

# STATE OF NORTH CAROLINA

**UNIVERSITY OF NORTH CAROLINA HOSPITALS**

**CHAPEL HILL, NORTH CAROLINA**

**FINANCIAL STATEMENT AUDIT REPORT**

**FOR THE YEAR ENDED JUNE 30, 2008**

**OFFICE OF THE STATE AUDITOR**

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

**STATE AUDITOR**

**UNIVERSITY OF NORTH CAROLINA HOSPITALS**

**CHAPEL HILL, NORTH CAROLINA**

**FINANCIAL STATEMENT AUDIT REPORT**

**FOR THE YEAR ENDED JUNE 30, 2008**

**BOARD OF GOVERNORS**

**THE UNIVERSITY OF NORTH CAROLINA**

**ERSKINE B. BOWLES, PRESIDENT**

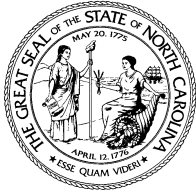
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STATE OF NORTH CAROLINA  
Office of the State Auditor

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State Auditor

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**AUDITOR'S TRANSMITTAL**

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

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

The results of our tests disclosed no deficiencies in internal control over financial reporting that we consider to be material weaknesses in relation to our audit scope or any instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

*North Carolina General Statutes* require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

*Leslie W. Merritt, Jr.*

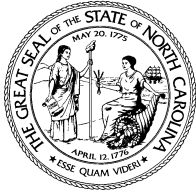
Leslie W. Merritt, Jr., CPA, CFP  
State Auditor

November 18, 2008

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**INDEPENDENT AUDITOR'S REPORT**

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

We have audited the accompanying basic financial statements of the University of North Carolina Hospitals, which is a part of the University of North Carolina Health Care System, which is a part of the University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2008, as listed in the table of contents. These financial statements are the responsibility of the Hospitals' management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of North Carolina Hospitals as of June 30, 2008, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 15 to the financial statements, the Hospitals implemented Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and Statement 50, *Pension Disclosures*, during the year ended June 30, 2008.

## INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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In accordance with *Government Auditing Standards*, we have also issued our report dated November 12, 2008, on our consideration of the Hospitals' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

*Leslie W. Merritt, Jr.*

Leslie W. Merritt, Jr., CPA, CFP  
State Auditor  
November 12, 2008

## **UNIVERSITY OF NORTH CAROLINA HOSPITALS MANAGEMENT'S DISCUSSION AND ANALYSIS**

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### **Introduction**

The following discussion and analysis is provided by the University of North Carolina Hospitals' (Hospitals) financial management as an overview to assist the reader in interpreting and understanding the accompanying basic financial statements. It includes comparative financial analysis with discussion of significant changes between fiscal years 2008 and 2007, as well as pertinent facts, decisions, and conditions.

### **Using the Financial Statements**

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

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

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

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

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

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

### **Comparison of Two-Year Data for 2008 to 2007**

Comparative financial data of 2008 to 2007 is summarized in Table 1. Discussion of comparative data is included in the following section.

### **Analysis of Overall Financial Position and Results of Operations**

#### **Statement of Net Assets**

Assets increased overall by \$82.5 million or 6.3% from the prior year. Cash and capital assets were the two largest categorical increases from fiscal year 2007 to 2008. Cash increased due to a strong cash flow from current year operations. Depreciable and Nondepreciable capital assets increased \$36 and \$57.3 million respectively, including the continued spending for capital projects related to the North Carolina State Capital Facilities Act of 2004. In contrast to fiscal year 2007, the value of investments decreased \$49.2 million during fiscal year 2008 due to negative investment market conditions. The Hospitals purchased an additional \$25 million of equity investments in the current fiscal year.

Liabilities increased overall by \$12.2 million or 2.9% while net assets increased \$70.3 million from fiscal year 2007 to 2008. The increase in liabilities was driven by an increase in net Estimated Third Party Settlements. Noncurrent liabilities were reduced by payments made on outstanding bonds and notes payable debt which is described in more detail in Note 6.

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

The Statement of Revenues, Expenses, and Changes in Net Assets reflects operating income of \$12.8 million and an overall increase in net assets of \$70.3 million. Operating income is much lower when compared to FY2007 because of \$33.1 million in prior year third party settlements that were recognized at that time as a result of catching up a backlog of open



## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

---

years and is not expected to reoccur. Operating income is also lower this year compared to the prior year because operating expenses, primarily salaries and benefits, grew at a faster pace than net patient service revenue.

Net patient service revenue, excluding third party settlements, increased 4.9% over last year in spite of the collection percentage deteriorating from 46.6% as of June 30, 2007 to 44.1% as of June 30, 2008. Collection rates continued to decline during the year as a result of charges increasing while many payers pay on a lower fixed rate schedule. Collection rates were also negatively impacted by an increase in self-pay patients. The increase in revenue can be attributed to volume growth and rate increases.

Total operating expenses increased by 8% with the largest categorical dollar increase occurring in salaries and benefits. Salary expense increased 13.4% over the prior year and includes the accrued expense of a performance bonus that was paid to qualifying employees in October 2008 in recognition of organizational patient, employee and financial goals that were attained. The largest percentage change was in medical malpractice expense which decreased again this year by 40.3%. Medical malpractice expense continued to decrease during fiscal year 2008 and is the result of a positive trend in malpractice claims and total reserve requirements.

Nonoperating revenues decreased 97.7% or \$100.5 million compared to the prior year as a result of a decrease in investment income. The decrease in investment income is directly attributed to negative investment market performance and the Hospitals increase in equity investments that began in the last quarter of fiscal year 2006 and continued through July 2007. These investments enabled the Hospitals to benefit from a favorable stock market during fiscal year 2007 but these same investments suffered losses of \$49.2 million during fiscal year 2008 as market conditions declined.

In the other revenues (expenses) section, capital grants increased from \$39 million to \$74.1 million from fiscal year 2007 to 2008. Significant capital spending and the corresponding capital grants recognized in this section will continue through fiscal year 2010 as construction on the North Carolina Cancer Hospital progresses. Effective July 1, 2005, the Hospitals agreed to fund the UNC Health Care System Enterprise Fund. These expenses totaled \$18.9 million during fiscal year 2008 and are reported separately in this section as Health Care System Assessments and support initiatives as the Chief Executive Officer of the University of North Carolina Health Care System deems appropriate with the recommendations from the leadership team.

### **Analysis of Net Asset Balances**

At June 30, 2008, net assets invested in capital assets, net of related debt, totaled \$317.2 million representing the gross value of plant assets \$864.0 million plus bond issuance costs of \$1.3 million less accumulated depreciation \$333.8 million and related debt of \$214.3 million.

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

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Restricted expendable net assets totaled \$128.4 million representing amounts subject to externally imposed restrictions.

Unrestricted net assets totaled \$508.6 million representing amounts not subject to externally imposed stipulations but internally designated for various activities and initiatives, including future construction projects.

### **Discussion of Capital Asset and Long-Term Debt Activity**

#### **Capital Assets**

The Hospitals expended \$42.6 million during the year for capital equipment throughout the facilities and \$94.9 million for the construction of buildings/infrastructure and renovations.

On August 5th, 2004, House Bill 1264 of the 2004 North Carolina Legislative Session was ratified and authorized the State to issue special indebtedness of up to \$180 million in principal for acquiring, constructing, and equipping a cancer rehabilitation and treatment center, a nearby physicians' office building, and a walkway between the two. These facilities will be located at the University of North Carolina Hospitals at Chapel Hill. \$128.1 million has been spent and reimbursed to the Hospitals on this project as of June 30th. The physicians' office building was completed in May while completion and occupancy of the North Carolina Cancer Hospital is expected in fiscal year 2010.

