



STATE OF NORTH CAROLINA

NORTH CAROLINA SCHOOL OF THE ARTS

WINSTON-SALEM, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2007

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, 2007

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THE UNIVERSITY OF NORTH CAROLINA

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STATE OF NORTH CAROLINA
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AUDITOR'S TRANSMITTAL

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

We have completed a financial statement audit of North Carolina School of the Arts for the year ended June 30, 2007, 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

April 28, 2008

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of North Carolina School of the Arts, a constituent institution of the multi-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, 2007, 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 percent, 0 percent, and 1 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., 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 provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of North Carolina School of the Arts and its discretely presented component unit as of June 30, 2007, and the respective changes in financial position and cash flows, where

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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 April 11, 2008, 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., CPA, CFP
State Auditor

April 11, 2008

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



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, 2007. 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 standards issued by the Governmental Accounting Standards Board. 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. The three financial statements presented include: the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows. For the purpose of this discussion, we will address the Statement of Net Assets and the Statement of Revenues, Expenses, and Changes in Net Assets.

Statement of Net Assets

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

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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 earned on 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.

Condensed Statement of Net Assets

	<u>Year Ended June 30,</u>	
	<u>2007</u>	<u>2006</u>
Assets		
Current Assets	\$ 10,203,969.41	\$ 6,501,657.50
Capital Assets, Net	95,675,294.04	98,016,386.68
Other Noncurrent Assets	16,779,952.07	12,812,831.48
	<u>122,659,215.52</u>	<u>117,330,875.66</u>
Liabilities		
Current Liabilities	3,139,254.29	3,071,269.20
Noncurrent Liabilities	12,126,960.55	12,917,528.77
	<u>15,266,214.84</u>	<u>15,988,797.97</u>
Net Assets		
Invested in Capital Assets, Net of Related Debt	84,766,620.52	87,131,271.61
Restricted:		
Nonexpendable	7,127,505.41	6,604,830.65
Expendable	9,020,250.92	5,051,379.15
Unrestricted	6,478,623.83	2,554,596.28
	<u>\$ 107,393,000.68</u>	<u>\$ 101,342,077.69</u>

The total assets of the School increased by \$5,328,339.86 for the year, which includes an increase in current assets and other noncurrent assets of \$3,702,311.91 and \$3,967,120.59, respectively, and a decrease of \$2,341,092.64 in capital assets. This increase was primarily due to a \$6,109,314.86 increase in cash and cash equivalents. Current cash and cash equivalents increased by \$3,515,994.29 due in part to \$1,300,000.00 in proceeds from a mediation settlement for the construction default on the Student Commons Building Renovation project, an increase in the cash carried forward of \$589,735.62 in State appropriations due to budget flexibility, and a cash surplus of \$336,903.32 resulting from a new School production, West Side Story, which was not applicable in the prior year. Noncurrent cash increased by \$2,593,320.57 due to funding from the State for repairs and renovation and library planning funds. In addition to the cash and cash equivalents increase,

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

the noncurrent endowment investments increased by \$1,363,775.62 due to endowment gifts of \$525,000.00 and a positive return on endowment investments. The decrease in net capital assets of \$2,341,092.64 resulted from a decrease of \$645,814.10 in capital assets and an increase of \$1,695,278.54 in accumulated depreciation. This change in capital assets was mainly due to the disposal of equipment and motor vehicles due to obsolescence and the sale of the Chancellor's old residence.

The total liabilities of the School decreased by \$722,583.13 for the year, which includes an increase of \$67,985.09 in current liabilities and a decrease of \$790,568.22 in noncurrent liabilities. The increase in total current liabilities was primarily the result of a \$104,721.48 increase in unearned revenue from the carry-forward of summer school revenue and payments of tuition and fees for the 2007-08 Fall term. The decrease in noncurrent liabilities was primarily the result of a \$751,418.11 net decrease in long-term liabilities during the year due to capital debt retirements.

Statement of Revenues, Expenses, and Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Net Assets reports 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 and the expenses paid by the School, both 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)

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

	Year Ended June 30,	
	2007	2006
Operating Revenues		
Student Tuition and Fees, Net	\$ 9,144,690.46	\$ 8,782,433.11
Federal Grants and Contracts	607,599.82	570,099.38
Sales and Services, Net	5,719,909.09	4,354,986.84
Interest Earnings on Loans	931.09	3,866.73
Other Operating Revenues	717,189.09	674,675.00
	<u>16,190,319.55</u>	<u>14,386,061.06</u>
Total Operating Revenues		
Total Operating Expenses	<u>45,192,768.93</u>	<u>42,550,205.21</u>
Operating Loss	<u>(29,002,449.38)</u>	<u>(28,164,144.15)</u>
Nonoperating Revenues (Expenses)		
State Appropriations	23,589,423.86	21,947,079.02
Noncapital Grants	425,689.00	350,083.00
Noncapital Gifts	3,534,305.46	3,248,318.69
Investment Income (Net of Investment Expense)	1,282,826.10	742,600.32
Interest and Fees on Capital Asset-Related Debt	(499,638.09)	(603,686.94)
Other Nonoperating Revenues	71,982.48	1,139.60
	<u>28,404,588.81</u>	<u>25,685,533.69</u>
Net Nonoperating Revenues		
Loss Before Other Revenues	<u>(597,860.57)</u>	<u>(2,478,610.46)</u>
Capital Appropriations	3,394,310.00	3,375,800.00
Capital Grants	1,531,315.71	3,899,030.29
Additions to Endowments	525,000.00	1,530,000.00
Special Items	1,198,157.85	
	<u>6,648,783.56</u>	<u>8,804,830.29</u>
Total Other Revenues		
Increase in Net Assets	6,050,922.99	6,326,219.83
Beginning Net Assets	<u>101,342,077.69</u>	<u>95,015,857.86</u>
Ending Net Assets	<u>\$ 107,393,000.68</u>	<u>\$ 101,342,077.69</u>

