The University of Tennessee

For the Year Ended
June 30, 2003

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

February 26, 2004

The Honorable Phil Bredesen, 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. Joseph E. Johnson, Interim 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, 2003. 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

John G. Morgan
Comptroller of the Treasury

JGM/sds
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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, 2003

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.

INTERNAL CONTROL FINDINGS

University Collection Policies for Accounts Receivable Were Not Followed
At the University of Tennessee at Martin, for 11 of 30 student account receivable balances tested at June 30, 2003, departmental personnel did not follow prescribed collection procedures. University *Fiscal Policy* requires that "after six months, an external collection agency [should be] used for all past due accounts totaling $50 or more." Each of these balances was more than six months old, exceeded $50, and had not been turned over to a collection agency (page 11).

Need to Follow Procurement Card Procedures
Based on audits performed by the university's internal audit staff, departmental personnel are not complying with university *Fiscal Policy* relating to procurement card transactions. Instances were discovered where invoices were split to avoid bid limits. Receipts were sometimes missing or inadequate. There were missing procurement card statements, statements not signed by the cardholder, statements not properly verified, and statements not properly approved. The failure of university personnel to follow *Fiscal Policy* as to procurement card transactions could lead to unauthorized, imprudent, and/or fraudulent transactions (page 12).

Compliance Findings

Failure to Properly Record Serial Numbers and Tag Numbers for Federal Equipment*
Departmental personnel are failing to enter the serial numbers and tag numbers of equipment purchased with federal funds on the university accounting system. Without the prompt recording of this information on the university's accounting system, the university will lack the ability to properly safeguard and control these equipment assets (page 8).

Federal Financial Reports Were Not Submitted on a Timely Basis
Seven of 25 financial reports tested for the university's federal research and development programs were not submitted on a timely basis. The seven reports originated on the Memphis campus and were all Financial Status Reports for National Institute of Health grants. The reports were submitted between 10 and 161 days late (page 9).

Student Status Changes Were Not Reported on a Timely Basis
At the University of Tennessee at Memphis, the university did not properly report enrollment changes for Federal Family Education Loan borrowers who dropped classes, withdrew, or graduated (page 10).

* This finding is repeated from the prior audit.

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, 2003

TABLE OF CONTENTS

TABLE OF CONTENTS (CONT.)

The University of Tennessee
For the Year Ended June 30, 2003

INTRODUCTION

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 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, 2002, through June 30, 2003, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Financial statements are presented for the year ended June 30, 2003, and for comparative purposes, the year ended June 30, 2002. 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 June 4, 2003. 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 the need to improve program change policies and procedures for the Central Services Accounting system at Knoxville, the need to complete effort certification reports on a timely basis, the need to improve due diligence procedures for Perkins loans at Chattanooga, the need to properly conduct financial aid verifications at Chattanooga, the need to properly report student status changes at Knoxville, and the need to properly justify sole-source contracts.

REPEATED AUDIT FINDING

The prior audit report also contained a finding concerning the failure to properly record serial numbers and tag numbers for federal equipment. This finding has not been resolved and is repeated in this report.

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, 2003, 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 auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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*

November 21, 2003

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, 2003, and have issued our report thereon dated November 21, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

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 another less significant instance 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 certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. 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 conditions were noted:

- Departmental personnel are not complying with university *Fiscal Policy* related to procurement card transactions.

- At UT Martin, departmental personnel are not following collection procedures for student accounts receivable.

These conditions are 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 none of the reportable conditions described above is 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
November 21, 2003
Page Three

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

AAH/sds

FINDINGS AND RECOMMENDATIONS

1. Failure to properly record serial numbers and tag numbers for federal equipment

Finding

The university's equipment records are maintained on its accounting system, the Integrated R/3 Information System (IRIS). As reported in the prior audit, the university is not properly recording serial numbers and tag numbers on the university's equipment system. For 16 of 40 equipment items tested which were purchased with federal research and development funds during the year ended June 30, 2003 (40%), the serial number of the item was not entered in the system. For 13 of the 40 items tested (33%), the tag number was not entered in the system.

The university's *Fiscal Policy* requires that departments "promptly tag equipment and record the tag (inventory) numbers into the accounting system."

Office of Management and Budget Circular A-110, .34f, requires that "equipment records shall be maintained accurately and shall include . . . [the] manufacturer's serial number, model number, federal stock number, national stock number, or other identification number."

Under the university's IRIS accounting system, equipment items are initially entered in the system during the requisition process. Later, when assets are received, departmental personnel enter the serial number and the tag number for each asset. According to controller's office personnel, departmental staff members are failing to enter this information. The controller's office has begun sending quarterly notifications to department heads and campus chief business officers which list equipment items that do not have tag numbers and serial numbers entered on the IRIS system.

Without the prompt recording of serial numbers and tag numbers on the university's equipment system, the university will lack adequate information to properly safeguard and control its equipment assets.

Recommendation

The university should make revisions to its IRIS accounting system or take other steps to ensure that departmental personnel are consistently and promptly entering serial numbers and tag numbers on the university's equipment system. Controller's office personnel should continue to send periodic notifications to departmental personnel, and department heads should be held accountable if serial numbers and tag numbers are not promptly entered.

Management's Comment

We concur. All reported missing information has been entered. Also, controller's office staff will send quarterly notifications to departments which list equipment items that do not have tag numbers or serial numbers entered in the IRIS system.

2. Federal financial reports were not submitted on a timely basis

Finding

Seven of 25 financial reports tested for the university's federal research and development programs (28%) were not submitted on a timely basis. The seven reports originated on the Memphis campus and were all Financial Status Reports (Form SF-269) for National Institute of Health (NIH) grants. The reports were submitted between 10 and 161 days late.

The *NIH Grants Policy Statement*, Part II, Subpart A, states:

> Reports of expenditures are required as documentation of the financial status of grants according to the official accounting records of the grantee organization. Financial or expenditure reporting is accomplished using the FSR (SF 269 or SF 269A). When required on an annual basis, the report must be submitted for each budget period no later than 90 days after the close of the budget period.

The Memphis departments administering these grants are currently given a 60-day grace period by accounting personnel to make any necessary adjustments to expenses on the general ledger. On many occasions, the grant accounting department must obtain additional information (or documentation) from departmental personnel in order to prepare the reports. There are also delays in obtaining signatures from university officials.

Recommendation

Grant accounting personnel in Memphis should ensure that federal financial reports are submitted in compliance with federal regulations.

Management's Comment

We concur. To ensure that financial reporting is submitted in compliance with federal regulations, the following procedures will be implemented by Memphis grant and contract personnel: (1) Account review of expired grants and contracts will be initiated 30 days after account expiration. (2) The departmental business personnel will be contacted to determine if additional transactions are pending. The department should submit a written response within 15 days, detailing the charges/credits to come. (3) All pending charges/credits should be processed within 60 days following the account expiration. (4) If a departmental response is not provided within the allotted time period, the financial reports will be submitted based upon the information reflected in the university accounting records.

3. Student status changes were not reported on a timely basis

Finding

At the University of Tennessee at Memphis, the university did not properly report student status changes for Federal Family Education Loan (FFEL) borrowers who dropped classes, withdrew, or graduated. According to the *Student Financial Aid Handbook*, volume 8, page 61:

> Student enrollment information is extremely important, because it is used to determine if the student is still considered in school, must be moved into repayment, or is eligible for an in-school deferment. For students moving into repayment, the *out of school status effective date* determines when the grace period begins and how soon a student must begin repaying loan funds.
>
> Changes in enrollment to less than half-time, graduated or withdrawn must be reported [to the National Student Loan Data System] within 30 days. However, if a Roster file is expected within 60 days, [the school] may provide the data on that roster file.

Testwork at the University of Tennessee at Memphis revealed that for 2 of 25 FFEL student borrowers tested (8%), enrollment status changes were not reported within the required time frame. One of the students was dismissed on July 8, 2002, and the university became aware of the other student's withdrawal on July 9, 2002. These status changes were reported on NSLDS on September 16, 2002.

The status changes were reported late because the director of enrollment services and registrar in Memphis waited until the next Roster file submission to report the changes.

The failure to report student status changes could result in inappropriate deferments or the failure to properly begin a student's grace period.

In addition, the director of enrollment services and registrar did not retain NSLDS reports for three years. According to the *Student Financial Aid Handbook*, volume 8, page 4:

> A school must keep all records relating to the school's participation in the Direct Loan or FFEL program for at least three years after the end of the award year in which the records are submitted.

Recommendation

The director of enrollment services and registrar should ensure that all student status changes for FFEL loan recipients are reported in compliance with federal regulations. Documentation of reporting should be retained.

Management's Comment

We concur. In some situations, student status changes were not reported on a timely basis. The Roster file has been the mechanism used for reporting these changes to the NSLDS. We incorrectly understood that the quarterly reporting of the Roster file was in compliance.

We now understand that changes in enrollment to less than half-time, graduated, or withdrawn must be reported to the National Student Loan Data System within 30 days. However, if a Roster file is expected within 60 days, the school may provide the data on that Roster file. To ensure that student status reporting is submitted in compliance with federal regulations, the following procedures will be implemented:

- An electronic change of status form has been implemented campus-wide. Notification of withdrawal, leave of absence, and dismissal is provided immediately to the office of enrollment services and registrar via e-mail. This process will expedite the initial notification to the campus reporting office.
- The office of enrollment services and registrar will use the website www.nsldsfap.edu.gov to report student change of status forms within the required 30 day time frame.
- Changes will also be reported on the Roster file that is prepared and submitted on a quarterly basis.

In addition, the NSLDS reports will be kept for at least three years after the end of the award year in which the records are submitted.

4. University collection policies for accounts receivable were not followed

Finding

At the University of Tennessee at Martin, for 11 of 30 student accounts receivable balances tested at June 30, 2003 (36.6%), responsible departmental personnel did not follow prescribed collection procedures. University *Fiscal Policy* number 035 requires that "after six months, an external collection agency [should be] used for all past due accounts totaling $50 or more." Each of these balances was more than six months old, exceeded $50, and had not been turned over to a collection agency. Seven of the accounts were more than three years old.

Collection efforts for certain student accounts receivable at UT Martin are conducted departmentally. According to bursar's office personnel in Martin, the decentralized collection efforts led to this failure to follow university policy. Departmental personnel were not aware of these requirements.

The failure to use prompt and aggressive collection techniques could lead to the write-off of university receivables. The ability to collect receivables usually decreases with the passage of time.

Recommendation

Departmental personnel at Martin should follow the collection procedures described in university *Fiscal Policy* number 035. Consideration should be given to the centralization of collection efforts.

Management's Comment

We concur. The Martin campus will consider centralizing collection efforts, including budgeting impacts. Otherwise, departmental personnel will be trained to follow the collection procedures described in university *Fiscal Policy* 035.

5. Need to follow procurement card procedures

Finding

Based on audits performed by the university's internal audit staff, departmental personnel are not complying with university *Fiscal Policy* related to procurement card transactions. According to *Fiscal Policy*, each card has a spending limit of $2,000 per transaction and cardholders may not split single transactions in excess of $2,000 into smaller transactions. Bid requirements begin at the $2,000 threshold. Cardholders must obtain and keep receipts and maintain detailed information for each card transaction. Receipts must contain an itemized description of goods or services purchased (including unit price), the vendor name, transaction date, and the transaction total. The cardholder must print the monthly statement from the on-line procurement card system, review the statement for accuracy, attach the receipts, sign the statement, and forward the statement and receipts for verification. The departmental verifier (usually a bookkeeper) then matches the appropriate receipts with transactions listed on the cardholder's monthly statement. The verifier then signs the statement and electronically verifies the transactions. Although not actually stipulated in university *Fiscal Policy,* the verifier is responsible for monitoring the transactions as to propriety and necessity. The department head (or designee) then ensures the cardholder statements have been verified via electronic review and approves (electronically) the accounting distribution of monthly charges. The signed procurement card statements and related receipts are maintained departmentally for six years.

