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, 2014

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

A Constituent Institution of the University of North Carolina System and a Component Unit of the State of North Carolina

STATE OF NORTH CAROLINA
Office of the State Auditor

Beth A. Wood, CPA
State Auditor

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

AUDITOR'S TRANSMITTAL

The Honorable Pat McCrory, 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, 2014, and our audit results are included in this report. You will note from the independent auditor's report that we determined that the financial statements are presented fairly in all material respects.

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

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

Beth A. Wood

Beth A. Wood, CPA
State Auditor

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INDEPENDENT AUDITOR'S REPORT

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

Report on the Financial Statements

We have audited the accompanying 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, 2014, and the related notes to the financial statements, which collectively comprise the Hospitals' basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Hospitals' preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Hospitals' internal control. Accordingly, we express no such opinion. An audit also includes

evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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, 2014, and the changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

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.

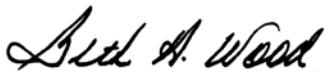
As discussed in Note 17 to the financial statements, during the year ended June 30, 2014, the University of North Carolina Hospitals at Chapel Hill adopted new accounting guidance, Governmental Accounting Standards Board Statement No. 65 – *Items Previously Reported as Assets and Liabilities*. Our opinion is not modified with respect to this matter.

Other Matters – Required Supplementary Information

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 a 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 our audit of the basic financial statements. 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.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated October 24, 2014 on our consideration of the Hospitals' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Hospitals' internal control over financial reporting and compliance.



Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

October 24, 2014

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The Management's Discussion and Analysis section of the University of North Carolina Hospitals at Chapel Hill (Hospitals) annual financial report is provided as an overview of the financial position and operating results as of and for the fiscal years ended June 30, 2014 and 2013. This discussion and analysis should be read in conjunction with the combined financial statements and related notes which follow this discussion and analysis.

Using this Financial Report

The Hospitals' financial statements report information of the Hospitals using accounting methods similar to those used by private-sector health organizations. These statements offer short and long-term financial information about its activities.

Statement of Net Position

The statement of net position shows the financial position of the Hospitals and includes all of the Hospitals' assets (resources), deferred outflows of resources, liabilities (claims to resources), deferred inflows of resources, and net position (equity). The statement of net position also provides the basis for evaluating the capital structure, liquidity and financial flexibility of the Hospitals.

Statement of Revenues, Expenses and Changes in Net Position

Revenues and expenses are accounted for in the statement of revenues, expenses and changes in net position. This statement measures the success of the Hospitals' operations and can be used to determine whether the Hospitals successfully recovered all of its costs through its fees and other sources of revenue, profitability and credit worthiness.

Statement of Cash Flows

The statement of cash flows reports cash receipts, cash payments and net changes in cash resulting from operating, investing and capital and related financing activities, and noncapital related financing activities. It also provides answers to such questions as where cash comes from, what cash was used for, and what the change in the cash balance was during the reporting period.

Notes to the Combined Financial Statements

Notes to the financial statements are designed to give the reader additional information concerning the Hospitals and further supports the statements noted above.

Financial Analysis

The statement of revenues, expenses and changes in net position reports the net position of the Hospitals and the changes affecting them. The Hospitals' net position, the difference between assets (plus deferred outflows) and liabilities (plus deferred inflows), are a way to measure

financial health or financial position. Over time, increases or decreases in the Hospitals' net position are one indicator of whether its financial health is improving or deteriorating. However, one will also need to consider other non-financial factors such as changes in economic conditions, population growth and new or changed governmental legislation.

Condensed Statements of Net Position

The following condensed statements of net position show the Hospitals' financial position at June 30, 2014 and 2013.

STATEMENTS OF NET POSITION

	FY14	FY13 (as restated)	Change
Current Assets	$ 469,319,146	$ 490,535,784	$ (21,216,638)
Capital Assets, Net	756,394,190	725,959,295	30,434,895
Other Noncurrent Assets	653,006,302	595,345,630	57,660,672
TOTAL ASSETS	1,878,719,638	1,811,840,709	66,878,929
DEFERRED OUTFLOWS OF RESOURCES	28,314,908	30,185,885	(1,870,977)
Current Liabilities	271,911,621	259,431,950	12,479,671
Noncurrent Liabilities	355,460,968	343,385,465	12,075,503
TOTAL LIABILITIES	627,372,589	602,817,415	24,555,174
DEFERRED INFLOWS OF RESOURCES	0	0	0
Net Investment in Capital Assets	534,729,643	498,133,285	36,596,358
Restricted for Expendable Uses	213,523,584	198,925,368	14,598,216
Unrestricted	531,408,730	542,150,526	(10,741,796)
TOTAL NET POSITION	**$ 1,279,661,957**	**$ 1,239,209,179**	**$ 40,452,778**

Total assets increased $66.9 million in 2014. The increase results from operations, return on investments, investment in capital assets, and increase in receivables due from UNC Health Care System.

Total liabilities increased $24.6 million from June 30, 2013. Drivers of this increase include vendor payment liabilities, accrued salaries and benefits, and a $12.9 million license payable related to the electronic medical record system. Some of this comprised of year end timing of liabilities.

Net position increased $40.5 million during the year ended June 30, 2014 as the result of operating income of $74.7 million, investment earnings and other nonoperating net income of $51.8 million, and UNC Health Care System assessments and capital gifts of $86.1 million. For further information on this change, see the following statement of revenues, expenses, and changes in net position.

Capital Assets

In 2014, the Hospitals expended $81.5 million on the acquisition and construction of buildings, infrastructure, and renovations. An additional $25.0 million was paid during the year for capital equipment throughout the facilities and $9.3 million on software. Total capital investment was just over $100 million for the year as shown in Note 5.

Long-term Debt Activities

At June 30, 2014, the Hospitals had outstanding bond indebtedness in the amount of $265.5 million of which $40.5 million is due within the next year. Standard & Poor's and Moody's Rating Services classify these bonds at AA and Aa3, respectively. The Hospitals participate in no other rating reviews. The Hospitals entered into an additional $6.9 million in capital leases during the year. The outstanding indebtedness of the Hospitals is described in Note 6.

