



STATE OF NORTH CAROLINA

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM FUNDS

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 HEALTH CARE SYSTEM FUNDS

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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Beth A. Wood, CPA
State Auditor

STATE OF NORTH CAROLINA
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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 Health Care System Funds (System Fund) 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.

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying basic financial statements of the University of North Carolina Health Care System Funds (System Fund), 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 University of North Carolina Health Care System's 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 Health Care System Funds (System Fund) 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 University of North Carolina Health Care System Funds (System Fund) 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.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

In accordance with *Government Auditing Standards*, we have also issued our report dated November 15, 2012 on our consideration of the University's 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, CPA
State Auditor

November 15, 2012

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM FUNDS MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

Management's discussion and analysis provides an overview of the financial activities of the University of North Carolina Health Care System (UNC Health Care) Funds (System Fund) for the fiscal year ending June 30, 2012.

UNC Health Care was established November 1, 1998, by *North Carolina General Statute* 116-37. UNC Health Care is governed by a Board of Directors as an affiliated enterprise of the University of North Carolina System. UNC Health Care and UNC Chapel Hill School of Medicine (UNC School of Medicine) are affiliated entities within the University System. The University of North Carolina Physicians & Associates (UNC P&A) is the clinical service component of the UNC School of Medicine and provides a full range of care to the patients of UNC Health Care. Rex Healthcare, Inc. (Rex), Chatham Hospital, Inc. (Chatham), and UNC Physicians Network (UNCPN), formerly Triangle Physician Network, LLC (TPN), are owned and controlled entities within UNC Health Care, an integrated health care provider.

The entities listed above collectively perform the operating functions of UNC Health Care and the UNC School of Medicine. The System Fund, conversely, does not perform revenue generating activities. The System Fund functions as a centralized financial clearinghouse for the integrated health care system.

The System Fund assesses, holds, and allocates funds across the entities of UNC Health Care. Initially formed as the Enterprise Fund to facilitate investments in support of the clinical, academic and research missions of UNC Health Care and the UNC School of Medicine, the Enterprise Fund today exists as a sub-account within the System Fund. Since its formation, the System Fund has been used to enable additional types of transfers between entities of UNC Health Care. As such, the Enterprise Fund, Outreach Fund, Patient Safety Fund, Recruitment Fund, and Shared Administrative Services Fund each function as sub-accounts of the System Fund.

Using the Financial Statements

The Governmental Accounting Standards Board (GASB) requires three basic financial statements: the *Statement of Net Assets*, the *Statement of Revenues, Expenses, and Changes in Net Assets*, and the *Statement of Cash Flows*.

The financial statement balances reported are presented in a classified format to aid the reader in understanding the nature of the operations. The *Notes to the Financial Statements* provide information relative to the significant accounting principles applied in the financial statements and further detail concerning the organization and its operations. 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.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

The *Statement of Net Assets* provides information relative to the 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 it is anticipated that they will 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 unrestricted. 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 System Fund 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 System Fund's operations, nonoperating activities, and other activities affecting net assets, which occurred during the fiscal year. Nonoperating activities include interest income. Other activities include transfers in and transfers out from/to UNC Health Care entities. Overall, the *Statement of Revenues, Expenses, and Changes in Net Assets* provides information relative to the management of the organization's operations and its ability to maintain its financial stability.

The *Statement of Cash Flows* provides information relative to the System Fund's sources and uses of cash for noncapital 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*.

Comparison of Two-Year Data for 2011 to 2012

Audited data for 2012 and 2011 are presented in this report and discussed in the following sections. Discussion in the following sections is pertinent to fiscal year 2012 results and changes relative to ending balances in fiscal year 2011.

