The University of Tennessee

For the Year Ended
June 30, 2000

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

January 4, 2001

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable J. Steven Ennis, Chairman
Finance and Administration Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180
and
Dr. J. Wade Gilley, President
The University of Tennessee
831 Andy Holt Tower
Knoxville, Tennessee 37996-0180

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the University of Tennessee for the year ended June 30, 2000. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The university's administration has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/sdr
00/084

State of Tennessee

Audit Highlights

Comptroller of the Treasury — Division of State Audit

Financial and Compliance Audit
The University of Tennessee
For the Year Ended June 30, 2000

AUDIT OBJECTIVES

The objectives of the audit were to consider the university's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, contracts, and grants; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

AUDIT FINDINGS

Failure to Properly Calculate Title IV Financial Aid Refunds
The University of Tennessee, Knoxville campus, did not calculate all Title IV financial aid refunds according to federal regulations. The university incorrectly calculated these Title IV refunds because of an error in its computerized refund worksheet (page 7).

Effort Certification Reports Should Be Prepared on a Timely Basis
Effort certification reports are not being prepared and returned to the controller's office on a timely basis. These reports document payroll costs charged to federally sponsored grants and contracts (page 8).

Single Audit Requirements Should Be Communicated to Federal Subrecipients
The university's contracts with subrecipients of federal funds do not always include the single audit requirements described in Office of Management and Budget Circular A-133 (page 9).

Failure to Adequately Reconcile Accounts Receivable
The University of Tennessee at Chattanooga and the University of Tennessee's Memphis campus do not properly reconcile student accounts receivable balances to the university's general ledger. At June 30, 2000, unreconciled balances at Chattanooga and Memphis were $43,252.13 and $37,765.10, respectively (page 10).

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

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Audit Report
The University of Tennessee
For the Year Ended June 30, 2000

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The University of Tennessee
For the Year Ended June 30, 2000

INTRODUCTION

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POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the University of Tennessee. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated,* which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated,* authorizes the Comptroller of the Treasury to audit any books and records of any state governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The University of Tennessee was first established as Blount College in 1794 by the legislature of the Federal Territory. In 1807, the General Assembly renamed the institution East Tennessee College and in 1840 designated it a university. East Tennessee University was selected by the General Assembly to be Tennessee's land-grant institution under the terms of the Morrill Act of 1862. In 1879, the General Assembly chose the school to be Tennessee's state university and changed the name to the University of Tennessee.

Since its establishment, the university has grown into an institution with 20 different colleges and schools. With its campuses, various experiment stations, and extension services, the university provides services throughout the state. The university has three accredited units: The University of Tennessee (Knoxville campus, Health Sciences Center, Space Institute, Institute of Agriculture, and Institute for Public Service), the University of Tennessee at Chattanooga, and the University of Tennessee at Martin.

ORGANIZATION

The University of Tennessee is governed by the University of Tennessee Board of Trustees. In 1968, the board reorganized the institution into a university system, giving a central administrative staff the responsibility for the entire operation of the university. In 2000, the university was reorganized from a four-campus system into three accredited units: the University of Tennessee, the University of Tennessee at Chattanooga, and the University of Tennessee at Martin.

AUDIT SCOPE

The audit was limited to the period July 1, 1999, through June 30, 2000, and was conducted in accordance with generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 2000. The University of Tennessee is an integral part of state government. As such, it has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report.*

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the university's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grants;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The university filed its report with the Department of Audit on August 30, 2000. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the university has corrected previous audit findings concerning not removing surplus or missing equipment from its equipment system, not properly bidding custodial services, not monitoring class attendance for Title IV recipients, and not communicating federal program descriptions to subrecipients.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the university's financial statements for the year ended June 30, 2000, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted government auditing standards. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. Immaterial instances of noncompliance, along with recommendations and management's responses, are included in the findings and recommendations.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the university's financial statements.

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Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

October 13, 2000

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, as of and for the year ended June 30, 2000, and have issued our report thereon dated October 13, 2000. We conducted our audit in accordance with generally accepted government auditing standards.

<u>Compliance</u>

As part of obtaining reasonable assurance about whether the university's financial statements are free of material misstatement, we performed tests of the university's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We did, however, note certain immaterial instances of noncompliance that we have included in the Findings and Recommendations section of this report. We also noted certain other less significant instances of noncompliance, which we have reported to the university's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the university's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted one matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the university's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable condition was noted:

- Student accounts receivable balances at Chattanooga and Memphis were not properly reconciled to the university's general ledger.

This condition is described in the Findings and Recommendations section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the university's management in a separate letter.

The Honorable John G. Morgan
October 13, 2000
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This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/sdr

FINDINGS AND RECOMMENDATIONS

1. <u>Failure to properly calculate Title IV financial aid refunds</u>

Finding

The financial aid office at the University of Tennessee at Knoxville failed to correctly calculate 5 of 40 Title IV financial aid refunds tested (12.5%) according to the refund requirements in the 1999-2000 *Federal Student Financial Aid Handbook*. Chapter 3, page 96, describes a "fair and equitable" refund policy as one that provides for a refund of at least the largest amount under

- applicable state law;
- specific refund requirements established by the school's nationally recognized accrediting agency, as approved by the Department; or
- the pro rata refund calculation defined in the Higher Education Amendments of 1992 if the student is attending the school for the first time, and withdrew on or before the 60% point of the period of enrollment for which the student has been charged.

> If none of the three options above applies to a particular student, the school must then calculate a refund according to the Federal Refund Policy found in the regulations. The school must compare the Federal Refund Policy with the refund amount under its own institutional refund policy (if any), and issue the larger of the two refunds.

The university incorrectly calculated these Title IV refunds because of an error in its computerized refund worksheet which was discovered upon recalculation of the refunds by the auditors. The school returned the amount calculated under its institutional refund policy rather than the larger amount calculated by using the Federal Refund Policy. As a result, the school refunded an inadequate amount to the Title IV programs. Questioned costs total $16,592.84.

Recommendation

The university should ensure it complies with the Title IV refund regulations. The financial aid office should institute a review process to ensure the accuracy of refund worksheets.

Management's Comment

The university concurs with the finding. Current procedures dictate the Office of Financial Aid performs a computerized calculation of the Title IV refund owed by a student upon total withdrawal from classes. The calculations are reviewed by Bursar's Office staff and are then processed by the Bursar's Office to refund Title IV funds to the appropriate accounts as required by federal regulations.

The university is reviewing all refund calculations made during the 1999-2000 academic year to ensure that proper calculations were made and that appropriate levels of funding were refunded to the federal accounts. The review of all files should be completed by December 22, 2000.

New refund calculation software from the U.S. Department of Education has been installed and is being utilized to determine the proper calculation of Title IV refunds effective for fall 2000. Software calculations have been checked and verified for accuracy.

New office staff responsible for calculating refunds have received training regarding the proper procedures for refund calculations.

2. Effort certification reports are not prepared on a timely basis

Finding

The university uses after-the-fact effort certification forms to document distribution of payroll costs to sponsored agreements. This type of certification is required of all salaried personnel whenever a portion of their salary is charged to a grant or contract account through the university's payroll system. The university distributes the forms either on an academic term or monthly basis to applicable staff. The forms are submitted by departmental personnel to a campus business office for review and then forwarded to the university-wide controller's office. As of October 10, 2000, for the 1999 fiscal year (which ended on June 30, 1999), 9% of effort certification reports (1,260) had not been returned to the controller's office by departmental personnel. In addition, another 16.8% of the 1999 forms (2,355) had been returned to the Knoxville Office of the Director of Finance but had not been forwarded to the controller's office. These Knoxville campus forms had not been reviewed to ensure that any necessary payroll adjustments had been made. For the 2000 fiscal year (which ended on June 30, 2000), 10.2% of effort certification reports had not been returned to the controller's office by departmental personnel.

Office of Management and Budget (OMB) Circular A-21, Section J.8, Subsection c.(2)(c), states that these "reports will reasonably reflect the activities for which employees are compensated by the institution. To confirm that the distribution of activity represents a reasonable estimate of the work performed by the employee during the period, the reports will be signed by the employee, principal investigator, or responsible official(s) using suitable means of verification that the work was performed."

Salary transfer vouchers (Form T-17) are prepared by departmental personnel whenever actual certified time or effort on a grant or contract varies by 5% or more from the percentage of estimated salary charged. Therefore, the failure to prepare effort certification forms on a timely basis and to conduct timely reviews could lead to incorrect charges to federal programs. In addition, if supporting effort reports are never submitted, federal payroll costs are not documented as required per OMB A-21.

Recommendation

The university should take steps to ensure that effort certification forms are prepared and are returned to the controller's office on a timely basis. Campus business offices should review and submit the forms on a timely basis. The outstanding forms related to the 1999 and 2000 fiscal years should be submitted, and any necessary transfer vouchers should be prepared.

Management's Comment

The university concurs with the finding. The university will print another effort certification form for all those forms which have not been returned for FY 1999 and FY 2000 and will make appropriate changes to the related accounting records.

