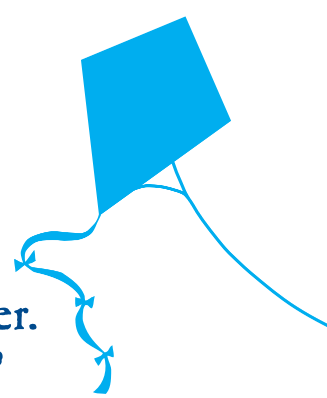
Penn

05-06 Annual Report

TERCENTENNIAL ANNIVERSARY OF THE BIRTH OF PENN'S FOUNDER



"Tell me and I forget.
Teach me and I remember.
Involve me and I learn."

– Benjamin Franklin

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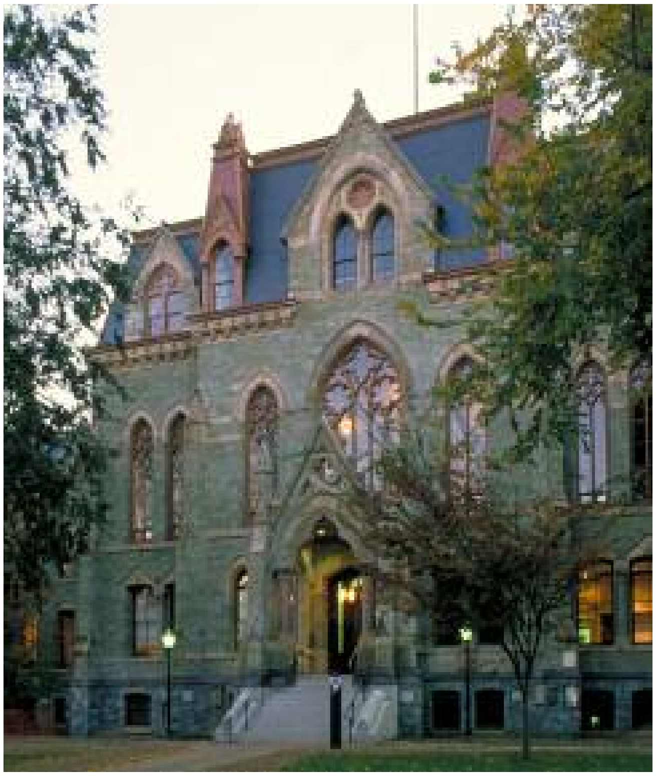
Benjamin Franklin was born in Boston in 1706. At 17, he settled in Philadelphia, where he began his lifelong quest to serve humanity. A printer by trade, Franklin was also an inventor, innovator, statesman, philanthropist, writer and visionary. As a statesman, he represented Pennsylvania at the revolutionary meetings that resulted in the Declaration of Independence and the U.S. Constitution. Best known for his famous kite and key experiment, he also invented the lightning rod, Franklin stove, swim fins, and bifocals. He established the first volunteer firefighting company, the first public lending library, Daylight Savings Time, and the American Philosophical Society.

Penn helped to lead the Franklin tercentennial celebration in 2006. We feel a special pride and kinship in our association with Franklin, he not only founded Penn, the nation's first university, but also established the nation's first public hospital, Pennsylvania Hospital, which now is an integral part of the University of Pennsylvania Health System.



At-a-Glance

FY 06 Financial Report

Student Enrollment [1]

Undergraduate students 10,733
Graduate and professional students 10,176

Undergraduate Admissions Statistics[1]

Applications 20,483
Percent accepted 17.7%
Percent matriculated 66.2%
Average SAT scores[2] 2103

Faculty

Standing faculty 2,427
Associated faculty 1,808

Financial Summary

Total operating revenue $4,432,719
Total operating expenditures $4,197,595

Principal Sources of Revenue

Tuition and fees (net) $599,190
Sponsored programs $746,231
Hospitals and physician practices[3] $2,386,850
Contributions $408,874
Investment income[4] $600,869

Principal Purposes of Expenditures

Instruction $800,863
Research $592,791
Hospitals and physician practices[3] $2,225,647

Endowment

Market value $5,313,268
One-year endowment performance 12.5%

Net Assets

Unrestricted $3,612,342
Temporarily restricted $1,757,485
Permanently restricted $1,953,575

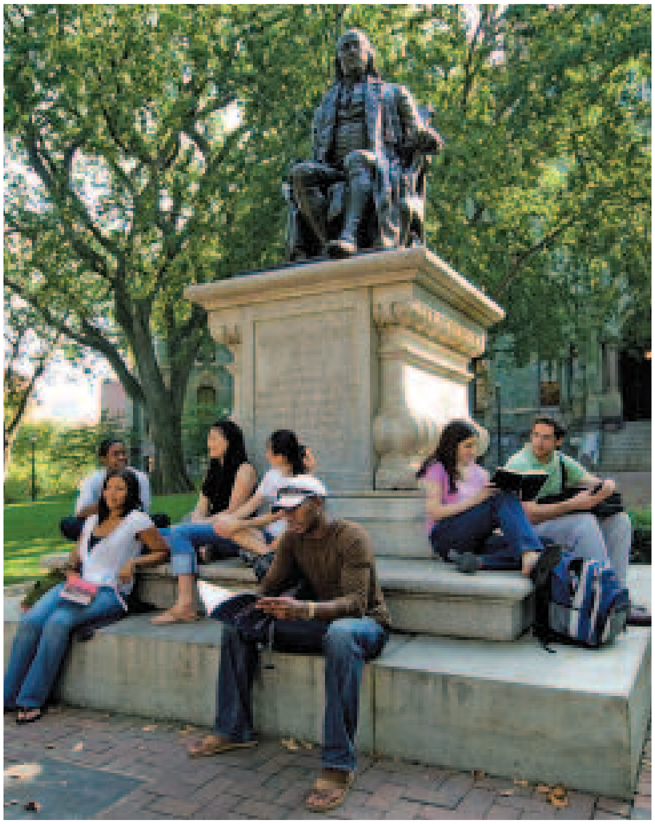
dollars in thousands

1 Note that full-time equivalent enrollment is calculated based on the number of full-time students plus 1/3 of the headcount for part-time students. Student, admission and faculty statistics are for academic year beginning September 2006, while financial statistics are for fiscal year ending June 30, 2006.

2 SAT format changed, new Writing component added to Reading and Math, total possible score now 2400

3 Includes inter-entity eliminations

4 Includes gains and losses on investments



"Think of whence we came and whence we are going and to whom we must account."

– Benjamin Franklin

In 1757, the first graduating class of the Pennsylvania Academy consisted of seven men who were awarded Bachelor of Arts and Masters of Arts degrees. Today, more than 20,000 students representing six continents are enrolled in our twelve different schools. These men and women pursue studies among more than 80 undergraduate majors and concentrations as well as dozens of graduate programs.

Message from the Vice President for Finance and the Treasurer

"Think of whence we came and whence we are going…" This quote serves as a fitting introduction to this year's annual report as 2006 marks the 300th anniversary of the birth of Benjamin Franklin. This occasion encourages us to look back on Franklin's accomplishments and affirm that, after many generations, we continue to advance our founder's vision which challenges us to continually grow and strengthen our financial performance.

FY 06 produced many first-time achievements, including two historic milestones: the endowment gained $943.5 million, soaring past the $5 billion mark; and contributions exceeded $400 million. Steadfast support and generous gifts from our alumni and friends were mainly directed to student aid, instruction and capital projects.

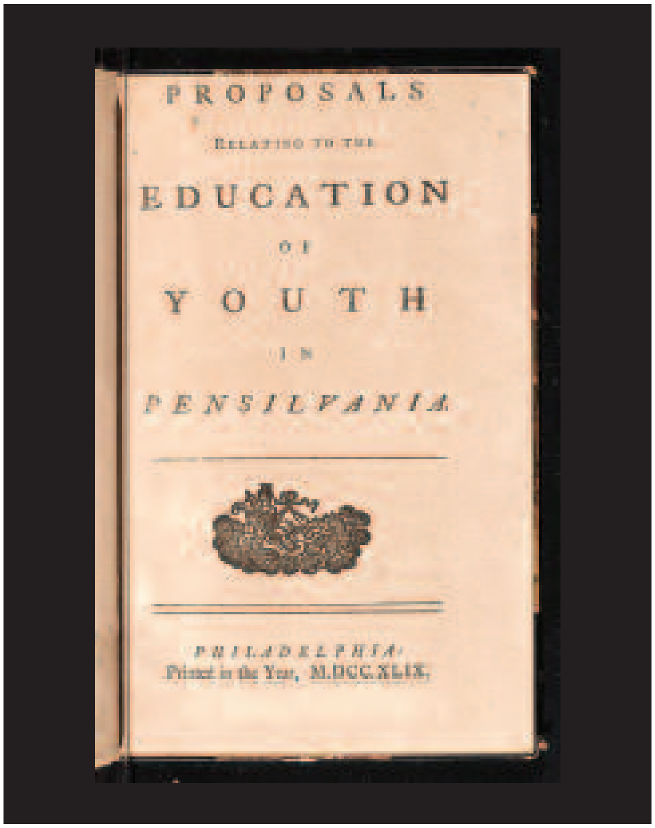
The consolidated University's strong performance was driven by improved operating revenues and higher Health System operating margins. Total net assets increased by $935.5 million primarily due to investment gains and improved operations. For the sixth consecutive year UPHS generated strong financial results and accounted for almost two-thirds of the total revenue growth. A sizable decrease in total receivables translated to a significant increase in cash flow from operations, due, in large part, to the sale of the Stafford loan portfolio and the steady decline in the Health System's accounts receivable.

The goals of the Penn Compact are deeply rooted in Franklin's writings and achievements. We made substantial progress toward increasing access, integrating knowledge and engaging locally and globally: $64 million in contributions were added to financial aid resources and 187 new undergraduate scholarships were established; the first Penn Integrates Knowledge professor was named; and momentum gathered as striking architectural drawings were unveiled that illustrate plans for the eastward campus expansion, Penn Connects.

Penn continues to attract outstanding students as both student applications and yield reached historic highs. Internationalism in our community continues to thrive as 17% of our incoming students arrived from countries around the world.

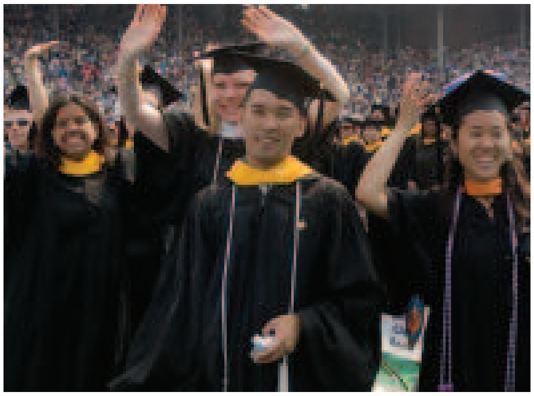
The University's reputation continues to flourish. Two of our students were named Rhodes and Marshall Scholars. Doctors and staff at the New Bolton Center gained international attention as they cared for their most famous patient, Kentucky Derby winner Barbaro.

"Well done is better than well said." Though simply stated, Franklin lived these words by taking action on so many of the ideas he put forth in his writings. Following his example, we continue to pioneer innovations in education and research as spotlighted in a special section in this year's report. Coupled with documenting the University's FY 06 progress towards achieving eminence, the following pages pay tribute to Franklin's extraordinary life and legacy.



"As to their studies...It is therefore proposed that they learn those things that are most useful and most ornamental. Regard being had for several professions for which they are intended."

– Benjamin Franklin



"To comprehend our complex world, we must better integrate knowledge from different disciplines and professional perspectives in our research and teachings."

– Amy Gutmann
On integrating knowledge
Excerpt from Penn Compact

Fiscal Year 2006 Performance Highlights

Total net assets rose by $935.5 million or 14.6% for the fiscal year, doubling last year's increase. Investment performance, contributions and UPHS all registered double digit increases. Penn ended the fiscal year on June 30, 2006 with total assets of $10.4 billion, total liabilities of $3.1 billion and net assets of $7.3 billion.

The consolidated University achieved a sizable increase in net assets from operating activities of $235.1 million, an increase of $158.2 million from the previous fiscal year. The Academic Component accounted for $69.1million of this increase, due primarily to improved operations. The Health System generated an operating surplus of $166.0 million—an excess of revenue over expenses—marking its sixth consecutive year of positive net income from operations.

The University's total revenue increased $386.5 million, or 9.6%, to $4.43 billion. Reflecting an overall increase in patient activity, the Health System accounted for $249.7 million or 64.6% of this overall growth in revenue. Tuition and fees (net of student aid) grew $46.3 million or 8.4%. Total gifts and pledges (excluding private grants) reached $408.9 million, a 19.3% increase over the previous fiscal year; student financial aid contributions totaled $100.4 million, an increase of 40% over FY 05. Non-operating contributions–which include gifts for endowment and capital—increased by $59.0 million or 23.6%.

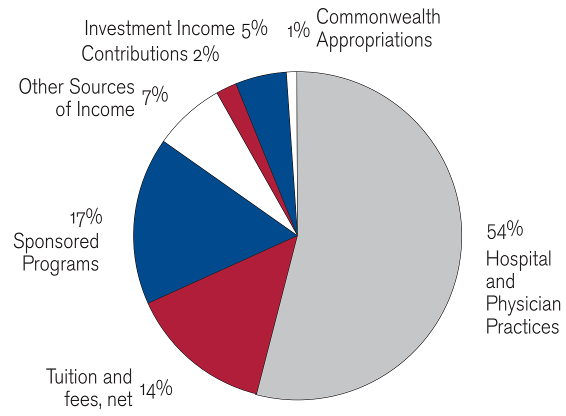
Total expenses increased $228.4 million or 5.8%. Hospital and physician practice expenses accounted for 58.2% of total growth, increasing $132.9 million or 6.4%. Instruction and research expenses grew at rate of 6.3% and 2.3%, respectively. Management and general expenses increased 7.0%, due primarily to increases in wage and benefit costs.

