School of the Arts 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 School and its component units. While the Board of Governors of the University of North Carolina System has ultimate responsibility, the Chancellor, the Board of Trustees, and the Board of Trustees of the Endowment Fund have delegated responsibilities for financial accountability of the School's funds. The School's component units are discretely presented in the School's financial statements. Discretely presented component units' financial data are reported in separate financial statements because of their use of different GAAP reporting models and to emphasize their legal separateness.

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

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

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

During the year ended June 30, 2005, the Foundation distributed $1,932,409.00 to the School for both restricted and unrestricted purposes. Complete financial statements for the Foundation can be obtained from the North Carolina School of the Arts Foundation, Inc., PO Box 12189, Winston-Salem, NC 27107.

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

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

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

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

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

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

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

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

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

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

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

F. **Receivables –** Receivables consist of tuition and fees charged to students, charges for auxiliary enterprises' sales and services, and student loans. Receivables also include amounts due from the federal and State governments, and from private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants. Student and note receivables are recorded net of estimated uncollectible amounts. All other receivables are shown at book value with no provision for uncollectible amounts considered necessary.

G. **Inventories –** Inventories, consisting of expendable supplies and postage, are valued at cost using the last invoice cost. Merchandise for resale is valued using the retail inventory method.

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

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

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

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

I. **Restricted Assets –** Unexpended capital contributions are classified as restricted assets because their use is limited by applicable donor/grantor agreements. Certain other assets are classified as restricted because their use is limited by external parties or statute.

J. **Noncurrent Long-Term Liabilities –** Noncurrent long-term liabilities include principal amounts of bonds payable, notes payable, and compensated absences that will not be paid within the next fiscal year. Premiums, discounts, and issuance costs are expensed for bonds and notes payable.

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

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

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

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

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

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

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

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

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

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

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

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

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

O. Internal Sales Activities – The School has miscellaneous sales and service units that operated either on a reimbursement or charge basis. All internal sales activities to School departments from sales and service units have been eliminated in the accompanying financial statements. These eliminations are recorded by removing the revenue and expense in the 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 School 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 School to deposit its institutional trust funds with the State Treasurer. Although specifically exempted, the School may voluntarily deposit endowment funds, special funds, revenue bond proceeds, and debt service funds with the State Treasurer. Special funds consist of moneys for agency funds held directly by the School.

At June 30, 2005, the School's deposit with the State Treasurer's Short-Term Investment Fund totaled $4,450,221.99. Deposit and investment risks associated with the State Treasurer's Investment Pool (which includes the State Treasurer's Short-Term Investment Fund) are included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page http://www.ncosc.net/ and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

The carrying amount of the School's deposits not with the State Treasurer was $3,905,038.00 and the bank balance was $4,118,669.92. Custodial credit risk is the risk that in the event of a bank failure, the School's deposits may not be returned to it. The School does not have a deposit policy for custodial credit risk. As of June 30, 2005, the School's bank balance was exposed to custodial credit risk as follows:

Uninsured and Uncollateralized	$ 3,825,377.45

B. Investments - The School 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 in the same manner as the State Treasurer is required to invest, as discussed below.

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

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

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

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

The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2005, for the Long-Term Investment Pool. 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 School's Endowment Board does not have a formal investment policy that addresses interest rate risk.

Long-Term Investment Pool

	Fair Value	Investment Maturities (in Years) Less Than 1
Investment Type		
Debt Securities		
Money Market Funds	$ 19,017.58	$ 19,017.58
Other Securities		
Other Mutual Funds	213,020.04	
Corporate Stocks	735,618.65	
Total Long-Term Investment Pool	$ 967,656.27	

Credit Risk: The School's Endowment Board does not have a formal policy that addresses credit risk. As of June 30, 2005, the Money Market Funds, with fair value of $19,017.58, were rated AAA by Standard and Poors.

Custodial Credit Risk: For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the School will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The School Endowment Board does not have a formal policy for custodial credit risk. The School's investments in the Long-Term Investment Pool were exposed to custodial credit risk as follows:

Investment Type	Held by Counterparty
Corporate Stocks	$ 735,618.65
Money Market Funds	19,017.58
Other Mutual Funds	213,020.04
Total	$ 967,656.27

Concentration of Credit Risk: The School Endowment Board places no limit on the amount the Board may invest in any one issuer. At June 30, 2005, the School's Long-term Investment Pool investments did not have 5% of investments in any one issuer.

Foreign Currency Risk: Foreign currency risk is defined by GASB Statement No. 40 as the risk that changes in exchange rates will adversely affect the fair value of an investment. The School Endowment Board does not have a formal policy for foreign currency risk. At June 30, 2005, the School's long-term investments were not exposed to foreign currency risk.

