

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 YEAR ENDED JUNE 30, 2018

AN AFFILIATED ENTERPRISE OF THE UNIVERSITY OF NORTH CAROLINA
SYSTEM AND A COMPONENT UNIT OF THE STATE OF NORTH CAROLINA



NCOSA
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
<https://www.ncauditor.net>

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 year ended June 30, 2018, 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 black ink that reads "Beth A. Wood".

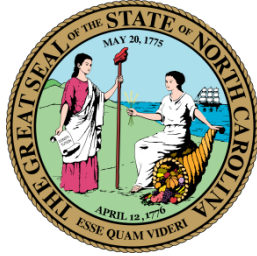
Beth A. Wood, CPA
State Auditor



Beth A. Wood, CPA
State Auditor

TABLE OF CONTENTS

	PAGE
INDEPENDENT AUDITOR’S REPORT	1
MANAGEMENT’S DISCUSSION AND ANALYSIS	4
BASIC FINANCIAL STATEMENTS	
EXHIBITS	
A-1 STATEMENT OF NET POSITION	9
A-2 STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION	10
A-3 STATEMENT OF CASH FLOWS	11
NOTES TO THE FINANCIAL STATEMENTS	12
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 <i>GOVERNMENT AUDITING STANDARDS</i>	29
ORDERING INFORMATION	31



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
<https://www.ncauditor.net>

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 year ended June 30, 2018, 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, 2018, 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 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, 2018, the changes in its financial position, or its cash flows, for the year 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.

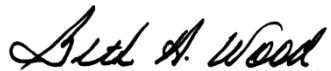
Other Matters – Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis, 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 10, 2019 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, reading "Beth A. Wood". The signature is written in a cursive style with a large, stylized "B" and "W".

Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

July 10, 2019



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 year ended June 30, 2018 and includes comparative information for the fiscal year ended June 30, 2017.

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 the 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 Rockingham Health Care (Rockingham), UNC Physicians Network, LLC (UNCPN), 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 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*, along with accompanying *Notes to the Financial Statements*.

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 investment transactions. Other activities include transfers in and transfers out from/to UNC Health Care entities and the UNC School of Medicine. 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 and investments, fair value measurements, investment in affiliates, the System Fund's escrow account for certified public expenditures, information on long-term liabilities, capital assets, receivables, payables, transfers in and out, related parties, and subsequent events. 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 2018 to 2017

Data for 2018 and 2017 is presented in Table 1 of this report and discussed in the following sections. Discussion in the following sections is pertinent to fiscal year 2018 results and changes relative to ending balances in fiscal year 2017.

Analysis of Overall Financial Position and Results of Operations

Statement of Net Position

The sub-accounts of the System Fund collectively hold assets of \$581.0 million, an increase of \$70.2 million, or 13.8%, over the prior year. Cash and cash equivalents decreased by \$42.7 million, of which a portion was related to a \$25.0 million purchase of investments and the payout of \$26.1 million in prior year mission support funds to UNC School of Medicine. Noncurrent assets increased by \$92.2 million primarily due to \$50.4 million additional funding in the Certified Public Expenditures Escrow (see Note 6) and the System Fund's additional investment of \$25.0 million with the UNC Management Company. See Note 2 and Note 3 for further details on investments. The System Fund continued to invest in its capital infrastructure by acquiring a wellness center and additional IT equipment as optimization of the Electronic Medical Record (EMR) system continues. In addition, the System Fund transferred \$14.3 million in computer software to High Point Regional Health, Inc. See Note 5 to the financial statements for further details on capital assets.

Total liabilities increased by \$30.4 million, or 8.3%. Other current liabilities decreased \$56.2 million, or 28.7%, due to the timing of shared services expense reimbursements as compared to prior year. Noncurrent long-term liabilities decreased by \$28.6 million, or 25.9%, over the prior year due in part to \$16.0 million in payments made on the outstanding notes payable along with the \$14.3 million write-off of HPRH's outstanding note payable (in exchange for an equivalent portion of computer software). See Note 8 to the financial statements for further details. These decreases were offset by an increase in other noncurrent liabilities of

\$116.9 million, or 262.0%, over the prior year due to increases in user fees paid in advance of \$66.5 million and the increase in funds held in escrow of \$50.4 million.

Net position increased \$39.8 million compared to fiscal year 2017. The net investment in capital assets was \$90.5 million as of June 30, 2018, which is an increase of \$42.9 million. The increase in net investment in capital assets is due to capital asset additions as well as the System Fund receiving assessments to pay off capital debt associated with the acquisition and construction of capital assets.

