STATE OF NORTH CAROLINA

UNIVERSITY OF NORTH CAROLINA HOSPITALS

CHAPEL HILL, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2010

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

UNIVERSITY OF NORTH CAROLINA HOSPITALS

CHAPEL HILL, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2010

BOARD OF GOVERNORS

THE UNIVERSITY OF NORTH CAROLINA

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STATE OF NORTH CAROLINA
Office of the State Auditor

Beth A. Wood, CPA
State Auditor

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

AUDITOR'S TRANSMITTAL

The Honorable Beverly E. Perdue, 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 at Chapel Hill for the year ended June 30, 2010, 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.

Beth A. Wood

Beth A. Wood, CPA
State Auditor

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying basic financial statements of 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 multi-campus University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2010, 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 accounting principals 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, 2010, 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 16 to the financial statements, the Hospitals implemented Governmental Accounting Standards Board Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* and Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, during the year ended June 30, 2010.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

In accordance with *Government Auditing Standards*, we have also issued our report dated October 19, 2010 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, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

Beth A. Wood

Beth A. Wood, CPA
State Auditor

October 19, 2010

UNIVERSITY OF NORTH CAROLINA HOSPITALS
MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The following discussion and analysis is provided by the University of North Carolina Hospitals at Chapel Hill (Hospitals) fiscal 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 2010 and 2009, 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. Management estimates are necessary in some instances to determine current or noncurrent categorization. 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 gain or 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 and Health Care System assessments. Overall, the *Statement of Revenues, Expenses, and Changes in Net Assets* provides information relative to the Hospitals' management of its operations and its ability to maintain its financial strength.

The *Statement of Cash Flows* provides information relative to the Hospitals' sources and uses of cash for operating activities, noncapital financing activities, capital and related financing activities, and investing activities. The Statement provides a reconciliation of cash balance changes throughout the year 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 2010 to 2009

Comparative financial data of 2010 to 2009 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 $108.5 million or 8.1% from fiscal year 2009 to 2010 due primarily to positive investment returns, increases in prepaid expenses, and recording a new account category, deferred outflow of resources. Depreciable capital assets continued to increase due to routine capital equipment purchases and multiple capital projects, the largest by far being the North Carolina Cancer Hospital which opened during the fiscal year. Investment returns fluctuated but increased by $26.7 million overall and was a welcome change compared to the $97.1 million loss in the previous year. The fiscal year 2011 Health Care System Assessment was paid, in part, during the current year due to positive economic position and accounts for $20 million of the increase in prepaid expenses. Deferred outflow of resources was recorded in compliance with GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* and is the offset to the hedging derivative liabilities that are recorded in the Liabilities section and described more fully in Note 3 in the *Notes to the Financial Statements*.

Liabilities increased overall by $23.6 million or 5.4% while net assets increased $84.9 million or 9.3% from fiscal year 2009 to 2010. The largest change in liabilities was in the noncurrent section as a result of recording the hedging derivative liability of $18.8 million which is the offset to the deferred outflow of resources reported in the Noncurrent Assets section.

Statement of Revenues, Expenses, and Changes in Net Assets

The *Statement of Revenues, Expenses, and Changes in Net Assets* reflects positive operating income of $66.5 million and an overall increase in net assets of $84.9 million.

Total operating revenue grew year-over-year as a result of growth in net patient service revenue. Net patient service revenue, excluding third party settlements, increased $82.1 million or 9.8% due to volume increase and a slightly higher collection percentage that offset a decrease in prior year third party settlements recognized during the current fiscal year. The Hospitals recognized some improvement in revenue due to the settlement of Medicare and Medicaid Cost Report activities; however, management increased reserves for potential unknowns that may result from the Medicare and Medicaid claims audit programs. See Note 5 in the *Notes to the Financial Statements* for more information on estimated third party settlements.

Total operating expenses increased by only $34.1 million or 4.0% due to an organization-wide effort to actively manage operating expenses within budget and also from decreased spending on marketing and consulting services. Regularly scheduled meetings are held by the Chief Financial Officer with divisional vice presidents and applicable departmental managers to review actual to budget results by area and identify corrective measures needed to ensure operations are managed within budget successfully. The largest categorical dollar increase occurred in salaries and benefits, and medical malpractice costs again represented the largest percentage change. Salary and benefit expense increased $25.9 million or 5.5% over the prior year and includes the accrued expense of a nondiscretionary incentive compensation payment that was made to qualifying employees in October 2010 as a result of attaining specific clinical quality, patient satisfaction, employee, and financial goals at an organizational level. Medical malpractice costs increased 153.0% this year. Increases/Decreases in medical malpractice expense are a function of assessments made of the participants by the Liability Insurance Trust Fund (the Fund) of the UNC Health Care System. The assessment made by the Fund and the resulting expense is an estimate of the funds needed to ensure the solvency of the Fund. Changes in reserves and net assets of the Fund are impacted by multiple components such as investment return, claims payments and defense costs as well as favorable/unfavorable developments from previous year estimates. The Fund is managed rigorously by the Hospitals' Risk Management department to ensure patient safety and minimize overall risk. See Note 12 in the *Notes to the Financial Statements* for more information on the Fund. Depreciation expense increased $7.2 million or 16.1% year-over-year and is largely the result of completing the North Carolina Cancer Hospital and placing the building and associated equipment into service.

Nonoperating revenues increased $122 million comparatively due to investment gains of $26.7 million in the current year compared to losses of $97.1 million in the prior year. State appropriations remained flat while interest expense decreased due to historically low variable interest rates.

In the other revenues (expenses) section, capital grants decreased again from $35.9 million to $16.1 million from fiscal year 2009 to 2010. The decrease in capital grants recognized is

indicative of the North Carolina Cancer Hospital project nearing conclusion and opening during the fiscal year. Effective July 1, 2005, the Hospitals agreed to fund the UNC Health Care System Enterprise Fund that supports initiatives as the Chief Executive Officer of the University of North Carolina Health Care System deems appropriate with the recommendations from the senior leadership team. These expenses totaled $62.4 million during fiscal year 2010 and are reported separately in this section as Health Care System Assessments and are described in more detail in Note 14 in the *Notes to the Financial Statements*.

Analysis of Net Asset Balances

At June 30, 2010, net assets invested in capital assets, net of related debt, totaled $390.5 million representing the gross value of plant assets $964.2 million plus bond issuance costs of approximately $0.9 million less accumulated depreciation $401.8 million and related debt of $172.8 million.

Restricted expendable net assets totaled $156.5 million representing amounts subject to externally imposed restrictions.

Unrestricted net assets totaled $448.7 million representing amounts not subject to externally imposed stipulations but internally designated for various activities and initiatives, including future construction projects.

Discussion of Capital Asset and Long-Term Debt Activity

Capital Assets

The Hospitals expended $37.7 million during the year for capital equipment throughout the facilities, $35.8 million for the construction of buildings, infrastructure and renovations and $18 million for land in Hillsborough, NC that will eventually be used for a satellite campus.

On August 5, 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 are located at the University of North Carolina Hospitals at Chapel Hill. The $28.6 million physicians' office building was completed in May 2008 and transferred to the University of North Carolina at Chapel Hill for occupancy in September 2008, while the North Carolina Cancer Hospital was completed and occupied in September 2009.