Analysis of Overall Financial Position and Results of Operations

Statement of Net Assets

The sub-accounts of the System Fund collectively hold assets of \$119.2 million. Total assets increased by 62.4% over the prior year. Total liabilities increased by 42.9%. Pre-payments of UNC Hospitals' fiscal year 2013 commitments increased by \$1.8 million year over year and account for 23.5% of the System Fund assets and 35.4% of the System Fund liabilities as of June 30, 2012. Assets associated with the Enterprise Fund, the Patient Safety Fund, and the Shared Administrative Services Fund increased with enhanced entity participation in the mission support program as well as increased volume of shared administrative services. Noncurrent assets and liabilities increased due to non-current portion of Notes Receivable and Notes Payable. Notes Receivable were from Chatham Hospital and UNC Physicians Network and Notes Payable were to UNC Hospitals.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Revenues, Expenses, and Changes in Net Assets

Transfers in and out of the System Fund increased during fiscal year 2012, compared to fiscal year 2011. This was largely due to increased shared administrative services, increased reimbursement via the supplemental Medicaid reimbursement program and increased mission support payments from UNC Hospitals and Rex Healthcare. Shared Administrative Services have increased from the prior year as UNC Health Care has continued to integrate more of its administrative functions. Doing so has increased the number of administrative functions and departments throughout UNC Health Care that contribute to the overall operations and as such are included in the Shared Administrative Services category. Transfers in to the System Fund ultimately exceeded transfers out of the System Fund by \$21.8 million. Thus, Net Assets increased by \$22.1 million including interest income.

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

UNC Health Care derives the vast majority of its operating revenues from patient care services. Because the System Fund provides no revenue-generating services, it is entirely dependent upon the financial wherewithal of the entities within UNC Health Care. In recent years, the largest entities of UNC Health Care have achieved strong operating performance. Their performance has enabled the investments made through the System Fund in support of the clinical, education, and research programs of UNC P&A and the UNC School of Medicine. These investments have, in turn, yielded positive results as measured by growth in needed services, expansion of the medical school class and increased research funding. Further, UNC Health Care has been able to support the fledgling UNCPN during its start-up period and Chatham Hospital despite adverse economic conditions in its primary service area.

The conditions impacting UNC Health Care's operating entities constitute the greatest risk to the System Fund. National health policy changes are altering the financial outlook for health systems. Adapting to new models requires greater coordination of patient care, major investments in information technology, and an increased focus on wellness. Successfully managing in the future requires tighter integration of administrative functions across the entities of UNC Health Care, caring for patients in lower cost delivery settings, and comprising sufficient scale to spread the cost of major investments across a broad base. UNC Health Care has begun planning for these changes through a health system-wide planning and implementation process.

Payments for professional services continue to pressure the performance of physician providers. The pressure is strongest in academic medicine. Funding from major sources, patient care revenues for clinical services, research revenues for research discovery, and education revenue from State appropriated funds are each under pressure and inadequate to fully cover their costs. At the same time, improvements to the Medicaid payment mechanism will help reduce what have been large and increasing losses.

The private health insurance market has driven important changes in patient coverage and in how/when patients seek care. As premiums have increased in a soft employment market, some employers have dropped employer-provided insurance. For others, the premiums have

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

driven plan design decisions that have shifted cost to employees or created disincentives for seeking care, particularly for elective procedures. UNC Health Care relies heavily on privately insured patients as indigent and government payers generally do not cover the full cost of care. As this trend continues, UNC Health Care will face increasing pressure to reduce expenses.

Community-based practices face challenges attributable to similar health care financings and broader economic trends. As such, many community physicians have sought employment within health systems. UNC Health Care formed UNCPN to facilitate employment of community primary care providers. As a start-up, UNCPN has required cash infusions to develop central administrative infrastructure and deploy electronic medical records in the physician offices. Additionally, primary care practices historically situated within Rex Hospital, Inc. or UNC Hospitals moved into UNCPN. The losses from these practices are now incurred by UNCPN. These capital and operating investments will continue in future years.

Physicians newly employed by UNCPN also have short-term negative cash flow. Acquiring physical assets at fair market value constitute a relatively small investment. More importantly, UNCPN incurs operating expenses as providers and their support staffs begin employment with UNCPN. Conversely, payments for providing patient care typically lag by several months.

To further the mission of promoting the health of North Carolinians, UNC Health Care contractually agreed to fund the development of a coordinated system of clinical care for Piedmont Health Services, Inc. Piedmont Health Services, Inc. is a North Carolina non-profit corporation with six locations serving 14 counties in the Piedmont region. The purpose of this development is to increase access to care for the uninsured. The System Fund contributed \$750,000 to PHS for this program during the year ended June 30, 2012.