Statement of Revenues, Expenses, and Changes in Net Position

User fees revenue increased \$11.8 million during fiscal year 2018 in order to pay off the additional notes payable borrowed for the system-related capital purchases discussed above. Other operating revenues of \$4.2 million represent additional services provided to UNC Health Care entities. Depreciation and amortization expense increased \$5.0 million during fiscal year 2018 due to the additions to capital assets. Net investment income increased \$1.7 million, or 270.5%, over the prior year due to higher investment returns and the purchase of investments as mentioned above.

Both transfers in and out of the System Fund increased during fiscal year 2018, compared to fiscal year 2017. This was largely due to the continued inclusion of additional shared services across UNC Health Care, the continued implementation of the electronic medical record system, and mission support assessments.

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.

We continue to respond 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. 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.

UNC Health Care is committed to connecting with patients where they are and is investing in several new access points and services. Rex opened a new area in its Emergency Department

for behavioral health patients and construction continues at our Holly Spring campus. Other major investments in the communities we serve include developing a replacement perioperative tower on the Chapel Hill campus, additional inpatient beds on the Hillsborough campus, and developing a state of the art cancer center on the Rex campus. A virtual care service called UNC Urgent Care 24/7 was introduced to provide physician access by phone, tablet, or computer. UNC Health Care has implemented an integrated medical record system across the system at all of the owned network entities and is extending the EMR to managed entities as well.

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 20 remain unaffiliated with larger systems. Nationally and in North Carolina, the increasing demands on providers, both physician groups and hospitals, have caused many to seek partners in larger systems. Several of these, such as Caldwell Memorial Hospital and Johnston Health Services Corporation, have joined UNC Health Care. During the fiscal year ended June 30, 2018, UNC Health Care acquired Morehead Memorial Hospital, now UNC Rockingham Health Care.

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 of a Medicare Advantage Health Maintenance Organization (HMO) product for seniors in Wake County, North Carolina in the fall of 2014. The Hospitals also participates in the UNC Health Alliance, a Clinically Integrated Network. The Health Alliance started participating in Centers for Medicare and Medicaid Services' Next Generation Accountable Care Organization (ACO) in January 2017. The Next Generation ACO Model is a value-based payment model that encourages providers to assume greater accountability in coordinating the health care of Medicare fee-for-service beneficiaries. Learning from these programs will allow UNC Health Care to more rapidly scale and ramp-up our initiatives when appropriate.

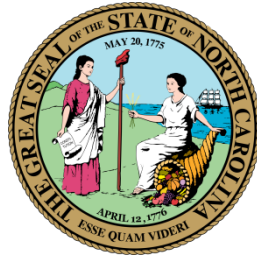
Further information about UNC Health Care can be found in our annual report available at <https://www.unchealthcare.org/about-us/annual-reports/>.

University of North Carolina Health Care System Funds
Summary of Condensed Financial Statements Totals

Table 1

	<u>FY18</u>	<u>FY17</u>	<u>Change</u>	<u>% Change</u>
CONDENSED STATEMENTS OF NET POSITION				
Current Assets	\$ 196,317,607	\$ 227,262,237	\$ (30,944,630)	(13.6%)
Capital Assets, Net	187,375,295	178,440,785	8,934,510	5.0%
Noncurrent Assets	<u>197,302,042</u>	<u>105,058,537</u>	<u>92,243,505</u>	87.8%
TOTAL ASSETS	<u>580,994,944</u>	<u>510,761,559</u>	<u>70,233,385</u>	13.8%
DEFERRED OUTFLOWS OF RESOURCES				
	<u>0</u>	<u>0</u>	<u>0</u>	
Current:				
Long-Term Liabilities - Current Portion	15,189,077	16,866,331	(1,677,254)	(9.9%)
Other Current Liabilities	139,341,088	195,530,741	(56,189,653)	(28.7%)
Noncurrent:				
Long-Term Liabilities	81,905,001	110,542,189	(28,637,188)	(25.9%)
Other Noncurrent Liabilities	<u>161,531,836</u>	<u>44,621,571</u>	<u>116,910,265</u>	262.0%
TOTAL LIABILITIES	<u>397,967,002</u>	<u>367,560,832</u>	<u>30,406,170</u>	8.3%
DEFERRED INFLOWS OF RESOURCES				
	<u>0</u>	<u>0</u>	<u>0</u>	
Net Investment in Capital Assets	90,526,215	47,582,207	42,944,008	90.3%
Unrestricted	<u>92,501,727</u>	<u>95,618,520</u>	<u>(3,116,793)</u>	(3.3%)
TOTAL NET POSITION	<u>\$ 183,027,942</u>	<u>\$ 143,200,727</u>	<u>\$ 39,827,215</u>	27.8%
CONDENSED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION				
Operating Revenues:				
User Fees	\$ 36,344,526	\$ 24,569,465	\$ 11,775,061	47.9%
Other Operating Revenue	<u>4,238,066</u>		<u>4,238,066</u>	100.0%
Total Operating Revenues	<u>40,582,592</u>	<u>24,569,465</u>	<u>16,013,127</u>	65.2%
Operating Expenses:				
Depreciation and Amortization	39,459,405	34,431,617	5,027,788	14.6%
Other Operating Expenses	<u>1,442,569</u>		<u>1,442,569</u>	100.0%
Total Operating Expenses	<u>40,901,974</u>	<u>34,431,617</u>	<u>6,470,357</u>	18.8%
Operating Loss	<u>(319,382)</u>	<u>(9,862,152)</u>	<u>(9,542,770)</u>	(96.8%)
Nonoperating Revenues (Expenses):				
Investment Income (Net of Investment Expense)	2,353,346	635,096	1,718,250	270.5%
Interest and Fees on Debt	(2,847,350)	(2,523,500)	323,850	12.8%
Gain on Investment in Affiliates	<u>693,314</u>	<u>1,578,704</u>	<u>(885,390)</u>	(56.1%)
Net Nonoperating Revenues (Expenses)	<u>199,310</u>	<u>(309,700)</u>	<u>509,010</u>	164.4%
Transfers In	741,862,161	691,626,634	50,235,527	7.3%
Transfers Out	<u>701,914,874</u>	<u>654,565,338</u>	<u>47,349,536</u>	7.2%
Increase in Net Position	<u>39,827,215</u>	<u>26,889,444</u>	<u>12,937,771</u>	48.1%
Net Position - Beginning of Year	<u>143,200,727</u>	<u>116,311,283</u>	<u>26,889,444</u>	23.1%
Net Position - End of Year	<u>\$ 183,027,942</u>	<u>\$ 143,200,727</u>	<u>\$ 39,827,215</u>	27.8%

