



University of  
North Carolina  
Health Care System

**2005**  
Annual Report

*For the year ending June 30, 2005*

**UNC**  
HEALTH CARE

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# INTRODUCTION

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Chapel Hill, North Carolina  
For the year ending June 30, 2005

## Greeting

January 17, 2006

Dear Friends:

This report makes public for the first time the fiscal operations of the entire UNC Health Care System. It is a voluntary initiative on our part, and it will be an annual update on our efforts to deliver state-of-the-art patient care in the most efficient, fiscally responsible manner. Because we firmly believe that our health care system is accountable to all the people of North Carolina, we are pleased to share with you the financial information and measurements that underpin UNC Health Care's efforts to meet our important missions.

This first report will also serve as a benchmark against which we can measure future progress in terms of both patient care and financial results. An important near-term financial goal is to have a positive operating margin of three percent. Attaining this modest margin will allow us to invest in the latest medical technology, build world-class medical facilities, provide leading-edge care, attract and retain the best physicians and staff, and assist in providing affordable health care for all North Carolinians. Being forthright and diligent in this pursuit will ensure that we can provide the highest quality care for an increasing number of patients, many of whom need financial assistance from our system.

Pursuing this goal required us to examine how our overall system operates. For the past 18 months, work teams have been busy evaluating many of our critical processes to ensure our services are delivered in an efficient, patient-friendly manner. Additionally, it has required making changes that are difficult but that will nonetheless result in a stronger foundation for our health care system in the future.

We are pleased to report to you that for the first time in four years UNC Hospitals has had a positive operating margin, with an operating income of \$8.7 million. Our medical group, UNC Physicians and Associates, has also shown a dramatic change in its financial results with a \$6.7 million improvement this fiscal year—the best results in seven years.

These very encouraging financial results are the product of hard work by our superb team of faculty, staff, trainees, and students. Because of their dedication to excellence, we have a bright future for the people of North Carolina.

Even as we put increased emphasis on our financial foundation, we are mindful of the reasons our system's financial health is so important to the 6,000 employees who make up our outstanding health care team and to the nearly half-a-million patients we serve across the state. Our determination to improve our financial performance is fueled by the requirements of a changing health care environment that challenges even the strongest institutions. Our desire for a strong foundation is based in our vision to be the nation's leading public academic health system and is guided by the values that drive us to exceed the expectations of those we serve. Our Vision and Values statement on page 5 of this report underlies all that we do at UNC Health Care.

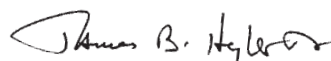
We offer this comprehensive look at our financial status as a means of informing our stakeholders about the stewardship of their resources and ensuring the accountability of the UNC Health Care System to all North Carolinians. Only the strongest foundation will allow us to fulfill our commitment to *leading, teaching, and caring* for the benefit of the patients we serve and for the advancement of medical knowledge and discovery.

The financial statements reported herein for the UNC Health Care System (UNC HCS) are proforma in nature due to the complexities of blending its various entities. The UNC HCS was created by North Carolina General Statute 116-37, which provided that the operations of the University of North Carolina Hospitals (UNCH) and the clinical patient care programs of the School of Medicine of the University of North Carolina at Chapel Hill (the University) shall be governed by the board of directors of the UNC HCS. Rex Healthcare, Inc. (REX) and various community-based clinics have been added since the legislation was passed. While REX and UNCH are individually audited, the operations of the clinical patient care programs of the University's School of Medicine, which are defined as UNC Physicians and Associates, are included in the overall audit of the University. The production of consolidated financial statements for the UNC HCS and a separate audit would be difficult, if not impossible to obtain, due to bond covenants for each of the individual entities and other commitments that restrict the use of funds. It is our belief that these proforma statements are the best way to reflect the overall operations of the UNC HCS. Further discussion of the financial statement proforma presentation and its implications can be found in the Management's Discussion and Analysis section, as well as in the notes to the report.

Sincerely,



William L. Roper, MD, MPH  
*Chief Executive Officer*  
*University of North Carolina Health Care System*



James B. Hyler, Jr.  
*Chair, Board of Directors (November 2003-October 2005)*  
*University of North Carolina Health Care System*

## Vision and Values

Over the past year, we developed a new UNC Health Care System vision and values statement. We did it with great care, knowing it would stand as a continual reminder of who we are, what we stand for, and what we strive to achieve. By articulating for ourselves what we care most deeply about, we can better concentrate our energies on fulfilling our vision: to be the nation's leading public academic health care system.

One measure of living out our vision and values is reflected in the type and level of accomplishments of our institution. The honors and achievements that UNC Health Care has accumulated in the past year make us proud, not for their own sake but because they so closely reflect the vision and values we have outlined for ourselves.

Our vision and values proclaim ongoing commitment to serve all patients including those

who have no other place to go, to remain at the forefront of biomedical discovery and to dedicate ourselves to the teaching mission of the School of Medicine. They will continue to guide us in our pursuit of excellence for our patients.

This year's milestones also serve as tangible examples of what we mean by the values we have articulated. First among those values is caring about our patients and their families. When UNC physicians and scientists helped organize a national family education weekend to share their expertise on a rare respiratory disease, they showed what caring about our patients means. And, when the World Burn Congress met last year, it was in Chapel Hill, hosted by the North Carolina Jaycee Burn Center at UNC-Chapel Hill, bringing the best thinking in burn treatment to our institution as well as spotlighting the superb work UNC does in this area.





We demonstrated our commitment to improving the health of all North Carolinians in many ways. One of particular significance is the creation of the new North Carolina Cancer Hospital, to be built with \$180 million in funding approved last year by the North Carolina General Assembly. The new cancer hospital will greatly improve our capacity to provide the highest quality care to the State's 250,000 cancer patients, a number that is expected to double over the next 30 years.

The cancer hospital will also enable us to teach new cancer physicians and other health care providers and to attract more research dollars. Its specially designed features will enhance clinical research and innovative care options and improve the ability of UNC's multidisciplinary clinics to provide coordinated care. The North Carolina Cancer Hospital illustrates how we want to bring state-of-the-art care to our patients.

Additionally, we have high expectations for the reputation of our health care system. High national rankings, for example, help us recruit and retain more top physicians, thus providing the people of North Carolina with some of the best medical talent available anywhere. This year's *U.S. News & World Report* hospital rankings show that we are already making very solid progress toward our vision. The magazine ranked nine medical specialties offered at UNC Hospitals among the top 50 programs of their kind nationwide. The School of Medicine ranked second in primary care and tied for 23rd in research among medical schools in the U.S. News list of America's Best Graduate Schools. The U.S. News rankings are just one result of our dedication to delivering excellent service and operating leading programs.

UNC Hospitals also leads the way in innovative use of new medical devices. In February, John Huffstetler of Wake Forest, North Carolina, was the first patient to undergo laparoscopic prostate removal surgery using our new da Vinci® robotic instrument. Surgeons like the instrument's precision and responsiveness. What Mr. Huffstetler liked best was that he only had to stay in the hospital one night, needed no post-surgery pain medication, and was walking a mile four days after his surgery.

Another of our values is to provide students and trainees with a well-rounded experience that integrates outstanding clinical care and leading academic research. In the fiscal year 2004, the UNC School of Medicine received \$212.9 million in research grants from the National Institutes of Health, and a ranking of 17th in all U.S. medical schools. Among those grants were three from NIH's Roadmap for Medical Research initiative designed to transform the nation's research capabilities. Only 21 of these prestigious Roadmap grants were awarded nationwide – and no other university was awarded three. Then, in October 2005, UNC garnered eight Roadmap grants – again, more than any other academic institution in the country. Grant funding like this allows us to live our mission to

be deeply and broadly engaged with the people of North Carolina and the nation to meet their health challenges.

This year we expanded our commitment and responsibility to act as the state's safety net health care provider by instituting a 25 percent fee reduction for uninsured North Carolinians along with additional financial assistance for low-income patients. Combined with a new financial intervention and assistance policy, we are better able to help uninsured and low-income patients to manage their health care needs. Overall this year, UNC Health Care provided approximately \$88 million in uncompensated care – more than twice the state's FY 2005 appropriation for indigent care of about \$39 million.

As a health care system with high expectations for the standard of care we provide our patients, we want UNC Health Care to continue to garner recognition for its accomplishments. These honors are rooted in values that are expressed daily through quality care delivered to individual patients. They serve as a reminder that living our vision and values not only has a positive impact on the reputation of our system, but on the health of all the people UNC Health Care serves.