MANAGEMENT DISCUSSION AND ANALYSIS (CONCLUDED)

University of North Carolina Health Care System Funds (System Fund)
 Summary of Condensed Financial Statements Totals
 For the Fiscal Years Ended June 30, 2012 and 2011

Table 1

	FY12	FY11	Change
STATEMENT OF NET ASSETS			
Current Assets	\$ 109,580,867	\$ 69,425,766	\$ 40,155,101
Noncurrent Assets	9,663,073	4,000,000	5,663,073
TOTAL ASSETS	119,243,940	73,425,766	45,818,174
Current Liabilities	69,324,706	51,294,268	18,030,438
Noncurrent Liabilities	9,663,073	4,000,000	5,663,073
TOTAL LIABILITIES	78,987,779	55,294,268	23,693,511
Unrestricted Net Assets	\$ 40,256,161	\$ 18,131,498	\$ 22,124,663
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS			
Nonoperating Revenues	\$ 353,377	\$ 412,724	\$ (59,347)
Transfers In	204,645,345	138,112,605	66,532,740
Transfers Out	182,874,059	139,960,750	42,913,309
INCREASE (DECREASE) IN NET ASSETS	22,124,663	(1,435,421)	23,560,084
NET ASSETS - BEGINNING OF YEAR	18,131,498	19,566,919	(1,435,421)
NET ASSETS - END OF YEAR	\$ 40,256,161	\$ 18,131,498	\$ 22,124,663

University of North Carolina Health Care System Funds
Statement of Net Assets
June 30, 2012

Exhibit A-1

ASSETS

Current Assets:

Cash and Cash Equivalents:

Undesignated Funds (Note 2)	\$ 6,618,746
Designated for UNC Hospitals Program Support (Note 2)	1,700,000
Designated for UNC Physicians and Associates Program Support (Note 2)	32,665,330
Designated for UNC Physicians and Associates Mission Support (Note 2)	12,000,000
Designated for Shared Administrative Services (Note 2)	3,862,035
Designated for UNC Faculty Recruitment (Note 2)	7,000,000
Designated for Graduate Medical Education Support (Note 2)	<u>2,000,000</u>

Cash and Cash Equivalents Total	65,846,111
Due from UNC Health Care Entities (Note 3)	41,818,988
Notes Receivable	<u>1,915,768</u>

Total Current Assets	<u>109,580,867</u>
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Noncurrent Assets:

Cash and Cash Equivalents:

Designated for Graduate Medical Education Support (Note 2)	2,000,000
Notes Receivable	<u>7,663,073</u>

Total Noncurrent Assets	<u>9,663,073</u>
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Total Assets	<u>119,243,940</u>
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LIABILITIES

Current Liabilities:

Due to UNC Health Care Entities (Note 4)	34,797,344
Due to UNC School of Medicine	4,611,594
Notes Payable (Note 5)	1,915,768
Assessments Paid in Advance	<u>28,000,000</u>

Total Current Liabilities	<u>69,324,706</u>
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Noncurrent Liabilities:

Due to UNC Health Care Entities (Note 4)	2,000,000
Notes Payable (Note 5)	<u>7,663,073</u>

Total Noncurrent Liabilities	<u>9,663,073</u>
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Total Liabilities	<u>78,987,779</u>
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NET ASSETS

Unrestricted	<u>\$ 40,256,161</u>
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The accompanying notes to the financial statements are an integral part of this statement.

