STATE OF
NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

UNIVERSITY OF NORTH CAROLINA HOSPITALS

CHAPEL HILL, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2005

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT OF

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STATE OF NORTH CAROLINA
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 Directors, The University of North Carolina Health Care System

We have completed a financial statement audit of the University of North Carolina Hospitals 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

January 26, 2006

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INDEPENDENT AUDITOR'S REPORT

Board of Directors
The University of North Carolina Health Care System
Chapel Hill, North Carolina

We have audited the accompanying basic financial statements of the University of North Carolina Hospitals, which is a part of The University of North Carolina Health Care System, which is a part of The University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2005, as listed in the table of contents. These financial statements are the responsibility of the Hospitals' management. Our responsibility is to express an opinion on these financial statements based on our audit.

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. 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 provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the University of North Carolina Hospitals and are not intended to present fairly the financial position of The University of North Carolina Health Care System and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of North Carolina Hospitals as of June 30, 2005, and the changes in its financial position and its cash flows 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 Hospitals 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 16, 2005, on our consideration of the Hospitals' 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

November 16, 2005

UNIVERSITY OF NORTH CAROLINA HOSPITALS
MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The following discussion and analysis is provided by the University of North Carolina Hospitals' financial management as an overview to assist the reader in interpreting and understanding the accompanying basic financial statements. It includes comparative financial analysis with discussion of significant changes between fiscal years 2005 and 2004, as well as, pertinent facts, decisions, and conditions.

Using the Financial Statements

The financial statements of the Hospitals provide information regarding its financial position and results of operations as of the report date. The Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows comprise the basic financial statements required by the Governmental Accounting Standards Board (GASB). In accordance with the GASB, the financial statements are presented and follow reporting concepts consistent with those required of a private business enterprise. The financial statement balances reported are presented in a classified format to aid the reader in understanding the nature of the financial statement balance. The Notes to the Financial Statements accompany the financial statements and should be read in conjunction with the statements.

The Statement of Net Assets provides information relative to the Hospitals' assets, liabilities, and net assets as of the last day of the fiscal year. Assets and liabilities on this Statement are categorized as either current or noncurrent. Current assets are those that are available to pay for expenses in the next fiscal year and are anticipated to be used to pay for current liabilities. Current liabilities are those payable in the next fiscal year. Net assets on this Statement are categorized as invested in capital assets (net of related debt), restricted or unrestricted. Restricted net assets are categorized as expendable for the purposes noted. Overall, the Statement of Net Assets provides information relative to the financial strength of the Hospitals and its ability to meet current and long-term obligations.

The Statement of Revenues, Expenses, and Changes in Net Assets provides information relative to the results of the Hospitals' operations, nonoperating activities, and other activities affecting net assets, which occurred during the fiscal year. Nonoperating activities include subsidies from the State in the form of appropriations, noncapital gifts and grants, as well as interest expense on financing activities, investment income (net of investment expenses), loss realized on the disposition of capital assets, and gain or loss on affiliate activity. Overall, the Statement of Revenues, Expenses, and Changes in Net Assets provides information relative to the Hospitals' management of its operations and its ability to maintain its financial strength.

The Statement of Cash Flows provides information relative to the Hospitals' sources and uses of cash for operating activities, noncapital financing activities, capital and related financing activities, and investing activities. The Statement provides a reconciliation of beginning cash balances to ending cash balances and is representative of the activity reported on the Statement of Revenues, Expenses, and Changes in Net Assets as adjusted for changes in the beginning and ending balances of noncash accounts on the Statement of Net Assets.

The Notes to the Financial Statements provide information relative to 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 postemployment benefits, insurance against losses, commitments and contingencies, accounting changes, and a discussion of adjustments to prior periods and events subsequent to the Hospitals' financial statement period when appropriate. Overall, these disclosures provide information to better understand details, risk, and uncertainty associated with the amounts reported and are considered an integral part of the financial statements.

Comparison of Two-Year Data for 2005 to 2004

Comparative financial data of 2005 to 2004 is summarized in Table 1. Discussion of comparative data is included in the following section.

Analysis of Overall Financial Position and Results of Operations

Statement of Net Assets

Overall assets increased by $11.2 million or 1.1% from the prior year. Cash and cash equivalents decreased overall by $5.6 million due to the ongoing relocation and renovation of space and normal capital replacement. Current patient accounts receivable – net decreased by $18.3 million as a result of the efforts of Patient Accounting to collect amounts due and also as a result of fully reserving accounts receivable balances older than 180 days. Estimated third party settlements increased significantly due to the revaluation of the settlement amounts due from both Medicare and Medicaid.

Liabilities decreased overall by $14.2 million as a result of netting the asset and liability by payor within the estimated third party settlement category. All outstanding estimated third party assets are now considered to be current since they will be settled within the next 12 months.

Statement of Revenues, Expenses, and Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Net Assets reflects an operating loss of $19.3 million before net nonoperating revenues. However, this translates into $20.0 million of income after taking the State appropriation of $39.3 million into account and an additional $5.4 million in nonoperating and other revenue, primarily from capital grant funds received for expenditures on the Cancer Hospital, for a total increase in net assets of $25.4 million.

Net patient service revenue continues to be strong as evidenced by a 12.1% increase over the prior year in spite of a deteriorating reimbursement rate. The increase in revenue is attributed primarily to the Hospitals implementing an average rate increase of 11.1% to gross charges because the CMI (case mix index), inpatient days of care, discharges and outpatient visits all remained relatively flat as compared to fiscal year 2004.

Total operating expenses increased by 8.1%. Salaries and benefits comprise 55.5% of the total operating expenses for FY2005 and increased by 5.1% over the prior year due to salary increases. The second largest component of operating expenses, medical and surgical supplies, represented 18.3% of the total operating expenses and experienced an increase of 10.3% over the prior year due to inflation. The largest categorical increase in expense was in medical malpractice costs which increased by $5 million or 77.1%.

Analysis of Net Asset Balances

At June 30, 2005, net assets invested in capital assets, net of related debt, totaled $191.8 million representing the gross value of plant assets $634.6 million plus bond issuance costs $1.6 million less accumulated depreciation $246.2 million and related debt $198.2 million.

Restricted expendable net assets totaled $77.3 million representing amounts subject to externally imposed restrictions.

Unrestricted net assets totaled $383.6 million representing amounts not subject to externally imposed stipulations but internally designated for various activities and initiatives, as well as future construction projects.

Discussion of Capital Asset and Long-Term Debt Activity

Capital Assets

The Hospitals expended $35.6 million during the year for the construction of buildings/infrastructure and the renovation or repair of its facilities. A balance of $9.9 million remains from the 2001 series of bond funds that will continue to be used to renovate inpatient care space vacated with the opening of Women's and Children's Hospitals.

On August 5, 2004, House Bill 1264 of the 2004 North Carolina Legislative Session was ratified and authorized the State to issue special indebtedness of up to $180 million in principal for acquiring, constructing, and equipping a new cancer rehabilitation and treatment center, a nearby physicians' office building, and a walkway between the two. These facilities will be located at the University of North Carolina Hospitals at Chapel Hill. The Hospitals had spent and been reimbursed $5 million for planning, engineering and design on this project as of June 30, 2005. Completion and occupancy is expected in fiscal year 2010.

At June 30, 2005, outstanding commitments on construction contracts were $10.7 million while outstanding commitments related to capital purchase orders for fixed and movable equipment totaled $5.3 million.

The Hospitals continued to modernize capital equipment throughout the facilities during the year as evidenced by an investment of $30.4 million in new or replacement equipment.

The annualized average age of plant and equipment is 6.2 years.

Long-Term Debt Activities

At June 30, 2005, the Hospitals had outstanding bond indebtedness in the amount of $287.0 million of which $6.1 million is due within the next year. Standard and Poor's and Moody's Ratings Services classify these bonds as AA- and A1 respectively.

