
The University of
North Carolina
Health Care System
2006
Annual Report
For the year ending June 30, 2006
UNC
HEALTH CARE

Table of Contents

INTRODUCTION

Chapel Hill, North Carolina
For the year ending June 30, 2006

Greeting

January 16, 2007

Dear Friends:

Thank you for your interest in learning more about the successes, challenges and future plans of the UNC Health Care System. This is the second year that we have provided a voluntary accounting of operations across our complex 6,000-employee system. We are making public these financial results—as well as key details about the way we care for patients—because we continue to believe that those whose tax dollars support our work deserve to know how their money is spent. UNC Health Care truly belongs to the people of North Carolina.

Every day, more than 2,000 men, women and children from all over the state and from all walks of life, witness UNC Health Care employees carrying out its mission: to provide care to all North Carolinians regardless of where they live or whether they can afford to pay all of the bill. To be true to that mission, we continually strive to remove barriers to care, whether they are barriers of geography or of economics. For example, because we believe that people living in the western mountains or Down East deserve the same level of care enjoyed by residents of the Triangle, we are able to provide special training to physicians in remote areas so that they can provide a higher level of care. We also serve patients in areas beyond the resource-rich Triangle by providing consultations via "distance medicine" technologies—technologies that are erasing geographic barriers to the best health care available in North Carolina.

For patients with financial concerns—whether they are poor and uninsured or middle-class but burdened by the need for complex care—we remove barriers to care each day. About one-third of the people we treat systemwide cannot afford to pay for all or part of their care. We provide them, on average, $507,000 in medical care each day. We accept our responsibility to be the medical safety net for the state's most vulnerable residents.

We are the state's safety-net institution, but we refuse to deliver a level of care that has often defined such systems as providing a sub-par level of care with limited resources to serve a growing need. In order to care for patients at the highest levels, whether they are from the Triangle or elsewhere, or fully insured or homeless, we must have a stable financial base. The good news is that for the second year in a row we have maintained our financial stability at a level consistent with other leading public health care systems.

Our financial goal is an operating margin of 3 to 4 percent (the minimum recommended for academic medical centers) to ensure we have the resources, staff and technology to provide all North Carolinians with world-class health care. Still, providing charity and uncompensated care and supporting the needs of a leading academic medical center combine to make our operating costs much higher than those of many private-sector institutions. Our system provided more uncompensated care last year — $185 million — than ever before, while our state support was $44.5 million in FY06. Through the hard work of our employees, we have turned the corner from a negative margin to a stable foundation that will serve our patients well in a challenging health care future.

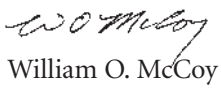
One way to ensure financial stability is to request that those patients who are most able to afford our services pay their insurance deductibles and co-payments; in some cases, we ask patients to pay a portion of their bill at the time of a procedure to reduce costs associated with billing and collection. We believe that recovering costs from those who can pay even a little represents good stewardship of the public money we receive each year. At the same time, we are changing practices to ensure every patient who needs financial assistance has access to counselors who will help them obtain appropriate resources.

It is in reaching out to those living beyond the Triangle and to those least able to afford medical care that our motto—*Leading, Teaching, Caring*—becomes more than words. So, in addition to opening our books for your inspection, we also want to share a story with you—a story about how our outreach efforts benefit the people of North Carolina. You can read about these efforts on the next few pages.

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

Sincerely,

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



William O. McCoy
Chair, Board of Directors (November 2005-Present)
University of North Carolina Health Care System

Removing financial barriers to care

Every person who seeks medical care at any UNC Health Care facility receives it, whether they have health insurance and a seven-figure portfolio, no insurance and a modest income, or are receiving state or federal benefits. The clinicians and other professionals who treat the men, women and children who enter our doors are need-blind. Nearly one-third of these patients will end up receiving some sort of financial assistance from UNC Health Care. In fact, the system provides $507,000 in uncompensated care every single day. Last fiscal year, UNC Health Care provided $185 million worth of uncompensated care, the most in the system's history.

To make sure that no ill or injured North Carolinian slips through the safety net that UNC Health Care represents, the following policies and procedures are in place:

- All uninsured patients receive an automatic 25 percent discount on physician and hospital services.
- More North Carolina families are eligible for charity care than ever before due to a policy change that lowered the income threshold.
- Every uninsured person admitted for care at UNC Hospitals is assigned a Medical Assistance Counselor to be their advocate.

The 22 Medical Assistance Counselors, or MACs as they are informally known, must balance the needs and concerns of patients against the financial viability of the system. Thanks to their training, compassion and judgment, they are usually able to do both successfully. They make sure that patients who are eligible for state Medicaid and federal Social Security benefits receive them. They also help patients with

insurance but little income manage their out-of-pocket costs, and they assist patients who don't have coverage for long-term care navigate the system to get there. However, as their patients often tell them in letters, calls and hugs, they help people get better by taking away their financial worries.

Here are some actual accounts of UNC Health Care patients—all of them uninsured—whose worries were lessened by the MAC team.

Easing the financial burden when tragedy strikes

No one expects to spend their vacation in a hospital, much less in intensive care fighting for their life. But that's exactly what happened to 25-year-old Christopher McAllister in July 2006. Christopher was in Sampson County to attend a family reunion when he was in a devastating car wreck. Due to the severity of his injuries, he was air-lifted to UNC Hospitals, where he would end up staying for several months. Because Christopher had no health insurance, UNC Health Care Medical Assistance Counselor (MAC) Cathy Harrison stepped in to help him and his mother, Helen Robinson, with financial arrangements.

The first thing Cathy did was advise the two of them to figure out where Christopher would live after he was discharged since he had been working in Pennsylvania before his accident. Once it was decided that Christopher would live with his mother in Archerville, N.C., Cathy helped him apply for Medicaid benefits through the state; and when Christopher's doctors told

him his paralysis was permanent, Cathy helped him apply for Social Security disability benefits.

"The family told me that once the great financial burden was removed from them, they were able to focus on Christopher's recovery," says Cathy, who notes that Christopher's costs for hospitalization and rehabilitation reached the mid six-figures. "Christopher and his mother have told me on several occasions how appreciative they are of the care and service they received at UNC Health Care."

Christopher was discharged from the Rehabilitation Unit in November 2006; and Cathy reports that during their most recent phone conversation, he was in good spirits.

For Cathy, a 13-year veteran of the MAC office, helping Christopher and the hundreds of other uninsured patients who are assigned to her each year is both rewarding and humbling. "The motto I try to remember before going to see a patient is to first step into their shoes and to treat people the way I would want to be treated."

Going above and beyond the call of duty is all in a day's work

Learning that you have terminal lung cancer is harrowing enough without worrying how you and your loved ones are going to afford treatment. That's the grim situation in which 59-year-old Catherine Burke of Fuquay-Varina found herself in the fall of 2005; but Catherine and her husband, Herbert, felt some measure of relief when they met Angie Allen during Catherine's admittance to UNC Hospitals that October. Angie, a Medical Assistance Counselor, helped the Burkes file for Social Security disability benefits and Medicaid because Catherine had no health insurance. Without these benefits, Catherine's treatment costs would have burdened her husband long after her death.

Even after all the paperwork was processed, Angie still kept tabs on Catherine; and when she learned that Catherine was feeling self-conscious and depressed about the tracheotomy opening in her neck, Angie decided to help once again. She used her own money to buy two pretty crocheted scarves that Catherine could use to improve her appearance.

"They were a lightweight material so they wouldn't block her airway," says Angie. "I just wanted her to know I was thinking about her."

The Burkes were so touched by Angie's support that when Catherine passed away in the spring of 2006, Herbert called to let her know how much the gift had meant to her and to thank her for making things so smooth for them.