As discussed in a summary report of procurement card audits performed by the university's internal auditors from September 2002 to August 2003, departmental personnel are not adhering to the documentation, verification, and approval requirements stipulated in university *Fiscal Policy*. The following discrepancies were noted:

- Fifty-nine purchases totaling $186,557.10 were split to avoid the university's $2,000 bid limit.
- Three hundred twenty-five of 9,186 transactions tested (3.5%), totaling $48,878.31, had no receipt on file.
- An additional 432 of 9,186 transactions tested (4.7%), totaling $135,776.69, did not have receipts that met the requirements of university *Fiscal Policy*.
- Sixty-six of 2,532 monthly procurement card statements tested (2.6%) were not on file.
- Three hundred four of 2,532 monthly procurement card statements tested (12%) were not signed by the cardholder to indicate the charges were correct and all expenses were properly authorized business purchases.
- Five hundred of 2,532 monthly procurement card statements tested (19.7%) were not verified to indicate that all receipts were on hand for the transactions listed and that all receipts were acceptable documentation and appeared legitimate in nature.
- Six hundred sixty-five of 2,532 monthly procurement card statements tested (26.3%) were not approved by a university department head (or designee). (Approval is performed on-line.)

Annual summary reports released every year since September of 1999 have revealed similar discrepancies. Currently, there are approximately 2,000 cardholders at the university, each having a monthly procurement card statement. There are approximately 10,000 procurement card transactions per month (120,000 annually), averaging approximately $2,000,000.00 per month ($24,000,000.00 annually).

These discrepancies have persisted because the main responsibility for record keeping and verification is vested at the departmental level. With the exception of internal audits, there is little on-going oversight of procurement card transactions and related documentation outside of the department. Department heads are not always held accountable for discrepancies within their department. In addition, the departmental verifier is usually a bookkeeper, secretary, or other nonexempt employee. The verifier many times lacks the authority to require exempt employees to provide adequate receipts and the ability to assess the necessity and propriety of procurement card transactions. In addition, training for verifiers as to procurement card policy is available but not required. Also, approval is done electronically and the department head is not required to actually review the signed procurement card statements and attached receipts.

The failure of university personnel to follow *Fiscal Policy* as to procurement card transactions could lead to unauthorized, imprudent, and/or fraudulent transactions. Internal audits have revealed unsupported or inadequately supported transactions. The splitting of invoices has led to the failure to meet bid requirements.

Recommendation

The university should reassess the operation of its procurement card system to ensure that all transactions are properly supported, reviewed, and approved. All transactions should be reviewed and approved by a party other than the cardholder. The approving department head (or designee) should have adequate documentation available during the review process to determine the propriety of transactions. Training regarding procurement card policies should be required for all departmental verifiers. There should be a zero-tolerance policy as to personal purchases and the obvious splitting of invoices to avoid bid requirements. Department heads should be held accountable for departmental discrepancies.

Consideration should be given to some degree of centralization, perhaps at the college or campus level, to allow for oversight and review outside of the originating department. The establishment of management positions at the campus and/or system-wide levels to provide full-time, day-to-day oversight and monitoring of the procurement card system should also be considered.

Management's Comment

We concur. The university continues to modify the procurement card program to enhance internal controls and accountability. Some of the enhancements made as a result of the on-going audits are as follows:

- Implemented software that takes the monthly bank download and performs several tests to identify possible split transactions, appropriate vendor types, and allowable purchases.
- Instituted an on-line test that all cardholders must take to familiarize themselves with *Fiscal Policy* prior to card issuance.
- Modified *Fiscal Policy* to clarify cardholder, departmental verifier, and department head responsibilities.
- Added a unique web page devoted exclusively to procurement card information and processes.
- Designed and developed a "sleeve" for all procurement cards to be stored in. The sleeve will list the allowable and unallowable uses, along with the sales tax exemption number for transactions.

- Implemented new procedures to formalize enforcement of policies and corrective actions for noncompliance.

The recommendations to examine some degree of centralization and establishment of management positions for day-to-day oversight and monitoring will be considered and integrated into the university's on-going program reviews. The university has gained a significant degree of purchasing efficiency and cost-savings with the implementation of the procurement card program. The savings occur with a streamlined purchasing and payment process by eliminating paper and disbursement checks. As pointed out in the finding, there are over 120,000 transactions annually that result in no checks being written. Industry studies set the cost of issuing a check in the range of $50 to $75 each. Considering this information and the current transaction volume for the university, the value of this program is significant. The university is committed to further develop its procurement card program into a fiscally sound and efficient process and will consider the audit recommendations as part of this development effort.

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Independent Auditor's Report

November 21, 2003

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

Dear Mr. Morgan:

We have audited the accompanying statements of net assets of the University of Tennessee, which is a component unit of the State of Tennessee, as of June 30, 2003, and June 30, 2002, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years 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 audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 audits provide 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, 2003, and June 30, 2002, and the revenues, expenses, and changes in net assets and the cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 21, during the year ended June 30, 2002, the university implemented GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* and GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The university also implemented GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and GASB Statement No. 38*, Certain Financial Statement Note Disclosures*. The university also changed its capitalization threshold for buildings, land improvements, and infrastructure, discontinued the capitalization of its livestock, and changed its method of capitalizing library holdings. The university also changed its method of accounting for accumulated federal capital contributions under its federal loan programs.

The management's discussion and analysis on pages 18 through 27 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 21, 2003, 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

AAH/sds

Management's Discussion and Analysis

This section of the University of Tennessee's annual financial report presents a discussion and analysis of the financial performance of the university during the fiscal year ended June 30, 2003, with comparative information presented for the fiscal year ended June 30, 2002. This discussion has been prepared by management along with the financial statements and related note disclosures and should be read in conjunction with them. The financial statements, notes, and this discussion are the responsibility of management.

Using This Annual Report

This report consists of three basic financial statements. The statement of net assets; the statement of revenues, expenses, and changes in net assets; and the statement of cash flows provide information on the University of Tennessee as a whole and present a long-term view of the university's finances.

The Statement of Net Assets

The statement of net assets presents the financial position of the university at the end of the fiscal year and includes all assets and liabilities of the university. The difference between total assets and total liabilities—net assets—is an indicator of the current financial condition of the university. Assets and liabilities are generally measured using current values. Capital assets, however, are stated at historical cost less an allowance for depreciation.

Net assets are divided into three major categories. The first category, invested in capital assets, net of related debt, provides the university's equity in property, plant, and equipment owned by the university. The next asset category is restricted net assets, which is divided into two categories, nonexpendable and expendable. The corpus of nonexpendable restricted resources is only available for investment purposes. Expendable restricted net assets are available for expenditure by the university but must be spent for purposes as determined by donors and/or external entities that have placed time or purpose restrictions on the use of the assets. The final category is unrestricted net assets. Unrestricted net assets are available to the university for any lawful purpose of the institution.

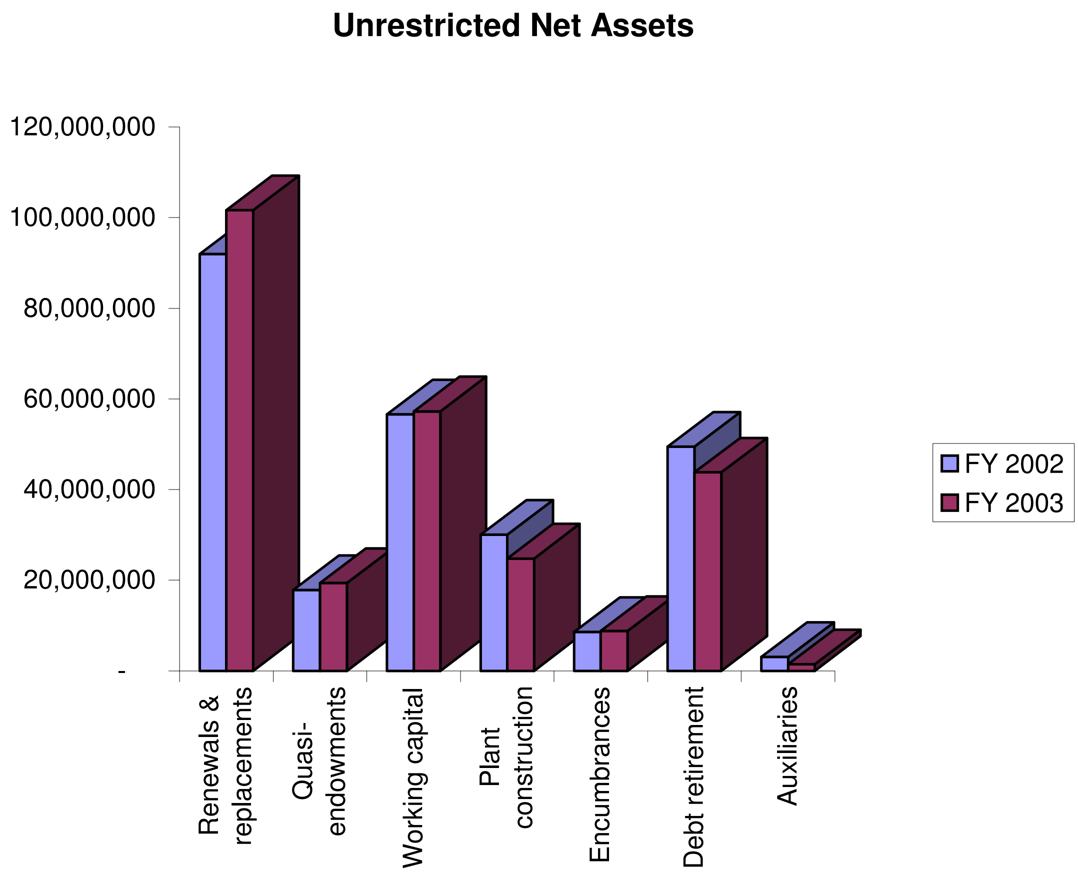
Statements of Net Assets
(in thousands of dollars)

	2003	**2002**
Assets:		
Current assets	$311,931	$315,277
Capital assets, net	943,877	852,381
Other assets	828,919	792,256
Total assets	2,084,727	1,959,914
Liabilities:		
Current liabilities	233,459	210,003
Noncurrent liabilities	289,881	282,716
Total liabilities	523,340	492,719
Net Assets:		
Invested in capital assets, net of related debt	730,451	653,532
Restricted – expendable	298,644	292,189
Restricted – nonexpendable	316,191	294,865
Unrestricted	216,101	226,609
Total net assets	$1,561,387	$1,467,195

Material assets consist of cash and cash equivalents; investments; accounts, notes, and grants receivable; and capital assets. Decreases in current assets can be found in cash and cash equivalents, investments, and inventories. Increases in current assets are in accounts, notes, and grants receivable. Increases in noncurrent assets can be found in cash and cash equivalents; accounts, notes, and grants receivable; and capital assets. Decreases in noncurrent assets can be found in investments.

Material liabilities include long-term bonded debt, compensated absences, accounts payable, accrued liabilities, and deferred revenue. The current portion of compensated absences increased, shifting the liability from noncurrent to current.

