STATE OF NORTH CAROLINA

UNIVERSITY OF NORTH CAROLINA HOSPITALS

AT CHAPEL HILL

CHAPEL HILL, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2012

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

UNIVERSITY OF NORTH CAROLINA HOSPITALS

AT CHAPEL HILL

CHAPEL HILL, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2012

BOARD OF GOVERNORS

THE UNIVERSITY OF NORTH CAROLINA

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STATE OF NORTH CAROLINA
Office of the State Auditor

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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, 2012, 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

TABLE OF CONTENTS

PAGE

INDEPENDENT AUDITOR'S REPORT 1

MANAGEMENT'S DISCUSSION AND ANALYSIS 3

BASIC FINANCIAL STATEMENTS

Hospitals Exhibits

A-1 Statement of Net Assets 10

A-2 Statement of Revenues, Expenses, and Changes in Net Assets 12

A-3 Statement of Cash Flows 13

Notes to the Financial Statements 15

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* 53

ORDERING INFORMATION 55

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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 at Chapel Hill, 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, 2012, 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 at Chapel Hill 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 principles 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 at Chapel Hill as of June 30, 2012, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 16, 2012 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.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis be presented to supplement the basic financial statements. Such information, although not part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during the audit of the basic financial statements. However, we do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Beth A. Wood

Beth A. Wood, CPA
State Auditor

October 16, 2012

UNIVERSITY OF NORTH CAROLINA HOSPITALS AT CHAPEL HILL
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 team 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 2012 and 2011, 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 donated capital equipment 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.

Financial Highlights

- The Hospitals' total net assets increased $61 million during the year.
- Net patient service revenue increased 13% or $135 million from the prior year.
- Medical and surgical supplies increased 25% over last year largely as a result of volume and price increases in blood products and pharmaceutical costs.
- Medical malpractice expense declined $5 million from the prior year due to favorable risk management activities that provided reduced actuarial forecasts requiring a decrease in required reserves.
- Operating income of $121 million represents an increase of 24% over the prior year.
- State appropriations of $18 million represent a $16 million decrease from the prior year.
- Equity investment returns resulted in a $6.2 million loss and a decrease of $97.2 million when compared to prior year returns.
- The Health Care System assessments category is $20 million lower, compared to the prior year, as a result of reduced required assessments.

Comparison of Two-Year Data for 2012 to 2011 and an Analysis of Overall Financial Position and Results of Operations

Comparative financial data of 2012 to 2011 is summarized below. Discussion of comparative data is included in the sections following.

Statements of Net Assets

	FY12	FY11	Change
Current Assets	$ 566,386,526	$ 380,179,500	$ 186,207,026
Capital Assets, Net	620,787,236	584,390,895	36,396,341
Other Noncurrent Assets	576,287,711	663,194,802	(86,907,091)
TOTAL ASSETS	**1,763,461,473**	**1,627,765,197**	**135,696,276**
Current Liabilities	194,402,720	133,796,812	60,605,908
Noncurrent Liabilities	381,259,839	367,237,009	14,022,830
TOTAL LIABILITIES	**575,662,559**	**501,033,821**	**74,628,738**
Invested in Capital Assets, Net of Related Debt	423,159,922	382,881,572	40,278,350
Restricted for Expendable Uses	182,221,420	163,467,426	18,753,994
Unrestricted	582,417,572	580,382,378	2,035,194
TOTAL NET ASSETS	**$ 1,187,798,914**	**$ 1,126,731,376**	**$ 61,067,538**

Assets increased overall by $136 million or 8% from fiscal year 2011 to 2012 due to operations, the resulting increase in patient accounts receivable, an increase in receivables related to the UPL program and increases in capital assets. The Hospitals transitioned from being reimbursed through the Medicaid cost report opting to participate in a newly implemented Upper Payment Limit (UPL) program which resulted in a receivable of $138 million related to fiscal years 2011 and 2012 of which it is estimated that the Hospitals had a net benefit of $32 million. $105 million would have been received through cost report settlements for fiscal years 2011 and 2012. The UPL program is discussed in more detail within Note 4 in "Estimated Third Party Settlements."

While assets increased overall, cash and investments decreased year-over-year. Cash decreased $57 million as a result of ongoing operating obligations and payment delays associated with implementing the UPL program as noted above. Investments decreased in value by 3% or $10 million. It should be noted that the Hospitals engaged an investment management company, UNC Management Company, in an effort to better align returns with future capital needs. The Cash and Investments Designated for Capital Projects decreased 12% or $49 million from the previous year due to payments on these projects during the fiscal year as well as from projected total spending in future years. This decrease prompted a reallocation of cash and investments designated for this purpose.

Liabilities increased $75 million or 15% from fiscal year 2011. The largest increases within the current liabilities section occurred in the due to state of North Carolina component units, accounts payable, and the accrued salaries and benefits categories. The increase in the amount due to state of North Carolina component units resulted from the timing of payments related to Mission Support and Home Office Expenses. Accounts payable increased due to the timing of payments and the amount of invoices processed during the exercise of capturing all applicable invoices in the correct fiscal year. Accrued salaries increased compared to last year based on the payroll calendar of days to be accrued as well as salary increases and an increase in the employee incentive accrual.

Noncurrent liabilities also increased year over year due to interest rate swaps and reserves set aside for Recovery Audit Contractor (RAC) and Medicaid Integrity Contractor (MIC) audits. The mark-to-market value of interest rate swaps declined $11 million as of June 30, 2012 and is recorded in the hedging derivative liability category. An increase in RAC and MIC reserves was recorded in estimated third party settlements in preparation for future audits of prior year results.