Condensed Statements of Revenues, Expenses, and Changes in Net Position

While the combined statements of net position show the financial position of the Hospitals, the following condensed statements of revenues, expenses, and changes in net position provides answers to the nature and source of changes in net position for the years ended June 30, 2014 and 2013:

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION

	FY14	FY13 (as restated)	Change
Net Patient Service Revenue	$ 1,223,303,736	$ 1,181,901,473	$ 41,402,263
Other Operating Revenues	32,413,169	29,871,981	2,541,188
TOTAL OPERATING REVENUES	**1,255,716,905**	**1,211,773,454**	**43,943,451**
Salaries and Benefits	651,619,625	622,244,019	29,375,606
Medical and Surgical Supplies	241,904,515	210,940,628	30,963,887
Contracted Services	126,323,552	107,078,458	19,245,094
Other Supplies and Services	72,074,864	72,875,117	(800,253)
Medical Malpractice Cost	906,560	1,947,437	(1,040,877)
Communications, Utilities, and Travel	26,268,619	24,124,171	2,144,448
Depreciation and Amortization	61,880,237	58,646,298	3,233,939
TOTAL OPERATING EXPENSES	**1,180,977,972**	**1,097,856,128**	**83,121,844**
OPERATING INCOME	**74,738,933**	**113,917,326**	**(39,178,393)**
Investment Activity	61,462,166	47,411,194	14,050,972
Other Nonoperating Revenues	889,935	1,019,557	(129,622)
Nonoperating Expenses	(10,579,567)	(11,713,653)	1,134,086
NET NONOPERATING REVENUES	**51,772,534**	**36,717,098**	**15,055,436**
Capital Gifts	598,925	432	598,493
Health Care System Assessments	(86,657,614)	(92,724,464)	6,066,850
INCREASE IN NET POSITION	**40,452,778**	**57,910,392**	**(17,457,614)**
NET POSITION - BEGINNING OF YEAR, AS RESTATED	**1,239,209,179**	**1,181,298,787**	**57,910,392**
NET POSITION - END OF YEAR	**$ 1,279,661,957**	**$ 1,239,209,179**	**$ 40,452,778**

Net patient revenue increased $41.4 million as inpatient volumes were relatively flat year-over-year reflecting capacity constraints while outpatient volume increased approximately 3%. This increase is attributable slightly to operations as well as pricing and reimbursement rates.

Operating expenses increased $83.1 million year-over year. For the year ended June 30, 2014, operating expenses include $25.8 million of expenses specifically related to the fiscal year 2014 implementation of the EPIC electronic health record system. These operating costs related to the implementation are primarily related to training costs and impact salaries, contracted services, and other supplies and services. Salaries and benefits also include increases driven by volume and market adjustments. The increase in medical supplies reflects a significant increase in pharmaceutical supplies expense as a result of increases in volume and cost.

Net nonoperating revenues increased $15.1 million year-over-year driven by improved investment returns.

Health Care System assessments reflect funding by the Hospitals of initiatives that the Chief Executive Officer of University of North Carolina Health Care System deems appropriate. These assessments are quantified based on recommendations made from the Senior Leadership Team to further patient care, research and the teaching mission of the UNC Health Care System. These assessments are described in more detail in Note 14.

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

The fiscal state of healthcare across the nation is in the midst of rapid change. Increasingly, third-party payors, including governmental sponsored programs, are migrating from fee-for-service to fee-for-value. UNC Health Care is positioning itself to be a leader in the new health care environment that will ultimately reimburse less for services currently provided to our patients. We are testing a number of different programs aimed at learning how to continue to prosper in this new health care environment. We have implemented programs aimed at different aspects of population health management at each of our medical institutions. These programs include an operational and strategic partnership with Alignment Healthcare for population management. This partnership will kick off with the offering of a new Medicare Advantage HMO plan for seniors in Wake County, North Carolina in the fall of 2014. Learning from these programs will allow UNC Health Care to more rapidly scale and ramp-up our initiatives when appropriate.

UNC Health Care implemented a new electronic medical record system at its Triangle locations in fiscal year 2014. UNC Health Care is able to better serve our patients across numerous locations by accessing patient care records that have been consolidated on the same platform.

Continued reductions to payment levels for Medicaid patients, added legislative burdens, and cuts to the University of North Carolina School of Medicine place added pressures on UNC Hospitals. Management is committed to proper expense management while maintaining high

quality patient care, innovation, and very satisfied patients. Our teams will continue to focus on our *Commitment to Caring* which has proven to be a differentiator in care delivered by UNC Hospitals for many years.

ASSETS		
Current Assets:		
Cash and Cash Equivalents (Note 2)	$	43,554,656
Restricted Cash and Cash Equivalents (Note 2)		2,514,810
Receivables:		
Patient Accounts Receivable, Net (Note 3)		175,911,112
Accrued Interest Receivable		70,355
Other Accounts Receivable, Net		43,343,454
Due from Primary Government		4,878,536
Due from State of North Carolina Component Units		70,434,033
Estimated Third Party Settlements (Note 4)		53,416,882
Inventories		31,439,613
Prepaid Expense		40,111,458
Notes Receivable (Note 14)		3,644,237
Total Current Assets		469,319,146
Noncurrent Assets:		
Restricted Cash and Cash Equivalents (Note 2)		132,746,078
Restricted Investments (Note 2)		72,941,187
Investments (Note 2)		67,205,213
Investments Designated for Capital Projects (Note 2)		310,070,000
Due from State of North Carolina Component Units		9,554,572
Advanced Deposits with Liability Insurance Trust Fund (Note 12)		7,363,790
Patient Accounts Receivables, Net (Note 3)		451,175
Start-Up Cost, Net		432,147
Investments in Affiliates (Note 15)		15,004,037
Notes Receivable (Note 14)		37,238,103
Capital Assets - Nondepreciable (Note 5)		184,513,302
Capital Assets - Depreciable, Net (Note 5)		571,880,888
Total Noncurrent Assets		1,409,400,492
Total Assets		1,878,719,638
DEFERRED OUTFLOWS OF RESOURCES		
Deferred Loss on Refunding		10,741,712
Accumulated Decrease in Fair Value of Hedging Derivatives		17,573,196
Total Deferred Outflows of Resources		28,314,908
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities		79,200,467
Accrued Salaries and Benefits		62,976,225
Estimated Third Party Settlements (Note 4)		21,340,684
Due to Patients or Third parties		6,465,974
Due to Primary Government		7,683,302
Due to State of North Carolina Component Units		32,094,400
Funds Held for Others		1,272,014
Interest Payable		1,051,788
Long-Term Liabilities - Current Portion (Note 6)		59,826,767
Total Current Liabilities		271,911,621