Net assets from non-operating activities increased by $700.4 million, representing a 65.5% increase over FY 05 due to gains on investments and higher endowment contributions. Capital and endowment gifts totaled nearly—$260 million, a 23.8% increase over the prior year results. Net non-operating investment income totaled $364.4 million.

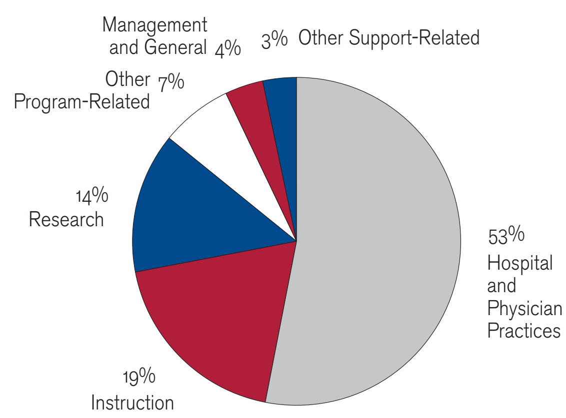
In FY 06 the endowment surpassed the $5 billion mark, reaching $5.3 billion, an increase of 21.6% over the previous fiscal year. The endowment returned 12.5% for the fiscal year ending June 30, 2006, ahead of the AIF Composite Index benchmark of 11.8%

Short-term working capital, measured by operating cash, grew by $151.4 million or 21.3%, due in part to improvements in the collection of receivables at the University and the Health System. UPHS continues to benefit from cost-control systems it implemented two years ago, with days in accounts receivable plummeting from 71 to 37 days, a remarkable achievement. Cash flow from operating activities totaled $714.0 million and exceeded the previous fiscal year level by $205.7 million, or 40.5%.

Operating Revenue by Source - $4.43 Billion



Operating Expenses by Source - $4.20 Billion



“Genius without education is like silver in the mine.”

– Benjamin Franklin

“We must make an excellent Penn education available to all outstanding students of talent and potential.”

– Amy Gutmann
On increasing access
Excerpt from Penn Compact

Tuition, Fees and Financial Aid

A total of 13.5% of Penn's revenue is provided by tuition and fees (net of student aid). Penn received tuition dollars for its undergraduate, graduate and professional programs and for study abroad and executive education. Fees used to support student programs and services provided additional revenue.

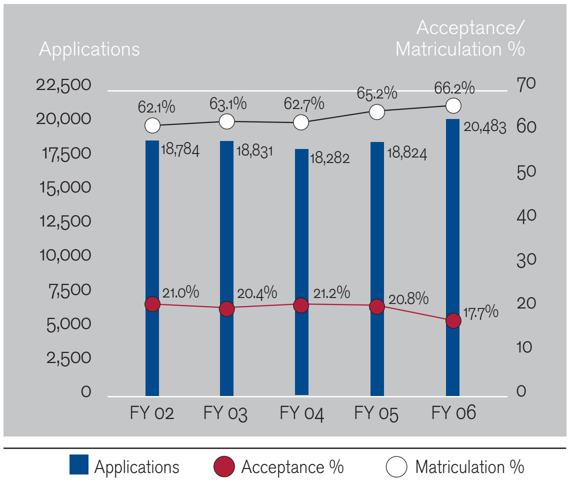
The University continues to build on its commitment to need-blind admission and need-based financial aid by meeting the full financial needs of all admitted students. In addition, the University announced a new financial aid policy by which students whose families earn less than $50,000 annually will receive financial aid packages that do not include loans. For students whose packages do include loans, a new online program, the Student Borrowing Management system, was introduced this year. This system allows students to check the status of loans, view correspondence, submit online requests to reduce or cancel loans, and request additional Stafford loan funds in one central location.

In FY 06, 4,184 undergraduates with financial need were awarded $118.8 million in aid. Of this total aid, $93.0 million was grant or scholarship, with $79.0 million coming from University resources. Thirteen percent of University grants were funded from endowment income. The average grant-aided freshman package increased 3.2% to $29,316. In the five-year period from FY 02 to FY 06, grants from endowment income increased by 114%, while grants from general funds increased by 44%. Overall, 6,399 undergraduates funded all or part of their education with $111.1 million from grants/tuition waivers, $54.6 million from educational loans and $15.6 million from work-study jobs.

A total of 6,850 graduate and professional students received $109.4 million in grants, including teaching and research assistantships and fellowships, $178.0 million in educational loans, and $3.1 million in work-study programs.

Penn encourages study abroad to facilitate a deeper understanding of other cultures and languages. Study abroad can be combined with volunteer and service work, summer research, and overseas jobs and internships. Last year, a total of 1,744 students enriched their formal undergraduate education by participating in one of more than 100 programs in 50 countries. Penn's campus also has a cosmopolitan flavor; more than 17% of this year's freshman class are international students and more than 4,500 international students at all levels of study are currently enrolled at Penn.

Undergraduate Application/Admission Statistics



"Nothing is more important for the public weal than to train youth in wisdom and virtue. Wise and good men, in my opinion are the strength of the state..."

– Benjamin Franklin

Penn is heralded as a world-class research university for the scale and scope of the innovative work conducted in our facilities. A total of 174 research centers and institutes and more than 4,200 faculty, 870 postdoctoral fellows, 3,800 graduate students and 5,400 academic support staff and graduate assistants make up our dynamic research community.

Sponsored Programs and Commonwealth Appropriations

Benjamin Franklin believed that government has a responsibility to promote and support the common good. Today, federal funding provides three quarters of Penn's research dollars while appropriations from the Commonwealth support programs across the University.

Sponsored program activity provides 16.8% of the University's total revenue. Sponsored program support includes the direct and indirect costs of sponsored research activity. In FY 06, sponsored program revenue totaled $746.2 million, an increase of almost $14 million or 1.9% compared to FY 05. The indirect cost component grew by $5.6 million to $194.0 million, an increase of 3.0%. Total awards received reached $789.8 million, a 5.3% increase, which is significant despite the fact that total National Institutes of Health annual budget increases have dropped from double digits over the past decade to less than 1% in FY 06.

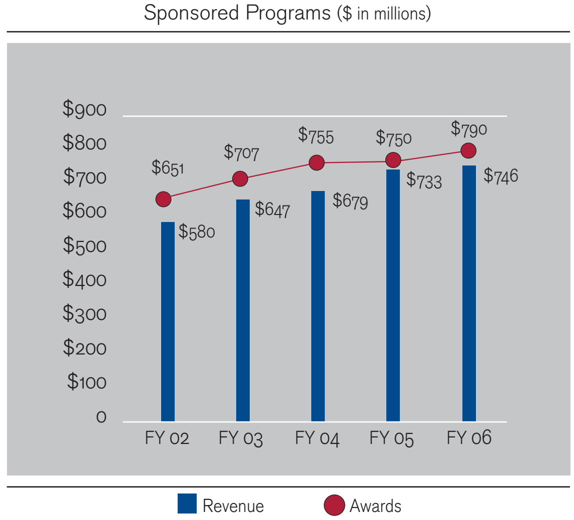
Nearly $599 million or 75.8% of total awards were received from the federal government with the lion's share of $471 million or 78.6% coming directly from the NIH. The University maintained its second place ranking in NIH funding for the latest available federal fiscal year (FY 05), receiving a total of 1,153 awards for research, training, fellowships and R&D contracts. The National Science Foundation accounted for 4.1% or $32 million, while other federal agencies added $86 million. Foundation, association and corporate support increased by $50 million or 35.5% from $141 million in FY 05 to $191 million in FY 06.

The School of Medicine received 68.8% of total award dollars or $543 million, $399 million of this total coming from the NIH. The School of Medicine also maintained second place in NIH awards to academic medical schools in the United States. For FY 05, Penn's SOM received 924 total awards. The School of Arts and Sciences accounts for nearly 10% of total awards, Engineering 5.5%, Vet 3.7%. All other schools and centers made up the remaining 12%.

In one stunning illustration of using NIH funding for the common good, a team of researchers at Penn School of Medicine have created a new technique to engineer nerve tissues. "We have created a three-dimensional neural network, a mini nervous system in culture, which can be transplanted en masse," explained Neurology Professor Douglass Smith, M.D., Director of the Center for Brain Injury and Repair. This promising research has the potential for future applications in repairing spinal cord injuries.

Agriculture is the primary driver of Pennsylvania's economy. Accordingly, the School of Veterinary Medicine continued to be the main recipient of the Commonwealth Appropriations, receiving 84.9% of the $44.9 million allocated in FY 06. With reports of Avian flu mounting worldwide, the Commonwealth has directed future additional funding for preemptive research at the New Bolton Center.

Sponsored Programs ($ in millions)



"The doors of wisdom are never shut."

– Benjamin Franklin

The Perelman Center for Advanced Medicine, a 500,000 square foot outpatient facility scheduled to open in 2008, will set an international standard in providing a collaborative continuum of care for patients.

University of Pennsylvania Health System

In FY 06, the University of Pennsylvania Health System appreciably strengthened its financial position. UPHS improved its performance through activity increases in its "Relentless Advance of Medicine" programs and continued focus on revenue cycle, balance sheet improvement, and operating expense control.

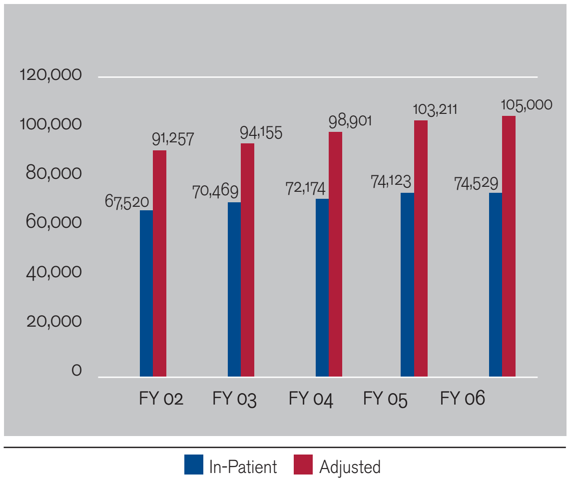
For the sixth consecutive fiscal year, UPHS generated a surplus, with a net operating margin of $158.4 million (excluding investment income), $82 million better than budget and $85 million better than FY 05. Total financial assets increased by 26% to $1.5 billion. Outpatient visits involving the Penn hospitals and the faculty practices (Clinical Practices of the University of Pennsylvania—CPUP) increased by 11%, especially in the areas of medical oncology and radiation therapy. Admissions were 105,000 or 1.5% higher than FY 05. Major capital expenditures included the Perelman Center for Advanced Medicine and the Roberts Proton Therapy Center.

The Health System's strong operating performance was attained in part through measures undertaken to increase revenue and reduce expenses, notably the revenue cycle enhancement project and supply chain initiatives. Service line activity also contributed to improved operating performance, with transplant cases and hematology/oncology admissions increasing by 25% and 13%, respectively. The UPHS operating performance was also enhanced by initiatives taken by the Clinical Effectiveness & Quality Initiatives (CEQI) program. These measures yielded significant net present-value savings.

The Health System role as a major "safety net" provider for uninsured and under-insured patients is rooted in its long and uninterrupted tradition of community service. This year, the Health System provided more than $60 million in uncompensated care.

Again in 2006, UPHS received numerous prestigious awards, citations and commendations. The clinical specialties at the Hospital of the University of Pennsylvania have been consistently ranked among the nation's best by U.S. News & World Report. UPHS physicians were featured prominently in Philadelphia Magazine's "Top Docs" issue. The American Hospital Association and the American Alliance of Healthcare Providers also singled out the Health System for commendation. Abramson Cancer Center was awarded the prestigious designation of "Comprehensive Cancer Center" by the National Cancer Institute; this award marks the 30th consecutive year Penn has received this honor. Independence Blue Cross recognized the Hospital of the University of Pennsylvania and Penn Presbyterian Medical Center as Blue Distinction Centers for Cardiac Care for their programs in bariatric surgery, cardiac care and transplant surgery. Additionally, Penn Presbyterian Medical Center was named one of the nation's 100 Top Cardiovascular Hospitals for the sixth consecutive year.

Hospital Admission



In 1751, Franklin presented a proposal to the Pennsylvania Assembly for the establishment of a small hospital in Philadelphia. He served on the Pennsylvania Hospital Board of Managers and continued to support the hospital for the rest of his life.

Today, Pennsylvania Hospital operates a 515-bed facility, seeing 201,000 outpatient visits and 24,500 inpatient admissions each year. Recognized for excellence in heart care and surgery by U.S. News & World Report in 2006, Pennsylvania Hospital provides a full range of diagnostic and therapeutic medical services and functions as a major teaching and clinical research institution.

Hospitals at Penn

Benjamin Franklin's trademark values of innovation, scientific collaboration, and public service are part of the legacy bequeathed to the hospitals in the University of Pennsylvania Health System.

