STATE OF NORTH CAROLINA

UNIVERSITY OF NORTH CAROLINA HOSPITALS

CHAPEL HILL, 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

UNIVERSITY OF NORTH CAROLINA HOSPITALS

CHAPEL HILL, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2007

BOARD OF GOVERNORS

THE UNIVERSITY OF NORTH CAROLINA

ERSKINE B. BOWLES, PRESIDENT

BOARD OF DIRECTORS

WILLIAM MCCOY, CHAIRMAN

ADMINISTRATIVE OFFICERS

GARY L. PARK, PRESIDENT

JOHN P. LEWIS, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER

STATE OF NORTH CAROLINA
Office of the State Auditor

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

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet
http://www.ncauditor.net

AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Board of Directors, University of North Carolina Health Care System

We have completed a financial statement audit of the University of North Carolina Hospitals for the year ended June 30, 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., CPA, CFP
State Auditor

November 13, 2007

TABLE OF CONTENTS

STATE OF NORTH CAROLINA
Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet
http://www.ncauditor.net

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

INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying basic financial statements of University of North Carolina Hospitals, which is a part of the University of North Carolina Health Care System, which is a part of the University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2007, as listed in the table of contents. These financial statements are the responsibility of the Hospitals' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the University of North Carolina Hospitals and are not intended to present fairly the financial position of the University of North Carolina Health Care System nor the University of North Carolina System, and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of University of North Carolina Hospitals as of June 30, 2007, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 5, 2007, on our consideration of the Hospitals' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations,

contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

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

November 5, 2007

UNIVERSITY OF NORTH CAROLINA HOSPITALS
MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The following discussion and analysis is provided by the University of North Carolina Hospitals' financial management as an overview to assist the reader in interpreting and understanding the accompanying basic financial statements. It includes comparative financial analysis with discussion of significant changes between fiscal years 2007 and 2006, as well as pertinent facts, decisions, and conditions.

Using the Financial Statements

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

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

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

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

The Notes to the Financial Statements provide information relative to the significant accounting principles applied in the financial statements, authority for and associated risk of deposits and investments, detailed information on long-term liabilities, detailed information on accounts receivable, accounts payable, revenues and expenses, required information on pension plans and other post employment benefits, insurance against losses, commitments and contingencies, accounting changes, and a discussion of adjustments to prior periods and events subsequent to the Hospitals' financial statement period when appropriate. Overall, these disclosures provide information to better understand details, risk, and uncertainty associated with the amounts reported and are considered an integral part of the financial statements.

Comparison of Two-Year Data for 2007 to 2006

Comparative financial data of 2007 to 2006 is summarized in Table 1. Discussion of comparative data is included in the following section.

Analysis of Overall Financial Position and Results of Operations

Statement of Net Assets

Assets increased overall by $187.5 million or 16.8% from the prior year. Cash and investments, net of an additional $150 million purchase of equity investments, were the two largest categorical increases from fiscal year 2006 to 2007. Cash increased due to a strong cash flow from current year operations and net receipts of $48 million from prior year third-party settlements. Investments increased $56.3 million over and above the additional $150 million purchased during the year due to positive stock market conditions throughout the majority of the year and a diversified equity portfolio. Nondepreciable capital assets increased $48.9 million and reflect $39 million in increased spending on the NC Cancer Hospital.

Liabilities decreased overall by $7.3 million while net assets increased $194.8 million from fiscal year 2006 to 2007. Liabilities were reduced within the noncurrent section by payments made on outstanding bond and note payable debt which is described in more detail in Note 6.

Statement of Revenues, Expenses, and Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Net Assets reflect operating income of $60.5 million and an overall increase in net assets of $182.9 million. This translates into a $64.8 million improvement on operations and a $146.6 million improvement in the change in net assets compared to the prior year. While this is a dramatic increase in income it is

important to note that $33.1 million of the operating income is from prior year third party settlements and that this level of income is not expected to reoccur in subsequent years. Note 4 provides a detailed overview of the status of third party settlements.

Revenue excluding third party settlements was still strong as evidenced by the 12.9% increase in net patient service revenue over last year in spite of the collection percentage deteriorating from 48% as of June 30, 2006, to 46.6% as of June 30, 2007. The increase in revenue can be attributed to volume growth, continued revenue cycle improvements and rate increases.

Total operating expenses increased by 10.7% with the largest categorical dollar increase occurring in contracted services and the largest percentage change in medical malpractice expense which decreased by 52.4%. Salary expense increased 6.6% over the prior year and includes the accrued expense of a 3% performance bonus that was paid to qualifying employees in September 2007 in recognition of organizational patient, employee and financial goals that were attained. Contracted services expense increased significantly during the year primarily from obligations to UNC Physicians and Associates. Medical malpractice expense continued to decrease during fiscal year 2007 and is the result of a positive trend in malpractice claims and total reserve requirements.

Nonoperating revenues increased 112.4% or $54.4 million compared to the prior year as a result of an increase in investment income. The increase in investment income is directly attributed to the increase in equity investments that began in the last quarter of fiscal year 2006 and continued through December 2007 which enabled the Hospitals to benefit from a favorable stock market.

In the other revenues (expenses) section, capital grants increased from $10 million to $39 million from fiscal year 2006 to 2007 and will continue to increase significantly through 2010 as construction on the North Carolina Cancer Hospital progresses. Effective July 1, 2005, the Hospitals agreed to fund the UNC Health Care System Enterprise Fund. These expenses totaled $22.9 million during fiscal year 2007 and are reported separately in this section as Health Care System Assessments and support initiatives as the Chief Executive Officer of the University of North Carolina Health Care System deems appropriate with the recommendations from the leadership team.

Analysis of Net Asset Balances

At June 30, 2007, net assets invested in capital assets, net of related debt, totaled $216.2 million representing the gross value of plant assets $738.9 million plus bond issuance costs of $1.4 million less accumulated depreciation $302.0 million and related debt of $222.1 million.

Restricted expendable net assets totaled $118.9 million representing amounts subject to externally imposed restrictions.

Unrestricted net assets totaled $548.7 million representing amounts not subject to externally imposed stipulations but internally designated for various activities and initiatives, including future construction projects.

Discussion of Capital Asset and Long-Term Debt Activity

Capital Assets

The Hospitals expended $28.7 million during the year for capital equipment throughout the facilities and $56.2 million for the construction of buildings, infrastructure and renovations.

On August 5th, 2004, House Bill 1264 of the 2004 North Carolina Legislative Session was ratified and authorized the State to issue special indebtedness of up to $180 million in principal for acquiring, constructing, and equipping a cancer rehabilitation and treatment center, a nearby physicians' office building, and a walkway between the two. These facilities will be located at the University of North Carolina Hospitals at Chapel Hill. $54 million has been spent and reimbursed to the Hospitals on this project as of June 30th. Completion and occupancy is expected in fiscal year 2010.

At June 30, 2007, outstanding commitments on construction contracts were $108.9 million while outstanding commitments related to capital purchase orders for fixed and movable equipment totaled $6.7 million.

The annualized average age of plant and equipment is 7.8 years.

Long-Term Debt Activities

At June 30, 2007, the Hospitals had outstanding bond indebtedness in the amount of $259.7 million of which $6.4 million is due within the next year. Standard and Poor's and Moody's Ratings Services classify these bonds as AA- and A1 respectively.

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

UNC Hospitals continued to experience robust growth during fiscal year 2007, particularly in inpatient admission. This growth has been driven, by a larger population within the region but also by capturing synergies within the UNC Health Care System. Some results from these synergies are increased physician productivity which translated into more patient visits and the improved performance of key programs such as Oncology and Cardiology. Improvements in Oncology, Cardiology and other programs are the direct result of investments from the Health Care System in staff, facilities and equipment that are now paying dividends of improved performance.

The increase in growth has been driven, in part, by solving many physician access problems which resulted in more visits for all payor classes and reduced the wait times patients experienced when seeing specialists. The patient volume increase has been accommodated by maintaining a focus on improving patient throughput and a more efficient use of capacity.