At June 30, 2010, outstanding commitments on construction contracts were $18.9 million while outstanding commitments related to capital purchase orders for fixed and movable equipment totaled $28.3 million.

The annualized average age of plant and equipment is 7.6 years.

Long-Term Debt Activities

At June 30, 2010, the Hospitals had outstanding bond indebtedness in the amount of $240.7 million of which $7.6 million is due within the next year. Standard and Poor's and Moody's Ratings Services classify these bonds as AA- and Aa3 respectively. The Hospitals anticipate issuing $50 million in new debt in the next fiscal year as described in Note 17 in the *Notes to the Financial Statements*.

Discussion of Conditions That May Have a Significant Effect on Net Assets or Revenues, Expenses, and Changes in Net Assets

Health policy changes at the Federal and State level have been enacted but the ultimate impact of these policy changes on the finances of the Hospitals is largely unknown as of the date of this report. The Hospitals has begun to assimilate and assess the known impacts, but models to accurately predict any impact are still being developed.

The state of the national and regional economy will continue to pressure revenues and collections whether or not additional health policy changes are made at the Federal and State level. The Hospitals remains concerned about the rising expense incurred as a result of carrying out its mission.

The Hospitals receives some state funding through general appropriation to carry out its mission. This appropriation is not specifically tied to any particular program. Given the general state of North Carolina's economy and its budget, the annual appropriation is subject to available funds as directed by the legislature and may increase or decrease.

The Medicare and Medicaid programs have implemented additional audits to recoup errant payments to hospitals. These Recovery Audit Contractor (RAC) and Medicaid Integrity Contractor (MIC) audits have been recently instituted and potentially create additional revenue risk. The Hospitals was not contacted during fiscal year 2010, yet reserves have been set aside as a contingency toward potential future audits of prior year results.

The Hospitals' management realizes that investment risk will be ongoing. Additional flexibility with investment alternatives from the North Carolina State Treasurer will continue to be sought during fiscal year 2011 in order to minimize investment risk to the extent possible.

University of North Carolina Hospitals
Summary of Condensed Financial Statements Totals
For the Fiscal Years Ended June 30, 2010 and 2009

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

	FY10	FY09	Change
STATEMENTS OF NET ASSETS			
Current Assets	$ 347,352,673	$ 433,518,299	(86,165,626)
Capital Assets, Net	562,424,230	531,351,062	31,073,168
Other Noncurrent Assets	545,141,526	381,558,862	163,582,664
TOTAL ASSETS	**1,454,918,429**	**1,346,428,223**	
Current Liabilities	135,130,597	133,112,835	2,017,762
Noncurrent Liabilities	324,125,616	302,510,790	21,614,826
TOTAL LIABILITIES	**459,256,213**	**435,623,625**	
Invested in Capital Assets, Net of Related Debt	390,509,594	343,497,012	47,012,582
Restricted for Expendable Uses	156,477,477	138,779,160	17,698,317
Unrestricted	448,675,145	428,528,426	20,146,719
TOTAL NET ASSETS	**$ 995,662,216**	**$ 910,804,598**	
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS			
Net Patient Service Revenue	$ 922,397,680	$ 840,265,530	82,132,150
Other Operating Revenues	23,514,569	19,215,856	4,298,713
Prior Year Third Party Settlements	8,195,293	30,670,072	(22,474,779)
TOTAL OPERATING REVENUES	**954,107,542**	**890,151,458**	
Salaries and Benefits	497,762,304	471,823,604	25,938,700
Medical and Surgical Supplies	161,315,247	157,956,222	3,359,025
Contracted Services	94,193,202	104,475,637	(10,282,435)
Other Supplies and Materials	56,525,000	54,462,052	2,062,948
Communication, Utilities, and Travel	20,794,282	17,695,251	3,099,031
Medical Malpractice Costs	4,356,494	1,721,648	2,634,846
Depreciation and Amortization	52,639,101	45,349,232	7,289,869
TOTAL OPERATING EXPENSES	**887,585,630**	**853,483,646**	
OPERATING INCOME	**66,521,912**	**36,667,812**	
State Appropriations	41,811,381	42,002,451	(191,070)
Investment Activity	33,323,745	(84,617,399)	117,941,144
Noncapital Gifts and Grants	244,443	235,586	8,857
Nonoperating Expenses	(9,429,186)	(13,682,821)	(4,253,635)
NET NONOPERATING REVENUES (EXPENSES)	**65,950,383**	**(56,062,183)**	
Capital Grants	16,100,742	35,880,913	(19,780,171)
Refund of Prior Years Capital Appropriations	(1,326,801)		1,326,801
Health Care System Assessments	(62,388,618)	(28,092,240)	34,296,378
Transfer of Physicians' Office Building		(28,562,885)	(28,562,885)
INCREASE (DECREASE) IN NET ASSETS	**84,857,618**	**(40,168,583)**	
NET ASSETS - BEGINNING OF YEAR, AS RESTATED	**910,804,598**	**950,973,181**	
NET ASSETS - END OF YEAR	**$ 995,662,216**	**$ 910,804,598**	

University of North Carolina Hospitals
Statement of Net Assets
June 30, 2010

Exhibit A-1

ASSETS		
Current Assets:		
Cash and Cash Equivalents (Note 2)	$	110,011,529
Restricted Cash and Cash Equivalents (Note 2)		9,832,151
Receivables:		
Patient Accounts Receivable, Net (Note 4)		118,286,225
Accrued Interest Receivable		421,207
Other Accounts Receivable, Net		22,770,230
Due from Primary Government		1,978,352
Due from State of North Carolina Component Units		9,300,719
Estimated Third Party Settlements (Note 5)		35,499,834
Inventories		14,639,280
Prepaid Expenses		24,613,146
Total Current Assets		347,352,673
Noncurrent Assets:		
Restricted Cash and Cash Equivalents (Note 2)		143,819,965
Investments (Note 2)		102,999,827
Cash and Investments Designated for Capital Projects (Note 2)		260,954,793
Advanced Deposits with Liability Insurance Trust Fund (Note 12)		6,261,669
Patient Accounts Receivable, Net (Note 4)		8,167,610
Bond Issuance Costs, Net		1,178,653
Deferred Outflow of Resources (Note 3)		18,809,646
Start-Up Costs, Net		515,594
Investments in Affiliates (Note 15)		2,433,769
Capital Assets - Nondepreciable (Note 6)		73,168,470
Capital Assets - Depreciable, Net (Note 6)		489,255,760
Total Noncurrent Assets		1,107,565,756
Total Assets		1,454,918,429
LIABILITIES		
Current Liabilities:		
Accounts Payable		31,327,983
Accrued Salaries and Benefits		36,888,766
Estimated Third Party Settlements (Note 5)		21,481,653
Due to Patients or Third Parties		2,715,894
Due to Primary Government		4,328,919
Due to State of North Carolina Component Units		23,330,252
Bond Interest Payable		433,321
Funds Held for Others		1,208,686
Long-Term Liabilities - Current Portion (Note 7)		13,415,123
Total Current Liabilities		135,130,597
Noncurrent Liabilities:		
Long-Term Liabilities (Note 7)		257,449,561
Hedging Derivative Liability (Note 3)		18,809,646
Estimated Third Party Settlements (Note 5)		47,866,409
Total Noncurrent Liabilities		324,125,616
Total Liabilities		459,256,213

