



STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT OF

WESTERN CAROLINA UNIVERSITY

CULLOWHEE, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2005

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT OF

WESTERN CAROLINA UNIVERSITY

CULLOWHEE, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2005

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THE UNIVERSITY OF NORTH CAROLINA

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AUDITOR'S TRANSMITTAL

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

We have completed a financial statement audit of Western Carolina University for the year ended June 30, 2005, and our audit results are included in this report. You will note from the independent auditor's report that we determined that the financial statements are presented fairly in all material respects.

Our consideration of internal control over financial reporting and compliance and other matters based on an audit of the financial statements resulted in no audit findings.

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.

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

June 16, 2006

TABLE OF CONTENTS

	PAGE
INDEPENDENT AUDITOR'S REPORT	1
MANAGEMENT'S DISCUSSION AND ANALYSIS	3
BASIC FINANCIAL STATEMENTS	
University Exhibits	
A-1 Statement of Net Assets	14
A-2 Statement of Revenues, Expenses, and Changes in Net Assets	16
A-3 Statement of Cash Flows	17
Component Unit Exhibits	
B-1 Statement of Financial Position	19
B-2 Statement of Activities	20
Notes to the Financial Statements	21
INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH <i>GOVERNMENT AUDITING STANDARDS</i>	47
ORDERING INFORMATION	49



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INDEPENDENT AUDITOR'S REPORT

Board of Trustees
Western Carolina University
Cullowhee, North Carolina

We have audited the accompanying financial statements of Western Carolina University, a constituent institution of the 16-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component unit, as of and for the year ended June 30, 2005, which collectively comprise the University's basic financial statements as listed in the table of contents. These financial statements are the responsibility of Western Carolina University's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of Western Carolina University Foundation, which represent 5 percent, 6 percent, and 2 percent, respectively, of the assets, net assets and revenues of the University; nor the financial statements of Western Carolina University Research and Development Corporation which represent 100% of the University's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for those entities, is based on the reports of the other auditors.

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. The financial statements of Western Carolina University Foundation and Western Carolina University Research and Development Corporation were not audited in accordance with *Government Auditing Standards*. 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of Western Carolina University and its discretely presented component unit as of June 30, 2005, and the respective changes in financial position and cash flows, where applicable, thereof for

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 16 to the financial statements, the University implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures*, during the year ended June 30, 2005.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 12, 2006 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis, 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 required supplementary information. However, we did not audit the information and express no opinion on it.



Leslie W. Merritt, Jr., CPA, CFP
State Auditor

May 12, 2006

**WESTERN CAROLINA UNIVERSITY
MANAGEMENT'S DISCUSSION AND ANALYSIS**

Introduction

The University's financial report includes three financial statements: the *Statement of Net Assets*, which presents the assets, liabilities, and net assets of the institution as of the end of the fiscal year; the *Statement of Revenues, Expenses, and Changes in Net Assets*, which reflects revenues and expenses recognized during the fiscal year; and the *Statement of Cash Flows*, which provides information on all of the institution's cash inflows and outflows during the fiscal year by major category. These financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) pronouncements.

The following discussion and analysis provides an overview of the financial position and activities of Western Carolina University (the "University") for the years ended June 30, 2005 and 2004. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

Statement of Net Assets

The *Statement of Net Assets* presents the financial position of the University at the end of the fiscal year and includes all assets and liabilities of the University. The difference between total assets and total liabilities - net assets - is one indicator of the current financial condition of the University, while the change in net assets is an indicator of whether the overall financial condition has improved or worsened during the year. Assets and liabilities are generally measured using current values. One notable exception is capital assets, which are stated at historical cost less an allowance for depreciation.

Condensed Summary of Net Assets

	<u>2005</u>	<u>2004</u>	<u>\$ Change</u>	<u>% Change</u>
Assets				
Current Assets	\$ 55,504,650	\$ 58,171,163	\$ (2,666,513)	(4.58) %
Capital Assets, Net	194,138,544	164,852,965	29,285,579	17.76 %
Other Noncurrent Assets	54,781,890	48,835,032	5,946,858	12.18 %
Total Assets	<u>304,425,084</u>	<u>271,859,160</u>	<u>32,565,924</u>	<u>11.98</u> %
Liabilities				
Current Liabilities	12,781,283	14,048,037	(1,266,754)	(9.02) %
Noncurrent Liabilities	48,135,638	38,915,977	9,219,661	23.69 %
Total Liabilities	<u>60,916,921</u>	<u>52,964,014</u>	<u>7,952,907</u>	<u>15.02</u> %
Net Assets				
Invested in Capital Assets, Net of Related Debt	167,156,113	148,893,781	18,262,332	12.27 %
Restricted – Nonexpendable	14,770,319	14,428,685	341,634	2.37 %
Restricted – Expendable	26,470,407	14,674,298	11,796,109	80.39 %
Unrestricted	35,111,324	40,898,382	(5,787,058)	(14.15) %
Total Net Assets	<u>\$ 243,508,163</u>	<u>\$ 218,895,146</u>	<u>\$ 24,613,017</u>	<u>11.24</u> %

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

A review of the University's *Statement of Net Assets* at June 30, 2005 and 2004, indicates that the University improved its already strong financial position, with Total Net Assets increasing by \$24.6 million (11.2%) over the previous year.

Total assets of the University increased by \$32.6 million. Net capital assets contributed \$29.3 million of this amount, mostly due to a \$41.3 million net increase in Buildings and Infrastructure, offset by a decrease of \$18.7 million in Construction In Progress due to the capitalization of completed capital projects. In addition, there was a \$3.2 million increase in Land resulting from the purchase of property for the University's Millennial Initiative.

The \$2.7 million decrease in Current Assets was mainly attributable to a \$2.4 million decrease in restricted current cash related to contract and grant, student loan, and capital improvement activities. Noncurrent restricted cash and cash equivalents increased by \$3.7 million, resulting in a net increase in restricted cash of \$1.4 million. Changes in the level of the current portion of restricted cash and cash equivalents are related to changes in the noncurrent portion of restricted cash and cash equivalents and to changes in the level of current liabilities. This relationship exists because current restricted cash and cash equivalents is that portion of restricted cash and cash equivalents needed to satisfy the current portion of liabilities in restricted accounts.

The \$5.9 million increase in Other Noncurrent Assets resulted primarily from the \$3.7 million increase in noncurrent cash and cash equivalents and a \$1.7 million increase in endowment investments, more than half of which was due to favorable market fluctuations.

The decrease of \$1.3 million in current liabilities was primarily attributable to a decrease of \$3.6 million in accounts payable and accrued liabilities offset by a \$2.3 million increase in deferred revenue. The significant decline in accounts payable and accrued liabilities is primarily the result of a decrease in amounts payable to vendors for major construction projects due to the completion of several large projects. The increase in deferred revenue resulted from the receipt of federal grant proceeds that did not meet the criteria for revenue recognition in 2005.

Noncurrent liabilities increased 9.2 million due to an increase in Capital Leases Payable for the new Norton Road Residence Hall.

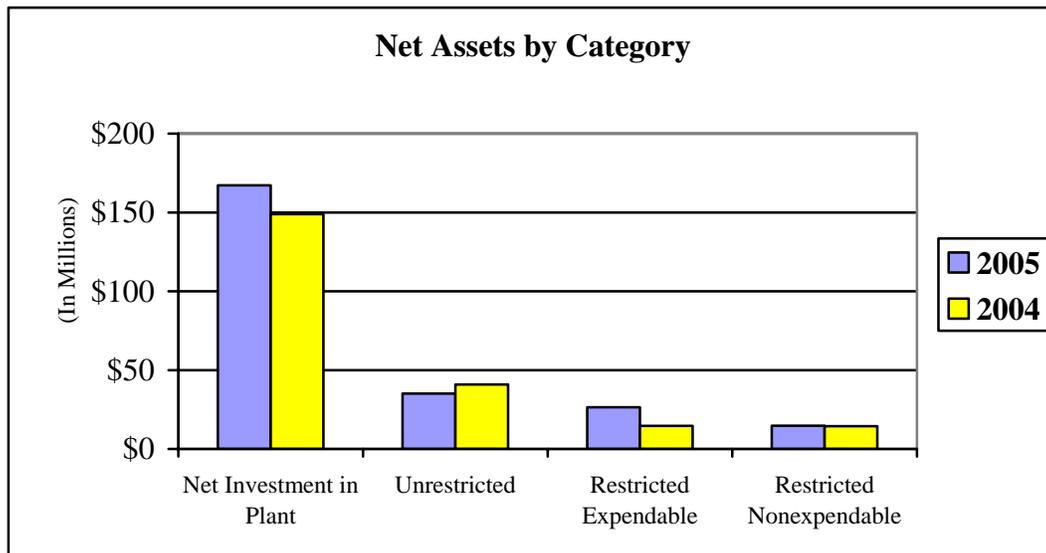
Net assets represent residual interest in the University's assets after all liabilities are deducted. For reporting purposes, they are divided into three major components:

- "Invested in Capital Assets, Net of Related Debt" represents the University's investment in capital assets such as movable equipment, buildings, land, infrastructure, and improvements, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets. At June 30, 2005, \$167.2 million (68.6%) of the \$243.5 million in net assets was attributable to the University's investment in capital assets.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

- Restricted net assets are subject to externally imposed restrictions governing their use and are further divided into two categories: nonexpendable and expendable. “Restricted – Nonexpendable” net assets primarily include the University’s permanent endowment funds received from donors for the purpose of creating present and future income. These funds must be held inviolate and in perpetuity and are, therefore, not expendable. Earnings on these funds support various programs determined by donors. The nonexpendable category makes up approximately \$14.8 million (6.1%) of the \$243.5 million net assets total. “Restricted - Expendable” net assets are available for expenditure in accordance with externally imposed restrictions. Examples include funds for scholarships, debt service, and capital projects. At June 30, 2005, expendable net assets totaled \$26.5 million (10.9% of total net assets).
- “Unrestricted” net assets are not subject to externally imposed stipulations, although management has designated these funds for various academic and research programs and initiatives, as well as capital projects. This year, unrestricted net assets totaling \$35.1 million represent 14.4% of total net assets.

