



STATE OF NORTH CAROLINA

WESTERN CAROLINA UNIVERSITY

CULLOWHEE, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2006

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

WESTERN CAROLINA UNIVERSITY

CULLOWHEE, NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

FOR THE YEAR ENDED JUNE 30, 2006

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THE UNIVERSITY OF NORTH CAROLINA

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STATE 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, 2006, 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

December 19, 2006

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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, 2006, 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 3 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 opinions, insofar as they relate 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 provides 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, 2006,

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 13, 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.

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

November 13, 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 were 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, 2006 and 2005. 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. 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; however, one notable exception are capital assets, which are stated at historical cost less an allowance for depreciation.

Condensed Summary of Net Assets

	<u>2006</u>	<u>2005</u>	<u>\$ Change</u>	<u>% Change</u>
Assets				
Current Assets	\$ 66,592,904.50	\$ 55,504,650.24	\$ 11,088,254.26	19.98%
Capital Assets, Net	219,595,688.89	194,138,544.46	25,457,144.43	13.11%
Other Noncurrent Assets	<u>53,207,113.52</u>	<u>54,781,889.47</u>	<u>(1,574,775.95)</u>	-2.87%
Total Assets	<u>339,395,706.91</u>	<u>304,425,084.17</u>	<u>34,970,622.74</u>	11.49%
Liabilities				
Current Liabilities	13,404,152.23	12,781,282.86	622,869.37	4.87%
Noncurrent Liabilities	<u>58,078,305.68</u>	<u>48,135,637.84</u>	<u>9,942,667.84</u>	20.66%
Total Liabilities	<u>71,482,457.91</u>	<u>60,916,920.70</u>	<u>10,565,537.21</u>	17.34%
Net Assets				
Invested in Capital Assets, Net of Related Debt	182,065,630.91	167,993,723.92	14,071,906.99	8.38%
Restricted – Nonexpendable	17,046,677.72	14,770,319.52	2,276,358.20	15.41%
Restricted – Expendable	24,757,619.12	19,390,800.82	5,366,818.30	27.68%
Unrestricted	<u>44,043,321.25</u>	<u>41,353,319.21</u>	<u>2,690,002.04</u>	6.50%
Total Net Assets	<u>\$ 267,913,249.00</u>	<u>\$ 243,508,163.47</u>	<u>\$ 24,405,085.53</u>	10.02%

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

A review of the University's *Statement of Net Assets* at June 30, 2006 and 2005, indicates that the University improved its already strong financial position, with Total Net Assets increasing by \$24.4 million (10%).

Total assets of the University increased by \$35 million. Net capital assets contributed \$25.5 million of this amount, mostly due to a \$48.7 million net increase in Buildings, offset by a net decrease of \$20.4 million in Construction in Progress due to the capitalization of completed capital projects and current depreciation expense on buildings of \$3.6 million. This increase in buildings includes the acquisition of the Norton Road Residence Hall (cost of \$9.7 million) through a capital lease payable to the WCU Research and Development Corporation.

The \$11.1 million increase in Current Assets was mainly attributable to increases of: \$5.8 million in unrestricted cash and cash equivalents that included state appropriations and receipts to be carried forward for use in fiscal year 2007; \$1.5 million in restricted short-term investments due to transfers from University of North Carolina – General Administration (UNC-GA) for matching funds to endowed professorship gifts; \$1 million in restricted short-term investments due to proceeds held in trust under terms of a capital lease financing arrangement for information technology network upgrades expenditures planned for fiscal year 2007; and \$1.2 million in receivables due from the federal government for student loan activities.

In addition, there was a \$926,014 increase in current restricted cash related to contract and grant, student loan, and capital improvement activities. Noncurrent restricted cash and cash equivalents decreased by \$6.5 million, resulting in a net decrease in total restricted cash of \$5.6 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 \$1.6 million decrease in Other Noncurrent Assets resulted primarily from a \$4.9 million increase in endowment investments offset by a \$6.5 million decrease in noncurrent cash and cash equivalents. Over half of the increase in endowment investments is a result of the establishment of four endowed professorships funded with private gifts from University donors during fiscal year 2006. Matching funds from UNC-GA were received late in fiscal year 2006 and are included in restricted short-term investments in the *Statement of Net Assets*.

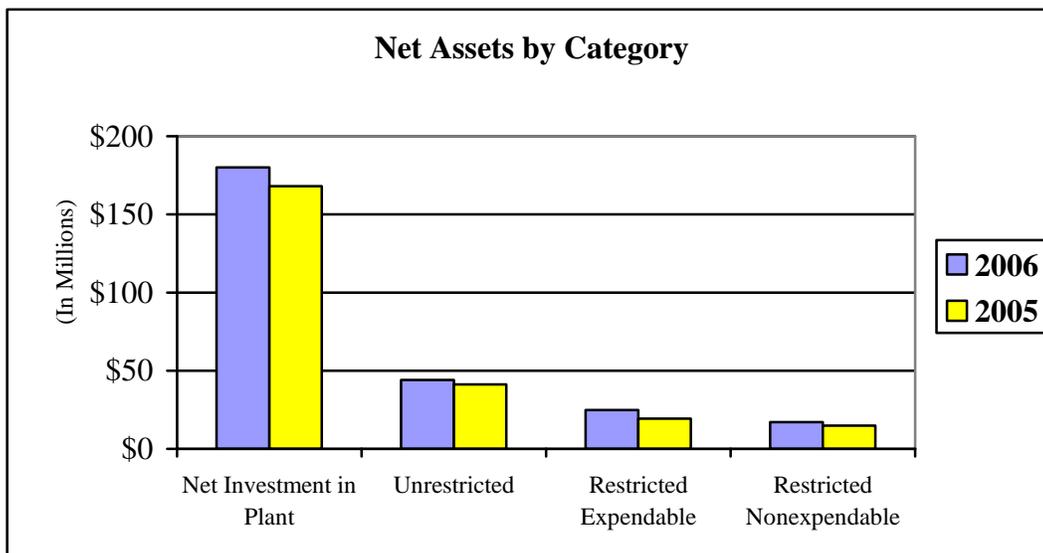
Noncurrent liabilities increased \$9.9 million primarily due to an increase in capital leases payable for the new Norton Road Residence Hall.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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, 2006, \$182.1 million (68 %) of the \$267.9 million in net assets was attributable to the University's investment in capital assets.
- 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 \$17 million (6.4%) of the \$267.9 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, 2006, expendable net assets totaled \$24.8 million (9.2% of total net assets).
- "Unrestricted" net assets are not subject to externally imposed restrictions, 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 \$44 million represent 16.4 % of total net assets.

The following chart displays the contribution of each category to the total in both 2006 and 2005:



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 and expenses are integral components 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 revenue, 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 on the statement after "Income Before Other Revenues."

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, 2006, compared with that of 2005.

