

# STATE OF NORTH CAROLINA

OFFICE OF THE STATE AUDITOR

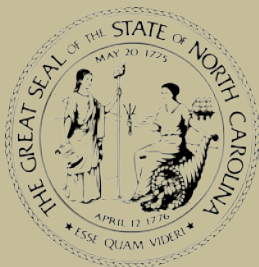
BETH A. WOOD, CPA



## UNIVERSITY OF NORTH CAROLINA HOSPITALS AT CHAPEL HILL

CHAPEL HILL, NORTH CAROLINA  
FINANCIAL STATEMENT AUDIT REPORT  
FOR THE YEAR ENDED JUNE 30, 2016

A CONSTITUENT INSTITUTION OF THE UNIVERSITY OF NORTH CAROLINA  
SYSTEM AND A COMPONENT UNIT OF THE STATE OF NORTH CAROLINA



**NC OSA**  
The Taxpayers' Watchdog

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 27699-0600  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
<http://www.ncauditor.net>

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## AUDITOR'S TRANSMITTAL

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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, 2016, and our audit results are included in this report. You will note from the independent auditor's report that we determined that the financial statements are presented fairly in all material respects.

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

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

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

Beth A. Wood, CPA  
State Auditor



Beth A. Wood, CPA  
State Auditor

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Article V, Chapter 147 of the *North Carolina General Statutes*, gives the Auditor broad powers to examine all books, records, files, papers, documents, and financial affairs of every state agency. The Auditor also has the power to summon people to produce records and to answer questions under oath.



# INDEPENDENT AUDITOR'S REPORT

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 27699-0600  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
<http://www.ncauditor.net>

## **INDEPENDENT AUDITOR'S REPORT**

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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 (Hospitals), which is a part of the University of North Carolina Health Care System that is 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, 2016, 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, based on our audit, 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, 2016, and the changes in financial position and 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.

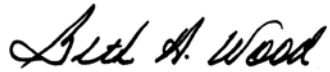
### Other Matters – Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis and other required supplementary information, as listed in the table of contents, 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 19, 2016 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

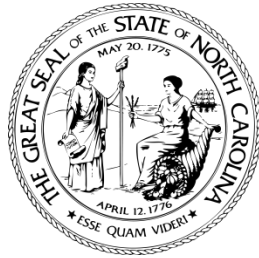
accordance with *Government Auditing Standards* in considering the Hospitals' internal control over financial reporting and compliance.

A handwritten signature in black ink that reads "Beth A. Wood". The signature is written in a cursive, flowing style.

Beth A. Wood, CPA  
State Auditor

Raleigh, North Carolina

October 19, 2016



# **MANAGEMENT'S DISCUSSION AND ANALYSIS**



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, 2016 and 2015. This discussion and analysis should be read in conjunction with the 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 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, 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 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 it. The Hospitals' net position, the difference between assets (plus deferred outflows) and liabilities (plus deferred inflows), is a way to measure financial health or financial position. Over time, increases or decreases in the Hospitals' net position are indicators 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, clinical advances, 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, 2016 and 2015.

**STATEMENTS OF NET POSITION**

	FY16	FY15 (As Restated)	Change	% Change
Current Assets	\$ 678,438,778	\$ 608,825,428	\$ 69,613,350	11.4%
Capital Assets, Net	766,333,435	809,352,835	(43,019,400)	(5.3)%
Other Noncurrent Assets	669,560,761	596,174,946	73,385,815	12.3%
<b>TOTAL ASSETS</b>	<b>2,114,332,974</b>	<b>2,014,353,209</b>	<b>99,979,765</b>	<b>5.0%</b>
<b>DEFERRED OUTFLOWS OF RESOURCES</b>	<b>81,919,932</b>	<b>78,741,509</b>	<b>3,178,423</b>	<b>4.0%</b>
Current Liabilities	338,387,562	279,124,740	59,262,822	21.2%
Long-Term Liabilities	410,714,679	338,937,938	71,776,741	21.2%
Other Noncurrent Liabilities	100,512,006	96,098,947	4,413,059	4.6%
<b>TOTAL LIABILITIES</b>	<b>849,614,247</b>	<b>714,161,625</b>	<b>135,452,622</b>	<b>19.0%</b>
<b>DEFERRED INFLOWS OF RESOURCES</b>	<b>34,922,046</b>	<b>154,799,410</b>	<b>(119,877,364)</b>	<b>(77.4)%</b>
Net Investment in Capital Assets	574,580,319	595,066,247	(20,485,928)	(3.4)%
Restricted for Expendable Uses	254,742,323	232,537,835	22,204,488	9.5%
Unrestricted	482,393,971	396,529,601	85,864,370	21.7%
<b>TOTAL NET POSITION</b>	<b>\$ 1,311,716,613</b>	<b>\$ 1,224,133,683</b>	<b>\$ 87,582,930</b>	<b>7.2%</b>

Total assets increased \$100 million as of June 30, 2016. Included within this change, current assets increased \$69.6 million primarily from operating performance and from an increase in due from state of NC component units for capital assets transferred to the Health Care System during the fiscal year. Capital asset spending remained strong as the remaining \$21.3 million in expenses were made on the UNC Hospitals Hillsborough Campus, \$7.7 million was spent on a 27 Bed Certificate of Need, and \$1.3 million in planning was expended for a Perioperative Tower. Overall, the year-end capital asset balance decreased \$43 million largely from the transfer of assets noted. Noncurrent assets increased \$73.4 million from designating more investments for capital projects. With the increase in cash from operating performance, the Hospitals used more cash funds to meet the required maintenance reserve which enabled it to designate more investments.

Deferred outflows of resources increased from \$78.7 million to \$81.9 million primarily from the recognition of deferred outflows in connection with the State of North Carolina Teachers' and State Employees' Retirement System Plan (see Note 11).

Total liabilities increased \$135.5 million from June 30, 2015. The increase in current liabilities of \$59.3 million is due primarily from \$45 million in Upper Payment Limit (UPL) reserve liability. In past years, this reserve was netted against a corresponding UPL Receivable. The fiscal year 2016 UPL payment was received in June, leaving no UPL accounts receivable balance to net against this reserve. Other changes in current liabilities include vendor payment liabilities, accrued salaries and benefits which are the result of the timing of year-end liabilities. The \$76.2 million increase in noncurrent liabilities is attributable to the increase

in the net pension liability of \$88.8 million. See Note 11 to the audited financial statements for further details related to the pension plan.

Deferred inflows of resources decreased \$119.9 million as a result of the recognition of differences between actual and expected pension plan experience, including investment performance, related to the pension plan in accordance with the Governmental Accounting Standards Board (GASB) Statement No. 68, which became effective June 30, 2015.

Net position improved \$87.6 million during the fiscal year ended June 30, 2016 and was driven by operating income of \$230.3 million, offset by other net nonoperating expenses and investment losses of \$13 million, and UNC Health Care System assessments of \$129.7 million. For further information on this change, see the following statement of revenues, expenses, and changes in net position.

### **Capital Assets**

The Hospitals expended \$11.8 million on the acquisition and construction of buildings, infrastructure, and renovations during the fiscal year. An additional \$37.5 million was expended during the year for capital equipment throughout the facilities and \$7.3 million on software resulting in a total capital investment of approximately \$57 million for the year as shown in Note 6. The Hospitals also transferred approximately \$30 million of capital assets to the Health Care System. Capital spending declined in fiscal year 2016 as compared to fiscal year 2015 as the Hillsborough campus was placed into service and spending on this project wound down. Capital spending is expected to increase in the future as planning is underway for a new surgical tower to modernize a significant number of operating rooms located on the UNC Chapel Hill campus. Completion is expected within the next five years.

### **Long-term Debt Activities**

At June 30, 2016, the Hospitals had outstanding bond indebtedness in the amount of \$242.7 million, of which \$12.1 million is due within the next year. Standard & Poor's and Moody's Rating Services classify these bonds at AA and Aa3, respectively. A bond issuance is planned in fiscal year 2017 in order to fund upcoming capital projects, primarily the surgical tower. No material new lease commitments are planned in the coming year. The current outstanding indebtedness of the Hospitals is described in Note 7.