## UNC Health Care and UNC Hospitals A Year of Achievements

- July 2004* The National Parkinson Foundation designates UNC-Chapel Hill as the first NPF Center of Excellence in North Carolina – the only such center in the three-state region of North Carolina, South Carolina, and Virginia.
- October 2004* The North Carolina Jaycee Burn Center at UNC Hospitals hosts the World Burn Conference.
- February 2005* Dr. Anthony A. Meyer is given the 2005 Parker J. Palmer “Courage to Teach” award by the Accreditation Council for Graduate Medical Education. He is one of only 10 residency program directors to receive the award.
- February 2005* Dr. John F. Boggess is the first physician in North Carolina to be certified to perform gynecological procedures with the da Vinci® surgical robotic system.
- May 2005* Dr. Douglas A. Drossman receives the 2005 Joseph B. Kirsner Award in Clinical Research in Gastroenterology, given by the AGA/Miles & Shirley Fiterman Foundation.
- June 2005* Dr. William L. Roper, CEO of UNC Health Care, is elected to the National Quality Forum board of directors. He is named chairman-elect of the group.
- July 2005* Dr. Myron S. Cohen of UNC’s Center for Infectious Diseases is selected to help lead research efforts in the Center for HIV/AIDS Vaccine Immunology, a National Institutes of Health-funded consortium that may receive more than \$300 million over seven years to address HIV vaccine development and design. UNC is selected to be in charge of one of five core research sites in support of the initiative.
- Summer 2005* *U.S. News & World Report* ranks nine specialties at UNC among the nation’s best. Best Doctors, Inc. names more than 130 UNC physicians to its list of the “Best Doctors in America.”
- July 2005* UNC Health Care became one of five clinical centers nationwide to receive funds from the National Institutes of Health as part of the first large-scale investigation of severe liver injury associated with drugs.

## Rex Healthcare • 2005 Highlights

- The Data Management and Research national survey showed physician and staff satisfaction scores in the nation's top 5 percent. Patient satisfaction scores were in the top 10 percent.
- *Healthgrades* placed Rex in the top 5 percent of hospitals nationally for Clinical Excellence and presented Rex with the Distinguished Hospital Award.
- The American College of Surgeons' Commission on Cancer granted the Rex Cancer Center Three-Year Approval with Commendation for providing the highest quality of care.
- Rex was named #1 in North Carolina in overall Neurological Services and Gastrointestinal Surgery and ranked in the top 5 in North Carolina for overall cardiology and cardiac services by *Healthgrades*.
- The Rex Hospital Open, a Nationwide Tour event, raised anticipated net proceeds of approximately \$300,000 to support Rex Hospital's cancer and heart disease education and detection programs. This brought its 18-year total to more than \$4.3 million.
- Rex Emergency Response Team (ERT) was designated as the National Disaster Medical System patient medical reception team for Raleigh-Durham International Airport.
- Rex Hospital's Access Management Department won the Franklin Award of Distinction from the American Case Management Association and Joint Commission on Accreditation of Healthcare Organizations.
- Gaynell Stone, RN, received the National Cherokee Inspired Comfort Award, a national honor for nursing excellence, after being nominated by a local family.



## Letter of Transmittal

October 31, 2005

To the Governor, the State Auditor, Members of the General Assembly, Members of the UNC Board of Governors, UNC Chapel Hill Board of Trustees, Supporters of the University of North Carolina Health Care System and Members of the UNC HCS Board of Directors.

### INTRODUCTION

This Annual Report includes a compilation of the operating results and financial position of the University of North Carolina Health Care System (UNC HCS) as established by General Statute 116-37. The financial reports as presented represent a summary of data generated by the various entities under the control of the Board of Directors of the UNC HCS. The University of North Carolina Hospitals (UNCH) and Rex Healthcare, Inc. (REX) prepare and publish their own separate audit reports on an annual basis. The University of North Carolina Physicians & Associates (UNC P&A) is included in the audited report for The University of North Carolina at Chapel Hill (UNC-Chapel Hill). Additional information regarding the organization structure can be found in the notes to the annual report.

This annual report is compiled to provide useful information about the entity's operations and programs and to ensure its accountability to the citizens of North Carolina. While the management of the UNC HCS believes this information to be accurate, it should be noted that these documents are **unaudited** and not intended to be used for any financial decisions.

The **Financial Section** presents management's discussion and analysis and two proforma financial statements for UNC HCS and two financial statements for UNC P&A. This section includes selected statistical and financial ratio information. Management's discussion and analysis provides a review of the financial operations and the notes to the annual report provide additional explanations for the reader.

### FINANCIAL INFORMATION

#### Internal Control Structure

The management of the UNC HCS establishes and maintains an internal control structure to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Management applies the internal control standards to meet each of the internal control objectives and to assess internal control effectiveness. When assessing the effectiveness of internal control over financial reporting and compliance with financial-related laws and regulations, management follows the assessment process to ensure the State of North Carolina and the public that the UNC HCS is committed to safeguarding its assets and providing reliable financial information. One objective of an internal control structure is to provide management with reasonable, although not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition. Another objective is to ensure that transactions are executed in accordance with appropriate authorization and recorded properly in the financial records to permit the preparation of financial statements in accordance with generally accepted accounting principles. Annually, management provides assurances on internal control in its Performance and Accountability Report, including a separate assurance on internal control over financial reporting, along with a report on identified material weaknesses and corrective actions.

As a recipient of Federal and State funds, the UNC HCS is responsible for ensuring compliance with all applicable laws and regulations. A combination of State and UNC HCS policies and procedures, integrated with a system of internal controls, provides for this compliance. The accounts and operations of UNC Hospitals and UNC P&A (as a part of UNC-Chapel Hill) are subject to an annual examination by the Office of the State Auditor. REX has an annual audit performed by an outside independent CPA firm. All three entities are an integral part of the State's reporting entity



represented in the *State's Comprehensive Annual Financial Report* and the *State's Single Audit Report*. The audit procedures are conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States.

#### **Budgetary Controls**

On an annual basis, the Board of Directors of the UNC HCS reviews the budget for UNC P&A and approves a budget for UNCH and REX. Each member of the UNC HCS produces monthly reports that compare budget and actual operating results. Department Heads are expected to review the reports and identify significant variances from their budget. If necessary, action plans are implemented that will improve negative variances. In addition to the monthly reports, an encumbrance system is maintained to track open purchase orders and commitments made to vendors. N. C. General Statute 116-37 granted to the UNC HCS flexibility

for management of UNCH in regard to its policies for personnel and salary management, purchasing of goods, services and property and property construction. On an annual basis, the UNC HCS submits a report on its activity under this flexibility. The report is sent to the Health Affairs Committee of the Board of Governors and the Joint Legislative Commission on Governmental Operations on or before September 30 each year.

The UNC HCS is subject to the provisions of the Executive Budget Act and as such, monthly reports are submitted to the Office of State Budget and Management. Under the budgetary procedure followed by the State, all State revenues are appropriated by the General Assembly pursuant to appropriation acts adopted every two years. The UNC HCS receives State appropriations of approximately \$40 million on an annual basis. The General Assembly appropriates these funds from the General Fund to cover a portion of operating expenses, including a portion of operating

expenses attributable to the cost of providing (i) care to indigent patients and (ii) graduate medical education.

#### **Debt Administration**

The UNC HCS recently adopted a debt swap policy regarding the use of Interest Rate Exchange Agreements or Interest Rate Swap Agreements to cover the use of fixed and variable rate debt. The policy was enacted to minimize interest rate exposure and to ensure that the UNC HCS considers all types of funding sources for future building projects and equipment acquisition. The UNC HCS must ensure that its bond ratings are maintained at the highest level in order to provide access to the tax-exempt bond market for future issues.

#### **Cash and Investment Management**

The UNC HCS is reviewing the investment policies of UNCH and REX in light of recent changes in the General Statutes to ensure that the earnings on its funds are maximized and any risk is minimized. The cash management policy includes all areas of receipts and disbursements so that investment earnings are maximized and vendor relations are maintained.

#### **Risk Management**

Exposures to loss are handled by a combination of methods, including participation in State-administered insurance programs, purchase of commercial insurance and self-retention of certain

risks. The key to managing risk is to ensure that programs are in place that educate and guide employees to the best practices for our industry. We have a responsibility to safeguard our patients so that no additional harm comes to them while under our care. In addition, we have to ensure a safe workplace for our employees.

In addition to the typical litigation risks with which we are faced, we have to recognize the risk and rewards associated with starting new programs or initiatives. Risk taking is a way to improve our competitive advantage within the health care market.

#### **Acknowledgements**

Preparation for this Annual Report in a timely manner would not have been possible without the coordinated efforts of the various financial staffs within the UNC HCS, with special assistance from the CEO's office and Public Affairs Office.