Statements of Revenues, Expenses, and Changes in Net Assets

	FY12	FY11	Change
Net Patient Service Revenue	$ 1,162,864,633	$ 1,027,785,502	$ 135,079,131
Adjustment to Estimated Medical Malpractice Liability	1,993,881		1,993,881
Other Operating Revenues	19,865,034	20,137,412	(272,378)
TOTAL OPERATING REVENUES	**1,184,723,548**	**1,047,922,914**	**136,800,634**
Salaries and Benefits	596,593,672	538,913,056	57,680,616
Medical and Surgical Supplies	217,391,956	173,857,402	43,534,554
Contracted Services	109,041,356	100,829,076	8,212,280
Other Supplies and Services	59,875,577	55,953,893	3,921,684
Communications, Utilities, and Travel	22,714,755	21,521,784	1,192,971
Medical Malpractice Costs		3,461,541	(3,461,541)
Depreciation and Amortization	57,719,792	55,741,256	1,978,536
TOTAL OPERATING EXPENSES	**1,063,337,108**	**950,278,008**	**113,059,100**
OPERATING INCOME	**121,386,440**	**97,644,906**	**23,741,534**
State Appropriations	18,000,000	33,743,133	(15,743,133)
Investment Activity	(6,284,495)	91,574,248	(97,858,743)
Other Nonoperating Revenues	1,036,647	968,879	67,768
Nonoperating Expenses	(13,470,567)	(9,781,841)	(3,688,726)
NET NONOPERATING REVENUES (EXPENSES)	**(718,415)**	**116,504,419**	**(117,222,834)**
Capital Gifts	570,694	54,950	515,744
Health Care System Assessments	(60,171,181)	(80,637,615)	20,466,434
INCREASE IN NET ASSETS	**61,067,538**	**133,566,660**	**(72,499,122)**
NET ASSETS - BEGINNING OF YEAR	**1,126,731,376**	**993,164,716**	**133,566,660**
NET ASSETS - END OF YEAR	**$ 1,187,798,914**	**$ 1,126,731,376**	**$ 61,067,538**

Revenue grew 12% in inpatient and 15% in outpatient services year-over-year. Inpatient days increased while discharges remained neutral reflecting a growing average length of stay. Volume increased in both inpatient and outpatient surgical services as well as in lab procedures but remained relatively neutral in most other areas. Inpatient volume growth continues to be constrained as a result of operating in a facility that consistently operates at greater than 80% of licensed inpatient capacity. Revenues benefitted from the case mix index increasing from 1.7 to 1.8, reflecting more complex procedures being performed but were offset by the continued shift in the payor mix from commercial payors to Medicare and Medicaid. The Hospitals recognized some improvement in revenue due to the UPL program that replaced the Medicaid Cost Report settlement. Reserves were maintained for the settlement of Medicare and prior year Medicaid Cost Report activities since many years'

audits are still not complete by federal or state agencies. Reserves also continue to be required for the Medicare and Medicaid claims audit programs. See Note 4 in the *Notes to the Financial Statements* for more information on estimated third party settlements.

Total operating expenses increased by 12% year-over-year. Expenses continue to be actively managed via regularly scheduled meetings held by the Chief Financial Officer with the Hospitals' vice presidents and directors. These meetings ensure regular reviews of results by area and identify corrective measures needed in order to ensure operations are managed within budget successfully and any variances can otherwise be explained by volume or other factors. The largest categorical dollar increases in expense occurred in salaries and benefits, medical and surgical supplies, and contracted services. Salaries and benefits expense increased $58 million or 11% over the prior year and includes market rate adjustments, staffing to cover volume growth, retirement rate increases, and the expense of a nondiscretionary incentive compensation payment that was again made to qualifying employees in October 2012 as a result of attaining specific clinical quality, patient satisfaction, employee, and financial goals at an organizational level. The increase in medical and surgical supplies is attributed to volume and significantly to the costs of blood products and chargeable drugs. Medical malpractice costs decreased $5 million as a result of positive risk management activities.

Nonoperating revenues decreased $114 million in total year-over-year resulting from investment losses. A $16 million or 47% decrease in state appropriations also contributed materially to this decrease.

In the other revenues and expenses section, the Hospitals continues to support the UNC Health Care System Fund via assessments that fund initiatives the Chief Executive Officer of the UNC Health Care System deems appropriate. These assessments are quantified based on recommendations made from the senior leadership team to further the patient care, research, and teaching mission of the UNC Health Care System. Health Care System assessments are described in more detail in Note 14 within the *Notes to the Financial Statements*.

Analysis of Net Asset Balances

At June 30, 2012, net assets invested in capital assets, net of related debt, totaled $423 million. This represents the gross value of plant assets of $1,106 million plus bond issuance costs of $1 million less accumulated depreciation of $485 million and related debt of $199 million.

Restricted expendable net assets totaled $182 million and represent amounts subject to externally imposed restrictions including the Maintenance Reserve Fund, Liability Insurance Trust Fund, Trust Fund Donations, and Minority Interest in Carolina Dialysis, LLC. Unrestricted net assets increased $2 million year-over-year.

Discussion of Capital Asset and Long-Term Debt Activity

Capital Assets

The Hospitals expended $29 million during the year for capital equipment throughout the facilities and an additional $67 million on the acquisition of land, buildings, infrastructure, and renovations. See Note 5 for more information on capital assets.

At June 30, 2012, outstanding commitments on construction contracts were $43 million.

Long-Term Debt Activities

At June 30, 2012, the Hospitals had outstanding bond indebtedness in the amount of $274 million, of which $10 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 rating from Standard and Poor's improved by one notch from AA- to AA and is attributed to the Hospitals improved operating and excess income levels over the last several fiscal years and its strong unrestricted liquidity position and stable outlook. The outstanding long-term debt of the Hospitals is described in Note 6 within 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 continue to be assessed. 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 state appropriation was cut approximately in half while the economic climate keeps pressure on the need to fund the School of Medicine.

The Hospitals received $18 million in state funding through a 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 during the year based on the fiscal strength of the state of North Carolina. The Hospitals reliance on state appropriated funding is a small percentage of its annual operating revenues. Further, the Hospitals appropriation has been eliminated in the state of North Carolina's budgeting process for fiscal year 2013.

The economic climate remains less than ideal but the need for providing patient care continues as space and bed limitations at the Hospitals have neutralized overall growth and limited the patients that can be served. This ongoing problem is being addressed with the Hillsborough Hospital expansion which is still on target for fiscal year 2016 (July 2015) and by expanding the base of affiliated entities through consolidation, affiliation, or other contracting.

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 instituted and create additional revenue risk. This activity is expected to increase and reserves have been set aside as a contingency toward potential future audits of prior year results. Medicare has recently announced pre-payment reviews which could have the impact of reducing overall and timely cash flows.

The Hospitals, in consultation with the Board of Trustees, has created an investment committee in an effort to more actively manage available funds. This committee has met several times and effectively went through the process of selecting an investment management company that has experience in managing funds with similar investment return and risk requirements. The need for additional investments and the management of these funds will continue to be monitored.