The following chart displays the contribution of each category to the total in both 2005 and 2004:



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Statement of Revenues, Expenses, and Changes in Net Assets

The *Statement of Revenues, Expenses, and Changes in Net Assets* presents the revenues earned and the expenses incurred during the year. Activities are reported as either operating or nonoperating. Given a public university's dependency on revenues such as state appropriations, gifts, and investment income, which are prescribed by GASB as nonoperating revenues, operating expenses will exceed operating revenues, resulting in an operating loss. Net nonoperating revenues or expenses are an integral component in determining the increase or decrease in net assets.

Generally speaking, operating revenues are generated through the provision of goods and services, and include tuition and fees, contract and grant revenues, interest earnings on student loans, and sales and service revenue generated by student housing, the bookstore, and other enterprises. Operating expenses are the costs incurred to acquire or produce the goods and services provided and to conduct the affairs of the institution.

Nonoperating revenues are revenues received for which goods and services are not provided. For example, State appropriations, while budgeted for operations, are reported as nonoperating revenue because they are provided by the state legislature without the legislature directly receiving commensurate goods and services in return for those revenues. Nonoperating expenses include interest expense, extraordinary items, and other expenses not incurred in the normal operations of the University.

Capital grants and gifts are considered neither operating nor nonoperating revenues and are reported after "Income (Loss) before other revenues, expenses, gains or losses."

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The following is a condensed *Statement of Revenues, Expenses, and Changes in Net Assets* for Western Carolina University as of June 30, 2005, compared with that of 2004.

Condensed Summary of Revenues, Expenses, and Changes in Net Assets

	<u>2005</u>	<u>2004</u>	<u>\$ Change</u>	<u>% Change</u>
Operating Revenues				
Student Tuition and Fees, Net	\$ 26,662,394	\$ 22,401,622	\$ 4,260,772	19.02 %
Grants and Contracts	15,989,627	16,404,243	(414,616)	(2.53) %
Sales and Services, Net	20,962,142	18,047,805	2,914,337	16.15 %
Other Operating Revenues	<u>2,648,194</u>	<u>5,725,464</u>	<u>(3,077,270)</u>	<u>(53.75) %</u>
Total Operating Revenues	66,262,357	62,579,134	3,683,223	5.89 %
Operating Expenses	<u>126,534,765</u>	<u>116,559,161</u>	<u>9,975,604</u>	<u>8.55 %</u>
Operating Income/(Loss)	<u>(60,272,408)</u>	<u>(53,980,027)</u>	<u>(6,292,381)</u>	11.66 %
Nonoperating Revenues (Expenses)				
State Appropriations	59,294,421	53,144,187	6,150,234	11.57 %
Gifts and Grants	2,461,983	2,767,827	(305,844)	(11.05) %
Investment Income (Net of Investment Expense)	3,422,638	4,857,098	(1,434,460)	(29.53) %
Other Nonoperating Revenues and Expenses	<u>(2,160,328)</u>	<u>(1,324,914)</u>	<u>(835,414)</u>	<u>63.05 %</u>
Net Nonoperating Revenues	<u>63,018,714</u>	<u>59,444,198</u>	<u>3,574,516</u>	<u>6.01 %</u>
Income Before Other Revenues, Expenses, Gains, or Losses	<u>2,746,306</u>	<u>5,464,171</u>	<u>(2,717,865)</u>	<u>(49.74) %</u>
Capital Appropriations	1,226,900		1,226,900	
Capital Grants	20,132,820	30,180,854	(10,048,034)	(33.29) %
Capital Gifts	300,000	909	299,091	32903.30 %
Additions to Permanent Endowments	<u>206,991</u>	<u>289,581</u>	<u>(82,590)</u>	<u>(28.52) %</u>
Total Other Revenue	<u>21,866,711</u>	<u>30,471,344</u>	<u>(8,604,633)</u>	<u>(28.24) %</u>
Change in Net Assets	24,613,017	35,935,515	(11,322,498)	(31.51) %
Beginning Net Assets, as restated	<u>218,895,146</u>	<u>182,959,631</u>	<u>35,935,515</u>	<u>19.64 %</u>
Ending Net Assets	<u>\$ 243,508,163</u>	<u>\$ 218,895,146</u>	<u>\$ 24,613,017</u>	<u>11.24 %</u>

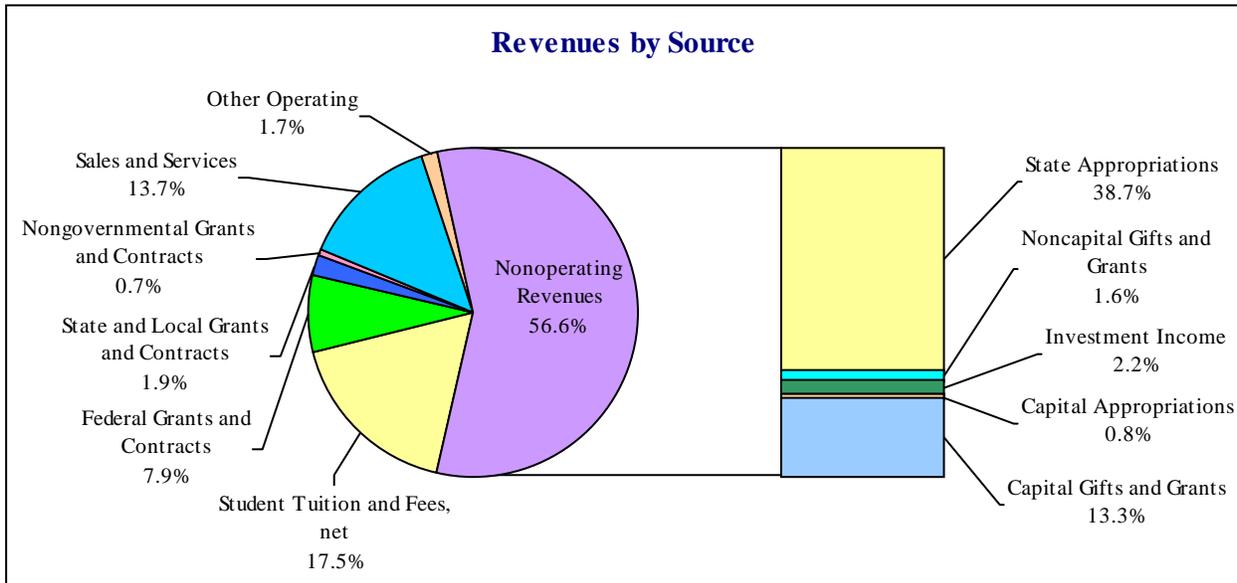
The *Statement of Revenues, Expenses, and Changes in Net Assets* reflects a positive year ending June 30, 2005, with an increase in net assets of \$24.6 million.

Among the University's greatest strengths are the diverse revenue streams that supplement student tuition and fees. These include gifts from individuals, foundations, and corporations, along with state appropriations, investment income, and federal, state, and private grants and contracts. The University has sought and will continue to seek funding from available

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

sources that are consistent with its mission and will continue prudently to manage the financial resources realized from these efforts in order to supplement tuition revenues and fund its operating activities.

The following is a graphic illustration of the breakdown of revenues by source (both operating and nonoperating), which are used to fund the University's operating activities for the year ended June 30, 2005. As defined by GASB, significant recurring sources of the University's revenues, such as state appropriations and private gifts, are considered nonoperating.