The Statement of Revenues, Expenses, and Changes in Net Assets reports an increase in the net assets at the end of the year. Total net revenues were \$51,243,691.92 for 2007 and \$48,876,425.04 for 2006. The increase in total net revenues of \$2,367,266.88, is primarily the result of increases in sales and services revenue, State appropriations, and special items, of \$1,364,922.25, \$1,642,344.84, and \$1,198,157.85, respectively, with an offsetting decrease in capital grants revenue of \$2,367,714.48. Some highlights of the information presented on the Statement of Revenues, Expenses, and Changes in Net Assets are as follows:

- Sales and services revenue increased mainly due to \$717,860.00 in ticket sales from the new School production of West Side Story and an increase of approximately \$492,000.00 in student auxiliary related fees.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

- State appropriations increased primarily due to an increase in operating funds for facilities constructed and legislative salary increases.
- Special Items, a caption not applicable in the prior year, were reported at \$1,198,157.85 at year end. The School received a total of \$1,300,000.00 from a mediation settlement involving default judgments on a construction contract. The School also had a gain on the sale of property of \$464,732.61, of which \$403,937.85 was the gain on the sale of the Chancellor's old residence at 28 Cascade Avenue. The net proceeds from this sale of \$505,780.00 were transferred to 411 South Marshall St., LLC., an organization established by the North Carolina School of the Arts Foundation, Inc., to reduce the debt from a term loan on the Chancellor's new residence. See Note 15 of the Notes to the Financial Statements for additional discussion on this account-type.
- Capital grants continued to decrease due to a reduction in construction projects funded under the UNC bond projects.

Capital Asset and Debt Administration

No new debt was issued during the 2006-07 fiscal year.

Economic Outlook

The School did not face a budget reduction in 2007, but continued to manage a very lean budget. Unfunded inflationary increases in utilities and building supplies had to be funded with non-recurring lapsed salary funds. The School is expected to face a budget reduction of \$160,167.00 in the 2007-2008 fiscal year. As instructed by the General Assembly, the School plans to address this reduction with PACE initiative savings.

PACE is an acronym used for the President's Advisory Committee on Efficiency and Effectiveness. The University of North Carolina System President established this committee to study and advise on ways universities could operate more effectively and efficiently. The School identified efficiency improvements in Financial Services, Facility Operations, Human Resources, Information Technologies, Advancement, and Student Support Services. These improvements will be implemented in the 2007-2008 fiscal year.

The School will receive enrollment increase funding in 2008 for increasing the student budgeted enrollment FTE by 16 to 1,096. The General Assembly also provided for inflationary increase funding, pay increases, equipment replacement funds, and funds to support benefit changes in 2008. The Center for Design Innovation will receive a permanent allocation of \$500,000.00 in 2007-2008 to support program costs. North Carolina School of the Arts will also receive \$500,000.00 in non-recurring funds for equipment needs.

In the 2007-2008 fiscal year, the School will receive \$24,920,000.00 to support the planning and construction of a new library. The School will also receive \$1,606,000.00 in Repair and Renovation funding for projects such as a roof replacement at the School of Filmmaking, classroom improvements, floor replacement in the School of Design and Production, and energy saving projects.

North Carolina School of the Arts
Statement of Net Assets
June 30, 2007

Exhibit A-1

ASSETS

Current Assets:

Cash and Cash Equivalents	\$ 8,746,018.72
Restricted Cash and Cash Equivalents	606,089.86
Restricted Short-Term Investments	400,000.00
Receivables, Net (Note 4)	151,572.23
Due from State of North Carolina Component Units	9,000.00
Due from School Component Unit	18,544.07
Inventories	176,006.84
Notes Receivable, Net (Note 4)	96,737.69
	<hr/>
Total Current Assets	10,203,969.41
	<hr/>

Noncurrent Assets:

Restricted Cash and Cash Equivalents	6,438,897.56
Restricted Due from Primary Government	369,734.46
Endowment Investments	8,462,781.26
Restricted Investments	433,325.00
Other Investments	123,886.70
Notes Receivable, Net (Note 4)	332,008.09
Capital Assets - Nondepreciable (Note 5)	5,361,366.03
Capital Assets - Depreciable, Net (Note 5)	90,313,928.01
Bond Issuance Costs, Net of Amortization of \$21,420	619,319.00
	<hr/>
Total Noncurrent Assets	112,455,246.11
	<hr/>

