STATE OF
NORTH CAROLINA

NORTH CAROLINA SCHOOL OF THE ARTS

WINSTON-SALEM, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2008

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

North Carolina School of the Arts

Winston-Salem, North Carolina

Financial Statement Audit Report

For the Year Ended June 30, 2008

Administrative Officers

John F. Mauceri, Chancellor

George M. Burnette, Chief Operating Officer

STATE OF NORTH CAROLINA
Office of the State Auditor

Beth A. Wood, CPA
State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Beverly E. Perdue, Governor
The General Assembly of North Carolina
Board of Trustees, North Carolina School of the Arts

We have completed a financial statement audit of North Carolina School of the Arts for the year ended June 30, 2008, 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 disclosed a deficiency that is detailed in the Audit Findings and Responses section of this report. The School's response is included following the finding.

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.

Beth A. Wood

Beth A. Wood, CPA
State Auditor

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of North Carolina School of the Arts, a constituent institution of the multi-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component unit, as of and for the year ended June 30, 2008, which collectively comprise the School's basic financial statements as listed in the table of contents. These financial statements are the responsibility of North Carolina School of the Arts' management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the NCSA Housing Corporation, which represent 5 percent, and 2 percent, respectively, of the assets, and revenues of the School, or the financial statements of the North Carolina School of the Arts Foundation, Inc., the School's discretely presented component unit. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinions, insofar as they relate to the amounts included for those entities, are based on the reports of the other auditors.

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

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of North Carolina School of the Arts and its discretely presented component unit as of June 30, 2008, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 15 to the financial statements, the School implemented Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, Statement 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, and Statement 50, *Pension Disclosures*, during the year ended June 30, 2008.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 27, 2009 on our consideration of the School's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

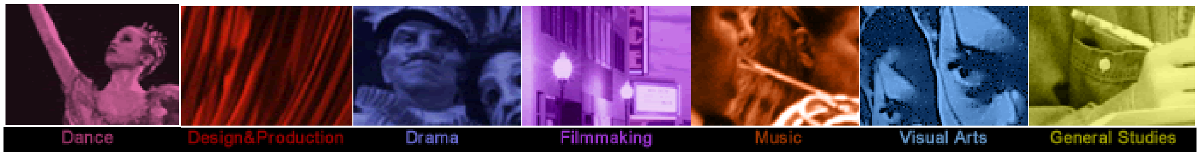
The Management's Discussion and Analysis, as listed in the table of contents, is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which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

Beth A. Wood

Beth A. Wood, CPA
State Auditor

February 27, 2009

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



Introduction

This section of the North Carolina School of the Arts financial report provides an overview of the financial position and activities for the year ended June 30, 2008. This discussion has been prepared by management along with the financial statements and related notes to the financial statements and should be read in conjunction with the financial statements and the notes thereto, which follow this section. This discussion and analysis is designed to focus on current activities, resulting change, and current known facts.

Using the Financial Statements

This annual report consists of a series of financial statements, prepared in accordance with standards issued by the Governmental Accounting Standards Board. These financial statements contain comparative information from the prior fiscal year and focus on the financial condition of the School, the results of operations, and cash flows of the School as a whole. The three financial statements presented include: the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows. For the purpose of this discussion, we will address the Statement of Net Assets and the Statement of Revenues, Expenses, and Changes in Net Assets.

Statement of Net Assets

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

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

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

Condensed Statement of Net Assets

	Year Ended June 30,	
	2008	**2007**
Assets		
Current Assets	$ 10,638,991.60	$ 10,203,969.41
Capital Assets, Net	95,897,095.68	95,675,294.04
Other Noncurrent Assets	16,592,927.00	16,779,952.07
Total Assets	123,129,014.28	122,659,215.52
Liabilities		
Current Liabilities	3,202,362.79	3,139,254.29
Noncurrent Liabilities	11,777,373.24	12,126,960.55
Total Liabilities	14,979,736.03	15,266,214.84
Net Assets		
Invested in Capital Assets, Net of Related Debt	85,750,634.62	84,766,620.52
Restricted:		
Nonexpendable	8,152,738.05	7,127,505.41
Expendable	8,073,147.37	9,020,250.92
Unrestricted	6,172,758.21	6,478,623.83
Total Net Assets	$ 108,149,278.25	$ 107,393,000.68

The Statement of Net Assets at June 30, 2008, indicates an improvement in the School's financial position compared to the previous fiscal year. The total assets of the School increased $469,798.76 for the fiscal year, with a $435,022.19 increase in current assets, a $221,801.64 increase in capital assets, and an $187,025.27 decrease in other noncurrent assets.

The $435,022.19 increase in current assets was primarily due to a $322,034.19 increase in cash gifts and interest earnings during the year. The $221,801.64 increase in capital assets resulted from an increase of $1,716,195.61 for new acquisitions and constructed assets capitalized during the year, an increase of $2,375,853.93 in accumulated depreciation during the year, and a beginning balance restatement of $881,459.96 to accumulated depreciation to correct errors in establishing useful lives. The $187,025.27 decrease in other noncurrent assets was primarily due to a $127,739.06 reduction in the receivable for restricted due from primary government due to the completion of construction projects funded through the University Improvement General Obligation Bonds of 2000. Within the other noncurrent assets category, endowment investments reported a net decrease of $8,971.55 compared to the prior year that consisted of an increase of $1,706,541.43 of new investments and net gains on sales, and a decrease of $1,715,512.98 of losses and decreases in market values. The decreases in market values are as a result of the downward trend in the economy. Refer to Note 17 of the Notes to the Financial Statements for the declining market value of these endowment investments as of December 31, 2008.

The total liabilities of the School decreased $286,478.81 for the year, and include an increase of $63,108.50 in current liabilities and a decrease of $349,587.31 in noncurrent liabilities. The increase in current liabilities was primarily the result of an increase of $134,517.97 in unearned revenue from the carry-forward of summer school revenue and payments of tuition and fees for the 2008-09 Fall term, a $246,609.58 increase in accounts payable and accrued liabilities, and a decrease of $313,250.53 in current long-term liabilities due to the retirement of debt. The decrease in noncurrent liabilities was primarily the result of a $320,775.26 net decrease in long-term liabilities during the year due to the retirement of debt.