Fiscal year 2018, revenues (excluding transfers in) totaled \$43,629,252 and expenses (excluding transfers out) totaled \$43,749,324.
Fiscal year 2017, revenues (excluding transfers in) totaled \$26,783,265 and expenses (excluding transfers out) totaled \$36,955,117.



FINANCIAL STATEMENTS

University of North Carolina Health Care System Funds
Statement of Net Position
June 30, 2018

Exhibit A-1

ASSETS

Current Assets:

Cash and Cash Equivalents (Note 2):	
Undesignated Funds	\$ 3,984,350
Designated for UNC School of Medicine Program Support	42,603,069
Designated for UNC School of Medicine Mission Support	750,000
Designated for Shared Administrative Services	30,812,947
Designated for UNC Faculty Recruitment	5,750,000
	<hr/>
Cash and Cash Equivalents Total	83,900,366
Due from UNC Health Care Entities (Note 4)	104,234,411
Due from UNC School of Medicine	5,441,931
Notes Receivable (Note 11)	2,040,899
Line of Credit (Note 11)	700,000
	<hr/>
Total Current Assets	196,317,607
	<hr/>

Noncurrent Assets:

Investments (Note 2)	46,383,278
Assets Whose Use is Limited or Restricted (Note 2)	61,206,296
Notes Receivable (Note 11)	17,904,585
Investment in Affiliates (Note 12)	71,807,883
Capital Assets - Nondepreciable (Note 5)	8,500,556
Capital Assets - Depreciable, Net (Note 5)	178,874,739
	<hr/>
Total Noncurrent Assets	384,677,337
	<hr/>
Total Assets	580,994,944
	<hr/>

DEFERRED OUTFLOWS OF RESOURCES

0

LIABILITIES

Current Liabilities:

Due to UNC Health Care Entities (Note 7)	51,766,619
Due to UNC School of Medicine	12,369,398
Notes Payable (Note 8)	15,189,077
Assessments Paid in Advance	47,115,000
User Fees Paid in Advance	24,695,595
Funds Held for Others	3,394,476
	<hr/>
Total Current Liabilities	154,530,165
	<hr/>

Noncurrent Liabilities:

Notes Payable (Note 8)	81,905,001
User Fees Paid in Advance	100,325,540
Funds Held in Escrow (Note 6)	61,206,296
	<hr/>
Total Noncurrent Liabilities	243,436,837
	<hr/>
Total Liabilities	397,967,002
	<hr/>

DEFERRED INFLOWS OF RESOURCES

0

NET POSITION

Net Investment in Capital Assets	90,526,215
Unrestricted	92,501,727
	<hr/>
Total Net Position	\$ 183,027,942
	<hr/>

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 Year Ended June 30, 2018

Exhibit A-2

REVENUES

Operating Revenues:

User Fees	\$ 36,344,526
Other Operating Revenue	4,238,066
Total Operating Revenues	<u>40,582,592</u>

EXPENSES

Operating Expenses:

Depreciation and Amortization	39,459,405
Other Operating Expenses	1,442,569
Total Operating Expenses	<u>40,901,974</u>
Operating Loss	<u>(319,382)</u>