"In my opinion, it's all in a day's work," Angie says.

Paperwork is just part of the process for MACs

When she arrived at UNC Hospitals after being ejected from her car, no one expected Millie Brewington to survive. But Millie's fighting spirit and her physicians' skills were more than a match for the Sampson County car accident that hospitalized her. Once she started getting better, Medical Assistance Counselor Robin Davidson helped her apply for Medicaid and Social Security disability benefits. Because Millie was still immobile from her injuries, Robin made frequent visits to her room to complete the lengthy and completed forms.

"Ms. Brewington thanked me for assisting her in getting Medicaid and for being part of a 'team of angels' at UNC Health Care that assisted in her healing," reports Robin. "Even today, five years after the accident, when Ms. Brewington returns to our facility for care she occasionally drops by to see me and update me on how she is progressing with her recovery."

For Robin, helping patients navigate the complicated process of receiving state and federal benefits is always rewarding. "I feel very proud to be a part of the MAC team and for the role we have in helping patients in their healing and recovery."

UNC Hospitals by the Numbers

Number of emergency room encounters per year: 61,200

Number of clinic visits per year: 741,980

Number of surgical cases per year: 22,347

Number of transplant cases per year: 279

Number of births per year: 4,000

Number of beds: 708

Number of attending physicians: 1,188

Number of medical residents: 714

Number of hours provided by volunteers: 61,797

Number of employees: 5,768

(Source: Useful Facts - UNC Hospitals Fiscal Year 2007 Budget)

Removing geographic barriers to care

As the state's leading public academic health care system, UNC attracts patients from the mountains to the coast. Physicians across North Carolina refer their patients to the UNC Health Care System and its satellite facilities for surgery, cancer treatment, organ transplants, high-risk pregnancies and medical issues that they lack the training or resources to treat. In fact, some 70 percent of patients who are treated within the UNC Health Care System come from outside the Triangle area.

But it's not just patients who are traveling. For decades, physicians on staff at UNC Health Care have lent their expertise to clinics and practices far from the Triangle, often in rural areas or towns underserved by specialists. Whether by providing training to fellow physicians or specialized care to patients, the physician outreach team at UNC Health Care has made a difference in the lives of thousands of North Carolinians.

For two UNC Health Care pediatricians, the long commute they make frequently is well worth the trip—they know there aren't enough pediatric sub-specialists to effectively treat the 14 percent of North Carolina children who have one or more chronic conditions.

Dr. Stuart Gold, a pediatric hematologist, is no stranger to parental gratitude when his care improves—or even saves—the life of a child suffering from a blood cancer or other disorder. But he thinks the parents of the children he sees once a month at a pediatric specialties clinic at Wilmington's New Hanover Regional Medical Center are even more appreciative.

"The families are very grateful because they don't have to travel," says Dr. Gold, an 18-year veteran of the physician outreach team. "They also like the added expertise we provide, and they know they can follow up with us directly if they have questions."

Since there is no pediatric hematologist in the Wilmington area, Dr. Gold sees a lot of patients—about 30 each time he makes a visit. Some children come in for follow-ups after treatment for leukemia or other blood cancers; others are referred for diagnoses relating to abnormal blood work; still others are seen for treatment of sickle-cell diseases.

Dr. Gold notes that it's sometimes easier to get closer to the patients in Wilmington than the ones he sees in Chapel Hill. "We've developed a nice rapport there."

Another UNC physician whose services are in demand outside the Triangle is Dr. John Cotton, a pediatric cardiologist. Since there are no pediatric cardiologists in either the Rutherfordton or Wilmington areas, he makes trips there monthly and weekly, respectively. He sees patients ranging from pregnant women carrying fetuses with heart abnormalities to children, adolescents and young adults with cardiac conditions such as arrhythmias and valve problems.

Like Dr. Gold, Dr. Cotton finds the outreach experience especially rewarding. "It's much more efficient for us to go to them, especially since some of the parents don't have the means or opportunity to travel," says Dr. Cotton, who has been making these long commutes since 1998. "The parents are very grateful that we come, and when we can't sometimes—like when hurricanes or tornadoes are predicted or seen and our plane is grounded—people are very understanding."

The clinics and pediatric practices Drs. Gold, Cotton and their colleagues visit are members of the N.C. Area Health Education Centers program (AHEC), which matches resource-rich medical systems and providers with underserved communities and populations in nine regions of the state. The AHEC program office has been headquartered at the UNC-Chapel Hill School of Medicine since 1972. Through AHEC and similar initiatives, UNC will continue expanding its presence throughout North Carolina to treat patients who need the most help.

UNC Health Care and UNC Hospitals:
Achievements from July 2005 to July 2006

September 2005	The federal Agency for Healthcare Research and Quality (AHRQ), in collaboration with UNC Health Care, hosts the AHRQ's first town hall meeting with consumers and health care quality experts at the Friday Center for Continuing Education in Chapel Hill.
	Ground is broken for construction of the North Carolina Cancer Hospital. The keynote speaker for the groundbreaking ceremony is Dr. Andrew von Eschenbach, director of the National Cancer Institute.
	A special online publication of The New England Journal of Medicine publishes results from ACRIN Digital Mammographic Imaging Screening Trial (DMIST), for which UNC's Dr. Etta Pisano was lead investigator and lead author. The study found that digital mammography detected significantly (up to 28 percent) more cancers than screen film mammography in women ages 50 and younger, premenopausal and perimenopausal women, and women with dense breasts.
October 2005	The National Cancer Institute names the UNC Lineberger Comprehensive Cancer Center as one of seven institutions nationwide in the NCI Alliance for Nanotechnology in Cancer.
	The Agency for Healthcare Research and Quality (AHRQ) selects the University of North Carolina at Chapel Hill to conduct studies testing what treatments work best for particular health conditions — and with the goal of promoting better patient outcomes. UNC is one of 13 centers nationwide named as part of AHRQ's new Effective Health Care program.
December 2005	A computerized system developed by University of North Carolina at Chapel Hill and N.C. Division of Public Health experts to detect bioterrorism and infectious disease outbreaks receives a prestigious national award for excellence. The Healthcare Information and Management Systems Society (HIMSS) announces that the N.C. Disease Event Tracking and Epidemiological Collection Tool (NC DETECT) is one of two recipients of the 2005 Nicholas E. Davies Award of Excellence in the public health category.

UNC Hospitals partners with Cape Fear Valley Health System to bring air ambulance service to Fayetteville, N.C.

January 2006

UNC Hospitals is the first in North Carolina and one of the first medical centers nationwide to establish a Pediatric Rapid Response Team.

Researchers at UNC, in collaboration with colleagues in Australia, publish an article in The New England Journal of Medicine reporting that inhaling a saltwater aerosol solution twice a day is an effective treatment for lung problems associated with cystic fibrosis.

A UNC-led data review establishes that a chemotherapy regimen known as FOLFOX4 is as safe and effective for the elderly as it is for younger patients. Dr. Richard Goldberg presents these findings to a gastrointestinal cancer symposium in San Francisco convened by the American Society of Clinical Oncology, the American Society of Radiation Oncology, the American Gastroenterological Association and the Society of Surgical Oncology.

March 2006

The Agency for Healthcare Research and Quality releases a report on cesarean delivery on maternal request by researchers at the RTI International-University of North Carolina at Chapel Hill (RTI-UNC) Evidence-based Practice Center. UNC's Dr. Anthony Visco served as clinical director for the evidence review that led to the report.

U.S. News & World Report releases its annual "America's Best Graduate Schools" issue. Overall, the UNC School of Medicine is ranked 2nd for primary care and ties for 20th in research. In specialty areas, UNC ranks 2nd in family medicine, ties for 4th in rural medicine and ranks 9th in women's health.