Statement of Revenues, Expenses, and Changes in Net Assets

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

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

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

	Year Ended June 30, 2008	2007
Operating Revenues		
Student Tuition and Fees, Net	$ 9,739,970.07	$ 9,144,690.46
Federal Grants and Contracts	758,125.63	607,599.82
Sales and Services, Net	5,085,947.42	5,719,909.09
Interest Earnings on Loans	1,334.79	931.09
Other Operating Revenues	718,310.71	717,189.09
Total Operating Revenues	16,303,688.62	16,190,319.55
Operating Expenses:		
Salaries and Benefits	28,769,372.26	26,773,384.52
Supplies and Materials	6,386,899.95	4,968,815.69
Services	8,911,868.68	7,833,411.10
Scholarships and Fellowships	869,091.07	801,974.09
Utilities	2,071,689.85	1,920,368.62
Depreciation	2,699,428.69	2,894,814.91
Total Operating Expenses	49,708,350.50	45,192,768.93
Operating Loss	(33,404,661.88)	(29,002,449.38)
Nonoperating Revenues (Expenses)		
State Appropriations	26,937,054.44	23,589,423.86
Noncapital Grants	338,321.00	425,689.00
Noncapital Gifts	3,255,982.97	3,534,305.46
Investment Income (Net of Investment Expense)	200,703.29	1,282,826.10
Interest and Fees on Capital Asset-Related Debt	(479,129.69)	(499,638.09)
Other Nonoperating Revenues	12,549.48	71,982.48
Net Nonoperating Revenues	30,265,481.49	28,404,588.81
Loss Before Other Revenues	(3,139,180.39)	(597,860.57)
Capital Appropriations	1,606,000.00	3,394,310.00
Refund of Prior Year Capital Appropriation	(1,000,000.00)	
Capital Grants	1,407,973.00	1,531,315.71
Additions to Endowments	1,000,025.00	525,000.00
Special Items		1,198,157.85
Total Other Revenues	3,013,998.00	6,648,783.56
Increase (Decrease) in Net Assets	(125,182.39)	6,050,922.99
Beginning Net Assets	107,393,000.68	101,342,077.69
Restatement of Net Assets (Note 16)	881,459.96	
Ending Net Assets	$ 108,149,278.25	$ 107,393,000.68

The Statement of Revenues, Expenses, and Changes in Net Assets reported an increase in net assets at the end of the year. Total net revenues were $49,583,168.11 for 2008 and $51,243,691.92 for 2007. The decrease in total net revenues of $1,660,523.81 is primarily the result of a decrease in investment income of $1,082,122.81; a decrease in capital appropriations, including a refund of a prior year capital appropriation, of $2,788,310.00; and a decrease of $1,198,157.85 in special items that was not applicable for the 2008 fiscal year. These decreases are offset by an increase of $3,347,630.58 in State appropriations. Some highlights of the revenue accounts presented on the Statement of Revenues, Expenses, and Changes in Net Assets are as follows:

- Student tuition and fees increased $595,279.61 primarily due to rate increases associated with this revenue.

- Sales and services revenue decreased $633,961.67 after last year's increase in revenues due to the School's prior year production of West Side Story.

- State appropriations increased $3,347,630.58 due to increases in operating costs.

- Investment income decreased $1,082,122.81 as a result of economic problems facing the investment industry.

- Capital appropriations decreased $2,788,310.00 due to a reduction in construction projects funded under the UNC bond projects. In addition, the School transferred $1,000,000 of prior year capital appropriations to another University for the purchase of equipment for the Center for Design Innovation, an institute of the University of North Carolina System. The School has administrative oversight for the institute.

Operating expenses totaled $49,708,350.50 for the year compared to $45,192,768.93 from the previous year, an increase of $4,515,581.57. The most significant increases in expenses occurred in salaries and benefits, with an increase of $1,995,987.74 and supplies and materials, with an increase of $1,418,084.26. The salaries and benefits increase was primarily due to legislative salary increases and new employees in the Advancement Division. The supplies and materials increase was primarily due to increased supply purchases, as well as increased capital improvement spending in repair and renovation projects related to dormitory sprinklers, new windows, and fire alarms.

Capital Assets and Debt Administration

The School's capital assets, net of accumulated depreciation at June 30, 2008, were $95,897,095.68. For more information about the School's asset holdings, refer to Note 5 of the Notes to the Financial Statements.

The School had $11,841,504.35 in outstanding long-term debt at June 30, 2008, and continues to make all of its debt payments in a timely manner. No new debt was issued during the 2007-2008 fiscal year. Refer to Note 7 of the Notes to the Financial Statements for more detailed information about the School's debt obligations.

Economic Outlook

The School experienced a budget reduction in the 2007-2008 fiscal year due to efficiency improvements mandated by General Administration through PACE. PACE is an acronym for the President's Advisory Committee on Efficiency and Effectiveness. The University of

North Carolina System President established this committee in 2007 to study and advise on ways universities could operate more efficiently and effectively. The School identified efficiency improvements in Financial Services, Facility Operations, Human Resources, Information Technologies, Advancement, and Student Support Services. These savings amounted to $160,167 and were reverted permanently to the State of North Carolina. Another $73,171 will be permanently reverted in fiscal year 2008-2009. The School will also face a recurring budget reduction in 2008-2009 in the amount of $158,000, as well, as a non-recurring reversion in the amount of $480,000. North Carolina has experienced a decline in revenue and a predicted shortfall could be as high as $60,000,000. If this prediction is accurate, the School can expect to see more budget reductions in 2008-2009 as well as the 2009-2011 biennium.

The School will receive enrollment increase funding of $629,000 in 2008-2009 for increasing the student budgeted enrollment FTE by 21 to 1,117. The General Assembly also provided for inflationary increase funding, pay increases, equipment replacement funds, and funds to support benefit changes in 2008-2009. North Carolina School of the Arts will also receive $750,000 in recurring funds for special needs.

In 2008-2009, the School expects to receive $11,000,000 to support the construction of a Central Storage and Campus Police Operations Facility. This project will be funded by Certificates of Participation (COPS) and the receipt of the funds will depend upon the sale of these certificates by the State. The School will also receive $773,000 in Repair and Renovation funding for projects such as fire alarms and sprinklers for student housing, Pierce Building HVAC and controls, boiler replacement in Workplace/Gray Building, and energy saving projects. A revised campus master plan will also be completed in 2008-2009.