ASSETS		
Current Assets:		
Cash and Cash Equivalents (Note 2)	$	144,227,747
Restricted Cash and Cash Equivalents (Note 2)		8,759,573
Receivables		
Patient Accounts Receivable, Net (Note 3)		157,560,814
Accrued Interest Receivable		173,040
Other Accounts Receivable, Net		20,732,772
Due from Primary Government		3,620,902
Due from State of North Carolina Component Units		22,115,032
Estimated Third Party Settlements (Note 4)		142,623,806
Inventories		23,051,779
Prepaid Expense		33,942,220
Notes Receivable (Note 14)		9,578,841
Total Current Assets		566,386,526
Noncurrent Assets:		
Restricted Cash and Cash Equivalents (Note 2)		178,475,155
Investments (Note 2)		200,861
Cash and Investments Designated for Capital Projects (Note 2)		360,864,543
Advanced Deposits with Liability Insurance Trust Fund (Note 12)		6,507,063
Patient Accounts Receivable, Net (Note 3)		416,744
Deferred Outflow of Resources (Note 7)		26,832,040
Bond Issuance Costs, Net		1,488,232
Start-Up Cost, Net		473,871
Investments in Affiliates (Note 15)		1,029,202
Capital Assets - Nondepreciable (Note 5)		90,670,046
Capital Assets - Depreciable, Net (Note 5)		530,117,190
Total Noncurrent Assets		1,197,074,947
Total Assets		1,763,461,473
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities		52,748,639
Accrued Salaries and Benefits		55,119,726
Estimated Third Party Settlements (Note 4)		30,384,085
Due to Patients or Third Parties		3,296,265
Due to Primary Government		6,618,861
Due to State of North Carolina Component Units		29,625,222
Funds Held for Others		1,166,938
Interest Payable		1,292,621
Long-Term Liabilities - Current Portion (Note 6)		14,150,363
Total Current Liabilities		194,402,720
Noncurrent Liabilities:		
Long-Term Liabilities (Note 6)		293,438,051
Hedging Derivative Liability (Note 7)		26,832,040
Estimated Third Party Settlements (Note 4)		60,989,748
Total Noncurrent Liabilities		381,259,839
Total Liabilities		575,662,559

NET ASSETS		
Invested in Capital Assets, Net of Related Debt		423,159,922
Restricted for Expendable:		
Maintenance Reserve Fund		169,568,872
Liability Insurance Trust Fund		6,507,063
Trust Fund Donations		444,837
Minority Interest in Carolina Dialysis, LLC		5,700,648
Unrestricted		582,417,572
Total Net Assets	$	1,187,798,914

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

University of North Carolina Hospitals at Chapel Hill
Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Year Ended June 30, 2012

Exhibit A-2

REVENUES		
Operating Revenues:		
Net Patient Service Revenue (Note 9)	$	1,162,864,633
Adjustment to Estimated Medical Malpractice Liability		1,993,881
Other Operating Revenues		19,865,034
Total Operating Revenues		1,184,723,548
EXPENSES		
Operating Expenses:		
Salaries and Benefits		596,593,672
Medical and Surgical Supplies		217,391,956
Contracted Services		109,041,356
Other Supplies and Services		59,875,577
Communications, Utilities, and Travel		22,714,755
Depreciation and Amortization		57,719,792
Total Operating Expenses		1,063,337,108
Operating Income		121,386,440
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		18,000,000
Noncapital Gifts and Grants		236,103
Federal Interest Subsidy on Debt		800,544
Investment Loss (Net of Investment Expense of $1,734,025)		(6,198,485)
Loss on Investments in Affiliates (Note 15)		(86,010)
Interest and Fees on Debt		(10,018,476)
Loss on Disposal of Capital Assets		(1,741,523)
Other Nonoperating Expenses		(1,710,568)
Net Nonoperating Expenses		(718,415)
Income Before Other Revenues and Expenses		120,668,025
Capital Gifts		570,694
Health Care System Assessments (Note 14)		(60,171,181)
Increase in Net Assets		61,067,538
NET ASSETS		
Net Assets - July 1, 2011		1,126,731,376
Net Assets - June 30, 2012	$	1,187,798,914

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

CASH FLOWS FROM OPERATING ACTIVITIES		
Received from Customers	$	1,059,959,676
Payments to Employees and Fringe Benefits		(588,567,274)
Payments to Vendors and Suppliers		(376,306,914)
Payments for Medical Malpractice		(1,194,173)
Other Receipts		13,461,185
Net Cash Provided by Operating Activities		107,352,500
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State Appropriations		18,000,000
Health Care System Assessments		(60,171,181)
Interest and Fees Paid on Revenue Bonds		(481,733)
Principal Paid on Revenue Bonds		(952,000)
Noncapital Gifts and Grants		236,103
Net Cash Used by Noncapital Financing Activities		(43,368,811)
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES		
Principal Paid on Capital Revenue Bonds		(8,748,000)
Principal Paid on Notes Payable		(1,380,447)
Interest and Fees Paid on Capital Debt		(8,826,089)
Acquisition and Construction of Capital Assets		(95,314,552)
Proceeds from Sale of Capital Assets		48,450
Federal Interest Subsidy on Debt Received		800,544
Net Cash Used by Capital Financing and Related Financing Activities		(113,420,094)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment Income		3,738,060
Investments In and Loans to Affiliated Enterprises:		
Cash Payments		(11,347,277)
Net Cash Used by Investing Activities		(7,609,217)
Net Decrease in Cash and Cash Equivalents		(57,045,622)
Cash and Cash Equivalents - July 1, 2011		410,043,565
Cash and Cash Equivalents - June 30, 2012	$	352,997,943

RECONCILIATION OF NET OPERATING REVENUES (EXPENSES) TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating Income	$	121,386,440
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation and Amortization Expense		57,719,792
Changes in Assets and Liabilities:		
Patient Accounts Receivable		(23,324,947)
Due from Primary Government		768,961
Due from State of North Carolina Component Units		(5,521,057)
Other Accounts Receivable		(9,129,938)
Estimated Third Party Settlements		(79,946,413)
Inventories		(4,831,591)
Prepaid Expenses		(3,174,806)
Advance Deposits with Liability Insurance Trust Fund		(3,188,054)
Accrued Salaries and Benefits		13,649,922
Accounts and Other Payables		16,340,586
Due to Patients or Third Parties		(444,611)
Due to Primary Government		1,336,077
Due to State of North Carolina Component Units		23,046,464
Funds Held for Others		42,053
Compensated Absences		2,623,622
Net Cash Provided by Operating Activities	$	107,352,500
RECONCILIATION OF CASH AND CASH EQUIVALENTS		
Current Assets:		
Cash and Cash Equivalents	$	144,227,747
Restricted Cash and Cash Equivalents		8,759,573
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		178,475,155
Cash Designated for Capital Projects		21,535,468
Total Cash and Cash Equivalents - June 30, 2012	$	352,997,943
NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES		
Investments in Affiliated Enterprises:		
Current Loss from Equity Method Adjustments	$	(86,010)
Change in Fair Value of Investments		(9,623,470)
Loss on Disposal of Capital Assets		(1,741,523)
Capital Gifts		570,694

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

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 806 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 Executive Vice President & Chief Financial Officer, University of North Carolina Hospitals at Chapel Hill, 101 Manning Drive, Med Wing E - Room 310, 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, include state appropriations, Health Care System assessments, certain grants, and donations. Revenues are recognized, net of estimated uncollectible amounts, as soon as all eligibility requirements imposed by the provider have been met, if probable of collection.