NET ASSETS	
Invested in Capital Assets, Net of Related Debt	390,509,594
Restricted for Expendable Uses for:	
Maintenance Reserve Fund	142,052,698
Liability Insurance Trust Fund	6,261,669
Trust Fund Donations	504,794
Minority Interest in Carolina Dialysis, LLC	7,658,316
Unrestricted	448,675,145
Total Net Assets	$ 995,662,216

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, 2010

Exhibit A-2

REVENUES		
Operating Revenues:		
Net Patient Service Revenue (Note 9)	$	922,397,680
Other Operating Revenues		23,514,569
Prior Year Third Party Settlements		8,195,293
Total Operating Revenues		954,107,542
EXPENSES		
Operating Expenses:		
Salaries and Benefits		497,762,304
Medical and Surgical Supplies		161,315,247
Contracted Services		94,193,202
Other Supplies and Services		56,525,000
Communication, Utilities, and Travel		20,794,282
Medical Malpractice Costs		4,356,494
Depreciation and Amortization		52,639,101
Total Operating Expenses		887,585,630
Operating Income		66,521,912
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		41,811,381
Noncapital Gifts and Grants		244,443
Investment Income (Net of Investment Expense of $1,110,505.64)		32,945,887
Gain on Investments in Affiliates (Note 15)		377,858
Interest and Fees on Debt		(8,307,663)
Loss on Disposal of Capital Assets		(1,121,523)
Net Nonoperating Revenues		65,950,383
Income Before Other Revenues, Expenses, Gains, or Losses		132,472,295
Capital Grants		16,100,742
Refund of Prior Years Capital Appropriations		(1,326,801)
Health Care System Assessments (Note 14)		(62,388,618)
Increase in Net Assets		84,857,618
NET ASSETS		
Net Assets - July 1, 2009		910,804,598
Net Assets - June 30, 2010	$	995,662,216

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, 2010

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES		
Received from Patient or Third Parties	$	934,966,948
Payments to Employees and Fringe Benefits		(491,075,595)
Payments to Vendors and Suppliers		(342,660,899)
Payments for Medical Malpractice		(2,975,000)
Other Receipts		17,392,613
Net Cash Provided by Operating Activities		115,648,067
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State Appropriations		41,811,381
Health Care System Assessments		(62,388,618)
Interest and Fees Paid on Revenue Bonds		(359,768)
Principal Paid on Revenue Bonds		(952,000)
Noncapital Gifts and Grants		244,443
Net Cash Used by Noncapital Financing Activities		(21,644,562)
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES		
Principal Paid on Capital Revenue Bonds		(6,438,000)
Principal Paid on Notes Payable		(11,722,616)
Interest and Fees Paid on Capital Debt		(7,196,581)
Capital Grants		16,041,744
Refund of Prior Years Capital Appropriations		(1,326,801)
Acquisition and Construction of Capital Assets		(86,878,697)
Refund of Funds Held in Escrow		3,446
Proceeds from Sale of Capital Assets		80,400
Net Cash Used by Capital Financing and Related Financing Activities		(97,437,105)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment Income		6,054,613
Investments In and Loans to Affiliated Enterprises:		
Cash Receipts		139,497
Net Cash Provided by Investing Activities		6,194,110
Net Increase in Cash and Cash Equivalents		2,760,510
Cash and Cash Equivalents - July 1, 2009		362,498,492
Cash and Cash Equivalents - June 30, 2010	$	365,259,002

RECONCILIATION OF NET OPERATING REVENUES (EXPENSES) TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating Income	$	66,521,912
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation and Amortization Expense		52,639,101
Changes in Assets and Liabilities:		
Patient Accounts Receivable		(1,916,595)
Other Accounts Receivable		(4,466,499)
Estimated Third Party Settlements		7,560,441
Inventories		622,203
Prepaid Expenses		(22,142,092)
Advance Deposits with Liability Insurance Trust Fund		1,381,494
Accrued Salaries and Benefits		6,188,966
Accounts and Other Payables		11,686,720
Due to Patients or Third Parties		(1,269,576)
Funds Held for Others		(294)
Compensated Absences		(1,157,714)
Net Cash Provided by Operating Activities	$	115,648,067
RECONCILIATION OF CASH AND CASH EQUIVALENTS		
Current Assets:		
Cash and Cash Equivalents	$	110,011,529
Restricted Cash and Cash Equivalents		9,832,151
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		143,819,965
Cash Designated for Capital Projects		101,595,357
Total Cash and Cash Equivalents - June 30, 2010	$	365,259,002
NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES		
Investments in Affiliated Enterprises:		
Current Gain from Equity Method Adjustments	$	377,858
Change in Fair Value of Investments		26,739,976
Loss on Disposal of Capital Assets		(1,121,523)

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

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NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

A. Organization - The University of North Carolina Hospitals at Chapel Hill (the Hospitals) is the only state-owned teaching hospital in North Carolina. With a licensed base of 799 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, North Carolina Women's Hospital and North Carolina Cancer 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 (GAAP), 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 multi-campus University of North Carolina System, 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), component units of the Hospitals, are reported as if they were part of the Hospitals.

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

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

Separate financial statements for the LLC and CDLLC may be obtained from the Chief Financial Officer, University of North Carolina Hospitals, 307 Med Wing E, 101 Manning Drive, Chapel Hill, North Carolina, 27514, or by calling (919) 966-5112. Other related foundations and similar nonprofit corporations for which the Hospitals is not financially accountable are not part of the accompanying financial statements.

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

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

accordingly, is reported within a single column in the basic financial statements.

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

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

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

E. Cash and Cash Equivalents - This classification includes undeposited receipts, petty cash, security deposits, cash on deposit with private bank accounts, cash on deposit with fiscal agents, and deposits held by the State Treasurer in the Short-Term Investment Fund. The Short-Term Investment Fund maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty.

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 estimated amounts 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 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 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, including intangible assets, that have a value or cost of $5,000 or greater at the date of acquisition and an estimated useful life of more than one year except for internally generated software which is capitalized when the value or cost is $1,000,000 or greater. Useful life estimates are assigned based on the American Hospital Association publication *Estimated Useful Lives of Depreciable Hospital Assets*.

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

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 equal to 7.5% of gross patient revenue as limited by applicable revenue bond covenants, and resources designated for liability insurance claims. 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 funds.

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

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

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

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

Paid Time Off (PTO) Plan - The PTO program combines the various leave types that employees may earn into one earning rate that varies depending upon years of service. This program is mandatory for all new employees. The policy provides for a maximum accumulation of 280 hours of unused PTO 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 has a sell back feature that allows employees to sell back 100% of their accumulated hours over a minimum floor. Prior to fiscal year 2010, this sell back feature was annual, with a payout in January. Beginning July 1, 2009, the sell back feature became semi-annual, with payouts in June and December. During fiscal year 2010, the annual payout in January was available to eligible employees who had made the election in the previous year. However, starting in fiscal year 2011, only the semi-annual payouts in June and December will be available. Under the semi-annual payout plan, employees can sell back from eight to 100 hours of their PTO balance with a balance of at least 140 hours at the time of the sell back. There is a 10% forfeiture of the cash value to remain compatible with IRS regulations regarding taxability.

