



# STATE OF NORTH CAROLINA

**NORTH CAROLINA SCHOOL OF THE ARTS**

**WINSTON-SALEM, NORTH CAROLINA**

**FINANCIAL STATEMENT AUDIT REPORT**

**FOR THE YEAR ENDED JUNE 30, 2006**

**OFFICE OF THE STATE AUDITOR**

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

**STATE AUDITOR**

**NORTH CAROLINA SCHOOL OF THE ARTS**

**WINSTON-SALEM, NORTH CAROLINA**

**FINANCIAL STATEMENT AUDIT REPORT**

**FOR THE YEAR ENDED JUNE 30, 2006**

**BOARD OF GOVERNORS**

**THE UNIVERSITY OF NORTH CAROLINA**

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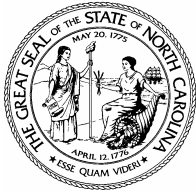
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STATE OF NORTH CAROLINA  
Office of the State Auditor

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**AUDITOR'S TRANSMITTAL**

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

We have completed a financial statement audit of North Carolina School of the Arts for the year ended June 30, 2006, 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.*

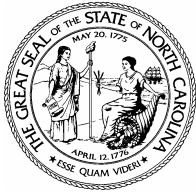
Leslie W. Merritt, Jr., CPA, CFP  
State Auditor

March 19, 2007

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**INDEPENDENT AUDITOR'S REPORT**

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

We have audited the accompanying financial statements of North Carolina School of the Arts, a constituent institution of the 16-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component unit, as of and for the year ended June 30, 2006, which collectively comprise the School's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the North Carolina School of the Arts' management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the NCSA Housing Corporation, which represents 5.69 percent, (.54) percent, and 2.23 percent, respectively, of the assets, net assets and revenues of the School; the financial statements of the North Carolina School of the Arts Program Support Corporation, which represents 1.05 percent, 1.18 percent, and .01 percent, respectively, of the assets, net assets and revenues of the School; or the financial statements of the North Carolina School of the Arts Foundation, Inc., which represents 100% of the School's discretely presented component unit. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as they relate to the amounts included for those entities, are based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the North Carolina School of the Arts Foundation, Inc., were not audited in accordance with *Government Auditing Standards*. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provides a reasonable basis for our opinions.

## INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of North Carolina School of the Arts and its discretely presented component unit as of June 30, 2006, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 31, 2007, on our consideration of the School's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

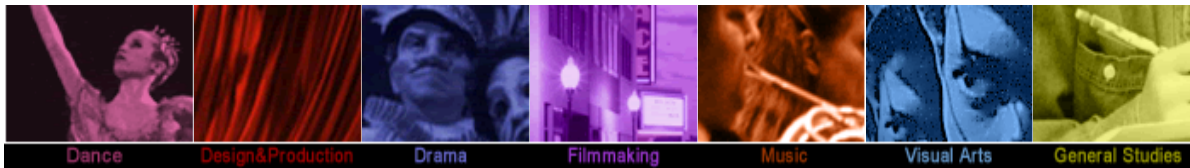
*Leslie W. Merritt, Jr.*

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

January 31, 2007

## NORTH CAROLINA SCHOOL OF THE ARTS MANAGEMENT'S DISCUSSION AND ANALYSIS

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### **Introduction**

This section of the North Carolina School of the Arts financial report provides an overview of the financial position and activities for the year ended June 30, 2006. This discussion has been prepared by management along with the financial statements and related notes to the financial statements and should be read in conjunction with the financial statements and the notes thereto, which follow this section. This discussion and analysis is designed to focus on current activities, resulting change, and current known facts.

### **Using the Financial Statements**

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

### **Statements of Net Assets**

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

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

Net assets are divided into three major categories. The first category, invested in capital assets, net of related debt, provides the School's equity in property, plant and equipment

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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

### Statement of Net Assets

	Year Ended June 30,	
	2006	2005 (As Restated)
<b>Assets</b>		
Current Assets	\$ 6,501,657.50	\$ 7,130,542.65
Capital Assets, Net	98,016,386.68	96,673,156.86
Other Noncurrent Assets	12,812,831.48	7,493,677.43
Total Assets	<u>117,330,875.66</u>	<u>111,297,376.94</u>
<b>Liabilities</b>		
Current Liabilities	3,071,269.20	3,951,625.07
Noncurrent Liabilities	12,917,528.77	12,329,894.01
Total Liabilities	<u>15,988,797.97</u>	<u>16,281,519.08</u>
<b>Net Assets</b>		
Invested in Capital Assets, Net of Related Debt	87,131,271.61	85,348,387.86
Restricted:		
Nonexpendable	6,604,830.65	4,857,324.73
Expendable	5,051,379.15	1,996,128.94
Unrestricted	<u>2,554,596.28</u>	<u>2,814,016.33</u>
Total Net Assets	<u>\$ 101,342,077.69</u>	<u>\$ 95,015,857.86</u>

The total assets of the School increased by \$6,033,498.72 for the year, which includes a decrease of \$628,885.15 in current assets and an increase of \$6,662,383.87 in noncurrent assets. This overall increase was due to a \$3,938,361.34 increase in capital assets, net of accumulated depreciation of \$2,595,131.52, bringing the net capital assets increase to \$1,343,229.82. The largest capital assets increase was in construction in progress, with a \$3,041,604.05 increase primarily attributable to increased expenditures in the general obligation bond projects during the 2005-2006 fiscal year. There was also \$9,506,900.31 of adjustments out of the construction in progress account into the appropriate capital asset accounts due to completion of construction. The \$9,506,900.31 in adjustments was to the



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

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following capital assets accounts: \$9,301,269.84 to buildings, \$139,176.00 to general infrastructure, and \$66,454.47 to land. The School's endowments increased by \$5,431,529.08. This increase was due to additional gifts in the amount of \$1,530,000.00 for the establishment of three new endowments and additional gifts to existing endowments. The Board of Trustees of the Endowment Fund hired an investment manager, Wachovia Trust, resulting in the investment of \$4,197,542.58 that was previously held in a money market account. In addition to the capital assets and endowment investment increases, the School received \$1,375,800.00 for 2005 Repair and Renovation projects.