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

While the condensed statements of net position show the financial position of the Hospitals, the following condensed statements of revenues, expenses and changes in net position provide answers to the nature and source of changes in net position for the years ended June 30, 2016 and 2015:

**STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION**

	FY16	FY15 (As Restated)	Change	% Change
Net Patient Service Revenue	\$ 1,551,326,267	\$ 1,385,582,463	\$ 165,743,804	12.0%
Other Operating Revenues	39,079,109	35,614,214	3,464,895	9.7%
<b>TOTAL OPERATING REVENUES</b>	<b>1,590,405,376</b>	<b>1,421,196,677</b>	<b>169,208,699</b>	11.9%
Salaries and Benefits	581,746,106	566,677,140	15,068,966	2.7%
Medical and Surgical Supplies	344,883,927	292,986,700	51,897,227	17.7%
Contracted Services	275,804,098	220,627,909	55,176,189	25.0%
Other Supplies and Services	64,389,701	67,244,628	(2,854,927)	(4.2)%
Medical Malpractice Cost	4,348,331	658,579	3,689,752	560.3%
Communications, Utilities, and Travel	22,165,190	22,618,785	(453,595)	(2.0)%
Depreciation and Amortization	66,806,623	65,241,775	1,564,848	2.4%
<b>TOTAL OPERATING EXPENSES</b>	<b>1,360,143,976</b>	<b>1,236,055,516</b>	<b>124,088,460</b>	10.0%
<b>OPERATING INCOME</b>	<b>230,261,400</b>	<b>185,141,161</b>	<b>45,120,239</b>	24.4%
Investment Income (Loss)	(6,175,873)	43,529,903	(49,705,776)	(114.2)%
Other Nonoperating Revenues	1,822,743	958,199	864,544	90.2%
Nonoperating Expenses	(8,611,895)	(6,495,669)	(2,116,226)	32.6%
<b>NET NONOPERATING REVENUES (EXPENSES)</b>	<b>(12,965,025)</b>	<b>37,992,433</b>	<b>(50,957,458)</b>	(134.1)%
Health Care System Assessments	(129,713,445)	(112,227,270)	(17,486,175)	15.6%
<b>INCREASE IN NET POSITION</b>	<b>87,582,930</b>	<b>110,906,324</b>	<b>(23,323,394)</b>	(21.0)%
<b>NET POSITION - BEGINNING OF YEAR, AS RESTATED</b>	<b>1,224,133,683</b>	<b>1,113,227,359</b>	<b>110,906,324</b>	10.0%
<b>NET POSITION - END OF YEAR</b>	<b>\$ 1,311,716,613</b>	<b>\$ 1,224,133,683</b>	<b>\$ 87,582,930</b>	7.2%
TOTAL REVENUES	\$ 1,592,228,119	\$ 1,465,684,779	\$ 126,543,340	8.6%
TOTAL EXPENSES	1,504,645,189	1,354,778,455	149,866,734	11.1%
<b>INCREASE IN NET POSITION</b>	<b>\$ 87,582,930</b>	<b>\$ 110,906,324</b>	<b>\$ (23,323,394)</b>	(21.0)%

Net patient revenue increased \$165.7 million and reflects a 2% increase in total patient days, inpatient and outpatient surgeries increasing 6.5% and 11.9%, respectively, and an 18% increase in Emergency Department visits. Volume and gross revenue has increased, to some extent, from the opening of the Hillsborough Hospital Campus while net revenue has benefitted from continued pricing and collection improvements.

Operating expenses increased \$124.1 million over the prior year. Note that the increase in salaries and benefits of \$15.1 million is net of a favorable \$32.4 million adjustment to pension expense as required by GASB Statement No. 68. This adjustment somewhat offsets the impact of increased salary and benefit expense that has occurred due to the expansion of hospital operations, market increases in pay, and the significant investments in staffing that have been made to support the more complex analytics required by population health and

value based reimbursement movements in healthcare. Medical supply expenses increased \$51.9 million year-over-year and reflects a significant increase in pharmaceutical supplies expense as a result of increases in outpatient pharmacy volume and inpatient patient acuity. Contracted services increased \$55.2 million. A large portion of this increase is attributable to UNC Health Care's initiation of a constructive review of the entire healthcare system focused on improving quality, efficiency and value for all our constituents. Deemed "Carolina Value," the ultimate goal is improvement in performance fiscally and clinically as the System becomes a fully integrated healthcare delivery network. This work will better position UNC Hospitals and UNC Health Care for the continuing movement toward value-based purchasing.

Net nonoperating revenues decreased \$51 million year-over-year due to lower investment returns as compared to historically high investment returns recognized in fiscal year 2015. Cash required for day to day operations is deposited with the State Treasurer in the Short Term Investment Fund (STIF). Funds set aside to be held for the longer term, in order to fund specific capital projects and the future growth of the Hospitals, have been invested with the UNC Investment Fund, LLC. as described in Note 2.

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 initiatives are selected and applicable assessments are quantified based on recommendations made from Senior Leadership. These assessments increased by \$17.5 million from 2015 to 2016 due to an increase in support provided to UNC Health Care to fund investment in programs of UNC Faculty Practice and the UNC School of Medicine. These assessments are described in more detail in Note 15.

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

The Hospitals derives the vast majority of its revenue from patient care services. Ongoing strong operating performance has enabled UNC Hospitals to continue to make investments in support of clinical education and research programs of UNC Faculty Practice, the UNC School of Medicine and other network entities. These investments continue to yield positive results as measured by growth in needed services, expansions of the medical school class, and increased research funding.

The Hospitals has sought to remain a leader by evolving to meet the changing health care environment. We are making infrastructure investments to modernize our patient care. The inpatient census at UNC Hospitals is regularly near maximum capacity. To address this need, we have constructed and opened our Hillsborough campus, an extension of UNC Hospitals. Acute care services began in early fiscal year 2016. We are also in the process of developing a replacement perioperative tower on the Chapel Hill campus. These facilities are designed to optimize efficiency and the patient experience and allow for an appropriate and safe care environment. The Hospitals have been awarded Certificates of Need for an additional 95 acute patient beds which will be constructed with operating funds on the Chapel Hill and Hillsborough campuses. As discussed earlier and in Note 20, the Hospitals intends on borrowing up to \$110 million through a bond issuance to finance the initial phase of construction of a new surgical pavilion to replace operating suites and support facilities.

With the entire UNC Health Care System, the Hospitals is engaged in a review of all of our operations through a program known as *Carolina Value*. This program is being developed

and executed to enable UNC Health Care System to be more integrated operationally and clinically. The intended goal is to improve the health of North Carolina, provide exceptional patient care and service, become more efficient, and work together as one team across the System exploiting best practices through our talented staff members.

Third-party payors, including governmental sponsored programs, continue to migrate 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 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. Alignment Healthcare began offering a Medicare Advantage HMO product for seniors in Wake County, North Carolina in the fall of 2014. The Hospitals also participate in the UNC Health Alliance, a Clinically Integrated Network. Learning from these programs will allow UNC Health Care to more rapidly scale and ramp-up our initiatives when appropriate.

Continued reductions to payment levels for Medicaid patients, added legislative burdens, market consolidation, and cuts to the UNC 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* patient experience which has proven to be a differentiator in care delivered by UNC Hospitals for many years.



# FINANCIAL STATEMENTS

**University of North Carolina Hospitals at Chapel Hill**  
**Statement of Net Position**  
**June 30, 2016**

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

**ASSETS**

Current Assets:

Cash and Cash Equivalents (Note 2)	\$ 190,080,877
Restricted Cash and Cash Equivalents (Note 2)	1,724,444
Receivables, Net	
Patient Accounts Receivable, Net (Note 4)	207,675,435
Other Accounts Receivable, Net	39,051,802
Due from Primary Government	6,601,832
Due from State of North Carolina Component Units	150,374,185
Estimated Third Party Settlements (Note 5)	11,378,212
Inventories	45,913,341
Prepaid Expense	16,494,171
Notes Receivable (Note 15)	9,144,479
	<hr/>
Total Current Assets	678,438,778

Noncurrent Assets:

Restricted Cash and Cash Equivalents (Note 2)	124,726,053
Restricted Investments (Note 2)	123,316,350
Investments Designated for Capital Projects (Note 2)	358,417,708
Due from State of North Carolina Component Units	2,568,240
Advanced Deposits with Liability Insurance Trust Fund (Note 13)	6,285,896
Patient Accounts Receivable, Net (Note 4)	863,268
Start-Up Cost, Net	390,423
Notes Receivable (Note 15)	41,886,337
Investments in Affiliates (Note 16)	11,106,486
Capital Assets - Nondepreciable (Note 6)	75,132,956
Capital Assets - Depreciable, Net (Note 6)	691,200,479
	<hr/>
Total Noncurrent Assets	1,435,894,196

Total Assets	<hr/> <hr/> 2,114,332,974
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**DEFERRED OUTFLOWS OF RESOURCES**

Deferred Loss on Refunding	8,993,613
Accumulated Decrease in Fair Value of Hedging Derivatives	19,422,898
Deferred Outflows Related to Pensions	53,503,421
	<hr/>
Total Deferred Outflows of Resources	81,919,932

**LIABILITIES**

Current Liabilities:

Accounts Payable and Accrued Liabilities	88,758,504
Accrued Salaries and Benefits	48,058,048
Estimated Third Party Settlements (Note 5)	80,382,478
Due to Patients or Third Parties	15,734,652
Due to Primary Government	12,830,277
Due to State of North Carolina Component Units	57,738,483
Interest Payable	969,789
Long-Term Liabilities - Current Portion (Note 7)	33,915,331
	<hr/>
Total Current Liabilities	338,387,562



**University of North Carolina Hospitals at Chapel Hill**  
**Statement of Net Position**  
**June 30, 2016**

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

Noncurrent Liabilities:	
Long-Term Liabilities (Note 7)	410,714,679
Hedging Derivative Liability (Note 8)	19,422,898
Estimated Third Party Settlements (Note 5)	81,089,108
	<hr/>
Total Noncurrent Liabilities	511,226,685
	<hr/>
Total Liabilities	849,614,247
	<hr/>
<b>DEFERRED INFLOWS OF RESOURCES</b>	
Deferred Inflows Related to Pensions	34,922,046
	<hr/>
<b>NET POSITION</b>	
Net Investment in Capital Assets	574,580,319
Restricted for Expendable:	
Maintenance Reserve Fund	248,042,403
Liability Insurance Trust Fund	6,285,896
Trust Fund Donations	414,024
	<hr/>
Unrestricted	482,393,971
	<hr/>
Total Net Position	<u><u>\$ 1,311,716,613</u></u>