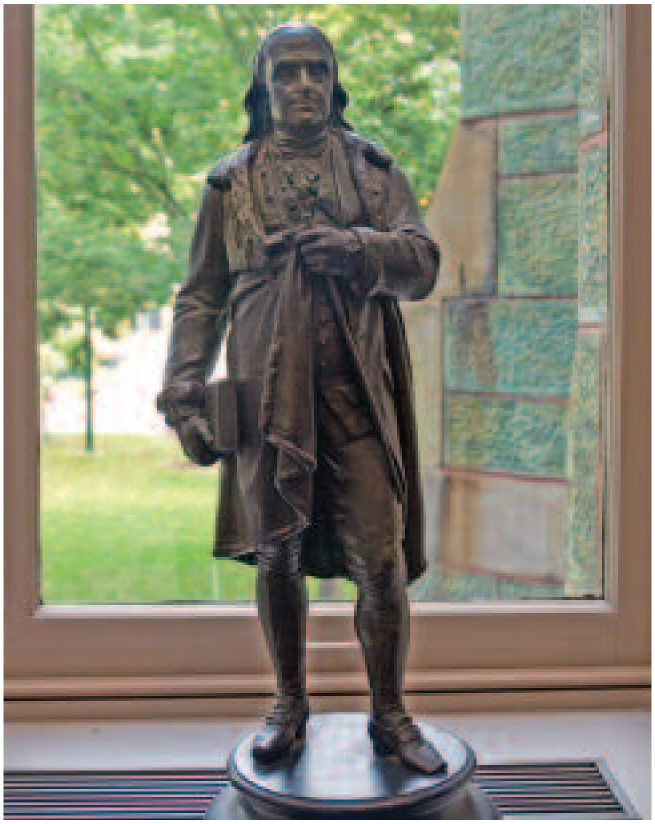
The Perelman Center for Advanced Medicine (CAM) will set the stage for a new model for patient-centered care. Cardiology, vascular medicine, cardiac and vascular surgery services and a cardiovascular imaging center will be among the suite of services provided at the Center. Oncology services provided by the relocated Abramson Cancer Center will offer prompt diagnosis and delivery, coordination of care, and interdisciplinary care in a single location, including a state-of-the-art Radiation Oncology floor. Additionally, CAM will be the new home for Penn's nationally recognized Heart Failure and Transplant Center, Cardiac Arrhythmia Center, and the cardiac and vascular outpatient surgery practice.

This year also marked the groundbreaking for the Roberts Proton Therapy Center, located adjacent to CAM. Anticipated to be most advanced facility of its kind in the nation, the Center will combine both conventional radiation and cutting-edge proton therapy to treat cancer in both adults and children. To be completed in 2009, the Center will use proton energy to target cancer cells without harming surrounding tissue and will be the only facility of its kind to have a designated staff devoted exclusively to proton therapy research.

The Hospital of the University of Pennsylvania continues to be recognized for its exceptional clinical care, faculty, and scientific achievements. In recognition of its recent installation of three new, state-of-the-art, high-powered MRI (Magnetic Resonance Imaging) systems – a "Radiology First" for any hospital in the United States – HUP was selected in 2006 by a professional association of radiologists as one of the "25 Most Influential" movers and shakers in the radiology industry. The 2006 Albert Lasker Award for Clinical Medical Research was awarded to Aaron T. Beck, Abramson Cancer Center member and Professor of Psychiatry, University of Pennsylvania. Additionally, HUP's physician scientists continue to publish pioneering research in leading medical journals in such areas as immunology, neurology, and cancer.

Franklin's tradition of innovation can be seen at the Penn Presbyterian Medical Center (PPMC), where the use of robots is helping physicians revolutionize the treatment of diseases. As one of the select facilities in the world offering this kind of minimally invasive, high-tech treatment, PPMC is helping translate the kind of success provided by robot-assisted laproscopic prostatectomy to other cancers as well.

Community service has been a cornerstone of UPHS medical programs and activity. For example, at Pennsylvania Hospital there are health care community services in the areas of diabetes education, cancer screenings and support groups, adult mental health, and women and children's health.



"The noblest question in the world is What good may I do in it?"

– Benjamin Franklin

Franklin's legacy of philanthropy continues to flourish at Penn. The Benjamin Franklin Society recognizes Penn's most generous donors of unrestricted support for University programs.

Development and Alumni Relations

As a philanthropist, Franklin was credited with mounting a successful fundraising campaign for the original Pennsylvania Hospital. He later said that "I do not remember any of my political maneuvers, the success of which gave me at the time more pleasure."

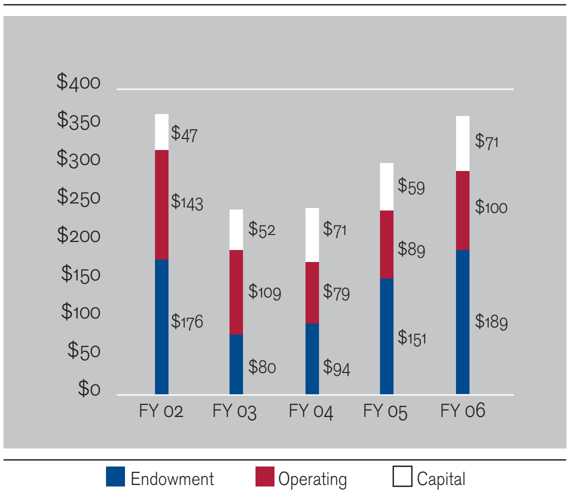
FY 06 marked the first year of the "silent phase" of Penn's new comprehensive campaign, setting all-time records for annual fundraising at the University. New gifts and pledges totaled $408.9 million, with cash receipts totaling $359.6 million. Ninety-seven new gifts and pledges of $1 million or more set a record for Penn, and 61% of those gifts came from first-time donors at that level.

Annual giving programs across the University raised $46.2 million, more than $21 million of that support coming from undergraduate alumni contributions to The Penn Fund. New gifts for undergraduate financial aid exceeded $64 million, shattering all previous records for scholarship fundraising in a single year while creating 187 new scholarship funds. Revenue from bequests and other planned giving instruments totaled $51.7 million, and new gifts added to the University's endowment totaled $146.5 million.

During the year, President Gutmann traveled to meet with Penn alumni, parents, and friends across the country and around the world. Trips abroad included visits to Mumbai, Hong Kong, Beijing, and Singapore. As the year ended, Provost Daniels was planning to participate in regional alumni events in London and Toronto. Penn's regional alumni engagement has grown significantly over the past two years, resulting in 26 new alumni clubs for a total of 62 clubs across the United States and 45 clubs internationally.

Nearly 5,000 alumni and class reunion celebrants attended Alumni Weekend festivities. Visits to the Alumni Weekend website and online class reunion websites totaled 240,000 – a 25% increase over the previous year. During the registration period for Alumni Weekend, 3,000 new users signed on to Penn's Alumni Online Community.

Gift Receipts ($ in millions)



Franklin established Pennsylvania Academy located at 4th and Arch streets in Philadelphia; it later moved to 9th and Chestnut streets. In 1872, Penn bought land in West Philadelphia, since known as University City.

The acquisition of the postal lands provides an unprecedented opportunity to transform the Penn campus. The land will enable the University, for the first time in history, to establish a major presence along the Schuylkill River corridor, to create new gateways to the campus from Center City and to establish new connections with the surrounding communities.

Capital Investments

During FY 06, the University invested a record-breaking $368.7 million in property, plant and equipment, representing a 44.9% increase over FY 05 and demonstrating our intense commitment to providing exceptional research, teaching and residential facilities for the Penn community. Penn's campus echoed with the sounds of construction as over 100 projects were started, progressed or completed. Looking at a breakdown of expenditures by project, there were eighty at less than $2 million, seven between $2 million and $10 million and seven greater than $10 million.

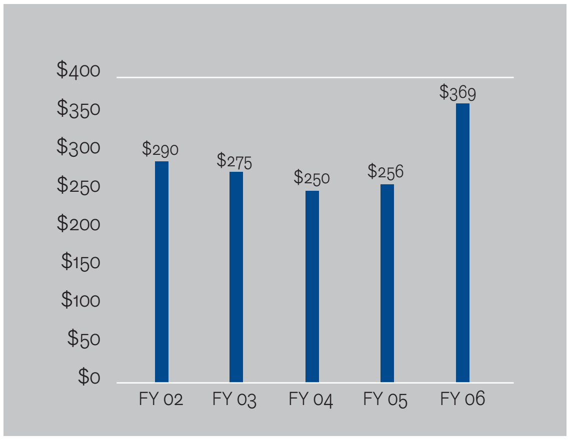
New construction centered on a trio of teaching and research facilities. On the east end of the campus, Skirkanich Hall, the 58,000 square foot state-of-the-art bioengineering facility, was being readied for its fall dedication. At the west end of campus, the Lynch Life Science Laboratories opened, hailed as a magnet for interdisplinary research and the new home of Penn Genomics Institute. Directly across the street, the Hill Pavilion, the School of Veterinary Medicine's new world-class teaching and research facility, neared completion.

Several academic-oriented building projects were completed, including the new McNeil Center for Early American Studies as well as renovations to the Nursing Education Building, Fisher-Bennett Hall, and the new orthodontic clinic in the Evans Building.

Since Franklin formed the first fire company, it seems appropriate that renovations to the fire and sprinkler systems were completed on all the college houses in FY 06. In a cooperative project with several neighboring organizations, new outdoor lighting was installed to brighten much of University City.

Using an intriguing approach to monitor progress, mounted video cameras provide up to the minute on-line pictures of the daily construction on the Perelman Center for Advanced Medicine. This creative use of technology can be viewed at www.uphs.upenn.edu/ about_uphs/webcam.html

Purchase of Plant, Property and Equipment ($ in millions)



Despite merely two years of formal education, Franklin surrounded himself with books throughout his lifetime. An avid reader, he became a printer by trade, writing and publishing, among other works, the Pennsylvania Gazette and Poor Richard's Almanac. Seeking to share knowledge and his love of learning with others, Franklin founded the first public lending library.

Many serial publications are available on campus, including the *Almanac, Penn Gazette, Penn Current* and the independent student newspaper *The Daily Pennsylvanian*. Penn's two presses, the University of Pennsylvania Press and the University Museum Press, contribute to the dissemination of knowledge. Penn's library system, which is open to the public, contains over 5.6 million books in 15 libraries.

Campus and Community

"The good particular men do separately…is small compared with what they may do collectively." stated Franklin. Against a backdrop of a vibrant urban center, Penn's community continues to be guided by Franklin's spirit of limitless inquiry and learning. With open green spaces and diverse architecture, the 269-acre West Philadelphia campus provides a home for social interaction beyond the educational pursuits of the Penn community—culture, athletics, student activities, and community service. Nearly 50,000 people live, learn, and work at the University and Health System. Their leisure activities all contribute to Other Sources of Income, making up 7.2% of consolidated University revenue.

Penn's 12 schools are all located on campus within walking distance of one another; this geographical proximity facilitates Penn's interdisciplinary approach to education and research. This same space hosts 12 College Houses that bring together undergraduates, graduate students, faculty, and staff. Penn Dining also offers four dining halls and nearly a dozen retail dining locations on campus. Visitors also enjoy the campus as well, and can find hospitality in area hotels, including the Sheraton University City and the Inn at Penn. Combined with retail options offered at the University Square and Hamilton Village shops, Penn's campus is truly an integrated neighborhood of living and learning.

Situated in Philadelphia, students and faculty enjoy cultural opportunities and offerings on campus as well as in the city. On campus, 40 unique student-run performance organizations present cultural offerings to the Penn community. The Annenberg Center also offers an extensive array of cultural programming, including jazz, world music, theater, dance and children's programs. As a member of the Ivy League, Penn participates in intercollegiate competition in 17 men's and 16 women's varsity sports. The Division of Recreation and Intercollegiate Athletics also offers intramural and club sports, which boast a combined enrollment of nearly 10,000 individuals.

The Division of the Vice Provost for University Life (VPUL) provides support services to the Penn community. Core programs include academic support services such as the Tutoring Center and the Weingarten Learning Resources Center, campus resource centers such as Career Services and the Greenfield Intercultural Center, and health and wellness programs such as Student Health Services and the Office for Health Education. VPUL also oversees more than 250 student activities and organizations as well as fraternities and sororities.

Penn makes a substantial investment in the surrounding neighborhood and assists students in making community service an important part of their educational experience. Approximately 6,500 students, faculty, and staff take part in more than 300 volunteer and community service programs.

"We should be glad of the opportunity to serve others by any invention of ours."

– Benjamin Franklin

Penn admitted its first class of undergraduates to the innovative interdisciplinary Vagelos Program in Life Sciences and Management. The joint program between SAS and Wharton, integrates science and business curricula, providing students with the entrepreneurial background necessary for biotechnology. This program joins three other highly successful interdisciplinary programs: the Jerome T. Fisher Program in Management and Technology, the Huntsman Program in International Studies and Business, and the Nursing and Healthcare Management Program.

Innovations

Franklin said "An investment in education pays the best interest." An innovator as well as an inventor, Franklin combined the theoretical and the practical in his work. His legacy of applying abstract ideas to the needs of everyday life still thrives at Penn, where researchers across disciplines strive to improve and change the world.

The Wharton School, the nation's first collegiate business school, has been an innovator since its beginning. In its latest initiative to use technology in the classroom, the Wharton School launched three new simulation programs in management, economics, and operations and information management, enabling students to engage in real-world business exercises.

Researchers at the School of Medicine continue to make important breakthroughs in the health fields. Among the many accomplishments of the past year, one group of researchers successfully cured mice with established breast tumors using a vaccine; this alternative to chemotherapy is now being prepared for clinical trials.

Penn's Museum of Archaeology and Anthropology pioneered an application of technology that will change the way museums curate and educate. With the assistance of Internet2, the high speed research and education network, the institution is transforming the role of museums by sharing data and artifacts with scientists, students, and individuals from locations around the world.

The School of Arts and Sciences continued to achieve advances in a wide array of fields, a testament to the diversity of subjects studied within this school. This year, an international team of researchers led by Penn astronomers launched a telescope carried by a balloon the size of a football stadium. In addition to gathering data about the formation of stars and galaxies, the project pioneered new technology that will aid the development of future balloon projects around the world.

A Penn research team identified a new source of adult stem cells: human hair follicles. The stem cells in hair follicles have the all-important ability—just like the more controversial embryonic stem cells—to "differentiate" into various cell types, including nerve cells, skin pigment cells and smooth muscle cells. That means researchers can take the hair cells and grow them into different kinds of cell types that could in turn be used to treat human health problems from spinal cord injuries to Parkinson's disease.