May 2006

Dr. Robert S. Sandler, chief of UNC's Division of Gastroenterology and Hepatology, becomes vice president of the American Gastroenterological Association.

The University of North Carolina at Chapel Hill is named the lead institution in a new study of rare genetic airways disorders, such as cystic fibrosis and primary ciliary dyskinesia, launched as part of the National Institute of Health's Rare Diseases Clinical Research Network (RDCRN). UNC also heads a multi-center group within the network called the Genetic Diseases of Mucociliary Clearance Consortium (GDMCC).

The University of North Carolina at Chapel Hill receives a $22.6 million grant from the Bill & Melinda Gates Foundation to support a pivotal clinical trial of a promising new oral drug for treating African sleeping sickness. Dr. Richard R. Tidwell, a professor in UNC's Schools of Medicine and Pharmacy, is the project's principal investigator.

June 2006

The Journal of the American Medical Association publishes a collaborative study co-authored by Dr. Lisa Carey, Dr. Charles Perou and others from the UNC Schools of Medicine and Public Health which finds that breast cancer in younger black women is more likely to be an aggressive variety.

UNC Health Care is named a laureate and finalist in the Computerworld Honors Program for the Web Clinical Information System (WebCIS), which links 7,000 doctors and nurses at UNC Hospitals and across the state with the records generated by 1 million UNC patient visits each year. The annual Computerworld Honors Program honors organizations and individuals for innovative uses of information technology.

Rex Healthcare 2006 Accomplishments and Accolades

- Rex Healthcare was chosen as a 2006 Consumer Choice Award winner. Each year, National Research Corporation honors those hospitals whose consumers select as them as having the best quality of care and image based on a national study of over 200,000 households. Rex was once again the only hospital in Raleigh to receive this honor. The outstanding service provided to patients and their families is why this award was received.

- Rex Hospital was the first hospital in the Triangle to receive Magnet recognition from the American Nursing Association, placing Rex nurses in the top 2% in the nation.

- Rex received the Distinguished Hospital Award for both Clinical Excellence and Patient Safety ™ by HealthGrades, an independent national healthcare research organization.

- HealthGrades also awarded Rex the 2006 Women's Health Excellence Award, ranking it among the top 10% in the nation for Women's Health and the only hospital in North Carolina with that ranking, as well as the only five star-rated hospital for Women's Health in North Carolina.

- Physician Satisfaction Scores – Physician satisfaction scores show a 97% satisfaction rate for FY2006.

- Surgery Numbers — Rex's number of outpatient surgeries increased by 9% from FY2005 to FY2006, for a total of 23,701. The number of inpatient surgeries increased by 5%, totaling 8,071.

- Market Share — Rex market share increased by 3%.

- New Rex Surgery Center — Rex held a grand opening for a new state-of-the-art surgery center with 12 operating rooms. The first patients were served in June.

- Cancer Center Renovations — Renovations in the Rex Cancer Center were complete in June and the Center re-opened there. Rex Hematology Oncology added two new oncologists. The radiation oncology area added one new oncologist.

- Record OB Deliveries — The Rex Family Birth Center delivered a record 6,300 babies. The increase from the annual average of 5,000 deliveries resulted from the closing of the maternity unit at Duke Health Raleigh.

- Wakefield Additions — Rex opened Rex Urgent Care of Wakefield in March. Rex also added MRI to Wakefield and broke ground for a new Wellness Center on December 7, 2006.

- Electronic Medical Records — Rex began installing our new electronic medical records system, RCare, for utilization beginning in early 2007. This system will further improve patient safety.

Letter of Transmittal

November 30, 2006

To the Governor, the State Auditor, members of the General Assembly, members of the UNC Board of Governors, UNC Chapel Hill Board of Trustees, supporters of the University of North Carolina Health Care System, members of the UNC HCS Board of Directors, and William L. Roper, CEO.

INTRODUCTION

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

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

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

FINANCIAL INFORMATION

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

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

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

Budgetary Controls

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

N. C. General Statute 116-37 granted to the UNC HCS flexibility for management of UNCH in regard to its policies for personnel and salary management, purchasing of goods, services and property, and property construction. On an annual basis, the UNC HCS submits a report on its activity under this flexibility. The report is sent to the Health Affairs Committee of the Board of Governors and the Joint Legislative Commission on Governmental Operations on or before September 30 each year.

The UNC HCS is subject to the provisions of the Executive Budget Act; and, as such, monthly reports are submitted to the Office of State Budget and Management. Under the budgetary procedure followed by the state, all state revenues are appropriated by the General Assembly pursuant to appropriation acts adopted every two years. The UNC HCS receives state Appropriations of approximately $44 million on an annual basis. The General Assembly appropriates these funds from the

General Fund to cover a portion of operating expenses, which includes a portion of costs attributable to providing care to indigent patients and graduate medical education.

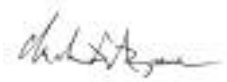
Debt Administration
During the past year, UNCH and REX borrowed funds for the purchase of capital equipment items. These borrowings were done at a favorable interest rate that allowed these entities to retain their existing funds invested. There were no instances of default or covenant compliance in regard to debt service payments. The UNC HCS's goal is to continue to maintain its bond ratings at the highest level possible in order to provide access to the tax-exempt bond market for future issues.

Cash and Investment Management
The UNC HCS worked with the Office of the State Treasurer to begin an investment plan for UNCH. This option became available after the General Assembly made changes in the General Statutes during its 2005 session. The additional investment earnings will subsidize operating income and enable UNC HCS to make more services available to the citizens of the State of North Carolina. The cash management policy includes all areas of receipts and disbursements so that investment earnings are maximized and vendor relations are maintained.

Risk Management
Exposures to loss are handled by a combination of methods, including participation in state-administered insurance programs, purchase of commercial insurance and self-retention of certain risks. The key to managing risk is to ensure that programs are in place that educate and guide employees to the best practices for our industry. We have a responsibility to safeguard our patients so that no additional harm comes to them while under our care. In addition, we have to ensure a safe workplace for our employees.

