STATE OF
NORTH CAROLINA

THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

CHAPEL HILL, 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

THE UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

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STATE OF NORTH CAROLINA
Office of the State Auditor

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

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AUDITOR'S TRANSMITTAL

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

We have completed a financial statement and compliance audit of The University of North Carolina at Chapel Hill 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 and our consideration of the University's administration of federal programs in accordance with applicable laws, regulations, contracts and grants 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

March 19, 2007

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INDEPENDENT AUDITOR'S REPORT

Board of Trustees
The University of North Carolina at Chapel Hill
Chapel Hill, North Carolina

We have audited the accompanying financial statements of The University of North Carolina at Chapel Hill, 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 units, 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 The University of North Carolina at Chapel Hill's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, or the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc., 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 The Medical Foundation of North Carolina, Inc., The Educational Foundation Scholarship Endowment Trust, and the University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc. were not audited in accordance with *Government Auditing Standards*. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

INDEPENDENT AUDITOR'S REPORT (CONCLUDED)

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 The University of North Carolina at Chapel Hill and its discretely presented component units as of June 30, 2006, 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 January 16, 2007, 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

January 16, 2007

Introduction

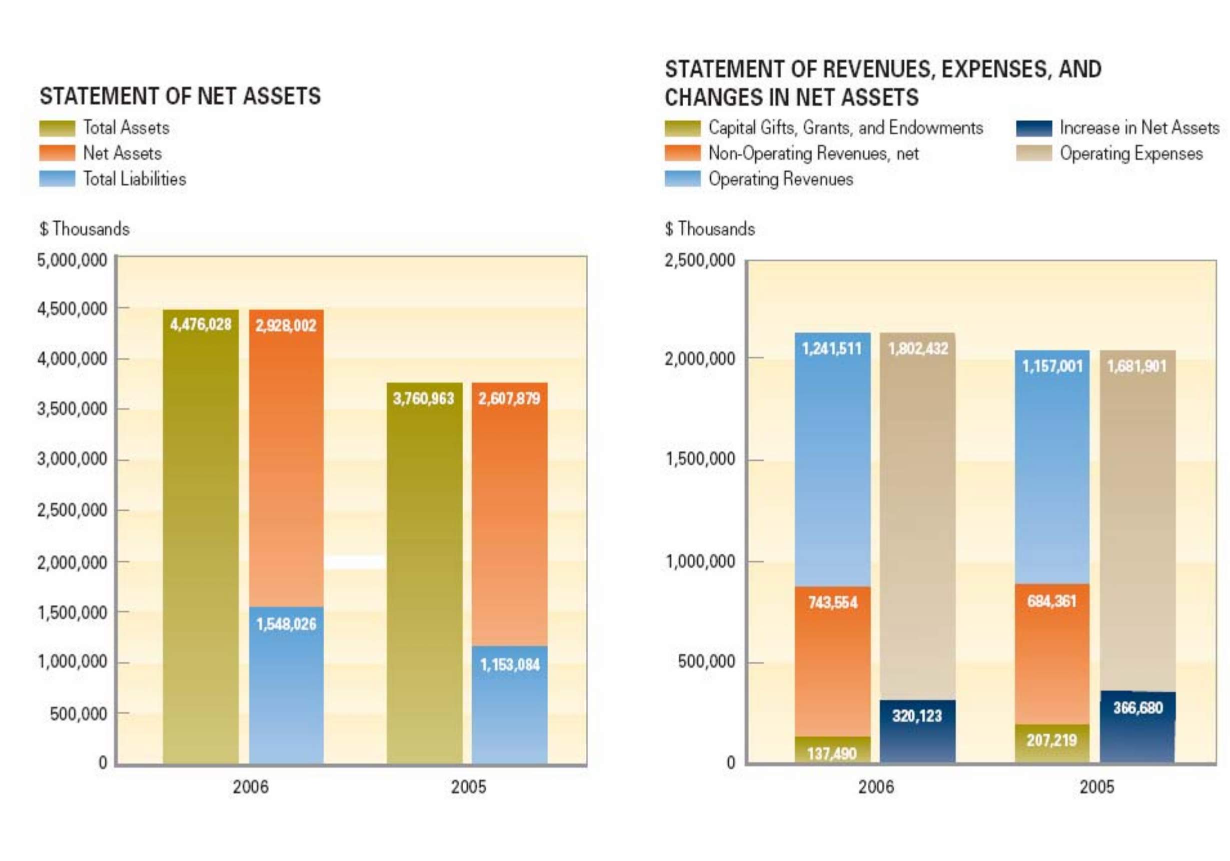
Management's Discussion and Analysis provides an overview of the financial position and activities of The University of North Carolina at Chapel Hill (the "University") for the fiscal year ended June 30, 2006, with comparative information for the fiscal year ended June 30, 2005. Management has prepared the discussion and analysis to be read in conjunction with the financial statements and accompanying note disclosures.

The University is a constituent institution of the 16-campus University of North Carolina System (UNC System), a component unit of the State of North Carolina and an integral part of the State's *Comprehensive Annual Financial Report* (CAFR). The Financial Reporting Entity for the financial statements is comprised of the University and 11 component units. Eight component units are reported as if they were part of the University, and three are reported as discretely presented component units based on the nature and significance of their relationship to the University. The reader may refer to note 1A for detail information on the financial reporting entity.

Management's Discussion and Analysis includes a separate section regarding the three component units that are discretely reported in the financial statements. The remainder of the Management's Discussion and Analysis pertains to the University and the eight component units reported as part of the University.

Financial Highlights

The University's financial position at June 30, 2006, remained sound with total assets of $4.5 billion. Net assets, which represent the residual interest in the University's assets after deducting liabilities, were $2.9 billion at June 30, 2006. The University's net assets increased by $320 million in fiscal year 2005-2006, when operating, nonoperating, and other changes are included. A comparison of the total assets, liabilities, and net assets at June 30, 2006, and 2005, and a comparison of the major components of the changes in net assets for the two fiscal years is presented below:



Net assets increased 12.3% at June 30, 2006, over the prior year. Total assets increased 19.0% and total liabilities increased 34.3% for the same period. Operating revenues increased at a slightly greater rate than operating expenses in 2005-2006 over the prior year, 7.3% and 7.2% respectively. Net nonoperating revenues and expenses increased 8.6% in 2005-2006 over the prior year. The State appropriations growth of 8.2% was significant. Investment income growth remained substantial with a 33.9% increase in 2005-2006 over the prior year. Research funding, fund raising for operational and capital needs and construction funding through the North Carolina Higher Education Bond Referendum of 2000 continued to be positive factors in the sustained financial well-being of the University.

Using the Financial Statements

The financial statements have been prepared in accordance with generally accepted accounting principals as prescribed by the Governmental Accounting Standards Board (GASB), which establishes standards for external financial reporting for public colleges and universities. The financial statements are presented on a consolidated basis to focus on the University as a whole. 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.

Effective for the fiscal year ended June 30, 2006, the University implemented GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, GASB Statement No. 44, *Economic Condition Reporting*: *The Statistical Section*, and GASB Statement No. 47, *Accounting for Termination Benefits*. Statement No. 42 establishes standards for reporting the impairment of capital assets, which occurs when an asset's service utility has declined significantly and unexpectedly. The statement also clarifies and establishes accounting requirements for insurance recoveries. Statement No. 44 amends prior guidance on the preparation of the statistical section of the CAFR to enhance the understandability and usefulness of the reported information and also by adding information to the statistical section based on the current financial reporting model. Statement No. 47 establishes accounting standards for termination benefits.

The University's Annual Financial Report includes the following three financial statements.

- Statement of Net Assets
- Statement of Revenues, Expenses, and Changes in Net Assets
- Statement of Cash Flows

Management's Discussion and Analysis provides information regarding each of these financial statements.

Condensed Statement of Net Assets

The Statement of Net Assets presents the financial position of the University at the end of the fiscal year, includes all assets and liabilities of the University and segregates the assets and liabilities into current and noncurrent components. Net assets represent the difference between total assets and total liabilities and are one indicator of the University's current financial condition. The following table summarizes the University's assets, liabilities, and net assets at June 30, 2006 and 2005.

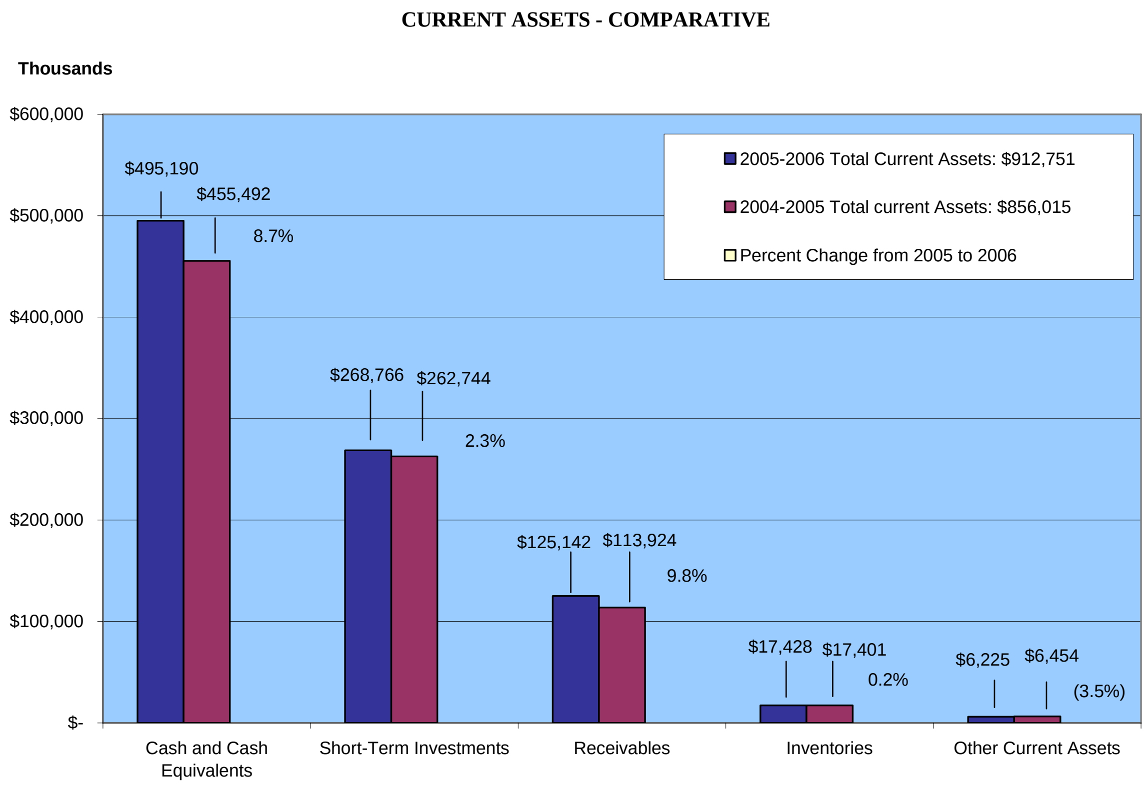
Assets, Liabilities, and Net Assets
(Dollars in Thousands)

	2006	2005	% Change
Assets:			
Current Assets	$ 912,751	$ 856,015	6.6
Noncurrent Assets:			
Endowment Investments	1,145,669	972,461	17.8
Other Long-Term Investments	458,860	283,641	61.8
Capital Assets, Net	1,874,486	1,550,201	20.9
Other Noncurrent Assets	84,262	98,645	(14.6)
Total Assets	4,476,028	3,760,963	19.0
Liabilities:			
Current Liabilities	391,685	420,350	(6.8)
Noncurrent Liabilities:			
Funds Held in Trust for Pool Participants	326,419	260,960	25.1
Long-Term Liabilities	797,852	440,423	81.2
Other Noncurrent Liabilities	32,070	31,351	2.3
Total Liabilities	1,548,026	1,153,084	34.3
Net Assets:			
Invested in Capital Assets, Net of Related Debt	1,119,040	1,017,383	10.0
Restricted:			
Nonexpendable	430,316	378,234	13.8
Expendable	853,133	736,631	15.8
Unrestricted	525,513	475,631	10.5
Total Net Assets	$ 2,928,002	$ 2,607,879	12.3

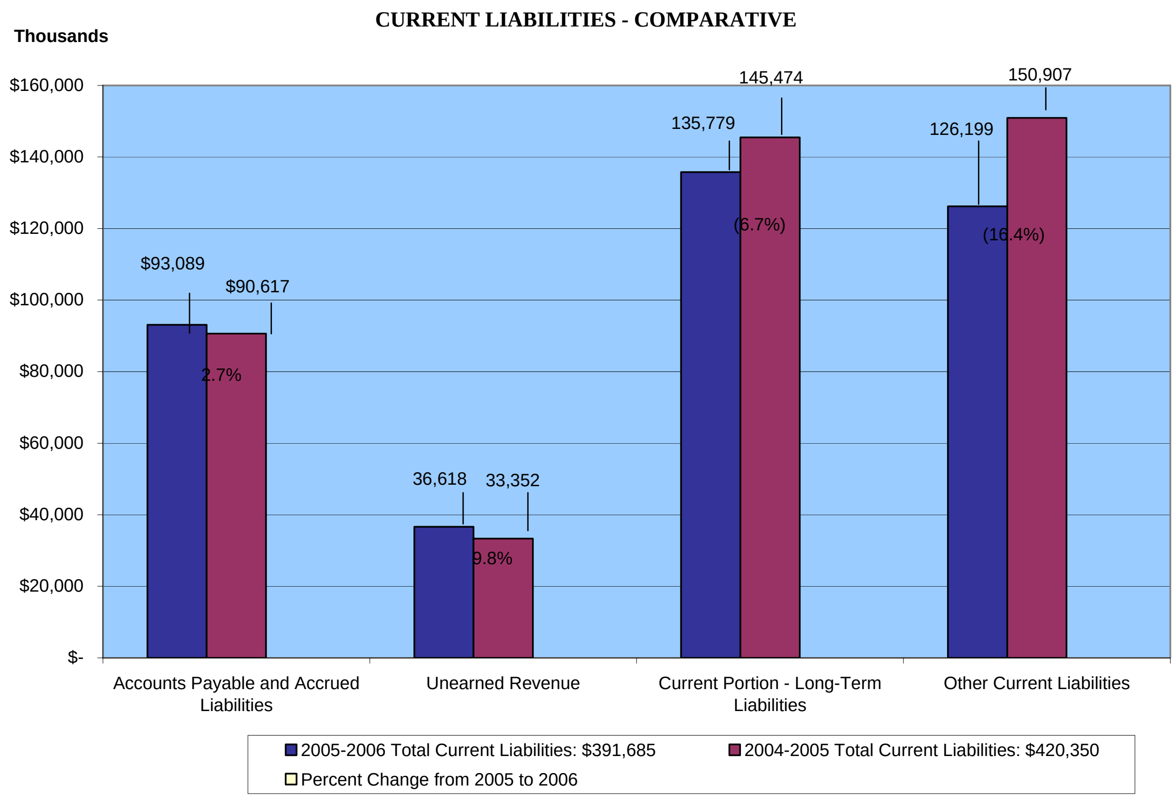
Current Assets and Liabilities

The Statement of Net Assets shows the University had total assets of $4.5 billion at June 30, 2006, an increase of 19% over the prior year. Working capital, which is current assets less current liabilities, was $521.1 million at June 30, 2006, an increase of 19.6%, or $85.4 million, over the previous year. The significant factors which resulted in the working capital improvement were an increase in cash and cash equivalents of $39.7 million and a decrease in short-term debt and the current portion of long-term liabilities of $33.4 million. The cash and cash equivalents increase was due in part to a participating, University-affiliated foundation electing to invest endowment assets in the Investment Fund effective June 30, 2006, of which $32.1 million were in cash assets. A portion of short-term debt was replaced by long-term debt during 2005-2006 as part of the University's financing strategy for the capital construction program.

Current assets are represented graphically below:



Current liabilities are represented graphically below:



Endowment and Other Long-Term Investments

Endowment investments increased 17.8% during 2005-2006 and were $1.146 billion at June 30, 2006, and $972.5 million at June 30, 2005, and include permanent endowments, funds internally designated as endowments and similar funds such as gift annuities and charitable trusts. Net assets of endowment and similar funds were $1.12 billion at June 30, 2006, and $930.6 million for the prior year.

The endowment assets are invested with The University of North Carolina at Chapel Hill Foundation Investment Fund, Inc. ("Investment Fund"), which is reported as a governmental external investment pool in the financial statements. The Investment Fund is a 501(c)(3) nonprofit corporation established to support the University by operating an investment pool for charitable, nonprofit foundations, associations, trusts, endowments, and funds that are organized and operated primarily to support the University.

The investment objective is to earn an average real total return of at least 5.5% per year, net of all fees, over rolling five- and ten-year periods. The earnings distribution policy is to provide a stable source of spending support that is sustainable over the long term while preserving the purchasing power of the endowment. The earnings distribution rate was established at 5% of the previous year's market value, with annual increases based on inflationary factors. Each year's distribution is subject to a 4% floor and a 7% cap based on estimated fiscal year-end market value.