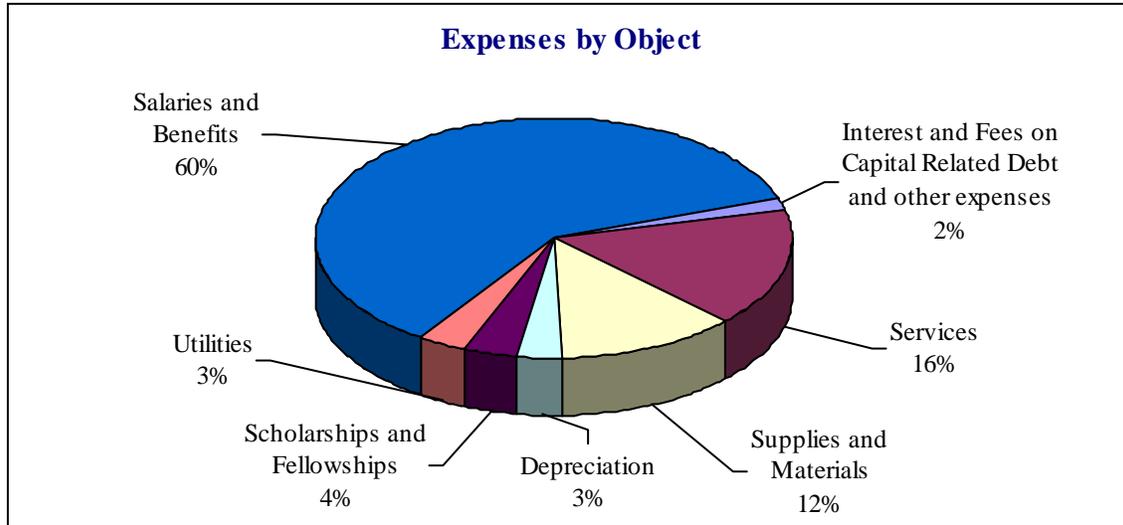
Operating revenues for 2005 totaled \$66.3 million, compared with \$62.6 million for 2004. The most significant source of operating revenue for the University was tuition and fees (net of scholarship allowances) totaling \$26.7 million at June 30, 2005, and \$22.4 million at June 30, 2004. This 19% increase primarily reflects an overall increase in tuition and fee rates of approximately 14% for in-State students and 4% for out-of-State students, as well as an 11% growth in number of students. Other major revenue sources in 2005 include sales and services of \$21 million (\$18 million in 2004) and grants and contracts of \$16 million (\$16.4 million in 2004). Approximately \$2.5 million of the \$2.9 million increase in sales and services resulted from increases in revenue from residential life and dining services. Rate increases of approximately 5% in housing services and student meal plans, along with increased occupancy in the residence halls in general, and the new higher-priced residence halls in particular, were responsible for these revenue increases. The substantial decrease of over \$3 million in Other Operating Revenues is mostly due to large surety payments remitted to the University in 2004 by National Fire Insurance Company of Hartford for construction work necessary to complete the Central Drive Residence Hall after the original contractor was declared to be in default.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Like most public institutions, the University receives significant nonoperating revenues which offset the loss generated by operating activities. During 2004, the operating loss of \$60 million was offset by \$63 million in net nonoperating revenues. The primary source of this revenue is state appropriations, which totaled \$59.3 million and accounted for 39% of total revenue. Other major sources of nonoperating revenue in 2005 are investment income of \$3.4 million and noncapital gifts and grants of \$2.5 million. A decrease in investment income in 2005 of \$1.4 million was largely attributable to market fluctuations.

Capital grants totaled \$20.1 million and \$30.2 million for the years ended June 30, 2005, and June 30, 2004, respectively. The primary sources of this revenue are state general obligation bond proceeds of \$18.2 million in 2005 (\$27.9 million in 2004). As explained more fully in Note 14D to the financial statements, in 2000 the voters of North Carolina approved the issuance of general obligation bonds to provide funds for capital improvements on the University of North Carolina campuses. The Office of State Budget and Management allocates these funds based on the University's projected cash requirements related to the construction projects funded by this bond issue. Decreased construction activity on these projects in 2005, due to completion of several major projects in 2004, accounts for the decrease of \$10 million in state capital grants.

The following is a graphic illustration of expenses (both operating and nonoperating) by their natural (object) classification:



Operating expenses increased \$10 million for the fiscal year ending June 30, 2005. Operating expenses are mainly attributable to salaries and benefits for the faculty and staff of the University. Of the \$126.9 million in operating expenses, \$77.2 million (61%) was used for this purpose in 2005. Other elements included in operating expenses are supplies and materials, services, scholarships and fellowships, utilities, and depreciation. All categories of

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

expense were consistent with last year in terms of their percent of contribution to total expenses with the exception of supplies and materials that decreased by 3%. A \$1.6 million decrease in supplies and materials in 2005 was mostly due to a decline in expenditures related to construction or sponsored research projects.

Statement of Cash Flows

The *Statement of Cash Flows* provides additional information about the University's financial results by reporting the major sources and uses of cash. Cash provided or used is categorized based on the following four types of activities: operating, noncapital financing, capital financing, and investing. The statement also provides an assessment of the University's financial flexibility and liquidity, its ability to meet obligations as they come due, and its need for external financing. A comparative summary of the *Statement of Cash Flows* for the years ended June 30, 2005 and 2004, is as follows:

Statement of Cash Flows

	<u>2005</u>	<u>2004</u>
Cash provided (used) by:		
Operating Activities	\$ (59,341,515)	\$ (50,512,804)
Noncapital Financing Activities	63,748,815	56,026,252
Capital and Related Financing Activities	(4,371,825)	(2,404,120)
Investing Activities	1,591,804	1,248,497
Net Change in Cash	1,627,279	4,357,825
Cash, Beginning of Year	66,357,106	61,999,281
Cash, End of Year	<u>\$ 67,984,385</u>	<u>\$ 66,357,106</u>

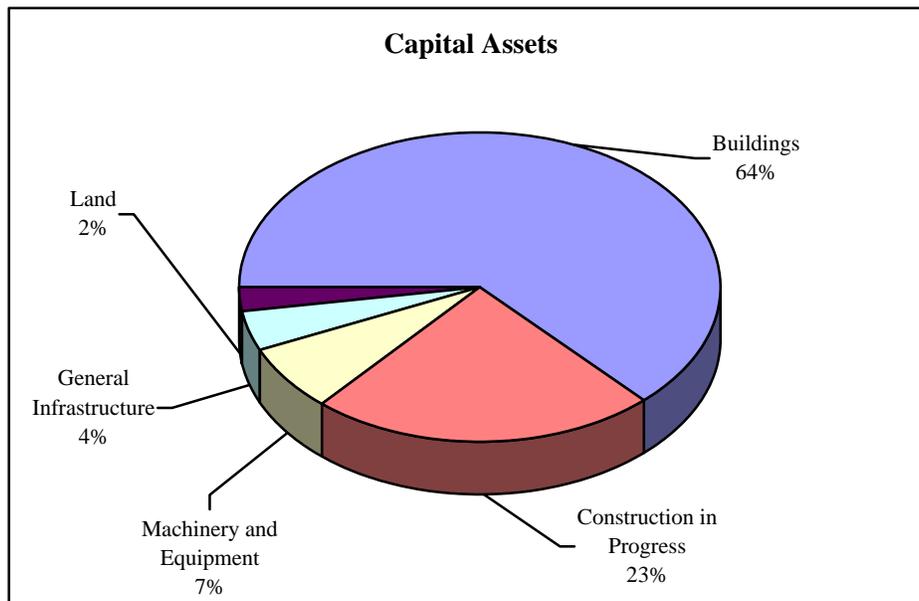
Net cash used in operating activities should be viewed in conjunction with net cash provided by noncapital financing activities. State appropriations and gifts are significant sources of recurring revenues in support of operating expenses, but are required to be classified as noncapital financing activities under generally accepted accounting principles. Therefore, when considering cash flows related to operating activities, it is important also to consider these noncapital financing activities, which support operating expenses. Net cash flow provided by these two activities amounted to \$4.4 million in the year ended June 30, 2005.

Net cash provided by investing activities of \$1.6 million reflects receipts from sales and maturities of investments less disbursements for purchases of investments. Unrealized losses and gains from the change in fair value of investments are non-cash transactions for valuation purposes only, and do not affect cash flows from investing activities.

The University's cash and cash equivalents increased \$1.6 million during 2005 due to the positive flow of funds provided by noncapital financing and investing activities.

Capital Asset and Debt Administration

At June 30, 2005, the University had approximately \$253.2 million invested in capital assets, and accumulated depreciation of \$59.1 million. Depreciation charges for the current year totaled \$4 million. The following chart displays the relationship of each category to capital assets as a whole.



A critical factor in achieving quality in the University's academic endeavors, while enriching the quality of all students' campus experience, is the development and renewal of capital assets. The University continues to implement a long-range plan for modernizing its older teaching, research, and student life facilities, balanced with new construction. Capital asset additions and improvements during the current year were funded with federal and State capital grants, debt proceeds, and gifts and unrestricted net assets designated for capital purposes.