While throughput and utilization have improved, infrastructure must now expand considerably to meet future demand. This remains the Hospitals' most pressing future imperative in striving to meet the needs of the patient community.

Staffing increases were concentrated in direct patient care areas while overhead growth has been tightly controlled. As a result, the strong revenue growth translated into improved margins. Volume growth carried across all payer groups resulting in uncompensated care reaching record levels. Underlying strong performance was enhanced by the filing of prior years cost reports. This has had a significant positive impact on income and cash that is related to prior years and is therefore not expected to reoccur in subsequent years (see Note 4). Investment in equities contributed to nonoperating performance and provided a much needed infusion of cash for long-term capacity expansion plans.

University of North Carolina Hospitals
Summary of Condensed Financial Statements Totals
For the Fiscal Years Ended June 30, 2007 and 2006

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

	FY07	FY06	Change
STATEMENTS OF NET ASSETS			
Current Assets	$ 386,712,240	$ 269,471,402	$ 117,240,839
Capital Assets, Net	436,848,591	391,563,137	45,285,454
Other Noncurrent Assets	482,192,173	457,241,581	24,950,592
TOTAL ASSETS	1,305,753,004	1,118,276,120	187,476,884
Current Liabilities	128,539,074	121,721,684	6,817,390
Noncurrent Liabilities	293,440,220	307,606,742	(14,166,522)
TOTAL LIABILITIES	421,979,294	429,328,426	(7,349,132)
Invested in Capital Assets, Net of Related Debt	216,150,155	158,957,206	57,192,949
Restricted for Expendable Uses	118,905,084	121,107,866	(2,202,782)
Unrestricted	548,718,471	408,882,622	139,835,849
TOTAL NET ASSETS	$ 883,773,710	$ 688,947,694	$ 194,826,016
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS			
Net Patient Service Revenue	$ 737,970,982	$ 653,618,962	$ 84,352,020
Other Operating Revenues	16,727,568	15,256,124	1,471,444
Prior Year Third Party Settlements	33,097,009	(16,238,463)	49,335,472
TOTAL OPERATING REVENUES	787,795,559	652,636,623	135,158,936
Salaries and Benefits	389,677,290	365,412,061	24,265,229
Medical and Surgical Supplies	134,386,727	123,753,572	10,633,155
Other Operating Expenses	203,265,897	167,837,858	35,428,039
TOTAL OPERATING EXPENSES	727,329,914	657,003,491	70,326,423
OPERATING INCOME (LOSS)	60,465,645	(4,366,868)	64,832,513
State Appropriations	45,673,970	44,510,208	1,163,762
Investment Activity	71,066,912	18,219,599	52,847,313
Other Nonoperating Revenues	175,810	237,622	(61,812)
Nonoperating Expenses	(14,149,584)	(14,593,625)	444,041
NET NONOPERATING REVENUES	102,767,108	48,373,804	54,393,304
Capital Appropriations	3,000,000		3,000,000
Capital Grants	38,958,073	9,956,085	29,001,988
Capital Gifts	526,159	101,820	424,339
Health Care System Assessment	(22,850,000)	(17,780,000)	(5,070,000)
INCREASE IN NET ASSETS	182,866,985	36,284,841	146,582,144
NET ASSETS - BEGINNING OF YEAR	688,947,694	652,665,522	36,282,172
RESTATEMENT	11,959,031	(2,669)	11,961,700
NET ASSETS - END OF YEAR	$ 883,773,710	$ 688,947,694	$ 194,826,016

University of North Carolina Hospitals
Statement of Net Assets
June 30, 2007

Exhibit A-1

ASSETS		
Current Assets:		
Cash and Cash Equivalents	$	213,622,192
Restricted Cash and Cash Equivalents		7,119,763
Receivables:		
Patient Accounts Receivable, Net (Note 3)		113,477,778
Accrued Interest Receivable		1,189,657
Other Accounts Receivable		19,450,438
Estimated Third Party Settlements (Note 4)		13,752,171
Inventories		14,925,414
Prepaid Expenses		3,174,827
Total Current Assets		386,712,240
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		103,760,782
Investments (Note 2)		356,672,376
Restricted Investments (Note 2)		9,222,824
Advanced Deposits with Liability Insurance Trust Fund (Note 11)		5,367,780
Patient Accounts Receivable, Net (Note 3)		3,447,598
Bond Issuance Costs, Net		1,710,948
Start-Up Costs, Net		542,180
Investments in Affiliates (Note 14)		1,467,685
Capital Assets - Nondepreciable (Note 5)		94,936,757
Capital Assets - Depreciable, Net (Note 5)		341,911,834
Total Noncurrent Assets		919,040,764
Total Assets		1,305,753,004
LIABILITIES		
Current Liabilities:		
Accounts Payable		43,804,773
Accrued Salaries and Benefits		27,477,500
Estimated Third Party Settlements (Note 4)		22,151,491
Due to Patients or Third Parties		2,586,819
Bond Interest Payable		2,071,767
Long-Term Liabilities - Current Portion (Note 6)		22,336,227
Funds Held for Others		8,110,497
Total Current Liabilities		128,539,074
Noncurrent Liabilities:		
Long-Term Liabilities (Note 6)		293,440,220
Total Liabilities		421,979,294

NET ASSETS

Invested in Capital Assets, Net of Related Debt		216,150,155
Restricted for Expendable Uses for:		
Chatham Escrow		1,999,000
Master Facility Research Fund		3,000,000
Bond Covenants		98,891,775
Capital Equipment		9,222,824
Liability Insurance Trust Fund		5,367,780
Trust Fund Donations		423,705
Unrestricted		548,718,471
Total Net Assets	$	883,773,710

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

University of North Carolina Hospitals
Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Year Ended June 30, 2007

Exhibit A-2

REVENUES		
Operating Revenues:		
Net Patient Service Revenue (Note 8)	$	737,970,982
Other Operating Revenue		16,727,568
Prior Year Third Party Settlements		33,097,009
Total Operating Revenues		787,795,559
EXPENSES		
Operating Expenses:		
Salaries and Benefits		389,677,290
Medical and Surgical Supplies		134,386,727
Contracted Services		96,133,447
Other Supplies and Services		49,953,912
Communications, Utilities and Travel		14,846,550
Medical Malpractice Costs		3,770,613
Depreciation and Amortization		38,561,375
Total Operating Expenses		727,329,914
Operating Income		60,465,645
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		45,673,970
Noncapital Gifts and Grants		175,810
Investment Income (Net of Investment Expense of $575,969)		71,140,459
Gain on Investments in Affiliates (Note 14)		378,049
Minority Interest - LLC		(451,596)
Interest and Fees on Debt		(13,821,585)
Loss on Disposal of Capital Assets		(327,999)
Net Nonoperating Revenues		102,767,108
Income Before Other Revenues, Expenses, Gains, or Losses		163,232,753
Capital Appropriations		3,000,000
Capital Grants		38,958,073
Capital Gifts		526,159
Health Care System Assessments (Note 13)		(22,850,000)
Increase in Net Assets		182,866,985
NET ASSETS		
Net Assets - July 1, 2006, as Restated (Note 15)		700,906,725
Net Assets - June 30, 2007	$	883,773,710

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

University of North Carolina Hospitals
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2007