**University of North Carolina Health Care System Funds
Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Year Ended June 30, 2012**

Exhibit A-2

REVENUES

Operating Revenues \$ 0

EXPENSES

Operating Expenses

NONOPERATING REVENUES

Interest Income 353,377

TRANSFERS IN

Regular Assessments (Note 6) 37,799,601
 Special Assessments (Note 6) 36,485,419
 Mission Support Assessments (Note 6) 22,778,061
 Shared Administrative Services Assessments (Note 6) 107,582,264

Total Transfers In 204,645,345

TRANSFERS OUT

Program Support (Note 7) 65,410,570
 Shared Administrative Services (Note 7) 105,263,489
 Mission Support (Note 7) 12,200,000

Total Transfers Out 182,874,059

Increase in Net Assets 22,124,663

NET ASSETS

Net Assets - July 1, 2011 18,131,498

Net Assets - June 30, 2012 \$ 40,256,161

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

University of North Carolina Health Care System Funds
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2012

Exhibit A-3

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Transfers In from Entities	\$ 170,148,551
Transfers Out to Entities	<u>(170,559,389)</u>
Net Cash Used by Noncapital Financing Activities	<u>(410,838)</u>

CASH FLOWS FROM INVESTING ACTIVITIES

Interest Income	<u>353,377</u>
Net Decrease in Cash and Cash Equivalents	(57,461)
Cash and Cash Equivalents - July 1, 2011	<u>67,903,572</u>
Cash and Cash Equivalents - June 30, 2012	<u><u>\$ 67,846,111</u></u>

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:	
Cash and Cash Equivalents	\$ 65,846,111
Noncurrent Assets:	
Cash and Cash Equivalents	<u>2,000,000</u>
Total Cash and Cash Equivalents - June 30, 2012	<u><u>\$ 67,846,111</u></u>

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

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM FUNDS
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

- A. Organization** - The University of North Carolina Health Care System (UNC Health Care) was established November 1, 1998 by *North Carolina General Statute* 116-37. UNC Health Care was established by the North Carolina General Assembly to provide patient care, facilitate the education of physicians and other health care providers, conduct research collaboratively with the health sciences schools of the University of North Carolina at Chapel Hill (UNC-CH), and render other services designed to promote the health and well-being of the citizens of North Carolina.

UNC Health Care is governed by a Board of Directors (Board) as an affiliated enterprise of the University of North Carolina (UNC) System. UNC Health Care and UNC-CH are affiliated entities within the University of North Carolina System. The University of North Carolina Physicians & Associates (UNC P&A) is the clinical service component of the UNC School of Medicine and provides a full range of care to patients of UNC Health Care. Rex Healthcare, Inc. (Rex), Chatham Hospital, Inc. (Chatham), and UNC Physicians Network, LLC (UNCPN) are owned and controlled entities within UNC Health Care, an integrated health care provider.

The Board's vision for UNC Health Care is to be the nation's leading public academic health care system. The Board authorized the creation of the UNC Health Care System Funds (System Fund) to enable fund transfers among entities in the health system in support of the articulated vision and statutory missions.

The System Fund assesses, holds, and allocates funds across the entities of UNC Health Care. Initially formed as the Enterprise Fund to facilitate investments in support of the clinical, academic and education missions of UNC Health Care and the UNC School of Medicine, the Enterprise Fund today exists as a sub-account within the System Fund.

Since its formation, the System Fund has broadened its scope to include five distinct funds. These funds function as sub-accounts and collectively constitute the System Fund. These funds are as follows:

The Enterprise Fund – The Enterprise Fund provides support for the teaching, research and clinical missions of UNC Health Care and the UNC School of Medicine. It is funded by assessments against revenues

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

of UNC Hospitals, UNC School of Medicine, UNC P&A, and Rex, made at least annually. Assessments to the constituent entities are determined on an annual basis or more often as necessary. UNC Hospitals, UNC P&A and Rex make additional mission support contributions to the Enterprise Fund if they have met required organizational goals. The overwhelming majority of transfers from the Enterprise Fund are made to the clinical departments of the UNC School of Medicine and UNC P&A for their teaching, research, and clinical programs.

The Outreach Fund – The Outreach Fund was initially invested in innovative projects designed to improve the health of the community with particular focus on geriatrics and other underserved constituencies. The initial funds were formed by a one-time contribution from UNC Hospitals. These funds were fully expended by the end of fiscal year 2009. The Outreach Fund was subsequently re-chartered in fiscal year 2010 by a transfer from the Enterprise Fund in the amount of \$10,000,000. These funds are being expended at a rate of \$2,000,000 per year to offset expenses incurred by clinical departments for graduate medical education (GME). These funds will be fully expended by the end of fiscal year 2014.