In an interdisciplinary project, a Penn biology professor, at the request of the Navy, designed a suspended-load backpack; the device that uses a person's natural walking motion to generate electricity. His invention creates enough electricity to power several portable electronic devices at once and may see military application in the future.

Lastly, a Penn psychologist completed ground-breaking research on how people experience the phenomena of color. His pioneering experiments investigated how humans interpret color and colored objects differently.

"Tell me and I forget.
Teach me and I remember.
Involve me and I learn."

– Benjamin Franklin

"Throughout our collaborative engagement with communities all over the world, Penn is poised to advance the central values of democracy: life, liberty, opportunities and mutual respect."

– Amy Gutmann
On engaging locally and globally
Excerpt from Penn Compact

Summary and Future Outlook

"Can anything be constant in a world which is eternally changing?" asked Franklin. In the 18th century, Franklin pictured a modern liberal arts curriculum at a college where students could prepare for lives in business, public service, and other practical endeavors. In the 21st century, Penn continues to fulfill our founder's vision. Over Penn's long history, a deep and relentless commitment to Franklin's legacy has remained constant despite the challenges of a rapidly changing world.

The fiscal year ending June 30, 2006, produced remarkable success and innovation at Penn. Penn's endowment surpassed $5 billion. With support from alumni and friends of the University, contributions exceeded $400 million. Three state-of-the-art research and teaching buildings were erected. The Health System posted its sixth year of positive operating performance as its mission to provide quality health care and to implement revolutionary medical research remained unyielding. Because of the University's status as a local and global leader, outstanding students chose to study at Penn, as evidenced by the highest number of applications, lowest acceptance rate and highest matriculation rate ever for this year's freshman class.

Current events including world conflicts, global health and environmental concerns and shifts in political ideology may influence the path of the nation and the world. Many of these issues will have an impact on higher education as the world looks for answers through research and education. From our AIDS clinic in Botswana to a collaborative academic effort to develop scenarios to control pandemics, Penn is already actively engaged in finding solutions for many of the challenges facing today's world.

In this constantly changing world, Penn will continue to strive to implement the principal components of the Penn Compact under the leadership of Dr. Gutmann and her senior management team. Future opportunities and challenges will arise with the campus expansion eastward as detailed plans for the postal lands emerge. Through our campus redevelopment, Penn will grow dramatically in size and scope, creating a unique opportunity to strengthen and build new connections with the city, region and global communities.

As we look towards the future, Penn's proud traditions, combined with the numerous talents of our eminent faculty, accomplished students, and dedicated staff, will serve to propel the University forward "from excellence to eminence."

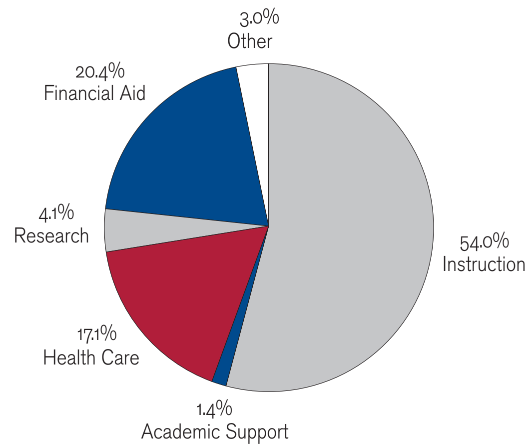
Scott R. Douglass
Vice President for Finance
and Treasurer

Endowment and Investments

Penn's endowment ended the 2006 fiscal year with $5.3 billion in investment assets. This represents an increase of more than 20% over the prior year-end due to a combination of new gifts, transfers and investment returns. Over the course of the fiscal year, payouts from the endowment provided $176 million in budgetary support to the University, roughly 3.8% of the operating budget.

Penn's total endowment includes individual endowments from all of Penn's schools and centers, which serve a variety of purposes as shown in the chart.

Endowment By Purpose



Associated Investments Fund

The vast majority of the endowment (89%) is invested in the Associated Investments Fund (AIF), a pooled investment vehicle in which individual endowments and trusts hold individual shares or units. The AIF had a market value of $4.751 billion as of June 30, 2006.

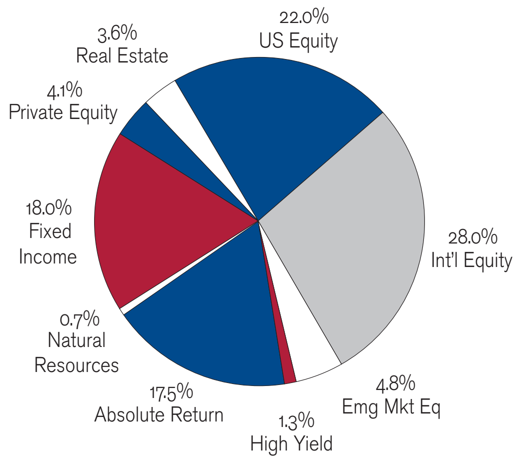
The AIF is managed by the Office of Investments under the oversight of an Investment Board appointed by the Trustees of the University. The Investment Board is responsible for setting asset allocation policy. The Investment Office is responsible for recommending external investment managers and for monitoring performance. Over the past several years, the University has made a substantial investment to expand the Office of Investments in keeping with the University's move to an increasingly diversified and sophisticated investment strategy.

The AIF is invested with the goal of achieving high, steady absolute returns while protecting against any permanent loss of capital. In the 1980's and 1990's, Penn achieved these objectives by relying on a value-oriented equity strategy that was largely focused on domestic markets. Over the last decade, Penn has diversified the portfolio with new investments in international equity, emerging markets, absolute return (hedge funds), private equity, real estate and natural resources.

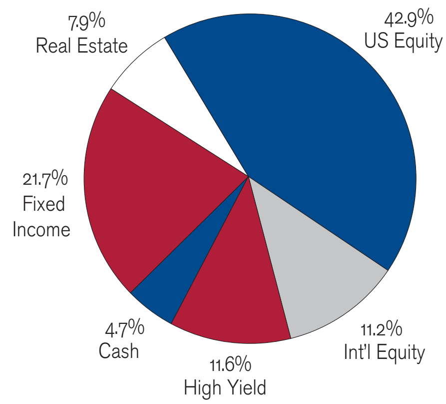
Today, Penn's long-term strategic asset allocation is similar to that of many of its large endowment peers. However, actual allocations to private equity, real estate and natural resources are below their long-term targets. The Investment Board has charged the Office of Investments with prudently building up to the long-term target weights over the course of the next several years. In the meantime, the difference between the target and actual weights in these asset classes is allocated to a combination of domestic and international public equity.

Associated Investments Fund

AIF Asset Allocation 6/30/06



AIF Asset Allocation 6/30/96



AIF Performance

The environment for US investors was tepid during the course of the fiscal year. Although earnings remained relatively robust, concerns mounted that the economy might slow more than expected as a result of high oil prices and a series of Fed rate hikes. The benchmark Russell 3000 index rose 9.6%, while the Lehman Government Bond index actually lost - 1.2%. A balanced portfolio of 70% US equities and 30% US bonds would have returned only 6.2%.

Meanwhile, the MSCI World ex-US index was up 26.9%, and the MSCI Emerging Markets Free index returned 35.7%. Non-US markets benefited from the appreciation of most non-dollar currencies, significant earnings recovery in Germany and Japan and continued macro stability in the emerging markets coupled with strong pricing for commodities exports.

Against this backdrop, the AIF returned 12.5% for the fiscal year ended June 30, 2006, benefiting from Penn's significant allocation to international and emerging market equities. The AIF outperformed the composite benchmark by 70 bps for fiscal year 2006. The AIF has outperformed its composite benchmark for the one, three, five and ten year periods ending June 30, 2006. The AIF has also consistently outperformed a simple 70/30 benchmark made up of the Russell 3000 and Lehman Government/Credit indices.

Total Return Performance Comparison

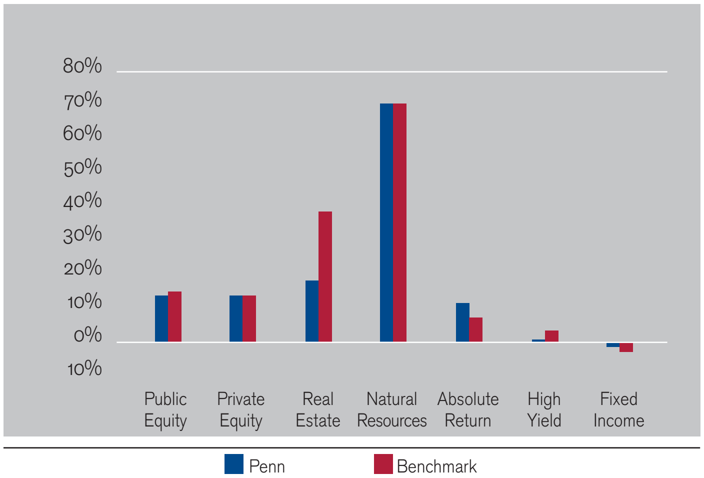
Periods Ended June 30, 2006
Annualized Returns (%)

Category	10 Years	5 Years	3 Years	1 Year
Associated Investments Fund (A.I.F.)	9.2	8.3	12.5	12.5
Composite Index *	8.0	6.1	11.6	11.8
70% Russell 3000/30% Lehman Govt/Credit	8.1	4.6	9.5	6.2

* The Composite Index is a benchmark that weights the Russell 3000, MSCI World ex-US, MSCI Emerging Markets Equity, NCREIF, Citigroup High Yield, and Lehman Government. indices proportional to the weights of the underlying assets classes in the AIF strategic asset allocation.

The performance of individual asset classes for the year ended June 30, 2006, are shown below along with the relevant asset class benchmarks.

Asset Class Returns



Penn's public equity portfolio returned 15.8%, benefiting from significant exposure to international and emerging market equities. A tactical overweight to international equities above and beyond the interim policy target also added value. However, many of Penn's public equity managers are value investors and struggled to keep pace with their asset class benchmarks in a rising market.

The private equity portfolio returned 15.1%. These returns were driven by a handful of mature buyout funds, which delivered dazzling returns as our managers benefited from solid earnings growth and low cost leverage. However, given that Penn's private equity portfolio is relatively immature, this represented a relatively small portion of the total portfolio.

Penn's real estate portfolio returned 20.3% as a surge in appetite for stabilized properties with predictable cash flow yield drove cap rates to all time lows. Returns would have been higher still but for a number of poorly performing legacy investments. Notwithstanding strong absolute performance, the portfolio lagged behind its asset class benchmark, which was made significantly more difficult this year by adjusting NCREIF returns for the use of leverage.

The natural resources portfolio registered a spectacular return of 71.5%; however, this return was off a very small invested base and did not have a meaningful impact on overall AIF returns.

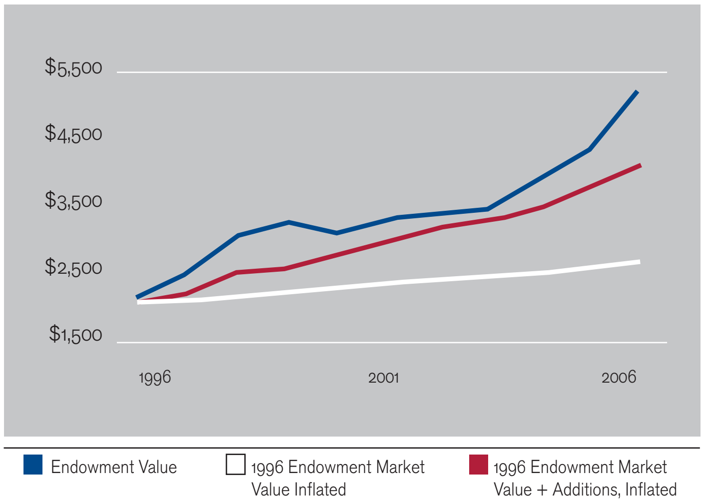
The absolute return portfolio returned 13.2%, significantly outperforming its asset class benchmark. Many of our multi-strategy and long-short managers benefited from having increased their exposure to international and emerging market equities. In addition, many of our distressed oriented managers continued to eke out solid returns from legacy positions.

Finally, Penn's fixed income portfolio returned 1.0%, outperforming the Lehman Government index as a result of a tactical decision to reduce portfolio duration in anticipation of an eventual increase in long-term rates.

Associated Investments Fund

Investment performance has significantly added to the value of the endowment over both inflation and gifts as shown below.

Endowment Growth vs. Inflation



AIF Spending Rule

The University's endowment spending policy is designed to smooth the impact of short-term market moves that may affect the endowment's market value. The spending policy aims to make future endowment distributions more predictable for purposes of managing and planning the University's operating budget. For FY 06, the spending policy is 4.7% of the three-year average market value of the AIF, lagged by one year. The market value of the AIF is calculated net of all external management fees and net of the internal costs of managing the endowment.

A Five-Year Review of Investments

(thousands of dollars)

	2006	2005	2004	2003	2002
Investments:					
Investments:					
Fair Value					
Stocks	$2,354,324	$2,155,577	$1,932,096	$1,548,637	$1,689,648
Bonds	824,692	1,122,377	1,017,242	1,101,299	1,095,028
Short-term	1,014,993	331,897	367,685	354,914	303,812
Real estate	197,536	172,536	131,087	133,367	171,924
Absolute return	843,133	712,546	594,323	498,394	334,691
Private equity	207,275	159,279	118,154	81,875	64,882
Natural resources	34,909	14,812	0	0	0
Other	2,021	4,040	4,757	6,432	12,479
Total Investments*	$5,478,883	$4,673,064	$4,165,344	$3,724,917	$3,672,464
Endowment:					
Fair Value	$5,313,268	$4,369,782	$4,018,660	$ 3,547,473	$3,393,297
Associated Investments Fund:					
Fair Value	$ 4,751,157	$3,873,965	$3,356,467	$2,859,041	$2,772,040

* Total investments held by the University not invested in the Associated Investment Fund include $238 million held in trust, $72 million in assets held under indenture and escrow agreements, $96 million held in internally managed trusts, $284 million in other investments held by UPHS and $38 million in other investments held by the University. Total investments exclude securities held as collateral under a securities lending program.