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

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



Charles F. Ayscue
Chief Financial Officer

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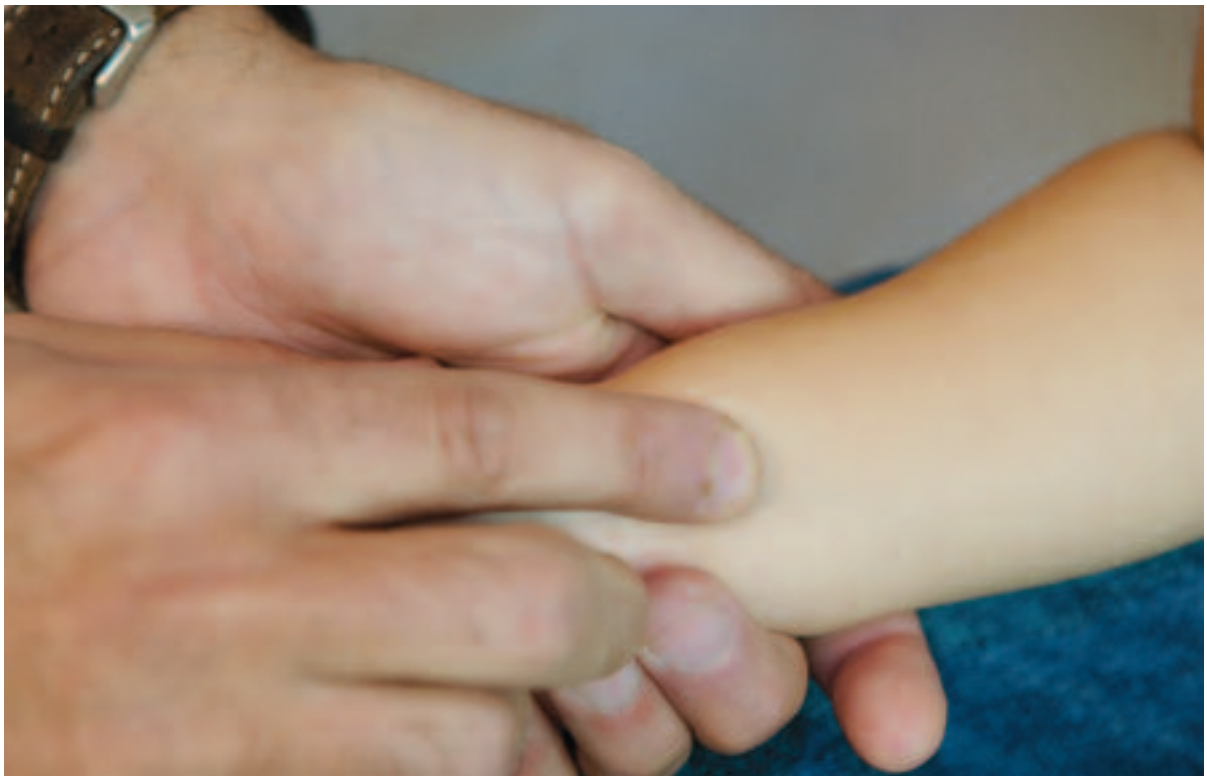
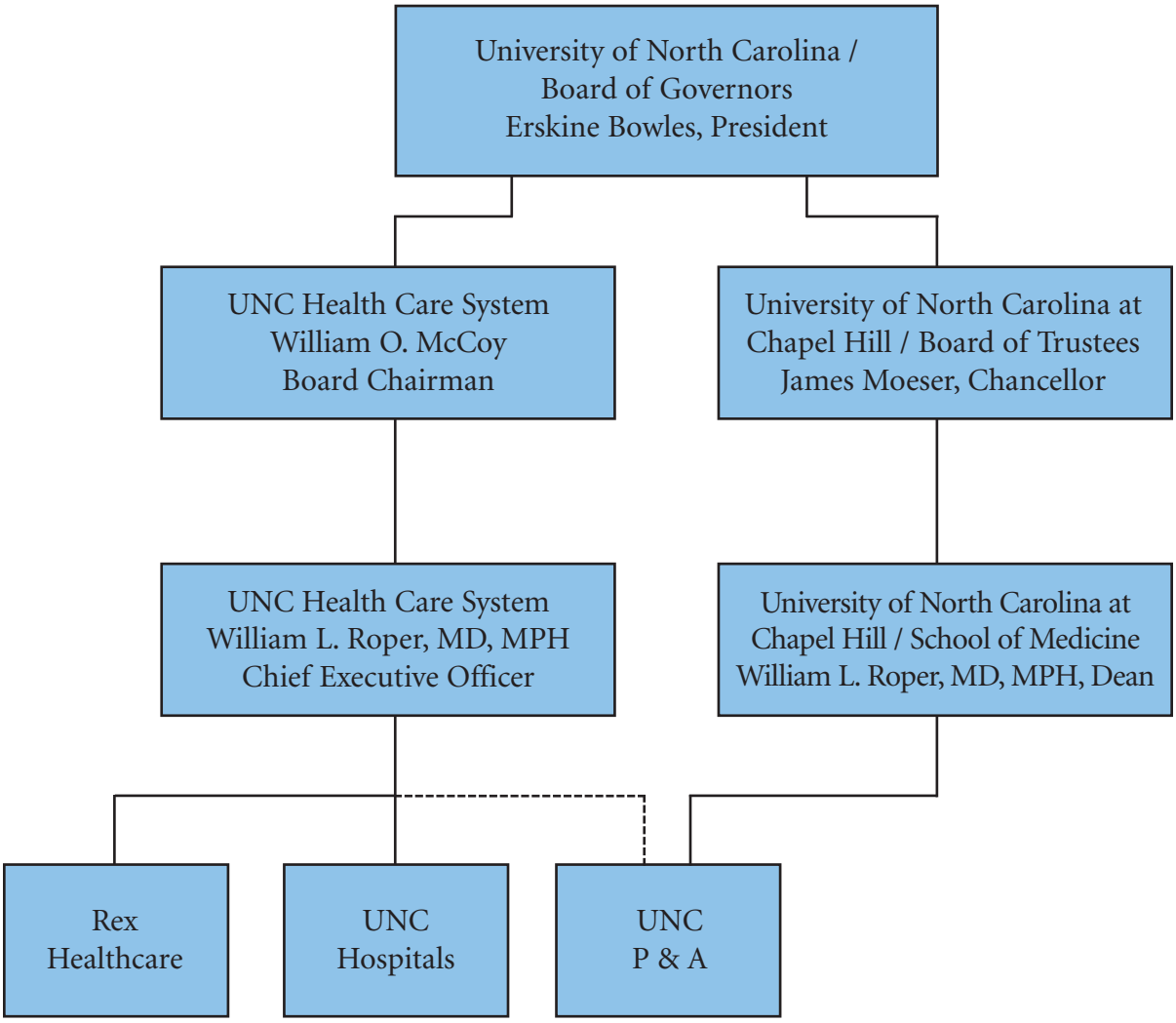


UNC Health Care System Reporting Structure for the year ended June 30, 2006



FINANCIALS AND STATISTICS

Chapel Hill, North Carolina
For the year ending June 30, 2006

Management's Discussion and Analysis

Introduction
Management's discussion and analysis provides an introduction and overview of the financial position and activities of the University of North Carolina Health Care System (UNC HCS) for the fiscal years ended June 30, 2005 and 2006. The financial statements included for the UNC HCS are labeled "Proforma" to demonstrate that they are an aggregation of assets and liabilities and results of financial activities which cannot be the subject of an unqualified opinion by an independent auditor. The reasons for the proforma descriptive are as follows:

> The UNC HCS was established November 1, 1998 by North Carolina General Statute 116-37. The original legislation included only the University of North Carolina Hospitals (UNCH) and the clinical patient care programs of the University of North Carolina at Chapel Hill (UNC-Chapel Hill). The UNC HCS is governed by a Board of Directors and as an affiliated enterprise of the University of North Carolina. The UNC HCS and UNC-Chapel Hill are sister entities. Rex Healthcare, Inc. (REX) and various community-based clinics have been added to the organization since its inception.

As illustrated on the organization chart on page 20 in the Introductory Section, the UNC HCS owns or controls the net assets and financial operations of UNCH and REX. UNC-CH owns and controls the net assets and financial operations of UNC Physicians & Associates (UNC P&A.) The UNC HCS Board of Directors governs and oversees physician credentialing, quality and patient safety, and resident training while monetary operations of UNC P&A remain within UNC-Chapel Hill. The physicians who provide patient care at UNCH and

in UNC-Chapel Hill clinics are employees of UNC-Chapel Hill. Non-physician employees who assist in providing patient care and the associated administrative, billing and collection services are employees of UNC HCS.

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

In the interest of being concise, we have included proforma consolidated financial statements for the UNC HCS, which include UNCH, REX, and UNC P&A. Since UNC P&A's financial activities are not separately disclosed elsewhere, we are also presenting UNC P&A's Statements for the fiscal years ending June 30, 2005 and 2006.

Using the Financial Statements

The Governmental Accounting Standards Board (GASB) requires three basic statements: the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows.

The proforma financial statements are presented and follow reporting concepts consistent with those required of a private business enterprise. The balances reported are presented in a classified format to aid the reader in understanding the nature of the operations. The accompanying notes are an integral part of this report and should be read in conjunction with the financial statements to enhance understanding.