Many of the university's unrestricted net assets have been designated or reserved for specific purposes such as repairs and replacement of capital assets, future debt service, quasi-endowments, and capital projects. The following graph shows the allocations:



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

The statement of revenues, expenses, and changes in net assets presents the operating results of the university, as well as the nonoperating revenues and expenses. Annual state appropriations, while budgeted for operations, are considered nonoperating revenues according to generally accepted accounting principles.

Statements of Revenues, Expenses, and Changes in Net Assets
(in thousands of dollars)

	2003	2002
Operating revenues:		
Net tuition and fees	$192,977	$189,143
Auxiliary	123,724	120,549
Grants and contracts	356,451	343,616
Other	81,214	128,829
Total operating revenues	754,366	782,137
Operating expenses	1,315,836	1,273,972
Operating loss	(561,470)	(491,835)
Nonoperating revenues and expenses:		
State and local appropriations	423,816	419,793
Gifts	67,281	50,851
Investment income (loss)	42,407	(3,104)
Other revenues and expenses	32,039	26,760
Total nonoperating revenues and expenses	565,543	494,300
Income (loss) before other revenues, expenses, gains, or losses	4,073	2,465
Other revenues, expenses, gains, or losses:		
Capital appropriations	32,584	34,102
Capital grants and gifts	47,165	8,859
Additions to permanent endowments	12,341	23,128
Other	(1,971)	986
Total other revenues, expenses, gains, or losses	90,119	67,075
Increase (decrease) in net assets	94,192	69,540
Net assets at beginning of year	1,467,195	2,284,168
Cumulative effect of changes in accounting principle	-	(886,513)
Net assets at end of year	$1,561,387	$1,467,195

The increase in tuition and fees is primarily due to a 7.5% increase in fees for the 2003 academic year. Operating grants and contracts increased by $13 million due to a general increase in federal and private grants and contracts, offsetting a decrease in state grants and contracts. The largest increases were in grants from the Department of Health and Human Services and the new Bowld Hospital leased employees agreement. Other operating income decreased due to the transfer of the Bowld Hospital operations to Methodist Healthcare – Memphis Hospitals.

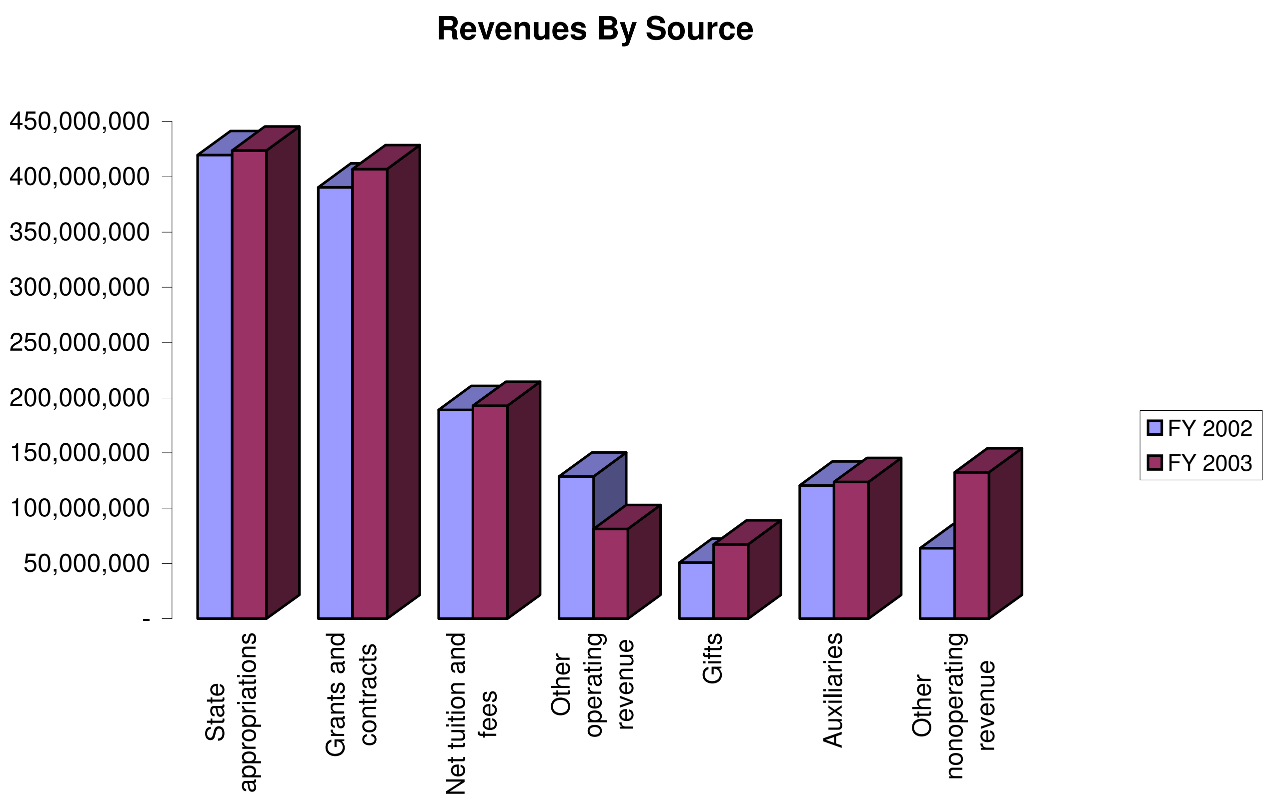
In fiscal year 2003, nonoperating gifts increased substantially due to a single gift totaling $11.2 million. The gain on investments was due to an increase of endowment income and a significant reduction of the previous year's capital market decline.

The increase in capital grants and gifts for 2003 consisted of the donation of several buildings at the Memphis campus. Additions to permanent endowments decreased due to reduced levels of new gifts to endowments for the 2003 fiscal year.

Total operating expenses increased approximately $42 million in fiscal year 2003 primarily due to increased salaries and wages and staff benefits. The university intentionally attempted to bring faculty and staff salaries to a more competitive level. In addition to the staff benefits related to salary increases, health insurance premiums increased 25% in fiscal year 2003.

<u>Revenues</u>

The following is a graphic illustration of revenues by source (both operating and nonoperating), which were used to fund the university's activities for the years ended June 30, 2003, and June 30, 2002.



Approximately 70% of UT's revenue is attributed to state appropriations, grants and contracts, and tuition and fees.

Expenses

Operating expenses can be displayed in two formats, natural classification and functional classification. Both formats are displayed below (in thousands of dollars).

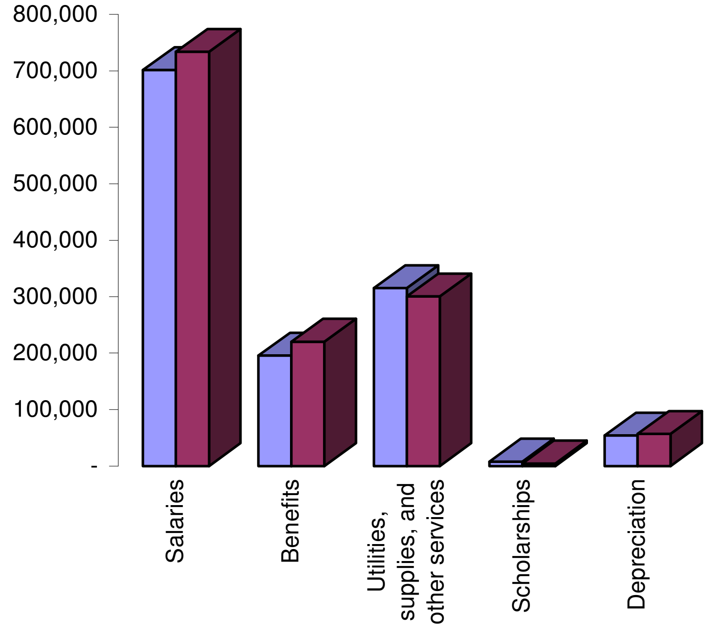
2003 Natural Classification

2003 Functional Classification	Salaries	Benefits	Utilities, supplies, and other services	Scholarships	Depreciation	Total
Instruction	$289,078	$68,378	$51,741	$ -	$ -	$409,197
Research	101,628	27,803	56,388	-	-	185,819
Public service	67,284	22,443	33,887	-	-	123,614
Academic support	53,339	14,509	15,196	-	-	83,044
Student services	27,102	7,904	17,036	-	-	52,042
Institutional support	53,503	15,876	3,571	-	-	72,950
Operation and maintenance of plant	26,236	8,917	39,735	-	-	74,888
Scholarships	3,043	23,768	11,318	4,651	-	42,780
Auxiliary	30,235	7,240	59,516	-	-	96,991
Hospital	6,816	1,844	12,217	-	-	20,877
Independent operations	75,176	21,475	-	-	-	96,651
Depreciation	-	-	-	-	56,983	56,983
Total expenses	$733,440	$220,157	$300,605	$4,651	$56,983	$1,315,836

2002 Natural Classification

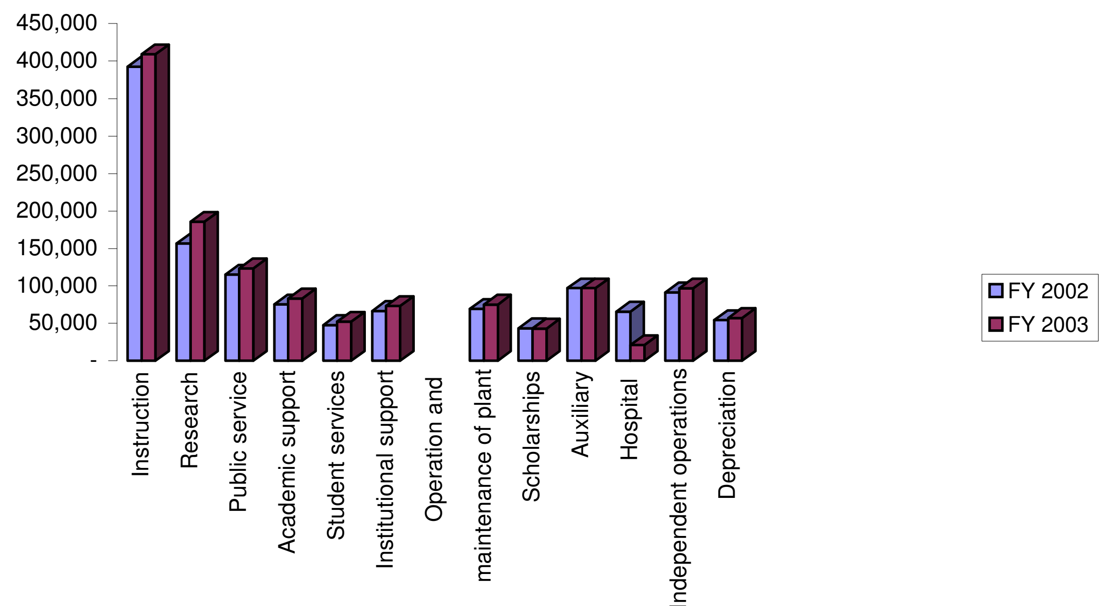
2002 Functional Classification	Salaries	Benefits	Utilities, supplies, and other services	Scholarships	Depreciation	Total
Instruction	$275,198	$66,427	$50,983	$ -	$ -	$392,608
Research	87,489	18,011	51,277	-	-	156,777
Public service	64,132	15,839	35,379	-	-	115,350
Academic support	49,270	13,541	12,374	-	-	75,185
Student services	24,898	6,354	16,273	-	-	47,525
Institutional support	51,158	14,768	443	-	-	66,369
Operation and maintenance of plant	24,593	7,900	36,708	-	-	69,201
Scholarships	2,752	21,637	11,052	7,816	-	43,257
Auxiliary	29,431	7,556	59,876	-	-	96,863
Hospital	19,829	4,743	40,969	-	-	65,541
Independent operations	72,456	18,693	-	-	-	91,149
Depreciation	-	-	-	-	54,147	54,147
Total expenses	$701,206	$195,469	$315,334	$7,816	$54,147	$1,273,972

Operating Expenses by Natural Classification
(in thousands of dollars)



At June 30, 2003, approximately 72% of operating expenses are attributed to salaries and benefits. Utilities, supplies, and other services represent 23% of total operating expenses. Scholarships and depreciation represent the remaining 5% of operating expenses.