At June 30, 2008, outstanding commitments on construction contracts were \$43.1 million while outstanding commitments related to capital purchase orders for fixed and movable equipment totaled \$16.6 million.

The annualized average age of plant and equipment is 8.2 years.

#### **Long-Term Debt Activities**

At June 30, 2008, the Hospitals had outstanding bond indebtedness in the amount of \$253.9 million of which \$6.9 million is due within the next year. Standard and Poor's and Moody's Ratings Services classify these bonds as AA- and Aa3 respectively.

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

The Hospitals operating performance remained strong in fiscal year 2008. Volume increased in most services, particularly for outpatient care. Surgical, Oncology, and Cardiology cases each grew at a particularly strong pace. Inpatient admissions increased, but at a rate lower than in prior years. Inpatient growth has been constrained by capacity limitations.

In an effort to ease inpatient congestion, in addition to capacity expansion, management has developed a major throughput improvement initiative. This effort has helped reduce length-of-stay in several areas and will enable increased future growth in admissions. Expanded inpatient capacity is under construction as well with a net 10% increase coming on line over the next two years.

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

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Staffing levels increased in proportion to volume growth. Following an extremely strong fiscal year 2007, management made several important investments in our staff. First, we added staff, particularly in direct patient care areas. Secondly, we reviewed compensation for all staff and increased in those areas where our rates tended to be below market. As a result, vacancy and turnover rates fell while employee and patient satisfaction rose.

The poor investment climate had a substantial and negative impact on net income. Equities losses tracked closely with the broader stock indices. These investment losses drove a modest net loss for the Hospitals. Despite the non-operating performance, the Hospitals Statement of Net Assets remains strong. Our capital investment plan has been aggressive, and we continue to prioritize both capacity growth and replacement of outdated facilities.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

University of North Carolina Hospitals  
 Summary of Condensed Financial Statements Totals  
 For the Fiscal Years Ended June 30, 2008 and 2007

### Summary of Condensed Financial Statements Totals

Table 1

	FY08	FY07	Change
<b>STATEMENTS OF NET ASSETS</b>			
Current Assets	\$ 391,931,220	\$ 386,712,240	\$ 5,218,980
Capital Assets, Net	530,176,143	436,848,591	93,327,552
Other Noncurrent Assets	466,146,316	482,192,173	(16,045,857)
<b>TOTAL ASSETS</b>	<b>1,388,253,679</b>	<b>1,305,753,004</b>	<b>82,500,675</b>
Current Liabilities	153,722,129	128,539,074	25,183,055
Noncurrent Liabilities	280,446,797	293,440,220	(12,993,423)
<b>TOTAL LIABILITIES</b>	<b>434,168,926</b>	<b>421,979,294</b>	<b>12,189,632</b>
Invested in Capital Assets, Net of Related Debt	317,172,871	216,150,155	101,022,716
Restricted for Expendable Uses	128,361,305	118,905,084	9,456,221
Unrestricted	508,550,577	548,718,471	(40,167,894)
<b>TOTAL NET ASSETS</b>	<b>\$ 954,084,753</b>	<b>\$ 883,773,710</b>	<b>\$ 70,311,043</b>
<b>STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS</b>			
Net Patient Service Revenue	\$ 774,434,422	\$ 737,970,982	\$ 36,463,440
Other Operating Revenues	18,136,106	16,727,568	1,408,538
Prior Year Third Party Settlements	5,380,349	33,097,009	(27,716,660)
<b>TOTAL OPERATING REVENUES</b>	<b>797,950,877</b>	<b>787,795,559</b>	<b>10,155,318</b>
Salaries and Benefits	441,711,464	389,677,290	52,034,174
Medical and Surgical Supplies	145,440,490	134,386,727	11,053,763
Other Operating Expenses	198,021,560	203,265,897	(5,244,337)
<b>TOTAL OPERATING EXPENSES</b>	<b>785,173,514</b>	<b>727,329,914</b>	<b>57,843,600</b>
<b>OPERATING INCOME</b>	<b>12,777,363</b>	<b>60,465,645</b>	<b>(47,688,282)</b>
State Appropriations	47,409,965	45,673,970	1,735,995
Investment Activity	(32,376,655)	71,066,912	(103,443,567)
Other Nonoperating Revenues	189,917	175,810	14,107
Nonoperating Expenses	(12,908,017)	(14,149,584)	1,241,567
<b>NET NONOPERATING REVENUES</b>	<b>2,315,210</b>	<b>102,767,108</b>	<b>(100,451,898)</b>
State Grant - Master Facility Reseach Unallotted Fund		3,000,000	(3,000,000)
Capital Grants	74,118,470	38,958,073	35,160,397
Capital Gifts		526,159	(526,159)
Health Care System Assessment	(18,900,000)	(22,850,000)	3,950,000
<b>INCREASE IN NET ASSETS</b>	<b>70,311,043</b>	<b>182,866,985</b>	<b>(112,555,942)</b>
<b>NET ASSETS - BEGINNING OF YEAR RESTATEMENT</b>	<b>883,773,710</b>	<b>688,947,694</b>	<b>194,826,016</b>
		11,959,031	(11,959,031)
<b>NET ASSETS - END OF YEAR</b>	<b>\$ 954,084,753</b>	<b>\$ 883,773,710</b>	<b>\$ 70,311,043</b>

**University of North Carolina Hospitals**  
**Statement of Net Assets**  
**June 30, 2008**

**Exhibit A-1**

**ASSETS**

Current Assets:

Cash and Cash Equivalents	\$ 224,472,537
Restricted Cash and Cash Equivalents	5,847,162
Receivables:	
Patient Accounts Receivable, Net (Note 3)	111,666,900
Accrued Interest Receivable	1,262,681
Other Accounts Receivable	17,564,511
Due from Primary Government	1,182,732
Due from State of North Carolina Component Units	7,023,239
Estimated Third Party Settlements (Note 4)	3,100,000
Inventories	16,528,916
Prepaid Expenses	3,282,542
	<hr/>
Total Current Assets	391,931,220

Noncurrent Assets:

Restricted Cash and Cash Equivalents	118,131,143
Investments (Note 2)	332,508,957
Advanced Deposits with Liability Insurance Trust Fund (Note 11)	5,264,811
Patient Accounts Receivable, Net (Note 3)	6,021,022
Bond Issuance Costs, Net	1,600,605
Start-Up Costs, Net	524,318
Investments in Affiliates (Note 14)	2,095,460
Capital Assets - Nondepreciable (Note 5)	152,265,057
Capital Assets - Depreciable, Net (Note 5)	377,911,086
	<hr/>
Total Noncurrent Assets	996,322,459

Total Assets	<hr/> <hr/> 1,388,253,679
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**LIABILITIES**

Current Liabilities:

Accounts Payable	44,274,673
Accrued Salaries and Benefits	26,137,041
Estimated Third Party Settlements (Note 4)	46,241,840
Due to Patients or Third Parties	2,548,879
Due to Primary Government	3,484,612
Due to State of North Carolina Component Units	4,732,840
Bond Interest Payable	1,610,136
Funds Held for Others	1,071,206
Long-Term Liabilities - Current Portion (Note 6)	23,620,902
	<hr/>
Total Current Liabilities	153,722,129

Noncurrent Liabilities:

Long-Term Liabilities (Note 6)	<hr/> 280,446,797
	<hr/>
Total Noncurrent Liabilities	280,446,797
	<hr/>
Total Liabilities	434,168,926