North Carolina School of the Arts
Statement of Net Assets
June 30, 2008 — *Exhibit A-1*

ASSETS		
Current Assets:		
Cash and Cash Equivalents	$	8,712,502.55
Restricted Cash and Cash Equivalents		1,328,124.05
Receivables, Net (Note 4)		161,943.00
Due from State of North Carolina Component Units		9,000.00
Due from School Component Unit		16,958.00
Inventories		282,930.92
Notes Receivable, Net (Note 4)		127,533.08
Total Current Assets		10,638,991.60
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		6,338,364.00
Restricted Due from Primary Government		242,995.40
Endowment Investments		8,453,809.71
Restricted Investments		519,723.01
Other Investments		47,355.82
Notes Receivable, Net (Note 4)		392,780.06
Capital Assets - Nondepreciable (Note 5)		5,523,770.81
Capital Assets - Depreciable, Net (Note 5)		90,373,324.87
Bond Issuance Costs, Net of Amortization of $21,420		597,899.00
Total Noncurrent Assets		112,490,022.68
Total Assets		123,129,014.28
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities (Note 6)		924,352.83
Unearned Revenue		1,656,611.54
Interest Payable		57,535.58
Long-Term Liabilities - Current Portion (Note 7)		563,862.84
Total Current Liabilities		3,202,362.79
Noncurrent Liabilities:		
Deposits Payable		54,892.81
U. S. Government Grants Refundable		444,838.92
Long-Term Liabilities (Note 7)		11,277,641.51
Total Noncurrent Liabilities		11,777,373.24
Total Liabilities		14,979,736.03

NET ASSETS		
Invested in Capital Assets, Net of Related Debt		85,750,634.62
Restricted for:		
Nonexpendable:		
Scholarships and Fellowships		305,000.00
Endowed Professorships		4,502,841.33
Departmental Uses		3,267,025.00
Loans		77,871.72
Expendable:		
Scholarships and Fellowships		729,696.70
Professorships		514,777.25
Departmental Uses		538,414.66
Capital Projects		5,770,535.75
Debt Service		519,723.01
Unrestricted		6,172,758.21
Total Net Assets	$	108,149,278.25

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

North Carolina School of the Arts
Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Year Ended June 30, 2008 — *Exhibit A-2*

REVENUES		
Operating Revenues:		
Student Tuition and Fees, Net (Note 9)	$	9,739,970.07
Federal Grants and Contracts		758,125.63
Sales and Services, Net (Note 9)		5,085,947.42
Interest Earnings on Loans		1,334.79
Other Operating Revenues		718,310.71
Total Operating Revenues		16,303,688.62
EXPENSES		
Operating Expenses:		
Salaries and Benefits		28,769,372.26
Supplies and Materials		6,386,899.95
Services		8,911,868.68
Scholarships and Fellowships		869,091.07
Utilities		2,071,689.85
Depreciation		2,699,428.69
Total Operating Expenses		49,708,350.50
Operating Loss		(33,404,661.88)
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		26,937,054.44
Noncapital Grants		338,321.00
Noncapital Gifts		3,255,982.97
Investment Income (Net of Investment Expense of $43,847.85)		200,703.29
Interest and Fees on Debt		(479,129.69)
Other Nonoperating Revenues		12,549.48
Net Nonoperating Revenues		30,265,481.49
Loss Before Other Revenues		(3,139,180.39)
Capital Appropriations		1,606,000.00
Refund of Prior Year Capital Appropriation		(1,000,000.00)
Capital Grants		1,407,973.00
Additions to Endowments		1,000,025.00
Decrease in Net Assets		(125,182.39)
NET ASSETS		
Net Assets - July 1, 2007, as Restated (Note 16)		108,274,460.64
Net Assets - June 30, 2008	$	108,149,278.25

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

North Carolina School of the Arts
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2008 — ***Exhibit A-3***

CASH FLOWS FROM OPERATING ACTIVITIES	
Received from Customers	$ 16,428,075.31
Payments to Employees and Fringe Benefits	(28,630,289.19)
Payments to Vendors and Suppliers	(17,343,325.23)
Payments for Scholarships and Fellowships	(869,091.07)
Loans Issued	(145,083.00)
Collection of Loans	61,861.78
Interest Earned on Loans	885.20
U.S. Government Grants Refundable	(5,988.20)
Student Deposits Received	70,700.00
Student Deposits Returned	(72,857.19)
Net Cash Used by Operating Activities	(30,505,111.59)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State Appropriations	26,937,054.44
Noncapital Grants	338,321.00
Noncapital Gifts	3,255,982.97
Additions to Endowments	1,000,025.00
William D. Ford Direct Lending Receipts	4,963,469.00
William D. Ford Direct Lending Disbursements	(4,963,469.00)
Related Activity Agency Disbursements	(24,311.72)
Net Cash Provided by Noncapital Financing Activities	31,507,071.69
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES	
State Capital Appropriations	1,606,000.00
Refund of Prior Year Capital Appropriations	(1,000,000.00)
Capital Grants	1,534,712.06
Proceeds from Sale of Capital Assets	12,549.48
Acquisition and Construction of Capital Assets	(1,950,870.20)
Principal Paid on Capital Debt and Leases	(762,212.46)
Interest and Fees Paid on Capital Debt and Leases	(462,478.21)
Net Cash Used by Capital Financing and Related Financing Activities	(1,022,299.33)
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from Sales and Maturities of Investments	1,369,695.91
Investment Income	1,023,068.40
Purchase of Investments and Related Fees	(1,784,440.62)
Net Cash Provided by Investing Activities	608,323.69
Net Increase in Cash and Cash Equivalents	587,984.46
Cash and Cash Equivalents - July 1, 2007	15,791,006.14
Cash and Cash Equivalents - June 30, 2008	$ 16,378,990.60

North Carolina School of the Arts
Statement of Cash Flows — ***Exhibit A-3***
For the Fiscal Year Ended June 30, 2008 — ***Page 2***

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

Operating Loss	$	(33,404,661.88)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:		
Depreciation Expense		2,699,428.69
Allowances, Write-Offs, and Amortizations		141,365.54
Changes in Assets and Liabilities:		
Receivables (Net)		(8,660.47)
Due from School Component Unit		1,586.07
Inventories		(106,924.08)
Accounts Payable and Accrued Liabilities		157,354.48
US Government Grants Refundable		(5,988.20)
Unearned Revenue		(21,420.00)
Compensated Absences		128,186.67
Deposits Payable		(2,157.19)
Student Loans Issued		(145,083.00)
Student Loan Principal Repayments		61,861.78
Net Cash Used by Operating Activities	$	(30,505,111.59)

