

STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA STATE UNIVERSITY

RALEIGH, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2003

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT OF

NORTH CAROLINA STATE UNIVERSITY

RALEIGH, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2003

BOARD OF GOVERNORS

THE UNIVERSITY OF NORTH CAROLINA

MOLLY CORBETT BROAD, PRESIDENT

BOARD OF TRUSTEES

PEACHES GUNTER BLANK, CHAIRMAN

RICHARD G. ROBB, VICE CHAIRMAN

DERICK S. CLOSE, VICE CHAIRMAN

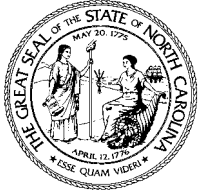
**MICHAEL D. ANTHONY
D. MCQUEEN CAMPBELL, III
WILLIAM STEVEN EDWARDS
ANN B. GOODNIGHT
SUZANNE GORDON**

**EDWARD E. HOOD, JR.
ROBERT L. MATTOCKS, II
WENDELL MURPHY
C. RICHARD VAUGHN
CASSIUS S. WILLIAMS**

ADMINISTRATIVE OFFICERS

DR. MARYE ANNE FOX, CHANCELLOR

GEORGE WORSLEY, VICE CHANCELLOR FOR FINANCE AND BUSINESS



Ralph Campbell, Jr.
State Auditor

STATE OF NORTH CAROLINA
Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet <http://www.osa.state.nc.us>

AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Board of Trustees, North Carolina State University

This report presents the results of our financial statement audit of North Carolina State University, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, for the year ended June 30, 2003. Our audit was made by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

The accounts and operations of the University are an integral part of the State's reporting entity represented in the State's *Comprehensive Annual Financial Report (CAFR)* and the State's *Single Audit Report*. In those reports, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor also presents the audit results on the State's internal controls and on the State's compliance with laws, regulations, contracts, and grants applicable to the State's financial statements and to its federal financial assistance programs.

As part of the audit work necessary for the CAFR and the *Single Audit Report*, the accounts and operations of the University were subjected to audit procedures as we considered necessary. In addition, we performed auditing procedures that we considered necessary for us to report on the accompanying financial statements that relate solely to North Carolina State University. The audit procedures were 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.

The purpose of this report is to present the results of our audit on the accompanying financial statements that relate solely to North Carolina State University. A summary of our reporting objectives and audit results is:

- 1. Objective** – To express an opinion on the accompanying financial statements that relate solely to North Carolina State University.

Results - The accompanying financial statements present fairly, in all material respects, the amounts and disclosures made in accordance with accounting principles generally accepted in the United States of America. These matters are more fully described in the Independent Auditor's Report on the Financial Statements.

AUDITOR'S TRANSMITTAL (CONCLUDED)

2. **Objective** – To present significant deficiencies, if any, in internal control over financial reporting which could adversely affect the University's ability to record, process, summarize, and report financial data in the financial statements and present instances of noncompliance, if any, with laws, regulations, contracts, or grants.

Results - Our tests disclosed no material weaknesses in internal control over financial reporting and no instances of noncompliance which require disclosure herein under *Government Auditing Standards*. These matters are more fully described in the Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting.

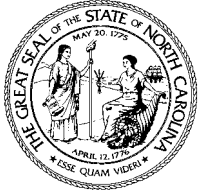
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.



Ralph Campbell, Jr.
State Auditor

TABLE OF CONTENTS

	PAGE
INDEPENDENT AUDITOR’S REPORT	1
MANAGEMENT’S DISCUSSION AND ANALYSIS	3
BASIC FINANCIAL STATEMENTS	
Exhibits	
A Statement of Net Assets	19
B Statement of Revenues, Expenses, and Changes in Net Assets	21
C Statement of Cash Flows	22
Notes to the Financial Statement	25
SUPPLEMENTARY INFORMATION	
Schedule	
1 Schedule of General Obligation Bond Project Authorizations, Budgets, and Expenditures	64
INDEPENDENT AUDITOR’S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH <i>GOVERNMENT AUDITING</i> <i>STANDARDS</i>	67
DISTRIBUTION OF AUDIT REPORT	69



Ralph Campbell, Jr.
State Auditor

STATE OF NORTH CAROLINA
Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet <http://www.osa.state.nc.us>

INDEPENDENT AUDITOR'S REPORT

Board of Trustees
North Carolina State University
Raleigh, North Carolina

We have audited the accompanying basic financial statements of North Carolina State University, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, as of and for the year ended June 30, 2003, as listed in the table of contents. These financial statements are the responsibility of the University's management. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of North Carolina State University as of June 30, 2003, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 17 to the financial statements, the University implemented Governmental Accounting Standards Board Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, during the year ended June 30, 2003.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 25, 2003 on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

The Management's Discussion and Analysis (MD&A), as listed in the table of contents, is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedule 1 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



Ralph Campbell, Jr.
State Auditor

November 25, 2003

MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The following discussion and analysis provides an overview to assist the reader in interpreting and understanding the accompanying basic financial statements. This overview includes comparative financial analysis with discussion of significant changes from the prior year, as well as, a discussion of currently known facts, decisions, and conditions. This information is provided by the University's financial management in conjunction with the issuance of the accompanying financial statements.

Using the Financial Statements

The financial statements of the University provide information regarding its financial position and results of operations as of the report date. The *Statement of Net Assets* is used to evaluate the University's financial position; and the *Statement of Revenues, Expenses, and Changes in Net Assets* is used to evaluate its results of operations. These two financial statements are inter-related in that the accounting transactions associated with the University's activities are reflected on both statements. One side of the transaction records the effect on assets and liabilities, while the other side records the effect on revenue and expenses. These statements are articulated by agreeing the ending net asset balance reported on both statements.

The financial statements also include a *Statement of Cash Flows*. This statement is used to identify the University's sources and uses of cash. This statement articulates with the other statements by agreeing the ending cash reported to the *Statement of Net Assets* and the net operating loss reported to the *Statement of Revenues, Expenses, and Changes in Net Assets*.

The three statements described above are the basic financial statements required by the Governmental Accounting Standards Board (GASB) accounting principles. In accordance with the GASB, the financial statements are presented on the University as a whole and are similar to that required of private universities and use reporting concepts in a manner similar to that required of a business enterprise. The financial statement balances reported are presented in a classified format to aid the reader in understanding the nature of the financial statement balance. These new statements were effective beginning with fiscal year 2002.

In using the financial statements, the *Note Disclosures* accompanying the financials statements should be read in conjunction with the financial statements. The note disclosures provide information regarding the significant accounting principles applied in the financial statements, authority for and associated risk of deposits and investments, detailed information on long-term liabilities, detailed information on accounts receivable, accounts payable, revenues and expenses, required information on pension plans and other post employment benefits, insurance against losses, commitments and contingencies, accounting changes, and if necessary a discussion of adjustments to prior periods and events subsequent to the University's financial statement period. Overall, these disclosures provide information to better understand details, risk, and uncertainty associated with amounts reported in the Financial Statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Comparative Condensed Financial Statement Information

Statement of Net Assets

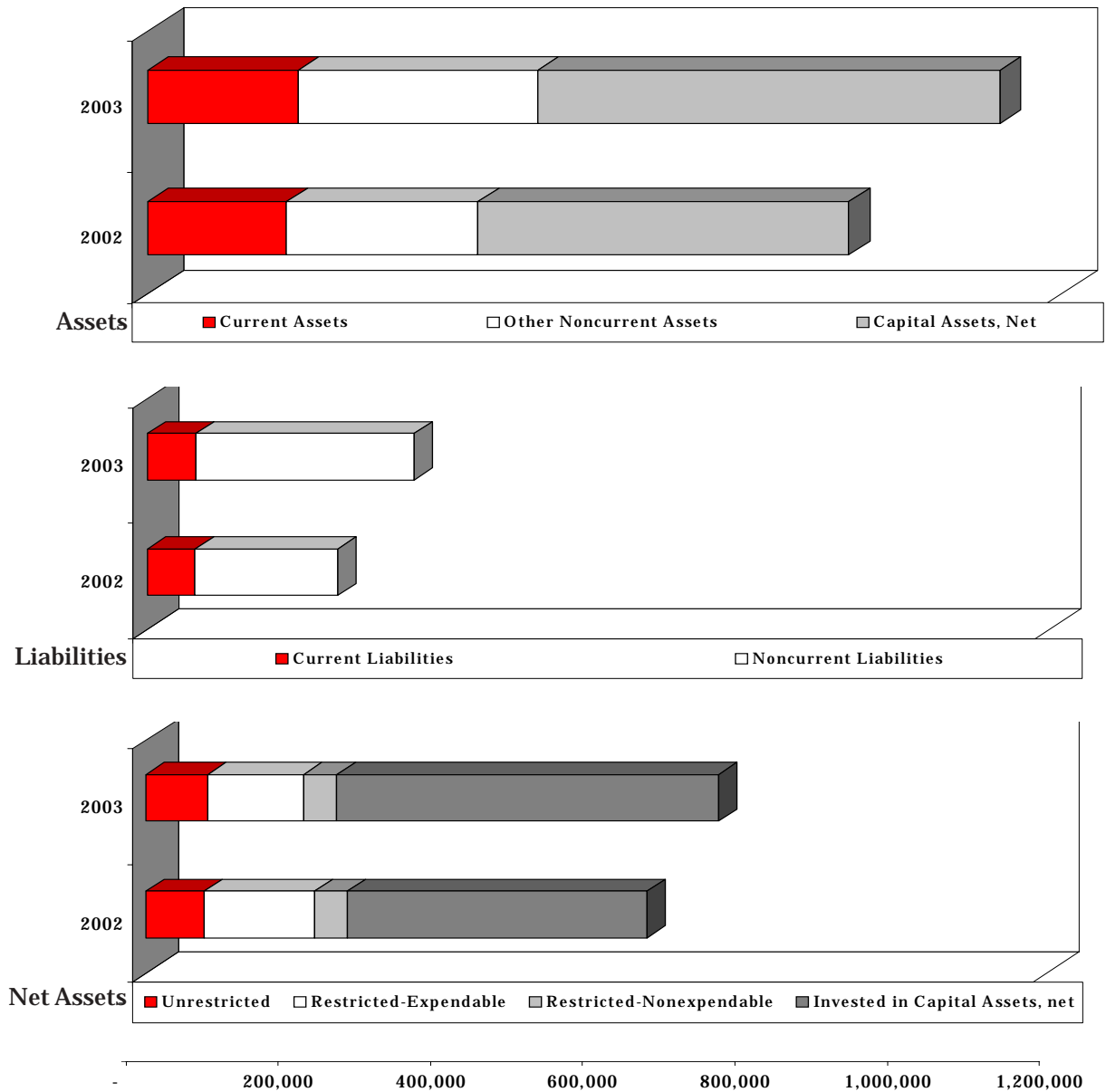
The *Statement of Net Assets* provides information regarding the University's assets, liabilities, and net assets as of June 30, 2003. The asset and liability balances are classified as either current or non-current. Assets classified as current are those that are available to pay for current liabilities or current year expenditures. Liabilities classified as current are those that are due and payable in the next fiscal year. The net asset balances are classified as either invested in capital assets (net of related debt), restricted or unrestricted. In addition, net assets classified as restricted are classified as either nonexpendable or expendable. Overall, the *Statement of Net Assets* provides information to evaluate the financial strength of the University and its ability to meet current and long-term obligations.

Following is a comparative analysis of the condensed balances reported in the *Statement of Net Assets* as of June 30, 2003 and 2002 (in thousands).

	2003	2002	Percent Change %
ASSETS			
Current Assets	\$ 197,371	\$182,982	7.8
Capital Assets, Net	606,398	486,825	24.6
Other Noncurrent Assets	314,667	250,977	25.4
Total Assets	<u>1,118,436</u>	<u>920,784</u>	21.5
LIABILITIES			
Current Liabilities	\$ 64,943	\$ 64,453	.8
Noncurrent Liabilities	290,879	188,905	54.0
Total Liabilities	<u>355,822</u>	<u>253,358</u>	40.4
NET ASSETS			
Invested in Capital Assets, Net of Related Debt	\$ 508,624	\$399,440	27.3
Restricted			
Nonexpendable	44,784	43,368	3.3
Expendable	127,673	147,185	-13.3
Unrestricted	81,533	77,433	5.3
Total Net Assets	<u>762,614</u>	<u>667,426</u>	14.3

The following graphically illustrates the assets, liabilities and net assets of the University (in thousands).

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)



Assets totaled \$1,118,436,000, an increase of \$197,652,000 or 21.5% over the previous year. This is attributable to the borrowing of funds for capital expansion, facilities improvements provided by the State's higher education improvement bond program and the North Carolina State University Student Aid Association Inc., and an increase in external participation in the NC State Investment Fund.

Liabilities totaled \$355,822,000, an increase of \$102,464,000 or 40.4% over the previous year. This is attributable to the borrowing of funds for capital expansion, an increase in compensated absences granted by the state legislature to employees, and an increase in external participation in the NC State Investment Fund.

Net assets totaled \$762,614,000, an increase of \$95,188,000 or 14.3% over the previous year. This is attributable to an increase of \$109,184,000 in facilities improvements, an increase of

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

\$1,416,000 in permanent endowments, a decrease of \$19,512,000 in expendable restricted resources, primarily in scholarship and capital projects funds, and an increase of \$4,100,000 in unrestricted resources.

Overall, the University's financial position remains strong with a 14.3% growth in its net assets over the previous year. Current assets are more than sufficient to cover current liabilities with a ratio of 3.04 as compared to 2.84 in the prior year. The University's total assets excluding capital assets, net of depreciation, are more than sufficient to cover total liabilities with a ratio of 1.44 as compared to 1.71 in the prior year. The University's total assets are significantly more than the universities liabilities with a ratio of 3.14 as compared to 3.63 in the prior year.

Statement of Revenues, Expenses, and Changes in Net Assets

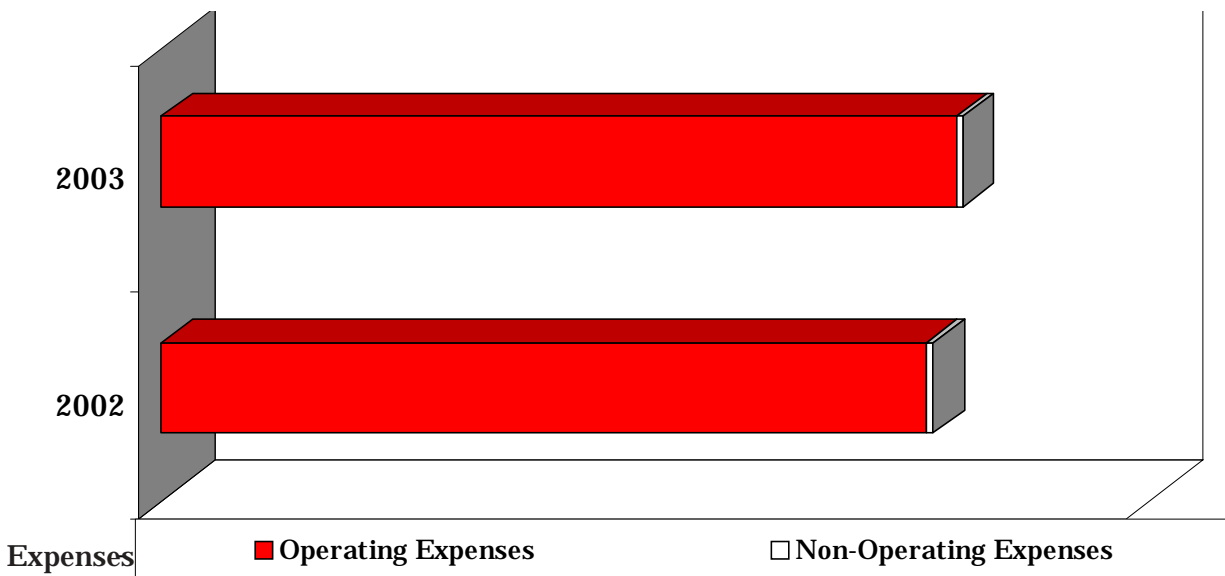
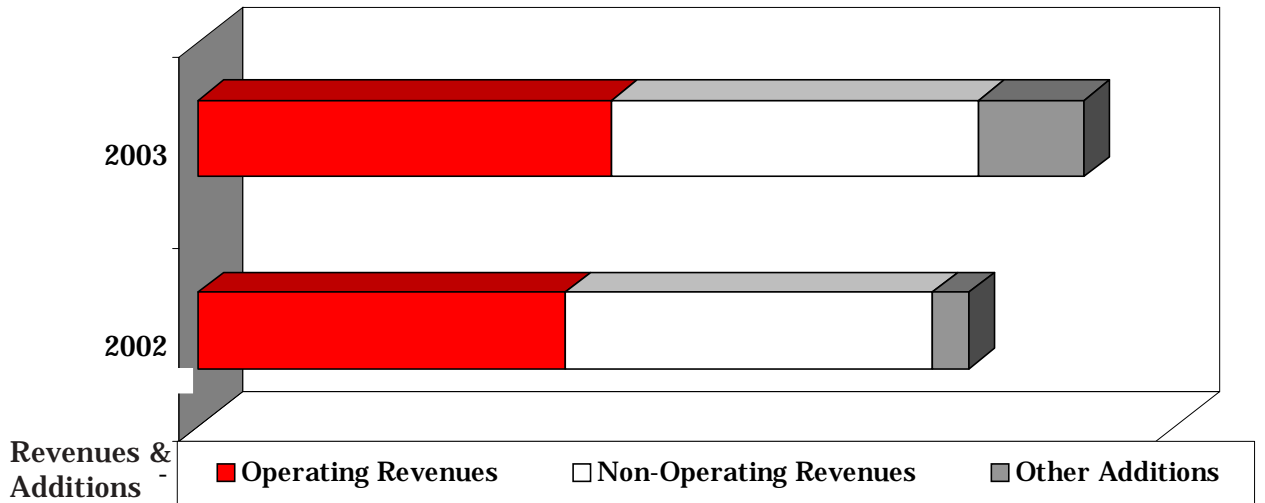
The *Statement of Revenues, Expenses, and Changes in Net Assets* provides information regarding the University's activities for the year ending June 30, 2003. The activity balances are classified as operating, non-operating, or other. Activities classified as operating include all revenues of the university except those considered non-operating or those associated with funds received to enhance capital assets or permanent endowments, and all expenses except those related to interest expense on financing activities, loss on disposal of capital assets, and investment expenses (shown as net against investment income). Activities classified as non-operating include state appropriations, non-capital gifts and grants revenue, investment income (net of investment expenses), and losses on disposal of capital assets. Activities classified as other include capital gifts or grants and additions to permanent endowments. Overall the *Statement of Revenues, Expenses, and Changes in Net Assets* provides information to evaluate the University's management of operations and maintenance of financial strength.