The total liabilities of the School decreased by \$292,721.11 for the year, which includes a decrease of \$880,355.87 in current liabilities and an increase of \$587,634.76 in noncurrent liabilities. The decrease in total current liabilities was primarily attributable to a \$1,115,996.02 decrease in accounts payable, payroll, and contracts retained. The increase in noncurrent liabilities was primarily attributable to a \$568,834.87 net increase in long-term liabilities during the year.

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

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

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

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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

	Year Ended June 30,	
	2006	2005 (As Restated)
<b>Operating Revenues</b>		
Student Tuition and Fees, Net	\$ 8,782,433.11	\$ 8,167,556.61
Federal Grants and Contracts	570,099.38	566,336.58
Sales and Services, Net	4,354,986.84	3,783,221.25
Interest Earnings on Loans	3,866.73	1,051.32
Other Operating Revenues	674,675.00	996,591.73
Total Operating Revenues	<u>14,386,061.06</u>	<u>13,514,757.49</u>
Total Operating Expenses	<u>42,550,205.21</u>	<u>38,671,333.41</u>
Operating Loss	<u>(28,164,144.15)</u>	<u>(25,156,575.92)</u>
<b>Nonoperating Revenues (Expenses)</b>		
State Appropriations	21,947,079.02	20,592,001.64
Noncapital Grants	350,083.00	21,181.42
Noncapital Gifts	3,248,318.69	3,331,246.18
Investment Income (Net of Investment Expense)	742,600.32	225,046.00
Interest and Fees on Capital Asset-Related Debt	(603,686.94)	(597,268.21)
Other Nonoperating Revenues	1,139.60	8,643.12
Net Nonoperating Revenues	<u>25,685,533.69</u>	<u>23,580,850.15</u>
Loss Before Other Revenues	<u>(2,478,610.46)</u>	<u>(1,575,725.77)</u>
Capital Appropriations	3,375,800.00	564,400.00
Capital Grants	3,899,030.29	8,108,434.00
Capital Gifts	1,530,000.00	11,400.00
Additions to Permanent Endowments	<u>1,530,000.00</u>	<u>1,749,427.38</u>
Total Other Revenues	<u>8,804,830.29</u>	<u>10,433,661.38</u>
Change in Net Assets	6,326,219.83	8,857,935.61
Beginning Net Assets	<u>95,015,857.86</u>	<u>86,157,922.25</u>
Ending Net Assets	<u>\$ 101,342,077.69</u>	<u>\$ 95,015,857.86</u>

The Statement of Revenues, Expenses, and Changes in Net Assets reflects an increase in the net assets at the end of the year. Total net revenues were \$48,876,425.04 for 2006 and \$47,529,269.02 for 2005. The increase in total net revenues, \$1,347,156.02, is due primarily to the increase in operating revenues of \$871,303.57, the increase in State appropriations of \$1,355,077.38, and the increase in capital appropriations of \$2,811,400.00. These increases are offset by an increase in operating expenses of \$3,878,871.80. Some highlights of the information presented on the Statement of Revenues, Expenses, and Changes in Net Assets are as follows:

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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- Student tuition and fees reflects a slight increase primarily due to an increase in fees.
- Other operating revenues decreased due to the income from Center Stage Apartments being recorded as Sales and Services in the current year.
- State appropriations increased due to an increase for operating funds for new acquisitions, facilities constructed, and legislative salary increases.
- Noncapital grants increased due to receipt of \$333,333.00, the first of three installments for operating funds for the Center for Design Innovation.
- Investment income increased this year due to improved earnings on endowment investments. This was the result of hiring an investment manager by the Board of Trustees of the Endowment Fund to manage the School's endowment investments.
- The expenses associated with interest and fees on capital asset-related debt increased with the addition of the debt for Center Stage Apartments (NCSA Housing Corporation).
- Capital grants continued to decrease due to a reduction in construction projects funded under the UNC bond projects.
- The School's endowments continued to grow with the addition of \$1,530,000.00 in gifts for the establishment of two scholarship endowments (Wills Family Scholarship Endowment and Rubin Scholarship Endowment) and additional gifts to the Forsyth Dance, Forsyth Drama, Forsyth Music, and A.J. Fletcher Endowments.

### **Capital Asset and Debt Administration**

The NCSA Housing Corporation, a blended entity of the School, took out certificates of participation in the amount of \$7,200,000.00 to provide funds to discharge certain indebtedness used for the acquisition, construction, equipping and subsequent improvements of the Center Stage Apartment complex. The NCSA Housing Corporation has leased the apartment complex to the School to operate and maintain. Rentals from the apartment complex are pledged for the retirement of this debt. The debt service repayment schedule runs through June 2036, with interest rates ranging from 3.50% to 4.50%.

### **Economic Outlook**

The School continues to face budgetary challenges. Operations and procedures are constantly reviewed to identify cost-saving opportunities while providing the needed services in ways necessary to deliver a high standard of classroom instruction and a high quality of student life.

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

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

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The connector building between Moore and Sanford Halls (high school dormitories) and the Dance Costume Shop was placed into service during fiscal year 2005-2006. The Crawford Hall/DeMille Theatre/Gray Building renovation project should be completed in fiscal year 2006-2007.

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

The North Carolina School of the Arts Foundation, Inc. purchased a new Chancellor's residence on September 15, 2006. The residence is a newly constructed condominium that has 6,000 square feet. The condominium is located five minutes from campus and will provide more room to host fund raising dinners and receptions for the School. The School has entered into a lease with the Foundation for the use of the condominium as the Chancellor's residence.

The North Carolina School of the Arts (NCSA) and Winston-Salem State University (WSSU) established the Center for Design Innovation (CDI), with UNC Board of Governors' approval, as an inter-institutional center of mutual interest and benefit that will further the instructional, creative, service and research objectives of NCSA and WSSU in a manner consistent with their status as non-profit educational and research institutions. The inaugural Director for the CDI began her duties on September 1, 2006. Progress was made toward establishing an interim facility for the CDI supported with funding provided by the Golden Leaf Foundation. Recently \$10 million for construction of the permanent CDI facility was approved by the Council of State. This funding was directed to WSSU as the lead on the construction of the permanent facility. The architect for the project is Calloway, Johnson, Moore, and West of Winston-Salem.