Charles F. Ayscue  
Chief Financial Officer



## Members of the Board of Directors

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*President, University of North Carolina*  
Chapel Hill, NC

**Richard L. Daugherty**

*Retired, Vice President, International  
Business Machines Corporation*  
Raleigh, NC

**M. Andrew Greganti, MD**

*Vice Chair, Department of Medicine,  
UNC School of Medicine*  
Chapel Hill, NC

**Richard M. Krasno**

*Executive Director, William R. Kenan, Jr.,  
Charitable Trust*  
Chapel Hill, NC

**Thomas F. Marsico**

*CEO, Marsico Capital Management*  
Cherry Hills Village, CO

**James Moeser**

*Chancellor,  
University of North Carolina at Chapel Hill*  
Chapel Hill, NC

**Gary L. Park**

*President, UNC Hospitals*  
Chapel Hill, NC

**Wyndham Robertson**

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Fortune Magazine*  
Chapel Hill, NC

**Marschall Runge, MD, PhD**

*President, UNC Physicians;  
Chair, Department of Medicine,  
UNC School of Medicine*  
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**William O. McCoy (Vice Chair)**

*Franklin Street Partners*  
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**Richard S. Myers, MD**

*Chairman, Board of Trustees, Rex Hospital*  
Raleigh, NC

**Paul J. Rizzo**

*Franklin Street Partners*  
Chapel Hill, NC

**William L. Roper, MD, MPH**

*Dean, UNC School of Medicine;  
Vice Chancellor for Medical Affairs;  
CEO, UNC Health Care System*  
Chapel Hill, NC

**Charles Sanders, MD**

*Retired Chairman and CEO, Glaxo Inc.*  
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**John S. Stevens**

*Attorney, Roberts & Stevens*  
Asheville, NC

**Robert S. Thomas**

*President and CEO, Charles & Colvard, Inc.*  
Raleigh, NC

**Nancy Suttentfield**

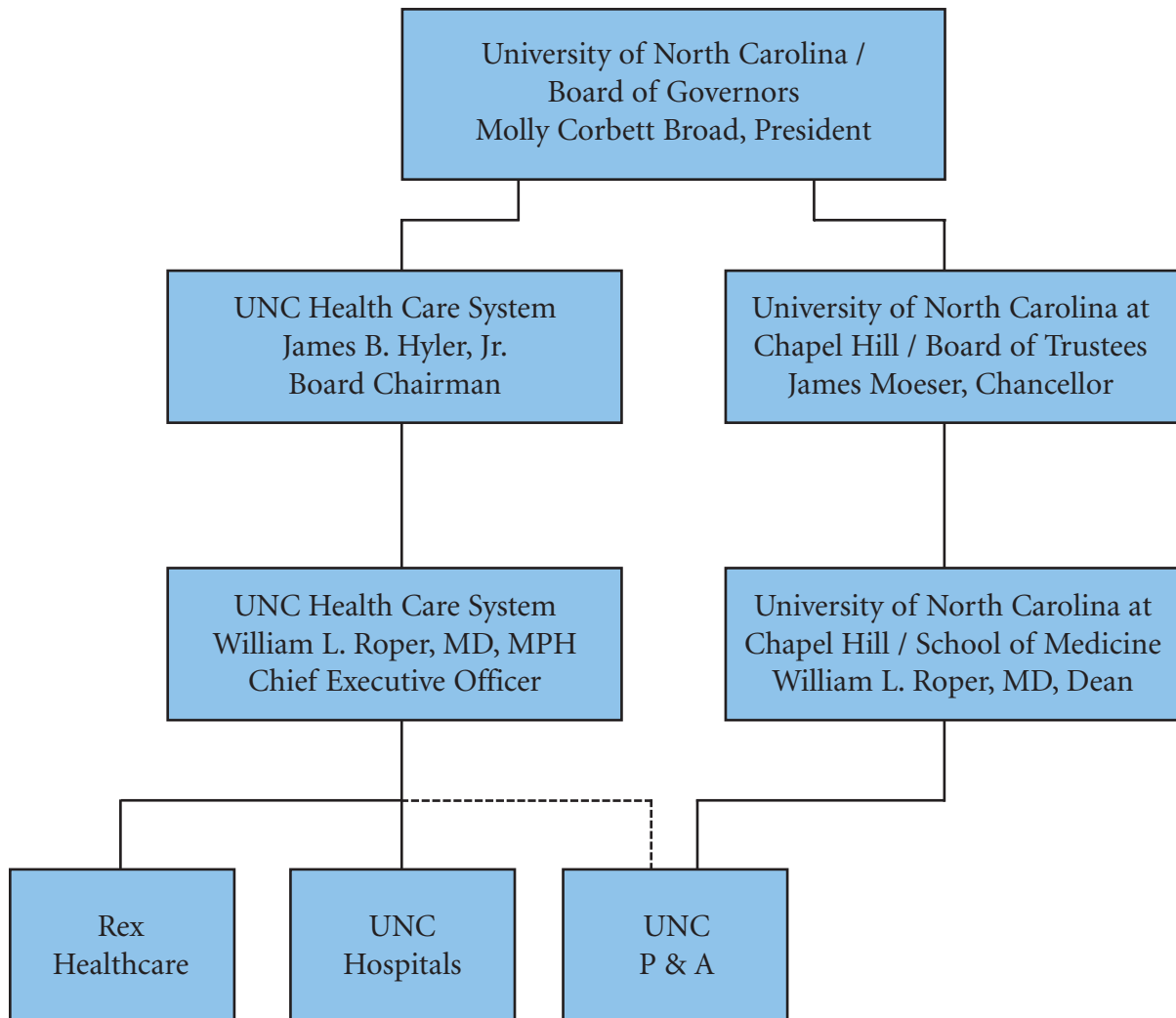
*Vice Chancellor for Finance and Administration,*  
*University of North Carolina at Chapel Hill*  
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**Phail Wynn, Jr., EdD, MBA**