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, 2016**

**Exhibit A-2**

**REVENUES**

Operating Revenues:

Net Patient Service Revenue (Note 10)	\$ 1,551,326,267
Other Operating Revenues	39,079,109
	<hr/>
Total Operating Revenues	1,590,405,376

**EXPENSES**

Operating Expenses:

Salaries and Benefits	581,746,106
Medical and Surgical Supplies	344,883,927
Contracted Services	275,804,098
Other Supplies and Services	64,389,701
Medical Malpractice Cost	4,348,331
Communications, Utilities, and Travel	22,165,190
Depreciation and Amortization	66,806,623
	<hr/>
Total Operating Expenses	1,360,143,976
	<hr/>
Operating Income	230,261,400

**NONOPERATING REVENUES (EXPENSES)**

Noncapital Gifts and Grants	1,080,719
Federal Interest Subsidy on Debt	722,533
Investment Loss (Net of Investment Expense of \$1,192,041)	(6,175,873)
Interest and Fees on Debt	(8,520,576)
Loss on Disposal of Capital Assets	(91,319)
Other Nonoperating Revenues	19,491
	<hr/>
Net Nonoperating Expenses	(12,965,025)
	<hr/>
Income Before Other Expenses	217,296,375
	<hr/>
Health Care System Assessments (Note 15)	(129,713,445)
	<hr/>
Increase in Net Position	87,582,930

**NET POSITION**

Net Position - July 1, 2015, as Restated (Note 19)	1,224,133,683
	<hr/>
Net Position - June 30, 2016	\$ 1,311,716,613
	<hr/> <hr/>

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

**University of North Carolina Hospitals at Chapel Hill**  
**Statement of Cash Flows**  
**For the Fiscal Year Ended June 30, 2016**

**Exhibit A-3**  
**Page 1 of 2**

**CASH FLOWS FROM OPERATING ACTIVITIES**

Received from Patients or Third Parties	\$ 1,628,912,780
Payments to Employees and Fringe Benefits	(669,137,575)
Payments to Vendors and Suppliers	(646,947,817)
Payments for Medical Malpractice	(82,801)
Other Receipts	46,508,419
	<hr/>
Net Cash Provided by Operating Activities	359,253,006
	<hr/>

**CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES**

Health Care System Assessments	(129,713,445)
Principal Paid on Revenue Bonds	(1,224,000)
Interest and Fees Paid on Revenue Bonds	(358,747)
Noncapital Gifts and Grants	1,080,719
	<hr/>
Net Cash Used by Noncapital Financing Activities	(130,215,473)
	<hr/>

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

Proceeds from Sale of Capital Assets	10,070,438
Acquisition and Construction of Capital Assets	(60,543,190)
Principal Paid on Capital Revenue Bonds	(10,511,000)
Principal Paid on Notes and Capital Lease Payable	(4,629,915)
Interest and Fees Paid on Capital Debt and Leases	(7,740,184)
Federal Interest Subsidy on Debt Received	722,533
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(72,631,318)
	<hr/>

**CASH FLOWS FROM INVESTING ACTIVITIES**

Investment Income	3,478,402
Investments in and Loans to Affiliated Enterprises	(10,842,714)
	<hr/>
Net Cash Used by Investing Activities	(7,364,312)
	<hr/>
Net Increase in Cash and Cash Equivalents	149,041,903
Cash and Cash Equivalents - July 1, 2015	167,489,471
	<hr/>
Cash and Cash Equivalents - June 30, 2016	\$ 316,531,374
	<hr/> <hr/>

**University of North Carolina Hospitals at Chapel Hill**  
**Statement of Cash Flows**  
**For the Fiscal Year Ended June 30, 2016**

**Exhibit A-3**  
**Page 2 of 2**

**RECONCILIATION OF NET OPERATING LOSS  
TO NET CASH PROVIDED BY OPERATING ACTIVITIES**

Operating Income	\$	230,261,400
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation/ Amortization Expense		66,806,623
Pension Expense		13,837,446
Miscellaneous Pension Adjustments		50,029
Changes in Assets, Liabilities, and Deferred Outflows of Resources:		
Patient Accounts Receivable, Net		(27,116,946)
Due from Primary Government		(1,387,345)
Due from State of North Carolina Component Units		(35,629,925)
Estimated Third Party Settlements		99,498,171
Other Accounts Receivable, Net		(2,467,358)
Inventories		(9,628,818)
Prepaid Expenses		45,649,626
Advanced Deposits with Liability Insurance Trust Fund		4,265,530
Accounts Payable and Accrued Liabilities		16,970,840
Accrued Salaries and Benefits		(17,903,188)
Due to Patients or Third Parties		6,592,632
Due to Primary Government		4,812,073
Due to State of North Carolina Component Units		7,303,451
Deferred Outflows for Contributions Subsequent to the Measurement Date		(46,286,571)
Compensated Absences		3,625,336
Net Cash Provided by Operating Activities	\$	<u>359,253,006</u>

**RECONCILIATION OF CASH AND CASH EQUIVALENTS**

Current Assets:		
Cash and Cash Equivalents	\$	190,080,877
Restricted Cash and Cash Equivalents		1,724,444
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		<u>124,726,053</u>
Total Cash and Cash Equivalents - June 30, 2016	\$	<u>316,531,374</u>

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

Change in Fair Value of Investments	\$	(8,533,984)
Loss on Disposal of Capital Assets		(91,319)
Increase in Receivables Related to Sale of Capital Assets		18,850,510
Assets Acquired through the Assumption of a Liability		1,269,735

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



# NOTES TO THE FINANCIAL STATEMENTS

**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 929 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, North Carolina Cancer Hospital, and UNC Hospitals – Hillsborough Campus. 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, which is a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report*.

The accompanying financial statements present all funds belonging to the Hospitals and its component unit 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 Directors 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 LCC 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 (984) 974-5112.

Condensed combining information regarding the blended component unit is provided in Note 17.

- 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, include 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 petty cash on hand and 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 participation in an equity investment fund through the UNC Management Company, Inc. To the extent available, investments are reported at fair value based on quoted market prices in active markets on a trade-date basis. Additional information regarding the fair value measurement of investments is disclosed in Note 3. The fair value investments in the UNC Investment Fund is based on amounts reported to the Hospitals by UNC Management Company, Inc. 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 consists of unbilled (in house patients, inpatients discharged but not final billed and outpatients not final billed) and billed amounts. Payment of these charges comes primarily from Managed Care payers, Medicare, Medicaid and, to a lesser extent, the patient. These amounts are recorded in the financial statements net of charity care, contractual allowances, avoidable and other losses, 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 48 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, accrued interest receivable on deposits, education loan receivables, amounts due from affiliates and other state agencies, 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 or acquisition value at date of donation in the case of gifts, 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 of the assets. Upon



disposition, the asset and related accumulated depreciation accounts are relieved and any gain or loss is credited or charged to nonoperating revenues and expenses.

Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets in the following manner:

<u>Asset Class</u>	<u>Estimated Useful Life</u>
Buildings	10-40 years
Machinery & Equipment	3-20 years
General Infrastructure	5-25 years
Computer Software	3-10 years

- K. Designated Assets** - Investments Designated for Capital Projects include 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 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, net pension liability, capital lease obligations, financing agreements, and compensated absences that will not be paid within the next fiscal year.

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.

The net pension liability represents the Hospitals' proportionate share of the collective net pension liability reported in the State of North Carolina's 2015 *Comprehensive Annual Financial Report*. This liability represents the Hospitals' portion of the collective total pension liability less the fiduciary net position of the Teachers' and State Employees' Retirement System. See Note 11 for further information regarding the Hospitals' policies for recognizing liabilities, expenses, and deferred outflows and inflows related to pensions.

- 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. The minimum hours will be phased down to 80 by November 2016. There is a 10% forfeiture of the cash value to comply with IRS regulations.

**Liability Calculation** - The liability for accumulated annual leave, holiday leave, and PTO leave for each employee at June 30 equals the leave carried forward at the previous December 31 plus the leave earned, less the leave taken between January 1 and June 30 with appropriate caps depending on plan type. 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 liabilities 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, royalties, 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 position include consideration of deferred outflows and inflows 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 expenses.

- Q. Net Patient Service Revenue** - Patient service revenue is recorded at the Hospitals' established rates and includes all charges for inpatient accounts discharged after June 30, 2015, (less amounts previously recorded at June 30, 2015, for in house patients) and all charges on in house accounts and all charges for outpatient accounts registered after June 30, 2015. 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, avoidable and other losses, 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 or avoidable and other losses.

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 13 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.

Cash on hand at June 30, 2016 was \$41,514. The carrying amount of the Hospitals' deposits not with the State Treasurer was \$9,880,205 and the bank balance was \$10,473,926. 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, 2016, \$638,366 of the Hospitals' bank balance was insured and collateralized, and \$9,835,560 was exposed to custodial credit risk.