Management Responsibility for Financial Statements

The management of the University of Pennsylvania is responsible for the preparation, integrity and fair presentation of the financial statements. The financial statements, presented on pages 31 to 51, have been prepared in accordance of generally accepted accounting principles and, as such, include amounts based on judgments and estimates by management. The University also prepared the other information included in this annual report and is responsible for its accuracy and consistency with the financial statements.

The financial statements have been audited by the independent accounting firm PriceWaterhouseCoopers LLP, which was given unrestricted access to all financial records and related data, including minutes of all meetings of trustees. The University believes that all representations made to the auditors during their audit were valid and appropriate. PriceWaterhouseCoopers' audit opinion is presented on page 30.

The University maintains a system of external controls over financial reporting, which is designed to provide a reasonable assurance to the University's management and board of trustees regarding the preparation of reliable published financial statements. Such controls are maintained by the establishment and communication of accounting and financial policies and procedures, by the selection and training of qualified personnel, and by an internal audit program designed to identify internal control weaknesses in order to permit management to take appropriate corrective action on a timely basis. There are, however, inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and the circumvention of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Furthermore, the effectiveness of the internal control system can change with circumstances.

The trustees of the University of Pennsylvania, through the Committee on Audit and Compliance comprised of trustees not employed by the University, is responsible for engaging the independent auditors and meeting with management, internal auditors and the independent auditors to ensure that each carry out their responsibilities. Both internal auditors and the independent auditors have full and free access to the Committee on Audit and Compliance.

Amy Gutmann
President

Craig R. Carnaroli
Executive Vice President

Scott R. Douglass
Vice President for Finance
and Treasurer

John Horn
Comptroller

Report of Independent Auditors

To the Trustees of the
University of Pennsylvania

In our opinion, the accompanying statement of financial position and the related statements of activities and changes in net assets, cash flows, and expenses by function present fairly, in all material respects, the financial position of the University of Pennsylvania at June 30, 2006, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the University of Pennsylvania's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized comparative information has been derived from the University of Pennsylvania's 2005 financial statements, and in our report dated November 14, 2005, we expressed an unqualified opinion on those financial statements. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

October 11, 2006

Statement of Financial Position

(thousands of dollars)

	June 30, 2006	June 30, 2005
Assets		
Cash and cash equivalents	$ 862,789	$ 711,422
Accounts receivable, net of allowances of $11,224 and $10,763	140,326	140,653
Patient receivables, net of allowances of $110,946 and $89,808	219,113	255,885
Contributions receivable, net	326,663	257,776
Loans receivable, net of allowances of $3,083 and $3,147	89,455	196,467
Other assets	122,718	138,346
Investments, at fair value	5,699,086	4,859,151
Plant, net of depreciation	2,909,176	2,760,840
Total assets	$10,369,326	$ 9,320,540
Liabilities		
Accounts payable	$ 93,179	$ 91,943
Accrued expenses and other liabilities	861,678	751,728
Collateral due broker	220,203	186,087
Deferred income	80,266	76,210
Deposits, advances, and agency funds	123,099	116,979
Federal student loan advances	77,737	78,328
Accrued retirement benefits	215,303	273,309
Debt obligations	1,374,459	1,358,041
Total liabilities	3,045,924	2,932,625
Net assets		
Unrestricted	3,612,342	3,086,908
Temporarily restricted	1,757,485	1,552,907
Permanently restricted	1,953,575	1,748,100
	7,323,402	6,387,915
Total liabilities and net assets	$10,369,326	$ 9,320,540

The accompanying notes are an integral part of these financial statements.

Statement of Activities

for the year ended June 30, 2006 (with summarized financial information for the year ended June 30, 2005)
(thousands of dollars)

	Unrestricted	Restricted Temporarily	Restricted Permanently	2006	2005
Revenue and other support:					
Tuition and fees, net	$ 599,190			$ 599,190	$ 552,933
Commonwealth appropriations	44,866			44,866	44,022
Sponsored programs	746,231			746,231	732,607
Contributions	38,793	$ 61,290		100,083	92,983
Investment income	140,678	95,752		236,430	188,277
Hospitals and physician practices	2,386,850			2,386,850	2,137,164
Sales and services of auxiliary enterprises	93,820			93,820	92,335
Other income	166,381			166,381	144,830
Independent operations	58,868			58,868	61,057
Net assets released from restrictions	170,193	(170,193)			
	4,445,870	(13,151)		4,432,719	4,046,208
Expenses:					
Program:					
Instruction	800,863			800,863	753,303
Research	592,791			592,791	579,417
Hospitals and physician practices	2,225,647			2,225,647	2,092,749
Auxiliary enterprises	109,820			109,820	106,719
Other educational activities	134,388			134,388	118,006
Student services	41,753			41,753	37,853
Support:					
Academic support	57,613			57,613	55,629
Management and general	177,544			177,544	165,961
Independent operations	57,176			57,176	59,603
	4,197,595			4,197,595	3,969,240
Increase (decrease) in net assets before nonoperating revenue, net gains, reclassifications and other	248,275	(13,151)		235,124	76,968
Nonoperating revenue, net gains, reclassifications and other:					
Gain on investment, net	145,196	230,655	$ 42,278	418,129	240,361
Investment income, net of amounts classified as operating revenue	(16,432)	(38,537)	1,279	(53,690)	(55,518)
Contributions	53,010	93,863	161,918	308,791	249,821
Change in minimum pension liability	45,953			45,953	(43,432)
Income from discontinued operations					32,455
Transfers to Phoenixville Foundation					(460)
Net assets released from restrictions	68,252	(68,252)			
Increase in net assets before cumulative effect of change in accounting principle	544,254	204,578	205,475	954,307	500,195
Cumulative effect of change in accounting principle	(18,820)			(18,820)	
Increase in net assets after cumulative effect of change in accounting principle	525,434	204,578	205,475	935,487	500,195
Net assets, beginning of year	3,086,908	1,552,907	1,748,100	6,387,915	5,887,720
Net assets, end of year	$ 3,612,342	$ 1,757,485	$ 1,953,575	$ 7,323,402	$ 6,387,915

The accompanying notes are an integral part of these financial statements.

Statement of Cash Flows

for the years ended June 30, 2006 and 2005
(thousands of dollars)

	2006	2005
Cash flows from operating activities:		
Increase in net assets	$ 935,487	$ 500,195
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	211,500	209,719
Provision for bad debts	145,617	133,755
Loss on extinguishment of debt		16,736
Gain on investments, net	(418,129)	(240,361)
Loss on disposal of plant, property and equipment	509	13,317
Donated equipment	(61)	(851)
Nonoperating income designated for the acquisition of long-lived assets and long-term investment	(255,101)	(193,843)
Change in minimum pension liability	(45,953)	43,432
Cumulative effect of change in accounting principle	18,820	
Changes in operating assets and liabilities:		
Patient, accounts and loans receivable	(16,833)	(38,357)
Contributions receivable	7,215	2,758
Other assets	14,770	(29,853)
Accounts payable, accrued expenses and accrued retirement benefits	105,999	87,359
Deposits, advances and agency funds	6,120	(2,296)
Deferred income	4,056	6,562
Net cash provided by operating activities	714,016	508,272
Cash flows from investing activities:		
Purchase of investments	(8,110,486)	(4,239,304)
Proceeds from sale of investments	7,700,285	4,068,069
Purchase of plant, property and equipment	(368,668)	(254,408)
Net cash used by investing activities	(778,869)	(425,643)
Cash flows from financing activities:		
Proceeds from contributions received designated for the acquisition of long-lived assets and long-term investment	199,584	156,680
Federal student loan advances	(591)	(384)
Repayment of long-term debt	(128,886)	(857,121)
Proceeds from issuance of long-term debt	146,113	797,230
Net cash provided by financing activities	216,220	96,405
Net increase in cash and cash equivalents	151,367	179,034
Cash and cash equivalents, beginning of year	711,422	532,388
Cash and cash equivalents, end of year	$ 862,789	$ 711,422
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 51,806	$ 42,931

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

1. Significant Accounting Policies

Organization

The University of Pennsylvania (the University), located in Philadelphia, Pennsylvania, is an independent, nonsectarian, not-for-profit institution of higher learning founded in 1740. The University Academic Component (Academic Component) provides educational services, primarily for students at the undergraduate, graduate, professional and postdoctoral levels and performs research, training and other services under grants, contracts and similar agreements with sponsoring organizations, primarily departments and agencies of the United States Government. The University also operates an integrated health care delivery system, the University of Pennsylvania Health System (UPHS). The University is a tax-exempt organization under Section 501(c) (3) of the Internal Revenue Code.

Basis of Presentation

The financial statements have been prepared on the accrual basis and include the accounts of the University of Pennsylvania and its subsidiaries. All material transactions between the University and its subsidiaries have been eliminated.

The net assets of the University are classified and reported as follows:

Unrestricted - Net assets that are not subject to donor-imposed restrictions.

Temporarily restricted - Net assets that are subject to legal or donor-imposed restrictions that will be met by actions of the University and/or the passage of time. These net assets include gifts donated for specific purposes and capital appreciation on permanent endowment, which is restricted by Pennsylvania law on the amounts that may be expended in a given year.

Permanently restricted - Net assets that are subject to donor-imposed restrictions that require the original contribution be maintained in perpetuity by the University, but permits the use of the investment earnings for general or specific purposes.

Expenses are reported as a decrease in unrestricted net assets. Gains and losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of temporary restrictions recognized on net assets are reported as net assets released from restrictions from temporarily restricted net assets to unrestricted net assets.

The financial statements include certain prior-year summarized comparative information in total, but not by net asset category. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the University's financial statements for the year ended June 30, 2005 from which the summarized information was derived. Certain reclassifications have been made to the summarized financial information for comparative purposes.

Cash and Cash Equivalents

Cash equivalents include short-term, highly liquid investments and are carried at cost which approximates fair value. Short-term investments with maturities of three months or less when purchased are classified as cash equivalents, except for restricted investments which are classified as Investments.

Investments

Investments in equity and debt securities with readily determinable fair values are reported at fair value. Changes in fair value of investments are reported in the University's Statement of Activities. Fixed income investments with a maturity of less than one year when purchased are included in short-term investments. Derivative financial instruments held for investment purposes are carried at fair value with the resulting gains and losses included in investment earnings for the period. For the fiscal year ended June 30, 2006, the University's principal derivative financial instruments are domestic and international equity future contracts and forward currency contracts. For the fiscal year ended June 30, 2005, the University's principal derivative financial instruments were international equity future contracts and forward currency contracts. Alternative investments that include hedge funds, private equity, natural resources and real estate investments held through limited partnerships or commingled funds are carried at estimated fair value provided by the management of the alternative investment partnerships or funds as of

March 31, 2006 and 2005, as adjusted by cash receipts, cash disbursements, and securities distributions through June 30, 2006 and 2005.

The University believes that the carrying amount of its alternative investments is a reasonable estimate of fair value as of June 30, 2006 and 2005. Because alternative investments are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investments existed and such differences could be material.

The majority of the endowment funds of the University have been pooled in the University's Associated Investments Fund (A.I.F.), which is invested in equities, bonds, hedge funds, natural resources, private equity and real estate limited partnerships. The University has adopted an endowment spending policy governing the expenditure of the total return of funds invested in the A.I.F. The spending policy is designed to manage annual spending levels and is independent of the cash yield and appreciation of investments for the year. For the fiscal years ended June 30, 2006 and June 30, 2005, the spending policy for the A.I.F. was 4.7% of the three year average market value lagged one year.

Loans Receivable

Student loans receivable are reported at their net realizable value. Such loans include donor-restricted and federally-sponsored student loans with mandated interest rates and repayment terms. Determination of the fair value of student loans receivable is not practicable.

Plant

Plant is stated at cost, or fair value at the date of donation, less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. Upon disposal of assets, the cost and related accumulated depreciation are removed from the accounts and the resulting net gain or loss is included in total expenses. Rare books and other collectibles, which appreciate in value, are not subject to depreciation.

Split-Interest Agreements

The University's split-interest agreements with donors consist primarily of charitable gift annuities, pooled income funds and irrevocable charitable remainder trusts for which the University serves as trustee. Assets are invested and payments are made to donors and/or other beneficiaries in accordance with the respective agreements.

Contribution revenue for charitable gift annuities and charitable remainder trusts is recognized at the date the agreement is established, net of the liability recorded for the present value of the estimated future payments. Contribution revenue for pooled income funds is recognized upon establishment of the agreement at the fair value of the estimated future receipts discounted for the estimated time period to complete the agreement.

The present value of payments to beneficiaries of charitable gift annuities and charitable remainder trusts and the estimated future receipts from pooled income funds are calculated using discount rates which represent the risk-free rates in existence at the date of the gift. Gains or losses resulting from changes in actuarial assumptions and accretions of the discount are recorded as increases or decreases in the respective contribution revenue net asset category in the Statement of Activities.

Tuition and Fees

The University maintains a policy of offering qualified undergraduate applicants admission to the University without regard to financial circumstance. This policy provides financial aid to eligible students in the form of direct grants, loans and employment during the academic year. Tuition and fees have been reduced by certain grants and scholarships in the amount of $153,299,000 in 2006 and $143,384,000 in 2005.

Sponsored Programs

The University receives grant and contract revenue from governmental and private sources. In 2006 and 2005, grant and contract revenue earned from governmental sources totaled $643,407,000 and $621,262,000, respectively. The University

Notes to Financial Statements

recognizes revenue associated with the direct costs of sponsored programs as the related costs are incurred. Indirect costs recovered on federally-sponsored programs are generally based on predetermined reimbursement rates negotiated with the University's cognizant federal agency, the Department of Health and Human Services. Indirect costs recovered on all other grants and contracts are based on rates negotiated with the respective sponsor. Funds received for sponsored research activity are subject to audit. Based upon information currently available, management believes that any liability resulting from such audits will not materially affect the financial position or operations of the University.