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:		
Cash and Cash Equivalents	$	8,712,502.55
Restricted Cash and Cash Equivalents		1,328,124.05
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		6,338,364.00
Total Cash and Cash Equivalents - June 30, 2008	$	16,378,990.60

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Change in Fair Value of Investments	$	(858,429.07)
Reinvested Distributions		495,789.64

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

North Carolina School of the Arts Foundation, Inc.
Statement of Financial Position
June 30, 2008

Exhibit B-1

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
ASSETS				
Cash and Cash Equivalents	$ 266,197	$ 1,386,260	$ 14,145	$ 1,666,602
Investments		1,940,016	15,305,525	17,245,541
Annuity Investments			845,847	845,847
Beneficial Interest in Perpetual Trusts			795,840	795,840
Beneficial Interest in Charitable Remainder Trusts			144,573	144,573
Pledges Receivable, Net of Allowance and Discount of $665,222	33,071	292,068	1,673,300	1,998,439
Accounts Receivable	8,625	33,132		41,757
Due From (To) Other Funds	123,400	(123,400)		
Prepaid Expenses	8,870	4,064		12,934
Staff, Faculty, and Student Loans Receivable	9,830	4,656		14,486
Property and Equipment, Net	659,403	1,481,199		2,140,602
Total Assets	1,109,396	5,017,995	18,779,230	24,906,621
LIABILITIES				
Accounts Payable and Accrued Expenses	17,153	10,391		27,544
Annuity Payment Liability			486,934	486,934
Notes Payable		205,563		205,563
Total Liabilities	17,153	215,954	486,934	720,041
NET ASSETS				
Unrestricted	1,092,243			1,092,243
Temporarily Restricted		4,802,041		4,802,041
Permanently Restricted			18,292,296	18,292,296
Total Net Assets	1,092,243	4,802,041	18,292,296	24,186,580
Total Liabilities and Net Assets	$ 1,109,396	$ 5,017,995	$ 18,779,230	$ 24,906,621

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

North Carolina School of the Arts Foundation, Inc.
Statement of Activities
For the Fiscal Year Ended June 30, 2008 — *Exhibit B-2*

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES				
Gifts and Grants	$ 509,073	$ 922,248	$ 473,074	$ 1,904,395
Interest and Dividend Income	85,370	374,943		460,313
Realized and Unrealized Losses		(2,219,081)		(2,219,081)
Change in Fair Value of Split-Interest Agreements			13,845	13,845
Change in Fair Value of Beneficial Interest in Perpetual Trusts		21,572	(46,029)	(24,457)
Other Income	82,872	185,024		267,896
Net Assets Released from Restrictions	2,099,317	(2,099,317)		
Total Revenues	2,776,632	(2,814,611)	440,890	402,911
EXPENSES				
Program Services:				
Scholarships and Awards	994,864			994,864
School Programs	1,000,645			1,000,645
Total Program Services	1,995,509			1,995,509
Supporting Services:				
Administrative Costs	228,582			228,582
Investment Management Fees	30,936			30,936
Development Costs	465,708			465,708
Depreciation and Amortization Expense	108,021			108,021
Miscellaneous Expense	91,672			91,672
Total Supporting Services	924,919			924,919
Total Expenses	2,920,428			2,920,428
Change in Net Assets Before Transfers	(143,796)	(2,814,611)	440,890	(2,517,517)
Transfers	(40,000)	15,000	25,000	
Change in Net Assets	(183,796)	(2,799,611)	465,890	(2,517,517)
NET ASSETS				
Net Assets - Beginning of Year	1,276,039	7,601,652	17,826,406	26,704,097
Net Assets - End of Year	$ 1,092,243	$ 4,802,041	$ 18,292,296	$ 24,186,580

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

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NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

During the year ended June 30, 2008, the Foundation distributed $1,995,509.00 to the School for both restricted and unrestricted purposes. Complete financial statements for the Foundation can be obtained from the North Carolina School of the Arts Foundation, Inc., PO Box 12189, Winston-Salem, NC 27107.

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

Pursuant to the provisions of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic*

Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities, the full scope of the School's activities is considered to be a single business-type activity and accordingly, is reported within a single column in the basic financial statements.

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

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

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

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

E. **Investments** - Investments generally are reported at fair value, as determined by quoted market prices or an estimated amount determined by management if quoted market prices are not available. Because of the inherent uncertainty in the use of estimates, values that are based on estimates may differ from the values that would have been used had a ready market existed for the investments. The net decrease in the fair value of investments is recognized as a component of investment income.

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

Endowment investments include the principal amount of gifts and bequests that, according to donor restrictions, must be held in perpetuity or for a specified period of time, along with any accumulated investment earnings on such amounts. Further, endowment investments also include amounts internally designated by the School for investment in an endowment capacity (i.e. quasi-endowments), along with accumulated investment earnings on such amounts.

F. **Receivables** - Receivables consist of tuition and fees charged to students and charges for auxiliary enterprises' sales and services. Receivables also include amounts due from the federal government, State and local governments, and private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants. Receivables are recorded net of estimated uncollectible amounts.

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

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

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

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 50 years for general infrastructure and buildings, and 5 to 15 years for equipment, except for specialized filmmaking equipment (20 years) and specialized musical instruments (15 to 50 years).

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

I. **Restricted Assets** - Certain resources are reported as restricted assets because restrictions on asset use change the nature or normal understanding of the availability of the asset. Resources that are not available for current operations and are reported as restricted include resources restricted or designated for the acquisition or construction of capital assets and resources legally segregated for the payment of principal and interest as required by debt covenants.

J. Noncurrent Long-Term Liabilities - Noncurrent long-term liabilities include principal amounts of bonds payable, certificates of participation, capital lease obligations, and compensated absences that will not be paid within the next fiscal year.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 2 - DEPOSITS AND INVESTMENTS

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

At June 30, 2008, the amount shown on the Statement of Net Assets as cash and cash equivalents includes $15,159,234.50 which represents the School's equity position in the State Treasurer's Short-Term Investment Fund. The Short-Term Investment Fund (a portfolio within the State Treasurer's Investment Pool, an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating) had a weighted average maturity of 2.9 years as of June 30, 2008. 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, 2008 was $6,095.00. The carrying amount of the School's deposits not with the State Treasurer was $1,213,661.10 and the bank balance was $1,349,836.11. Custodial credit risk is the risk that in the event of a bank failure, the School's deposits may not be returned to it. The School does not have a deposit policy for custodial credit risk. As of June 30, 2008, $1,073,784.59 of the School's bank balance was exposed to custodial credit risk as uninsured and uncollateralized.