Discussion of Conditions that may have a Significant Effect on Net Assets or Revenues, Expenses, and Changes in Net Assets

The major source of funding for the Hospitals is the revenue it generates from patient care services. While billing rates are adjusted annually, overall reimbursement has continued to deteriorate in recent years due to payer reimbursement rates and payer mix while salaries, supplies and other operating expenses have continued to increase. These circumstances prompted management to engage Navigant Consulting to review operations and to implement many of their recommendations over the last year.

The more aggressive position taken on cost reduction and revenue enhancement that began in FY2004 in response to the economic challenges in the healthcare industry continued successfully during FY2005. These initiatives and the positive results achieved to date have raised the bar regarding future performance expectations for the Hospitals.

University of North Carolina Hospitals
Summary of Condensed Financial Statements Totals
For the Fiscal Years Ended June 30, 2005 and 2004

Summary of Condensed Financial Statements Totals **Table 1**

	FY05	FY04	Change
STATEMENTS OF NET ASSETS			
Current Assets	$ 202,814,820	$ 206,793,633	$ (3,978,813)
Capital Assets, Net	388,326,662	360,553,782	27,772,880
Other Noncurrent Assets	409,728,546	422,322,026	(12,593,480)
TOTAL ASSETS	1,000,870,028	989,669,441	11,200,587
Current Liabilities	66,693,198	70,706,288	(4,013,090)
Noncurrent Liabilities	281,511,308	291,695,875	(10,184,567)
TOTAL LIABILITIES	348,204,506	362,402,163	(14,197,657)
Invested in Capital Assets, Net of Related Debt	191,755,372	176,261,291	15,494,081
Restricted for Expendable Uses	77,290,871	67,861,682	9,429,189
Unrestricted	383,619,279	383,144,305	474,974
TOTAL NET ASSETS	$ 652,665,522	$ 627,267,278	$ 25,398,244
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS			
Net Patient Service Revenue	$ 601,084,189	$ 536,334,520	$ 64,749,669
Other Operating Revenues	13,711,800	13,936,265	(224,465)
TOTAL OPERATING REVENUES	614,795,989	550,270,785	64,525,204
Salaries and Benefits	352,188,207	335,100,889	17,087,318
Medical and Surgical Supplies	116,084,226	105,255,835	10,828,391
Other Operating Expenses	165,841,307	146,096,543	19,744,764
TOTAL OPERATING EXPENSES	634,113,740	586,453,267	47,660,473
OPERATING LOSS	(19,317,751)	(36,182,482)	16,864,731
State Appropriations	39,333,826	37,787,880	1,545,946
Investment Activity	12,685,032	15,448,627	(2,763,595)
Other Nonoperating Revenues	216,928	142,082	74,846
Nonoperating Expenses	(12,593,413)	(12,086,853)	(506,560)
NET NONOPERATING REVENUES	39,642,373	41,291,736	(1,649,363)
Capital Grants	5,044,622		5,044,622
Capital Gifts	29,000		29,000
INCREASE IN NET ASSETS	25,398,244	5,109,254	20,288,990
NET ASSETS - BEGINNING OF YEAR	627,267,278	622,158,024	5,109,254
NET ASSETS - END OF YEAR	$ 652,665,522	$ 627,267,278	$ 25,398,244

University of North Carolina Hospitals
Statement of Net Assets
June 30, 2005 — *Exhibit A-1*

ASSETS		
Current Assets:		
Cash and Cash Equivalents	$	48,210,198
Restricted Cash and Cash Equivalents		3,810,641
Patient Accounts Receivable, Net (Note 3)		97,103,734
Accrued Interest Receivable - Bonds		968,925
Restricted Accrued Interest Receivable -Trust Funds		35,417
Estimated Third Party Settlements (Note 4)		20,075,852
Inventories		14,336,037
Other Accounts Receivable		16,608,506
Prepaid Expenses		1,665,510
Total Current Assets		202,814,820
Noncurrent Assets:		
Cash and Cash Equivalents		315,181,243
Restricted Cash and Cash Equivalents		89,304,052
Advance Deposits with Liability Insurance Trust Fund (Note 11)		100,000
Patient Accounts Receivable, Net (Note 3)		1,417,544
Bond Issuance Costs, Net		1,917,275
Start-Up Costs, Net		577,903
Investments in Affiliates (Note 14)		1,230,529
Capital Assets - Nondepreciable (Note 5)		50,541,957
Capital Assets - Depreciable, Net (Note 5)		337,784,705
Total Noncurrent Assets		798,055,208
Total Assets		1,000,870,028

LIABILITIES	
Current Liabilities:	
Accounts Payable - Operating	23,037,255
Accounts Payable - Capital	8,406,735
Accrued Salaries and Benefits	10,798,589
Due to Patients or Third Parties	3,974,503
Bond Interest Payable	1,525,719
Notes Payable (Note 6)	902,463
Bonds Payable (Note 6)	6,115,000
Arbitrage Rebate Payable (Note 6)	875,988
Compensated Absences (Note 6)	4,873,668
Funds Held for Others	6,183,278
Total Current Liabilities	66,693,198
Noncurrent Liabilities:	
Notes Payable (Note 6)	728,114
Bonds Payable, Net (Note 6)	264,759,110
Arbitrage Rebate Payable (Note 6)	2,893,806
Compensated Absences (Note 6)	13,130,278
Total Noncurrent Liabilities	281,511,308
Total Liabilities	348,204,506
NET ASSETS	
Invested in Capital Assets, Net of Related Debt	191,755,372
Restricted for Expendable Uses for:	
Bond Covenants	76,624,581
Liability Insurance Trust Fund	100,000
Trust Fund Donations	566,290
Unrestricted	383,619,279
Total Net Assets	$ 652,665,522

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

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

REVENUES		
Operating Revenues:		
Net Patient Service Revenue (Note 8)	$	601,084,189
Other Operating Revenue		12,385,553
Prior Year Third Party Settlements		1,326,247
Total Operating Revenues		614,795,989
EXPENSES		
Operating Expenses:		
Salaries and Benefits		352,188,207
Medical and Surgical Supplies		116,084,226
Contracted Services		64,628,921
Other Supplies and Services		36,728,471
Communications, Utilities and Travel		13,078,448
Medical Malpractice Costs		11,584,788
Depreciation and Amortization		39,820,679
Total Operating Expenses		634,113,740
Operating Loss		(19,317,751)
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		39,333,826
Noncapital Unrestricted Gifts and Grants		205,951
Noncapital Restricted Gifts and Grants		712
Investment Income (Net of Investment Expense)		12,843,621
Gain on Investments in Affiliates		1,305,603
Minority Interest - LLC		(1,464,192)
Interest and Fees on Debt		(11,355,598)
Restricted Interest Income		10,265
Loss on Disposal of Capital Assets		(1,237,815)
Net Nonoperating Revenues		39,642,373
Income Before Other Revenues		20,324,622
Capital Grants		5,044,622
Capital Gifts		29,000
Increase in Net Assets		25,398,244
NET ASSETS		
Net Assets - July 1, 2004		627,267,278
Net Assets - June 30, 2005	$	652,665,522

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

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

CASH FLOWS FROM OPERATING ACTIVITIES	
Received from Patients and Third Parties	$ 582,440,439
Payments to Employees and Fringe Benefits	(350,158,060)
Payments to Vendors and Suppliers	(221,059,536)
Payments for Medical Malpractice	(7,670,078)
Other Receipts	13,310,497
Net Cash Provided by Operating Activities	16,863,262
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State Appropriations	39,333,826
Interest and Fees Paid on Revenue Bonds	(1,453,194)
Principal Paid on Revenue Bonds	(680,000)
Noncapital Gifts and Grants	216,928
Cash Provided by Noncapital Financing Activities	37,417,560
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES	
Proceeds from Sale of Capital Assets	137,896
Issuance Costs Paid	(79,422)
Principal Paid on Capital Revenue Bonds	(4,850,026)
Interest and Fees Paid on Capital Debt	(9,372,920)
Capital Grants	5,044,622
Principal Paid on Capital Leases and Notes Payable	(868,080)
Acquisition and Construction of Capital Assets	(63,065,288)
Net Cash Used by Capital Financing and Related Financing Activities	(73,053,218)
CASH FLOWS FROM INVESTING ACTIVITIES	
Investment Income	12,981,304
Investments In and Loans to Affiliated Enterprises:	
Cash Received	554,650
Cash Payments	(355,566)
Net Cash Provided by Investing Activities	13,180,388
Net Decrease in Cash and Cash Equivalents	(5,592,008)
Cash and Cash Equivalents - July 1, 2004	462,098,142
Cash and Cash Equivalents - June 30, 2005	$ 456,506,134