Passage of North Carolina's Higher Education Bond Referendum in November 2000 gave Western more than \$100 million in state funds over a six-year period, beginning in fiscal year 2001, to fund facility construction projects, infrastructure improvements, land acquisitions, and technology expansion.

In April 2005, the University celebrated the completion of \$2.9 million in renovations to the Killian Annex Building. This facility includes the University's new One Stop Student Support Center, which is designed to enable students to conduct a wide range of university-related business in a single location, instead of traveling to offices spread across campus.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The \$30 million Fine and Performing Arts Center, an exciting new cultural arts and art education destination for Western North Carolina and the surrounding region, is in the final stages of completion with a grand opening scheduled for October 22, 2005. The center combines state-of-the-art educational opportunities for students and instructors with a fresh and inspiring venue for world-class performers and artists. Other capital projects funded by the 2000 bond issue are renovations recently begun on the Stillwell Laboratory Building (\$16.8 million); completed renovations to Breese Gymnasium, including conversion of the old gymnasium area to physical education and dance program usage, as well as energy upgrades (\$1.3 million); and completed construction of a 300-bed residence hall on Central Drive (\$21.5 million).

The 2000 bond issue also made possible the acquisition of 344 acres of property adjacent to the University's main campus that will be home to a mix of academic buildings, research facilities, business, industry and housing as part of the University's Millennial Initiative. The Millennial Initiative is designed to enable the University to engage in public-private partnerships that enhance educational opportunities for students in high-tech programs and increase the ability of faculty to conduct cutting-edge research, while simultaneously promoting economic development. A comprehensive master plan is being developed to determine the most logical building sites for the different types of structures to be located on the property.

Construction projects funded from a variety of other sources, and in various stages of completion, include a track, soccer and tennis complex (\$5.4 million); the relocation of Centennial Drive; a 290-bed residence hall on Norton Road (\$10.1 million); and a new softball field complex (\$2.4 million).

Projects currently in design, with total combined budgets of \$74.2 million, are: a new Student Recreation Center; a pedestrian quadrangle; a dining facility to replace Dodson Cafeteria; a new School of Health and Gerontological Science building; and a planned Hospitality Management Studies Center.

The University's financial statements indicate \$26,514,000 in bonds payable, \$1,811,808 in notes payable, and \$10,228,053 in capital leases payable at June 30, 2005. Total annual debt service payments for bonds and notes were \$2.6 million in both 2005 and 2004.

For additional information on Capital Assets and Debt Administration, see Notes 5, 7, and 8 to the financial statements.

Enrollment

A significant factor in the University's capacity to generate resources relates to its ability to recruit and retain high quality students. In an effort to boost enrollment and to improve the quality of education available at Western, the University continues its emphasis on new, career-focused programs of study. Programs added during FY 2004-2005 included construction management, emergency management, and telecommunications engineering technology.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

Enrollment growth targets for the next 8 - 10 years have been established, and the University continues vigorously to pursue growth in all categories of enrollment: resident credit and distance learning enrollments at both the undergraduate and graduate levels. With the total enrollment for Fall 2005 reaching an all-time high of nearly 8,700 students, a 3.4% increase over last fall's enrollment of 8,396, the total enrollment target of 10,000 by the year 2009 appears reachable. Increases in enrollment will generate increases in revenues such as tuition and fees, sales and services, and State appropriations, as well as the corresponding operating expenses incurred in serving larger numbers of students.

Economic Outlook

Looking toward the future, management believes that the University is well positioned to maintain its strong financial condition and to advance both the quality and scope of its services to students, the State, and the region.

A crucial element in the University's future will be our relationships with The University of North Carolina System and the North Carolina General Assembly, as we work to remain competitive in price while providing an outstanding education for our students. There is a direct relationship between the growth of the University and the demand for State appropriations to operate the University. Also, declines in State appropriations generally exert pressure for increased tuition and fees. As an institution targeted for growth in the years ahead, Western will be greatly affected by the availability and levels of State operating funds and capital resources to support that growth.

Private gifts are an important supplement to the University's base revenue from State appropriations and student tuition. Such gifts can provide the support needed to boost programs to higher levels of quality and service. Reflecting national positive trends in philanthropy, Western experienced an increase of over \$233,000 (10%) in total (noncapital and capital) gifts in 2005. Though some indicators suggest that the overall state of the economy will continue to improve moderately in the months to come, local, State and national economies remain susceptible to political and market uncertainties. The economic pressures affecting donors, as well as investment returns, will continue to affect the level of support the University receives from corporate and individual giving. Other factors that could have an impact on fundraising at Western are the increased competition for discretionary dollars represented by the growing number of charitable entities (which now total more than 1.5 million organizations in the United States) and the philanthropic response to natural disasters like the recent hurricanes, Katrina and Rita.

The University will continue to pursue its long-term investment strategy to maximize total returns, at an appropriate level of risk, while utilizing a spending rate policy that is consistent with long-term market results and that insulates operations from temporary market volatility.

While the future cannot be predicted with certainty, management believes that the University's strong financial condition equips it well to weather the economic uncertainties presently known and those that can be reasonably expected.

Western Carolina University
Statement of Net Assets
June 30, 2005

Exhibit A-1

ASSETS

Current Assets:

Cash and Cash Equivalents	\$	38,214,138.07
Restricted Cash and Cash Equivalents		8,719,031.64
Restricted Short-Term Investments		533,592.76
Receivables, Net (Note 4)		4,024,027.32
Inventories		3,228,987.60
Notes Receivable, Net (Note 4)		784,872.85

Total Current Assets		<u>55,504,650.24</u>
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Noncurrent Assets:

Restricted Cash and Cash Equivalents		21,051,215.01
Restricted Due from Primary Government		4,005,033.70
Endowment Investments		22,536,065.51
Other Long-Term Investments		1,732,978.77
Notes Receivable, Net (Note 4)		5,456,596.48
Capital Assets - Nondepreciable (Note 5)		64,372,396.57
Capital Assets - Depreciable, Net (Note 5)		129,766,147.89

Total Noncurrent Assets		<u>248,920,433.93</u>
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Total Assets		<u>304,425,084.17</u>
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LIABILITIES

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)		6,510,423.64
Due to Primary Government		44,958.10
Deferred Revenue		4,061,448.07
Interest Payable		322,815.10
Long-Term Liabilities - Current Portion (Note 7)		1,841,637.95

Total Current Liabilities		<u>12,781,282.86</u>
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Noncurrent Liabilities:

Deposits Payable		51,507.60
Funds Held for Others		538,601.94
U. S. Government Grants Refundable		5,668,506.80
Long-Term Liabilities (Note 7)		41,877,021.50

Total Noncurrent Liabilities		<u>48,135,637.84</u>
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Total Liabilities		<u>60,916,920.70</u>
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Western Carolina University
Statement of Net Assets
June 30, 2005

Exhibit A-1
Page 2

NET ASSETS

Invested in Capital Assets, Net of Related Debt	167,156,112.78
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	7,270,623.69
Endowed Professorships	6,570,683.83
Loans	929,012.00
Expendable:	
Scholarships and Fellowships	6,856,971.71
Research	224,928.27
Endowed Professorships	1,078,378.71
Departmental Uses	4,380,030.55
Loans	434,352.40
Capital Projects	988,176.61
Debt Service	12,507,569.09
Unrestricted	<u>35,111,323.83</u>
Total Net Assets	<u><u>\$ 243,508,163.47</u></u>

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

Western Carolina University
Statement of Revenues, Expenses, and
Changes in Net Assets
For the Fiscal Year Ended June 30, 2005

Exhibit A-2

REVENUES

Operating Revenues:

Student Tuition and Fees, Net (Note 9)	\$ 26,662,394.03
Federal Grants and Contracts	12,008,901.65
State and Local Grants and Contracts	2,842,825.55
Nongovernmental Grants and Contracts	1,137,899.83
Sales and Services, Net (Note 9)	20,962,142.41
Interest Earnings on Loans	14,813.59
Other Operating Revenues	2,633,379.78

Total Operating Revenues	66,262,356.84
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EXPENSES

Operating Expenses:

Salaries and Benefits	77,231,433.95
Supplies and Materials	15,750,661.89
Services	20,616,072.82
Scholarships and Fellowships	4,815,087.41
Utilities	4,121,653.13
Depreciation	3,999,855.86

Total Operating Expenses	126,534,765.06
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Operating Loss	(60,272,408.22)
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NONOPERATING REVENUES (EXPENSES)

State Appropriations	59,294,420.63
Noncapital Grants	184,001.44
Noncapital Gifts	2,277,981.25
Investment Income (Net of Investment Expense of \$36,948.59)	3,422,638.05
Interest and Fees on Capital Asset-Related Debt	(1,749,325.46)
Other Nonoperating Expenses	(411,001.51)

Net Nonoperating Revenues	63,018,714.40
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Income Before Other Revenues	2,746,306.18
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Capital Appropriations	1,226,900.00
Capital Grants	20,132,820.02
Capital Gifts	300,000.00
Additions to Endowments	206,991.05

Increase in Net Assets	24,613,017.25
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NET ASSETS

Net Assets - July 1, 2004	218,895,146.22
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Net Assets - June 30, 2005	\$ 243,508,163.47
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The accompanying notes to the financial statements are an integral part of this statement.