Total Assets

122,659,215.52

LIABILITIES

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)	677,743.25
Unearned Revenue	1,522,093.57
Interest Payable	62,304.10
Long-Term Liabilities - Current Portion (Note 7)	877,113.37
	<hr/>
Total Current Liabilities	3,139,254.29
	<hr/>

Noncurrent Liabilities:

Deposits Payable	57,050.00
Funds Held for Others	24,311.72
U. S. Government Grants Refundable	447,182.06
Long-Term Liabilities (Note 7)	11,598,416.77
	<hr/>
Total Noncurrent Liabilities	12,126,960.55
	<hr/>

Total Liabilities

15,266,214.84

***North Carolina School of the Arts
Statement of Net Assets
June 30, 2007***

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

NET ASSETS

Invested in Capital Assets, Net of Related Debt	84,766,620.52
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	305,000.00
Endowed Professorships	4,002,841.33
Departmental Uses	2,767,000.00
Loans	52,664.08
Expendable:	
Scholarships and Fellowships	595,652.10
Professorships	799,392.89
Departmental Uses	691,208.95
Capital Projects	6,500,671.98
Debt Service	433,325.00
Unrestricted	<u>6,478,623.83</u>
Total Net Assets	<u><u>\$ 107,393,000.68</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, 2007***

Exhibit A-2

REVENUES

Operating Revenues:

Student Tuition and Fees, Net (Note 9)	\$ 9,144,690.46
Federal Grants and Contracts	607,599.82
Sales and Services, Net (Note 9)	5,719,909.09
Interest Earnings on Loans	931.09
Other Operating Revenues	717,189.09
	<hr/>
Total Operating Revenues	16,190,319.55

EXPENSES

Operating Expenses:

Salaries and Benefits	26,773,384.52
Supplies and Materials	4,968,815.69
Services	7,833,411.10
Scholarships and Fellowships	801,974.09
Utilities	1,920,368.62
Depreciation	2,894,814.91
	<hr/>
Total Operating Expenses	45,192,768.93

Operating Loss (29,002,449.38)

NONOPERATING REVENUES (EXPENSES)

State Appropriations	23,589,423.86
Noncapital Grants	425,689.00
Noncapital Gifts	3,534,305.46
Investment Income (Net of Investment Expense of \$13,989.91)	1,282,826.10
Interest and Fees on Debt	(499,638.09)
Other Nonoperating Revenues	71,982.48
	<hr/>

Net Nonoperating Revenues 28,404,588.81

Loss Before Other Revenues (597,860.57)

Capital Appropriations	3,394,310.00
Capital Grants	1,531,315.71
Additions to Endowments	525,000.00
Special Items (Note 15)	1,198,157.85
	<hr/>

Increase in Net Assets 6,050,922.99

NET ASSETS

Net Assets - July 1, 2006	<u>101,342,077.69</u>
Net Assets - June 30, 2007	<u><u>\$ 107,393,000.68</u></u>

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, 2007

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$ 16,281,348.49
Payments to Employees and Fringe Benefits	(26,811,602.90)
Payments to Vendors and Suppliers	(14,632,635.44)
Payments for Scholarships and Fellowships	(801,974.09)
Loans Issued	(145,675.79)
Collection of Loans	166,742.66
Interest Earned on Loans	673.53
US Government Grants Refundable	(1,429.91)
Student Deposits Received	67,600.00
Student Deposits Returned	(77,311.33)
	<hr/>
Net Cash Used by Operating Activities	(25,954,264.78)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations	23,589,423.86
Noncapital Grants	425,689.00
Noncapital Gifts	3,534,305.46
Additions to Endowments	525,000.00
William D. Ford Direct Lending Receipts	4,711,434.00
William D. Ford Direct Lending Disbursements	(4,711,434.00)
Related Activity Agency Receipts	8,364.76
	<hr/>
Net Cash Provided by Noncapital Financing Activities	28,082,783.08

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

State Capital Appropriations	3,394,310.00
Capital Grants	1,493,628.76
Default Judgments on Construction Contracts	1,300,000.00
Proceeds from Sale of Capital Assets	516,967.72
Acquisition and Construction of Capital Assets	(751,673.74)
Principal Paid on Capital Debt and Leases	(700,967.55)
Interest and Fees Paid on Capital Debt and Leases	(483,355.36)
Other Payments	(505,780.00)
	<hr/>
Net Cash Provided by Capital Financing and Related Financing Activities	4,263,129.83

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	4,744,242.88
Investment Income	723,341.31
Purchase of Investments and Related Fees	(5,749,917.46)
	<hr/>
Net Cash Used by Investing Activities	(282,333.27)
	<hr/>
Net Increase in Cash and Cash Equivalents	6,109,314.86
Cash and Cash Equivalents - July 1, 2006	9,681,691.28
	<hr/>
Cash and Cash Equivalents - June 30, 2007	\$ 15,791,006.14