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

F. Investments - This classification represents the participation in an equity investment fund through the UNC Investment Fund, LLC. 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 consist 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 accounts receivable. 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 accounts are used to determine net patient accounts receivable and are calculated based on the historical collection rates 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. Designated Assets - Cash and Investments Designated for Capital Projects includes assets set aside or designated for the acquisition or construction of capital assets (over which the UNC Health Care System Board retains control and may at its discretion subsequently use for other purposes).

L. 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 funds equal to 7.5% of gross patient revenue as limited by applicable revenue bond covenants, unexpended debt proceeds and resources restricted 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 CDLLC minority interest.

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

Revenue 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.

N. 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 semi-annual sell back feature with payouts in June and December. This sell back feature allows employees to sell back from eight to 120 hours of their PTO balance if they have a balance of at least 140 hours at the time of sell back. There is a 10% forfeiture of the cash value to comply with IRS regulations.

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 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.

O. 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.

P. 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. Health Care System assessments are presented separately after nonoperating revenues and expenses.

Q. 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, 2011, (less amounts previously recorded at June 30, 2011, for in house patients) and all charges on in house accounts and all charges for outpatient accounts registered after June 30, 2011. 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.

Net patient service revenue also includes estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

R. Medical Malpractice - Actuarially determined contributions to the Liability Insurance Trust Fund ordinarily result in expense. On occasion, favorable developments in the actuarial report may require an adjustment to the previously recorded estimated liability. In any year where the amount of these favorable developments results in negative expense, those amounts will be reclassified to income as Adjustment to Estimated Medical Malpractice Liability for presentation purposes.

S. 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 Board of Directors of the UNC Health Care System may deposit or invest the Hospitals' funds as defined in this statute. This includes 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. These moneys may be deposited or invested in interest-bearing accounts or other investments in the exercise of the Board's sound discretion, without regard to any statue or rule of law relating to the investment of funds by fiduciaries. The Hospitals may voluntarily deposit special funds, revenue bond proceeds, and debt service funds with the State Treasurer. Special funds consist of moneys for agency funds held directly by the 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, 2012, the amount shown on the Statement of Net Assets as cash and cash equivalents includes $335,374,491 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 1.5 years as of June 30, 2012. 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 "Reports" or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

Cash on hand at June 30, 2012 was $35,110. The carrying amount of the Hospitals' deposits not with the State Treasurer was $17,588,342 and the bank balance was $17,997,384. 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, 2012, $16,765,669 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).

UNC Investment Fund, LLC - *North Carolina General Statute* 116-37.2 as revised by S.L. 2011-145, Section 9.6E.(c), allows the UNC Health Care System Board to be responsible for the custody and management of funds, including developing policies for deposit, investment, and administration of funds. With this legislative flexibility and under the guidance of the Finance Committee of the Board, the Hospitals contracted with UNC Management Company (UNCMC) in November 2011 to manage the Hospitals' investment fund.

At June 30, 2012, the Hospitals' investments include $339,529,936 which represents the Hospitals' equity position in the UNC Investment Fund, LLC (UNC Investment Fund). The UNC Investment Fund is an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating. Asset and ownership interests of the UNC Investment Fund are determined on a market unit valuation basis each month. Investment risks associated with the UNC Investment Fund are included in audited financial statements of the UNC Investment Fund, LLC which may be obtained from UNC Management Company, Inc., 1400 Environ Way, Chapel Hill, NC 27517.

C. Reconciliation of Deposits and Investments - A reconciliation of deposits and investments for the Hospitals as of June 30, 2012, is as follows:

Cash on Hand	$	35,110
Amount of Deposits with Private Financial Institutions		17,588,342
Deposits in the Short-Term Investment Fund		335,374,491
Investments in the UNC Investment Fund		339,529,936
Total Deposits and Investments	$	692,527,879
Deposits		
Current:		
Cash and Cash Equivalents	$	144,227,747
Restricted Cash and Cash Equivalents		8,759,573
Noncurrent:		
Restricted Cash and Cash Equivalents		178,475,155
Cash Designated for Capital Projects		21,535,468
Total Deposits		352,997,943
Investments		
Noncurrent:		
Investments		200,861
Investments Designated for Capital Projects		339,329,075
Total Investments		339,529,936
Total Deposits and Investments	$	692,527,879

NOTE 3 - PATIENT ACCOUNTS RECEIVABLE, NET

A. Current - Net patient accounts receivable consisted of amounts due from patients and third parties at estimated realizable value. Included in gross receivables are amounts receivable at established billing rates less payments received through June 30, 2012. 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, 2012:

	Amount
In House Patients	$ 56,504,141
Discharged (Not Final Billed) Patients	71,179,205
Total Unbilled	127,683,346
Discharged (Billed) Patients	304,066,879
Payment Arrangements	6,187,021
Charity Care Provided	(57,912,543)
Current Gross	380,024,703
Allowance for Bad Debts	(22,963,126)
Contractual Allowances	(199,500,763)
Total Allowances	(222,463,889)
Current - Net	$ 157,560,814

B. Noncurrent - Noncurrent patient accounts receivable is $416,744 and consists of a gross amount of $5,864,344 net of $5,447,600 estimated uncollectible. This represents the net value of patient payment arrangements that are initiated at the request of the patient. These payment arrangements are based on agreements for specific monthly amounts that extend beyond one year but are capped at three years.