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

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

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

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

Invested in Capital Assets, Net of Related Debt - This represents the Hospitals' total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been

incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

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

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

Restricted and unrestricted resources are tracked using a fund accounting system and are spent in accordance with established fund authorities. Fund authorities provide rules for the fund activity and are separately established for restricted and unrestricted activities. When both restricted and unrestricted funds are available for 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 capital assets, are considered nonoperating since these are either investing, capital, or noncapital financing activities.

Capital grants 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, 2009, (less amounts previously recorded at June 30, 2009, for in house patients) and all charges on in house accounts and all charges for outpatient accounts registered after June 30, 2009. The difference between established rates and the estimated amount collectible is recognized as revenue deductions on an accrual basis and deducted from gross patient service revenue to report service revenue at net realizable value. Revenue deductions consist of charges for charity care, contractual allowances, and bad debt.

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

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

Q. Medical Malpractice Cost - Medical malpractice costs represent the actuarially determined contribution to the Liability Insurance Trust Fund. See Note 12 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 *North Carolina 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, 2010, the amount shown on the Statement of Net Assets as cash and cash equivalents includes $348,312,699 which represents the Hospitals' equity position in the State Treasurer's Short-Term Investment Fund. The Short-Term Investment Fund (a portfolio within the State Treasurer's Investment Pool, an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating) had a weighted average maturity of 1.6 years as of June 30, 2010. 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.osc.nc.gov/ and clicking on "Proceed directly to OSC's index page," then "Reports," or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

Cash on hand at June 30, 2010 was $35,963. The carrying amount of the Hospitals' deposits not with the State Treasurer was $16,910,340 and the bank balance was $22,064,452. 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, 2010, $21,374,358 of the Hospitals' bank balance was uninsured and uncollateralized.

B. Investments - Pursuant to *North Carolina 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, 2010, the amount shown on the Statement of Net Assets which represents funds deposited with and invested by the State Treasurer is $262,359,263. The State Treasurer contracted with an external party (Trustee) to create the University of North Carolina Hospitals at Chapel Hill Trust (Trust). The 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.osc.nc.gov/ and clicking on "Proceed directly to OSC's index page," then "Reports," or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

C. Reconciliation of Deposits and Investments

A reconciliation of deposits and investments for the Hospitals at June 30, 2010, is as follows:

Cash on Hand	$	35,963
Carrying Amount of Deposits with Private Financial Institutions		16,910,340
Deposits in the Short Term Investment Fund		348,312,699
Investments with the State Treasurer		262,359,263
Total Deposits and Investments	$	627,618,265
Deposits		
Current:		
Cash and Cash Equivalents	$	110,011,529
Restricted Cash and Cash Equivalents		9,832,151
Noncurrent:		
Restricted Cash and Cash Equivalents		143,819,965
Cash Designated for Capital Projects		101,595,357
Total Deposits		365,259,002
Investments		
Noncurrent:		
Investments		102,999,827
Investments Designated for Capital Projects		159,359,436
Total Investments		262,359,263
Total Deposits and Investments	$	627,618,265

NOTE 3 - DERIVATIVE INSTRUMENTS

Derivative instruments held at June 30, 2010, are as follows:

		Change in Fair Value		Fair Value at June 30, 2010	
Type	Notional Amount	Classification	Decrease	Classification	Liability
Hedging Derivative Instruments					
Cash Flow Hedges					
Pay-Fixed Interest Rate Swap 2003A & 2003B Bonds	$ 94,600,000	Deferred Outflow of Resources	$ (4,352,717)	Hedging Derivative Liability	$ (13,574,099)
Pay-Fixed Interest Rate Swap 2009A Bonds	$ 42,020,000	Deferred Outflow of Resources	(1,243,851)	Hedging Derivative Liability	(5,235,547)
			$ (5,596,568)		$ (18,809,646)

Hedging derivative instruments held at June 30, 2010, are as follows:

Type	Objective	Notional Amount	Effective Date	Maturity Date	Terms
Pay-Fixed Interest Rate Swap	Hedge of Changes in Cash on the 2003 A&B Series	$ 94,600,000	2/13/2003	2/1/2029	Pay 3.48% Receive 67% LIBOR
Pay-Fixed Interest Rate Swap	Hedge of Changes in Cash on the 2009A Series Bonds	$ 42,020,000	2/12/2009	2/1/2024	Pay 3.48% Receive 67% LIBOR

The fair value of the pay-fixed interest rate swaps was estimated by Bank of America, National Association (BOA) using the zero coupon method. This method calculates the present value of the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for London Inter-Bank Offered Rate (LIBOR) due on the date of each future net settlement on the swap.

The Hospitals' interest rate swap hedging derivatives have been determined to be effective using the synthetic instrument method.

Risks

Interest Rate Risk: The Hospitals is exposed to interest rate risk on its interest rate swaps. The fair values of these instruments are sensitive to interest rate changes. Because rates have changed since the effective dates of the swaps, both of the swaps have a negative fair value as of

June 30, 2010. The negative fair value may be countered by a reduction in total interest payments required under the variable-rate bonds, creating lower synthetic interest rates. Because the coupons on the Hospitals' variable-rate bonds adjust to changing interest rates, the bonds do not have corresponding fair value increases. As the yield curve rises, the value of the swaps will increase and as rates fall, the value of the swaps will decrease. The fair values reported are the market values as of June 30, 2010.

Credit Risk: As of June 30, 2010, the Hospitals is not exposed to credit risk because the swaps have a negative fair value. However, should interest rates change and the fair value of the swaps become positive, the Hospitals would be exposed to credit risk in the amount of the derivatives' fair value. The Hospitals has a policy of requiring collateral to support hedging derivative instruments subject to credit risk. This policy states that at such time that BOA's 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).

The Hospitals entered into a master agreement with the International Swap Dealers Association, Inc. (ISDA) in January 2003. In this agreement, master netting arrangements were established between the contractual parties. All derivative instruments held by the Hospitals are subject to this agreement.

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 contracts use 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 the 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.

NOTE 4 - 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 30, 2010. 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, 2010:

	Amount
In House Patients	$ 41,846,087
Discharged (Not Final Billed) Patients	62,356,276
Total Unbilled	104,202,363
Discharged (Billed) Patients	240,968,257
Payment Arrangements	494,552
Charity Care Provided	(47,060,395)
Current Gross	298,604,777
Allowance for Bad Debts	(19,752,755)
Contractual Allowances	(160,565,797)
Total Allowances	(180,318,552)
Current - Net	$ 118,286,225

B. Noncurrent - Net patient accounts receivable consisted of $8,167,610 (net of $7,408,386 estimated uncollectible) and represents the value of patient payment arrangements that are initiated at the request of the patient. These payment arrangements are based on signed contractual agreements for the specific monthly amounts that extend beyond one year but are capped at three years.

NOTE 5 - ESTIMATED THIRD PARTY SETTLEMENTS

The Hospitals renders care to patients covered by the 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, the Hospitals receives interim pass-through payments from Medicare for costs such as organ costs, graduate medical education, bad debts, etc., that are ultimately settled through the annual Medicare Cost Report. 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 allowable cost through the filing of an annual cost report. In addition to Tricare/Champus payments for services on an interim basis, the Tricare/Champus program reimburses the Hospitals for a portion of capital and direct medical education costs based on the Medicare cost report.