Other long-term investments of $458.9 million at June 30, 2006, include funds of $317.4 million of affiliated entities that are neither part of the University's financial reporting entity nor reported discretely but do invest through the System Fund. The remaining component is bond reserves and related funds of $141.5 million.

Most of the University's endowment assets are currently managed within the System Fund, a pooled investment fund vehicle. The System Fund is designed to provide long-term, stable rates of return on the invested assets through the use of a highly diversified portfolio strategy. As reported by UNC Management Company, Inc., the nominal return on the endowment assets invested in the System Fund for fiscal year 2005-2006 was 19.2%, with a real return of 15% after inflation. The respective returns for fiscal year 2004-2005 were 15.5% and 13%. The System Fund return of 19.2% for 2005-2006 far outdistanced the Strategic Investment Policy Portfolio ("SIPP") return of 14.1% by 5.1%. The System Fund's return also exceeded the 70% S&P 500 / 30% Lehman Brothers Bond Index ("70/30") return of 5.8% for the year.

The continuing strong investment performance has increased the three-year annualized return to 16.9% at June 30, 2006. This three-year return measure compares well with the corresponding measure of 14.5% for the SIPP and 8.5% for the 70/30. For the five years ended June 30, 2006, the System Fund earned a 10.6% annualized return compared to 7.3% for the SIPP and 3.5% for the 70/30.

The System Fund has also outperformed its long term objective of real return, after inflation, of 5.5% for each of the time periods noted above as well as for longer time periods. For the 10-, 15-, and 20-year time periods ended June 30, 2006, the System Fund returned 11.6%, 12.2%, and 11.7% respectively. Comparatively, the CPI plus 5.5% has been 8.2%, 8.3%, and 8.8% respectively for the corresponding time periods. The System Fund is very well positioned in the current environment and remains invested according to the approved investment policy that provides excellent diversification in both bull and bear markets.

Capital Assets and Debt Management

An essential aspect for enhancing and maintaining the University's academic, research, and service programs and its residential life is the development and renewal of its capital assets. The University Board of Trustees approved the campus master plan to guide the University's physical development in the 21st Century. The master plan meshes the critical pieces needed for smart growth in the 21st Century – transportation, parking, housing, utilities, and environmental sustainability – with the program needs of a growing campus. The master plan combines the practical requirements of a research university with the beauty that inspired its founders. The University will continue to grow dramatically in the coming years.

A summary of changes in capital assets is disclosed in Note 5. Capital assets, net of accumulated depreciation, at June 30, 2006, and June 30, 2005, were as follows:

Capital Assets
(Dollars in Thousands)

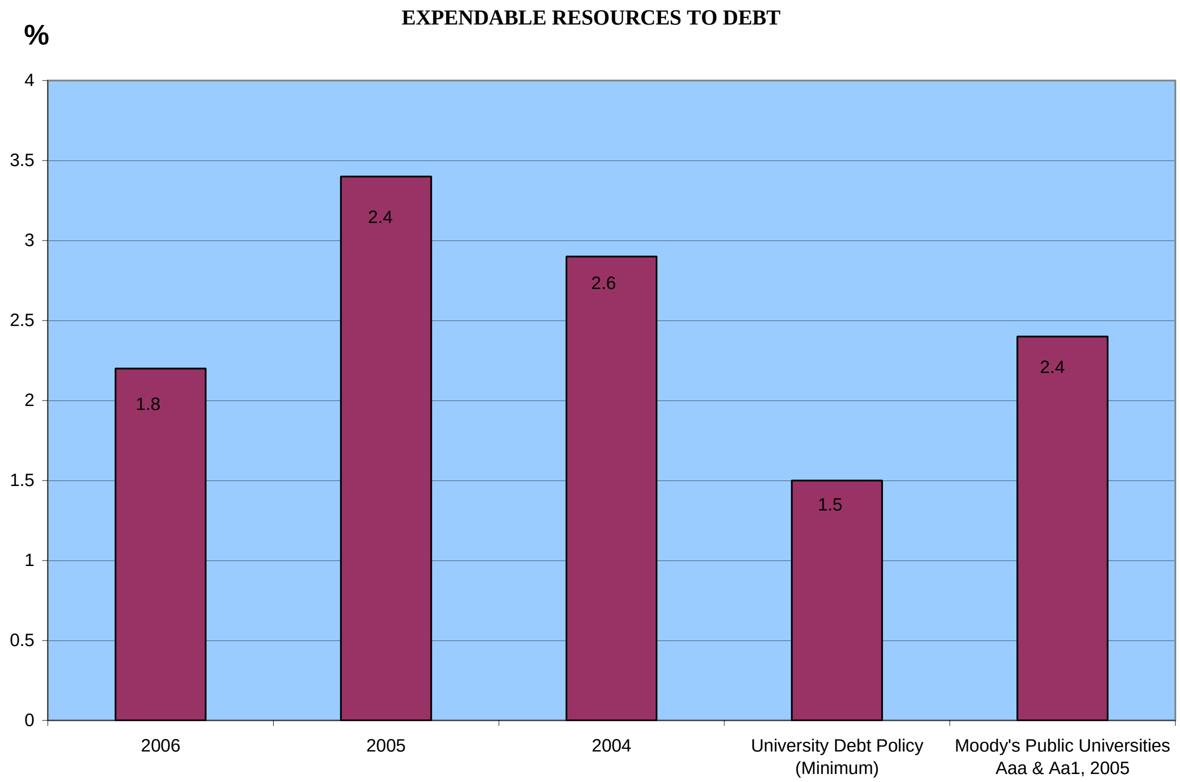
	2006	2005	% Change
Construction in Progress	$ 585,216	$ 377,522	55.0
Land and Other Nondepreciable Assets	93,980	86,347	8.8
Buildings	910,763	798,181	14.1
General Infrastructure	190,898	202,594	(5.8)
Machinery and Equipment	93,629	85,557	9.4
Total	$ 1,874,486	$ 1,550,201	20.9

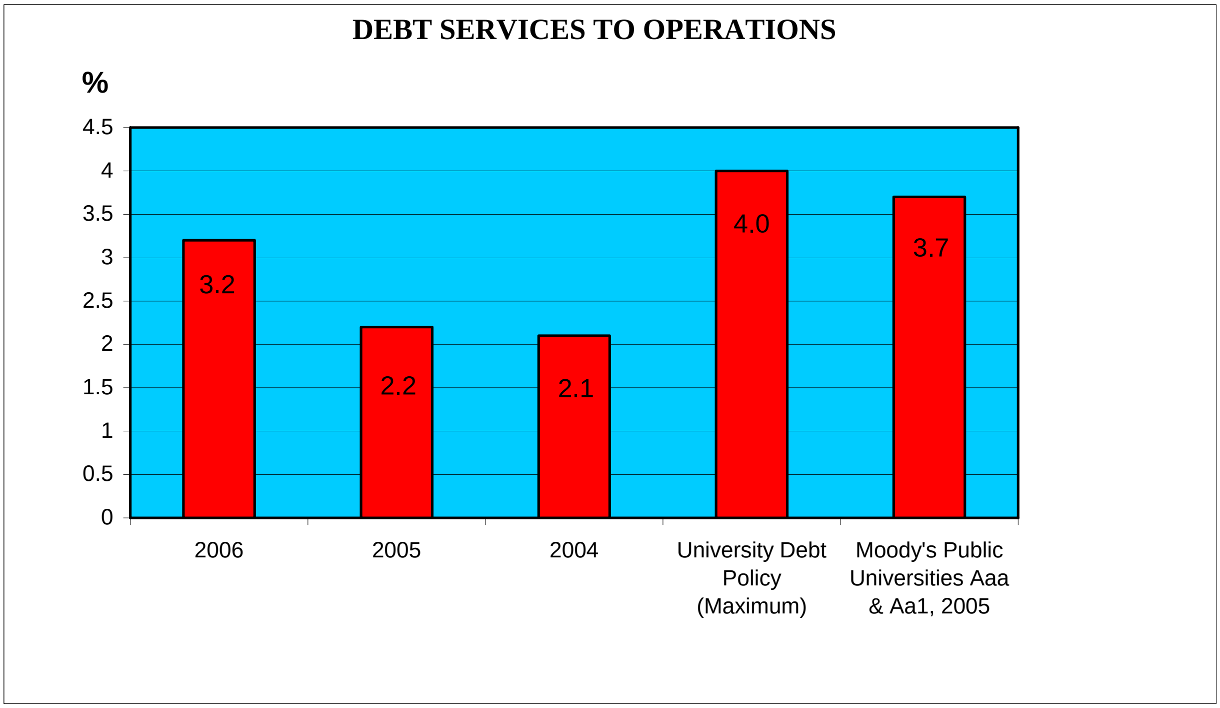
The University is engaged in a $1.8 billion capital construction program that began in 2000 and will continue through the next several years. This program includes major capital renewal of existing buildings and infrastructure to address both deferred maintenance and programmatic needs. The 53 completed projects total $459 million, or 26% of the $1.8 billion capital construction program. The 41 projects under construction total $867 million or 48%, and the 60 projects under design represent $474 million or 26%. Capital funds resulting from North Carolina Higher Education Bonds continue to provide essential resources for construction. The University is directly investing in its capital construction program using a variety of other funding sources including general revenue bonds, cost reimbursements from research grants, internal reserves, and private gifts.

In August 2005, the University issued $405 million in fixed-rate bonds, of which approximately $245 million was used to fund project costs for the University's capital improvement program and approximately $121 million to refund outstanding commercial paper which had already been issued to provide construction financing for the capital improvement program. The University continues to use its commercial paper program to provide low-cost bridge financing for capital projects until gifts are received or in anticipation of an external bond issue. Commercial paper debt was $117.4 million at June 30, 2006, and $141.1 million at June 30, 2005.

The University maintains a combination of variable and fixed rate debt, consistent with its debt management policy. The effective, combined interest rate for variable and fixed rate debt was 4.65% for fiscal year 2005-2006 and 4.5% for 2004-2005. The interest rate on the commercial paper program for fiscal year 2005-2006 was 3% and for 2004-2005 was 1.82%. Interest rates on the University's variable rate, long-term bonds were 2.93% for fiscal year 2005-2006 and 1.82% for 2004-2005. Interest rates on fixed rate, long-term bonds are disclosed in Note 8B. The University's financial strength allowed it to achieve ratings of AA+/Aa1 by the national rating agencies.

The University's debt policy uses two key ratios to measure debt capacity, financial health, and credit quality. The expendable resources to debt ratio measures the availability of expendable assets to cover long-term obligations should the University be required to repay all its obligations immediately. The debt service to operations ratio measures the University's ability to repay annual principal and interest associated with all outstanding debt and its impact on the overall budget. Each ratio is compared to the University's debt policy standard and the appropriate peer group comparison for fiscal year 2004-2005 (the latest available numbers). The debt policy floor for expendable resources to debt is 1.5 times, and the metrics indicate the University has sufficient expendable resources to pay its long-term debt obligations. The debt policy ceiling for debt service to operations is 4%, and the metrics indicate the University's annual debt service requirements are a reasonable proportion of the operating budget.





Other Noncurrent Assets

Other noncurrent assets were $84.3 million at June 30, 2006 and $98.6 million at June 30, 2005, a 14.6% decrease. Included in this category at June 30, 2006, are restricted cash and cash equivalents of $19 million, receivables for pledged gifts of $23.2 million, notes receivable for student loans of $30.5 million, restricted resources due from the primary government of $3.2 million, and an investment in a joint venture of $8.3 million.

The decrease in other noncurrent assets from the prior year resulted primarily from a $23.9 million decline in restricted resources due from the primary government. Restricted resources due from the primary government represent receivables for designated capital construction projects funded from proceeds from Statewide higher education bonds and other State resources. The decline resulted from a $22.7 million decrease in Statewide higher education bonds due as funding for capital construction projects shifts to other resources. The investment in a joint venture represents the construction of the Southern Astrophysical Research Telescope (SOAR), situated in Cerro Pachon, Chile, in South America, as part of an international consortium including the University.

Noncurrent Liabilities

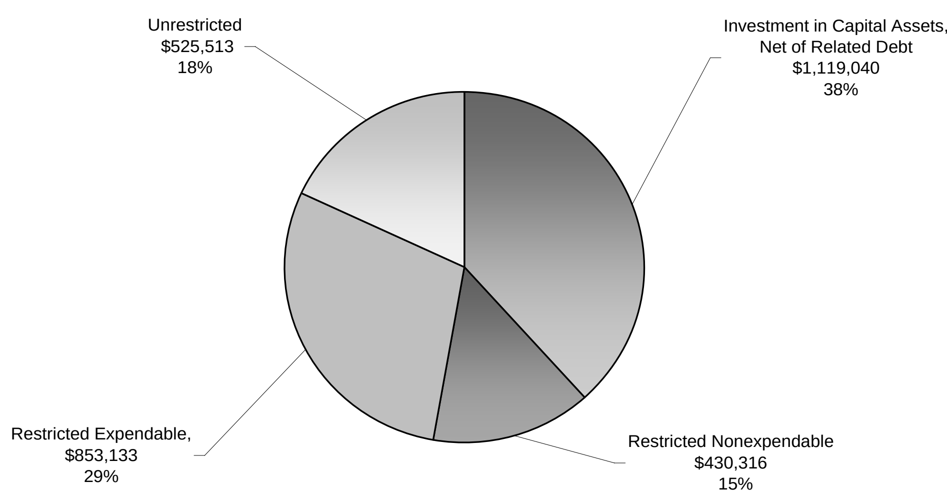
Noncurrent liabilities were $1.2 billion at June 30, 2006, and $732.7 million at June 30, 2005, and include funds held in trust for the University's affiliated foundations and other campuses in the UNC System and their affiliates of $326.4 million and $261 million, respectively. These entities are not part of the University's financial reporting entity nor are they discretely presented, but the entities do invest through the System Fund. The increase in funds held in trust of 25.1% over the prior year resulted from strong investment performance, participant contributions, and new participants in the System Fund.

Long-term liabilities of $797.9 million at June 30, 2006, and $440.4 million at June 30, 2005, are the noncurrent portion of bonds payable, notes payable, capital leases payable, compensated absences, and annuities payable. The 81.2% increase from the prior year resulted from the University's issuance of $405 million in fixed-rate bonds to fund project costs for the University's capital improvement program. The reader may refer to Note 8 for summary of changes in long-term liabilities. Other noncurrent liabilities of $32.1 million at June 30, 2006, and $31.4 million at June 30, 2005, are refundable U.S. government grants that provide resources for student loan programs.

Net Assets

Net assets represent the value of the University's assets after liabilities are deducted. The University's net assets were $2.9 billion at June 30, 2006, an increase of $320.1 million over the prior year.

2006 NET ASSETS
$2,928,002 (IN THOUSANDS)



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

The Statements of Revenues, Expenses, and Changes in Net Assets present the University's results of operations. The statements for the fiscal year ended June 30, 2006, and the prior year are summarized as follows:

University Operations
(Dollars in Thousands)

	2006	2005	% Change
Operating Revenues:			
Student Tuition and Fees, Net	$ 195,882	$ 164,457	19.1
Grants and Contracts	554,047	524,476	5.6
Sales and Services, Net	485,627	462,460	5.0
Other	5,955	5,608	6.2
Total Operating Revenues	1,241,511	1,157,001	7.3
Operating Expenses:			
Salaries and Benefits	1,042,452	966,629	7.8
Supplies and Materials	152,911	148,440	3.0
Services	432,212	407,690	6.0
Scholarships and Fellowships	54,105	51,170	5.7
Utilities	56,277	47,870	17.6
Depreciation	64,475	60,102	7.3
Total Operating Expenses	1,802,432	1,681,901	7.2
Operating Loss	(560,921)	(524,900)	6.9
Nonoperating Revenues (Expenses):			
State Appropriations	440,070	406,673	8.2
Noncapital Grants	67,388	62,544	7.7
Noncapital Gifts, Net	68,824	73,693	(6.6)
Investment Income, Net	207,423	154,900	33.9
Interest and Fees on Capital Asset-Related Debt	(39,921)	(21,823)	82.9
Other Nonoperating	(230)	8,374	102.7
Income Before Other Changes	182,633	159,461	14.5
Capital Grants	52,277	152,844	(65.8)
Capital Appropriations	15,776	5,166	205.4
Capital Gifts	13,368	11,521	16.0
Additions to Permanent Endowments	56,069	37,688	48.8
Increase in Net Assets	320,123	366,680	(12.7)
Net Assets – July 1	2,607,879	2,241,199	16.4
Net Assets – June 30	$ 2,928,002	$ 2,607,879	12.3

Fiscal year 2005-2006 revenues and other changes total $2,162,706, and expenses total $1,842,583.
Fiscal year 2004-2005 revenues and other changes total $2,070,404, and expenses total $1,703,724.