Following is a comparative analysis of the condensed balances reported in the *Statement of Revenues, Expenses, and Changes in Net Assets* for the fiscal years ended June 30, 2003 and 2002 (in thousands).

	2003	2002	Percent Change %
OPERATING ACTIVITIES			
Operating Revenues	\$ 423,528	\$ 375,774	12.7
Operating Expenses	805,078	774,280	4.0
Net Operating Loss	<u>-381,550</u>	<u>-398,506</u>	-4.3
NON-OPERATING ACTIVITIES			
Non-Operating Revenues	375,665	376,315	-.2
Non-Operating Expenses	6,738	7,145	-5.7
Net Non-Operating Revenues	<u>368,927</u>	<u>369,170</u>	-.1
OTHER ACTIVITIES			
Capital Grants and Gifts	106,484	34,674	207.1
Additions to Permanent Endowments	1,327	2,586	-48.7
Total Other Activity Increases	<u>107,811</u>	<u>37,260</u>	189.3
Increase in Net Assets	<u>\$ 95,188</u>	<u>\$ 7,924</u>	1,101.3

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The following graphically illustrates the revenues, expenses and changes in net assets of the University (in thousands).



- 200,000 400,000 600,000 800,000 1,000,000

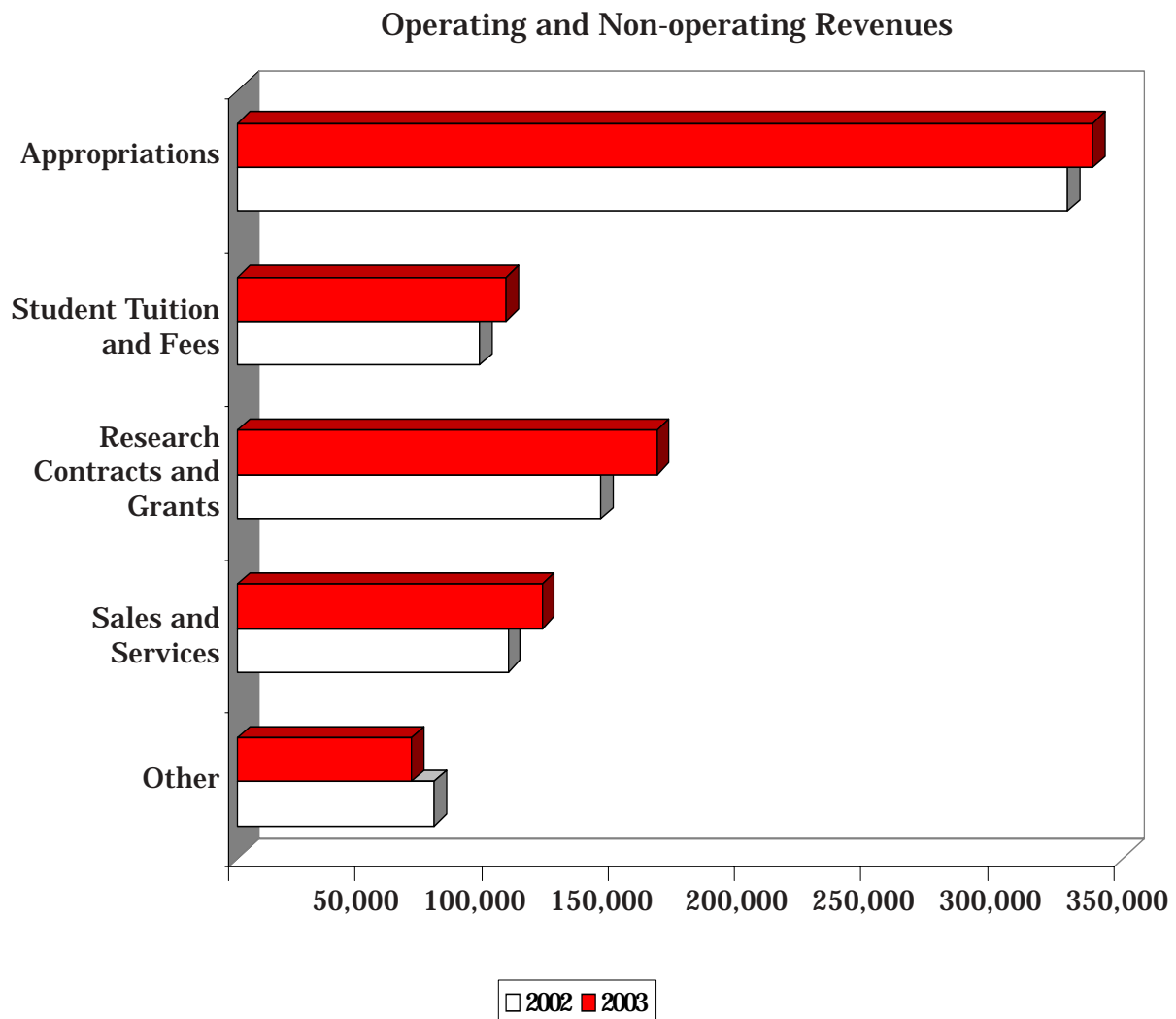
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Operating and Non-Operating Activities

The net operating loss totaled \$381,550,000, a decrease of \$16,956,000 or 4.3% under the previous year. This is attributable to a 12.7% increase in operating revenue, specifically in student tuition and fees, sales and services, and research contracts and grants, as compared to a 4.0% increase in operating expenses.

The net non-operating revenues totaled \$368,927,000, a decrease of \$243,000 over the previous year. This is an insignificant change from the previous year.

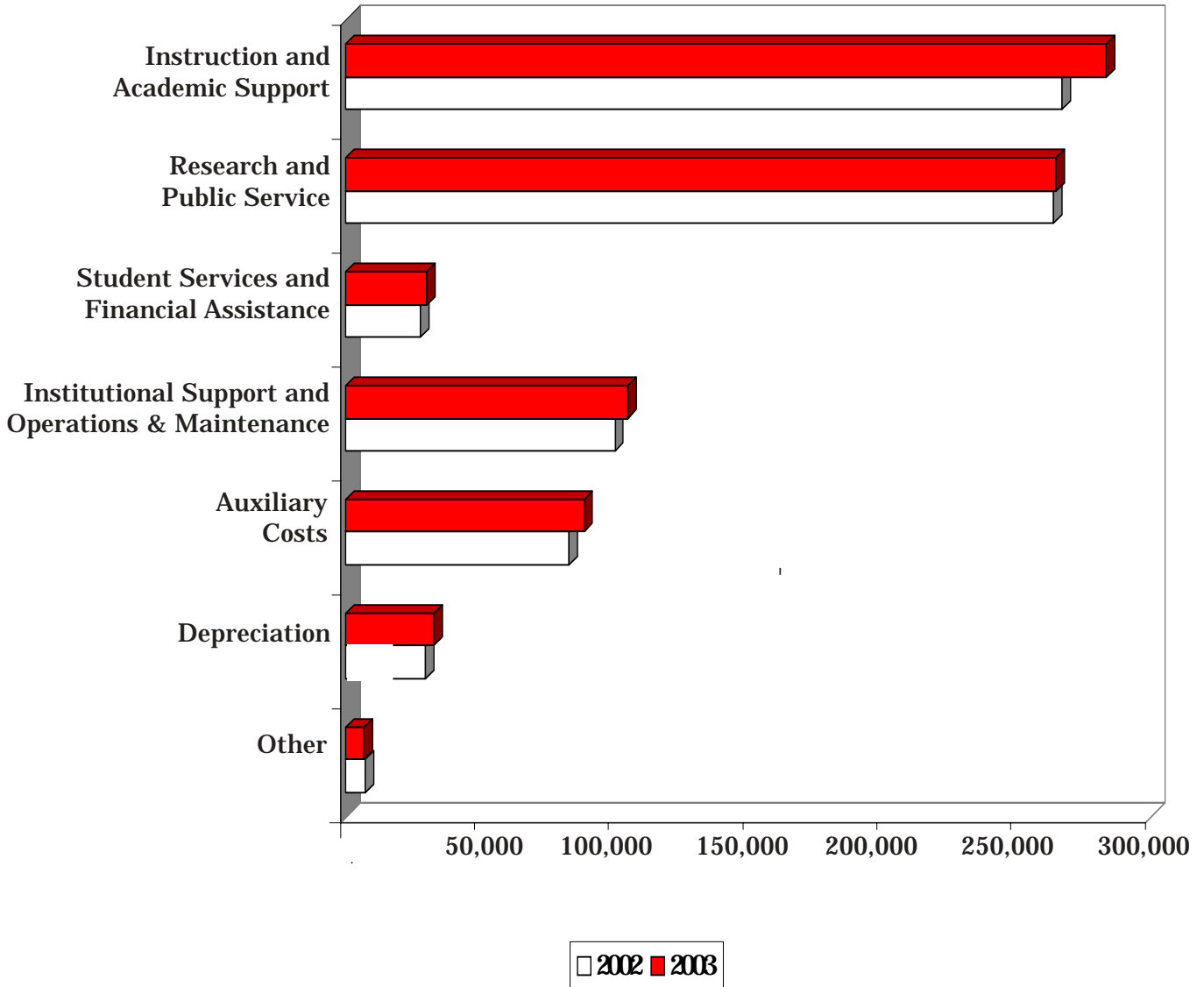
The following graphically illustrates the University's operating and non-operating revenues/expenses by source/function (in thousands).



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The significant increases in the University's revenue is attributable to increases in appropriations due to enrollment growth, in tuition due to increased rates, in increased revenues generated from research contract and grant activities, as well as, sales and service activities.

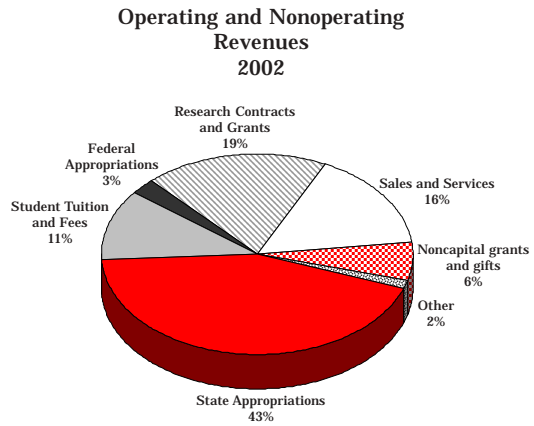
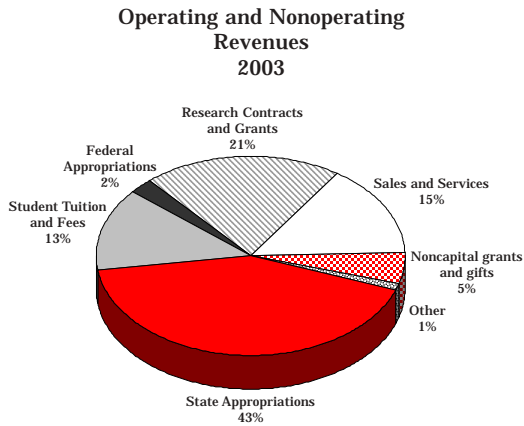
Operating and Non-operating Expenses



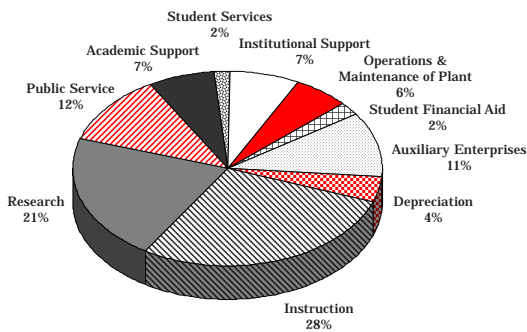
Overall, expenses increased \$30,798,000 or 4.0% over the previous year. Increases were attributable to technology improvements, the ten day bonus leave granted by the state legislature to employees, financial aid increases, and an increase in depreciation.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

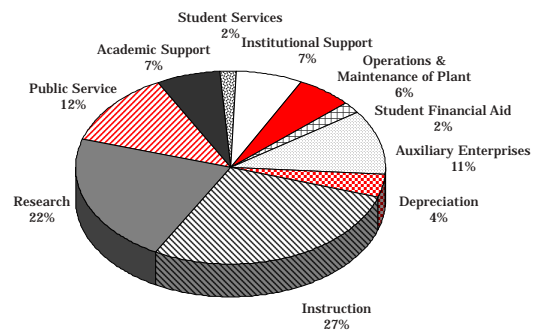
The following graphically illustrates the relationships of operating and non-operating revenue sources and expense functions to total revenues/expenses.



Operating and Nonoperating Expenses 2003



Operating and Nonoperating Expenses 2002

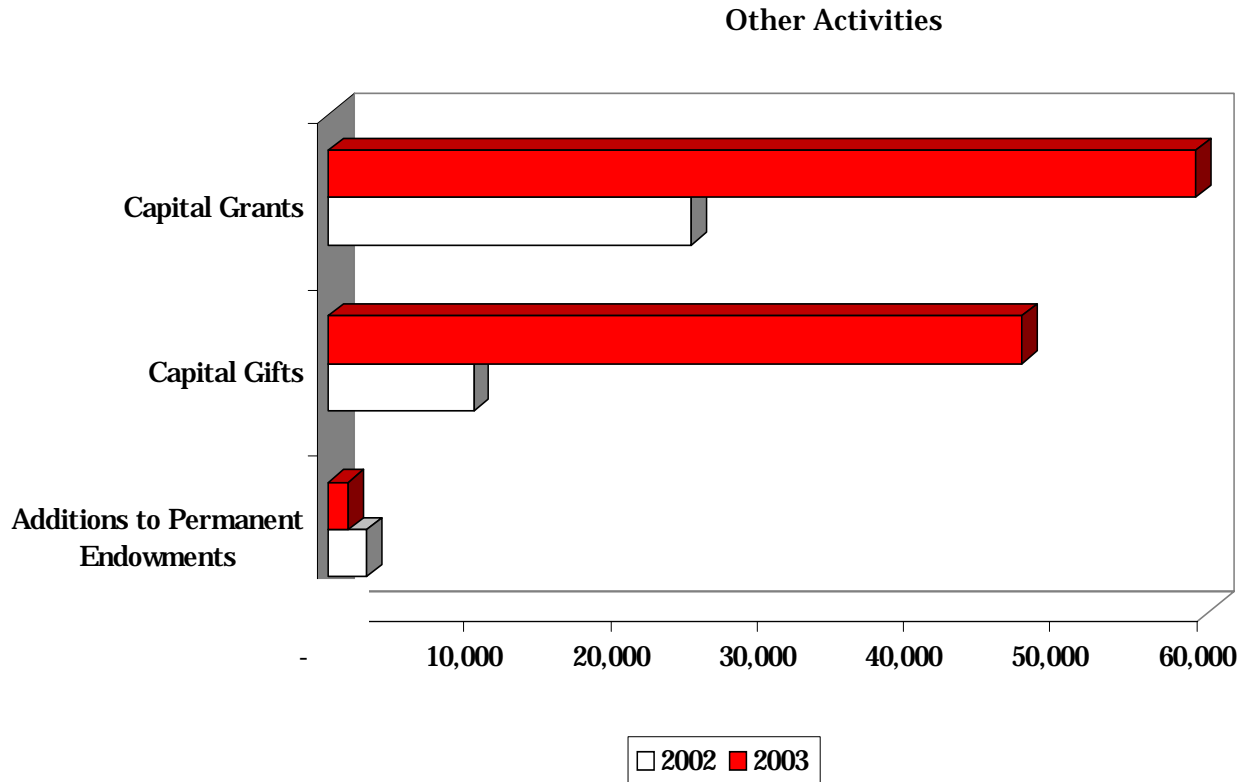


MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Other Activity

The total other activity additions totaled \$107,811,000, an increase of \$70,551,000 or 189.3% over the previous year. This is attributable to an increase in capital gifts and grants, specifically from the State's higher education improvement bond program and the North Carolina State University Student Aid Association, Inc.