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES		
Received from Patients and Third Parties	$	754,067,565
Payments to Employees and Fringe Benefits		(385,080,832)
Payments to Vendors and Suppliers		(282,543,862)
Payments for Medical Malpractice		(6,169,852)
Other Receipts		14,621,928
Net Cash Provided by Operating Activities		94,894,947
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State Appropriations		45,673,970
Health Care System Assessments		(22,850,000)
Principal Paid on Revenue Bonds		(816,000)
Interest and Fees Paid on Revenue Bonds		(2,805,940)
Noncapital Gifts and Grants		175,810
Net Cash Provided by Noncapital Financing Activities		19,377,840
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES		
Principal Paid on Capital Revenue Bonds		(5,404,000)
Principal Paid on Notes Payable		(10,026,308)
Interest and Fees Paid on Capital Debt		(10,449,614)
Capital Grants		38,958,073
Capital Appropriations		3,000,000
Proceeds from Sale of Capital Assets		23,801
Acquisition and Construction of Capital Assets		(82,199,803)
Net Cash Used by Capital Financing and Related Financing Activities		(66,097,851)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment Income		14,899,511
Purchase of Investments and Related Fees		(150,000,000)
Proceeds from Sale of Restricted Investments		20,465,024
Investments In and Loans to Affiliated Enterprises:		
Cash Payments		(201,043)
Net Cash Used by Investing Activities		(114,836,508)
Net Decrease in Cash and Cash Equivalents		(66,661,572)
Cash and Cash Equivalents - July 1, 2006		391,164,309
Cash and Cash Equivalents - June 30, 2007	$	324,502,737

RECONCILIATION OF NET OPERATING REVENUES (EXPENSES) TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating Income	$	60,465,645
Adjustments to Reconcile Operating Income to Net Cash Provided (Used) by Operating Activities:		
Depreciation and Amortization Expense		38,561,375
Changes in Assets and Liabilities:		
Patient Accounts Receivable (Net)		(7,510,270)
Other Accounts Receivable		(2,004,636)
Estimated Third Party Settlements		(8,448,664)
Inventories		(348,449)
Prepaid Expenses		(736,425)
Advance Deposits with Liability Insurance Trust Fund		(2,399,239)
Accrued Salaries and Benefits		2,212,948
Accounts and Other Payables		13,861,648
Due to Patients or Third Parties		(2,329,913)
Funds Held for Others		1,288,421
Compensated Absences		2,282,506
Net Cash Provided by Operating Activities	$	94,894,947
RECONCILIATION OF CASH AND CASH EQUIVALENTS		
Current Assets:		
Cash and Cash Equivalents	$	213,622,192
Restricted Cash and Cash Equivalents		7,119,763
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		103,760,782
Total Cash and Cash Equivalents - June 30, 2007	$	324,502,737
NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES		
Investments in Affiliated Enterprises:	$	
Current Loss from Equity Method Adjustments		(451,596)
Assets Acquired through a Gift		526,159
Change in Fair Value of Investments		56,295,439
Loss on Disposal of Capital Assets		(327,999)

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

[This Page Left Blank Intentionally]

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

A. **Organization** - The University of North Carolina Hospitals (the Hospitals) is the only State-owned teaching hospital in North Carolina. With a licensed base of 724 beds, this facility serves as an acute care teaching hospital for The University of North Carolina at Chapel Hill. The Hospitals consists of North Carolina Memorial Hospital, North Carolina Children's Hospital, North Carolina Neurosciences Hospital, and North Carolina Women's Hospital. As a State agency, the Hospitals is required to conform to financial requirements established by various statutory and constitutional provisions. While the Hospitals is exempt from both federal and State income taxes, a small portion of its revenue is subject to the unrelated business income tax.

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

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

The accompanying financial statements present all funds belonging to the Hospitals and its component units for which the UNC Health Care System Board of Directors is responsible. The Hospitals' component units are blended in the Hospitals' financial statements. The blended component units, although legally separate, are, in substance, part of the Hospitals' operations and therefore, are reported as if they were part of the Hospitals.

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

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

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

Separate financial statements for the LLC and CDLLC may be obtained from the Chief Financial Officer, University of North Carolina Hospitals, 6011 East Wing, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-1728. Other related foundations and similar nonprofit corporations for which the Hospitals is not financially accountable are not part of the accompanying financial statements.

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

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

In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Hospitals does not apply Financial

Accounting Standards Board (FASB) pronouncements issued after November 30, 1989, unless the GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date.

D. Basis of Accounting - The financial statements of the Hospitals have been prepared using the economic resource measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned, and expenses are recorded when an obligation has been incurred, regardless of the timing of the cash flows.

Nonexchange transactions, in which the Hospitals receives (or gives) value without directly giving (or receiving) equal value in exchange includes State appropriations, a capital grant for the NC Cancer Hospital, Health Care System Assessments, certain grants, and donations. Revenues are recognized, net of estimated uncollectible amounts, as soon as all eligibility requirements imposed by the provider have been met, if probable of collection.

E. Cash and Cash Equivalents – This classification includes undeposited receipts, petty cash, security deposits, cash on deposit with private bank 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.

F. Investments - This classification includes federal, state and local government securities, commercial paper, domestic corporate bonds and participation in an equity investment fund through the University of North Carolina Hospitals at Chapel Hill Trust. Investments are accounted for at fair value, as determined by quoted market prices, or an amount determined by the investment manager if quoted market prices are not available. The net increase (decrease) in the fair value of investments is recognized as a component of investment income.

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

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

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

H. Other Receivables - In addition to patient accounts receivable, the Hospitals recognizes other receivables related to its operations. These items include the sales tax refund due from the North Carolina Department of Revenue, education loan receivables, amounts due from affiliates and other State agencies, and billings to outside companies for ancillary testing, critical care transportation, and pharmacy supplies.

I. Inventories - Inventories consist of medical and surgical supplies, pharmaceuticals, prosthetics, and other supplies that are used to provide patient care or by service departments within the Hospitals. Inventories are valued at cost using FIFO (first-in, first-out) method. Merchandise for resale is valued at the lower of cost or market using the retail inventory method.

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

The Hospitals capitalizes assets that have a value or cost in excess of $5,000 at the date of acquisition and an estimated useful life of three years or more. Useful life estimates are assigned based on the American Hospital Association publication Estimated Useful Lives of Depreciable Hospital Assets.

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

K. Restricted Assets – Unexpended proceeds of revenue bonds, related interest income, unexpended capital contributions and funds equal to 7.5% of gross patient revenue 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. The advance deposits with the Liability Insurance Trust Fund, the remaining proceeds of the capital equipment financing arrangement and certain other trust funds are classified as restricted because external parties or statute limits their use.

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

Bonds payable are reported net of unamortized premiums or discounts and deferred losses on refunds. The Hospitals amortizes bond premiums/discounts over the life of the bonds using the effective interest method. The deferred losses on refunds are amortized over the life of the new debt using the straight-line method. Issuance costs are also amortized over the life of the bonds using the straight-line method.

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

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

Paid Time Off (PTO) Plan – The PTO program combines the various leave types that employees may earn into one earning rate that varies depending upon years of service. This program is mandatory for all new employees. The policy provides for a maximum accumulation of 280 hours of unused PTO time at the last day of the last pay period of the calendar year that includes December 31. At that time, the excess accumulation over 280 hours is converted to long term sick leave, which is treated similar to sick leave in the Traditional Plan. Upon termination of employment, employees are paid for their current balance in PTO based upon their years of service. Once an employee has more than five years of service, the entire accumulated balance is paid up to 280 hours.

The PTO program also has an annual sell back feature that allows employees to sell back 50% of their accumulated hours over a minimum floor. The payout occurs in January each year.

Liability Calculation – The liability for accumulated annual leave, holiday leave, and PTO leave 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. The liability is equal to the accumulated hours multiplied by the employee's current hourly rate plus benefits for social security and State retirement.

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

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

N. Net Assets – The Hospitals' net assets are classified as follows:

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

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

Unrestricted Net Assets – Unrestricted net assets include resources derived from patient care and ancillary services, unrestricted gifts and investment income.

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

O. Revenue and Expense Recognition – The Hospitals classifies its revenues and expenses as operating or nonoperating in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets.

Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the Hospitals' principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as charges for inpatient and outpatient services as well as external customers who purchase medical services. Operating expenses are all expense transactions incurred other than those related to capital and noncapital financing or investing activities as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

Nonoperating revenues include activities that have the characteristics of nonexchange transactions. Revenues from nonexchange transactions, State appropriations that represent subsidies or gifts to the Hospitals, as well as investment income and gain (loss) on disposal of fixed assets are considered nonoperating since these are either investing, capital or noncapital financing activities. The minority interest of the Dialysis LLC is considered nonoperating because it is related to investments in affiliates.

