

STATE OF NORTH CAROLINA

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA



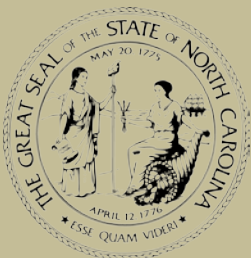
UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM FUNDS

CHAPEL HILL, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEARS ENDED JUNE 30, 2016 AND 2015

AN AFFILIATED ENTERPRISE 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

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AUDITOR'S TRANSMITTAL

The Honorable Roy Cooper, Governor
The General Assembly of North Carolina
Board of Directors, University of North Carolina Health Care System

We have completed a financial statement audit of the University of North Carolina Health Care System Funds for the years ended June 30, 2016 and 2015, 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

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Office of the State Auditor



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INDEPENDENT AUDITOR'S REPORT

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

Report on the Financial Statements

We have audited the accompanying financial statements of the University of North Carolina Health Care System Funds (System Fund), which is a part of the University of North Carolina Health Care System that is an affiliated enterprise of the multi-campus University of North Carolina System, a component unit of the State of North Carolina, as of and for the years ended June 30, 2016 and 2015, and the related notes to the financial statements, which collectively comprise the System Fund's 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 System Fund's 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 System Fund's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness

of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of North Carolina Health Care System Funds, as of June 30, 2016 and 2015, and the changes in financial position and cash flows thereof for the years 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 of the University of North Carolina Health Care System Funds are intended to present the financial position, changes in financial position, and cash flows that are only attributable to the transactions of the University of North Carolina Health Care System Funds. They do not purport to, and do not, present fairly the financial position of the University of North Carolina Health Care System nor the University of North Carolina System as of June 30, 2016 and 2015, the changes in its financial position, or its cash flows, for the years then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters – Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis 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 July 6, 2017 on our consideration of the System Fund's 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 System Fund's 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

July 6, 2017



MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

Management's discussion and analysis provides an overview of the financial position activities of the University of North Carolina Health Care System (UNC Health Care) Funds (System Fund) for the fiscal years ending June 30, 2016 and 2015.

UNC Health Care was established November 1, 1998, by *North Carolina General Statute 116-37*. UNC Health Care is governed by a Board of Directors as an affiliated enterprise of the University of North Carolina System. UNC Health Care and UNC Chapel Hill School of Medicine (UNC School of Medicine) are affiliated entities within the University System. The University of North Carolina Faculty Physicians (UNCFP) is the clinical service component of the UNC School of Medicine and provides a full range of care to the patients of UNC Health Care. Rex Healthcare, Inc. (Rex), Chatham Hospital, Inc. (Chatham), High Point Regional Health, Inc. (HPRH), Caldwell Memorial Hospital (Caldwell), UNC Physicians Network, LLC (UNCPN), Johnston Health Services Corporation, and UNC Physicians Network Group Practice (UNCPNGP) have been added to the organization since its inception. Entities listed above, along with UNC Hospitals at Chapel Hill, collectively perform the operating functions of UNC Health Care and the UNC School of Medicine. The System Fund, conversely, does not perform revenue generating activities. The System Fund functions as a centralized financial clearinghouse for the integrated health care system.

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

Using this Financial Report

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

The *Statement of Net Position* provides the financial position and includes all assets (resources), deferred outflows of resources, liabilities (claims to resources), deferred inflows of resources, and net position (equity). Assets and liabilities on this Statement are categorized as either current or noncurrent. Current assets are those that are available to pay for expenses in the next fiscal year, and it is anticipated that they will be used to pay for current liabilities. Current liabilities are those payable in the next fiscal year. Net position on this statement is categorized as net investment in capital assets and unrestricted. Management estimates are necessary in some instances to determine current or noncurrent categorization. The *Statement of Net Position* provides information relative to the financial strength of the System Fund and its ability to meet current and long-term obligations.

The *Statement of Revenues, Expenses, and Changes in Net Position* provides information relative to the results of the System Fund's operations, nonoperating activities, and other activities affecting net position. Operating revenues include activities that have characteristics of exchange transactions, such as the user fees charged to UNC Health Care entities for using assets held by the System Fund. Nonoperating activities include interest

income. Other activities include transfers in and transfers out from/to UNC Health Care entities. The *Statement of Revenues, Expenses, and Changes in Net Position* provides information relative to the management of the organization's operations and its ability to maintain its financial stability.

The *Statement of Cash Flows* provides information relative to the System Fund's sources and uses of cash for operating activities, noncapital financing activities, capital and related financing activities, and investing activities. The Statement provides a reconciliation of cash balance changes and is representative of the activity reported on the *Statement of Revenues, Expenses, and Changes in Net Position* as adjusted for changes in the beginning and ending balances of noncash accounts on the *Statement of Net Position*.

The *Notes to the Financial Statements* provide information relative to the significant accounting principles applied in the financial statements, authority for and associated risk of deposits, information on long-term liabilities, capital assets, receivables, payables, and transfers in and out. These disclosures provide information to better understand details, risk and uncertainty associated with the amounts reported and are considered an integral part of the financial statements.

Comparison of Two-Year Data for 2016 to 2015

Data for 2016 and 2015 are presented in Table 1 of this report and discussed in the following sections. Discussion in the following sections is pertinent to fiscal year 2016 results and changes relative to ending balances in fiscal year 2015.

Analysis of Overall Financial Position and Results of Operations

Statement of Net Position

The sub-accounts of the System Fund collectively hold assets of \$434.6 million. Total assets increased by \$69.9 million or 19.2% over the prior year. Cash on hand decreased by \$37.1 million of which a significant portion of the decrease was related to UNC Hospitals' prepayment of \$46.9 million for fiscal year 2016 commitments in 2015. No prepayment was made in 2016. Assets associated with the Enterprise Fund and the Shared Administrative Services Fund increased due to higher assessments in fiscal year 2016 to support UNC Health Care initiatives which will be disbursed in 2017.

The other significant increases in total assets resulted from the capital assets associated with the implementation of a system-wide electronic medical record (EMR) system during the year across all entities in the Triangle area. Implementation costs for the EMR system were approximately \$78.3 million for fiscal year 2016. Implementation costs will continue into fiscal year 2017 as the EMR system is implemented at the remaining entities. See Note 5 to the financial statements for further details on capital assets.

Total liabilities increased by \$43.7 million or 15.9%. This increase is mainly related to the amounts that are owed to UNC Health Care entities for shared administrative services and capital contributions.

The purchase of system-related capital for UNC Health Care benefit was divided into two phases. In fiscal year 2014, phase one established notes between the System Fund and its affiliates to fund the purchase of \$77.1 million in new capital. In fiscal year 2016, phase two established additional notes to fund the purchase of \$76 million in new capital. As of

June 30, 2016, only \$44.1 million of the approved phase two funding has been requested. There will be an additional draw in June of fiscal year 2017 to fund the full amount. The notes for both phases end on June 30, 2024. See Note 8 to the financial statements for further details on notes payable.