3. Single audit requirements were not communicated to federal subrecipients

Finding

Three of 33 agreements with subrecipients of federal awards tested (9.09%) did not include a clause conveying the single audit requirements under Office of Management and Budget Circular A-133. The contracts were drafted at the Institute of Agriculture, the Knoxville campus, and the Memphis campus. Office of Management and Budget (OMB) Circular A-133, Subpart B, Section 210(a), states that "federal awards expended as a subrecipient . . . would be subject to audit under this part." Subrecipients expending $300,000 or more in federal subawards during the subrecipient's fiscal year should have audits conducted in accordance with OMB Circular A-133.

If the university does not communicate the single audit requirements to each subrecipient, its subrecipients may not be aware of the audit requirements and noncompliance could result.

Recommendation

University management should take steps to ensure that single audit requirements are communicated to each subrecipient of federal awards.

Management's Comment

The university concurs with the finding. The university will instruct all offices that prepare subcontracts to be certain that the single audit requirements are communicated to each subrecipient.

4. Failure to adequately reconcile accounts receivable

Finding

The University of Tennessee at Chattanooga implemented a new student accounts receivable system during the 2000 fiscal year. The university did not attempt to reconcile total accounts receivable per its new Banner accounting system (the subsidiary system) to the general ledger until late in the fiscal year. When the reconciliation process did begin, university personnel realized that additional data were needed from the Banner system to complete the reconciliation process. University staff members are attempting to develop the special reports necessary to perform monthly reconciliations.

A partial reconciliation prepared at June 30, 2000, reflected an unexplained difference of $43,252.13, with the general ledger exceeding the subsidiary ledger balance.

In addition, based on discussions with university personnel, another student fee receivable account at the Memphis campus (account number A07050030; accounts receivable – applied aid) has never been reconciled by university personnel. The account was established in June of 1989.

The unreconciled difference at June 30, 2000, was $37,765.10, with the subsidiary ledger balance exceeding the general ledger.

Recommendation

Management should ensure that these subsidiary ledgers are reconciled to the general ledger on a monthly basis. The unexplained differences above should be investigated and any necessary adjustments made.

Management's Comment

The university concurs with the finding. UT Chattanooga personnel have been working to resolve the difference between the general ledger and subsidiary ledger balance at the end of the 1999-2000 fiscal year and to perform monthly reconciliations this fiscal year. However, problems in the Banner system, including a lack of detailed information to facilitate reconciliation, continues to exist. UTC personnel are currently working to resolve the deficiencies in the system that are causing this problem.

A concerted effort is currently underway to reconcile accounts receivable for FY 1999-2000 as well as through November of the current fiscal year by alternative measures. However, additional modifications to the Banner system will be necessary to facilitate monthly reconciliations. This will require assistance from Banner service personnel whose earliest availability will be in February of 2001. Accordingly, every effort will be made to complete the modifications necessary to resolve the problem by March of 2001.

UT Memphis personnel will reconcile the Accounts Receivable Applied Aid subsidiary ledger to the general ledger on a monthly basis. This reconciliation has been assigned to the Bursar's Office accountant.

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Independent Auditor's Report

October 13, 2000

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying balance sheet of the University of Tennessee, which is a component unit of the State of Tennessee, as of June 30, 2000, and the related statements of changes in fund balances and current funds revenues, expenditures, and other changes for the year then ended. These financial statements are the responsibility of the university's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

We conducted our audit in accordance with generally accepted government auditing standards. 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of Tennessee, as of June 30, 2000, and the changes in fund balances and the current funds revenues, expenditures, and other changes for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note 16, the university changed the threshold for capitalizing equipment.

The Honorable John G. Morgan
October 13, 2000
Page Two

In accordance with *Government Auditing Standards*, we have also issued our report dated October 13, 2000, on our consideration of the university's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr.

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/sdr

Exhibit A

THE UNIVERSITY OF TENNESSEE
BALANCE SHEET
JUNE 30, 2000, WITH TOTALS AS OF JUNE 30, 1999

	Current Funds					Plant Funds				Totals (Memorandum Only)	
ASSETS	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Unexpended	Retirement of Indebtedness and Renewals and Replacements	Investment in Plant	Agency Funds	2000	1999
Cash and cash equivalents (Note 2)	$ 134,486,098.04	$ 36,954,602.13	$ 4,990,907.25	$ 2,900,297.00	$ 814,438.22	$ 23,841,080.38	$ 103,352,892.90	$ -	$ 7,448,558.75	$ 314,788,874.67	$ 345,344,743.40
Assets with UHS Ventures, Inc. (Note 13)	-	-	-	-	-	-	-	-	-	-	6,679,250.23
Assets with trustees (Notes 2 and 9)	-	667,681.00	-	4,174,124.53	-	-	339,310.80	-	-	5,181,116.33	4,999,778.97
Investments (Note 2)	-	374,869.79	-	431,906,008.58	55,027,477.80	168,200.00	-	-	4,959,287.96	492,435,844.13	427,432,815.86
Investment in UT-Battelle, LLC (Note 10)	125,000.00	-	-	-	-	-	-	-	-	125,000.00	-
Accounts receivable (net of allowance of $9,490,413.36 at June 30, 2000, and $47,985,918.68 at June 30, 1999)	37,874,872.08	69,403,252.85	877,929.54	2,048,749.97	14,193.57	-	9,235.74	-	1,980,494.53	112,208,728.28	142,743,854.71
Notes receivable (net of allowance of $1,107,058.04 at June 30, 2000, and $1,203,144.19 at June 30, 1999)	1,581,903.62	-	34,501,113.59	-	-	-	-	-	-	36,083,017.21	33,833,087.74
Lease payments receivable (Note 15)	-	-	-	-	-	16,337,299.12	-	-	-	16,337,299.12	-
State capital outlay and maintenance receivable	-	-	-	-	-	11,153,684.57	-	-	-	11,153,684.57	1,886,169.06
Tennessee State School Bond Authority debt proceeds receivable	-	-	-	-	-	8,247,538.28	-	-	-	8,247,538.28	2,332,245.83
Due from other funds	248,082.28	-	-	-	-	-	-	-	-	248,082.28	5,169,359.68
Inventories	9,624,055.36	-	-	-	-	-	-	-	-	9,624,055.36	10,469,203.60
Prepaid expenses and deferred charges	2,846,066.55	-	-	-	-	-	-	-	-	2,846,066.55	3,697,630.08
Land	-	-	-	-	-	-	-	40,197,390.28	-	40,197,390.28	37,951,133.03
Structures and improvements	-	-	-	-	-	-	-	1,040,505,810.28	-	1,040,505,810.28	1,188,200,474.84
Machinery and equipment	-	-	-	-	-	-	-	209,692,429.58	-	209,692,429.58	434,885,615.34
Library holdings	-	-	-	-	-	-	-	253,180,300.00	-	253,180,300.00	249,544,291.00
Livestock	-	-	-	-	-	-	-	2,054,549.71	-	2,054,549.71	1,884,764.00
Total assets	$ 186,786,077.93	$ 107,400,405.77	$ 40,369,950.38	$ 441,029,180.08	$ 55,856,109.59	$ 59,747,802.35	$ 103,701,439.44	$ 1,545,630,479.85	$ 14,388,341.24	$ 2,554,909,786.63	$ 2,897,054,417.37
LIABILITIES AND FUND BALANCES											
Liabilities:											
Accounts payable	$ 45,921,974.67	$ 3,486,715.41	$ -	$ 870,116.41	$ -	$ 10,501,587.46	$ 108,801.02	$ -	$ 250,360.30	$ 61,139,555.27	$ 66,095,114.80
Accrued liabilities	24,912,178.88	318,667.82	-	-	-	-	-	1,044,477.82	-	26,275,324.52	28,609,112.50
Tennessee State School Bond Authority indebtedness (Note 4)	-	-	-	-	-	8,247,538.28	-	168,441,933.72	-	176,689,472.00	306,122,709.97
Due to other funds	-	-	-	-	248,082.28	-	-	-	-	248,082.28	5,169,359.68
Annuities payable	-	-	-	-	10,985,350.00	-	-	-	-	10,985,350.00	8,617,026.33
Notes payable (Note 4)	-	-	-	-	-	-	-	50,926.85	-	50,926.85	70,259.50
Accrued compensated absences	44,817,519.33	6,826,158.05	-	-	-	-	-	-	-	51,643,677.38	51,831,935.45
Lease obligations payable (Note 6)	-	-	-	-	-	-	-	387,239.52	-	387,239.52	1,069,779.51
Deferred revenue	25,175,719.25	-	-	-	-	15,500,438.72	-	-	-	40,676,157.97	26,761,127.76
Amounts held in custody for others	-	-	-	-	-	-	-	-	14,137,980.94	14,137,980.94	10,440,664.99
Deposits payable	4,812,444.44	-	-	-	-	-	-	-	-	4,812,444.44	3,940,423.01
Total liabilities	145,639,836.57	10,631,541.28	-	870,116.41	11,233,432.28	34,249,564.46	108,801.02	169,924,577.91	14,388,341.24	387,046,211.17	508,727,513.50
Fund balances:											
Allocation for working capital	45,391,685.13	-	-	-	-	-	-	-	-	45,391,685.13	90,839,113.29
Allocation for encumbrances (Note 11)	7,804,504.70	-	-	-	-	-	-	-	-	7,804,504.70	9,014,160.92
Allocation for compensated absences	(44,817,519.33)	-	-	-	-	-	-	-	-	(44,817,519.33)	(51,831,935.45)
Other allocations	15,496,477.36	-	-	-	-	-	-	-	-	15,496,477.36	14,155,728.26
Restricted	-	96,768,864.49	-	-	-	-	-	-	-	96,768,864.49	83,926,524.29
U.S. Government grants refundable - restricted	-	-	32,734,405.68	-	-	-	-	-	-	32,734,405.68	31,721,492.77
Institutional loan funds - restricted	-	-	7,635,544.70	-	-	-	-	-	-	7,635,544.70	7,350,648.88
Endowment	-	-	-	412,345,432.10	-	-	-	-	-	412,345,432.10	355,438,052.11
Quasi-endowment - unrestricted	-	-	-	9,878,442.22	-	-	-	-	-	9,878,442.22	7,394,189.35
Quasi-endowment - restricted	-	-	-	17,935,189.35	-	-	-	-	-	17,935,189.35	15,109,980.86
Annuities	-	-	-	-	12,602,275.47	-	-	-	-	12,602,275.47	13,990,501.64
Life income	-	-	-	-	32,020,401.84	-	-	-	-	32,020,401.84	32,218,821.67
Plant - unrestricted	-	-	-	-	-	23,238,692.54	103,056,692.86	-	-	126,295,385.40	136,181,008.65
Plant - restricted	-	-	-	-	-	2,259,545.35	535,945.56	-	-	2,795,490.91	1,757,406.30
Net investment in plant	-	-	-	-	-	-	-	1,375,705,901.94	-	1,375,705,901.94	1,605,943,176.30
Unallocated	17,271,093.50	-	-	-	-	-	-	-	-	17,271,093.50	35,118,034.03
Total fund balances	41,146,241.36	96,768,864.49	40,369,950.38	440,159,063.67	44,622,677.31	25,498,237.89	103,592,638.42	1,375,705,901.94	-	2,167,863,575.46	2,388,326,903.87
Total liabilities and fund balances	$ 186,786,077.93	$ 107,400,405.77	$ 40,369,950.38	$ 441,029,180.08	$ 55,856,109.59	$ 59,747,802.35	$ 103,701,439.44	$ 1,545,630,479.85	$ 14,388,341.24	$ 2,554,909,786.63	$ 2,897,054,417.37