Capital grants, capital appropriations, capital gifts and Health Care System assessments are presented separately after nonoperating revenues and expenses.

P. Net Patient Service Revenue – Patient service revenue is recorded at the Hospitals' established rates and includes all charges for inpatient accounts discharged after June 30, 2006, (less amounts previously recorded at June 30, 2006, for in house patients) and all charges on in house accounts and all charges for outpatient accounts registered after June 30, 2006. The difference between established rates and the estimated amount collectible is recognized as revenue deductions on an accrual basis and deducted from gross patient service revenue to report service revenue at net realizable value. Revenue deductions consist of charges for charity care, contractual allowances and bad debt.

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

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

Q. Medical Malpractice Cost – Medical malpractice costs represent the actuarially determined contribution to the Liability Insurance Trust Fund. See Note 11 for further discussion of the Liability Insurance Trust Fund.

R. Donated Services - No amounts have been included for donated services since no objective basis is available to measure the value of such services. However, a substantial number of volunteers donated significant amounts of their time to the Hospitals' operations.

NOTE 2 - DEPOSITS AND INVESTMENTS

A. Deposits – Pursuant to General Statute 116-37.2, the Hospitals is required to deposit its funds as defined in this statute; including moneys received from fees and other payments for services rendered in its hospitals and/or clinical operations, gifts, grants, and moneys received from or for the operation of any of the Hospitals self-supporting auxiliary enterprises; with the State Treasurer. The Hospitals may voluntarily deposit special funds, revenue bond proceeds, and debt service funds. Special funds consist of moneys for agency funds held directly by the Hospitals. Bond proceeds and debt service funds are invested in accordance with bond resolutions. These funds are currently on deposit with the State Treasurer and therefore, available on demand to comply with applicable bond covenants.

At June 30, 2007, the amount shown on the Statement of Net Assets as cash and cash equivalents includes $313,394,375 which represents the Hospitals' 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 by calling the State Controller's Financial Reporting Section at (919) 981-5454.

Cash on hand at June 30, 2007 was $31,470. The carrying amount of the Hospitals' deposits not with the State Treasurer was $11,076,892 and the bank balance was $11,710,705. Custodial credit risk is the risk that in the event of a bank failure, the Hospitals' deposits may not be returned to it. Pursuant to G.S. 116-36.1, funds received for health care services not deposited with the State Treasurer shall be fully secured in the manner as prescribed by the State Treasurer for the security of public deposits. The Hospitals does not have a deposit policy for custodial credit risk. As of June 30, 2007, $11,375,252 of the Hospitals' bank balance was uninsured and uncollateralized.

B. Investments - Pursuant to General Statute 116-37(e) all receipts, except for General Fund appropriations, may be invested by the State Treasurer on behalf of the Hospitals as allowed in G.S. 147-69.2(b3).

University of North Carolina Hospitals Investment Fund with The Treasurer of the State of North Carolina – At June 30, 2007, the amount shown on the Statement of Net Assets which represents funds deposited with and invested by the State Treasurer is $356,672,376. The State Treasurer contracted with an external party (Trustee) to create the University of North Carolina Hospitals at Chapel Hill Trust (Trust). The UNC Hospitals is the only depositor in the Trust, however, the Trust is a participant of a commingled equity investment fund. The Trustee manages the assets, primarily in equity and equity-based securities in accordance with General Statutes. The Trustee maintains custody of the underlying securities in the name of the Trust, services the securities and maintains all related accounting records. The investments are valued at fair market value. Deposit and investment risks associated with the Trust 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.

Other Investments – Investments are subject to the following risks.

Interest Rate Risk: Interest rate risk is the risk the Hospitals may face should interest rate variances affect the fair value of investments. The Hospitals 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 Hospitals does not have a formal policy that addresses credit risk however, the Hospitals has a contractual agreement with an investment advisor that specifies the types and ratings of investments permitted.

Custodial Credit Risk: Custodial credit risk is the risk that, in the event of the failure of the counterparty, the Hospitals will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Hospitals does not have a formal policy for custodial credit risk.

The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2007, for the Hospitals' other investments.

		Investment Maturities (in Years)	
	Fair Value	Less Than 1	More than 10
Investment Type			
Debt Securities			
U.S. Agencies	$ 132,507	$ 132,507	$ 0
State and Local Government	4,559,039		4,559,039
Commercial Paper	2,696,713	2,696,713	
Domestic Corporate Bonds	1,834,565	1,834,565	
	$ 9,222,824	$ 4,663,785	$ 4,559,039

At June 30, 2007, the Hospitals' other investments had the following credit quality distribution for securities with credit exposure:

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa
U.S. Agencies	$ 132,507	$ 132,507	$ 0	$ 0	$ 0
State and Local Government	4,559,039	4,559,039			
Commercial Paper	2,696,713			2,696,713	
Domestic Corporate Bonds	1,834,565	253,840	457,095	783,060	340,570

Rating Agency: S & P and Moodys

At June 30, 2007, the Hospitals' other investments were exposed to custodial credit risk as follows:

Investment Type	Held by Counterparty
U.S. Agencies	$ 132,507
State and Local Government	4,559,039
Commercial Paper	2,696,713
Domestic Corporate Bonds	1,834,565
Total	$ 9,222,824

NOTE 3 - PATIENT ACCOUNTS RECEIVABLE - NET

A. Current - Net patient accounts receivable consist of amounts due from patients and third parties at estimated realizable value. Included in gross receivables are amounts receivable at established billing rates less payments received through June 30th. Allowances for uncollectible accounts and contractual adjustments are estimated using historical collection statistics. The components of current net Patient Accounts Receivable reflected in the accompanying Statement of Net Assets are as follows at June 30, 2007:

	Amount
In House Patients	$ 38,378,197
Discharged (Not Final Billed) Patients	50,616,535
Total Unbilled	88,994,732
Discharged (Billed) Patients	186,032,526
Payment Arrangements	891,552
Charity Care Provided	(16,537,095)
Current Gross	259,381,715
Allowance for Bad Debts	(26,969,975)
Contractual Allowances	(118,933,962)
Total Allowances	(145,903,937)
Current - Net	$ 113,477,778

B. **Noncurrent** - Net Patient Accounts Receivable consisted of $3,447,598 as of June 30, 2007. Noncurrent amounts represent patient payment arrangements that extend beyond one year and are based on signed contractual agreements for a specific monthly payment amount.

NOTE 4 - ESTIMATED THIRD PARTY SETTLEMENTS

UNC Hospitals renders care to patients covered by Medicare, Medicaid and Tricare/Champus programs. Inpatient acute care services rendered to Medicare patients are paid at prospectively determined rates per discharge. Medicare outpatient services are reimbursed at prospectively determined rates. Additionally, UNC Hospitals receives interim pass-through payments from Medicare for certain portions of inpatient acute care costs such as organ costs, graduate medical education, etc., that are ultimately settled on cost or an adjusted cost through the annual Medicare Cost Report. The Hospitals earned $13,832,182 in pass-through payments for 2007. On an interim, Medicaid inpatient services are reimbursed on a prospectively determined rate per discharge and Medicaid outpatient services are reimbursed on an interim basis at an agreed upon rate. Ultimately, both Medicaid inpatient and outpatient services are settled at cost through the filing of an annual cost report. In addition to Tricare/Champus payments for services on an interim basis, the program reimburses the Hospitals for a portion of capital and direct medical education costs based on the Medicare cost report.