Operating Revenues

The operating revenues represent resources generated by the University in fulfilling its instruction, research, and public service missions. Student tuition and fees are reported net of the scholarship discount, which was $45.3 million for fiscal year 2005-2006 and $37.9 million for the prior year. Total revenues from student tuition and fees increased 19.1% over the prior year. While 2005-2006 tuition rates for undergraduate residents did not change, tuition rates increased 4.3% for undergraduate nonresidents, 5.9% for graduate residents, and 5.7% for graduate nonresidents. There were also limited tuition increases for the professional schools. Beginning in 2005-2006, mandatory student charges used to support designated auxiliary operations are reported as student fees. Previously, these charges were reported as sales and services revenues.

Revenues from grants and contracts increased 5.6% over the prior year as reflected in the financial statements. Discussion of grants and contracts in terms of awards provides another useful perspective. The University is among the nation's leading public research universities, with a diversified portfolio of research that attracted more than $593 million in sponsored program funding during fiscal year 2005-2006, a 2.4% increase over the previous year.

During the federal fiscal year 2004-2005 (the latest available numbers), University faculty attracted $296.6 million in National Institutes of Health (NIH) funding (up from $289 million in 2003-2004), ranking 15th overall among U.S. private and public universities. The growth comes at a time when the NIH, which historically has accounted for slightly more than half of all research funding at the University, experienced a cut in appropriations in 2005-2006 with no increase expected for 2006-2007.

Health-related research continues to receive the bulk of research dollars, with the medical school bringing in $288 million in 2005-2006. The School of Public Health received $61 million, and the College of Arts and Sciences received $60 million. Interdisciplinary research centers, institutes and other units that do not fall under one particular school accounted for $132 million. Funding sources include State and federal agencies, industry and foundations and nonprofit organizations.

Sales and services and patient services revenues of $485.6 million for fiscal year 2005-2006, represent an increase of 5% over the prior year and include the revenues of campus auxiliary operations such as student housing, student stores, student health services, the utilities system, and parking and transportation, as well as revenues from patient services provided by the professional health-care clinics. Net revenues generated by the health-care clinics increased 7.1% in 2005-2006, while revenues from auxiliary operations increased 3.8%. Other revenues of $6 million for fiscal year 2005-2006 represent operating resources not separately identified and include, as examples, an assessment to the Investment Fund to support administrative services, library fines, and interest income from student loans.

Operating Expenses

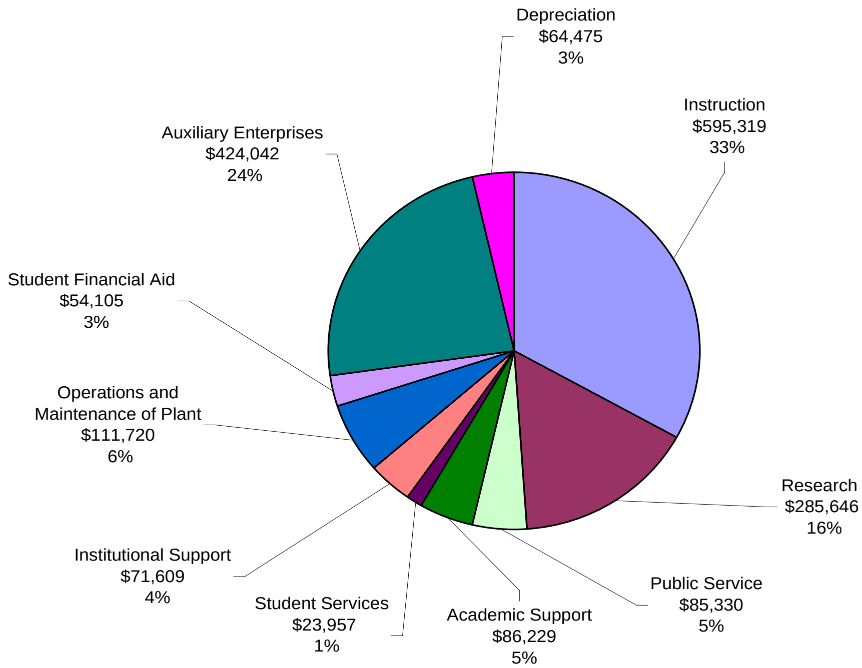
The University's operating expenses were $1.8 billion for the fiscal year ended June 30, 2006, an increase of 7.2% over the prior year. The operating expenses are reported by natural classification in the financial statements and by functional classification in the note disclosures (Note 12). The following table illustrates the University's operating expenses by the functional classification:

Operating Expenses by Function
(Dollars in Thousands)

	2006	2005	% Change
Instruction	$ 595,319	$ 575,951	3.4
Research	285,646	271,208	5.3
Public Service	85,330	83,005	2.8
Academic Support	86,229	75,384	14.4
Student Services	23,957	21,653	10.6
Institutional Support	71,609	67,426	6.2
Operations and Maintenance of Plant	111,720	92,860	20.3
Student Financial Aid	54,105	51,170	5.7
Auxiliary Enterprises	424,042	383,142	10.7
Depreciation	64,475	60,102	7.3
Total Operating Expenses	$ 1,802,432	$ 1,681,901	7.2

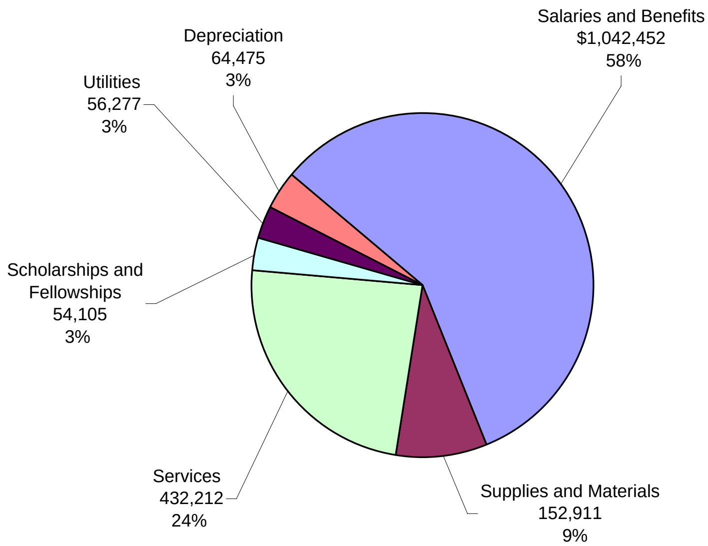
The following graph illustrates the University's operating expenses by function.

2006 OPERATING EXPENSES BY FUNCTION
$1,802,432 (IN THOUSANDS)



The following graph illustrates the University's operating expenses by the natural classification.

2006 OPERATING EXPENSES BY NATURE
$1,802,432 (IN THOUSANDS)



Operating expense categories reported by natural classification increased at a comparable rate to total operating expenses with one exception. The 17.6% increase in utilities expenses in 2005-2006 over the prior year was caused by higher costs for purchased electricity, natural gas and propane, and coal and related additives; consumption increases based on campus growth; and higher rates to fund increased debt service to finance capital construction program for campus utilities operations. Salaries and benefits increased 7.8%, supplies and materials increased 3%, expenses for services increased 6%, scholarships and fellowships increased 5.7%, and depreciation increased 7.3%.

Nonoperating Revenues and Expenses

State appropriations of $440.1 million, noncapital grants of $67.4 million, noncapital gifts of $68.8 million, investment income of $207.4 million, interest and fees on capital asset-related debt of ($39.9) million, and other revenues and expenses of ($0.2) million comprise net nonoperating revenues and expenses. These revenues are considered nonoperating because they were not generated by the University's principal, ongoing operations. For example, State appropriations were not generated by the University but were provided to help fund operating expenses.

The University's initial budget for State appropriations was $415.9 million for fiscal year 2005-2006. The University received budget increases totaling $30.5 million to fund employee salary and benefit increases, enrollment increases, expansion items and other program enhancements. In response to legislative action, the University, excluding AHEC operations, was required to take a permanent budget reduction of 1.72%. The reduction totaled $6.3 million, resulting in an appropriated budget of $440.1 million for 2005-2006, an increase of 8.2% over fiscal year 2004-2005.

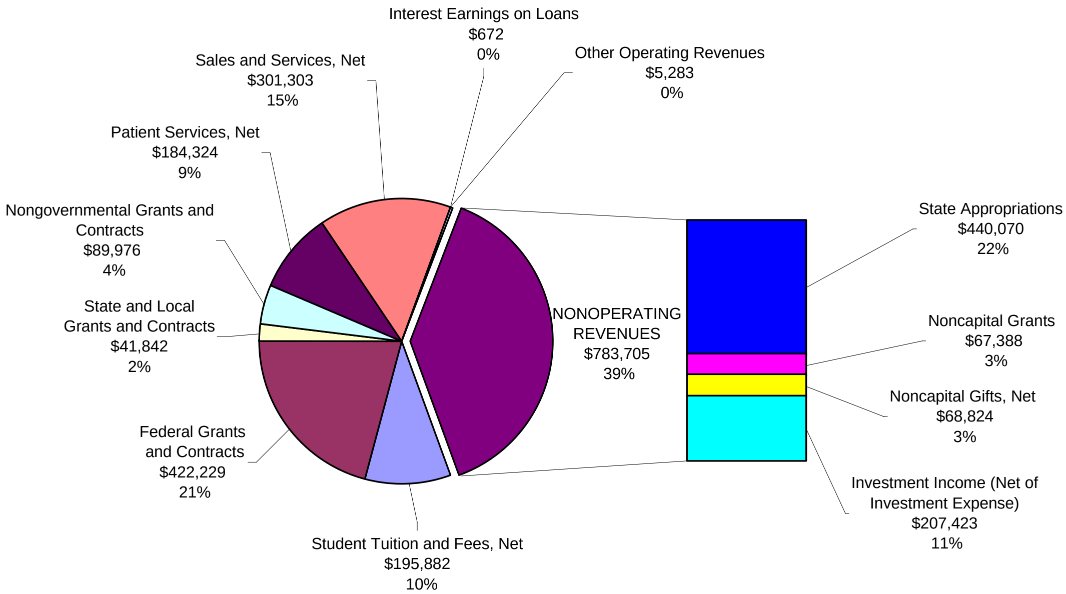
Noncapital grants increased by 7.7% to $67.4 million in fiscal year 2005-2006 and represent federal awards that are not considered to be operating revenues. Net noncapital gifts decreased by 6.6% to $68.8 million and represent expendable gifts received and pledges made and are net of an allowance for uncollectible pledges. Net investment income of $207.4 million, an increase of 33.9% over 2005-2006, includes income and realized and unrealized gains and is net of realized and unrealized losses and investment management fees. For detail discussion, the reader may refer to Endowment and Other Long-term Investments section of Management's Discussion and Analysis. Interest and fees on capital asset-related debt were ($39.9) million, an increase of 82.9% over the prior year.

Other nonoperating revenues and expenses were ($0.2) million, a decrease of $8.6 million from the prior year. Other nonoperating revenues and expenses for 2004-2005 included a $6.6 million increase in the net assets of annuities and charitable remainder trusts. These annuities and charitable remainder trusts include split-interest agreements that have a liability component for the present value of projected future distributions to the annuitant or donor and liabilities to other organizations where the University reporting entity serves as trustee but not the beneficiary of the split-interest agreements. Changes in the actuarial calculations of the liabilities will increase or decrease the net assets of the annuities and charitable remainder trusts.

Total Operating and Nonoperating Revenues

Operating and nonoperating revenues such as State appropriations, noncapital grants, noncapital gifts, and investment income are used to fund University operations. The following chart illustrates the University's operating and nonoperating revenues which total $2 billion for fiscal year 2005-2006.

2006 TOTAL REVENUES BY SOURCE
$2,025,216 (IN THOUSANDS)



Other Changes in Net Assets

Capital grants of $52.3 million for 2005-2006 and $152.8 million for 2004-2005 are from Statewide higher education bond proceeds for capital construction projects. Capital appropriations of $15.8 million for 2005-2006 and $5.2 million for the prior year were received from the State for repairs and replacements. Net capital gifts of $13.4 million for 2005-2006 and $11.5 million for the prior year resulted from fund-raising efforts and also provided funding for construction projects. Nonexpendable gifts and funds from the State's program to match gifts for distinguished professorship endowments resulted in additions to permanent endowments of $56.1 million during fiscal year 2005-2006 and $37.7 million during fiscal year 2004-2005.

Condensed Statement of Cash Flows

The Statement of Cash Flows provides additional information about the University's financial results by reporting the major sources and uses of cash. Cash increased by $54.9 million during the fiscal year 2005-2006, compared with a decrease of $85.3 million during fiscal year 2004-2005. Factors which caused the increase in the cash position at June 30, 2006, include $32.1 million in cash assets of University-affiliated foundation that was transferring endowment assets to the Investment Fund for investment. Also, funds invested in the State Treasurer's short-term investment fund (STIF), which is classified as a cash equivalent, increased by $8 million. The primary factor which caused the decrease in the cash position at

June 30, 2005, was the decreased use of STIF for the University's temporary investment pool. The temporary investment pool's investment in STIF was $120 million at June 30, 2004, and zero at June 30, 2005. The statements for the fiscal year ended June 30, 2006, and the prior year are summarized as follows:

Cash Flows
(Dollars in Thousands)

	2006	2005	% Change
Cash Flows Provided (Used):			
Operating Activities	$ (492,016)	$ (460,046)	6.9
Noncapital Financing Activities	704,641	589,302	19.6
Capital and Related Financing Activities	(16,732)	(67,227)	(75.1)
Investing Activities	(141,021)	(147,354)	(4.3)
Net Increase (Decrease) in Cash	54,872	(85,325)	(164.3)
Cash – July 1	459,363	544,688	(15.7)
Cash – June 30	$ 514,235	$ 459,363	11.9

Component Units Reported using Discrete Presentation

Three affiliated foundations were categorized as component units using discrete presentation. Discrete presentation provides readers with complete information regarding the financial activities of the components units. The reader may refer to Note 1A to for additional information regarding the three affiliated foundations.

Summary information regarding the financial activities of the three affiliated foundations follows:

Total Net Assets
(Dollars in Thousands)

	2006	2005	% Change
Total Assets	$ 501,142	$ 431,587	16.1
Total Liabilities	3,954	2,166	82.5
Total Net Assets	$ 497,188	$ 429,421	15.8
Net Assets Composition:			
Unrestricted	$ 23,708	$ 20,653	14.8
Temporarily Restricted	284,351	238,745	19.1
Permanently Restricted	189,129	170,023	11.2
Total Net Assets	$ 497,188	$ 429,421	15.8

The growth in total assets and net assets resulted from increased levels of contributions and investment returns. Liabilities increased as the UNC Chapel Hill Arts and Sciences Foundation entered into a loan agreement during 2005-2006 with principal of $3,000,000 outstanding at June 30, 2006, to finance a building lease in London, England benefiting the Foundation and the University. The University plans to refinance the loan with fund raising and program revenues.

Changes in Net Assets
(Dollars in Thousands)

	2006	2005	% Change
Total Revenues	$ 103,510	$ 75,806	36.5
Total Expenses	35,743	33,574	6.5
Increase in Net Assets	67,767	42,232	60.5
Net Assets – July 1	429,421	387,189	10.9
Net Assets – June 30	$ 497,188	$ 429,421	15.8

The net assets of the three affiliated foundations increased $67.8 million during fiscal year 2005-2006. The main factors attributing to the increase were $43 million in contributions and $35.8 million in investment income which is comprised of net gains on investments and interest and dividend income.

Economic Outlook

Fiscal year 2005-2006 demonstrated an improvement on a solid financial foundation. The University's comparatively low tuition levels enhance its appeal to prospective students and provide a possible source of additional resources, should campus-based tuition increases be enacted. The University's support from the State continues to improve, sponsored awards are a proven and reliable source in support of the University's research mission, philanthropic efforts should have ongoing success, and investment returns are expected to remain at high levels. The University's strong debt credit ratings of Aa1 and AA+ allow it to obtain competitive financing for capital construction.

Campus-based tuition rates increased for fiscal year 2006-2007 by 7.8% for undergraduate residents, 6.5% for undergraduate nonresidents, 13.8% for graduate residents, and 2.8% for graduate nonresidents. There were limited tuition increases for the professional schools. The University's academic standing allows it to continuously attract top students. The University's ratio of accepted applications as a percentage of total applications was 36.6% for 2005-2006. The ratio of enrolled students as a percentage of accepted applications was 55.7% for 2005-2006. The CAFR Statistical Section includes historical data for these two and other metrics.

The Carolina Covenant provides qualified students from low income families with a Carolina education debt-free. Carolina Covenant Scholars agree to work on campus 10 to 12 hours weekly in a federal work-study job, and the University meets the rest of their needs through a combination of federal, State, university, and other privately funded grants and scholarships. Effective with the Fall semester of 2005, the Carolina Covenant expanded the program to include families with incomes up to 200% of the federal poverty level. This move covered a family of four with an annual income of about $37,000 or a single parent with a child who makes about $24,000.

To attract additional high-achieving students, the University expanded merit-based scholarships. Fund raising efforts have provided resources for more than 600 scholarships and fellowships in support of both need and merit, a 60% increase since the campaign began. The University now directs all of its trademark licensing revenue to scholarships, allowing the establishment of 68 new merit scholarships in 2005-2006 and 2006-2007.