NOTE 4 - ESTIMATED THIRD PARTY SETTLEMENTS

The Hospitals provides 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 receive interim pass-through payments from Medicare for costs such as organs, graduate medical education, bad debts, etc., that are ultimately settled through the annual Medicare cost report. Prior to October 1, 2010, Medicaid inpatient services were reimbursed on an interim basis based on a prospectively determined rate per discharge and Medicaid outpatient services were reimbursed on an interim basis at an agreed upon rate. Ultimately, Medicaid inpatient and outpatient services were settled at allowable cost through the filing of an annual cost report. Beginning October 1, 2010, Medicaid pays inpatient and outpatient supplemental payments and no longer requires a cost settlement. See Note 9 (Net Patient Service Revenue) for more detail regarding the supplemental payments. 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 2012. Medicare and traditional Medicaid cost report settlements owed to Medicare and Medicaid are estimated to be $21,626,415 and $8,757,670 respectively within the next twelve months and $32,058,554 and $28,931,194 are owed respectively on a noncurrent basis. Tricare/Champus currently owes the Hospitals $4,727,228. An estimate is made for the current year's Medicare and Tricare/Champus settlements by using the most current statistics, costs, settlement data, and charges. The Hospitals also included in its estimated liability for both Medicare and Medicaid a reserve for the claims audit programs. The Centers for Medicare and Medicaid Services audit recovery programs are to identify improper underpayments or overpayments made to health care providers.

Once a cost report is filed, it is subject to an initial tentative settlement and a subsequent 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 currently 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. Medicare audits are current through the June 30, 2004 fiscal year and Medicaid audits are current through the June 30, 2003 fiscal year.

Effective October 1, 2010, the Hospitals is participating in the UNC Upper Payment Limit (UPL) Plan specific to the UNC Health Care System of hospitals. The $137,896,578 UPL receivable is for October 1, 2010 through June 30, 2012, of which $58,163,402 is applicable to fiscal year 2011. The Hospitals estimates a net benefit of approximately $32,300,000 above what it would have received from cost report settlements. In the receivable amount above, the Hospitals included a reserve for future UPL audits. Payment on the UPL receivable amounts are expected within twelve months and as a result have been recorded as a current asset. See Note 9 (Net Patient Service Revenue) for more detail regarding the supplemental payments.

NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2012 is presented as follows:

	Balance July 1, 2011	Increases	Decreases	Balance June 30, 2012
Capital Assets, Nondepreciable:				
Land and Permanent Easements	$ 41,377,850	$ 6,760,396	$ 1,665,477	$ 46,472,769
Construction in Progress	16,683,729	52,789,332	25,275,784	44,197,277
Total Capital Assets, Nondepreciable	58,061,579	59,549,728	26,941,261	90,670,046
Capital Assets, Depreciable:				
Buildings	561,445,398	32,684,717	11,981	594,118,134
Machinery and Equipment	369,687,409	24,374,870	17,091,978	376,970,301
General Infrastructure	5,207,920	86,069		5,293,989
Computer Software	34,728,212	4,811,250	723,898	38,815,564
Total Capital Assets, Depreciable	971,068,939	61,956,906	17,827,857	1,015,197,988
Less Accumulated Depreciation/Amortization for:				
Buildings	160,783,194	24,040,053	796	184,822,451
Machinery and Equipment	254,452,758	28,007,818	16,761,068	265,699,508
General Infrastructure	4,505,642	135,822		4,641,464
Computer Software	24,998,029	5,515,237	595,891	29,917,375
Total Accumulated Depreciation/Amortization	444,739,623	57,698,930	17,357,755	485,080,798
Total Capital Assets, Depreciable, Net	526,329,316	4,257,976	470,102	530,117,190
Capital Assets, Net	$ 584,390,895	$ 63,807,704	$ 27,411,363	$ 620,787,236

NOTE 6 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2012 is presented as follows:

	Balance July 1, 2011	Additions	Reductions	Balance June 30, 2012	Current Portion
Revenue Bonds Payable	$ 296,020,000	$ 0	$ 9,700,000	$ 286,320,000	$ 10,235,000
Add Premium	669,861		292,943	376,918	
Deduct Deferred Charge on Refunding	(13,633,507)		(963,931)	(12,669,576)	
Total Revenue Bonds Payable	283,056,354		9,029,012	274,027,342	10,235,000
Notes Payable	1,380,447		1,380,447		
Arbitrage Rebate Payable	25,002	100,008		125,010	
Compensated Absences	30,812,440	45,345,097	42,721,475	33,436,062	3,915,363
Total Long-Term Liabilities	$ 315,274,243	$ 45,445,105	$ 53,130,934	$ 307,588,414	$ 14,150,363

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, 2012	Principal Outstanding June 30, 2012
Rex Acquisition and Hospital Renovations	2001A	0.14%*				
	2001B	0.14%*	02/15/2031	$ 110,000,000	$ 13,200,000	$ 96,800,000
Refund Portion of 1996 Revenue Bonds	2003A	3.57%**				
	2003B	3.47%**	02/01/2029	98,015,000	4,525,000	93,490,000
Refund Portion of 1996 Revenue Bonds	2005A	5.00%	02/01/2015	30,540,000	18,880,000	11,660,000
Refund 1999 Revenue Bonds	2009A	3.63%**	02/01/2024	44,290,000	6,995,000	37,295,000
General Revenue Bonds	2010A	3.00% to 4.00%	02/01/2014	5,585,000	1,800,000	3,785,000
	2010B	2.45% to 6.33%	02/01/2031	43,290,000		43,290,000
Total Revenue Bonds Payable (principal only)				$ 331,720,000	$ 45,400,000	286,320,000
Less: Unamortized Loss on Refunding						(12,669,576)
Plus: Unamortized Premium						376,918
Total Revenue Bonds Payable						$ 274,027,342

*For variable rate debt, interest rates in effect at June 30, 2012 are shown.
**For variable rate debt with interest rate swaps, the synthetic fixed rates in effect at June 30, 2012 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 Revenue 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, U.S. 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 0.58% with the long-term agreement that became effective on July 11, 2005.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase to and including the 60th day thereafter and while they are Bank Bonds, bear interest at the Formula Rate (Base Rate equal to the higher of the Prime Rate plus 1.00% for such day or the sum of 1.00% plus the Federal Funds Rate) and from and including the 61st day following the Purchase Date and thereafter bear interest at the higher of the Formula Rate or 7.00%, subject to a maximum rate as permitted by law; provided however, that at no time shall the Base Rate be less than the applicable rate of interest on the bonds which are not Bank Bonds. 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, 2012, 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 $96,800,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $25,184,000, $24,273,000, $22,917,000, $21,562,000, and $20,207,000 in years one, two, three, four, and five respectively under the installment loan agreement assuming a Base Rate of 4.25% (Prime plus 1.00%) for the first 60 days and a maximum rate of 7.00% thereafter.