UNC Hospitals has calculated the estimated third party settlements for the outstanding Medicare and Medicaid cost reports during the fiscal year ended 2007. It is estimated that the Hospitals owes Medicare and Medicaid $4,962,005 and $17,189,486 respectively and that Tricare/Champus owes the Hospitals $13,752,171. Included in the estimated liability for Medicare and Medicaid is a reserve for potential audit adjustments for all outstanding cost reports based on industry practice and the recommendation of an advisor from a CPA firm that is recognized as a national health care reimbursement consultant. The reserve for Medicare equals 4 – 10% of at-risk items for all outstanding cost reports (4% reserved in 2001, increasing 1% each year, until 10% reserve was reached in 2007). The reserve for Medicaid equals 3% of allowable costs. During fiscal year 2007, Medicare provided the Hospitals with the required Provider Statistical and Reimbursement Summary Reports for 2001 – 2006. Upon receipt of the required Medicare claims and statistical reports, the Hospitals filed Medicare cost reports for years ended June 30, 2001 – 2006 and Medicaid for years ended June 30, 2005, and 2006 during this fiscal year. An estimate is made for the current year's Medicare, Tricare and Medicaid settlements by using the most current available statistics, costs, settlement data and charges.

Once a cost report is filed, it is subject to an initial tentative settlement and subsequent on-site audit. Each report is audited by the programs for compliance with the applicable regulations established for the Medicaid, Medicare and Tricare/Champus programs. Each cost report can also be re-opened or appealed for issues that the Hospitals, Medicare or Medicaid programs feel are warranted. There are several such requests under consideration, as well as, audits that are incomplete at this time. Any of the above can result in a change to the reimbursement requiring a refund from the program or payment to the program.

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	$ 26,420,912	$ 0	$ 0	$ 26,420,912
Construction in Progress	19,659,252	56,229,917	7,373,324	68,515,845
Total Capital Assets, Nondepreciable	46,080,164	56,229,917	7,373,324	94,936,757
Capital Assets, Depreciable:				
Buildings	318,855,577	7,388,324		326,243,901
Machinery and Equipment	294,322,341	28,652,250	10,600,565	312,374,026
General Infrastructure	5,323,924			5,323,924
Total Capital Assets, Depreciable	618,501,842	36,040,574	10,600,565	643,941,851
Less Accumulated Depreciation/Amortization for:				
Buildings	86,440,742	11,680,018		98,120,760
Machinery and Equipment	183,158,654	26,641,264	9,543,135	200,256,783
General Infrastructure	3,419,473	233,001		3,652,474
Total Accumulated Depreciation	273,018,869	38,554,283	9,543,135	302,030,017
Total Capital Assets, Depreciable, Net	345,482,973	(2,513,709)	1,057,430	341,911,834
Capital Assets, Net	$ 391,563,137	$ 53,716,208	$ 8,430,754	$ 436,848,591

NOTE 6 - 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	$ 280,865,000	$ 0	$ 6,220,000	$ 274,645,000	$ 6,420,000
Plus: Premium	1,744,672		332,893	1,411,779	
Less: Discount	(579,809)		(15,777)	(564,032)	
Less: Deferred Charge on Refunding	(16,620,115)		(856,939)	(15,763,176)	
Total Bonds Payable	265,409,748		5,680,177	259,729,571	6,420,000
Notes Payable	44,030,832	1,669,668	11,316,030	34,384,470	10,751,833
Arbitrage Rebate Payable	268,892			268,892	
Compensated Absences	19,111,007	31,359,169	29,076,662	21,393,514	5,164,394
Total Long-Term Liabilities	$ 328,820,479	$ 33,028,837	$ 46,072,869	$ 315,776,447	$ 22,336,227

B. Revenue Bonds Payable and Certificates of Participation - The Hospitals was indebted for bonds payable for the purposes shown in the following table:

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2007	Principal Outstanding June 30, 2007
Refund 1992 Revenue Bonds	1999	4.00% to 5.25%	02/15/2024	$ 58,925,000	$ 11,670,000	$ 47,255,000
Rex Acquisition and Hospital Renovations	2001A	3.94%				
	2001B	3.90%	02/15/2031	110,000,000	6,400,000	103,600,000
Refund Portion of 1996 Revenue Bonds	2003A	3.65%				
	2003B	3.64%	02/01/2029	98,015,000	1,895,000	96,120,000
Refund Portion of 1996 Revenue Bonds	2005A	3.00% to 5.00%	02/01/2015	30,540,000	2,870,000	27,670,000
Total Bonds Payable (principal only)				$ 297,480,000	$ 22,835,000	274,645,000
Less: Unamortized Loss on Refunding						(15,763,176)
Less: Unamortized Discount						(564,032)
Plus: Unamortized Premium						1,411,779
Total Bonds Payable						$ 259,729,571

* For variable rate debt, interest rates in effect at June 30, 2007 are presented.
** For variable rate debt with interest rate swaps, the synthetic fixed rates in effect at June 30, 2007 are presented.

C. Demand Bonds - Included in bonds payable are several variable rate demand bond issues. Demand bonds are securities that contain a "put" feature that allows bondholders to demand payment before the maturity of the debt upon proper notice to the Hospitals' Remarketing Agents.

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

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

While in daily mode, the bonds are subject to purchase on any business day upon demand by telephonic notice of tender to the Remarketing Agent on the purchase date and delivery to the bond Tender Agent, Wachovia Bank, National Association. The Hospitals' Remarketing Agents; Merrill Lynch, Pierce, Fenner & Smith Incorporated (Series 2001A) and Banc of America Securities LLC (Series 2001B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to either .05% or .08% of the outstanding principal amount of the bonds assigned to each agent, depending upon their performance in comparison to an established benchmark.

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and *Landesbank Hessen-Thuringen Girozentrale,* a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require an adjustable facility fee based on the long-term rating of the bonds, which is calculated as a percentage of the available commitment. Payments are made quarterly in arrears, on the first business day of each July, October,

January and April thereafter until the expiration date or the termination date of the Agreements. For the past fiscal year the percentage was .25% with the new long-term agreement that became effective on July 11, 2005. The percentage will remain .25% unless the bond ratings change.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Formula Rate (Base Rate equal to the higher of the Prime Rate for such day or the sum of .50% plus the Federal Funds Rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is due quarterly (the first business day of January, April, July and October) for each period in which Bank Bonds are outstanding. At June 30, 2007, there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The agreements allow the Hospitals to redeem bank bonds in equal quarterly installments, on the first business day of January, April, July and October. The payments will commence with the first business day of any such month that is at least 90 days following the applicable Purchase Date of the Bank Bond and end no later than the fifth anniversary of such Purchase Date. If the take out agreement were to be exercised because the entire outstanding $103,600,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $25,496,456 a year for five years under the installment loan agreement assuming an 8.25 percent prime interest rate.

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

University of North Carolina Hospitals at Chapel Hill Revenue Refunding Bonds - Series 2003A and Series 2003B: On February 13, 2003, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of $63,770,000 (2003A) and $34,245,000 (2003B) that have a final maturity date of February 1, 2029. The bonds are subject to mandatory sinking fund redemption that began

on February 1, 2004. The proceeds were used to advance refund $88,325,000 of the Series 1996 Bonds. While initially bearing interest in a weekly mode, the mode on these bonds may change to a daily rate, a unit pricing rate, a term rate or a fixed rate.

While in the weekly mode, the bonds are subject to purchase on demand with seven days' notice to the Remarketing Agent and delivery to the bond Tender Agent, Wachovia Bank, National Association. The Hospitals' Remarketing Agents, Banc of America Securities LLC (Series 2003A) and Wachovia Bank, National Association (Series 2003B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to .08% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003A and is equal to .07% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003B.