The Governor and the North Carolina General Assembly have continued to demonstrate strong financial support for higher education. The budgeted funding level for State appropriations for 2006-2007 totals $490.2 million, which represents an increase of 11.4% over fiscal year 2005-2006 actual State appropriations. This level of State appropriation funding includes faculty and staff pay and benefit increases of $26 million. The fiscal year 2006-2007 pay increase of 5.5% for staff and average 6% for faculty is the third consecutive year of base salary increases for all employees. Other budget increases included $3.7 million for student enrollment increases, $8.5 million for planned operating expenses for new construction, and $5.9 million for the Renaissance Computing Institute based in Chapel Hill and created in partnership with Duke and North Carolina State Universities. The 2006-2007 appropriations budget also included a base budget reduction of $1.4 million, and a base budget increase of $7.4 million for new programs. While additional budget reductions or reversions are not anticipated for fiscal year 2006-2007, it is not certain.

A critical priority is to strengthen faculty support through recruitment and retention efforts and providing them with the necessary resources for teaching, researching, and serving the public. Significant progress has been made in this area, and the University's Five-Year Financial Plan calls for attaining the 67th percentile for faculty salaries among our public and private peers by 2011. This goal will necessitate average annual 6% legislative salary increases over the next 5 years, supplemented by modest campus-based tuition increases.

External funding from contracts and grants increased to $593 million in 2005-2006. While this funding level is notable, attracting more private funding is one area that is essential to continued growth. The University's commitment to improving private funding is demonstrated by the planning for Carolina North, the University's 21st century living-and-learning community. The goal is for the Carolina North campus to be a national model for sustainability, addressing the long-term needs for accelerated transfer of new knowledge into the economy, housing for faculty and staff, and new collaborations with the private sector. A Leadership Advisory Committee of community, State, and university representatives is recommending guiding principles for building Carolina North.

As announced by Chancellor Moeser in his 2006 "State of the University" address, the University's goal is to secure $1 billion in external research funding by 2015. The growth of research funding also translates into economic growth for the State. Data that reflect the economic impact of technological development include the number of patents, spin-off companies, jobs and licensed technology. In 2005-2006, the University was awarded 21 patents; started five new companies, bringing the total to 35; licensed 43 inventions and received a total of $2.2 million in licensed technology.

Management believes the investment performance of its endowment fund will continue to earn attractive returns and provide important resources for University operations. The University's investment management operation is separately organized as the UNC Management Company, Inc., a nonprofit corporation organized and operated as a 501(c)(3) entity, to provide investment management services and administrative services to the University and to the other campuses of the UNC System and their affiliated nonprofit foundations as appropriate. Management believes this structure will continue to enhance the ability to attract and retain investment professionals and increase the pool of funds and resulting investment returns.

The University's fund-raising efforts continued to achieve a high level of success. Private gifts and grants, along with State matching funds, totaled a record $241.2 million in fiscal year 2005-2006, marking the first time that the University, in a single year, has raised more than $200 million in cash and other assets. The University's Carolina First Campaign has raised $1.81 billion and has passed its initial goal of $1.8 billion. The campaign's goal was increased to $2 billion in October 2005. The campaign, which began in July 1999, also was extended by six months and will end December 31, 2007. The campaign finished 2005-2006 ahead of pace to reach $2 billion, with 90% of the goal attained and just 82% of the campaign completed.

Increased support from the State, the ability to attract top prospective students, vibrant research funding, continued strength in investment performance, a dynamic capital construction program, and an exceptional fund-raising campaign all contribute to a positive outlook for the University. The University's commitment to sound financial and budgetary planning, protection and enhancement of its endowed and physical assets, and observance of compliance and control standards support a solid financial future for the University.

The University of North Carolina at Chapel Hill
Statement of Net Assets
June 30, 2006 — *Exhibit A-1*

ASSETS		
Current Assets:		
Cash and Cash Equivalents	$	158,591,038
Restricted Cash and Cash Equivalents		336,599,057
Short-Term Investments		175,089,510
Restricted Short-Term Investments		93,676,248
Receivables, Net (Note 4)		125,141,916
Due from State of North Carolina Component Units		3,022,098
Inventories		17,427,497
Notes Receivable, Net (Note 4)		3,203,171
Total Current Assets		912,750,535
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		19,045,146
Receivables, Net (Note 4)		23,181,244
Restricted Due from Primary Government		3,211,019
Endowment Investments		1,145,668,496
Other Long-Term Investments		458,860,725
Investment in Joint Venture		8,318,917
Notes Receivable, Net (Note 4)		30,505,262
Capital Assets - Nondepreciable (Note 5)		679,195,885
Capital Assets - Depreciable, Net (Note 5)		1,195,290,353
Total Noncurrent Assets		3,563,277,047
Total Assets		4,476,027,582
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities (Note 6)		93,089,196
Due to Primary Government		190,708
Due to State of North Carolina Component Units		3,006,265
Deposits Payable		1,902,918
Unearned Revenue		36,617,440
Interest Payable		3,685,390
Short-Term Debt (Note 7)		117,414,000
Long-Term Liabilities - Current Portion (Note 8)		135,778,820
Total Current Liabilities		391,684,737
Noncurrent Liabilities:		
U. S. Government Grants Refundable		32,069,778
Funds Held in Trust for Pool Participants		326,419,316
Long-Term Liabilities (Note 8)		797,851,618
Total Noncurrent Liabilities		1,156,340,712
Total Liabilities		1,548,025,449

NET ASSETS		
Invested in Capital Assets, Net of Related Debt		1,119,039,950
Restricted for:		
Nonexpendable (Note 10)		430,315,566
Expendable (Note 10)		853,133,381
Unrestricted		525,513,236
Total Net Assets	$	2,928,002,133

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

The University of North Carolina at Chapel Hill
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 11)	$	195,882,460
Patient Services, Net (Note 11)		184,324,052
Federal Grants and Contracts		422,228,732
State and Local Grants and Contracts		41,841,926
Nongovernmental Grants and Contracts		89,975,881
Sales and Services, Net (Note 11)		301,302,925
Interest Earnings on Loans		672,155
Other Operating Revenues		5,282,547
Total Operating Revenues		1,241,510,678
EXPENSES		
Operating Expenses:		
Salaries and Benefits		1,042,451,851
Supplies and Materials		152,911,484
Services		432,211,908
Scholarships and Fellowships		54,105,093
Utilities		56,276,744
Depreciation		64,475,131
Total Operating Expenses		1,802,432,211
Operating Loss		(560,921,533)
NONOPERATING REVENUES (EXPENSES)		
State Appropriations		440,070,173
Noncapital Grants		67,387,887
Noncapital Gifts, Net (Note 11)		68,823,820
Investment Income (Net of Investment Expense of $4,313,989)		207,423,036
Interest and Fees on Capital Asset-Related Debt		(39,921,063)
Other Nonoperating Expenses		(230,054)
Net Nonoperating Revenues		743,553,799
Income Before Other Revenues		182,632,266
Capital Appropriations		15,775,900
Capital Grants		52,277,305
Capital Gifts		13,368,446
Additions to Endowments		56,068,953
Increase in Net Assets		320,122,870
NET ASSETS		
Net Assets - July 1, 2005		2,607,879,263
Net Assets - June 30, 2006	$	2,928,002,133

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

The University of North Carolina at Chapel Hill
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2006 — *Exhibit A-3*

CASH FLOWS FROM OPERATING ACTIVITIES		
Received from Customers	$	1,240,267,585
Payments to Employees and Fringe Benefits		(1,026,926,673)
Payments to Vendors and Suppliers		(642,243,427)
Payments for Scholarships and Fellowships		(54,105,093)
Loans Issued		(9,753,347)
Collection of Loans		9,755,263
Other Payments		(9,010,507)
Net Cash Used by Operating Activities		(492,016,199)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State Appropriations		440,070,173
Noncapital Grants		68,580,247
Noncapital Gifts		78,174,625
Additions to Endowments		56,068,953
Related Activity Agency Receipts		61,747,872
Cash Provided by Noncapital Financing Activities		704,641,870
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES		
Proceeds from Capital Debt		535,861,847
State Capital Appropriations		15,775,900
Capital Grants		76,155,362
Capital Gifts		13,368,446
Acquisition and Construction of Capital Assets		(389,465,953)
Principal Paid on Capital Debt and Leases		(228,037,306)
Interest and Fees Paid on Capital Debt and Leases		(40,390,066)
Net Cash Used by Capital Financing and Related Financing Activities		(16,731,770)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from Sales and Maturities of Investments		1,099,071,632
Investment Income		55,893,747
Purchase of Investments and Related Fees		(1,295,986,840)
Net Cash Used by Investing Activities		(141,021,461)
Net Increase in Cash and Cash Equivalents		54,872,440
Cash and Cash Equivalents - July 1, 2005		459,362,801
Cash and Cash Equivalents - June 30, 2006	$	514,235,241

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

Operating Loss	$	(560,921,533)
Adjustments to Reconcile Operating Loss to Net Cash Used by Operating Activities:		
Depreciation Expense		64,475,131
Allowances, Write-Offs, and Amortizations		(296,049)
Changes in Assets and Liabilities:		
Receivables (Net)		(11,768,770)
Inventories		(26,971)
Notes Receivable (Net)		(680,917)
Accounts Payable and Accrued Liabilities		1,509,876
Due to Primary Government		(22,094)
US Governmental Grants Refundable		718,851
Deferred Revenue		1,479,152
Compensated Absences		13,517,125
Net Cash Used by Operating Activities	$	(492,016,199)

RECONCILIATION OF CASH AND CASH EQUIVALENTS

Current Assets:		
Cash and Cash Equivalents	$	158,591,038
Restricted Cash and Cash Equivalents		336,599,057
Noncurrent Assets:		
Restricted Cash and Cash Equivalents		19,045,146
Total Cash and Cash Equivalents - June 30, 2006	$	514,235,241

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through the Assumption of a Liability	$	393,128
Assets Acquired through a Gift		810,695
Change in Fair Value of Investments		123,601,604

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

The University of North Carolina at Chapel Hill Foundations
Statement of Financial Position
June 30, 2006 — *Exhibit B-1*

	UNC-CH Arts and Sciences Foundation, Inc.	The Educational Foundation Scholarship Endowment Trust	The Medical Foundation of North Carolina, Inc.
ASSETS			
Current Assets:			
Cash and Cash Equivalents	$ 8,198,054	$ 9,929,344	$ 34,039,129
Investments		139,180,017	103,723,020
Unconditional Promises to Give, Net	7,375,017	7,380,012	2,719,831
Contributions Receivable from Split-Interest Agreements		3,567,710	
Accounts Receivable	63,187		
Funds Held in Trust	125,387		
Accrued Income Receivable	23,698		189,431
Prepaid Expenses			24,971
Miscellaneous Receivables			250,452
Total Current Assets	15,785,343	160,057,083	140,946,834
Property and Equipment:			
Building			436,340
Furniture and Equipment	88,464		420,692
Leasehold Interest - Building	3,750,483		
Vehicle	8,930		
	3,847,877		857,032
Less: Allowance for Depreciation	(162,301)		(447,615)
Total Property and Equipment	3,685,576		409,417
Other Assets:			
Investments	97,259,535		46,722,237
Unconditional Promises to Give, Net	17,406,059		12,383,080
Restricted Cash	2,994,510		86,459
Split - Interest Agreements	422,070		
Real Estate Interests Held for Investment	49,500		
Restricted Investments			441,073
Student Loans Receivable			39,095
Cash Surrender Value of Life Insurance		2,061,825	392,632
Total Other Assets	118,131,674	2,061,825	60,064,576
Total Assets	$ 137,602,593	$ 162,118,908	$ 201,420,827
LIABILITIES			
Current Liabilities:			
Accounts Payable	$ 15,568	$ 0	$ 365,229
Annuities Payable		187,868	
Accrued Expenses	144,423		240,913
Total Current Liabilities	159,991	187,868	606,142
Long Term Debt	3,000,000		
Total Liabilities	3,159,991	187,868	606,142
NET ASSETS			
Unrestricted	11,844,297		11,864,250
Temporarily Restricted	61,705,510	80,417,301	142,228,198
Permanently Restricted	60,892,795	81,513,739	46,722,237
Total Net Assets	134,442,602	161,931,040	200,814,685
Total Liabilities and Net Assets	$ 137,602,593	$ 162,118,908	$ 201,420,827

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

The University of North Carolina at Chapel Hill Foundations
Statement of Activities
For the Fiscal Year Ended June 30, 2006

Exhibit B-2

	UNC-CH Arts and Sciences Foundation, Inc.	The Educational Foundation Scholarship Endowment Trust	The Medical Foundation of North Carolina, Inc.
REVENUES			
Support:			
Contributions	$ 20,314,671	$ 6,707,515	$ 15,953,101
Developed Assesment Fee	1,313,333		
Change in Value of Split - Interest Agreements	35,141		
Donated Facilities	40,000		
Actuarial Adjustment of Annuties Payable		14,868	
Endowment Investment Return Designated for Current Operations		5,801,413	
Total Support	21,703,145	12,523,796	15,953,101
Revenue:			
Interest and Dividend Income			4,517,132
Net Unrealized and Realized Gains (Losses) on Investments	13,580,443		14,959,590
Investment Income	2,755,490		
Loss on Sale of Real Estate Investments			(22,213)
Gain on Sale of Property and Equipment			3,500
Other Income	42,945		988,469
Total Revenues	16,378,878		20,446,478
Total Support and Revenue	38,082,023	12,523,796	36,399,579
EXPENSES			
Program Services:			
Grants	9,324,790		14,859,381
Scholarship Expense Distribution		5,790,442	
Annuity Payments		10,971	
Administrative Expenses		40,983	
Other Expenses		1,064,112	
Total Program Services	9,324,790	6,906,508	14,859,381
Supporting Services:			
Fundraising Expenses	1,753,190		1,118,782
Management and General	801,358		979,122
Total Supporting Services	2,554,548		2,097,904
Total Expenses	11,879,338	6,906,508	16,957,285
Change in Net Assets From Operations	26,202,685	5,617,288	19,442,294
OTHER CHANGES:			
Investment Return in Excess of Amounts Designated for Current Operations		16,504,962	
Change in Net Assets	26,202,685	22,122,250	19,442,294
NET ASSETS			
Net Assets - Beginning of Year	108,239,917	139,808,790	181,372,391
Net Assets - End of Year	$ 134,442,602	$ 161,931,040	$ 200,814,685

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

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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. The University of North Carolina at Chapel Hill (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 Units - Although legally separate, The University of North Carolina at Chapel Hill Foundation Investment Fund, Inc. (Investment Fund), UNC Investment Fund, LLC (System Fund), UNC Management Company, Inc. (Management Company), The University of North Carolina at Chapel Hill Foundation, Inc. (UNC-Chapel Hill Foundation), The Kenan-Flagler Business School Foundation (Business School Foundation), The School of Social Work Foundation, Inc. (Social Work Foundation), UNC Law Foundation, Inc. (Law Foundation), and The University of North Carolina at Chapel Hill School of Education Foundation, Inc. (School of Education Foundation) are reported as if they were part of the University.

The Investment Fund is governed by a board consisting of 11 ex-officio directors and one or two elected directors. Ex-officio directors include all of the members of the Board of Trustees of the Endowment Fund of the University, the Vice Chancellor for Finance and Administration, and the Vice Chancellor for University Advancement. The UNC-Chapel Hill Foundation Board may, in its discretion, elect one or two of its at-large members to the Investment Fund Board. The Investment Fund supports the University by operating an investment fund for charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support the University. Because members of the Board of Directors of the Investment Fund are officials or appointed by officials of the University and the Investment Fund's primary purpose is to benefit the University and other organizations operated primarily to support the University, its financial statements have been blended with those of the University.

In December 2002, The System Fund was organized by the Investment Fund to allow the University, the University of North Carolina and its other constituent institutions (UNC System), affiliated foundations, associations, trusts, and endowments that support the University and the UNC System, to pool their resources and invest collectively in investment opportunities identified, structured and arranged by the Management Company. The membership interests are offered only to government entities or tax-exempt organizations that are controlled by or support the University or UNC System. The Investment Fund contributed and assigned all of its assets to the System Fund effective January 1, 2003, in exchange for its membership interest in the System Fund. Upon such contribution and assignment, and in consideration thereof, the System Fund has assumed all liabilities and obligations of the Investment Fund in respect of such contributed assets. At June 30, 2006, the Investment Fund membership interest was approximately 92.5% of the System Fund total membership interests. Because the Investment Fund is the organizer and a predominant member of the System Fund, the financial statements of the System Fund have been blended with those of the University.

The Management Company is a North Carolina nonprofit corporation organized and operated exclusively to support the educational mission of the University. The Management Company will also provide investment management services to the University, UNC System, and institutions and affiliated tax-exempt organizations, and perform other functions for and generally carry out the purposes of the University. The Management Company is governed by five ex-officio directors and one or two additional directors as fixed or changed from time to time by the board, elected by the ex-officio directors. The ex-officio directors consist of the Chancellor of the University, the Vice Chancellor for Finance and

Administration, the Chairman of the University's Board of Trustees, the Chairman of the Board of Directors of the Investment Fund, and the President of the Management Company. Because members of the Board of Directors of the Management Company are officials or appointed by officials of the University and the Management Company's primary purpose is to benefit the University and other organizations operated primarily to support the University, its financial statements have been blended with those of the University.