NONOPERATING REVENUES (EXPENSES)

Investment Income (Net of Investment Expense of \$51,967)	2,353,346
Interest and Fees on Debt	(2,847,350)
Gain on Investment in Affiliates	693,314
Net Nonoperating Revenues	<u>199,310</u>

TRANSFERS IN

Regular Assessments (Note 9)	77,865,500
Special Assessments (Note 9)	133,729,972
Mission Support Assessments (Note 9)	29,413,670
Shared Administrative Services Assessments (Note 9)	500,853,019
Total Transfers In	<u>741,862,161</u>

TRANSFERS OUT

Program Support (Note 10)	185,807,782
Shared Administrative Services (Note 10)	497,207,092
Mission Support (Note 10)	18,900,000
Total Transfers Out	<u>701,914,874</u>
Increase in Net Position	39,827,215

NET POSITION

Net Position - July 1, 2017	<u>143,200,727</u>
Net Position - June 30, 2018	<u>\$ 183,027,942</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 Year Ended June 30, 2018

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Entities	\$ 123,132,011
Payments to Vendors and Suppliers	(1,442,569)
Net Cash Provided by Operating Activities	<u>121,689,442</u>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Transfers In from Entities	716,656,466
Transfers Out to Entities	(833,269,404)
Upper Payment Limit Pass-through Payments Received	119,837,370
Upper Payment Limit Pass-through Payments	(113,724,275)
Certified Public Expenditures Funds Received	50,164,145
Certified Public Expenditures Funds to Escrow	(50,164,145)
Notes Receivable Issued to Entities	(16,000,000)
Line of Credit Issued to Entities	(250,000)
Net Cash Used by Noncapital Financing Activities	<u>(126,749,843)</u>

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

Principal Paid on Notes Payable	(16,005,147)
Interest Paid on Notes Payable	(2,847,350)
Assessment for Capital Acquisition	67,605,428
Acquisition and Construction of Capital Assets	(62,401,461)
Net Cash Used by Capital Financing and Related Financing Activities	<u>(13,648,530)</u>

CASH FLOWS FROM INVESTING ACTIVITIES

Investment Income	1,013,317
Purchase of Investments and Related Fees	(25,008,230)
Assessments for Investment in Affiliates	1,000,000
Investment in Affiliates	(1,000,000)
Net Cash Used by Investing Activities	<u>(23,994,913)</u>
Net Decrease in Cash and Cash Equivalents	(42,703,844)
Cash and Cash Equivalents - July 1, 2017	<u>126,604,210</u>
Cash and Cash Equivalents - June 30, 2018	<u>\$ 83,900,366</u>

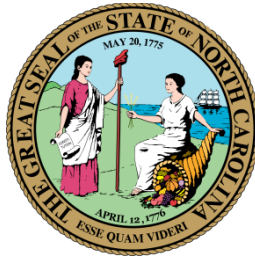
RECONCILIATION OF OPERATING LOSS TO NET CASH PROVIDED BY OPERATING ACTIVITIES

Operating Loss	\$ (319,382)
Adjustments to Reconcile Operating Loss to Net Cash Provided by Operating Activities:	
Depreciation and Amortization Expense	39,459,405
Changes in Assets and Deferred Outflows of Resources:	
Notes Receivable	847,391
Changes in Liabilities and Deferred Inflows of Resources:	
User Fees Paid in Advance	<u>81,702,028</u>
Cash Provided by Operating Activities	<u>\$ 121,689,442</u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through the Assumption of a Liability	\$ 3,264,133
Change in Fair Value of Investments	1,246,313
Exchange of Capital Assets and Notes Payable	(14,309,295)

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 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., UNC Rockingham Health Care (Rockingham), 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, Johnston Health Services Corporation, Wayne Health Corporation, and Lenoir Memorial Hospital 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 the 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, UNC School of Medicine, 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 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 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 and 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 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*, UNC Health Care is considered to be a single business-type activity that qualifies for reporting in a single column in the basic financial statements. 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, include 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.

- F. Investments** - To the extent available, investments are recorded 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. 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 change in the value of investments is recognized as a component of investment income.

Money market mutual funds are reported at cost, if purchased, or at fair value or appraised value at date of gift, if donated.

- G. 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

H. 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.

I. Revenue and Expense Recognition - The System Fund classifies its revenues and expenses as operating or nonoperating in the accompanying Statement of Revenues, Expenses, and Changes in Net Position. 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.

J. 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 the 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 UNC School of Medicine 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, UNC School of Medicine, 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 made mission support payments to the System Fund during fiscal year 2018.