Other noncurrent liabilities decreased 57.9% compared to fiscal year 2015. During fiscal year 2016, the System Fund disbursed \$14,844,132 of funds held in escrow back to the appropriate UNC Health Care entities based on original funding sources. See Note 6 to the financial statements for further details on the funds held in escrow.

Net position increased \$26.2 million compared to fiscal year 2015. The net investment in capital assets is a negative \$19,752,980 and \$2,153,564 as of June 30, 2016 and 2015, respectively. The negative balance is due to the unpaid capital debt associated with the acquisition and construction of capital assets. The System Fund anticipates paying off the capital debt through future assessments to the entities. Unrestricted net position increased \$43.8 million during fiscal year 2016 due to the transfer activity discussed below.

Statement of Revenues, Expenses, and Changes in Net Position

Depreciation and amortization expense increased \$11.2 million during fiscal year 2016 due to the additions to capital assets.

Both transfers in and out of the System Fund increased during fiscal year 2016, compared to fiscal year 2015. This was largely due to the inclusion of additional shared services across UNC Health Care, the continued implementation of the electronic medical record system, and mission support assessments. Transfers in to the System Fund exceeded transfers out by \$40.8 million. However, overall net position only increased by \$26.2 million due to a net loss realized from operating and nonoperating activities.

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

UNC Health Care derives the vast majority of its operating revenues from patient care services. Strong operating performance has enabled UNC Health Care to make investments in support of the clinical, education, and research programs of UNC Faculty Physicians, the UNC School of Medicine, and other network entities. These continued investments have yielded positive results as measured by growth in needed services, expansion of the medical school class, and increased research funding.

UNC Health Care strives to remain a leader by evolving to meet the demands of an ever changing environment. Pressure on healthcare providers comes in a variety of forms including expectations to provide greater value at a lower cost, to have fully interoperable electronic health records, to care for the uninsured, to integrate care for individual patients, and to improve wellness across populations. We are addressing these demands in a number of ways including expansion of access points as well as looking at streamlining operations to maximize efficiencies.

UNC Health Care is committed to connecting with patients where they are and is investing in several new access points and services including the construction of the North Carolina Heart and Vascular Hospital on the Rex campus which opened March 2017. Other major investments in the communities we serve include developing a replacement perioperative tower on the Chapel Hill campus, increasing UNC Health Care's presence in Holly Springs, and developing a state of the art cancer center on the Rex campus. There are also several

smaller initiatives to increase services such as expansion of behavioral health, imaging, pharmacy, among other services.

UNC Health Care is completing a review of all operations through a program known as Carolina Value. This program was developed and executed to enable UNC Health Care to be more integrated operationally and clinically. The ongoing 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 UNC Health Care.

UNC Health Care has implemented an integrated medical record across the system at all of the owned network entities. UNC Health Care long operated with electronic medical records. However, the systems used at the various locations were often unique and did not interface well with one another. Any form of data transfer between them was limited and cumbersome. Therefore, we established a vision for one patient to have one record everywhere within the system.

Third party payors, including government sponsored programs, continue to migrate from fee-for-service to fee-for-value. Traditional fee-for-service payment mechanisms have paid providers for each intervention. As a result, providers have been paid more for providing more care, not necessarily for providing better care. For the most part, providers have been insulated from the total cost of care they provide. In order to be successful in a fee-for-value environment, UNC Health Care is developing and implementing changes in our care delivery model that reduce reliance on continued growth in interventions and encourage providers to focus on the overall health of the populations we serve. Payment in a fee-for-value environment rewards improvement in the quality of care we provide and the reduction of total cost of care for a population. The risk, accountability, and reward for providing the right care, at the right time, in the right setting shifts to UNC Health Care. UNC Health Care is positioning itself to be a leader in the new healthcare environment that will ultimately reimburse less for services currently provided to our patients. Through this leadership, UNC Health Care endeavors to attract larger populations to our enterprise.

We are engaging with new partners as the provider community consolidates. Of the more than 100 hospitals in North Carolina, today fewer than 25 remain unaffiliated with larger systems. Nationally and in North Carolina, the increasing demands on providers, both physician groups and hospitals, has caused many to seek partners in larger systems. Several of these – High Point Regional Health System, Caldwell Memorial Hospital, and Johnston Health Services Corporation have joined UNC Health Care. With our help, these hospitals will be able to provide more of the care needed in local communities, they will be able to access our state-of-the-art information systems that are otherwise unaffordable, and they will become more efficient by leveraging UNC Health Care's scale.

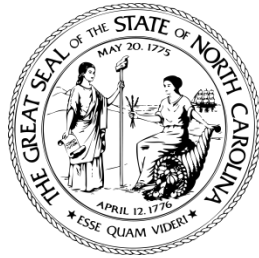
We are responding to the State's needs and the needs of underserved populations. UNC Health Care has proudly cared for underserved patients as a safety net provider. In recent years, the cost we incur for those unable to pay for their care has exceeded \$300 million.

Successfully managing in the future requires tighter integration of administrative functions across the entities of UNC Health Care, caring for patients in lower cost delivery settings, and comprising sufficient scale to spread the cost of major investments across a broad base. UNC Health Care continues to plan for these changes through a health system-wide planning and implementation process.

University of North Carolina Health Care System Funds
 Summary of Condensed Financial Statements Totals
 For the Fiscal Years Ended June 30, 2016 and 2015