The following graphically illustrates the University's other activities by source (in thousands).



Overall, the University has managed its financial resources effectively. Operating revenues increased by 12.7% and expenditure growth was limited to 4.0%. Operating expenses to current assets remains stable with a ratio of 4.1 as compared to 4.2 in the previous year. Operating expenses to expendable net assets also remain stable with a ratio of 3.8 as compared to 3.4 in the previous year.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Cash Flows

The *Statement of Cash Flows* provides information regarding the University's sources and uses of cash funds. The sources and uses of cash are classified as operating, non-capital financing, capital financing, and investing activities.

Following is a comparative analysis of the condensed balances reported in the *Statement of Cash Flows* for the fiscal years ended June 30, 2003 and 2002 (in thousands).

	2003	2002	Percent Change %
OPERATING ACTIVITIES			
Sources	\$ 426,672	\$391,971	8.9
Uses	769,175	751,242	2.4
Cash Used by Operating Activities	<u>-342,503</u>	<u>-359,271</u>	-4.7
NONCAPITAL FINANCING ACTIVITIES			
Sources	461,986	430,012	7.4
Uses	58,140	50,452	15.2
Cash Provided by Noncapital Financing Activities	<u>403,846</u>	<u>379,560</u>	6.4
CAPITAL FINANCING ACTIVITIES			
Sources	143,790	34,890	312.1
Uses	126,048	81,373	54.9
Cash Provided (Used) by Capital Financing Activities	<u>17,742</u>	<u>-46,483</u>	-138.2
INVESTING ACTIVITIES			
Sources	570,638	597,399	-4.5
Uses	583,116	589,771	-1.1
Cash Provided (Used) by Investing Activities	<u>-12,478</u>	<u>7,628</u>	-263.6
Net Increase (Decrease) in Cash	<u>\$ 66,607</u>	<u>\$-18,566</u>	458.8

Cash used by operating activities totaled \$342,503,000, a decrease of \$16,768,000 or 4.7% under the previous year. This is attributable to an increase in receipts from customers.

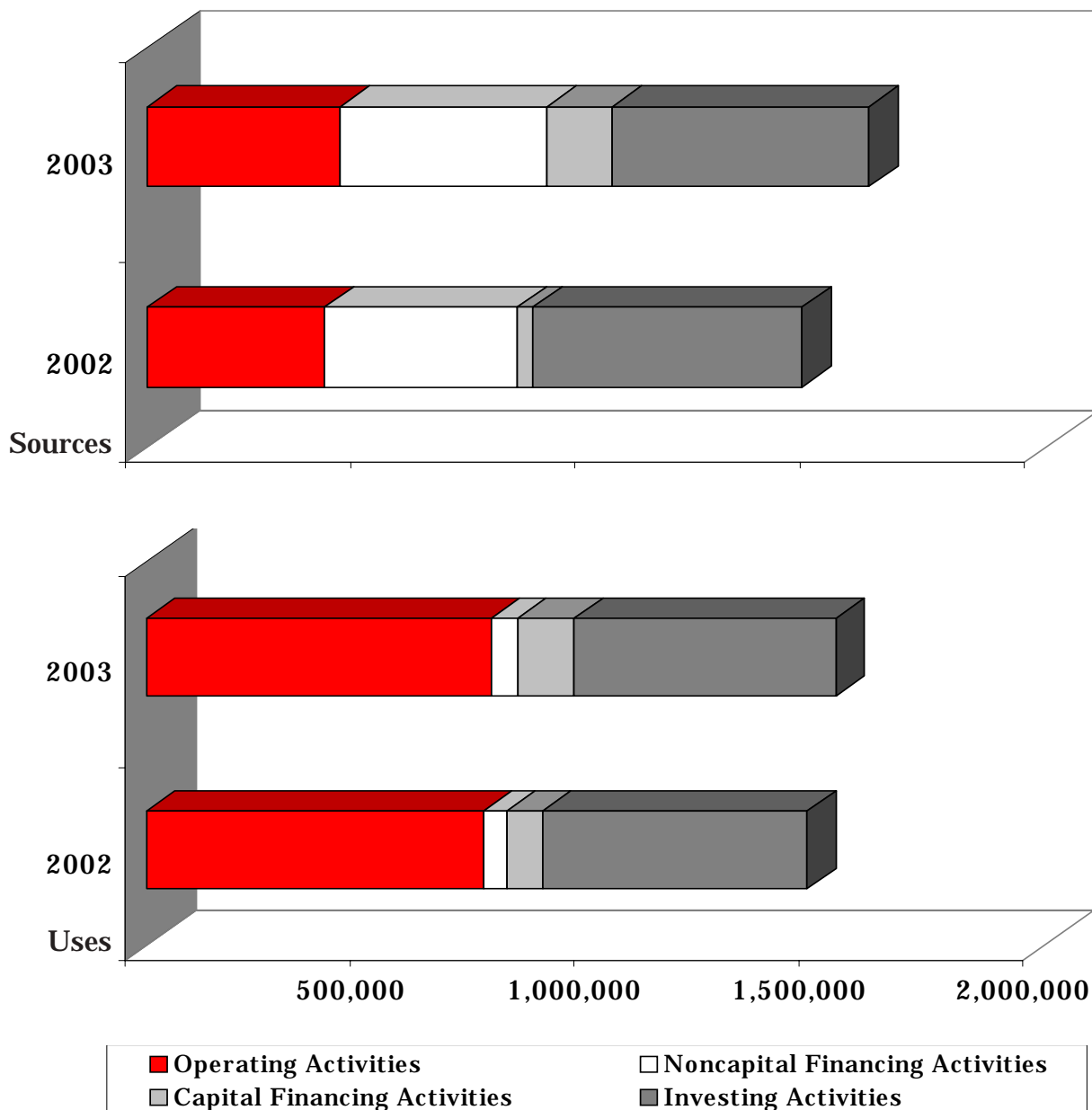
Cash provided by noncapital financing activities totaled \$403,846,000, an increase of \$24,286,000 or 6.4% over the previous year. This is attributable to the increase in external participation in the Investment Fund.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Cash provided by financing activities totaled \$17,742,000, an increase of \$64,225,000 or 138.2% over the previous year. This is attributable to new debt proceeds unspent at year-end.

Cash used by investing activities totaled \$12,478,000, an increase of \$20,106,000 or 263.6% over the previous year. This is attributable to additional investments in the Investment Fund.

The following graphically illustrates the cash activities of the University (in thousands).



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Capital Assets and Long-term Debt Activities

Capital Assets

Due to the passage of the Higher Education Improvement Bond Referendum by North Carolina voters on November 7, 2000, the University has undertaken a number of major construction projects to improve and modernize its facilities. The Referendum provided \$468,257,000 in State funds to the University beginning in fiscal year 2001. As of June 30, 2003, the University had received \$70,131,000 from the State and had \$398,126,000 outstanding pending future bond sales and allotment approvals.

During the report period, the University received \$57,598,000 in funds from the referendum, \$1,558,000 from Federal funds, \$72,032,000 from debt financing, and \$11,661,000 from available unrestricted funds. In total, the University received or provided from available funds \$142,849,000 during the report period for its capital improvements. In addition, the North Carolina State University Student Aid Association, Inc. paid for and gave the University \$42,695,000 in improvements to the University's athletic facilities.

The University expended \$118,031,000 during the year for the construction of new buildings/infrastructure and for the renovation or repair of its facilities. Of this amount, \$27,215,000 was expended on improvements to Centennial Campus.

Centennial Campus

Centennial Campus is a research and advanced technology community where the University, industry and government partners interact in multi-disciplinary programs directed toward the solution of contemporary problems. Since the Centennial Campus opened its first laboratory in 1989, its inventory of buildings has grown to 18 buildings, containing a total of approximately 1.5 million square feet of developed space. Of this space, approximately 25% is used by the University, 9% is for Governmental use, 61% is leased to private companies, and 5% is available for lease.



The College of Engineering began construction of its Phase I Complex at Centennial Campus. This new building will supply Chemical Engineering and Materials Science Engineering with laboratories, offices and classrooms.

Construction began on the Partners III Research Building located at Centennial Campus. This 80,000 square foot facility will provide office and lab space for Physical and Mathematical Sciences and the College of Agricultural and Life Sciences.



You can find out more information about Centennial Campus by visiting <http://www.centennial.ncsu.edu/>.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Main Campus



Construction of the Arboretum Education Center was completed this year. The new 12,350 square foot center provides space for plant science as well as landscape design classes and activities.

More information on the JC Raulston Arboretum can be found at <http://www.ncsu.edu/jcraulstonarboretum/>.

The College of Veterinary Medicine began construction of a new 103,000 square foot building. The new facility will house research laboratories, offices and conference rooms and is scheduled for completion in the spring of 2005.



University Housing began construction of the new Wolf Village Apartments. The eight building complex will house 1,200 students in fully furnished apartments. Each four-bedroom apartment will have two bathrooms, a living room, kitchen and washer/dryer unit. The first building phase should be completed in the fall of 2004. For more information on the Wolf Village apartments, visit <http://www.ncsu.edu/housing/apartments/index.html>.



During fiscal year 2003, the North Carolina State University Student Aid Association Inc. provided improvements to the University located at the Carter Finley Stadium. The Association completed and granted to the University the Wendell H. Murphy Football Center, improvements to the stadium's south endzone, the new Carter-Finley stadium video scoreboard and a football practice field complex.

At June 30, 2003, outstanding commitments on construction contracts were \$110,251,000.

More information about the University's long-range capital plan is located at <http://www.ncsu.edu/facilities/masterplan/index.htm>.

Long-term Debt Activities

As authorized by the General Assembly in fiscal year 2002, the University adopted a new financing methodology to allow it to pledge its available funds when issuing general revenue bonds. Under this new financing methodology, the University entered into a joint Commercial Paper program with the University of North Carolina at Chapel Hill (UNC-CH) in March 2002. Proceeds of the program are available to UNC-CH (up to \$75,000,000) and to the University (up to \$25,000,000). During fiscal year 2003, the University issued and renewed \$14,000,000 in commercial paper with interest rates ranging from 1.0% to 1.15% and terms from 8 to 120 days to finance construction

MANAGEMENT’S DISCUSSION AND ANALYSIS (CONTINUED)

projects. The University refinanced these borrowings as part of the June 2003 issuance of permanent financing.

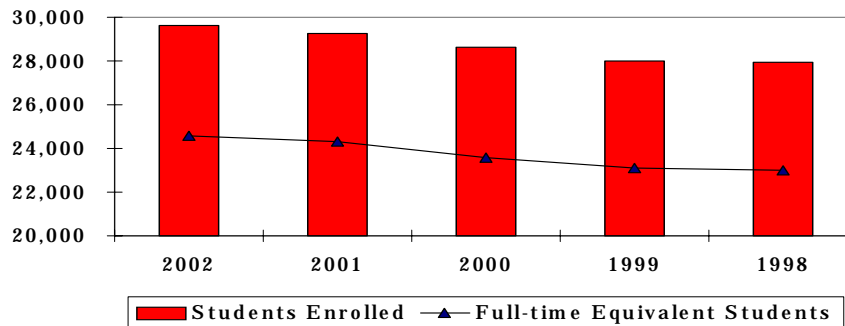
In June 2003, the University issued \$72,395,000 in general revenue bonds. General Revenue Bonds, Series 2003A and 2003B were issued to (1) provide funds for the University Apartments project, renovation of certain Greek fraternity houses and the Doak field baseball and tennis complex, (2) refund outstanding commercial paper and (3) pay the issuance costs incurred. The University’s bond ratings remained the same: Aa3 from Moody’s Investor Service and AA from Standards and Poor’s for the University’s series 2003A and 2003B General Revenue Bonds.

At June 30, 2003, the University had outstanding long-term bond indebtedness in the principal amount of \$153,159,000.

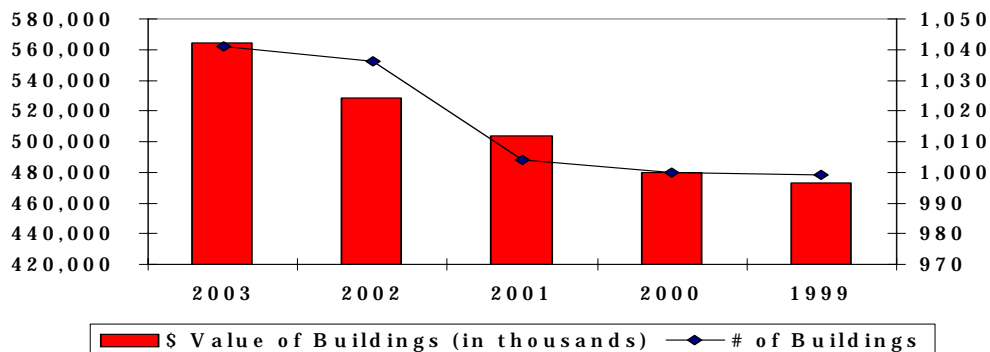
Economic Factors That Will Affect the Future

Trend analysis of Key Factors are important to understanding the stability and growth of the University as it goes forward into the future. The following graphically illustrates the trends of Key Factors such as student enrollment, University buildings, research contract and grant revenues, athletic program revenues, University foundation support, as well as tuition and fees and appropriations.