The current expiration date of the Agreements is December 31, 2015. The Liquidity Provider has the option to terminate its commitment on October 11, 2013 or October 11, 2015 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, U.S. Bank National Association. The Hospitals' Remarketing Agents, Banc of America Securities LLC (Series 2003A) and Wells Fargo Bank, N.A. (Series 2003B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to 0.08% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003A and is equal to 0.07% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003B.

Under separate Standby Bond Purchase Agreements for the Series 2003A and Series 2003B (Agreements) between the Hospitals and Bank of America, N.A. (Series 2003A) and Wells Fargo Bank, N.A. (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, N.A. is payable quarterly in arrears, on the first business day of each November, February, May, and August. The Commitment Rate is equal to 0.51% per annum effective July 1, 2011 until July 1, 2013. The Commitment Rate remains in effect over the life of the Agreement so long as the rating assigned to Parity Debt 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 such rating:

S&P	Moody's	Commitment Rate
A	A2	0.71%
A- or lower	A3 or lower	0.91%

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, 2012, 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 $60,805,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $23,119,000, $22,308,000, and $21,142,000 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 2003B Agreement with Wells Fargo Bank, N.A. required a commitment fee of 0.50% for fiscal year 2012. Payments are made quarterly in arrears, on the first business day of each February, May, August, and November thereafter until July 31, 2013. The commitment fee remains in effect over the life of the Agreement so long as the rating assigned to Parity Debt 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 Hospitals' adjusted 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	0.65%
A-	A3	0.80%
BBB+	Baa1	1.00%
BBB	Baa2	1.25%
BBB-	Baa3	1.55%
Below Investment Grade	Below Investment Grade	2.55%

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%, 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, 2012, 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 of the Base Rate plus 2.00% 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 $32,685,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $10,964,000, $13,780,000, and $12,643,000 in years one, two, and three respectively following the Purchase Date of the Bank Bonds assuming a Base Rate of 7.00%.

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 days before the Purchase Date and upon delivering such Series 2009A bonds to the bond Tender Agent, U.S. Bank, N.A., 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 receipt 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 receipt 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, 2012 are as follows:

	Annual Requirements		
	Revenue Bonds Payable		
Fiscal Year	Principal	Interest	Interest Rate Swaps, Net
2013	$ 10,235,000	$ 2,391,336	$ 4,494,891
2014	10,625,000	2,122,432	4,390,823
2015	11,010,000	1,840,684	4,277,191
2016	11,735,000	1,682,353	4,103,945
2017	12,075,000	1,630,768	3,812,921
2018-2022	67,555,000	7,126,277	14,524,242
2023-2027	82,675,000	4,815,578	6,369,724
2028-2031	80,410,000	1,520,307	617,232
Total Requirements	$ 286,320,000	$ 23,129,735	$ 42,590,969

Interest rates on variable rate 2001 A&B, 2003 A&B, and 2009A bonds are calculated at 0.14%, 0.14%, 0.07%, 0.06% and 0.14% effective June 30, 2012.

This schedule also includes the debt service requirements for debt associated with interest rate swaps. Synthetic interest on the variable rate 2003A, 2003B, and 2009A revenue bonds is calculated based upon the synthetic rate at June 30, 2012, of 3.57%, 3.47%, and 3.63%, respectively. More detailed information about interest rate swaps is presented in Note 7 Derivative Instruments.

NOTE 7 - DERIVATIVE INSTRUMENTS

Derivative instruments held at June 30, 2012 are as follows:

		Change in Fair Value		Fair Value at June 30, 2012	
Type	Notional Amount	Classification	Decrease	Classification	Liability
Hedging Derivative Instruments					
Cash Flow Hedges					
Pay-Fixed Interest Rate Swap 2003 A & B Bonds	$ 93,490,000	Deferred Outflow of Resources	$ (9,185,451)	Hedging Liability	$ (20,544,823)
Pay-Fixed Interest Rate Swap 2009A Bonds	$ 37,295,000	Deferred Outflow of Resources	(1,825,072)	Hedging Liability	(6,287,217)
Total Derivative Instruments			$ (11,010,523)		$ (26,832,040)

Hedging derivative instruments held at June 30, 2012 are as follows:

Type	Objective	Notional Amount	Effective Date	Maturity Date	Terms
Pay-Fixed Interest Rate Swap	Hedge of Changes in Cash on 2003 A & B Series Bonds	$ 93,490,000	02/13/2003	02/01/2029	Pay 3.48% Receive 67% LIBOR
Pay-Fixed Interest Rate Swap	Hedge of Changes in Cash on the 2009A Series Bonds	$ 37,295,000	02/12/2009	02/01/2024	Pay 3.61% Receive 67% LIBOR

The fair value value of the pay-fixed interest rate swaps was estimated by Bank of America, N.A. (BOA) using a methodology it deems reasonable and appropriate. As stated in BOA's derivative disclosure statement, valuations for derivative instruments represent, or are derived from, mid-market values and represent the value of the trade as of the date indicated. The Mark-to-Market value in the above table represents the value of the trade as of June 30, 2012 and is inclusive of interest accruals and exclusive of any third party fees, if applicable.

The Hospitals' interest rate swap hedging derivatives have been determined to be effective as of June 30, 2012 using the synthetic instrument method.

Hedging Derivative Risks

Credit Risk: As of June 30, 2012, 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 derivative's 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 falls 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). As of June 30, 2012, the credit rating for Bank of America, N.A. is A3 by Moody's and A by S&P.

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.

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, 2012. 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, 2012.

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 Hospitals is exposed to termination risk because 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 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 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, 2012:

Fiscal Year	Amount
2013	$ 3,943,374
2014	4,361,452
2015	3,783,828
2016	3,551,481
2017	3,029,892
2018-2022	13,006,177
2023-2027	10,121,030
2028-2032	1,197,228
Total Minimum Lease Payments	$ 42,994,462

Rental expense for all operating leases during the year was $3,752,785.

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 4, Estimated Third Party Settlements.

Medicare reimburses the Hospitals for inpatient hospital services furnished in the inpatient rehabilitation unit, referred to as an inpatient rehabilitation facility (IRF), under the provisions of the Inpatient Rehabilitation Facility Prospective Payment System (IRF PPS).

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).