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

	<u>2006</u>	<u>2005</u>	<u>\$ Change</u>	<u>% Change</u>
Operating Revenues				
Student Tuition and Fees, Net	\$ 28,692,604.02	\$ 26,662,394.03	\$ 2,030,209.99	7.61%
Grants and Contracts	16,784,061.78	15,989,627.03	794,434.75	4.97%
Sales and Services, Net	23,621,945.29	20,962,142.41	2,659,802.88	12.69%
Other Operating Revenues	1,208,860.99	2,648,193.37	(1,439,332.38)	-54.35%
Total Operating Revenues	70,307,472.08	66,262,356.84	4,045,115.24	6.10%
Operating Expenses	<u>144,944,442.66</u>	<u>126,534,765.06</u>	<u>18,409,677.60</u>	14.55%
Operating Income/(Loss)	<u>(74,636,970.58)</u>	<u>(60,272,408.22)</u>	<u>(14,364,562.36)</u>	23.83%
Nonoperating Revenues (Expenses)				
State Appropriations	74,579,645.56	59,294,420.63	15,285,224.93	25.78%
Noncapital Gifts and Grants	4,037,736.56	2,461,982.69	1,575,753.87	64.00%
Investment Income (Net of Investment Expense)	4,709,304.44	3,422,638.05	1,286,666.39	37.59%
Other Nonoperating Expenses	(3,287,981.96)	(2,160,326.97)	(1,127,654.99)	52.20%
Net Nonoperating Revenues	<u>80,038,704.60</u>	<u>63,018,714.40</u>	<u>17,019,990.20</u>	27.01%
Income Before Other Revenues	<u>5,401,734.02</u>	<u>2,746,306.18</u>	<u>2,655,427.84</u>	96.69%
Capital Appropriations	1,818,000.00	1,226,900.00	591,100.00	48.18%
Capital Gifts and Grants	14,668,696.19	20,432,820.02	(5,764,123.83)	-28.21%
Additions to Permanent Endowments	2,516,655.32	206,991.05	2,309,664.27	1115.83%
Total Other Revenue	<u>19,003,351.51</u>	<u>21,866,711.07</u>	<u>(2,863,359.56)</u>	-13.09%
Change in Net Assets	24,405,085.53	24,613,017.25	(207,931.72)	-0.84%
Beginning Net Assets, as Restated	<u>243,508,163.47</u>	<u>218,895,146.22</u>	<u>24,613,017.25</u>	11.24%
Ending Net Assets	<u>\$ 267,913,249.00</u>	<u>\$ 243,508,163.47</u>	<u>\$ 24,405,085.53</u>	10.02%

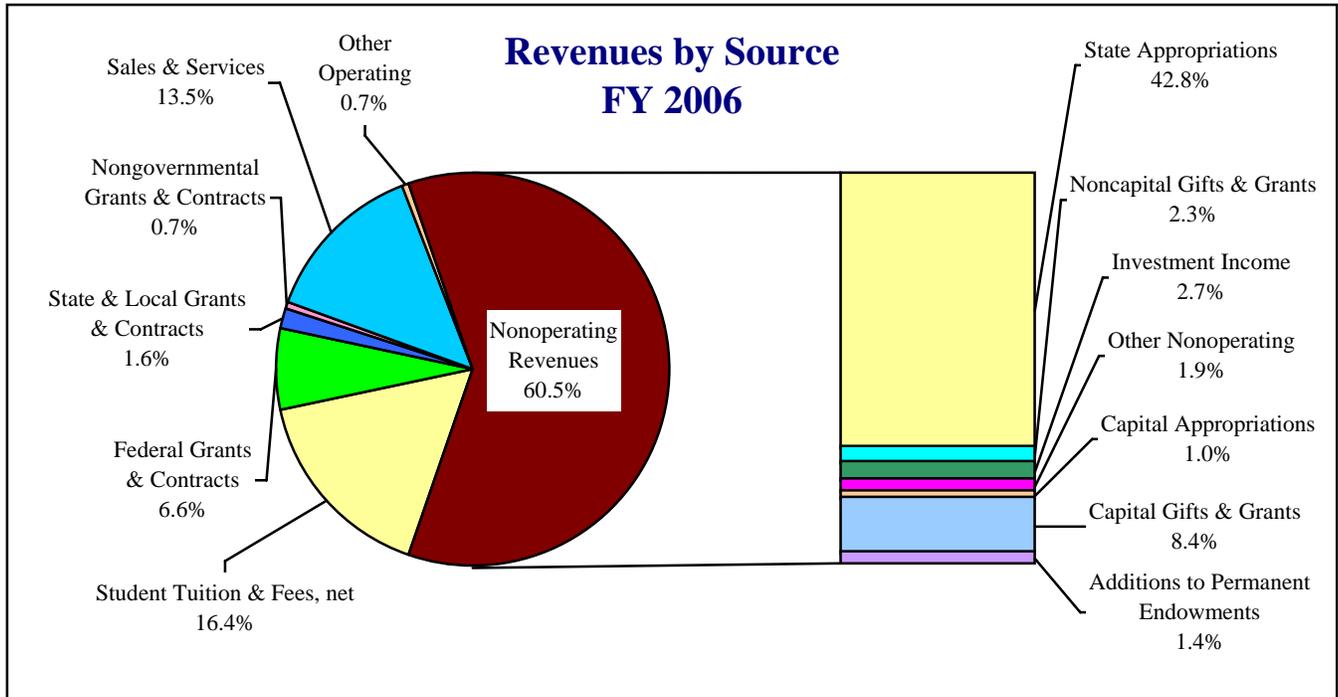
The *Statement of Revenues, Expenses and Changes in Net Assets* reflects a positive year ending June 30, 2006, with an increase in ending net assets of \$24.4 million.

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 sources that are consistent with its mission and will continue prudently to manage the

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

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, 2006. 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 2006 totaled \$70.3 million, compared with \$66.3 million for 2005. The most significant source of operating revenue for the University was tuition and fees (net of scholarship allowances) totaling \$28.7 million at June 30, 2006, and \$26.7 million at June 30, 2005. This 7.6% increase primarily reflects an overall increase in tuition and fee rates of approximately 5.1% for in-state and 1.4% for out-of-state undergraduate students, and 13.1% for in-state and 3.4% for out-of-state graduate students. In addition, the University experienced a 2.3% growth in number of students. Other major revenue sources in 2006 include sales and services of \$23.6 million (\$21 million in 2005) and grants and contracts of \$16.8 million (\$16 million in 2005). Approximately \$2.3 million of the \$2.7 million increase in sales and services resulted from increases in revenue generated from residential living facilities. Rate increases of approximately 14% in residential living facilities fees, along with increased occupancy in the residence halls in general, and the new higher-priced residence halls in particular, were responsible for the 32.8% housing revenue increases. Rates for the three new residence halls placed in service over the last two years range from 25% - 65% higher than the older residence halls. The decrease of over \$1.4 million in Other Operating Revenues is mostly due to final surety payments totaling \$1.8 million remitted to the