Operating Expenses by Function
(in thousands of dollars)



For the year ended June 30, 2003, 55% of operating expenses by function is attributable to instruction, research, and public service. The percentages for the remaining functional areas range from 2% to 8% of total operating expenses.

The Statement of Cash Flows

The statement of cash flows provides information about cash receipts and cash payments during the year. This statement also assists users in assessing the university's ability to generate net cash flows, its ability to meet its obligations as they come due, and its need for external financing.

Statements of Cash Flows
(in thousands of dollars)

	2003	2002
Cash provided (used) by:		
Operating activities	$(487,276)	$(440,257)
Noncapital financing activities	524,428	477,018
Investing activities	68,479	16,603
Capital and related financing activities	(65,550)	(72,273)
Net increase (decrease) in cash	40,081	(18,909)
Cash, beginning of year	369,837	388,746
Cash, end of year	$409,918	$369,837

Material sources of cash included state appropriations, tuition and fees, and grants and contracts. Material uses of cash are reflected in payments to suppliers and vendors, payments to employees, payments for benefits, and the purchase of capital assets and construction.

The net increase in cash and cash equivalents amounted to $40,081,653.55 for the year ended June 30, 2003. The net decrease in cash and cash equivalents amounted to $18,908,968.54 for the year ended June 30, 2002.

Capital Asset and Debt Administration

Capital Assets

At June 30, 2003, the University of Tennessee had $943,877,229.62 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled $56,983,060.02 for the current fiscal year. Details of these assets are shown below.

Schedule of Capital Assets, Net of Depreciation
(in thousands of dollars)

	2003	2002
Land	$48,358	$45,102
Land improvements & infrastructure	30,314	29,508
Buildings	595,986	527,410
Equipment	99,158	93,922
Software	11,176	10,883
Library holdings	49,666	46,333
Projects in progress	109,219	99,223
Total	$943,877	$852,381

Major capital additions for UT during 2002-2003 include the $28.9 million Plant Sciences Biotech Building at the Agriculture campus, the $11 million Alumni Memorial Building, and the $2 million Black Cultural Center, all in Knoxville, and the $1.7 million Hunter Hall HVAC Improvements project in Chattanooga.

For the next fiscal year, the state has approved more than $7.7 million in capital maintenance appropriations for UT. Some of these approved projects include the roof replacements of several buildings in Knoxville, a fire alarm systems upgrade project in Martin, and Central Energy Plant Improvements in Memphis and Chattanooga. More detailed information about the university's capital assets is presented in Note 5 to the financial statements.

Debt

At June 30, 2003, the university had $215,734,196.85 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

Outstanding Debt Schedule
(in thousands of dollars)

	2003	2002
Bonds-current portion	$13,851	$13,506
Bonds-noncurrent	183,723	181,401
Commercial paper-noncurrent	18,160	7,457
Total TSSBA authorized debt	215,734	202,364
Notes-current portion	-	10
Total Debt	$215,734	$202,374

The university retired more than $16.2 million in bonds and notes in fiscal year 2002-2003. The Tennessee State School Bond Authority (TSSBA), in addition to its authority to issue bonds and notes to finance capital projects, has responsibility for approving all long-term debt of the university. TSSBA currently is rated as AA - by Standard & Poor's. More detailed information about the university's long-term liabilities is presented in Note 7 to the financial statements.

Economic Factors That Will Affect the Future

For fiscal year 2004, the University of Tennessee Board of Trustees has authorized a fee increase of 9% that is expected to generate approximately $19 million in new funding net of related scholarships. The university sustained a 5% state appropriation budget reduction in fiscal year 2003 followed by a 9% cut for fiscal year 2004. The university received additional state appropriations to fund health insurance premium increases for fiscal year 2004.

Requests for Information

This financial report is designed to provide a general overview of the university's finances for all those with an interest in the university's finances. Questions concerning any of the information provided in this report or requests for additional information should be directed to Mr. Ron Maples, Controller, 201 Andy Holt Tower, Knoxville, Tennessee, 37996-0100.

Exhibit A

THE UNIVERSITY OF TENNESSEE
STATEMENTS OF NET ASSETS
June 30, 2003, and June 30, 2002

	June 30, 2003	June 30, 2002
ASSETS		
Current assets:		
Cash and cash equivalents (Note 2)	$ 149,506,729.33	$ 158,661,157.27
Investments (Note 2)	49,693,424.57	50,067,193.46
Accounts, notes, and grants receivable (net) (Note 4)	100,933,143.95	92,987,084.86
Inventories	8,051,167.21	10,117,661.10
Prepaid expenses and deferred charges	3,746,806.01	3,443,491.06
Total current assets	311,931,271.07	315,276,587.75
Noncurrent assets:		
Cash and cash equivalents (Note 2)	260,411,983.16	211,175,901.67
Investments (Note 2)	374,272,838.43	398,534,574.00
Investment in UT - Battelle, LLC (Note 12)	2,043,045.23	1,789,206.24
Accounts, notes, and grants receivable (net) (Note 4)	173,426,660.16	164,305,023.16
Lease payments receivable (Note 16)	18,675,783.73	16,272,083.36
Capital assets (net) (Note 5)	943,877,229.62	852,381,537.22
Prepaid expenses and deferred charges	88,803.41	178,486.68
Total noncurrent assets	1,772,796,343.74	1,644,636,812.33
Total assets	2,084,727,614.81	1,959,913,400.08
LIABILITIES		
Current liabilities:		
Accounts payable	69,876,639.28	62,242,891.07
Accrued liabilities	33,943,551.77	34,720,912.03
Deferred revenue	64,219,889.64	63,148,100.33
Deposits payable	6,098,535.71	4,045,375.64
Annuities payable	1,332,314.59	1,619,887.96
Long-term liabilities, current portion (Note 7)	50,012,220.41	37,434,754.17
Deposits held in custody for others	7,975,831.88	6,791,205.53
Total current liabilities	233,458,983.28	210,003,126.73
Noncurrent liabilities:		
Deferred revenue (Note 7)	15,500,438.71	15,500,438.71
Long-term liabilities, noncurrent portion (Note 7)	229,479,360.87	224,129,364.69
Due to grantors (Note 7)	36,320,989.59	34,507,427.06
Annuities payable (Note 7)	8,580,703.69	8,578,451.55
Total noncurrent liabilities	289,881,492.86	282,715,682.01
Total liabilities	523,340,476.14	492,718,808.74
NET ASSETS		
Invested in capital assets, net of related debt	730,451,305.11	653,531,666.90
Restricted:		
Nonexpendable:		
Scholarships and fellowships	130,901,070.13	121,490,322.81
Libraries	12,705,596.83	12,751,472.70
Research	16,495,388.54	9,867,940.34
Instructional department uses	103,184,308.66	50,648,145.62
Academic support	25,442,049.41	-
Other	27,463,145.24	100,108,419.51
Expendable:		
Scholarships and fellowships	76,395,468.44	90,834,768.15
Libraries	3,931,251.13	4,046,989.13
Research	56,600,655.69	32,480,248.62
Instructional department uses	67,482,202.40	37,500,480.72
Academic support	37,956,565.60	-
Loans	8,102,948.61	8,346,883.77
Capital projects	8,843,290.02	3,464,394.12
Debt service	388,651.34	592,815.76
Other	38,942,341.74	114,920,718.49
Unrestricted (Note 19)	216,100,899.78	226,609,324.70
Total net assets	$ 1,561,387,138.67	$ 1,467,194,591.34

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

Exhibit B

THE UNIVERSITY OF TENNESSEE
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Years Ended June 30, 2003, and June 30, 2002

	Year Ended June 30, 2003	Year Ended June 30, 2002
REVENUES		
Operating revenues:		
Student tuition and fees (net of scholarship allowances of $39,341,406.75 for the year ended June 30, 2003, and $31,687,598.45 for the year ended June 30, 2002)	$ 192,976,707.52	$ 189,142,951.97
Federal appropriations	11,839,019.95	13,760,809.80
Governmental grants and contracts	186,473,181.70	189,090,028.66
Non-governmental grants and contracts	169,977,983.18	154,525,909.50
Sales and services of educational departments	39,343,533.55	37,554,072.87
Auxiliary enterprises:		
Residential life (net of scholarship allowances of $1,010,832.18 for the year ended June 30, 2003, and $986,407.82 for the year ended June 30, 2002; all revenues are used as security for varying revenue bonds; see Note 7)	29,043,875.15	29,485,142.09
Food services	2,755,073.44	2,661,886.18
Bookstore	19,662,412.44	20,407,597.39
Parking	8,070,559.06	7,669,470.48
Athletics	58,485,696.62	54,586,749.14
Other auxiliaries	5,706,130.08	5,738,310.24
Hospital	16,462,146.60	57,814,869.56
Interest earned on loans to students	75,425.90	82,818.70
Other operating revenues	13,494,313.49	19,616,431.68
Total operating revenues	754,366,058.68	782,137,048.26
EXPENSES		
Operating expenses:		
Salaries and wages	733,440,402.53	701,206,933.17
Fringe benefits	220,157,170.03	195,469,039.04
Utilities, supplies, and other services	300,605,152.29	315,333,196.68
Scholarships and fellowships	4,650,947.67	7,816,121.78
Depreciation expense	56,983,060.02	54,146,985.75
Total operating expenses	1,315,836,732.54	1,273,972,276.42
Operating income (loss)	(561,470,673.86)	(491,835,228.16)
NONOPERATING REVENUES (EXPENSES)		
State and local appropriations	423,816,452.04	419,792,940.89
Gifts	67,281,587.48	50,851,804.57
Grants and contracts	50,525,720.79	46,905,377.96
Investment income (loss)	42,406,799.02	(3,104,052.28)
Interest on capital asset - related debt	(11,592,333.70)	(9,757,152.23)
Bond issuance costs	-	(434,669.40)
Other nonoperating expenses	(6,894,216.53)	(9,954,658.64)
Net nonoperating revenues	565,544,009.10	494,299,590.87
Income before other revenues, expenses, gains, or losses	4,073,335.24	2,464,362.71
Capital appropriations	32,583,739.37	34,102,220.31
Capital grants and gifts	47,165,410.96	8,859,062.66
Additions to permanent endowments	12,341,823.96	23,127,540.82
Additions to annuity and life income trusts	1,774,230.20	811,482.57
Other	(3,745,992.40)	174,973.67
Total other revenues	90,119,212.09	67,075,280.03
Increase in net assets	94,192,547.33	69,539,642.74
NET ASSETS		
Net assets at beginning of year	1,467,194,591.34	2,284,168,171.87
Cumulative effect of changes in accounting principle (Note 21)	-	(886,513,223.27)
Net assets at beginning of year, as restated	1,467,194,591.34	1,397,654,948.60
Net assets at end of year	$ 1,561,387,138.67	$ 1,467,194,591.34