***University of North Carolina Hospitals***  
***Statement of Net Assets***  
***June 30, 2008***

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

**NET ASSETS**

Invested in Capital Assets, Net of Related Debt	317,172,871
Restricted for Expendable Uses for:	
Chatham Escrow	1,999,000
Master Facility Research Fund	1,661,260
Maintenance Reserve Fund	113,110,083
Liability Insurance Trust Fund	5,264,811
Trust Fund Donations	261,624
Minority Interest in Carolina Dialysis, LLC	6,064,527
Unrestricted	<u>508,550,577</u>
Total Net Assets	<u><u>\$ 954,084,753</u></u>

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

***University of North Carolina Hospitals  
Statement of Revenues, Expenses, and  
Changes in Net Assets  
For the Fiscal Year Ended June 30, 2008***

***Exhibit A-2***

**REVENUES**

Operating Revenues:	
Net Patient Service Revenue (Note 8)	\$ 774,434,422
Other Operating Revenue	18,136,106
Prior Year Third Party Settlements	5,380,349
	<hr/>
Total Operating Revenues	797,950,877
	<hr/>

**EXPENSES**

Operating Expenses:	
Salaries and Benefits	441,711,464
Medical and Surgical Supplies	145,440,490
Contracted Services	89,781,590
Other Supplies and Services	49,467,463
Communication, Utilities, and Travel	15,772,570
Medical Malpractice Costs	2,249,744
Depreciation and Amortization	40,750,193
	<hr/>
Total Operating Expenses	785,173,514
	<hr/>
Operating Income	12,777,363
	<hr/>

**NONOPERATING REVENUES (EXPENSES)**

State Appropriations	47,409,965
Noncapital Gifts and Grants	189,917
Investment Loss (Net of Investment Expense of \$1,287,709)	(32,430,892)
Gain on Investments in Affiliates (Note 14)	54,237
Interest and Fees on Debt	(12,277,065)
Loss on Disposal of Capital Assets	(630,952)
	<hr/>
Net Nonoperating Revenues	2,315,210
	<hr/>
Income Before Other Revenues, Expenses, Gains, or Losses	15,092,573
	<hr/>
Capital Grants	74,118,470
Health Care System Assessment (Note 13)	(18,900,000)
	<hr/>
Increase in Net Assets	70,311,043

**NET ASSETS**

Net Assets - July 1, 2007	883,773,710
	<hr/>
Net Assets - June 30, 2008	\$ 954,084,753
	<hr/> <hr/>

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

***University of North Carolina Hospitals***  
***Statement of Cash Flows***  
***For the Fiscal Year Ended June 30, 2008***

***Exhibit A-3***

**CASH FLOWS FROM OPERATING ACTIVITIES**

Received from Customers	\$ 805,534,784
Payments to Employees and Fringe Benefits	(441,010,911)
Payments to Vendors and Suppliers	(303,646,473)
Payments for Medical Malpractice	(2,146,775)
Other Receipts	17,380,471
	<hr/>
Net Cash Provided by Operating Activities	76,111,096
	<hr/>

**CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES**

State Appropriations	47,409,965
Health Care System Assessment	(18,900,000)
Interest and Fees Paid on Revenue Bonds	(2,112,484)
Principal Paid on Revenue Bonds	(816,000)
Noncapital Gifts and Grants	189,917
	<hr/>
Net Cash Provided by Noncapital Financing Activities	25,771,398
	<hr/>

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

Principal Paid on Capital Revenue Bonds	(5,604,000)
Principal Paid on Notes Payable	(10,870,051)
Interest and Fees Paid on Capital Debt	(9,966,540)
Capital Grants	74,118,470
Acquisition and Construction of Capital Assets	(125,962,666)
Proceeds from Sale of Capital Assets	41,609
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(78,243,178)
	<hr/>

**CASH FLOWS FROM INVESTING ACTIVITIES**

Investment Income	16,659,503
Purchase of Investments and Related Fees	(25,000,000)
Proceeds from Sale of Restricted Investments	9,222,824
Investments In and Loans to Affiliated Enterprises:	
Cash Payments	(573,538)
	<hr/>
Net Cash Provided by Investing Activities	308,789
	<hr/>

Net Increase in Cash and Cash Equivalents	23,948,105
Cash and Cash Equivalents - July 1, 2007	324,502,737
	<hr/>
Cash and Cash Equivalents - June 30, 2008	\$ 348,450,842
	<hr/> <hr/>



**University of North Carolina Hospitals**  
**Statement of Cash Flows**  
**For the Fiscal Year Ended June 30, 2008**

**Exhibit A-3**

**Page 2**

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

Operating Income	\$	12,777,363
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation and Amortization Expense		40,750,193
Changes in Assets and Liabilities:		
Patient Accounts Receivable (Net)		(1,945,278)
Other Accounts Receivable		(5,137,312)
Estimated Third Party Settlements		34,742,520
Inventories		(1,603,502)
Prepaid Expenses		(107,715)
Advance Deposits with Liability Insurance Trust Fund		102,969
Accrued Salaries and Benefits		2,137,291
Accounts and Other Payables		(1,473,143)
Due to Patients or Third Parties		(37,940)
Funds Held for Others		(7,039,289)
Compensated Absences		2,944,939
		<hr/>
Net Cash Provided by Operating Activities	\$	<u><u>76,111,096</u></u>

**RECONCILIATION OF CASH AND CASH EQUIVALENTS**

Current Assets:		
Cash and Cash Equivalents	\$	224,472,537
Restricted Cash and Cash Equivalents		5,847,162
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		118,131,143
		<hr/>
Total Cash and Cash Equivalents - June 30, 2008	\$	<u><u>348,450,842</u></u>

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

Change in Fair Value of Investments	\$	(49,163,419)
Loss on Disposal of Capital Assets		(630,952)
Assets Acquired through the Assumption of a Liability		2,081,893

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

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**UNIVERSITY OF NORTH CAROLINA HOSPITALS**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2008**

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES**

- A. **Organization** - The University of North Carolina Hospitals (the Hospitals) is the only State-owned teaching hospital in North Carolina. With a licensed base of 727 beds, this facility serves as an acute care teaching hospital for The University of North Carolina at Chapel Hill. The Hospitals consists of North Carolina Memorial Hospital, North Carolina Children's Hospital, North Carolina Neurosciences Hospital, and North Carolina Women's Hospital. As a State agency, the Hospitals is required to conform to financial requirements established by various statutory and constitutional provisions. While the Hospitals is exempt from both federal and state income taxes, a small portion of its revenue is subject to the unrelated business income tax.
- B. **Financial Reporting Entity** - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements.

The Hospitals is a part of the University of North Carolina (UNC) Health Care System which is a part of the University of North Carolina System, 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 Hospitals and its component units for which the UNC Health Care System Board of Directors is responsible. While the Board of Governors of the University of North Carolina System has ultimate responsibility, the Board of Directors of the UNC Health Care System has delegated responsibilities for financial accountability of the Hospitals' funds. The Hospitals' component units are blended in the Hospitals' financial statements. The blended component units, although legally separate, are, in substance, part of the Hospitals' operations and therefore, are reported as if they were part of the Hospitals.

**Blended Component Units** – Although legally separate, Health System Properties, LLC (the LLC) and Carolina Dialysis, LLC, (the CDLLC),

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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component units of the Hospitals, are reported as if they were part of the Hospitals.

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

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

Separate financial statements for the LLC and CDLLC may be obtained from the Chief Financial Officer, University of North Carolina Hospitals, 307 Med Wing E, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-5111. Other related foundations and similar nonprofit corporations for which the Hospitals is not financially accountable are not part of the accompanying financial statements.