Non-Pooled Investments - The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2005, for the School's non-pooled investments. 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 School does not have a formal investment policy that addresses interest rate risk.

Non-Pooled Investments

	Fair Value	Investment Maturities (in Years) Less Than 1	6 to 10
Investment Type			
Debt Securities			
Mutual Bond Funds	$ 169,199.87	$ 0.00	$ 169,199.87
Money Market Funds	117,678.34	117,678.34	
		$ 117,678.34	$ 169,199.87
Other Securities			
Other Mutual Funds	513,412.26		
Total Non-Pooled Investments	$ 800,290.47		

Credit Risk: The School does not have a formal policy that addresses credit risk. As of June 30, 2005, the School's non-pooled investments were rated as follows:

	Fair Value	AAA	AA
Mutual Bond Funds	$ 169,199.87	$ 0.00	$ 169,199.87
Money Market Funds	117,678.34	117,678.34	
Total	$ 286,878.21	$ 117,678.34	$ 169,199.87

Rating Agency: Standard and Poors

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

Investment Type	Held by Counterparty
Money Market Funds	$ 117,678.34
Other Mutual Funds	513,412.26
Mutual Bond Funds	169,199.87
Total	$ 800,290.47

Concentration of Credit Risk: The School places no limit on the amount that may be invested in any one issuer. At June 30, 2005, the School's non-pooled investments did not have more than 5% in any one issuer.

Foreign Currency Risk: Foreign currency risk is defined by GASB Statement No. 40 as the risk that changes in exchange rates will adversely affect the fair value of an investment. The School does not have a formal policy for foreign currency risk. At June 30, 2005, the School's non-pooled investments were not exposed to foreign currency risk.

NOTE 3 - ENDOWMENT INVESTMENTS

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

NOTE 4 - RECEIVABLES

Receivables at June 30, 2005, were as follows:

	Gross Receivables	Less Allowance for Doubtful Accounts	Net Receivables
Current Receivables:			
Students	$ 137,118.12	$ 10,669.70	$ 126,448.42
Accounts	32,676.47		32,676.47
Interest on Loans	22,022.37		22,022.37
Total Current Receivables	$ 191,816.96	$ 10,669.70	$ 181,147.26
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	$ 134,518.15	$ 26,293.44	$ 108,224.71
Institutional Student Loan Programs	9,160.45	6,434.20	2,726.25
Total Notes Receivable - Current	$ 143,678.60	$ 32,727.64	$ 110,950.96
Notes Receivable - Noncurrent:			
Federal Loan Programs	$ 460,394.87	$ 105,207.03	$ 355,187.84

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	$ 3,253,093.11	$ 74,286.69	$ 15,525.43	$ 0.00	$ 3,342,905.23
Art, Literature, and Artifacts	261,964.44		11,400.00	15,000.00	258,364.44
Construction in Progress	25,639,320.94	(26,098,015.01)	6,982,269.18		6,523,575.11
Total Capital Assets, Nondepreciable	29,154,378.49	(26,023,728.32)	7,009,194.61	15,000.00	10,124,844.78
Capital Assets, Depreciable:					
Buildings	66,720,690.64	23,750,468.53	165,173.36		90,636,332.53
Machinery and Equipment	9,432,499.00	6,485.00	262,839.90	561,465.01	9,140,358.89
General Infrastructure	2,635,335.71	2,266,774.79	5,848.91		4,907,959.41
Total Capital Assets, Depreciable	78,788,525.35	26,023,728.32	433,862.17	561,465.01	104,684,650.83
Less Accumulated Depreciation for:					
Buildings	15,319,921.96		1,750,398.00		17,070,319.96
Machinery and Equipment	7,248,580.14		603,643.95	520,469.15	7,331,754.94
General Infrastructure	306,355.51		86,454.14		392,809.65
Total Accumulated Depreciation	22,874,857.61		2,440,496.09	520,469.15	24,794,884.55
Total Capital Assets, Depreciable, Net	55,913,667.74	26,023,728.32	(2,006,633.92)	40,995.86	79,889,766.28
Capital Assets, Net	$ 85,068,046.23	$ 0.00	$ 5,002,560.69	$ 55,995.86	$ 90,014,611.06

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

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

	Amount
Accounts Payable	$ 1,226,375.22
Accrued Payroll	413,534.89
Contract Retainage	244,415.61
Total Accounts Payable and Accrued Liabilities	$ 1,884,325.72