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. The System Fund 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

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

At June 30, 2018, the amount shown on the Statement of Net Position as cash and cash equivalents of \$83,900,366 represents 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 1.4 years as of June 30, 2018. 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 North Carolina Department of State Treasurer Investment Programs' separately issued audit report. This separately issued report can be obtained from the Department of State Treasurer, 3200 Atlantic Avenue, Raleigh, NC 27604 or can be accessed from the Department of State Treasurer's website at <https://www.nctreasurer.com/> in the Audited Financial Statements section.

A summary of deposits and corresponding designations as of June 30, 2018 is as follows:

Designation	Enterprise Fund	Recruitment Fund	Patient Safety Fund	Shared Administrative Services Fund	Total
Undesignated Funds	\$ 3,600,342	\$ 0	\$ 384,008	\$ 0	\$ 3,984,350
Designated for UNC-SOM Program Support	36,727,926			5,875,143	42,603,069
Designated for UNC-SOM Mission Support	750,000				750,000
Designated for Shared Administrative Services				30,812,947	30,812,947
Designated for UNC Faculty Recruitment		5,750,000			5,750,000
Total Deposits	\$ 41,078,268	\$ 5,750,000	\$ 384,008	\$ 36,688,090	\$ 83,900,366

- 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 UNC Health Care as allowed in G.S. 147-69.2(b3).

North Carolina General Statute 116-37.2, as revised by Session Law 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. With this legislative flexibility and under the guidance of the Finance Committee of the Board, the System Fund has made investments as described below.

Investments are subject to the following risks as defined by GASB Statement No. 40, *Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3*.

Interest Rate Risk: Interest rate risk is the risk the System Fund may face should interest rate variances affect the value of investments. System Fund does not have a formal policy that addresses interest rate risk.

Credit Risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. System Fund does not have a formal policy that addresses credit risk.

Custodial Credit Risk: Custodial credit risk is the risk that, in the event of the failure of the counterparty, the System Fund will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The System Fund does not have a formal policy for custodial credit risk.

UNC Investment Fund, LLC - At June 30, 2018, the System Fund's investments include \$46,383,278 which represents the System Fund's equity position in the UNC Investment Fund, LLC (UNC Investment Fund). The UNC Investment Fund is an external investment pool that is not registered with the Securities and Exchange Commission, does not have a credit rating, and is not subject to any regulatory oversight. Investment risks associated with the UNC Investment Fund are included in audited financial statements of the UNC Investment Fund, LLC which may be obtained from UNC Management Company, Inc., 1400 Environ Way, Chapel Hill, NC 27517.

Non-Pooled Investments - The following table presents investments by type and investments subject to interest rate risk at June 30, 2018, for the System Fund's non-pooled investments. These investments are held in escrow for purposes of the Certified Public Expenditures. See Note 6 for further details.

Non-Pooled Investments

Investment Type	Amount	Investment Maturities (in Years)
		Less Than 1
Debt Securities		
Money Market Mutual Funds	\$ 61,206,296	\$ 61,206,296

At June 30, 2018, the System Fund's non-pooled investments had the following credit quality distribution for securities with credit exposure:

	Amount	Aaa
Money Market Mutual Funds	\$ 61,206,296	\$ 61,206,296

Rating Agency: Moody's

C. Reconciliation of Deposits and Investments - A reconciliation of deposits and investments for the System Fund as of June 30, 2018, is as follows:

Deposits in the Short-Term Investment Fund	\$ 83,900,366
Investment in the UNC Investment Fund	46,383,278
Non-Pooled Investments	<u>61,206,296</u>
Total Deposits and Investments	<u>\$ 191,489,940</u>
Deposits	
Current	
Cash and Cash Equivalents	<u>\$ 83,900,366</u>
Total Deposits	<u>83,900,366</u>
Investments	
Noncurrent:	
Investments	46,383,278
Assets Whose Use is Limited or Restricted	<u>61,206,296</u>
Total Investments	<u>107,589,574</u>
Total Deposits and Investments	<u>\$ 191,489,940</u>

NOTE 3 - FAIR VALUE MEASUREMENTS

To the extent available, the System Fund's investments are recorded at fair value as of June 30, 2018. 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 - At year-end, cash and cash equivalents valued at \$83,900,366 were held in the STIF. 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. Pool investments are measured at fair value in accordance with GASB 72. The System Fund's position in the pool is measured and reported at fair value and the STIF is not required to be categorized within the fair value hierarchy.

UNC Investment Fund - At year-end, the System Fund's investments held in the UNC Investment Fund were valued at \$46,383,278. 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. Valuation of the underlying assets is performed by the custodian. Pool investments are measured at fair value in accordance with GASB 72. The System Fund's position in the pool is measured and reported at fair value and the UNC Investment Fund is not required to be categorized within the fair value hierarchy.