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

Exhibit C

THE UNIVERSITY OF TENNESSEE
STATEMENTS OF CASH FLOWS
For the Years Ended June 30, 2003, and June 30, 2002

	Year Ended June 30, 2003	Year Ended June 30, 2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Tuition and fees	$ 194,780,479.56	$ 189,281,671.03
Federal appropriations	10,589,019.95	13,760,809.80
Grants and contracts	358,498,584.90	333,499,903.17
Sales and services of educational activities	32,858,045.76	44,579,120.00
Payments to suppliers and vendors	(296,806,191.23)	(325,459,746.84)
Payments to employees	(734,101,158.75)	(693,931,502.51)
Payments for benefits	(215,705,943.80)	(190,025,977.97)
Payments for scholarships and fellowships	(4,650,947.67)	(21,285,322.62)
Loans issued to students	(5,486,336.91)	(5,632,359.39)
Collection of loans from students	6,880,849.31	5,077,750.49
Interest earned on loans to students	679,023.62	800,168.82
Auxiliary enterprise charges:		
Residence halls	29,043,875.15	30,917,997.01
Bookstore	19,662,412.44	24,512,571.63
Food service	2,755,073.44	2,981,467.22
Parking	8,070,559.06	8,543,972.18
Athletics	54,564,926.51	53,717,774.43
Other auxiliaries	5,706,130.08	6,284,683.76
Hospital	30,313,526.82	54,798,356.37
Other receipts (payments)	15,071,797.34	27,321,715.35
Net cash provided (used) by operating activities	(487,276,274.42)	(440,256,948.07)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations	423,521,491.35	411,372,497.00
Local appropriations	3,889,155.69	3,871,848.89
Gifts and grants for other than capital or endowment purposes	80,261,170.41	73,281,681.11
Private gifts for endowment purposes	14,116,054.16	20,780,921.37
Split-interest transactions receipts	2,265,898.77	3,793,928.77
Split-interest transactions disbursements	(2,922,067.60)	(3,630,549.03)
Federal student loan receipts	130,428,115.18	117,823,747.00
Federal student loan disbursements	(130,428,115.18)	(117,823,747.00)
Changes in deposits held for others	986,267.52	(2,863,304.06)
Net cash balance implicitly financed (repaid)	6,056,682.07	(29,326,447.36)
Other noncapital receipts (payments)	(3,745,992.40)	(262,554.08)
Net cash provided (used) by noncapital financing activities	524,428,659.97	477,018,022.61
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from capital debt	30,916,551.79	21,593,783.49
Capital appropriations	39,681,113.52	29,884,165.40
Capital grants and gifts received	47,165,410.96	4,871,265.30
Proceeds from sale of capital assets	1,130,918.32	1,085,999.17
Purchase of capital assets and construction	(155,880,014.78)	(101,670,770.44)
Principal paid on capital debt and leases	(16,237,301.28)	(17,919,300.85)
Interest paid on capital debt and leases	(11,352,492.59)	(8,848,537.01)
Deposit with trustee	-	373,749.29
Other capital and related financing receipts (payments)	(974,166.98)	(1,643,821.31)
Net cash provided (used) by capital and related financing activities	(65,549,981.04)	(72,273,466.96)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	153,051,212.19	90,349,133.87
Interest on investments	43,044,443.13	38,704,585.56
Purchase of investments	(127,616,406.28)	(112,450,295.55)
Net cash provided (used) by investing activities	68,479,249.04	16,603,423.88
Net increase (decrease) in cash and cash equivalents	40,081,653.55	(18,908,968.54)
Cash and cash equivalents at beginning of year	369,837,058.94	388,746,027.48
Cash and cash equivalents at end of year	$ 409,918,712.49	$ 369,837,058.94

THE UNIVERSITY OF TENNESSEE
STATEMENTS OF CASH FLOWS
For the Years Ended June 30, 2003, and June 30, 2002

	Year Ended June 30, 2003	Year Ended June 30, 2002
RECONCILIATION OF NET OPERATING LOSS TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating loss	$ (561,470,673.86)	$ (491,835,228.16)
Adjustments to reconcile operating loss to net cash provided (used) by operating activities:		
Depreciation expense	56,983,060.02	54,146,985.75
Other adjustments	-	472,827.11
Changes in assets and liabilities:		
Receivables, net	5,169,083.43	(14,618,397.39)
Inventories	2,066,493.89	(706,745.03)
Prepaid expenses and deferred charges	(303,314.95)	(802,529.73)
Accrued interest receivable	603,597.72	717,350.12
Accounts payable	1,927,360.63	(12,958,195.29)
Accrued liabilities	(777,360.26)	15,730,038.07
Deferred revenue	1,071,789.31	5,151,799.28
Deposits	2,053,160.07	532,046.97
Compensated absences	4,567,830.27	4,467,709.13
Other additions:		
Loans to students	832,699.31	(554,608.90)
Net cash provided (used) by operations	$ (487,276,274.42)	$ (440,256,948.07)

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

The University of Tennessee
Notes to the Financial Statements
June 30, 2003, and June 30, 2002

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 23 members, including one student and one faculty member, all either *ex officio* or 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; the University of Tennessee Foundation; the UT Medical Group, Inc.; the University of Chattanooga Foundation; the Tennessee Geographic Alliance; Tristar Enterprises; the University of Tennessee Research Foundation; and the Tennessee 4-H Club Foundation. 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. Consequently, none of these organizations is included in the financial statements of the university.

Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This was followed by GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The financial statement presentation required by those statements provides a comprehensive, entity-wide perspective of the university's assets, liabilities, net assets, revenues, expenses, changes in net assets, and cash flows, and replaces the fund-group perspective previously required.

A significant accounting change, adoption of depreciation on capital assets, was made in order to comply with the new requirements.

Basis of Accounting

For financial statement purposes, the university is considered a special-purpose government engaged only in business-type activities. Accordingly, the financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met. All significant interfund transactions have been eliminated.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board (GASB). The university has the option of following private-sector guidance issued subsequent to November 30, 1989, subject to the above limitation. The university has elected not to follow private-sector guidance issued subsequent to November 30, 1989.

Amounts reported as operating revenues include (1) tuition and fees, net of waivers and discounts; (2) federal appropriations; (3) federal, state, local, and private grants and contracts; (4) sales and services of auxiliary enterprises; (5) sales and services of the university's hospital; and (6) other sources of revenue. Operating expenses for the institution include (1) salaries and wages; (2) employee benefits; (3) scholarships and fellowships; (4) depreciation; and (5) utilities, supplies, and other services.

All other activity is nonoperating in nature. This activity includes (1) state and local appropriations for operations; (2) investment income; (3) bond issuance costs; (4) interest on capital asset-related debt; (5) nonoperating grants and contracts; and (6) gifts.

When both restricted and unrestricted resources are available for use, generally it is the institution's policy to use the restricted resources first.

Inventories

Inventories are valued at the lower of cost or 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, 2003. All other investments are reported at fair value.

Capital Assets

Capital assets, which include property, plant, equipment, software, and library holdings, are reported in the statement of net assets at historical cost or at fair value at date of donation, less accumulated depreciation. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend the assets' useful lives are not capitalized.

A capitalization threshold of $100,000 is used for buildings, land improvements, and infrastructure. Equipment and software are capitalized when the unit acquisition cost is $5,000 or greater and the estimated useful life is one year or more. The capitalization threshold for additions and improvements to buildings, infrastructure, and land improvements is also $100,000.

These assets, with the exception of land, are depreciated using the straight-line method over the estimated useful lives, which range from 5 to 40 years.

Accounts Payable

Included in accounts payable are checks payable in the amount of $14,513,003.51 as of June 30, 2003. 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.

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 who do not accrue annual leave. The amount of these liabilities and their related benefits are reported in the statement of net assets.

Net Assets

The institution's net assets are classified as follows:

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

Expendable restricted net assets - Expendable restricted net assets include resources in which the university is legally or contractually obligated to spend resources in accordance with restrictions imposed by external third parties.

Nonexpendable restricted net assets - Nonexpendable restricted net assets consist of endowment and similar type funds in which donors or other outside sources have stipulated, as a condition of the gift instrument, that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may be expendable or added to principal.

Unrestricted net assets - Unrestricted net assets represent resources derived from student tuition and fees, state appropriations, and the sales and services of educational departments, auxiliary enterprises, and the university's hospital. These resources are used for transactions relating to the educational and general operations of the institution, and may be used at the discretion of the institution to meet current expenses for any purpose.

Scholarship Discounts and Allowances

Student tuition and fee revenues, and certain other revenues from students, are reported net of scholarship discounts and allowances in the statement of revenues, expenses, and changes in net assets. Scholarship discounts and allowances are the difference between the stated charge for goods and services provided by the university and the amount that is paid by the student and/or third parties making payments on the student's behalf. Certain governmental grants, such as Pell grants, and other federal, state, or nongovernmental programs, are recorded as either operating or nonoperating revenues in the institution's financial statements. To the extent that revenues from such programs are used to satisfy tuition and fees, and other student charges, the institution has recorded a scholarship discount and allowance.

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.*

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.

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, 2003, cash and cash equivalents consisted of $12,700,145.01 in bank accounts, $1,480,898.67 of petty cash on hand, $300,000.00 of certificates of deposit, and $359,891,706.55 in the university's cash management investment pool. At June 30, 2002, cash and cash equivalents consisted of $19,168,603.03 in bank accounts, $1,256,697.12 of petty cash on hand, and $344,641,163.04 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 $35,545,962.26 at June 30, 2003, and $4,770,595.75 at June 30, 2002, 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, 2003, the carrying amount of the university's deposits was $13,000,145.01, and the bank balance including accrued interest was $4,997,890.30. The entire bank balance was category 1.

At June 30, 2002, the carrying amount of the university's deposits was $19,168,603.03, and the bank balance including accrued interest was $19,839,299.36. The entire bank balance was category 1.

During the year ended June 30, 2003, the university had uncollateralized deposits on several days, ranging from $8,544.25 to $2,259,389.73.

During the year ended June 30, 2002, the university had uncollateralized deposits on several days, ranging from $88,797.96 to $4,908,084.90.

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, 2003, and June 30, 2002, was $359,891,706.55 and $344,641,163.04, respectively. The cost of the cash management pool at June 30, 2003, and June 30, 2002, was $357,271,785.92 and $340,555,735.26, respectively. Management has elected to classify all securities in the cash management investment pool as cash equivalents. 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, 2003, was $108,310,658.33. The cost of these same securities at June 30, 2003, was $108,182,794.37. 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, 2002, was $71,906,888.63. The cost of these same securities at June 30, 2002, was $71,800,173.90. The securities in the pool are categorized on the following schedule, 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 $3,400,000.00 at June 30, 2003, and $18,422,523.77 at June 30, 2002.