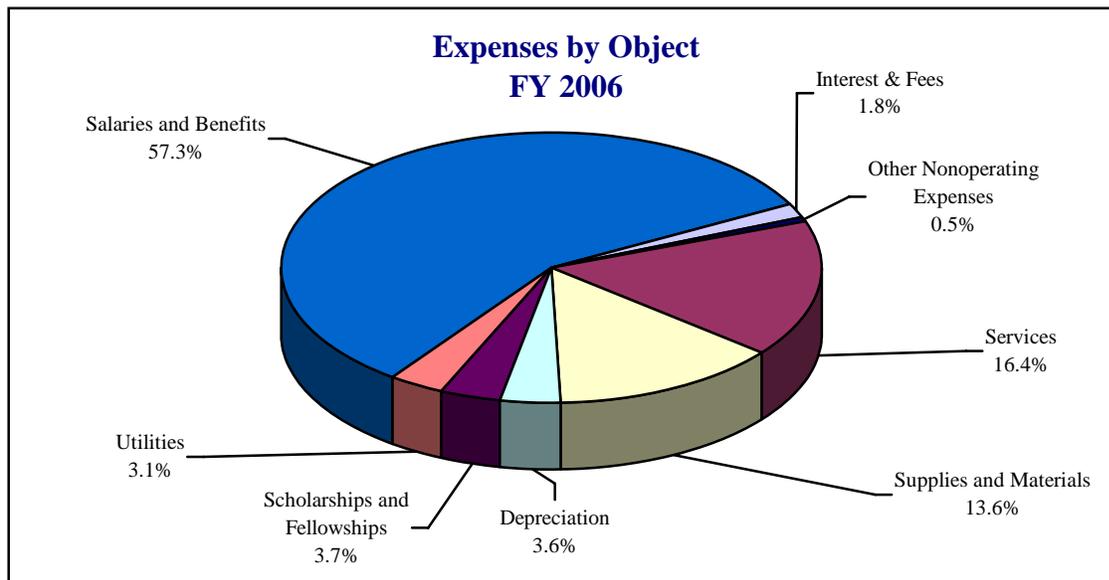
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

University in the prior fiscal year (2005) 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.

Like most public institutions, the University receives significant nonoperating revenues which offset the loss generated by operating activities. During 2006, the operating loss of \$74.6 million was offset by \$80 million in net nonoperating revenues. The primary sources of this revenue are state appropriations, which totaled \$74.6 million and accounted for 42.8% of total revenue. Other major sources of nonoperating revenue in 2006 were investment income of \$4.7 million and noncapital gifts and grants of \$4 million. An increase in investment income in 2006 of \$1.3 million was largely attributable to favorable market fluctuations.

Capital grants totaled \$14.4 million and \$20.1 million for the years ended June 30, 2006, and June 30, 2005, respectively. The primary sources of this revenue were state general obligation bond proceeds of \$13 million in 2006 (\$18.2 million in 2005). 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 allots 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 2006, due to completion of several major projects in 2005, is the primary reason for the decrease of \$5.2 million in state capital grants.

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

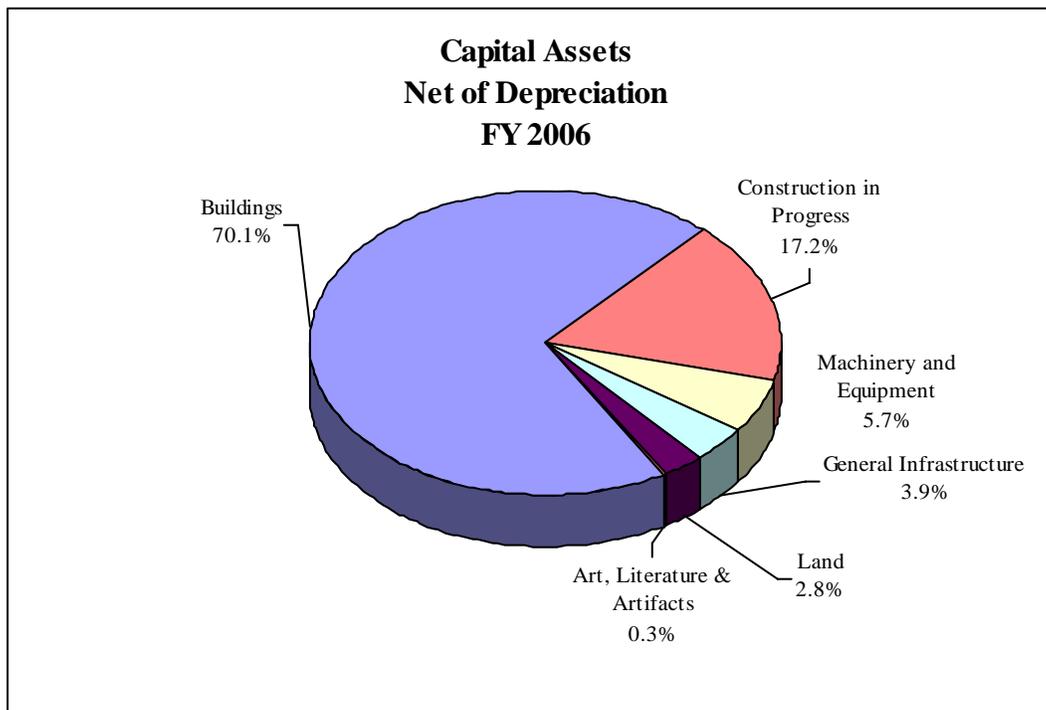


MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Operating expenses increased \$18.4 million for the fiscal year ending June 30, 2006. Operating expenses are mainly attributable to salaries and benefits for the faculty and staff of the University. Of the \$144.9 million in operating expenses, \$85 million (58.6%) was used for this purpose in 2006. Other elements included in operating expenses are supplies and materials, services, scholarships and fellowships, utilities, and depreciation. All categories of expense were fairly consistent with last year in terms of their percent of contribution to total expenses.

Capital Asset and Debt Administration

At June 30, 2006, the University had approximately \$283.6 million invested in capital assets, and accumulated depreciation of \$64 million. Depreciation charges for the current year totaled \$5.3 million. The following chart displays the relationship of each category to capital assets as a whole.



A critical factor for 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 fiscal year were funded with federal and state capital grants, debt proceeds, gifts, and unrestricted net assets designated for capital purposes.

Passage of North Carolina's Higher Education Bond Referendum in November 2000 gave the University more than \$100 million in state funds over a six-year period, beginning in fiscal

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

year 2001, to fund facility construction projects, infrastructure improvements, land acquisitions, and technology expansion.

In September 2005, the University held a ribbon-cutting ceremony to celebrate the completion of the \$2.9 million renovation 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.