Student Enrollment
Fall Semester

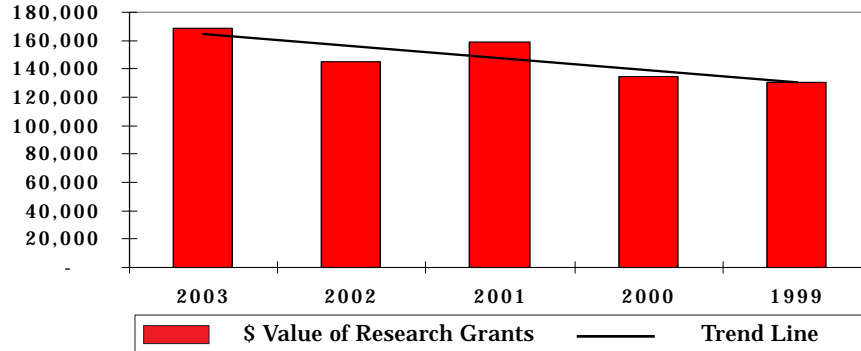


University Buildings
(number and value)

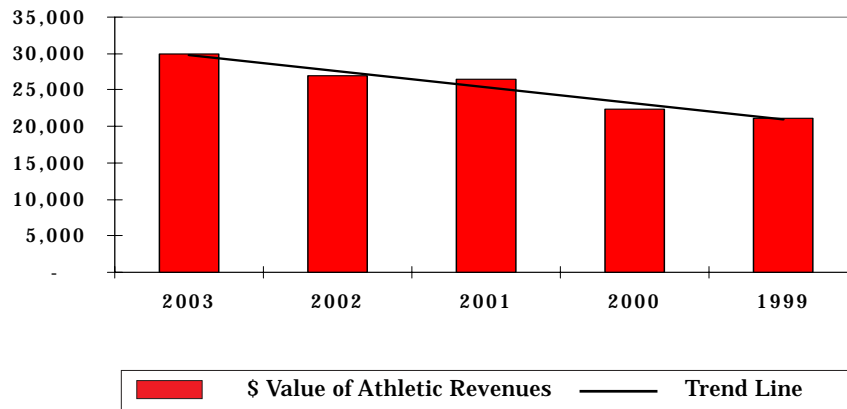


MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

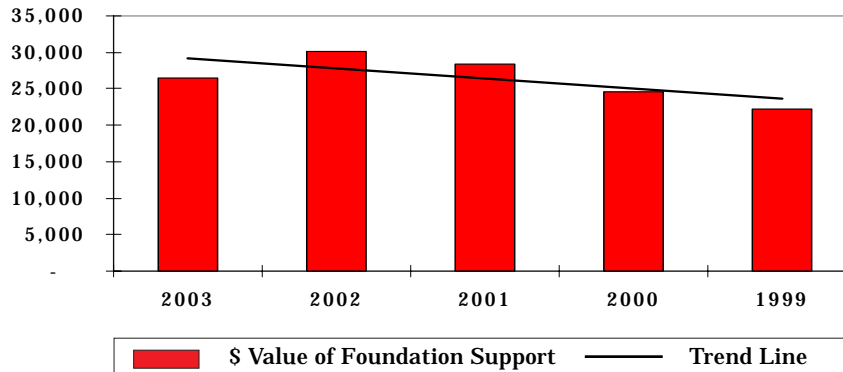
Research Contract and Grant Revenues
(in thousands)



Athletic Program Revenues
(in thousands)

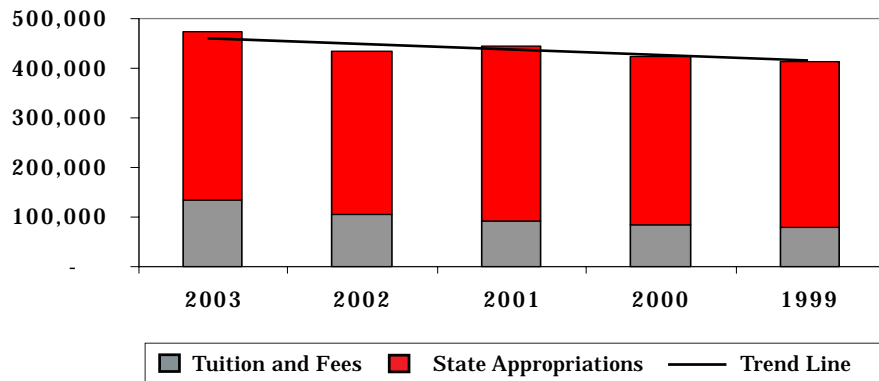


University Foundation Support (noncapital)
(in thousands)



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

Tuition & Fees / State Appropriations
(in thousands)



As illustrated, the trends of Key Factors are positive signs of economic stability and growth. Student enrollment is stable with some growth, facilities continue to expand and improve, revenues from research contracts and grants continue to grow, athletic program revenues continue to increase, related foundations continue to provide excellent support, and tuition and fees, together with appropriations, show stability with some growth.

Reductions in support from University foundations is due to losses in the investment markets and is likely to continue until the markets improve and endowments are replenished to required levels.

North Carolina State University
Statement of Net Assets
June 30, 2003
(in thousands)

Exhibit A

ASSETS

Current Assets:

Cash and Cash Equivalents	\$	109,805
Restricted Cash and Cash Equivalents		38,397
Restricted Short-Term Investments		2,476
Receivables, Net (Note 4)		31,355
Due from Primary Government		8,426
Due from State of North Carolina Component Units		1,246
Inventories		4,305
Notes Receivable, Net (Note 4)		1,361
Total Current Assets		197,371

Noncurrent Assets:

Restricted Cash and Cash Equivalents		68,879
Restricted Due from Primary Government		16,513
Endowment Investments		119,947
Other Long-Term Investments		100,075
Notes Receivable, Net (Note 4)		9,253
Capital Assets - Nondepreciable (Note 5)		124,940
Capital Assets - Depreciable, Net (Note 5)		481,458
Total Noncurrent Assets		921,065
Total Assets		1,118,436

LIABILITIES

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)		29,977
Due to Primary Government		617
Due to State of North Carolina Component Units		167
Deferred Revenue		24,748
Interest Payable		754
Long-Term Liabilities - Current Portion (Note 8)		8,680
Total Current Liabilities		64,943

Noncurrent Liabilities:

Deposits Payable		196
Funds Held for Others		4,103
U. S. Government Grants Refundable		6,820
Funds Held in Trust for Pool Participants		98,353
Long-Term Liabilities (Note 8)		181,407
Total Noncurrent Liabilities		290,879
Total Liabilities		355,822

North Carolina State University
Statement of Net Assets
June 30, 2003
(in thousands)

Exhibit A
Page 2

NET ASSETS

Invested in Capital Assets, Net of Related Debt	508,624
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	7,106
Endowed Professorships	23,583
Departmental Uses	13,055
Other	1,040
Expendable:	
Scholarships and Fellowships	4,482
Research	7,513
Endowed Professorships	43,423
Departmental Uses	31,148
Loans	6,368
Capital Projects	21,657
Debt Service	7,178
Other	5,904
Unrestricted	81,533
Total Net Assets	\$ 762,614

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

North Carolina State University
Statement of Revenues, Expenses, and
Changes in Net Assets
For the Fiscal Year Ended June 30, 2003
(in thousands)

Exhibit B

REVENUES

Operating Revenues:

Student Tuition and Fees, Net (Note 10)	\$	106,213
Federal Appropriations		19,574
Federal Grants and Contracts		92,978
State and Local Grants and Contracts		29,549
Nongovernmental Grants and Contracts		43,244
Sales and Services, Net (Note 10)		120,466
Interest Earnings on Loans		220
Other Operating Revenues (Note 10)		11,284

Total Operating Revenues 423,528

EXPENSES

Operating Expenses:

Salaries and Benefits		505,475
Supplies and Materials		91,977
Services		140,012
Scholarships and Fellowships		14,100
Utilities		20,002
Depreciation		33,512

Total Operating Expenses 805,078

Operating Loss (381,550)

NONOPERATING REVENUES (EXPENSES)

State Appropriations		337,976
Noncapital Grants		2,918
Noncapital Gifts		36,628
Investment Income (Net of Investment Expense of \$570)		(1,857)
Interest and Fees on Capital Asset-Related Debt		(4,679)
Other Nonoperating Expenses		(2,059)

Net Nonoperating Revenues 368,927

Loss Before Other Revenues, Expenses, Gains, or Losses (12,623)

Capital Grants		59,156
Capital Gifts		47,328
Additions to Permanent Endowments		1,327

Increase in Net Assets 95,188

NET ASSETS

Net Assets - July 1, 2002 667,426

Net Assets - June 30, 2003 \$ 762,614

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

North Carolina State University
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2003
(in thousands)

Exhibit C

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$	413,084
Payments to Employees and Fringe Benefits		(496,970)
Payments to Vendors and Suppliers		(256,090)
Payments for Scholarships and Fellowships		(14,100)
Loans Issued to Students and Employees		(2,015)
Loans Collected from Students and Employees		2,093
Interest Earned on Loans		211
Other Receipts		11,284
Net Cash Used by Operating Activities		(342,503)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations		337,976
Grants for Other than Capital Purposes		1,279
Noncapital Gifts		37,954
Federal Family Education Loan Receipts		58,274
Federal Family Education Loan Disbursements		(58,140)
External Participation in Investment Fund		25,003
Other Receipts		1,500
Net Cash Provided by Noncapital Financing Activities		403,846

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

Proceeds from Capital Debt		86,865
Capital Grants		56,269
Capital Gifts		280
Proceeds from Sale of Capital Assets		376
Purchases of Capital Assets		(100,864)
Principal Paid on Capital Debt and Leases		(20,384)
Interest Paid on Capital Debt and Leases		(4,191)
Other Payments		(609)
Net Cash Provided by Capital Financing and Related Financing Activities		17,742

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments		558,641
Dividends and Interest on Investments		11,997
Purchase of Investments		(583,116)
Net Cash Used by Investing Activities		(12,478)

Net Increase in Cash		66,607
Cash - Beginning of Year		150,474
Cash - End of Year	\$	217,081

North Carolina State University
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2003
(in thousands)

Exhibit C
Page 2

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

Operating Loss	\$	(381,550)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:		
Depreciation Expense		33,512
Allowances, Write-Offs, and Amortizations		316
Changes in Assets and Liabilities:		
Receivables (Net)		287
Inventories		869
Accounts Payable and Accrued Liabilities		(3,883)
Deposits Payable		(1,939)
Deferred Revenue		1,297
Compensated Absences		8,588
Net Cash Used by Operating Activities	\$	(342,503)

RECONCILIATION OF CASH AND CASH EQUIVALENT BALANCES

Current Assets:		
Cash and Cash Equivalents	\$	109,805
Restricted Cash and Cash Equivalents		38,397
Noncurrent Assets:		68,879
Total Cash and Cash Equivalent Balances	\$	217,081

NONCASH INVESTING, CAPITAL AND FINANCING ACTIVITIES

Assets Acquired through Gifts	\$	47,049
Change in Fair Value of Investments		(13,229)

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

[This Page Left Blank Intentionally]

NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

- A. 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, 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. North Carolina State University is a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report*.

The accompanying financial statements present all funds belonging to the University and its component units. While the Board of Governors of the University of North Carolina System has ultimate responsibility, the Chancellor, the Board of Trustees, and the Board of Trustees of the Endowment Fund have delegated responsibilities for financial accountability of the University's funds. Although legally separate, the NC State Investment Fund, Inc., (Investment Fund) and the NC State University Partnership Corporation (Corporation), component units of the University, are reported as if they were part of the University.

The Investment Fund is governed by a Members Board consisting of six ex officio directors and five elected representatives from the participating entities. The Investment Fund's purpose is to support the University by operating an investment fund for charitable, nonprofit foundations, associations, trusts, endowments, and funds that are organized and operated primarily to support the University. The Investment Fund is an external governmental investment pool. Because the majority of the Members Board of the Investment Fund consists of University administrators and Board Members and the Investment Fund's primary purpose is to benefit North Carolina State University, its financial statements have been blended with those of the University.

The Corporation is governed by a Board of Directors appointed by the Chancellor of the University. The Corporation's purpose is to support and benefit the University with the aims of creating new knowledge and improving the lives of the people of North Carolina. In addition, the Corporation formed NC State University Conference Center, LLC (LLC)

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

on January 25, 2002 to develop, own, and operate a hotel, conference center, and public golf course on the Centennial Campus as outlined in the Campus Master Plan. Because the Corporation's Board is appointed by the Chancellor and its sole purpose is to support and benefit the University, both the Corporation and the LLC are considered part of the University for financial reporting purposes.

Separate financial statements for the Investment Fund may be obtained from the Foundations Accounting and Investments Office, Campus Box 7207, Raleigh, NC 27695, or by calling (919) 515-2110. Financial information relative to the Corporation and the LLC may be obtained from the Corporation's Executive Director, Campus Box 7012, Raleigh, NC 27695, or by calling (919) 515-0388. Other related foundations and similar nonprofit corporations for which the University is not financially accountable are not part of the accompanying financial statements.

- B. Basis of Presentation** - The accompanying financial statements are presented in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB).

Pursuant to the provisions of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities*, the full scope of the University's activities is considered to be a single business-type activity (BTA) and accordingly, is reported within a single column in the basic financial statements.

In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the University does not apply Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989, for proprietary activities, unless the GASB amends its pronouncements issued after that date.

- C. Basis of Accounting** - The financial statements of the University 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.

Nonexchange transactions, in which the University receives (or gives) value without directly giving (or receiving) equal value in exchange

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

includes State appropriations, certain grants, and donations. Revenues are recognized, net of estimated uncollectible amounts, as soon as all eligibility requirements imposed by the provider have been met, if probable of collection.

- D. Cash and Cash Equivalents** – This classification includes undeposited receipts, petty cash, cash on deposit with private bank accounts, cash on deposit with fiscal agents, and short-term investments with the State Treasurer’s Cash and Investment Pool (a governmental external investment pool). The short-term investment portfolio 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.
- E. Investments** - This classification includes long-term fixed income investments, equity investments, mutual funds, money market funds, real estate investment trusts, real estate, and other asset holdings by the University. Except for money market funds, real estate not held by a governmental external investment pool and other asset holdings, investments are accounted for at fair value, as determined by quoted market prices, or an amount determined by management if quoted market prices are not available. The net increase (decrease) in the fair value of investments is recognized as a component of investment income.

Money market funds, real estate not held by a governmental external investment pool and other asset holdings are reported at cost, if purchased, or at fair value or appraised value at date of gift, if donated.

- F. Receivables** – Receivables consist of tuition and fee charges to students and charges for auxiliary enterprises’ sales and services. Receivables also include amounts due from the federal government, State and local governments, private sources in connection with reimbursement of allowable expenditures made pursuant to contracts and grants, and pledges that are verifiable, measurable, and expected to be collected and available for expenditures for which the resource provider’s conditions have been satisfied. Receivables are recorded net of estimated uncollectible amounts.
- G. Inventories** – Inventories, consisting of expendable supplies and merchandise for resale, are valued at the lower of cost or market value using the first-in, first-out method except for the bookstore that uses the retail method and physical plant that uses the moving weighted average method.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- H. Capital Assets** – Capital assets are stated at cost at date of acquisition or fair value at date of donation in the case of gifts.

The University capitalizes assets that have a value or cost equal to or greater than \$5,000 at the date of acquisition and an expected useful life of more than one year. Library books are generally not considered to have a useful life of more than one year unless part of a collection and are expensed in the year of acquisition.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 15 to 75 years for general infrastructure, 10 to 50 years for buildings, and 3 to 15 years for equipment.

The University does not capitalize its collections. Collections not capitalized adhere to the University's policy to maintain for public exhibition, education or research; protect, keep unencumbered, care for and preserve; and requires proceeds from their sale to be used to acquire other collection items. Accounting principles generally accepted in the United States of America permit collections maintained in this manner to be charged to operations at time of purchase rather than be capitalized.

- I. Restricted Assets** – Unexpended proceeds of revenue bonds and unexpended capital contributions are classified as restricted assets because their use is limited by applicable bond covenants or donor/grantor agreements. Certain other assets are classified as restricted because their use is limited by external parties or statute.
- J. Funds Held in Trust for Pool Participants** – Funds held in trust for pool participants represent the external portion of the University's governmental external investment pool more fully described in Note 2.
- K. Noncurrent Long-Term Liabilities** – Noncurrent long-term liabilities include principal amounts of bonds payable, capital lease obligations, and compensated absences that will not be paid within the next fiscal year.

Bonds payable are reported net of unamortized premium or discount. The University amortizes bond premiums/discounts over the life of the bonds using the straight-line method. Losses on refundings and issuance costs on bonds payable are not material to the accompanying financial statements and are expensed in the year incurred.

- L. Compensated Absences** - The University's policy is to record the cost of vacation leave when earned. The policy provides for a maximum accumulation of unused vacation leave of 30 days which can be carried forward each January 1st or for which an employee can be paid upon

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

termination of employment. Also, any accumulated vacation leave in excess of 30 days at year-end is converted to sick leave. Under this policy, the accumulated vacation leave for each employee at June 30th equals the leave carried forward at the previous December 31st plus the leave earned, less the leave taken between January 1st and June 30th.

In addition to the vacation leave described above, compensated absences includes the accumulated unused portion of the special annual leave bonus awarded by the North Carolina General Assembly to all full-time permanent employees as of September 30, 2002. The unused portion of this leave remains available until used notwithstanding the limitation on annual leave carried forward described above.

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

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

M. Net Assets – The University’s net assets are classified as follows:

Invested in Capital Assets, Net of Related Debt – This represents the University’s total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

Restricted Net Assets – Nonexpendable – Nonexpendable restricted net assets include endowments and similar type assets whose use is limited by donors or other outside sources and as a condition of the gift, the principal is to be maintained in perpetuity.

Restricted Net Assets – Expendable – Expendable restricted net assets include resources in which the University is legally or contractually obligated to spend the resources in accordance with restrictions imposed by external parties.

Unrestricted Net Assets – Unrestricted net assets include resources derived from student tuition and fees, sales and services, unrestricted gifts, royalties, and interest income.