University of North Carolina Hospitals
Statement of Cash Flows — *Exhibit A-3*
For the Fiscal Year Ended June 30, 2005 — *Page 2*

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

Operating Loss	$	(19,317,751)
Adjustments to Reconcile Operating (Loss) to Net Cash Provided (Used) by Operating Activities:		
Depreciation and Amortization Expense		39,820,679
Changes in Assets and Liabilities:		
Patient Accounts Receivable		17,874,552
Other Accounts Receivable		3,866,339
Estimated Third Party Settlements		(13,075,752)
Inventories		(114,308)
Prepaid Expenses		517,749
Advance Deposits with Liability Insurance Trust Fund		1,443,962
Accrued Salaries and Benefits		(2,046,500)
Accounts and Other Payables		11,527,837
Due to Patients or Third Parties		(27,230,596)
Funds Held for Others		2,461,799
Compensated Absences		1,135,252
Net Cash Provided by Operating Activities	$	16,863,262

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:		
Cash and Cash Equivalents	$	48,210,198
Restricted Cash and Cash Equivalents		3,810,641
Noncurrent Assets:		
Cash and Cash Equivalents		315,181,243
Restricted Cash and Cash Equivalents		89,304,052
Total Cash and Cash Equivalents - June 30, 2005	$	456,506,134

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES:

Investments in Affiliated Enterprises:		
Current Gain from Discontinued Affiliated Operations	$	835,856
Current Loss from Equity Method Adjustments		(1,464,192)
Assets Acquired through a Gift		29,000
Bonds Issued to Partially Refund Series 1996 Bonds		30,540,000
Loss on Disposal of Capital Assets		(1,237,815)

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

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

A. Organization - The University of North Carolina Hospitals (the Hospitals) is the only State-owned teaching hospital in North Carolina. With a licensed base of 690 beds, this facility serves as an acute care teaching hospital for The University of North Carolina at Chapel Hill. The Hospitals consists of North Carolina Memorial Hospital, North Carolina Children's Hospital, North Carolina Neurosciences Hospital, and North Carolina Women's Hospital. As a State agency, the Hospitals is required to conform to financial requirements established by various statutory and constitutional provisions. While the Hospitals is exempt from both federal and State income taxes, a small portion of its revenue is subject to the unrelated business income tax.

B. Financial Reporting Entity - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements.

The Hospitals is a part of the University of North Carolina (UNC) Health Care System which is a part of the University of North Carolina System. The University of North Carolina System is a component unit of the State of North Carolina and an integral part of the State of North Carolina's *Comprehensive Annual Financial Report*.

The accompanying financial statements present all funds belonging to the Hospitals for which the UNC Health Care System Board of Directors is responsible. The Hospitals' component units are blended in the Hospitals' financial statements.

Blended Component Units - Although legally separate, Health System Properties, LLC (the LLC) and Carolina Dialysis, LLC, (the CDLLC), component units of the Hospitals, are reported as if they were part of the Hospitals.

The LLC was established to purchase, develop and/or lease real property. The LLC is reported as part of the Hospitals because the UNC Health Care System is the sole member manager and the LLC is governed by the same Board that directs the Hospitals' operations. Additionally, the only properties owned to date by the LLC are for the sole use and benefit of the Hospitals.

The Hospitals has a two-third ownership interest in the CDLLC. Renal Research Institute owns the remaining one-third interest. A Board of Managers comprised of six members manages the CDLLC, with four appointed by the Hospitals through the Chief Executive Officer and two appointed by Renal Research Institute. The CDLLC was formed for the purposes of owning and operating chronic dialysis programs, thus improving the quality of care to end-stage renal disease patients by providing dialysis services and conducting research in the field of nephrology in the State of North Carolina. The CDLLC is included as part of the Hospitals because of the nature and significance of the relationship of the CDLLC with the Hospitals. Because the CDLLC provides services almost entirely to the Hospitals' patients, its financial statements have been blended with those of the Hospitals.

Separate financial statements for the LLC and CDLLC may be obtained from the Chief Financial Officer, University of North Carolina Hospitals, 6011 East Wing, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-1727. Other related foundations and similar nonprofit corporations for which the Hospitals is not financially accountable are not part of the accompanying financial statements.

C. 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* and as amended by GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, the full scope of the Hospitals' 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 Hospitals 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.

D. Basis of Accounting - The financial statements of the Hospitals 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 Hospitals receives (or gives) value without directly giving (or receiving) equal value in exchange, include State appropriations, a capital grant for the cancer hospital, 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.

E. Cash and Cash Equivalents - This classification includes petty cash, security deposits, cash on deposit in private bank accounts, cash on deposit with fiscal agents, and deposits held by the State Treasurer in the short-term investment fund. The short-term investment fund 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.

F. Patient Accounts Receivable - The Hospitals' patient accounts receivable consists of unbilled (in house patients, inpatients discharged but not final billed and outpatients not final billed) and billed amounts. Payment of these charges comes primarily from Managed Care payers, Medicare, Medicaid and, to a lesser extent, the patient. These amounts are recorded in the financial statements net of indigent care, contractual allowances and allowances for bad debt to determine the net realizable value of the accounts receivable balance. See the section Net Patient Service Revenue later in the Significant Accounting Policies for a further discussion of these reductions.

The reserves recorded for these deductions are used to determine net patient accounts receivable and are calculated based on the historical collection percentage realized for each payer. The collection rates are updated monthly in order to reflect the most up to date information available.

The Hospitals has established flexible payment arrangements for patient balances ranging from a minimum of 3 months to a maximum of 36 months depending on the outstanding balance due. Amounts due beyond one year under these arrangements are classified as noncurrent assets.

G. **Other Receivables** - In addition to patient accounts receivable, the Hospitals recognizes other receivables related to its operations. These items include the sales tax refund due from the North Carolina Department of Revenue, Nurse Scholarship receivables, amounts due from affiliates and other State agencies, and billings to outside companies for ancillary testing.

H. **Inventories** - Inventories consist of medical and surgical supplies, pharmaceuticals, prosthetics, and other supplies that are used to provide patient care or by service departments within the Hospitals. Inventories are stated at FIFO (first-in, first-out) cost.

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

The Hospitals capitalizes assets having a cost or fair value of at least $5,000 at the date of acquisition and an estimated useful life of three years or more. Useful life estimates are assigned based upon the American Hospital Association publication *Estimated Useful Lives of Depreciable Hospital Assets*.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 3 to 20 years for equipment, 10 to 40 years for buildings and fixed equipment, and 5 to 25 years for general infrastructure.

J. **Restricted Assets** - Unexpended proceeds of revenue bonds, related interest income and unexpended capital contributions are classified as restricted assets because their use is limited by applicable bond covenants or donor/grantor agreements. In addition, assets equal to 7.5% of gross patient revenue at June 30 are designated as restricted as required by the general trust indenture bond covenants. This amount is calculated annually in July. The advance deposits with the Liability Insurance Trust Fund and certain other trust funds are classified as restricted because external parties or statute limits their use.

K. **Bonds Payable** - Bonds payable are reported net of unamortized premiums or discounts and deferred losses on refunds. The Hospitals amortizes bond premiums/discounts over the life of the bonds using the effective interest method. The deferred losses on refunds are amortized over the life of the old debt (new debt and old debt payoff at the same time) using the straight-line method. Bond issuance costs are amortized using the straight-line method over the life of the bonds.