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

Exhibit B

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CHANGES IN FUND BALANCES
FOR THE YEAR ENDED JUNE 30, 2000

	Current Funds					Plant Funds			
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Unexpended	Retirement of Indebtedness and Renewals and Replacements	Investment in Plant	Totals (Memorandum Only) 2000
REVENUES AND OTHER ADDITIONS									
Unrestricted current funds revenues	$ 880,973,631.07	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 880,973,631.07
Restricted gifts and grants	-	370,840,321.78	-	21,768,116.69	3,078,010.44	-	-	-	395,686,448.91
Federal Perkins loan funds	-	-	545,814.25	-	-	-	-	-	545,814.25
Federal nursing and health professions loan funds	-	-	191,709.28	-	-	-	-	-	191,709.28
Interest on notes receivable	-	-	801,384.92	-	-	-	-	-	801,384.92
Endowment income	-	9,461,061.38	107,625.35	598,901.74	-	-	-	-	10,167,588.47
Investment income	-	379,347.72	148,774.25	43,985,700.41	-	723,876.68	406,832.33	-	45,644,531.39
State appropriations for capital outlay	-	-	-	-	-	26,732,147.67	-	-	26,732,147.67
Tennessee State School Bond Authority proceeds	-	-	-	-	-	23,734,574.69	-	-	23,734,574.69
Capital lease acquisitions	-	-	-	-	-	-	-	682,539.99	682,539.99
Gifts and other sources	-	-	13,953.96	-	-	39,198,701.11	167,253.16	585,643.60	39,965,551.83
Student debt service fees	-	-	-	-	-	-	3,544,358.83	-	3,544,358.83
Federal interest subsidy grants	-	-	-	-	-	-	147,464.00	-	147,464.00
Expended for plant facilities (including $33,004,732.35 charged to current fund expenditures)	-	-	-	-	-	-	-	107,033,510.36	107,033,510.36
Retirement of indebtedness	-	-	-	-	-	-	-	160,253,439.73	160,253,439.73
Total revenues and other additions	880,973,631.07	380,680,730.88	1,809,262.01	66,352,718.84	3,078,010.44	90,389,300.15	4,265,908.32	268,555,133.68	1,696,104,695.39
EXPENDITURES AND OTHER DEDUCTIONS									
Unrestricted current fund expenditures	819,929,101.33	-	-	-	-	-	-	-	819,929,101.33
Restricted current fund expenditures	-	350,398,436.63	-	-	-	-	-	-	350,398,436.63
Administration and collection costs	-	-	8,126.46	-	-	-	-	-	8,126.46
Loan cancellations and write-offs	-	-	358,901.78	-	-	-	-	-	358,901.78
Expended for plant facilities (including $8,586,174.65 of uncapitalized expenditures)	-	-	-	-	-	81,889,792.07	725,160.59	-	82,614,952.66
Retirement of indebtedness	-	-	-	-	-	-	11,169,401.59	-	11,169,401.59
Interest on indebtedness	-	-	-	-	-	-	7,763,131.68	-	7,763,131.68
Disposal of plant facilities	-	-	-	-	-	-	-	498,580.50	498,580.50
Buildings and improvements written off and adjustments	-	-	-	-	-	-	-	4,747,694.78	4,747,694.78
Physical inventory adjustments	-	-	-	-	-	-	-	9,330,920.97	9,330,920.97
Increase in indebtedness	-	-	-	-	-	-	-	24,885,576.66	24,885,576.66
Indirect costs recovered	-	23,443,172.03	-	-	-	-	-	-	23,443,172.03
Adjustment of actuarial liability for annuities payable	-	-	-	-	1,203,621.66	-	-	-	1,203,621.66
Disposition of hospital net operating assets and real property (Note 14)	59,610,115.91	-	-	909,374.59	-	-	58,960,547.73	317,852,506.13	437,332,544.36
Other	-	389,231.47	214,935.61	1,626.11	800,938.52	-	-	-	1,406,731.71
Total expenditures and other deductions	879,539,217.24	374,230,840.13	581,963.85	911,000.70	2,004,560.18	81,889,792.07	78,618,241.59	357,315,279.04	1,775,090,894.80

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CHANGES IN FUND BALANCES
FOR THE YEAR ENDED JUNE 30, 2000

	Current Funds					Plant Funds			
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Unexpended	Retirement of Indebtedness and Renewals and Replacements	Investment in Plant	Totals (Memorandum Only) 2000
TRANSFERS AMONG FUNDS - ADDITIONS (DEDUCTIONS)									
Mandatory:									
Principal and interest	(16,797,333.60)	-	-	-	-	-	16,797,333.60	-	-
Loan funds matching	(87,086.57)	16,576.00	70,510.57	-	-	-	-	-	-
Endowment and similar funds	-	-	-	2,251,115.72	(2,251,115.72)	-	-	-	-
Nonmandatory:									
Restricted current funds	(325,304.54)	6,375,873.45	-	(6,083,870.97)	(408,980.54)	439,258.21	3,024.39	-	-
Endowment and similar funds	(607,878.46)	-	-	607,878.46	-	-	-	-	-
Unexpended plant	(15,333,796.25)	-	-	-	-	25,931,332.51	(10,597,536.26)	-	-
Retirement of indebtedness	(24,431,874.10)	-	-	-	-	-	24,431,874.10	-	-
Total transfers	(57,583,273.52)	6,392,449.45	70,510.57	(3,224,876.79)	(2,660,096.26)	26,370,590.72	30,634,695.83	-	-
Net increase (decrease) for the year	(56,148,859.69)	12,842,340.20	1,297,808.73	62,216,841.35	(1,586,646.00)	34,870,098.80	(43,717,637.44)	(88,760,145.36)	(78,986,199.41)
Fund balance at June 30, 1999	97,295,101.05	83,926,524.29	39,072,141.65	377,942,222.32	46,209,323.31	(9,371,860.91)	147,310,275.86	1,605,943,176.30	2,388,326,903.87
Cumulative effect of change in accounting principle (Note 16)	-	-	-	-	-	-	-	(141,477,129.00)	(141,477,129.00)
Fund balance at June 30, 1999, restated	97,295,101.05	83,926,524.29	39,072,141.65	377,942,222.32	46,209,323.31	(9,371,860.91)	147,310,275.86	1,464,466,047.30	2,246,849,774.87
Fund balance at June 30, 2000	$ 41,146,241.36	$ 96,768,864.49	$ 40,369,950.38	$ 440,159,063.67	$ 44,622,677.31	$ 25,498,237.89	$ 103,592,638.42	$ 1,375,705,901.94	$ 2,167,863,575.46

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

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CURRENT FUNDS REVENUES, EXPENDITURES, AND OTHER CHANGES
FOR THE YEAR ENDED JUNE 30, 2000
WITH COMPARATIVE TOTALS FOR THE YEAR ENDED JUNE 30, 1999