Table 1

	FY16	FY15	Change	% Change
STATEMENTS OF NET POSITION				
Current Assets	\$ 203,091,634	\$ 180,609,271	\$ 22,482,363	12.4%
Capital Assets, Net	156,525,469	101,814,538	54,710,931	53.7%
Noncurrent Assets	<u>74,965,674</u>	<u>82,300,300</u>	<u>(7,334,626)</u>	(8.9%)
DEFERRED OUTFLOWS OF RESOURCES	<u>0</u>	<u>0</u>	<u>0</u>	
TOTAL ASSETS	<u>434,582,777</u>	<u>364,724,109</u>	<u>69,858,668</u>	19.2%
Current Liabilities	212,379,855	185,817,802	26,562,053	14.3%
Long-Term Liabilities	95,124,558	63,161,523	31,963,035	50.6%
Other Noncurrent Liabilities	<u>10,767,081</u>	<u>25,596,299</u>	<u>(14,829,218)</u>	(57.9%)
TOTAL LIABILITIES	<u>318,271,494</u>	<u>274,575,624</u>	<u>43,695,870</u>	15.9%
DEFERRED INFLOWS OF RESOURCES	<u>0</u>	<u>0</u>	<u>0</u>	
Net Investment in Capital Assets	(19,752,980)	(2,153,564)	(17,599,416)	(817.2%)
Unrestricted	<u>136,064,263</u>	<u>92,302,049</u>	<u>43,762,214</u>	47.4%
TOTAL NET POSITION	<u>\$ 116,311,283</u>	<u>\$ 90,148,485</u>	<u>\$ 26,162,798</u>	29.0%
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION				
Operating Revenues:				
User Fees	\$ 8,719,208	\$ 8,719,208	\$ 0	0.0%
Operating Expenses:				
Depreciation and Amortization	23,098,932	11,850,117	11,248,815	94.9%
Operating Loss	<u>(14,379,724)</u>	<u>(3,130,909)</u>	<u>11,248,815</u>	359.3%
Nonoperating Revenues (Expenses):				
Interest Income	576,895	262,740	314,155	119.6%
Interest and Fees on Debt	(1,833,882)	(877,993)	955,889	108.9%
Gain on Investment in Affiliates	<u>1,013,328</u>	<u>1,675,643</u>	<u>(662,315)</u>	(39.5%)
Net Nonoperating Revenues (Expenses)	<u>(243,659)</u>	<u>1,060,390</u>	<u>(1,304,049)</u>	(123.0%)
Transfers In	619,160,966	500,255,856	118,905,110	23.8%
Transfers Out	<u>578,374,785</u>	<u>461,533,918</u>	<u>116,840,867</u>	25.3%
Increase in Net Position	26,162,798	36,651,419	12,009,009	32.8%
Net Position - Beginning of Year	<u>90,148,485</u>	<u>28,839,257</u>	<u>61,309,228</u>	212.6%
Restatement to Net Position		24,657,809		
Net Position - End of Year	<u>\$ 116,311,283</u>	<u>\$ 90,148,485</u>	<u>\$ 26,162,798</u>	29.0%
Total Revenues	\$ 629,470,397	\$ 510,913,447	\$ 118,556,950	23.2%
Total Expenses	603,307,599	474,262,028	129,045,571	27.2%



FINANCIAL STATEMENTS

University of North Carolina Health Care System Funds
Statement of Net Position
June 30, 2016 and 2015

Exhibit A-1

	<u>2016</u>	<u>2015</u>
ASSETS		
Current Assets:		
Cash and Cash Equivalents:		
Undesignated Funds (Note 2)	\$ 4,812,663	\$ 477,000
Designated for UNC School of Medicine Program Support (Note 2)	9,286,463	56,022,015
Designated for UNC School of Medicine Mission Support (Note 2)		10,000,000
Designated for UNC Physicians Network Program Support (Note 2)		8,228,525
Designated for Shared Administrative Services (Note 2)	28,284,747	4,782,454
Designated for UNC Faculty Recruitment (Note 2)	<u>5,750,000</u>	<u>5,750,000</u>
Cash and Cash Equivalents Total	48,133,873	85,259,994
Due from UNC Health Care Entities (Note 4)	133,032,138	77,205,987
Due from UNC School of Medicine	20,875,623	18,143,290
Line of Credit (Note 11)	<u>1,050,000</u>	
Total Current Assets	<u>203,091,634</u>	<u>180,609,271</u>
Noncurrent Assets:		
Assets Whose Use is Limited or Restricted (Note 6)	10,767,081	25,596,299
Investment in Affiliates (Note 12)	64,198,593	56,704,001
Capital Assets - Nondepreciable (Note 5)	4,142,311	4,778,630
Capital Assets - Depreciable, Net (Note 5)	<u>152,383,158</u>	<u>97,035,908</u>
Total Noncurrent Assets	<u>231,491,143</u>	<u>184,114,838</u>
Total Assets	<u>434,582,777</u>	<u>364,724,109</u>
DEFERRED OUTFLOWS OF RESOURCES		
	<u>0</u>	<u>0</u>
LIABILITIES		
Current Liabilities:		
Due to UNC Health Care Entities (Note 7)	161,613,755	91,663,333
Due to UNC School of Medicine	27,818,525	40,228,535
Notes Payable (Note 8)	19,215,158	7,044,408
Assessments Paid in Advance		46,881,526
Funds Held for Others	<u>3,732,417</u>	
Total Current Liabilities	<u>212,379,855</u>	<u>185,817,802</u>
Noncurrent Liabilities:		
Notes Payable (Note 8)	95,124,558	63,161,523
Funds Held in Escrow (Note 6)	<u>10,767,081</u>	<u>25,596,299</u>
Total Noncurrent Liabilities	<u>105,891,639</u>	<u>88,757,822</u>
Total Liabilities	<u>318,271,494</u>	<u>274,575,624</u>
DEFERRED INFLOWS OF RESOURCES		
	<u>0</u>	<u>0</u>
NET POSITION		
Net Investment in Capital Assets	(19,752,980)	(2,153,564)
Unrestricted	<u>136,064,263</u>	<u>92,302,049</u>
Total Net Position	<u>\$ 116,311,283</u>	<u>\$ 90,148,485</u>

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

University of North Carolina Health Care System Funds
Statement of Revenues, Expenses, and
Changes in Net Position
For the Fiscal Years Ended June 30, 2016 and 2015

Exhibit A-2

	<u>2016</u>	<u>2015</u>
REVENUES		
Operating Revenues:		
User Fees	\$ 8,719,208	\$ 8,719,208
EXPENSES		
Operating Expenses:		
Depreciation and Amortization	23,098,932	11,850,117
Operating Loss	(14,379,724)	(3,130,909)
NONOPERATING REVENUES (EXPENSES)		
Interest Income	576,895	262,740
Interest and Fees on Debt	(1,833,882)	(877,993)
Gain on Investment in Affiliates	1,013,328	1,675,643
Net Nonoperating Revenues (Expenses)	(243,659)	1,060,390
TRANSFERS IN		
Regular Assessments (Note 9)	74,298,004	52,240,353
Special Assessments (Note 9)	66,004,591	94,846,732
Mission Support Assessments (Note 9)	24,724,029	24,421,305
Shared Administrative Services Assessments (Note 9)	454,134,342	328,747,466
Total Transfers In	619,160,966	500,255,856
TRANSFERS OUT		
Program Support (Note 10)	150,988,805	122,690,949
Shared Administrative Services (Note 10)	420,385,980	324,342,969
Mission Support (Note 10)	7,000,000	14,500,000
Total Transfers Out	578,374,785	461,533,918
Increase in Net Position	26,162,798	36,651,419
NET POSITION		
Net Position - Beginning of Year, as Restated (Note 14)	90,148,485	53,497,066
Net Position - End of Year	<u>\$ 116,311,283</u>	<u>\$ 90,148,485</u>

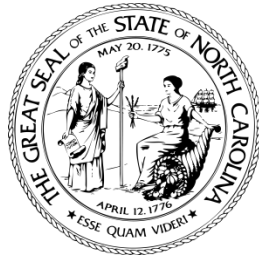
The accompanying notes to the financial statements are an integral part of this statement.