L. Compensated Absences - The Hospitals' policy is to record the cost of annual leave when earned. Employees earn annual leave at varying rates depending upon years of service and the leave plan in which they participate.

Traditional Plan - The policy provides for a maximum accumulation of unused annual leave of 30 days that can be carried forward beyond the pay period that includes December 31. During the pay period that includes December 31, any excess accumulation over 30 days of annual leave is converted to sick leave. Upon termination of employment, employees are paid for the current balance of annual leave accumulated up to the maximum of 30 days. Employees earn holiday leave at the rate of 11 or 12 days per year with an unlimited accumulation. The Hospitals' policy requires that employees use holiday hours in excess of 40 prior to using earned annual leave. At termination, employees are paid for any accumulated holiday leave. Employees earn sick leave at the rate of one day per month with an unlimited accumulation.

Paid Time Off (PTO) Plan - The PTO program combines the various leave types that employees may earn into one earning rate that varies depending upon years of service. This program is mandatory for all new employees, and existing employees were allowed the option to convert to the PTO program at the end of calendar year 2002, 2003, and 2004. This is a voluntary choice, but once they change, employees cannot return to the traditional program. The policy provides for a maximum accumulation of 280 hours of unused PTO time at the last day of the last pay period of the calendar year that includes December 31. At that time, the excess accumulation over 280 hours is converted to catastrophic leave, which is treated similar to sick leave in the Traditional Plan. Upon termination of employment, employees are paid for their current balance in PTO based upon their years of service. Once an employee has more than five years of service, the entire accumulated balance is paid up to 280 hours. The PTO program also has an annual sell back feature that allows employees to sell back 50% of their accumulated hours over a minimum floor. The payout occurs in January each year.

Liability Calculation - The liability for accumulated annual leave, holiday leave, and PTO leave is calculated for each employee at year end by taking the leave carried forward at the previous December 31 plus the leave earned, less the leave taken between January 1 and June 30. The liability is equal to the accumulated hours multiplied by the employee's current hourly rate plus benefits for social security and State retirement.

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 Hospitals 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 Hospitals' net assets are classified as follows:

Invested in Capital Assets, Net of Related Debt - This represents the Hospitals' 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 – Expendable - Expendable restricted net assets include resources for which the Hospitals is legally or contractually obligated to spend the resources in accordance with restrictions imposed by external parties.

Unrestricted Net Assets - Unrestricted net assets include resources derived from patient care and ancillary services, unrestricted gifts and investment 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 and determined by Hospitals' departmental managers. For projects funded by tax-exempt debt proceeds and other sources, the debt proceeds are always used first.

N. Revenue and Expense Recognition - The Hospitals 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 Hospitals' principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as charges for inpatient and outpatient services as well as external customers who purchase medical services. 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, State appropriations and capital grant funds that represent subsidies or gifts to the Hospitals, as well as investment income and gain (loss) on disposal of fixed assets are considered nonoperating since these are either investing, capital or noncapital financing activities. The minority interest of Dialysis LLC is considered nonoperating because it is related to investments in affiliates. Capital contributions are presented separately after nonoperating revenues and expenses.

O. Net Patient Service Revenue - Patient service revenue is recorded at the Hospitals' established rates and includes all charges for inpatient accounts discharged after June 30, 2004, (less amounts previously recorded at June 30, 2004 for in house patients) and all charges on in house accounts and all charges for outpatient accounts registered after June 30, 2004. The difference between established rates and the estimated amount collectable is recognized as revenue deductions on an accrual basis and deducted from gross patient service revenue to report service revenue at net realizable value. Revenue deductions consist of charges for indigent care, contractual allowances and bad debt.

Indigent care provided represents health care services that were provided free of charge to individuals who meet the criteria of the Hospitals' charity care policy. Indigent care provided is not considered to be revenue to the Hospitals and is deducted in determining gross patient service revenue.

Differences between the amounts paid for services under third party reimbursement programs and established rates are accounted for as contractual adjustments. Retroactively calculated adjustments are recorded as prior year third party settlements in the year in which the adjustment can be reasonably estimated.

P. Medical Malpractice Costs - Medical malpractice costs represent the actuarially determined contribution to the Liability Insurance Trust Fund. See Note 11 for further discussion of the Liability Insurance Trust Fund.

Q. Donated Services - No amounts have been included for donated services since no objective basis is available to measure the value of such services.

However, a substantial number of volunteers donated significant amounts of their time to the Hospitals' operations.

NOTE 2 - DEPOSITS

Unless specifically exempt, the Hospitals 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 Hospitals 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 Hospitals 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 agency funds held directly by the Hospitals. Bond proceeds and debt service funds are invested in accordance with the bond resolutions. These funds are currently on deposit with the State Treasurer and therefore, available on demand to comply with applicable bond covenants.

At June 30, 2005, the Hospitals' deposits with the State Treasurer's Short-Term Investment Fund totaled $451,571,874. The Short-Term Investment Fund (a portfolio within the State Treasurer's Investment Pool, an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating) had a weighted average maturity of 1.41 years as of June 30, 2005. Assets and shares of the Short-Term Investment Fund are valued at amortized cost, which approximates fair value. Deposit and investment risks associated with the State Treasurer's Investment Pool (which includes the State Treasurer's Short-Term Investment Fund) are included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page http://www.ncosc.net/ and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

The carrying amount of the Hospitals' deposits not with the State Treasurer was $4,910,895 and the bank balance was $492,898. As of June 30, 2005, $203,092 of the Hospitals' $492,898 bank balance was exposed to custodial credit risk. The Hospitals does not have a deposit policy for custodial credit risk, which is the risk that in the event of a bank failure, the Hospitals' deposits may not be returned to it.

NOTE 3 - PATIENT ACCOUNTS RECEIVABLE - NET

A. Current - Net patient accounts receivable consist of amounts due from patients and third parties at estimated realizable value. Included in gross receivables are amounts receivable at established billing rates less payments received through June 30th. Allowances for uncollectible accounts and contractual adjustments are estimated using historical collection statistics. The components of current net Patient Accounts Receivable reflected in the accompanying Statement of Net Assets are as follows at June 30, 2005:

	Amount
In House Patients	$ 30,189,200
Discharged (not final billed) Patients	43,186,336
Total Unbilled	73,375,536
Discharged (billed) Patients	137,117,883
Payment Arrangements	1,106,891
Indigent Care Provided	(9,206,449)
Current Gross	202,393,861
Allowance for Bad Debts	(10,602,250)
Contractual Allowances	(94,687,877)
Total Allowances	(105,290,127)
Current - Net	$ 97,103,734

B. Noncurrent - Net Patient Accounts Receivable consisted of $1,417,544 as of June 30, 2005. Noncurrent amounts represent patient payment arrangements that extend beyond one year and are based on signed contractual agreements for a specific monthly payment amount.

NOTE 4 - ESTIMATED THIRD PARTY SETTLEMENTS

UNC Hospitals renders care to patients covered by the Medicare, Medicaid and Tricare/Champus programs. Medicare pays for inpatient acute care services at prospectively determined rates per discharge while outpatient services are reimbursed at prospectively determined rates. Additionally, UNC Hospitals receives interim pass-through payments from Medicare for items that are ultimately settled on cost or an adjusted cost through the annual

Medicare Cost Report. On an interim, Medicaid inpatient services are reimbursed on a prospectively determined rate per discharge and outpatient services are reimbursed on an interim basis at an agreed upon rate. Ultimately, both Medicaid inpatient and outpatient services are settled at cost through the filing of an annual cost report. Tricare/Champus pays for the services on an interim basis and reimburses the Hospitals for a portion of capital and direct medical education costs based on the Medicare cost report.