The Hospitals has calculated the estimated third party settlements for the outstanding Medicare, Medicaid, and Tricare/Champus cost reports during the fiscal year ended 2010. It is estimated that the Hospitals owes Medicare $21,481,653 within the next twelve months and that $19,559,406 and $28,307,003 are owed to Medicare and Medicaid respectively on a noncurrent basis. Medicaid and Tricare/Champus currently owe the Hospitals $31,499,834 and $4,000,000 respectively. Included in the estimated liability amounts above, management reserved $62,107,055 for all outstanding Medicare and Medicaid cost reports. The reserve for Medicare is calculated based on at-risk items for all outstanding Medicare cost reports while the reserve for Medicaid equals a percentage of allowable Medicaid costs deemed appropriate by management. The Hospitals also included in its estimated liability for both Medicare and Medicaid a reserve for the claims audit program. This program is in the process of being implemented by Centers for Medicare and Medicaid Services to identify improper underpayments or overpayments made to health care providers. An estimate is made for the current year's Medicare, Tricare/Champus, and Medicaid settlement 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 or the Medicare or Medicaid programs feel are warranted. There are several such requests under consideration, as well as audits that are incomplete at this time. Any of the above can result in a change to the reimbursement requiring a refund from the program or payment to the program.

NOTE 6 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2010, is presented as follows:

	Balance July 1, 2009	Increases	Decreases	Balance June 30, 2010
Capital Assets, Nondepreciable:				
Land	$ 23,352,302	$ 18,025,548	$ 0	$ 41,377,850
Construction in Progress	149,189,678	35,797,267	153,196,325	31,790,620
Total Capital Assets, Nondepreciable	172,541,980	53,822,815	153,196,325	73,168,470
Capital Assets, Depreciable:				
Buildings	366,460,959	153,196,326	8,790,501	510,866,784
Machinery and Equipment	334,215,113	31,759,613	19,959,298	346,015,428
General Infrastructure	5,197,281			5,197,281
Computer Software	25,779,295	5,983,425	2,784,716	28,978,004
Total Capital Assets, Depreciable	731,652,648	190,939,364	31,534,515	891,057,497
Less Accumulated Depreciation/Amortization for:				
Buildings	124,192,581	19,580,543	5,383,594	138,389,530
Machinery and Equipment	224,708,359	32,168,468	18,188,769	238,688,058
General Infrastructure	4,102,016	211,068		4,313,084
Computer Software	19,840,610	644,402	73,947	20,411,065
Total Accumulated Depreciation	372,843,566	52,604,481	23,646,310	401,801,737
Total Capital Assets, Depreciable, Net	358,809,082	138,334,883	7,888,205	489,255,760
Capital Assets, Net	$ 531,351,062	$ 192,157,698	$ 161,084,530	$ 562,424,230

NOTE 7 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2010, is presented as follows:

	Balance July 1, 2009	Additions	Reductions	Balance June 30, 2010	Current Portion
Revenue Bonds Payable	$ 262,150,000	$ 0	$ (7,390,000)	$ 254,760,000	$ 7,615,000
Add Premium	815,860		(236,739)	579,121	
Deduct Deferred Charge on Refunding	(15,561,371)		963,932	(14,597,439)	
Total Revenue Bonds Payable	247,404,489		(6,662,807)	240,741,682	7,615,000
Notes Payable	14,430,820		(11,722,616)	2,708,204	2,708,204
Arbitrage Rebate Payable	268,892			268,892	
Compensated Absences	28,303,620	42,302,098	(43,459,812)	27,145,906	3,091,919
Total Long-Term Liabilities	$ 290,407,821	$ 42,302,098	$ (61,845,235)	$ 270,864,684	$ 13,415,123

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, 2010	Principal Outstanding June 30, 2010
Rex Acquisition and Hospitals Renovations	2001A	0.20% *				
	2001B	0.21% *	02/15/2031	$ 110,000,000	$ 10,400,000	$ 99,600,000
Refund Portion of 1996 Revenue Bonds	2003A	3.51% **				
	2003B	3.55% **	02/01/2029	98,015,000	3,415,000	94,600,000
Refund Portion of 1996 Revenue Bonds	2005A	3.00% to 5.00 %	02/01/2015	30,540,000	12,000,000	18,540,000
Refund 1999 Revenue Bonds	2009A	3.59% **	02/01/2024	44,290,000	2,270,000	42,020,000
Total Revenue Bonds Payable (principal only)				$ 282,845,000	$ 28,085,000	254,760,000
Less: Unamortized Loss on Refunding						(14,597,439)
Plus: Unamortized Premium						579,121
Total Revenue Bonds Payable						$ 240,741,682

* For variable rate debt, interest rates in effect at June 30, 2010 are included.
** For variable rate debt with interest rate swaps, the synthetic fixed rates in effect at June 30, 2010 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 with the exception of Series 2009A Advanced Refunding bonds, for which the Hospitals acts as its own liquidity facility.

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 were used for the renovation of space vacated after the opening of the North Carolina Women's Hospital, North Carolina Children's Hospital, and associated support services. While initially bearing interest in a daily mode, the mode on these bonds may change to a weekly rate, a unit pricing rate, a term rate or a fixed rate.

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

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and Landesbank Hessen-Thuringen Girozentrale, a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require an adjustable facility fee based on the long-term rating of the bonds, which is calculated as a percentage of the available commitment. Payments are made quarterly in arrears, on the first business day of each July, October, January, and April thereafter until the expiration date or the termination date of the Agreements. For the 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, 2014.

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, 2010, there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The Agreements allow the Hospitals to redeem bank bonds in equal quarterly installments, on the first business day of January, April, July, and October. The payments will commence with the first business day of any such month that is at least 90 days following the applicable Purchase Date of the Bank

Bond and end no later than the fifth anniversary of such Purchase Date. If the take out agreement were to be exercised because the entire outstanding $99,600,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $21,662,956 a year for five years under the installment loan agreement assuming a 3.25% 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 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, Wells Fargo Bank, National Association. The Hospitals' Remarketing Agents, Banc of America Securities LLC (Series 2003A) and Wells Fargo 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, National Association (Series 2003A) and Wells Fargo Bank, National Association (Series 2003B), Liquidity Facilities have 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.

The 2003A Agreement with Bank of America, National Association was amended on June 9, 2010, and requires a facility fee equal to 0.58% of the available commitment for Series 2003A payable quarterly in arrears, beginning on August 1, 2010, and on each November 1, February 1, May 1, and August 1, thereafter until the expiration date or the termination date of the Agreement. The facility fee remains in effect over the life of the Agreement so long as the rating assigned to Parity Debt assigned by Moody's and S&P is A1/A+ or higher. If the rating assigned to Parity Debt by either Moody's or S&P is downgraded below A1 or A+, respectively, the Commitment Rate assigned to such lower rating as set forth below shall apply, effective as of the public announcement of the rating:

S&P	Moody's	Commitment Rate
A	A2	0.78%
A- or lower	A3 or lower	0.98%

Under the 2003A Agreement, 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 equal to the greater of the Prime rate plus 1.50% or the Federal Funds Rate plus 3.00%, the Base Rate, for the first 90 days and then the Base Rate plus 0.50% from the 91st day to the 367th day following the date of purchase and the Base Rate plus 1.00% from the 368th day following such date of purchase and thereafter 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 calendar month following the date on which such Bank Bond became a Bank Bond. At June 30, 2010, there were no Bank Bonds held by the 2003A Liquidity Facility.