Restricted and unrestricted resources are tracked using a fund accounting system and are spent in accordance with established fund authorities. Fund authorities provide rules for the fund activity and are separately

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

established for restricted and unrestricted activities. When both restricted and unrestricted funds are available for expenditure, the decision for funding is transactional based within the departmental management system in place at the University. For projects funded by tax-exempt debt proceeds and other sources, the debt proceeds are always used first.

N. Scholarship Discounts – Student tuition and fees revenues and certain other revenues from University charges are reported net of scholarship discounts in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. The scholarship discount is the difference between the actual charge for goods and services provided by the University and the amount that is paid by students or by third parties on the students' behalf. Student financial assistance grants, such as Pell grants, and other federal, State, or nongovernmental programs, are recorded as operating revenues in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. To the extent that revenues from these programs are used to satisfy tuition, fees, and other charges, the University has recorded a scholarship discount.

O. Revenue and Expense Recognition – The University classifies its revenues and expenses as operating or nonoperating in the accompanying Statement of Revenues, Expenses, and Changes in Net Assets. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the University's principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as (1) student tuition and fees, (2) sales and services of auxiliary enterprises, (3) certain federal, State and local grants and contracts that are essentially contracts for services, and (4) interest earned on loans. Operating expenses are all expense transactions incurred other than those related to capital and noncapital financing activities or investing activities as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

Nonoperating revenues include activities that have characteristics of nonexchange transactions. Revenues from nonexchange transactions and State appropriations that represent subsidies or gifts to the University, as well as investment income, are considered nonoperating since these are either investing, capital or noncapital financing activities. Capital contributions are presented separately after nonoperating revenues and expenses.

P. Internal Sales Activities – Certain institutional auxiliary operations provide goods and services to University departments as well as to its

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

customers. These institutional auxiliary operations include activities such as central stores, University Graphics, the Copy Center, the Creamery, telecommunications, physical plant, and motor pool. In addition, the University has other miscellaneous sales and service units that operated either on a reimbursement or charge basis. All internal sales activities to University departments from auxiliary operations and sales and service units have been eliminated in the accompanying financial statements. These eliminations are recorded by removing the revenue and expense in the auxiliary operations and sales and service units and, if significant, allocating any residual balances to those departments receiving the goods and services during the year.

NOTE 2 - DEPOSITS AND INVESTMENTS

- A. Deposits** – Unless specifically exempt, the University is required by General Statute 147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. In addition, the University of North Carolina Board of Governors, pursuant to General Statute 116-36.1, requires the University to deposit its institutional trust funds, except for funds received for services rendered by health care professionals, with the State Treasurer. Although specifically exempted, the University may voluntarily deposit endowment funds, special funds, revenue bond proceeds, debt service funds, and funds received for services rendered by health care professionals with the State Treasurer. Special funds consist of moneys for intercollegiate athletics and agency funds held directly by the University.

Deposits include cash and cash equivalents totaling \$217,050,000. At year-end, cash on hand was \$31,000. The University's portion of the State Treasurer's Investment Pool was \$216,436,000. It is the State Treasurer's policy and practice for deposits not covered by federal depository insurance to be covered by collateral held by the State of North Carolina's agent in the name of the State and for investments to be held by the State's agent in the State's name. The carrying amount of the University's deposits not with the State Treasurer was \$615,000 and the bank balance was \$714,000. Of the bank balance, \$358,000 was covered by federal depository insurance and \$356,000 was uninsured and uncollateralized.

North Carolina General Statutes 147-69.1(c), applicable to the State's General Fund, and 147-69.2, applicable to institutional trust funds, authorize the State Treasurer to invest in the following: obligations of or fully guaranteed by the United States; obligations of certain federal

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

agencies; repurchase agreements; obligations of the State of North Carolina; time deposits of specified institutions; prime quality commercial paper, and asset-backed securities with specified ratings. Also, General Statute 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified ratings. General Statute 147-69.2 authorizes the following: general obligations of other states; general obligations of North Carolina local governments; and obligations of certain entities with specified ratings.

The financial statements and disclosures for the State Treasurer's Investment Pool are included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page <http://www.osc.state.nc.us/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

- B. Investments** - The University is authorized by The University of North Carolina Board of Governors pursuant to General Statute 116-36.2 and Chapter VI of the Administrative Manual of North Carolina, to invest its special funds and funds received for services rendered by health care professionals in the same manner as the State Treasurer is required to invest, as previously discussed.

In accordance with the bond resolutions, bond proceeds and debt service funds are invested in obligations which will by their terms mature on or before the date funds are expected to be required for expenditure or withdrawal.

General Statute 116-36(e) provides that the trustees of the Endowment Fund shall be responsible for the prudent investment of the Fund in the exercise of their sound discretion, without regard to any statute or rule of law relating to the investment of funds by fiduciaries but in compliance with any lawful condition placed by the donor upon that part of the Endowment Fund to be invested.

Investments of the Investment Fund, a University component unit, are subject to and restricted by General Statute 36B "Uniform Management of Institutional Funds Act" (UMIFA) and any requirements placed on them by contract or donor agreements.

Investments of various funds may be pooled unless prohibited by statute or by terms of the gift or contract. The University utilizes the following investment pools:

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Long-Term Investment Pool - This is an internal investment pool that is utilized for the investment of the endowment funds. Pool ownership is measured using the unit value method. Under this method, each participating fund's investment balance is determined on a market value basis. The investment strategy, including the selection of investment managers, is based on the directives of the University's Endowment Board. This pool also participates in the Investment Fund.

The Investment Fund – This is a governmental external investment pool sponsored by the University. The Investment Fund was established in April 1999. The Investment Fund is utilized as one of the investment managers for the Long-Term Investment Pool (the Investment Fund's internal participant) and to manage the investments for other affiliated organizations that are organized and operated primarily to support the University (the Investment Fund's external participants). Fund ownership of the pool is measured using the dollar-day method, which assigns a weighted value for the time the funds are on deposit. The external portion of the pool is presented in the accompanying financial statements as "Funds Held in Trust for Pool Participants."

The Investment Fund is not registered with the SEC and is not subject to any formal oversight other than that provided by the Investment Fund Members Board. The Members Board is responsible for adopting investment objectives and policies and for monitoring policy implementation and investment performance. The Members Board has chosen not to make individual security selection decisions. Subordinate to the Members Board, the Board of Directors has responsibility to oversee the allocation of the Fund's portfolio among the asset classes, investment vehicles, and investment managers.

State Street Bank & Trust Company is the custodian for the fund and provides the University with quarterly statements defining income and fair value information which is then allocated among the fund's participants. There are no involuntary participants in the fund. The University has not provided or obtained any legally binding guarantees during the period to support the value of the fund's investments. Separate financial statements for the Investment Fund may be obtained from the Foundations Accounting and Investments Office, Campus Box 7207, Raleigh, NC 27695, or by calling (919) 515-2110.

Credit Risk Categories - The University's investments (pooled and non-pooled) are categorized below to give an indication of the level of risk assumed by the entity at year-end. The credit risk categories are concerned with custodial credit risk, which is the risk that a government will not be able to recover the value of investment or collateral securities

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

that are in the possession of an outside party if the counterparty to the investment transaction fails. There are three categories of credit risk. Category 1 includes investments that are insured or registered or for which the securities are held by the University or its agent in the University's name. Category 2 includes uninsured and unregistered investments for which the securities are held by a counterparty's trust department or agent in the University's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by a counterparty's trust department or agent but not in the University's name.

A summary of the University's investments at June 30, 2003 is presented below: (*in thousands*)

*Long-Term Investment Pool**

	Fair Value			Total
	Risk Category			
	1	2	3	
Categorized Investments:				
U.S. Government Securities	\$ 8,732	\$ 0	\$ 0	\$ 8,732
Collateralized Mortgage Obligations	395			395
State and Municipal Securities	34			34
Corporate Bonds	3,572			3,572
International Bonds	363			363
Total Categorized Investments	\$ 13,096	\$ 0	\$ 0	13,096
Investments Not Categorized:				
Money Market Funds				1,964
Mutual Funds				5,482
Pooled Investments (Life Income Pools)				257
Other Investments				5,672
Total Investments Not Categorized				13,375
Total Long-Term Investments				\$ 26,471

*Excludes amounts reported in the Investment Fund

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Investment Fund (External Investment Pool)

	Risk Category			Total
	1	2	3	
Categorized Investments:				
U.S. Government Securities	\$ 1,562	\$ 0	\$ 0	\$ 1,562
Corporate Stocks	80,468			80,468
International Stocks	5,433			5,433
Total Categorized Investments	\$ 87,463	\$ 0	\$ 0	87,463
Investments Not Categorized:				
Money Market Funds				2,084
Mutual Funds				73,223
Real Estate Investment Trusts				8,441
Total Investments Not Categorized				83,748
Total External Pool Investments				\$ 171,211

Non-Pooled Investments

	Fair Value			Total
	Risk Category			
	1	2	3	
Categorized Investments:				
U.S. Government Securities	\$ 460	\$ 0	\$ 0	\$ 460
Corporate Stocks	1,388			1,388
Total Categorized Investments	\$ 1,848	\$ 0	\$ 0	1,848
Investments Not Categorized:				
Money Market Funds				3,949
Real Estate				18,498
Other Investments				521
Total Investments Not Categorized				22,968
Total Non-Pooled Investments				\$ 24,816

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Total Investments

	Fair Value			Total
	Risk Category			
	1	2	3	
Total Categorized Investments	\$ 102,407	\$ 0	\$ 0	\$ 102,407
Total Investments Not Categorized				120,091
Total Investments				\$ 222,498

C. Derivative and Similar Transactions - A derivative is a financial instrument created from, or whose value depends on (is derived from), the value of one or more underlying assets, reference rates, or indexes of asset values. These instruments may include forwards, futures, currency and interest rate swaps, options, floaters/inverse floaters and caps/floors/collars. During the year the University did not invest in derivative investments but did invest in transactions similar to a derivative instrument. Investment transactions similar to a derivative may include securitized assets, such as mortgage-backed securities and other asset-backed securities. As required by accounting principles generally accepted in the United States of America, the nature of derivative or similar transactions entered into by the University, and the reasons for entering into those transactions follow:

Mortgage-Backed Securities - The University invests in mortgage-backed securities issued by the Government National Mortgage Association (GNMA), an agency of the United States government, government sponsored enterprises including the Federal Home Loan Mortgage Corporation (FHLMC) or the Federal National Mortgage Association (FNMA), and private trusts or corporations. The University invests in these securities to increase the yield and return on its investment portfolio given the available alternative investment opportunities.

The values of mortgage-backed securities are generally based on the cash flows from principal and interest receipts on the underlying mortgage pools. These securities may include mortgage pass-through securities and collateralized mortgage obligations (CMOs). Mortgage pass-through securities pay the holder of the security the principal and interest amounts received from the underlying pool of mortgages as these amounts are collected from the mortgage holders. In a CMO, the cash flows from principal and interest payments from one or more mortgage pass-through

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

securities or a pool of mortgages may be reallocated to multiple security classes with different priority claims and payment streams (commonly referred to as tranches.) A holder of the CMO security thus chooses the classes of security that best meet its risk and return objectives. Both pass-through securities and CMOs are subject to significant market risk due to fluctuations in interest rates, prepayment rates and various liquidity factors related to their specific markets.

The mortgage pass-through securities issued by GNMA, FNMA, and FHLMC are classified by the University as U.S. government securities. The mortgage pools underlying the GNMA pass-through securities are backed by the full faith and credit of the U.S. government by the Federal Housing Administration (FHA), Veterans Administration (VA), and the Farmers Home Administration (FHA). The FNMA and FHLMC securities are collateralized by underlying pools of mortgages primarily issued by GNMA, FNMA or FHLMC which guarantee full and timely payment of principal and interest.

The CMOs held by the University include mortgage-backed securities issued by FNMA, FHLMC, and certain trusts and private corporations (including REMIC issuers). In addition, nontraditional mortgage pass-through securities, such as “interest-only strips” and “principal-only strips”, if held by the University, are classified as CMOs. The University did not hold any nontraditional pass-through securities during the year.

As of June 30, 2003, the University was holding \$7,261,000 in mortgage-backed securities valued at fair value representing approximately 3.26% of its total investments. Of this amount, \$395,000 represents investments in CMOs and \$1,562,000 represents investment with the Investment Fund.

Other Asset-Backed Securities - The University invests in various asset-backed securities such as automobile loan securitizations, credit card securitizations, and home equity loans. The University invests in the various asset-backed securities to increase the yield and return on its investment portfolio given the available alternative investment opportunities.

The values of these other asset-backed securities are generally based on the cash flows to be received from the underlying pools of assets. Accordingly, these securities are subject to market risk due to fluctuations in interest rates, prepayment rates, and various liquidity factors related to their specific markets. The market risk is reduced by the University's preference to invest in the shorter average life securities.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

These security holdings are subject to credit-related losses in the event of nonperformance by the issuers or counterparties to these instruments. However, the University does not expect any issuers or counterparties to fail to meet their obligation given their high credit ratings. The assets that collateralize these securities, which could be liquidated at market values at the time of nonperformance, reduce the credit risk.

As of June 30, 2003, the University was holding \$461,000 in asset-backed securities valued at fair value representing approximately .21% of its total investments.

Indirect Derivative Holdings - The University utilizes external investment managers to identify specific investment funds that meet asset allocation and investment management objectives. These managers and related funds are used to increase the yield and return on its investment portfolio given the available alternative investment opportunities and to diversify its asset holdings. These investments generally include equity and bond funds. Certain investments expose the University to market risk by trading or holding derivative instruments and by leveraging the securities in the fund. Derivative holdings are limited by type and duration constraints as well as being backed by liquid assets.

The University's holdings in indirect derivatives are primarily used to decrease risk by managing interest rate and volatility exposure. The indirect derivatives are used by the University's investment managers primarily to hedge underlying positions and to gain exposure to specific markets in an efficient, inexpensive, liquid and diversified manner. The University considers the risk associated with these holdings to be prudent and within acceptable bounds.

As of June 30, 2003, the Long-Term Investment Fund (excluding the Investment Fund investments) was holding \$5,739,000 in mutual and pooled investment funds for which investments in derivatives totaled \$3,083,000 valued at fair value representing approximately 1.39% of the University's total investments.

In addition, the Investment Fund was holding \$73,222,000 in various mutual funds for which investment in derivative instruments totaled \$10,828,000 valued at fair value representing approximately 4.87% of the University's total investments. Of this amount \$4,614,000 or 42.608% was held for the Endowment Fund and \$6,214,000 or 57.392% was held for the participating Foundations.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 3 - ENDOWMENT INVESTMENTS

Investments of the University's endowment funds are pooled, unless required to be separately invested by the donor. If a donor has not provided specific instructions, State law permits the Endowment Board of Trustees to authorize for expenditure the net appreciation, realized and unrealized, of the investments of the endowment funds.