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, 2003

	Category 1	Category 2	Category 3	Reported Amount	Cost
Cash equivalents					
Government securities	$ 251,581,048.22	$ -	$ -	$ 251,581,048.22	$249,088,991.55
Repurchase agreements	-	3,400,000.00	-	3,400,000.00	3,400,000.00
Commercial paper	104,910,658.33	-	-	104,910,658.33	104,782,794.37
	356,491,706.55	3,400,000.00	-	359,891,706.55	357,271,785.92
Investments					
Domestic securities					
Government securities	9,014,603.83	37,849,068.43	-	46,863,672.26	43,348,416.87
Corporate bonds	2,663,575.14	24,247,030.15	-	26,910,605.29	25,157,029.52
Corporate stocks	81,805,075.58	6,630,867.01	-	88,435,942.59	83,394,314.89
Mortgages and notes	1,206,912.51	-	-	1,206,912.51	1,119,227.52
Other investments	23,349.53	-	-	23,349.53	29,054.00
International securities					
Corporate stocks	2,622,422.00	291,297.16	-	2,913,719.16	2,563,645.31
Assets with trustees	-	-	4,408,454,56	4,408,454.56	4,360,420.94
	97,335,938.59	69,018,262.75	4,408,454.56	170,762,655.90	159,972,109.05
	$ 453,827,645.14	$ 72,418,262.75	$ 4,408,454.56		

University cash equivalents and investments not susceptible to categorization:

	Reported Amount	Cost
Cash equivalents - assets with First Tennessee Bank as custodian	35,545,962.26	35,545,962.26
Limited partnership - venture capital funds	24,582,083.09	42,557,369.11
Mutual funds	144,091,596.89	142,783,661.21
Investments in hedge funds	54,089,325.00	60,000,000.00
Real estate equity funds	25,613,443.01	22,627,028.15
Real estate gifts	4,827,159.11	5,270,445.67
Total investments and cash equivalents	819,403,931.81	826,028,361.37
Less: Cash equivalents	395,437,668.81	392,817,748.18
Total investments	$ 423,966,263.00	$ 433,210,613.19

June 30, 2002

	Category 1	Category 2	Category 3	Reported Amount	Cost
Cash equivalents					
Government securities	$ 235,851,073.59	$ -	$ -	$ 235,851,073.59	$232,039,352.74
Repurchase agreements	16,000,000.00	2,000,000.00	-	18,000,000.00	18,000,000.00
Commercial paper	90,790,089.45	-	-	90,790,089.45	90,516,382.52
	342,641,163.04	2,000,000.00	-	344,641,163.04	340,555,735.26
Investments					
Domestic securities					
Government securities	8,167,250.35	37,813,080.14	-	45,980,330.49	42,931,731.08
Corporate bonds	4,124,930.21	32,269,301.05	-	36,394,231.26	36,019,872.39
Corporate stocks	119,382,907.29	5,651,149.03	-	125,034,056.32	131,514,349.41
Mortgages and notes	1,199,521.42	-	-	1,199,521.42	1,176,247.37
Other investments	168,538.06	-	-	168,538.06	183,070.74
International securities					
Corporate stocks	591,740.00	-	-	591,740.00	545,037.97
Assets with trustees	-	-	4,442,321.32	4,442,321.32	4,551,601.03
	133,634,887.33	75,733,530.22	4,442,321.32	213,810,738.87	216,921,909.99
	$ 476,276,050.37	$ 77,733,530.22	$ 4,442,321.32		

University cash equivalents and investments not susceptible to categorization:

	Reported Amount	Cost
Cash equivalents - assets with First Tennessee Bank as custodian	4,770,595.75	4,770,595.75
Limited partnership - venture capital funds	29,543,346.75	38,994,767.92
Mutual funds	143,318,009.82	146,547,931.14
Investments in hedge funds	35,025,746.00	40,000,000.00
Real estate equity funds	21,794,167.92	18,316,724.89
Real estate gifts	5,109,758.10	6,270,244.67
Total investments and cash equivalents	798,013,526.25	812,377,909.62
Less: Cash equivalents	349,411,758.79	345,326,331.01
Total investments	$ 448,601,767.46	$ 467,051,578.61

Included in the assets with trustees at June 30, 2002, are securities held in debt service reserve at First Tennessee Bank totaling $150,157.84.

The university's assets subject to long-term investment (endowments and annuity and life income assets) use various external managers and funds consistent with investment objectives for those invested assets. A significant part of these assets is the university's Consolidated Investment Pool, 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 five hedge funds: the Commonfund Global Hedged Partners; the Balentine Hedge Fund Select; the Gerber/Taylor Offshore Fund, Ltd.; the Maplewood Associates II, L.P.; and the Pointer Offshore, Ltd., 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 17 primarily equity hedge fund managers operating and investing in the United States, Europe, and Asia. Investment strategies are predominantly long/short, but also include international and event-driven arbitrage. The university's investment of $20,000,000 was valued at $19,024,040 at June 30, 2003, and $19,877,020 at June 30, 2002.

Balentine Hedge Fund, L.P., was created in 2000 as a multi-manager partnership. Currently, portfolio assets are 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. Effective January 1, 2001, the partnership changed its name to Ballentine Hedge Fund Select, L.P. The university's investment of $20,000,000 was valued at $14,311,260 at June 30, 2003, and $15,148,726 at June 30, 2002.

Gerber/Taylor Offshore Fund, Ltd., was created in 2000 as a multi-manager fund that conducts its activities through Gerber/Taylor Partners, L.P. Utilizing the "fund of funds" approach, the fund seeks to identify investment managers or investment pools which implement hedged or market neutral strategies. The university's investment of $5,000,000 was valued at $5,274,500 at June 30, 2003.

Maplewood Associates II, L.P., created in 2001, is a limited partnership managed by Ivy Asset Management Corporation. The partnership seeks above-average capital appreciation on portfolio assets while attempting to minimize risk without incurring any unrelated business taxable income. The partnership seeks to achieve this objective with diversified asset management utilizing independent investment managers through non-U.S. investment corporations. Investment strategies include value-oriented equities investing, special situations investing, and relative value trading. The university's investment of $10,000,000 was valued at $10,338,210 at June 30, 2003.

Pointer Offshore, Ltd., Fund was created in 2002 and is managed by Pointer Offshore, LLC. By allocating its assets to a select number of long/short equity-based managers, the fund seeks capital appreciation through a balanced level of risk. The fund is a "fund of funds" that utilizes diversified strategies to achieve its objective. The university's investment of $5,000,000 was valued at $5,141,315 at June 30, 2003.

NOTE 3. ENDOWMENT, ANNUITY, AND LIFE INCOME AGREEMENTS

There are two categories of university assets which are subject to long-term investment: endowments and amounts held in trust under annuity and life income agreements. 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 assets over which it had full investment discretion (and on which the donor or governing gift instrument does not require separate investment) in a 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 endowments 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.

If a donor has not provided specific instructions, state law permits the university to authorize for expenditure the net appreciation (realized and unrealized) of the investments of endowment funds. When administering its power to spend net appreciation, the university is required to consider the university's long-term and short-term needs, present and anticipated financial requirements, expected total return on its investments, price-level trends, and general economic conditions. Any net appreciation that is spent is required to be spent for the purposes for which the endowment was established.

The university chooses to spend only a portion of the investment income (including changes in the value of investments) each year. Under the spending plan established by the university, five percent of a three-year moving average of the fair value of endowment investments has been authorized for expenditure. The remaining amount, if any, is retained to be used in future years when the amount computed using the spending plan exceeds the investment income. At June 30, 2003, net appreciation of $93,398,134.90 is available to be spent, of which $88,761,939.85 is restricted to specific purposes. At June 30, 2002, net appreciation of $117,997,386.12 was available to be spent, of which $113,006,575.21 was restricted to specific purposes. The per unit fair value for participating endowments was $3.018461 at June 30, 2003, and $3.229534 at June 30, 2002. Income distributed was $.18873 per share in 2003, or $23,197,139.61 and $.18848 per share in 2002, or $21,833,345.92.

The university's consolidated investment pool is invested to maximize total return rather than current income consistent with provisions of the Uniform Management of Institutional Funds Act adopted by the State of Tennessee in 1973. During the past three years, the total return for the consolidated investment pool has been negative or below the defined spending plan for the participating endowments. As a result, there were 746 true endowments at June 30, 2003, that had a market value of $83,996,721.67 and historic gift value of $96,604,046.11, yielding a net "underwater" position of $12,607,324.44. Since the principal amount of a true endowment is categorized as a restricted non-expendable net asset, this depreciation of market value has been charged to unrestricted net assets for financial statement presentation. There were 669 true endowments at June 30, 2002, that had a market value of $73,369,659.59 and a historic gift value of $81,179,406.06, yielding a net "underwater" position of $7,809,746.47.
See also Note 20.

All endowments 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 endowments amounted to $630,755.29 for 2003, and $857,163.19 for 2002.

Annuity and life income amounts held in trust 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 2003 amounted to $1,894,002.88 and, for 2002, amounted to $2,321,619.45.

NOTE 4. ACCOUNTS, NOTES, AND GRANTS RECEIVABLE

Accounts, notes, and grants receivable included the following at June 30, 2003:

Student accounts receivable	$6,850,844.78
Grants receivable	102,259,926.60
Notes receivable	7,466,298.33
Pledges receivable	77,860,277.96
State capital outlay receivable	4,029,835.46
TSSBA debt proceeds receivable	4,084,378.00
Other receivables	53,718,285.07
Subtotal	256,269,846.20
Less allowance for doubtful accounts	(11,161,427.40)
Total	$245,108,418.80

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of $1,503,086.81.

Federal Perkins Loan Program funds include the following at June 30, 2003:

Perkins loans receivable	$29,251,385.31
Less allowance for doubtful accounts	-
Total	$29,251,385.31

Accounts, notes, and grants receivable included the following at June 30, 2002:

Student accounts receivable	$5,314,582.32
Grants receivable	110,903,868.45
Notes receivable	5,279,021.23
Pledges receivable	42,343,911.71
State capital outlay receivable	11,127,209.61
TSSBA debt proceeds receivable	5,403,996.36
Other receivables	65,130,281.15
Subtotal	245,502,870.83
Less allowance for doubtful accounts	(20,189,241.49)
Total	$225,313,629.34

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of $953,740.91.

Federal Perkins Loan Program funds included the following at June 30, 2002:

Perkins loans receivable	$32,812,165.49
Less allowance for doubtful accounts	(833,686.81)
Total	$31,978,478.68

NOTE 5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2003, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Land	$45,102,339.68	$3,845,205.50	$ -	$(590,000.00)	$48,357,545.18
Land improvements and infrastructure	52,265,079.13	2,017,813.82	2,127,572.79	(31,086.40)	56,379,379.34
Buildings	954,252,646.56	48,017,736.34	44,170,868.43	(1,966,809.11)	1,044,474,442.22
Equipment	241,352,039.20	28,563,633.96	11,112.30	(19,215,765.96)	250,711,019.50
Software	14,759,841.48	698,427.14	3,392,183.31	-	18,850,451.93
Library holdings	79,991,937.80	11,372,033.79	-	(6,555,035.12)	84,808,936.47
Projects in progress	99,222,586.11	59,867,042.02	(49,701,736.83)	(168,950.81)	109,218,940.49
Total	1,486,946,469.96	154,381,892.57	-	(28,527,647.40)	1,612,800,715.13
Less accumulated depreciation:					
Land improvements and infrastructure	(22,756,984.28)	(3,308,010.83)	-	-	(26,064,995.11)
Buildings	(426,842,975.34)	(22,052,225.70)	-	407,175.55	(448,488,025.49)
Equipment	(147,429,965.13)	(19,785,598.20)	-	15,662,144.05	(151,553,419.28)
Software	(3,876,549.40)	(3,797,889.85)	-	152.53	(7,674,286.72)
Library holdings	(33,658,458.59)	(8,039,335.44)	-	6,555,035.12	(35,142,758.91)
Total accumulated depreciation	(634,564,932.74)	(56,983,060.02)	-	22,624,507.25	(668,923,485.51)
Capital assets, net	$852,381,537.22	$97,398,832.55	$ -	$(5,903,140.15)	$943,877,229.62