Noncurrent Liabilities:	
Long-Term Liabilities, Net (Note 6)	284,777,348
Hedging Derivative Liability (Note 7)	17,573,196
Estimated Third Party Settlements (Note 4)	53,110,424
Total Noncurrent Liabilities	355,460,968
Total Liabilities	627,372,589
DEFERRED INFLOWS OF RESOURCES	0
NET POSITION	
Net Investment in Capital Assets	534,729,643
Restricted for Expendable:	
Maintenance Reserve Fund	205,687,265
Liability Insurance Trust Fund	7,363,790
Trust Fund Donations	472,529
Unrestricted	531,408,730
Total Net Position	$ 1,279,661,957

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 Position
For the Fiscal Year Ended June 30, 2014 *Exhibit A-2*

REVENUES		
Operating Revenues:		
Net Patient Service Revenue (Note 9)	$	1,223,303,736
Other Operating Revenues		32,413,169
Total Operating Revenues		1,255,716,905
EXPENSES		
Operating Expenses:		
Salaries and Benefits		651,619,625
Medical and Surgical Supplies		241,904,515
Contracted Services		126,323,552
Other Supplies and Services		72,074,864
Medical Malpractice Cost		906,560
Communications, Utilities, and Travel		26,268,619
Depreciation/ Amortization		61,880,237
Total Operating Expenses		1,180,977,972
Operating Income		74,738,933
NONOPERATING REVENUES (EXPENSES)		
Noncapital Grants and Gifts		145,260
Federal Interest Subsidy on Debt		741,905
Investment Income (Net of Investment Expense of $913,513)		61,462,166
Interest and Fees on Debt		(9,355,957)
Loss on Disposal of Capital Assets		(1,223,610)
Other Nonoperating Revenues		2,770
Net Nonoperating Revenues		51,772,534
Income Before Other Revenues and Expenses		126,511,467
Capital Gifts		598,925
Health Care System Assessments (Note 14)		(86,657,614)
Increase in Net Position		40,452,778
NET POSITION		
Net Position - July 1, 2013, as Restated (Note 17)		1,239,209,179
Net Position - June 30, 2014	$	1,279,661,957

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

CASH FLOWS FROM OPERATING ACTIVITIES		
Received from Patients or Third Parties	$	1,212,141,113
Payments to Employees and Fringe Benefits		(701,240,906)
Payments to Vendors and Suppliers		(442,737,633)
Payments for Medical Malpractice		(2,576,648)
Other Receipts		19,967,056
Net Cash Provided by Operating Activities		85,552,982
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Health Care System Assessments		(86,657,614)
Principal Paid on Revenue Bonds		(1,088,000)
Interest and Fees Paid on Revenue Bonds		(363,391)
Noncapital Gifts and Grants		145,460
Net Cash Used by Noncapital Financing Activities		(87,963,545)
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES		
Proceeds from Sale of Capital Assets		18,380,256
Acquisition and Construction of Capital Assets		(104,938,968)
Principal Paid on Capital Revenue Bonds		(9,537,000)
Principal Paid on Notes Payable and Leases		(4,101,064)
Interest and Fees Paid on Capital Debt and Leases		(8,264,166)
Federal Interest Subsidy on Debt Received		741,905
Net Cash Used by Capital Financing and Related Financing Activities		(107,719,037)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment Income		1,964,312
Purchase of Investments		(10,000,000)
Investments in and Loans to Affiliated Enterprises		(40,426,608)
Net Cash Used by Investing Activities		(48,462,296)
Net Decrease in Cash and Cash Equivalents		(158,591,896)
Cash and Cash Equivalents - July 1, 2013		337,407,440
Cash and Cash Equivalents - June 30, 2014	$	178,815,544

RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating Income	$	74,738,933
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation/ Amortization Expense		61,880,237
Changes in Assets and Liabilities:		
Patient Accounts Receivables, Net		(22,593,866)
Due from Primary Government		(120,917)
Due from State of North Carolina Component Units		(64,037,966)
Other Accounts Receivable		(8,205,370)
Estimated Third Party Settlements		8,209,588
Inventories		(6,378,764)
Prepaid Expenses		9,445,910
Advanced Deposits with Liability Insurance Trust Fund		(1,670,088)
Accounts Payable and Accrued Liabilities		15,548,267
Accrued Salaries and Benefits		(1,860,441)
Due to Patients or Third Parties		3,213,818
Due to Primary Government		7,674,966
Due to State of North Carolina Component Units		5,221,272
Funds Held for Others		128,754
Compensated Absences		4,358,649
Net Cash Provided by Operating Activities	$	85,552,982
RECONCILIATION OF CASH AND CASH EQUIVALENTS		
Current Assets:		
Cash and Cash Equivalents	$	43,554,656
Restricted Cash and Cash Equivalents		2,514,810
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		132,746,078
Total Cash and Cash Equivalents - June 30, 2014	$	178,815,544
NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES		
Assets Acquired through the Assumption of a Liability	$	7,557,390
Assets Acquired through a Gift		598,925
Change in Fair Value of Investments		60,559,250
Loss on Disposal of Capital Assets		(1,223,878)
Amortization of Bond Premiums		(122,010)

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 830 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 unit is blended in the Hospitals' financial statements.

Blended Component Unit - Although legally separate, Health System Properties, LLC (the LLC), a component unit of the Hospitals, is reported as if it were part of the Hospitals.

The LLC was established to purchase, develop and/or lease real property. Because the UNC Health Care System is the sole member manager of the LLC, the elected directors of the LLC are the same members of the UNC Health Care System Board of Trustees that directs Hospitals' operations, and as the LLC's primary purpose is to benefit the Hospitals, its financial statements have been blended with those of the Hospitals.

Separate financial statements for the LLC may be obtained from the Executive Vice President & Chief Financial Officer, University of North Carolina Hospitals, 101 Manning Drive, Med Wing E – Room 310, Chapel Hill, North Carolina, 27514, or by calling (919) 966-5112.

Condensed combining information regarding the blended component unit is provided in Note 16.

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.