Investment return of the University's endowment funds is predicated on the total return concept (yield plus appreciation). Annual payouts from the University's pooled endowment funds, which were 4.6% for the current year, are determined by applying the 4.6% rate to the average market value of each fund for the twelve quarters ending with the proper fiscal year. To the extent that the total return for the current year exceeds the payout, the excess is added to principal. If current year earnings do not meet the payout requirements, the University uses accumulated income and appreciation from restricted, expendable net asset endowment balances to make up the difference. At June 30, 2003, the endowment fund had \$85,668,000 in expendable revenues and appreciation of which \$73,677,000 was restricted to specific purposes.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 4 - RECEIVABLES

Receivables at June 30, 2003 were as follows: *(in thousands)*

	<u>Gross Receivables</u>	<u>Less Allowance for Doubtful Accounts</u>	<u>Net Receivables</u>
Current Receivables:			
Students	\$ 2,760	\$ 1,350	\$ 1,410
Accounts	17,303	2,262	15,041
Intergovernmental	13,578		13,578
Investment Earnings	470		470
Interest on Loans	309	262	47
Other	809		809
	<u>35,229</u>	<u>3,874</u>	<u>31,355</u>
	<u>\$ 35,229</u>	<u>\$ 3,874</u>	<u>\$ 31,355</u>
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	\$ 1,166	\$ 0	\$ 1,166
Institutional Student Loan Programs	195		195
	<u>1,361</u>	<u>0</u>	<u>1,361</u>
	<u>\$ 1,361</u>	<u>\$ 0</u>	<u>\$ 1,361</u>
Notes Receivable - Noncurrent:			
Federal Loan Programs	\$ 9,638	\$ 747	\$ 8,891
Institutional Student Loan Programs	509	147	362
	<u>10,147</u>	<u>894</u>	<u>9,253</u>
	<u>\$ 10,147</u>	<u>\$ 894</u>	<u>\$ 9,253</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 5 - CAPITAL ASSETS

A summary of changes in the capital assets for the year ended June 30, 2003, is presented as follows: *(in thousands)*

	Balance July 1, 2002	Adjustments	Increases	Decreases	Balance June 30, 2003
Capital Assets, Non-depreciable:					
Land	\$ 10,364		\$ 1,685	\$ 0	\$ 12,049
Construction in Progress	38,044	(4,304)	79,151		112,891
Total Capital Assets, Non-depreciable	48,408	(4,304)	80,836		124,940
Capital Assets, Depreciable:					
Buildings	528,275	4,304	32,479	661	564,397
Machinery and Equipment	208,801		30,186	14,906	224,081
General Infrastructure	60,902		11,968		72,870
Total Capital Assets, Depreciable	797,978	4,304	74,633	15,567	861,348
Less Accumulated Depreciation/Amortization for:					
Buildings	210,601		13,756	448	223,909
Machinery and Equipment	134,927		17,838	12,682	140,083
General Infrastructure	14,033		1,865		15,898
Total Accumulated Depreciation	359,561		33,459	13,130	379,890
Total Capital Assets, Depreciable, Net	438,417	4,304	41,174	2,437	481,458
Capital Assets, Net	\$ 486,825	\$ 0	\$ 122,010	\$ 2,437	\$ 606,398

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2003 were as follows: *(in thousands)*

	Amount
Accounts Payable	\$ 21,364
Accrued Payroll	3,578
Contract Retainage	3,372
Other	1,663
Total Accounts Payable and Accrued Liabilities	\$ 29,977

NOTE 7 - SHORT-TERM DEBT – COMMERCIAL PAPER PROGRAM

The University has available Commercial Paper Program financing for short-term credit up to \$25,000,000 to finance capital construction projects. The University's available funds are pledged to the Commercial Paper Program

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

financing with the anticipation of converting to general revenue bond financing in the future. As of June 30, 2003, no Commercial Paper was outstanding.

Short-term debt activity for the year ended June 30, 2003 was as follows: (*in thousands*)

	Balance July 1, 2002	Draws	Repayments	Balance June 30, 2003
Commercial Paper Program	\$ 2,000	\$ 12,000	\$ 14,000	\$ 0

NOTE 8 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2003 is presented as follows: (*in thousands*)

	Balance July 1, 2002	Additions	Reductions	Balance June 30, 2003	Current Portion
Bonds Payable	\$ 87,092	\$ 72,395	\$ 6,328	\$ 153,159	\$ 6,587
Add/Deduct Premium/Discount	17	2,471	37	2,451	
Total Bonds Payable	87,109	74,866	6,365	155,610	6,587
Capital Leases Payable	275		57	218	62
Compensated Absences	25,671	32,957	24,369	34,259	2,031
Total Long-Term Liabilities	\$ 113,055	\$ 107,823	\$ 30,791	\$ 190,087	\$ 8,680

Additional information regarding capital lease obligations is included in Note 9.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

B. Bonds Payable - The University was indebted for bonds payable for the purposes shown in the following table: *(in thousands)*

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2003	Principal Outstanding 06/30/2003
STUDENT HOUSING SYSTEM						
Dormitory - Sullivan Hall	(1) F	3.625%	09/01/2004	\$ 2,200	\$ 1,995	\$ 205
Dormitory Complex	(1) G	3.00%	09/01/2006	3,225	2,690	535
Avent Ferry Complex	(1) M	5.3-6.1%	09/01/2014	11,820	10,775	1,045
Refund Housing System Series H, J & K	(1) N	5-5.8%	09/01/2009	4,110	2,070	2,040
Residence Hall Improvement Project	(1) (A)	3.25-5%	10/01/2010	15,770	4,330	11,440
Housing System Project	(1) (B)	5-5.5%	10/01/2010	3,020	490	2,530
Refund Housing System Series L & M	(9) 2002B	2-5%	10/01/2014	8,800	645	8,155
Housing System Projects	(9) 2003A	2-5%	10/01/2018	26,655		26,655
Housing System Projects	(9) 2003B	Variable	10/01/2027	41,720		41,720
Total Student Housing System				<u>117,320</u>	<u>22,995</u>	<u>94,325</u>
DINING HALL SYSTEM						
Dining Hall System Refunding Bonds	(2) 1996	4-5.3%	02/01/2012	<u>2,345</u>	<u>530</u>	<u>1,815</u>
STUDENT HEALTH SYSTEM						
Student Health Facility Project	(3) (A)	3.25-5.25%	10/01/2013	<u>5,615</u>	<u>1,145</u>	<u>4,470</u>
PARKING SYSTEM						
Parking System Refunding Bonds	(4) 1996	4-5.1%	06/01/2009	<u>6,530</u>	<u>2,365</u>	<u>4,165</u>
ATHLETIC SYSTEM						
Entertainment and Sports Arena Project	(5) (A)	3.25-5.25%	10/01/2018	6,325	850	5,475
Doak Field Project	(9) 2003A	2-5%	10/01/2018	80		80
Doak Field Project	(9) 2003B	Variable	10/01/2023	<u>3,940</u>		<u>3,940</u>
Total Athletic System				<u>10,345</u>	<u>850</u>	<u>9,495</u>
CENTENNIAL CAMPUS SYSTEM						
Centennial Campus Projects	(6) 1997A	6.55-7.04%	12/15/2010	7,765	2,645	5,120
Centennial Campus Projects	(6) 1997B	5.125%	12/15/2016	7,090		7,090
Centennial Campus Projects	(6) 1999A	Variable	12/15/2019	13,500	300	13,200
Centennial Campus Projects	(6) 1999B	7.04%	12/15/2004	2,117	1,213	904
Refunding Centennial Campus Series 1993	(9) 2002C	2.75-6.45%	10/01/2013	<u>7,160</u>	<u>470</u>	<u>6,690</u>
Total Centennial Campus System				<u>37,632</u>	<u>4,628</u>	<u>33,004</u>
STUDENT CENTER SYSTEM						
University Student Center	(7) 1996	4.5-5.1%	11/01/2009	<u>2,210</u>	<u>630</u>	<u>1,580</u>
OTHER						
Gymnasium Refunding Bonds	(8) (A)	3.25-4.5%	10/01/2007	1,695	555	1,140
Central Stores Expansion Project	(8) (B)	5-5.75%	10/01/2020	<u>3,370</u>	<u>205</u>	<u>3,165</u>
Total Other				<u>5,065</u>	<u>760</u>	<u>4,305</u>
Total Bonds Payable (principal only)				<u>\$ 187,062</u>	<u>\$ 33,903</u>	153,159
Less: Unamortized Discount						(273)
Plus: Unamortized Premium						<u>2,724</u>
Total Bonds Payable						<u>\$ 155,610</u>

(A) The University of North Carolina System Pool Revenue Bonds, Series 1998B

(B) The University of North Carolina System Pool Revenue Bonds, Series 2000

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Designated student fees and revenue streams related to the systems financed above have been pledged for the payment of these bonds. In addition, fund reservations required by the Bond Indentures have been established and recorded as restricted net assets. The following revenues as summarized in Note 10 have been pledged or are security for the bonds:

- | | |
|---|--|
| (1) Residential Life Revenues (Housing) | (6) Other Revenues (Centennial Campus) |
| (2) Dining Revenues | (7) Student Center Revenues |
| (3) Student Health Revenues | (8) Other Sales and Service Revenues
(Central Stores and Gymnasium) |
| (4) Parking Revenues | (9) Available Funds (General Revenue Bonds) |
| (5) Athletic Revenues | |

Available funds, as defined in the General Indenture dated October 1, 2001, are any funds of NC State in each fiscal year remaining after satisfying debt obligations excluding (1) State appropriations, (2) tuition payments, (3) funds restricted by gift, grant, or payee, (4) revenues from Special Facilities, and (5) funds restricted by law. Available funds are not pledged to the trustee, but rather are the source from which principal and interest on the Bonds will be paid.

- C. Demand Bonds** - Included in bonds payable are several variable rate demand bond issues. Demand bonds are securities that contain a “put” feature that allows bondholders to demand payment before the maturity of the debt upon proper notice to the University’s remarketing or paying agents.

With regards to the following demand bonds, the University has entered into legal agreements, which would convert the demand bonds not successfully remarketed into another form of long-term debt.

The North Carolina State University at Raleigh Variable Rate Revenue Bonds (Centennial Campus Projects), Series 1999A: On September 22, 1999 the University issued tax-exempt variable rate revenue demand bonds in the amount of \$13,500,000 that have a final maturity date of December 15, 2019. The bonds are subject to mandatory sinking fund redemption that began on December 1, 2000. The University’s proceeds of this issuance were used to (i) discharge a portion of a loan from First Union National Bank, the proceeds from which were used for the construction and equipping of a building known as the Partners II Building located on the Centennial Campus of NC State, (ii) paying the cost of relocating utility easements on the Centennial Campus of NC State, and (iii) paying the costs incurred in connection with the issuance of the 1999A Bonds.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven (7) days notice and delivery to the paying agent, The Bank of New York. Upon notice from the paying agent, the remarketing agent, Lehman Brothers, Inc., has agreed to exercise its best efforts to remarket the bonds for which a notice of purchase has been received.

Under a Standby Bond Purchase Agreement (Agreement) between the Board of Governors of the University of North Carolina and Wachovia Bank, N.A., a Liquidity Facility has been established for the Trustee (The Bank of New York) to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. This Agreement requires a commitment fee equal to 0.20% of the available commitment, payable quarterly in arrears, beginning on October 1, 1999 and on each January 1, April 1, and July 1 thereafter until the expiration date or the termination date of the Agreement.

Under the Agreement, any bonds purchased through the Liquidity Facility become Liquidity Provider Bonds and shall, from the date of such purchase and while they are Liquidity Provider Bonds, bear interest at the Liquidity Provider Rate (the greater of the Bank prime commercial lending rate and Federal Funds Rate plus 0.5%). Upon remarketing of Liquidity Provider Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Liquidity Provider Bonds. Payment of the interest on the Liquidity Provider Bonds is due the first business day of each month in which Liquidity Provider Bonds are outstanding. At June 30, 2003, there were no Liquidity Provider Bonds held by the Liquidity Facility. The original Liquidity facility has been extended and is scheduled to expire on September 15, 2008, unless otherwise extended based on the terms of the agreement.

Upon expiration or termination of the Agreement, the University is required to redeem (purchase) the Liquidity Provider Bonds held by the Liquidity Facility in twenty (20) quarterly installments, beginning the first business day that is at least 180 days following such expiration date or termination date along with accrued interest at the Liquidity Provider Rate.

Effective October 1, 1999, the University entered into an interest rate swap contractual agreement with Lehman Brothers, Inc. on \$9,000,000 of these demand bonds. Under this agreement the University will pay interest at a fixed rate of 4.574%. On a monthly basis the difference between 67% of the weighted average of the weekly LIBOR (London

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Interbank Offered Rates) rate and the fixed rate will be calculated. If the fixed rate is greater than the LIBOR calculated rate, the University will pay the difference to Lehman Brothers, Inc. If the LIBOR rate is greater, Lehman Brothers will refund the difference to the University. During the fiscal year the University paid Lehman Brothers \$321,000 under this agreement.

The North Carolina State University at Raleigh Variable Rate General Revenue Bonds, Series 2003B: On June 20, 2003 the University issued tax-exempt variable rate revenue demand bonds in the amount of \$45,660,000 that have a final maturity date of October 1, 2027. The bonds are subject to mandatory sinking fund redemption that begins on October 1, 2004. The University's proceeds of this issuance were used to pay a portion of the costs of certain improvements on the campus of the University, to refund certain debt previously incurred for that purpose, and to pay the costs incurred in connection with the issuance of the 2003B bonds.

While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven (7) days notice and delivery to the paying agent, The Bank of New York. Upon notice from the paying agent, the remarketing agent, UBS Financial Services Inc., has agreed to exercise its best efforts to remarket the bonds for which a notice of purchase has been received.

Under a Standby Bond Purchase Agreement (Agreement) between the Board of Governors of the University of North Carolina and Bayerische Landesbank, a Liquidity Facility has been established for the Trustee (The Bank of New York) to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. This Agreement requires a commitment fee equal to 0.20% of the available commitment, payable quarterly in arrears, beginning on July 1, 2003 and on each October 1, January 1, April 1, and July 1 thereafter until the expiration date or the termination date of the Agreement.

Under the Agreement, any bonds purchased through the Liquidity Facility become Liquidity Provider Bonds and shall, from the date of such purchase and while they are Liquidity Provider Bonds, bear interest at the Liquidity Provider Rate (the greater of the Bank prime commercial lending rate and Federal Funds Rate plus 0.5%). Upon remarketing of Liquidity Provider Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Liquidity Provider Bonds. Payment of the interest on the Liquidity Provider Bonds is due the first business day of each month in which Liquidity Provider

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Bonds are outstanding. At June 30, 2003, there were no Liquidity Provider Bonds held by the Liquidity Facility. The original Liquidity facility is scheduled to expire on June 19, 2008, unless otherwise extended based on the terms of the agreement.

Upon expiration or termination of the Agreement, the University is required to redeem (purchase) the Liquidity Provider Bonds held by the Liquidity Facility in twenty (20) quarterly installments, beginning the first business day of January, April, July or October, whichever first occurs on or following the Purchase Date along with accrued interest at the Liquidity Provider Rate.

Effective June 20, 2003, the University entered into an interest rate swap contractual agreement with Bank of America Inc., on \$24,655,000 of these demand bonds. Under this agreement the University will pay interest at a fixed rate of 3.54%. On a monthly basis the difference between the weighted average of the weekly BMA (the Bond Market Association Municipal Swap Index) rate and the fixed rate will be calculated. If the fixed rate is greater than the BMA calculated rate, the University will pay the difference to Bank of America Inc. If the BMA rate is greater, Bank of America will refund the difference to the University. During the fiscal year the University paid Bank of America \$19,000 under this agreement.

Effective June 20, 2003, the University entered into an interest rate swap contractual agreement with Bank of America Inc., on \$21,005,000 of these demand bonds. Under this agreement the University will pay interest at a fixed rate of 1.19%. On a monthly basis the difference between the weighted average of the weekly BMA (the Bond Market Association Municipal Swap Index) rate and the fixed rate will be calculated. If the fixed rate is greater than the BMA calculated rate, the University will pay the difference to Bank of America Inc. If the BMA rate is greater, Bank of America will refund the difference to the University. During the fiscal year the University paid Bank of America \$1,000 under this agreement.

Interest Rate Swaps

Objective: In order to protect against the potential of rising interest rates, the University entered into three separate pay-fixed, receive-variable interest rate swaps at a cost anticipated to be less than what the University would have paid to issue fixed-rate debt.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Terms, fair values, and credit risk: The University's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled or anticipated reductions in the associated "bonds payable" category. The terms, fair values, and credit ratings of the outstanding swaps as of June 30, 2003 were as follows: (*in thousands*)

Associated Bond Issue	Notional Amounts	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Counterparty Credit Rating
Centennial Campus 1999A	\$ 9,000	10/01/1999	4.574%	67% of LIBOR ¹	\$ (1,529)	12/1/2019	A2/A/A+
General Revenue 2003B	24,655	06/20/2003	3.54%	BMA ^{2,3}	(21)	10/1/2027	Aa1/AA-/AA
General Revenue 2003B	<u>21,005</u>	06/20/2003	1.19%	BMA	<u>38</u>	7/1/2005 ⁴	Aa1/AA-/AA
Total	<u>\$ 54,660</u>				<u>\$ (1,512)</u>		

¹ London Interbank Offered Rate

² The Bond Market Association Municipal Swap Index TM

³ Variable rate received is BMA Municipal Swap Index from 6/20/03 to 7/1/06, thereafter, the variable rate received will be 75% of LIBOR

⁴ Counterparty has the option to extend the swap to July 1, 2007

Because rates have declined, two of the three swaps have negative fair values as of June 30, 2003. The negative fair values may be countered by reductions in total interest payments required under the variable-rate bonds, creating lower synthetic interest rates. Because the coupons on the University's variable-rate bonds adjust to changing interest rates, the bonds do not have corresponding fair value increases. The fair values are the market values as of June 30, 2003.