NOTE 4 - DUE FROM UNC HEALTH CARE ENTITIES

Amounts due from UNC Health Care Entities at June 30, 2018 by type and entity were as follows:

	<u>Amount</u>
Assessments	
Owned Entities	\$ 32,926,954
Managed Entities	<u>700,000</u>
Total Assessments	<u>33,626,954</u>
Shared Administrative Services	
Owned Entities	69,235,354
Managed Entities	<u>1,372,103</u>
Total Shared Administrative Services	<u>70,607,457</u>
Total Due from UNC Health Care Entities	<u><u>\$ 104,234,411</u></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 year ended June 30, 2018, is presented as follows:

	Balance July 1, 2017	Increases	Decreases	Balance June 30, 2018
Capital Assets, Nondepreciable:				
Land	\$ 0	\$ 8,479,431	\$ 0	\$ 8,479,431
Construction in Progress		21,125		21,125
Computer Software in Development	1,194,771		1,194,771	
Total Capital Assets, Nondepreciable	1,194,771	8,500,556	1,194,771	8,500,556
Capital Assets, Depreciable:				
Buildings	6,135,238	22,982,229		29,117,467
Machinery and Equipment	68,141,559	14,360,527		82,502,086
Computer Software	173,993,729	18,054,669	16,469,341	175,579,057
Total Capital Assets, Depreciable	248,270,526	55,397,425	16,469,341	287,198,610
Less Accumulated Depreciation/Amortization for:				
Buildings	1,215,293	913,807		2,129,100
Machinery and Equipment	21,713,967	17,031,299		38,745,266
Computer Software	48,095,252	21,514,299	2,160,046	67,449,505
Total Accumulated Depreciation/Amortization	71,024,512	39,459,405	2,160,046	108,323,871
Total Capital Assets, Depreciable, Net	177,246,014	15,938,020	14,309,295	178,874,739
Capital Assets, Net	\$ 178,440,785	\$ 24,438,576	\$ 15,504,066	\$ 187,375,295

NOTE 6 - ESCROW FOR CERTIFIED PUBLIC EXPENDITURES

With the help of the North Carolina Hospital Association, UNC Health Care entered into an agreement with other Public Hospitals in North Carolina to receive the benefit of additional Certified Public Expenditures (CPEs) (as defined by Federal Regulation 45 CFR 95.13 and 42 CFR 433.51) 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, 2018, \$61,206,296 was held by the Escrow Agent, First Citizens Bank & Trust Company.

NOTE 7 - DUE TO UNC HEALTH CARE ENTITIES

Amounts due to UNC Health Care entities at June 30, 2018 by type and entity were as follows:

	<u>Amount</u>
Program Support	
Owned Entities	<u>\$ 14,826,746</u>
Shared Administrative Services	
Owned Entities	36,881,875
Managed Entities	<u>57,998</u>
Total Shared Administrative Services	<u>36,939,873</u>
Total Due to UNC Health Care Entities	<u><u>\$ 51,766,619</u></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, as a part of Phase II, an additional \$44,133,785 was borrowed from UNC Hospitals, Rex, UNC School of Medicine, UNC Physicians Network, Chatham, Caldwell, Johnston, and Pardee. In 2017, an additional \$32,275,301 was borrowed to complete Phase II. The principal amount for Phase II is to be repaid in 96 monthly installments at a simple interest rate equal to 2.5%. There were no additional borrowings in 2018. 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.

During fiscal year 2018, the \$14,309,295 remaining balance of the note payable to High Point Regional Health, Inc. was written off in exchange for an equivalent portion of the EMR system software. See Note 5 for related decrease in computer software and accumulated amortization.

Notes payable activity for the year ended June 30, 2018 is presented as follows:

Entity	Balance July 1, 2017	Additions	Reductions	Balance June 30, 2018	Current Portion
Owned Entities	\$ 96,134,749	\$ 0	\$ 26,174,423	\$ 69,960,326	\$ 10,944,362
Managed Entities	18,264,357		2,417,834	15,846,523	2,478,978
UNC School of Medicine	13,009,414		1,722,185	11,287,229	1,765,737
Total Notes Payable	<u>\$ 127,408,520</u>	<u>\$ 0</u>	<u>\$ 30,314,442</u>	<u>\$ 97,094,078</u>	<u>\$ 15,189,077</u>

NOTE 9 - TRANSFERS IN

Transfers in by source and entity for the year ended June 30, 2018 were as follows:

	<u>Amount</u>
Regular Assessments:	
Owned Entities	\$ 57,643,440
UNC School of Medicine	<u>20,222,060</u>
Total Regular Assessments	<u>77,865,500</u>
Special Assessments:	
Owned Entities	111,785,073
Managed Entities	19,650,223
UNC School of Medicine	<u>2,294,676</u>
Total Special Assessments	<u>133,729,972</u>
Mission Support:	
Owned Entities	<u>29,413,670</u>
Shared Administrative Services:	
Owned Entities	390,681,304
Managed Entities	53,802,715
UNC School of Medicine	<u>56,369,000</u>
Total Shared Administrative Services	<u>500,853,019</u>
Total Transfers In	<u><u>\$ 741,862,161</u></u>