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

- E. Cash and Cash Equivalents** - This classification includes undeposited receipts, petty cash, security deposits, cash on deposit with private bank accounts, money market accounts, and deposits held by the State Treasurer in the short-term investment fund. The short-term investment fund maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty.
- F. Investments** - This classification represents the participation in an equity investment fund through the University of North Carolina Hospitals at Chapel Hill Trust. 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 increase (decrease) in the fair value of investments is recognized as a component of investment income.
- G. Patient Accounts Receivable** - The Hospitals' patient accounts receivable consists of unbilled (in house patients, inpatients discharged but not final billed and outpatients not final billed) and billed amounts. Payment of these charges comes primarily from Managed Care payers, Medicare, Medicaid and, to a lesser extent, the patient. These amounts

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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are recorded in the financial statements net of charity care, contractual allowances and allowances for bad debt to determine the net realizable value of the accounts receivable balance. See the section Net Patient Service Revenue later in the Significant Accounting Policies for a further discussion of these reductions.

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

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

- H. Other Receivables** - In addition to patient accounts receivable, the Hospitals recognizes other receivables related to its operations. These items include the sales tax refund due from the North Carolina Department of Revenue, education loan receivables, amounts due from affiliates and other State agencies, and billings to outside companies for ancillary testing, critical care transportation, and pharmacy supplies. Receivables are recorded net of estimated uncollectible amounts.
- I. Inventories** - Inventories consist of medical and surgical supplies, pharmaceuticals, prosthetics, and other supplies that are used to provide patient care or by service departments within the Hospitals. Inventories are valued at cost using the first-in, first-out method. Merchandise for resale is valued at the lower of cost or market using the retail inventory method.
- J. Capital Assets** - Capital assets are stated at cost at date of acquisition or fair value at date of donation in the case of gifts. The value of assets constructed includes all material direct and indirect construction costs. Interest costs incurred are capitalized during the period of construction.

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

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 5 to 25 years for general

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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infrastructure, 10 to 40 years for buildings, and 3 to 20 years for equipment.

- K. 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, funds held in an escrow account to serve as collateral for some of the financial covenants related to the Chatham Hospital debt, and funds equal to 7.5% of gross patient revenue as limited by applicable revenue bond covenants. Current restricted resources include certain trust funds restricted because external parties or statute limits their use, resources legally segregated for the payment of principal and interest as required by debt covenants, funds held for workers compensation, and unexpended capital contributions.
- L. Noncurrent Long-Term Liabilities** - Noncurrent long-term liabilities include principal amounts of bonds payable, notes payable, arbitrage payable, and compensated absences that will not be paid within the next fiscal year.

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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**Paid Time Off (PTO) Plan** - The PTO program combines the various leave types that employees may earn into one earning rate that varies depending upon years of service. This program is mandatory for all new employees. The policy provides for a maximum accumulation of 280 hours of unused PTO time at the last day of the last pay period of the calendar year that includes December 31. At that time, the excess accumulation over 280 hours is converted to long term sick leave, which is treated similar to sick leave in the Traditional Plan. Upon termination of employment, employees are paid for their current balance in PTO based upon their years of service. Once an employee has more than five years of service, the entire accumulated balance is paid up to 280 hours. The PTO program also has an annual sell back feature that allows employees to sell back 50% of their accumulated hours over a minimum floor. The payout occurs in January each year.

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

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

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

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

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

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



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

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

Nonoperating revenues include activities that have the characteristics of nonexchange transactions. Revenues from nonexchange transactions and State appropriations that represent subsidies or gifts to the Hospitals, as well as investment income and gain (loss) on disposal of fixed assets, are considered nonoperating since these are either investing, capital or noncapital financing activities.

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

- P. Net Patient Service Revenue** - Patient service revenue is recorded at the Hospitals' established rates and includes all charges for inpatient accounts discharged after June 30, 2007, (less amounts previously recorded at June 30, 2007, for in house patients) and all charges on in house accounts and all charges for outpatient accounts registered after June 30, 2007. The difference between established rates and the estimated amount

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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collectible is recognized as revenue deductions on an accrual basis and deducted from gross patient service revenue to report service revenue at net realizable value. Revenue deductions consist of charges for charity care, contractual allowances and bad debt.

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

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

- Q. Medical Malpractice Cost** - Medical malpractice costs represent the actuarially determined contribution to the Liability Insurance Trust Fund. See Note 11 for further discussion of the Liability Insurance Trust Fund.
- R. Donated Services** - No amounts have been included for donated services since no objective basis is available to measure the value of such services. However, a substantial number of volunteers donated significant amounts of their time to the Hospitals' operations.

### NOTE 2 - DEPOSITS AND INVESTMENTS

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

At June 30, 2008, the amount shown on the Statement of Net Assets as cash and cash equivalents includes \$330,235,233 which represents the Hospitals' equity position in the State Treasurer's Short-Term Investment Fund. The Short-Term Investment Fund (a portfolio within the State Treasurer's Investment Pool, an external investment pool that is not

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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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 \$32,808. The carrying amount of the Hospitals' deposits not with the State Treasurer was \$18,182,801 and the bank balance was \$18,346,911. Custodial credit risk is the risk that in the event of a bank failure, the Hospitals' deposits may not be returned to it. Pursuant to G.S. 116-36.1, funds received for health care services not deposited with the State Treasurer shall be fully secured in the manner as prescribed by the State Treasurer for the security of public deposits. The Hospitals does not have a deposit policy for custodial credit risk. As of June 30, 2008, \$16,006,731 of the Hospitals' bank balance was uninsured and uncollateralized.

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

**University of North Carolina Hospitals Investment Fund with The Treasurer of the State of North Carolina** - At June 30, 2008, the amount shown on the Statement of Net Assets which represents funds deposited with and invested by the State Treasurer is \$332,508,957. The State Treasurer contracted with an external party (Trustee) to create the University of North Carolina Hospitals at Chapel Hill Trust (Trust). The UNC Hospitals is the only depositor in the Trust; however, the Trust is a participant of a commingled equity investment fund. The Trustee manages the assets, primarily in equity and equity-based securities in accordance with General Statutes. The Trustee maintains custody of the underlying securities in the name of the Trust, services the securities and maintains all related accounting records. The investments are valued at fair market value. Deposit and investment risks associated with the Trust are included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page <http://www.ncosc.net/> and clicking on "Financial Reports," or

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

### NOTE 3 - PATIENT ACCOUNTS RECEIVABLE - NET

**A. Current** - Net patient accounts receivable consisted of amounts due from patients and third parties at estimated realizable value. Included in gross receivables are amounts receivable at established billing rates less payments received through June 30th. Allowances for uncollectible accounts and contractual adjustments are estimated using historical collection statistics. The components of current net Patient Accounts Receivable reflected in the accompanying Statement of Net Assets are as follows at June 30, 2008:

	<b>Amount</b>
In-House Patients	\$ 37,625,301
Discharged (Not Final Billed) Patients	49,417,878
Total Unbilled	87,043,179
Discharged (Billed) Patients	191,982,331
Payment Arrangements	678,956
Charity Care Provided	(23,016,617)
Current Gross	256,687,849
Allowance for Bad Debts	(18,002,922)
Contractual Allowances	(127,018,027)
Total Allowances	(145,020,949)
Current - Net	\$ 111,666,900

**B. Noncurrent** - Net patient accounts receivable consist of \$6,021,022 (net of \$5,367,031 estimated uncollectible) and represents the value of patient payment arrangements that are initiated at the request of the patient. These payment arrangements are for a specific monthly payment amount that extend beyond one year but are capped at three years.