***North Carolina School of the Arts  
Statement of Net Assets  
June 30, 2006***

***Exhibit A-1***

**ASSETS**

Current Assets:

Cash and Cash Equivalents	\$ 5,557,848.98
Restricted Cash and Cash Equivalents	278,265.31
Restricted Short-Term Investments	225,000.00
Receivables, Net (Note 4)	154,747.45
Due from School Component Unit	13,814.00
Inventories	149,978.58
Notes Receivable, Net (Note 4)	122,003.18
	<hr/>
Total Current Assets	6,501,657.50

Noncurrent Assets:

Restricted Cash and Cash Equivalents	3,845,576.99
Restricted Due from Primary Government	332,047.51
Endowment Investments	7,099,005.44
Other Long-Term Investments	536,297.72
Notes Receivable, Net (Note 4)	359,164.82
Capital Assets - Nondepreciable (Note 5)	5,337,808.38
Capital Assets - Depreciable, Net (Note 5)	92,678,578.30
Bond Issuance Costs, Net of Amortization of \$16,063	640,739.00
	<hr/>
Total Noncurrent Assets	110,829,218.16

Total Assets	<hr/> <hr/> 117,330,875.66
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**LIABILITIES**

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)	773,085.84
Unearned Revenue	1,417,372.09
Interest Payable	67,441.37
Long-Term Liabilities - Current Portion (Note 7)	813,369.90
	<hr/>
Total Current Liabilities	3,071,269.20

Noncurrent Liabilities:

Deposits Payable	80,653.88
Funds Held for Others	15,946.96
U. S. Government Grants Refundable	471,093.05
Long-Term Liabilities (Note 7)	12,349,834.88
	<hr/>
Total Noncurrent Liabilities	12,917,528.77

Total Liabilities	<hr/> <hr/> 15,988,797.97
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***North Carolina School of the Arts  
Statement of Net Assets  
June 30, 2006***

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

**NET ASSETS**

Invested in Capital Assets, Net of Related Debt	87,131,271.61
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	280,000.00
Endowed Professorships	4,002,841.33
Departmental Uses	2,267,000.00
Loans	54,989.32
Expendable:	
Scholarships and Fellowships	334,326.11
Endowed Professorships	336,305.43
Departmental Uses	222,012.52
Capital Projects	3,725,410.09
Debt Service	433,325.00
Unrestricted	<u>2,554,596.28</u>
Total Net Assets	<u><u>\$ 101,342,077.69</u></u>

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

***North Carolina School of the Arts  
Statement of Revenues, Expenses, and  
Changes in Net Assets  
For the Fiscal Year Ended June 30, 2006***

***Exhibit A-2***

**REVENUES**

Operating Revenues:

Student Tuition and Fees, Net (Note 9)	\$ 8,782,433.11
Federal Grants and Contracts	570,099.38
Sales and Services, Net (Note 9)	4,354,986.84
Interest Earnings on Loans	3,866.73
Other Operating Revenues	674,675.00

Total Operating Revenues	14,386,061.06
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**EXPENSES**

Operating Expenses:

Salaries and Benefits	26,113,573.94
Supplies and Materials	4,325,806.94
Services	6,849,421.29
Scholarships and Fellowships	621,876.51
Utilities	2,044,395.01
Depreciation	2,595,131.52

Total Operating Expenses	42,550,205.21
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Operating Loss	(28,164,144.15)
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**NONOPERATING REVENUES (EXPENSES)**

State Appropriations	21,947,079.02
Noncapital Grants	350,083.00
Noncapital Gifts	3,248,318.69
Investment Income (Net of Investment Expense of \$49,528.52)	742,600.32
Interest and Fees on Debt	(603,686.94)
Other Nonoperating Revenues	1,139.60

Net Nonoperating Revenues	25,685,533.69
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Loss Before Other Revenues	(2,478,610.46)
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Capital Appropriations	3,375,800.00
Capital Grants	3,899,030.29
Additions to Endowments	1,530,000.00

Increase in Net Assets	6,326,219.83
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**NET ASSETS**

Net Assets - July 1, 2005, as Restated (Note 15)	95,015,857.86
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Net Assets - June 30, 2006	\$ 101,342,077.69
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The accompanying notes to the financial statements are an integral part of this statement.

***North Carolina School of the Arts  
Statement of Cash Flows  
For the Fiscal Year Ended June 30, 2006***

***Exhibit A-3***

**CASH FLOWS FROM OPERATING ACTIVITIES**

Received from Customers	\$ 14,625,436.30
Payments to Employees and Fringe Benefits	(25,970,155.37)
Payments to Vendors and Suppliers	(13,286,026.42)
Payments for Scholarships and Fellowships	(621,876.51)
Loans Issued	(170,402.75)
Collection of Loans	129,514.38
Interest Earned on Loans	3,535.63
US Government Grants Refundable	(7,952.31)
Student Deposits Received	103,379.91
Student Deposits Returned	(77,697.03)
	<hr/>
Net Cash Used by Operating Activities	(25,272,244.17)

**CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES**

State Appropriations	21,947,079.02
Noncapital Grants	350,083.00
Noncapital Gifts	3,249,189.04
Additions to Endowments	1,530,000.00
William D. Ford Direct Lending Receipts	4,408,080.00
William D. Ford Direct Lending Disbursements	(4,408,080.00)
Related Activity Agency Receipts	3,509.01
	<hr/>
Net Cash Provided by Noncapital Financing Activities	27,079,860.07

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

Proceeds from Capital Debt	7,200,000.00
State Capital Appropriations	3,375,800.00
Capital Grants	5,380,314.77
Proceeds from Sale of Capital Assets	1,139.60
Acquisition and Construction of Capital Assets	(4,697,202.18)
Principal Paid on Capital Debt	(6,998,914.93)
Interest and Fees Paid on Capital Debt	(1,222,495.57)
	<hr/>
Net Cash Provided by Capital Financing and Related Financing Activities	3,038,641.69

**CASH FLOWS FROM INVESTING ACTIVITIES**

Proceeds from Sales and Maturities of Investments	4,578,920.31
Investment Income	492,510.34
Purchase of Investments and Related Fees	(10,326,590.31)
	<hr/>
Net Cash Used by Investing Activities	(5,255,159.66)
	<hr/>
Net Decrease in Cash and Cash Equivalents	(408,902.07)
Cash and Cash Equivalents - July 1, 2005	10,090,593.35
	<hr/>
Cash and Cash Equivalents - June 30, 2006	\$ 9,681,691.28