The proforma Statement of Net Assets provides information relative to the assets, liabilities and net assets as of the last day of the fiscal year. Assets and liabilities on this Statement are categorized as either current or noncurrent. Current assets are those that are available to pay for expenses in the next fiscal year, and it is anticipated that they will be used to pay for current liabilities. Current liabilities are those payable in the next fiscal year. Under GASB, the net assets should be categorized as invested in capital assets (net of related debt), restricted or unrestricted; but due to the complexities of the various entities, no such distinction has been

made. Overall, the Statement of Net Assets provides information relative to the financial strength of the organization and its ability to meet current and long-term obligations.

The proforma Statement of Revenues and Expenses provides information relative to the results of the enterprise's operations, nonoperating activities and other activities affecting net assets, which occurred during the fiscal year. Nonoperating activities include noncapital gifts and grants, investment income (net of investment expenses), and loss realized on the disposition of capital assets. Other activities include change in fair value of investments and gain or loss on affiliate activity. Under GASB, the subsidy from the State of North Carolina in the form of appropriation and bond interest expense are considered nonoperating activities; but for these proforma statements, they are presented as operating. In general, the Statement of Revenues and Expenses provides information relative to the management of the organization's operations and its ability to maintain its financial strength.

The proforma Statement of Cash Flows provides information relative to the sources and uses of cash for operating activities, noncapital financing activities, capital and related financing activities, and investing activities. The statement provides a reconciliation of beginning cash balances to ending unrestricted cash balances and is representative of the activity reported on the proforma Statement of Revenues, Expenses, and Changes in Net Assets as adjusted for changes in the beginning and ending balances of noncash accounts on the proforma Statement of Net Assets. The proforma statement does not reflect all of the changes in cash that are in the Assets Whose Use is Limited or Restricted category.

The Notes provide information relative to the significant accounting principles applied in the financial statements and further detail concerning the organization and its operations. In general, these disclosures provide information to better understand details, risk, and uncertainty associated with the amounts reported and are considered an integral part of the financial statements.

Comparison of Two-Year Data

Comparative data for 2005 and 2006 is presented this year and a discussion of the data is in the following sections.

Analysis of Overall Financial Position and Results of Operations

The UNC HCS Statement of Net Assets reflects a large, successful system, with over one billion dollars in net assets. Net assets increased by 9% during the year ending June 30, 2006. UNCH and REX combine for over $969 million, while UNC P&A has approximately $112.6 million in net assets. For the year, the System generated an operating margin of 3.3%, or $42.0 million on net operating revenue of $1.3 billion. Net income was $71.8 million, or 5.5% compared to 4.0% for the prior year. In order to remain financially strong, to reinvest in new facilities and to retain the most highly trained work force, the UNC HCS's goal is to average at least 3% for its annual operating margin.

UNC P&A also had a very successful year financially. Its net income was $14.7 million or 7.1% on operating revenue of $206.6 million. This compares with the prior year net income of $10.6 million, or 5.5% on operating revenue of $192.5 million.

Discussion of Capital Asset and Long-Term Debt Activity

Capital Assets

The System continued to improve and modernize its facilities during the past year. Projects at UNCH included the start of the cancer hospital and physicians' office building, the acquisition of land for future wellness center and clinic ventures, and renovation of patient space for bed expansion and relocation.

Capital projects placed in service at REX included an expansion of the Rex Surgery Center (12 state-of-the-art, digital operating suites), the Minor Procedure Center, the replacement of two MRIs on the Rex main campus and the opening of a new MRI at Rex Healthcare of Cary.

Long-Term Debt Activity

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

During the past fiscal year, UNCH and REX entered into capital lease financing arrangements to fund equipment purchases. Additional information about this activity can be found in the notes to the proforma statements.

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

The major source of funding for the UNC HCS is the revenue it generates from patient care services. Despite adjustments to billing rates on an annual basis, overall reimbursement has continued to deteriorate in recent years due to pressure from third-party payors and changes in the mix of the patient population. Meanwhile salaries, supplies and other operating expenses have continued to increase.

During the past fiscal year, the UNCH and UNC P&A implemented a self-pay discount policy which provides a 25% discount on medically necessary procedures to all patients who do not have insurance coverage. The funding for this policy came from improved efficiency and cost reductions in supply chain management. The system continues to pursue cost reduction and revenue enhancement, while not sacrificing the level of patient care. This approach produced favorable results for the past year. However, the UNC HCS faces more challenges as the health care environment changes, along with the additional competition for governmental dollars that may be diverted away from the Medicare and Medicaid programs to fund other programs.

These changes are a result of efforts by the federal and state governments, private insurance companies and business coalitions to reduce and contain health care costs, including, but not limited to, the costs of inpatient and outpatient care, physician fees, capital expenditures and the costs of graduate medical education. Continuously under consideration are a wide variety of federal and state regulatory actions and legislative and policy changes by both governmental and private agencies that administer Medicare, Medicaid and other third-party payor programs that could impact our reimbursement. In addition, UNC HCS is subject to actions by, among others, the Joint Commission on Accreditation of Healthcare Organizations (JCAHO), the Centers for Medicare and Medicaid Services (CMS) of the U.S. Department of Health and Human Services (DHHS) and other federal, state and local government agencies. The biggest concern for the UNC HCS would be the elimination of cost-based reimbursement that is currently received by UNCH and UNC P&A from the Medicaid program and any changes to the appropriation support received from the State of North Carolina.

Medicaid Cost Report income represents an important source of funding for UNC P&A as represented by the $6.8 million in net proceeds in FY05 and $16.2 million in FY06. Per the State Plan for Medical Assistance for North Carolina, the medical faculty practice plan of UNC-Chapel Hill is reimbursed at cost and is cost-settled at year-end for services provided to Medicaid patients. A change to terminate this North Carolina Medicaid reimbursement methodology would materially alter the financial outlook for UNC P&A.

Congress acted to freeze the 2007 Medicare reimbursement rates at the 2006 level. Future years could have decreases without Congressional action.

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM
PROFORMA STATEMENT OF NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2006 AND JUNE 30, 2005

	2006	2005
Current Assets		
Cash and Investments	$ 229,365,221	148,423,090
Patient Accounts Receivable – Net	196,253,102	182,941,405
Inventories	21,208,965	20,196,037
Estimated Third-Party Settlements	6,973,403	20,075,852
Other Assets and Receivables	23,946,352	23,079,551
Assets Whose Use is Limited or Restricted	27,823,372	10,249,207
Prepaid Expenses	8,903,402	8,629,510
Total Current Assets	514,473,816	413,594,652
Non-current Assets		
Property, Plant, and Equipment – Net	598,041,172	576,218,692
Assets Whose Use is Limited or Restricted	586,859,686	517,768,295
Other Assets	11,240,895	10,684,943
Total Non-current Assets	1,196,141,753	1,104,671,930
TOTAL ASSETS	**$ 1,710,615,569**	**1,518,266,582**
Current Liabilities		
Accounts and Other Payables	43,886,730	51,891,613
Accrued Salaries and Benefits	49,902,226	25,871,145
Estimated Third-Party Settlements	36,271,429	6,963,000
Notes and Bonds Payable	29,363,394	12,639,700
Interest Payable	2,557,071	1,974,719
Other	14,421,420	12,284,553
Total Current Liabilities	167,555,605	111,624,730
Non-current Liabilities		
Notes and Bonds Payable – Net and Arbitrage	414,552,478	376,542,141
Compensated Absences	37,356,037	35,747,558
Total Non-current Liabilities	460,755,181	412,289,699
TOTAL LIABILITIES	**628,310,786**	**523,914,429**
NET ASSETS	**1,082,304,783**	**994,352,153**
TOTAL LIABILITIES AND NET ASSETS	**$1,710,615,569**	**$1,518,266,582**