NOTE 7 - LONG-TERM LIABILITIES

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

	Balance July 1, 2004	Additions	Reductions	Balance June 30, 2005	Current Portion
Bonds Payable	$ 4,245,000.00	$ 1,900,000.00	$ 2,160,000.00	$ 3,985,000.00	$ 260,000.00
Notes Payable	1,200,000.00		300,000.00	900,000.00	300,000.00
Compensated Absences	1,445,149.70	765,308.04	965,755.40	1,244,702.34	228,471.33
Total Long-Term Liabilities	$ 6,890,149.70	$ 2,665,308.04	$ 3,425,755.40	$ 6,129,702.34	$ 788,471.33

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2005	Principal Outstanding 06/30/2005
Housing and Dining System						
Refunding 1998B and 2000 UNC System Pool Revenue Bonds	(B)	3.00%-4.25%	04/01/2019	$ 1,900,000.00	$ 0.00	$ 1,900,000.00
Fitness and Student Center Project	(A)	3.25%-5.25%	10/01/2018	2,650,000.00	565,000.00	2,085,000.00
Total Bonds Payable				$ 4,550,000.00	$ 565,000.00	$ 3,985,000.00

(A) The University of North Carolina System Pool Revenue Bonds, Series 1998B
(B) The University of North Carolina System Pool Revenue Bonds, Series 2005B

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

In addition, fund reservations in the amount of $99,975.00 required by the Series 2000 Bond Indenture for the Series 2000 Bonds had been established and recorded in a Bond Reserve Fund with the fiscal agent. Although the Series 2000 Bonds have been refinanced and were defeased as of June 30, 2005, the 2000 Bond Reserve Fund was not refunded by the fiscal agent until after July 1, 2005. At June 30, 2005, the balance in the Bond Reserve Fund was $100,470.38.

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

	Annual Requirements			
	Bonds Payable		Notes Payable	
Fiscal Year	Principal	Interest	Principal	Interest
2006	$ 260,000.00	$ 159,093.94	$ 300,000.00	$ 27,540.00
2007	265,000.00	152,281.26	300,000.00	18,360.00
2008	285,000.00	143,081.26	300,000.00	9,180.00
2009	290,000.00	133,231.26		
2010	295,000.00	122,531.26		
2011-2015	1,555,000.00	408,771.88		
2016-2019	1,035,000.00	99,337.50		
Total Requirements	$ 3,985,000.00	$ 1,218,328.36	$ 900,000.00	$ 55,080.00

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

Housing and Dining System: On April 14, 2005, the School defeased $1,805,000.00 of outstanding UNC System Pool Revenue Bonds, Series 1998B (original issue amount $1,970,000.00) and Series 2000 (original issue amount $1,005,000.00). 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 School's Statement of Net Assets. As a result, the School increased its debt service requirements by $196,775.18 over the next 14 years and obtained an economic gain of $6,614.34. By doing so, the School created room for additional capacity over the next 8 years to comfortably accommodate additional lease payments in order to expand the number and types of rooms offered through the Housing System. At June 30, 2005, the outstanding balance of the defeased UNC System Pool Revenue Bonds was $1,805,000.00.

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

Purpose	Financial Institution	Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2005	Principal Outstanding 06/30/2005
Student Commons Building Renovations	Wachovia Bank, N.A.	3.06%	04/17/2008	$ 1,500,000.00	$ 600,000.00	$ 900,000.00

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

NOTE 8 - OPERATING LEASE OBLIGATIONS

The School entered into operating leases for copiers and land. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2005:

Fiscal Year	Amount
2006	$ 41,123.88
2007	27,360.48
2008	22,494.96
2009	15,380.96
2010	6,000.00
2011-2012	12,000.00
Total Minimum Lease Payments	$ 124,360.28

Rental expense for all operating leases during the year was $41,698.47.

NOTE 9 - REVENUES

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

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Add Bad Debt Recoveries	Net Revenues	Revenues Pledged as Security for Debt	
Operating Revenues:							
Student Tuition and Fees	$ 10,339,409.96	$ 0.00	$ 2,176,319.84	$ 4,466.49	$ 8,167,556.61	$ 181,358.45	(A)
Sales and Services:							
Sales and Services of Auxiliary Enterprises:							
Residential Life	$ 2,235,015.05	$ 0.00	$ 489,741.43	$ 0.00	$ 1,745,273.62	$ 1,745,273.62	(B)
Dining	1,587,424.15		342,225.82		1,245,198.33	1,245,198.33	(B)
Health and Recreation Services	147,568.97				147,568.97		
Bookstore	248,660.40				248,660.40		
Parking	46,978.45				46,978.45		
Other	21,801.74				21,801.74		
Sales and Services of Education and Related Activities	357,609.88	29,870.14			327,739.74		
Total Sales and Services	$ 4,645,058.64	$ 29,870.14	$ 831,967.25	$ 0.00	$ 3,783,221.25	$ 2,990,471.95	