The UNC-Chapel Hill Foundation is governed by a 17-member board consisting of nine ex-officio directors and eight elected directors. Ex-officio directors include the Chairman of the University Board of Trustees, the Chancellor, the Vice Chancellor for Finance and Administration, and the Vice Chancellor for University Advancement (nonvoting). In addition, the Board of Trustees elects two ex-officio directors from among its own members as well as three ex-officio directors from the Board of Trustees of the Endowment Fund who have not otherwise been selected. The eight remaining directors are elected as members of the UNC-Chapel Hill Foundation Board of Directors by action of the ex-officio directors. The UNC-Chapel Hill Foundation aids, supports, and promotes teaching, research and service in the various educational, scientific, scholarly, professional, artistic and creative endeavors of the University. Because members of the Board of Directors of the UNC-Chapel Hill Foundation are officials or appointed by officials of the University and the UNC-Chapel Hill Foundation's sole purpose is to benefit the University, its financial statements have been blended with those of the University.

The Business School Foundation is governed by a board consisting of four ex-officio directors and four or more elected directors. Ex-officio directors include the Dean of the Kenan-Flagler Business School (Business School), as well as the school's Chief Financial Officer, Associate Dean of Academic Affairs, and Associate Dean for MBA Programs. The remaining directors are elected to the Business School Foundation Board of Directors by action of the ex-officio directors. The Business School Foundation aids, promotes and supports the Kenan-Flagler Business School at the University. Because members of the Board of Directors of the Business School Foundation are officials or appointed by officials of the University, the financial statements of the Business School Foundation have been blended with those of the University.

The Social Work Foundation is governed by a board consisting of two ex-officio directors and eight elected directors. Ex-officio directors include the Dean of the School of Social Work as well as the Chairman of the school's Board of Advisors and the Assistant Dean for External Affairs. The remaining eight directors are elected to the Social Work Foundation Board of Directors by action of the ex-officio directors. The Social Work Foundation fosters and promotes the growth, progress, and general welfare of social work practice and research at the School of Social Work of the University. Because members of the Board of Directors of the Social Work Foundation are officials or appointed by officials of the University, the financial statements of the Social Work Foundation have been blended with those of the University.

The Law Foundation is governed by a board consisting of one ex-officio director, six appointed directors and six elected directors. The ex-officio director is the Dean of the School of Law of the University. The ex-officio director appoints six directors and the Board of Directors of the Law Alumni Association of the UNC, Inc. elects the other six directors. The Law Foundation provides support, fosters, and encourages the study and teaching of law at the University Law School. Because a majority of the members of the Board of Directors of the Law Foundation are officials or appointed by officials of the University, the financial statements of the Law Foundation have been blended with those of the University.

The School of Education Foundation is governed by a board consisting of seven ex-officio directors and five elected directors. Ex-officio directors include the Dean of the School of Education, as well as the school's Associate Dean for Academic Programs, Assistant Dean for External Relations, Assistant Dean for Administration and Finance, Director of Alumni Relations, President of the Alumni Council, and President-elect of the Alumni Council. The remaining directors are elected to the School of Education Foundation Board of Directors by action of the ex-officio directors. The School of Education Foundation aids, supports and promotes teaching, research and service at the School of Education. Because members of the Board of Directors of the School of Education Foundation are officials or appointed by officials of the University, the financial statements of the School of Education Foundation have been blended with those of the University.

Separate financial statements for the Investment Fund, System Fund, the Management Company, and blended foundations may be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

Discretely Presented Component Units – The Medical Foundation of North Carolina, Inc. (Medical Foundation), The Educational Foundation Scholarship Endowment Trust (Educational Foundation Trust), and the

University of North Carolina at Chapel Hill Arts and Sciences Foundation, Inc. (Arts and Sciences Foundation) are legally separate, nonprofit, tax-exempt organizations and are reported as discretely presented component units based on the nature and significance of their relationship to the University.

The Medical Foundation is governed by a 57-member Board of Directors, elected annually by its members. Its purpose is to support educational and research efforts of the University's Medical School and UNC Hospitals. Historically, the University's Medical School has been the major recipient of financial support from the Medical Foundation as compared to UNC Hospitals. Although the University does not control the timing or amount of receipts from the Medical Foundation, the majority of resources or income that the Medical Foundation holds and invests are restricted to the activities of the University by the donors. Because these restricted resources held by the Medical Foundation can only be used by, or for the benefit of the University, the Medical Foundation is considered a component unit of the University.

The Arts and Sciences Foundation is governed by a board consisting of three ex-officio directors, 24 elected directors and such number of emeritus directors determined from time to time by the Board of Directors. The 24 elected directors are elected for staggered terms, by the Board of Directors in office at the time of election. The purpose of the Arts and Sciences Foundation is to promote and support the University's College of Arts and Sciences. Although the University does not control the timing or amount of receipts from the Arts and Sciences Foundation, the majority of resources or income that the Arts and Sciences Foundation holds and invests are restricted to the activities of the University by the donors. Because these restricted resources held by the Arts and Sciences Foundation can only be used by, or for the benefit of the University, the Arts and Sciences Foundation is considered a component unit of the University.

The Educational Foundation Trust is governed by The Educational Foundation Scholarship Endowment Trust Agreement which designates the voting members of the Investment Committee of The Educational Foundation, Inc. as trustees. The Investment Committee consists of five members elected from the membership of the Educational Foundation, Inc. The Educational Foundation Trust operates solely to assist the University in providing financial assistance to students at the University. On an annual basis, the Board of Trustees of the Educational Foundation Trust appropriates a portion of the net appreciation on its assets to the Educational Foundation, Inc. in its capacity as agent for the Educational Foundation Trust. The distribution from the Educational Foundation

Trust to the Educational Foundation, Inc. is then forwarded by the Educational Foundation, Inc. to the University to provide financial assistance to students at the University. Although the University does not control the timing or amount of receipts from the Educational Foundation Trust, the majority of resources or income that the Educational Foundation Trust holds and invests are restricted to the students of the University by the donors. Because these restricted resources held by the Educational Foundation Trust can only be used for the benefit of the students of the University, the Educational Foundation Trust is considered a component unit of the University.

The Medical Foundation, the Arts and Sciences Foundation, and the Educational Foundation Trust are private, nonprofit organizations that report their financial results under Financial Accounting Standards Board (FASB) Statements. As such, certain revenue recognition criteria and presentation features are different from Governmental Accounting Standards Board (GASB) revenue recognition criteria and presentation features. No modifications have been made to the financial information in the University's financial reporting entity for these differences.

During the year ended June 30, 2006, the Medical Foundation, Arts and Sciences Foundation, and the Educational Foundation Trust distributed in total $29,974,613 to the University for both restricted and unrestricted purposes. Complete financial statements for the Medical Foundation, Arts and Sciences Foundation, and Educational Foundation Trust can be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

Other related foundations and similar nonprofit corporations for which the University is not financially accountable are not part of the accompanying financial statements.

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

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

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

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, savings accounts, cash on deposit with fiscal agents, and deposits held by the State Treasurer in the short-term investment portfolio. The short-term investment portfolio maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty.

E. **Investments** - This classification includes long-term fixed income investments, equity investments, mutual funds, money market funds, certificates of deposit, investment agreements, limited partnerships, real estate investment trusts, real estate, and other asset holdings by the University. Except for money market funds, certificates of deposit, investment agreements, 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, certificates of deposit, investment agreements, 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.

Short-term investments include marketable securities representing the investment of cash that is available for current operations. A majority of this available cash is invested in the University's Temporary Pool, a governmental external investment pool.

F. **Receivables** – Receivables consist of tuition and fees charged to students and charges to patients for services provided by the UNC Physicians & Associates and the Dental Faculty Practices. 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, and notes receivables from loans to students. Patients, pledges, and notes receivables are recorded net of allowance for doubtful accounts. The accounts and other receivables are shown at book value with no provision for doubtful accounts considered necessary.

G. **Inventories** – Inventories held by the University are priced at cost or average cost except for Student Stores inventory, which is valued at the lower of cost or market. Inventories consist of expendable supplies, postage, fuel held for consumption, textbooks, and other merchandise for resale.

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 over the estimated useful lives of the assets, generally 10 to 40 years for general infrastructure, 10 to 50 years for buildings, and 2 to 10 years for equipment.

The University's historic property, artworks, and literary collections are capitalized at cost or fair value at the date of donation. These property and 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. **Funds Held in Trust for Pool Participants –** Funds held in trust for pool participants represent the external portion of the University's governmental external investment pool more fully described in Note 2.

K. **Funds Held in Trust by Others –** Funds held in trust by others are resources neither in the possession nor the control of the University, but held and administered by an outside organization, with the University deriving income from such funds. Such funds established under irrevocable trusts where the University has legally enforceable rights or claims have not been recorded on the accompanying financial statements. The value of these assets at June 30, 2006 is approximately $29.5 million.

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

Bonds payable are reported net of unamortized premiums or discounts and deferred losses on refunds. The University amortizes bond premiums/discounts over the life of the bonds using the straight-line method. The deferred losses on refunds are amortized over the life of the old debt or new debt (whichever is shorter) using the straight-line method. Issuance costs are expensed.

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

N. **Net Assets –** The University's net assets are classified as follows:

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

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

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

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

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

O. **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.

P. 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 student tuition and fees, sales and services of auxiliary enterprises, certain federal, State and local grants and contracts that are essentially contracts for services, and 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.

Q. 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 utility services, telecommunications, central stores, printing and copy centers, postal services, repairs and maintenance 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.

R. Related Parties – Related parties are nonprofit organizations established to assist and provide support to University programs by funding scholarships, fellowships, professorships, and other needs of specific schools as well as the University's overall academic endeavors. Except as described in Note 1A, the University's financial statements do not include the assets, liabilities, net assets or operational transactions of these organizations except for support from each organization to the University.

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 $468,253,187, 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 by calling the State Controller's Financial Reporting Section at (919) 981-5454.

Cash on hand at June 30, 2006 was $153,936. The carrying amount of the University's deposits not with the State Treasurer, including certificates of deposit and investment agreements, was $155,653,846 and the bank balance was $119,114,733. 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, of the University's bank balance, $117,796,531 was exposed to custodial credit as uninsured and uncollateralized.

B. Investments - The University is authorized by The University of North Carolina Board of Governors pursuant to G.S. 116-36.2 and Section 600.2.4 of the Policy Manual of the University of North Carolina, to invest its special funds and funds received for services rendered by health care professionals in the same manner as the State Treasurer is required to invest, as discussed below.

G.S. 147-69.1(c), applicable to the State's General Fund, and G.S. 147-69.2, applicable to institutional trust funds, authorize the State Treasurer to invest in the following: obligations of or fully guaranteed by the United States; obligations of certain federal agencies; repurchase agreements; obligations of the State of North Carolina; time deposits of specified institutions; prime quality commercial paper, and asset-backed securities with specified ratings. Also, G.S. 147-69.1(c) authorizes the following: specified bills of exchange or time drafts and corporate bonds and notes with specified ratings. G.S. 147-69.2 authorizes the following: general obligations of other states; general obligations of North Carolina local governments; and obligations of certain entities with specified ratings.

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

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

Investments of the University's component units, UNC-Chapel Hill Foundation, Investment Fund, System Fund, Business School Foundation, Social Work Foundation, Law Foundation, School of Education Foundation, Medical Foundation, Arts and Sciences Foundation, and Educational Foundation Trust, 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 does not have a formal policy that addresses credit risk.

Foreign Currency Risk: Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. The University does not have a formal policy for foreign currency risk.

Temporary Investment Pool (Temporary Pool) - This is a fixed income portfolio managed by the UNC Management Company, Inc. (Management Company) and Tanglewood Asset Management, LLC. It operates in conjunction with the University's Bank of America disbursing account for all special funds, funds received for services rendered by health care professionals, and endowment revenue funds (internal portion) and funds of affiliated foundations (external portion). Because of the participation in the Temporary Pool by affiliated foundations, it is considered a governmental external investment pool. The external portion of the Temporary Pool is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants. The Temporary Pool is not registered with the SEC and the University has not provided legally binding guarantees during the period to support the value of the pool's investments. There are no involuntary participants in the Temporary Pool.

The Northern Trust Company is the custodian for the Temporary Pool and provides the University with monthly statements defining income and market value information. Investments of the Temporary Pool are highly liquid and generally include U.S. government securities, collateralized mortgage obligations, corporate bonds, mutual funds, and money market funds. The University has elected to invest a portion of the Temporary Pool assets in the University's Investment Fund.

Through written request to accounting services, participants may purchase and sell shares in the Temporary Pool at a fixed value of $1 per share. Generally, the purchase and sale of participation shares occur only at the beginning of the month. Income distribution is determined each quarter by multiplying the distribution rate by the average of the invested fund balance. Statements are provided via internet website to each participating account or group of accounts on a quarterly basis reflecting the participants' balance and income distribution. The rate earned by an account is dependent upon its account classification and investable fund balance. The rates are set in coordination between the Management Company and the Vice Chancellor for Finance and Administration.

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

Temporary Pool Investments

		Investment Maturities (in Years)			
	Fair Value	Less Than 1	1 to 5	6 to 10	More than 10
Investment Type					
Debt Securities					
U.S. Treasuries	$ 7,353,461	$ 993,633	$ 6,359,828	$ 0	$ 0
U.S. Agencies	19,618,258	13,044,357	3,972,180	2,219,231	382,490
Motrgage Pass Throughs	44,521,559	1,292,113	5,986,636	4,279,725	32,963,085
Collateralized Mortgage Obligations	127,924,584		2,087,670	5,994,564	119,842,350
State and Local Government	2,095,385		2,095,385		
Asset-Backed Securities	1,927,251			1,427,836	499,415
Mutual Bond Funds	11,159,375		770,610	10,388,765	
Money Market Mutual Funds	87,935,156	87,935,156			
Domestic Corporate Bonds	7,585,369		4,622,485		2,962,884
Foreign Corporate Bonds	5,000,000		5,000,000		
	315,120,398	$ 103,265,259	$ 30,894,794	$ 24,310,121	$ 156,650,224
Other Securities					
Certificates of Deposit	1,000,000				
Other Mutual Funds	5,253,779				
Real Estate Investment Trust	1,881,900				
Domestic Stocks	30,000				
Total Temporary Pool Investments	$ 323,286,077				

Certificates of deposit reported as investments are also a component of the deposit totals reported in the deposits section of this note.

At June 30, 2006, investments in the Temporary Pool had the following credit quality distribution for securities with credit exposure:

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	Unrated
U.S. Agencies	$ 17,016,537	$ 10,059,399	$ 3,139,164	$ 0	$ 0	$ 3,817,974
Motrgage Pass Throughs	44,521,559					44,521,559
Collateralized Mortgage Obligations	127,924,584	62,380,216	7,433,612	38,478,257	1,275,248	18,357,251
State and Local Government	2,095,385	2,095,385				
Asset-backed Securities	1,927,251	1,427,836			499,415	
Mutual Bond Funds	11,159,375	770,610		8,167,475		2,221,290
Money Market Mutual Funds	87,935,156			87,935,156		
Domestic Corporate Bonds	7,585,369	1,762,650		4,078,608	1,744,111	
Foreign Corporate Bonds	5,000,000		5,000,000			
	$ 305,165,216	$ 78,496,096	$ 15,572,776	$ 138,659,496	$ 3,518,774	$ 68,918,074

Rating Agencies: Moody's/Standard & Poor's/Fitch

Since a separate annual financial report of the Temporary Investment Pool has not and is not planned to be issued, the following additional disclosures are being provided in the University's financial statements.

The Temporary Investment Pool's Statement of Net Assets and Statement of Operations and Changes in Net Assets as of and for the period ended June 30, 2006, are as follows:

Statement of Net Assets
June 30, 2006

	Amount
Assets:	
Accrued Investment Income	$ 1,447,181
Investments Fund Equity	40,990,401
Investments	323,286,077
Total Assets	$ 365,723,659
Liabilities:	
Deferred Income	$ 1,025,175
Total Liabilities	1,025,175
Net Assets:	
Internal Portion	249,198,474
External Portion	115,500,010
Total Net Assets	364,698,484
Total Liabilities and Net Assets	$ 365,723,659

Statement of Operations and Changes in Net Assets
For the Fiscal Year Ended June 30, 2006

	Amount
Increase in Net Assets from Operations:	
Revenues:	
Investment Income	$ 15,078,618
Expenses:	
Investment Management	409,075
Net Increase in Net Assets Resulting from Operations	14,669,543
Distributions to Participants:	
Distributions Paid and Payable	14,669,543
Share Transactions:	
Net Share Purchases	8,827,280
Total Increase in Net Assets	8,827,280
Net Assets:	
Beginning of Year	355,871,204
End of Year	$ 364,698,484

UNC-Chapel Hill Foundation Investment Fund Inc. (Investment Fund) - This is a North Carolina nonprofit corporation exempt from income tax pursuant to Section 501(c)(3). It was established in January 1997 and is classified as a governmental external investment pool. The pool is utilized to manage the investments for charitable, nonprofit foundations, associations, trusts, endowments, and funds that are organized and operated primarily to support the University. The University's Endowment, UNC-Chapel Hill Foundation, Business School Foundation, Social Work Foundation, School of Education Foundation, Law Foundation, Medical Foundation, Arts and Sciences Foundation, and Educational Foundation Trust are participants in the Investment Fund and are included in the University's reporting entity (internal portion). Other affiliated organizations (external portion) in the Investment Fund are not included in the University's reporting entity. Fund ownership of the University's Investment Fund is measured using the unit value method. Under this method, each participant's investment balance is determined on a market value basis. The external portion of the Investment Fund is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants.