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM
PROFORMA STATEMENT OF REVENUES AND EXPENSES
FOR THE YEARS ENDED JUNE 30, 2006 AND JUNE 30, 2005

	2006	2005
Operating Revenue		
Net Patient Service Revenue	$ 1,185,526,263	$1,106,407,800
State Appropriations	44,510,208	39,333,826
Other Operating Revenue	68,809,271	61,491,252
TOTAL OPERATING REVENUE	**$1,298,845,742**	**1,207,232,878**
Operating Expenses		
Salaries and Fringe Benefits	721,766,613	670,935,496
Medical and Surgical Supplies	218,390,227	199,469,207
Contracted Services	104,449,164	97,491,291
Other Supplies and Services	81,722,518	75,953,518
Communications and Utilities	26,597,719	23,600,383
Medical Malpractice Costs	16,620,796	28,963,665
Depreciation	59,453,148	63,243,169
Bond and Other Interest Expense	19,700,823	18,074,068
Medical School Trust Fund (MSTF)	7,819,766	7,459,983
TOTAL OPERATING EXPENSES	**$ 1,256,520,774**	**1,185,190,780**
NET OPERATING INCOME	**42,324,968**	**22,042,098**
Non-operating Gains (Losses)		
Interest and Investment Income	32,132,980	24,534,445
Non-operating Income (Expense)	(12,677,294)	2,214,820
Capital Grants	10,057,905	-
TOTAL NON-OPERATING GAINS (LOSSES)	**29,513,591**	**26,749,265**
NET INCOME (LOSS)	**$ 71,838,559**	**$ 48,791,363**

Note: Due to UNC-Chapel Hill transfers and other eliminations between UNC HCS entities, the Net Income shown above is not equal to the change in Net Assets reflected on the Statement of Net Assets.

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM
PROFORMA STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2006

	2006
CASH FLOWS FROM OPERATING ACTIVITIES	
Received from Patients and Third Parties	$ 1,214,625,444
Payments to Employees and Fringe Benefits	(696,127,284)
Payments to Vendors and Suppliers	(422,589,541)
Payments for Medical Malpractice	(26,540,518)
Other Receipts	68,256,700
Net Cash Provided (Used)	137,624,800
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES	
State Appropriations	44,510,208
Net Cash Provided (Used)	44,510,208
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES	
Principal and Arbitrage Paid on Outstanding Debt	(32,399,517)
Interest and Fees Paid on Debt	(17,640,821)
Capital Grants	10,057,905
Proceeds from Equipment Loan Financing Agreement	80,000,000
Acquisition and Construction of Capital Assets	(83,199,022)
Net Cash Provided (Used)	(43,181,455)
CASH FLOWS FROM INVESTING ACTIVITIES	
Investment Income and Other Activity	32,132,980
Purchase of Investments and Related Fees	(69,091,391)
Investments In and Loans to Affiliated Enterprises–Net	(21,053,012)
Net Cash Provided (Used)	(58,011,423)
NET INCREASE (DECREASE)	**80,942,130**
BEGINNING CASH AND CASH EQUIVALENTS	**148,423,090**
ENDING CASH AND CASH EQUIVALENTS	**229,365,220**

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM
UNIVERSITY OF NORTH CAROLINA PHYSICIANS & ASSOCIATES
STATEMENT OF NET ASSETS (UNAUDITED)
FOR THE YEARS ENDED JUNE 30, 2006 AND JUNE 30, 2005

	2006	2005
Current Assets		
Cash and Investments	$ 90,393,445	$83,242,096
Patient accounts Receivable – Net	25,356,369	24,048,671
Inventories	-	-
Estimated Third-Party Settlements	-	-
Other Assets and Receivables	6,377,324	1,868,887
Assets Whose Use is Limited or Restricted	13,491,405	6,438,566
Prepaid Expenses	-	-
Total Current Assets	135,618,543	115,598,220
Non-current Assets		
Property, Plant and Equipment – Net	9,548,400	10,598,100
Assets Whose Use is Limited or Restricted	-	-
Other Assets	-	-
Total Non-current Assets	9,548,400	10,598,100
TOTAL ASSETS	**$** 145,166,943	126,196,320
Current Liabilities		
Accounts and Other Payables	2,359,866	7,280,884
Accrued Salaries and Benefits	5,230,917	4,846,650
Estimated Third-Party Settlements	-	-
Notes & Bonds Payable	1,149,700	1,049,700
Interest Payable	-	-
Other	1,771,198	1,660,996
Total Current Liabilities	10,511,680	14,838,230
Non-current Liabilities		
Notes and Bonds Payable – Net and Arbitrage	8,398,700	9,548,400
Compensated Absences	13,847,408	9,990,518
Estimated Third-Party Settlements	-	-
Total Non-current Liabilities	22,246,108	19,538,918
TOTAL LIABILITIES	**32,757,788**	**34,377,148**
NET ASSETS	**112,409,154**	**91,819,172**
TOTAL LIABILITIES AND NET ASSETS	**$ 145,166,943**	**$ 126,196,320**

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM
UNIVERSITY OF NORTH CAROLINA PHYSICIANS & ASSOCIATES
STATEMENT OF REVENUES AND EXPENSES (UNAUDITED)
FOR THE YEARS ENDED JUNE 30, 2006 AND JUNE 30, 2005

	2006	2005
Operating Revenue		
Net Patient Service Revenue	$ 170,080,764	160,400,482
State Appropriations	-	-
Other Operating Revenue	36,507,147	32,077,595
NET OPERATING REVENUE	$ 206,587,911	192,478,077
Operating Expenses		
Salaries and Fringe Benefits	158,140,552	137,266,362
Medical and Surgical Supplies	473,655	265,546
Contracted Services	6,108,223	3,001,381
Other Supplies and Services	22,940,137	19,684,001
Communications and Utilities	4,304,189	4,532,935
Medical Malpractice Costs	2,995,157	10,233,164
Depreciation	217,781	411,297
Bond and Other Interest Expense	1,456,776	1,355,470
Medical School Trust Fund (MSTF)	7,819,766	7,459,983
TOTAL OPERATING EXPENSES	$ 204,456,236	184,210,139
OPERATING INCOME (LOSS)	2,131,675	8,267,938
Non-operating Gains (Losses)		
Interest and Investment Income	4,361,866	3,232,824
Non-operating Income (Expense)	(875,672)	(909,936)
Gain (Loss) on Investment in Affiliates	-	-
Realized and Unrealized Investment Activity	-	-
Transfers to HCS Enterprise Fund	(750,000)	
Transfers from HCS Enterprise Fund	9,800,000	
TOTAL NON-OPERATING GAINS (LOSSES)	12,536,194	2,322,888
NET INCOME (LOSS)	$ 14,667,869	10,590,826

Note: Due to UNC-Chapel Hill transfers and other eliminations between UNC HCS entities, the Net Income shown above is not equal to the change in Net Assets reflected on the Statement of Net Assets.