	Current Year			Prior Year
	Unrestricted	Restricted	Total	Total
REVENUES				
Tuition and fees	$ 179,712,820.20	$ -	$ 179,712,820.20	$ 157,569,885.56
Federal appropriations	13,533,799.85	-	13,533,799.85	13,602,258.86
State appropriations	375,872,400.00	9,461,100.53	385,333,500.53	385,095,980.70
Local appropriations	3,758,348.96	-	3,758,348.96	3,073,655.49
Federal grants and contracts	16,859,184.43	112,237,211.69	129,096,396.12	112,630,077.00
State grants and contracts	3,145,753.36	19,077,836.23	22,223,589.59	25,875,000.15
Local grants and contracts	2,597,189.06	7,531,551.32	10,128,740.38	10,562,908.61
Private grants and contracts	3,559,150.32	53,541,006.85	57,100,157.17	56,745,171.56
Private gifts	3,287,764.71	34,177,505.22	37,465,269.93	27,356,307.56
Endowment income - university and other	69,798.83	17,739,887.13	17,809,685.96	16,053,629.85
Sales and services of educational activities	34,664,835.44	-	34,664,835.44	33,087,914.99
Investment income	16,166,050.15	-	16,166,050.15	12,954,418.02
Other sources	32,998,635.49	-	32,998,635.49	13,688,208.42
Total educational and general	686,225,730.80	253,766,098.97	939,991,829.77	868,295,416.77
Sales and services of auxiliary enterprises	121,207,359.63	80,230.30	121,287,589.93	116,324,832.84
Sales and services of hospitals	73,540,540.64	880,633.64	74,421,174.28	318,449,286.64
Independent operations (Note 14)	-	95,671,473.72	95,671,473.72	-
Total current revenues	880,973,631.07	350,398,436.63	1,231,372,067.70	1,303,069,536.25
EXPENDITURES AND TRANSFERS				
Educational and general expenditures:				
Instruction	299,115,498.82	52,369,506.11	351,485,004.93	321,966,814.63
Research	42,417,598.83	98,482,888.02	140,900,486.85	135,043,992.67
Public service	48,725,595.54	62,374,698.87	111,100,294.41	98,865,764.12
Academic support	76,136,319.28	7,769,254.35	83,905,573.63	79,620,661.32
Student services	42,828,122.81	2,145,548.83	44,973,671.64	44,890,390.60
Institutional support	60,848,358.14	638,421.80	61,486,779.94	61,231,265.34
Operation and maintenance of plant	55,164,910.19	474,591.32	55,639,501.51	50,899,276.74
Scholarships and fellowships	25,095,889.24	29,511,189.67	54,607,078.91	51,839,116.54
Total educational and general expenditures	650,332,292.85	253,766,098.97	904,098,391.82	844,357,281.96
Mandatory transfers for:				
Principal and interest	4,438,271.38	-	4,438,271.38	4,371,056.19
Loan funds	87,086.57	-	87,086.57	131,562.83
Nonmandatory transfers for:				
Retirement of indebtedness	17,894,805.87	-	17,894,805.87	23,527,328.94
Endowment and similar funds	607,878.46	-	607,878.46	16,778.00
Restricted current funds	305,304.54	-	305,304.54	1,161,448.45
Unexpended plant	11,521,004.11	-	11,521,004.11	425,414.88
Auxiliary enterprises	(4,042,159.71)	-	(4,042,159.71)	(3,836,277.27)
Hospitals	(354,892.00)	-	(354,892.00)	(1,620,797.86)
Total educational and general expenditures and transfers	680,789,592.07	253,766,098.97	934,555,691.04	868,533,796.12
Auxiliary enterprises:				
Expenditures	94,784,118.30	80,230.30	94,864,348.60	90,772,523.21
Mandatory transfer for:				
Principal and interest	11,719,462.34	-	11,719,462.34	12,318,030.89
Nonmandatory transfers for:				
Retirement of indebtedness	6,537,068.23	-	6,537,068.23	5,579,377.31
Unexpended plant	2,837,034.37	-	2,837,034.37	1,578,279.53
Restricted current funds	20,000.00	-	20,000.00	20,000.00
Educational and general	4,042,159.71	-	4,042,159.71	3,836,277.27
Total auxiliary enterprises expenditures and transfers	119,939,842.95	80,230.30	120,020,073.25	114,104,488.21
Hospitals:				
Expenditures	74,812,690.18	880,633.64	75,693,323.82	294,984,284.75
Mandatory transfer for:				
Principal and interest	639,599.88	-	639,599.88	8,006,415.99
Nonmandatory transfers for:				
Educational and general	354,892.00	-	354,892.00	1,620,797.86
Unexpended plant	975,757.77	-	975,757.77	4,641,737.69
Total hospitals expenditures and transfers	76,782,939.83	880,633.64	77,663,573.47	309,253,236.29
Independent operations:				
Expenditures (Note 14)	-	95,671,473.72	95,671,473.72	-
Total independent operations expenditures	-	95,671,473.72	95,671,473.72	-
Total expenditures and transfers	877,512,374.85	350,398,436.63	1,227,910,811.48	1,291,891,520.62
Excess (deficiency) revenues over (under) expenditures and transfers				
Educational and general	5,436,138.73	-	5,436,138.73	(238,379.35)
Auxiliary enterprises	1,267,516.68	-	1,267,516.68	2,220,344.63
Hospitals	(3,242,399.19)	-	(3,242,399.19)	9,196,050.35
Independent operations	-	-	-	-
OTHER TRANSFERS AND ADDITIONS (DEDUCTIONS)				
Restricted receipts in excess of expenditures	-	30,282,294.25	30,282,294.25	21,473,095.87
Indirect costs recovered	-	(23,443,172.03)	(23,443,172.03)	(20,011,793.12)
Other deductions	-	(389,231.47)	(389,231.47)	(697,457.60)
Disposition of hospital net operating assets (Note 14)	(59,610,115.91)	-	(59,610,115.91)	-
Restricted gifts transferred from other funds	-	6,392,449.45	6,392,449.45	3,287,437.49
Net increase (decrease) in fund balances	$ (56,148,859.69)	$ 12,842,340.20	$ (43,306,519.49)	$ 15,229,298.27

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

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The university is a component unit of the State of Tennessee and is discretely presented in the *Tennessee Comprehensive Annual Financial Report*. Although the university is a separate legal entity, the state is financially accountable for the university because the state appoints a majority of its governing body and provides financial support.

The University of Tennessee System is comprised of the University of Tennessee, the University of Tennessee at Chattanooga, and the University of Tennessee at Martin. The University of Tennessee is comprised of the University of Tennessee Knoxville campus; the University of Tennessee - Center for the Health Sciences, including the Memphis campus, the Memorial Research Center at Knoxville, Clinical Education Centers at Chattanooga and Knoxville, Family Practice Centers at Jackson, Knoxville, and Memphis, and a hospital in Memphis; the University of Tennessee Space Institute at Tullahoma; the University of Tennessee Institute of Agriculture, including the College of Agriculture at Knoxville, the Agricultural Experiment Stations, the Agricultural Extension Service, and the College of Veterinary Medicine at Knoxville; the Institute for Public Service, which includes the County Technical Assistance Service and the Municipal Technical Advisory Service; and the University-Wide Administration. The university is governed by a board of 19 members, including one student member, all appointed by the governor, who also serves as chairman. The president is the Chief Executive Officer of the university system.

The university benefits from a number of organizations that exist mainly to support the various purposes and activities of the university system. These organizations include student organizations; the University Faculty Association, Inc.; the University Physicians Foundation; the University of Chattanooga Foundation; the Tennessee Geographic Alliance; Tristar Enterprises, Inc.; and the Tennessee 4-H Club Foundation, Inc. In addition, the university is a participant in a joint venture with Battelle Memorial Institute called UT-Battelle, LLC, which was established for the sole purpose of management and operation of the Oak Ridge National Laboratory for the U.S. Department of Energy. Each of these organizations is legally independent and fully self-governing. Consequently, none of these organizations is included in the financial statements of the university.

Basis of Presentation

The financial statements for the University of Tennessee are prepared in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. The university uses the AICPA College Guide model for accounting and financial reporting.

Basis of Accounting

The financial statements of the University of Tennessee have been prepared on the accrual basis except that depreciation on plant assets is not recorded and revenues and expenditures of an academic term encompassing more than one fiscal year are reported solely in the fiscal year in which the term is predominately conducted. All unrestricted resources are reported as revenue in the year they are earned. All restricted resources are recorded as additions to the fund balances of the appropriate fund groups. Restricted current resources are then recorded as revenues during the period in which they are expended. The statement of current funds revenues, expenditures, and other changes is a statement of financial activities of current funds related to the current reporting period. It does not purport to present the results of operations or the net income or loss for the period, as would a statement of income or a statement of revenues and expenses.

To the extent that current funds are used to finance plant assets, the funds are accounted for as (1) expenditures, for normal replacement of movable equipment and library holdings; (2) mandatory transfers, for required debt amortization and interest and equipment renewal and replacement; and (3) nonmandatory transfers, for all other cases.

Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available, the university maintains accounts in accordance with the principles of fund accounting. With this procedure, resources for various purposes are classified for accounting and reporting purposes into funds for specified activities or objectives. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds with similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

Within each fund group, fund balances restricted by outside sources are so indicated and are distinguished from unrestricted funds which are allocated to specific purposes by the governing board. Externally restricted funds may be used only in accordance with the purposes established by the source of such funds and contrast with unrestricted funds over which the governing board retains full control to use in achieving any of its institutional purposes. Other allocations for fund balances include unemployment compensation, revolving accounts, unexpended gifts, and reappropriations. These were made in accordance with university policies.