The Recruitment Fund – The Recruitment Fund was established through a special assessment at the end of fiscal year 2010 in the amount of \$7,000,000 to enable critical faculty recruitments to the UNC School of Medicine. The Recruitment Fund is designed to provide salary support for recruitments deemed critical to the missions of the UNC School of Medicine. It was formed by contributions from UNC Hospitals, UNC P&A, and several UNC School of Medicine clinical departments in response to a crisis in UNC Health Care’s cardiac surgery program. These funds are set aside to enable UNC Hospitals, UNC P&A, and the UNC School of Medicine to collaboratively recruit faculty physicians to better serve the people of North Carolina. No funds were expended from the Recruitment Fund in fiscal year 2012.

The Patient Safety Fund – The Patient Safety Fund (Performance Improvement and Patient Safety Innovations Fund or PIPSIF) enables UNC Health Care to designate resources specifically intended to improve patient care and further reduce potential harm to patients. UNC Hospitals contributed \$1,000,000 during the fiscal year in support of this effort.

The Shared Administrative Services Fund – The Shared Administrative Services Fund is used to assess and allocate administrative expenses for UNC Health Care’s centralized services. These services (including but not limited to information technology, human resources, finance, strategic planning, risk management, etc.) are provided more efficiently and effectively on a consolidated basis.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- 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 System Fund is a part of UNC Health Care, an affiliated enterprise of the multi-campus University of North Carolina System. The University of North Carolina System is a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report*.

The accompanying financial statements present all funds belonging to the System Fund, for which the UNC Health Care Board is responsible. *North Carolina G.S. 116-37* grants authority and responsibility to meet patient-care, educational, research, and public service goals of UNC Health Care.

- C. Basis of Presentation** - The accompanying financial statements are presented in accordance with GAAP 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*, UNC Health Care is considered to be a single business type activity that qualifies for reporting in a single column. Since the System Fund is a component of UNC Health Care, it is also presented in a single column.

In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the System Fund 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 System Fund 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Nonexchange transactions, in which the System Fund receives (or gives) value without directly giving (or receiving) equal value in exchange includes assessments, mission support, and contributions.

- E. Cash and Cash Equivalents** - This classification includes 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. Net Assets** - The System Fund's net assets are classified as unrestricted. Unrestricted net assets include resources derived from assessments, mission support, shared administrative services, and interest income.
- G. Transfers In and Transfers Out** - The System Fund supports UNC Health Care and UNC School of Medicine clinical, research, and teaching initiatives based on recommendations by the management team, ultimately approved by the Chief Executive Officer. The transfers in and transfers out reported for the System Fund supporting these initiatives result from the following:

Regular Assessments – Ongoing funding needs which are estimated annually based on requests submitted, reviewed and approved, and paid for by monies transferred from UNC Hospitals, UNC P&A, UNC School of Medicine, and Rex. Funding amounts required and the corresponding assessments are determined annually but may be revised throughout the year as necessary.

Special Assessments – Funding needs that arise during the year that were not identified during the annual budgeting process are approved as needed by the Chief Executive Officer of UNC Health Care.

Mission Support Assessments and Transfers Out – UNC Hospitals and UNC P&A are entities of UNC Health Care with highly interdependent activities. Mission Support aligns incentives by creating shared organizational goals. The level of support increases with better performance on quality, research, education, patient satisfaction, employee satisfaction, and financial metrics. This approach impels employees across the enterprise to improve in the research, education, and clinical missions.

UNC Hospitals and UNC P&A make additional payments to the System Fund if a specific set of pre-determined organizational goals are achieved. Mission Support was first established in fiscal year 2009, and has been paid in each subsequent year. UNC Hospitals and Rex made additional mission support payments to the System Fund during the fiscal year and

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the goal is for all of the other UNC Health Care entities to contribute in the future.

Program Support – The primary function of the System Fund is to support those programs that have been identified as being beneficial to achieving UNC Health Care’s patient-care, research and education mission but that cannot support themselves or otherwise need additional funding to achieve the desired outcome. Program Support payments fill the funding gap for these programs. For the current fiscal year, 70% of the program support payments went to UNC P&A and UNC School of Medicine.