*President, Durham Technical College*  
Durham, NC

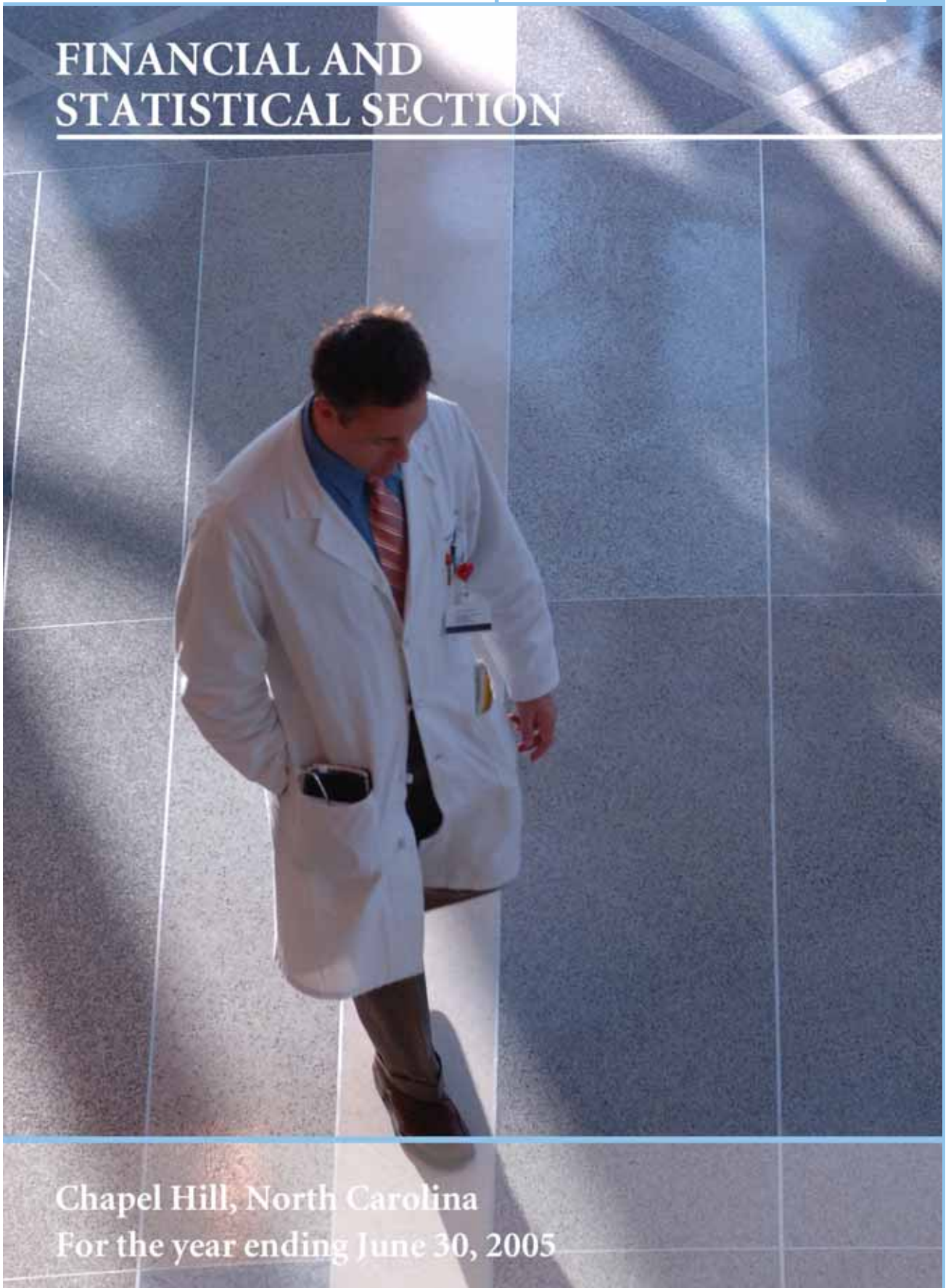


# UNC Health Care System Reporting Structure for the year ended June 30, 2005





# FINANCIAL AND STATISTICAL SECTION



Chapel Hill, North Carolina  
For the year ending June 30, 2005

## Management's Discussion and Analysis

### Introduction

Management's discussion and analysis provides an introduction and overview of the financial position and activities of the University of North Carolina Health Care System (UNC HCS) for the fiscal year ended June 30, 2005. The financial statements included for the UNC HCS — Statement of Net Assets and Statement of Revenues and Expenses — are labeled "Proforma" to demonstrate that they are an aggregation of assets and liabilities and results of financial activities which cannot be the subject of an unqualified opinion by an independent auditor. The reasons for the proforma descriptive are as follows:

The UNC HCS was established November 1, 1998 by North Carolina General Statute 116-37. The original legislation included only the University of North Carolina Hospitals (UNCH) and the clinical patient care programs of the School of Medicine of

the University of North Carolina at Chapel Hill. The UNC HCS is governed by a Board of Directors and as an affiliated enterprise of the University of North Carolina. The UNC HCS and UNC-Chapel Hill are sister entities. Rex Healthcare, Inc. (REX) and various community-based clinics have been added to the organization since its inception.

As illustrated on the organization chart on page 15 in the Introductory Section, the UNC HCS controls the net assets and financial operations of UNCH and REX. UNC-Chapel Hill owns and controls the net assets and financial operations of UNC Physicians & Associates (UNC P&A.) The UNC HCS Board of Directors governs and oversees physician credentialing, quality and patient safety, and resident training and acts to advise and review the financial activities of UNC P&A. Final direct control of the monetary





operations of UNC P&A remains within UNC-Chapel Hill. The physicians who provide patient care at UNCH and in UNC-Chapel Hill clinics are employees of UNC-Chapel Hill. Non-physician employees who assist in providing patient care and the associated administrative, billing, and collection services are employees of UNC HCS.

For purposes of these financial statements, UNC P&A serves as a financial proxy for the “clinical patient care programs of the School of Medicine.” The financial statements for the two entities directly controlled by the UNC HCS, UNCH and REX, are separately audited on an annual basis and have received unqualified opinions for their prior year reports. The financial activities of UNC P&A are included in the financial report and audit report of UNC-Chapel Hill, which have also received unqualified opinions for their prior year reports. Since an unqualified audit opinion on the aggregation of financial information for these three entities cannot be obtained, we have used the term “proforma” to describe fairly the full financial scope and worth of the UNC HCS.

In the interest of being concise, we have included proforma consolidated financial statements for

the UNC HCS, which include UNCH, REX, and UNC P&A. Since UNC P&A’s financial activities are not separately disclosed elsewhere, we are also presenting UNC P&A’s Statement of Net Assets and Statement of Revenues and Expenses for the fiscal year ending June 30, 2005.

#### **Using the Financial Statements**

The Governmental Accounting Standards Board (GASB) requires three basic statements: the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows. For the current year, the management of UNC HCS is only presenting proforma financial statements for the Statement of Net Assets and the Statement of Revenues and Expenses. In the future, the Statement of Cash Flows will be included as well; but this statement requires two years of comparative numbers for some of its calculations. The two statements for the current year provide information regarding the financial position and results of operations as of the report date. The proforma financial statements are presented and follow reporting concepts consistent with those required of a private business enterprise. The balances reported are presented in a classified format to aid the reader in understanding the nature of the operations. The accompanying notes are an integral part of this report and should be read in conjunction with the financial statements to enhance understanding. The

proforma Statement of Net Assets provides information relative to the assets, liabilities, and net assets as of the last day of the fiscal year. Assets and liabilities on this Statement are categorized as either current or non-current. 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. Under GASB, the net assets should be categorized as invested in capital assets (net of related debt), restricted or unrestricted; but due to the complexities of the various entities, no such distinction has been made. Overall, the Statement of Net Assets provides information relative to the financial strength of the organization and its ability to meet current and long-term obligations.

The proforma Statement of Revenues and Expenses provides information relative to the results of the enterprise's operations, non-operating activities and other activities affecting net assets, which occurred during the fiscal year. Non-operating activities include non-capital gifts and grants, investment income (net of investment expenses) and loss realized on the disposition of capital assets. Other activities include change in fair value of investments and gain or loss on affiliate activity. Under GASB, the subsidies from the State of North Carolina in the form of appropriations and bond interest expense are considered non-operating activities; but for these proforma statements, they are presented as operating. In addition, there would normally be included a beginning and ending balance for Net Assets; but since this is the first year of reporting, there is no beginning balance to present. In general, the Statement of Revenues and Expenses provides information relative to the management of the organization's operations and its ability to maintain its financial strength.

The Notes provide information relative to the significant accounting principles applied in the financial statements and further detail concerning the organization and its operations. In general, 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**

Since this is the first year of presenting proforma statements for the UNC HCS, there is no comparative data. It is management's intent to have comparative statements in succeeding years.

### **Analysis of Overall Financial Position and Results of Operations**

The UNC HCS Statement of Net Assets reflects a large, successful system, with almost \$1 billion in net assets. UNCH and REX combine for slightly over \$900 million, while UNC P&A has approximately \$92 million in net assets. For the year, the System generated an operating margin of 1.8%, or \$22.0 million on net operating revenue of \$1.2 billion. Net income was \$48.8 million, or 4.0%. In order to remain financially strong, to reinvest in new facilities and to retain the most highly trained work force, the UNC HCS's goal is to average at least 3% for its annual operating margin.

UNC P&A also had a very successful year financially. Its operating margin was 4.3% or \$8.3 million on operating revenue of \$192.5 million. Net income was \$10.6 million, or 5.5%.

#### **Discussion of Capital Asset and Long-Term Debt Activity**

##### *Capital Assets*

The System continued to improve and modernize its facilities during the past year. Projects at UNCH included the completion

of renovations for an Administrative Office Building for Information Services, the renovation of Seventh Floor Rehabilitation space, the replacement of the Patient Kitchen and additional renovation of inpatient care space vacated by the opening of the Women's and Children's Hospitals.

Capital projects placed in service at REX included a surgery center, expansion of operating rooms, and a Positron Emission Tomography (PET) scanner.

Looking to the future, considerable progress has been made on projects in planning. On August 5th, 2004, House Bill 1264 of the 2004 North Carolina Legislative Session was ratified and authorized the State to issue special indebtedness of up to \$180,000,000 in principal for acquiring, constructing and equipping a new cancer rehabilitation and

treatment center, a nearby physicians' office building and a walkway between the two.

#### *Long-Term Debt Activity*

The UNC HCS has no borrowing authority. Both UNCH and REX have issued revenue bonds in the past and may issue additional debt in the future if the need arises to finance construction projects and the market rates are favorable. UNC P&A issues its bonds through UNC-Chapel Hill. As such, its revenues and assets are a part of the bond covenants of UNC-Chapel Hill.

During the past fiscal year, UNCH refunded a portion of its bonds issued in 1996. As a result of this refunding, UNCH reduced its debt service requirements by \$1,871,194 over the next ten years and obtained an economic gain of \$1,167,053. Standard and Poor's and Moody's Ratings Services classified the 2005 bonds as AA- and A1 respectively.



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

The major source of funding for the UNC HCS is the revenue it generates from patient care services. Despite adjustments to billing rates on an annual basis, overall reimbursement has continued to deteriorate in recent years due to pressure from third-party payors and changes in the mix of the patient population. Meanwhile salaries, supplies and other operating expenses have continued to increase. These circumstances prompted management to engage Navigant Consulting and to implement many of their recommendations over the last year.