UNC Hospitals has calculated the estimated third party settlements for the outstanding Medicare and Medicaid cost reports during the fiscal year ended 2005. It is estimated that Medicare, Medicaid and Tricare/Champus owe the Hospitals $909,985, $14,120,551 and $3,673,403 respectively. Medicare has not supplied the Hospitals with the required Provider Statistical and Reimbursement Summary Reports (or adequate substitute data) to complete the cost reports for 2001-2005. In order to estimate the Medicare settlement amounts the Hospitals estimated program charges and reimbursement based on actual detailed payment data and estimated other items that are settled through the cost report based on historical data. The Hospitals prepared draft Medicaid cost reports using actual cost, statistical, charge and settlement data.

Once the cost reports are filed, they are subject to an initial tentative settlement and subsequent on-site audits which may result in adjustments to the reimbursements. The reports are audited by the programs for compliance with the applicable regulations established for the Medicaid, Medicare and Tricare/Champus programs. Cost reports can also be re-opened or appealed for issues that the Hospitals or the Medicare or Medicaid programs feel are warranted. There are several such requests under consideration, as well as, audits that are incomplete at this time.

Medicare Pass-through Payments - Medicare makes interim payments to the Hospitals for certain portions of inpatient acute care costs that continue to be reimbursed at cost or adjusted cost under the Prospective Payment System. The Hospitals earned $13,282,466 in pass-through payments for 2005, including $1,371,913 earned but not received as of June 30, 2005.

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	$ 22,378,736	$ 0	$ 2,342,053	$ 0	$ 24,720,789
Construction in Progress	19,011,359	(28,754,520)	35,564,329		25,821,168
Total Capital Assets, Nondepreciable	41,390,095	(28,754,520)	37,906,382		50,541,957
Captial Assets, Depreciable:					
Buildings	263,751,164	28,570,608			292,321,772
Machinery and Equipment	269,205,489	183,912	30,383,205	(13,891,296)	285,881,310
General Infrastructure	5,813,800			(4,720)	5,809,080
Total Capital Assets, Depreciable:	538,770,453	28,754,520	30,383,205	(13,896,016)	584,012,162
Less Accumulated Depreciation for:					
Buildings	65,472,890		9,773,522		75,246,412
Machinery and Equipment	151,216,672		28,998,333	(12,515,817)	167,699,188
General Infrastructure	2,917,204		369,373	(4,720)	3,281,857
Total Accumulated Depreciation	219,606,766		39,141,228	(12,520,537)	246,227,457
Total Capital Assets, Depreciable, Net	319,163,687	28,754,520	(8,758,023)	(1,375,479)	337,784,705
Capital Assets, Net	$ 360,553,782	$ 0	$ 29,148,359	$ (1,375,479)	$ 388,326,662

NOTE 6 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of the 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
Notes Payable	$ 2,328,601	$ 1,765,181	$ (2,463,205)	$ 1,630,577	$ 902,463
Capital Leases Payable	$ 170,057	$ 0	$ (170,057)	$ 0	$ 0
Bonds Payable	$ 293,145,000	$ 30,540,000	$ (36,705,000)	$ 286,980,000	$ 6,115,000
Plus: Premium		1,965,883		1,965,883	
Less: Discount	(698,004)		103,285	(594,719)	
Less: Deferred Charge on Refunding	(16,788,024)	(1,414,142)	725,112	(17,477,054)	
Total Bonds Payable	$ 275,658,972	$ 31,091,741	$ (35,876,603)	$ 270,874,110	$ 6,115,000
Arbitrage Rebate Payable	$ 3,703,029	$ 66,765	$ 0	$ 3,769,794	$ 875,988
Compensated Absences	$ 16,868,694	$ 28,568,058	$ (27,432,806)	$ 18,003,946	$ 4,873,668

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

Purpose	Financial Institution	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2005	Principal Outstanding 06/30/2005
IBM Equipment	IBM Credit	4.95%	06/01/2007	$ 1,765,181	$ 134,604	$ 1,630,577

C. **Bonds Payable -** The Hospitals 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
Construction of Women's and Children's Hospitals (net of refundings)	1996	4.20% to 4.75%	02/15/2006	$ 14,455,000	$ 11,770,000	$ 2,685,000
Refund 1992 Revenue Bonds	1999	4.00% to 5.25%	02/15/2024	58,925,000	8,215,000	50,710,000
Rex Acquisition and Hospital Renovations	2001A 2001 B	Variable	02/15/2031	110,000,000	4,000,000	106,000,000
Refund portion of 1996 Revenue Bonds	2003A 2003 B	Variable	02/01/2029	98,015,000	970,000	97,045,000
Refund portion of 1996 Revenue Bonds	2005A	3.00% to 5.00%	02/01/2015	30,540,000		30,540,000
Total Bonds Payable (principal only)				$ 311,935,000	$ 24,955,000	286,980,000
Less: Unamortized Loss on Refunding						(17,477,054)
Less: Unamortized Discount						(594,719)
Plus: Unamortized Premium						1,965,883
Total Bonds Payable						$ 270,874,110

D. **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 Hospitals' Remarketing Agents.

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

University of North Carolina Hospitals at Chapel Hill Revenue Bonds-Series 2001A and Series 2001B: On January 31, 2001, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of $55,000,000 (2001A) and $55,000,000 (2001B) that have a final maturity date of February 15, 2031. The bonds are subject to mandatory sinking fund redemption that began on February 15, 2002. A portion of the proceeds was used to reimburse the Hospitals for $75,000,000 spent allowing the UNC Health Care System to acquire controlling interest in Rex Healthcare, Inc. The remaining proceeds are being used for the renovation of space vacated after the opening of the North Carolina Women's Hospital, North Carolina Children's Hospital, and associated support services. While initially bearing interest in a daily mode, the mode on these bonds may change to a weekly rate, a unit pricing rate, a term rate or a fixed rate.

While in daily mode, the bonds are subject to purchase on any business day upon demand by telephonic notice of tender to the Remarketing Agent on the purchase date and delivery to the bond Tender Agent, Wachovia Bank, National Association. The Hospitals' Remarketing Agents, Merrill Lynch, Pierce, Fenner & Smith Incorporated (Series 2001A) and Banc of America Securities LLC (Series 2001B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to either 0.05% or 0.08% of the outstanding principal amount of the bonds assigned to each agent, depending upon their performance in comparison to an established benchmark.

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and *Landesbank Hessen-Thuringen Girozentrale,* a Liquidity Facility has been established for the Tender Agent 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. These Agreements require an adjustable facility fee based on the long-term ratings of the bonds, which is calculated as a percentage of the available commitment. Payments are made quarterly in arrears on the first business day of each July, October, January and April thereafter until the expiration date or the termination date of the Agreements. For the past fiscal year, the percentage was 0.22% of the total available commitment, but with the new long-term agreement that became effective on July 11, 2005, the percentage will be 0.25% unless the bond ratings change.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Formula Rate (Base Rate equal to the higher of the Prime Rate for such day or the sum of .50% plus the Federal Funds Rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is due quarterly (the first business day of January, April, July and October) for each period in which Bank Bonds are outstanding. At June 30, 2005, there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The agreements allow the Hospitals to redeem bank bonds in equal quarterly installments, on the first business day of January, April, July and October. The payments will commence with the first business day of any such month that is at least 90 days following the applicable Purchase Date of the Bank Bond and end no later than the fifth anniversary of such Purchase Date. If the take out agreement were to be exercised because the entire outstanding $106,000,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $24,848,616 a year for five years under the installment loan agreement assuming a 6.25 percent prime interest rate.

The current expiration date of the Agreements is December 31, 2015. The Liquidity Provider has the option to terminate its commitment on October 11, 2008, October 11, 2011, or October 11, 2014 by providing adequate notice of its intention. The Hospitals may request additional extensions of at least one year from the previous termination date. Extensions are at the discretion of Liquidity Provider.

University of North Carolina Hospitals at Chapel Hill Revenue Refunding Bonds-Series 2003A and Series 2003B: On February 13, 2003, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of $63,770,000 (2003A) and $34,245,000 (2003B) that have a final maturity date of February 1, 2029. The bonds are subject to mandatory sinking fund redemption that began on February 1, 2004. The proceeds were used to advance refund $88,325,000 of the Series 1996 Bonds. While initially bearing interest in a weekly mode, the mode on these bonds may change to a daily rate, a unit pricing rate, a term rate or a fixed rate.