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, officially opened the weekend of October 22-23, 2005 with a series of gala events. The Center includes a 1,000-seat auditorium capable of hosting Broadway-quality productions, four separate art galleries, atrium space comprising nearly 10,000 square feet to house and display the University's permanent collection and rotating displays of contemporary art and student work.

In August 2006, the University obtained occupancy after the Phase I renovation of the Stillwell Laboratory Building (\$24.3 million), which included renovations of classrooms, offices, and support space for many departments within Arts & Sciences. Phase II renovations of other classroom and laboratory space are underway with a scheduled completion date of November 2007.

The 2000 bond issue also made possible the acquisition of 344 acres of property adjacent to the University's main campus. On May 12, 2006, the University of North Carolina Board of Governors approved *Millennial Campus* designation for the newly acquired property. A comprehensive master plan was approved by the campus and Board of Trustees to serve as a guide for the development of this property. The 2006 General Assembly approved advance planning funds for the design of a new 145,200 square foot Health and Gerontological Science Building (\$46.2 million). This building will be the first building on the University's west campus and will house expanded programs in nursing and health-related programming, while providing the opportunity to develop degree programs in occupational therapy, gerontology, and a masters degree in social work with specializations in rural and gerontological social work.

Projects currently in design, with total combined budgets of \$95.2 million, are: a new student recreation center; a pedestrian quadrangle; a dining facility to replace Dodson Cafeteria; two new residence halls to replace Helder and Leatherwood Residence Halls; a partial renovation of the Forsyth Building; and a planned Hospitality Management Studies Center.

The University's financial statements indicate \$25,664,000 in bonds payable, \$1,525,347 in notes payable, and \$21,626,069 in capital leases payable at June 30, 2006. Total annual debt service payments were \$4.2 million in 2006 and \$3.2 million in 2005.

For additional information on capital assets and debt administration, see Notes 5, 7, and 8 to the financial statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Enrollment

A significant factor in the University's capacity to generate resources is the 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 is emphasizing continued as well as new career-focused programs of study. Undergraduate programs approved during FY 2005-2006 included motion picture and television production, and forensic science; graduate programs approved included sport management, science and entrepreneurship, and Certified Registered Nurse Anesthetist.

Enrollment growth targets for the next 8 to 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 2006 reaching an all-time high of 8,861 students, a 2.2% increase over last fall's enrollment of 8,665, the total enrollment target of 10,000 by the year 2009 appears to be within reach. 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 by 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's enrollment and facilities and the demand for state appropriations to operate the University. Declines in state appropriations generally exert pressure on institutions to increase tuition and fees. As an institution targeted for growth in the years ahead, the University 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, the University experienced an increase of \$1.2 million (47%) in total (noncapital and capital) gifts in 2006. Also in 2006, the University received its largest-ever gift commitment. Though only a portion of the pledge was received in 2006, this gift over time will yield more than \$10 million, including matching funds from the North Carolina Distinguished Professors Endowment Trust Fund, to create permanent endowments that will support faculty, students, and programs in perpetuity.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

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.

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, 2006

Exhibit A-1

ASSETS

Current Assets:

Cash and Cash Equivalents	\$ 44,068,511.32
Restricted Cash and Cash Equivalents	9,645,045.81
Restricted Short-Term Investments	3,476,807.10
Receivables, Net (Note 4)	5,250,255.45
Due from State of North Carolina Component Units	200,000.00
Inventories	3,488,934.70
Notes Receivable, Net (Note 4)	463,350.12
	<hr/>
Total Current Assets	66,592,904.50
	<hr/>

Noncurrent Assets:

Restricted Cash and Cash Equivalents	14,559,814.74
Receivables, Net (Note 4)	184,435.55
Restricted Due from Primary Government	4,451,083.14
Endowment Investments	27,423,862.44
Other Long-Term Investments	1,161,415.41
Notes Receivable, Net (Note 4)	5,426,502.24
Capital Assets - Nondepreciable (Note 5)	44,541,369.06
Capital Assets - Depreciable, Net (Note 5)	175,054,319.83
	<hr/>
Total Noncurrent Assets	272,802,802.41
	<hr/>

Total Assets	339,395,706.91
	<hr/>

LIABILITIES

Current Liabilities:

Accounts Payable and Accrued Liabilities (Note 6)	6,371,494.32
Due to Primary Government	49,841.59
Funds Held for Others	42,193.00
Unearned Revenue	3,913,221.54
Interest Payable	422,044.92
Long-Term Liabilities - Current Portion (Note 7)	2,605,356.86
	<hr/>
Total Current Liabilities	13,404,152.23
	<hr/>

Noncurrent Liabilities:

Deposits Payable	67,048.19
Funds Held for Others	408,088.60
U. S. Government Grants Refundable	5,662,669.08
Long-Term Liabilities (Note 7)	51,940,499.81
	<hr/>

Total Noncurrent Liabilities	58,078,305.68
	<hr/>

Total Liabilities	71,482,457.91
	<hr/>

Western Carolina University
Statement of Net Assets
June 30, 2006

Exhibit A-1
Page 2

NET ASSETS

Invested in Capital Assets, Net of Related Debt	182,065,630.91
Restricted for:	
Nonexpendable:	
Scholarships and Fellowships	7,475,993.89
Endowed Professorships	9,570,683.83
Expendable:	
Scholarships and Fellowships	11,311,969.62
Research	1,221,167.54
Endowed Professorships	1,604,285.63
Departmental Uses	1,501,355.17
Loans	1,380,671.46
Capital Projects	4,494,641.68
Debt Service	3,243,528.02
Unrestricted	<u>44,043,321.25</u>
Total Net Assets	<u><u>\$ 267,913,249.00</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, 2006

Exhibit A-2

REVENUES

Operating Revenues:	
Student Tuition and Fees, Net (Note 9)	\$ 28,692,604.02
Federal Grants and Contracts	11,451,405.06
State and Local Grants and Contracts	4,044,204.15
Nongovernmental Grants and Contracts	1,288,452.57
Sales and Services, Net (Note 9)	23,621,945.29
Interest Earnings on Loans	14,809.42
Other Operating Revenues	1,194,051.57
	<hr/>
Total Operating Revenues	70,307,472.08
	<hr/>

EXPENSES

Operating Expenses:	
Salaries and Benefits	85,002,808.45
Supplies and Materials	20,113,817.69
Services	24,328,972.76
Scholarships and Fellowships	5,511,173.75
Utilities	4,658,987.06
Depreciation	5,328,682.95
	<hr/>
Total Operating Expenses	144,944,442.66
	<hr/>
Operating Loss	(74,636,970.58)
	<hr/>

NONOPERATING REVENUES (EXPENSES)