All gains and losses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund that owned such assets. Ordinary income derived from investments, receivables, and the like is accounted for in the fund owning such assets, except for income derived from investments of endowment and similar funds. This income is accounted for in the fund to which it is restricted or, if unrestricted, as revenues in unrestricted current funds. All other unrestricted revenue is accounted for in the unrestricted current funds. Restricted gifts, grants, appropriations, endowment income, and other restricted resources are accounted for in the appropriate restricted funds. Restricted current funds are reported as revenues and expenditures when expended for current operating purposes.

Current Funds

Unrestricted current funds consist of those funds over which the university retains full control for use in achieving any of its authorized institutional purposes. Auxiliary enterprises activities are included in unrestricted current funds and include student housing, bookstores, food services, parking services, the men's athletic department at Knoxville, and certain other activities. Hospital activities are also included in unrestricted current funds. Restricted current funds are externally restricted and may be used only in accordance with the purposes established by their source.

Loan Funds

Loan funds consist of resources made available for student loans.

Endowment and Similar Funds

Endowment funds are subject to the restrictions of gift instruments requiring in perpetuity that the principal be invested and only the income be used. Although quasi-endowment funds have been established by the governing board for the same purpose as endowment funds, any portion of quasi-endowment funds may be expended. Since these funds are internally designated, the governing board retains the right to alter or amend such designation.

Annuity and Life Income Funds

Annuity and life income funds are funds held in trust by the university under agreement with donors whereby designated beneficiaries receive an annuity or specified interests in annual income of the trust. Upon death of the beneficiaries or other termination of the trust, such trust assets become available to the university for use as set forth in each agreement.

Plant Funds

The plant funds group consists of (1) unexpended plant funds, which are to be used for the construction or acquisition of physical properties for institutional purposes; (2) retirement of indebtedness and renewal and replacement funds, which are funds set aside for debt service charges and for the retirement of indebtedness on institutional properties, and major maintenance items on institutional properties, respectively; and (3) investment in plant funds, which are funds expended for, and thus invested in, institutional properties.

Agency Funds

The university acts solely as an agent in the handling of these funds; consequently, transactions of these funds do not affect the university's operating statements.

Inventories

Inventories are valued at cost, which is lower than market, based on the retail, specific identification, average cost, or first-in, first-out basis.

Investments

Investments in commercial paper are reported at amortized cost at June 30, 2000. All other investments are reported at fair value.

Investment in Plant

Physical plant, equipment, and land are stated at cost at date of purchase or at fair value at date of donation. Depreciation on the physical plant and equipment is not recorded. Purchases of library books and holdings are recorded as current fund expenditures and capitalized at standardized costs in the plant funds. Library books are valued at $48 per volume and other library holdings are valued at various standardized values which approximate current costs. Livestock is valued at estimated market value. Equipment expenditures are capitalized when the unit acquisition cost is $5,000 or greater and the estimated useful life is two years or more.

Capitalized Interest

The university capitalizes interest cost in excess of earnings on debt associated with capital projects as a component of buildings. Therefore, asset values in the investment in plant subgroup include such interest costs.

Accounts Payable

Included in unrestricted current funds - accounts payable are checks payable in the amount of $13,605,707.67 as of June 30, 2000. These amounts represent the sum of checks written in excess of the university's checking account balance because of the use of a controlled disbursement account. In this way, the university maximizes interest income by transferring from an investment account only funds necessary to cover the checks that clear the bank daily.

Accrued Compensated Absences

The university's employees accrue annual leave at varying rates, depending on length of service or classification. Some employees also earn compensatory time. Generally, all permanent full-time employees and certain part-time employees are entitled to accrue and carry forward calendar year maximums of 42 days annual vacation leave, except nine-month faculty members do not accrue annual leave. The amount reflects, as of June 30, all unused vacation leave payable upon termination. The liability is inventoried at fiscal year-end current salary costs and the cost of the salary-related benefit payments and is recorded in current funds. The net change in the liability is recorded in the current year in the applicable current funds functional expenditure categories. Since the liability is expected to be funded primarily from future unrestricted and restricted revenue sources, a related allocation has been made to the current fund balances so that these fund balances reflect current available funds.

Allocation for Working Capital

The unrestricted fund balance is allocated for the amount of working capital. "Working capital" is defined as the total of all petty cash, accounts receivable, inventories, and prepaid expenses in the unrestricted current fund at the balance sheet date, except for student receivables credited to deferred revenue, accrued interest, and amounts due on federal letters of credit, less the accrued benefits on accrued faculty salaries.

Income Taxes

The university, as a public corporation and an instrumentality of the State of Tennessee, is exempt from federal income taxes under Section 115 of the *Internal Revenue Code*. Contributions to the university are deductible by donors as provided under Section 170 of the *Internal Revenue Code*.

Tennessee State School Bond Authority Debt Proceeds Receivable

Tennessee State School Bond Authority Debt Proceeds Receivable in unexpended plant consist of Tennessee State School Bond Authority debt issued for which the proceeds have not yet been received.

Totals (Memorandum Only)

Total columns on the general-purpose financial statements are captioned “memorandum only” to indicate that they are presented only to facilitate financial analysis. Data in these columns do not present financial position or results of operations in conformity with generally accepted accounting principles. Neither are such data comparable to a consolidation. Interfund eliminations have not been made in the aggregation of this data.

NOTE 2. DEPOSITS AND INVESTMENTS

Investment Policy

The University of Tennessee maintains a cash management investment pool that is available for use by all fund groups. State statutes and university investment policies authorize the university’s cash management pool to invest in collateralized Tennessee bank or savings and loan association certificates of deposit, U.S. Treasury obligations, U.S. government agency obligations, repurchase agreements of those securities, highest quality commercial paper, prime bankers’ acceptances, and money market mutual funds meeting certain criteria.

In accordance with state statutes, commercial banks and savings and loan associations that do not participate in the State of Tennessee Collateral Pool for Public Deposits must pledge securities with third parties as collateral to secure university time and demand deposits. Market values of these securities are regularly monitored to ascertain that 105% of university deposits, less the amounts protected by the Federal Deposit Insurance Corporation, are secured.

There are two categories of university funds which are subject to long-term investment: the endowment and similar funds and the annuity and life income funds. The investment of these funds is governed by the gift instrument and the investment policies established by the Board of Trustees. For a more complete description of these investments, please refer to Note 3, "Endowment and Similar Funds and Annuity and Life Income Funds."

Cash and Cash Equivalents

In addition to petty cash and demand deposits, this classification includes instruments which are readily convertible to known amounts of cash. At June 30, 2000, cash and cash equivalents consisted of $9,119,726.62 in bank accounts, $1,285,466.91 of petty cash on hand, $2,750,000.00 of certificates of deposit, and $297,734,845.17 in the university's cash management investment pool. Additionally, the university maintains custodial accounts at First Tennessee Bank for funds contractually managed by independent investment counsel. In accordance with the custody agreement, First Tennessee Bank placed cash equivalents of $3,898,835.97 at June 30, 2000, in the bank's money market mutual fund.

Deposits

Deposits with financial institutions are required to be categorized to indicate the level of custodial risk assumed by the university. Category 1 consists of deposits that are insured or collateralized with securities held by the university or by its agent in the university's name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution's trust department or agent in the university's name. Category 3 deposits are uncollateralized. This category includes any bank balance that is collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the university's name.

Some of the university's bank accounts are in financial institutions which participate in the bank collateral pool administered by the Treasurer of the State of Tennessee. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure.

At June 30, 2000, the carrying amount of the university's deposits was $11,869,726.62, and the bank balance including accrued interest was $11,746,917.87. The entire bank balance was category 1.

During the year ended June 30, 2000, the university had uncollateralized deposits on several days, ranging from $1,070.91 to $5,155,485.45.

The laws of the State of Tennessee require that collateral be pledged to secure all uninsured deposits.

Cash Management Investment Pool

The cash management investment pool consists of marketable securities and government repurchase agreements as previously described. The reported amount of the cash management pool at June 30, 2000, was $297,734,845.17. The cost of the cash management pool at June 30, 2000, was $299,075,482.98. The reported amount of securities in the pool with a maturity date of three months or less from the date of purchase at June 30, 2000, was $59,684,421.93. The cost of these same securities at June 30, 2000, was $59,216,084.85. The securities in the pool are categorized on the following page, listed as cash equivalents, to indicate the level of risk assumed by the university. The university's standard "Master Repurchase Agreements" require that the securities underlying repurchase agreements have fair value equal to or exceeding 100% of the cost of the repurchase agreement and that the securities be delivered to its agent's trust account at the Federal Reserve Bank - Memphis. The fair value of securities underlying repurchase agreements was $23,201,068.70 at June 30, 2000.

Investments

The university's investments are categorized below to indicate the level of custodial risk assumed by the university at year end. Category 1 consists of insured or registered investments or investments for which the securities are held by the university or its agent in the university's name. Category 2 consists of uninsured or unregistered investments for which the securities are held by the counterparty's trust department or agent in the university's name. Category 3 consists of uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the university's name.