Under separate Standby Bond Purchase Agreements for the Series 2003A and Series 2003B (Agreements) between the Hospitals and Bank of America, N.A. (Series 2003A) or Wachovia Bank, National Association (Series 2003B) a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require a facility fee equal to .22% of the available commitment for Series 2003A and Series 2003B, payable quarterly in advance, beginning on February 13, 2003, and on each February 1, May 1, August 1, and November 1 thereafter until the expiration date or the termination date of the Agreements.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Bank Bond Interest Rate (for Series 2003A, the rate equals London Inter-Bank Offered Rate (LIBOR) plus 2.50% for the first 90 days and then equals LIBOR plus 4.00%; for Series 2003B, the rate equals Prime Rate for the first 90 days and then equals Prime plus 1.00%) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is on the first business day of each month for each period in which Bank Bonds are outstanding. At June 30, 2007, there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within

90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The Series 2003A agreement allows the Hospitals to redeem Bank Bonds in twelve equal quarterly installments beginning on the first February 1, May 1, August 1, or November 1 that occurs at least 90 days following the applicable Purchase Date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding $62,525,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $24,131,072 a year for three years under the installment loan agreement assuming a 9.32 percent interest rate (LIBOR plus 4%). The Series 2003B agreement allows the Hospitals to redeem Bank Bonds in 36 equal monthly installments, on the first business day of each calendar month after the loan date. Payments commence with the first business day of any such month that is at least 120 days following the applicable Purchase Date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding $33,595,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $12,866,700 a year for three years under the installment loan agreement assuming a 9.25 percent interest rate (Prime plus 1%).

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

Interest Rate Swap Agreement

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

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

The swap agreement terminates February 1, 2029. As of June 30, 2007, rates were as follows:

	Terms	2003A Rates	2003B Rates
Fixed Payment to BOA	Fixed	3.48 %	3.48 %
Variable Payment from BOA	LIBOR* - BBA**	3.56 %	3.56 %
Net Interest Rate Swap Payments		(0.08)	(0.08)
Variable Rate Bond Coupon Payments		3.73	3.72
Synthetic Interest Rate on Bonds		3.65	3.64

* London Inter-Bank Offered Rate
** British Bankers Association

The swap agreement has a mark-to-market value of $2,664,205 as of June 30, 2007. BOA develops the mark-to-market value. Their method calculates the present value of the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for LIBOR due on the date of each future net settlement on the swap.

As of June 30, 2007, the Hospitals is exposed to credit risk equal to the market value of the swap. BOA's current long-term ratings are AA+ by Fitch Ratings, Aaa by Moody's Investor's Service, and AA+ by Standard and Poor's Corporation. At such time that their ratings fall below A3 for Moody's or below A- for S&P, BOA will be required to collateralize a portion of their exposure (up to 100%). The following instruments can serve as eligible collateral: Cash, U.S. Treasury Obligations, U.S. Government Agency Fixed Rate Fixed Maturity Securities, U.S. Government Agency Single Class Mortgage-Backed Securities, U.S. Treasury STRIPS and other U.S. Government Agency Mortgage-Backed Securities. Posted collateral received will be entered in one or more accounts with a domestic office of a commercial bank, trust company or financial institution organized under the laws of the United States (or any state or a political subdivision thereof).

Basis risk: The Hospitals receives 67% of 1-month LIBOR-BBA Index from BOA and pays a floating rate to its bondholders set by the Remarketing Agent. The Hospitals incurs basis risk when its bonds trade at a yield above 67% of 1-month LIBOR-BBA Index. If the relationship of the Hospitals' bonds trade to a percentage of LIBOR greater than 67%,

the Hospitals will experience an increase in debt service above the fixed rate on the swap.

Termination risk: The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The Hospitals or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If the swap is terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the Hospitals would be liable to the counterparty for that amount. Termination could result in the Hospitals being required to make an unanticipated termination payment.

D. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2007, are as follows:

	Annual Requirements				
	Revenue Bonds Payable			Notes Payable	
Fiscal Year	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest
2008	$ 6,420,000	$ 11,288,924	$ (81,087)	$ 10,751,833	$ 1,046,017
2009	6,860,000	10,959,216	(80,407)	10,320,185	678,298
2010	7,135,000	10,644,306	(80,105)	10,604,248	321,566
2011	7,410,000	10,309,699	(79,654)	2,708,204	23,250
2012	7,705,000	9,968,832	(79,316)		
2013-2017	45,115,000	43,886,402	(381,318)		
2018-2022	56,450,000	33,158,495	(284,831)		
2023-2027	69,780,000	20,398,566	(148,274)		
2028-2031	67,770,000	5,763,981	(15,027)		
Total Requirements	$ 274,645,000	$ 156,378,421	$ (1,230,019)	$ 34,384,470	$ 2,069,131

Interest on the variable rate 2001A and 2001B revenue bonds is calculated based upon the daily rates at which the bonds were remarketed at 3.94% and 3.90% respectively, at June 30, 2007. Interest on the variable rate 2003A and 2003B revenue bonds is calculated based upon the synthetic rates of 3.65% and 3.64%, respectively, at June 30, 2007. This schedule also includes the debt service requirements for debt associated with interest rate swaps. More detailed information about interest rate swaps is presented in Note 6C.

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

Purpose	Financial Institution	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2007	Principal Outstanding June 30, 2007
IBM Equipment	IBM Credit	2.48% to 5.88%	07/01/2008	$ 1,666,897	$ 745,959	$ 920,938
Medical Equipment	SunTrust	3.40%	09/29/2010	50,000,000	16,536,468	33,463,532
Total Notes Payable				$ 51,666,897	$ 17,282,427	$ 34,384,470

NOTE 7 - OPERATING LEASE OBLIGATIONS

The Hospitals entered into operating leases for space rental. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2007:

Fiscal Year	Amount
2008	$ 864,350
2009	749,954
2010	605,382
2011	546,870
2012	432,030
2013-2017	1,448,172
Total Minimum Lease Payments	$ 4,646,758

Rental expense for all operating leases during the year was $2,213,396.

NOTE 8 NET PATIENT SERVICE REVENUE

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

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

Medicare reimburses the Hospitals for inpatient hospital services furnished in the inpatient rehabilitation unit, referred to as an inpatient rehabilitation facility (IRF), under the provisions of the Inpatient Rehabilitation Facility Prospective Payment System (IRF PPS). IRF PPS utilizes information from a patient assessment instrument (IRF PAI) to classify patients into distinct groups based on clinical characteristics and expected resource needs. Payments are calculated for each group, including case and facility adjustments. Payments made under this system cover the inpatient operating and capital costs of covered rehabilitation services and are made on a per discharge basis.

Medicare is transitioning reimbursement of inpatient services provided in the Hospitals' inpatient psychiatric unit under the provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 to Inpatient Psychiatric Facility Prospective Payment System (IPF PPS) over a three year period beginning July 1, 2005, for UNC Hospitals. During the three year transition period, the Hospitals receives a blended payment consisting of a federal per diem payment amount and a facility specific payment amount which would have been received under TEFRA. The third year payment is 25% of TEFRA and 75% of the IRF PPS payment amount. The Hospitals is also eligible for outlier payments for longer lengths of stay and high costs on a per case basis.

The Balanced Budget Act of 1997 required the implementation of a prospective payment system for outpatient services. The system became effective August 1, 2000, and is based on ambulatory payment classifications (APC). It applies to most hospital outpatient services other than ambulance, rehabilitation services, clinical diagnostic laboratory services, dialysis for end-stage renal disease, non-implantable durable medical equipment, prosthetic devices and orthotics which are paid based on fee schedules.

Medicaid: Medicaid reimburses inpatient services on an interim basis under a prospective payment system using diagnostic related groups as its basis. A settlement is made at year end to adjust from the interim reimbursement to a cost-based reimbursement basis.

Medicaid reimburses outpatient services on an interim basis based on an agreed-upon rate based on documented costs. Medicaid also reimburses the Hospitals for graduate medical education costs. Final settlement is determined after submission of annual cost reports by the Hospitals. Several services such as ambulance, hearing aids, durable medical equipment (DME), outpatient

pharmaceuticals, home health, dialysis and diagnostic laboratory services are paid on fee schedules.