State Appropriations	74,579,645.56
Noncapital Grants	525,977.37
Noncapital Gifts, Net	3,511,759.19
Investment Income (Net of Investment Expense of \$45,207.18)	4,709,304.44
Interest and Fees on Debt	(2,614,233.51)
Other Nonoperating Expenses	(673,748.45)
	<hr/>
Net Nonoperating Revenues	80,038,704.60
	<hr/>

Income Before Other Revenues	5,401,734.02
Capital Appropriations	1,818,000.00
Capital Grants	14,392,041.94
Capital Gifts, Net	276,654.25
Additions to Endowments	2,516,655.32
	<hr/>
Increase in Net Assets	24,405,085.53

NET ASSETS

Net Assets - July 1, 2005	243,508,163.47
	<hr/>
Net Assets - June 30, 2006	\$ 267,913,249.00
	<hr/> <hr/>

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, 2006

Exhibit A-3

CASH FLOWS FROM OPERATING ACTIVITIES

Received from Customers	\$ 68,402,247.00
Payments to Employees and Fringe Benefits	(84,367,548.26)
Payments to Vendors and Suppliers	(48,385,338.79)
Payments for Scholarships and Fellowships	(5,511,173.75)
Loans Issued	(1,317,093.66)
Collection of Loans	1,417,102.60
Interest Earned on Loans	14,809.42
Student Deposits Received	740,976.43
Student Deposits Returned	(692,066.24)
Other Receipts	1,206,071.07
	<hr/>
Net Cash Used by Operating Activities	(68,492,014.18)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State Appropriations	74,579,645.56
Noncapital Grants	542,765.12
Noncapital Gifts	2,528,706.13
Additions to Endowments	2,516,655.32
William D. Ford Direct Lending Receipts	23,732,222.50
William D. Ford Direct Lending Disbursements	(24,981,029.00)
Related Activity Agency Receipts	933,845.91
Related Activity Agency Disbursements	(1,061,373.57)
Other Payments	(673,748.45)
	<hr/>
Net Cash Provided by Noncapital Financing Activities	78,117,689.52

CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES

Proceeds from Capital Debt	1,097,170.19
State Capital Appropriations	1,818,000.00
Capital Grants	13,987,615.15
Capital Gifts	276,654.25
Acquisition and Construction of Capital Assets	(19,879,796.02)
Principal Paid on Capital Debt and Leases	(1,697,060.23)
Interest and Fees Paid on Capital Debt and Leases	(2,515,003.69)
	<hr/>
Net Cash Used by Capital Financing and Related Financing Activities	(6,912,420.35)

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	1,034,870.35
Investment Income	2,962,710.07
Purchase of Investments and Related Fees	(6,421,848.26)
	<hr/>
Net Cash Used by Investing Activities	(2,424,267.84)

Net Increase in Cash and Cash Equivalents	288,987.15
Cash and Cash Equivalents - July 1, 2005	67,984,384.72
	<hr/>
Cash and Cash Equivalents - June 30, 2006	\$ 68,273,371.87

Western Carolina University
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2006

Exhibit A-3
Page 2

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

Operating Loss	\$ (74,636,970.58)
Adjustments to Reconcile Operating (Loss) to Net Cash Provided Used by Operating Activities:	
Depreciation Expense	5,328,682.95
Allowances, Write-Offs, and Amortizations	579,266.17
Nonoperating Other Income	21,013.05
Changes in Assets and Liabilities:	
Receivables (Net)	(495,577.81)
Due from State of North Carolina Component Units	(200,000.00)
Inventories	(259,947.10)
Accounts Payable and Accrued Liabilities	337,118.28
Due to Primary Government	4,883.49
Unearned Revenue	17,742.61
Compensated Absences	646,713.30
Deposits Payable	48,910.19
Note Principal Repayments	1,433,244.93
Notes Issued	(1,317,093.66)
	<hr/>
Net Cash Used by Operating Activities	<u>\$ (68,492,014.18)</u>
Current Assets:	
Cash and Cash Equivalents	\$ 44,068,511.32
Restricted Cash and Cash Equivalents	9,645,045.81
Noncurrent Assets:	
Restricted Cash and Cash Equivalents	<u>14,559,814.74</u>
Total Cash and Cash Equivalents - June 30, 2006	<u>\$ 68,273,371.87</u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through the Assumption of a Liability	\$ 10,137,750.82
Assets Acquired through a Gift	622,718.05
Change in Fair Value of Investments	72,559.81
Reinvested Distributions	2,355,375.53

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, 2006

Exhibit B-1

ASSETS

Current Assets:

Cash and Cash Equivalents	\$ 1,659,015.00
Net Investment in Capital Leases, net of unearned interest income	<u>349,859.00</u>
Total Current Assets	<u>2,008,874.00</u>

Other Assets:

Certificate Issuance Costs, net of accumulated amortization	1,118,872.00
Net Investment in Capital Leases, net of unearned interest income	<u>19,667,094.00</u>
Total Other Assets	<u>20,785,966.00</u>

Total Assets	<u><u>\$ 22,794,840.00</u></u>
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LIABILITIES

Current Liabilities:

Current Portion of Long-Term Debt	\$ 510,000.00
Accrued Expenses	<u>74,354.00</u>
Total Current Liabilities	584,354.00

Noncurrent Liabilities:

Certificates of Participation Payable	<u>21,885,000.00</u>
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Total Liabilities	<u>22,469,354.00</u>
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NET ASSETS

Unrestricted	<u>325,486.00</u>
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Total Liabilities and Net Assets	<u><u>\$ 22,794,840.00</u></u>
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The accompanying notes to the financial statements are an integral part of this statement.

Western Carolina University Research and Development Corporation
Statement of Activities
For the Fiscal Year Ended June 30, 2006

Exhibit B-2

REVENUES

Management Fee	\$ 329,135.00
Investment Interest Income	68,482.00
Interest Earned from Investments in Capital Leases	<u>1,116,504.00</u>
Total Revenues	<u>1,514,121.00</u>

EXPENSES

Amortization of Certificate Issuance Costs	40,499.00
Insurance	89,443.00
Interest	875,921.00
Professional Fees	10,818.00
Other Operating	<u>525.00</u>
Total Expenses	<u>1,017,206.00</u>

CHANGE IN NET ASSETS

496,915.00

Net Assets, Beginning of Year (171,429.00)

Net Assets, End of Year \$ 325,486.00

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

WESTERN CAROLINA UNIVERSITY
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2006

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 26-member board consisting of 4 ex officio directors and 22 elected 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 elected 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 828-227-7323. Other related foundations and similar nonprofit corporations for which the University is not financially accountable are not part of the accompanying financial statements.

Discretely Presented Component Unit – 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 is a private not-for-profit organization that reports its financial results under Financial Accounting Standards Board (FASB) Statements. As such, certain revenue recognition criteria and presentation features are different from the Governmental Accounting Standards Board (GASB) revenue recognition criteria and presentation features. No modifications have been made to the Corporation's financial information in the University's financial reporting entity for these differences.