A more aggressive approach to cost reduction and revenue enhancement while not sacrificing the level of patient care has produced favorable results for this past year. However, the UNC HCS faces more challenges as the health care environment changes, along with the additional competition for governmental dollars that may be diverted away from the Medicare and Medicaid programs to fund other programs.

These changes are a result of efforts by the federal and state governments, private insurance companies and business coalitions to reduce and contain health care costs, including, but not limited to: the costs of inpatient and outpatient care, physician fees, capital expenditures and the costs of graduate medical education. Continuously under consideration are a wide variety of federal and state regulatory actions and legislative and policy changes by both governmental and private

agencies that administer Medicare, Medicaid, and other third-party payor programs that could impact our reimbursement. In addition, we are subject to actions by, among others, the Joint Commission on Accreditation of Healthcare Organizations (JCAHO), the Centers for Medicare and Medicaid Services (CMS) of the U.S. Department of Health and Human Services (DHHS), and other federal, state and local government agencies. The biggest concern for UNC HCS would be the elimination of cost based reimbursement that is currently received by UNCH and UNC P&A from the Medicaid program.

Medicaid Cost Report income represents an important source of funding for UNC P&A as represented by the \$6.8 million in net proceeds in FY05. Per the State Plan for Medical Assistance for North Carolina, the medical faculty practice plan of the UNC-Chapel Hill is reimbursed at cost and is cost-settled at year-end for services provided to Medicaid patients. A change to terminate this North Carolina Medicaid reimbursement methodology would materially alter the financial outlook for UNC P&A.

The outlook for Medicare reimbursement rates for UNC P&A is uncertain. Currently, there is a 4.3% reduction in payments scheduled for calendar year 2006. Medicare represents a significant sponsor for UNC P&A, and thus the scheduled reduction will negatively impact net patient service revenue. However, there is legislation that is currently proposed which would reverse the cut and instead institute a 1% increase in Medicare reimbursement rates.

**UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM  
PROFORMA STATEMENT OF NET ASSETS  
FOR THE YEAR ENDED JUNE 30, 2005**

	<b>2005</b>
<b>Current Assets</b>	
Cash and Investments	\$ 148,423,090
Patient Accounts Receivable – Net	182,941,405
Inventories	20,196,037
Estimated Third-Party Settlements	20,075,852
Other Assets and Receivables	23,079,551
Assets Whose Use is Limited or Restricted	10,249,207
Prepaid Expenses	8,629,510
<b>Total Current Assets</b>	<b>413,594,652</b>
<b>Non-current Assets</b>	
Property, Plant, and Equipment – Net	576,218,692
Assets Whose Use is Limited or Restricted	517,768,295
Other Assets	10,684,943
<b>Total Non-current Assets</b>	<b>1,104,671,930</b>
<b>TOTAL ASSETS</b>	<b>\$1,518,266,582</b>
<b>Current Liabilities</b>	
Accounts and Other Payables	51,891,613
Accrued Salaries and Benefits	25,871,145
Estimated Third-Party Settlements	6,963,000
Notes & Bonds Payable	12,639,700
Interest Payable	1,974,719
Other	12,284,553
<b>Total Current Liabilities</b>	<b>111,624,730</b>
<b>Non-current Liabilities</b>	
Notes & Bonds Payable – Net & Arbitrage	376,542,141
Compensated Absences	35,747,558
<b>Total Non-current Liabilities</b>	<b>412,289,699</b>
<b>TOTAL LIABILITIES</b>	<b>523,914,429</b>
<b>NET ASSETS</b>	<b>994,352,153</b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>1,518,266,582</b>

*Presented for Illustrative Purposes*

**UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM  
PROFORMA STATEMENT OF REVENUES AND EXPENSES  
FOR THE YEAR ENDED JUNE 30, 2005**

	2005
<b>Operating Revenue</b>	
Net Patient Service Revenue	\$ 1,106,407,800
State Appropriations	39,333,826
Other Operating Revenue	61,491,252
<b>NET OPERATING REVENUE</b>	<b>\$1,207,232,878</b>
<b>Operating Expenses</b>	
Salaries and Fringe Benefits	670,935,496
Medical and Surgical Supplies	199,469,207
Contracted Services	97,491,291
Other Supplies and Services	75,953,518
Communications and Utilities	23,600,383
Medical Malpractice Costs	28,963,665
Depreciation	63,243,169
Bond and Other Interest Expense	18,074,068
Medical School Trust Fund (MSTF)	7,459,983
<b>TOTAL OPERATING EXPENSES</b>	<b>\$1,185,190,780</b>
<b>OPERATING INCOME (LOSS)</b>	<b>22,042,098</b>
<b>Non-operating Gains (Losses)</b>	
Interest and Investment Income	19,056,445
Non-operating Income (Expense)	2,163,799
Gain (Loss) on Investment in Affiliates	51,021
Realized & Unrealized Investment Activity	5,478,000
<b>TOTAL NON-OPERATING GAINS (LOSSES)</b>	<b>26,749,265</b>
<b>NET INCOME (LOSS)</b>	<b>\$ 48,791,363</b>



**UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM  
UNIVERSITY OF NORTH CAROLINA PHYSICIANS & ASSOCIATES  
STATEMENT OF NET ASSETS (UNAUDITED)  
FOR THE YEAR ENDED JUNE 30, 2005**

	2005
<b>Current Assets</b>	
Cash and Investments	\$ 83,242,096
Patient Accounts Receivable – Net	24,048,671
Inventories	-
Estimated Third-Party Settlements	-
Other Assets and Receivables	1,868,887
Assets Whose Use is Limited or Restricted	6,438,566
Prepaid Expenses	-
<b>Total Current Assets</b>	<b>115,598,220</b>
<b>Non-current Assets</b>	
Property, Plant and Equipment – Net	10,598,100
Assets Whose Use is Limited or Restricted	-
Other Assets	-
<b>Total Non-current Assets</b>	<b>10,598,100</b>
<b>TOTAL ASSETS</b>	<b>\$126,196,320</b>
<b>Current Liabilities</b>	
Accounts and Other Payables	7,280,884
Accrued Salaries and Benefits	4,846,650
Estimated Third-Party Settlements	-
Notes & Bonds Payable	1,049,700
Interest Payable	-
Other	1,660,996
<b>Total Current Liabilities</b>	<b>14,838,230</b>
<b>Non-current Liabilities</b>	
Notes & Bonds Payable – Net & Arbitrage	9,548,400
Compensated Absences	9,990,518
<b>Total Non-current Liabilities</b>	<b>19,538,918</b>
<b>TOTAL LIABILITIES</b>	<b>34,377,148</b>
<b>NET ASSETS</b>	<b>91,819,172</b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>\$126,196,320</b>

**UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM  
UNIVERSITY OF NORTH CAROLINA PHYSICIANS & ASSOCIATES  
STATEMENT OF REVENUES AND EXPENSES (UNAUDITED)  
FOR THE YEAR ENDED JUNE 30, 2005**

	2005
<b>Operating Revenue</b>	
Net Patient Service Revenue	\$ 160,400,482
State Appropriations	-
Other Operating Revenue	32,077,595
<b>NET OPERATING REVENUE</b>	<b>\$192,478,077</b>
<b>Operating Expenses</b>	
Salaries and Fringe Benefits	137,266,362
Medical and Surgical Supplies	265,546
Contracted Services	3,001,381
Other Supplies and Services	19,684,001
Communications and Utilities	4,532,935
Medical Malpractice Costs	10,233,164
Depreciation	411,297
Bond and Other Interest Expense	1,355,470
Medical School Trust Fund (MSTF)	7,459,983
<b>TOTAL OPERATING EXPENSES</b>	<b>\$184,210,139</b>
<b>OPERATING INCOME (LOSS)</b>	<b>8,267,938</b>
<b>Non-operating Gains (Losses)</b>	
Interest and Investment Income	3,232,824
Non-operating Income (Expense)	(909,936)
Gain (Loss) on Investment in Affiliates	-
Realized & Unrealized Investment Activity	-
<b>TOTAL NON-OPERATING GAINS (LOSSES)</b>	<b>2,322,888</b>
<b>NET INCOME (LOSS)</b>	<b>\$ 10,590,826</b>

**UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM  
PROFORMA SELECTED STATISTICS AND RATIOS  
FOR THE YEAR ENDED JUNE 30, 2005**

	<b>Rex Sites</b>	<b>UNC Sites</b>	<b>UNC HCS Total</b>
<b>Patient Service Statistics</b>			
Patient Days	104,037	221,540	325,577
Inpatient Discharges	27,287	34,365	61,652
Average Length of Stay	3.81	6.45	5.28
Inpatient Operating Room Cases	7,707	9,259	16,966
Outpatient Operating Room Cases	21,826	11,404	33,230
Emergency Department Visits	52,915	65,894	118,809
Clinic Visits	40,541	680,689	721,230
Births/Deliveries	5,201	3,574	8,775
<b>Financial Ratios</b>			
Operating Margin Percentage			1.83%
Days in Net Accounts Receivable			60.35
Days of Cash on Hand			175.75
Average Payment Period (days)			36.31
Long-Term Debt to Equity			27.47%
Annual Debt Service Coverage			4.24

# University of North Carolina Health Care System Notes to the Annual Report for the year ended June 30, 2005

## NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES:

**Organization** - The University of North Carolina Health Care System (UNC HCS) was established November 1, 1998 by North Carolina General Statute 116-37. It is governed and administered as an affiliated enterprise of The University of North Carolina system with its stated purpose 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-Chapel Hill), and render other services designed to promote the health and well being of the citizens of North Carolina.