As of June 30, 2003, the University was exposed to credit risk in the amount of the positive fair value on the short-term General Revenue 2003B derivative's fair value. The swap agreements do not contain a requirement for collateral, although the General Revenue 2003B swaps require termination should the University's or the counterparty's credit rating fall below either Baa2 as issued by Moody's Investors Services or BBB as issued by Standard & Poors or Fitch Ratings. Also, under the terms of the swap agreements, should one party become insolvent or otherwise default on its obligations, provisions permit the nondefaulting party to accelerate and terminate all outstanding transactions. Of the three agreements entered into by the University, two swaps, approximating 83% of the notional amount of the swaps outstanding, are held with one counterparty. All counterparties are rated Aa1 or better.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Basis risk: The University is exposed to basis risk on the swaps when the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence, the expected cost savings may not be realized. As of June 30, 2003, the BMA rate was 1.01 percent, whereas 67% of LIBOR was 1.18 percent.

Termination risk: The University or the counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. If any of the swaps are terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the University would be liable to the counterparty for that amount.

Swap payments and associated debt: Using rates as of June 30, 2003, debt service requirements of the University's outstanding variable-rate debt and net swap payments are as follows. As rates vary, variable-rate bond interest payments and net swap payments will vary. (*in thousands*)

Variable Rate Bonds

Fiscal Year Ending June 30	Principal	Interest	Interest Rate Swaps, Net	Total
2004	\$ 0	\$ 528	\$ 965	\$ 1,493
2005	695	521	951	2,167
2006	400	320	901	1,621
2007	400	316	887	1,603
2008	500	311	871	1,682
2009-2013	2,800	1,469	4,078	8,347
2014-2018	3,600	1,299	3,529	8,428
2019-2023	900	1,171	3,115	5,186
2024-2027	24,655	717	1,285	26,657
Total	\$ 33,950	\$ 6,652	\$ 16,582	\$ 57,184

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

D. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2003 are as follows: (*in thousands*)

<u>Fiscal Year</u>	Annual Requirements Bonds Payable	
	Principal	Interest
	2004	\$ 6,587
2005	6,582	6,545
2006	6,960	6,220
2007	7,265	5,887
2008	7,450	5,544
2009-2013	35,690	22,418
2014-2018	33,200	13,972
2019-2023	24,770	7,224
2024-2028	24,655	2,363
Total Requirements	\$ 153,159	\$ 76,690

Interest on the variable rate 1999A is calculated at 4.574% and the 2003B revenue bonds is calculated at 4% at June 30, 2003.

The variable rate is changed weekly every Wednesday by the Remarketing agent with a maximum rate of 12%. In addition, the University has entered into interest rate swaps to synthetically fix a portion of the 1999A and 2003B bonds.

E. Bond Defeasance - The University has extinguished long-term debt obligations by the issuance of new long-term debt instruments as follows:

In fiscal year 2002, the University defeased \$7,520,000 of outstanding North Carolina State University at Raleigh Housing System Revenue Bonds of 1994, Series M. An irrevocable trust was established with an escrow agent to provide for all future debt service payments on the defeased bonds. The trust assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2003, the outstanding balance of the defeased Housing System Revenue Bonds was \$7,520,000.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 9 - LEASE OBLIGATIONS

- A. Capital Lease Obligations** – A capital lease obligation relating to a DNA Analyzer Sequencer is recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2003: (*in thousands*)

<u>Fiscal Year</u>	<u>Amount</u>
2004	\$ 79
2005	79
2006	79
2007	<u>13</u>
Total Minimum Lease Payments	250
Amount Representing Interest (8.77% Rate of Interest)	<u>32</u>
Present Value of Future Lease Payments	<u><u>\$ 218</u></u>

Leased assets amounted to \$319,000 less accumulated depreciation of \$68,000 at June 30, 2003.

- B. Operating Lease Obligations** – The University entered into operating leases for various equipment and property rental. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2003: (*in thousands*)

<u>Fiscal Year</u>	<u>Amount</u>
2004	\$ 2,964
2005	2,296
2006	1,172
2007	935
2008	<u>358</u>
Total Minimum Lease Payments	<u><u>\$ 7,725</u></u>

Rental expense for all operating leases during the year was \$2,556,000.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 10 - REVENUES

A summary of eliminations and allowances by revenue classification and revenues pledged as security for revenue bonds is presented as follows: (*in thousands*)

	Gross Revenues	Internal Sales Eliminations	Less Scholarship Discounts	Less Allowance for Uncollectibles	Net Revenues	Revenues Pledged as Security for Debt
Operating Revenues:						
Student Tuition and Fees	\$ 135,262	\$ 0	\$ 28,785	\$ 264	\$ 106,213	\$ 14,768 (D,E,F,G)
Other Revenues	\$ 13,947	\$ 2,663	\$ 0	\$ 0	\$ 11,284	\$ 4,151 (A)
Sales and Services:						
Residential Life	\$ 28,784	\$ 276	\$ 4,365	\$ (3)	\$ 24,146	\$ 28,784 (B)
Dining	20,784	1,824	1,424	(37)	17,573	20,784 (C)
Bookstore	13,045	601			12,444	
Athletic	25,654	66			25,588	25,654 (D)
Parking	5,961	572		(51)	5,440	5,961 (E)
Student Center	684	108			576	684 (F)
Student Health	3,368		565		2,803	3,368 (G)
Other	11,586	8,868	1,488	(19)	1,249	2,243 (H)
Sales and services of educational and related activities	48,388	17,936		(195)	30,647	406 (H)
Total Sales and Services	\$ 158,254	\$ 30,251	\$ 7,842	\$ (305)	\$ 120,466	\$ 87,884

Revenue Bonds Secured by Pledged Revenues:

- (A) Centennial Campus System
- (B) Student Housing System
- (C) Dining System
- (D) Athletics System
- (E) Parking System
- (F) Student Center System
- (G) Student Health System
- (H) Other

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 11 - OPERATING EXPENSES BY FUNCTION

The University's operating expenses by functional classification are presented as follows: (*in thousands*)

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 191,575	\$ 18,734	\$ 17,971	\$ 0	\$ 5	\$ 0	\$ 228,285
Research	116,526	14,633	37,506		450		169,115
Public Service	67,348	8,418	19,209		262		95,237
Academic Support	29,936	13,131	11,932		17		55,016
Student Services	8,474	1,260	3,860				13,594
Institutional Support	40,648	3,249	13,504		361		57,762
Operations and Maintenance of Plant	16,509	11,026	3,797		16,006		47,338
Student Financial Aid	519	66	1,736	14,100			16,421
Auxiliary Enterprises	33,940	21,460	30,497		2,901		88,798
Depreciation						33,512	33,512
Total Operating Expenses	<u>\$ 505,475</u>	<u>\$ 91,977</u>	<u>\$ 140,012</u>	<u>\$ 14,100</u>	<u>\$ 20,002</u>	<u>\$ 33,512</u>	<u>\$ 805,078</u>

NOTE 12 - PENSION PLANS

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

The Teachers' and State Employees' Retirement System 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.

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes 135-5* and *135-8* and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2003, the General Assembly required no contribution by employers and 6% of covered payroll for members.

For the year ended June 30, 2003, the University had a total payroll of \$450,266,000, of which \$235,783,000 was covered under the Teachers'

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

and State Employees' Retirement System. Total employee contributions for pension benefits for the year were \$14,147,000. No employer contributions were required. The University made one hundred percent of its annual required contributions for the years ended June 30 2003, 2002, and 2001, which were \$0, \$4,628,000, and \$11,938,000, respectively.

The Teachers' and State Employees' Retirement System's financial information is included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page <http://www.osc.state.nc.us/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

The Optional Retirement Program (Program) is a defined contribution retirement plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Administrators and eligible faculty of the 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 and designates the companies authorized to offer investment products. The Board has authorized the following carriers: Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), Lincoln Life Insurance Company, Variable Annuity Life Insurance Company (VALIC), and Fidelity Investments. Participants may elect to allocate their contributions and the University contributions to the carrier of their choice. Each carrier offers a variety of investment funds, including both fixed and variable account investment options and mutual funds.

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

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 2003, these rates were set at 6.84% of covered payroll for employers and 6% of covered payroll for members. The University assumes no liability other than its contribution.

For the year ended June 30, 2003, the University had a total payroll of \$450,266,000, of which \$127,901,000 was covered under the Optional Retirement Program. Total employee and employer contributions for

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

pension benefits for the year were \$7,674,000 and \$8,748,000, respectively.

- B. Deferred Compensation and Supplemental Retirement Income Plans** - IRC Section 457 Plan - The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement, or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, *the North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to \$1,082,000 for the year ended June 30, 2003.

IRC Section 401(k) Plan - All members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the Plan are the responsibility of the Plan participants. No costs are incurred by the University except for a 5% employer contribution for the University's law enforcement officers, which is mandated under General Statute 143-166.30(e). Total employer contributions on behalf of University law enforcement officers for the year ended June 30, 2003 were \$96,000. The voluntary contributions by employees amounted to \$2,691,000 for the year ended June 30, 2003.

IRC Section 403(b) and 403(b)(7) Plans - Eligible University employees can participate in tax sheltered annuity plans created under Internal Revenue Code Sections 403(b) and 403(b)(7). The employee's eligible contributions, made through salary reduction agreements, are exempt from federal and State income taxes until the annuity is received or the contributions are withdrawn. These plans are exclusively for employees of universities and certain charitable and other nonprofit institutions. All costs of administering and funding these plans are the responsibility of the Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to \$7,448,000 for the year ended June 30, 2003.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- C. Federal Employment Retirement** – The Federal Retirement System is a multiple-employer retirement system and is composed of three retirement programs: the Civil Service Retirement System (CSRS) for participants employed prior to January 1, 1987, the Federal Employees Retirement System (FERS) for participants employed after January 1, 1987, and the Civil Service Retirement Offset System for reemployed CSRS employees.

North Carolina Cooperative Extension employees with federal appointments prior to January 1, 1987 participate in the Civil Service Retirement System. Currently, 203 employees participate in CSRS. Participating employees are required by federal statute to contribute 7% of salary. During the year the required employer contribution ranged from 8.51% in July, to 7.5% starting in October, to 7% starting in January. In addition, the employees may contribute up to 8% of salary to the Thrift Savings Plan (a defined contribution plan managed by the Federal Retirement Thrift Investment Board). The contribution for CSRS for the year ended June 30, 2003, was \$1,961,000, which consisted of \$1,028,000 from the University and, \$933,000 from the employees. Employees contributed \$49,000 to the Thrift Savings Plan.

Under the Federal Employees Retirement System (FERS), employees are required to contribute .8% of salary and the University 10.7%. Currently, 15 employees participate in FERS. The University is also required to contribute 1% of participant's salary to the Thrift Savings Plan, plus up to an additional 4% depending upon employee's contribution, which can range from 0% to 13% of their salary. The contribution for the year ended June 30, 2003 was \$115,000, which consisted of \$8,000 from employees and \$107,000 from the University for FERS and \$86,000 from employees and \$49,000 from the University for the Thrift Savings Plan.

NOTE 13 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees** - The University participates in State-administered programs which provide postemployment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System or the Optional Retirement Program. These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The University contributed 2.35% of the covered payroll under the Teachers' and State Employees' Retirement System and the Optional

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Retirement Program for these health care benefits. For the fiscal year ended June 30, 2003, the University's total contribution to the Plan was \$8,547,000. The University assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.

- B. Long-Term Disability** - The University participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The University contributes .52% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the fiscal year ended June 30, 2003, the University's total contribution to the DIPNC was \$1,891,000. The University assumes no liability for long-term disability benefits under the Plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 14 - RISK MANAGEMENT

The University is exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled via a combination of methods, including participation in State-administered insurance programs, purchase of commercial insurance, and self-retention of certain risks. There have been no significant reductions in insurance coverage from the previous year and settled claims have been within coverage limits in any of the past three fiscal years.

Tort claims of up to \$500,000 are self-insured under the authority of the State Tort Claims Act. In addition, the State provides excess public officers' and employees' liability insurance up to \$11,000,000 via contract with a private insurance company. The University pays the premium, based on a composite rate, directly to the private insurer.

The University is required to maintain fire and lightning coverage on all State-owned buildings and contents through the State Property Fire Insurance Fund (Fund), an internal service fund of the State. Such coverage is provided at no cost to operations supported by the State's General Fund. Other operations not

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a \$500 per occurrence deductible, except for the peril of theft with an applicable \$1,000 per occurrence deductible. University departments, as an individual business decision, may also purchase through the Fund primary extended coverage for buildings and contents. Coverage may also be purchased through the Fund for theft, vandalism, sprinkler leakage, or all-risk perils. University departments also have the option to purchase all-risk coverage for specific computers and "miscellaneous equipment" on a scheduled basis or retain the risk.

All State-owned vehicles are covered by liability insurance through a private insurance company as administered by the North Carolina Department of Insurance. The liability limits for losses occurring in-State are \$500,000 per claim and \$5,000,000 per occurrence and out-of-State are \$1,000,000 per claim and \$5,000,000 per occurrence. The University pays premiums to the Department of Insurance for the coverage. While liability coverage is required by statute for all University vehicles, departments may also individually opt to purchase collision and comprehensive physical damage coverage.

The University is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is administered by the North Carolina Department of Insurance. Universities are charged a premium by the private insurance company. Coverage limit is \$1,000,000 per occurrence with a \$10,000 deductible.

The University purchased other authorized coverage from private insurance companies through the North Carolina Department of Insurance and the State's Agent of Record. The types of insurance policies purchased include: Medical Professional Liability, Veterinary Professional Liability, Fine Arts Property, Master Crime, Inland Marine Property For Musical Instruments, Campers Accident and Sickness, Athletic Accident, Boiler and Machinery, Watercraft, Oceanographic Equipment, Nuclear Energy Liability, and Surety Bonds.

University employees and retirees are provided comprehensive major medical care benefits. Coverage is funded by contributions to the State Health Plan (Plan), a pension and other employee benefit trust fund of the State of North Carolina. The Plan has contracted with third parties to process claims.

The North Carolina Workers' Compensation Program provides benefits to workers injured on the job. All employees of the State and its component units are included in the program. When an employee is injured, the University's primary responsibility is to arrange for and provide the necessary treatment for work related injury. The University is responsible for paying medical benefits and compensation in accordance with the North Carolina Workers' Compensation Act. The University is self-insured for workers' compensation.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Term life insurance (death benefits) of \$25,000 to \$50,000 is provided to eligible workers. This Death Benefit Plan is administered by the State Treasurer and funded via employer contributions. The employer contribution rate was .16% for the current fiscal year.

Additional details on the State-administered risk management programs are disclosed in the State's *Comprehensive Annual Financial Report*, issued by the Office of the State Controller.

NOTE 15 - COMMITMENTS AND CONTINGENCIES

- A. Commitments** - The University has established an encumbrance system to track its outstanding commitments on construction projects and other purchases. Outstanding commitments on construction contracts were \$110,251,000 at June 30, 2003.
- B. Pending Litigation and Claims** - As previously reported, the Environmental Protection Agency (EPA) filed a civil action against the University pursuant to the Comprehensive Environmental Response, Compensation and Liability Act. The complaint sought relief that would cause the University to enter into remediation of a hazardous waste site known as "Lot 86." The University is involved in ongoing discussions and negotiations with the EPA concerning the appropriate means for addressing the remediation. A Consent Decree executed by North Carolina State University and the EPA has been approved by the Court. Remedial clean-up pursuant to the Consent Decree continues. The remediation costs paid by the University for the year ended June 30, 2003 totaled \$249,000.

As previously reported, litigation is still pending in Superior Court between NC School Boards Association, et. al. V. Harlan Boyles, et. al. which involves various State officials in their official capacity which seeks a judicial determination as to whether the State constitution requires certain monetary payments collected by State agencies to be paid to the local county school funds rather than statutorily designated recipients. The complaint alleges in part that the monetary payments collected pursuant to statutory authority by the University for violations of parking traffic regulations and library fines are "civil penalties" which the State constitution requires to be paid to the school fund in the county where they are collected. The lawsuit seeks declaratory judgment that the State Civil Penalty and Forfeiture Fund, the State School Technology Fund, and the Public Settlement Reserve Fund are unconstitutional. The Wake County Superior Court ruled in favor of the plaintiffs. The order is retroactive for a three year statute of limitations from the date the civil

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

action was filed to include all affected civil fines and penalties collected by State agencies since December 1995. The court has stayed enforcement of this ruling, pending the State's appeal. The record was filed with the court on April 16, 2002. The Court of Appeals reversed the trial court's decision that held that the library, traffic and parking fines are payable to the public schools but held in favor of the plaintiff on certain other fines and penalties affecting other State agencies. The Department of Transportation, however, has appealed as of right on the overweight penalties, a decision that went against them in the majority opinion of the court and the School Board has filed an appeal covering all issues decided adversely to the Board, including the fines and penalties that affect the University. The North Carolina Supreme Court must now rule on whether to accept the discretionary issues and set a timetable for briefing. Thus, the matter remains pending until the Supreme Court renders a decision regarding the appeals that have been filed. If the Supreme Court reverses the Appeals Court decision, the University may be required to pay Wake County School Boards parking and library fines amounting to approximately \$6,741,000 since 1995 and approximately \$700,000 annually.