***North Carolina School of the Arts
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2007***

Exhibit A-3

Page 2

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

Operating Loss	\$ (29,002,449.38)
Adjustments to Reconcile Operating Loss to Net Cash Usec by Operating Activities:	
Depreciation Expense	2,894,814.91
Allowances, Write-Offs, and Amortizations	70,712.55
Changes in Assets and Liabilities:	
Receivables (Net)	7,944.61
Due from State of North Carolina Component Units	(9,000.00)
Due from School Component Unit	(4,730.07)
Inventories	(26,028.26)
Accounts Payable and Accrued Liabilities	84,210.39
US Government Grants Refundable	(1,429.91)
Unearned Revenue	104,721.48
Compensated Absences	(70,494.09)
Deposits Payable	(23,603.88)
Student Loans Issued	(145,675.79)
Student Loans Principal Repayments	166,742.66
	<hr/>
Net Cash Used by Operating Activities	<u><u>\$ (25,954,264.78)</u></u>

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:	
Cash and Cash Equivalents	\$ 8,746,018.72
Restricted Cash and Cash Equivalents	606,089.86
Noncurrent Assets:	
Restricted Cash and Cash Equivalents	6,438,897.56
	<hr/>
Total Cash and Cash Equivalents - June 30, 2007	<u><u>\$ 15,791,006.14</u></u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through the Assumption of a Liability	\$ 83,787.00
Change in Fair Value of Investments	113,814.79
Reinvested Distributions	415,832.06

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, 2007

Exhibit B-1

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
ASSETS				
Cash and Cash Equivalents	\$ 402,673	\$ 1,325,136	\$ 45,269	\$ 1,773,078
Investments		4,583,212	14,639,171	19,222,383
Annuity Investments			1,029,872	1,029,872
Beneficial Interest in Perpetual Trusts			841,869	841,869
Beneficial Interest in Charitable Remainder Trusts			136,330	136,330
Pledges Receivable, Net of Allowance and Discount of \$714,117	12,147	664,547	1,726,956	2,403,650
Accounts Receivable	8,547	4,514		13,061
Due From (To) Other Funds	134,972	(134,972)		
Prepaid Expenses	6,381	7,958		14,339
Staff, Faculty, and Student Loans Receivable	11,725	5,842		17,567
Property and Equipment, Net	708,614	1,579,018		2,287,632
Total Assets	1,285,059	8,035,255	18,419,467	27,739,781
LIABILITIES				
Accounts Payable and Accrued Expenses	9,020	51,807		60,827
Annuity Payment Liability			593,061	593,061
Notes Payable		381,796		381,796
Total Liabilities	9,020	433,603	593,061	1,035,684
NET ASSETS				
Unrestricted	1,276,039			1,276,039
Temporarily Restricted		7,601,652		7,601,652
Permanently Restricted			17,826,406	17,826,406
Total Net Assets	\$ 1,276,039	\$ 7,601,652	\$ 17,826,406	\$ 26,704,097

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, 2007

Exhibit B-2

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
REVENUES				
Gifts and Grants	\$ 663,087	\$ 1,053,605	\$ 213,457	\$ 1,930,149
Interest and Dividend Income	152,046	320,941		472,987
Realized and Unrealized Gains		2,148,395		2,148,395
Change in Fair Value of Split-Interest Agreements			102,315	102,315
Change in Fair Value of Beneficial Interest in Perpetual Trusts	11,787	8,991	33,598	54,376
Other Income	33,874	28,824		62,698
Net Assets Released from Restrictions	<u>2,116,720</u>	<u>(2,116,720)</u>		
Total Revenues	2,977,514	1,444,036	349,370	4,770,920
EXPENSES				
Program Services:				
Scholarships and Awards	963,585			963,585
School Programs	<u>1,031,706</u>			<u>1,031,706</u>
Total Program Services	1,995,291			1,995,291
Supporting Services:				
Administrative Costs	233,865			233,865
Investment Management Fees	44,357			44,357
Development Costs	454,607			454,607
Depreciation and Amortization Expense	84,211			84,211
Miscellaneous Expense	<u>41,599</u>			<u>41,599</u>
Total Supporting Services	858,639			858,639
Total Expenses	<u>2,853,930</u>			<u>2,853,930</u>
Change in Net Assets Before Transfers	<u>123,584</u>	<u>1,444,036</u>	<u>349,370</u>	<u>1,916,990</u>
Proceeds from Sale of Residence from the School		<u>505,780</u>		<u>505,780</u>
Change in Net Assets	123,584	1,949,816	349,370	2,422,770
NET ASSETS				
Net Assets - Beginning of Year	1,152,455	5,651,836	17,477,036	24,281,327
Net Assets - End of Year	<u>\$ 1,276,039</u>	<u>\$ 7,601,652</u>	<u>\$ 17,826,406</u>	<u>\$ 26,704,097</u>

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

NORTH CAROLINA SCHOOL OF THE ARTS
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2007

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 multi-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 unit, although legally separate, is, in substance, part of the School's operations and therefore, is reported as if it was part of the School. The discretely presented component unit's financial data is reported in separate financial statements because of its use of a different GAAP reporting model and to emphasize its legal separateness.