Shared Administrative Services Assessments and Transfers Out – Shared administrative services refers to those administrative functions across UNC Health Care’s affiliated entities that benefit multiple locations and the resulting cost should be shared or allocated across the System. UNC Health Care assesses each entity for services received and then reimburses the entities providing the service and incurring the shared cost. The assessment is established annually based on budgeted shared costs.

NOTE 2 - DEPOSITS

The System Fund is the name of UNC Health Care’s bank account for central administrative functions. It contains several distinct funds and is subject to the provisions of the Executive Budget Act, except for trust funds identified in *North Carolina General Statutes* 116-36.1 (Regulation of Institutional Trust Funds) and 116-37.2 (Regulation of UNC Hospitals Funds). These statutes primarily apply to the receipts generated by patient billings and other revenues from the operations of UNC Hospitals and UNC P&A. As defined in the statutes, these funds may consist of moneys received from or for the operation by an institution of any of its self-supporting auxiliary enterprises or moneys received by an institution in respect to fees and other payments for services rendered by medical, dental or other health care professionals under an organized practice plan approved by the institution or under a contractual agreement between the institution and a hospital or other health care provider.

At June 30, 2012, the amount shown on the Statement of Net Assets as current cash and cash equivalents of \$65,846,111 and noncurrent cash and cash equivalents of \$2,000,000 represents the System Fund’s equity position in the State Treasurer’s Short-Term Investment Fund. The Short-Term Investment Fund (a portfolio within the State Treasurer’s Investment Pool, an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating) had a weighted average maturity of 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

A reconciliation of deposits and corresponding designations as of June 30, 2012 is as follows:

	Enterprise Fund	Outreach Fund	Recruitment Fund	Patient Safety Fund	Shared Administrative Services Fund	Total
Deposits						
Current:						
Undesignated Funds	\$ 5,509,093	\$ 0	\$ 0	\$ 1,109,653	\$ 0	\$ 6,618,746
Designated for UNC Hospitals Program Support	1,700,000					1,700,000
Designated for UNC P&A Program Support	32,665,330					32,665,330
Designated for UNC P&A Mission Support	12,000,000					12,000,000
Designated for Shared Administrative Services					3,862,035	3,862,035
Designated for UNC Faculty Recruitment			7,000,000			7,000,000
Designated for Graduate Medical Education Support		2,000,000				2,000,000
Noncurrent:						
Designated for Graduate Medical Education Support		2,000,000				2,000,000
Total Deposits	<u>\$ 51,874,423</u>	<u>\$ 4,000,000</u>	<u>\$ 7,000,000</u>	<u>\$ 1,109,653</u>	<u>\$ 3,862,035</u>	<u>\$ 67,846,111</u>

NOTE 3 - DUE FROM UNC HEALTH CARE ENTITIES

Amounts due from UNC Health Care entities at June 30, 2012 by type and entity were as follows:

	<u>Amount</u>
Assessments	
UNC Hospitals	\$ 5,817,954
UNC Physicians & Associates	6,853,894
Rex Healthcare	1,437,338
Chatham Hospital	329,016
UNC Physicians Network	371,528
Mission Support	
UNC Hospitals	10,331,975
Rex Healthcare	2,711,629
Shared Administrative Services	
UNC Hospitals	10,142,035
UNC Physicians & Associates	2,112,751
Rex Healthcare	491,667
Chatham Hospital	1,032,381
UNC Physicians Network	186,820
Total Due from Health Care Entities	<u>\$ 41,818,988</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 4 - DUE TO UNC HEALTH CARE ENTITIES

Amounts due to UNC Health Care entities at June 30, 2012 by type and entity were as follows:

	<u>Amount</u>
Current:	
Assessments	
UNC Hospitals	\$ 1,700,000
UNC Physicians & Associates	3,962,104
UNC Physicians Network	554,851
Mission Support	
UNC Physicians & Associates	12,000,000
Shared Administrative Services	
UNC Hospitals	14,909,520
UNC Physicians & Associates	1,367,533
Rex Healthcare	78,574
UNC Physicians Network	<u>224,762</u>
Total Current Due to Health Care Entities	<u><u>\$ 34,797,344</u></u>
Noncurrent:	
Assessments	
UNC Physicians & Associates	<u><u>\$ 2,000,000</u></u>