Included in the 2003A Agreement is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within the earlier of the termination date and 367 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 six consecutive, equal semi-annual installments of principal beginning on the first business day of the month that occurs at least five and not more than six months following the termination date, until fully paid. In any event, all principal and accrued and unpaid interest shall be due and payable on the date the sixth installment is due. If the take out agreement were to be exercised because the entire outstanding $61,530,000 of demand bonds was "put" and not resold, the

Hospitals would be required to pay $23,394,218, $22,573,820 and $21,394,496 in years one, two and three respectively following the termination date under the installment loan agreement assuming a Base Rate of 4.75% (Prime plus 1.50%).

The current expiration date of the Series 2003A Agreement is July 1, 2011. The Hospitals may request additional extensions, which are approved at the discretion of the Liquidity Provider.

The 2003B Agreement with Wells Fargo Bank, National Association was amended on June 30, 2010 and requires a facility fee equal to 0.60% of the available commitment for Series 2003B payable quarterly in arrears, beginning on November 1, 2010, and on each February 1, May 1, August 1, and November 1 thereafter until the expiration date or the termination date of the Agreement. The facility fee remains in effect over the life of the Agreement so long as the rating assigned to Parity Debt assigned by S&P and Moody's is A+/A1 or higher. If the rating assigned to Parity Debt by either S&P or Moody's is downgraded below A+ or A1, respectively, the adjusted Hospitals' Commitment Rate (lowest rating to be used) assigned to such lower rating as set forth below shall apply, effective as of the public announcement of the rating:

S&P	Moody's	Commitment Rate
A	A2	0.75%
A-	A3	0.90%
BBB+	Baa1	1.10%
BBB+	Baa2	1.35%
BBB-	Baa3	1.65%
Below investment grade	Below investment grade	2.65%

Under the 2003B Agreement, 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 equal to the greater of the Prime rate plus 1.00%, the Federal Funds Rate plus 2.00% or 7.00%, the Base Rate, plus 2.00% 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. At June 30, 2010, there were no Bank Bonds held by the 2003B Liquidity Facility.

Included in the 2003B Agreement is a take out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" by the termination date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The Series 2003B Agreement allows the Hospitals to redeem bank bonds in 11 equal quarterly

installments of principal, on the first business day of each February, May, August, and November, beginning on the first of such dates that occurs at least 90 days after the Purchase Date of such Bank Bonds. The Hospitals shall pay interest in arrears on each date that would be an Interest Payment Date for the Series 2003B Bonds, beginning on the first Interest Payment Date that occurs after the Loan Date. If the take out agreement were to be exercised because the entire outstanding $33,070,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $11,093,482, $13,874,369, and $12,792,077 in years one, two, and three respectively following the purchase date of the Bank Bonds assuming a Base Rate of 7.00%.

The current expiration date of the Series 2003B Agreement is July 31, 2011. The Hospitals may request additional extensions, which are approved at the discretion of the Liquidity Provider.

University of North Carolina Hospitals at Chapel Hill Revenue Refunding Bonds - Series 2009A: On February 12, 2009, the Hospitals issued Series 2009A tax-exempt variable rate demand bonds in the amount of $44,290,000 that have a final maturity date of February 1, 2024. The bonds are subject to mandatory sinking fund redemption that began on February 1, 2010. The proceeds were used to advance refund $43,505,000 of the Series 1999 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 upon delivering irrevocable written notice of tender or irrevocable telephonic notice of tender to the Remarketing Agent not later than 4:00 p.m. on a Business Day not less than seven (7) days before the Purchase Date and upon delivering such Series 2009A bonds to the bond Tender Agent, U.S. Bank, National Association, no later than noon on such Purchase Date. The Hospitals' Remarketing Agent, Banc of America Securities LLC has 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 0.09% of the weighted average daily principal amount of Series 2009A Bonds outstanding during such periods in which the Series 2009A Bonds are Variable Rate Bonds.

Under a separate Liquidity Agreement with the Trustee, the Hospitals has established itself as Liquidity Facility 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. Upon receipts of any notice from the Remarketing Agent that there is a

Projected Funding Amount on the Business Day prior to each Purchase Date or Mandatory Purchase Date, and upon receipts of written demand for payment from the Tender Agent by noon on each Purchase Date or Mandatory Purchase Date, the Hospitals shall wire to the Tender Agent, in immediately available funds, an amount equal to the Actual Funding Amount, which shall be equal to the Purchase Price of all Series 2009A bonds tendered or deemed tendered, less the aggregate amount of remarketing proceeds received by the Remarketing Agent, by not later than 2:00 p.m. on the Purchase Date or Mandatory Purchase Date.

D. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2010, are as follows:

	Annual Requirements				
	Revenue Bonds Payable			Notes Payable	
Fiscal Year	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest
2011	$ 7,615,000	$ 1,380,516	$ 4,479,997	$ 2,708,204	$ 23,250
2012	7,900,000	1,201,394	4,390,408		
2013	8,380,000	1,010,714	4,275,311		
2014	8,695,000	812,968	4,174,625		
2015	9,000,000	604,887	4,064,812		
2016-2020	52,195,000	2,123,794	16,709,162		
2021-2025	63,580,000	1,473,095	9,015,127		
2026-2030	79,195,000	659,865	2,176,056		
2031-2035	18,200,000	23,510			
Total Requirements	$ 254,760,000	$ 9,290,743	$ 49,285,498	$ 2,708,204	$ 23,250

Interest on the variable rate 2001A and 2001B revenue bonds is calculated based upon the fiscal year 2010 effective rates at which the bonds were remarketed of 0.20% and 0.21%, respectively. Interest on the variable rate 2003A, 2003B, and 2009A revenue bonds is calculated based upon the synthetic rates at June 30, 2010, of 3.51%, 3.55%, and 3.59%, respectively. This schedule also includes the debt service requirements for debt associated with interest rate swaps. See Note 7C for more information on the demand bonds and Note 3 for more information on 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	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2010	Principal Outstanding June 30, 2010
Medical Equipment	SunTrust	3.43%	09/29/2010	$ 50,000,000	$ 47,291,796	$ 2,708,204

NOTE 8 - 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, 2010:

Fiscal Year	Amount
2011	$ 2,310,042
2012	2,126,352
2013	2,023,972
2014	1,619,369
2015	1,027,404
2016-2020	1,973,516
Total Minimum Lease Payments	$ 11,080,655

Rental expense for all operating leases during the year was $2,940,342.

NOTE 9 - 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, including capital related costs and add-on payments for indirect medical education and disproportionate share.

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 5, 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.

Medicare reimburses the Hospitals for services furnished in the inpatient psychiatric unit under the provisions of the Inpatient Psychiatric Facility Prospective Payment System (IPF PPS). Under this system, payment to IPFs is based on a federal per diem base rate that includes both inpatient operating and capital-related costs (including routine and ancillary services) but excludes certain pass-through costs (i.e., bad debt and direct medical education). The federal per diem base rate provides patient-level and facility-level adjustments including wage index and teaching adjustments. The payment for an individual patient is further adjusted for factors such as the Diagnosis Related Group classification, age, length of stay, and the presence of specified comorbidities. Additional payments are provided for cost outlier cases, a qualifying emergency department (ED) and electroconvulsive therapy treatments.