Western Carolina University
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2005

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$ 64,821,165.71
Payments to Employees and Fringe Benefits	(77,149,179.01)
Payments to Vendors and Suppliers	(44,509,406.22)
Payments for Scholarships and Fellowships	(4,815,087.41)
Loans Issued	(1,486,049.80)
Collection of Loans	1,147,015.75
Interest Earned on Loans	14,813.59
Other Receipts	2,635,212.54
	<hr/>
Net Cash Used by Operating Activities	(59,341,514.85)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations	59,294,420.63
Noncapital Grants	150,703.83
Noncapital Gifts	4,476,388.97
Additions to Endowments	206,991.05
William D. Ford Direct Lending Receipts	23,159,156.00
William D. Ford Direct Lending Disbursements	(23,262,963.00)
Related Activity Agency Receipts	339,758.99
Related Activity Agency Disbursements	(204,639.79)
Other Payments	(411,001.51)
	<hr/>
Net Cash Provided by Noncapital Financing Activities	63,748,815.17

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

State Capital Appropriations	1,226,900.00
Capital Grants	20,244,126.50
Capital Gifts	300,000.00
Acquisition and Construction of Capital Assets	(22,923,910.39)
Principal Paid on Capital Debt and Leases	(1,460,716.21)
Interest and Fees Paid on Capital Debt and Leases	(1,758,225.67)
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(4,371,825.77)

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	970,865.61
Investment Income	2,062,009.70
Purchase of Investments and Related Fees	(1,441,071.01)
	<hr/>
Net Cash Provided by Investing Activities	1,591,804.30

Net Increase in Cash and Cash Equivalents	1,627,278.85
Cash and Cash Equivalents - July 1, 2004	66,357,105.87
	<hr/>
Cash and Cash Equivalents - June 30, 2005	\$ 67,984,384.72

Western Carolina University
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2005

Exhibit A-3
Page 2

**RECONCILIATION OF NET OPERATING REVENUES (EXPENSES)
TO NET CASH USED BY OPERATING ACTIVITIES**

Operating Loss	\$ (60,272,408.22)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:	
Depreciation Expense	3,999,855.86
Allowances, Write-Offs, and Amortizations	(246,265.08)
Changes in Assets and Liabilities:	
Receivables (Net)	1,004,168.19
Inventories	(212,714.49)
Accounts Payable and Accrued Liabilities	(3,581,378.81)
Due to Primary Government	(2,803.24)
Deferred Revenue	98,926.00
Compensated Absences	185,807.88
Deposits Payable	9,432.68
Note Principle Repayments	1,161,914.18
Notes Issued	(1,486,049.80)
	<u>(1,486,049.80)</u>
Net Cash Used by Operating Activities	<u>\$ (59,341,514.85)</u>

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:	
Cash and Cash Equivalents	\$ 38,214,138.07
Restricted Cash and Cash Equivalents	8,719,031.64
Noncurrent Assets:	
Restricted Cash and Cash Equivalents	<u>21,051,215.01</u>
Total Cash and Cash Equivalents - June 30, 2005	<u>\$ 67,984,384.72</u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through a Gift	\$ 371,738.97
Change in Fair Value of Investments	908,311.51
Reinvested Distributions	720,292.43

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

Western Carolina University Research and Development Corporation
Statement of Financial Position
June 30, 2005

Exhibit B-1

ASSETS

Current Assets:	
Cash and Cash Equivalents	\$ 6,671,792
Net Investment in Direct Financing Lease	146,467
Property and Equipment:	
Construction in Progress	7,244,920
Other Assets:	
Certificate Issuance Costs, net of accumulated amortization	1,159,371
Net Investment in Direct Financing Lease	10,067,123
Total Assets	<u>25,289,673</u>

LIABILITIES

Current Liabilities:	
Current Portion of Long Term Debt	\$ 500,000
Construction Contracts Payable	1,847,611
Construction Retainage Payable	643,147
Accrued Expenses	75,344
Total Current Liabilities	<u>3,066,102</u>
Noncurrent Liabilities:	
Certificates of Participation Payable	<u>22,395,000</u>
Total Liabilities	<u>25,461,102</u>

NET ASSETS

Unrestricted Net Assets	<u>(171,429)</u>
Total Liabilities and Net Assets	<u>\$ 25,289,673</u>

Western Carolina University Research and Development Corporation
Statement of Activities
For the Fiscal Year Ended June 30, 2005

Exhibit B-2

REVENUES

Management Fee	\$	109,045
Interest Income		376,420
		<hr/>
Total Revenues		485,465

EXPENSES

Trustee Fees		5,250
Interest Expense		522,174
Insurance		70,649
Bank Charges		19
Annual Filing Fee		200
Amortization of Certificate Issuance Costs		40,499
		<hr/>
Total Expenses		638,791

CHANGE IN NET ASSETS

		<hr/>	(153,326)
Net Assets at Beginning of Year		<hr/>	(18,103)
Net Assets at End of Year	\$	<hr/> <hr/>	(171,429)

WESTERN CAROLINA UNIVERSITY
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2005

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. Western Carolina University is a constituent institution of the 16-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. The University’s component units are either blended or discretely presented in the University’s financial statements. The blended component units, although legally separate, are, in substance, part of the University’s operations and therefore, are reported as if they were part of the University. Discretely presented component units’ financial data are reported in separate financial statements because of their use of different GAAP reporting models and to emphasize their legal separateness.

Blended Component Unit – Although legally separate, Western Carolina University Foundation (Foundation), a component unit of the University, is reported as if it were part of the University. The Foundation is governed by a 31-member board consisting of 4 ex officio directors and 27 appointed directors. The Foundation’s purpose is to aid, support and promote teaching, research, and service in the various educational, scientific, scholarly, professional, artistic, and creative endeavors of the University. Because the directors of the Foundation are appointed by the members of the Western Carolina University Board of Trustees and the Foundation’s sole purpose is to benefit Western Carolina University, its financial statements have been blended with those of the University.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Separate financial statements for the Foundation may be obtained from the University Controller's Office, HFR 317, Cullowhee, NC 28723, or by calling 828-227-7308.

Discretely Presented Component Unit – The Western Carolina University Research and Development Corporation (Corporation) is a legally separate not-for-profit corporation and is reported as a discretely presented component unit based on the nature and significance of its relationship to the University. The Corporation's purpose is to aid and promote the education and charitable functions of the University.

The Corporation reports its financial results under Financial Accounting Standards Board (FASB) Statements. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications have been made to the Foundation's financial information in the University's financial reporting entity for these differences.

Separate financial statements for the Corporation may be obtained from the University Controller's Office, HFR 317, Cullowhee, NC 28723, or by calling 828-227-7308. 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 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, unless the GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- 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 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 deposits held by the State Treasurer in the short-term investment fund. The short-term investment fund 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, limited partnerships, real estate investment trusts, real estate, and other asset holdings by the University. Except for 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.

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 fees charged 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

G. Inventories – Inventories, consisting of expendable supplies and merchandise for resale, are valued at cost using the last invoice cost.

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 value of assets constructed includes all material direct and indirect construction costs. Interest costs incurred are capitalized during the period of construction.

The University capitalizes assets that have a value or cost in excess of \$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.

Certain book and art collections are capitalized at cost or fair value at the date of donation. These collections are depreciated over the life of the collections using the straight-line method. The estimated useful lives for the collections are 25 years.

Artifact collections are capitalized at cost or fair value at the date of donation. These collections are considered inexhaustible and are therefore not depreciated.

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. Noncurrent Long-Term Liabilities – Noncurrent long-term liabilities include principal amounts of bonds payable, notes payable, annuities payable, capital lease obligations, and compensated absences that will not be paid within the next fiscal year.

Bond issuance costs are considered immaterial and are expensed.

K. 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 1 or for which an employee can be paid upon termination of employment. Also, any accumulated vacation leave in

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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

In addition to the vacation leave described above, compensated absences includes the accumulated unused portion of the special annual leave bonuses awarded by the North Carolina General Assembly to all full-time permanent employees as of September 30, 2002, and as of July 1, 2003. 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.

L. 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 for which the University is legally or contractually obligated to spend 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.

M. 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 either operating or nonoperating 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.

N. 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 or investing activities as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

Nonoperating revenues include activities that have the characteristics of nonexchange transactions. Revenues from nonexchange transactions 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- O. Internal Sales Activities** – Certain institutional auxiliary operations provide goods and services to University departments, as well as to its customers. These institutional auxiliary operations include activities such as food, residential, and printing services. 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 *North Carolina 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 G.S. 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.