The Investment Fund is not registered with the SEC and is not subject to any formal oversight other than that provided by the Investment Fund Board of Directors (See Note 1A).

The Northern Trust Company is the custodian for the Investment Fund and provides the University with monthly statements defining income and market value information. The Investment Fund uses a unit basis to determine each participant's market value and to distribute the fund's earnings according to the fund's spending policy. There are no involuntary participants in the Investment Fund. The University has not provided or obtained any legally binding guarantees during the period to support the value for the Investment Fund. The audited financial statements for the Investment Fund may be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

The Investment Fund consists of an approximately 92.5% membership in the System Fund categorized below.

UNC Investment Fund, LLC (System Fund) - This is a limited liability company organized under the laws of the State of North Carolina. It was established in December 2002 by the Investment Fund and is classified as a governmental external investment pool. The pool is utilized to manage the investments for The University of North Carolina, its constituent institutions, and affiliates of the constituent institutions. This includes charitable, nonprofit foundations, associations, trusts, endowments, and funds that are organized and operated primarily to support these institutions. The Investment Fund, with an approximately 92.5% membership interest as of June 30, 2006, is the predominant member of the System Fund. The University's reporting entity portion of the Investment Fund is characterized as the internal portion. Other affiliated organizations in the Investment Fund in addition to other members of the System Fund not included in the University's reporting entity are characterized as the external portion. The external portion of the System Fund is presented in the accompanying financial statements as Funds Held in Trust for Pool Participants. Membership interests of the System Fund are measured using the unit value method. Under this method, each member's investment balance is determined on a market value basis.

The System Fund is not registered with the SEC and is not subject to any formal oversight other than that provided by the Investment Fund as the controlling member and the Management Company (See Note 1A). Effective January 1, 2003, the Management Company entered into an investment management services agreement with the System Fund and will provide investment management and administrative services.

The Northern Trust Company is the custodian for the System Fund and provides the University with monthly statements defining income and market value information. The System Fund uses a unit basis to determine each member's market value and to distribute the fund's earnings. There are no involuntary participants in the System Fund. The University has not provided or obtained any legally binding guarantees during the period to support the value for the System Fund investments. The audited financial statements for the System Fund may be obtained from the University Controller's Office, Campus Box 1270, Chapel Hill, NC 27599-1270, or by calling (919) 962-1370.

The following table presents the fair value of the System Fund investments by type and investments subject to interest rate risk at June 30, 2006.

System Fund Pool Investments

		Investment Maturities (in Years)			
	Fair Value	Less Than 1	1 to 5	6 to 10	More than 10
Investment Type					
Debt Securities					
U.S. Treasuries	$ 20,265,538	$ 0	$ 0	$ 0	$ 20,265,538
U.S. Agencies	2,673,856			127,152	2,546,704
Motrgage Pass Throughs	6,390,017			2,566,150	3,823,867
Collateralized Mortgage Obligations	4,074,450				4,074,450
Mutual Bond Funds	14,420,337		9,791,119	4,629,218	
Money Market Mutual Funds	43,753,740	43,753,740			
Domestic Corporate Bonds	12,160,992			997,636	11,163,356
Foreign Corporate Bonds	4,333,497			4,333,497	
	108,072,427	$ 43,753,740	$ 9,791,119	$ 12,653,653	$ 41,873,915
Other Securities					
International Mutual Funds	10,549,596				
Other Mutual Funds	60,193,988				
Limited Partnerships	755,425,654				
Domestic Stocks	72,338,746				
Foreign Stocks	28,533,808				
Hedge Equity	421,059,702				
Absolute Return	109,447,921				
Other	33,931,454				
Total System Fund Pool Investments	$ 1,599,553,296				

At June 30, 2006, investments in the System Fund Pool had the following credit quality distribution for securities with credit exposure:

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	CCC Caa	Unrated
U.S. Agencies	$ 2,546,704	$ 1,199,933	$ 0	$ 0	$ 0	$ 0	$ 0	$ 1,346,771
Motrgage Pass Throughs	6,390,017	3,823,867						2,566,150
Collateralized Mortgage Obligations	4,074,450		949,353					3,125,097
Mutual Bond Funds	14,420,337	2,456,049		2,302,151			8,281,970	1,380,167
Money Market Mutual Funds	43,753,740			43,753,740				
Domestic Corporate Bonds	12,160,992			5,515,857	6,645,135			
Foreign Corporate Bonds	4,333,497					4,333,497		
	$ 87,679,737	$ 7,479,849	$ 949,353	$ 51,571,748	$ 6,645,135	$ 4,333,497	$ 8,281,970	$ 8,418,185

Rating Agencies: Moody's/Standard & Poor's/Fitch

Foreign Currency Risk: At June 30, 2006, the System Fund Pool's exposure to foreign currency risk is as follows:

Investment	Currency	Fair Value (U.S. Dollars)
Limited Partnerships	Euro	$ 21,086,107
Limited Partnerships	British Pound Sterling	4,461,863
Foreign Stock	Canadian Dollar	3,798,248
Foreign Stock	Euro	1,606,851
Foreign Stock	Hong Kong Dollar	848,938
Foreign Stock	Japanese Yen	16,059,851
Foreign Stock	New Zealand Dollar	720,351
Foreign Stock	Singapore Dollar	1,624,435
Total		$ 50,206,644

In addition to the foreign currency risk disclosed above, the System Fund includes investments with fair values highly sensitive to interest rate changes. The System Fund invests in Hedge Funds containing securities that are highly sensitive to rate changes.

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.

Non-Pooled Investments

	Fair Value	Investment Maturities (in Years): Less Than 1	1 to 5	6 to 10	More than 10
Investment Type					
Debt Securities					
U.S. Treasuries	$ 343,537	$ 29,171	$ 30,413	$ 47,154	$ 236,799
U.S. Treasury Strips	2,336,594		2,336,594		
U.S. Agencies	875,569		291,624	67,616	516,329
Motrgage Pass Throughs	112,615		47,957		64,658
Collateralized Mortgage Obligations	301,163				301,163
State and Local Government	154,415		30,902	35,139	88,374
Asset-Backed Securities	34,682				34,682
Mutual Bond Funds	6,501,657		102,748	5,385,907	1,013,002
Money Market Mutual Funds	33,177,286	33,177,286			
Domestic Corporate Bonds	80,595	26,021	25,276		29,298
	43,918,113	$ 33,232,478	$ 2,865,514	$ 5,535,816	$ 2,284,305
Other Securities					
Investment Agreements	108,825,728				
International Mutual Funds	2,475,122				
Other Mutual Funds	35,914,003				
Investments in Real Estate	14,771,265				
Real Estate Investment Trust	1,020,505				
Domestic Stocks	6,562,927				
Other	17,644,652				
Total Non-Pooled Investments	$ 231,132,315				

Investment Agreements reported as investments are also a component of the deposit totals reported in the deposits section of this note.

At June 30, 2006, the University's Non-Pooled Investments had the following credit quality distribution for securities with credit exposure:

	Fair Value	AAA Aaa	AA Aa	A	BBB Baa	BB Ba	Unrated
U.S. Agencies	$ 875,569	$ 875,569	$ 0	$ 0	$ 0	$ 0	$ 0
Motrgage Pass Throughs	112,615	94,866					17,749
Collateralized Mortgage Obligations	301,163	206,652		94,511			
State and Local Government	154,415	30,902	88,374		35,139		
Asset-Backed Securities	34,682			34,682			
Mutual Bond Funds	6,501,657	2,058,687	3,418,214	280,495	445,568	298,693	
Money Market Mutual Funds	33,177,286	268,097		32,909,189			
Domestic Corporate Bonds	80,595		25,276	29,298	26,021		
	$ 41,237,982	$ 3,534,773	$ 3,531,864	$ 33,348,175	$ 506,728	$ 298,693	$ 17,749

Rating Agencies: Moody's/Standard & Poor's/Fitch

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

	Fair Value
Investment Type	
Debt Securities	
U.S. Treasuries	$ 27,962,536
U.S. Treasury Strips	2,336,594
U.S. Agencies	23,167,683
Motrgage Pass Throughs	51,024,191
Collateralized Mortgage Obligations	132,300,197
State and Local Government	2,249,800
Asset-Backed Securities	1,961,933
Mutual Bond Funds	32,081,369
Money Market Mutual Funds	164,866,182
Domestic Corporate Bonds	19,826,956
Foreign Corporate Bonds	9,333,497
	467,110,938
Other Securities	
Certificates of Deposit	1,000,000
Investment Agreements	108,825,728
International Mutual Funds	13,024,718
Other Mutual Funds	101,361,770
Investments in Real Estate	14,771,265
Real Estate Investment Trust	2,902,405
Limited Partnerships	755,425,654
Domestic Stocks	78,931,673
Foreign Stocks	28,533,808
Hedge Equity	421,059,702
Absolute Return	109,447,921
Other	51,576,106
Total Investments	$ 2,153,971,688

Total investments include $280,676,709 held in the System Fund for component units that are discretely presented in the accompanying financial statements. The University's reporting entity, including the three discretely presented component units, comprises 84.61% of the System Fund.

Component Units - Investments of the University's discretely presented component units, the Medical Foundation of North Carolina, Inc., 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. Because the Medical Foundation reports under the FASB reporting model, disclosures of the various investment risks are not required. The following is an analysis of investments not held by the University by type:

Investment Type		Carrying Value
Bonds	$	29,973,176
Mutual Funds		19,574,845
Investments in Real Estate		48,500
Common Stock		53,089,902
Total Investments	$	102,686,423

NOTE 3 - ENDOWMENT INVESTMENTS

Substantially all of the investments of the University's endowment funds are pooled in the Investment Fund. Investment return of the University's pooled endowment funds is predicated on the total return concept (yield plus appreciation). Annual distributions from the Investment Fund to the University's pooled endowment funds are generally based on an adopted spending distribution policy. Under this policy, the prior year distribution is increased by the rate of inflation as measured by the Consumer Price Index (CPI). Each year's distribution, however, is subject to a minimum of 4% and a maximum of 7% of the pooled fund's average market value for the previous year.

To the extent that the total return for the current year exceeds the distribution, the excess is added to principal. If current year earnings do not meet the distribution requirements, the University uses accumulated income and appreciation to make up the difference. At June 30, 2006, accumulated income and appreciation of $513,705,631 was available in the University's pooled endowment funds of which $462,455,242 was restricted to specific purposes.

NOTE 4 - RECEIVABLES

Receivables at June 30, 2006, were as follows:

	Gross Receivables	Less Allowance for Doubtful Accounts	Net Receivables
Current Receivables:			
Students	$ 2,600,480	$ 0	$ 2,600,480
Patients	72,767,678	45,296,039	27,471,639
Accounts	42,236,435		42,236,435
Intergovernmental	32,682,430		32,682,430
Pledges	16,767,630	419,191	16,348,439
Investment Earnings	3,194,790		3,194,790
Interest on Loans	587,288		587,288
Other	20,415		20,415
Total Current Receivables	$ 170,857,146	$ 45,715,230	$ 125,141,916
Noncurrent Receivables:			
Pledges	$ 23,775,635	$ 594,391	$ 23,181,244
Notes Receivable:			
Notes Receivable - Current:			
Federal Loan Programs	$ 2,629,003	$ 96,894	$ 2,532,109
Institutional Student Loan Programs	743,829	72,767	671,062
Total Notes Receivable - Current	$ 3,372,832	$ 169,661	$ 3,203,171
Notes Receivable - Noncurrent:			
Federal Loan Programs	$ 27,260,668	$ 979,709	$ 26,280,959
Institutional Student Loan Programs	4,366,416	142,113	4,224,303
Total Notes Receivable - Noncurrent	$ 31,627,084	$ 1,121,822	$ 30,505,262

Pledges are receivable over varying time periods ranging from one to 10 years, and have been discounted based on a projected interest rate of 3.58% for the outstanding periods, and allowances are provided for the amounts estimated to be uncollectible.

Scheduled receipts, the discounted amount under these pledge commitments, and allowances for uncollectible pledges are as follows:

Fiscal Year	Amount
2007	$ 16,767,630
2008	10,273,251
2009	6,979,224
2010	3,330,767
2011	1,284,815
2012-2016	5,180,938
Total Pledge Receipts Expected	43,816,625
Discount Amount Representing Interest (3.58% rate of Interest)	(3,273,360)
Present Value of Pledge Receipts Expected	40,543,265
Less Allowance for Uncollectible	(1,013,582)
Pledges Receivable	$ 39,529,683

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	$ 26,069,522	$ 3,182,514	$ 0	$ 29,252,036
Art, Literature, and Artifacts	59,277,930	4,826,335	376,473	63,727,792
Construction in Progress	377,522,418	281,227,365	73,533,726	585,216,057
Intangible	1,000,000			1,000,000
Total Capital Assets, Nondepreciable	463,869,870	289,236,214	73,910,199	679,195,885
Capital Assets, Depreciable:				
Buildings	1,220,833,481	152,542,473		1,373,375,954
Machinery and Equipment	222,264,175	21,982,480	11,759,289	232,487,366
General Infrastructure	365,310,029	2,259,801		367,569,830
Total Capital Assets, Depreciable	1,808,407,685	176,784,754	11,759,289	1,973,433,150
Less Accumulated Depreciation/Amortization for:				
Buildings	422,652,927	39,959,925		462,612,852
Machinery and Equipment	136,706,970	10,560,155	8,408,751	138,858,374
General Infrastructure	162,716,520	13,955,051		176,671,571
Total Accumulated Depreciation	722,076,417	64,475,131	8,408,751	778,142,797
Total Capital Assets, Depreciable, Net	1,086,331,268	112,309,623	3,350,538	1,195,290,353
Capital Assets, Net	$ 1,550,201,138	$ 401,545,837	$ 77,260,737	$ 1,874,486,238

NOTE 6 - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

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

		Amount
Accounts Payable	$	53,629,335
Accrued Payroll		24,866,003
Contract Retainage		14,513,919
Intergovernmental Payables		79,939
Total Accounts Payable and Accrued Liabilities	$	93,089,196

NOTE 7 - SHORT-TERM DEBT – COMMERCIAL PAPER

Short-term debt activity for the year ended June 30, 2006, was as follows:

	Balance July 1, 2005	Issued	Redeemed	Balance June 30, 2006
Commercial Paper Program	$ 141,141,000	$ 97,000,000	$ 120,727,000	$ 117,414,000

Commercial paper was issued from The University of North Carolina General Revenue Bonds, Series 2002A, to provide interim financing for the construction of capital projects. Commercial paper was redeemed with proceeds from The University of North Carolina General Revenue and Revenue Refunding Bonds, Series 2005.