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 at an agreed-upon rate based on documented costs. Medicaid also reimburses the Hospitals for graduate medical education costs. In addition, Medicaid reimburses the Hospitals for providing services to a disproportionate share of uninsured and low income patients. 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.

Commercial/Managed Care Payer Agreements: The Hospitals has entered into reimbursement agreements with certain commercial insurance carriers and managed care organizations to accept patients on a discounted fee for service basis. The basis for reimbursement under these agreements includes case rates

per discharge, discounts from established charges, fee schedules, and per diem rates.

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

A summary of net patient service revenue for the year ended June 30, 2010, follows:

	2010
Inpatient Routine	$ 387,581,178
Inpatient Ancillary	755,364,789
Outpatient	890,033,121
Charity Care Provided	(121,756,249)
Gross Patient Service Revenue	1,911,222,839
Medicare Contractual Allowance	(353,384,430)
Medicaid Contractual Allowance	(256,720,787)
Managed Care Contractual Allowance	(307,874,550)
Other Contractual Allowances	(22,903,522)
Bad Debt	(47,941,870)
Contractual Adjustments	(988,825,159)
Net Patient Service Revenue	$ 922,397,680

NOTE 10 - PENSION PLANS

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

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

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2010, these rates were set at 3.57% of covered payroll for employers and 6% of covered payroll for members.

For the current fiscal year, the Hospitals had a total payroll of $390,301,553, of which $331,129,294 was covered under the Teachers' and State Employees' Retirement System. Total employer and employee contributions for pension benefits for the year were $11,821,316 and $19,867,758, respectively.

Required employer contribution rates for the years ended June 30, 2009, and 2008, were 3.36% and 3.05%, respectively, while employee contributions were 6% each year. The Hospitals made 100% of its annual required contributions for the years ended June 30, 2010, 2009, and 2008, which were $11,821,316, $10,453,508, and $8,746,589, respectively.

The Teachers' and State Employees' Retirement System's financial information is included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page http://www.osc.nc.gov/ and clicking on "Proceed directly to OSC's index page," then "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 $728,564 for the year ended June 30, 2010.

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 *North Carolina General Statute* 143-166.30(e). Total employer contributions on behalf of the Hospitals' law enforcement officers for the year ended June 30, 2010, were $57,819. The voluntary contributions by employees amounted to $2,568,974 for the year ended June 30, 2010.

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 $3,555,804 for the year ended June 30, 2010.

NOTE 11 - 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 their retirement system prior to disability or retirement.

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

By General Statute, a Retiree Health Benefit Fund (the Fund) has been established as a fund in which accumulated contributions from employers and any earnings on those contributions shall be used to provide health benefits to retired and disabled employees and applicable beneficiaries. By statute, the Fund is administered by the Board of Trustees of the Teachers' and State Employees' Retirement System and contributions to the Fund are irrevocable. Also by law, Fund assets are dedicated to providing benefits to retired and disabled employees and applicable

beneficiaries and are not subject to the claims of creditors of the employers making contributions to the Fund. Contribution rates to the Fund, which are intended to finance benefits and administrative expenses on a pay-as-you-go basis, are determined by the General Assembly.

For the current fiscal year the Hospitals contributed 4.5% of the covered payroll under the Teachers' and State Employees' Retirement System to the Fund. Required contribution rates for the years ended June 30, 2009, and 2008, were 4.1% and 4.1%, respectively. The Hospitals made 100% of its annual required contributions to the Plan for the years ended June 30, 2010, 2009, and 2008, which were $14,900,818, $12,755,768, and $11,757,710, respectively. The Hospitals assumes no liability for retiree health care benefits provided by the programs other than its required contribution.

Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page http://www.osc.nc.gov/ and clicking on "Proceed directly to OSC's index page," then "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 *North Carolina 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 by the General Assembly. For the fiscal year ended June 30, 2010, 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, 2009, and 2008, were .52% and .52%, respectively. The Hospitals made 100% of its annual required contributions to the DIPNC for the years ended June 30, 2010, 2009, and 2008, which were $1,721,872, $1,617,805, and $1,491,222, respectively. The Hospitals assumes no liability for long-term disability benefits under DIPNC other than its contribution.

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

NOTE 12 - 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 retained 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. 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.

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 $10,000,000 per occurrence. The Hospitals pays premiums to the North Carolina Department of Insurance for the coverage.

The Hospitals is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is handled by the North Carolina Department of Insurance. The Hospitals is charged a premium by the private insurance company. Coverage limit is $5,000,000 per occurrence. The private insurance company pays 90% of each loss less a $75,000 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;

- Directors and Officers Liability insurance up to $15,000,000 with a deductible of $200,000 per occurrence; with excess coverage of $10,000,000;
- 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; with excess coverage of $5,000,000;
- General Liability for Helipad on Premises insurance up to $20,000,000 with a deductible of $10,000 per aircraft;
- General Liability for Non-owned Aircraft insurance up to $20,000,000 per occurrence 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 $100,000 with a deductible of $1,000 per occurrence.

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

The North Carolina Workers' Compensation Program provides benefits to workers injured on the job. All employees of the State and its component units are included in the program. When an employee is injured, the Hospitals' primary responsibility is to arrange for and provide the necessary treatment for work related injury. The Hospitals is responsible for paying medical benefits and compensation in accordance with the North Carolina Workers' Compensation Act. The Hospitals retains the risk 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 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 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 Hospitals. Only the UNC P&A and the 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 13 members as follows: one member each appointed by the State Attorney General, the State Auditor, the State Insurance Commissioner, the Director of the Office of State Budget and Management, the State Treasurer, (each serving at the pleasure of the appointer); and eight members appointed to three year terms (with no limit on the number of terms) by the UNC System's Board of Governors.

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

For the period July 1, 2009, through June 30, 2010, 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, as the Trust Fund chose to retain 100% of the liability. In lieu of reinsurance, the participants contributed $10,000,000 in the aggregate toward the Reimbursement Fund for future losses. In addition, during fiscal year 2010, the participants contributed additional $1,006,106 to replenish the Reimbursement Fund to its original $10,000,000 level. For the fiscal year ended June 30, 2010, 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 Trust Fund from further obligation. The related claim liabilities have been removed from estimated malpractice costs.

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

At June 30, 2010, the Hospitals' assets in the Trust Fund totaled $28,551,750 while Hospitals' liabilities totaled $22,290,081 resulting in net assets of $6,261,669.

Additional disclosures relative to the funding status and obligations of the Trust 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, University of North Carolina Health Care System, 211 Friday Center Drive, Hedrick Building, Room 2029, Chapel Hill, NC 27517.

NOTE 13 - 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 $18,899,797 and on other purchases were $28,296,650 at June 30, 2010.

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.

NOTE 14 - RELATED PARTIES

University of North Carolina Health Care System Enterprise Fund - The Board of Directors of UNC Health Care System (System) authorized and approved the creation of an Enterprise Fund to support the System's mission and vision to be the nation's leading public academic health care system. The key components of the System contributing to the Enterprise Fund during fiscal year 2010 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 ended June 30, 2010, the Hospitals was assessed $43,088,618 to fund initiatives supported by the Enterprise Fund.