***North Carolina School of the Arts  
Statement of Cash Flows  
For the Fiscal Year Ended June 30, 2006***

***Exhibit A-3***

***Page 2***

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

Operating Loss	\$ (28,164,144.15)
Adjustments to Reconcile Operating Loss to Net Cash Usec by Operating Activities:	
Depreciation Expense	2,595,131.52
Allowances, Write-Offs, and Amortizations	28,331.25
Changes in Assets and Liabilities:	
Receivables (Net)	55,213.56
Due from School Component Unit	4,633.00
Inventories	25,727.84
Accounts Payable and Accrued Liabilities	(370,313.45)
US Government Grants Refundable	(7,952.31)
Unearned Revenue	188,811.21
Compensated Absences	392,648.37
Deposits Payable	20,557.36
Student Loans Issued	(170,402.75)
Student Loans Principal Repayments	129,514.38
	<u>129,514.38</u>
Net Cash Used by Operating Activities	<u>\$ (25,272,244.17)</u>

**RECONCILIATION OF CASH AND CASH EQUIVALENTS**

Current Assets:	
Cash and Cash Equivalents	\$ 5,557,848.98
Restricted Cash and Cash Equivalents	278,265.31
Noncurrent Assets:	
Restricted Cash and Cash Equivalents	3,845,576.99
	<u>3,845,576.99</u>
Total Cash and Cash Equivalents - June 30, 2006	<u>\$ 9,681,691.28</u>

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

Change in Fair Value of Investments	271,684.12
Reinvested Distributions	256,241.48
Loss on Disposal of Capital Assets	12,018.67

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

**North Carolina School of the Arts Foundation, Inc.**  
**Statement of Financial Position**  
**June 30, 2006**

**Exhibit B-1**

	<b>Unrestricted</b>	<b>Temporarily Restricted</b>	<b>Permanently Restricted</b>	<b>Total</b>
<b>ASSETS</b>				
Cash and Cash Equivalents	\$ 73,679	\$ 574,751	\$ 144,695	\$ 793,125
Investments		4,300,397	14,322,462	18,622,859
Annuity Investments			982,327	982,327
Beneficial Interest in Perpetual Trusts			795,281	795,281
Beneficial Interest in Charitable Remainder Trusts			128,561	128,561
Pledges Receivable, Net of Allowance and Discount of \$729,002	16,212	940,621	1,743,772	2,700,605
Accounts Receivable	10,022	2,681		12,703
Due From (To) Other Funds	350,167	(350,167)		
Prepaid Expenses	4,526	6,858		11,384
Staff, Faculty, and Student Loans Receivable	12,886	7,596		20,482
Property and Equipment, Net	708,614	263,847		972,461
<b>Total Assets</b>	<b>1,176,106</b>	<b>5,746,584</b>	<b>18,117,098</b>	<b>25,039,788</b>
<b>LIABILITIES</b>				
Accounts Payable and Accrued Expenses	23,651	56,715		80,366
Annuity Payment Liability			640,062	640,062
Notes Payable		38,033		38,033
<b>Total Liabilities</b>	<b>23,651</b>	<b>94,748</b>	<b>640,062</b>	<b>758,461</b>
<b>NET ASSETS</b>				
Unrestricted	1,152,455			1,152,455
Temporarily Restricted		5,651,836		5,651,836
Permanently Restricted			17,477,036	17,477,036
<b>Total Net Assets</b>	<b>\$ 1,152,455</b>	<b>\$ 5,651,836</b>	<b>\$ 17,477,036</b>	<b>\$ 24,281,327</b>

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

**North Carolina School of the Arts Foundation, Inc.**  
**Statement of Activities**  
**For the Fiscal Year Ended June 30, 2006**

**Exhibit B-2**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
<b>REVENUES</b>				
Gifts and Grants	\$ 355,408	\$ 1,745,216	\$ 1,162,757	\$ 3,263,381
Interest and Dividend Income	5,084	429,318		434,402
Realized and Unrealized Gains		693,530		693,530
Change in Fair Value of Split-Interest Agreements			102,059	102,059
Change in Fair Value of Beneficial Interest in Perpetual Trusts		54,835	37,267	92,102
Other Income	10,649	104,260		114,909
Net Assets Released from Restrictions	<u>2,084,484</u>	<u>(2,084,484)</u>		
Total Revenues	2,455,625	942,675	1,302,083	4,700,383
<b>EXPENSES</b>				
Program Services:				
Scholarships and Awards	920,691			920,691
School Programs	<u>1,172,543</u>			<u>1,172,543</u>
Total Program Services	2,093,234			2,093,234
Supporting Services:				
Administrative Costs	272,470			272,470
Investment Management Fees	53,322			53,322
Development Costs	334,186			334,186
Depreciation and Amortization Expense	15,561			15,561
Miscellaneous Expense	<u>118,075</u>			<u>118,075</u>
Total Supporting Services	793,614			793,614
Total Expenses	<u>2,886,848</u>			<u>2,886,848</u>
Change in Net Assets Before Transfers	<u>(431,223)</u>	<u>942,675</u>	<u>1,302,083</u>	<u>1,813,535</u>
Transfers	<u>84,251</u>	<u>(84,251)</u>		
Change in Net Assets	(346,972)	858,424	1,302,083	1,813,535
<b>NET ASSETS</b>				
Net Assets - Beginning of Year	<u>1,499,427</u>	<u>4,793,412</u>	<u>16,174,953</u>	<u>22,467,792</u>
Net Assets - End of Year	<u>\$ 1,152,455</u>	<u>\$ 5,651,836</u>	<u>\$ 17,477,036</u>	<u>\$ 24,281,327</u>

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

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**NORTH CAROLINA SCHOOL OF THE ARTS  
NOTES TO THE FINANCIAL STATEMENTS  
JUNE 30, 2006**

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES**

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

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

**Blended Component Units** – Although legally separate, the NCSA Housing Corporation and the North Carolina School of the Arts Program Support Corporation, component units of the School, are reported as if they were part of the School.

The NCSA Housing Corporation is governed by a five-member board. Its purpose is to aid, support and promote the School, specifically by the ownership of the Center Stage apartment complex at 900 Center Stage Court, Winston-Salem, NC 27127. Because the directors are appointed by the Chancellor and its primary purpose is to benefit North Carolina School of the Arts, its financial statements have been blended with those of the School.