- 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).

**Short-Term Investment Fund** - At June 30, 2016, the amount shown on the Statement of Net Position as cash and cash equivalents includes \$306,609,655 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 or subject to any other regulatory oversight and does not have a credit rating) had a weighted average maturity of 1.5 years as of June 30, 2016. Assets and shares of the STIF are valued at 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.

**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 Liability Insurance Trust Fund and UNC Health Care 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, 2016, the amount shown on the Statement of Net Position which represents funds deposited with and invested by UNC Investment Fund is \$481,734,058. UNC Investment Fund manages the assets, primarily in equity and equity-based securities in accordance with the investment policy approved by its Board. UNC Investment Fund services the securities and maintains all related accounting records. Deposit and investment risks associated with UNC Investment Fund are included in audited financial statements of the UNC Investment Fund, LLC which may be obtained from UNC Management Company, Inc., 1400 Environ Way, Chapel Hill, NC 27517.

**C. Reconciliation of Deposits and Investments** - A reconciliation of deposits and investments for the Hospitals as of June 30, 2016, is as follows:

Cash on Hand	\$	41,514
Amount of Deposits with Private Financial Institutions		9,880,205
Deposits in the Short Term Investment Fund		306,609,655
UNC Investment Fund		<u>481,734,058</u>
<b>Total Deposits and Investments</b>	<b>\$</b>	<b><u>798,265,432</u></b>
Deposits		
Current:		
Cash and Cash Equivalents	\$	190,080,877
Restricted Cash and Cash Equivalents		1,724,444
Noncurrent:		
Restricted Cash and Cash Equivalents		<u>124,726,053</u>
<b>Total Deposits</b>		<u>316,531,374</u>
Investments		
Noncurrent:		
Restricted Investments		123,316,350
Investments Designated for Capital Projects		<u>358,417,708</u>
<b>Total Investments</b>		<u>481,734,058</u>
<b>Total Deposits and Investments</b>	<b>\$</b>	<b><u>798,265,432</u></b>

**NOTE 3 - FAIR VALUE MEASUREMENTS**

To the extent available, the Hospitals' investments and derivatives are recorded at fair value as of June 30, 2016. GASB Statement No. 72 - *Fair Value Measurement and Application*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This statement establishes a hierarchy of valuation inputs based on the extent to which the inputs are observable in the marketplace. Inputs are used in applying the various valuation techniques and take into account the assumptions that market participants use to make valuation decisions. Inputs

may include price information, credit data, interest and yield curve data, and other factors specific to the financial instrument. Observable inputs reflect market data obtained from independent sources. In contrast, unobservable inputs reflect the entity's assumptions about how market participants would value the financial instrument. Valuation techniques should maximize the use of observable inputs to the extent available.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. The following describes the hierarchy of inputs used to measure fair value and the primary valuation methodologies used for financial instruments measured at fair value on a recurring basis:

- Level 1 Investments whose values are based on quoted prices (unadjusted) for identical assets or liabilities in active markets that a government can access at the measurement date.
- Level 2 Investments with inputs – other than quoted prices included within Level 1 – that are observable for an asset or liability, either directly or indirectly.
- Level 3 Investments classified as Level 3 have unobservable inputs for an asset or liability and may require a degree of professional judgment.

The following table summarizes the Hospitals' investments and derivatives within the fair value hierarchy at June 30, 2016:

	Fair Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
<b>Investments by Fair Value Level</b>				
Other Securities				
Short-Term Investment Fund	\$ 306,609,655	\$ 0	\$ 306,609,655	\$ 0
UNC Investment Fund	481,734,058			481,734,058
<b>Total Investments Measured Fair Value</b>	<b>\$ 788,343,713</b>	<b>\$ 0</b>	<b>\$ 306,609,655</b>	<b>\$ 481,734,058</b>
<b>Derivative Instruments</b>				
Hedging Derivative Instruments				
Interest Rate Swap	\$ (19,422,898)	\$ 0	\$ (19,422,898)	\$ 0

**Short-Term Investment Fund** - Ownership interest of the STIF is determined on a fair market valuation basis as of fiscal year end in accordance with the STIF operating procedures. Valuation of the underlying assets is performed by the custodian.



**UNC Investment Fund** - Ownership interests of the UNC Investment Fund are determined on a market unit valuation basis each month and in accordance with the UNC Investment Fund's operating procedures.

**Derivative Instruments** - The Hospitals' hedging derivative instruments are managed by Bank of America, N.A. Valuations of derivative instruments represent, or are derived from, mid-market values and consider benchmark interest rates and foreign exchange rates.

**NOTE 4 - PATIENT ACCOUNTS RECEIVABLE, NET**

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, 2016. 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, 2016:

	Amount
In House Patients	\$ 88,593,302
Discharged (Not Final Billed) Patients	<u>67,348,366</u>
Total Unbilled	<u>155,941,668</u>
Discharged (Billed) Patients	372,613,768
Payment Arrangements	7,051,996
Charity Care Provided	<u>(39,664,892)</u>
Current Gross	<u>495,942,540</u>
Allowance for Bad Debts	(111,522,174)
Contractual Allowances	<u>(176,744,931)</u>
Total Allowances	<u>(288,267,105)</u>
Current - Net	<u>\$ 207,675,435</u>

The noncurrent net patient accounts receivable under flexible payment arrangement reflected in the accompanying Statement of Net Position is \$863,268 as of June 30, 2016.

**NOTE 5 - 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 10 (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 2016. Medicare cost report settlements owed to Medicare are estimated to be \$22,600,012 within the next twelve months and \$39,613,614 on a noncurrent basis. Traditional Medicaid cost report settlements owed to Medicaid are estimated to be \$12,568,393 within the next twelve months and \$41,475,494 on a noncurrent basis. Tricare/Champus currently owes the Hospitals \$11,378,212. 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 cost 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, 2009 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 \$45,214,073 UPL liability at year end includes reserves for future UPL audits within the next twelve months. See Note 10 (Net Patient Service Revenue) for more detail regarding the supplement.

**NOTE 6 - CAPITAL ASSETS**

A summary of changes in the capital assets for the year ended June 30, 2016, is presented as follows:

	Balance July 1, 2015	Increases	Decreases	Balance June 30, 2016
Capital Assets, Nondepreciable:				
Land and Permanent Easements	\$ 46,807,242	\$ 0	\$ 0	\$ 46,807,242
Construction in Progress	180,446,230	11,772,159	171,597,204	20,621,185
Goodwill	7,704,529			7,704,529
<b>Total Capital Assets, Nondepreciable</b>	<b>234,958,001</b>	<b>11,772,159</b>	<b>171,597,204</b>	<b>75,132,956</b>
Capital Assets, Depreciable:				
Buildings	713,428,051	171,597,204	1,693,489	883,331,766
Machinery and Equipment	427,447,077	37,478,784	27,053,523	437,872,338
General Infrastructure	5,295,662			5,295,662
Computer Software	61,167,237	7,331,774	17,603,521	50,895,490
<b>Total Capital Assets, Depreciable</b>	<b>1,207,338,027</b>	<b>216,407,762</b>	<b>46,350,533</b>	<b>1,377,395,256</b>
Less Accumulated Depreciation/Amortization for:				
Buildings	267,102,254	34,824,215	23,425	301,903,044
Machinery and Equipment	311,100,864	26,461,538	6,339,309	331,223,093
General Infrastructure	4,875,576	67,364		4,942,940
Computer Software	49,864,499	5,432,645	7,171,444	48,125,700
<b>Total Accumulated Depreciation/Amortization</b>	<b>632,943,193</b>	<b>66,785,762</b>	<b>13,534,178</b>	<b>686,194,777</b>
<b>Total Capital Assets, Depreciable, Net</b>	<b>574,394,834</b>	<b>149,622,000</b>	<b>32,816,355</b>	<b>691,200,479</b>
<b>Capital Assets, Net</b>	<b>\$ 809,352,835</b>	<b>\$ 161,394,159</b>	<b>\$ 204,413,559</b>	<b>\$ 766,333,435</b>

**NOTE 7 - LONG-TERM LIABILITIES**

**A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2016, is presented as follows:**

	Balance July 1, 2015	Additions	Reductions	Balance June 30, 2016	Current Portion
Revenue Bonds Payable	\$ 254,450,000	\$ 0	\$ 11,735,000	\$ 242,715,000	\$ 12,075,000
Net Pension Liability	42,860,194	88,783,923		131,644,117	
Notes Payable	311,157		311,157		
Arbitrage Rebate Payable	425,034		425,034		
Capital Leases Payable	21,900,681		4,318,758	17,581,923	4,342,558
Compensated Absences	42,077,881	71,153,562	67,528,226	45,703,217	13,080,260
Other Long-Term License Payable	9,246,360	2,156,906	4,417,513	6,985,753	4,417,513
<b>Total Long-Term Liabilities</b>	<b>\$ 371,271,307</b>	<b>\$ 162,094,391</b>	<b>\$ 88,735,688</b>	<b>\$ 444,630,010</b>	<b>\$ 33,915,331</b>

Additional information regarding capital lease obligations is included in Note 9.  
 Additional information regarding the net pension liability is included in Note 11.  
 Additional information regarding the license payable is included in Note 15.