B. Investments

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

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

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

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

Investments of the School's component unit, the Foundation, are subject to and restricted by G.S. 36B "Uniform Management of Institutional Funds Act" (UMIFA) and any requirements placed on them by contract or donor agreements.

Investments are subject to the following risks.

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

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

Foreign Currency Risk: Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. The School does not have a formal policy for foreign currency risk.

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

The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2008, for the Long-Term Investment Pool.

Long-Term Investment Pool

	Fair Value	Investment Maturities (in Years) Less Than 1	6 to 10	More than 10
Investment Type				
Debt Securities				
Mutual Bond Funds	$ 3,242,011.60	$ 0.00	$ 2,917,186.20	$ 324,825.40
Money Market Mutual Funds	173,560.67	173,560.67		
		$ 173,560.67	$ 2,917,186.20	$ 324,825.40
Other Securities				
International Mutual Funds	1,471,672.18			
Other Mutual Funds	3,566,565.26			
Total Long-Term Investment Pool	$ 8,453,809.71			

At June 30, 2008, investments in the Long-Term Investment Pool had the following credit quality distribution for securities with credit exposure:

	Fair Value	AAA Aaa	AA Aa	BB/Ba and below	Unrated
Mutual Bond Funds	$ 3,242,011.60	$ 0.00	$ 2,431,400.52	$ 485,785.68	$ 324,825.40
Money Market Mutual Funds	173,560.67	173,560.67			
Total	$ 3,415,572.27	$ 173,560.67	$ 2,431,400.52	$ 485,785.68	$ 324,825.40

Rating Agency: Standard and Poors

Non-Pooled Investments - The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2008, for the School's non-pooled investments.

Non-Pooled Investments

	Fair Value	Investment Maturities (in Years) Less Than 1
Investment Type		
Debt Securities		
Money Market Mutual Funds	$ 567,078.83	$ 567,078.83

At June 30, 2008, the Money Market Mutual Funds, with a fair value of $567,078.83, were rated AAA by Standard and Poors.

Total Investments - The following table presents the fair value of the total investments at June 30, 2008:

	Fair Value
Investment Type	
Debt Securities	
Mutual Bond Funds	$ 3,242,011.60
Money Market Mutual Funds	740,639.50
Other Securities	
International Mutual Funds	1,471,672.18
Other Mutual Funds	3,566,565.26
Total Investments	$ 9,020,888.54

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

	Fair Value
Investment Type	
Equity Securities	$ 8,052,370.00
Fixed Income Securities and Other Bonds	1,279,383.00
Government Bonds	883,241.00
International Fixed Income	244,207.00
AMC Financial Trust	530,330.00
UNC Investment Fund	5,806,210.00
Short-Term Investments	449,800.00
Total Investments	$ 17,245,541.00

NOTE 3 - ENDOWMENT INVESTMENTS

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

Investment return of the School's endowment funds is predicated on the total return concept (yield plus appreciation). To the extent that the total return for the current year exceeds the payout, the excess is added to principal. If current year earnings do not meet the payout requirements, the School uses accumulated income and appreciation from restricted, expendable net asset endowment balances to make up the difference. At June 30, 2008, net appreciation of $373,942.22 was available to be spent for restricted purposes.

NOTE 4 - RECEIVABLES

Receivables at June 30, 2008, were as follows:

	Gross Receivables	Less Allowance for Doubtful Accounts	Net Receivables
Current Receivables:			
Students	$ 20,641.57	$ 14,295.90	$ 6,345.67
Accounts	109,769.74		109,769.74
Intergovernmental	14,349.34		14,349.34
Interest on Loans	31,478.25		31,478.25
Total Current Receivables	$ 176,238.90	$ 14,295.90	$ 161,943.00
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	$ 153,979.42	$ 26,734.59	$ 127,244.83
Institutional Student Loan Programs	7,027.45	6,739.20	288.25
Total Notes Receivable - Current	$ 161,006.87	$ 33,473.79	$ 127,533.08
Notes Receivable - Noncurrent:			
Federal Loan Programs	$ 528,117.63	$ 135,337.57	$ 392,780.06

NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2008, is presented as follows:

	Balance July 1, 2007 (as restated)	Increases	Decreases	Balance June 30, 2008
Capital Assets, Nondepreciable:				
Land	$ 3,898,463.80	$ 40,752.71	$ 0.00	$ 3,939,216.51
Art, Literature, and Artifacts	1,383,364.44	12,000.00		1,395,364.44
Construction in Progress	79,537.79	731,240.52	621,588.45	189,189.86
Total Capital Assets, Nondepreciable	5,361,366.03	783,993.23	621,588.45	5,523,770.81
Capital Assets, Depreciable:				
Buildings	105,671,881.95	712,838.45		106,384,720.40
Machinery and Equipment	8,173,518.00	1,164,527.14	323,574.76	9,014,470.38
General Infrastructure	5,107,656.50			5,107,656.50
Total Capital Assets, Depreciable	118,953,056.45	1,877,365.59	323,574.76	120,506,847.28
Less Accumulated Depreciation for:				
Buildings	21,939,094.74	2,130,079.11		24,069,173.85
Machinery and Equipment	5,231,897.14	482,904.44	323,574.76	5,391,226.82
General Infrastructure	586,676.60	86,445.14		673,121.74
Total Accumulated Depreciation	27,757,668.48	2,699,428.69	323,574.76	30,133,522.41
Total Capital Assets, Depreciable, Net	91,195,387.97	(822,063.10)	0.00	90,373,324.87
Capital Assets, Net	$ 96,556,754.00	$ (38,069.87)	$ 621,588.45	$ 95,897,095.68

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2008, were as follows:

	Amount
Accounts Payable	$ 691,606.39
Accrued Payroll	215,786.42
Contract Retainage	16,125.28
Intergovernmental Payables	834.74
Total Accounts Payable and Accrued Liabilities	$ 924,352.83

NOTE 7 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2008, is presented as follows:

	Balance July 1, 2007	Additions	Reductions	Balance June 30, 2008	Current Portion
Revenue Bonds Payable	$ 3,460,000.00	$ 0.00	$ 285,000.00	$ 3,175,000.00	$ 290,000.00
Certificates of Participation	7,045,000.00		135,000.00	6,910,000.00	140,000.00
Total Bonds and Certificates of Participation Payable	10,505,000.00		420,000.00	10,085,000.00	430,000.00
Notes Payable	329,733.58		329,733.58		
Capital Leases Payable	73,939.94		12,478.88	61,461.06	13,243.28
Compensated Absences	1,566,856.62	885,989.00	757,802.33	1,695,043.29	120,619.56
Total Long-Term Liabilities	$ 12,475,530.14	$ 885,989.00	$ 1,520,014.79	$ 11,841,504.35	$ 563,862.84

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

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

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2008	Principal Outstanding June 30, 2008	See Table Below
Revenue Bonds Payable							
The University of North Carolina System Pool Revenue Bonds							
Fitness and Student Center Project	A	3.25%-5.25%	10/01/2008	$ 2,650,000.00	$ 910,000.00	$ 1,740,000.00	(1)
Refunding 1998B and 2000 UNC System Pool Revenue Bonds	B	3.00%-4.25%	04/01/2019	1,900,000.00	465,000.00	1,435,000.00	(2), (3)
Total UNC System Pool Revenue Bonds				4,550,000.00	1,375,000.00	3,175,000.00	
Certificates of Participation							
Student Housing Project	C	3.50%-4.50%	06/01/2036	7,200,000.00	290,000.00	6,910,000.00	(3)
Total Bonds Payable and Certificates of Participation				$ 11,750,000.00	$ 1,665,000.00	$ 10,085,000.00	

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

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

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

Fund reservations in the amount of $433,325.00 required by the Series 2005 Certificates of Participation Indenture for the Student Housing Project were established and recorded in a Reserve Fund with the fiscal agent. At June 30, 2008, the balance in the Reserve Fund was $480,680.82. In addition, the School began contributing to a Maintenance and Equipment Reserve Fund also required by the indenture during the year. At June 30, 2008, the balance in this reserve was $86,398.01.

The School has pledged future revenues, net of specific operating expenses, to repay revenue bonds and certificates of participation as shown in the table below:

Ref	Revenue Source	Total Future Revenues Pledged	Current Year Revenues Net of Expenses	Current Year Principal & Interest	Estimate of % of Revenues Pledged
(1)	Facility Debt Fee Revenues	2,222,471.90	254,777.00	203,893.76	79%
(2)	Dining Revenues	858,200.00	117,547.55	112,093.75	66%
(3)	Housing Revenues	12,913,118.88	695,725.64	542,493.75	77%

C. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2008, are as follows:

	Annual Requirements			
	Revenue Bonds Payable		Certificates of Participation	
Fiscal Year	Principal	Interest	Principal	Interest
2009	$ 290,000.00	$ 133,231.26	$ 140,000.00	$ 290,675.00
2010	295,000.00	122,531.26	145,000.00	285,775.00
2011	310,000.00	109,728.13	150,000.00	280,700.00
2012	325,000.00	96,975.00	155,000.00	275,450.00
2013	335,000.00	82,887.50	160,000.00	270,025.00
2014-2018	1,345,000.00	210,831.25	895,000.00	1,256,900.04
2019-2023	275,000.00	7,687.50	1,090,000.00	1,064,987.54
2024-2028			1,335,000.00	816,437.54
2029-2033			1,655,000.00	495,968.76
2034-2036			1,185,000.00	108,000.00
Total Requirements	$ 3,175,000.00	$ 763,871.90	$ 6,910,000.00	$ 5,144,918.88

NOTE 8 - LEASE OBLIGATIONS

A. Capital Lease Obligations - Capital lease obligations relating to a bus are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2008:

Fiscal Year	Amount
2009	$ 16,548.48
2010	16,548.48
2011	16,548.48
2012	19,515.50
Total Minimum Lease Payments	69,160.94
Amount Representing Interest (5.96% Rate of Interest)	7,699.88
Present Value of Future Lease Payments	$ 61,461.06

Machinery and equipment acquired under capital lease amounted to $83,787.00 at June 30, 2008.

B. Operating Lease Obligations - The School entered into operating leases for copiers and land. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2008:

Fiscal Year	Amount
2009	$ 63,800.06
2010	36,101.21
2011	17,872.00
2012	8,760.00
2013	4,320.00
Total Minimum Lease Payments	$ 130,853.27

Rental expense for all operating leases during the year was $78,814.36.

NOTE 9 - REVENUES

A summary of eliminations and allowances by revenue classification is presented as follows:

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Change in Allowance for Uncollectibles	Net Revenues
Operating Revenues:					
Student Tuition and Fees	$ 12,476,780.14	$ 0.00	$ 2,738,657.88	$ 1,847.81	$ 9,739,970.07
Sales and Services:					
Sales and Services of Auxiliary Enterprises:					
Residential Life	$ 3,021,002.00	$ 0.00	$ 686,937.40	$ 426.82	$ 2,334,491.42
Dining	1,902,794.34		423,636.47	373.27	1,479,531.14
Health and Recreation Services	171,179.98				171,179.98
Bookstore	296,421.83				296,421.83
Parking	57,921.40				57,921.40
Other	49,595.63				49,595.63
Sales and Services of Education and Related Activities:					
School Production Revenues	664,930.05				664,930.05
Other	68,231.43	36,355.46			31,875.97
Total Sales and Services	$ 6,232,076.66	$ 36,355.46	$ 1,110,573.87	$ 800.09	$ 5,085,947.42

NOTE 10 - OPERATING EXPENSES BY FUNCTION

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

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	$ 12,319,003.57	$ 1,413,594.97	$ 1,152,375.39	$ 0.00	$ 223.72	$ 0.00	$ 14,885,197.65
Public Service	564,202.64	61,877.52	894,710.28				1,520,790.44
Academic Support	3,466,165.20	571,317.28	513,939.93				4,551,422.41
Student Services	839,122.35	31,377.42	127,068.62				997,568.39
Institutional Support	5,302,651.19	788,262.00	3,085,229.35		3,112.55		9,179,255.09
Operations and Maintenance of Plant	3,682,618.09	2,598,560.81	688,903.49		1,630,375.35		8,600,457.74
Student Financial Aid				869,091.07			869,091.07
Auxiliary Enterprises	2,595,609.22	921,909.95	2,449,641.62		437,978.23		6,405,139.02
Depreciation						2,699,428.69	2,699,428.69
Total Operating Expenses	$ 28,769,372.26	$ 6,386,899.95	$ 8,911,868.68	$ 869,091.07	$ 2,071,689.85	$ 2,699,428.69	$ 49,708,350.50

NOTE 11 - PENSION PLANS

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

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

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2008, these rates were set at 3.05% of covered payroll for employers and 6% of covered payroll for members.