### NOTE 4 - ESTIMATED THIRD PARTY SETTLEMENTS

UNC Hospitals renders care to patients covered by Medicare, Medicaid and Tricare/Champus programs. Inpatient acute care services rendered to Medicare patients are paid at prospectively determined rates per discharge. Medicare outpatient services are reimbursed at prospectively determined rates. Additionally, UNC Hospitals receives interim pass-through payments from Medicare for certain portions of inpatient acute care costs such as organ costs, graduate medical education, etc., that are ultimately settled on cost or an

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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adjusted cost through the annual Medicare Cost Report. The Hospitals earned \$19,180,316 in pass-through payments for 2008. On an interim basis, Medicaid inpatient services are reimbursed on a prospectively determined rate per discharge and Medicaid outpatient services are reimbursed on an interim basis at an agreed upon rate. Ultimately, most of Medicaid inpatient and outpatient services are settled at cost through the filing of an annual cost report. In addition to Tricare/Champus payments for services on an interim basis, the Tricare program reimburses the Hospitals for a portion of capital and direct medical education costs based on the Medicare cost report.

UNC Hospitals has calculated the estimated third party settlements for the outstanding Medicare and Medicaid cost reports during the fiscal year ended 2008. It is estimated that the Hospitals owes Medicare and Medicaid \$41,459,085 and \$4,782,755 respectively and that Tricare/Champus owes the Hospitals \$3,100,000. Included in the estimated liability for Medicare and Medicaid is a reserve for potential audit adjustments for all outstanding cost reports based on industry practice and the recommendation of an advisor from a CPA firm that is recognized as a national health care reimbursement consultant. The reserve for Medicare equals 4 – 10% of at-risk items for all outstanding cost reports (4% reserved in 2001, increasing 1% each year, until 10% reserve was reached in 2007). The reserve for Medicaid equals 3% of allowable costs. An estimate is made for the current year's Medicare, Tricare and Medicaid settlements by using the most current available statistics, costs, settlement data and charges.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### 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	Increases	Decreases	Balance June 30, 2008
Capital Assets, Nondepreciable:				
Land	\$ 26,385,685	\$ 0	\$ 0	\$ 26,385,685
Construction in Progress	68,551,072	94,886,316	37,558,016	125,879,372
<b>Total Capital Assets, Nondepreciable</b>	<b>94,936,757</b>	<b>94,886,316</b>	<b>37,558,016</b>	<b>152,265,057</b>
Capital Assets, Depreciable:				
Buildings	326,243,901	35,409,859	116,822	361,536,938
Machinery and Equipment	312,374,026	42,577,118	10,085,371	344,865,773
General Infrastructure	5,323,924		9,463	5,314,461
<b>Total Capital Assets, Depreciable</b>	<b>643,941,851</b>	<b>77,986,977</b>	<b>10,211,656</b>	<b>711,717,172</b>
Less Accumulated Depreciation/Amortization for:				
Buildings	98,120,760	12,409,807	116,822	110,413,745
Machinery and Equipment	200,256,783	28,087,820	8,824,834	219,519,769
General Infrastructure	3,652,474	229,561	9,463	3,872,572
<b>Total Accumulated Depreciation</b>	<b>302,030,017</b>	<b>40,727,188</b>	<b>8,951,119</b>	<b>333,806,086</b>
<b>Total Capital Assets, Depreciable, Net</b>	<b>341,911,834</b>	<b>37,259,789</b>	<b>1,260,537</b>	<b>377,911,086</b>
<b>Capital Assets, Net</b>	<b>\$ 436,848,591</b>	<b>\$ 132,146,105</b>	<b>\$ 38,818,553</b>	<b>\$ 530,176,143</b>

### NOTE 6 - LONG-TERM LIABILITIES

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

	Balance July 1, 2007	Additions	Reductions	Balance June 30, 2008	Current Portion
Revenue Bonds Payable	\$ 274,645,000	\$ 0	\$ (6,420,000)	\$ 268,225,000	\$ 6,860,000
Plus: Premium	1,411,779		(318,282)	1,093,497	
Less: Discount	(564,032)		15,815	(548,217)	
Less: Deferred Charge on Refunding	(15,763,176)		856,939	(14,906,237)	
<b>Total Bonds Payable</b>	<b>\$ 259,729,571</b>	<b>\$ 0</b>	<b>\$ (5,865,528)</b>	<b>\$ 253,864,043</b>	<b>\$ 6,860,000</b>
Notes Payable	34,384,470	2,081,893	(10,870,051)	25,596,312	11,165,492
Arbitrage Rebate Payable	268,892			268,892	
Compensated Absences	21,393,514	35,865,160	(32,920,222)	24,338,452	5,595,410
<b>Total Long-Term Liabilities</b>	<b>\$ 315,776,447</b>	<b>\$ 37,947,053</b>	<b>\$ (49,655,801)</b>	<b>\$ 304,067,699</b>	<b>\$ 23,620,902</b>

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**B. Revenue Bonds Payable** - The Hospitals was indebted for revenue bonds payable for the purposes shown in the following table:

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2008	Principal Outstanding June 30, 2008
Refund 1992 Revenue Bonds	1999	4.00% to 5.25%	02/15/2024	58,925,000	13,505,000	45,420,000
Rex Acquisition and Hospital Renovations	2001A 2001B	2.66% 2.50%	02/15/2031	110,000,000	7,600,000	102,400,000
Refund Portion of 1996 Revenue Bonds	2003A 2003B	1.55% 1.45%	02/01/2029	98,015,000	2,385,000	95,630,000
Refund Portion of 1996 Revenue Bonds	2005A	3.00% to 5.00%	02/01/2015	30,540,000	5,765,000	24,775,000
Total Bonds Payable (Principal Only)				\$ 297,480,000	\$ 29,255,000	268,225,000
Less: Unamortized Loss on Refunding						(14,906,237)
Less: Unamortized Discount						(548,217)
Plus: Unamortized Premium						1,093,497
Total Bonds Payable						\$ 253,864,043

\* For variable rate debt, interest rates in effect at June 30, 2008 are shown.

\*\* For variable rate debt with interest rate swaps, the synthetic fixed rates in effect at June 30, 2008 are shown.

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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mode, the mode on these bonds may change to a weekly rate, a unit pricing rate, a term rate or a fixed rate.

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

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and *Landesbank Hessen-Thüringen Girozentrale*, a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require an adjustable facility fee based on the long-term rating of the bonds, which is calculated as a percentage of the available commitment. Payments are made quarterly in arrears, on the first business day of each July, October, January and April thereafter until the expiration date or the termination date of the Agreements. For the past fiscal year the percentage was 0.25% with the long-term agreement that became effective on July 11, 2005. This agreement has been extended to October 11, 2011 at a percentage of .40% effective October 11, 2008.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Formula Rate (Base Rate equal to the higher of the Prime Rate for such day or the sum of .50% plus the Federal Funds Rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is due quarterly (the first business day of January, April, July and October) for each period in which Bank Bonds are outstanding. At June 30, 2008 there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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redeem the Bank Bonds held by the Liquidity Facility. The agreements allow the Hospitals to redeem bank bonds in equal quarterly installments, on the first business day of January, April, July and October. The payments will commence with the first business day of any such month that is at least 90 days following the applicable Purchase Date of the Bank Bond and end no later than the fifth anniversary of such Purchase Date. If the take out agreement were to be exercised because the entire outstanding \$102,400,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay \$23,273,632 a year for five years under the installment loan agreement assuming an 5.0 percent prime interest rate.