**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, 2016	Principal Outstanding June 30, 2016
Rex Acquisition and Hospital Renovations	2001A	0.09%*	02/15/2031	\$ 55,000,000	\$ 9,900,000	\$ 45,100,000
	2001B	0.09%*	02/15/2031	55,000,000	9,900,000	45,100,000
Refund Portion of 1996 Revenue Bonds	2003A	3.59%*	02/01/2029	63,770,000	7,465,000	56,305,000
	2003B	3.75%*	02/01/2029	34,245,000	3,975,000	30,270,000
Refund 1999 Revenue Bonds	2009A	3.88%*	02/01/2024	44,290,000	17,590,000	26,700,000
General Revenue Bonds	2010B	3.54% to 6.33%**	02/01/2031	43,290,000	4,050,000	39,240,000
<b>Total Revenue Bonds Payable</b>				<u>\$ 295,595,000</u>	<u>\$ 52,880,000</u>	<u>\$ 242,715,000</u>

\* For variable rate debt, interest rates in effect at June 30, 2016 are included. For variable rate debt with interest rate swaps, the synthetic fixed rates are included.

\*\* 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.

**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.

Effective September 21, 2015, Wells Fargo Bank, N.A. replaced Merrill Lynch; Pierce, Fenner & Smith Incorporated; and Banc of America Securities, LLC as the Remarketing Agent for the Series 2001A and 2001B bonds. 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 Agent has agreed to exercise its best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears, on the first business day of each March, June, September, and December, commencing December 1, 2015 and is equal to 0.05% of the outstanding principal amount of the bonds assigned to the agent.

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and Landesbank Hessen-Thüringen Girozentrale, a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require an adjustable facility fee based on the long-term rating of the bonds, which is calculated as a percentage of the available commitment. Payments are made quarterly in arrears, on the first business day of each April, July, October, and January thereafter until the expiration date or the termination date of the Agreements. 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. On September 1, 2015, the Hospitals entered into a new multiple-year agreement with Landesbank Hessen-Thüringen to provide liquidity service at a fee of 0.28% effective September 21, 2015. The applicable percentage will be determined based upon the long-term ratings of the bonds (without regard to any credit enhancement), as follows:

<u>S&amp;P</u>	<u>Moody's</u>	<u>Commitment Rate</u>
AA- or better	Aa3	0.28%
A+	A1	0.38%
A	A2	0.48%
A-	A3	0.73%
BBB+ or lower	Baa1	1.78%

In the event that there is a disparity between Moody's and S&P's ratings on the bonds, the lower rating will prevail for the purpose of calculating the Commitment Fee. In addition, should an Event of Default Occur or the long-term unenhanced ratings on the bonds or any Parity Debt be withdrawn or suspended by one or more of the rating agencies for credit-related reasons, the Fee Rate shall automatically be increased to 1.78% per annum.

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, 2016, 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 \$90,200,000 of demand bonds was “put” and not resold, the Hospitals would be required to pay \$23,504,617, \$22,617,650, \$21,354,850, \$20,092,050, and \$18,829,250 in years one, two, three, four, and five, respectively, under the installment loan agreement assuming a Base Rate of 4.50% (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 September 20, 2020. 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 0.33% for fiscal year 2016. Payments are made quarterly in arrears, on the first business day of each November, February, May, and August thereafter until July 3, 2017. 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:

<u>S&amp;P</u>	<u>Moody's</u>	<u>Commitment Rate</u>
A	A2	0.53%
A- or lower	A3 or lower	0.73%

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, 2016, 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 \$56,305,000 of demand bonds was “put” and not resold, the Hospitals would be required to pay \$21,536,664, \$20,739,009, and \$19,612,911 in years one, two and three, respectively, following the termination date under the installment loan agreement assuming a Base Rate of 5.00% (Prime plus 1.50%).

The 2003B Agreement with Wells Fargo Bank, N.A. required a Commitment Fee of 0.35% for fiscal year 2016. 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:

<u>S&amp;P</u>	<u>Moody’s</u>	<u>Commitment Rate</u>
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, 2016, 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 \$30,270,000 of demand bonds was “put” and not resold, the Hospitals would be required to pay \$10,154,209, \$12,761,556, and \$11,708,988 in years one, two and three, respectively, following the Purchase Date of the Bank Bonds assuming a Base Rate of 7.00%.

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

Effective September 21, 2015, TD Securities (USA) LLC replaced Banc of America Securities, LLC as the Remarketing Agent for the Series 2009A bonds. While in the weekly mode, TD Securities has agreed to exercise its 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 0.07% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2009A.

Effective September 21, 2015, the Hospitals has contracted with TD Bank, N.A. as the liquidity provider for Series 2009A bonds through a Standby Bond Purchase Agreement (2009A Agreement). Under the 2009A 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 a rate equal to the Base Rate until



180 days after the initial date of purchase, and thereafter at the Base Rate plus 1.00% per annum and thereafter. 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.

The 2009A Agreement with TD Bank, N.A. requires a Commitment Fee of 0.32% commencing November 1, 2015. Payments are to be made quarterly in arrears, on the first business day of each February, May, August, and November, commencing November 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 A+/A1 or higher. If the rating assigned to Parity Debt by either Moody's or S&P is downgraded below A+ or A1, respectively, the Commitment Rate assigned to such lower rating as set forth below shall apply, effective as of the public announcement of the rating:

<u>S&amp;P</u>	<u>Moody's</u>	<u>Commitment Rate</u>
A1 or higher	A+	0.32%
A2	A	0.57%
A3	A-	0.89%

In the event that there is a disparity between Moody's and S&P's ratings on the Bonds, the lower rating will prevail for the purpose of calculating the Commitment Fee. In addition, should an Event of Default occur or the long-term unenhanced ratings on the bonds or any Parity Debt be withdrawn or suspended by one or more of the rating agencies for credit-related reasons, the Fee Rate shall automatically increase to 1.50% per annum. All such increases in the Commitment Rate contemplated above will be adjusted at the beginning of the quarter following the rate change.

Included in the 2009A 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 365 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The Series 2009A Agreement allows the Hospitals to redeem Bank Bonds in monthly installments of principal beginning on the first business day of the month until the fourth anniversary of the Purchase Date, until fully paid. If the take out agreement were to be exercised because the entire outstanding \$26,700,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay \$7,599,442, \$7,432,110, and \$7,135,849, and \$6,839,589 in years one, two, three, and four, respectively, following the termination date under the installment loan agreement assuming a Base Rate of 3.50%.

The current expiration date of the Agreements is September 21, 2020. 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.

**D. Annual Requirements** - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2016, are as follows:

Fiscal Year	Annual Requirements Revenue Bonds Payable		
	Principal	Interest	Interest Rate Swaps, Net
2017	\$ 12,075,000	\$ 2,381,762	\$ 3,729,535
2018	12,635,000	2,297,270	3,450,068
2019	13,015,000	2,195,640	3,155,091
2020	13,420,000	2,088,274	2,853,725
2021	14,025,000	1,972,378	2,527,413
2022-2026	79,230,000	7,782,516	7,622,677
2027-2031	98,315,000	3,237,919	1,367,178
<b>Total Requirements</b>	<b>\$ 242,715,000</b>	<b>\$ 21,955,759</b>	<b>\$ 24,705,687</b>

Interest on the variable rate 2001 A&B, 2003 A&B, and 2009A bonds is calculated at 0.09%, 0.09%, 0.12%, 0.11%, and 0.11% at June 30, 2016.

This schedule also includes the debt service requirements for debt associated with interest rate swaps. More detailed information about interest rate swaps is presented in Note 8 Derivative Instruments.

**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 06/30/2016	Principal Outstanding 06/30/2016
Medical Equipment	Phillips Medical	0.00%	06/25/2016	\$ 650,600	\$ 650,600	\$ 0

**NOTE 8 - DERIVATIVE INSTRUMENTS**

Derivative instruments held at June 30, 2016 are as follows:

Type	Notional	Change in Fair Value		Fair Value at June 30, 2016	
		Classification	Decrease	Classification	Liability
<i>Hedging Derivative Instruments</i>					
<i>Cash Flow Hedges</i>					
Pay-Fixed Interest Rate Swap	\$ 86,575,000	Deferred Outflow of	\$ 2,660,279	Hedging Derivative	\$ (15,997,320)
Pay-Fixed Interest Rate Swap	26,700,000	Deferred Outflow of	32,610	Hedging Derivative	(3,425,578)
<b>Total Derivative Instruments</b>			<b>\$ 2,692,889</b>		<b>\$ (19,422,898)</b>

Hedging derivative instruments held at June 30, 2016 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	\$ 86,575,000	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	26,700,000	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, 2016.

The Hospitals' interest rate swap hedging derivatives have been determined to be effective as of June 30, 2016 using the synthetic instrument method.

*Hedging Derivative Risks*

*Credit Risk:* As of June 30, 2016, 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 fall below A3 for Moody's or below A- for S&P, BOA will be required to collateralize a portion of its 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, 2016, the credit rating for Bank of America, N.A. is A1 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 highly 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, 2016. 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, 2016.