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

Nonexchange transactions, in which the Hospitals receives (or gives) value without directly giving (or receiving) equal value in exchange, includes 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 all highly liquid investments with an original maturity of three months or less when purchased, including deposits held by the State Treasurer in the Short-Term Investment Fund (STIF). The STIF 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 Management Company, Inc. 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. Hospitals management reviews and evaluates the values provided by UNC Management Company, Inc. as well as the valuation methods and assumptions used in determining the fair value of such investments. 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 supplies, 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 asset acquisitions are recorded at cost and include interest on funds used to finance the acquisition or construction of major capital projects. Assets under capital lease are stated at the present value of the minimum lease payments at the inception of the lease.

Expenditures for repairs and maintenance are charged to expense as incurred. The costs for major renewals and betterments are capitalized and depreciated over the estimated useful lives. Upon disposition, the asset and related accumulated depreciation accounts are relieved and any gain or loss is credited or charged to non-operating revenues and expenses.

Depreciation and amortization are 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 - 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 designated for liability insurance claims. Current restricted resources include certain trust funds restricted because external parties or statute limits their use, and resources legally segregated for the payment of principal and interest as required by debt covenants.

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

Revenue bonds payable are reported net of unamortized premiums or discounts. The Hospitals amortizes bond premiums/discounts over the life

of the bonds using the effective interest method. The deferred charges on refundings are amortized over the life of the old debt or new debt (whichever is shorter) using the straight-line method, and are included as Deferred Outflows or Deferred Inflows of Resources on the Statement of Net Position. Issuance costs are expensed.

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 quarterly sell-back feature with payouts in March, June, September, and December. This sell-back feature allows employees to sell back 25%, 50%, 75%, or 100% of all hours over 140. There is a 10% forfeiture of the cash value to comply with IRS regulation.

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

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

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

O. Net Position - The Hospitals' net position is classified as follows:

Net Investment in Capital Assets - 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 Net Investment in Capital Assets. Additionally, deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of capital assets or related debt are also included in this component of net position.

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

Unrestricted Net Position - Unrestricted net position includes 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. Both restricted and unrestricted net positions include consideration of deferred inflows and outflows of resources.

P. Revenue and Expense Recognition - 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 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 expense.

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, 2013, (less amounts previously recorded at June 30, 2013, for in house patients) and all charges on in house accounts and all charges for outpatient accounts registered after June 30, 2013. 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 Cost - Medical malpractice costs represent the actuarially determined contribution to the Liability Insurance Trust Fund. See Note 12 for further discussion of the Liability Insurance Trust Fund.

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 statute 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.

June 30, 2014, the amount shown on the Statement of Net Position as cash and cash equivalents includes $178,289,834 which represents the Hospitals' equity position in the State Treasurer's STIF. The STIF (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 1.3 years as of June 30, 2014. Assets and shares of the STIF 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 STIF) 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, 2014 was $35,342. The carrying amount of the Hospitals' deposits not with the State Treasurer was $490,368 and the bank balance was $388,816. 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, 2014, all Hospitals' bank balance was insured and collateralized.

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 - NCGS § 116-37.2 as revised by S.L. 2011-145, Section 9.6E.(c)., allows UNC Health Care's Board to be responsible for the custody and management of funds, including developing policies for deposit, investment, and administration of funds. In addition to the Hospitals' assets, the LITF and Health System assets can also be invested under the new guidelines. With this legislative flexibility and under the guidance of the Finance Committee of the Board, the Hospitals contracted with UNC Investment Fund, LLC (UNC Investment Fund) in November 2011 to manage the Hospitals' investment fund. The UNC Investment Fund is an external investment pool that is not registered with the Securities and Exchange Commission, does not have a credit rating, and is not subject to any regulatory oversight. Asset and ownership interests of the UNC Investment Fund are determined on a market unit valuation basis each month. At June 30, 2014, the amount shown on the Statement of Net Position which represents funds deposited with and invested by UNC Investment Fund is $450,216,400. UNC Investment Fund manages the assets, primarily in equity and equity-based securities in accordance with the Hospitals' investment policy approved by its Board. UNC Investment Fund services the securities and maintains all related accounting records. The investments are valued at fair market value. Deposit and investment risks associated with UNC Investment Fund are included in audited financial statement 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, 2014 is as follows:

Cash on Hand	$	35,342
Amount of Deposits with Private Financial Institutions		490,368
Deposits in the Short-Term Investment Fund		178,289,834
UNC Investment Fund		450,216,400
Total Deposits and Investments	$	629,031,944
Deposits		
Current:		
Cash and Cash Equivalents	$	43,554,656
Restricted Cash and Cash Equivalents		2,514,810
Noncurrent:		
Restricted Cash and Cash Equivalents		132,746,078
Total Deposits		178,815,544
Investments		
Noncurrent:		
Restricted Investments		72,941,187
Investments		67,205,213
Investments Designated for Capital Projects		310,070,000
Total Investments		450,216,400
Total Deposits and Investments	$	629,031,944

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, 2014. 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 Position are as follows at June 30, 2014:

	Amount	
In House Patients	$	71,590,644
Discharged (Not Final Billed) Patients		59,441,014
Total Unbilled		131,031,658
Discharged (Billed) Patients		390,564,093
Payment Arrangements		6,565,308
Charity Care Provided		(62,971,718)
Current Gross		465,189,341
Allowance for Bad Debts		(43,276,641)
Contractual Allowances		(246,001,588)
Total Allowances		(289,278,229)
Current - Net	$	175,911,112

B. Noncurrent - Noncurrent patient accounts receivable is $451,175 and consists of a gross amount of $5,884,785 net of $5,433,610 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 receives 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 2014. Medicare cost report settlements owed to Medicare are estimated to be $21,340,684 within the next twelve months and $29,816,079 on a noncurrent basis. Traditional Medicaid cost report settlements owed to Medicaid are estimated to be $23,294,345 on a noncurrent basis. Tricare/Champus currently owes the Hospitals $5,580,205. 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, 2010 fiscal year and Medicaid audits are current through the June 30, 2006 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 $47,836,677 UPL receivable at year end is net of reserves 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 supplement.

NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2014 is presented as follows:

	Balance July 1, 2013 (as restated)	Increases	Decreases	Balance June 30, 2014
Capital Assets, Nondepreciable:				
Land and Permanent Easements	$ 46,807,242	$ 0	$ 0	$ 46,807,242
Construction in Progress	104,574,816	80,625,927	55,199,212	130,001,531
Goodwill	7,704,529			7,704,529
Total Capital Assets, Nondepreciable	159,086,587	80,625,927	55,199,212	184,513,302
Capital Assets, Depreciable:				
Buildings	625,346,615	56,114,904	1,144,028	680,317,491
Machinery and Equipment	429,324,397	24,992,264	36,351,974	417,964,687
General Infrastructure	5,295,662			5,295,662
Computer Software	47,476,962	9,269,686	1,474,580	55,272,068
Total Capital Assets, Depreciable	1,107,443,636	90,376,854	38,970,582	1,158,849,908
Less Accumulated Depreciation/Amortization for:				
Buildings	210,213,281	28,239,083	484,549	237,967,815
Machinery and Equipment	289,380,236	27,623,327	15,851,351	301,152,212
General Infrastructure	4,722,511	78,546		4,801,057
Computer Software	36,254,900	7,983,227	1,190,191	43,047,936
Total Accumulated Depreciation/Amortization	540,570,928	63,924,183	17,526,091	586,969,020
Total Capital Assets, Depreciable, Net	566,872,708	26,452,671	21,444,491	571,880,888
Capital Assets, Net	$ 725,959,295	$ 107,078,598	$ 76,643,703	$ 756,394,190

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, 2014 is presented as follows:

	Balance July 1, 2013 (as restated)	Additions	Reductions	Balance June 30, 2014	Current Portion
Revenue Bonds Payable	$ 276,085,000	$ 0	$ 10,625,000	$ 265,460,000	$ 40,515,000
Plus: Unamortized Premium	170,341		122,010	48,331	
Total Revenue Bonds Payable	276,255,341		10,747,010	265,508,331	40,515,000
Notes Payable	1,422,871	650,600	1,422,871	650,600	339,443
Arbitrage Rebate Payable	225,018	100,008		325,026	
Capital Leases Payable	19,678,717	6,906,790	2,678,193	23,907,314	3,457,471
Compensated Absences	36,909,291	57,349,172	52,990,523	41,267,940	12,124,521
Other Long-Term License Payable		14,794,176	1,849,272	12,944,904	3,390,332
Total Long-Term Liabilities	$ 334,491,238	$ 79,800,746	$ 69,687,869	$ 344,604,115	$ 59,826,767

Additional information regarding capital lease obligations and license payable is included in Note 8 and Note 14, respectively.

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, 2014	Principal Outstanding June 30, 2014
Rex Acquisition and Hospital Renovations	2001A	0.06%*	02/15/2031	$ 55,000,000	$ 8,200,000	$ 46,800,000
	2001B	0.06%*	02/15/2031	55,000,000	8,200,000	46,800,000
Refund Portion of 1996 Revenue Bonds	2003A	3.46%*	02/01/2029	63,770,000	3,745,000	60,025,000
	2003B	3.42%*	02/01/2029	34,245,000	1,975,000	32,270,000
Refund Portion of 1996 Revenue Bonds	2005A	5.00%	02/01/2015	30,540,000	26,465,000	4,075,000
Refund 1999 Revenue Bonds	2009A	3.59%*	02/01/2024	44,290,000	12,090,000	32,200,000
General Revenue Bonds	2010A	4.00%	02/01/2014	5,585,000	5,585,000	
	2010B	2.45% to 6.33%**	02/01/2031	43,290,000		43,290,000
Total Revenue Bonds Payable (principal only)				$ 331,720,000	$ 66,260,000	265,460,000
Plus: Unamortized Premium						48,331
Total Revenue Bonds Payable						$ 265,508,331

* For variable rate debt, effective interest rates at June 30, 2014 are shown. For variable rate debt with interest rate swaps, the synthetic fixed rates in effect at June 30, 2014 are shown.

** The Hospitals has elected to treat these bonds as federally taxable "Build America Bonds" for the purposes of the American Recovery and Reinvestment Act and to receive a cash subsidy from the U.S. Treasury equal to 32% of the interest payable on these bonds. For these bonds, the interest rate included is the taxable rate, which does not factor the cash subsidy from the U.S. Treasury.

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 or paying agents.

With regard to the following demand bonds, the Hospitals has entered into take out 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 amended in 2011. This long-term agreement was renegotiated in July 2013 with a decrease in liquidity fee to 0.35% effective October 11, 2013 through December 31, 2015.

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, 2014, 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 $93,600,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $24,352,000, $23,470,000, $22,160,000, $20,850,000, and $19,540,000 in years one, two, three, four, and five, respectively, under the installment loan agreement assuming a Base Rate of 4.25% (Prime Rate 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 Hospitals may request additional extensions of at least one year from the previous termination date. Extensions are at the discretion of the Liquidity Provider.

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

While in the weekly mode, the bonds are subject to purchase on demand with seven days' notice to the Remarketing Agent and delivery to the bond Tender Agent, 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. required a commitment fee of 0.36% for fiscal year 2014. Payments are made quarterly in arrears, on the first business day of each November, February, May, and August thereafter until July 1, 2014. The long-term agreement was renegotiated in June 2014 with a decrease in liquidity fee to 0.34% effective July 1, 2014 through July 1, 2015. 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 rating:

S&P	Moody's	Commitment Rate
A	A2	0.56%
A- Or lower	A3 or lower	0.76%

Provided, however, that the Commitment Rate shall be increased (A) by 150 basis points (1.50%) upon the occurrence and during the continuance of an Event of Default, and (B) by 150 basis points (1.50%) if either Moody's or S&P withdraws or suspends its rating for any reason (other than for the payment in full or defeasance of the Bonds). Any such increase in the Commitment Rate shall take effect as of the date of any such event described in the preceding sentence. All such increases in the Commitment Rate contemplated above shall be cumulative.