June 30, 2000

	Category 1	Category 2	Category 3	Reported Amount	Cost
Cash equivalents					
Government securities	$ 169,730,974.62	$ -	$ -	$ 169,730,974.62	$ 171,904,442.56
Repurchase agreements	22,000,000.00	-	-	22,000,000.00	22,000,000.00
Commercial paper	106,003,870.55	-	-	106,003,870.55	105,171,040.42
	297,734,845.17	-	-	297,734,845.17	299,075,482.98
Investments					
Domestic securities					
Government securities	11,759,339.99	43,569,262.10	-	55,328,602.09	56,222,579.08
Corporate bonds	4,089,299.19	23,804,559.00	-	27,893,858.19	28,987,086.93
Corporate stocks	132,893,533.29	9,590,863.13	1,432,346.50	143,916,742.92	126,461,860.15
Mortgages and notes	2,678,280.40	-	-	2,678,280.40	2,703,146.87
Other investments	208,313.36	-	-	208,313.36	234,975.42
International securities					
Corporate stocks	1,241,111.50	-	-	1,241,111.50	1,317,995.64
Assets with trustees	-	-	5,181,116.33	5,181,116.33	3,092,169.44
	152,869,877.73	76,964,684.23	6,613,462.83	236,448,024.79	219,019,813.53
	$ 450,604,722.90	$ 76,964,684.23	$ 6,613,462.83		

University cash equivalents and investments not susceptible to categorization:

	Reported Amount	Cost
Cash equivalents - assets with First Tennessee Bank as custodian	3,898,835.97	3,898,835.97
Limited partnership - venture capital funds	35,918,565.66	27,135.902.55
Mutual funds	160,233,476.04	119,822,405.40
Investments in hedge funds	40,478,780.00	40,000,000.00
Real estate equity funds	17,587,380.17	16,846,444.13
Real estate gifts	6,950,733.80	7,220,485.45
Total investments and cash equivalents	799,250,641.60	733,019,370.01
Less: Cash equivalents	301,633,681.14	302,974,318.95
Total investments and assets with trustees	$ 497,616,960.46	$ 430,045,051.06

Assets with trustees of $139,424.76 at June 30, 2000, in retirement of indebtedness consisted of securities held in debt service reserve with First Tennessee Bank. Assets with trustees of $199,886.04 at June 30, 2000, in retirement of indebtedness consisted of securities in an interest rate reserve fund with the Tennessee State School Bond Authority.

The university's funds subject to long term investment (endowment and annuity and life income funds) use various external managers and funds consistent with investment objectives for those invested funds. A significant part of these funds is the university's Consolidated Investment Pool (Note 3) which is a carefully crafted portfolio of broadly diversified asset classes including an alternative asset class comprised of hedge funds. Currently, the Consolidated Investment Pool invests in two hedge funds, the Commonfund Global Hedged Partners and the Balentine Hedge Fund. The hedge fund investments expose the university to significant amounts of credit risk and market risk by trading or holding derivative securities and by leveraging the securities in the fund. These investments are briefly described as follows.

Commonfund Global Hedged Partners, LLC, was created in 2000 as a multi-manager fund investing in a diversified group of 15 primarily equity hedge fund managers operating and investing in the United States, Europe, and Asia. Investment strategies are predominately long/short but also include international and event-driven arbitrage. The university's investment of $20,000,000 was made during the second calendar quarter and was valued at $19,445,520 at June 30, 2000.

Balentine Hedge Fund, L.P., was created in 2000 as a multi-manager partnership allocated among 12 managers with 40% of the managers biased toward net long positions in U.S. large capitalization companies and 60% using widely diverse strategies to moderate overall volatility. These strategies include long equity positions, distressed securities, mortgage-backed securities, and private equity. The university's investment of $20,000,000 was made late in the second calendar quarter and was valued at $21,033,260 at June 30, 2000.

NOTE 3. ENDOWMENT AND SIMILAR FUNDS AND ANNUITY AND LIFE INCOME FUNDS

There are two categories of university funds which are subject to long-term investment: the endowment and similar funds and the annuity and life income funds. The investment of these funds is governed by the gift instrument and the investment policies established by the Board of Trustees.

Effective July 1, 1954, the university adopted the policy of investing endowment and similar funds over which it had full investment discretion (and on which the donor or governing gift instrument does not require separate investment) in the Consolidated Investment Pool. This pooling of investments affords closer supervision of the investment portfolio and provides, regardless of size, the advantages of participation in a well-diversified portfolio of domestic and international equities, private equity, bonds, real estate, and hedge funds. All contributing endowments participate in the income and capital appreciation of the Pool on a per-share basis commensurate with its contribution to the Pool. New endowment funds purchase shares in the Pool at the end of each month at the then current fair value per share, determined by valuing the Pool at month end fair value and dividing by the number of pool units outstanding. Net realized capital gains are reinvested and may be used for any shortfall between current income and spending plan distributions. The spending plan provides distributions equal to 5% of a three-year moving average Pool fair value determined as of December 31. The per unit fair value for participating endowments was $4.023180 at June 30, 2000. Income distributed was $.15959 per share in 2000 or $16,255,096.76. All endowment and similar funds not invested as part of the Consolidated Investment Pool are separately invested to observe requirements or limitations imposed by donors. Income earned and distributed on separately invested endowment and similar funds amounted to $666,340.49 for 2000.

Annuity and life income funds are separately invested entities requiring detailed accounting to reflect specific compliance with terms of each trust and applicable federal regulations. The investment objectives as reflected in each agreement vary widely since they are affected by the age, income level, and needs of the beneficiaries as well as motives and objectives of the donors. Interest, dividend, rent, and royalty income realized on these funds for 2000 amounted to $2,565,111.32.

The fair value of endowment and similar funds at June 30, 2000, was $441,029,180.08 and the cost was $378,100,800.58. The fair value of annuity and life income funds at June 30, 2000, was $55,856,109.59 and cost was $53,265,770.53.

NOTE 4. TSSBA INDEBTEDNESS AND NOTES PAYABLE

Tennessee State School Bond Authority (TSSBA) bonds, with interest rates ranging from 3.0% to 6.9%, are due serially to 2028 and are secured by pledges of the facilities' revenue to which they relate and certain other revenues and fees of the university, including state appropriations. The total outstanding bonded indebtedness for the university was $150,303,915.92 at June 30, 2000. The total bonded indebtedness reported on the balance sheet at June 30, 2000, is shown net of unaccreted bonds payable of $7,169,225.68 and assets of $10,284,858.90 held by the Tennessee State School Bond Authority.

Included in the total outstanding indebtedness is a $242,000.00 note with the Department of Education, which was issued in March 1989. The note carries an interest rate of 3% and is due semi-annually to 2003. The outstanding balance of the note payable at June 30, 2000, was $50,926.85.

The university's debt service requirements to maturity for all bonds and the Department of Education note payable at June 30 are as follows:

	Principal	Interest
2001	$ 10,353,263.44	$ 6,351,006.29
2002	10,751,326.60	5,989,183.45
2003	10,769,075.31	5,593,706.90
2004	10,859,856.49	5,194,397.76
2005	9,144,135.79	4,767,706.96
Subsequent Years	98,477,185.14	44,591,532.25
	$ 150,354,842.77	$ 72,487,533.61

Commercial Paper Program

The Tennessee State School Bond Authority also authorized the issuance of commercial paper to finance costs of various capital projects. At June 30, 2000, $43,839,640.66 had been issued for projects at the University of Tennessee.

For the commercial paper program, the Tennessee State School Bond Authority maintains an interest rate reserve fund. The university contributes amounts to the reserve fund based on the amounts drawn. The principal of the reserve will be contributed to pay off notes or credited back to the university when the notes are converted to bonds. The interest earned on the reserve is used to pay interest due during the month.

The total indebtedness of the university at June 30, 2000, was $194,194,483.43.

NOTE 5. OPERATING LEASES

The university has entered into various operating leases for buildings and equipment. It is expected that in the normal course of business, such leases will continue to be required. Net expenditures for rentals under leases for the year ended June 30, 2000, amounted to $6,810,940.37.

The following is a schedule of future minimum rental payments required under noncancelable operating leases that have initial or remaining lease terms of more than one year at June 30, 2000.

Year Ending June 30	
2001	$178,196.25
2002	115,334.16
2003	9,110.00
2004	9,110.00
2005	9,110.00
Later Years	72,880.00
Total Minimum Payments Required	$393,740.41

NOTE 6. CAPITAL LEASES

The university leases certain items of equipment which are classified as capital leases. These agreements have beginning and ending dates ranging from February 1997 to January 2001 and imputed interest rates ranging from 5.75% to 6.55%. Future minimum lease payments under capital leases together with the present value of the net minimum lease payments at June 30, 2000 are as follows:

Year Ending June 30	
2001	$ 395,492.65
Less amounts representing interest	8,253.13
Present value of net minimum lease payments	$ 387,239.52

The total value of equipment capitalized under lease obligations was $2,310,071.34 at June 30, 2000.