Separate financial statements for the Corporation may be obtained from Western Carolina University's Controller's Office, HFR 317, Cullowhee, NC 28723 or by calling 828-227-7323.

- 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, 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, money market funds, limited partnerships, real estate, and other asset holdings by the University. Except for money market funds, real estate not held by a governmental external investment pool, and other asset holdings, investments are accounted for at fair value, as determined by quoted market prices, or an amount determined by management if quoted market prices are not available. The net increase (decrease) in the fair value of investments is recognized as a component of investment income.

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

- F. Receivables** – Receivables consist of tuition and 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 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 collection using the straight-line method. The estimated useful lives for the collections are 25 years.

Art 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. These assets are also classified as noncurrent since they cannot be used for current operations. 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, capital lease obligations, annuity and life income payable, and compensated absences that will not be paid within the next fiscal year.

Bond issuance costs 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

termination of employment. Also, any accumulated vacation leave in excess of 30 days at year-end is converted to sick leave. Under this policy, the accumulated vacation leave for each employee at June 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 include the accumulated unused portion of the special annual leave bonuses awarded by the North Carolina General Assembly. The bonus leave balance on December 31 is retained by employees and transferred into the next calendar year. It is not subject to the limitation on annual leave carried forward described above and is not subject to conversion to sick leave.

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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Fund authorities provide rules for the fund activity and are separately 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, 2006, the amount shown on the Statement of Net Assets as cash and cash equivalents includes \$68,167,758.06 which represents the University's equity position in the State Treasurer's Short-Term Investment Fund. 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 1.18 years as of June 30, 2006. 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 (which includes the State Treasurer's Short-Term Investment Fund) 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

by calling the State Controller's Financial Reporting Section at (919) 981-5454.

Cash on hand at June 30, 2006 was \$37,485.00. The carrying amount of the University's deposits not with the State Treasurer was \$68,128.81 and the bank balance was \$396,396.92. 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, 2006, 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>296,396.92</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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 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.

Investments are subject to the following risks.

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

Credit Risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The University has a formal policy that addresses credit risk.

Long-Term Investment Pool – This is an internal investment pool that is utilized for the investment of the endowment 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2006, for the Long-Term Investment Pool.

Long-Term Investment Pool

Investment Type	<u>Fair Value</u>
Mutual Funds	\$ 26,662,349.40
Investments in Real Estate	3,220.00
Limited Partnerships	<u>843,320.00</u>
Total Long-Term Investment Pool	<u><u>\$ 27,508,889.40</u></u>

Non-Pooled Investments – The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2006, for the University’s non-pooled investments.

Non-Pooled Investments

Investment Type	<u>Fair Value</u>	<u>Investment Maturities Less Than 1 Year</u>
Debt Securities:		
Money Market Mutual Funds	\$ 3,476,807.10	<u>\$ 3,476,807.10</u>
Other Securities:		
Mutual Funds	20,440.45	
Investments in Real Estate	93,800.00	
Domestic Stocks	960,026.00	
Other	<u>2,122.00</u>	
Total Non-Pooled Investments	<u><u>\$ 4,553,195.55</u></u>	

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Total Investments – The following table presents the fair value of the total investments at June 30, 2006:

	<u>Fair Value</u>
Investment Type	
Debt Securities	
Money Market Funds	\$ 3,476,807.10
Other Securities	
Mutual Funds	26,682,789.85
Investments in Real Estate	97,020.00
Limited Partnerships	843,320.00
Domestic Stocks	960,026.00
Other	<u>2,122.00</u>
Total Investments	<u>\$ 32,062,084.95</u>

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, 2006, net appreciation of \$12,535,117.05 was available to be spent, of which \$8,530,600.94 was restricted to specific purposes.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 4 - RECEIVABLES

Receivables at June 30, 2006, were as follows:

	<u>Gross Receivables</u>	<u>Less Allowance for Doubtful Accounts</u>	<u>Net Receivables</u>
Current Receivables:			
Students	\$ 1,153,989.21	\$ 806,407.31	\$ 347,581.90
Accounts	1,525,927.26		1,525,927.26
Intergovernmental	1,545,001.16		1,545,001.16
Pledges	137,723.77	11,386.46	126,337.31
Investment Earnings	54.32		54.32
Interest on Loans	151,150.16		151,150.16
Other	1,554,203.34		1,554,203.34
Total Current Receivables	<u><u>\$ 6,068,049.22</u></u>	<u><u>\$ 817,793.77</u></u>	<u><u>\$ 5,250,255.45</u></u>
Noncurrent Receivables:			
Pledges	<u><u>\$ 206,373.00</u></u>	<u><u>\$ 21,937.45</u></u>	<u><u>\$ 184,435.55</u></u>
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	\$ 459,784.94	\$ 0.00	\$ 459,784.94
Institutional Student Loan Programs	49,054.99	45,489.81	3,565.18
Total Notes Receivable - Current	<u><u>\$ 508,839.93</u></u>	<u><u>\$ 45,489.81</u></u>	<u><u>\$ 463,350.12</u></u>
Notes Receivable - Noncurrent:			
Federal Loan Programs	\$ 6,379,140.64	\$ 957,052.00	\$ 5,422,088.64
Institutional Student Loan Programs	4,413.60		4,413.60
Total Notes Receivable - Noncurrent	<u><u>\$ 6,383,554.24</u></u>	<u><u>\$ 957,052.00</u></u>	<u><u>\$ 5,426,502.24</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, 2006, is presented as follows:

	Balance July 1, 2005	Increases	Decreases	Balance June 30, 2006
Capital Assets, Nondepreciable:				
Land	\$ 6,172,706.75	\$ 0.00	\$ 0.00	\$ 6,172,706.75
Art, Literature, and Artifacts	105,433.00	590,055.00		695,488.00
Construction in Progress	58,094,256.82	17,877,901.79	38,298,984.30	37,673,174.31
Total Capital Assets, Nondepreciable	64,372,396.57	18,467,956.79	38,298,984.30	44,541,369.06
Capital Assets, Depreciable:				
Buildings	155,960,525.96	48,741,610.27		204,702,136.23
Machinery and Equipment	18,293,932.00	1,823,446.29	482,506.31	19,634,871.98
Art, Literature, and Artifacts	153,188.00			153,188.00
General Infrastructure	14,453,163.42	142,371.16		14,595,534.58
Intangible	1.00			1.00
Total Capital Assets, Depreciable	188,860,810.38	50,707,427.72	482,506.31	239,085,731.79
Less Accumulated Depreciation/Amortization for:				
Buildings	47,146,051.46	3,625,847.54		50,771,899.00
Machinery and Equipment	6,303,122.36	1,122,601.56	391,933.48	7,033,790.44
Art, Literature, and Artifacts	86,721.00	1,606.00		88,327.00
General Infrastructure	5,558,767.67	578,627.85		6,137,395.52
Total Accumulated Depreciation	59,094,662.49	5,328,682.95	391,933.48	64,031,411.96
Total Capital Assets, Depreciable, Net	129,766,147.89	45,378,744.77	90,572.83	175,054,319.83
Capital Assets, Net	\$ 194,138,544.46	\$ 63,846,701.56	\$ 38,389,557.13	\$ 219,595,688.89