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

NOTE 10 - TRANSFERS OUT

Transfers out by purpose and entity for the year ended June 30, 2018 were as follows:

	<u>Amount</u>
Program Support:	
Owned Entities	\$ 80,627,839
UNC School of Medicine	<u>105,179,943</u>
Total Program Support	<u>185,807,782</u>
Shared Administrative Services:	
Owned Entities	450,445,309
UNC School of Medicine	<u>46,761,783</u>
Total Shared Administrative Services	<u>497,207,092</u>
Mission Support:	
UNC School of Medicine	<u>18,900,000</u>
Total Transfers Out	<u><u>\$ 701,914,874</u></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 – 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 was assessed \$373,312,665 in fiscal year 2018 for assessments, mission support, and shared administrative services to the System Fund. In turn, the System Fund made payments of \$354,163,842 to UNC Hospitals for program support and shared administrative service expenses as well as principal repayments in the amount of \$5,969,427. As of June 30, 2018, the System Fund had receivables of \$26,344,847, payables of \$37,653,430, and outstanding notes payable of \$39,123,719.

University of North Carolina School of Medicine – UNC School of Medicine, which includes UNC Faculty Physicians, provides 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.

UNC School of Medicine was assessed \$78,885,736 in fiscal year 2018 for assessments and shared administrative services to the System Fund. In turn, the System Fund made payments of \$170,841,726 for program support, shared administrative services, and mission support as well as principal repayments in the amount of \$1,722,185. As of June 30, 2018, the System Fund had receivables of \$5,441,931, payables of \$12,369,398, and outstanding notes payable of \$11,287,229.

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 Rex.

Rex was assessed \$140,415,766 in fiscal year 2018 for assessments, mission support, and shared administrative services to the System Fund. The System Fund also made payments to Rex in the amount of \$57,207,257 for shared administrative service expenses as well as principal repayments in the amount of \$3,464,828. As of June 30, 2018, the System Fund had receivables of \$2,578,887, payables of \$7,638,298, and outstanding notes payable of \$22,708,532.

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.

Chatham was assessed \$6,244,626 in fiscal year 2018 for assessments and shared administrative services to the System Fund. The System Fund also made payments to Chatham in the amount of \$4,174,915 for program support and shared administrative service expenses as well as principal repayments in the amount of \$42,099. As of June 30, 2018, the System Fund had payables of \$85,974. The System Fund extended a \$16,000,000 note receivable to Chatham

during the fiscal year 2018, of which \$1,141,238 is due in the next year. As of June 30, 2018, the System Fund had outstanding notes payable of \$275,918.

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) and beyond.

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 was assessed \$18,124,751 in fiscal year 2018 for assessments and shared administrative services to the System Fund. The System Fund also made payments to UNCPN in the amount of \$68,346,062 for program support and shared administrative service expenses as well as principal repayments in the amount of \$133,074. As of June 30, 2018, the System Fund had receivables of \$233,843, payables of \$4,284,335, and outstanding notes payable of \$872,166.

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% (4.00%). As of June 30, 2018, the balance outstanding was \$425,000. This agreement was renewed on July 1, 2018 and all unpaid amounts including accrued interest are due on June 30, 2019.

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% (4.00%). All unpaid amounts including accrued interest are due on November 30, 2018. As of June 30, 2018, there was no balance outstanding.

Effective July 1, 2016, the Garner Family Practice 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 July 1, 2015 plus 0.75% (4.00%). As of June 30, 2018, the balance outstanding was \$275,000. This agreement was renewed on July 1, 2018 and all unpaid amounts including accrued interest are due on June 30, 2020.

The following table summarizes the activity in the lines of credit for the year ended June 30, 2018:

Entity	Balance July 1, 2017	Borrowings	Payments	Balance June 30, 2018
Boylan Clinic	\$ 300,000	\$ 125,000	\$ 0	\$ 425,000
Garner Family Practice Clinic	150,000	125,000		275,000
	<u>\$ 450,000</u>	<u>\$ 250,000</u>	<u>\$ 0</u>	<u>\$ 700,000</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 was assessed \$37,154,036 in fiscal year 2018 for assessments and shared administrative services to the System Fund. The System Fund also made payments to HPRH in the amount of \$9,296,910 for program support and shared administrative service expenses. Principal repayments in the amount of \$1,190,705 were made during the year on an outstanding note payable. As discussed in Note 8, the remaining balance of \$14,309,295 was written off in exchange for an equivalent portion of the EMR software. As of June 30, 2018, the System Fund had receivables of \$59,325,812 and payables of \$926,851. See Note 13 for the subsequent event with HPRH.