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

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

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

A summary of net patient service revenue for the year ended June 30, 2007, follows:

	Amount
Inpatient Routine	$ 306,888,442
Inpatient Ancillary	617,983,268
Outpatient	583,262,735
Charity Care Provided	(70,923,567)
Gross Patient Service Revenue	1,437,210,878
Medicare Contractual	(204,150,087)
Medicaid Contractual	(150,495,870)
Managed Care Contractual	(280,673,642)
Other Contractuals	(12,447,590)
Bad Debt	(51,472,707)
Contractual Adjustments	(699,239,896)
Net Patient Service Revenue	$ 737,970,982

NOTE 9 - PENSION PLANS

A. Retirement Plans - Each permanent full-time employee, as a condition of employment, is a member of the Teachers' and State Employees' Retirement System.

The 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 Hospitals had a total payroll of $303,437,338 of which $253,396,188 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were $15,203,771 and $6,740,339 respectively. The Hospitals made 100% of its annual required contributions for the years ended June 30, 2007, 2006, and 2005, which were $6,740,339, $5,318,419, and $4,812,216, 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.

B. Deferred Compensation and Supplemental Retirement Income Plans - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement or financial

hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, the North Carolina Public Employee Deferred Compensation Trust Fund. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the Hospitals. The voluntary contributions by employees amounted to $465,639 for the year ended June 30, 2007.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the Hospitals except for a 5% employer contribution for the Hospitals' law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of Hospitals' law enforcement officers for the year ended June 30, 2007, were $50,044. The voluntary contributions by employees amounted to $1,790,900 for the year ended June 30, 2007.

IRC Section 403(b) and 403(b)(7) Plans - Eligible employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the Hospitals. The voluntary contributions by employees amounted to $5,065,220 for the year ended June 30, 2007.

NOTE 10 - OTHER POSTEMPLOYMENT BENEFITS

A. Health Care for Long-Term Disability Beneficiaries and Retirees – The Hospitals participates in State-administered programs that provide post employment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System. These benefits were established by Chapter 135, Article 3, Part 3 of the General Statutes and

may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The Hospitals contributed 3.80% of the covered payroll under the Teachers' and State Employees' Retirement System for these health care benefits. For the fiscal year ended June 30, 2007, the Hospitals' total contribution to the plan was $9,629,055. The Hospitals assumes no liability for retiree health care benefits provided by the programs other than its required contributions. Additional detailed information about these programs can be located in the State of North Carolina's Comprehensive Annual Financial Report.

B. Long-Term Disability - The Hospitals participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The Hospitals contributes .52% of covered payroll under the Teachers' and State Employees' Retirement System to the DIPNC. For the year ended June 30, 2007, the Hospitals' total contribution to the DIPNC was $1,317,660. The Hospitals assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's Comprehensive Annual Financial Report.

NOTE 11 - RISK MANAGEMENT

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

Tort claims of up to $500,000 are self-insured under the authority of the State Tort Claims Act.

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

Other operations not supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a $500 per occurrence deductible. Premiums are paid based on square footage and the value of building contents. The Hospitals also purchased through the Fund "all risks" replacement cost basis insurance for buildings and contents subject to a $25,000 per occurrence deductible. No significant losses occurred during the year.

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

The Hospitals is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is handled by the North Carolina Department of Insurance. The Hospitals is charged a premium by the private insurance company. Coverage limit is $5,000,000 per occurrence with a $75,000 deductible and a 10% participation in each loss above the deductible.

The Hospitals purchased other authorized coverage from private insurance companies through the North Carolina Department of Insurance. The coverage includes:

- Boiler and Machinery insurance up to $25,000,000 with a deductible of $5,000 per occurrence
- Directors and Officers Liability insurance up to $15,000,000 with a deductible of $200,000 per occurrence
- Master Crime insurance up to $500,000 with a deductible of $1,000
- Comprehensive General Liability insurance up to $2,000,000 with a deductible of $10,000 per occurrence
- Automobile Physical Damage (for vehicles costing greater than $75,000) insurance up to $5,000,000 per accident with a deductible of $500 per occurrence
- General Liability for Helipad on Premises insurance up to $20,000,000 with a deductible of $10,000 per occurrence
- General Liability for Non-owned Aircraft insurance up to $20,000,000 with no deductible
- Business Travel insurance for aircraft flight team up to $600,000 per accident with no deductible

- Computerized Business Equipment replacement cost insurance up to $1,441,204 with a deductible of $10,000 per occurrence
- Fine Arts Floater insurance up to $50,000 ($5,000 per item) with a deductible of $1,000 per occurrence
- Health System Properties, LLC real property coverage up to $700,000 with a deductible of $25,000 per occurrence

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

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

Term life insurance (death benefits) of $25,000 to $50,000 is provided to eligible workers. This Death Benefit Plan is administered by the State Treasurer and funded via employer contributions. 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.

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

The Trust Fund is an unincorporated entity created by Chapter 116, Article 26, of the *North Carolina General Statutes* and The University of North Carolina Board of Governors Resolution of June 9, 1978. The Trust Fund is a self-insurance program established to provide professional medical malpractice liability covering The University of North Carolina Hospitals at Chapel Hill ("UNC Hospitals") and The University of North Carolina at Chapel Hill

Physicians and Associates ("UNC P&A"), the program participants. The Trust Fund provides coverage for program participants and individual health care practitioners working as employees, agents, or officers of program participants. The Trust Fund is exempt from federal and state income taxes, and is not subject to regulation by the North Carolina Department of Insurance.

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

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

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

For the period July 1, 2006, through June 30, 2007, the Trust Fund provided coverage on an occurrence basis of $3,000,000 per individual and $7,000,000 in the aggregate per claim. The Trust Fund entered into an excess of loss agreement with an unaffiliated reinsurer in prior years. However, excess reinsurance coverage was not purchased for the policy year ended June 30, 2007, as the Trust Fund chose to retain 100% of the liability. In lieu of reinsurance, the participants contributed $10,000,000 in the aggregate toward the Reimbursement Fund for future losses. For the fiscal year ending June 30, 2007, the Trust Fund purchased a direct insurance policy to cover the first $1,000,000 per occurrence and $3,000,000 in the aggregate for dental residents. North Carolina General Statutes Chapter 116 was amended during

1987 to authorize the Trust Fund to borrow necessary amounts up to $30,000,000, in the event that the Trust Fund may have insufficient funds to pay existing and future claims. Any such borrowing would be repaid from the assets and revenues of program participants. No line of credit or borrowing has been established pursuant to this authorization. The Council believes adequate funds are on deposit in the Trust Fund to meet estimated losses based upon the results of the independent actuary's report.

The Trust Fund has purchased annuity contracts to settle claims for which the claimant has signed an agreement releasing the Fund from further obligation. The related claim liabilities have been removed from estimated malpractice costs.

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

At June 30, 2007, the Hospitals' assets in the Trust Fund totaled $29,616,245 while Hospitals liabilities totaled $24,248,465 resulting in net assets of $5,367,780.

Additional disclosures relative to the funding status and obligations of the Fund are set forth in the audited financial statements of the Liability Insurance Trust Fund. Copies of this report may be obtained from The University of North Carolina Liability Insurance Trust Fund, 4030 Bondurant Hall, CB #7000, Chapel Hill, North Carolina 27599-7000, or by calling (919) 966-1712.

NOTE 12 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The Hospitals has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were $108,863,732 and $59,093,221 on inventory, capital and all other purchases at June 30, 2007.

B. Pending Litigation and Contingencies - The Hospitals is party to other litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of those matters, no provision for any liability has been made in the accompanying financial statements. Hospitals' management is of the opinion that the liability, if any, for any of these matters will not have a material adverse effect on the financial position of the Hospitals.