University of North Carolina Health Care System Funds
Statement of Cash Flows
For the Fiscal Years Ended June 30, 2016 and 2015

Exhibit A-3

	<u>2016</u>	<u>2015</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
User Fees Received	\$ 8,492,509	\$ 8,303,591
Cash Provided by Operating Activities	<u>8,492,509</u>	<u>8,303,591</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Transfers In from Entities	555,441,891	444,535,154
Transfers Out to Entities	(605,693,184)	(417,162,853)
Upper Payment Limit Pass-through Payments Received	76,953,288	35,524,957
Upper Payment Limit Pass-through Payments	(85,305,473)	(26,412,693)
Certified Public Expenditures Funds Received	14,892,957	10,732,004
Certified Public Expenditures Funds to Escrow or Entities	<u>(14,844,132)</u>	<u>(10,732,004)</u>
Net Cash Provided (Used) by Noncapital Financing Activities	<u>(58,554,653)</u>	<u>36,484,565</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from Capital Debt	40,574,466	25,946,060
Principal Paid on Notes Payable		(6,870,659)
Interest Paid on Notes Payable	(817,870)	(1,694,848)
Acquisition and Construction of Capital Assets	<u>(26,890,854)</u>	<u>(23,792,264)</u>
Net Cash Provided (Used) by Capital and Related Financing Activities	<u>12,865,741</u>	<u>(6,411,711)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest Income	596,085	274,626
Assessments for Investment in Affiliates	1,992,000	27,400,000
Investment in Affiliates	<u>(2,517,803)</u>	<u>(27,400,000)</u>
Net Cash Provided by Investing Activities	<u>70,282</u>	<u>274,626</u>
Net Increase (Decrease) in Cash and Cash Equivalents	(37,126,121)	38,651,071
Cash and Cash Equivalents - July 1, 2015 and 2014	<u>85,259,994</u>	<u>46,608,923</u>
Cash and Cash Equivalents - June 30, 2016 and 2015	<u>\$ 48,133,873</u>	<u>\$ 85,259,994</u>
RECONCILIATION OF NET OPERATING LOSS TO CASH PROVIDED BY OPERATING ACTIVITIES		
Operating Loss	\$ (14,379,724)	\$ (3,130,909)
Adjustments to Reconcile Operating Loss to Cash Provided by Operating Activities:		
Depreciation/ Amortization Expense	23,098,932	11,850,117
Changes in Assets:		
Due from UNC Health Care Entities	<u>(226,699)</u>	<u>(415,617)</u>
Cash Provided by Operating Activities	<u>\$ 8,492,509</u>	<u>\$ 8,303,591</u>
RECONCILIATION OF CASH AND CASH EQUIVALENTS		
Current Assets:		
Cash and Cash Equivalents	<u>\$ 48,133,873</u>	<u>\$ 85,259,994</u>
Total Cash and Cash Equivalents - June 30, 2016 and 2015	<u>\$ 48,133,873</u>	<u>\$ 85,259,994</u>
NONCASH CAPITAL AND FINANCING ACTIVITIES		
Assets Acquired through Assumption of a Liability	\$ 131,997,154	\$ 34,177,787
Increase in Receivables Related to Capital Debt Proceeds	3,559,319	

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

UNC Health Care is governed by a Board of Directors (Board) as an affiliated enterprise of the University of North Carolina (UNC) System. UNC Health Care and UNC-CH are affiliated entities within the University of North Carolina System. The University of North Carolina Faculty Physicians (UNCFP) is the clinical service component of the UNC School of Medicine and provides a full range of care to patients of UNC Health Care. UNC Hospitals at Chapel Hill, Rex Healthcare, Inc. (Rex), Chatham Hospital, Inc. (Chatham), High Point Regional Health Inc., Caldwell Memorial Hospital, UNC Physicians Network, LLC (UNCPN), and UNC Physicians Network Group Practices, LLC are owned and controlled entities within UNC Health Care, an integrated health care provider. UNC Health Care signed management service agreements with Henderson County Hospital Corporation d/b/a Margaret R. Pardee Memorial Hospital, Nash Health Care Systems, and Johnston Health Services Corporation which are considered managed entities within UNC Health Care.

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

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

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

The Enterprise Fund – The Enterprise Fund provides support for the teaching, research, and clinical missions of UNC Health Care and the UNC School of Medicine. It is funded by assessments against revenues of UNC Health Care entities and UNC School of Medicine, made at least annually. Assessments to the constituent entities are determined on an annual basis or more often as necessary. UNC Hospitals, UNCFP, and

Rex make additional mission support contributions to the Enterprise Fund if they have met required organizational goals.

The Recruitment Fund – The Recruitment Fund was established through a special assessment at the end of fiscal year 2010 in the amount of \$7,000,000, to enable critical faculty recruitments to the UNC School of Medicine. The Recruitment Fund is designed to provide salary support for recruitments deemed critical to the missions of the UNC School of Medicine. It was formed by contributions from UNC Hospitals, UNCFP, and several UNC School of Medicine clinical departments in response to a crisis in UNC Health Care’s cardiac surgery program. These funds are set aside to enable UNC Hospitals, UNCFP, and the UNC School of Medicine to collaboratively recruit faculty physicians to better serve the people of North Carolina.

The Patient Safety Fund – The Patient Safety Fund (Performance Improvement and Patient Safety Innovations Fund or PIPSIF) enables UNC Health Care to designate resources specifically intended to improve patient care and further reduce potential harm to patients.

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

- B. Financial Reporting Entity** - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America (GAAP), the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements. The System Fund is a part of UNC Health Care, an affiliated enterprise of the multi-campus University of North Carolina System. The University of North Carolina System is a component unit of the State of North Carolina and an integral part of the State’s *Comprehensive Annual Financial Report*.

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

- C. Basis of Presentation** - The accompanying financial statements are presented in accordance with GAAP as prescribed by the Governmental Accounting Standards Board (GASB).

Pursuant to the provisions of GASB Statement No. 34 - *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended by GASB Statement No. 35 - *Basic Financial Statements - and Management's Discussion and Analysis - for Public Colleges and Universities*, UNC Health Care is considered to be a single business type activity that qualifies for reporting in a single column. Since the System Fund is a part of UNC Health Care, it is also presented in a single column.

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

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

- E. **Cash and Cash Equivalents** - This classification includes deposits held by the State Treasurer in the Short-Term Investment Fund (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. Additional information regarding the fair value measurement of investments is disclosed in Note 3.