While in the weekly mode, the bonds are subject to purchase on demand with seven days' notice to the Remarketing Agent and delivery to the bond Tender Agent, Wachovia Bank, National Association. The Hospitals' Remarketing Agents, Banc of America Securities LLC (Series 2003A) and Wachovia Bank, National Association (Series 2003B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to 0.08% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003A and is equal to 0.07% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003B.

Under separate Standby Bond Purchase Agreements for the Series 2003A and Series 2003B (Agreements) between the Hospitals and Bank of America, N.A. (Series 2003A) or Wachovia Bank, National Association (Series 2003B) a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require a facility fee equal to 0.22% for Series 2003A (previously 0.20% under the agreement which expired July 1, 2005) and 0.22% for Series 2003B of the available commitment, payable quarterly in advance, beginning on February 13, 2003, and on each February 1, May 1, August 1, and November 1 thereafter until the expiration date or the termination date of the Agreements.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Bank Bond Interest Rate (for Series 2003A, the rate equals LIBOR plus 2.50% for the first 90 days and then equals LIBOR plus 4.00%; for Series 2003B, the rate equals Prime Rate for the first 90 days and then equals Prime plus 1.00%) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is on the first business day of each month for each period in which Bank Bonds are outstanding. At June 30, 2005, there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The Series 2003A agreement allows the Hospitals to redeem bank bonds in twelve equal quarterly installments beginning on the first February 1, May 1, August 1 or November 1 that occurs at least 90 days following the applicable Purchase Date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding $63,135,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $23,638,756 a year for three years under the installment loan agreement assuming a 7.34 percent interest rate (LIBOR plus 4%). The Series 2003B agreement allows the Hospitals to redeem bank bonds in 36 equal monthly installments, on the first business day of each calendar month after the loan date. Payments commence with the first business day of any such month that is at least 120 days following the applicable Purchase Date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding $33,910,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $12,611,076 a year for three years under the installment loan agreement assuming a 7.25 percent interest rate (Prime plus 1%).

The current expiration date of the Series 2003A Agreement is July 1, 2008, and July 31, 2006, for the Series 2003B Agreement. The Hospitals may request additional extensions, which are approved at the discretion of the Liquidity Provider.

Interest Rate Swap Agreement

Objective: In order to protect against the risk of interest rate changes, the Hospitals entered into an interest rate swap contract agreement with Bank of America, N.A. (BOA) on February 13, 2003. The agreement covers the Variable Rate Revenue Refunding Bonds, Series 2003A ($63,770,000) and Series 2003B ($34,245,000). The 2003 series of bonds partially refunded Fixed Rate Revenue Bonds, Series 1996.

Terms, fair values, and credit risk: Under this agreement, BOA pays the Hospitals interest on the notional amount based on 67% of the arithmetic mean of the USD-LIBOR-BBA (with a designated maturity of one month) on a monthly basis. Also on a monthly basis, the Hospitals pays BOA interest at the fixed rate of 3.48%. No cash was paid or received by the Hospitals upon initiation of the agreement. The notional amount of the swap reduces annually; the reductions began in February 2004 and end in February 2029.

The swap agreement terminates February 1, 2029. As of June 30, 2005, rates were as follows:

	Terms	2003A Rates	2003B Rates
Fixed Payment to BOA	Fixed	3.48	3.48
Variable Payment from BOA	LIBOR(1)-BBA(2)	2.15	2.15
Net Interest Rate Swap Payments		1.33	1.33
Variable Rate Bond Coupon Payments		2.30	2.26
Synthetic Interest Rate on Bonds		3.63	3.59

(1) London Inter-Bank Offered Rate
(2) British Bankers Association

The swap agreement has a negative mark-to-market value of ($5,753,348) as of June 30, 2005. BOA develops the mark-to-market value. Their method calculates the present value of the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for LIBOR due on the date of each future net settlement on the swap.

As of June 30, 2005, the Hospitals is not exposed to credit risk, since the agreement has a negative market value. In the future, if the interest rates were to change and the market value becomes positive, then the credit risk would be equal to the market value of the swap. BOA's current long-term ratings are AA- by Fitch Ratings, Aa1 by Moody's Investor's Service, and AA by Standard and Poor's Corporation. At such time that their ratings fall below A3 for Moody's or below A- for S&P, BOA will be required to collateralize a portion of their exposure (up to 100%). The following instruments can serve as eligible collateral: Cash, U.S. Treasury Obligations, U.S. Government Agency Fixed Rate Fixed Maturity Securities, U.S. Government Agency Single Class Mortgage-Backed Securities, U.S. Treasury STRIPS and other U.S. Government Agency Mortgage-Backed Securities. Posted collateral received will be entered in one or more accounts with a domestic office of a commercial bank, trust company or financial institution organized under the laws of the United States (or any State or a political subdivision thereof).

Basis risk: The Hospitals receives 67% of 1-month LIBOR-BBA Index from BOA and pays a floating rate to its bondholders set by the Remarketing Agent. The Hospitals incurred basis risk at June 30, 2005 because its bonds traded at a yield above 67% of 1-month LIBOR-BBA Index. If the relationship of the Hospitals' bonds trade to a percentage of LIBOR greater than 67%, the Hospitals will experience an increase in debt service above the fixed rate on the swap.

Termination risk: The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The Hospitals or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If the swap is 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 Hospitals would be liable to the counterparty for that amount. Termination could result in the Hospitals being required to make an unanticipated termination payment.

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 Hospitals' variable-rate debt and net swap payments, assuming current interest rates remain the same, for their term, were as follows.

Fiscal Year	Principal	Interest	Interest Rate Swaps, Net	Total Payments
2006	$ 455,000	$ 2,214,224	$ 1,288,228	$ 3,957,452
2007	470,000	2,203,681	1,282,096	3,955,777
2008	490,000	2,196,284	1,277,792	3,964,076
2009	505,000	2,177,872	1,267,081	3,949,953
2010	525,000	2,169,675	1,262,312	3,956,987
2011-2015	2,935,000	10,656,191	6,199,753	19,790,944
2016-2020	27,445,000	9,015,243	5,245,058	41,705,301
2021-2025	33,025,000	5,575,918	3,244,066	41,844,984
2026-2029	31,195,000	1,524,440	886,919	33,606,359
Total	$ 97,045,000	$ 37,733,528	$ 21,953,305	$ 156,731,833

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

	Bonds Payable	
Fiscal Year	Principal	Interest
2006	$ 6,115,000	$ 9,562,250
2007	6,220,000	9,790,615
2008	6,420,000	9,568,380
2009	6,860,000	9,276,845
2010	7,135,000	8,983,563
2011-2015	40,725,000	39,989,553
2016-2020	51,990,000	30,264,114
2021-2025	64,120,000	19,422,840
2026-2030	79,195,000	7,824,096
2031-2035	18,200,000	260,335
Total Requirements	$ 286,980,000	$ 144,942,591

Interest on the variable rate 2001A and 2001B revenue bonds is calculated based upon the daily rates at which the bonds were remarketed on June 30, 2005, of 2.26% and 2.28%, respectively. Interest on the variable rate 2003A and 2003B revenue bonds is calculated based upon the synthetic rates of 3.63% and 3.59% as noted above. See Note 6D for more information on the demand bonds and the interest rate swap agreement.

	Notes Payable	
Fiscal Year	Principal	Interest
2006	$ 902,463	$ 65,318
2007	728,114	16,627
Total Requirements	$ 1,630,577	$ 81,945

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

On May 25, 2005, the Hospitals defeased $31,090,000 of outstanding University of North Carolina Hospitals at Chapel Hill Revenue Bonds Series 1996 (original issue amount $133,870,000 of which $88,325,000 was refunded in February 2003 and the final $2,685,000 is due and payable on February 15, 2006). 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 Hospitals' Statement of Net Assets.