NOTE 7. INSURANCE-RELATED ACTIVITIES

Risk Management

The university is exposed to various risks of loss related to general liability; automobile liability; professional malpractice; workers' compensation; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters.

a. The university carries commercial insurance for losses related to hired and nonowned automobiles, losses related to railroad protection, and losses related to ten university-owned aircraft. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

b. The state purchases commercial insurance for real property losses above $5 million per year and surety bond coverage on the state's officials and employees. During the year ended June 30, 1999, the state incurred losses in Clarksville and Jackson due to damage from tornadoes. Final settlement has not been made but is expected to be approximately $6 million. In the prior two fiscal years, the state had not had any claims filed with the commercial insurer. A designation for casualty losses in the amount of $8.219 million has been established in the state's general fund to provide for any property losses other than the commercial insurance coverage. At June 30, 2000, the scheduled coverage for the university was $2,292,964,100 for buildings and $832,311,400 for contents.

c. The state has set aside assets for claim settlement in an internal service fund, the Claims Award Fund. This fund services all claims for risk of loss to which the state is exposed, including general liability, automobile liability, professional malpractice, and workers' compensation. The university participates in the Claims Award Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on a percentage of the university's expected loss costs, which include both experience and exposures. This charge considers recent trends in actual claims experience of the state as a whole. An actuarial valuation is performed as of fiscal year-end to determine the fund liability and premium allocation. Since the university participates in the Claims Award Fund, it is subject to the liability limitations under the provisions of the Tennessee Claims Commission Act, *Tennessee Code Annotated*, Section 9-8-101 et seq. Liability for negligence of the university for bodily injury and property damage is limited to \$300,000 per person and \$1,000,000 per occurrence. The limits of liability under workers' compensation are set forth in *Tennessee Code Annotated*, Section 50-6-101 et seq. Claims are paid through the state's Claims Award Fund. The premium assessed to the university by the Claims Award Fund for the period July 1, 1999, through June 30, 2000, was \$3,686,400.

The state has also set aside assets in the Employee Group Insurance Fund, an internal service fund, to provide a program of health insurance coverage for the employees of the state with the risk retained by the state. All full-time and some part-time university employees are eligible to participate in the Employee Group Insurance Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on estimates of the ultimate cost of claims that have been reported but not settled and of claims that have been incurred but not reported. Employees and providers have 13 months to file medical claims. The university pays approximately 80% of the cost of insurance, and the employee pays the remaining 20%. All assets, liabilities, and payments are administered by the state. At June 30, 2000, 11,982 university employees were enrolled in the basic plan or Health Maintenance Organization.

NOTE 8. PENSION PLANS

Defined Benefit Plans

Tennessee Consolidated Retirement System

Plan Description

The University of Tennessee contributes to the State Employees, Teachers, and Higher Education Employees Pension Plan (SETHEEPP), a cost-sharing multiple-employer defined benefit pension plan administered by the Tennessee Consolidated Retirement System (TCRS). TCRS provides retirement, death, and disability benefits as well as annual cost-of-living adjustments to plan members and their beneficiaries. Title 8, Chapters 34-37, *Tennessee Code Annotated,* establishes benefit provisions. State statutes are amended by the Tennessee General Assembly. The TCRS issues a publicly available financial report that includes financial statements and required supplementary information for SETHEEPP. That report may be obtained by writing to the Tennessee Department of the Treasury, Consolidated Retirement System, 10th Floor Andrew Jackson Building, Nashville, Tennessee, 37243-0230 or by calling (615) 741-8202.

Funding Policy

Plan members are noncontributory. The university is required to contribute at an actuarially determined rate. The current rate is 5.43% of annual covered payroll. The contribution requirements of the plan members are established by state statute. Contribution requirements for the university are established and may be amended by the TCRS' Board of Trustees. The university's contributions to TCRS for the years ended June 30, 2000, 1999, and 1998, were $12,426,308.08, $12,482,257.13, and $8,249,822.51, respectively. Those contributions met the required contributions for each year.

Federal Retirement Program

Plan Description

The University of Tennessee contributes to the Federal Retirement Program, a cost-sharing multiple-employer defined benefit pension plan administered by the Civil Service Retirement System (CSRS) for participants employed prior to January 1, 1984, and the Federal Employees Retirement System (FERS) for participants employed after December 31, 1983. Both systems provide retirement, death, and disability benefits, as well as annual cost-of-living adjustments, to plan members and their beneficiaries. All regular full-time employees of the University of Tennessee Agricultural Extension Service who hold federal appointments for 51% or more of their time are required to participate in either one of the two Federal Retirement Programs. For both systems, benefit provisions are established in federal statutes. Federal statutes are amended by the U. S. Congress.

CSRS and FERS issue publicly available financial reports that include financial statements and required supplementary information. These reports may be obtained by writing to the Office of Personnel Management, Retirement Information Office, P. O. Box 45, Boyers, PA 16017-0045, or by calling (202) 606-0500.

Funding Policy

Participating employees, with some exceptions, are required by federal statute to contribute 7.4% of covered salaries to the CSRS plan. The university is required to contribute 8.51%. Contributions to CSRS for the year ended June 30, 2000, were $1,841,878.45, which consisted of $1,012,825.11 from the university and $829,053.34

from the employees; contributions for the year ended June 30, 1999, were $1,858,184.24, which consisted of $1,033,656.58 from the university and $824,527.66 from the employees; and contributions for the year ended June 30, 1998, were $1,807,425.56, which consisted of $993,182.54 from the university and $814,243.02 from the employees.

Federal statute requires employees participating in FERS to contribute 1.2% of their salaries to the Basic Benefit Plan. The university is required to contribute 10.7%. In addition, the university is required to contribute 1% of each participant's salary to the Thrift Savings Plan plus up to an additional 4% depending upon employees' contributions, which can range from 0 to 10% of their salaries. Contributions for the Basic Benefit Plan were $979,328.69 for the year ended June 30, 2000, which consisted of $93,175.27 from employees and $886,153.42 from the university; $947,581.70 for the year ended June 30, 1999, which consisted of $75,606.59 from employees and $871,975.11 from the university; and $884,560.16 for the year ended June 30, 1998, which consisted of $60,638.43 from employees and $823,921.73 from the university. Contributions for the Thrift Savings Plan were $859,548.84 for the year ended June 30, 2000, which consisted of $531,727.00 from employees and $327,821.84 from the university; $837,473.64 for the year ended June 30, 1999, which consisted of $521,089.00 from employees and $316,384.64 from the university; and $747,733.09 for the year ended June 30, 1998, which consisted of $466,120.97 from employees and $281,612.12 from the university. Contributions met the requirements for each year.

Defined Contribution Plans

Optional Retirement Plans (ORP)

The university contributes to three defined contribution plans: Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), Aetna Life Insurance and Annuity Company, and Variable Annuity Life Insurance Company (VALIC). These plans are administered by the Tennessee Department of the Treasury. Each plan provides retirement benefits to faculty and staff who are exempt from the overtime provisions of the Fair Labor Standards Act and who waive membership in TCRS. Benefits depend solely on amounts contributed to the plan plus investment earnings. Plan provisions are established by state statute in Title 8, Chapter 35, Part 4, *Tennessee Code Annotated.* State statutes are amended by the Tennessee General Assembly.

Plan members are noncontributory. The university contributes an amount equal to 10% of the employee's base salary below the social security wage base and 11% above the social security wage base. Contribution requirements are established and amended by state statute. The contribution made by the university to the plans for the year ended

June 30, 2000, was $30,901,830.29, and for the year ended June 30, 1999, was $31,199,221.93. Contributions met the requirements for each year.

Joint Contributory Retirement System Plan A (JCRS-A)

The Joint Contributory Retirement System Plan A (JCRS-A) is a defined contribution plan with minimum benefits and is administered by the Tennessee Consolidated Retirement System and TIAA-CREF. Employees who were enrolled in the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) before July 1977 are members of JCRS-A. Enrollment in this plan for new employees has been closed since July 1977. Although JCRS-A members participate in Aetna, TIAA-CREF, or VALIC, they may also, under certain circumstances, receive a supplementary benefit from the State of Tennessee. Plan provisions are established by *Tennessee Code Annotated*, Chapter 35, Part 4. State statutes are amended by the Tennessee General Assembly.

Plan members are noncontributory. The university's contributions for JCRS-A members were calculated using the base salary amounts of $59,926,194.08 for fiscal year 2000. Contribution requirements are established and amended by state statute. The contributions are included in the ORP amounts. University contributions to fund the state supplemental benefit totaled $3,253,991.92 in fiscal year 2000, and $3,615,516.66 in fiscal year 1999. Contributions met the requirements for each year.

Deferred Compensation Plans

The University of Tennessee offers its employees three deferred compensation plans. The university, through the State of Tennessee, provides two plans, one established pursuant to *Internal Revenue Code (IRC)*, Section 457, and the other pursuant to *IRC*, Section 401(k). The third plan is administered by the university and was established in accordance with *IRC*, Section 403(b). These plans, available to all university employees, permit them to defer a portion of their salaries to future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All costs of administering and funding these plans, with the exclusion of the $20 monthly university match for the Section 401(k) plan, are the responsibility of plan participants.

Since Section 457 and 401(k) plan assets remain the property of the contributing employees, they are not presented in the State of Tennessee financial statements. Effective January 1996, the university began providing a $20 monthly match from unrestricted current funds for employees making a minimum monthly contribution of $20 to the Section 401(k) plan. During the year ended June 30, 2000, contributions totaling $8,164,929.06 were made by employees participating in the plan, with a related match of $1,835,910.00 made by the university. In accordance with the *IRC*, employee contributions through the 403(b) plan remain the assets of the employee; therefore, these employee contributions are not reflected in the university's financial statements.