- F. **Capital Assets** - Capital assets are stated at cost at date of acquisition or acquisition value at date of donation in the case of gifts. Donated capital assets acquired prior to July 1, 2015 are stated at fair value as of the date of donation. The value of assets constructed includes all material direct and indirect construction costs. Interest costs incurred are capitalized during the period of construction.

The System Fund capitalizes assets that have a value or cost of \$5,000 or greater at the date of acquisition and an estimated useful life of more than one year except for internally generated software which is capitalized when the value or cost is \$1,000,000 or greater.

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
Computer Software	3-10 years

G. Net Position - The System Fund's net position is classified as follows:

Net Investment in Capital Assets - This represents the System Fund's 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.

Unrestricted Net Position - Unrestricted net position includes resources derived from assessments, mission support, shared administrative services, and investment income.

H. Revenue and Expense Recognition - Operating revenues and expenses generally result from providing services in connection with the System Fund's principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as the user fees charged to UNC Health Care entities for using assets held by the System Fund. 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, such as investment income, include activities that have the characteristics of nonexchange transactions. Transfers in and out are presented separately after nonoperating revenues.

I. Transfers In and Transfers Out - The System Fund supports UNC Health Care and UNC School of Medicine clinical, research, and teaching initiatives based on recommendations by the management team, ultimately approved by the Chief Executive Officer. The transfers in and transfers out reported for the System Fund supporting these initiatives result from the following:

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

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

Mission Support Assessments and Transfers Out – UNC Hospitals and UNCFP are entities of UNC Health Care with highly interdependent activities. Mission Support aligns incentives by creating shared organizational goals. The level of support increases with better performance on quality, research, education, patient satisfaction, employee satisfaction, and financial metrics. This approach impels

employees across the enterprise to improve in the research, education, and clinical missions.

UNC Hospitals, UNCFP, and Rex make additional payments to the System Fund if a specific set of predetermined organizational goals is achieved. Mission Support was first established in fiscal year 2009 and has been paid in each subsequent year. UNC Hospitals and Rex made mission support payments to the System Fund during fiscal year 2016 and UNC Hospitals also made payments during fiscal year 2015. The goal is for all of the other UNC Health Care entities to contribute in the future.

Program Support – The primary function of the System Fund is to support those programs that have been identified as being beneficial to achieving UNC Health Care’s patient care, research, and education mission but that cannot support themselves or otherwise need additional funding to achieve the desired outcome. Program Support payments fill the funding gap for these programs.

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

NOTE 2 - DEPOSITS AND INVESTMENTS

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

Pursuant to *General Statute* 116-37(e), all receipts, except for General Fund appropriations, may be invested by the State Treasurer on behalf of UNC Health Care as allowed in G.S. 147-69.2(b3).

At June 30, 2016 and 2015, the amounts shown on the Statement of Net Position as cash and cash equivalents of \$48,133,873 and \$85,259,994,

respectively, represent the System Fund's equity position in the State Treasurer's Short-Term Investment Fund (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 and 2015. 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 on the North Carolina Office of the State Controller's website at <http://www.osc.nc.gov> or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

A reconciliation of deposits and corresponding designations as of June 30, 2016 and 2015 are as follows:

Deposit Designation	Enterprise Fund	Recruitment Fund	Patient Safety Fund	Shared Administrative Services Fund	2016 Total
Undesignated Funds	\$ 3,734,895	\$ 0	\$ 1,077,768	\$ 0	\$ 4,812,663
Designated for UNC-SOM Program Support	3,510,915			5,775,548	9,286,463
Designated for Shared Administrative Services				28,284,747	28,284,747
Designated for UNC Faculty Recruitment		5,750,000			5,750,000
Total Deposits	\$ 7,245,810	\$ 5,750,000	\$ 1,077,768	\$ 34,060,295	\$ 48,133,873

Deposit Designation	Enterprise Fund	Recruitment Fund	Patient Safety Fund	Shared Administrative Services Fund	2015 Total
Undesignated Funds	\$ 0	\$ 0	\$ 477,000	\$ 0	\$ 477,000
Designated for UNC-SOM Program Support	46,533,454			9,488,561	56,022,015
Designated for UNC-SOM Mission Support	10,000,000				10,000,000
Designated for UNCPN Program Support				8,228,525	8,228,525
Designated for Shared Administrative Services				4,782,454	4,782,454
Designated for UNC Faculty Recruitment		5,750,000			5,750,000
Total Deposits	\$ 56,533,454	\$ 5,750,000	\$ 477,000	\$ 22,499,540	\$ 85,259,994

NOTE 3 - FAIR VALUE MEASUREMENTS

To the extent available, the System Fund's investments are recorded at fair value as of June 30, 2016 and 2015. 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 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 either directly or indirectly.
- Level 3 Investments classified as Level 3 have unobservable inputs for an asset and may require a degree of professional judgment.

Short-Term Investment Fund – As of June 30, 2016 and 2015, all of the System Fund's investments valued at \$48,133,873 and \$85,259,994, respectively, were held in the STIF which is a Level 2 investment. 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.

NOTE 4 - DUE FROM UNC HEALTH CARE ENTITIES

Amounts due from UNC Health Care entities at June 30, 2016 and 2015 by type and entity were as follows:

	<u>2016</u>	<u>2015</u>
Assessments		
Owned Entities	\$ 5,231,260	\$ 1,651,795
Mission Support		
Owned Entities	<u>24,724,029</u>	<u>24,421,305</u>
Shared Administrative Services		
Owned Entities	92,104,526	51,132,887
Managed Entities	<u>10,972,323</u>	
Subtotal	<u>103,076,849</u>	<u>51,132,887</u>
Total Due from UNC Health Care Entities	<u>\$ 133,032,138</u>	<u>\$ 77,205,987</u>

Additional information regarding transactions with the entities is included in Note 11.

NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the years ended June 30, 2016 and 2015 is presented as follows:

	Balance July 1, 2015	Increases	Decreases	Balance June 30, 2016
Capital Assets, Nondepreciable:				
Computer Software in Development	\$ 4,778,630	\$ 4,142,311	\$ 4,778,630	\$ 4,142,311
Total Capital Assets, Nondepreciable	4,778,630	4,142,311	4,778,630	4,142,311
Capital Assets, Depreciable:				
Buildings	5,965,598	169,640		6,135,238
Computer Software	94,695,898	41,277,595		135,973,493
Machinery and Equipment	10,022,203	36,845,119		46,867,322
Total Capital Assets, Depreciable	110,683,699	78,292,354		188,976,053
Less Accumulated Depreciation/Amortization for:				
Buildings	400,413	405,557		805,970
Computer Software	10,802,814	15,707,547		26,510,361
Machinery and Equipment	2,444,564	6,832,000		9,276,564
Total Accumulated Depreciation/ Amortization	13,647,791	22,945,104		36,592,895
Total Capital Assets, Depreciable, Net	97,035,908	55,347,250		152,383,158
Capital Assets, Net	\$ 101,814,538	\$ 59,489,561	\$ 4,778,630	\$ 156,525,469
	Balance July 1, 2014	Increases	Decreases	Balance June 30, 2015
Capital Assets, Nondepreciable:				
Computer Software in Development	\$ 0	\$ 4,778,630	\$ 0	\$ 4,778,630
Construction in Progress	5,355,079		5,355,079	0
Total Capital Assets, Nondepreciable	5,355,079	4,778,630	5,355,079	4,778,630
Capital Assets, Depreciable:				
Buildings		5,965,598		5,965,598
Computer Software	79,492,051	15,203,847		94,695,898
Machinery and Equipment	6,528,570	3,493,633		10,022,203
Total Capital Assets, Depreciable	86,020,621	24,663,078		110,683,699
Less Accumulated Depreciation/Amortization for:				
Buildings		400,413		400,413
Computer Software	1,492,900	9,309,914		10,802,814
Machinery and Equipment	304,774	2,139,790		2,444,564
Total Accumulated Depreciation/ Amortization	1,797,674	11,850,117		13,647,791
Total Capital Assets, Depreciable, Net	84,222,947	12,812,961		97,035,908
Capital Assets, Net	\$ 89,578,026	\$ 17,591,591	\$ 5,355,079	\$ 101,814,538

NOTE 6 - ESCROW FOR CERTIFIED PUBLIC EXPENDITURES

With the help of the North Carolina Hospital Association, UNC Health Care entered into an agreement to receive the benefit of additional Certified Public Expenditures (CPEs) (as defined by Federal Regulation 45 CFR 95.13 and 42 CFR 43351) from public hospitals (as defined in the North Carolina State Plan for Medicaid payments) which decided to assist UNC Health Care in meeting its obligations to fund the remaining Disproportionate Share Hospital (DSH) allotment. DSH payments are special payments for hospitals which serve a disproportionate share of low income patients. By making additional CPE's available, the public hospitals risk possible DSH overpayments that would require repayment to state or federal agencies. In order to mitigate the public hospitals' risk, UNC Health Care established a reserve fund to be held in escrow. The fund will reimburse participating public hospitals for any repayments that should result from this program. At June 30, 2016 and 2015, \$10,767,081 and \$25,596,299, respectively, were held by the Escrow Agent, First Citizens Bank & Trust Company. During fiscal year 2016, prior year CPE escrow funds of \$14,844,132 were returned to the appropriate UNC Health Care entities based upon the original funding sources.

NOTE 7 - DUE TO UNC HEALTH CARE ENTITIES

Amounts due to UNC Health Care entities at June 30, 2016 and 2015 by type and entity were as follows:

	<u>2016</u>	<u>2015</u>
Shared Administrative Services		
Owned Entities	\$ 161,613,755	\$ 91,663,333
Total Due To UNC Health Care Entities	<u>\$ 161,613,755</u>	<u>\$ 91,663,333</u>

Additional information regarding transactions with the entities is included in Note 11.

NOTE 8 - NOTES PAYABLE

The System Fund originally borrowed \$77,076,590 from UNC Hospitals, Rex, and UNC School of Medicine to fund the purchase and implementation of UNC Health Care's electronic medical record system (EMR) in Phase I. The principal amount is to be repaid in 120 monthly installments at a simple interest rate equal to 2.5%. In 2016, an additional \$44,133,785 was borrowed from UNC Hospitals, Rex, UNC School of Medicine, UNC Physicians Network, Chatham, Caldwell, Johnston, and Pardee in Phase II. The principal amount is to be repaid in 96 monthly installments at a simple interest rate equal to 2.5%. The holders acknowledge that the System Fund's ability to repay the note is dependent upon EMR user fees charged to the UNC Health Care constituent

entities. In the event such user fees fail to support the note's repayment, the parties agree to negotiate, in good faith, a restructuring of the note.

Notes payable activity for the years ended June 30, 2016 and 2015 is presented as follows:

Entity	Balance July 1, 2015	Additions	Reductions	Balance June 30, 2016	Current Portion
Owned Entities	\$ 58,796,251	\$ 29,286,239	\$ 0	\$ 88,082,490	\$ 15,297,226
Managed Entities		11,447,314		11,447,314	1,309,006
UNC School of Medicine	11,409,680	3,400,232		14,809,912	2,608,926
Total Notes Payable	\$ 70,205,931	\$ 44,133,785	\$ 0	\$ 114,339,716	\$ 19,215,158

Entity	Balance July 1, 2014	Additions	Reductions	Balance June 30, 2015	Current Portion
Owned Entities	\$ 64,550,309	\$ 0	\$ 5,754,058	\$ 58,796,251	\$ 5,899,570
UNC School of Medicine	12,526,281		1,116,601	11,409,680	1,144,838
Total Notes Payable	\$ 77,076,590	\$ 0	\$ 6,870,659	\$ 70,205,931	\$ 7,044,408

NOTE 9 - TRANSFERS IN

Transfers in by source and entity at June 30, 2016 and 2015 are as follows:

	2016	2015
Regular Assessments:		
Owned Entities	\$ 55,269,270	\$ 36,915,816
UNC School of Medicine	19,028,734	15,324,537
Total Regular Assessments	74,298,004	52,240,353
Special Assessments:		
Owned Entities	57,756,776	88,877,259
Managed Entities	3,236,706	550,000
UNC School of Medicine	5,011,109	5,419,473
Total Special Assessments	66,004,591	94,846,732
Mission Support:		
Owned Entities	24,724,029	24,421,305
Shared Administrative Services:		
Owned Entities	373,391,972	273,947,659
Managed Entities	19,716,169	
UNC School of Medicine	61,026,201	54,799,807
Total Shared Administrative Services	454,134,342	328,747,466
Total Transfers In	\$ 619,160,966	\$ 500,255,856

Additional information regarding transactions with the entities is included in Note 11.

NOTE 10 - TRANSFERS OUT

Transfers out by purpose and entity at June 30, 2016 and 2015 are as follows:

	<u>2016</u>	<u>2015</u>
Program Support		
Owned Entities	\$ 50,408,772	\$ 44,434,387
UNC School of Medicine	<u>100,580,033</u>	<u>78,256,562</u>
Total Program Support	<u>150,988,805</u>	<u>122,690,949</u>
Shared Administrative Services:		
Owned Entities	382,856,558	290,595,345
Managed Entities	1,062,500	800,000
UNC School of Medicine	<u>36,466,922</u>	<u>32,947,624</u>
Total Shared Administrative Services	<u>420,385,980</u>	<u>324,342,969</u>
Mission Support:		
Owned Entities	<u>7,000,000</u>	<u>14,500,000</u>
Total Transfers Out	<u>\$ 578,374,785</u>	<u>\$ 461,533,918</u>

Additional information regarding transactions with the entities is included in Note 11.