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 primary and specialty care physicians and advanced practice professionals. UNC Health Care became the sole corporate member of Caldwell on May 1, 2013.

Caldwell was assessed \$12,771,643 in fiscal year 2018 for assessments and shared administrative services to the System Fund. The System Fund also made payments to Caldwell in the amount of \$14,384,162 for program support and shared administrative service expenses as well as principal repayments in the amount of \$1,064,995. As of June 30, 2018, the System Fund had receivables of \$12,178,919, payables of \$1,119,412, and outstanding notes payable of \$6,979,991.

UNC Rockingham Health Care, Inc. – UNC Rockingham Health Care, Inc. (Rockingham) is a not-for-profit acute care hospital located in Eden, North Carolina providing inpatient, outpatient, emergency care, and nursing services to communities in north central North Carolina and south central Virginia.

Rockingham was assessed \$1,500,000 in fiscal year 2018 for assessments and shared administrative services to the System Fund. The System Fund made

payments to Rockingham in the amount of \$10,000,000 for program support and shared administrative service expenses. An additional payment of \$13,500,000 was made to the bankruptcy trustee to release the assets to Rockingham for continued operations. As of June 30, 2018, the System Fund had receivables of \$1,500,000 and payables of \$321.

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

The managed entities were assessed \$73,452,938 in fiscal year 2018 for assessments and shared administrative services to the System Fund. The System Fund has a note receivable with a balance of \$3,945,484 as of June 30, 2018, of which \$899,661 is due within the next year. The System Fund also made payments to the managed entities in the amount of \$2,417,834 for principal repayments. As of June 30, 2018, the System Fund had receivables of \$2,072,103, payables of \$57,998, and outstanding notes payable of \$15,846,523.

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 started operating 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 using the equity method. A summary of changes in the investments in affiliates for the year ended June 30, 2018 is presented as follows:

Affiliate	Balance July 1, 2017	Additions	Reductions	Balance June 30, 2018
Johnston Health Services Corporation	\$ 61,213,746	\$ 1,693,314	\$ 0	\$ 62,907,060
Alignment Healthcare Partners, LP	6,111,274			6,111,274
Provider-Led and Patient-Centered Care, LLC	2,789,549			2,789,549
Total Investment in Affiliates	\$ 70,114,569	\$ 1,693,314	\$ 0	\$ 71,807,883

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,

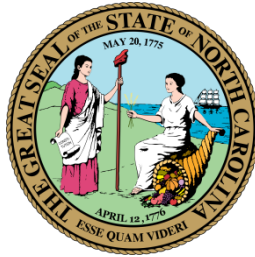
North Carolina. UNC Health Care has a 35.25 percent membership in JHSC and has agreed to provide \$57,600,000 in contributions over the years. UNC Health Care transferred \$26,200,000 of the contribution for the year ended June 30, 2014. A second cash contribution of \$27,400,000 was made for the year ended June 30, 2015. Furthermore, a cash contribution of \$1,000,000 is due annually starting February 2016 and ending February 2019.

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.

UNC Health Care owns a small minority ownership interest (less than 10%) in Provider-Led and Patient-Centered Care, LLC (PLPCC), a company that is a collaboration of 11 North Carolina health systems formed to develop a provider-led and owned Medicaid Prepaid Health Plan (PHP). PLPCC is acting in support of the General Assembly and Governor's goal to transform the State's current Medicaid system to a program that provides budget predictability for the taxpayers of the State while ensuring adequate access and high quality of care to those in need.

NOTE 13 - SUBSEQUENT EVENT

On September 1, 2018, UNC Health Care completed its sale of High Point Regional Health, Inc. to Wake Forest Baptist Medical Center.



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
<https://www.ncauditor.net>

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

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

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the University of North Carolina Health Care System Funds (System Fund) which is 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 year ended June 30, 2018, 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 10, 2019.

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, 2018, the changes in its financial position, or its cash flows, for the year 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 10, 2019

ORDERING INFORMATION

COPIES OF THIS REPORT MAY BE OBTAINED BY CONTACTING:

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

Telephone: 919-807-7500
Facsimile: 919-807-7647
Internet: <https://www.ncauditor.net>

To report alleged incidents of fraud, waste or abuse in state government contact the
Office of the State Auditor Fraud Hotline: **1-800-730-8477**
or download our free app.



<https://play.google.com/store/apps/details?id=net.ncauditor.ncauditor>



<https://itunes.apple.com/us/app/nc-state-auditor-hotline/id567315745>

For additional information contact:
Brad Young
Director of External Affairs
919-807-7513



This audit required 715 hours at an approximate cost of \$73,645.