Contributions

Contributions are reported as increases in the appropriate net asset category based on donor restrictions. Contributions, including unconditional promises to donate, are recognized as revenue in the period received. Unconditional pledges are recognized at their estimated net present value, net of an allowance for uncollectible amounts, and are classified in the appropriate net asset category. Unconditional promises to donate and contributions of cash and other assets designated for the acquisition of long-lived assets and long-term investment are reported with Nonoperating revenue, net gains, reclassifications and other.

Because of uncertainties with regard to their realizability and valuation, bequest intentions and other conditional promises are not estimated by management and are recognized if and when the specified conditions are met. Irrevocable bequest intentions where the donor is over 75 years of age are recorded as revenue in the year the intention is made at the net present value of the gift.

Hospital and physician practices

Hospital and physician practices revenue is derived primarily from UPHS patient services and is accounted for at established rates on the accrual basis in the period the service is provided. Patient service revenue is net of charity care and community service. Certain revenue received from third-party payers is subject to audit and retroactive adjustment. Additionally, UPHS has entered into certain contracts under which it is responsible for providing medical care to covered members at predetermined rates. Any changes in estimates under these contracts are recorded in operations currently.

Allocation of Certain Expenses

The Statement of Activities presents expenses by functional classification. Operation and maintenance of plant and depreciation are allocated to functional classifications based on square footage. Interest expense is allocated to the functional classifications of the activity that directly benefited from the proceeds of the debt.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

New Authoritative Pronouncements

In 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47), which is effective for the University as of July 1, 2005. FIN 47 was issued to provide clarity surrounding the recognition of conditional asset retirement obligations, as referred to in FASB Statement No. 143, "Accounting for Asset Retirement Obligations". FIN 47 defines a conditional asset retirement obligation as a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. Uncertainty with respect to the timing and/or method of settlement of the asset retirement obligation, does not defer recognition of a liability. The obligation to perform the asset retirement activity is unconditional, and accordingly, a liability should be recognized. FIN 47 also provides guidance with respect to the criteria to be used to determine whether sufficient information exists to reasonably estimate the fair value of an asset retirement obligation. Based on the guidance in FIN 47, management of the University determined that sufficient information was available to reasonably estimate the fair value of known asset retirement obligations.

Notes to Financial Statements

FIN 47 requires the initial application of the interpretation to be recognized as a cumulative effect of a change in accounting principle. Specifically, FIN 47 requires the recognition, as a cumulative effect, the cumulative accretion and accumulated depreciation for the time period from the date the liability would have been recognized had the provisions of the interpretation been in effect when the liability was incurred to the date of adoption of this Interpretation. The liability incurred date is presumed to be the date upon which the legal requirement to perform the asset retirement activity was enacted. The University's conditional asset retirement obligations primarily relate to asbestos contained in buildings and underground steam distribution piping.

Upon initial application of FIN 47, the University recognized $18,820,000 as the Cumulative effect of a change in accounting principle in the Statement of Activities. As of June 30, 2006, $20,960,000 of conditional asset retirement obligations is included within Accrued Expenses in the Statement of Financial Position.

2. University of Pennsylvania Health System - Summarized financial information

The Trustees of the University of Pennsylvania formed Penn Medicine, the governance structure which oversees the activities of UPHS and the University of Pennsylvania School of Medicine. The governing body operates, oversees and coordinates the academic, research and clinical missions of Penn Medicine.

UPHS is comprised of the Clinical Practices of the University of Pennsylvania, Clinical Care Associates, Hospital of the University of Pennsylvania, Penn Presbyterian Medical Center, Pennsylvania Hospital of the University of Pennsylvania Health System and Wissahickon Hospice of the University of Pennsylvania Health System, Franklin Casualty Insurance Company, a wholly owned Risk Retention Group, and Quaker Insurance Company Ltd., a wholly owned offshore captive insurance company, (collectively referred to as RRG/Captive).

Throughout the year, certain transactions are conducted between UPHS and the University. The effect of these transactions (primarily billings for allocations of common costs, physicians' salaries and benefits, certain purchased services and support for the School of Medicine) is included in the summarized financial information of UPHS. The University owed UPHS $141,000 at June 30, 2006 and UPHS owed the University $3,783,000 at June 30, 2005, which represents normal current inter-entity activity and is eliminated in the consolidated financial statements.

UPHS transferred to the School of Medicine from its operations $23,165,000 and $27,198,000 in 2006 and 2005, respectively, to further research and educational activities. These activities are integral to the overall mission of Penn Medicine and the effect of the transfers is reflected in UPHS, nonoperating, net. This transaction is eliminated in the consolidated financial statements.

Final adjustments to revenue, resulting from settlements with third-party payers, are recorded in the year in which they are settled. The 2006 and 2005 Medicare net patient service revenue was increased by $4,248,000 and $6,459,000, respectively, as a result of final settlements and the revision or removal of allowances previously estimated that were no longer necessary.

During 2002, UPHS and Independence Blue Cross (IBC) reached agreement on terms of a five-year agreement. Payments made for inpatient services provided to IBC traditional and managed care subscribers are effected on a per case rate basis for most procedural based services and high intensity medical cases (over 60% of all inpatient admissions in all) and a per diem basis for all other services. Payment for outpatient services is principally based upon negotiated fee schedules. Hospital rates also provide for annual inflationary increases.

During 2005, UPHS and Aetna reached agreement on terms of a five-year agreement. The terms of the agreement provide payments for inpatient hospital services on a per case rate basis. Payments for outpatient services continue to be predominantly based upon negotiated fee schedules.

UPHS also has reimbursement agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for reimbursement under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined per diem rates.

Notes to Financial Statements

Summarized financial information for UPHS as of and for the years ended June 30, 2006 and 2005, prior to eliminations for transactions between UPHS and other entities of the University, is as follows (in thousands):

	2006	2005
Net patient service	$ 2,272,914	$ 2,043,862
Other revenue	124,815	104,509
Total expenses	(2,239,328)	(2,075,887)
Excess of revenues over expenses from operations	158,401	72,484
Other unrestricted income, net	64,395	20,325
Excess of revenue over expenses	222,796	92,809
Nonoperating, net	89,243	(17,358)
Unrealized gain, net	7,913	1,600
Cumulative affect of change in accounting principle	(8,183)	
Increase in net assets	$ 311,769	$ 77,051
Total current assets	$ 648,189	$ 552,869
Assets whose use is limited (including board designated funds of $516,659 and $345,514 and trustee held funds of $68,427 and $129,363 for 2006 and 2005, respectively)	1,090,858	935,697
Plant, net of depreciation	653,927	594,795
Investments and other assets	78,366	73,498
Total assets	$ 2,471,340	$ 2,156,859
Total current liabilities	$ 395,719	$ 336,620
Long-term debt, net of current portion	741,141	774,724
Other liabilities	364,097	386,901
Total liabilities	$ 1,500,957	$ 1,498,245
Net assets		
Unrestricted	$ 521,944	$ 249,922
Temporarily restricted	321,645	289,045
Permanently restricted	126,794	119,647
Total net assets	970,383	658,614
Total liabilities and net assets	$ 2,471,340	$ 2,156,859

On August 1, 2004 UPHS sold the assets and certain liabilities of Phoenixville Hospital (PHX-UPHS) for $100,800,000, resulting in a gain to UPHS of $31,835,000. Assets sold included property and equipment, certain prepayments and inventory. Liabilities included accounts payable and compensated absences. Additionally, PHX-UPHS' donor restricted funds were transferred to the Phoenixville Foundation. Income from operations for PHX-UPHS for the month of July 2004 was $620,000, and is included in income from operations in the accompanying 2005 combined statement of operations. Additionally, long term debt and capital leases of $33,954,000 were redeemed as a result of this transaction.

Notes to Financial Statements

3. Investments

A summary of investments, stated at fair value, at June 30, 2006 and 2005 is as follows (in thousands):

	2006	2005
Short-term	$ 1,234,997	$ 517,983
Stocks	2,354,324	2,155,577
Bonds	824,891	1,122,377
Real estate	197,536	172,536
Absolute return	843,133	712,546
Private equity	207,275	159,279
Natural resources	34,909	14,812
Other	2,021	4,041
End of year	$ 5,699,086	$ 4,859,151
Beginning of year	$ 4,859,151	$ 4,312,544

Included in investments are assets held in trust for the University with an aggregate fair value of $353,566,000 at June 30, 2006 and $320,370,000 at June 30, 2005.

In connection with a University-sponsored loan program, the University is required to invest in certificates of deposit of the lending institution. At June 30, 2006 and 2005, short-term investments held under this arrangement aggregated $3,221,000 and $3,715,000, respectively.

At June 30, 2006 and 2005, investments with a fair value of $71,841,000 and $133,676,000, respectively, were held by trustees under indenture and escrow agreements.

Included in investments is $5,273,000 and $4,925,000 of cash that is held in escrow at June 30, 2006 and 2005, respectively.

At June 30, 2006 and 2005, investments with a fair value of $214,633,000 and $179,465,000, respectively, were loaned on an overnight basis to various brokers. The University receives lending fees and continues to earn interest and dividends on the loaned securities. These securities are returnable on demand and are collateralized by cash deposits and U.S. Treasury obligations. Cash deposits included in short-term investments are $220,004,000 and $186,087,000 at June 30, 2006 and 2005, respectively. U.S. Treasury obligations included in Bonds are $199,000 and $0 at June 30, 2006 and 2005, respectively. The University is indemnified against borrower default by the financial institution that is acting as its lending agent.

At June 30, 2006 and 2005, short-term investments include $32,381,000 and $3,015,000, respectively, of investments sold receivables. At June 30, 2006 and 2005, short-term investments include $21,601,000 and $2,629,000, respectively, of investments purchased payables.

The University is obligated under certain limited partnership investment fund agreements to advance additional funding periodically up to specified levels. At June 30, 2006, the University had unfunded commitments of $531,738,000 to a variety of private equity, real estate, natural resources and other drawdown funds. Based upon past experience, the University expects these commitments to be funded over the next 3 to 5 years depending on market conditions.

Notes to Financial Statements

A summary of the University's total investment return for the years ended June 30, 2006 and 2005 as reported in the Statement of Activities is presented below (in thousands):

	2006	2005
A.I.F. investment income	$ 100,551	$ 83,038
A.I.F. realized and unrealized gains and (losses)	388,298	234,784
Return on A.I.F.	488,849	317,822
Other investment income, gains and losses	112,020	55,298
Total return on investments	$ 600,869	$ 373,120

Income distributed for operations under the A.I.F. spending rule exceeded available income, net of expenses and net of income permanently reinvested, by $62,554,000 in 2006 and by $63,847,000 in 2005.

Investments include amounts held to meet legally mandated annuity reserves of $31,093,000 and $28,034,000 as of June 30, 2006 and 2005, respectively, as required by the laws of the following states where certain individual donors reside: California, New Jersey and New York.

4. Accounts Receivable

The major components of receivables, net of reserve for doubtful accounts of $11,224,000 and $10,763,000 at June 30, 2006 and 2005, respectively, are as follows (in thousands):

	2006	2005
Sponsored research	$ 67,365	$ 72,697
Student	12,134	14,713
Trade	32,332	24,766
Investment income	7,717	4,735
Other	20,778	23,742
Total Accounts receivable	$ 140,326	$ 140,653

5. Contributions Receivable

A summary of contributions receivable is as follows at June 30, 2006 and 2005 (in thousands):

	2006	2005
Unconditional promises expected to be collected in:		
Less than one year	$ 145,623	$ 164,287
One year to five years	251,777	153,909
Over five years	23,197	17,117
	420,597	335,313
Less: Discount and allowance for doubtful amounts	(93,934)	(77,537)
Contributions receivable, net	$ 326,663	$ 257,776

Notes to Financial Statements

6. Other Assets

The major components of Other assets at June 30, 2006 and 2005, respectively, are as follows (in thousands):

	2006	2005
Goodwill	$ 31,585	$ 33,184
Defined benefit pension asset	23,173	22,285
Inventory	23,398	19,861
Prepaid expenses	19,492	20,266
Deferred financing fees	16,215	17,879
Unrecognized prior service costs		13,231
Other	8,855	11,640
Total Other assets	$ 122,718	$ 138,346

Goodwill of $31,585,000 at June 30, 2006 and $33,184,000 at June 30, 2005 associated with the statutory merger of the Presbyterian Medical Center of Philadelphia into UPHS is being amortized over thirty years on a straight-line basis.

7. Plant, net of depreciation

The components of plant at June 30, 2006 and 2005 are as follows (in thousands):

	2006	2005
Land	$ 91,969	$ 81,401
Buildings	3,452,076	3,241,510
Contents	1,549,210	1,529,900
Construction-in-progress	241,178	202,252
	5,334,433	5,055,063
Less: accumulated depreciation	(2,425,257)	(2,294,223)
Plant, net of depreciation	$ 2,909,176	$ 2,760,840

The University recorded $209,183,000 and $207,550,000 of depreciation expense for the years ended June 30, 2006 and 2005, respectively. Rare books and other collectibles aggregate $21,262,000 at June 30, 2006 and $20,776,000 at June 30, 2005.