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, 2014, 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 $60,025,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay $22,822,000, $22,022,000, and $20,871,000 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 0.35% for fiscal year 2014. Payments are made quarterly in arrears, on the first business day of each February, May, August, and November thereafter until July 31, 2017. The commitment fee remains in effect over the life of the Agreement; however, the

Commitment Rate shall be increased to the per annum percentage described in the table below if (i) the debt rating assigned by Moody's or S&P to the long-term debt of the Hospitals, without regard to third-party credit enhancement, falls to the corresponding levels specified in such table, (ii) such rating is withdrawn or suspended or (iii) an Event of Default occurs and is continuing hereunder. After any such increases are made, the Commitment Rate shall be decreased to the per annum percentage described in the table below if the debt rating assigned by Moody's or S&P to the long-term debt of the Hospitals, without regard to third-party credit enhancement, rises to the corresponding levels specified in such table. Any such increases (or decreases, as the case may be) in the Commitment Rate shall be effective as of the date of such downgrade, upgrade, withdrawal, suspension or Event of Default, as applicable. The Commitment Rate shall be the fee listed below which corresponds to the lowest debt rating assigned to the Hospitals specified in the table below:

S&P	Moody's	Commitment Rate
A	A2	0.50%
A-	A3	0.65%
BBB+	Baa1	0.85%
BBB	Baa2	1.10%
BBB-	Baa3	1.40%
Below Investment Grade	Below Investment Grade	2.40%

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, 2014, 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 $32,270,000 of demand bonds was "put" and not resold, the

Hospitals would be required to pay $10,825,000, $13,605,000, and $12,483,000 in years one, two and three, respectively, following the Purchase Date of the Bank Bonds assuming a Base Rate of 7.00%. The current expiration date of the 2003B Agreement is July 1, 2015. Extensions are at the discretion of the Liquidity Provider.

University of North Carolina Hospitals at Chapel Hill Revenue Refunding Bonds-Series 2009A: On February 12, 2009, the Hospitals issued series 2009A tax-exempt variable rate demand bonds in the amount of $44,290,000 that have a final maturity date of February 1, 2024. The bonds are subject to mandatory sinking fund redemption that began on February 1, 2010. The proceeds were used to advance refund $43,505,000 of the Series 1999 Bonds. While initially bearing interest in a weekly mode, the mode on these bonds may change to a daily rate, a unit pricing rate, a term rate, or a fixed rate.

While in the weekly mode, the bonds are subject to purchase on demand upon delivering irrevocable written notice of tender or irrevocable telephonic notice of tender to the Remarketing Agent not later than 4:00 p.m. on a business day not less than seven 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.

The Hospitals is its own liquidity provider for the Series 2009A bonds. As a result, there is no established arm's-length agreement with an unrelated

third party to convert the bonds "put" but not resold into a form of long-term obligation. The Series 2009A bonds are therefore classified as current liabilities.

D. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2014 are as follows:

	Annual Requirements				
	Revenue Bonds Payable			Notes Payable	
Fiscal Year	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest
2015	$ 11,010,000	$ 2,664,527	$ 4,085,064	$ 339,443	$ 0
2016	11,735,000	2,352,530	4,052,555	311,157	
2017	12,075,000	2,284,624	3,763,501		
2018	12,635,000	2,206,507	3,480,753		
2019	13,015,000	2,111,636	3,182,347		
2020-2024	72,810,000	8,880,736	11,021,132		
2025-2029	90,005,000	5,089,219	3,445,855		
2030-2031	42,175,000	652,849			
Total Requirements	$ 265,460,000	$ 26,242,628	$ 33,031,207	$ 650,600	$ 0

Interest on variable rate 2001 A&B, 2003 A&B, and 2009A bonds are calculated at 0.06%, 0.06%, 0.07%, 0.06% and 0.08% effective June 30, 2014

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 rates at June 30, 2014 of 3.46%, 3.42%, and 3.59%, respectively. More detailed information about interest rate swaps is presented in Note 7 Derivative Instruments.

The fiscal year 2015 principal requirements include all bond principal payments due for 2015 only. This differs from the amount disclosed as current in Note 6A Changes in Long-Term Liabilities as the current portion of total bonds payable includes all outstanding principal for the 2009A demand bonds. See Note 6C Demand Bonds.

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

Purpose	Financial Institution	Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2014	Principal Outstanding 06/30/2014
Medical Equipment	IBM	0.40%	06/30/2014	$ 2,844,789	$ 2,844,789	$ 0
Medical Equipment	Phillips Medical	0.00%	06/25/2016	650,600		650,600
Total Notes Payable				$ 3,495,389	$ 2,844,789	$ 650,600

NOTE 7 - DERIVATIVE INSTRUMENTS

Derivative instruments held at June 30, 2014 are as follows:

Type	Notional	Change in Fair Value		Fair Value at June 30, 2014	
		Classification	Increase	Classification	Liability
Hedging Derivative Instruments Cash Flow Hedges					
Pay-Fixed Interest Rate Swap 2003 A & B Bonds	$ 92,295,000	Deferred Outflow of Resources	$ 365,051	Hedging Derivative Liability	$ (13,653,554)
Pay-Fixed Interest Rate Swap 2009A Bonds	$ 32,200,000	Deferred Outflow of Resources	541,993	Hedging Derivative Liability	(3,919,642)
Total Derivative Instruments			$ 907,044		$ (17,573,196)

Hedging derivative instruments held at June 30, 2014 are as follows:

Type	Objective	Notional Amount	Effective Date	Maturity Date	Terms
Pay-Fixed Interest Rate Swap	Hedge of Changes in Cash on the 2003 A & B Series Bonds	$ 92,295,000	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	$ 32,200,000	02/12/2009	02/01/2024	Pay 3.61%, Receive 67% LIBOR

The fair 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. In its sole discretion it may use a variety of models, methodologies**,** and assumptions to prepare the valuations depending upon the type of transaction, its characteristics, whether there is a liquid market and other factors. 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, 2014.

The Hospitals' interest rate swap hedging derivatives have been determined to be effective as of June 30, 2014 using the synthetic instrument method.

Hedging Derivative Risks

Credit Risk: As of June 30, 2014, 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 becomes 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, 2014, the credit rating for Bank of America, N.A. is A2 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, 2014. 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, 2014.

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 ISDA 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 - LEASE OBLIGATIONS

A. Capital Lease Obligations - Capital lease obligations relating to medical equipment and network/phone equipment are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2014:

Fiscal Year	Amount
2015	$ 3,739,327
2016	4,350,511
2017	4,350,511
2018	4,747,451
2019	3,238,616
2020-2024	4,927,789
Total Minimum Lease Payments	25,354,203
Amount Representing Interest (2% to 16% Rate of Interest)	1,446,889
Present Value of Future Lease Payments	$ 23,907,314

Medical equipment and network/phone equipment acquired under capital lease amounted to $20,837,239 and $7,623,099, respectively, at June 30, 2014. Depreciation for the capital assets associated with capital leases is included in depreciation expense, and accumulated depreciation for assets acquired under capital lease totaled $2,329,908 at June 30, 2014.