As a result, the Hospitals reduced its debt service requirements by $1,871,194 over the next 10 years and obtained an economic gain of $1,167,053. At June 30, 2005, the outstanding balance of the defeased University of North Carolina Hospitals at Chapel Hill Revenue Bonds, Series 1996 bonds was $31,090,000 associated with this advance refunding and a total of $119,415,000 for both advance refundings of the Series 1996 bonds.

NOTE 7 - OPERATING LEASE OBLIGATIONS

The Hospitals entered into operating leases for space rental. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2005:

Fiscal Year	Amount
2006	$ 370,403
2007	369,665
2008	351,098
2009	234,646
2010	112,663
2011-2015	200,046
Total Minimum Lease Payments	$ 1,638,521

Rental expense for all operating leases during the year was $1,400,956.81.

NOTE 8 - NET PATIENT SERVICE REVENUE

Medicare: The Hospitals is reimbursed for inpatient acute care services under the provisions of the Prospective Payment System (PPS). Under PPS, payment is made at predetermined rates for treating various diagnoses and performing procedures that have been grouped into defined diagnostic-related groups (DRGs) applicable to each patient discharge, rather than on the basis of the Hospitals' allowable charges. The difference in the standard hospital charge and the prospective payment for such services is reflected as an adjustment from patient service revenue. The DRG payments include adjustments for indirect medical education and disproportionate share. Capital-related costs are reimbursed based upon a predetermined amount per discharge.

Medicare makes payments for Direct Graduate Medical Education (DGME) in support of the direct costs of residency training. These pass-through payments are discussed further in Note 4, Estimated Third Party Settlements.

Medicare reimburses the Hospitals for inpatient hospital services furnished in the inpatient rehabilitation unit, referred to as an inpatient rehabilitation facility (IRF), under the provisions of the Inpatient Rehabilitation Facility Prospective Payment System (IRF PPS). Payments made under this system cover the inpatient operating and capital costs of covered rehabilitation services and are made on a per discharge basis.

Inpatient services provided in the Hospitals' inpatient psychiatric unit are reimbursed by Medicare under the provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. Under TEFRA, inpatient psychiatric units are paid on the basis of Medicare reasonable costs per case, limited by a hospital specific target amount per discharge. The Hospitals is also eligible for bonus payments if its costs are under or over its target limit.

The Balanced Budget Act of 1997 required the implementation of a prospective payment system for outpatient services. The system became effective August 1, 2000, and is based on ambulatory payment classifications. It applies to most hospital outpatient services other than ambulance, rehabilitation services, clinical diagnostic laboratory services, dialysis for end-stage renal disease, non-implantable durable medical equipment, prosthetic devices and orthotics. Previously, payment for outpatient services varied by type of service: fee schedule, the lower of cost or charges, or a blend of the fee schedules and cost.

Medicaid: Medicaid reimburses inpatient services on an interim basis under a Prospective Payment System. Medicaid uses the Medicare DRG system with the addition of six neonatal DRGs. A settlement is made at year end to adjust from the interim DRG reimbursement to a cost-based reimbursement basis.

Medicaid reimburses outpatient services on the basis of documented cost for all services except ambulance, hearing aids, durable medical equipment (DME), outpatient pharmacy, home health, dialysis and diagnostic laboratory services. Payment is made based on a tentative reimbursement rate with final settlement determined after submission of annual cost reports by the Hospitals.

Contracting Hospital Agreement (CHA): The Hospitals enters into a CHA each year with Blue Cross and Blue Shield of North Carolina (BCBS) whereby both parties accept a schedule of charges for all inpatient and outpatient services delivered. BCBS reimburses the Hospitals on behalf of its subscribers based upon 100% of the charges approved in the contract, less any deductibles or co-payments applicable to specific terms of insurance policies. All patient charges (regardless of payor) conform to the approved rates in the CHA and are subject to change at the Hospitals' discretion.

Other Agreements: The Hospitals has also entered into reimbursement agreements with certain commercial insurance carriers and managed care organizations to accept patients on a discounted fee for service basis. The basis for reimbursement under these agreements includes case rates per discharge, discounts from established charges, fee schedules and per diem rates.

In general, all payments for inpatient and outpatient services are subject to deductibles and co-payments that are the patient's responsibility. Additionally, insurance plans may reimburse their subscribers or make direct payment to the Hospitals on an assignment of benefits basis.

A summary of net patient service revenue for the years ended June 30, 2005, follows:

Inpatient Routine	$	246,655,455
Inpatient Ancillary		500,419,965
Outpatient		426,701,367
Indigent Care Provided		(44,370,954)
Gross Patient Service Revenue		1,129,405,833
Medicare Contractual		(141,186,131)
Medicaid Contractual		(125,895,790)
Managed Care Contractual		(198,168,996)
Other Contractuals		(18,886,534)
Bad Debt		(44,184,192)
Contractual Adjustments		(528,321,643)
Net Patient Service Revenue	$	601,084,189

NOTE 9 - PENSION PLANS

A. Retirement Plans - Each permanent full-time employee, as a condition of employment, is a member of the Teachers' and State Employees' Retirement System (the System). The 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. Graduate medical residents, temporary employees and permanent part-time employees with appointments of less than 30 hours per week are not covered by the plan.

Benefit and contribution provisions for the 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 Hospitals had a total payroll of $267,651,595 of which $221,761,114 was covered under the System. Total employee and employer contributions for pension benefits for the year were $13,305,667 and $4,812,216, respectively. The Hospitals made one hundred percent of its employer required contributions to the System for the years ended June 30, 2005, 2004, and 2003, which were $4,812,216, $485,598, and $0, respectively.

The 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.ncosc.net/ and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

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 Hospitals. The voluntary contributions by employees amounted to $324,795 for the year ended June 30, 2005.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System 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 Hospitals except for a 5% employer contribution for the Hospitals' law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of

Hospitals' law enforcement officers for the year ended June 30, 2005, were $48,625. The voluntary contributions by employees amounted to $1,270,313 for the year ended June 30, 2005.

IRC Section 403(b) and 403(b)(7) Plans - Eligible 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 Hospitals. The voluntary contributions by employees amounted to $4,802,979 for the year ended June 30, 2005.

NOTE 10 - OTHER POSTEMPLOYMENT BENEFITS

A. **Health Care for Long-Term Disability Beneficiaries and Retirees** - The Hospitals 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. 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 Hospitals contributed 3.20% of the covered payroll under the Teachers' and State Employees' Retirement System for these health care benefits. For the fiscal year ended June 30, 2005, the Hospitals' total contribution to the plan was $7,096,356. The Hospitals assumes no liability for retiree health care benefits provided by the programs other than its required contributions. 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 Hospitals 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. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The Hospitals contributes .445% of covered payroll under the Teachers' and State Employees' Retirement System to the DIPNC. For the year ended June 30, 2005, the Hospitals' total contribution to the DIPNC was $986,837. The Hospitals 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 11 - RISK MANAGEMENT

The Hospitals is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled by 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.

The Hospitals is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a $500 per occurrence deductible. The Hospitals also purchased through the Fund "all risks" replacement cost basis insurance for buildings and contents subject to a $25,000 per occurrence deductible. No significant losses occurred during the year.

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 Hospitals pays premiums to the North Carolina Department of Insurance for the coverage.

The Hospitals 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. The Hospitals is 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.