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

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

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

Under separate Standby Bond Purchase Agreements for the Series 2003A and Series 2003B (Agreements) between the Hospitals and Bank of America, N.A. (Series 2003A) or Wachovia Bank, National Association

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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(Series 2003B) a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require a facility fee equal to 0.22% of the available commitment for Series 2003A and Series 2003B, payable quarterly in advance, beginning on February 13, 2003, and on each February 1, May 1, August 1, and November 1 thereafter until the expiration date or the termination date of the Agreements.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Bank Bond Interest Rate (for Series 2003A, the rate equals London Inter-Bank Offered Rate (LIBOR) plus 2.50% for the first 90 days and then equals LIBOR plus 4.00%; for Series 2003B, the rate equals Prime Rate for the first 90 days and then equals Prime plus 1.00%) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is on the first business day of each month for each period in which Bank Bonds are outstanding. At June 30, 2008 there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The Series 2003A agreement allows the Hospitals to redeem bank bonds in twelve equal quarterly installments beginning on the first February 1, May 1, August 1 or November 1 that occurs at least 90 days following the applicable Purchase Date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding \$62,205,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay \$22,975,548 a year for three years under the installment loan agreement assuming a 6.46 percent interest rate (LIBOR plus 4%). The Series 2003B agreement allows the Hospitals to redeem bank bonds in 36 equal monthly installments, on the first business day of each calendar month after the loan date. Payments commence with the first business day of any such month that is at least 120 days following the applicable Purchase Date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding \$33,425,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay \$12,202,236 a year for three years under the installment loan agreement assuming a 6.0 percent interest rate (Prime plus 1%).

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The current expiration date of the Series 2003A Agreement is July 1, 2010 and July 31, 2009 for the Series 2003B Agreement. The Hospitals may request additional extensions, which are approved at the discretion of the Liquidity Provider.

### **Interest Rate Swap Agreement**

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

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

The swap agreement terminates February 1, 2029. As of June 30, 2008, rates were as follows:

	Terms	2003 A Rates	2003 B Rates
Fixed Payment to BOA	Fixed	3.48 %	3.48 %
Variable Payment from BOA	LIBOR* - BBA**	1.65 %	1.65 %
Net Interest Rate Swap Payments		1.83	1.83
Variable Rate Bond Coupon Payments		1.55	1.45
Synthetic Interest Rate on Bonds		3.38	3.28

\* London Inter-Bank Offered Rate

\*\* British Bankers Association

The swap agreement has a negative mark-to-market value of (\$3,390,314) as of June 30, 2008. The negative fair value of the swap may be countered by reductions in total interest payments required under the variable-rate bond, creating lower synthetic rates. Because the coupons on the Hospitals' variable rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. BOA develops the mark-to-market value. Their method calculates the present value of the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for LIBOR due on the date of each future net settlement on the swap.

As of June 30, 2008, the Hospitals is not exposed to credit risk because the swap has a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the Hospitals would be exposed to credit risk in the amount of the derivative's fair value. BOA's current long-term ratings are AA- by Fitch Ratings, Aaa by Moody's Investor's Service, and AA+ by Standard and Poor's Corporation. At such time that their ratings fall below A3 for Moody's or below A- for S&P, BOA will be required to collateralize a portion of their exposure (up to 100%). The following instruments can serve as eligible collateral: Cash, U.S. Treasury Obligations, U.S. Government Agency Fixed Rate Fixed Maturity Securities, U.S. Government Agency Single Class Mortgage-Backed Securities, U.S. Treasury STRIPS and other U.S. Government Agency Mortgage-Backed Securities. Posted collateral received will be entered in one or more accounts with a domestic office of a commercial bank, trust company or financial institution organized under the laws of the United States (or any state or a political subdivision thereof).

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Fiscal Year	Annual Requirements				
	Revenue Bonds Payable			Notes Payable	
	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest
2009	\$ 6,860,000	\$ 7,489,519	\$ 1,743,665	\$ 11,165,492	\$ 723,679
2010	7,135,000	7,198,933	1,737,103	11,635,262	341,488
2011	7,410,000	6,894,874	1,727,345	2,795,558	23,474
2012	7,705,000	6,579,422	1,719,987		
2013	8,210,000	6,225,540	1,703,963		
2014-2018	47,370,000	26,063,675	8,011,947		
2019-2023	58,790,000	18,527,514	5,627,506		
2024-2028	72,710,000	10,333,428	2,554,588		
2029-2033	52,035,000	2,171,804	88,950		
Total Requirements	<u>\$ 268,225,000</u>	<u>\$ 91,484,709</u>	<u>\$ 24,915,054</u>	<u>\$ 25,596,312</u>	<u>\$ 1,088,641</u>

Interest on the variable rate 2001A and 2001B revenue bonds is calculated based upon the daily rates at which the bonds were remarketed on June 30, 2008, of 2.66% and 2.50%, respectively. Interest on the variable rate 2003A and 2003B revenue bonds is calculated based upon the synthetic rates at June 30, 2008, of 3.38% and 3.28%, respectively. See Note 6C for more information on the demand bonds and the interest rate swap agreement.

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

Purpose	Financial Institution	Interest Rate/Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2008	Principal Outstanding June 30, 2008
IBM Equipment	IBM Credit	2.92% to 3.76%	07/01/2011	\$ 2,081,893	\$ 45,815	\$ 2,036,078
Medical Equipment	SunTrust	3.4%	09/29/2010	50,000,000	26,439,766	23,560,234
Total Notes Payable				<u>\$ 52,081,893</u>	<u>\$ 26,485,581</u>	<u>\$ 25,596,312</u>

### NOTE 7 - OPERATING LEASE OBLIGATIONS

The Hospitals entered into operating leases for space rental. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2008:

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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<u>Fiscal Year</u>	<u>Amount</u>
2009	\$ 1,125,115
2010	1,104,133
2011	1,046,033
2012	945,301
2013	866,897
2014-2018	<u>1,747,031</u>
Total Minimum Lease Payments	<u>\$ 6,834,510</u>

Rental expense for all operating leases during the year was \$ 1,609,075.

### NOTE 8 - NET PATIENT SERVICE REVENUE

**Medicare:** The Hospitals is reimbursed for inpatient acute care services under the provisions of the Prospective Payment System (PPS). Under PPS, payment is made at predetermined rates for treating various diagnoses and performing procedures that have been grouped into defined Medicare Severity Diagnosis-Related Groups (MSDRGs) applicable to each patient discharge, rather than on the basis of the Hospitals' allowable charges. The difference in the standard hospital charge and the prospective payment for such services is reflected as an adjustment from patient service revenue. The claims payments are MSDRG payments and add-on payments for indirect medical education and disproportionate share. MSDRG payments include capital related costs.

Medicare makes payments for Direct Graduate Medical Education (DGME) in support of the direct costs of residency training. Medicare also pays a portion of Medicare bad debts and organ acquisition costs for the Medicare beneficiaries. These pass-through payments are discussed further in Note 4, Estimated Third Party Settlements.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

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

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

Medicaid reimburses most outpatient services on an interim basis based on an agreed-upon rate based on documented costs. Medicaid also reimburses the Hospitals for graduate medical education costs. Final settlement is determined after submission of annual cost reports by the Hospitals. Several services such as hearing aids, durable medical equipment (DME), outpatient pharmaceuticals, home health, and diagnostic laboratory services are paid on fee schedules.

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

**Other Agreements:** The Hospitals has also entered into reimbursement agreements with certain commercial insurance carriers and managed care

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

organizations to accept patients on a discounted fee for service basis. The basis for reimbursement under these agreements includes case rates per discharge, discounts from established charges, fee schedules and per diem rates.