8. Split-Interest Agreements

The liability to donors and beneficiaries under terms of split-interest agreements included in Accrued expenses and other liabilities is as follows (in thousands):

	2006	2005
Charitable gift annuities	$ 25,791	$ 23,551
Charitable remainder trusts	31,238	27,169
Pooled income funds	1,206	1,130
Total split-interest agreements	$ 58,235	$ 51,850

Notes to Financial Statements

9. Debt Obligations

Debt obligations at June 30, 2006 and 2005 are as follows (in thousands):

	Maturity	Interest Rate at June 30, 2006	June 30, 2006	June 30, 2005
Academic Component:				
Fixed Rate Debt Obligations:				
Pennsylvania Higher Education Facility Authority (PHEFA)				
Series C of 2005 Revenue Bonds	09/2038	3.20% - 5.00%	$141,620	
Unamortized Premium			4,312	
Series A of 2005 Revenue Bonds	09/2025	3.00% - 5.00%	37,655	$ 37,655
Unamortized Premium			1,553	1,775
Series B of 2005 Revenue Bonds	09/2015	5.00% - 5.25%	66,930	66,930
Unamortized Premium			5,114	6,166
Series A of 2002 Revenue Bonds	07/2008	3.50% - 5.00%	9,185	11,950
Unamortized Premium			107	220
Series of 1998 Revenue Bonds	07/2038	4.50% - 5.50%	113,600	188,480
Unamortized Discount			(1,028)	(1,784)
Series A of 1995 Revenue Bonds	09/2015	N/A		5,280
Series B of 1995 Revenue Bonds	09/2015	N/A		2,380
Department of Education Bonds	03/2007	3.00%	60	126
Other Loans	Various	3.00% - 7.85%	3,626	12,999
Total Fixed Rate Debt Obligations			382,734	332,177
Variable Rate Debt Obligations:				
PHEFA				
Series B of 2002 Revenue Bonds	07/2032	3.43%	48,150	48,900
Series of 1990 Revenue Bonds	12/2020	3.69%	6,500	6,500
Series of 1985 Revenue Bonds	12/2015	3.69%	10,610	10,610
Quakertown General Authority				
Series of 2004	07/2034	3.43%	77,700	77,700
Washington County Authority				
Series of 2004	07/2034	3.66%	62,500	62,500
Other Loans	Various	5.49% - 5.71%	14,928	15,000
Total Variable Rate Debt Obligations			220,388	221,210
Total Academic Component Debt Obligations			603,122	553,387
UPHS:				
Fixed Rate Debt Obligations:				
PHEFA				
Series A of 2005 Revenue Bonds	08/2023	3.00% - 5.00%	272,980	273,280
Unamortized Premium			18,284	21,182
Series B of 2005 Revenue Bonds	08/2018	3.00% - 5.00%	86,555	86,555
Unamortized Premium			2,119	2,444
Series of 2004 Revenue Bonds	11/2010	3.40%	21,250	25,385
Pennsylvania Hospital Series of 2004	01/2024	7.50%	89,235	89,235
Series of 2002 Revenue Bonds	01/2024	7.50%	24,290	24,925
Series A of 1998 Revenue Bonds	01/2015	4.40% - 5.40%	38,750	38,750
Unamortized Premium			457	508
Series A and B of 1996 Revenue Bonds	01/2006	N/A		16,500
Notes Payable	10/2005	7.00%	133	4,441
Capital Leases	Various	4.60% - 5.90%	13,309	17,374
Total Fixed Rate Debt Obligations			$ 567,362	$ 600,579

Notes to Financial Statements

	Maturity	Interest Rate at June 30, 2006	June 30, 2006	June 30, 2005
Variable Rate Debt Obligations:				
PHEFA				
Series C of 2005 Revenue Bonds	4/2024	3.80%	$ 103,675	$ 103,675
Series D of 2005 Revenue Bonds	4/2027	3.90%	92,400	92,400
Pennsylvania Economic Development Financing Authority Series C of 1994 Revenue Bonds	09/2015	5.40%	7,900	8,000
Total Variable Rate Debt Obligations			203,975	204,075
Total UPHS Debt Obligations			771,337	804,654
Total University Debt Obligations			$1,374,459	$1,358,041

The fair value of the University's debt obligations was $1,360,922,000 and $1,363,149,000 at June 30, 2006 and 2005, respectively. The fair value represents the quoted market value for PHEFA Revenue Bonds and Department of Education Bonds and carrying amounts for all other debt, which approximates fair value.

Maturities of debt obligations are as follows (in thousands):

Fiscal Year	Amount
2007	$ 46,106
2008	49,533
2009	52,690
2010	54,382
2011	47,978
Thereafter	1,092,851
Total Principal	1,343,540
Unamortized Premium/Discount	30,919
Total Debt	$ 1,374,459

Academic Component

On August 18, 2005, PHEFA issued Revenue Bonds, Series 2005C ("PHEFA 2005C Bonds"), with an aggregate principal amount of $141,620,000. The proceeds were used to fund a construction project of approximately $70,000,000 and to fund an escrow which will be used to refund $72,640,000 from the PHEFA Series of 1998 Revenue Bonds ("Refunded 1998 Bonds"). The Refunded 1998 Bonds were legally defeased and, as such, have been excluded from the University's reported liabilities after August 18, 2005. The Refunded 1998 Bonds will be retired when they become callable on July 15, 2008. $113,600,000 of the PHEFA 1998 Bonds were not refunded and will be paid as they become due.

The note payable to the Redevelopment Authority of the City of Philadelphia, with an outstanding principal balance of $7,336,247 was satisfied on August 26, 2005.

On January 12, 2005, the Pennsylvania Higher Educational Facilities Authority ("PHEFA") issued Refunding Revenue Bonds, Series 2005A ("PHEFA 2005A Bonds") with an aggregate principal amount of $37,655,000. The proceeds were principally used to fund an escrow which will be used to refund $32,895,000 from the PHEFA Series B of 1995 Revenue Bonds ("Refunded 1995B Bonds"). The Refunded 1995B Bonds were legally defeased and, as such, have been excluded from the University's reported liabilities. The remaining PHEFA 1995B Bonds of $2,380,000 were repaid on September 1, 2005.

Interest on the PHEFA 2005A Bonds is fixed with coupons ranging between 3.00% and 5.00%. The PHEFA 2005A Bonds have serial maturities which are due in amounts ranging from $2,750,000 in September 2006 to $5,155,000 in 2025. The bonds are callable after September 1, 2015 at a price equal to 100% of the principal amount plus accrued interest.

Notes to Financial Statements

On June 7, 2005, PHEFA issued Refunding Revenue Bonds, Series 2005B ("PHEFA 2005B Bonds"), with an aggregate principal amount of $66,930,000. The proceeds were used to fund an escrow which will be used to refund $73,100,000 from the PHEFA Series A of 1995 Revenue Bonds ("Refunded 1995A Bonds"). The Refunded 1995A Bonds were legally defeased and, as such, have been excluded from the University's reported liabilities. The remaining PHEFA 1995A Bonds of $5,280,000 were repaid on September 1, 2005.

Interest on the PHEFA 2005B Bonds is fixed with coupons ranging between 5.00% and 5.25%. The PHEFA 2005B have serial maturities which are due in amounts ranging from $4,510,000 in September 2006 to $8,495,000 in 2015.

UPHS

Pennsylvania Higher Education Facilities Authority Revenue Bonds

The PHEFA Revenue Bonds, exclusive of Series of 2004 and 2002, are secured by master notes issued under the UPHS Master Trust Indenture (MTI). The MTI and related agreements contain certain restrictive covenants which limit the issuance of additional indebtedness, and among other things, require UPHS to meet an annual debt service coverage requirement of "income available for debt service" (excess of revenue over expenses plus depreciation, amortization, interest expense and extraordinary items) at an amount equal to 110% of the annual debt service requirements. If the coverage requirement for a particular year is not met, within six months of the close of that fiscal year UPHS must retain the services of a consultant to make recommendations to improve the coverage requirement. UPHS must also implement the recommendations of the consultant to the extent that they can be feasibly implemented. UPHS will not be considered to be in default of the provisions of the MTI so long as UPHS has sufficient cash flow to pay total operating expenses and to pay debt service for the fiscal year. In both 2006 and 2005, UPHS met its debt service coverage requirement under the MTI. Additionally, UPHS has pledged its gross revenues to secure its obligation under the MTI.

UPHS Series A of 2005 Bonds were issued on February 16, 2005 for the purpose of legally defeasing the non-current maturities of the Health Services Series A of 1996 bonds. The bonds mature in varying amounts ranging from $6,000,000 to $22,855,000, with a final maturity of $6,000,000 in 2023. The Bonds have stated interest rates that range from 3.00% to 5.00%. The Bonds are subject to optional redemption by the University as Obligated Group Agent on or after August 15, 2015 at a redemption price of 100% plus accrued interest. Payment of principal and interest on the 2009-2022 bond maturities is insured by Ambac Assurance Corporation.

UPHS Series B of 2005 Bonds were issued on February 16, 2005 for the purpose of funding various UPHS capital expenditures. The bonds mature in varying amounts ranging from $4,000,000 to $13,000,000, with a final maturity of $4,000,000 in 2018. The Bonds have stated interest rates that range from 3.00% to 5.00%. The Bonds are subject to optional redemption by the University as Obligated Group Agent on or after August 15, 2015 at a redemption price of 100% plus accrued interest. Payment of principal and interest on a portion of the 2008, 2009-2017 bond maturities is insured by Financial Guaranty Insurance Company.

UPHS Series C of 2005 Bonds were issued on April 6, 2005 for the purpose of legally defeasing the Health Services Series B of 1994 variable rate bonds. The bonds are subject to mandatory redemption in varying amounts ranging from $17,125,000 to $32,175,000 in 2024. Interest on the bonds is reset weekly through an auction process (3.80% at June 30, 2006). The Bonds are eligible to be changed to a fixed rate as elected by the University as Obligated Group Agent. The Bonds are subject to optional redemption by the University on any scheduled interest payment date or the first day of each rate period (as determined by the elected interest mode in effect) prior to their scheduled maturity at a redemption price of 100% plus accrued interest. Payment of principal and interest on the bonds is insured by Ambac Assurance Corporation.

UPHS Series D of 2005 Bonds were issued on April 6, 2005 for the purpose of legally defeasing the Health Services Series C of 1996 variable bonds. The bonds are subject to mandatory redemption in varying amounts ranging from $3,050,000 to $38,600,000, with a final maturity in 2027. Interest on the bonds is reset weekly by a remarketing agent (3.91% at June 30,

Notes to Financial Statements

2006). The Bonds are eligible to be changed to a fixed rate as elected by the University as Obligated Group Agent. The Bonds are subject to optional redemption by the University on any scheduled interest payment date or the first day of each rate period (as determined by the elected interest mode in effect) prior to their scheduled maturity at a redemption price of 100% plus accrued interest. Payment of principal and interest on the bonds is insured by Financial Guaranty Insurance Company.

UPHS Series of 2004 Bonds were issued November 12, 2004 for the purpose of retiring the Series A of 1994 Bonds. The bonds mature in varying amounts ranging from $4,375,000 to $5,735,000 with a final maturity of $5,405,000 in 2010. The Bonds have stated interest rate of 3.35%.

The Series of 2004 Bonds, were issued on November 12, 2004, on behalf of Pennsylvania Hospital, for the purpose of legally defeasing the Health Services Series B of 1998 variable bonds. The bonds mature in varying amounts ranging from $2,110,000 to $13,380,000, with a final maturity of $10,655,000 in 2024. The bonds have a stated interest rate of 7.50%. The holder of the bonds will have the option to put them on January 1, 2010, as described in a put option agreement between HUP and CPUP and Merrill Lynch Portfolio Management, Inc. The 2004 Bonds are also guaranteed by HUP and CPUP, for which they receive a guarantee fee from the bondholder. The put option fee and the guarantee fee reduce the net cost of funds to 3.45%. UPHS entered into an interest rate exchange agreement with Merrill Lynch Capital Services in order to synthetically convert the Series of 2004 Bonds to a variable interest rate. The interest rate exchange agreement will terminate on January 1, 2010. This agreement was not entered into for trading or speculative purposes. Under the terms of the agreement, UPHS receives a fixed rate of 3.00% and pays a variable interest rate defined as the BMA index on the notional principal amount of the outstanding bonds.

10. Natural Classification of Expenditures

Expenses incurred were for (in thousands):

	Compensation	Student Aid	Depreciation	Interest	Other Operating	Total
June 30, 2006						
Instruction	$ 494,425	$ 46,851	$ 32,725	$ 3,902	$ 222,960	$ 800,863
Research	338,087	8,961	29,087	10,040	206,616	592,791
Hospitals and physician practices	1,205,880		91,886	29,498	898,383	2,225,647
Auxiliary enterprises	21,752		14,879	4,069	69,120	109,820
Other educational activities	87,730	20	5,935	565	40,138	134,388
Student services	24,703	174		86	16,790	41,753
Academic support	26,358		20,798	869	9,588	57,613
Management and general	140,225	3	8,881	791	27,644	177,544
Independent operations	6,189		4,992	2,004	43,991	57,176
Total	$ 2,345,349	$ 56,009	$ 209,183	$ 51,824	$ 1,535,230	$ 4,197,595
June 30, 2005	$ 2,153,088	$ 55,675	$ 207,550	$ 54,628	$ 1,498,299	$ 3,969,240

Notes to Financial Statements

11. Operating Leases

The University leases research labs, office space and equipment under operating leases expiring through November 2024. Rental expense for the years ended June 30, 2006 and 2005 totaling $47,035,000 and $48,161,000, respectively, is included in the accompanying Statement of Activities.

At June 30, 2006, future minimum lease payments under operating leases with remaining terms greater than one year were as follows (in thousands):

2007	$ 38,540
2008	32,956
2009	30,341
2010	26,116
2011	19,273
Thereafter	88,446
Total minimum lease payments	$ 235,672

12. Pension and Other Postretirement Benefit Costs

Retirement benefits are provided for academic employees and certain administrative and support personnel through a defined contribution plan. The University's policy with respect to its contribution is to provide up to 9% of eligible employees' salaries. The University's contributions amounted to $67,951,000 in 2006 and $63,038,000 in 2005.