*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 9 - LEASE OBLIGATIONS

**A. Capital Lease Obligations** - Capital lease obligations relating to medical 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, 2016:

<u>Fiscal Year</u>	<u>Amount</u>
2017	\$ 4,655,479
2018	5,250,889
2019	3,543,585
2020	<u>4,882,957</u>
Total Minimum Lease Payments	18,332,910
Amount Representing Interest (1% to 9% Rate of Interest)	<u>750,987</u>
Present Value of Future Lease Payments	<u>\$ 17,581,923</u>

Medical equipment acquired under capital lease amounted to \$22,970,156 at June 30, 2016. Depreciation for the capital assets

associated with capital leases is included in depreciation expense, and accumulated depreciation for assets acquired under capital lease totaled \$8,588,107 at June 30, 2016.

**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, 2016:

<u>Fiscal Year</u>	<u>Amount</u>
2017	\$ 8,024,522
2018	7,675,835
2019	7,394,205
2020	6,183,728
2021	5,614,945
2022-2026	29,231,824
2027-2031	15,575,745
2032-2036	11,839,161
Total Minimum Lease Payments	<u>\$ 91,539,965</u>

Rental expense for all operating leases during the year was \$5,950,661.

**NOTE 10 - NET PATIENT SERVICE REVENUE**

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

Medicare makes payments for Direct Graduate Medical Education (DGME) in support of the direct costs of residency training. Medicare also pays a portion of Medicare bad debts and organ acquisition costs for the Medicare beneficiaries. These pass-through payments are discussed further in Note 5, Estimated Third Party Settlements.

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

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 and UNC DSH payments. The Hospitals is responsible for ensuring the State receives an amount equal to the federal share of the cost of providing care to uninsured patients at the Hospitals (\$87,657,952). The UPL Plan was effective on October 1, 2010.

The UPL payments of \$149,410,565 for federal fiscal year 2015 were received in August 2015 and November 2015 of which \$35,838,637 was related to the Hospitals' 2016 fiscal year. A UPL payment of \$110,426,902 for 3 quarters of federal fiscal year 2016 was received in June 2016.

**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, and per diem rates. Global rate reimbursements exist for solid organ and stem cell transplants. They include reimbursement amounts for both hospital and physician services. In addition, the Hospitals have agreements with the major Medicare Advantage plans in their various markets. These plans reimburse according to the Centers for Medicare and Medicaid Services' methodology.

In general, most commercial 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 a contract remains in force.

A summary of net patient service revenue for the year ended June 30, 2016 follows:

	2016
Inpatient	\$ 1,937,030,020
Outpatient	1,846,964,199
Charity Care Provided	(220,773,787)
Prior Year Third Party Settlements	9,298,180
	<hr/>
Gross Patient Service Revenue	3,572,518,612
	<hr/>
Medicare Contractual Allowance	(863,291,141)
Medicaid Contractual Allowance	(585,841,136)
Upper Payment Limit	157,644,584
Managed Care Contractual Allowance	(603,467,828)
Other Contractual Allowances	(23,796,219)
Bad Debt	(102,440,605)
	<hr/>
Contractual Adjustments	(2,021,192,345)
	<hr/>
Net Patient Service Revenue	\$ 1,551,326,267

**NOTE 11 - PENSION PLANS**

**A. Defined Benefit Plan**

*Plan Administration:* The State of North Carolina administers the Teachers' and State Employees' Retirement System (TSERS) plan. This plan is a cost-sharing, multiple-employer, defined benefit pension plan established by the State to provide pension benefits for general employees and law enforcement officers (LEOs) of the State, general employees and LEOs of its component units, and employees of Local Education Agencies (LEAs) and charter schools not in the reporting entity. Membership is comprised of employees of the State (state agencies and institutions), universities, community colleges, and certain proprietary component units along with the LEAs and charter schools. Benefit provisions are established by General Statute 135-5 and may be amended only by the North Carolina General Assembly.

*Benefits Provided:* TSERS provides retirement and survivor benefits. Retirement benefits are determined as 1.82% of the member's average final compensation times the member's years of creditable service. A member's average final compensation is calculated as the average of a member's four highest consecutive years of compensation. General employee plan members are eligible to retire with full retirement benefits at age 65 with five years of creditable service, at age 60 with 25 years of creditable service, or at any age with 30 years of creditable service. General employee plan members are eligible to retire with partial



retirement benefits at age 50 with 20 years of creditable service or at age 60 with five years of creditable service. Survivor benefits are available to eligible beneficiaries of general members who die while in active service or within 180 days of their last day of service and who also have either completed 20 years of creditable service regardless of age, or have completed five years of service and have reached age 60. Eligible beneficiaries may elect to receive a monthly Survivor's Alternate Benefit for life or a return of the member's contributions. The plan does not provide for automatic post-retirement benefit increases. Increases are contingent upon actuarial gains of the plan.

*Contributions:* Contribution provisions are established by General Statute 135-8 and may be amended only by the North Carolina General Assembly. Employees are required to contribute 6% of their annual pay. The contribution rate for employers is set each year by the NC General Assembly in the Appropriations Act based on the actuarially-determined rate recommended by the actuary. The Hospitals' contractually-required contribution rate for the year ended June 30, 2016 was 9.15% of covered payroll. Hospitals' contributions to the pension plan were \$46,286,571, and employee contributions were \$30,351,850 for the year ended June 30, 2016.

The TSERS Plan's financial information, including all information about the plan's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position, is included in the State of North Carolina's fiscal year 2015 *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.

*TSERS Basis of Accounting:* The financial statements of the TSERS plan were prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions are recognized when due and the employer has a legal requirement to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan. The plan's fiduciary net position was determined on the same basis used by the pension plan.

*Methods Used to Value TSERS Investment:* Pursuant to *North Carolina General Statutes*, the State Treasurer is the custodian and administrator of the retirement systems. The State Treasurer maintains various investment portfolios in its Investment Pool. The pension trust funds are the primary participants in the Long-term Investment portfolio and the sole participants in the External Fixed Income Investment, Equity Investment, Real Estate Investment, Alternative Investment, Credit Investment, and Inflation Protection Investment portfolios. The investment balance of each pension trust fund represents its share of the fair market value of the net position of the various portfolios within the pool. Detailed descriptions of the methods and significant assumptions



regarding investments of the State Treasurer are provided in the 2015 *Comprehensive Annual Financial Report*.

*Net Pension Liability:* At June 30, 2016, the Hospitals reported a liability of \$131,644,117 for its proportionate share of the collective net pension liability. The net pension liability was measured as of June 30, 2015. The total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of December 31, 2014, and update procedures were used to roll forward the total pension liability to June 30, 2015. The Hospitals' proportion of the net pension liability was based on the present value of future salaries for the Hospitals relative to the present value of future salaries for all participating employers, actuarially-determined. As of June 30, 2015, the Hospitals' proportion was 3.57%, which was a decrease of 0.09% from its proportion measured as of June 30, 2014.

*Actuarial Assumptions:* The following table presents the actuarial assumptions used to determine the total pension liability for the TSERS plan at the actuarial valuation date:

Valuation Date	12/31/2014
Inflation	3%
Salary Increases*	4.25% - 9.10%
Investment Rate of Return**	7.25%

\* Salary increases include 3.5% inflation and productivity factor.

\*\* Investment rate of return is net of pension plan investment expense, including inflation.

TSERS currently uses mortality tables that vary by age, gender, employee group (i.e. teacher, general, law enforcement officer) and health status (i.e. disabled and healthy). The current mortality rates are based on published tables and based on studies that cover significant portions of the U.S. population. The healthy mortality rates also contain a provision to reflect future mortality improvements.

The actuarial assumptions used in the December 31, 2014 valuations were based on the results of an actuarial experience study for the period January 1, 2005 through December 31, 2009.

Future ad hoc Cost of Living Adjustment (COLA) amounts are not considered to be substantively automatic and are therefore not included in the measurement.

The projected long-term investment returns and inflation assumptions are developed through review of current and historical capital markets data, sell-side investment research, consultant whitepapers, and historical performance of investment strategies. Fixed income return projections reflect current yields across the U.S. Treasury yield curve and market expectations of forward yields projected and interpolated for multiple tenors and over multiple year horizons. Global public equity return projections are established through analysis of the equity risk premium

and the fixed income return projections. Other asset categories and strategies' return projections reflect the foregoing and historical data analysis. These projections are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of arithmetic real rates of return for each major asset class included in the pension plan's target asset allocation as of June 30, 2015 (the valuation date) are summarized in the following table:

<u>Asset Class</u>	<u>Long-Term Expected Real Rate of Return</u>
Fixed Income	2.2%
Global Equity	5.8%
Real Estate	5.2%
Alternatives	9.8%
Credit	6.8%
Inflation Protection	3.4%

The information above is based on 30-year expectations developed with the consulting actuary for the 2014 asset, liability and investment policy study for the North Carolina Retirement Systems. The long-term nominal rates of return underlying the real rates of return are arithmetic annualized figures. The real rates of return are calculated from nominal rates by multiplicatively subtracting a long-term inflation assumption of 3.19%. All rates of return and inflation are annualized.