The North Carolina School of the Arts Program Support Corporation is governed by a five-member board. Its purpose is to foster, promote,

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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assist, and support the schools of Dance, Design and Production, Drama, Filmmaking, and Music, and any other related activity of North Carolina School of the Arts. Because the directors are appointed by the Chancellor and its primary purpose is to benefit North Carolina School of the Arts, its financial statements have been blended with those of the School.

Separate financial statements for the NCSA Housing Corporation and the North Carolina School of the Arts Program Support Corporation may be obtained from the School Controller's Office, PO Box 12189, Winston-Salem, NC 27107, or by calling (336) 770-3304. Other related foundations and similar nonprofit corporations for which the School is not financially accountable are not part of the accompanying financial statements.

**Discretely Presented Component Unit** – The North Carolina School of the Arts Foundation, Inc., (Foundation) is a legally separate not-for-profit corporation and is reported as a discretely presented tax-exempt component unit based on the nature and significance of its relationship to the School.

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

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

During the year ended June 30, 2006, the Foundation distributed \$1,284,925.00 to the School for both restricted and unrestricted purposes. Complete financial statements for the Foundation can be obtained from the North Carolina School of the Arts Foundation, Inc., PO Box 12189, Winston-Salem, NC 27107.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

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

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

- D. Cash and Cash Equivalents** – This classification includes undeposited receipts, petty cash, cash on deposit with private bank accounts, money market accounts, cash on deposit with fiscal agents, and deposits held by the State Treasurer in the short-term investment 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.
- E. Investments** – This classification includes mutual funds, money market funds, real estate investments, and certificates of deposit. Except for money market funds and certificates of deposit, investments are accounted for at fair value, as determined by quoted market prices, or an amount determined by management if quoted market prices are not

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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available. The net increase in the fair value of investments is recognized as a component of investment income.

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

- F. Receivables** – Receivables consist of tuition and fees charged to students, charges for auxiliary enterprises' sales and services, and student loans. Receivables also include amounts due from the federal and State governments, and from private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants. Student and note receivables are recorded net of estimated uncollectible amounts. All other receivables are shown at book value with no provision for uncollectible amounts considered necessary.
- G. Inventories** – Inventories, consisting of expendable supplies, are valued at cost using last invoice cost. Merchandise for resale is valued using the retail inventory method.
- H. Capital Assets** – Capital assets are stated at cost at date of acquisition or fair value at date of donation in the case of gifts. The value of assets constructed includes all material direct and indirect construction costs.

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

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

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

- I. Restricted Assets** – Unexpended capital contributions are classified as restricted assets because their use is limited by applicable donor/grantor agreements. These assets are also classified as noncurrent since they cannot be used for current operations. Certain other assets are classified as restricted because their use is limited by external parties or statute.
- J. Noncurrent Long-Term Liabilities** – Noncurrent long-term liabilities include principal amounts of bonds payable, notes payable, and compensated absences that will not be paid within the next fiscal year.



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Premiums, discounts and issuance costs for the School are expensed for bonds and notes payable. Bond issuance costs for the blended housing corporation were capitalized and amortized over the life of the bonds using the straight-line method.

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

In addition to the vacation leave described above, compensated absences include the accumulated unused portion of the special annual leave bonuses awarded by the North Carolina General Assembly. The bonus leave balance on December 31 is retained by employees and transferred into the next calendar year. It is not subject to the limitation on annual leave carried forward described above and is not subject to conversion to sick leave.

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

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

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

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

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

**Restricted Net Assets – Expendable** – Expendable restricted net assets include resources for which the School is legally or contractually

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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obligated to spend in accordance with restrictions imposed by external parties.

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

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

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

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

Nonoperating revenues include activities that have the characteristics of nonexchange transactions. Revenues from nonexchange transactions and

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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State appropriations that represent subsidies or gifts to the School, as well as investment income, are considered nonoperating since these are either investing, capital or noncapital financing activities. Capital contributions are presented separately after nonoperating revenues and expenses.

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

### NOTE 2 - DEPOSITS AND INVESTMENTS

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

At June 30, 2006, the amount shown on the Statement of Net Assets as cash and cash equivalents includes \$7,519,713.33 which represents the School's equity position in the State Treasurer's Short-Term Investment Fund. 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 1.18 years as of June 30, 2006. 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.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Cash on hand at June 30, 2006, was \$1,733,498.62. The carrying amount of the School's deposits not with the State Treasurer, including certificates of deposit, was \$653,479.33 and the bank balance was \$699,690.05. Custodial credit risk is the risk that in the event of a bank failure, the School's deposits may not be returned to it. The School does not have a deposit policy for custodial credit risk. As of June 30, 2006, the School's bank balance was exposed to custodial credit risk as follows:

Uninsured and Uncollateralized	<u>\$ 374,632.66</u>
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### B. Investments

**School** – The School is authorized by The University of North Carolina Board of Governors pursuant to G.S. 116-36.2 and Section 600.2.4 of the Policy Manual of the University of North Carolina, to invest its special funds in the same manner as the State Treasurer is required to invest, as discussed below.

G.S. 147-69.1(c), applicable to the State's General Fund, and G.S. 147-69.2, applicable to institutional trust funds, authorize the State Treasurer to invest in the following: obligations of or fully guaranteed by the United States; obligations of certain federal agencies; repurchase agreements; obligations of the State of North Carolina; time deposits of specified institutions; prime quality commercial paper, and asset-backed securities with specified ratings. Also, G.S. 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified ratings. G.S. 147-69.2 authorizes the following: general obligations of other states; general obligations of North Carolina local governments; and obligations of certain entities with specified ratings.

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

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

Investments of the School's component unit, the Foundation, are subject to and restricted by G.S. 36B "Uniform Management of Institutional

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Funds Act” (UMIFA) and any requirements placed on them by contract or donor agreements.

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

Investments are subject to the following risks:

**Interest Rate Risk:** Interest rate risk is the risk the School may face should interest rate variances affect the fair value of investments. The School does not have a formal policy that addresses interest rate risk.

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

**Long-Term Investment Pool** – This is an internal investment pool that is utilized for the investment of the endowment funds. Fund ownership is measured using the unit market value method. Under this method, each participating fund’s investment balance is based on the number of units of ownership purchased when joining the pool. Thereafter, the pooled assets are valued monthly and a new unit market value is determined. The investment strategy, including the selection of investment managers, is based on the directives of the School’s Endowment Board.