Other Post-Employment Benefits

Health Care

The State of Tennessee administers a group health insurance program which provides post-employment health insurance benefits to eligible university retirees. This benefit is provided by and administered by the State of Tennessee. The university assumes no liability for retiree health care programs. Information related to this plan is available at the statewide level in the *Tennessee Comprehensive Annual Financial Report*.

NOTE 9. AFFILIATED ENTITIES

The University of Chattanooga Foundation, Inc., a private, nonprofit corporation, maintains an endowment fund of which the University of Tennessee at Chattanooga is the sole income beneficiary. The financial records, investments, and other financial transactions are not managed by the university and accordingly are not included in these financial statements except for certain endowment assets. During the year ended June 30, 2000, the foundation transferred $3,223,398.00 to the university for support of designated projects at the Chattanooga campus. In addition, $477,646.66 was expended in 2000 directly by the foundation for the benefit of the University of Tennessee at Chattanooga.

Since fiscal year 1985, the Tennessee General Assembly has appropriated $22 million to a Chairs of Excellence Endowment for the University of Tennessee. The appropriations provided that the Chairs of Excellence Endowment be established as an irrevocable trust with the state treasurer and required the university to match the appropriation on a dollar-for-dollar basis. The university has fully matched 50 chairs as of June 30, 2000. The financial statements of the university include as restricted expenditures the amounts expended in the current year to match the state appropriations. The university's balance sheet does not include the amounts held in trust by the state treasurer. At June 30, 2000, the amounts held in trust totaled $119,215,822.18 at fair value.

NOTE 10. JOINT VENTURE

The university is a participant in a joint venture with Battelle Memorial Institute for the sole purpose of management and operation of the Oak Ridge National Laboratory (ORNL) for the U.S. Department of Energy. Each entity has a 50% interest in the venture, each having provided an initial investment of $125,000.00. The university's equity interest at June 30, 2000, was $125,000.00. The university and Battelle each receive a 50% distribution of the ORNL management fee after shared expenses are deducted. Because UT-Battelle, LLC, did not manage and operate ORNL until April 1, 2000, the university did not receive any fee distribution for the year ended June 30, 2000. During the year ended June 30, 2000, the university had expenditures of $8,677,107 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled $2,120,599 at June 30, 2000.

NOTE 11. CONTINGENCIES AND COMMITMENTS

Construction Commitment

The university has contractual obligations for the construction of new buildings and additions to and renovations of existing buildings. The outstanding commitments under such contracts at June 30, 2000, were $38,155,587.33. At June 30, 2000, amounts due from or receivable from the state totaled $97,202,241.45, and amounts due from or receivable from the School Bond Authority for capital construction, renovations, and maintenance totaled $8,247,538.28.

Construction in Progress

Construction in progress is included in structures and improvements in investment in plant. Fifty-two projects were under construction at June 30, 2000. Construction in progress totaled $96,222,859.53 at June 30, 2000.

Encumbrances

Encumbrances, which represent commitments of prior-year funds for goods that have been ordered but not delivered or services that have not been rendered as of June 30, 2000, are recorded as an allocation of the current fund balances. The allocation for encumbrances at June 30, 2000, was $7,804,504.70.

Sick Leave

The university records the cost of sick leave when paid. Generally, since sick leave (earned one day per month with unlimited accumulation) is paid only when an employee dies or is absent due to illness or injury, there is no liability for sick leave at June 30, 2000. The amount of unused sick leave at June 30, 2000, was $163,438,555.42.

Grants and Contracts

The university receives grants and contracts from various federal and state agencies to fund research and other activities. The costs, both direct and indirect, charged to these grants and contracts are subject to audit and disallowance by the granting agency. The university administration believes that any disallowance or adjustments would not have a material effect on the university's financial position.

Nonvested Equipment

Equipment in the possession of the university valued at $3,276,897.14 as of June 30, 2000, is not reflected in the financial statements. This equipment was purchased with restricted grant and contract funds and other funds, and title has not yet transferred to the university.

Litigation

The university is involved in several lawsuits, none of which are expected to have a material effect on the financial position of the university.

NOTE 12. PLEDGES

Pledges totaling $43,958,788.54, restricted to instruction, research, public service, library, operation and maintenance of physical plant, student aid, property, buildings, equipment, endowment, loans, and other restricted purposes, are due to be collected as follows:

Fiscal Year	
2000-2001	$ 9,310,802.83
2001-02	9,827,786.27
2002-03	7,310,115.07
2003-04	4,671,780.39
2004-05	3,850,432.48
Subsequent Years	8,987,871.50
	$43,958,788.54

It is not practicable to estimate the net realizable value of such pledges, and therefore, they are not reflected in the accompanying financial statements.

NOTE 13. TRANSFER OF SOLE MEMBERSHIP IN COMPONENT UNIT

Because the university controlled the majority of the governing board of UHS Ventures, Inc., it was presented as a component unit of the university at June 30, 1999, in accordance with GASB Statement 14, *The Financial Reporting Entity*. As of July 16, 1999, the university transferred its sole ownership in UHS Ventures, Inc., to a newly formed *Internal Revenue Code*, Section 501(c)(3) corporation, University Health System, Inc. This new corporation was formed in order to operate the UT Memorial Research Center and Hospital as described in Note 14 below. UHS Ventures, Inc., is no longer a component unit of the university and is therefore no longer included in the financial statements of the university.

NOTE 14. LEASE AND TRANSFER OF UT MEMORIAL RESEARCH CENTER AND HOSPITAL

On July 29, 1999, the university transferred ownership and control of its hospital located in Knoxville to University Health Systems, Inc., (UHS), an independent, private, not-for-profit organization operating under its own *Internal Revenue Code*, Section 501(c)(3) designation. The lease and transfer of the hospital from the university to UHS was accomplished through three main agreements: the Lease and Transfer Agreement, the Employee Services Agreement, and the Affiliation Agreement. Each of these agreements is summarized below.

Lease and Transfer Agreement

Pursuant to the enabling legislation, *Tennessee Code Annotated*, Section 49-9-112 and Section 49-9-1301 et. seq., UHS leased from the university the real property of the existing hospital and the Graduate School of Medicine. (See also Note 15.) The term of the lease is 50 years. The university also transferred to UHS all operating assets of the hospital. The consideration for the lease of the real property and transfer of the operating assets was payment by UHS of a) a sum sufficient to economically defease all of the debt issued by the Tennessee State School Bond Authority in the amount of $149,080,353.69, b) $25,000,000.00 paid to the university at closing, and c) a variable lease obligation of $50,000,000.00 to be paid to the university over twenty years. UHS assumed all prior hospital liabilities, known or unknown. UHS also executed a five-year lease for office space at the university's Henley Street facility at fair market value.

Employee Service Agreement

UHS has leased from the university all hospital employees as of the date of closing. UHS has paid to the university the amounts incurred by the university to pay the direct expenses relating to the hospital employees, including wages, salaries, and fringe benefits. These payroll expenditures on behalf of UHS, totaling $95,671,473.72, are reported in current restricted funds - independent operations. The term of the Employee Service Agreement is 50 years. All persons who began service at the hospital after the date the employee service agreement was signed are employees of UHS and not university employees.

Affiliation Agreement

The university and UHS agreed that UHS will continue to support the Graduate School of Medicine by providing appropriate facilities and resources of the hospital to the faculty and students at the Graduate School of Medicine. UHS agreed to pay the university $1,500,000 at closing for the benefit of the Graduate School of Medicine. In addition, UHS must pay monthly to the university, for the benefit of the Graduate School of Medicine the government funding, direct and indirect medical education funds, TennCare medical education funds, and other medical education funds received by UHS for the benefit of the Graduate School of Medicine. The amount payable by UHS shall be reduced by a) the fair market rental value of the space provided to the Graduate School of Medicine; b) the fair market value of the information system, telecommunication, network infrastructure, and human resource services provided by UHS to the Graduate School of Medicine; and c) retroactive adjustments made by payers to the graduate medical education payments.

NOTE 15. CAPITAL LEASE OF REAL PROPERTY TO UHS, INC.

The university's leasing operations consist exclusively of leasing the real property of the UT Memorial Research Center and Hospital to UHS for a term of 50 years. This lease is pursuant to the Lease and Transfer Agreement described in Note 14. This lease is classified as a direct financing lease. The guaranteed lease payment of $50 million will be paid by UHS in annual payments through 2019. The amount of the annual payments will equal the lesser of 1) 20% of the hospital's net operating profit for the applicable calendar year; or 2) $3 million or the greater amount resulting from the application of an index, as specified in the agreement. The payment of $50 million is guaranteed by December 31, 2019. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease. Per the Lease and Transfer Agreement, the first annual payment is due March 15, 2001.

The university recorded a Lease Payment Receivable in Unexpended Plant Funds in the amount of $16,337,299.12 which represents the net present value of the guaranteed $50 million discounted at 5.75%.

Total minimum lease payments to be received	$ 50,000,000.00
Less: Unearned income	(33,662,700.88)
Net investment in direct financing lease	$ 16,337,299.12

NOTE 16. CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE

During the year ended June 30, 2000, the threshold for capitalizing equipment increased from $1,000 to $5,000. As a result of this change, equipment decreased by $141,477,129.00. The cumulative effect of this change in accounting principle is reported in the accompanying financial statements as a restatement of the beginning fund balance.