Capital asset activity for the year ended June 30, 2002, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Land	$45,132,874.38	$228,121.30	$ -	$(258,656.00)	$45,102,339.68
Land improvements and infrastructure	58,041,289.55	58,235.37	(5,834,445.79)	-	52,265,079.13
Buildings	902,485,207.30	4,151,045.99	47,616,393.27	-	954,252,646.56
Equipment	224,451,240.34	29,304,724.57	-	(12,403,925.71)	241,352,039.20
Software	7,587,028.85	2,919,611.18	4,253,201.45	-	14,759,841.48
Library holdings	75,649,507.44	9,652,280.79	-	(5,309,850.43)	79,991,937.80
Projects in progress	87,843,473.10	57,936,820.97	(46,035,148.93)	(522,559.03)	99,222,586.11
Total	1,401,190,620.96	104,250,840.17	-	(18,494,991.17)	1,486,946,469.96
Less accumulated depreciation:					
Land improvements and infrastructure	(20,155,628.34)	(2,601,355.94)	-	-	(22,756,984.28)
Buildings	(406,381,057.57)	(20,461,917.77)	-	-	(426,842,975.34)
Equipment	(137,207,827.19)	(19,684,684.53)	-	9,462,546.59	(147,429,965.13)
Software	(78,812.08)	(3,797,889.85)	-	152.53	(3,876,549.40)
Library holdings	(31,367,171.36)	(7,601,137.66)	-	5,309,850.43	(33,658,458.59)
Total accumulated depreciation	(595,190,496.54)	(54,146,985.75)	-	14,772,549.55	(634,564,932.74)
Capital assets, net	$806,000,124.42	$50,103,854.42	$ -	$(3,722,441.62)	$852,381,537.22

NOTE 6. 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 expenses for rentals under leases were $8,003,773.58 for the year ended June 30, 2003, and $7,895,144.03 for the year ended June 30, 2002.

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, 2003. Only one such lease is currently in effect. Annual payments on this particular lease fluctuate in direct proportion to changes in the Consumer Price Index as required by contractual agreement. The schedule below is calculated based on the current Consumer Price Index.

Year Ending June 30	
2004	$ 11,410.00
2005	11,410.00
2006	11,410.00
2007	11,410.00
2008	11,410.00
2009 - 2012	45,640.00
Total Minimum Payments Required	$ 102,690.00

NOTE 7. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2003, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term liabilities:					
Bonds	$194,907,564.22	$16,172,849.34	$13,506,220.23	$197,574,193.33	$13,850,879.95
Commercial paper	7,456,509.58	13,424,084.09	2,720,590.15	18,160,003.52	-
Total TSSBA indebtedness	202,364,073.80	29,596,933.43	16,226,810.38	215,734,196.85	13,850,879.95
Notes	10,490.90	-	10,490.90	-	-
Compensated absences	59,189,554.16	40,729,170.73	36,161,340.46	63,757,384.43	36,161,340.46
Total long-term liabilities	261,564,118.86	70,326,104.16	52,398,641.74	279,491,581.28	$50,012,220.41
Other noncurrent liabilities:					
Deferred revenue	15,500,438.71	-	-	15,500,438.71	
Due to grantors	34,507,427.06	2,000,794.70	187,232.17	36,320,989.59	
Annuities payable	8,578,451.55	1,334,566.73	1,332,314.59	8,580,703.69	
Totals	$320,150,436.18	$73,661,465.59	$53,918,188.50	$339,893,713.27	

Long-term liability activity for the year ended June 30, 2002, was as follows

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term liabilities:					
Bonds	$164,135,512.00	$61,449,853.53	$30,677,801.31	$194,907,564.22	$13,506,220.25
Commercial paper	27,211,183.50	4,519,042.99	24,273,716.91	7,456,509.58	-
Total TSSBA indebtedness	191,346,695.50	65,968,896.52	54,951,518.22	202,364,073.80	13,506,220.25
Notes	31,009.87	-	20,518.97	10,490.90	10,490.90
Compensated absences	54,721,845.03	28,385,752.15	23,918,043.02	59,189,554.16	23,918,043.02
Total long-term liabilities	246,099,550.40	94,354,648.67	78,890,080.21	261,564,118.86	$37,434,754.17
Other noncurrent liabilities:					
Deferred revenue	15,500,438.71	-	-	15,500,438.71	
Due to grantors	33,764,403.58	877,951.02	134,927.54	34,507,427.06	
Annuities payable	9,709,264.76	489,074.75	1,619,887.96	8,578,451.55	
Totals	$305,073,657.45	$95,721,674.44	$80,644,895.71	$320,150,436.18	

Tennessee State School Bond Authority (TSSBA) bonds, with interest rates ranging from 3.0% to 7.75%, are due serially to 2032 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 $215,243,397.96 at June 30, 2003, and was $228,749,618.01 at June 30, 2002. The total bonded indebtedness reported on the statement of net assets at June 30, 2003, is shown net of unaccreted bonds payable of $3,846,215.04, assets of $9,910,725.81 held by the Tennessee State School Bond Authority, and unspent bond proceeds of $3,912,263.78. The total bonded indebtedness reported on the statement of net assets at June 30, 2002, is shown net of unaccreted bonds payable of $4,862,691.80, assets of $9,911,109.61 held by the Tennessee State School Bond Authority, and unspent bond proceeds of $19,068,252.38.

The university's debt service requirements to maturity for all bonds at June 30 are as follows:

Year Ending June 30	Principal	Interest
2004	$ 13,850,879.95	$ 10,923,409.42
2005	12,285,795.27	10,335,973.99
2006	11,218,017.97	9,817,848.27
2007	11,625,382.34	9,353,448.27
2008	11,137,268.35	8,884,073.23
2009-2013	49,833,833.15	37,175,657.22
2014-2018	37,488,889.50	25,376,560.15
2019-2023	32,466,233.39	14,793,142.24
2024-2028	23,529,826.69	6,775,420.19
2029-2032	11,807,271.35	1,545,368.28
	$215,243,397.96	$134,980,901.26

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, 2003, $18,160,003.52 was issued for projects at the University of Tennessee. At June 30, 2002, $7,456,509.58 was 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.

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 7.29% of annual covered payroll. 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, 2003, 2002, and 2001, were $18,125,448.74, $14,844,243.45, and $14,318,076.01, respectively. Contributions met the requirements 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 7.0% of covered salaries to the CSRS plan. The university is currently required to contribute 7.0%. Contributions to CSRS for the year ended June 30, 2003, were $1,435,605.13, which consisted of $761,592.31 from the university and $674,012.82 from the employees; contributions for the year ended June 30, 2002, were $1,368,041.75, which consisted of $706,073.01 from the university and $661,968.74 from the employees; and contributions for the year ended June 30, 2001, were $1,802,981.46, which consisted of $996,255.77 from the university and $806,725.69 from the employees.

Federal statute requires employees participating in FERS to contribute 0.8% 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 $975,623.14 for the year ended June 30, 2003, which consisted of $67,869.03 from employees and $907,754.11 from the university; $995,187.77 for the year ended June 30, 2002, which consisted of $69,230.98 from employees and $925,956.79 from the university; and $1,017,264.48 for the year ended June 30, 2001, which consisted of $87,035.01 from employees and $930,229.47 from the university. Contributions for the Thrift Savings Plan were $980,054.00 for the year ended June 30, 2003, which consisted of $595,517.00 from employees and $384,537.00 from the university; $953,719.31 for the year ended June 30, 2002, which consisted of $572,187.00 from employees and $381,532.31 from the university; and $898,677.53 for the year ended June 30, 2001, which consisted of

$562,632.00 from employees and $336,045.53 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, 2003, was $35,777,441.20 and for the year ended June 30, 2002, was $33,798,169.77. 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 $50,242,761.15 for fiscal year 2003, and $52,516,763.29 for fiscal year 2002. 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 $3,662,932.19 in fiscal year 2003, and $3,250,790.81 in fiscal year 2002. 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 and a third-party administrator is used to administer the plan assets, they are not presented in the State of Tennessee financial statements. Effective January 1996, the university began providing a $20 monthly match from unrestricted funds for employees making a minimum monthly contribution of $20 to the Section 401(k) plan. During the year ended June 30, 2003, contributions totaling $9,710,479.63 were made by employees participating in the plan, with a related match of $1,885,822.55 made by the university. During the year ended June 30, 2002, contributions totaling $9,101,147.15 were made by employees participating in the plan, with a related match of $1,920,510.28 made by the university. In accordance with the *IRC*, employee contributions through the 403(b) plan remain the assets of the employee. In addition, the amounts withheld from employees are remitted directly to third-party administrators. Therefore, these employee contributions are not reflected in the university's financial statements.

NOTE 9. OTHER POST-EMPLOYMENT BENEFITS

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*. That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 312 Eighth Avenue North, 14th Floor, William R. Snodgrass Tennessee Tower, Nashville, TN 37243-0298 or by calling (615) 741-2140.

NOTE 10. 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 of the foundation are not managed by the university and accordingly are not included in these financial statements except for certain endowment assets. As reported in the University of Chattanooga Foundation's most recently audited financial report, at June 30, 2003, the foundation's assets totaled $205,080,390, liabilities were $100,722,995, and the net assets amounted to $104,357,395.

The University of Tennessee Foundation, Inc., a private, nonprofit corporation, was created in October of 2000, with its offices located in Knoxville, Tennessee. The foundation was formed to provide flexibility for the university in carrying out its missions of teaching, research, and public service.

The University of Tennessee board of trustees approved a resolution at its April 2001 board meeting authorizing the University of Tennessee Foundation to accept private gifts on behalf of the university, effective July 1, 2001.

The university holds the endowment assets of the foundation. They are invested in the university's consolidated investment pool. At June 30, 2003, they totaled $983,346.01, and are reported on the university's statement of net assets as deposits held in custody for others. The other assets and other financial transactions of the foundation are not managed by the university and accordingly are not included in the university's financial statements. As reported in the University of Tennessee Foundation's most recently audited financial report, at June 30, 2003, the foundation's assets totaled $67,835,660.32, liabilities were $62,044,331.06, and the net assets amounted to $5,791,329.26.

NOTE 11. CHAIRS OF EXCELLENCE

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, 2003. The financial statements of the university include as expenditures the amounts expended in the current year to match the state appropriations. The university's statement of net assets does not include the amounts held in trust by the State Treasurer. At June 30, 2003, the amounts held in trust totaled $97,159,462.90 at fair value.

NOTE 12. 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 was $2,043,045.23 at June 30, 2003, and $1,789,206.24 at June 30, 2002. The university and Battelle each receive a 50% distribution of the ORNL management fee after shared expenses are deducted. The fee distribution for the year ended September 30, 2002, to the university was $1,168,945.22. During the year ended June 30, 2003, the university had expenses of $14,420,679.42 under contracts with UT-Battelle. During the year ended June 30, 2002, the university had expenses of $12,121,816.00 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled $7,000,392.22 at June 30, 2003, and $3,820,279.00 at June 30, 2002. To review the audit report of UT-Battelle, please contact the Controller's Office, The University of Tennessee, 201 Andy Holt Tower, Knoxville, Tennessee 37996-0100.

NOTE 13. INSURANCE-RELATED ACTIVITIES

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. In the past three fiscal years, the state has had no claims filed with the commercial insurer. Designations for casualty losses in the amount of $3.271 million for incurred losses at June 30, 2003, were established in the state's general fund to provide for any property losses not covered by the commercial insurance.