B. 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, 2014:

Fiscal Year	Amount
2015	$ 6,351,376
2016	6,217,660
2017	5,615,027
2018	5,502,564
2019	5,164,829
2020-2024	22,364,609
2025-2029	15,223,717
2030-2034	8,638,014
2035-2039	1,759,595
Total Minimum Lease Payments	$ 76,837,391

Rental expense for all operating leases during the year was $5,209,595.

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 University of North Carolina 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 University of North Carolina Health Care System, including the Hospitals, are eligible to receive UNC DSH payments up to the unreimbursed cost of serving uninsured patients. The University of North Carolina Health Care System is responsible for providing the non-federal share of the UPL payments. The Hospitals is also responsible for ensuring the State receives an amount equal to what was paid to the Hospitals for uncompensated care costs ($65,652,106). The UPL Plan was effective on October 1, 2010.

The UPL payments of $97,353,316 for federal fiscal year 2013 were received in September 2013 of which $25,950,710 was related to the Hospitals' 2014 fiscal year. A net amount of $71,173,027 was estimated to be due for the applicable 3 quarters of federal fiscal year 2014 and is included in the 2014 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. Insurance plans may reimburse their subscribers but make direct payment to the Hospitals on an assignment of benefits basis as long as a contract remains in force.

A summary of net patient service revenue for the year ended June 30, 2014 follows:

	2014
Inpatient	$ 1,608,539,841
Outpatient	1,344,026,511
Charity Care Provided	(191,354,929)
Prior Year Third Party Settlements	4,697,098
Gross Patient Service Revenue	2,765,908,521
Medicare Contractual Allowance	(587,637,965)
Medicaid Contractual Allowance	(429,215,452)
Upper Payment Limit	95,090,907
Managed Care Contractual Allowance	(446,838,551)
Other Contractual Allowances	(58,165,717)
Bad Debt	(115,838,007)
Contractual Adjustments	(1,542,604,785)
Net Patient Service Revenue	$ 1,223,303,736

NOTE 10 - PENSION PLANS

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

The Teachers' and State Employees' Retirement System (TSERS) 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. TSERS is administered by a 14-member Board of Trustees, with the State Treasurer serving as Chairman of the Board.

Benefit and contribution provisions for the TSERS 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, 2014, these rates were set at 8.69% of covered payroll for employers and 6% of covered payroll for members.

For the current fiscal year, the Hospitals had a total payroll of $514,278,710, of which $403,237,798 was covered under the TSERS. Total employer and employee contributions for pension benefits for the year were $35,041,365 and $24,194,268, respectively.

Required employer contribution rates for the years ended June 30, 2013, and 2012, were 8.33% and 7.44%, respectively, while employee contributions were 6% each year. The Hospitals made 100% of its annual required contributions for the years ended June 30, 2014, 2013, and 2012, which were $35,041,365, $32,520,721, and $28,426,083, 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.

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

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

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2014, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The Hospitals assumes no liability other than its contribution.

For the current fiscal year, the Hospitals had a total payroll of $514,278,710, of which $33,318,953 was covered under the Optional Retirement Program. Total

employer and employee contributions for pension benefits for the year were $2,279,016 and $1,999,137, respectively.

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 or the Optional Retirement Program. Coverage eligibility varies depending on years of contributory membership service in their retirement system prior to disability or retirement.

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

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

For the current fiscal year the Hospitals contributed 5.40% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the Fund. Required contributions rates for the years ended June 30, 2013, and 2012, were 5.30% and 5.0%, respectively. The Hospitals made 100% of its annual required contributions to the Plan for the years ended June 30, 2014, 2013, and 2012, which were $23,574,065, $21,471,851, and $19,103,551, 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 and the Optional Retirement Program. Benefit and contribution provisions are established by Chapter 135, Article 6, of the General Statutes, and may be amended only by the North Carolina General Assembly. The Plan does not provide for automatic post-retirement benefit increases.

Disability income benefits are funded by actuarially determined employer contributions that are established by the General Assembly. For the fiscal year ended June 30, 2014, the Hospitals made a statutory contribution of .44% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. Required contribution rates for the years ended June 30, 2013, and 2012 were .44% and .52%, respectively. The Hospitals made 100% of its annual required contributions to the DIPNC for the years ended June 20, 2014, 2013, and 2012, which were $1,920,850, $1,782,569, and $1,986,769, 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 $10,000,000 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 per occurrence;
- Directors and Officers Liability insurance up to $10,000,000 with a deductible of $500,000 per occurrence for anti-trust claims and $250,000 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 $1,806,641 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 $200,000 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 .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 Faculty Physicians (UNCFP), 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 UNCFP 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, 2013, through June 30, 2014, 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 ended June 30, 2014, 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, 2014, the Hospitals' assets in the Trust Fund totaled $27,700,717 while Hospitals' liabilities totaled $20,336,927 resulting in net position of $7,363,790.

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 $52,988,524 and on other purchases were $24,621,147 at June 30, 2014.

B. Pending Litigation and Claims - The Hospitals is a party to other litigation and claims in the ordinary course of its operations. Since it is not possible to predict the ultimate outcome of these matters, no provision for any liability has been made in the financial statements. Hospitals' management is of the opinion that the liability, if any, for any of these matters will not have a material adverse effect on the financial position of the Hospitals.

NOTE 14 - RELATED PARTIES

University of North Carolina Health Care System Enterprise 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.

In accordance with this mission, the System purchased and has substantially implemented a new electronic health record and patient accounting system that was funded, in part, by the Hospitals extending a note receivable to the System. This note and related implementation receivables from the System totaled $40,882,340 and $23,348,745, respectively, at year end. The Hospitals' $12,944,904 other long-term license payable (Note 6) is offset by these receivables from the System. The Hospitals was assessed $40,130,835 to fund initiatives supported by the System Fund and $48,963,705 to support the operations of System affiliates. The Hospitals also received $2,436,926 from the System Fund during the year ended June 30, 2014.

Rex Healthcare, Inc. (Rex) - Rex is a North Carolina not-for-profit corporation organized to provide a wide range of health care services to the residents of the Triangle area of North Carolina.

The System is the sole member of the corporation and 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 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 $2,128,958 from Rex and the Hospitals paying $10,686,157 to Rex during the year ended June 30, 2014.

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 corporation that owns and operates a critical access facility located in Siler City, North Carolina. The System is the sole member of Chatham Hospital, Inc. The System appoints nine of the 15 members on the Chatham Hospital, Inc. Board and reviews and approves its annual operating and capital budgets.