Blended Component Unit - Although legally separate, the NCSA Housing Corporation, a component unit of the School, is reported as if it was 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Separate financial statements for the NCSA Housing 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 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 (FASB) Statements. As such, certain revenue recognition criteria and presentation features are different from the Governmental Accounting Standards Board (GASB) revenue recognition criteria and presentation features. No modifications have been made to the Foundation's financial information in the School's financial reporting entity for these differences.

During the year ended June 30, 2007, the Foundation distributed \$1,302,963.00 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.

- 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).

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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, regardless of the timing of the cash flows.

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, 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 mutual funds, certificates of deposit, and real estate investments. Except for money market mutual 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 available. The net increase in the fair value of investments is recognized as a component of investment income.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Money market mutual 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 and charges for auxiliary enterprises' sales and services. Receivables also include amounts due from the federal government, State and local governments, and private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants. Receivables are recorded net of estimated uncollectible amounts.
- G. Inventories** - Inventories, consisting of expendable supplies, are valued at cost using last invoice cost. Merchandise for resale is valued at 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 estimated useful life of more than one year. Library books are generally not considered to have a useful life of more than one year unless part of a collection and are expensed in the year of acquisition.

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

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

- I. Restricted Assets** - Unexpended proceeds of revenue bonds and unexpended capital contributions are classified as restricted assets because their use is limited by applicable bond covenants or donor/grantor agreements. 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, certificates of participation, notes payable, capital lease obligations, and compensated absences that will not be paid within the next fiscal year.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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)

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*.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

- O. Internal Sales Activities** - The School has miscellaneous sales and service units that operated either on a reimbursement or charge basis. All internal sales activities to School departments from 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 intercollegiate athletics and agency funds held directly by the School.

At June 30, 2007, the amount shown on the Statement of Net Assets as cash and cash equivalents includes \$15,317,180.88, 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 1.6 years as of June 30, 2007. 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

by calling the State Controller's Financial Reporting Section at (919) 981-5454.

Cash on hand at June 30, 2007 was \$5,820.00. The carrying amount of the School's deposits not with the State Treasurer, including certificates of deposit, was \$868,005.26 and the bank balance was \$923,350.41. 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, 2007, \$616,142.00 of the School's bank balance was exposed to custodial credit risk as uninsured and uncollateralized.

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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Investments of the School's 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.

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, 2007, for the Long-Term Investment Pool.

Long-Term Investment Pool

Investment Type	Fair Value	Investment Maturities (in Years)		
		Less Than 1	6 to 10	More than 10
Debt Securities				
Mutual Bond Funds	\$ 3,120,146.09	\$ 0.00	\$ 2,804,602.65	\$ 315,543.44
Money Market Mutual Funds	401,269.09	401,269.09		
		\$ 401,269.09	\$ 2,804,602.65	\$ 315,543.44
Other Securities				
International Mutual Funds	1,613,955.61			
Other Mutual Funds	3,327,410.47			
Total Long-Term Investment Pool	\$ 8,462,781.26			

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

At June 30, 2007, investments in the Long-Term Investment Pool had the following credit quality distribution for securities with credit exposure:

	Fair Value	AAA Aaa	AA Aa	BBB Baa	BB/Ba and below
Mutual Bond Funds	\$ 3,120,146.09	\$ 2,013,679.71	\$ 316,919.42	\$ 315,543.44	\$ 474,003.52
Money Market Mutual Funds	401,269.09	401,269.09			
Total	\$ 3,521,415.18	\$ 2,414,948.80	\$ 316,919.42	\$ 315,543.44	\$ 474,003.52

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, 2007, for the School's non-pooled investments.

Non-Pooled Investments

	Fair Value	Investment Maturities (in Years) Less Than 1
Investment Type		
Debt Securities		
Money Market Mutual Funds	\$ 466,767.81	\$ 466,767.81
Other Securities		
Certificates of Deposit	400,000.00	
Investments in Real Estate	90,443.89	
Total Non-Pooled Investments	\$ 957,211.70	

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

At June 30, 2007, the Money Market Mutual Funds, with a fair value of \$466,767.81, 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, 2007:

	Fair Value
Investment Type	
Debt Securities	
Mutual Bond Funds	\$ 3,120,146.09
Money Market Mutual Funds	868,036.90
Other Securities	
Certificates of Deposit	400,000.00
Other Mutual Funds	3,327,410.47
International Mutual Funds	1,613,955.61
Investments in Real Estate	90,443.89
Total Investments	\$ 9,419,992.96

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 reports under the FASB reporting model, disclosures of the various investment risks are not required. The following is an analysis of investments by type:

	Fair Value
Investment Type	
Equity Securities	\$ 13,387,297.00
Fixed Income Securities and Other Bonds	1,453,055.00
Government Bonds	345,930.00
International Fixed Income	1,963,672.00
International Equities	1,494,769.00
Short-Term Investments	577,660.00
Total Investments	\$ 19,222,383.00

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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Investment return of the School's endowment funds is predicated on the total return concept (yield plus appreciation). To the extent that the total return for the current year exceeds the payout, the excess is added to principal. If current year earnings do not meet the payout requirements, the School uses the accumulated income and appreciation from restricted, expendable net asset endowment balances to make up the difference. At June 30, 2007, net appreciation of \$726,368.86 was available to be spent for restricted purposes.