Revenue Bonds Secured by Pledged Revenues:
(A) Facility Debt Fee for the Fitness and Student Center Project
(B) Housing and Dining System

NOTE 10 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	$ 10,653,744.42	$ 936,312.46	$ 504,138.41	$ 0.00	$ 0.00	$ 0.00	$ 12,094,195.29
Public Service	478,126.73	39,499.84	536,185.37				1,053,811.94
Academic Support	2,746,848.57	284,889.82	285,278.39				3,317,016.78
Student Services	723,222.62	52,666.27	337,264.37				1,113,153.26
Institutional Support	4,785,807.62	272,985.21	1,910,082.39		3,727.82		6,972,603.04
Operations and Maintenance of Plant	3,146,171.09	822,508.89	456,369.70		1,322,341.36		5,747,391.04
Student Financial Aid				564,523.27			564,523.27
Auxiliary Enterprises	2,041,825.96	713,405.78	1,810,427.23		212,804.06		4,778,463.03
Depreciation						2,440,496.09	2,440,496.09
Total Operating Expenses	$ 24,575,747.01	$ 3,122,268.27	$ 5,839,745.86	$ 564,523.27	$ 1,538,873.24	$ 2,440,496.09	$ 38,081,653.74

NOTE 11 - PENSION PLANS

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

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 School had a total payroll of $20,140,816.37, of which $9,509,878.76 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were $570,592.73 and $206,364.37, respectively. The School made 100% of its annual required contributions for the years ended June 30, 2005, 2004, and 2003, which were $206,364.37, $19,842.95, and $0.00, respectively.

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

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

Each carrier offers a variety of investment funds, including both fixed and variable account investment options and mutual funds.

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 School assumes no liability other than its contribution.

For the year ended June 30, 2005, the School had a total payroll of $20,140,816.37, of which $8,237,244.22 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were $494,234.65 and $563,427.50, respectively.

B. **Deferred Compensation and Supplemental Retirement Income Plans** - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement, or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, *the North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to $81,556.12 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 School except for a 5% employer contribution for the School's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of School law enforcement officers for the year ended June 30, 2005, were $57,710.60. The voluntary contributions by employees amounted to $137,314.38 for the year ended June 30, 2005.

IRC Section 403(b) and 403(b)(7) Plans - Eligible School employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to $155,065.42 for the year ended June 30, 2005.

NOTE 12 - OTHER POSTEMPLOYMENT BENEFITS

A. **Health Care for Long-Term Disability Beneficiaries and Retirees** - The School participates in State-administered programs that provide postemployment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System or the Optional Retirement Program. These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The School contributed 3.2% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program for these health care benefits. For the fiscal year ended June 30, 2005, the School's total contribution to the Plan was $567,907.94. The School assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.

B. **Long-Term Disability** - The School participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State

Employees' Retirement System and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The School contributes .445% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the year ended June 30, 2005, the School's total contribution to the DIPNC was $78,974.70. The School assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 13 - RISK MANAGEMENT

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

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

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

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

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

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

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

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

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

NOTE 14 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The School has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were $3,438,050.77 and on other purchases were $971,713.56 at June 30, 2005.

B. Pending Litigation and Claims – The School is a party to 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. School 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 School.

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 School, OSBM authorizes allotments. The School records the allotments as revenue on the accompanying financial statements. The School's remaining authorization of $4,881,587.00 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

NOTE 15 - CHANGE IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2005, the School 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.

NOTE 16 - SUBSEQUENT EVENTS

In September 2005, the NCSA Housing Corporation, a component unit of North Carolina School of the Arts, entered into permanent financing for the acquisition, construction, equipping, and subsequent renovations of Center Stage Apartments, an approximately 156-bed student-housing complex connected to the campus of the School. Certificates of Participation, in the amount of $7,200,000.00, were sold for this financing. NCSA Housing Corporation began to lease these apartments to the State and the School used the complex to meet its housing needs. Rental payments to NCSA Housing Corporation will be used to pay principal and interest on the Certificates of Participation.

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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 School of the Arts
Winston-Salem, North Carolina

We have audited the financial statements of North Carolina School of the Arts, a constituent institution of the 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 School's basic financial statements and have issued our report thereon dated October 31, 2005. We did not audit the financial statements of the North Carolina School of the Arts Foundation, Inc., and the NCSA Housing Corporation, which represent 100% of the School's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for the discretely presented component units, is based on the reports of the other auditors.

As discussed in Note 15 to the financial statements, the School implemented Governmental Accounting Standards Board Statement No. 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 School's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material

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)

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 School's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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

Leslie W. Merritt, Jr.

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

October 31, 2005

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

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November 29, 2005

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