At June 30, 2005, the University's deposit with the State Treasurer's Short-Term Investment Fund totaled \$67,856,696.10. The Short-Term Investment Fund (a portfolio within the State Treasurer's Investment Pool, an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating) had a weighted average maturity of 1.41 years as of June 30, 2005. Assets and shares of the Short-Term Investment Fund are valued at amortized cost, which approximates fair value. Deposit and investment risks associated with 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.ncosc.net/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The carrying amount of the University's deposits not with the State Treasurer was \$89,859.62 and the bank balance was \$468,029.76. Custodial credit risk is the risk that in the event of a bank failure, the University's deposits may not be returned to it. Pursuant to G.S. 116-36.1, funds received for health care services not deposited with the State Treasurer shall be fully secured in the manner as prescribed by the State Treasurer for the security of public deposits. The University does not have a deposit policy for custodial credit risk. As of June 30, 2005, the University's bank balance was exposed to custodial credit risk as follows:

Uninsured and Collateral Held by Pledging Bank's Trust Department not in University's Name	<u>\$ 356,218.98</u>
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- B. Investments** – The University is authorized by The University of North Carolina Board of Governors pursuant to G.S. 116-36.2 and Section 600.2.4 of the Policy Manual of the University 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 discussed below.

G.S. 147-69.1(c), applicable to the State's General Fund, and G.S. 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 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, G.S. 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified ratings. G.S. 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.

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

G.S. 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

condition placed by the donor upon that part of the Endowment Fund to be invested.

Investments of the University's component unit, the Western Carolina University Foundation, are subject to and restricted by G.S. 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 investment pools to manage investments and distribute investment income.

Long-Term Investment Pool – This is an internal investment pool that is utilized for the investment of the endowment funds and restricted funds. Fund 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 and the Board of Directors of the Western Carolina University Foundation.

The following table presents the fair value of investments by type at June 30, 2005, for the Long-Term Investment Pool.

Long-Term Investment Pool

	Fair Value
Investment Type	
Mutual Funds	23,650,185.40
Investments in Real Estate	3,220.00
Limited Partnerships	457,633.00
	<hr/>
Total Long-Term Investment Pool	<u><u>\$ 24,111,038.40</u></u>

Interest Rate Risk – Interest rate risk is defined by GASB Statement No. 40 as the risk a government may face should interest rate variances affect the fair value of investments. The University's Endowment Board does not have a formal investment policy that addresses interest rate risk; however as of June 30, 2005, the investments in the Long-Term Investment Pool were not subject to interest rate risk.

Credit Risk: The University has a formal policy that addresses credit risk. Fixed income securities are subject to credit risk, which is the chance that

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

a bond issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline. The circumstances may arise due to a variety of factors such as financial weakness, bankruptcy, litigation and/or adverse political developments.

A bond's credit quality is an assessment of the issuer's ability to pay interest on the bond, and ultimately pay the principal. Credit quality is evaluated by Moody's Investors Service, or comparable by Standard and Poor's (S&P). A lower rating will result in a greater chance, in the rating agency's opinion, that the bond issuer will default or fail to meet its payment obligations. The University's investment policy states that no more than 10% of each fund, at cost, may be invested in securities rated Baa or below.

Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk.

As of June 30, 2005, the University had no investments in the Long-Term Investment Pool subject to credit risk.

Concentration of Credit Risk: Concentration of credit risk is the risk associated with a lack of diversification of having too much invested in a few issuers, thereby exposing the University to greater risk resulting from adverse economic, political, regulatory, geographic, or credit developments.

The University investment policy with respect to the concentration of credit risk is to invest funds through individual securities, mutual funds, trusts, limited partnerships and international equities. In all cases, each portfolio must generally abide by the guidelines for the investment quality of assets in the separate accounts. Mutual funds investments shall be governed by the prospectus. The University's investment board must adhere to the asset allocation for the investment pool.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The University Endowment Board places no limit on the amount the Board may invest in any one issuer. More than 5% of the long-term investment pool investments are in the following funds:

Fund Name	Percent Invested
Artisan Mid-Cap Fund	7.15%
Common Fund High Quality Bond Fund	16.28%
TCW Funds	8.03%
Dodge & Cox Stock Fund	18.55%
PIMCO Moderate Duration Fund	13.67%
Templeton Funds	6.18%
Wasatch Small Growth	5.87%

Non-Pooled Investments – The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2005, for the University’s non-pooled investments. Interest rate risk is defined by GASB Statement No. 40 as the risk a government may face should interest rate variances affect the fair value of investments. The University does not have a formal investment policy that addresses interest rate risk.

Non-Pooled Investments

Investment Type	Fair Value	Investment Maturities (in Years) Less Than 1
Debt Securities:		
Domestic Corporate Bonds	\$ 15,394.56	\$ 15,394.56
Other Securities:		
Money Market Funds	533,592.76	
Investments in Real Estate	93,800.00	
Other Mutual Funds	19,165.00	
Domestic Stocks	27,494.00	
Other Collections	2,152.00	
Total Non-Pooled Investments	\$ 691,598.32	

Credit Risk: The University has a formal policy that addresses credit risk. Fixed income securities are subject to credit risk, which is the chance that a bond issuer will fail to pay interest or principal in a timely manner, or that negative perception of the issuer’s ability to make these payments will cause security prices to decline. The circumstances may arise due to a variety of factors such as financial weakness, bankruptcy, litigation and/or adverse political developments.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

A bond's credit quality is an assessment of the issuer's ability to pay interest on the bond, and ultimately, to pay in the principal. Credit quality is evaluated by Moody's Investors Service, or comparable by Standard and Poor's (S&P). A lower rating will result a greater chance, in the rating agency's opinion, that the bond issuer will default or fail to meet its payment obligations. The University's investment policy states that no more than 10% of each fund, at cost, may be invested in securities rated Baa or below.

Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk.

As of June 30, 2005, the University's domestic corporate bonds in the non-pooled investments were unrated. The domestic corporate bonds matured in August 2005.

Concentration of Credit Risk: The University places no limit on the amount that may be invested in any one issuer. More than 5% of the University's non-pooled investments are in money market funds and investments in real estate. These investments are 77% and 14%, respectively, of University's non-pooled investments.

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 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). The current spending policy for the University's pooled endowment funds provides 4.5% of a three-year average of market values as of December 31. The Board of Trustees annually reviews the spending policy and makes adjustments accordingly. At June 30, 2005, net appreciation of \$11,376,425.15 was available to be spent, of which \$7,258,047.57 was restricted to specific purposes.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 4 - RECEIVABLES

Receivables at June 30, 2005, were as follows:

	<u>Gross Receivables</u>	<u>Less Allowance for Doubtful Accounts</u>	<u>Net Receivables</u>
Current Receivables:			
Students	\$ 1,239,446.90	\$ 462,606.84	\$ 776,840.06
Accounts	1,447,579.59		1,447,579.59
Intergovernmental	1,263,146.82		1,263,146.82
Pledges	124,259.11	7,852.12	116,406.99
Investment Earnings	125,929.95		125,929.95
Interest on Loans	135,007.83		135,007.83
Other	159,116.08		159,116.08
Total Current Receivables	<u><u>\$ 4,494,486.28</u></u>	<u><u>\$ 470,458.96</u></u>	<u><u>\$ 4,024,027.32</u></u>
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	\$ 748,310.95	\$ 0.00	\$ 748,310.95
Institutional Student Loan Programs	82,932.57	46,370.67	36,561.90
Total Notes Receivable - Current	<u><u>\$ 831,243.52</u></u>	<u><u>\$ 46,370.67</u></u>	<u><u>\$ 784,872.85</u></u>
Notes Receivable - Noncurrent:			
Federal Loan Programs	\$ 6,291,936.73	\$ 840,941.00	\$ 5,450,995.73
Institutional Student Loan Programs	5,600.75		5,600.75
Total Notes Receivable - Noncurrent	<u><u>\$ 6,297,537.48</u></u>	<u><u>\$ 840,941.00</u></u>	<u><u>\$ 5,456,596.48</u></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, 2005, is presented as follows:

	Balance July 1, 2004	Adjustments	Increases	Decreases	Balance June 30, 2005
Capital Assets, Nondepreciable:					
Land	\$ 2,988,060.30	\$ 0.00	\$ 3,184,646.45	\$ 0.00	\$ 6,172,706.75
Art, Literature, and Artifacts	105,433.00				105,433.00
Construction in Progress	76,831,601.79	(34,861,458.96)	16,124,113.99		58,094,256.82
Total Capital Assets, Nondepreciable	<u>79,925,095.09</u>	<u>(34,861,458.96)</u>	<u>19,308,760.44</u>		<u>64,372,396.57</u>
Capital Assets, Depreciable:					
Buildings	112,775,561.76	33,340,701.53	9,844,262.67		155,960,525.96
Machinery and Equipment	12,883,637.41		4,537,612.42	648,075.26	16,773,174.57
Art, Literature, and Artifacts	103,188.00		50,000.00		153,188.00
General Infrastructure	14,941,042.23	1,520,757.43	364,372.29	852,251.10	15,973,920.85
Intangible	1.00				1.00
Total Capital Assets, Depreciable	<u>140,703,430.40</u>	<u>34,861,458.96</u>	<u>14,796,247.38</u>	<u>1,500,326.36</u>	<u>188,860,810.38</u>
Less Accumulated Depreciation/Amortization for:					
Buildings	44,552,245.81		2,593,805.65		47,146,051.46
Machinery and Equipment	5,809,577.26		1,013,791.29	520,246.19	6,303,122.36
Art, Literature, and Artifacts	84,851.09		1,869.91		86,721.00
General Infrastructure	5,328,885.93		390,389.01	160,507.27	5,558,767.67
Intangible					
Total Accumulated Depreciation	<u>55,775,560.09</u>		<u>3,999,855.86</u>	<u>680,753.46</u>	<u>59,094,662.49</u>
Total Capital Assets, Depreciable, Net	<u>84,927,870.31</u>	<u>34,861,458.96</u>	<u>10,796,391.52</u>	<u>819,572.90</u>	<u>129,766,147.89</u>
Capital Assets, Net	<u>\$ 164,852,965.40</u>	<u>\$ 0.00</u>	<u>\$ 30,105,151.96</u>	<u>\$ 819,572.90</u>	<u>\$ 194,138,544.46</u>

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2005, were as follows:

	Amount
Accounts Payable	\$ 2,434,143.67
Accrued Payroll	829,705.60
Contract Retainage	1,439,136.18
Other	1,807,438.19
Total Accounts Payable and Accrued Liabilities	<u>\$ 6,510,423.64</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 7 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities – A summary of changes in the long-term liabilities for the year ended June 30, 2005, is presented as follows:

	Balance July 1, 2004	Additions	Reductions	Balance June 30, 2005	Current Portion
Bonds Payable	\$ 27,434,000.00	\$ 0.00	\$ 920,000.00	\$ 26,514,000.00	\$ 950,000.00
Notes Payable	2,080,239.14		268,431.35	1,811,807.79	285,315.74
Capital Leases Payable	27,643.08	10,402,410.16	202,000.27	10,228,052.97	154,411.37
Annuity Payable	655,688.92		41,463.59	614,225.33	86,044.84
Compensated Absences	4,364,765.48	3,018,010.37	2,832,202.49	4,550,573.36	365,866.00
Total Long-Term Liabilities	\$ 34,562,336.62	\$ 13,420,420.53	\$ 4,264,097.70	\$ 43,718,659.45	\$ 1,841,637.95

Additional information regarding capital lease obligations is included in Note 8.

B. Bonds Payable – The University was indebted for bonds payable for the purposes shown in the following table:

Purpose	Series	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2005	Principal Outstanding 06/30/2005
Dormitory System						
Dormitory System Revenue Bonds - Series D		3.0	05/01/2007	\$ 2,394,000.00	\$ 2,190,000.00	\$ 204,000.00
UNC System Pool Revenue Bonds	(A)	3.25-5.25	10/01/2013	465,000.00	150,000.00	315,000.00
UNC System Pool Revenue Bonds	(B)	5.00-5.50	10/01/2010	1,370,000.00	360,000.00	1,010,000.00
Total Dormitory System				4,229,000.00	2,700,000.00	1,529,000.00
Student Center						
UNC System Pool Revenue Bonds	(B)	5.00-5.75	10/01/2025	5,355,000.00	460,000.00	4,895,000.00
Faculty Housing						
Faculty Housing Revenue Bonds		3.0	11/01/2007	280,000.00	250,000.00	30,000.00
Stadium System						
UNC System Pool Revenue Bonds	(C)	4.0-5.375	04/01/2027	8,070,000.00	440,000.00	7,630,000.00
UNC System Pool Revenue Bonds	(D)	2.0-5.25	04/01/2028	1,510,000.00	80,000.00	1,430,000.00
Total Stadium System				9,580,000.00	520,000.00	9,060,000.00
Student Recreation Center						
UNC System Pool Revenue Bonds	(D)	2.0-5.25	04/01/2028	11,610,000.00	610,000.00	11,000,000.00
Total Bonds Payable (principal only)				<u>\$ 31,054,000.00</u>	<u>\$ 4,540,000.00</u>	<u>\$ 26,514,000.00</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

(C) The University of North Carolina System Pool Revenue Bonds, Series 2002A

(D) The University of North Carolina System Pool Revenue Bonds, Series 2003A

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

C. Notes Payable – The University was indebted for notes payable for the purpose shown in the following table:

Purpose	Financial Institution	Interest Rate/ Ranges	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2005	Principal Outstanding 06/30/2005
University Center Renovation	First Union National	6.18	12/01/2010	\$ 3,800,000.00	\$ 1,988,192.21	\$ 1,811,807.79

D. Annual Requirements – The annual requirements to pay principal and interest on the long-term obligations at June 30, 2005, are as follows:

Fiscal Year	Annual Requirements			
	Bonds Payable		Notes Payable	
	Principal	Interest	Principal	Interest
2006	\$ 950,000.00	\$ 1,270,131.28	\$ 285,315.74	\$ 103,931.50
2007	984,000.00	1,236,106.28	303,456.37	85,790.87
2008	920,000.00	1,197,136.28	322,750.39	66,496.85
2009	950,000.00	1,159,411.28	343,271.15	45,976.09
2010	1,000,000.00	1,111,586.28	365,096.64	24,150.60
2011-2015	4,810,000.00	4,905,864.44	191,917.50	2,706.12
2016-2020	5,700,000.00	3,637,581.29		
2021-2025	7,290,000.00	2,047,748.76		
2026-2030	3,910,000.00	328,087.50		
Total Requirements	<u>\$ 26,514,000.00</u>	<u>\$ 16,893,653.39</u>	<u>\$ 1,811,807.79</u>	<u>\$ 329,052.03</u>

E. Charitable Gift Annuity Split Interest Agreement – In October 2003, joint donors entered into a charitable gift annuity agreement with the Foundation. Under the terms of the agreement, the Foundation received property with a fair market value of \$1,082,315. In consideration of this property transfer, the annuitants will receive for their joint lives, an annual annuity of \$86,045, payable in quarterly installments. The obligation of the Foundation to make annuity payments, if any remain, shall terminate upon the deaths of the donors. Based on the donors' life expectancy and an expected 2.823% rate of return, the liability at June 30, 2005, was adjusted to its present value as follows:

	Amount
Value of Annuity Liability at June 30, 2004	\$ 655,689.40
Interest Earned on Investment	28,820.17
Quarterly Payments	(86,044.84)
Present Value Adjustment at Year End	<u>15,760.60</u>
Value of Annuity Liability at June 30, 2005	<u>\$ 614,225.33</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 8 - LEASE OBLIGATIONS

- A. Capital Lease Obligations** – Capital lease obligations relating to machinery and equipment are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2005:

<u>Fiscal Year</u>	<u>Amount</u>
2006	\$ 775,632.90
2007	773,506.59
2008	768,240.50
2009	766,387.50
2010	764,100.00
2011-2015	3,827,987.50
2016-2020	3,829,425.00
2021-2025	3,827,632.50
2026-2030	3,821,450.00
2031-2035	<u>2,297,000.00</u>
Total Minimum Lease Payments	21,451,362.49
Amount Representing Interest (6.10% to 7.48% Rate of Interest)	<u>11,223,309.52</u>
Present Value of Future Lease Payments	<u><u>\$ 10,228,052.97</u></u>

Buildings acquired under capital lease amounted to \$9,844,262.67 at June 30, 2005. Machinery and equipment acquired under capital leases amounted to \$617,320.91 at June 30, 2005.