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM
PROFORMA STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2006

	2006
CASH FLOWS FROM OPERATING ACTIVITIES	
Received from Patients and Third Parties	$ 168,773,066
Payments to Employees and Fringe Benefits	(153,899,395)
Payments to Vendors and Suppliers	(38,003,708)
Payments for Medical Malpractice	(10,936,608)
Operating Grants	9,800,000
Other Receipts	30,101,057
Net Cash Provided (Used)	5,834,412
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State Appropriations	-
Net Cash Provided (Used)	-
CASH FLOWS FROM CAPITAL FINANCING AND RELATED FINANCING ACTIVITIES	
Principal and Arbitrage Paid on Outstanding Debt	(1,049,700)
Interest and Fees Paid on Debt	(369,558)
Proceeds from Equipment Loan Financing Agreement	-
Acquisition and Construction of Capital Assets	-
Net Cash Provided (Used)	(1,419,258)
CASH FLOWS FROM INVESTING ACTIVITIES	
Investment Income and Other Activity	4,361,866
Investments In and Loans to Affiliated Enterprises - Net	(1,625,672)
Net Cash Provided (Used)	2,736,194
NET INCREASE (DECREASE)	**7,151,348**
BEGINNING CASH AND CASH EQUIVALENTS	**83,242,096**
ENDING CASH AND CASH EQUIVALENTS	**90,393,445**

UNIVERSITY OF NORTH CAROLINA HEALTH CARE SYSTEM
PROFORMA SELECTED STATISTICS AND RATIOS
FOR THE YEARS ENDED JUNE 30, 2006 AND JUNE 30, 2005

			2006	2005
	Rex Sites	UNC Sites	UNC HCS Total	UNC HCS Total
Patient Service Statistics				
Patient Days	109,431	221,249	330,680	325,577
Inpatient Discharges	32,224	35,494	67,718	61,652
Average Length of Stay	3.40	6.23	4.88	5.28
Inpatient Operating Room Cases	8,071	9,168	17,239	16,966
Outpatient Operating Room Cases	34,943	12,058	47,001	33,230
Emergency Department Visits	54,612	63,426	118,038	118,809
Clinic Visits	58,831	696,543	755,374	721,230
Births/Deliveries	5,571	3,673	9,244	8,775
Financial Ratios				
Operating Margin Percentage			3.26%	1.83%
Days in Net Accounts Receivable			60.42	60.35
Days of Cash on Hand			196.39	175.75
Average Payment Period (days)			37.46	47.77
Long-Term Debt to Equity			27.71%	27.47%
Annual Debt Service Coverage			4.68	4.24

University of North Carolina Health Care System Notes to the Annual Report for the year ending June 30, 2006

NOTE 1 -
SIGNIFICANT ACCOUNTING POLICIES

Organization - The University of North Carolina Health Care System (UNC HCS) was established November 1, 1998 by North Carolina General Statute 116-37. It is governed and administered as an affiliated enterprise of The University of North Carolina system with its stated purpose to provide patient care, facilitate the education of physicians and other health care providers, conduct research collaboratively with the health sciences schools of the University of North Carolina at Chapel Hill (UNC-Chapel Hill) and render other services designed to promote the health and well-being of the citizens of North Carolina.

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

The University of North Carolina Hospitals is the only state-owned teaching hospital in North Carolina. With a licensed base of 708 beds, this facility serves as an acute care teaching hospital for The University of North Carolina at Chapel Hill. UNCH consists of North Carolina Memorial Hospital, North Carolina Children's Hospital, North Carolina Neurosciences Hospital, and North Carolina Women's Hospital. As a State agency, UNCH is required to conform to financial requirements established by various statutory and constitutional provisions. While UNCH is exempt from both federal and State income taxes, a small portion of its revenue is subject to the unrelated business income tax.

Other activities blended into the financial statements for UNCH include:

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

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

The University of North Carolina Physicians & Associates - (UNC P&A) is the clinical service component of the UNC School of Medicine. At the heart of UNC P&A are the approximately 900 physicians who provide a full range of specialty and primary care services for patients of UNC Health Care. While the great majority of services are rendered on the UNC campus at UNC Hospitals and the outpatient clinics, there is a growing range of services provided at clinics in the community. There are seventeen clinical departments, two affiliated departments and two administrative units that collectively form UNC P&A:

Clinical Departments:

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

Affiliated Departments:

Allied Health Sciences
Center for Development and Learning

Administrative Units:

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

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

Rex Healthcare Inc. (REX) is a North Carolina not-for-profit corporation organized to provide a broad range of health care services to residents of the Triangle area of North Carolina. Acting through its network of operating affiliates, REX provides health care to patients from several locations through continued development of acute care and non-hospital programs.

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

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

Rex Hospital, Inc. - Rex Hospital, Inc. (the "Hospital"), located in Raleigh, North Carolina, is a 394-bed acute care hospital, which also operates 6 hospice beds. The Hospital provides inpatient, outpatient and emergency services primarily to the residents of Wake County, North Carolina. The Hospital also operates Rex Heart Center, Rex Cancer Center, Rex Convalescent Care Center, a 120-bed nursing facility and 20-bed home for the aged, and Rex Primary Care. During 2003, the Hospital worked with the physician groups comprising Rex Primary Care to return most of the groups to private practice.

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

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

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

Community-Based Practices (CBP's) - The network of Community-Based Practices is an outreach activity of the UNC HCS which brings quality primary and specialty outpatient care to communities in the Triangle region, including several rural communities. This network has 16 outreach clinics providing nearly 150,000 visits a year. Nine of the 16 practices are HCS sponsored, with financial support coming from both UNC P&A and UNCH. The physicians practicing in the network clinics spend all or almost all of their time providing ambulatory patient care. The other seven practices are sponsored by and the financial responsibility of UNC School of Medicine departments, with consultative support provided by CBP Administration. These CBPs are the source of a significant amount of ancillary testing, inpatient care and specialty care referred to the main Chapel Hill HCS campus while providing convenient, community-based health care.

Basis of Presentation - The accompanying financial statements present all activities under the direction of the UNC HCS Board of Directors. The financial statements for UNC HCS are presented as a compilation of the various statements generated by its separate entities. UNCH and REX issue their own audited financial statements while UNC P&A is included as a part of the audited statements for UNC-Chapel Hill.

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

Basis of Accounting - The statements of the various entities have been prepared using the accrual basis of accounting for UNCH and REX and the modified basis of accounting for UNC P&A. Under the accrual basis, revenues are recognized when earned; and expenses are recorded when an obligation has been incurred. When preparing the financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and

expenses during the reporting period. Actual results could differ from the estimates. For UNC P&A, their monthly financials are maintained on a cash basis; and then at year-end, adjustments are made to accrue all known material amounts for revenue and expense.

Financial Statement Classifications and Categories

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

Revenue and Expense Recognition - Revenues and expenses are classified as operating or nonoperating in the accompanying Statements 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 principal ongoing operations. Operating revenues include activities that have characteristics of exchange transactions, such as charges for inpatient and outpatient services as well as external customers who purchase medical services or supplies. Operating expenses are all expense transactions incurred other than those related to capital and noncapital financing or investing activities.

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

Cash and Cash Equivalents - This classification includes petty cash, security deposits, cash on deposit in private bank accounts and deposits held by the State Treasurer in its short-term investment fund (STIF). The STIF account has the general characteristics of a demand deposit account in that participants may deposit and withdraw cash at any time without prior notice or penalty. All highly liquid investments with an original maturity of three months or less, and which are not designated as investments, are considered to be cash equivalents and are recorded at cost, which approximates market.

UNC-Chapel Hill manages the funds of UNC P&A as authorized by The University of North Carolina Board of Governors pursuant to General Statute 116-36.2 and Section 600.2.4 of the Policy Manual of the University of North Carolina. Special funds and funds received for services rendered by health care professionals pursuant to General Statute 116-36.1(h) are invested in the same manner as the State Treasurer is required to invest. Investments of various funds may be pooled unless prohibited by statute or by terms of the gift or contract. UNC-Chapel Hill utilizes investment pools to manage investments and distribute investment income. Shares in the Temporary pool trade at a fixed value of $1 per share.

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

Patient Accounts Receivable, Net - Net patient accounts receivable consist of unbilled (in-house patients, inpatients discharged but not final billed and outpatients not final billed) and billed amounts. Payment of these charges comes primarily from managed care payors, Medicare, Medicaid and, to a lesser extent, the patient. The amounts recorded in the financial statements are net of indigent care, contractual allowances and allowances for bad debt to determine the net realizable value of the accounts receivable balance.