*Discount Rate:* The discount rate used to measure the total pension liability was 7.25%. The projection of cash flows used to determine the discount rate assumed that contributions from plan members will be made at the current contribution rate and that contributions from employers will be made at statutorily required rates, actuarially determined. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of the current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

*Sensitivity of the Net Pension Liability to Changes in the Discount Rate:* The following presents the net pension liability of the plan calculated using the discount rate of 7.25%, as well as what the net pension liability would be if it were calculated using a discount rate that is 1-percentage point lower (6.25%) or 1-percentage point higher (8.25%) than the current rate:

<u>Net Pension Liability (Asset)</u>		
<u>1% Decrease (6.25%)</u>	<u>Current Discount Rate (7.25%)</u>	<u>1% Increase (8.25%)</u>
\$ 396,212,463	\$ 131,644,117	\$ (92,872,632)

*Deferred Inflows of Resources and Deferred Outflows of Resources Related to Pensions:* For the year ended June 30, 2016, the Hospitals recognized pension expense of \$13,837,446. At June 30, 2016, the Hospitals reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

Employer Balances of Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions by Classification:

	Deferred Outflows of Resources	Deferred Inflows of Resources
Difference Between Actual and Expected Experience	\$ 0	\$ 14,967,936
Changes of Assumptions		
Net Difference Between Projected and Actual Earnings on Pension Plan Investments		14,262,525
Change in Proportion and Differences Between Agency's Contributions and Proportionate Share of Contributions	7,216,850	5,691,585
Contributions Subsequent to the Measurement Date	46,286,571	
Total	<u>\$ 53,503,421</u>	<u>\$ 34,922,046</u>

The amount of \$46,286,571 reported as deferred outflows of resources related to pensions will be included as a reduction of the net pension liability in the fiscal year ended June 30, 2017. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

Schedule of the Net Amount of the Employer's Balances of Deferred Outflows of Resources and Deferred Inflows of Resources That will be Recognized in Pension Expense:

Year ended June 30:	Amount
2017	\$ (16,130,861)
2018	(16,130,861)
2019	(16,130,861)
2020	20,689,575
Total	<u>\$ (27,703,008)</u>

- B. Defined Contribution Plan** - The Optional Retirement Program (Program) is a defined contribution pension plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Eligible employees 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, 2016, 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 \$613,820,830, of which \$63,919,957 was covered under the Optional Retirement Program. Total employer and employee contributions for pension benefits for the year were \$4,372,125 and \$3,835,197, respectively. The amount of pension expense recognized in the current year related to ORP is equal to the employer contributions.

## NOTE 12 - 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 (TSERS) or the Optional Retirement Program (ORP). 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 TSERS 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 5.60% of the covered payroll under TSERS and ORP to the Fund. Required contribution rates for the years ended June 30, 2015, and 2014, were 5.49% and 5.40%, respectively. The Hospitals made 100% of its annual required contributions to the Plan for the years ended June 30, 2016, 2015, and 2014, which were \$29,104,124, \$24,807,472, and \$23,574,065, 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 TSERS and ORP. 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, 2016, the Hospitals made a statutory contribution of .41% of covered payroll under TSERS and ORP to the DIPNC. Required contribution rates for the years ended June 30, 2015, and 2014, were .41% and .44%, respectively. The Hospitals made 100% of its annual required contributions to the DIPNC for the years ended June 30, 2016, 2015, and 2014, which were \$2,130,838, \$1,852,653, and \$1,920,850, 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 13 - 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.

#### **A. Employee Benefit Plans**

##### **1. State Health Plan**

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.

##### **2. Death Benefit Plan of North Carolina**

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.

#### **B. Other Risk Management and Insurance Activities**

##### **1. Automobile, Fire, and Other Property Losses**

The Hospitals is required to maintain fire and lightning coverage on all state-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Premiums are paid based on square footage and the value of building contents. The Hospitals purchased through the Fund “all risks” replacement cost basis insurance for buildings and contents subject to a \$25,000 per occurrence deductible.

All state-owned vehicles are covered by liability insurance through a private insurance company and handled by the North Carolina Department of Insurance. The liability limits for losses are \$1,000,000 per claim and \$10,000,000 per occurrence. The Hospitals pays premiums to the North Carolina Department of Insurance for the coverage. The Hospitals also has an insurance policy from a private insurance company through the North Carolina Department of Insurance for Auto Physical Damage (for vehicles costing greater than \$75,000). Coverage limit is \$5,000,000 per accident with a deductible of \$500 per occurrence.

##### **2. Public Officers’ and Employees’ Liability Insurance**

The risk of tort claims of up to \$1,000,000 per claimant is retained under the authority of the State Tort Claims Act.

### 3. Employee Dishonesty and Computer Fraud

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 \$100,000 deductible.

### 4. Statewide Workers' Compensation Program

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.

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.

### 5. Other Insurance Held by the Hospitals

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 (DNO) Liability insurance up to \$10,000,000 aggregate with retention of \$200,000 DNO, and First Excess insurance with limits of \$10,000,000 and Second Excess insurance with limits of \$5,000,000;
- Master Crime insurance up to \$500,000 per occurrence with a deductible of \$1,000;
- Comprehensive General Liability insurance up to \$1,000,000 per occurrence, \$2,000,000 aggregate 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 and Non-Owned Aircraft insurance up to \$20,000,000 with no deductible;
- Fine Arts Floater insurance up to \$5,000 per item and \$100,000 policy aggregate with no deductible;



- Surety Bond of \$350,000 for Suppliers of Durable Medical Equipment, Prosthetics, Orthotics and Supplies Medicare Program (DMEPOS);
- Lawyers Professional Liability insurance with limits of \$5,000,000 aggregate and \$25,000 retention.

**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, 2015, through June 30, 2016, 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, 2016, 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, 2016, the Hospitals' assets in the Trust Fund totaled \$24,807,263 while Hospitals' liabilities totaled \$18,521,367 resulting in net position of \$6,285,896.

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 14 - 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 \$17,075,036 and on other purchases were \$6,420,500 at June 30, 2016.

- 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 15 - 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 provides and receives certain shared services (primarily information technology, revenue cycle, and administration) to the Hospitals and the affiliated entities. The System implemented a new electronic health record and patient accounting system that was funded, in part, by notes receivable extended to the System. This note and related implementation receivables from the System totaled \$51,030,816 and \$48,943,580 respectively at year end. There are additional receivables from the System of \$94,031,218 for asset acquisitions and shared services expenses. The Hospitals' \$6,985,753 other long-term license payable (Note 7) is offset by these receivables. The Hospitals was assessed \$69,864,096 to fund initiatives supported by the System Fund and \$62,790,887 to fund System affiliates. The Hospitals also received \$2,941,538 from the System Fund during the year ended June 30, 2016.

**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 Rex Healthcare, Inc.

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 \$2,886,501 from Rex and the Hospitals paying \$8,473,196 to Rex during the year ended June 30, 2016.

**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 Hospitals has entered into various administrative and clinical services agreements with Chatham Hospital, Inc. resulting in the Hospitals receiving \$2,374,342 and the Hospitals paying \$39,135 to Chatham Hospital, Inc. during the fiscal year for those services.

**UNC Physicians Network, LLC** – UNC Physicians Network is a wholly owned subsidiary of the System, but a private employer, that owns and operates more than forty 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 Physicians Network paid the Hospitals \$4,710,132 for supplies and services during the fiscal year, and the Hospitals paid \$201,324 to UNC Physicians Network during the year ended June 30, 2016.

**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 \$3,757,054 for services received during fiscal year 2016 and the Hospitals paid \$1,807,815 to Pardee Memorial Hospital for supplies and services 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.

The Hospitals paid HPRH \$388,714 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 \$86,255 for services during fiscal year 2016. The Hospitals paid Caldwell Memorial Hospital \$642,022 for supplies and services.

**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 \$1,952,169 for services received during fiscal year 2016. The Hospitals paid Nash Health Care Systems \$95,209 for supplies and services.

**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 \$9,275,827 for services received during fiscal year 2016. The Hospitals paid Johnston Health Services Corporation \$3,476,914 for supplies and services during the fiscal year.

**Wayne Health Corporation** – Wayne Health Corporation is a private, not for profit health corporation located in Goldsboro, North Carolina that operates Wayne Memorial Hospital, Wayne Health Physicians, Wayne MRI, Wayne Health Enterprises, American Management Associates, Wayne Health Properties, and Wayne Health Foundation. It serves patients primarily from Wayne and neighboring counties. Wayne Health Corporation signed a management services agreement with UNC Health Care System on January 1, 2016 to provide certain management services over an initial term of 10 years.

Wayne Health Corporation paid the Hospitals \$662,623 for services received during fiscal year 2016.

**Lenoir Memorial Hospital, Inc.** – Lenoir Memorial Hospital, Inc. is a private, not for profit hospital located in Kinston, North Carolina that operates Lenoir Memorial Hospital and several physician practices. It serves patients primarily from Lenoir and neighboring counties. Lenoir Memorial Hospital, Inc. signed a management services agreement with UNC Health Care System on May 17, 2016 to provide certain management services over an initial term of 10 years.

Lenoir Memorial Hospital, Inc. paid the Hospitals \$74,194 for services received during fiscal year 2016.