NOTE 11 - RELATED PARTIES

University of North Carolina Hospitals at Chapel Hill – The UNC Hospitals at Chapel Hill (UNC Hospitals) is the only state-owned teaching hospital in North Carolina. With a licensed base of 929 beds, this facility serves as an acute care teaching hospital for the University of North Carolina at Chapel Hill.

UNC Hospitals paid \$317,853,084 and \$269,749,779 for fiscal years 2016 and 2015, respectively, for assessments, mission support, and shared administrative services to the System Fund and extended a \$13,792,714 note receivable to the System Fund during fiscal year 2016. Likewise, the System Fund also made \$341,913,294 and \$249,173,069 for fiscal years 2016 and 2015, respectively, in payments to UNC Hospitals for program support and shared administrative service expenses. As of June 30, 2016 and 2015, UNC Hospitals had receivables of \$200,218,963 and \$122,004,191, respectively, and payables of \$48,292,096 and \$39,044,060, respectively.

University of North Carolina School of Medicine – The UNC School of Medicine was assessed and paid the System Fund \$1,942,892 and \$2,475,852 for fiscal years 2016 and 2015, respectively, and received \$21,964,642 and \$18,857,512 for fiscal years 2016 and 2015, respectively, in program support. As of June 30, 2016 and 2015, UNC School of Medicine had receivables of \$15,966,050 and \$11,708,711, respectively, and payables of \$3,049,112 and \$2,066,202, respectively.

University of North Carolina Faculty Physicians – The UNC Faculty Physicians (UNCFP) is the clinical service component of the UNC School of Medicine. At the heart of UNCFP are the approximately 1,228 physicians who provide a full range of specialty and primary care services for patients of UNC Health Care. While the great majority of services are rendered at the inpatient units of UNC Hospitals and the outpatient clinics on the UNC campus, there is a growing range of services provided at clinics in the community. There are 19 clinical departments, two affiliated departments, and two administrative units that collectively form UNCFP.

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

UNCFP paid \$83,123,152 and \$73,067,965 for fiscal years 2016 and 2015, respectively, for assessments and shared administrative services to the System Fund and extended a \$3,400,232 note receivable to the System Fund during fiscal year 2016. The System Fund also made payments to UNCFP in the amount of \$122,082,313 and \$106,846,674 for fiscal years 2016 and 2015, respectively, for program support, mission support, and shared administrative services. As of June 30, 2016 and 2015, UNCFP had receivables of \$26,662,387 and \$39,929,504, respectively, and payables of \$17,826,511 and \$16,077,088, respectively.

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

UNC Health Care is the sole member of the corporation and appoints eight of the 13 seats on Rex's Board of Trustees and also reviews and approves Rex's annual operating and capital budgets.

Rex paid \$129,079,632 and \$115,775,361 for fiscal years 2016 and 2015, respectively, for assessments, mission support, and shared administrative services to the System Fund and extended a \$6,908,018 note receivable to the System Fund during fiscal year 2016. The System Fund also made payments to Rex in the amount of \$31,675,032 and \$36,395,789 for fiscal years 2016 and 2015, respectively, for shared administrative service expenses during the year ended June 30, 2016. As of June 30, 2016 and 2015, Rex had receivables of \$34,828,158 and \$27,996,044, respectively, and payables of \$15,965,543 and \$16,975,023, respectively.

Chatham Hospital, Inc. – Chatham Hospital, Inc. (Chatham) is a private, nonprofit corporation that owns and operates a critical access facility located in Siler City, North Carolina. UNC Health Care is the sole member of Chatham, appoints nine of the 15 members on the Chatham Board, and reviews and approves its annual operating and capital budgets.

Chatham paid \$7,334,056 and \$3,689,965 for fiscal years 2016 and 2015, respectively, for assessments and shared administrative services to the System Fund and extended a \$279,690 note receivable to the System Fund during fiscal year 2016. The System Fund also made payments to Chatham in the amount of \$4,641,428 and \$1,131,527 for fiscal years 2016 and 2015, respectively, for program support and shared administrative service expenses. As of June 30, 2016 and 2015, Chatham had receivables of \$693,580 and \$41,873, respectively, and payables of \$337,455 and \$184,197, respectively.

UNC Physicians Network, LLC and UNC Physicians Network Group Practices, LLC – UNC Physicians Network, LLC (UNCPN) and UNC Physicians Network Group Practices, LLC are wholly-owned subsidiaries of UNC Health Care, but are private employers that own and operate more than 60 community-based practices throughout the Triangle region of North Carolina (Raleigh, Durham, and Chapel Hill).

These are physician-led networks structured to meet the needs of the community and community practice physicians by creating a partnership for physicians and UNC Health Care to face the challenging health care environment.

UNCPN paid \$13,328,390 and \$10,373,397 for fiscal years 2016 and 2015, respectively, for assessments and shared administrative services to the System Fund and extended a \$828,682 note receivable to the System Fund during fiscal year 2016. The System Fund also made payments to UNCPN in the amount of \$29,431,843 and \$18,040,440 for fiscal years 2016 and 2015, respectively, for program support and shared administrative service expenses. As of June 30, 2016 and 2015, UNCPN had receivables of \$828,682 and \$417,476, respectively, and payables of \$3,916,098 and \$2,933,228, respectively.

Effective August 1, 2015, the Boylan Clinic entered into a line of credit agreement for up to \$475,000 with the System Fund for use in operations as necessary. Outstanding draws on this line of credit bear simple interest at a fixed rate of the prime rate as of August 1, 2015 plus 0.75% (4.25%). All unpaid amounts including accrued interest are due on August 1, 2017. This line of credit had a balance of approximately \$300,000 as of June 30, 2016.

Effective November 30, 2015, the Boylan Clinic entered into a second line of credit agreement for up to \$200,000 with the System Fund for use in funding income tax payments related to tax liabilities on its earned income. Outstanding draws on this line of credit bear simple interest at a fixed rate of the prime rate as of November 30, 2015 plus 0.75% (4.25%). All unpaid amounts including accrued interest are due on November 30, 2018. There was no balance on this line of credit as of June 30, 2016.

Effective July 1, 2015, the Garner Family Practice Clinic entered into a line of credit agreement for up to \$750,000 with the System Fund for use in operations as necessary. Outstanding draws on this line of credit bear simple

interest at a fixed rate of the prime rate as of July 1, 2015 plus 0.75% (4.25%). All unpaid amounts including accrued interest were due on June 30, 2016; however there was an unpaid balance of \$150,000 as of June 30, 2016, which rolled into the new line of credit due at the beginning of fiscal year 2018.