On May 9, 2002, the UNC Board of Governors authorized a resolution for the University to join as co-plaintiffs in a civil action filed against two business entities. This action is brought by the plaintiffs for patent infringement. An entity affiliated with one of the defendants in this action has filed a complaint for declaratory judgment in the U.S. District Court for the District of Alabama against the co-plaintiffs. The entity seeks a judgment that several of the University's patents relating to pasteurized liquid whole eggs are invalid and unenforceable. If successful, the University would not lose any money in the litigation, but could lose several million dollars in annual revenue that the University now earns from licensing the patents.

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

- C. University Improvement General Obligation Bonds** – The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of two billion five hundred million dollars of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The funds authorized are to be used solely for capital

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

facilities cost on the University of North Carolina campuses as specified in the legislation. The bond legislation specifies the amount of bond funding for each University campus and the level of bond funding intended for each project. The bonds are authorized to be issued over a six-year period beginning in 2001 at a level not to exceed amounts provided in the legislation. Using a cash flow financing approach, The University of North Carolina – General Administration (UNC-GA), establishes annual amounts not to exceed for each approved project. The amounts not to exceed are subject to change due to actual cash availability and needs during the year. Subsequent to the bond sales and the availability of bond proceeds, UNC-GA notifies the Office of State Budget and Management (OSBM) of the amounts not to exceed for each approved project. Within these amounts, based on an official request of cash needs from the University, OSBM authorizes allotments. The University records the allotments as revenue on the accompanying financial statements. The University's remaining authorization \$398,122,000 is contingent on future bond sales and OSBM allotment approval. Because of uncertainty and time restrictions the remaining authorization is not recorded as an asset or revenue on the accompanying financial statements.

- D. Other Contingent Receivables** – The University has received notification of other gifts and grants for which funds have not been disbursed by the resource provider and for which conditions attached to the gift or grant have not been satisfied or, in the case of permanent endowments, cannot begin to be satisfied. In accordance with accounting principles generally accepted in the United States of America, these amounts have not been recorded on the accompanying financial statements. The purpose and amount of other contingent receivables at year-end is as follows:

Purpose	Amount
Permanent Endowment for Scholarships	\$ 1,086,000

NOTE 16 - RELATED PARTIES

Foundations - There are twelve separately incorporated nonprofit foundations associated with the University. These foundations are the North Carolina Agricultural Foundation, Inc., North Carolina State University Foundation, Inc., North Carolina Dairy Foundation, Inc., North Carolina Tobacco Foundation, Inc., Pulp and Paper Foundation, Inc., North Carolina State University Physical and Mathematical Sciences Foundation, Inc., North

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Carolina Engineering Foundation, Inc., North Carolina Veterinary Medical Foundation, Inc., The North Carolina Forestry Foundation, Inc., North Carolina Textile Foundation, Inc., North Carolina State University Student Aid Association, Inc., and the North Carolina State Alumni Association, Inc. Subsequent to year-end the North Carolina Dairy Foundation, Inc. merged and became part of the North Carolina Agricultural Foundation, Inc.

These organizations serve as the primary fundraising arm of the University through which individuals, corporations, and other organizations support University programs by providing scholarships, fellowships, faculty salary supplements, and unrestricted funds to specific colleges and the University's overall academic environment. The University's financial statements do not include the assets, liabilities, net assets, or operational transactions of the foundations, except for support from each organization to the University. This support approximated \$26,455,000 for the year ended June 30, 2003.

In addition, the North Carolina State University Student Aid Association, Inc. (the Association) gave the University \$42,695,000 in expansion and improvements to the Carter Finley Stadium facilities. The Association issued bonds during fiscal year 2002 for the expansion and improvements. The bonds are secured by the Goal Line Drive pledges, Wolfpack Pride Campaign pledges, and certain property owned by the Association, as well as support from the University as described in the next paragraph. Effective March 15, 2002, the University gave ownership rights for the funds raised and pledges secured in the Wolfpack Pride Campaign to the Association with an agreement that they would be available to secure financing for the expansion and improvements to Carter Finley Stadium facilities.

In support of the expansion and improvements to Carter Finley Stadium facilities, the University also agreed on March 15, 2002, to provide the amounts actually received from the naming rights of the ESA (see following paragraphs) to reduce the Association's annual scholarship donations not to exceed \$13,184,000 and to further reduce the Association's annual scholarship donations by \$2,331,000 from scoreboard revenues over a ten year period. During the year, the University provided \$1,362,000 to the Association in scholarship credits toward this agreement.

Nonprofit Corporation – The Centennial Authority (Authority) was created by the 1995 General Assembly (Senate Bill 606) for the purpose of studying, designing, planning, constructing, owning, promoting, financing and operating a regional facility on land owned by the State. Prior to this act, the General Assembly authorized the construction by the University of a facility to be known as the "Entertainment and Sports Arena" (ESA). This facility serves as a regional sports entertainment center and is available for cultural

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

performances, sporting events and other activities of the University or of other entities (the Centennial Center project). With the 1995 legislation, the Centennial Center project was transferred to the Authority.

The Authority entered into a Ground Lease with the State of North Carolina to lease land for the ESA for a period of 99 years at an annual rent of \$1. The University entered into a Use Agreement with the Authority. Both parties agreed that the University shall be the primary and preferred user of all areas of the ESA. The University is required to pay the greater of 10% of gross ticket revenues or \$41,920 for each men's and \$18,334 for each women's basketball game to compensate the Authority for facility rental and operating expenses. Rent and expense payments for miscellaneous events will be negotiated on an event by event basis based on the availability of the ESA and the anticipated attendance.

During the year a naming rights agreement was executed to change the name of the ESA to the "RBC Center". As a result of this agreement, the University will receive \$13,184,000 over a ten-year period beginning in fiscal year 2003.

NOTE 17 - ACCOUNTING CHANGE

For the fiscal year ended June 30, 2003, the University implemented GASB Technical Bulletin No. 2003-1 that supercedes Technical Bulletin No. 94-1, and applies to derivatives that are not reported at fair value on the Statement of Net Assets. This standard provides an updated definition of derivatives and also requires disclosure of the University's objective for entering into the derivative and the derivative's terms, fair value, associated debt, and risk exposures.

**North Carolina State University
Schedule of General Obligation Bond Project Authorizations,
Budgets, and Expenditures
For Project-to-Date as of June 30, 2003 (in thousands)**

Schedule I

Capital Improvement Projects	Projected Start Date	General Obligation Bonds Authorized	Other Sources	Total Project Budget	Amount Expended	Percent Completed	Expected Completion Date
<i>Projects Started</i>							
40074-301/339 Undergraduate Science Teaching Lab Ph 1	Jul 2000	\$ 32,085	\$ 1,898	\$ 33,983	\$ 20,866	61.40%	May 2004
40074-302 Wither Hass conversion to academic use	Apr 2002	10,934		10,934	45	0.41%	Jan 2007
40074-303/336 College of Engineering Complex Phase 1	Nov 2000	38,860	1,800	40,660	9,571	23.54%	Jan 2005
40074-304/324/335 College of Vet Med Research Lab Bldg.	Jul 2000	19,461	15,921	35,382	4,983	14.08%	Sep 2005
40074-305 College of Engineering Complex Phase II	Dec 2000	32,154	8,000	40,154	106	0.26%	Nov 2005
40074-306 David Clark & Undergrad Sci Teach Lab Ph II	Jan 2001	23,712		23,712	2,476	10.44%	Oct 2005
40074-308 South Gardner Hall Laboratory Renovation	Jan 2003	14,580		14,580			Dec 2007
40074-309 1911 Building Comprehensive Renovation	May 2002	6,640		6,640	264	3.98%	Jan 2009
40074-311 Riddick Labs Comprehensive Renovation	May 2001	24,872		24,872	759	3.05%	Oct 2006
40074-312 Harrelson Classroom Building Renovation	May 2003	12,960		12,960	24	0.19%	Nov 2009
40074-313 Clark Hall Conversion & Renovation	Jan 2001	2,300		2,300	1,523	66.22%	Jul 2003
40074-314 Schaub Food Science Building Renovation	Jan 2002	10,105		10,105	360	3.56%	Dec 2006
40074-315 Williams Hall Laboratory Building Renovation	Dec 2002	12,343		12,343	33	0.27%	Jun 2008
40074-316 Polk Hall Laboratory Renovation	May 2003	14,426		14,426			Oct 2008
40074-317 Leazar Hall Laboratory Building Renovation	Feb 2002	7,988		7,988	36	0.45%	Nov 2006
40074-318 Daniels Hall Laboratory Building Renovation	Jun 2001	7,490		7,490	359	4.79%	Mar 2007
40074-319 Jordan Hall Lab & Classroom Addition	Jun 2001	12,998		12,998	915	7.04%	Sep 2005
40074-320 Library Addition	May 2002	8,756	100	8,856	150	1.69%	Sep 2006
40074-321 Support Services Center	Jan 2001	8,891	3,440	12,331	618	5.01%	Mar 2005
40074-321 Visitor's Center	Jan 2001	952	75	1,027	364	35.44%	Sep 2005
40074-322 Field Research Labs & Outlying Res. Facilities	Jan 2001	2,381		2,381	787	33.05%	Aug 2004
40074-323 Hort. Classroom @ Arboretum Ed. Ctr.	Jan 2001	476	3,714	4,190	4,156	100.00%	Dec 2002
40074-324 Partners III	May 2001	8,959	14,052	23,011	2,302	10.00%	Mar 2005
40074-324 Flex Building (1)	May 2001	6,404		6,404	5,507	85.99%	May 2005
40074-325 Environmental Research Lab - Broughton	Oct 2001	1,500		1,500	26	1.73%	Mar 2005
40074-325 Public Safety Facility	Dec 2000	4,480		4,480	281	6.27%	Oct 2004
40074-326 CVM Mech & Elec System Improvements	Jan 2001	13,425	225	13,650	396	2.90%	Dec 2005
40074-327 Technology Infrastructure Expansion	Jan 2003	2,424		2,424	475	19.60%	Jul 2004
40074-328 Chilled Water Central Plant - North Campus	Dec 2000	39,818	465	40,283	7,157	17.77%	Oct 2008
40074-330 Steam Dist & Capacity Improv. (Sullivan)	Mar 2001	3,090	48	3,138	784	24.98%	May 2004
40074-331 Backflow Preventors	Feb 2001	2,038		2,038	11	0.54%	Feb 2004
40074-331 Wayfinding	Feb 2001	2,242		2,242	276	12.31%	Apr 2004
40074-331 Pedestrian Tunnel	Feb 2003	2,999		2,999			Jul 2006
40074-332 College of Vet. Med. Infrastructure	Jan 2001	17,839	261	18,100	3,050	16.85%	Aug 2004
40074-333 Centennial Campus Infrastructure	Mar 2001	15,602	318	15,920	10,362	65.09%	Jul 2004
40074-334 Land Acquisition	Jan 2001	2,100		2,100	367	17.48%	Dec 2001
40074-337 Animal and Food Science Facility	May 2003	6,461	95	6,556			Jan 2006
40074-338 Research & Teaching Feed Mill	Jan 2001	2,582	288	2,870	2,146	74.77%	Jul 2003
40074-340 Beef Herd Relocation	Sep 2001	1,350	150	1,500	1,457	100.00%	Dec 2002
40074-340 Land Acquisition Lake Wheeler	Dec 2002	1,701	1,549	3,250	1,526	46.95%	Dec 2003
40074-350 Project Management Costs	Dec 2001	19,094		19,094	1,788	9.36%	Jun 2009

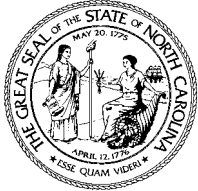
**North Carolina State University
 Schedule of General Obligation Bond Project Authorizations,
 Budgets, and Expenditures
 For Project-to-Date as of June 30, 2003 (in thousands)**

**Schedule 1
 Page 2**

Capital Improvement Projects	Projected Start Date	General Obligation Bonds Authorized	Other Sources	Total Project Budget	Amount Expended	Percent Completed	Expected Completion Date
<i>Projects Not Started - To Be Funded in Future Years</i>							
40074-310 Park Shops Comprehensive Renovation	Jan 2004	6,010		6,010			Sep 2008
40074-329 Chilled Water Brickyard Loop Extension	Jul 2003	2,775		2,775			Jun 2005
Total All Projects		\$ 468,257	\$ 52,399	\$ 520,656	\$ 86,306		

Note: The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of two billion five hundred million dollars of general obligation bonds of the State, as subsequently approved by a vote of qualified voters of the State, to provide funds for capital improvements for the University of North Carolina. The projects listed on this Schedule are those funded or to be funded by bond proceeds from the general obligation bonds authorized by Senate Bill 912.

[This Page Left Blank Intentionally]



Ralph Campbell, Jr.
State Auditor

STATE OF NORTH CAROLINA
Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet <http://www.osa.state.nc.us>

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

Board of Trustees
North Carolina State University
Raleigh, North Carolina

We have audited the financial statements of North Carolina State University, a constituent institution of the sixteen-campus University of North Carolina System, which is a component unit of the State of North Carolina, as of and for the year ended June 30, 2003, and have issued our report thereon dated November 25, 2003.

As discussed in Note 17 to the financial statements, the University implemented Governmental Accounting Standards Board Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, during the year ended June 30, 2003.

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.

Compliance

As part of obtaining reasonable assurance about whether the University's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control

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

over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Audit Committee, the Board of Trustees and Board of Governors, management and staff of the University, the Governor, the State Controller, the General Assembly, and federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties.



Ralph Campbell, Jr.
State Auditor

November 25, 2003

DISTRIBUTION OF AUDIT REPORT

In accordance with General Statutes 147-64.5 and 147-64.6(c)(14), copies of this report have been distributed to the public officials listed below. Additional copies are provided to other legislators, state officials, the press, and the general public upon request.

EXECUTIVE BRANCH

The Honorable Michael F. Easley
The Honorable Beverly M. Perdue
The Honorable Richard H. Moore
The Honorable Roy A. Cooper, III
Mr. David T. McCoy
Mr. Robert L. Powell
Ms. Molly Corbett Broad
Dr. Marye Anne Fox
Mr. George Worsley

Ms. Peaches Gunter Blank

Governor of North Carolina
Lieutenant Governor of North Carolina
State Treasurer
Attorney General
State Budget Officer
State Controller
President, The University of North Carolina
Chancellor, North Carolina State University
Vice Chancellor for Finance and Business
North Carolina State University
Chairman, Board of Trustees
North Carolina State University

LEGISLATIVE BRANCH

Appointees to the Joint Legislative Commission on Governmental Operations

President Pro Tempore
Senator Marc Basnight, Co-Chair
Senator Charles W. Albertson
Senator Patrick J. Ballantine
Senator Daniel G. Clodfelter
Senator Walter H. Dalton
Senator Charlie S. Dannelly
Senator James Forrester
Senator Linda Garrou
Senator Wilbur P. Gulley
Senator Fletcher L. Hartsell, Jr.
Senator David W. Hoyle
Senator Ellie Kinnaird
Senator Jeanne H. Lucas
Senator Stephen M. Metcalf
Senator Anthony E. Rand
Senator Eric M. Reeves
Senator Robert A. Rucho
Senator R. C. Soles, Jr.
Senator Scott Thomas

Speaker of the House
Representative James B. Black, Co-Chair
Representative Richard T. Morgan, Co-Chair
Representative Martha B. Alexander
Representative Rex L. Baker
Representative Bobby H. Barbee, Sr.
Representative Harold J. Brubaker
Representative Debbie A. Clary
Representative E. Nelson Cole
Representative James W. Crawford, Jr.
Representative William T. Culpepper, III
Representative W. Pete Cunningham
Representative W. Robert Grady
Representative Joe Hackney
Representative Julia C. Howard
Representative Joe L. Kiser
Representative Edd Nye
Representative William C. Owens, Jr.
Representative Wilma M. Sherrill
Representative Thomas E. Wright

Other Legislative Officials

Mr. James D. Johnson

Director, Fiscal Research Division

February 3, 2004

ORDERING INFORMATION

Copies of this report may be obtained by contacting the:

Office of the State Auditor
State of North Carolina
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0601

Internet: <http://www.ncauditor.net>

Telephone: 919/807-7500

Facsimile: 919/807-7647