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

A summary of net patient service revenue for the year ended June 30, 2008, follows:

	2008
Inpatient Routine	\$ 327,102,123
Inpatient Ancillary	665,076,114
Outpatient	666,523,798
Charity Care Provided	(88,845,624)
Gross Patient Service Revenue	<u>1,569,856,411</u>
Medicare Contractual Allowance	(220,491,112)
Medicaid Contractual Allowance	(198,918,259)
Managed Care Contractual Allowance	(319,328,420)
Other Contractual Allowances	(11,807,000)
Bad Debt	(44,877,198)
Contractual Adjustments	<u>(795,421,989)</u>
Net Patient Service Revenue	<u><u>\$ 774,434,422</u></u>

### NOTE 9 - PENSION PLANS

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

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

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 135-5 and 135-8 and may be amended only by the North



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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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 Hospitals had a total payroll of \$342,950,393, of which \$286,773,410 was covered under the Teachers' and State Employees' Retirement System. Total employer and employee contributions for pension benefits for the year were \$8,746,589 and \$17,206,405, 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 Hospitals made 100% of its annual required contributions for the years ended June 30, 2008, 2007, and 2006, which were \$8,746,589, \$6,740,339, and \$5,318,419, 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.

- B. Deferred Compensation and Supplemental Retirement Income Plans** - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement, or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, *the North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the Hospitals. The voluntary contributions by employees amounted to \$571,827 for the year ended June 30, 2008.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the Hospitals except for a 5% employer contribution for the Hospitals' law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of Hospitals' law enforcement officers for the year ended June 30, 2008, were \$52,549. The voluntary contributions by employees amounted to \$2,183,995 for the year ended June 30, 2008.

IRC Section 403(b) and 403(b)(7) Plans - Eligible Hospitals employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the Hospitals. The voluntary contributions by employees amounted to \$5,076,215 for the year ended June 30, 2008.

### NOTE 10 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Benefits** - The Hospitals 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. Coverage eligibility varies depending on years of contributory membership service in the retirement system prior to disability or retirement.

The Plan' 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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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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 Hospitals contributed 4.1% of the covered payroll under the Teachers' and State Employees' Retirement System to the Fund. Required contributions rates for the years ended June 30, 2007 and 2006, were 3.8% and 3.8% respectively. The Hospitals made 100% of its annual required contributions to the Plan for the years ended June 30, 2008, 2007, and 2006, which were \$11,757,710, \$9,629,055, and \$8,636,749, respectively. The Hospitals assumes no liability for retiree health care benefits provided by the programs other than its required contributions.

Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*. 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 Hospitals 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. 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 Hospitals made a statutory contribution of .52% of covered payroll under the Teachers' and State Employees' Retirement System to the DIPNC. Required contribution rates for the years ended June 30, 2007, and 2006, were .52% and .52%, respectively. The Hospitals made 100% of its annual required contributions to the DIPNC for the years ended

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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June 30, 2008, 2007, and 2006, which were \$1,491,222, \$1,317,660, and \$1,181,871, respectively. The Hospitals assumes no liability for long-term disability benefits under the Plan other than its contribution.

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

### NOTE 11 - RISK MANAGEMENT

The Hospitals is exposed to various risks of loss related to torts; theft of, damage to, and 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.

The Hospitals is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to the Hospitals for operations supported by the State's General Fund. Other Operations not supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a \$500 per occurrence deductible, except theft losses are subject to a \$1,000 per occurrence deductible. Premiums are paid based on square footage and the value of building contents. The Hospitals purchased through the Fund "all risks" replacement cost basis insurance for buildings and contents subject to a \$25,000 per occurrence deductible. No significant losses occurred during the year.

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

The Hospitals is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is handled by the North Carolina Department of Insurance. The Hospitals is charged a premium by the private insurance company. Coverage limit is \$5,000,000 per

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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occurrence with a \$75,000 deductible and a 10% participation in each loss above the deductible.

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

- Boiler and Machinery insurance up to \$25,000,000 with a deductible of \$5,000 per occurrence
- Directors and Officers Liability insurance up to \$15,000,000 with a deductible of \$200,000 per occurrence
- Master Crime insurance up to \$500,000 with a deductible of \$1,000
- Comprehensive General Liability insurance up to \$2,000,000 with a deductible of \$10,000 per occurrence
- Automobile Physical Damage (for vehicles costing greater than \$75,000) insurance up to \$5,000,000 per accident with a deductible of \$500 per occurrence
- General Liability for Helipad on Premises insurance up to \$20,000,000 with a deductible of \$10,000 per occurrence
- General Liability for Non-owned Aircraft insurance up to \$20,000,000 with no deductible
- Business Travel insurance for aircraft flight team up to \$600,000 per accident with no deductible
- Computerized Business Equipment replacement cost insurance up to \$603,850 with a deductible of \$10,000 per occurrence
- Fine Arts Floater insurance up to \$50,000 (\$5,000 per item) with a deductible of \$1,000 per occurrence
- Health System Properties, LLC real property coverage up to \$700,000 with a deductible of \$10,000 per occurrence

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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and compensation in accordance with the North Carolina Workers' Compensation Act. The Hospitals is self-insured for workers' compensation.

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

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

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

The Trust Fund is an unincorporated entity created by Chapter 116, Article 26, of the *North Carolina General Statutes* and The University of North Carolina Board of Governors Resolution of June 9, 1978. The Trust Fund is a self-insurance program established to provide professional medical malpractice liability covering The University of North Carolina Hospitals at Chapel Hill ("UNC Hospitals") and The University of North Carolina at Chapel Hill Physicians and Associates ("UNC P&A"), the program participants. The Trust Fund provides coverage for program participants and individual health care practitioners working as employees, agents, or officers of program participants. The Trust Fund is exempt from federal and state income taxes, and is not subject to regulation by the North Carolina Department of Insurance.

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

The Trust Fund is governed by the Liability Insurance Trust Fund Council (the Council). The Council consists of thirteen members as follows: one member each appointed by the State Attorney General, the State Auditor, the State

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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Insurance Commissioner, the Director of the Office of State Budget and Management, the State Treasurer, (each serving at the pleasure of the appointer); and eight members appointed to three year terms (with no limit on the number of terms) by the UNC System's Board of Governors.

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

For the period July 1, 2007 through June 30, 2008, the Trust Fund provided coverage on an occurrence basis of \$3,000,000 per individual and \$7,000,000 in the aggregate per claim. The Trust Fund entered into an excess of loss agreement with an unaffiliated reinsurer in prior years. However, excess reinsurance coverage has not been purchased for any policy year since June 30, 2006. In lieu of reinsurance, \$10,687,975 is maintained in the Reimbursement Fund for future losses. For the fiscal year ending June 30, 2008, the Trust Fund purchased a direct insurance policy to cover the first \$1,000,000 per occurrence and \$3,000,000 in the aggregate for dental residents. North Carolina General Statutes Chapter 116 was amended during 1987 to authorize the Trust Fund to borrow necessary amounts up to \$30,000,000, in the event that the Trust Fund may have insufficient funds to pay existing and future claims. Any such borrowing would be repaid from the assets and revenues of program participants. No line of credit or borrowing has been established pursuant to this authorization. The Council believes adequate funds are on deposit in the Trust Fund to meet estimated losses based upon the results of the independent actuary's report.

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

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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At June 30, 2008, the Hospitals' assets in the Trust Fund totaled \$32,673,444 while Hospitals liabilities totaled \$27,408,633 resulting in net assets of \$5,264,811.