C. North Carolina State Capital Facilities Act of 2004 – The North Carolina State Capital Facilities Act of 2004 (the Act) was ratified as part of House bill 1264 of the 2004 Session of the General Assembly of North Carolina. The Act authorizes the issuance or incurrence of special indebtedness of an aggregate maximum amount of $180 million to finance the construction and equipping of a new cancer rehabilitation and treatment center, a nearby physician's office building, and a walkway between the two, all to be located at the University of North Carolina Hospitals at Chapel Hill. The State, with the prior approval of the State Treasurer and the Council of State, as provided in Article 9 of Chapter 142 of the *North Carolina General Statutes*, is authorized to issue or incur special indebtedness in order to provide funds to the State to be used, together with other available funds, to pay the cost of this project. The Act requires both the Health and Wellness Trust Fund and the Tobacco Trust Fund to provide the debt service for the special indebtedness described above. The information for the Cancer Hospital project component of the Act is provided quarterly by the Hospitals' Planning Department via a report that outlines the estimated cash requirements needed to fund the remainder of the project as of that point in time. Within these amounts, based on an official request of cash needs from the Hospitals, the Office of State Budget and Management (OSBM) authorizes allotments. The Hospitals records the allotments as capital grant revenue on the accompanying financial statements. The Hospitals' remaining authorization of $126,041,219 is contingent on fund availability and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

D. Rex Capital Fund – On April 13, 2000, the UNC Health Care System (System) entered into a contractual agreement with Rex Healthcare, Inc., (Rex) and the John Rex Endowment to gain a controlling interest in the governance of Rex Healthcare, Inc., and related entities. At the signing of this agreement, the Hospitals transferred $100 million on behalf of the System to the John Rex Endowment. This agreement also called for future funding of Rex's capital needs over 10 years up to $58 million. This obligation may be satisfied contractually by the System paying Rex in incremental draws or by applying Rex's operating surplus to their capital needs. There have been no calls, to date, under the agreement because Rex's capital fund needs have been satisfied by their operating surplus.

NOTE 13 - RELATED PARTIES

University of North Carolina Health Care System Enterprise Fund – The Board of Directors of UNC Health Care System (System) authorized and approved the creation of an Enterprise Fund to support the System's mission and vision to be the nation's leading public academic health care system. The key components of the System are the University of North Carolina Hospitals, the clinical patient care programs established or maintained by the University of North Carolina at Chapel Hill School of Medicine and UNC Physicians & Associates, and Rex Healthcare, Inc. Pursuant to a memorandum of understanding effective July 1, 2005, the key components agreed to finance the Enterprise Fund. For the year ending June 30, 2007, UNC Hospitals was assessed $12,350,000 to fund initiatives supported by the Enterprise Fund.

Following the favorable settlement of several prior year cost reports, unbudgeted and unencumbered monies became available. The Board of Directors approved an additional assessment of $10,000,000 from UNC Hospitals.

A $500,000 assessment was also approved by the Board of Directors to create a fund to support innovations that improve the medical care of System patients through performance improvement and patient safety.

Rex Healthcare, Inc. – Rex Healthcare, Inc., (Rex) is a North Carolina not-for-profit corporation organized to provide a wide range of healthcare services to residents of the Triangle. By contractual agreement, the System has a controlling interest in the governance of Rex and related entities. The System appoints eight of the 13 seats on the Rex Board of Trustees and reviews and approves Rex's annual operating and capital budgets. The principal corporate entities under the common control of Rex Healthcare, Inc., are:

Rex Hospital, Inc. – Rex Hospital, Inc., is a 394 bed acute care hospital that provides inpatient, outpatient and emergency services primarily to the residents of Wake County, North Carolina. The Hospital also operates Rex Cancer Center, Rex Family Birth Center and Rex Rehab and Nursing Care Center of Raleigh. Rex Hospital has additional campuses in Cary, Wakefield (in Raleigh) and Apex. Rex Hospital also owns Rex Nursing Care Center of Apex, a nursing facility, and Rex Home Services, Inc., a not-for-profit corporation serving residents primarily in Wake County.

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

Rex Healthcare Foundation, Inc. – Rex Healthcare Foundation, Inc., is a North Carolina not-for-profit corporation organized to promote the

health and welfare of Triangle residents by promoting philanthropic contributions and public support of Rex Healthcare.

UNC Hospitals provides certain management, legal and contracting services to Rex. Likewise, Rex also provides certain employee contracting services to the Hospitals. These transactions resulted in the Hospitals receiving $2,057,355 from Rex and the Hospitals paying $764,820 to Rex during the year ended June 30, 2007.

The Medical Foundation of North Carolina, Inc. – The Hospitals is a participant in The Medical Foundation of North Carolina, Inc., (Foundation) a nonprofit Foundation for the University of North Carolina at Chapel Hill and the Hospitals, which solicits gifts and grants for both entities. The Board of Directors of the Medical Foundation administers the funds of the Foundation.

Chatham Hospital, Incorporated – Chatham Hospital is a private, nonprofit 501(c)(3) corporation that owns and operates a 25-bed critical access facility located in Siler City, North Carolina. Chatham Hospital provides a wide array of healthcare-related services and its mission is to deliver quality and fiscally responsible healthcare that meets the needs of its patients, physicians, employees and the communities within its service area.

UNC Hospitals entered into a five year management agreement with Chatham Hospital on August 1, 2006, which includes the following:

- Operational oversight by two UNC Health Care System employees who serve as the Chief Executive Officer and Chief Financial Officer.
- Certain consultative services are provided as part of the management fee and other services are available at cost plus an administrative fee.
- Strategic planning services regarding facility replacement, bond issuance, and physician recruitment.

The existing Chatham Hospital facility is being replaced at a new location using $30,540,000 in funding from a January 2007 bond issuance. In support of the bond issue, the System's Board approved funding support for Chatham Hospital's use during construction. To date, UNC Hospitals has established a $1,999,000 million escrow account to serve as collateral for some of the financial covenants related to the Chatham Hospital debt, but none of these funds have been used. Prior to the bond issuance, there existed a $2,200,000 line of credit to support Chatham's capital cash flow needs. During the past year, there were borrowings of $706,406 against the old line of credit. This entire amount was repaid with interest and the line of credit ended in April 2007.

NOTE 14 - INVESTMENTS IN AFFILIATES

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were $1,467,685 at June 30, 2007. The Hospitals' share of these affiliates and joint ventures is not significant individually. The summarized audited financial information below represents an aggregation of the ongoing affiliates and joint ventures:

		2007
TOTAL AFFILIATE ACTIVITY		
Current Assets	$	3,958,976
Noncurrent Assets		624,735
Current Liabilities		451,357
Shareholders Equity		4,132,354
Revenue		6,682,360
Net Gain		917,173
HOSPITALS' SHARE OF ACTIVITY		
Affiliate Gain - Ongoing Operations		379,747
Affiliate Loss - Discontinued Operations		(1,698)
Total Gain Realized from Affiliate Activities	$	378,049

NOTE 15 - NET ASSET RESTATEMENT

As of July 1, 2006, net assets as previously reported was restated as follows:

		Amount
July 1, 2006 Net Assets as Previously Reported	$	688,947,694
Restatements: Correction of an error in Third Party Settlements		11,959,031
July 1, 2006 Net Assets as Restated	$	700,906,725

STATE OF NORTH CAROLINA
Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet
http://www.ncauditor.net

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

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

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

We have audited the financial statements of University of North Carolina Hospitals, which is a part of the University of North Carolina Health Care System, which is a part of the University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2007, and have issued our report thereon dated November 5, 2007.

As discussed in Note 1, the financial statements present only the University of North Carolina Hospitals and are not intended to present fairly the financial position of the University of North Carolina Health Care System nor the University of North Carolina System, and the results of its operations and cash flows in conformity with auditing standards generally accepted in the United States of America.

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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Hospitals' 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 Hospitals' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Hospitals' 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 prevent or detect misstatements on a timely basis. A significant deficiency is a control

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

This report is intended solely for the information and use of management of the Hospitals, the Board of Governors, the Board of Directors of the University of North Carolina Health Care System, the Audit and Compliance 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., CPA, CFP
State Auditor

November 5, 2007

ORDERING INFORMATION

Audit reports issued by the Office of the State Auditor can be obtained from the web site at www.ncauditor.net. Also, parties may register on the web site to receive automatic email notification whenever reports of interest are issued. Otherwise, copies of audit reports may be obtained by contacting the:

Office of the State Auditor
State of North Carolina
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0601

Telephone: 919/807-7500

Facsimile: 919/807-7647