The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2006, for the Long-Term Investment Pool.

### *Long-Term Investment Pool*

Investment Type	Fair Value	Investment Maturities (in Years)	
		Less Than 1	6 to 10
Debt Securities			
Mutual Bond Funds	\$ 2,679,377.45	\$ 0.00	\$ 2,679,377.45
Money Market Mutual Funds	397,102.94	397,102.94	
		\$ 397,102.94	\$ 2,679,377.45
Other Securities			
International Mutual Funds	864,953.65		
Other Mutual Funds	3,157,571.40		
Total Long-Term Investment Pool	\$ 7,099,005.44		

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

At June 30, 2006, investments in the Long-Term Investment Pool had the following credit quality distribution for securities with credit exposure:

	Fair Value	AAA Aaa
Mutual Bond Funds	\$ 2,679,377.45	\$ 2,679,377.45
Money Market Mutual Funds	397,102.94	397,102.94
Total	\$ 3,076,480.39	\$ 3,076,480.39

Rating Agency: Standard and Poors

**Non-Pooled Investments** – The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2006, for the School’s non-pooled investments.

### *Non-Pooled Investments*

	Fair Value	(in Years) Less Than 1
<b>Investment Type</b>		
Debt Securities		
Money Market Funds	\$ 444,930.74	\$ 444,930.74
Other Securities		
Certificates of Deposit	225,000.00	
Investments in Real Estate	91,366.98	
Total Non-Pooled Investments	\$ 761,297.72	

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

As of June 30, 2006, the Money Market Funds, with fair value of \$444,930.74, were rated AAA by Standard and Poors.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**Total Investments** – The following table presents the fair value of the total investments at June 30, 2006:

<b>Investment Type</b>	Fair Value
Debt Securities	
Mutual Bond Funds	\$ 2,679,377.45
Money Market Funds	842,033.68
Other Securities	
Certificates of Deposit	225,000.00
International Mutual Funds	864,953.65
Other Mutual Funds	3,157,571.40
Investments in Real Estate	91,366.98
Total Investments	\$ 7,860,303.16

**Component Unit** – Investments of the School’s discretely presented component unit, the Foundation, are subject to and restricted by G.S. 36B “Uniform Management of Institutional Funds Act” (UMIFA) and any requirements placed on them by contract or donor agreements. Because the Foundation report is under the FASB reporting model, disclosures of the various investment risks are not required. The following is an analysis of investments by type:

<b>Investment Type</b>	Fair Value
Equity Securities	\$ 10,488,626.00
Cash in Transit to Equity Securities	1,900,000.00
Fixed Income Securities and Other Bonds	1,398,607.00
Government Bonds	346,575.00
International Fixed Income	2,168,927.00
International Equities	1,622,264.00
Short-Term Investments	697,860.00
	\$ 18,622,859.00

### NOTE 3 - ENDOWMENT INVESTMENTS

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

Investment return of the School’s endowment funds is predicated on the total return concept (yield plus appreciation). To the extent that the total return for

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the current year exceeds the payout, the excess is added to principal. If current year earnings do not meet the payout requirements, the School uses accumulated income and appreciation from restricted, expendable net asset endowment balances to make up the difference. At June 30, 2006, net appreciation of \$346,459.00 was available to be spent for restricted purposes.

### NOTE 4 - RECEIVABLES

Receivables at June 30, 2006, were as follows:

	<u>Gross Receivables</u>	<u>Less Allowance for Doubtful Accounts</u>	<u>Net Receivables</u>
<b>Current Receivables:</b>			
Students	\$ 40,129.23	\$ 10,048.32	\$ 30,080.91
Accounts	101,224.91	4,642.64	96,582.27
Investment Earnings	3,046.41		3,046.41
Interest on Loans	25,037.86		25,037.86
	<u>\$ 169,438.41</u>	<u>\$ 14,690.96</u>	<u>\$ 154,747.45</u>
<b>Notes Receivable:</b>			
<b>Notes Receivable - Current:</b>			
Federal Loan Programs	\$ 147,111.75	\$ 26,291.82	\$ 120,819.93
Institutional Student Loan Programs	7,922.45	6,739.20	1,183.25
	<u>\$ 155,034.20</u>	<u>\$ 33,031.02</u>	<u>\$ 122,003.18</u>
<b>Notes Receivable - Noncurrent:</b>			
Federal Loan Programs	<u>\$ 479,861.39</u>	<u>\$ 120,696.57</u>	<u>\$ 359,164.82</u>



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2006, is presented as follows:

	Balance July 1, 2005	Increases	Decreases	Balance June 30, 2006
Capital Assets, Nondepreciable:				
Land	\$ 3,794,231.23	\$ 101,933.86	\$ 0.00	\$ 3,896,165.09
Art, Literature, and Artifacts	1,383,364.44			1,383,364.44
Construction in Progress	6,523,575.11	3,041,604.05	9,506,900.31	58,278.85
<b>Total Capital Assets, Nondepreciable</b>	<b>11,701,170.78</b>	<b>3,143,537.91</b>	<b>9,506,900.31</b>	<b>5,337,808.38</b>
Capital Assets, Depreciable:				
Buildings	96,132,116.02	9,476,344.84		105,608,460.86
Machinery and Equipment	9,140,358.89	638,840.08	872,888.13	8,906,310.84
General Infrastructure	4,907,959.41	199,697.09		5,107,656.50
<b>Total Capital Assets, Depreciable</b>	<b>110,180,434.32</b>	<b>10,314,882.01</b>	<b>872,888.13</b>	<b>119,622,428.20</b>
Less Accumulated Depreciation for:				
Buildings	17,483,883.65	2,026,225.67		19,510,109.32
Machinery and Equipment	7,331,754.94	470,329.60	859,729.86	6,942,354.68
General Infrastructure	392,809.65	98,576.25		491,385.90
<b>Total Accumulated Depreciation</b>	<b>25,208,448.24</b>	<b>2,595,131.52</b>	<b>859,729.86</b>	<b>26,943,849.90</b>
<b>Total Capital Assets, Depreciable, Net</b>	<b>84,971,986.08</b>	<b>7,719,750.49</b>	<b>13,158.27</b>	<b>92,678,578.30</b>
<b>Capital Assets, Net</b>	<b>\$ 96,673,156.86</b>	<b>\$ 10,863,288.40</b>	<b>\$ 9,520,058.58</b>	<b>\$ 98,016,386.68</b>

### NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2006, were as follows:

	Amount
Accounts Payable	\$ 584,632.81
Accrued Payroll	158,803.03
Contract Retainage	29,650.00
<b>Total Accounts Payable and Accrued Liabilities</b>	<b>\$ 773,085.84</b>

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 7 - LONG-TERM LIABILITIES

#### A. Changes in Long-Term Liabilities – A summary of changes in the long-term liabilities for the year ended June 30, 2006, is presented as follows:

	Balance July 1, 2005	Additions	Reductions	Balance June 30, 2006	Current Portion
Bonds Payable	\$ 3,985,000.00	\$ 7,200,000.00	\$ 295,000.00	\$ 10,890,000.00	\$ 385,000.00
Notes Payable	7,339,769.00		6,703,914.93	635,854.07	307,800.00
Compensated Absences	1,244,702.34	2,134,778.27	1,742,129.90	1,637,350.71	120,569.90
<b>Total Long-Term Liabilities</b>	<b>\$ 12,569,471.34</b>	<b>\$ 9,334,778.27</b>	<b>\$ 8,741,044.83</b>	<b>\$ 13,163,204.78</b>	<b>\$ 813,369.90</b>

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2006	Principal Outstanding June 30, 2006
<b>Housing and Dining System</b>						
Refunding 1998B and 2000 UNC System Pool Revenue Bonds	B	3.00% - 4.25%	04/01/2019	\$ 1,900,000.00	\$ 150,000.00	\$ 1,750,000.00
Fitness and Student Center Project	A	3.25% - 5.25%	10/01/2018	2,650,000.00	675,000.00	1,975,000.00
Total University of North Carolina System Pool Revenue Bonds				4,550,000.00	825,000.00	3,725,000.00
Student Housing Project	C	3.50% - 4.50%	06/01/2036	7,200,000.00	35,000.00	7,165,000.00
Total Bonds Payable				\$ 11,750,000.00	\$ 860,000.00	\$ 10,890,000.00

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

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

(C) North Carolina School of the Arts Student Housing Project, Series 2005 Certificates of Participation

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

In addition, fund reservations in the amount of \$433,325.00 required by the Series 2005 Certificates of Participation Indenture for Student Housing Project has been established and recorded in a Reserve Fund with the fiscal agent. At June 20, 2006, the balance in the Reserve Fund was \$444,930.74.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**C. Annual Requirements** – The annual requirements to pay principal and interest on the long-term obligations at June 30, 2006, are as follows:

Fiscal Year	Annual Requirements					
	Revenue Bonds Payable		Certificates of Participation		Notes Payable	
	Principal	Interest	Principal	Interest	Principal	Interest
2007	\$ 265,000.00	\$ 152,281.26	\$ 120,000.00	\$ 299,600.00	\$ 307,800.00	\$ 18,742.50
2008	285,000.00	143,081.26	135,000.00	295,400.00	306,329.23	9,180.00
2009	290,000.00	133,231.26	140,000.00	290,675.00	21,724.84	
2010	295,000.00	122,531.26	145,000.00	285,775.00		
2011	310,000.00	109,728.13	150,000.00	280,700.00		
2012-2016	1,490,000.00	340,493.75	830,000.00	1,319,987.52		
2017-2021	790,000.00	57,887.50	1,010,000.00	1,147,068.80		
2022-2026			1,225,000.00	924,281.28		
2027-2036			3,410,000.00	896,431.28		
<b>Total Requirements</b>	<b>\$ 3,725,000.00</b>	<b>\$ 1,059,234.42</b>	<b>\$ 7,165,000.00</b>	<b>\$ 5,739,918.88</b>	<b>\$ 635,854.07</b>	<b>\$ 27,922.50</b>

**D. Notes Payable** – The School 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 June 30, 2006	Principal Outstanding June 30, 2006
Student Commons Building Renovations	Wachovia Bank, N.A.	3.06%	04/17/2008	\$ 1,500,000.00	\$ 900,000.00	\$ 600,000.00
Brookstown Inn	Southern Community Bank and Trust	5.00%	10/21/2008	100,000.00	64,145.93	35,854.07
Center Stage Bridge Loan	Southern Community Bank and Trust	4.00%	09/22/2008	6,400,000.00	6,400,000.00	
<b>Total Notes Payable</b>				<b>\$ 8,000,000.00</b>	<b>\$ 7,364,145.93</b>	<b>\$ 635,854.07</b>

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 8 - OPERATING LEASE OBLIGATIONS

The School entered into operating leases for copiers and land. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2006:

<u>Fiscal Year</u>	<u>Amount</u>
2007	\$ 48,297.36
2008	43,465.44
2009	25,452.18
2010	7,075.82
2011	6,000.00
2012	3,000.00
Total Minimum Lease Payments	<u>\$ 133,290.80</u>

Rental expense for all operating leases during the year was \$51,277.54.

### NOTE 9 - REVENUES

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

	<u>Gross Revenues</u>	<u>Internal Sales Eliminations</u>	<u>Less Scholarship Discounts</u>	<u>Add Bad Debt Recoveries</u>	<u>Net Revenues</u>	<u>Revenues Pledged as Security for Debt</u>
<b>Operating Revenues:</b>						
<b>Student Tuition and Fees</b>	<u>\$ 11,077,201.73</u>	<u>\$ 0.00</u>	<u>\$ 2,296,069.52</u>	<u>\$ 1,300.90</u>	<u>\$ 8,782,433.11</u>	<u>\$ 197,577.69 (A)</u>
<b>Sales and Services:</b>						
Sales and Services of Auxiliary Enterprises:						
Residential Life	\$ 2,629,618.55	\$ 0.00	\$ 624,105.03	\$ 7,357.80	\$ 2,012,871.32	\$ 2,012,871.32 (B)
Dining	1,753,698.11		359,600.61	103.26	1,394,200.76	1,394,200.76 (B)
Health and Recreation Services	172,866.49				172,866.49	
Bookstore	259,468.50				259,468.50	
Parking	48,528.25				48,528.25	
Other	14,322.43				14,322.43	
Sales and Services of Education and Related Services	<u>501,138.50</u>	<u>48,409.41</u>			<u>452,729.09</u>	
<b>Total Sales and Services</b>	<u>\$ 5,379,640.83</u>	<u>\$ 48,409.41</u>	<u>\$ 983,705.64</u>	<u>\$ 7,461.06</u>	<u>\$ 4,354,986.84</u>	<u>\$ 3,407,072.08</u>