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. Medicaid reimburses most outpatient services on an interim basis at an agreed upon rate based on documented costs. Several services such as hearing aids, durable medical equipment (DME), outpatient pharmaceuticals, home health, and diagnostic laboratory services are paid on fee schedules and not subject to the Upper Payment Limit program (UPL) which is described below.

In addition to the above, Medicaid also pays inpatient and outpatient supplemental payments for hospital services to hospitals owned or controlled by the UNC Health Care System, including the Hospitals. The total amount of payments to all of the eligible hospitals is the difference between what Medicare would pay for the services rendered to Medicaid patients and what Medicaid otherwise pays. These payments are called upper payment limit (UPL) payments. The Hospitals also receives disproportionate share hospital (DSH) payments, which are special payments for hospitals which serve a disproportionate share of low income patients. The Hospitals has historically been eligible to receive "Basic" DSH payments. Hospitals owned or controlled by the UNC Health Care System, including the Hospitals, are eligible to receive UNC DSH payments up to the unreimbursed cost of serving uninsured patients. The UNC Health Care System is responsible for providing the non-federal share of the UPL payments and UNC DSH payments and is also responsible for ensuring the state receives an amount equal to the federal share of the cost of providing care to uninsured patients at the Hospitals ($53,612,782 for federal fiscal year 2011). These costs are allocated among all UNC Health Care System hospitals.

The UPL Plan was retroactively effective on October 1, 2010, but net funds in the amount of $58,163,402 were not received until July 2012 and were applicable to the 2011 fiscal year. The net amount of $19,225,022 was received at the same time for the balance of the federal fiscal year ended September 30, 2011 that was related to the 2012 fiscal year. The UPL payments for federal fiscal year ended September 30, 2012 are scheduled to be paid in the Fall of 2012. A net amount of $60,508,154 was estimated to be due

for the applicable 3 quarters of federal fiscal year 2012 and is included in the 2012 revenues.

Commercial/Managed Care Payer Agreements: The Hospitals has entered into reimbursement agreements with most 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, global payments, and per diem rates. Global rate reimbursements include the hospital and physician component for solid organ transplant and bone marrow transplant.

In general, most payments for inpatient and outpatient services are subject to deductibles and co-payments that are the patient's responsibility. Additionally, insurance plans may in limited circumstances reimburse their subscribers but generally 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, 2012 follows:

	2012
Inpatient Routine	$ 492,876,726
Inpatient Ancillary	934,404,384
Outpatient	1,142,666,598
Charity Care Provided	(151,457,598)
Prior Year Third Party Settlements	3,234,798
Gross Patient Service Revenue	2,421,724,908
Medicare Contractual Allowance	(492,061,267)
Medicaid Contractual Allowance	(444,825,806)
Upper Payment Limit	137,896,578
Managed Care Contractual Allowance	(363,271,293)
Other Contractual Allowances	(39,948,604)
Bad Debt	(56,649,883)
Contractual Adjustments	(1,258,860,275)
Net Patient Service Revenue	$ 1,162,864,633

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 (Plan) 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, 2012, these rates were set at 7.44% of covered payroll for employers and 6% of covered payroll for members.

For the current fiscal year, the Hospitals had a total payroll of $453,826,110, of which $382,071,012 was covered under the Teachers' and State Employees' Retirement System. Total employer and employee contributions for pension benefits for the year were $28,426,083 and $22,924,261, respectively.

Required employer contribution rates for the years ended June 30, 2011, and 2010, were 4.93% and 3.57%, respectively, while employee contributions were 6% each year. The Hospitals made 100% of its annual required contributions for the years ended June 30, 2012, 2011, and 2010, which were $28,426,083, $17,385,661, and $11,821,316, 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 "Reports" or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

B. Deferred Compensation and Supplemental Retirement Income Plans - Internal Revenue Code 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 $965,370 for the year ended June 30, 2012.

Internal Revenue Code Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the Hospitals except for a 5% employer contribution for the Hospitals' law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of Hospitals law enforcement officers for the year ended June 30, 2012, were $59,649. The voluntary contributions by employees amounted to $2,917,916 for the year ended June 30, 2012.

Internal Revenue Code 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. The Plan administrator is the University of North Carolina System. No costs are incurred by the Hospitals. The voluntary contributions by employees amounted to $3,825,145 for the year ended June 30, 2012.

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 the State Treasurer and the Board of Trustees of the State Health Plan for Teachers and State Employees as authorized by Chapter 135, Article 3B, of the

General Statutes. 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 State Treasurer and the Board of Trustees of the State Health Plan for Teachers and State Employees.

For the current fiscal year the Hospitals contributed 5.0% of the covered payroll under the Teachers' and State Employees' Retirement System to the Fund. Required contribution rates for the years ended June 30, 2011, and 2010, were 4.9% and 4.5%, respectively. The Hospitals made 100% of its annual required contributions to the Plan for the years ended June 30, 2012, 2011, and 2010, which were $19,103,551, $17,279,866, and $14,900,818, 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 "Reports" or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

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

Disability income benefits are funded by actuarially determined employer contributions that are established by the General Assembly. For the fiscal

year ended June 30, 2012, the Hospitals made a statutory contribution of 0.52% of covered payroll under the Teachers' and State Employees' Retirement System to the DIPNC. Required contribution rates for the years ended June 30, 2011, and 2010, were 0.52% and 0.52%, respectively. The Hospitals made 100% of its annual required contributions to the DIPNC for the years ended June 30, 2012, 2011, and 2010, which were $1,986,769, $1,833,782, and $1,721,872, respectively. The Hospitals assumes no liability for long-term disability benefits under the Plan other than its contribution.

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

NOTE 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.

The risk of tort claims of up to $1,000,000 per claimant is 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 also has an insurance policy from a private insurance company through the North Carolina Department of Insurance for Auto Physical Damage (for vehicles costing greater than $75,000). Coverage limit is $5,000,000 per accident with a deductible of $500 per occurrence.

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 $50,000,000 with a deductible of $5,000;
- Directors and Officers Liability insurance up to $25,000,000 with a deductible of $350,000 per occurrence for anti-trust claims and $200,000 per occurrence for all other claims;
- Master crime insurance up to $5,000,000 per occurrence for employee dishonesty with a $75,000 per occurrence deductible plus 10% co-pay; $100,000 per occurrence with $2,500 deductible for forgery/alterations; $500,000 per occurrence for robbery/burglary with a deductible of $1,000;
- Comprehensive General Liability insurance up to $2,000,000 with a deductible of $10,000 per occurrence and Umbrella Excess insurance with limits of $5,000,000 per occurrence and aggregate;
- 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 $761,108 with a deductible of up to $10,000 per occurrence;
- Fine Arts Floater insurance up to $5,000 per item and $100,000 policy aggregate, with a deductible of $1,000 per occurrence;
- Surety Bond of $150,000 for Suppliers of Durable Medical Equipment, Prosthetics, Orthotics and Supplies Medicare Program (DMEPOS).