NOTE 5 - NOTES PAYABLE

The System Fund borrowed \$9,578,841 from UNC Hospitals in June 2012 to facilitate funding the operations of UNCPN and Chatham Hospital. The principal amount is to be repaid in 60 equal monthly installments at a simple interest variable rate equal to 2xLIBOR, plus three quarters of one percent (0.75%), until paid in full. Interest will not be charged if the principal amount is paid in full on or before October 15, 2012.

Notes Payable activity for the year ended June 30, 2012 was as follows:

<u>Balance</u> <u>July 1, 2011</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance</u> <u>June 30, 2012</u>	<u>Current</u> <u>Portion</u>
<u>\$ 0</u>	<u>\$ 9,578,841</u>	<u>\$ 0</u>	<u>\$ 9,578,841</u>	<u>\$ 1,915,768</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 6 - TRANSFERS IN

Transfers in by source and entity at June 30, 2012 are presented as follows:

	<u>Amount</u>
Regular Assessments:	
UNC Hospitals	\$ 28,583,022
UNC Physicians & Associates	7,269,919
UNC School of Medicine	300,000
Rex Healthcare	<u>1,646,660</u>
Total Regular Assessments	<u><u>\$ 37,799,601</u></u>
Special Assessments:	
UNC Hospitals	\$ 13,239,371
UNC Physicians & Associates	13,954,800
Rex Healthcare	8,756,281
Chatham Hospital	329,016
UNC Physicians Network	<u>205,951</u>
Total Special Assessments	<u><u>\$ 36,485,419</u></u>
Mission Support:	
UNC Hospitals	\$ 20,066,432
Rex Healthcare	<u>2,711,629</u>
Total Mission Support Assessments	<u><u>\$ 22,778,061</u></u>
Shared Administrative Services:	
UNC Hospitals	\$ 87,387,053
UNC Physicians & Associates	15,027,082
Rex Healthcare	2,702,538
Chatham Hospital	1,032,381
UNC Physicians Network	<u>1,433,210</u>
Total Shared Administrative Services	<u><u>\$ 107,582,264</u></u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 7 - TRANSFERS OUT

Transfers out by purpose and entity at June 30, 2012 are as follows:

	Amount
Program Support:	
UNC Physicians & Associates	
Anesthesiology	\$ 10,483,895
Emergency Medicine	1,096,000
Gastroenterology	300,000
Heart & Vascular	1,300,000
Nephrology	513,940
Neurology	2,659,346
Obstetrics Gynecology	350,000
Oncology	5,809,030
Ophthalmology	906,482
Orthopaedics	1,585,751
Other	8,195,622
Otolaryngology	125,000
Pediatrics	1,075,000
Physical Medicine & Rehabilitation	64,571
Primary Care	894,000
Psychiatry	150,000
Radiology	2,230,000
Surgery	3,110,000
Total UNC Physicians & Associates Program Support	40,848,637
UNC Hospitals	1,700,000
UNC School of Medicine	4,880,555
UNC Physicians Network	15,231,378
Chatham Hospital	2,000,000
Piedmont Health Services	750,000
Total Program Support	\$ 65,410,570
Shared Administrative Services:	
UNC Hospitals	\$ 98,656,618
UNC Physicians & Associates	6,079,734
Rex Healthcare	527,137
Total Shared Administrative Services	\$ 105,263,489
Mission Support:	
UNC Physicians & Associates	\$ 12,200,000

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 8 - RELATED PARTIES

University of North Carolina Hospitals at Chapel Hill - The UNC Hospitals at Chapel Hill (UNC 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. As a state agency, UNC Hospitals conforms to financial requirements established by statutory and constitutional provisions. While UNC Hospitals is exempt from both federal and state income taxes, a small portion of its revenue is subject to the unrelated business income tax.