For the current fiscal year, the School had a total payroll of $23,241,230.08, of which $11,310,745.72 was covered under the Teachers' and State Employees' Retirement System. Total employer and employee contributions for pension benefits for the year were $344,977.74 and $678,644.74, respectively.

Required employer contribution rates for the years ended June 30, 2007, and 2006, were 2.66% and 2.34%, respectively, while employee contributions were 6% each year. The School made 100% of its annual required contributions for the years ended June 30, 2008, 2007, and 2006, which were $344,977.74, $278,587.53, and $234,153.32, respectively.

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

The Optional Retirement Program (Program) is a defined contribution retirement plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Administrators and eligible faculty of the School may join the Program instead of the Teachers' and State Employees' Retirement System. The Board of Governors of The University of North Carolina is responsible for the administration of the Program and designates the companies authorized to offer investment products or the trustee responsible for the investment of contributions under the Program and approves the form and contents of the contracts and trust agreements.

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

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2008, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The School assumes no liability other than its contribution.

For the current fiscal year, the School had a total payroll of $23,241,230.08, of which $8,837,635.60 was covered under the Optional Retirement Program. Total employer and employee contributions for pension benefits for the year were $604,494.28 and $530,258.14, respectively.

B. **Deferred Compensation and Supplemental Retirement Income Plans** - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement, or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, *the North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to $78,213.98 for the year ended June 30, 2008.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k).

All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the School except for a 5% employer contribution for the School's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of School law enforcement officers for the year ended June 30, 2008, were $90,531.31. The voluntary contributions by employees amounted to $146,179.00 for the year ended June 30, 2008.

IRC Section 403(b) and 403(b)(7) Plans - Eligible School employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the School. The voluntary contributions by employees amounted to $185,489.84 for the year ended June 30, 2008.

NOTE 12 - OTHER POSTEMPLOYMENT BENEFITS

A. Health Benefits - The School participates in the Comprehensive Major Medical Plan (the Plan), a cost-sharing, multiple-employer defined benefit health care plan that provides postemployment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System or the Optional Retirement Program. Coverage eligibility varies depending on years of contributory membership service in their retirement system prior to disability or retirement.

The Plan's benefit and contribution provisions are established by Chapter 135-7, Article 1, and Chapter 135, Article 3, of the General Statutes and may be amended only by the North Carolina General Assembly. The Plan does not provide for automatic post-retirement benefit increases.

By General Statute, a Retiree Health Benefit Fund (the Fund) has been established as a fund in which accumulated contributions from employers and any earnings on those contributions shall be used to provide health benefits to retired and disabled employees and applicable beneficiaries. By statute, the Fund is administered by the Board of Trustees of the Teachers' and State Employees' Retirement System and contributions to the fund are irrevocable. Also by law, Fund assets are dedicated to providing benefits to retired and disabled employees and applicable beneficiaries and are not subject to the claims of creditors of the employers making contributions to the Fund. Contribution rates to the Fund, which are intended to finance benefits and administrative expenses on a pay-as-you-go basis, are determined by the General Assembly in the Appropriations Bill.

For the current fiscal year the School contributed 4.1% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the Fund. Required contribution rates for the years ended June 30, 2007, and 2006, were 3.8% and 3.8%, respectively. The School made 100% of its annual required contributions to the Plan for the years ended June 30, 2008, 2007, and 2006, which were $826,083.63, $711,237.90, and $702,335.20, respectively. The School assumes no liability for retiree health care benefits provided by the programs other than its required contribution.

Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page http://www.ncosc.net/ and clicking on "Financial Reports," or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

B. **Disability Income** - The School participates in the Disability Income Plan of North Carolina (DIPNC), a cost-sharing, multiple-employer defined benefit plan, to provide short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program . Benefit and contribution provisions are established by Chapter 135, Article 6, of the General Statutes, and may be amended only by the North Carolina General Assembly. The plan does not provide for automatic post-retirement benefit increases.

Disability income benefits are funded by actuarially determined employer contributions that are established in the Appropriations Bill by the General Assembly. For the fiscal year ended June 30, 2008, the School made a statutory contribution of .52% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. Required contribution rates for the years ended June 30, 2007, and 2006, were .52% and .52%, respectively. The School made 100% of its annual required contributions to the DIPNC for the years ended June 30, 2008, 2007, and 2006, which were $104,771.58, $97,327.29, and $96,109.03, respectively. The School assumes no liability for long-term disability benefits under the Plan other than its contribution.

Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 13 - RISK MANAGEMENT

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

Tort claims of up to $1,000,000 are self-insured under the authority of the State Tort Claims Act. In addition, the State provides excess public officers' and employees' liability insurance up to $5,000,000 via contract with a private insurance company. The School pays the premium, based on a composite rate, directly to the private insurer.

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

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 are $1,000,000 per claim and $5,000,000 per occurrence. The School pays premiums to the North Carolina Department of Insurance for the coverage.

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

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

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

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

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

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

NOTE 14 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The School has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were $253,268.47 and on other purchases were $543,473.20 at June 30, 2008.

B. Pending Litigation and Claims - The NC School Boards Association, et. al., filed a civil action against various State officials in their official capacity seeking a judicial determination as to whether the State Constitution requires certain monetary payments collected by State agencies to be paid to the local county school funds rather than statutorily designated recipients. In part, this action included a determination of whether monetary payments collected pursuant to statutory authority by the University for violations of parking traffic regulations and library fines were "civil penalties", which the State Constitution requires to be paid to the school fund in the county where they are collected. On July 1, 2005, the NC Supreme court held in favor of the school boards with regard to parking fines and held in favor of the University with regards to library fines. The matter was remanded back to the trial court for disposition in accordance with the Supreme Court's decision. On August 8, 2008, the trial court entered a judgment against the defendants. The manner and means by which the judgment is satisfied will be determined by the General Assembly. Approximately $152,049 represent transportation fines collected by the School for the period of January 1, 1996 to June 30, 2005, and of this amount 10% or $15,205 may be retained by the School to fund related operating expenses. Therefore, $136,844 may be payable by the School.