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

### NOTE 12 - COMMITMENTS AND CONTINGENCIES

- A. Commitments** - The Hospitals has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were \$43,148,600 and on other purchases were \$16,610,890 at June 30, 2008.
- B. Pending Litigation and Claims** - The Hospitals is a party to other litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of these matters, no provision for any liability has been made in the financial statements. Hospitals' management is of the opinion that the liability, if any, for any of these matters will not have a material adverse effect on the financial position of the Hospitals.
- C. North Carolina State Capital Facilities Act of 2004** - The North Carolina State Capital Facilities Act of 2004 (the Act) was ratified as part of House bill 1264 of the 2004 Session of the General Assembly of North Carolina. The Act authorizes the issuance or incurrence of special indebtedness of an aggregate maximum amount of \$180 million to finance the construction and equipping of a new cancer rehabilitation and treatment center, a nearby physician's office building, and a walkway between the two, all to be located at the University of North Carolina Hospitals at Chapel Hill. The State, with the prior approval of the State Treasurer and the Council of State, as provided in Article 9 of Chapter 142 of the *North Carolina General Statutes*, is authorized to issue or incur special indebtedness in order to provide funds to the State to be used, together with other available funds, to pay the cost of this project. The Act requires both the Health and Wellness Trust Fund and the Tobacco Trust Fund to provide the debt service for the special indebtedness described above. The information for the Cancer Hospital project component of the Act is provided quarterly by the Hospitals' Planning Department via a report that outlines the estimated cash



## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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requirements needed to fund the remainder of the project as of that point in time. Within these amounts, based on an official request of cash needs from the Hospitals, the Office of State Budget and Management (OSBM) authorizes allotments. The Hospitals records the allotments as capital grant revenue on the accompanying financial statements. The Hospitals' remaining authorization of \$51.9 million is contingent on fund availability and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

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

### NOTE 13 - RELATED PARTIES

**University of North Carolina Health Care System** - The Board of Directors of UNC Health Care System (System) authorized and approved the creation of the Enterprise Fund to support the System's mission and vision to be the nation's leading public academic health care system. The key components of the System are the University of North Carolina Hospitals, the clinical patient care programs established or maintained by the University of North Carolina at Chapel Hill School of Medicine and UNC Physicians & Associates, and Rex Healthcare, Inc. Pursuant to a memorandum of understanding effective July 1, 2005, the key components agreed to finance the Enterprise Fund. For the year ending June 30, 2008, UNC Hospitals was assessed \$18,900,000 to fund initiatives supported by the Enterprise Fund.

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

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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**Rex Hospital, Inc.** - Rex Hospital, Inc. is a 433-bed hospital located in Raleigh, North Carolina that provides inpatient, outpatient and emergency services primarily to the residents of Wake County. The Hospital operates Rex Cancer Center, Rex Women's Center, and Rex Rehab and Nursing Care Center of Raleigh on its main campus. Rex Hospital has additional campuses in Cary, Wakefield (in Raleigh) and Apex.

**Rex Enterprises, Inc.** - Rex Enterprises, Inc. is a North Carolina for-profit corporation organized to promote the health and welfare of residents of Wake County.

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

**Rex Home Services, Inc.** - Rex Hospital owns Rex Homes Services, Inc., a North Carolina not-for-profit corporation, organized to provide home care services primarily to the residents of Wake County.

UNC Hospitals provides certain management, legal and contracting services to Rex. Likewise, Rex also provides certain employee contracting services to the Hospitals. These transactions resulted in the Hospitals receiving \$1,494,095 from Rex and the Hospitals paying \$823,017 to Rex during the year ended June 30, 2008.

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

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

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

- Operational oversight by two UNC Health Care System employees who serve as the Chief Executive Officer and Chief Financial Officer.

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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- Certain consultative services are provided as part of the management fee and other services are available at cost plus an administrative fee.
- Strategic planning services regarding facility replacement, bond issuance and physician recruitment.

The existing Chatham Hospital facility has been replaced with a new facility on a 30 acre site within the Central Carolina Business Campus in Siler City using \$30,540,000 in funding from a January 2007 bond issuance. UNC Hospitals established a \$1,999,000 escrow account to serve as collateral for some of the financial covenants related to the Chatham Hospital debt, but none of these funds had been used as of June 30, 2008. As described in Note 16, the UNC Health Care System acquired a controlling interest in Chatham Hospitals subsequent to year-end.

### NOTE 14 - INVESTMENTS IN AFFILIATES

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were \$2,095,460 at June 30, 2008. The Hospitals' share of these affiliates and joint ventures is not significant individually. The summarized audited financial information below represents an aggregation of the ongoing affiliates and joint ventures:

	2008 (Unaudited)
<b>TOTAL AFFILIATE ACTIVITY</b>	
Current Assets	\$ 3,749,035
Noncurrent Assets	514,559
Current Liabilities	403,880
Shareholders Equity	3,859,714
Revenue	6,297,754
Net Gain	159,369
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<b>HOSPITALS' SHARE OF ACTIVITY</b>	
Affiliate Gain - Ongoing Operations	85,313
Affiliate Gain/(Loss) - Discontinued Operations	(31,076)
Total Gain Realized from Affiliate Activities	<u>\$ 54,237</u>

## NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

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### NOTE 15 - CHANGES IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2008, the Hospitals 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. 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*.

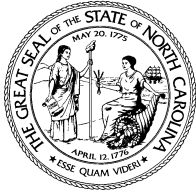
GASB Statement No. 50 aligns the financial reporting requirements for pensions with those of other postemployment benefits, to conform with GASB Statement No. 45. This Statement amends GASB Statement 27 to require note disclosure of the employer contribution rates and percentage of the amount contributed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

### NOTE 16 - SUBSEQUENT EVENTS

**Purchase of Chatham Hospital, Inc.** - On July 21, 2008, UNC Health Care System purchased a controlling interest in Chatham Hospital, Incorporated. At the direction of UNC Health Care System, UNC Hospitals transferred \$2,000,000 to Chatham Hospital, Inc., on the closing date and agreed to invest an additional \$9,300,000 to expand health care services in Chatham County over the next seven years.

**Decline in Value of Investments** - In the months subsequent to the Hospitals' fiscal year end at June 30, 2008, there has been significant decline in the world's financial markets. The Hospitals' investments have declined approximately \$98 million since year-end, as of October 31, 2008.

**Transfer of Physicians Office Building** - On September 29, 2008 UNC Hospitals received approval from the North Carolina Department of Health and Human Services to transfer the completed Physician's Office Building (POB) to the University of North Carolina at Chapel Hill for use as an academic building. The cost of the POB totaled \$28,936,312 and legal transfer of the building will take place during fiscal year 2009.



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

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

We have audited the financial statements of the University of North Carolina Hospitals, which is a part of the University of North Carolina Health Care System, which is a part of the University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2008, and have issued our report thereon dated November 12, 2008.

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

As discussed in Note 15 to the financial statements, the Hospitals' implemented Governmental Accounting Standards Board Statement No. 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.

Internal Control Over Financial Reporting

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

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

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A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Hospitals' ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Hospitals' financial statements that is more than inconsequential will not be prevented or detected by the Hospitals' internal control.

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

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

Compliance and Other Matters

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

This report is intended solely for the information and use of management of the Hospitals, the Board of Governors, the Board of Directors of the University Health Care System, the Audit and Compliance Committee, the Governor, the General Assembly, and the State Controller, and is not intended to be and should not be used by anyone other than these specified parties.

*Leslie W. Merritt, Jr.*

Leslie W. Merritt, Jr., CPA, CFP  
State Auditor  
November 12, 2008

## **ORDERING INFORMATION**

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

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