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

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

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

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

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

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

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

Property, Plant and Equipment - Property, plant and equipment are stated at cost at date of acquisition or fair value at date of donation in the case of gifts. The value of assets

constructed includes all material direct and indirect construction costs. Interest costs incurred during the period of construction are capitalized. Only assets having a cost or fair value of at least $5,000 and an estimated useful life of three years or more are capitalized. Assets under capital lease are stated at the present value of the minimum lease payments at the inception of the lease.

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

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

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

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

Notes and Bonds Payable - Note and bonds payable represent debt issued for the construction of buildings and the acquisition of equipment. The current amount is the portion of bonds due within one year, and the balance is reflected as noncurrent. The bonds carry interest rates ranging from 3.00% to 5.25%. The various bond series have fixed, variable or synthetic rates with final maturity in February 2031.

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

The notes payable carry various interest rates ranging from 0.91% to 5.92% with a final maturity in September 2010.

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

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

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

Net Assets - Net assets represent the difference between assets and liabilities. Due to the complexities of consolidating these entities, only a combined number is shown for net

assets. Normally, under general accepted accounting principles, the net asset category would be further categorized as the amounts (1) Invested in Capital Assets, Net of Related Debt, (2) Restricted Net Assets – Expendable and (3) Unrestricted Net Assets.

Net Patient Service Revenue - Patient service revenue is recorded at established rates when services are provided with contractual adjustments, estimated bad debt expenses and services qualifying as indigent (or charity care) deducted to arrive at net patient service revenue. Contractual adjustments arise under reimbursement agreements with Medicare, Medicaid, certain insurance carriers, health maintenance organizations and preferred provider organizations which provide for payments that are generally less than established billing rates. The difference between established rates and the estimated amount collectable is recognized as revenue deductions on an accrual basis.

Indigent care provided represents health care services that were provided free of charge to individuals who meet the criteria of the UNC HCS's charity care policy. Also included in this category is the 25% discount given to uninsured patients. Indigent care provided is not considered to be revenue.

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

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

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

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

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

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

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

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

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

The aggregate mix of gross receivables from patients and third-party payors on June 30 was Medicare - 21%, Managed care – 22%, Commercial – 14%, Medicaid – 17%, Self Pay – 19%, and Other – 8%.

NOTE 2 -
ESTIMATED THIRD-PARTY SETTLEMENTS

The amount shown as current assets represents estimated receivables due to UNCH from Tricare/Champus in the amount of $3,673,403 and due to P&A for Medicaid in the amount of $3,300,000.

The amount shown as current liabilities represents estimated payables due from REX to Medicaid in the amount of $3,791,000 and amounts due from UNCH to Medicaid of $33,149,502 net of a small receivable from Medicare.

Tricare/Champus is a federal insurance program for eligible active duty and retired military personnel and their dependents. Tricare/Champus makes adjustments to its interim payments for certain portions of direct medical education and capital costs. These amounts are computed upon completion of the Medicare Cost Report.

NOTE 3 - CAPITAL ASSETS

A summary of capital assets as of June 30 was:

Land and Improvements	51,775,912
Buildings and Improvements	537,979,901
Equipment	508,904,976
Construction in Progress	28,266,252
Less: Accumulated Depreciation	(528,885,869)
TOTAL	**$ 598,041,172**

NOTE 4 - LONG-TERM DEBT

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

Rex Series 1998 Bonds	97,960,000
UNC P&A Series Bonds	9,548,400
UNCH Series 1999 Bonds	49,020,000
UNCH Series 2001 Bonds	104,800,000
UNCH Series 2003 Bonds	96,590,000
UNCH Series 2005 Bonds	30,455,000
Face Value of Bonds Outstanding	**$388,373,400**
Deferred Costs - Discount on Insurance	(1,246,474)
Deferred Costs - Loss on Refunding	(16,620,115)
Deferred Costs - Premium on Insurance	1,744,672
Arbitrage Rebate Payable	268,892
Net Value of Bonds Outstanding	**$372,520,375**
Current Portion of Bonds	13,119,700
Current Portion of Notes	16,243,694
Total Current Bonds and Notes	29,363,394
Non-current Portion of Bonds	359,400,675
Notes and Other Non-current Payables	55,151,803
Total Non-current Notes and Bonds Payables	**$414,552,478**

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

The annual requirements to pay principal and interest on long-term obligations on June 30, 2006 are:

	Bonds Payable	
Fiscal Year	Principal	Interest
	$	$
2007	13,119,700	18,053,786
2008	13,619,700	17,241,993
2009	13,849,800	16,330,408
2010	14,489,800	15,474,073
2011	15,164,800	14,564,414
2012-2016	82,504,600	61,208,599
2017-2021	77,360,000	41,915,744
2022-2026	75,445,000	24,615,607
2027-2031	82,820,000	9,012,546
Total Requirements	**$ 388,373,400**	**$ 218,417,170**

NOTE 5 - PENSION PLANS

The UNC HCS has a variety of retirement plans available to its permanent full-time employees. The majority of employees of UNCH and UNC P&A are members of the Teachers' and State Employees' Retirement System as a condition of employment. The System is a cost-sharing multiple-employer defined benefit pension plan established by the State to provide pension benefits for employees of the State, its component units and local boards of education. The plan is administered by the North Carolina State Treasurer. Graduate medical residents, temporary employees and permanent part-time employees with appointments of less than 30 hours per week are not covered by the plan.

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

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

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

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

NOTE 6 - OTHER EMPLOYMENT BENEFITS

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

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

REX offers a full menu of employment benefits to its employees through various third-party

carriers. These include medical insurance, dental coverage, short-term and long-term disability benefits, and life insurance coverage.

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

NOTE 7 - RISK MANAGEMENT

The UNC HCS is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; employee injuries and illnesses; natural disasters; medical malpractice; and various employee plans for health, dental and accident. These exposures to loss are handled by a combination of methods, including participation in State-administered insurance programs, purchase of commercial insurance and self-retention of certain risks. There have been no significant reductions in insurance coverage from the previous year.

Liability Insurance Trust Fund - UNCH and UNC P&A participate in the Liability Insurance Trust Fund (the Fund), a claims-servicing public entity risk pool for professional liability protection. The Fund acts as a servicer of professional liability claims, managing separate accounts for each participant from which the losses of that participant are paid. Although participant assessments are determined on an actuarial basis, ultimate liability for claims remains with the participants; and, accordingly, the insurance risks are not transferred to the Fund. On June 30, 2006, the UNC HCS had advance deposits with the Fund totaling $16,245,683.

Additional disclosures relative to the funding status and obligations of the Fund are set forth in the audited financial statements of the Liability Insurance Trust Fund for the years ended June 30, 2006 and 2005. Copies of this

report may be obtained from The University of North Carolina Liability Insurance Trust Fund, Room 6001 East Wing, University of North Carolina Hospitals, 101 Manning Drive, Chapel Hill, North Carolina 27514, or by calling (919) 966-3041.

NOTE 8 - RELATED PARTY TRANSACTIONS

The Medical Foundation of North Carolina, Inc. - UNCH & UNC P&A are participants in The Medical Foundation of North Carolina, Inc., a nonprofit Foundation for the University of North Carolina at Chapel Hill and UNCH, which solicits gifts and grants for both entities. The Board of Directors of the Medical Foundation administers the funds of the Foundation. Transactions are recorded only by the Foundation. If the Foundation were to purchase any equipment for the Hospitals, then the amount would be recorded at the time of receipt on UNCH's financial statements.

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

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

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