The original legislation included the University of North Carolina Hospitals at Chapel Hill (UNCH) and the clinical patient care programs established or maintained by the School of Medicine of the University of North Carolina at Chapel Hill. The UNC HCS is under the governance of the board of directors of the UNC HCS. Rex Healthcare, Inc and various community-based clinics have been added to the organization since its inception.

**The University of North Carolina Hospitals** is the only State-owned teaching hospital in North Carolina. With a licensed base of 688 beds, this facility serves as an acute care teaching hospital for the UNC-Chapel Hill. UNCH consists of North Carolina Memorial Hospital, North Carolina Children's Hospital, North Carolina Neurosciences Hospital and North Carolina Women's Hospital. As a State agency, UNCH is required to conform to financial requirements established by various statutory and constitutional provisions. While UNCH is exempt

from both federal and State income taxes, a small portion of its revenue is subject to the unrelated business income tax.

Other activities blended into the financial statements for UNCH include:

**Health System Properties, LLC** - Health System Properties (HSP) was established to purchase, develop and/or lease real property. HSP is reported as part of UNCH because UNC HCS is the sole member manager and HSP is governed by the same Board that directs UNCH's operations. To date, the only properties owned by HSP either have been or are being developed for the sole use and benefit of UNCH.

**Carolina Dialysis, LLC** - Carolina Dialysis, LLC (CDLLC) was formed for the purpose of owning and operating chronic dialysis programs, thus improving the quality of care to end-stage renal disease patients by providing dialysis services and conducting research in the field of nephrology in the State of North Carolina. UNCH has a two-third ownership interest in the CDLLC. Renal Research Institute owns the remaining one-third interest. A Board of Managers comprised of six members manages the CDLLC, with four appointed by UNCH through the Chief Executive Officer and two appointed by Renal Research Institute. The CDLLC is included as part of UNCH because the CDLLC provides services almost entirely to the UNCH's patients.

**The University of North Carolina Physicians & Associates** - (UNC P&A) is the clinical service component of the UNC School of Medicine. At the heart of UNC P&A are the approximately 900 physicians who provide a full range of specialty and primary care services for patients of UNCH. While the great majority of services are rendered on the UNC campus at UNCH

and the outpatient clinics, there is a growing range of services provided at clinics in the community. There are seventeen clinical departments, two affiliated departments and two administrative units that collectively form UNC P&A:

#### Clinical Departments:

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

#### Affiliated Departments:

Allied Health Sciences  
Center for Development and Learning

#### Administrative Units:

Administrative Office (Billing & Collections, Managed Care)  
Ambulatory Administration

While UNC P&A is affiliated with the UNC HCS, the net assets of UNC P&A are held in a UNC-Chapel Hill trust fund. The operating income and expenses for UNC P&A are managed via the UNC-Chapel Hill's accounting infrastructure and as such, its operational results are included in the annual audit for UNC-Chapel Hill.

**Rex Healthcare Inc.** (REX) is a North Carolina not-for-profit corporation organized to provide

a broad range of health care services to residents of the Triangle area of North Carolina. Acting through its network of operating affiliates, REX provides health care to patients from several locations through continued development of acute care and non-hospital programs.

In April 2000, REX's sole member, the John Rex Endowment, assigned and transferred the membership interest in REX to the UNC HCS. The System appoints eight of the thirteen seats on REX's Board of Trustees. Additionally, the UNC HCS reviews and approves REX's annual operating and capital budgets.

The activities of the principal corporate entities under the common control of REX are summarized as follows:

***Rex Hospital, Inc.*** - Rex Hospital, Inc. (REXH), located in Raleigh, North Carolina, is a 394-bed acute care hospital, which also operates six hospice beds. REXH provides inpatient, outpatient, and emergency services primarily to the residents of Wake County, North Carolina. REXH also operates Rex Heart Center, Rex Cancer Center, Rex Convalescent Care Center, a 120-bed nursing facility and 20-bed home for the aged and Rex Primary Care. During 2003, REXH worked with the physician groups comprising Rex Primary Care to return most of the groups to private practice.

***Rex Outreach Services, Inc.*** - Rex Outreach Services, Inc. (Outreach) is a North Carolina not-for-profit corporation organized to provide a variety of community wellness programs to the residents of Wake County, North Carolina. Services provided include the operation of the 107-bed Apex Nursing Care Center and two wellness centers. Outreach also owns Rex Home Services, Inc., a North Carolina not-for-profit corporation, organized to provide home care

services primarily to residents of the Triangle area. ***Rex Enterprises, Inc.*** - Rex Enterprises, Inc. (Enterprises) is a North Carolina for-profit corporation organized to promote the health and welfare of the residents of Wake County.

***Rex Healthcare Foundation, Inc.*** - Rex Healthcare Foundation, Inc. (the Foundation) is a North Carolina not-for-profit corporation organized to promote the health and welfare of the people of the Triangle area by promoting philanthropic contributions and public support of REX.

***Community-Based Practices*** - The network of Community-Based Practices (CBPs) is an outreach activity of the UNC HCS which brings quality primary and specialty outpatient care to communities in the Triangle region, including several rural communities. This network has thirteen outreach clinics providing nearly 150,000 visits a year. Ten of the thirteen practices are UNC HCS sponsored, with financial support coming from both UNC P&A and UNC Hospitals. These practices primarily serve the UNC HCS's patient care mission, along with some education role. The physicians practicing in the network clinics spend all or almost all of their time providing ambulatory patient care. The other three practices are sponsored by and the financial responsibility of UNC School of Medicine departments, with consultative support provided by CBP Administration. These CBPs are the source of a significant amount of ancillary testing, inpatient care and specialty care referred to the main Chapel Hill UNC HCS campus.

**Basis of Presentation** - The accompanying financial statements present all activities under the direction of the UNC HCS Board of Directors. The financial statements for UNC HCS are

presented as a compilation of the various statements generated by its separate entities. UNCH and REX issue their own audited financial statements while UNC P&A is included as a part of the audited statements for the UNC-Chapel Hill.

In compiling the financial statements for the UNC HCS, significant intercompany transactions and balances between the related parties have been eliminated. In addition, while the general statutes refer to only the clinical operations of the School of Medicine, which are reported through UNC P&A, this annual report includes the assets, liabilities and net assets of UNC P&A, which are included in the audited financial statements for UNC-Chapel Hill.

**Basis of Accounting** - The statements of the various entities have been prepared using the accrual basis of accounting for UNCH and REX and the modified basis of accounting for UNC P&A. Under the accrual basis, revenues are recognized when earned, and expenses are recorded when an obligation has been incurred. When preparing the financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from the estimates. For UNC P&A, their monthly financials are maintained on a cash basis and then at year-end, adjustments are made to accrue all known material amounts for revenue and expense.

### Financial Statement Classifications and Categories

**Current and Non-current Designation** - Assets are classified as current when they are expected to be collected within the next twelve months or consumed for a current expense in the case of cash or prepaid items. Liabilities are classified as current if they are due and payable within the next twelve months.

**Revenue and Expense Recognition** - Revenues and expenses are classified as operating or non-operating in the accompanying Statements of Revenues and Expenses. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as charges for inpatient and outpatient services as well as external customers who purchase medical services or supplies. Operating expenses are all expense transactions incurred other than those related to capital and non-capital financing or investing activities.

Non-operating revenues include activities that have the characteristics of non-exchange transactions. Revenues from non-exchange transactions that represent subsidies or gifts, as well as investment income, are considered non-operating since these are either investing, capital, or non-capital financing activities.