Revenue Bonds Secured by Pledged Revenues:

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

(B) Housing and Dining System

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### NOTE 10 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 10,828,407.79	\$ 983,696.09	\$ 624,274.80	\$ 0.00	\$ 0.00	\$ 0.00	\$ 12,436,378.68
Public Service	485,544.62	68,801.70	697,526.42				1,251,872.74
Academic Support	2,960,670.92	344,558.12	285,157.05				3,590,386.09
Student Services	912,733.27	58,279.58	367,547.23				1,338,560.08
Institutional Support	5,429,888.88	466,266.15	1,967,140.08		4,245.82		7,867,540.93
Operations and Maintenance of Plant	3,243,667.34	1,695,692.46	545,115.88		1,656,648.58		7,141,124.26
Student Financial Aid				621,876.51			621,876.51
Auxiliary Enterprises	2,252,661.12	708,512.84	2,362,659.83		383,500.61		5,707,334.40
Depreciation						2,595,131.52	2,595,131.52
<b>Total Operating Expenses</b>	<b>\$ 26,113,573.94</b>	<b>\$ 4,325,806.94</b>	<b>\$ 6,849,421.29</b>	<b>\$ 621,876.51</b>	<b>\$ 2,044,395.01</b>	<b>\$ 2,595,131.52</b>	<b>\$ 42,550,205.21</b>

### NOTE 11 - PENSION PLANS

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

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

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2006, these rates were set at 2.34% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2006, the School had a total payroll of \$20,999,674.80, of which \$10,006,551.95 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$600,393.12

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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and \$234,153.32, respectively. The School made 100% of its annual required contributions for the years ended June 30, 2006, 2005, and 2004, which were \$234,153.32, \$206,364.37, and \$19,842.95, respectively.

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

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

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

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2006, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The School assumes no liability other than its contribution.

For the year ended June 30, 2006, the School had a total payroll of \$20,999,674.80, of which \$8,475,953.32 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$508,557.20 and \$579,755.21, respectively.

**B. Deferred Compensation and Supplemental Retirement Income Plans** – IRC Section 457 Plan – The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement, or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, *the North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to \$111,107.99 for the year ended June 30, 2006.

IRC Section 401(k) Plan – All members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the School except for a 5% employer contribution for the School's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of School law enforcement officers for the year ended June 30, 2006, were \$71,701.09. The voluntary contributions by employees amounted to \$128,070.00 for the year ended June 30, 2006.

IRC Section 403(b) and 403(b)(7) Plans – Eligible School employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to \$173,684.11 for the year ended June 30, 2006.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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### NOTE 12 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees –** The School participates in State-administered programs that provide postemployment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System or the Optional Retirement Program. These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The School contributed 3.8% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program for these health care benefits. For the fiscal year ended June 30, 2006, the School's total contribution to the Plan was \$702,335.20. The School assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.
- B. Long-Term Disability –** The School participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The School contributes .52% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the year ended June 30, 2006, the School's total contribution to the DIPNC was \$96,109.03. The School assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

### NOTE 13 - RISK MANAGEMENT

The School is exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled via a combination of methods, including participation in State-administered insurance programs, purchase of commercial insurance, and self-retention of certain risks. There have been no significant reductions in insurance coverage from the previous



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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year and settled claims have not exceeded coverage in any of the past three fiscal years.

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

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

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

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

The School purchased other authorized coverage from private insurance companies through the North Carolina Department of Insurance. The insurance purchased included general and professional liability insurance for School of Filmmaking student interns, student accident and health insurance, and accident and health insurance for students who study abroad.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

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

Term life insurance (death benefits) of \$25,000 to \$50,000 is provided to eligible workers. This Death Benefit Plan is administered by the State Treasurer and funded via employer contributions. The employer contribution rate was .16% for the current fiscal year.

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

### NOTE 14 - COMMITMENTS AND CONTINGENCIES

- A. Commitments** – The School has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were \$178,421.00 and on other purchases were \$311,016.52 at June 30, 2006.
- B. Pending Litigation and Claims** – The School is a party to litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of these matters, no provision for any liability has been made in the financial statements. School management is of the opinion that the liability, if any, for any of these matters will not have a material adverse effect on the financial position of the School.

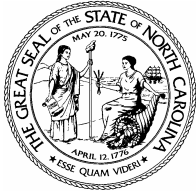
### NOTE 15 - NET ASSET RESTATEMENTS

As of July 1, 2005, net assets as previously reported was restated as follows:

During fiscal year 2005-2006, the School entered into a master lease with the NCSA Housing Corporation. Due to this direct benefit/burden relationship and the membership composition of the Board of Directors, this entity now meets the blending criteria for GASB 34.

Due to a reassessment of the North Carolina School of the Arts Program Support Corporation, the School now believes it falls within the blending criteria of GASB 34.

	<u>Amount</u>
July 1, 2005 Net Assets as Previously Reported	\$ 94,632,183.17
Restatements:	
NCSA Housing Corporation	(805,630.89)
North Carolina School of the Arts Program Support Corporation	<u>1,189,305.58</u>
July 1, 2005 Net Assets as Restated	<u>\$ 95,015,857.86</u>



STATE OF NORTH CAROLINA  
Office of the State Auditor

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

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

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

We have audited the financial statements of North Carolina School of the Arts, a constituent institution of the 16-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component unit, as of and for the year ended June 30, 2006, which collectively comprise the School's basic financial statements and have issued our report thereon dated January 31, 2007. Our report was modified to include a reference to other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the NCSA Housing Corporation, the North Carolina School of the Arts Program Support Corporation, and the discretely presented component unit, as described in our report on the School's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the discretely presented component unit were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the School's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our 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 REPORT  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING  
AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN  
AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH  
GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

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by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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

We noted certain matters that we reported to management of the School in a separate letter dated February 27, 2007.

This report is intended solely for the information and use of the Audit Committee, the Board of Governors, the Board of Trustees, management of the School, the Governor, the State Controller, and the General Assembly, 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

January 31, 2007

## ORDERING INFORMATION

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