Effective July 1, 2015, the Clinton Medical Clinic entered into a line of credit agreement for up to \$2,000,000 with the System Fund for use in operations as necessary. Outstanding draws on this line of credit bear simple interest at a fixed rate of the prime rate as of July 1, 2015 plus 0.75% (4.25%). All unpaid amounts including accrued interest were due on June 30, 2016; however there was an unpaid balance of \$600,000 as of June 30, 2016, which rolled into the new line of credit due at the beginning of fiscal year 2018.

The following table summarizes the activity in the lines of credit for the year ended June 30, 2016:

	Balance July 1, 2015	Borrowings	Payments	Balance June 30, 2016
Boylan Clinic	\$ 0	\$ 500,000	\$ 200,000	\$ 300,000
Garner Family Practice Clinic		500,000	350,000	150,000
Clinton Medical Clinic		1,000,000	400,000	600,000
	<u>\$ 0</u>	<u>\$ 2,000,000</u>	<u>\$ 950,000</u>	<u>\$ 1,050,000</u>

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

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

HPRH paid \$30,556,992 and \$17,341,236 for fiscal years 2016 and 2015, respectively, for assessments and shared administrative services to the System Fund and received \$14,268,158 and \$25,288,907 for fiscal years 2016 and 2015, respectively, for program support and shared administrative service expenses. As of June 30, 2016, HPRH had receivables of \$4,314,154. As of June 30, 2016 and 2015, HPRH had payables of \$41,163,630 and \$11,077,178, respectively.

Caldwell Memorial Hospital - Caldwell Memorial Hospital (Caldwell) is a private, not-for-profit community hospital in Lenoir, North Carolina and is an acute care hospital with a provider network of more than sixty primary and specialty care physicians and advanced practice professionals. UNC Health Care became the sole corporate member of Caldwell on May 1, 2013.

Caldwell paid \$12,989,893 and \$7,232,301 for fiscal years 2016 and 2015, respectively, for assessments and shared administrative services to the System Fund and extended a \$7,477,135 note receivable to the System Fund during fiscal year 2016. The System Fund also made payments to Caldwell in the amount of \$11,335,573 and \$5,000,000 for fiscal years 2016 and 2015, respectively, for program support and shared administrative service expenses. As of June 30, 2016, Caldwell had receivables of \$8,812,708. As of June 30, 2016 and 2015, Caldwell had payables of \$12,384,993 and \$6,992,301, respectively.

UNC Health Care Managed Entities - UNC Health Care signed management service agreements with Henderson County Hospital Corporation d/b/a Margaret R. Pardee Memorial Hospital, Nash Health Care Systems, and Johnston Health Services Corporation which are considered managed entities within UNC Health Care.

The managed entities paid \$22,952,875 and \$550,000 for fiscal years 2016 and 2015, respectively, for assessments and shared administrative services to the System Fund and extended a \$11,447,314 note receivable to the System Fund during fiscal year 2016. The System Fund also made payments to managed entities in the amount of \$1,062,500 and \$800,000 for fiscal year 2016 and 2015, respectively, for shared administrative service expenses. As of June 30, 2016, the managed entities had receivables of \$11,447,314 and payables of \$10,972,323.

WakeBrook Mental Health Campus – UNC Health Care agreed to provide, enhance and expand all services offered in the past at Wake County's WakeBrook facility. Pursuant to agreements with Wake County and Alliance Behavioral Health, UNC Health Care began with the operation of WakeBrook Crisis and Assessment services on February 1, 2013. WakeBrook is now fully operational, providing behavioral health and medical services in the areas of crisis and assessment, residential facility, detoxification beds, onsite medical care via the primary care clinic and Assertive Community Treatment Team.

The Enterprise Fund has committed to backstop the losses from WakeBrook operations.

NOTE 12 - INVESTMENT IN AFFILIATES

The System Fund has investments in affiliates and joint ventures accounted for on the equity method. Investments in affiliates were \$64,198,593 and \$56,704,001 at June 30, 2016 and 2015, respectively. See below for more information regarding the ongoing affiliates and joint ventures:

Effective February 1, 2014, Johnston Memorial Hospital Authority (JMHA) and UNC Health Care entered into a Master Agreement to form Johnston Health Services Corporation (JHSC), a joint venture created to achieve the long term vision of providing high quality health care to the residents of Johnston County, North Carolina. UNC Health Care has a 35.25 percent membership in

JHSC and has agreed to provide \$57,600,000 in contributions over the years. UNC Health Care transferred \$26,200,000 of the contribution for the year ended June 30, 2014. A second cash contribution of \$27,400,000 was made for the year ended June 30, 2015. Furthermore, a cash contribution of \$1,000,000 is due annually starting February 2016 and ending February 2019. As of June 30, 2016 and 2015, UNC Health Care's investments were \$58,672,790 and \$56,659,462, respectively.

UNC Health Care owns a small minority ownership interest (less than 5%) in Alignment Healthcare Partners, LP, a company that provides population health services to health systems and health plans with current operations in California, Florida, and North Carolina. UNC Health Care has no future financial obligation or commitment to Alignment Healthcare Partners, LP. Separate financial statements for Alignment Healthcare Partners, LP are not publicly available.

NOTE 13 - CHANGES IN FINANCIAL ACCOUNTING AND REPORTING

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

GASB Statement No. 72, Fair Value Measurement and Application

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

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. 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.

NOTE 14 - NET POSITION RESTATEMENT

As of July 1, 2014, net position as previously reported was restated as follows:

	Amount
July 1, 2014 Net Position as Previously Reported	\$ 28,839,257
Restatement:	
Correct Prior Period Error to Capitalize Investment in Affiliates	24,657,809
July 1, 2014 Net Position as Restated	\$ 53,497,066



INDEPENDENT AUDITOR'S REPORT

STATE OF NORTH CAROLINA
Office of the State Auditor



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

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

We have audited, 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 Health Care System Funds (System Fund) which is a part of the University of North Carolina Health Care System that is an affiliated enterprise of the multi-campus University of North Carolina System, a component unit of the State of North Carolina, as of and for the years ended June 30, 2016 and 2015, and the related notes to the financial statements, which collectively comprise the System Fund's basic financial statements, and have issued our report thereon dated July 6, 2017.

As discussed in Note 1, the financial statements of the University of North Carolina Health Care System Funds are intended to present the financial position, changes in financial position, and cash flows that are only attributable to the transactions of the University of North Carolina Health Care System Funds. They do not purport to, and do not, present fairly the financial position of the University of North Carolina Health Care System nor the University of North Carolina System as of June 30, 2016 and 2015, the changes in its financial position, or its cash flows, for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the System Fund's 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 System Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the System Fund's 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 System Fund's 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 System Fund's 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 System Fund's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the System Fund's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

July 6, 2017

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This audit required 705 audit hours at an approximate cost of \$72,615.