NOTE 8 - LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in the long-term liabilities for the year ended June 30, 2006, is presented as follows:

	Balance July 1, 2005	Additions	Reductions	Balance June 30, 2006	Current Portion
Bonds Payable	$ 500,820,000	$ 404,960,000	$ 79,130,000	$ 826,650,000	$ 108,912,048
Add/Deduct Premium/Discount	(42,446,866)	21,263,476	(2,619,722)	(18,563,668)	
Deduct Deferred Charge on Refunding	(2,280,078)	(2,285,907)	(325,725)	(4,240,260)	
Total Bonds Payable	456,093,056	423,937,569	76,184,553	803,846,072	108,912,048
Notes Payable	33,519,469	15,535,072	28,000,539	21,054,002	21,054,002
Capital Leases Payable	969,648	200,099	790,561	379,186	247,563
Compensated Absences	88,788,578	61,316,283	47,799,158	102,305,703	4,678,316
Annuity and Life Income Payable	6,526,199	489,268	969,992	6,045,475	886,891
Total Long-Term Liabilities	$ 585,896,950	$ 501,478,291	$ 153,744,803	$ 933,630,438	$ 135,778,820

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

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 June 30, 2006	Accretion on Capital Appreciation Bonds	Principal Outstanding June 30, 2006
Housing System							
	1997A	5.00%	11/01/2017	$ 9,170,000	$ 8,310,000	$ 0	$ 860,000
	1997B	4.500% - 5.000%	11/01/2011	7,210,000	2,620,000		4,590,000
Total Housing System				16,380,000	10,930,000		5,450,000
Utilities System							
	1997	5.250% - 5.500%	08/01/2021	84,135,000		(35,861,410)	48,273,590
Parking System							
	1997A	4.950% - 5.000%	05/15/2027	11,750,000	11,480,000		270,000
	1997B	4.900% - 5.100%	05/15/2009	8,245,000	5,660,000		2,585,000
Total Parking System				19,995,000	17,140,000		2,855,000
General Revenue							
	2001A	4.000% - 5.375%	12/01/2025	89,930,000	43,495,000		46,435,000
	2001B	Variable	12/01/2025	54,970,000	8,855,000		46,115,000
	2001C	Variable	12/01/2025	54,970,000	8,855,000		46,115,000
	2002B	5.000%	12/01/2011	66,555,000	20,135,000		46,420,000
	2003	2.000% - 5.000%	12/01/2033	107,960,000	2,950,000		105,010,000
	2005	3.000% - 5.000%	12/01/2034	404,960,000	480,000		404,480,000
Total General Revenue				779,345,000	84,770,000		694,575,000
Student Union	2000	5.000%	06/01/2022	12,465,000	10,610,000		1,855,000
Student Recreation Center	1997	4.650% - 5.000%	06/01/2011	3,545,000	1,685,000		1,860,000
U.S. EPA Project	1991	9.050%	02/15/2015	58,125,000	22,205,000	(10,571,385)	25,348,615
U.S. EPA Project	1996	6.72%	02/15/2006	2,400,000	2,400,000		
Total Bonds Payable (principal only)				$ 976,390,000	$ 149,740,000	$ (46,432,795)	780,217,205
Less: Unamortized Loss on Refunding							(4,240,260)
Plus: Unamortized Premium							27,869,127
Total Bonds Payable							$ 803,846,072

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

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

General Revenue, Series 2001B and 2001C: In 2001 the University issued two series of variable rate demand bonds in the amount of $54,970,000 (2001B) and $54,970,000 (2001C) that each have a final maturity date of December 1, 2025. The bonds are subject to mandatory sinking fund redemption on the interest payment date on or immediately preceding each December throughout the term of the bonds. The proceeds of these issuances were used to provide funds to refund in advance of their maturity the following issues: Ambulatory Care Clinic, Series 1990; Athletic Facilities, Series 1998; Carolina Inn, Series 1994; School of Dentistry, Series 1995; Kenan Stadium, Series 1996; and Parking System, Series 1997C. While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the University's remarketing agents, Lehman Brothers, Inc (2001B) and UBS Financial Services, Inc. (2001C).

The University renewed its line of credit, in the amount of $107,460,000, with JP Morgan Chase Bank effective February 1, 2006. Under the line of credit agreement, the University is entitled to draw amounts sufficient to pay the principal, and accrued interest on bonds delivered for purchase.

The University is required to pay a quarterly commitment fee for the line of credit of 0.095% per annum based on the unused portion of the line of credit commitment. If the University's credit rating for unsecured debt were to drop below Aa3 (or its equivalent) by Moody's Investors Service (Moody's), AA- (or its equivalent) by Standard & Poor's (S&P), or AA- (or its equivalent) by Fitch Ratings (Fitch), the quarterly commitment fee would increase to 0.145%. If the University's credit rating for unsecured debt were to drop below A3 (or its equivalent) by Moody's, A- (or its equivalent) by S&P, or A- (or its equivalent) by Fitch, the quarterly commitment fee would increase to 0.245%.

Under the line of credit agreement, the University has promised to repay loans that represent purchase drawings in equal semi-annual payments after termination of the line of credit. Interest at the rate of Prime plus 1.0% (Prime plus 2.0% after 60 days) is payable quarterly and upon draw repayment. At June 30, 2006, no purchase draws had been made under the line of credit.

The line of credit agreement expires on January 31, 2007. However, between November 3, 2006, and December 3, 2006, the University may request that the Bank extend the expiration date for another year. The Bank shall respond affirmatively or negatively within 30 days after receipt of such request.

In the event of termination of the line of credit, outstanding principal is to be repaid in semi-annual installments of principal on each February 1 and August 1, commencing on the first of such dates succeeding the termination date with the remaining principal amount payable on the second anniversary of the termination date. Further, accrued interest will continue to be due and payable on the first day of the calendar quarter and on the date any portion of principal is payable.

To protect against the risk of interest rate changes, effective October 3, 2000, the University entered into an interest rate swap agreement with Lehman Brothers Special Financing, Inc. (Lehman Brothers) related to $22,000,000 of The University of North Carolina at Chapel Hill Variable Rate Housing System Revenue Bonds, Series 2000. This series of bonds was refunded in its entirety by the issuance of the University's Variable Rate General Revenue Demand Bonds, Series 2001B (2001B Bonds), and the interest rate swap agreement was amended to reflect the refunding.

Under this amended agreement, Lehman Brothers pays the University interest on the notional amount based on the Bond Market Association (BMA) Municipal Bond Index on a quarterly basis. On a semiannual basis, the University pays Lehman Brothers interest at the fixed rate of 5.24%. The notional amount of the swap reduces annually in conjunction with the 2001B Bonds; the reductions began in November 2002 and end in November 2025. The swap agreement matures November 1, 2025. As of June 30, 2006, rates were as follows:

	Terms	Rates
Fixed Payment to Lehman	Fixed	5.24
Variable Payment from Lehman	BMA	3.61
Net Interest Rate Swap Payments		1.63
Variable Rate Bond Coupon Payments		3.95
Synthetic Interest Rate on Bonds		5.58

As of June 30, 2006, the swap had a fair value of negative $2,549,467. The fair value was developed by Lehman Brothers. Their method calculates the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for London Interbank Offered Rate (LIBOR) due on the date of each future net settlement on the swap.

As of June 30, 2006, the University was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the University would be exposed to credit risk in the amount of the derivative's positive fair value. Should the swap have a positive fair value of more than $1,000,000, at that point Lehman would be required to collateralize 103% of their exposure. Lehman Brothers Holdings, guarantor of Lehman Brothers Special Financing, Inc., was rated A1 by Moody's, A+ by S&P, and A+ by Fitch for unsecured long-term debt.

The University receives the BMA from Lehman Brothers and pays a floating rate to its bondholders set by the remarketing agent. The University incurs basis risk when its bonds begin to trade at a yield above the BMA. Basis risk also exists since swap payments are made quarterly while bond payments are made monthly. With the alternative tax structure of the swap, a change in tax law would trigger the swap being converted from a BMA swap to a percentage of LIBOR swap. This would introduce basis risk. If the weekly reset interest rates on the University's bonds are in excess of 65% of LIBOR, the University will experience an increase in debt service above the fixed rate on the swap to the extent that the interest rates on the bonds exceed 65% of LIBOR.

The swap agreement uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. Termination could result in the University being required to make an unanticipated termination payment. The swap terminates if the University or Lehman Brothers fails to perform under terms of the contract.

To protect against the risk of interest rates changes, the University entered into an interest rate swap agreement with the Bank of New York (BNY) on April 19, 2006, based on a notional amount of $150,000,000, effective December 1, 2007, maturing in April 1, 2036.

Under the agreement, BNY will pay the University 67% of the one-month LIBOR index times the notional amount, payable monthly. The University pays BNY a fixed rate of 3.785% on the notional amount, payable monthly. Since the effective date is in the future, there is no expected cash flow until after that date, but the agreement carries with it a fair market value based on swap market conditions. The University anticipates that changes in the cost of issuing traditional fixed-rate debt will be offset by the change in the fair value of the swap, and additionally, that interest on variable rate bonds will correlate highly with 67% of the one-month LIBOR index, such that the University has the option to (1) issue variable rate bonds in December 2007, thereby effectively creating synthetic fixed-rate debt, or (2) unwind the swap, capturing the value of the movement of interest rates from the issuance date, and issuing traditional fixed rate bonds.

As of June 30, 2006, the swap had a fair value of $438,777. The fair value was developed by BNY. Market value represents the amount that would be paid to (or received from) another swap dealer to assume the payments under the swap.

As of June 30, 2006, the University was exposed to credit risk because of the derivative’s positive fair value. Over the life of the swap, in the event that the swap carries a positive fair value for the University and in the event of a specified ratings downgrade of BNY’s unsecured long-term debt, BNY would be required to post collateral in the amount above the positive fair value of the swap and the thresholds in the below tables.

Ratings Moody's/S&P/Fitch	Threshold
Aa3/AA- or above	$Infinity
A1/A+	$15,000,000
A2/A	$10,000,000
A3/A- or below	$0

The University is also subject to the same provisions. BNY was rated AA- by S&P, AA- by Fitch and Aa2 by Moody’s. Since there have been no ratings downgrade, no posted collateral was required. In the event collateralization was required, the University is entitled to hold posted collateral or appoint a custodian to hold posted collateral. Collateral could be in the form of US lawful currency, US government or agency securities or other collateral acceptable to the University.

Changes in swap interest rates and tax-exempt bond interest rates may differ, introducing basis risk in the event the swap is unwound and traditional fixed-rate debt is issued. In the event that the University issues variable rate debt to create synthetic fixed rate debt, the University will pay a rate on the bonds that may not correlate with 67% of the one-month LIBOR index, altering the “fixed” cost of synthetic debt.

The swap agreement uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. Termination could result in the University being required to make an unanticipated termination payment. The swap terminates if the University or BNY fails to perform under terms of the contract.

D. **Capital Appreciation Bonds –** The University’s Series 1997 Utility System and the Series 1991 U.S. Environmental Protection Agency Project bond issues include capital appreciation bonds with an original issue amount of $30,379,142 and $3,828,921, respectively. These bonds are recorded in the amounts of $48,273,590 ($84,135,000 ultimate maturity less $35,861,410 discount) and $14,703,614, ($25,275,000 ultimate maturity less $10,571,386 discount), respectively, which is the accreted value at June 30, 2006. These bonds mature in the years from 2010 to 2021.

E. Annual Requirements - The annual requirements to pay principal and interest on the long-term obligations at June 30, 2006, are as follows:

	Annual Requirements				
	Bonds Payable			Notes Payable	
Fiscal Year	Principal	Interest	Interest Rate Swaps, Net *	Principal	Interest
2007	$ 21,775,000	$ 37,365,590	$ 341,526	$ 21,054,002	$ 422,774
2008	22,515,000	35,696,541	337,247		
2009	24,055,000	34,211,459	332,805		
2010	24,470,000	32,934,028	328,301		
2011	24,905,000	31,530,859	323,351		
2012-2016	122,950,000	144,161,556	1,474,376		
2017-2021	110,535,000	124,487,930	1,065,083		
2022-2026	83,100,000	106,023,141	400,613		
2027-2031	27,645,000	93,784,405			
2032-2036	364,700,000	44,682,375			
Total Requirements	$ 826,650,000	$ 684,877,884	$ 4,603,302	$ 21,054,002	$ 422,774

Interest on the variable rate General Revenue Bonds 2001B is calculated at 3.95% at June 30, 2006
Interest on the variable rate General Revenue Bonds 2001C is calculated at 3.92% at June 30, 2006
For General Revenue Bonds, Series 2001B and 2001C, interest rates change weekly.

This schedule also includes the debt service requirements for debt associated with interest rate swaps. More detailed information about interest rate swaps is presented in Note 8C.

* Computed using (5.24% - 3.61%) x ($22,000,000 - annual swap reduction)

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

Housing System, Parking System, and Student Fee: On August 30, 2005, the University issued $404,960,000 in The University of North Carolina at Chapel Hill General Revenue and Revenue Refunding Bonds, Series 2005A, with an average interest rate of 4.90%. The refunding component of this bond was used to advance refund $6,250,000 of outstanding University of North Carolina at Chapel Hill Housing System Revenue Bonds, Series 1997A, with an average interest rate of 4.98%; $9,900,000 of University of North Carolina at Chapel Hill Parking

System Revenue Bonds, Series 1997A, with an average interest rate of 5.60%; $8,750,000 of University of North Carolina at Chapel Hill Student Fee Revenue Bonds, Series 2000, with an average interest rate of 5.36%; and $33,310,000 of University of North Carolina at Chapel Hill General Revenue Bonds, Series 2001A, with an average interest rate of 5.23%. The net proceeds of the refunding bonds, along with other resources, were used to purchase U.S. government securities. These securities were deposited in an irrevocable trust with an escrow agent to provide for all future debt service on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability has been removed from the Statement of Net Assets. This advance refunding was undertaken to reduce total debt service payments by $4,157,055 over the next 23 years and resulted in an economic gain of $3,422,200. At June 30, 2006, the outstanding balance was $5,850,000 for the defeased University of North Carolina at Chapel Hill Housing System Revenue Bonds, Series 1997A; $9,900,000 for the defeased University of North Carolina at Chapel Hill Parking System Revenue Bonds, Series 1997A; $8,750,000 for the defeased University of North Carolina at Chapel Hill Student Fee Revenue Bonds, Series 2000; and $33,310,000 for the defeased University of North Carolina at Chapel Hill General Revenue Bonds, Series 2001A.

Dining System: On February 7, 2001, the University defeased $13,205,000 of outstanding Dining System Revenue Bonds, Series 1997. Securities were deposited into an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. The trust assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2006, the outstanding balance of the defeased Dining System bonds was $9,750,000.

Dormitory System: On December 1, 1999, the University defeased $1,225,000 of outstanding Dormitory System Revenue Bonds, Series E, F & G (1963). Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2006, the outstanding balance was $0 for the defeased outstanding Dormitory System Revenue Bonds, Series G (1963).

Student Union: On December 1, 1999, the University defeased $620,000 of outstanding Student Union Revenue Bonds, Series 1967. Securities were placed in an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. For financial reporting purposes, the trust account assets and the liability for the defeased bonds are not included in the University's Statement of Net Assets. At June 30, 2006, the outstanding balance was $170,000 for the defeased outstanding Student Union Revenue Bonds, Series 1967.

G. **Notes Payable** - The University was indebted for notes payable for the purposes shown in the following table:

Purpose	Financial Institution	Interest Rate/ Ranges	Final Maturity Date	Beginning Balance 7/1/2005	Draws	Repayments	Principal Outstanding June 30, 2006
Student Family Housing	Bank of America	4.08%	10/01/2005	$ 27,389,745	$ 0	$ 27,389,745	$ 0
Rizzo Center	Wachovia Bank	6.53%	09/22/2006	5,532,556	13,005,000		18,537,556
Real Property Purchases	Bank of America	5.73%	06/30/2007	597,168	2,530,072	610,794	2,516,446
Total Notes Payable				$ 33,519,469	$ 15,535,072	$ 28,000,539	$ 21,054,002

The UNC-Chapel Hill Foundation, part of the University's reporting entity, had a loan agreement for a Student Family Housing Project with Bank of America, originally in the amount of $35,000,000. The unsecured loan was refinanced on October 1, 2004, and the commitment was increased to $47,300,000 to provide additional funding with the maturity date extended to October 1, 2005. The outstanding balance under the credit facility accrues interest at the LIBOR Rate plus 0.40%. The University refinanced the note with other long-term financing.

The Kenan-Flagler Business School Foundation, part of the University's financial reporting entity, closed a $20 million unsecured line of credit with Wachovia Bank on September 22, 2004. This credit facility is used to fund the expansion of the Paul J. Rizzo Business Conference Center and will expire on September 22, 2006. Advances under the line of credit accrue interest at the variable rate of the LIBOR Market Index plus 1.20%. There is an availability fee due each year on the anniversary date of the line of credit and is calculated as 0.125% of the difference between the commitment amount and the average balance outstanding for the year leading up to the anniversary date. The University plans to repay the note with other long-term financing.

The UNC-Chapel Hill Foundation, part of the University's reporting entity, has a line of credit agreement issued by Bank of America, originally in the aggregate principal amount up to $10,000,000 to finance the costs of projects benefiting the Foundation or the University. The line of credit had a maturity date of June 30, 2005, and was extended until June 30, 2007, and the aggregate principal amount was reduced to $6,000,000. Advances under the line of credit accrue interest at the variable rate of the LIBOR Market Index plus 0.40%. An unused commitment fee is due each quarter calculated as 0.25% of the difference between the commitment amount and the average balance outstanding for the quarter through June 30, 2005, and 0.225% thereafter. The University repays draws on the note with capital improvement funds designated for land acquisition.

H. **Annuities Payable** – The University participates in split-interest agreements with donors that require benefits payments for a specified period to a designated beneficiary out of assets held in trust for this purpose. At the end of the predetermined period (e.g., the lifetime of the beneficiary specified by the donor), the remaining assets of the trust revert to the University for its use or for a purpose specified by the donor. At the end of each fiscal year, annuities and life income payable to the beneficiaries is calculated using IRS issued 90CM table, taking into consideration beneficiary's age and the amount of the gift, and using IRS issued Life Table 90CM.

NOTE 9 - LEASE OBLIGATIONS

A. **Capital Lease Obligations** - Capital lease obligations relating to medical and research equipment are recorded at the present value of the minimum lease payments. Future minimum lease payments under capital lease obligations consist of the following at June 30, 2006:

Fiscal Year	Amount
2007	$ 200,960
2008	137,177
2009	70,379
Total Minimum Lease Payments	408,516
Amount Representing Interest (5.0% - 29.9%% Rate of Interest)	29,330
Present Value of Future Lease Payments	$ 379,186

Machinery and equipment acquired under capital lease amounted to $396,424 at June 30, 2006.