NOTE 4 - RECEIVABLES

Receivables at June 30, 2007, were as follows:

	<u>Gross Receivables</u>	<u>Less Allowance for Doubtful Accounts</u>	<u>Net Receivables</u>
Current Receivables:			
Students	\$ 29,100.09	\$ 16,707.32	\$ 12,392.77
Accounts	104,438.51	1,158.63	103,279.88
Investment Earnings	8,515.98		8,515.98
Interest on Loans	<u>27,383.60</u>		<u>27,383.60</u>
Total Current Receivables	<u>\$ 169,438.18</u>	<u>\$ 17,865.95</u>	<u>\$ 151,572.23</u>
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	\$ 122,754.24	\$ 26,734.80	\$ 96,019.44
Institutional Student Loan Programs	<u>7,342.45</u>	<u>6,624.20</u>	<u>718.25</u>
Total Notes Receivable - Current	<u>\$ 130,096.69</u>	<u>\$ 33,359.00</u>	<u>\$ 96,737.69</u>
Notes Receivable - Noncurrent:			
Federal Loan Programs	<u>\$ 479,861.39</u>	<u>\$ 147,853.30</u>	<u>\$ 332,008.09</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, 2007, is presented as follows:

	Balance July 1, 2006	Increases	Decreases	Balance June 30, 2007
Capital Assets, Nondepreciable:				
Land	\$ 3,896,165.09	\$ 2,298.71	\$ 0.00	\$ 3,898,463.80
Art, Literature, and Artifacts	1,383,364.44			1,383,364.44
Construction in Progress	58,278.85	201,511.15	180,252.21	79,537.79
Total Capital Assets, Nondepreciable	<u>5,337,808.38</u>	<u>203,809.86</u>	<u>180,252.21</u>	<u>5,361,366.03</u>
Capital Assets, Depreciable:				
Buildings	105,608,460.86	180,252.21	116,831.12	105,671,881.95
Machinery and Equipment	8,906,310.84	452,097.90	1,184,890.74	8,173,518.00
General Infrastructure	5,107,656.50			5,107,656.50
Total Capital Assets, Depreciable	<u>119,622,428.20</u>	<u>632,350.11</u>	<u>1,301,721.86</u>	<u>118,953,056.45</u>
Less Accumulated Depreciation for:				
Buildings	19,510,109.32	2,302,821.00	36,257.53	21,776,672.79
Machinery and Equipment	6,942,354.68	497,507.59	1,163,278.84	6,276,583.43
General Infrastructure	491,385.90	94,486.32		585,872.22
Total Accumulated Depreciation	<u>26,943,849.90</u>	<u>2,894,814.91</u>	<u>1,199,536.37</u>	<u>28,639,128.44</u>
Total Capital Assets, Depreciable, Net	<u>92,678,578.30</u>	<u>(2,262,464.80)</u>	<u>102,185.49</u>	<u>90,313,928.01</u>
Capital Assets, Net	<u>\$ 98,016,386.68</u>	<u>\$ (2,058,654.94)</u>	<u>\$ 282,437.70</u>	<u>\$ 95,675,294.04</u>

The Special Items caption per the Statement of Revenues, Expenses, and Changes in Net Assets, include an insurance recovery of \$1,100,000.00 related to a mediation settlement with the general contractor of the Student Commons Renovation Project, who defaulted during construction. The School also received \$200,000.00 from the architect as part of the settlement.

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2007, were as follows:

	Amount
Accounts Payable	\$ 463,328.59
Accrued Payroll	199,003.16
Contract Retainage	15,411.50
Total Accounts Payable and Accrued Liabilities	<u>\$ 677,743.25</u>

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, 2007, is presented as follows:

	Balance July 1, 2006	Additions	Reductions	Balance June 30, 2007	Current Portion
Revenue Bonds Payable	\$ 3,725,000.00	\$ 0.00	\$ 265,000.00	\$ 3,460,000.00	\$ 285,000.00
Certificates of Participation	7,165,000.00		120,000.00	7,045,000.00	135,000.00
Total Bonds and Certificates of Participation Payable	<u>10,890,000.00</u>		<u>385,000.00</u>	<u>10,505,000.00</u>	<u>420,000.00</u>
Notes Payable	635,854.07		306,120.49	329,733.58	307,800.00
Capital Leases Payable		83,787.00	9,847.06	73,939.94	12,478.88
Compensated Absences	1,637,350.71	808,882.00	879,376.09	1,566,856.62	136,834.49
Total Long-Term Liabilities	<u>\$ 13,163,204.78</u>	<u>\$ 892,669.00</u>	<u>\$ 1,580,343.64</u>	<u>\$ 12,475,530.14</u>	<u>\$ 877,113.37</u>

Additional information regarding capital lease obligations is included in Note 8.