**Cash and Cash Equivalents** - This classification includes petty cash, security deposits, cash on deposit in private bank accounts, and deposits held by the State Treasurer in its short-term investment fund (STIF). The STIF account 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. All highly liquid investments with an original maturity of three months or less, and which are not designated as investments, are considered to be cash equivalents and are recorded at cost, which approximates market. UNC-Chapel Hill manages the funds of UNC P&A as authorized by The University of North Carolina Board of Governors pursuant to General Statute 116-36.1 and Section 600.2.4 of the Policy Manual of the University of North Carolina. Special funds and funds received for services rendered by health care professionals pursuant to General Statute 116-36.1(h) are invested in the same manner as the State Treasurer is required to invest. Investments of various funds may be pooled unless prohibited by statute or by terms of the gift or contract. UNC-Chapel Hill utilizes investment pools to manage investments and distribute investment income. Shares in the temporary pool trade at a fixed value of \$1 per share.

**Investments** - This classification includes marketable debt and equity securities with readily determinable fair values, including assets whose use is limited, and are measured at fair value. Investment income or loss (including realized and unrealized gains and losses on investments, interest, and dividends) is included in non-operating income (loss). The calculation of realized gains and losses is independent of a calculation of the net change in the fair value of investments.

**Patient Accounts Receivable, Net** - Net patient accounts receivable consists of unbilled (in-house patients, inpatients discharged but not final billed and outpatients not final billed) and billed amounts. Payment of these charges comes primarily from managed care payors, Medicare,

Medicaid and, to a lesser extent, the patient. The amounts recorded in the financial statements are net of indigent (charity) care, contractual allowances and allowances for bad debt to determine the net realizable value of the accounts receivable balance.

Reserves for these deductions are recorded based on the historical collection percentage realized for each payor and projections for future collection rates. Flexible payment arrangements with selected payors have been established to optimize collection of past-due accounts, and any amounts payable beyond one year are classified as non-current assets.

**Estimated Third-Party Settlements** - Estimated third-party amounts represent settlements with Medicare, Tricare and Medicaid programs that may result in a receivable or a payable. Reimbursement for cost-based items are paid at a tentative interim rate with final settlement determined after submission of annual cost reports and audits thereof by fiscal intermediaries. Final settlements under the Medicare and Medicaid programs are based on regulations established by the respective programs and as interpreted by fiscal intermediaries. The classification of patients under the Medicare and Medicaid programs as well as the appropriateness of their admission is subject to review. Several years of cost reports are currently under review.

**Inventories** - Inventories consist of medical and surgical supplies, pharmaceuticals, prosthetics, and other supplies that are used to provide patient care or by service departments. Inventories are stated at the lower of cost or market on the FIFO (first-in, first-out) basis.

**Other Assets and Receivables** - Other assets and

receivables relate to items such as sales tax refunds due from the North Carolina Department of Revenue, amounts due from affiliates and other state agencies, and billings to outside companies for ancillary testing.

**Assets Whose Use is Limited or Restricted** -

Current assets whose use is limited or restricted include the debt service funds established with the trustee in accordance with the bond indenture agreements and donor restrictions. The debt service funds will be used to pay bond interest and principal as it becomes due.

Non-current assets whose use is limited or restricted include the bond proceeds for construction projects, the funds required by the bond indenture agreements, funds in the maintenance reserve fund that will be used to acquire or construct future property, plant or equipment and the money on deposit with the Liability Insurance Trust Fund.

**Prepaid Expenses** - Prepaid expenses represent current year expenditures for services that extend beyond the current reporting cycle. Payments include insurance premiums, maintenance contracts and lease arrangements.

**Property, Plant and Equipment** - Property, plant and equipment are stated at cost at date of acquisition or fair value at date of donation in the case of gifts. The value of assets constructed includes all material direct and indirect construction costs. Interest costs incurred during the period of construction are capitalized. Only assets having a cost or fair value of at least \$5,000 and an estimated useful life of three years or more are capitalized. Assets under capital lease are stated at the present value of the minimum lease payments at the inception of the lease.



Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 3 to 20 years for equipment, 10 to 50 years for buildings and fixed equipment and 5 to 25 years for general infrastructure and building improvements. Assets under capital leases and leasehold improvements are depreciated over the related lease term, generally periods ranging from 5 to 7 years.

**Other Non-current Assets** - Other non-current assets include amounts for long-term payment arrangements for patient accounts receivable, bond issuance costs-net of amortization, and investments in affiliates.

**Accounts and Other Payables** - Accounts and other payables represent the accrual of expenses for goods and services that have been received as of the end of the year, but have not been paid.

**Accrued Salaries and Benefits** - Accrued salaries and benefits represent the accrual of salaries and associated benefits earned as of the end of the year, but which have not been paid.

**Notes and Bonds Payable** - Note and bonds payable represent debt issued for the construction of buildings and the acquisition of equipment. The current amount is the portion of bonds due within one year and the balance is reflected as non-current. The bonds carry various interest rates ranging from 2.26% variable at year-end to 5.25% fixed. The various bond series have fixed, variable or synthetic rates with final maturity in February 2031.

Bonds payable are reported net of unamortized discount, premium and deferred loss on refundings. Amortization of these amounts is done using either the effective interest method or the straight-line method.

The notes payable carry various interest rates ranging from 1.97% variable to 4.95% fixed with a final maturity in January 2009.

**Interest Payable** - Interest payable represents accrued interest at the end of the year that has not yet been paid.

**Other Current Liabilities** - Other current liabilities represent funds held for others and amounts due to patients or third parties for credit balances.

**Compensated Absences** - Compensated absences represent the liability for employees with accumulated leave balances earned through the various leave programs. These amounts would be payable if an employee terminated employment. Employees earn leave at varying rates depending upon their years of service and the leave plan in which they participate.

**Net Assets** - Net assets represent the difference between assets and liabilities. Due to the complexities of consolidating these entities, only a combined number is shown for net assets. Normally, under general accepted accounting principles, the net asset category would be further categorized as the amounts (1) Invested in Capital Assets, Net of Related Debt, (2) Restricted Net Assets - Expendable and (3) Unrestricted Net Assets.

**Net Patient Service Revenue** - Patient service revenue is recorded at established rates when services are provided; contractual adjustments, estimated bad debt expenses and services qualifying as indigent (or charity care) are deducted to arrive at net patient service revenue. Contractual adjustments arise under reimbursement agreements with Medicare, Medicaid, certain insurance carriers, health maintenance

organizations, and preferred provider organizations, which provide for payments that are generally less than established billing rates. The difference between established rates and the estimated amount collectable is recognized as revenue deductions on an accrual basis.

**Indigent care** provided represents health care services that were provided free of charge to individuals who meet the criteria of the UNC HCS's charity care policy. Indigent care provided is not considered to be revenue.

**Medicare** reimburses for inpatient acute care services under the provisions of the Prospective Payment System (PPS). Under PPS, payment is made at predetermined rates for treating various diagnoses and performing procedures that have been grouped into defined diagnostic-related groups (DRGs) applicable to each patient discharge, rather than on the basis of the Hospitals' allowable charges. Psychiatric and rehabilitation inpatient services are reimbursed under separate programs.

A prospective payment system for outpatient services was implemented August 1, 2000, and is based on ambulatory payment classifications. It applies to most hospital outpatient services other than ambulance, rehabilitation services, clinical diagnostic laboratory services, dialysis for end-stage renal disease, non-implantable durable medical equipment, prosthetic devices, and orthotics.

**Medicaid** reimburses inpatient services on an interim basis under a Prospective Payment System. Medicaid uses the Medicare DRG system with the addition of six neonatal

DRGs. Medicaid reimburses outpatient services on the basis of documented cost for all services except ambulance, hearing aids, durable medical equipment (DME), outpatient pharmacy, home health, dialysis, and diagnostic laboratory services. Payment is made based on a tentative reimbursement rate with final settlement determined after submission of annual cost reports.

**Medical and Surgical Supplies** - Medical and surgical supplies represent the items used to provide patient care. This includes instruments, special medical devices, and pharmaceuticals.

**Medical Malpractice Costs** - Medical malpractice costs represent the actuarially determined contributions required. This estimate is intended to include both reported claims and claims that have been incurred but not reported.

**Medical School Trust Fund** - Medical school trust fund (MSTF) expenses represent an assessment of 4.6% of net patient service revenue. The MSTF funds are at the Dean's discretion for the support of projects such as program development and recruitment incentives for new department chairs.

**Donated Services** - No amounts have been included for donated services since no objective basis is available to measure the value of such services. However, a substantial number of volunteers donated significant amounts of their time to the operations of the UNC HCS.

**Concentrations of Credit Risk** - The UNC HCS provides services to a relatively compact area surrounding the Research Triangle Park, without collateral or other proof of ability to pay. Concentration of credit risk with respect to patient accounts receivable are limited due to large numbers of patients served and formalized agreements with third-party payors. Significant accounts receivable are dependent upon the performance of certain governmental programs, primarily Medicare and North Carolina Medicaid for their collectibility. Management does not believe there are significant credit risks associated with these governmental programs.