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2006, were as follows:

	Amount
Accounts Payable	\$ 3,117,899.12
Accrued Payroll	818,252.49
Contract Retainage	963,088.58
Civil Penalty and Forfeiture Fund Payable	1,042,479.93
Other	429,774.20
Total Accounts Payable and Accrued Liabilities	\$ 6,371,494.32

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, 2006, is presented as follows:

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

	Balance July 1, 2005	Additions	Reductions	Balance June 30, 2006	Current Portion
Bonds Payable	\$ 26,514,000.00	\$ 0.00	\$ 850,000.00	\$ 25,664,000.00	\$ 1,084,000.00
Notes Payable	1,811,807.79		286,460.65	1,525,347.14	303,456.37
Capital Leases Payable	10,228,052.97	11,843,750.82	445,734.52	21,626,069.27	648,523.65
Compensated Absences	4,550,573.36	6,211,029.98	5,564,316.68	5,197,286.66	483,332.00
Annuity and Life Income Payable	614,225.33		81,071.73	533,153.60	86,044.84
Total Long-Term Liabilities	\$ 43,718,659.45	\$ 18,054,780.80	\$ 7,227,583.58	\$ 54,545,856.67	\$ 2,605,356.86

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

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 6/30/2006	Principal Outstanding 6/30/2006
Dormitory System						
Dormitory System Revenue Bonds	(D)	3.00	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	180,000.00	285,000.00
UNC System Pool Revenue Bonds	(B)	5.00-5.50	10/01/2010	1,370,000.00	505,000.00	865,000.00
Total Dormitory System				4,229,000.00	2,875,000.00	1,354,000.00
Student Center						
UNC System Pool Revenue Bonds	(B)	5.00-5.75	10/01/2025	5,355,000.00	590,000.00	4,765,000.00
Faculty Housing						
Faculty Housing Revenue Bonds		3.00	11/01/2007	280,000.00	260,000.00	20,000.00
Stadium System						
UNC System Pool Revenue Bonds	(C)	4.0-5.375	04/01/2027	8,070,000.00	635,000.00	7,435,000.00
UNC System Pool Revenue Bonds	(D)	2.0-5.25	04/01/2028	1,510,000.00	120,000.00	1,390,000.00
Total Stadium System				9,580,000.00	755,000.00	8,825,000.00
Student Recreation Center						
UNC System Pool Revenue Bonds	(D)	2.0-5.25	04/01/2028	11,610,000.00	910,000.00	10,700,000.00
Total Bonds Payable (principal only)				<u>\$ 31,054,000.00</u>	<u>\$ 5,390,000.00</u>	<u>\$ 25,664,000.00</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. Annual Requirements – The annual requirements to pay principal and interest on the long-term obligations at June 30, 2006, are as follows:

Fiscal Year	Annual Requirements			
	Revenue Bonds Payable		Notes Payable	
	Principal	Interest	Principal	Interest
2007	\$ 1,084,000.00	\$ 1,239,466.28	\$ 303,456.37	\$ 83,963.51
2008	920,000.00	1,197,136.28	322,750.39	64,669.49
2009	950,000.00	1,159,411.28	343,271.15	44,148.73
2010	1,000,000.00	1,111,586.28	365,096.64	22,323.24
2011	1,040,000.00	1,068,635.65	190,772.59	2,937.35
2012-2016	4,800,000.00	4,674,095.05		
2017-2021	5,985,000.00	3,353,742.53		
2022-2026	7,665,000.00	1,675,583.76		
2027-2031	2,220,000.00	147,225.00		
Total Requirements	\$ 25,664,000.00	\$ 15,626,882.11	\$ 1,525,347.14	\$ 218,042.32

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

Purpose	Financial Institution	Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2006	Principal Outstanding June 30, 2006
University Center Renovation	Wachovia Bank	5.98%	12/01/2010	\$ 3,800,000.00	\$ 2,274,652.86	\$ 1,525,347.14

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 \$1,082,314.80. In consideration of this property transfer, the annuitants will receive, for their joint lives, an annual annuity of \$86,044.84, 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 3.445% rate of return, the liability at June 30, 2006, was adjusted to its present value as follows:

	Amount
Value of Annuity Liability at June 30, 2005	\$ 614,225.33
Interest Earned on Investment	33,793.33
Sum of Quarterly Payments	(86,044.84)
Present Value Adjustment at Year End	(28,820.22)
Value of Annuity Liability at June 30, 2006	\$ 533,153.60

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

COMPONENT UNITS

The Western Carolina University Research and Development Corporation, a discretely presented component unit of the University, has constructed two dormitories that are recognized as capital leases by the University. The long-term debt of the component unit represents the construction cost of the two dormitories.

Long-term debt at June 30, 2006, consists of the following:

2003 certificates of participation with a balance of \$11,595,000, evidenced by undivided interests in the rights to receive certain revenues, including the Base Rentals under the lease with the University for the facility. The maturities and interest rates of the certificates are as follows:

<u>Due June 1</u>	<u>Principal Amount</u>	<u>Interest Rate</u>
2007	\$ 255,000	2.000%
2008	260,000	2.375%
2009	265,000	2.750%
2010	270,000	3.000%
2011	280,000	3.375%
Thereafter	<u>10,265,000</u>	3.500% - 5.000%
	<u>\$ 11,595,000</u>	

2005 certificates of participation with a balance of \$10,800,000, evidenced by undivided interests in the rights to receive certain revenues, including the Base Rentals under the lease with the University for the facility. The maturities and interest rates of the certificates are as follows:

<u>Due June 1</u>	<u>Principal Amount</u>	<u>Interest Rate</u>
2007	\$ 255,000	3.000%
2008	265,000	3.000%
2009	270,000	4.000%
2010	280,000	4.000%
2011	295,000	3.000%
Thereafter	<u>9,435,000</u>	3.000% - 4.350%
	<u>\$ 10,800,000</u>	

NOTE 8 - LEASE OBLIGATIONS

A. Capital Lease Obligations – Capital lease obligations relating to buildings, machinery and equipment are recorded at the present value of

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2006:

<u>Fiscal Year</u>	<u>Amount</u>
2007	\$ 1,797,982.85
2008	1,826,313.26
2009	1,821,510.26
2010	1,818,422.76
2011	1,730,374.16
2012-2016	7,231,962.54
2017-2021	7,239,467.50
2022-2026	7,237,454.80
2027-2031	7,230,700.00
2032-2036	2,216,242.80
Total Minimum Lease Payments	40,150,430.93
Amount Representing Interest (3.78% - 6.10% Rate of Interest)	<u>18,524,361.66</u>
Present Value of Future Lease Payments	<u><u>\$ 21,626,069.27</u></u>

Buildings acquired under capital lease amounted to \$19,116,158.11. Machinery and equipment acquired or obligated under capital lease amounted to \$2,509,911.16 at June 30, 2006.