UNC Hospitals paid \$149,275,878 for assessments, mission support, and shared administrative services to the System Fund and extended a \$9,578,841 note receivable to the System Fund over the course of the year. Likewise, the System Fund also made \$100,356,618 in payments to UNC Hospitals for program support and shared administrative services expenses during the year ended June 30, 2012.

University of North Carolina School of Medicine – The UNC School of Medicine was assessed and paid the System Fund \$300,000 during the year and received \$4,880,555 in program support during the year ended June 30, 2012.

University of North Carolina Physicians & Associates – The UNC Physicians & Associates (UNC P&A) is the clinical service component of the UNC School of Medicine. At the heart of UNC P&A are the approximately 1,200 faculty physicians who provide a full range of specialty and primary care services for patients of UNC Health Care. While the great majority of services are rendered at the inpatient units of UNC Hospitals and the outpatient clinics on the UNC campus, there is a growing range of services provided at clinics in the community. There are 18 clinical departments, one clinical center, two affiliated departments, and two administrative units that collectively form UNC P&A.

Clinical Departments:

Anesthesiology	Orthopaedics
Dermatology	Otolaryngology
Emergency Medicine	Pathology & Laboratory Medicine
Family Medicine	Pediatrics
Medicine	Psychiatry
Neurology	Physical Medicine & Rehabilitation
Neurosurgery	Radiation Oncology
Obstetrics & Gynecology	Radiology
Ophthalmology	Surgery

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Clinical Center:

Heart & Vascular

Affiliated Departments:

Allied Health Sciences
Carolina Institute for Developmental Disabilities

Administrative Units:

Administrative Office
Ambulatory Administration

While UNC P&A is affiliated with the UNC Health Care, the net assets of UNC P&A are held in UNC Chapel Hill (UNC-CH) trust funds. The operating income and expenses for UNC P&A are incorporated into UNC-CH's accounting infrastructure. As such, its operational results are included in the UNC-CH annual audit.

UNC P&A paid \$36,251,801 for assessments and shared administrative services to the System Fund over the course of the year. The System Fund also made payments to UNC P&A in the amount of \$59,128,371 for program support, mission support, and shared administrative services reimbursements during the year ended June 30, 2012.

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 health care services to the residents of Wake County, North Carolina and surrounding counties. UNC Health Care acquired Rex in 2000 and is the sole member of the corporation. UNC Health Care 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, Inc. also owns Rex Home Services, Inc.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

Rex paid \$15,817,108 for assessments and shared administrative services to the System Fund and received \$527,137 for shared administrative service expenses during the year ended June 30, 2012.

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.

UNC Health Care acquired Chatham Hospital in 2008 and is the sole member of the corporation. UNC Health Care appoints nine of the 15 members on the Chatham Hospital, Inc. Board and reviews and approves its annual operating and capital budgets.

Chatham paid \$1,361,397 for assessments and shared administrative services to the System Fund and received \$2,000,000 for program support and an additional \$2,000,000 in exchange for a note payable to the System Fund during the year ended June 30, 2012.

UNC Physicians Network, LLC - Formerly known as Triangle Physician Network, LLC (TPN), UNC Physicians Network, LLC (UNCPN) is a wholly-owned subsidiary of UNC Health Care, 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

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

physicians and UNC Health Care to face the challenging health care environment.

UNCPN paid \$1,639,161 for assessments and shared administrative services to the System Fund and received \$15,231,378 for program support and an additional \$7,578,841 in exchange for a note payable to the System Fund during the year ended June 30, 2012 to fund ongoing start-up expenses including information technology costs, administrative functions and central billing office.

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Beth A. Wood, CPA
State Auditor

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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 Health Care System Funds (System Fund), 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 November 15, 2012.

As discussed in Note 1, the financial statements present only the University of North Carolina Health Care System Funds (System Fund) 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.

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

**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING
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deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the System Fund's 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 System Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no 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 System Fund, the Board of Governors, the Board of Directors of the University of North Carolina Health Care System, the Audit and Compliance Committee, others within the entity, the Governor, the General Assembly, and the State Controller, and is not intended to be and should not be used by anyone other than these specified parties.



Beth A. Wood, CPA
State Auditor

November 15, 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:

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This audit required 138 audit hours at an approximate cost of \$9,936.