B. Operating Lease Obligations – Future minimum lease payments under noncancelable operating leases consist of the following at June 30, 2006:

Fiscal Year	Amount
2007	$ 6,495,852
2008	3,323,033
2009	1,343,936
2010	685,582
2011	458,936
Total Minimum Lease Payments	$ 12,307,339

Rental expense for all operating leases during the year was $13,120,011.

C. Other Lease Obligations – The UNC-Chapel Hill Foundation issued certificates of participation to provide for construction of alumni facilities. The University constructed the facilities as an agent for the UNC-Chapel Hill Foundation. In October 1989, the University entered into a 20-year lease agreement with the UNC-Chapel Hill Foundation and simultaneously entered into a sublease agreement with the General Alumni Association, an affiliated organization, for the same time period for the use of the alumni facilities.

Payments under the terms of the lease are a limited obligation of the University, payable solely from and secured by the annual rental income derived from the sublease of the alumni facilities. The University has no other obligations for repayment of the certificates of participation; therefore, the certificates are not reported as a liability in the accompanying financial statements. As of June 30, 2006, the aggregate principal amount of the certificates was $9,950,000.

If the University complies with all the terms of the lease agreement, title to the alumni facilities will be conveyed to the University.

NOTE 10 - RESTRICTED NET ASSETS

Restricted net assets at June 30, 2006, were as follows:

	Amount
Nonexpendable	
Scholarships and Fellowships	$ 99,281,194
Research	12,462,044
Library Acquisitions	23,967,171
Endowed Professorships	181,582,212
Departmental Uses	68,397,452
Loans	14,633,796
Other	29,991,697
Total Nonexpendable	$ 430,315,566
Expendable	
Scholarships and Fellowships	$ 177,456,611
Research	18,957,991
Library Acquisitions	45,795,208
Endowed Professorships	286,757,584
Departmental Uses	281,161,335
Instruction and Educational Agreements	14,017,472
Plant Improvements	11,413,994
Capital Projects	8,640,686
Debt Service	8,932,500
Total Expendable	$ 853,133,381

NOTE 11 - 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 Change in Allowance for Uncollectibles	Less Indigent Care and Contractual Adjustments	Net Revenues	Revenues Pledged as Security for Debt	
Operating Revenues:								
Student Tuition and Fees	$ 241,155,091	$ 0	$ 45,272,631	$ 0	$ 0	$ 195,882,460	$ 4,514,011	(B)
Patient Services	$ 462,812,680	$ 0	$ 0	$ 1,209,626	$ 277,279,002	$ 184,324,052	$ 0	
Sales and Services:								
Sales and Services of Auxiliary Enterprises:								
Residential Life	$ 31,448,415	$ 0	$ 5,769,860	$ 0	$ 0	$ 25,678,555	$ 25,573,973	(A)
Dining	20,178,095	4,729				20,173,366		
Student Union Services	216,761	172,824				43,937		
Health, Physical Education, and Recreation Services	6,149,798		262,182			5,887,616		
Bookstore	27,254,821	4,504,031	180,895			22,569,895		
Parking	18,358,099	4,922				18,353,177	18,353,177	(C)
Athletic	37,017,092	24,625				36,992,467		
Utilities	87,481,059	66,324,816				21,156,243	21,156,243	(D)
Telecommunications	14,164,271	11,036,024				3,128,247		
Other Professional Income	83,933,525	(394)				83,933,919		
Printing and Maintenance	9,282,000	6,319,924				2,962,076		
Repairs and Maintenance	23,767,929	20,442,603				3,325,326		
Materials Management and Disbursements	21,477,813	21,348,036				129,777		
Other	93,050,683	36,082,359				56,968,324	4,613,258	(E)
Total Sales and Services	$ 473,780,361	$ 166,264,499	$ 6,212,937	$ 0	$ 0	$ 301,302,925	$ 69,696,651	
Nonoperating - Noncapital Gifts	$ 68,617,537	$ 0	$ 0	$ (206,283)	$ 0	$ 68,823,820	$ 0	

Revenue Bonds Secured by Pledged Revenues:
(A) Housing System Revenue Bonds, Series 1997A & B
(B) Student Fee Revenue Bonds, Series 1997 & 2000
(C) Parking System Revenue Bonds, Series 1997A & B
(D) Utility System Revenue Bonds, Series 1997
(E) US EPA Project, Series 1991 & 1996

NOTE 12 - 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	$ 450,296,663	$ 26,932,047	$ 118,052,916	$ 0	$ 37,291	$ 0	$ 595,318,917
Research	188,139,916	39,762,505	57,707,493		35,962		285,645,876
Public Service	31,120,713	1,694,549	52,434,255		80,696		85,330,213
Academic Support	56,060,510	13,171,769	16,987,956		8,386		86,228,621
Student Services	11,279,677	717,306	11,959,208		861		23,957,052
Institutional Support	48,615,179	5,182,530	17,784,182		27,263		71,609,154
Operations and Maintenance of Plant	35,170,538	8,165,712	21,059,534		47,324,578		111,720,362
Student Financial Aid				54,105,093			54,105,093
Auxiliary Enterprises	221,768,655	57,285,066	136,226,364		8,761,707		424,041,792
Depreciation						64,475,131	64,475,131
Total Operating Expenses	$ 1,042,451,851	$ 152,911,484	$ 432,211,908	$ 54,105,093	$ 56,276,744	$ 64,475,131	$ 1,802,432,211

NOTE 13 - 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 $893,459,575, of which $366,969,405 was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were $22,018,164 and $8,587,084, respectively. The University made 100% of its annual required contributions for the years ended June 30, 2006, 2005, and 2004, which were $8,587,084, $7,633,965, and $757,757, respectively.

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

The Optional Retirement Program (Program) is a defined contribution retirement plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Administrators and eligible faculty of the University may join the Program instead of the Teachers' and State Employees' Retirement

System. The Board of Governors of The University of North Carolina is responsible for the administration of the Program and designates the companies authorized to offer investment products. The Board has authorized the following carriers: Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), Lincoln Life Insurance Company, Variable Annuity Life Insurance Company (VALIC), and Fidelity Investments. Participants may elect to allocate their contributions and the University contributions to the carrier of their choice. Each carrier offers a variety of investment funds, including both fixed and variable account investment options and mutual funds.

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

Participant eligibility and contributory requirements are established by General Statute 135-5.1. Employer and member contribution rates are set each year by the North Carolina General Assembly. For the year ended June 30, 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 $893,459,575, of which $347,656,657 was covered under the Optional Retirement Program. Total employee and employer contributions for pension benefits for the year were $20,859,399 and $23,779,715, respectively.

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

University. The voluntary contributions by employees amounted to $5,167,912 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 $107,598. The voluntary contributions by employees amounted to $2,904,228 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 $23,722,522 for the year ended June 30, 2006.

NOTE 14 - 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 $27,155,790. 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 $3,716,056. 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 15 - 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.

Public Officer's and Employee's Liability Insurance - 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.

Fire and Other Property Loss - 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 $500 per occurrence deductible. The University also purchased through the Fund extended coverage or all risk coverage with a $500 per occurrence deductible for certain buildings and contents.

Automobile Liability Insurance - 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.

Employee and Computer Fraud - 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.

Other authorized coverage not handled by the North Carolina Department of Insurance is purchased through the state's insurance agent of record. Examples include, but are not limited to, fine arts, boiler and machinery, medical professional liability, athletic accident and revenues and study abroad health insurance.

Comprehensive Major Medical Plan - 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.

Liability Insurance Trust Fund - The University participates in the Liability Insurance Trust Fund (Trust Fund), a claims-servicing public entity risk pool for healthcare professional liability protection. The Trust Fund services professional liability claims, managing separate accounts for each participant from which the losses of that participant are paid. Although participant assessments are determined on an actuarial basis, ultimate liability for claims remains with the participants and, accordingly, the insurance risks are not transferred to the Trust Fund.

The Trust Fund is an unincorporated entity created by Chapter 116, Article 26, of the North Carolina General Statutes and The University of North Carolina Board of Governors Resolution of June 9, 1978. The Trust Fund is a self-insurance program established to provide professional medical malpractice liability covering to The University of North Carolina Hospitals at Chapel Hill (the UNC Hospitals) and The University of North Carolina at Chapel Hill Physicians and Associates (UNC P&A), the program participants. The Trust Fund provides coverage for program participants and individual health care practitioners working as employees, agents, or officers of program participants. The Trust Fund is exempt from federal and State income taxes, and is not subject to regulation by the North Carolina Department of Insurance.

Participation in the Trust Fund is open to the University of North Carolina, any constituent institution of the University of North Carolina, the UNC Hospitals, and any health-care institution, agency or entity that has an affiliation agreement with the University of North Carolina, with a constituent institution of the University of North Carolina, or with the UNC Hospitals. Only the UNC P&A and the UNC Hospitals have participated in the Trust Fund to date. Participants provide management and administrative services to the Trust Fund at no cost.

The Trust Fund is governed by the Liability Insurance Trust Fund Council (the Council). The Council consists of 13 members as follows: one member each appointed by the State Attorney General, the State Auditor, the State Insurance Commissioner, the Director of the Office of State Budget and Management, the State Treasurer, (each serving at the pleasure of the appointer); and eight members appointed to three year terms (with no limit on the number of terms) by the UNC System's Board of Governors.

The Trust Fund establishes claim liabilities based on estimates of the ultimate cost of claims (including future expenses and claim adjustment expenses) that have been reported but not settled and of claims incurred but not reported. Claim liabilities are recomputed annually based on an independent actuary's study to produce current estimates that reflect recent settlements, claims frequency, inflation and other factors. Participant assessments are determined at a level to fund claim liabilities, discounted for future investment earnings. Each participant is required by statute to maintain a fund balance of $100,000 at all times. Participants are subject to additional premium assessments in the event of deficiencies.

For the period July 1, 2004, through June 30, 2006, the Trust Fund provided coverage on an occurrence basis of $3,000,000 per individual and $7,000,000 in the aggregate per claim. Effective July 1, 2004, through June 30, 2006, the Trust Fund entered into an excess of loss agreement with an unaffiliated reinsurer. Reinsurance coverage under this policy carries a $10,000,000 aggregate limit in excess of a self-insured aggregate of $33,000,000 ($30,000,000 in 2005) subject to a $7,000,000 per occurrence limit (sub-limit of $3,000,000 per individual) with a $200,000 ($300,000 in 2005) continuing underlying amount per claim. Excess of loss coverage is also in place at various levels for prior periods. For fiscal year ending June 30, 2006, the Trust Fund purchased a direct insurance policy to cover the first $1,000,000 per occurrence and $3,000,000 in the aggregate for dental residents. North Carolina General Statutes Chapter 116 was amended during 1987 to authorize the Trust Fund to borrow necessary amounts up to $30,000,000, in the event that the Trust Fund may have insufficient funds to pay existing and future claims. Any such borrowing would be repaid from the assets and revenues of program participants. No line of credit or borrowing has been established pursuant to this authorization. The Council believes adequate funds are on deposit in the Trust Fund to meet estimated losses based upon the results of the independent actuary's report.

The Trust Fund has purchased annuity contracts to settle claims for which the claimant has signed an agreement releasing the Fund from further obligation. The related claim liabilities have been removed from estimated malpractice costs. The likelihood that the Trust Fund will be required to make future payments on these claims is considered remote.

The Council may choose to terminate the Trust Fund, or the respective participants may choose to terminate their participation. In the event of such termination by either the Council or a participant, an updated actuarial study will be performed to determine amounts due to or from the participants based on loss experience up to the date of termination.

At June 30, 2006, University assets in the Trust Fund totaled $40,118,079 while University liabilities totaled $26,840,936 resulting in net assets of $13,277,143.

Additional disclosures relative to the funding status and obligations of the Trust Fund are set forth in the Audited Financial Statements of the Liability Insurance Trust Fund for the years ended June 30, 2006 and 2005. Copies of this report may be obtained from The University of North Carolina Liability Insurance Trust Fund, 6001 East Wing, University of North Carolina Hospitals, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-3041.

Term life insurance (death benefits) of $25,000 to $50,000 is provided to eligible workers. This Death Benefit Plan is administered by the State

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

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

NOTE 16 - COMMITMENTS AND CONTINGENCIES

A. Commitments - The University has commitments of $32,779,080 for various capital improvement projects that include construction and completion of new buildings, and renovations of existing buildings.

B. Pending Litigation and Claims – The Supreme Court of North Carolina issued a ruling on July 1, 2005, regarding litigation between North Carolina School Boards Association, et. al. v. Richard H. Moore, State Treasurer, et. al. which involves 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. The complaint alleged in part that the monetary payments collected pursuant to statutory authority by the University for violations of parking and traffic regulations and library fines are "civil penalties" which the State Constitution requires to be paid to the School fund in the county where they are collected. The lawsuit sought declaratory judgment that the State Civil Penalty and Forfeiture Fund, the State School Technology Fund, and the Public Settlement Reserve Fund are unconstitutional.

On December 14, 2001, the Wake County Superior Court ruled in favor of the Plaintiffs but has stayed enforcement of the ruling, pending appeal. The Defendants did appeal this judgment. The Court of Appeals affirmed in part and reversed in part the order of summary judgment by the Superior Court. The Supreme Court affirmed the Court of Appeals ruling that library fines are not civil penalties. The Supreme Court reversed the ruling that fines for parking and traffic regulations are not civil penalties. The Supreme Court ruling is under review to determine the financial impact on parking and traffic operations.

At issue is the effective date of the ruling. The amount of $10.2 million representing fines, net of refunds, from the Department of Public Safety has been collected from 1994-95 through 2004-05, and of that amount 10% may be retained by the University to fund related operating expenses. Therefore, $9.2 million may be payable by the University.

The amount of $3.6 million in collected fines remains unexpended should it be needed for a possible payment. Annual fines are approximately $900,000. Fines net of approved operating expenses have been remitted to the State Treasurer on a monthly basis beginning July 1, 2005. The current unexpended amount is based on the initial lawsuit date of December 14, 2001. An additional amount up to $5.6 million could be required if the effective date is determined to be earlier. It is not expected that the effective date of the ruling will be prior to fiscal year 1994-95.

The University is undertaking environmental remediation efforts on the Old Sanitary Landfill. The amount of the liability associated with this site cannot reasonably be estimated at this time.

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

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

Purpose	Amount
Pledges to Permanent Endowments	$ 43,985,497

NOTE 17 - RELATED PARTIES

Foundations - There are 12 separately incorporated nonprofit foundations associated with the University. These foundations are The Botanical Garden Foundation, Inc., The Dental Alumni Association, Inc., The Dental Foundation of North Carolina, Inc., The Educational Foundation, Inc., The General Alumni Association, The School of Government Foundation, Inc., The Law Alumni Association of N.C., Inc., The Morehead Scholarship Foundation, Inc., The Pharmacy Foundation of North Carolina, Inc., The School of Journalism and Mass Communication Foundation of North Carolina, Inc., The University of North Carolina at Chapel Hill Public Health Foundation, Inc., and The University of North Carolina at Chapel Hill School of Nursing Foundation, Inc.

These organizations serve, in conjunction with the University's component units (See Note 1A), as the primary fundraising arm of the University through which individuals, corporations, and other organizations support University programs by providing scholarships, fellowships, faculty salary supplements, and unrestricted funds to specific colleges and the University's overall academic environment. The alumni associations provide educational opportunities or other services to alumni. The University's financial statements do not include the assets, liabilities, net assets, or operational transactions of the foundations, except for support from each organization to the University. This support totaled approximately $18 million for the year ended June 30, 2006.

NOTE 18 - SUBSEQUENT EVENTS

In the last quarter of the fiscal year ending June 30, 2006, the Board of Governors, on behalf of The University of North Carolina at Chapel Hill and North Carolina State University, executed documents to increase the joint Commercial Paper Program from $240,000,000 to $500,000,000. Since the University provides liquidity support for the entire program, the University is in the process of obtaining a liquidity facility through Wachovia Bank in an initial committed amount of $300,000,000 (but with provisions that allow for the facility to be increased to up to $400,000,000, in increments of $25,000,000) to supplement its liquidity needs for the entire Commercial Paper program and the University's outstanding Variable Rate Demand Bonds. Currently, total outstanding bonds issued under the Commercial Paper Program are limited to $240,000,000 until the University delivers a new Offering Memorandum to the Issuing and Paying Agent for the Commercial Paper Program, the Bank of New York. This memorandum will be delivered upon the closing of the liquidity facility. Upon closing, this liquidity facility will replace the current liquidity facility in place with JP Morgan.

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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
The University of North Carolina at Chapel Hill
Chapel Hill, North Carolina

We have audited the financial statements of The University of North Carolina at Chapel Hill, 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 units, 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 January 16, 2007. 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 the discretely presented component units, as described in our report on the University's financial statements. The financial statements of the discretely presented component units were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide 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 AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *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*.

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

January 16, 2007

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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