The Hospitals has entered into various administrative and clinical services agreements with Chatham Hospital, Inc. resulting in the Hospitals receiving $2,021,385 and the Hospitals paying $70,284 to Chatham Hospital, Inc. during the fiscal year for those services.

UNC Physicians Network – UNC Physicians Network is a wholly owned subsidiary of the System, but a private employer, that owns and operates more than thirty community physician practices based primarily throughout the Triangle (Raleigh, Durham and Chapel Hill), North Carolina area.

It 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.

UNC Physician Network paid the Hospitals $3,740,207 for supplies and services during the fiscal year.

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. 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. On September 4, 2013 this agreement was extended to a term of twenty-five years. Pardee Memorial Hospital paid the Hospitals $1,025,249 for services received during fiscal year 2014. The Hospitals paid Pardee Memorial Hospital $1,300 for supplies and services received during the fiscal year.

High Point Regional Health, Inc. (HPRH) - HPRH is a North Carolina not-for-profit corporation located in High Point, North Carolina and is organized to promote and advance charitable, educational and scientific purposes, and to provide and support health care services.

The System became the sole corporate member of HPRH on March 31, 2013. HPRH is the parent holding company of High Point Regional Health Foundation, High Point Health Care Ventures, Inc., and High Point Regional Health Services, Inc.

HPRH paid the Hospitals $209,584 for services received during fiscal year 2014. The Hospitals paid HPRH $729,465 for supplies and services during the fiscal year.

Caldwell Memorial Hospital – Caldwell Memorial Hospital is a private, not-for-profit community hospital located in Lenoir, North Carolina and is an acute care hospital with a provider network of primary and specialty care physicians and advanced practice professionals. The System became the sole member of Caldwell Memorial Hospital on May 1, 2013.

Caldwell Memorial Hospital paid the Hospitals $151,844 for services during fiscal year 2014. The Hospitals paid Caldwell Memorial Hospital $36,731 for supplies and services and $39,398 to the Hospital Foundation.

Nash Health Care Systems – Nash Health Care Systems is a non-profit hospital authority comprised of Nash General Hospital, Nash Day Hospital, the Bryant T. Aldridge Rehabilitation Center, Community Hospital and Coastal Plain Hospital. It serves Nash, Edgecombe, Halifax, Wilson and Johnston counties, but draws patients from beyond these areas as well.

Nash Health Care Systems signed a management service agreement engaging the System to conduct and manage its operations effective April 1, 2014.

Nash Health Care Systems paid the Hospitals $167,847 for services received during fiscal year 2014. The Hospitals paid Nash Health Care Foundation $5,000 for operational support during the fiscal year.

Johnston Health Services Corporation (JHSC) - Effective February 1, 2014, Johnston Memorial Hospital Authority (JMHA) and the System entered into a Master Agreement to form JHSC, a joint venture created to achieve the long term vision of providing high quality health care to the residents of Johnston County. Oversight and governance of the joint venture is controlled by a Board of Directors consisting of appointees from both JMHA and the System. The System manages the day-to-day operations of JHSC under the terms of a Management Services Agreement entered into and effective November 1, 2013.

Johnston Health Services Corporation paid the Hospitals $814,261 for services received during fiscal year 2014.

NOTE 15 - INVESTMENT IN AFFILIATES

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were $15,004,037 at June 30, 2014. 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:

	2014 (Unaudited)
TOTAL AFFILIATE ACTIVITY	
Current Assets	$ 19,173,187
Noncurrent Assets	14,880,170
Current Liabilities	4,123,585
Shareholders Equity	29,929,772
Revenue	19,724,813
Net Gain	3,145,410
HOSPITALS' SHARE OF ACTIVITY	
Realized Affiliate Gain - Ongoing Operations	$ 2,022,456

NOTE 16 - BLENDED COMPONENT UNIT

Condensed combining information for the Hospitals' blended component unit for the year ended June 30, 2014 is presented as follows:

Condensed Statement of Net Position
June 30, 2014

	Health System Properties, LLC
ASSETS	
Current Assets	$ 135,661
Capital Assets	21,243,044
Total Assets	21,378,705
Deferred Outflows of Resources	0
LIABILITIES	0
Deferred Inflows of Resources	0
NET POSITION	
Net Investment in Capital Assets	21,243,044
Unrestricted	135,661
Total Net Position	$ 21,378,705

Condensed Statement of Revenues, Expenses, and Changes in Net Position
For the Fiscal Year Ended June 30, 2014

	Health System Properties, LLC
OPERATING REVENUES	
Rental income	$ 632,983
OPERATING EXPENSES	
Operating Expenses	710,219
Depreciation	691,797
Total Operating Expenses	1,402,016
Operating Loss	(769,033)
NONOPERATING REVENUES (EXPENSES)	0
Capital Contributions	2,121,774
Increase in Net Position	1,352,741
NET POSITION	
Net Position, July 1, 2013	20,025,964
Net Position, June 30, 2014	$ 21,378,705

Condensed Statement of Cash Flows
June 30, 2014

	Health System Properties, LLC
Net Cash Used by Operating Activities	$ (228)
Cash and Cash Equivalents, July 1, 2013	135,889
Cash and Cash Equivalents, June 30, 2014	$ 135,661

NOTE 17 - NET POSITION RESTATEMENT

As of July 1, 2013, net position as previously reported was restated as follows:

	Amount
July 1, 2013 Net Position as Previously Reported	$ 1,240,579,117
Restatement:	
Expense previously amortized bond issuance costs pursuant to GASB 65 requirements	(1,369,938)
July 1, 2013 Net Position as Restated	$ 1,239,209,179

STATE OF NORTH CAROLINA
Office of the State Auditor

Beth A. Wood, CPA
State Auditor

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

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

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

We have audited, in accordance with the 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, 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, 2014, and the related notes to the financial statements, which collectively comprise the Hospitals' basic financial statements, and have issued our report thereon dated October 24, 2014.

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.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Hospitals' internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of the Hospitals' internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable

possibility that a material misstatement of the Hospitals' financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Hospitals' financial statements are free from 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.*

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Hospitals' internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Hospitals' internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

October 24, 2014

ORDERING INFORMATION

Copies of this report may be obtained by contacting the:

Office of the State Auditor
State of North Carolina
2 South Salisbury Street
20601 Mail Service Center
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For additional information contact:
Bill Holmes
Director of External Affairs

This audit required 1,581 audit hours at an approximate cost of $148,614.