- B. Operating Lease Obligations** – The University entered into operating leases for automobiles and housing. Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2005:

<u>Fiscal Year</u>	<u>Amount</u>
2006	\$ 189,073.09
2007	135,420.22
2008	93,494.64
2009	<u>31,907.86</u>
Total Minimum Lease Payments	<u><u>\$ 449,895.81</u></u>

Rental expense for all operating leases during the year was \$331,571.69.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 9 - REVENUES

A summary of eliminations and allowances by revenue classification and revenues pledged as security for revenue bonds is presented as follows:

	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	\$ 31,536,067.93	\$ 23,978.25	\$ 4,617,463.54	\$ 232,232.11	\$ 26,662,394.03	\$ 481,932.25 (A)
Sales and Services:						
Sales and Services of Auxiliary Enterprises:						
Residential Life	\$ 9,014,566.11	\$ 474,528.01	\$ 1,326,653.56	\$ 86,757.51	\$ 7,126,627.03	\$ 7,126,627.03 (B)
Dining	7,842,133.81	623,208.37	1,045,139.81	33,265.06	6,140,520.57	
Book Rental	1,263,555.62	1,147.75	164,828.65	38,401.51	1,059,177.71	
Bookstore	1,738,738.37	135,152.62		1,511.21	1,602,074.54	
Print Shop	630,529.37	542,940.59			87,588.78	
Athletic	1,060,729.79				1,060,729.79	1,060,729.79 (C)
Other	996,365.81	29,614.34		902.91	965,848.56	65,854.00 (D)
Sales and Services of Education and Related Activities	2,540,310.69	1,502,566.34		615.05	1,037,129.30	
Independent Operations	1,964,036.43	81,590.30			1,882,446.13	
Total Sales and Services	<u>\$ 27,050,966.00</u>	<u>\$ 3,390,748.32</u>	<u>\$ 2,536,622.02</u>	<u>\$ 161,453.25</u>	<u>\$ 20,962,142.41</u>	<u>\$ 8,253,210.82</u>

Revenue Bonds Secured by Pledged Revenues:

- (A) Housing and Student Center System
- (B) Student Housing
- (C) Stadium System
- (D) Apartment Management

NOTE 10 - OPERATING EXPENSES BY FUNCTION

The University's operating expenses by functional classification are presented as follows:

	Salaries and Benefits	Supplies and Materials	Services	Scholarships and Fellowships	Utilities	Depreciation	Total
Instruction	\$ 38,664,636.59	\$ 2,083,624.19	\$ 2,451,053.69	\$ 7,959.70	\$ 2,274.54	\$ 0.00	\$ 43,209,548.71
Research	817,500.01	616,721.56	645,116.84	2,600.42	24,782.50		2,106,721.33
Public Service	7,213,089.54	677,813.74	2,608,297.86	170,883.80	61,201.64		10,731,286.58
Academic Support	5,548,648.75	1,547,426.31	685,612.72		1,122.61		7,782,810.39
Student Services	2,995,072.79	298,291.94	904,579.11				4,197,943.84
Institutional Support	8,601,831.08	1,466,950.04	2,706,977.55	236,394.80	22,577.95		13,034,731.42
Operations and Maintenance of Plant	5,442,580.05	3,233,542.64	471,414.24		2,634,201.52		11,781,738.45
Student Financial Aid	98,607.04	120.74	100.00	3,433,145.80			3,531,973.58
Auxiliary Enterprises	7,729,399.05	4,343,673.24	9,972,085.02	964,102.89	1,375,492.37		24,384,752.57
Independent Operations	120,069.05	1,482,497.49	170,835.79				1,773,402.33
Depreciation						3,999,855.86	3,999,855.86
Total Operating Expenses	<u>\$ 77,231,433.95</u>	<u>\$ 15,750,661.89</u>	<u>\$ 20,616,072.82</u>	<u>\$ 4,815,087.41</u>	<u>\$ 4,121,653.13</u>	<u>\$ 3,999,855.86</u>	<u>\$ 126,534,765.06</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 11 - 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, 2005, these rates were set at 2.17% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2005, the University had a total payroll of \$63,825,066.31, of which \$32,480,296.65 was covered under the Teachers’ and State Employees’ Retirement System. Total employee and employer contributions for pension benefits for the year were \$1,948,817.80 and \$704,822.44, respectively. The University made 100% of its annual required contributions for the years ended June 30, 2005, 2004, and 2003, which were \$704,822.44, \$65,833.49, and \$0.00, 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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, 2005, 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, 2005, the University had a total payroll of \$63,825,066.31, of which \$23,139,337.05 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$1,388,360.22 and \$1,582,730.65, 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the responsibility of the Plan participants. No costs are incurred by the University. The voluntary contributions by employees amounted to \$130,832.48 for the year ended June 30, 2005.

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, 2005, were \$24,626.99. The voluntary contributions by employees amounted to \$364,003.00 for the year ended June 30, 2005.

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 \$1,073,497.39 for the year ended June 30, 2005.

NOTE 12 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees –** The University participates in State-administered programs that 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 3.2% of the covered payroll under the Teachers’ and State Employees’ Retirement System and the Optional Retirement Program for these health care benefits. For the fiscal year ended June 30, 2005, the University’s total contribution to the Plan was

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

\$1,779,828.28. 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 .445% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the year ended June 30, 2005, the University's total contribution to the DIPNC was \$247,507.37. 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 13 - 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 not exceeded coverage 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 \$5,000,000 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 supported by the State's General Fund are charged for the coverage. Losses covered by the Fund are subject to a \$10,000 per occurrence

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

deductible. The University also purchased through the Fund extended coverage for most buildings which covers windstorm or hail and “all risk” for selected contents such as high value equipment, computers, and fine art. The extended coverage deductible is \$50,000 per occurrence.

All State-owned vehicles are covered by liability insurance through a private insurance company and handled by the North Carolina Department of Insurance. The liability limits for losses 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 North Carolina Department of Insurance for the coverage.

The University is protected for losses from employee dishonesty and computer fraud. This coverage is with a private insurance company and is handled by the North Carolina Department of Insurance. Universities are charged a premium by the private insurance company. Coverage limit is \$5,000,000 per occurrence with a \$50,000 deductible and a 10% participation in each loss above the deductible.

The University purchased other authorized coverage from private insurance companies through the North Carolina Department of Insurance. These coverages provide insurance for medical malpractice, accident coverage for students participating in University athletic events, boiler and machinery coverage, general liability, and various other commercial applications. These coverages were affected and placed by the North Carolina Department of Insurance through the State’s agent of record.

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.

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. There were no employer contributions required for the current fiscal year.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 14 - 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 \$20,280,408.48 and on other purchases were \$2,700,961.27 at June 30, 2005.
- B. Capital Lease Commitment** – The University entered into a thirty-two year lease agreement on February 9, 2005 with Affinity Housing, LLC, a sole member and manager of the Western Carolina University Research and Development Corporation. Under the agreement, Affinity Housing, LLC will lease the Norton Road Residence Hall to the University. The Norton Road residence facility was under construction at June 30, 2005 with an occupancy date of August 31, 2005. The University will begin capital lease payments during the June 30, 2006 fiscal year that will total \$18,407,955.10 during the life of the lease.
- C. Pending Litigation and Claims** – The University is a party to 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.
- D. University Improvement General Obligation Bonds** – The 1999-2000 Session of the General Assembly of North Carolina authorized the issuance of \$2.5 billion 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 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

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

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 of \$26,792,530.00 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.

NOTE 15 - RELATED PARTIES

Foundations – There are two separately incorporated nonprofit foundations associated with the University. These foundations are The Development Foundation of the North Carolina Center for the Advancement of Teaching, Inc. and The Highlands Biological Foundation, Inc. The University's financial statements do not include the assets, liabilities, net assets, or operational transactions of these foundations, except for support from the organization to the University.

The Development Foundation of the North Carolina Center for the Advancement of Teaching, Inc. was incorporated in North Carolina on January 31, 1994, for the purpose of supporting the programs of, and providing supplemental funding for, the North Carolina Center for the Advancement of Teaching. This support approximated \$534,799.96 for the year ended June 30, 2005.

The Highlands Biological Foundation, Inc. was incorporated in North Carolina on July 21, 1930, for the purpose of supporting, through grants and scholarships, the activities of the Highlands Biological Station. This support approximated \$37,758.08 for the year ended June 30, 2005.

NOTE 16 - CHANGE IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2005, the University implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures*. This Statement establishes and modifies disclosure requirements related to investment risks: credit risk, interest rate risk, and foreign currency risk. This statement also establishes and modifies disclosure requirements for deposit risks: custodial credit risk and foreign currency risk.

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Leslie W. Merritt, Jr., CPA, CFP
State Auditor

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

Board of Trustees
Western Carolina University
Cullowhee, North Carolina

We have audited the financial statements of Western Carolina University, a constituent institution of the 16-campus University of North Carolina System, which is a component unit of the State of North Carolina, and its discretely presented component unit, as of and for the year ended June 30, 2005, which collectively comprise the University's basic financial statements and have issued our report thereon dated May 12, 2006. We did not audit the financial statements of Western Carolina University Foundation, which represent 5 percent, 6 percent, and 2 percent, respectively, of the assets, net assets, and revenues of the University; nor the financial statements of Western Carolina University Research and Development Corporation, which represent 100% of the University's discretely presented component units. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for those entities, is based on the reports of the other auditors.

As discussed in Note 16 to the financial statements, the University implemented Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures*, during the year ended June 30, 2005.

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.

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 an opinion on the internal control 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 reportable condition in which the design or operation

**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN
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GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud 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.

Compliance and Other Matters

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 grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Audit Committee, the Board of Governors, the Board of Trustees, management 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.

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

May 12, 2006

ORDERING INFORMATION

Audit reports issued by the Office of the State Auditor can be obtained from the web site at www.ncauditor.net. Also, parties may register on the web site to receive automatic email notification whenever reports of interest are issued. Otherwise, copies of audit reports may be obtained by contacting the:

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