B. Operating Lease Obligations – The University entered into operating leases for automobiles, equipment, and housing. Future minimum lease payments under non-cancelable operating leases consist of the following at June 30, 2006:

<u>Fiscal Year</u>	<u>Amount</u>
2007	\$ 183,426.23
2008	139,002.74
2009	88,034.79
2010	31,561.67
2011	840.00
Total Minimum Lease Payments	<u><u>\$ 442,865.43</u></u>

Rental expense for all operating leases during the year was \$278,242.38.

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	\$ 33,726,549.61	\$ 23,947.02	\$ 4,614,774.99	\$ 395,223.58	\$ 28,692,604.02	\$ 411,703.07 (A)
Sales and Services:						
Sales and Services of Auxiliary Enterprises:						
Residential Life	\$ 11,198,746.57	\$ 86,186.75	\$ 1,477,579.70	\$ 172,423.50	\$ 9,462,556.62	\$ 9,462,556.62 (B)
Dining	8,070,182.71	689,923.68	1,008,725.10	53,527.70	6,318,006.23	
Book Rental	1,513,848.23	3,691.73	187,819.40	70,961.27	1,251,375.83	
Bookstore	1,646,255.70	127,482.70		1,903.28	1,516,869.72	
Print Shop	696,557.08	598,023.07			98,534.01	
Athletic	974,032.28	446.00			973,586.28	
Other	891,837.63	49,054.37		2,036.93	840,746.33	70,219.88 (C)
Sales and Services of Education and Related Activities	3,158,067.97	1,966,207.97		6,476.81	1,185,383.19	
Independent Operations	2,073,684.54	98,797.46			1,974,887.08	
Total Sales and Services	\$ 30,223,212.71	\$ 3,619,813.73	\$ 2,674,124.20	\$ 307,329.49	\$ 23,621,945.29	\$ 9,532,776.50

Revenue Bonds Secured by Pledged Revenues:

- (A) Housing and Student Center System
- (B) Student Housing
- (C) Rental Property

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	\$ 43,409,450.75	\$ 2,728,191.72	\$ 2,891,724.14	\$ 2,223.53	\$ 1,352.00	\$ 0.00	\$ 49,032,942.14
Research	641,864.33	802,830.52	634,710.88	5,666.81	21,935.83		2,107,008.37
Public Service	6,881,275.33	2,283,993.31	2,983,811.70	150,691.58	58,478.20		12,358,250.12
Academic Support	6,123,278.22	2,392,038.47	918,961.84	222.35	1,328.39		9,435,829.27
Student Services	3,538,430.74	313,832.99	1,097,640.29				4,949,904.02
Institutional Support	8,721,256.68	2,520,774.81	3,913,973.51	445,305.33	675.95		15,601,986.28
Operations and Maintenance of Plant	6,783,582.72	2,878,771.27	608,657.66		3,017,557.48		13,288,569.13
Student Financial Aid	84,213.93		32,206.27	3,865,941.42			3,982,361.62
Auxiliary Enterprises	8,614,562.74	4,930,560.14	11,141,518.80	1,041,122.73	1,557,659.21		27,285,423.62
Independent Operations	204,893.01	1,262,824.46	105,767.67				1,573,485.14
Depreciation						5,328,682.95	5,328,682.95
Total Operating Expenses	\$ 85,002,808.45	\$ 20,113,817.69	\$ 24,328,972.76	\$ 5,511,173.75	\$ 4,658,987.06	\$ 5,328,682.95	\$ 144,944,442.66

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, 2006, these rates were set at 2.34% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2006, the University had a total payroll of \$69,095,382.53, of which \$34,854,005.36 was covered under the Teachers’ and State Employees’ Retirement System. Total employee and employer contributions for pension benefits for the year were \$2,091,240.32 and \$815,583.73, respectively. The University made 100% of its annual required contributions for the years ended June 30, 2006, 2005, and 2004, which were \$815,583.73, \$704,822.44, and \$65,833.49, 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, 2006, 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, 2006, the University had a total payroll of \$69,095,382.53, of which \$25,904,724.64 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were \$1,554,283.48 and \$1,771,883.17, 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 \$140,120.48 for the year ended June 30, 2006.

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, 2006, were \$27,170.91. The voluntary contributions by employees amounted to \$385,253.00 for the year ended June 30, 2006.

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 \$1,136,443.22 for the year ended June 30, 2006.

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 3.8% 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, 2006, the University's total contribution to the Plan was

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

\$2,308,834.74. The University assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs can be located in the State of North Carolina's *Comprehensive Annual Financial Report*.

- B. Long-Term Disability** – The University participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System and the Optional Retirement Program. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. The University contributes .52% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. For the year ended June 30, 2006, the University's total contribution to the DIPNC was \$315,945.40. 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 the University for 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, except for high value equipment losses which are subject to a \$1,000 deductible per occurrence for theft losses and a \$500 deductible per occurrence for all other covered losses.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Treasurer and funded via employer contributions. The employer contribution rate was .16% for the current fiscal year.

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

NOTE 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 \$9,305,385.66 and on other purchases were \$1,048,639.13 at June 30, 2006.
- B. Pending Litigation and Claims** – The NC School Boards Association, et. al. filed a civil action against various State officials in their official capacity seeking a judicial determination as to whether the State Constitution requires certain monetary payments collected by State agencies to be paid to the local county school funds rather than statutorily designated recipients. In part, this civil action includes a determination of whether monetary payments collected pursuant to statutory authority by the University for violations of parking traffic regulations and library fines are “civil penalties” which the State Constitution requires to be paid to the school fund in the county where they are collected. On July 1, 2005, the NC Supreme Court held in favor of the school boards with regard to parking fines and held in favor of the University with regards to library fines. The matter had been remanded back to the trial court for disposition in accordance with the Supreme Court’s decision. At issue are transportation fines in the amount of \$1,042,479.93 for the period December 1995 to June 30, 2005. A liability for this amount has been recorded by the University.

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 other 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.

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

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 \$431,484.72 for the year ended June 30, 2006.

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 \$32,729.47 for the year ended June 30, 2006.

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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, 2006, which collectively comprise the University's basic financial statements and have issued our report thereon dated November 13, 2006. Our report was modified to include a reference to 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. Other auditors audited the financial statements of Western Carolina University Foundation and the discretely presented component unit, as described in our report on the University's financial statements.

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 opinions 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 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.

**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING
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GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

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*. However, we noted certain matters that we reported to management of the University in a separate letter dated November 13, 2006.

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, and the General Assembly, 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

November 13, 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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