The University has noncontributory defined benefit pension plans for substantially all other full-time employees. Benefits under these plans generally are based on the employee's years of service and compensation during the years preceding retirement. Contributions to the plans are made in amounts necessary to at least satisfy the minimum required contributions as specified in the Internal Revenue Service Code and related regulations.

Clinical Care Associates has a non-contributory defined contribution retirement plan covering all eligible employees. Clinical Care Associates has also established a non-qualified supplemental retirement plan to provide retirement benefits to a select group of physician employees. Contributions to these plans are based upon the annual compensation of the eligible employees. Retirement plan expense was $3,171,000 and $2,881,000 for 2006 and 2005, respectively

Notes to Financial Statements

Obligations and Funded Status

The components of accrued benefit costs for pension benefits and other postretirement benefits are as follows (in thousands):

	Pension Benefits		Other Postretirement Benefits	
	2006	2005	2006	2005
Change in benefit obligation:				
Benefit obligation at beginning of fiscal year	$ 853,333	$ 647,255	$ 433,238	$ 370,868
Service cost	30,304	21,270	14,991	13,766
Interest cost	43,794	39,941	21,619	21,565
Plan participants' contributions	106	100	1,828	1,169
Retiree drug subsidy			610	
Amendments			1,132	
Actuarial (gain) loss	(121,641)	164,834	(55,112)	41,673
Benefits paid	(20,839)	(20,067)	(15,896)	(15,803)
Benefit obligation at end of fiscal year	$ 785,057	$ 853,333	$ 402,410	$ 433,238
Change in plan assets:				
Fair value of plan assets at beginning of fiscal year	$ 654,234	$ 602,527	$ 117,060	$ 95,523
Actual return on plan assets	69,513	46,201	4,862	16,437
Employer contribution	30,876	25,473	30,779	19,734
Plan participants' contributions	106	100	1,828	1,169
Benefits paid	(20,839)	(20,067)	(15,896)	(15,803)
Fair value of plan assets at end of fiscal year	$ 733,890	$ 654,234	$ 138,633	$ 117,060
Reconciliation of funded status:				
Funded status	$ (51,167)	$(199,099)	$ (263,777)	$(316,178)
Unrecognized net actuarial loss	39,164	184,706	89,369	144,862
Unrecognized prior service cost (benefit)	11,593	13,231	(11,346)	(16,141)
Net amount recognized	$ (410)	$ (1,162)	$(185,754)	$ (187,457)
Amounts recognized on balance sheet:				
Prepaid benefit cost in other assets	$ 23,173	$ 22,248	$ -	$ -
Accrued retirement benefits	(23,583)	(23,410)	(185,754)	(187,457)
Net amount recognized	$ (410)	$ (1,162)	$(185,754)	$ (187,457)

The accumulated benefit obligation for all plans was $678,169,000 and $733,087,000 at June 30, 2006 and 2005, respectively. The accumulated benefit obligation for all defined benefit plans was $143,853 and $156,940 at June 30, 2006 and June 30, 2005, respectively.

Accrued retirement benefits includes $6,089,000 and $3,554,000 for faculty early retirement program at June 30, 2006 and 2005, respectively.

Notes to Financial Statements

Certain UPHS plans have an accumulated benefit obligation in excess of plan assets as follows (in thousands):

	2006	2005
Projected benefit obligation	$ 629,775	$ 682,801
Accumulated benefit obligation	$ 534,316	$ 576,147
Fair value of plan assets	$ 562,365	$ 493,847

Net Periodic Cost

The components of net periodic benefit cost for pension benefits and other postretirement benefits are as follows (in thousands):

	Pension Benefits		Other Postretirement Benefits	
	2006	2005	2006	2005
Service cost	$ 30,304	$ 21,270	$ 14,991	$ 13,766
Interest cost	43,794	39,941	21,619	21,565
Expected return on plan assets	(54,797)	(49,591)	(10,347)	(8,184)
Amortization of prior service cost	1,638	1,645	(3,664)	(3,754)
Amortization of net actuarial loss	9,183	93	5,867	4,990
Net periodic cost	$ 30,122	$ 13,358	$ 28,466	$ 28,383

Additional Information

In 2006, as a result of a reduction in the discount rate and improved investment performance, UPHS reversed the accumulated additional minimum pension liability required to account for an unfunded accumulated benefit obligation (ABO). The reversal is recognized as an increase to unrestricted nonoperating net assets for 2006 in the accompanying financial statements.

	2006	2005
(Decrease) increase in minimum liability included as nonoperating income	($45,953)	$43,432

Assumptions

The weighted average assumptions used in determining benefit obligations as of the end of the fiscal year are as follows:

	2006	2005
Discount rate	6.25%	5.17%
Salary Increase	4.125%	4.125%
Measurement Date	June 30, 2006	June 30, 2005

The weighted average assumptions used in determining net periodic cost are as follows:

	2006	2005
Discount Rate	5.17%	6.25%
Salary Increase	4.125%	4.125%
Expected Return on Plan Assets	8.375%	8.375%
Measurement Date	June 30, 2005	June 30, 2004

Notes to Financial Statements

The expected long-term rate of return of plan assets is management's best estimate of the average investment return expected to be received on the assets invested in the plan over the benefit period. The expected long-term rate of return on plan assets has been established by considering historical and future expected returns of the asset classes invested in by the pension trust, and the allocation strategy currently in place among those classes.

The assumed Health Care Cost Trend Rates used in determining benefit obligations are as follows:

	2006	2005
Initial Trend Rate	10.0%	11.0%
Ultimate Trend Rate	5.0%	5.0%
Fiscal Year End that Ultimate Trend Rate is Reached	2013	2013

Assumed health care cost trend rates have a significant effect on the amounts reported for the other postretirement benefits. A one-percentage-point change in assumed health care trend rates would have the following effects on other postretirement benefits (in thousands):

	1-Percentage Point Increase	1-Percentage Point Decrease
Effect on total of service and interest cost	$ 6,978	$ (5,442)
Effect on accumulated postretirement benefit obligation	$ 60,818	$ (49,161)

Plan Assets

The principal investment objectives for the pension and other postretirement benefits plans are: to ensure the availability of funds to pay pension benefits as they become due under a broad range of future economic scenarios; to maximize long-term investment returns with an acceptable level of risk based on the pension obligations; and to invest the pension trust in a diversified manner across equity and debt securities. The equity securities are diversified, and comprised predominantly of developed market liquid assets, across a range of investment styles. Domestic equities comprised 36% and international equities comprised 35% of plan assets at June 30, 2006. The average quality of debt securities at June 30, 2006 was AAA with an effective duration of 4.17 years. The target and actual allocation for plan assets is as follows:

	Target	2006	2005
Equity securities	73.0%	71.0%	68.0%
Debt securities	27.0%	29.0%	32.0%
	100.0%	100.0%	100.0%

Cash Flows

The University's expected contributions under the plans for the year ending June 30, 2007 total $45,657,000.

Notes to Financial Statements

Estimated Future Benefit Payments

The benefit payments to retirees which reflect future service are expected to be paid as follows (in thousands):

	Pension Benefits	Other Postretirement Benefits Before Medicare Part D Subsidy	Impact of Medicare Part D Subsidy
For the year ended June 30,			
2007	$ 23,925	$ 20,189	$ 2,563
2008	25,627	21,616	2,734
2009	27,570	23,319	2,951
2010	29,773	24,938	3,158
2011	32,523	26,405	3,341
2012 and beyond	219,406	154,228	19,751

13. Medical Professional Liability Claims

The University is insured for medical professional liability claims through the combination of the Medical Care Availability and Reduction of Error Fund (Mcare, formerly, the Medical Professional Liability Catastrophe Loss Fund of the Commonwealth of Pennsylvania -- CAT Fund), various commercial insurance companies and a risk retention program.

Mcare levies health care provider surcharge s, as a percentage of the Pennsylvania Joint Underwriters Association rates for basic coverage, to pay claims and pay administrative expenses of Mcare participants. These surcharges are recognized as expenses in the period incurred. In March 2002, the Pennsylvania General Assembly approved reforming the Commonwealth's medical malpractice insurance system. No provision has been made for any future Mcare assessments in the accompanying financial statements as the University's portion of the unfunded Mcare liability cannot be estimated.

The University accrues for estimated retained risks arising from both asserted and unasserted medical professional liability claims. The estimate of the liability for unasserted claims arising from unreported incidents is based on analysis of historical claims data by an independent actuary which is recorded utilizing a 5.0% discount rate at June 30, 2006.

From July 1998 through June 2001, the University was insured by a commercial insurer to provide claims made primary layer coverage on a claims-made premium basis. Premiums were expensed in each respective fiscal year. Additionally, the University has recorded the actuarially determined exposure for unreported and unasserted medical professional claims that occurred during the period covered by the commercial insurance policy.

Effective July 1, 2001, the University funded RRG/Captive, for purposes of administering its risk retention program, covering its primary layer exposures. The assets and respective liabilities of RRG/Captive are included in the accompanying financial statements.

Assets have been board designated to provide funding for the University's retained risk associated with medical professional liability claims. The assets are included in the accompanying financial statements.

Notes to Financial Statements

14. Contingencies, Guarantees and Commitments

The University has guaranteed certain obligations as follows (in thousands):

	June 30, 2006		June 30, 2005	
	Amount Guaranteed	Recognized Liability	Amount Guaranteed	Recognized Liability
Mortgage Loans	$ 36,903	$ -	$ 32,973	$ -
Student Loans	62,086	7,023	65,799	6,357
Other	8,416	351	8,522	388
	$ 107,405	$ 7,374	$ 107,294	$ 6,745

To encourage home ownership and home improvement in the University's geographic area, certain University and affiliate employee mortgage loans are guaranteed. On February 23, 2006, the University instituted a new mortgage guarantee program. Under this program, the University guarantees the employee's first mortgage amount that is in excess of 80% loan-to-value, up to 105% loan-to-value. The maximum amount that will be guaranteed on any single loan is limited to $250,000. For loans guaranteed prior to February 23, 2006, upon default by the borrower, the University may be required to pay any loss incurred following the lender's foreclosure process or the University may be required to purchase the loan. If the University purchases the loan, it will work with the borrower to make the loan current or it may foreclose and recover a portion of any loan from the sale of the mortgaged property. Of the amount guaranteed, $24,672,000 and $20,818,000 at June 30, 2006 and 2005, respectively, was estimated to be recoverable from subsequent sale of underlying assets the University would acquire if it performed under the guarantees. The University does not anticipate that any significant net payments will result from these guarantees. FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" does not require a guarantee liability to be recognized for employee mortgages.

The University offers various loan programs for students and families to pay tuition, fees and other costs. Certain loans issued by private lending institutions are guaranteed by the University. Upon default by the borrower, the University is required to pay all or a portion of the outstanding loan balance. In November 2004, certain graduate student loan guarantees were modified and an escrow was established to provide funding for future defaults. These modifications reduced the total amount guaranteed by the University by $70,292,000 and reduced the recognized liability by $2,500,000. Of the amount guaranteed, $15,720,000 and $15,216,000 at June 30, 2006 and 2005, respectively, was estimated to be recoverable from subsequent collection efforts on loans the University would acquire if it performed under the guarantees. The amount of the liability recognized for defaults in the portfolio of guaranteed loans exceeds the estimated fair value of the guarantee that is required to be recognized by FIN 45.

The Other category principally includes guarantees of indebtedness for certain businesses in the University's geographic area whose activities benefit employees, students and the community. Of the amount guaranteed, $4,851,000 at June 30, 2006 and $4,854,000 at June 30, 2005, was estimated to be recoverable from subsequent sale of underlying assets the University would acquire if it performed under the guarantees and from other partners in the businesses. The University does not anticipate that any significant net payments will result from these guarantees. The recognized liability reflects the fair value of guarantees issued after December 31, 2002.

Various lawsuits, claims and other contingent liabilities arise in the ordinary course of the University's education and health care activities. Based upon information currently available, management believes that any liability resulting therefrom will not materially affect the financial position or operations of the University.

The University is currently involved in various projects that have resulted in capital and property acquisition commitments from the University. As of June 30, 2006, approximately $524,970,000 has been committed by the University.

Trustees

as of June 30, 2006

Statutory Officers

as of June 30, 2006

President
Dr. Amy Gutmann

Provost
Dr. Ronald Daniels

Executive Vice President
Mr. Craig R. Carnaroli

Executive Vice President of the University of Pennsylvania for the Health System and Dean, School of Medicine
Dr. Arthur H. Rubenstein

Senior Vice President and General Counsel of the University of Pennsylvania and the University of Pennsylvania Health System
Wendy S. White, Esq.

Vice President for Budget and Management Analysis
Ms. Bonnie Gibson

Vice President for Business Services
Ms. Marie Witt

Vice President and Chief of Staff
Ms. Joann Mitchell

Vice President for Communications
Ms. Lori N. Doyle

Vice President for Development and Alumni Relations
Mr. John H. Zeller

Vice President for Finance and Treasurer
Mr. Scott R. Douglass

Vice President for Government and Community Affairs
Mr. Vanda McMurty

Vice President for Human Resources
Dr. John J. Heuer

Vice President for Information Systems and Computing
Ms. Robin H. Beck

Vice President for Public Safety
Ms. Maureen Rush

Vice President for Facilities and Real Estate Services
Mr. Thomas Stump (Interim)

Secretary of the University
Ms. Leslie Laird Kruhly

Comptroller
Mr. John Horn

Photos of Franklin on Campus:

Page	Artwork	Artist	Year	Location
v	Oil on Canvas	De L' Hospital	1779	Penn Bookstore
2, 22	Sculpture	Boyle	1899	College Green
6	Sculpture	McKenzie	1914	Weightman Hall
8	Oil on Burlap	Wyeth	1926	Hill House
10	Sculpture	Houdon	unknown	College Hall
14	Sculpture	Delvaux	unknown	College Hall
18	Sculpture	Lundeen	1987	37th & Locust Walk

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