Hospitals employees and retirees are provided comprehensive major medical care benefits. Coverage is funded by contributions to the State Health Plan (Plan), a discretely presented component unit 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 0.16% 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 Insurance Commissioner,

the Director of the Office of State Budget and Management, and the State Treasurer (each serving at the pleasure of the appointer); and nine members appointed 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, 2011, through June 30, 2012, 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 during fiscal year 2007. For the fiscal year ending June 30, 2012, 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, 2012, the Hospitals' assets in the Trust Fund totaled $29,327,245 while Hospitals' liabilities totaled $22,820,182 resulting in net assets of $6,507,063.

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 $43,482,315 and on other purchases were $15,341,794 at June 30, 2012.

B. Pending Litigation and Claims - The Hospitals is a party to litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of these matters, no provision for any liability has been made in the financial statements. 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 and Related Funds (System Fund) - The Board of Directors of UNC Health Care System (System) authorized and approved the creation of the System Fund to enable fund transfers among the entities within the System in support of the System's vision and mission to be the nation's leading public academic health care system. Initially formed as the Enterprise Fund, the Enterprise Fund today exists as a sub-account within the System Fund. The key components of the System contributing to the Enterprise Fund during fiscal year 2012 are the University of North Carolina Hospitals at Chapel Hill, the clinical patient care programs established or maintained by the University of North Carolina at Chapel Hill School of Medicine, UNC P&A, and Rex Healthcare, Inc. The Hospitals was assessed $51,323,561 to fund initiatives supported by the System Fund and also extended a $9,578,841 note receivable to the System Fund during the year ended June 30, 2012.

The System is the sole member of Chatham Hospital, Inc. and UNC Physicians Network, LLC. The Hospitals was assessed a total of $8,847,620 to support the operations of these entities, $2,000,000 and $6,847,620 respectively, during the course of the fiscal year.

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 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. Rex 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), Garner, Holly Springs, Knightdale, and Apex. Rex Hospital also owns Rex Home Services, Inc. that primarily serves residents of Wake County.

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 $667,774 from Rex and the Hospitals paying $4,035,365 to Rex during the year ended June 30, 2012.

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 executive staffing and assistance with operations and planning. Additionally, the Hospitals entered into various other administrative and clinical services agreements with Chatham Hospital, Inc. and was paid $78,887 during the fiscal year ended June 30, 2012 for those services.

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.

UNC Physicians Network, LLC (UNCPN) - Formerly known as Triangle Physician Network, LLC (TPN), UNCPN is a wholly owned subsidiary of the System, but a private employer, that owns and operates 32 community based practices throughout the Triangle (Raleigh, Durham, and Chapel Hill), North Carolina area.

UNCPN is a physician-led network structured to meet the needs of the community and community practice physicians by creating a partnership for physicians and the System to face the challenging health care environment. UNCPN incorporates legacy System community-based practices as well as newly acquired practices and is actively seeking affiliation with private practices throughout the region.

The Hospitals provides purchasing, accounts payable, and accounting services to UNCPN as well as supplies and bio-medical equipment services. UNCPN paid the Hospitals $4,536,917 for supplies and services during fiscal year 2012.

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 $3,174,157 for supplies and bio-medical equipment services received during fiscal year 2012.

Henderson County Hospital Corporation d/b/a Margaret R. Pardee Memorial Hospital (HCHC) - Henderson County is the sole member of HCHC, a North Carolina not-for-profit corporation, which is in turn the sole member of Henderson County Urgent Care Centers, Inc. and Western Carolina Medical Associates, Inc. HCHC was created by Henderson County to provide for the operation of a community hospital in Henderson County, North Carolina that is dedicated to serving the health care needs of Henderson County citizenry. These facilities include 201 licensed acute care beds, 21 licensed psychiatric beds, a physicians' services group, a home health agency, and an urgent care center which provide a variety of community-based services.

On June 22, 2011, HCHC signed a management service agreement engaging the Hospitals to conduct and effectively manage the day to day operations of Margaret R. Pardee Memorial Hospital and HCHC's affiliated operations over a term of ten years. Additionally, the Chief Executive Officer of HCHC is an employee of the System.

HCHC paid the Hospitals $573,059 for services received during fiscal year 2012.

NOTE 15 - INVESTMENTS IN AFFILIATES

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were $1,029,202 at June 30, 2012. 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:

	2012 (Unaudited)
TOTAL AFFILIATE ACTIVITY	
Current Assets	$ 1,019,482
Noncurrent Assets	570,954
Current Liabilities	13,566
Shareholders Equity	1,576,870
Net Loss	(86,010)
HOSPITALS' SHARE OF ACTIVITY	
Realized Affiliate Loss - Ongoing Operations	$ (86,010)

NOTE 16 - SUBSEQUENT EVENT

Merger with High Point Regional Health Care System - On September 25, 2012, High Point Regional Health Care System and UNC Health Care System announced an agreement in principle to form a strategic partnership. Under the terms of the agreement, which is expected to be finalized in early 2013, UNC Health Care System will become the sole member of High Point Regional Health Care System, and provide $150 million for capital improvements and $50 million for the establishment of a newly formed community health fund. High Point Regional Health Care System will remain a private, not-for-profit organization.

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

Board of 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 at Chapel Hill, 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, 2012, and have issued our report thereon dated October 16, 2012.

As discussed in Note 1 to the financial statements, the financial statements present only the University of North Carolina Hospitals at Chapel Hill 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 principles 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

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

A 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 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 Trustees, the Audit Committee, others within the entity, the Governor, the General Assembly, and the State Controller, and is not intended to be and should not be used by anyone other than these specified parties.

Beth A. Wood, CPA
State Auditor

October 16, 2012

ORDERING INFORMATION

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

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

Telephone: 919/807-7500

Facsimile: 919/807-7647

This audit required 1,968 audit hours at an approximate cost of $141,696. The cost represents 0.008% of the Hospitals' total assets and 0.013% of total expenses subjected to audit.