NOTE 15 - CHANGES IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2008, the School implemented the following pronouncements issued by the Governmental Accounting Standards Board (GASB):

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*.

GASB Statement No. 50, *Pension Disclosures*.

GASB Statement No. 45, requires cost-sharing employers to recognize OPEB expense for their contractually required contributions to the plan generally consistent with the approach adopted in GASB Statement No, 27, *Accounting for Pensions by State and Local Governmental Employers, with modifications to reflect differences between pension benefits and OPEB*.

GASB Statement No. 48, requires disclosures pertaining to future revenues that have been pledged in order to disclose information about which revenues will be unavailable for other purposes and how long they will continue to do so.

GASB Statement No. 50, aligns the financial reporting requirements for pensions with those of other postemployment benefits, to conform with GASB Statement No. 45. This Statement amends GASB Statement 27 to require note disclosure of the employer contribution rates and percentage of the amount contributed for the current and preceding two years and to disclose how the required contribution rates are established.

NOTE 16 - NET ASSET RESTATEMENT

As of July 1, 2007, net assets as previously reported were restated as follows:

	Amount
July 1, 2007, Net Assets as Previously Reported	$ 107,393,000.68
Restatement: Error in Establishing Useful Lives of Capital Assets	881,459.96
July 1, 2007, Net Assets as Restated	$ 108,274,460.64

NOTE 17 - SUBSEQUENT EVENTS

Fair Value of Investments

School - The fair market value of the School's endowment investments with Wachovia Bank, N.A. decreased from $8,453,809.71 at June 30, 2008, to $6,092,776.65 at December 31, 2008. This represents a $2,361,033.06 or 27.9 percent decrease in endowment investments over the six-month period.

Component Unit - The fair market value of the Foundation's investments decreased from $17,245,541.00 at June 30, 2008, to $12,742,587.03 at December 31, 2008, which includes $747,130.45 in withdrawals. This represents a $4,502,953.97 or 26.1 percent decrease in the Foundation's investments over the six-month period.

These changes are primarily due to unrealized losses on these investments as a result of the volatile and unstable world-wide financial markets. It is expected that this downward trend will continue into the foreseeable future. School and Foundation management, along with their investment management advisors, will continue to monitor investments for the purpose of managing investment risks and to maximize investment returns.

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

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

We have audited the financial statements of North Carolina School of the Arts, a constituent institution of the multi-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component unit, as of and for the year ended June 30, 2008, which collectively comprise the School's basic financial statements and have issued our report thereon dated February 27, 2009. Our report was modified to include a reference to other auditors.

As discussed in Note 15 to the financial statements, the School implemented Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, Statement 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, and Statement 50, *Pension Disclosures*, during the year ended June 30, 2008.

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the School's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the School's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the School's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

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 School's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the School's financial statements that is more than inconsequential will not be prevented or detected by the School's internal control. We consider the deficiencies described in the finding in the Audit Findings and Responses section of this report to be significant deficiencies in internal control over financial reporting.

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

Our consideration of the 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 the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters

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

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

instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

The School's response to the finding identified in our audit is described in the Audit Findings and Responses section of this report. We did not audit the School's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management of the School, the Board of Governors, the Board of Trustees, the Audit Committee, others within the entity, 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.

Beth A. Wood

Beth A. Wood, CPA
State Auditor

February 27, 2009.

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AUDIT FINDINGS AND RESPONSES

Matters Related to Financial Reporting

The following audit finding was identified during the current audit and describes conditions that represent significant deficiencies in internal control.

DEFICIENCIES IN FINANCIAL REPORTING

The financial statements prepared by North Carolina School of the Arts contained numerous misstatements that were corrected as a result of our audit. Without these corrections, the financial statements could have been misleading to readers. Misstatements noted in our audit included:

a. The School recorded the disposal of an asset incorrectly which understated supplies and materials expenses by $505,780 and accumulated depreciation for buildings by $15,173, and overstated other nonoperating expenses by $490,607.

b. The School did not properly capitalize building renovations causing an understatement of depreciable capital assets of $621,588 and an overstatement of supplies and materials expenses by the same amount. In addition, depreciation expense and accumulated depreciation for buildings were understated by $12,649.

c. The School overstated current unrestricted cash by $713,583 and understated current restricted cash and noncurrent restricted cash by $213,661 and $499,922, respectively. There were errors in reporting $122,446 of plant fund cash as current unrestricted cash; reporting restricted cash of $572,643 as current unrestricted cash; and the lack of reporting $18,494 of interfund borrowing from current unrestricted cash to cover deficit cash in the restricted funds.

d. The School did not properly record a debt service restriction on housing investments. Thus, noncurrent other investments were overstated by $519,723 and noncurrent restricted investments were understated by the same amount.

e. The School overstated nonexpendable loans and unrestricted net assets by $3,289 and $833,953, respectively, and understated net assets for expendable departmental uses, expendable debt service, and invested in capital assets net of related debt by $3,289, $15,666, and $818,287, respectively.

Recommendation: The School should place greater emphasis on the year-end financial reporting process and implement effective internal controls to ensure the completeness and accuracy of the financial statements.

Response: Management concurs with the recommendation. During Fiscal Year 2007-2008, the North Carolina School of the Arts implemented the Banner Financial System through a rapid implementation process. This process put the school behind in its typical year-end procedures and also necessitated the implementation of the accrual system in Banner. The Banner Accrual System was not available for use until August 1, 2008. This provided the School with less than 31 days to complete the preparation of its financial statements to meet the required statutory deadline of August 31 for having the School's year-end financial package to the North Carolina Office of the State Controller. This, along with the very small accounting staff at the School, created difficulties in the typical review processes and resulted in the errors noted by the Auditors.

To assist with controlling this process for future year-ends, the accounting staff is developing check lists and procedures for additional reviews of the financial statement entries, exhibits, and notes. Given that the School has now operated for a full year on the Banner System, the staff has a better understanding of how Banner processes year-end transactions. Every effort will be made to ensure that the financial statements and accompanying notes are complete and accurate for the 2008-2009 fiscal year-end.

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