B. Revenue Bonds Payable and Certificates of Participation - The School was indebted for revenue bonds payable and certificates of participation 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, 2007	Principal Outstanding June 30, 2007
<u>The University of North Carolina System Pool Revenue Bonds</u>						
Fitness and Student Center Project	A	3.25%-5.25%	10/01/2018	\$ 2,650,000.00	\$ 790,000.00	\$ 1,860,000.00
Refunding 1998B and 2000 UNC System Pool Revenue Bonds	B	3.00%-4.25%	04/01/2019	<u>1,900,000.00</u>	<u>300,000.00</u>	<u>1,600,000.00</u>
Total UNC System Pool Revenue Bonds				<u>4,550,000.00</u>	<u>1,090,000.00</u>	<u>3,460,000.00</u>
<u>Certificates of Participation</u>						
Student Housing Project	C	3.50%-4.50%	06/01/2036	<u>7,200,000.00</u>	<u>155,000.00</u>	<u>7,045,000.00</u>
Total Bonds Payable and Certificates of Participation				<u>\$ 11,750,000.00</u>	<u>\$ 1,245,000.00</u>	<u>\$ 10,505,000.00</u>

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

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

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

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

In addition, fund reservations in the amount of \$433,325.00 required by the Series 2005 Certificates of Participation Indenture for the Student Housing Project were established and recorded in a Reserve Fund with the fiscal agent. At June 30, 2007, the balance in the Reserve Fund was \$466,767.81.

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, 2007, are as follows:

Fiscal Year	Annual Requirements					
	Revenue Bonds Payable		Certificates of Participation		Notes Payable	
	Principal	Interest	Principal	Interest	Principal	Interest
2008	\$ 285,000.00	\$ 143,081.26	\$ 135,000.00	\$ 295,400.00	\$ 307,800.00	\$ 10,520.35
2009	290,000.00	133,231.26	140,000.00	290,675.00	21,933.58	374.03
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	325,000.00	96,975.00	155,000.00	275,450.00		
2013-2017	1,415,000.00	274,181.25	860,000.00	1,289,431.28		
2018-2022	540,000.00	27,225.00	1,050,000.00	1,106,668.80		
2023-2027			1,280,000.00	872,143.78		
2028-2036			3,130,000.00	744,075.02		
Total Requirements	\$ 3,460,000.00	\$ 906,953.16	\$ 7,045,000.00	\$ 5,440,318.88	\$ 329,733.58	\$ 10,894.38

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

Purpose	Financial Institution	Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2007	Principal Outstanding June 30, 2007
Student Commons Building Renovations	Wachovia Bank, N.A.	3.06%	04/17/2008	\$ 1,500,000.00	\$ 1,200,000.00	\$ 300,000.00
Brookstown Inn	Southern Community Bank and Trust	5.00%	10/21/2008	100,000.00	70,266.42	29,733.58
Total Notes Payable				\$ 1,600,000.00	\$ 1,270,266.42	\$ 329,733.58

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 8 - LEASE OBLIGATIONS

- A. Capital Lease Obligations** - Capital lease obligations relating to a bus are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2007:

<u>Fiscal Year</u>	<u>Amount</u>
2008	\$ 16,548.48
2009	16,548.48
2010	16,548.48
2011	16,548.48
2012	<u>19,515.50</u>
Total Minimum Lease Payments	85,709.42
Amount Representing Interest (5.96% Rate of Interest)	<u>11,769.48</u>
Present Value of Future Lease Payments	<u><u>\$ 73,939.94</u></u>

Machinery and equipment acquired under capital lease amounted to \$83,787.00 at June 30, 2007.

- B. 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, 2007:

<u>Fiscal Year</u>	<u>Amount</u>
2008	\$ 41,623.68
2009	22,778.10
2010	10,842.56
2011	6,000.00
2012	<u>3,000.00</u>
Total Minimum Lease Payments	<u><u>\$ 84,244.34</u></u>

Rental expense for all operating leases during the year was \$48,194.28.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 9 - REVENUES

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

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Less Allowance for Uncollectibles	Net Revenues	Revenues Pledged as Security for Debt
Operating Revenues:						
Student Tuition and Fees	\$ 11,599,006.64	\$ 0.00	\$ 2,449,827.25	\$ 4,488.93	\$ 9,144,690.46	\$ 194,585.29 (A)
Sales and Services:						
Sales and Services of Auxiliary Enterprises:						
Residential Life	\$ 2,906,262.17	\$ 0.00	\$ 625,115.99	\$ 1,295.44	\$ 2,279,850.74	\$ 2,279,850.74 (B)
Dining	1,914,625.04		402,503.07	874.63	1,511,247.34	1,511,247.34 (B)
Health and Recreation Services	188,524.69				188,524.69	
Bookstore	295,061.96				295,061.96	
Parking	54,062.83				54,062.83	
Other	65,076.18				65,076.18	
Sales and Services of Education and Related Activities:						
School Production Revenues	1,269,410.38				1,269,410.38	
Other	103,446.08	46,771.11			56,674.97	
Total Sales and Services	<u>\$ 6,796,469.33</u>	<u>\$ 46,771.11</u>	<u>\$ 1,027,619.06</u>	<u>\$ 2,170.07</u>	<u>\$ 5,719,909.09</u>	<u>\$ 3,791,098.08</u>