The Hospitals purchased other authorized coverages from private insurance companies through the North Carolina Department of Insurance. These coverages include:

- Boiler and Machinery insurance up to $25,000,000 with a deductible of $5,000 per occurrence;
- Directors and Officers Liability insurance up to $15,000,000 with a deductible of $200,000 per occurrence;
- Master Crime insurance up to $500,000 with a deductible of $1,000;
- Comprehensive General Liability insurance up to $1,000,000 with a deductible of $10,000 per occurrence;
- Automobile Physical Damage (for vehicles costing greater than $75,000) insurance up to $5,000,000 per accident with a deductible of $500 per occurrence;
- General Liability for Helipad on Premises insurance up to $20,000,000 with a deductible of $7,500 per occurrence;
- General Liability for Non-owned Aircraft insurance up to $20,000,000 with no deductible;
- Business Travel insurance for aircraft flight team up to $600,000 per accident with no deductible;
- Computerized Business Equipment replacement cost insurance up to $1,441,204 with a deductible of $10,000 per occurrence;
- Fine Arts Floater insurance up to $50,000 ($5,000 per item) with a deductible of $1,000 per occurrence.

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 Hospital's primary responsibility is to arrange for and provide the necessary treatment for work related injury. The Hospitals is responsible for paying medical benefits and compensation in accordance with the North Carolina Workers' Compensation Act. The Hospitals 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.

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

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

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

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

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

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

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

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

At June 30, 2005, the Hospitals had advance deposits with the Fund totaling $100,000.

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

NOTE 12 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The Hospitals has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were $10,684,941 and $22,564,372 on inventory, capital and all other purchases at June 30, 2005.

B. Pending Litigation and Claims - The Hospitals is party to other litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of those matters, no provision for any liability has been made in the accompanying financial statements. Hospitals' 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 Hospitals.

C. North Carolina State Capital Facilities Act of 2004 - The North Carolina State Capital Facilities Act of 2004 (the Act) was ratified as part of House bill 1264 of the 2004 Session of the General Assembly of North Carolina. The Act authorizes the issuance or incurrence of special indebtedness of an aggregate maximum amount of $180 million to finance the construction and equipping of a new cancer rehabilitation and treatment center, a nearby physician's office building, and a walkway between the two, all to be located at the University of North Carolina Hospitals at Chapel Hill.

The State, with the prior approval of the State Treasurer and the Council of State, as provided in Article 9 of Chapter 142 of the North Carolina General Statutes, is authorized to issue or incur special indebtedness in order to provide funds to the State to be used, together with other available funds, to pay the cost of this project. The Act requires both the Health and Wellness Trust Fund and the Tobacco Trust Fund to provide the debt service for the special indebtedness described above.

The information for the Cancer Hospital project component of the Act is provided quarterly by the Hospitals' Planning Department via a report that outlines the estimated cash requirements needed to fund the remainder of the project as of that point in time. Within these amounts, based on an official request of cash needs from the Hospitals, Office of State Budget and Management (OSBM) authorizes allotments. The Hospitals records the allotments as capital grant revenue on the accompanying financial statements. The Hospitals remaining authorization of $175 million is contingent on fund availability 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 13 - RELATED PARTY TRANSACTIONS

The Medical Foundation of North Carolina, Inc. - The Hospitals is a participant in The Medical Foundation of North Carolina, Inc., a nonprofit Foundation for the University of North Carolina at Chapel Hill and the Hospitals, which solicits gifts and grants for both entities. The Board of Directors of the Medical Foundation administers the funds of the Foundation. Transactions are recorded only by the Foundation. If the Foundation were to purchase any equipment for the Hospitals, then the amount would be recorded at the time of receipt in the accompanying financial statements.

UNC Health Care System - On April 13, 2000, the UNC Health Care System (System) entered into a contractual agreement with Rex Healthcare, Inc. (Rex) and the John Rex Endowment (a private, nonprofit corporation separate from the System) to gain a controlling interest in the governance of Rex Healthcare Inc. and related entities. As a result, the System now appoints eight of the 13 seats on Rex’s Board of Trustees and also reviews and approves Rex’s annual operating and capital budgets.

At the signing of the agreement, the Hospitals transferred $100 million on behalf of the System to the John Rex Endowment. This agreement also calls for future funding of Rex capital needs for the next 10 years up to $58 million. To date, there have been no calls under the agreement because Rex’s capital needs have been funded by their operating surplus.

Rex Healthcare, Inc. - Rex Healthcare, Inc. is a North Carolina not-for-profit corporation organized to provide a wide range of health are services to residents of the Triangle. The principal corporate entities under the common control of Rex Healthcare, Inc. are:

Rex Hospital, Inc. - Rex Hospital, Inc. is a 388-bed acute care hospital that provides inpatient, outpatient and emergency services primarily to the residents of Wake County, North Carolina. The Hospital also operates Rex Heart Center, Rex Cancer Center, Rex Convalescent Care Center, and Rex Primary Care.

Rex Outreach Services, Inc. - Rex Outreach Services, Inc. is a North Carolina not-for-profit corporation organized to provide a variety of community wellness programs to the residents of Wake County. Services provided include the operation of a 107-bed Apex Nursing Care Center and two wellness centers. Rex Outreach Services also owns Rex Home Services, Inc., a not-for-profit corporation, which is managed by UNC Home Health. Rex Outreach Services, Inc. was merged into Rex Hospital, Inc. effective June 30, 2005.

Rex Enterprises - Rex Enterprises, Inc. is a North Carolina not-for-profit corporation organized to promote the health and welfare of residents of Wake County.

Rex Health Care Foundation, Inc. - Rex Healthcare Foundation, Inc. is a North Carolina not-for-profit corporation organized to promote the health and welfare of Triangle residents by promoting philanthropic contributions and public support of Rex Health Care.

UNC Hospitals provides certain management, legal and contracting services to Rex. Likewise, Rex also provides certain employee contracting services to the Hospitals. These transactions resulted in the Hospitals receiving $1,477,634 from Rex and the Hospitals paying $1,515,195 to Rex during the year ended June 30, 2005.

John Rex Endowment - The John Rex Endowment (Endowment) operates as a 501(c)(3) corporation and is independent of the Board of Directors of the UNC Health Care System. Its purpose is to advance the health and well-being of the residents of the greater Triangle area, with specific funds set aside for charity care and to make grants to support health services, education, prevention and research. In discharging its purposes, priority consideration will be given to any funding requests from Rex, UNC Health Care System and their affiliates. The funding source for the Endowment is the $100 million transfer that came from UNC Hospitals. The Endowment has committed $25 million for capital projects at Rex Healthcare, Inc.

NOTE 14 - INVESTMENTS IN AFFILIATES

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were $1,230,529 at June 30, 2005. The Hospitals' share of these affiliates and joint ventures is not significant individually. The summarized unaudited financial information below represents an aggregation of the ongoing affiliates and joint ventures:

		(unaudited) 2005
TOTAL AFFILIATE ACTIVITY		
Current Assets	$	3,381,424
Noncurrent Assets		548,668
Current Liabilities		381,812
Shareholders Equity		3,548,280
Revenue		6,192,407
Net Gain		868,245
HOSPITALS' SHARE OF ACTIVITY		
Affiliate Gain - Ongoing Operations		435,287
Affiliate Gain - Discontinued Operations		870,316
Total Gain Realized from Affiliate Activities	$	1,305,603

NOTE 15 - CHANGE IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2005, the Hospitals implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosure*. 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

On July 18, 2005, the University of North Carolina Health Care System's Board of Directors approved entering into a tax-exempt lease purchase financing arrangement for routine medical and medical related capital equipment with an aggregate principal amount not to exceed $50 million.

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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 Directors
The University of North Carolina Health Care System
Chapel Hill, North Carolina

We have audited the financial statements of the University of North Carolina Hospitals, which is a part of The University of North Carolina Health Care System, which is a part of The University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2005, and have issued our report thereon dated November 16, 2005.

As discussed in Note 1, the financial statements present only the University of North Carolina Hospitals and are not intended to present fairly the financial position of The University of North Carolina Health Care System and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America. As discussed in Note 15 to the financial statements, the Hospitals 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.

<u>Internal Control Over Financial Reporting</u>

In planning and performing our audit, we considered the Hospitals' 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 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

INDEPENDENT AUDITOR'S REPORTON 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)

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 Hospitals' 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 Directors of The University of North Carolina Health Care System, management of the Hospitals, 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 16, 2005

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January 26, 2006

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