In fiscal year 2007 the System's Board of Directors approved a $10 million transfer to the UNC School of Medicine (SOM) with the intent of making transfers in fiscal year 2008 and fiscal year 2009 but did not due to uncertainty caused by the recession. The SOM has had an ongoing need for funding and the strong performance of the Hospitals during fiscal year 2010 made an additional $10 million transfer possible.

On July 21, 2008, the System purchased a controlling interest in Chatham Hospital, Inc. for $2 million on the closing date and a contractual commitment to pay an additional $9.3 million to expand health care services in Chatham County. At the direction of the System, the Hospitals transferred $2 million on the closing date and paid the remaining commitment during fiscal year 2010.

Rex Healthcare, Inc. - Rex Healthcare, Inc. (Rex) is a not-for-profit corporation and is exempt from federal and North Carolina income taxation as a 501(c)(3) charitable organization. Rex does not conduct active operations but serves as the parent corporation for a multi-entity health care delivery system that was organized to provide a wide range of health care services to the residents of Wake County, North Carolina and surrounding counties. The

System acquired Rex in 2000 and is the sole member of the corporation. The System appoints eight of the 13 seats on Rex's Board of Trustees and also reviews and approves Rex's annual operating and capital budgets. The principal corporate entities under the common control of Rex Healthcare, Inc. are:

Rex Hospital, Inc. - Rex Hospital, Inc. is a 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), Knightdale, and Apex. Rex Hospital, Inc. also owns Rex Home Services, Inc. that primarily serves residents of Wake County and Smithfield Radiation Oncology, LLC.

Rex Enterprises Company, Inc. - Rex Enterprises Company, Inc. is a North Carolina for-profit corporation organized to hold investments in various affiliates and to promote the development of real property in support of the mission of Rex. Rex Enterprises Company, Inc. is the sole member of Rex CDP Ventures, LLC, which is a limited liability company organized to own and develop real estate in the Wakefield community of northern 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 residents in Rex's service area by promoting philanthropic contributions and public support of Rex.

Rex Holdings, LLC - Rex Holdings, LLC was formed in 2007 to provide medical services through various affiliations, joint ventures and independent physician practices. Rex Holdings is the sole member of Rex Physicians, LLC, which was established in 2009 to employ physicians of specialty practices.

The 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 $1,962,537 from Rex and the Hospitals paying $618,915 to Rex during the year ended June 30, 2010.

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, Inc. - Chatham Hospital, Inc. is a private, nonprofit 501(c)(3) corporation that owns and operates a 25-bed critical access facility located in Siler City, North Carolina. The facility operates 21 acute/swing beds and four intensive care beds, along with a complement of surgical suites, emergency room, and ancillary services.

The Hospitals entered into a five year management agreement with Chatham Hospital, Inc. on August 1, 2006, which includes staffing and assistance with operations and planning.

The Hospitals was paid $196,743 for these services during the year ended June 30, 2010.

On February 8, 2007, the Hospitals established a $1,999,000 escrow account to serve as collateral for some of the financial covenants related to Chatham Hospital, Inc. debt. On February 10, 2010, the Department of Housing and Urban Development's Office of Insured Health Care Facilities approved the release of the escrow funds for deposit into the Chatham Hospital, Inc. MOB (medical office building) Construction Fund. According to the terms of the escrow agreement, the $1,999,000 balance converted into a note payable to the Hospitals effective upon the release of the escrow funds.

By contractual agreement, the System became the sole member of Chatham Hospital, Inc. on July 1, 2008. The System appoints nine of the 15 members on the Chatham Hospital, Inc. Board and reviews and approves its annual operating and capital budgets.

Triangle Physician Network, LLC - Triangle Physician Network, LLC (TPN) is a wholly owned subsidiary of the System that owns and operates twelve community based practices throughout the Triangle (Raleigh, Durham and Chapel Hill), North Carolina area. The purpose of the community based practices is to provide care close to home for the convenience of the patients and allow clinicians and staff of the System to be part of their local communities.

The Hospitals provides purchasing, accounts payable, and accounting services to TPN and has accrued $218,327 for services provided during the fiscal year. TPN also paid $1,952,946 for supplies and bio-medical equipment services received from the Hospitals during fiscal year 2010.

First Health-UNC HCS, LLC - First Health–UNC HCS, LLC is a joint venture between the System and First Health of the Carolinas, Inc., which was created to purchase and operate Sanford Hematology & Oncology (SHO), a

clinic located in Sanford, North Carolina. Each entity has a 50% ownership interest in SHO.

First Health - UNC HCS, LLC paid the Hospitals $1,491,019 for supplies and bio-medical equipment services received during fiscal year 2010.

NOTE 15 - INVESTMENT IN AFFILIATES

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were $2,433,769 at June 30, 2010. The Hospitals' share of these affiliates and joint ventures is not significant individually. The summarized financial information below represents an aggregation of the ongoing affiliates and joint ventures:

	2010 (Unaudited)
TOTAL AFFILIATE ACTIVITY	
Current Assets	$ 4,168,042
Noncurrent Assets	913,579
Current Liabilities	308,864
Shareholders Equity	4,772,757
Revenue	7,902,673
Net Gain	838,773
HOSPITALS' SHARE OF ACTIVITY	
Realized Affiliate Gain - Ongoing Operations	$ 377,858

NOTE 16 - CHANGES IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2010, the Hospitals implemented the following pronouncements issued by the Governmental Accounting Standards Board (GASB):

GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*.

GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*.

GASB Statement No. 51, requires reporting certain intangible assets as capital assets.

GASB Statement No. 53, requires reporting certain derivative instruments at fair value.

NOTE 17 - SUBSEQUENT EVENTS

On February 19, 2010, the Board of Governors of the University of North Carolina System approved the issuance of up to $50 million dollars in general revenue bonds to be used by the Hospitals. The University of North Carolina Health Care System Board of Directors ratified the issuance of these bonds on September 20, 2010. Bonds are expected to be issued before the end of the 2010 calendar year, and proceeds will be used to fund the Ambulatory Care Center Expansion and Renovation ($26.8 million) and the Imaging and Outpatient Center ($21.9 million); the remaining balance will fund general hospital renovations and equipment.

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STATE OF NORTH CAROLINA
Office of the State Auditor

Beth A. Wood, CPA
State Auditor

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

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

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

We have audited the financial statements of the University of North Carolina Hospitals, which is a part of the multi-campus University of North Carolina System, a component unit of the State of North Carolina, as of and for the year ended June 30, 2010, and have issued our report thereon dated October 19, 2010.

As discussed in Note 16 to the financial statements, the Hospitals implemented Governmental Accounting Standards Board Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* and Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, during the year ended June 30, 2010.

As discussed in Note 1 to the financial statements, 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 accounting standards generally accepted in the United States of America.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

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

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)

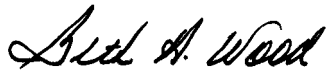
A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the Hospitals' financial statements will not be prevented, or detected and corrected on a timely basis.

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

Compliance and Other Matters

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

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



Beth A. Wood, CPA
State Auditor

October 19, 2010

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

Telephone: 919/807-7500

Facsimile: 919/807-7647