Revenue Bonds Secured by Pledged Revenues:

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

(B) Housing and Dining System

NOTE 10 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 11,347,380.69	\$ 1,246,320.69	\$ 675,839.73	\$ 0.00	\$ 181.88	\$ 0.00	\$ 13,269,722.99
Public Service	660,637.52	183,158.50	917,596.85		210.45		1,761,603.32
Academic Support	3,059,502.18	311,625.19	334,869.69		1,228.61		3,707,225.67
Student Services	841,502.53	20,334.61	92,368.16				954,205.30
Institutional Support	5,038,548.85	931,042.81	2,661,104.61		3,804.85		8,634,501.12
Operations and Maintenance of Plant	3,357,734.28	2,116,934.97	921,456.60		1,666,169.25		8,062,295.10
Student Financial Aid				801,974.09			801,974.09
Auxiliary Enterprises	2,468,078.47	159,398.92	2,230,175.46		248,773.58		5,106,426.43
Depreciation						2,894,814.91	2,894,814.91
Total Operating Expenses	<u>\$ 26,773,384.52</u>	<u>\$ 4,968,815.69</u>	<u>\$ 7,833,411.10</u>	<u>\$ 801,974.09</u>	<u>\$ 1,920,368.62</u>	<u>\$ 2,894,814.91</u>	<u>\$ 45,192,768.93</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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, 2007, these rates were set at 2.66% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2007, the School had a total payroll of \$21,748,978.86, of which \$10,473,215.41 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$628,392.92 and \$278,587.53, respectively. The School made 100% of its annual required contributions for the years ended June 30, 2007, 2006, and 2005, which were \$278,587.53, \$234,153.32, and \$206,364.37, 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.ncosc.net/> 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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, 2007, 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, 2007, the School had a total payroll of \$21,748,978.86, of which \$8,243,571.51 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$494,614.29 and \$563,860.29, 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to \$82,482.96 for the year ended June 30, 2007.

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, 2007, were \$77,020.55. The voluntary contributions by employees amounted to \$127,929.00 for the year ended June 30, 2007.

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 \$169,735.15 for the year ended June 30, 2007.

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, 2007, the School's total contribution to the Plan was

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

\$711,237.90. 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. Disability Income** - 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, 2007, the School's total contribution to the DIPNC was \$97,327.29. The School assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 13 - RISK MANAGEMENT

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

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

The School is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 \$75,000 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.

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.

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

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 \$321,143.84 and on other purchases were \$439,589.83 at June 30, 2007.
- 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 - SPECIAL ITEMS

Transactions totaling \$1,198,158.75 and processed by the School during the 2006-2007 fiscal year were considered to be outside of the School's normal course of business and as such have been reported as Special Items per the Statement of Revenues, Expenses, and Changes in Net Assets (Exhibit A-2). The Special Items are detailed as follows:

The School received a total of \$1,300,000.00 from a mediation settlement involving default judgments on a construction contract.

The School had a \$403,937.85 gain on the sale of the current Chancellor's Residence. The sale occurred on September 12, 2006, at a contract sales price of \$535,000.00. After closing costs of \$29,220.00, the School received a check for \$505,780.00. Session Law 2004-124 "...authorized the North Carolina School of the Arts to retain the proceeds of the sale of the Current Chancellor's Residence to acquire the New Chancellor's Residence". A lease agreement approved by the Governor and Council of State on November 1, 2005, and executed on January 9, 2006, established an agreement between the North Carolina School of the Arts Foundation, Inc., and the State of North Carolina to enter into an offer to purchase a residential condominium unit to be used exclusively as the New Chancellor's Residence. The base rental is \$1.00 for the lease term of five years. The lease was signed by 411 South Marshall St. LLC., an organization established as part of the North Carolina School of the Arts Foundation, Inc., for the operation and execution of the lease. A note for a term loan was executed by the LLC to construct the condominium. The condominium was completed in September 2006, and placed into service. Once the term loan is fully paid by the LLC, ownership of the residence is expected to be transferred to the State of North Carolina for the use and benefit of North Carolina School of the Arts. The School transferred the net proceeds of \$505,780.00 from the sale of the current Chancellor's Residence to 411 South Marshall St. LLC., to reduce the debt from the term loan on the new residence.

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STATE OF NORTH CAROLINA
Office of the State Auditor

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

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 multi-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, 2007, which collectively comprise the School's basic financial statements and have issued our report thereon dated April 11, 2008. 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 and the discretely presented component unit, the North Carolina School of the Arts Foundation, Inc., 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the School's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the School's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to

**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING
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GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the School's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the School's financial statements that is more than inconsequential will not be prevented or detected by the School's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the School's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

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

April 11, 2008

ORDERING INFORMATION

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