The aggregate mix of gross receivables from patients and third-party payors on June 30 was Medicare - 24%, Managed care- 23%, Commercial - 18%, Medicaid - 16%, Self pay - 13% and Other - 6%.

**NOTE 2 -  
ESTIMATED THIRD-PARTY SETTLEMENTS**

The amount shown as current assets represents estimated receivables due to UNCH from Medicare in the amount of \$909,985, Medicaid in the amount of \$14,120,551 and Tricare/Champus in the amount of \$3,673,403. In addition, there were \$1,371,913 in pass-through payments earned but not received from Medicare as of June 30.

The amount shown as current liabilities represents estimated payables due from REX to Medicare in the amount of \$50,000 and Medicaid in the amount of \$6,913,000.

Tricare/Champus is a federal insurance program for eligible active duty and retired military

personnel and their dependents. Tricare/Champus makes adjustments to its interim payments for certain portions of direct medical education and capital costs. These amounts are computed upon completion of the Medicare Cost Report.

**NOTE 3 - CAPITAL ASSETS:**

A summary of capital assets as of June 30 was:

Land and Improvements	50,070,789
Buildings and Improvements	487,725,952
Equipment	485,941,242
Construction in Progress	34,833,167
Less:	
Accumulated Depreciation	(482,352,458)
<b>TOTAL</b>	<b>\$ 576,218,692</b>

**NOTE 4 - LONG-TERM DEBT:**

A summary of outstanding bond debt and related issuance costs as of June 30 was:

Rex Series 1998 Bonds	103,435,000
UNC P&A Series Bonds	10,598,100
UNCH Series 1996 Bonds	2,685,000
UNCH Series 1999 Bonds	50,710,000
UNCH Series 2001 Bonds	106,000,000
UNCH Series 2003 Bonds	97,045,000
UNCH Series 2005 Bonds	30,540,000
<b>Face Value of Bonds Outstanding</b>	<b>\$ 401,013,100</b>
Deferred Costs - Discount on Insurance	(1,300,719)
Deferred Costs - Loss on Refunding	(17,477,054)
Deferred Costs - Premium on Insurance	1,965,883
Arbitrage Rebate Payable	3,769,794
<b>Net Value of Bonds Outstanding</b>	<b>\$ 387,971,004</b>
Current Portion of Bonds	12,639,700
Non-current Portion of Bonds	375,331,304
Notes and Other Non-current Payables	1,210,837
<b>Total Non-current Notes and Bonds Payables</b>	<b>\$ 376,542,141</b>

As currently constituted, the UNC HCS has no authority to issue debt. Only the individual entities within the system have assets and revenue that can be pledged as collateral for the debt.

The annual requirements to pay principal and interest on long-term obligations on June 30, 2005, are:

<u>Fiscal Year</u>	<u>Bonds Payable</u>	
	<u>Principal</u>	<u>Interest</u>
2006	\$ 12,639,700	\$ 14,711,250
2007	13,119,700	14,666,615
2008	13,619,700	14,142,380
2009	13,849,800	13,532,845
2010	14,489,800	12,974,563
2011-2015	80,074,400	55,252,553
2016-2020	79,210,000	36,806,114
2021-2025	76,615,000	20,692,840
2026-2030	79,195,000	7,824,096
2031	18,200,000	260,335
<b>Total Requirements</b>	<b>\$ 401,013,100</b>	<b>\$ 190,863,591</b>

#### NOTE 5 - PENSION PLANS

The UNC HCS has a variety of retirement plans available to its permanent full-time employees. The majority of employees of UNCH and UNC P&A are members of the Teachers' and State Employees' Retirement System (the System) as a condition of employment. The System is a cost-sharing multiple-employer defined benefit pension plan established by the State to provide pension benefits for employees of the State, its component units and local boards of education. The plan is administered by the North Carolina State Treasurer. Graduate medical residents,

temporary employees and permanent part-time employees with appointments of less than 30 hours per week are not covered by the plan.

The Optional Retirement Program (the Program) is a defined contribution retirement plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Administrators and eligible faculty of the University may join the Program instead of the Teachers' and State Employees' Retirement System. The Board of Governors of The University of North Carolina is responsible for the administration of the Program. Participants in the Program are immediately vested in the value of employee contributions. The value of employer contributions is vested after five years of participation in the Program. Participants become eligible to receive distributions when they terminate employment or retire.

REX sponsors a single-employer defined benefit retirement plan available to eligible employees. The benefit formula is based on the highest five consecutive years of an employee's compensation during the ten plan years preceding retirement. There are no employee contributions to the plan.

Funding amounts for all of the plans are based upon actuarial calculations.

In addition to the employer plans, the UNC HCS employees may elect to participate in any number of deferred compensation and Supplemental Retirement Income Plans. These include 401(k) plans, 403(b) plans and 457 Plans. All costs of administering and funding the plans are the responsibility of the participants. REX employees may contribute to a tax-deferred annuity plan.

**NOTE 6 - OTHER EMPLOYMENT BENEFITS**

UNCH & UNC P&A participate in State-administered programs that provide health insurance and life insurance to current and eligible former employees. Funding for the health care benefit is financed on a pay-as-you-go basis based upon actuarial reports. UNCH & UNC P&A assume no liability for retiree health care benefits provided by the programs other than their required contributions.

UNCH & UNC P&A participate in the Disability Income Plan of North Carolina (DIPNC). DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System. UNCH & UNC P&A assume no liability for long-term disability benefits under the plan other than their contribution.

REX offers a full menu of employment benefits to its employees through various third-party carriers. These include medical insurance, dental coverage, short-term and long-term disability benefits, and life insurance coverage.

More information about these plans can be found in the individual audit reports for the various entities.

**NOTE 7 - RISK MANAGEMENT**

The UNC HCS is exposed to various risks of loss related to torts; theft of, damage to and the destruction of assets; errors and omissions; employee injuries and illnesses; natural disasters; medical malpractice; and various employee plans for health, dental, and accident. These exposures to loss are handled by a combination of methods, including participation in State-

administered insurance programs, purchase of commercial insurance, and self-retention of certain risks. There have been no significant reductions in insurance coverage from the previous year.

**Liability Insurance Trust Fund** - UNCH and UNC P&A participate in the Liability Insurance Trust Fund (the Fund), a claims-servicing public entity risk pool for professional liability protection. The Fund acts as a servicer of professional liability claims, managing separate accounts for each participant from which the losses of that participant are paid. Although participant assessments are determined on an actuarial basis, ultimate liability for claims remains with the participants and, accordingly, the insurance risks are not transferred to the Fund. On June 30, 2005, the UNC HCS had advance deposits with the Fund totaling \$6,325,961.

Additional disclosures relative to the funding status and obligations of the Fund are set forth in the audited financial statements of the Liability Insurance Trust Fund for the years ended June 30, 2005 and 2004. Copies of this report may be obtained from The University of North Carolina Liability Insurance Trust Fund, Room 6001 East Wing, University of North Carolina Hospitals, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-3041.

**NOTE 8 - RELATED PARTY TRANSACTIONS**

**The Medical Foundation of North Carolina, Inc.** - UNCH & UNC P&A benefit from the support of The Medical Foundation of North Carolina, Inc., a nonprofit foundation affiliated with the University of North Carolina at Chapel Hill and UNCH, which solicits gifts and grants for the benefit of both entities. The Board of Directors of the Medical Foundation administers the funds

of the Foundation. Transactions are recorded only by the Foundation. If the Foundation were to purchase any equipment for UNCH, then the amount would be recorded at the time of receipt on UNCH's financial statements.

**UNC Health Care System** - On April 13, 2000, the UNC HCS entered into a contractual agreement with REX and the John Rex Endowment (a private, nonprofit corporation separate from the UNC HCS) to gain a controlling interest in the governance of REX and related entities. At the signing of the agreement, the UNCH transferred \$100 million on behalf of the UNC HCS to the John Rex Endowment as a result of the contractual agreement. The transaction was recorded as an equity transfer. In addition, the agreement calls for future funding of REX capital needs for the next ten years up to \$58 million. To date, there have been no calls under the agreement because the capital needs have been funded by REX's operating surplus.

**John Rex Endowment** - The John Rex Endowment (Endowment) operates as a 501(c)(3) corporation and is independent of the Board of Directors of the UNC HCS. Its purpose is to advance the health and well-being of the residents of the greater Triangle area, with specific funds set aside for indigent care and to make grants to support health services, education, prevention and research. In discharging its purposes, priority consideration will be given to any funding requests from REX, the UNC HCS and their affiliates. The funding source for the Endowment is the \$100 million transfer that came from UNCH. The Endowment has committed \$25 million for capital projects at REX.



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