**NOTE 16 - INVESTMENT IN AFFILIATES**

The Hospitals has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were \$11,106,486 at June 30, 2016. 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:

	2016 <u>(Unaudited)</u>
<b>Total Affiliate Activity</b>	
Current Assets	\$ 19,467,241
Noncurrent Assets	13,116,035
Current Liabilities	4,153,857
Shareholders' Equity	28,429,419
Revenue	20,053,792
Net Gain	2,103,971
<hr/>	
<b>Hospitals' Share of Activity</b>	
Realized Affiliate Gain - Ongoing Operations	<u>\$ 1,312,131</u>

**NOTE 17 - BLENDED COMPONENT UNIT**

Condensed combining information for the Hospitals' blended component unit for the year ended June 30, 2016, is presented as follows:

*Condensed Statement of Net Position  
June 30, 2016*

	<u>Health System Properties, LLC</u>
<b>ASSETS</b>	
Current Assets	\$ 135,216
Capital Assets	21,308,432
Total Assets	<u>21,443,648</u>
<b>TOTAL DEFERRED OUTFLOWS OF RESOURCES</b>	<u>0</u>
<b>LIABILITIES</b>	<u>0</u>
<b>TOTAL DEFERRED INFLOWS OF RESOURCES</b>	<u>0</u>
<b>NET POSITION</b>	
Investment in Capital Assets	21,308,432
Unrestricted	135,216
Total Net Position	<u>\$ 21,443,648</u>

*Condensed Statement of Revenues, Expenses, and  
Changes in Net Position  
For the Fiscal Year Ended June 30, 2016*

	<u>Health System Properties, LLC</u>
<b>OPERATING REVENUES</b>	
Rental Income	\$ 587,320
<b>OPERATING EXPENSES</b>	
Operating Expenses	1,817,261
Depreciation	716,205
Total Operating Expenses	<u>2,533,466</u>
Operating Loss	<u>(1,946,146)</u>
<b>NONOPERATING REVENUES</b>	<u>0</u>
Capital Contributions	1,946,070
Decrease in Net Position	<u>(76)</u>
<b>NET POSITION</b>	
Net Position, July 1, 2015	<u>21,443,724</u>
Net Position, June 30, 2016	<u>\$ 21,443,648</u>

*Condensed Statement of Cash Flows*  
*June 30, 2016*

	Health System Properties, LLC
Net Cash Used by Operating Activities	\$ (76)
Cash and Cash Equivalents, July 1, 2015	135,292
Cash and Cash Equivalents, June 30, 2016	\$ 135,216

**NOTE 18 - CHANGES IN FINANCIAL ACCOUNTING AND REPORTING**

For the fiscal year ended June 30, 2016, the Hospitals implemented the following pronouncements issued by the Governmental Accounting Standards Board (GASB):

*GASB Statement No. 72, Fair Value Measurement and Application*

*GASB Statement No. 73, Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement No. 68, and Amendments to Certain Provisions of GASB Statements No. 67 and 68*

*GASB Statement No. 76, The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*

*GASB Statement No. 79, Certain External Investment Pools and Pool Participants*

GASB Statement No. 72 provides guidance for determining a fair value measurement for financial reporting purposes. This statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements.

GASB Statement No. 73 establishes requirements for defined benefit pensions that are not within the scope of Statement No. 68, *Accounting and Financial Reporting for Pensions*, as well as for the assets accumulated for purposes of providing those pensions. In addition, it establishes requirements for defined contribution pensions that are not within the scope of Statement No. 68. It also amends certain provisions of Statement No. 67, *Financial Reporting for Pension Plans*, and Statement No. 68 for pension plans and pensions that are within their respective scopes.

GASB Statement No. 76 reduces the GAAP hierarchy to two categories of authoritative GAAP and addresses the use of authoritative and nonauthoritative literature in the event that the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP.

GASB Statement No. 79 establishes criteria for an external investment pool to qualify for making the election to measure all of its investments at amortized cost for financial reporting purposes.

**NOTE 19 - NET POSITION RESTATEMENT**

As of July 1, 2015, net position as previously reported was restated as follows:

	<u>Amount</u>
July 1, 2015 Net Position as Previously Reported	\$ 1,223,645,247
Restatement:	
To Correct Prior Year Trust Fund Liability	<u>488,436</u>
July 1, 2015 Net Position as Restated	<u><u>\$ 1,224,133,683</u></u>

**NOTE 20 - SUBSEQUENT EVENT**

On September 19, 2016, the Board of Directors of the University of North Carolina Health Care System approved a resolution for the issuance of University of North Carolina Hospitals at Chapel Hill revenue bonds to finance the initial phase of construction of a new surgical pavilion to replace operating suites and support facilities. The University of North Carolina Board of Governors ratified this bond issue at its October 14, 2016 meeting. The Hospitals intends to borrow up to \$110,000,000 through the financing.





# **REQUIRED SUPPLEMENTARY INFORMATION**

**University of North Carolina Hospitals at Chapel Hill  
Required Supplementary Information  
Schedule of the Proportionate Net Pension Liability  
Teachers' and State Employees' Retirement System  
Last Three Fiscal Years**

**Exhibit B-1**

	<u>2015</u>	<u>2014</u>	<u>2013</u>
(1) Proportionate Share Percentage of Collective Net Pension Liability	3.57%	3.66%	3.40%
(2) Proportionate Share of TSERS Collective Net Pension Liability	\$ 131,644,117	\$ 42,860,194	\$ 206,542,137
(3) Covered-Employee Payroll	\$ 463,324,935	\$ 455,896,086	\$ 438,969,093
(4) Net Pension Liability as a Percentage of Covered-Employee Payroll	28.41%	9.40%	47.05%
(5) Plan Fiduciary Net Position as a Percentage of the Total Pension Liability	94.64%	98.24%	90.60%

**University of North Carolina Hospitals at Chapel Hill  
Required Supplementary Information  
Schedule of Hospitals Contributions  
Teachers' and State Employees' Retirement System  
Last Ten Fiscal Years**

**Exhibit B-2**

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
(1) Contractually Required Contribution	\$ 46,286,571	\$ 42,394,233	\$ 39,617,587	\$ 36,566,116	\$ 31,904,755
(2) Contributions in Relation to the Contractually Determined Contribution	<u>46,286,571</u>	<u>42,394,233</u>	<u>39,617,587</u>	<u>36,566,116</u>	<u>31,904,755</u>
(3) Contribution Deficiency (Excess)	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>
(4) Covered-Employee Payroll	\$ 505,864,160	\$ 463,324,935	\$ 455,896,086	\$ 438,969,093	\$ 428,827,355
(5) Contributions as a Percentage of Covered-Employee Payroll	9.15%	9.15%	8.69%	8.33%	7.44%

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
(1) Contractually Required Contribution	\$ 19,493,557	\$ 13,220,302	\$ 11,724,115	\$ 9,802,290	\$ 7,540,649
(2) Contributions in Relation to the Contractually Determined Contribution	<u>19,493,557</u>	<u>13,220,302</u>	<u>11,724,115</u>	<u>9,802,290</u>	<u>7,540,649</u>
(3) Contribution Deficiency (Excess)	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>
(4) Covered-Employee Payroll	\$ 395,406,814	\$ 370,315,946	\$ 348,927,541	\$ 321,385,923	\$ 283,485,308
(5) Contributions as a Percentage of Covered-Employee Payroll	4.93%	3.57%	3.36%	3.05%	2.66%

**University of North Carolina Hospitals at Chapel Hill  
Notes to Required Supplementary Information  
Schedule of Hospitals Contributions  
Teachers' and State Employees' Retirement System  
Last Ten Fiscal Years**

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Changes of Benefit Terms:

<u>Cost of Living Increase</u>									
<u>2015*</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
1.00%	N/A	1.00%	N/A	N/A	N/A	2.20%	2.20%	3.00%	2.00%

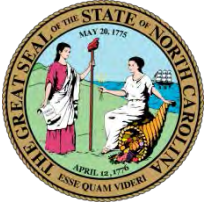
*Changes of assumptions.* In 2008, and again in 2012, the rates of withdrawal, mortality, service retirement and salary increase for active members and the rates of mortality for beneficiaries were adjusted to more closely reflect actual experience. Assumptions for leave conversions and loads were also revised in 2012.

\*Per the 2015 State of North Carolina *Comprehensive Annual Financial Report*, the 1.00% cost of living adjustment applies to retirees whose retirement began on or before July 1, 2013.



# INDEPENDENT AUDITOR'S REPORT

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 27699-0600  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
<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**

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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 (Hospitals), which is a part of the University of North Carolina Health Care System that is 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, 2016, and the related notes to the financial statements, which collectively comprise the Hospitals' basic financial statements, and have issued our report thereon dated October 19, 2016.

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 or the University of North Carolina System, and the results of operations and cash flows in conformity with accounting principles generally accepted in the United State 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 19, 2016

# ORDERING INFORMATION

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Office of the State Auditor  
State of North Carolina  
2 South Salisbury Street  
20601 Mail Service Center  
Raleigh, North Carolina 27699-0600

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For additional information contact:  
Bill Holmes  
Director of External Affairs  
**919-807-7513**



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This audit required 1,095.5 hours at an approximate cost of \$112,837.