At June 30, 2003, the scheduled coverage for the university was $2,249,267,800 for buildings and $791,102,600 for contents. At June 30, 2002, the scheduled coverage for the university was $2,228,094,100 for buildings and $766,847,300 for contents.

The university also carries commercial insurance for losses related to hired and non-owned 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.

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 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. The university participates 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.

NOTE 14. 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, 2003, were $48,564,699.08 and at June 30, 2002, were $58,886,211.99.

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, 2003, or at June 30, 2002. The amount of unused sick leave was $193,729,219.40 at June 30, 2003, and $188,177,974.57 at June 30, 2002.

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 $3,204,602.91 as of June 30, 2003, and at $4,148,188.59 as of June 30, 2002, 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 15. 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 16.) 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 20 years. UHS assumed all prior hospital liabilities, known or unknown. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease.

Employee Services 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 expenses on behalf of UHS, totaling $87,154,844.90 in 2003, and $91,146,720.15 in 2002, are reported as operating expenses in the statement of revenues, expenses, and changes in net assets. An equal amount of operating revenue is reported in the non-governmental grants and contracts category.

The term of the Employee Services 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 16. CAPITAL LEASE OF REAL PROPERTY TO UNIVERSITY HEALTH SYSTEMS, 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 15. 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. An annual lease payment to the university during the year ended June 30, 2003, totaled $456,818.00.

The university recorded a lease payment receivable in the amount of $18,675,783.73 at June 30, 2003, and $16,272,083.36 at June 30, 2002, which represent the net present value of the guaranteed $50 million discounted at 5.75%. The minimum lease payments to be received amount has been adjusted upward to reflect a contractually required adjustment to the final required lease payment.

	2003	2002
Total minimum lease payments to be received	$49,270,627.46	$47,948,734.52
Less: Unearned income	(30,594,843.73)	(31,676,651.16)
Net investment in direct financing lease	$18,675,783.73	$16,272,083.36

NOTE 17. MANAGEMENT AGREEMENT FOR WILLIAM F. BOWLD HOSPITAL

On November 1, 2002, the university transferred management and operations of its hospital located in Memphis to Methodist Healthcare-Memphis Hospitals (Methodist), a Tennessee non-profit corporation. The transfer of the hospital management and operations from the university to Methodist was accomplished through three main agreements: the Management Agreement, the Employee Services Agreement, and the Affiliation Agreement. Each of these agreements is summarized below.

Management Agreement

Effective November 1, 2002, the university and Methodist entered into a management agreement whereby Methodist will manage the operations of William F. Bowld Hospital. Bowld Hospital will operate programs for patients with complex chronic diseases, which will include transplant patients. The term of the agreement is from the effective date until the date all services comprising the hospital are relocated to Methodist University Hospital. As consideration for managing the hospital in the first two years, Methodist will retain the net margins or deficits from hospital operations as defined in the agreement. After the first two years, Methodist will distribute 50% of the cumulative net margins in excess of a minimum threshold, as defined in the agreement, if any, to the university. The university has agreed to allow Methodist to use, without limitation, all hospital assets. Methodist purchased the supplies inventories from the university. The university retained the patient accounts receivable as of the effective date.

Employee Services Agreement

Pursuant to the enabling legislation, *Tennessee Code Annotated,* Section 49-9-112 et seq., Methodist has leased from the university all hospital employees as of the effective date (November 1, 2002). Methodist 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 expenses on behalf of Methodist, totaling $10,498,784.27, are reported as operating expenses in the statement of revenues, expenses, and changes in net assets. An equal amount of operating revenue is reported in the non-governmental grants and contracts category. The term of the Employee Services Agreement is from the effective date until the date all services comprising the hospital are relocated from William F. Bowld Hospital to Methodist University Hospital. (There are certain provisions under which a limited number of leased employees could continue after this date. Under these circumstances, the agreement will terminate when there are no longer leased employees.) All persons who began service at the hospital after the date the employee service agreement was signed are employees of Methodist and not university employees.

Affiliation Agreement

The university and Methodist entered into a Master Affiliation Agreement dated March 18, 2002, wherein Methodist agreed to support the continuous development and improvement of the medical education, research, and public service programs of the university. The university and Methodist agreed that Methodist Central Hospital (renamed Methodist University Hospital) and LeBonheur Children's Medical Center (also a Methodist Hospital) will be the principal private teaching hospitals for the university in the Shelby County area.

The university shall be entitled to reimbursement for its expenses associated with the graduate medical education program rendered under this agreement including the costs of coverage under the Tennessee Claims Commission Act and defense costs. The university will cooperate, support, and assist in seeking adequate reimbursement from Medicare and the State of Tennessee for graduate medical education. The costs of providing residents and medical faculty supervision at Methodist will be paid by the university and the pro rata costs will be reimbursed by Methodist based upon the actual costs associated with the program at Methodist. Specific financial arrangements for residents and faculty will be negotiated annually and incorporated annually by addendum into this Master Affiliation Agreement as part of the Methodist annual budgeting process. The annual addendum will specify the numbers of faculty and residents to be provided along with the costs to be annually reimbursed under this agreement.

NOTE 18. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATIONS

The university's operating expenses by functional classification for the year ended June 30, 2003, are as follows:

	Natural Classification					
Functional Classification	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$289,077,959.71	$68,377,829.70	$51,741,274.70	$ -	$ -	$409,197,064.
Research	101,627,622.42	27,803,139.54	56,387,999.83	-	-	185,818,761.
Public service	67,284,293.71	22,442,699.92	33,886,686.63	-	-	123,613,680.
Academic support	53,339,183.12	14,508,661.92	15,195,803.02	-	-	83,043,648.
Student services	27,101,920.58	7,903,515.94	17,035,578.89	-	-	52,041,015.
Institutional support	53,503,167.98	15,876,385.83	3,571,176.02	-	-	72,950,729.
Operation & maintenance of plant	26,235,826.97	8,917,444.49	39,735,431.32	-	-	74,888,702.
Scholarships & fellowships	3,043,656.41	23,768,163.52	11,317,686.33	4,650,947.67	-	42,780,453.
Auxiliary	30,234,682.01	7,240,096.94	59,516,014.77	-	-	96,990,793.
Hospital	6,816,144.90	1,843,807.69	12,217,500.78	-	-	20,877,453.
Independent operations	75,175,944.72	21,475,424.54	-	-	-	96,651,369.
Depreciation	-	-	-	-	56,983,060.02	56,983,060.
Total expenses	$733,440,402.53	$220,157,170.03	$300,605,152.29	$4,650,947.67	$56,983,060.02	$1,315,836,732.

The university's operating expenses by functional classification for the year ended June 30, 2002, are as follows:

Functional Classification	Natural Classification					
	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$275,198,243.78	$66,426,641.85	$50,982,869.52	$ -	$ -	$392,607,755.
Research	87,488,829.89	18,011,441.43	51,276,562.72	-	-	156,776,834.
Public service	64,131,577.73	15,839,216.03	35,378,604.28	-	-	115,349,398.
Academic support	49,270,311.49	13,541,421.83	12,374,035.41	-	-	75,185,768.
Student services	24,898,362.95	6,354,629.93	16,273,821.90	-	-	47,526,814.
Institutional support	51,158,086.26	14,768,486.25	442,622.77	-	-	66,369,195.
Operation & maintenance of plant	24,593,358.95	7,900,158.39	36,708,006.14	-	-	69,201,523.
Scholarships & fellowships	2,752,335.69	21,637,370.03	11,051,956.14	7,816,121.78	-	43,257,783.
Auxiliary	29,430,866.07	7,555,825.77	59,875,566.86	-	-	96,862,258.
Hospital	19,828,880.62	4,743,207.12	40,969,150.94	-	-	65,541,238.
Independent operations	72,456,079.74	18,690,640.41	-	-	-	91,146,720.
Depreciation	-	-	-	-	54,146,985.75	54,146,985.
Total expenses	$701,206,933.17	$195,469,039.04	$315,333,196.68	$7,816,121.78	$54,146,985.75	$1,273,972,276.

NOTE 19. UNRESTRICTED NET ASSETS

Unrestricted net assets include funds that have been designated or reserved for specific purposes. These purposes include the following:

	June 30, 2003	June 30, 2002
Working capital	$57,276,157.94	$56,608,103.99
Encumbrances	8,772,158.74	8,553,587.76
Auxiliaries	1,464,038.19	3,051,800.21
Quasi-endowments	19,349,550.79	17,802,279.40
Plant construction	24,751,554.67	30,001,493.22
Renewal and replacement of capital assets	101,638,230.41	91,941,296.66
Debt retirement	43,798,560.42	49,512,522.71
Unreserved/undesignated	(40,949,351.38)	(30,861,759.25)
Total	$216,100,899.78	$226,609,324.70

NOTE 20. PRIOR-YEAR RESTATEMENTS

Due to changes in presentation made by the university for the year ended June 30, 2003, some reclassifications were made in the prior-year financial statements for comparative purposes. The TSSBA interest rate reserve, which was previously shown as assets with trustee, was reclassified as prepaid expense. Other amounts shown as assets with trustees have been reclassified as investments. Also, the note disclosure for unrestricted net assets was changed to show all of the components rather than just the designated amounts.

The university also reclassified $7,456,509.58 of current long-term liabilities as noncurrent long-term liabilities.

The university restated its restricted nonexpendable net assets at June 30, 2002. The university transferred $7,809,746.47 of unrestricted net assets to the nonexpendable restricted net assets category. As described in Note 3, there were 669 true endowments at June 30, 2002, that had a market value of $73,369,659.59 and a historic gift value of $81,179,406.06, yielding a net "underwater" position of $7,809,746.47. This restatement returns the endowments to their historic gift value.

The university also restated its depreciation expense for the year ended June 30, 2002, at $54,146,985.75 rather than $71,396,612.07. Renovations made to three buildings totaling $17,249,626.32 were fully depreciated in 2002 rather than being depreciated over the remaining useful lives of the assets. As a result, net capital assets and amounts invested in capital assets, net of related debt, at June 30, 2002, have been increased by $17,249,626.32.

NOTE 21. CUMULATIVE EFFECTS OF CHANGES IN ACCOUNTING PRINCIPLE

During the year ended June 30, 2002, the university implemented GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* and GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The university also implemented GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus,* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures.* As a result of this implementation, the university was required to adopt the depreciation of its capital assets, with accumulated depreciation totaling $595,190,496.55 at the beginning of the year. The university was also required to recognize certain deferred revenue originating under its grant and contract agreements, totaling $30,731,024.69 at the beginning of the year. In addition, the university was required to reduce amounts due from the Tennessee State School Bond Authority by $6,165,813.65 at the beginning of the year. The cumulative effect of this change in accounting principle is reported as a $632,087,334.89 decrease in beginning net assets in 2002.

During the year ended June 30, 2002, the university also changed its capitalization threshold for buildings, land improvements, and infrastructure from $50,000 to $100,000, discontinued the capitalization of its livestock assets, and changed its method of capitalizing library holdings. As a result, capital assets decreased by $35,869,397.59, $2,080,071.25, and $182,712,016.56, respectively. This cumulative effect of a change in accounting principle, totaling $220,661,485.40 is also reported as a restatement to beginning net assets in 2002.

The university also changed its method of accounting for accumulated federal capital contributions associated with its federal loan programs. At June 30, 2001, industry practice required the reporting of these amounts as a fund balance. During the year ended June 30, 2002, industry practice changed, and these amounts were to be reported as a liability. As a result, for the year ended June 30, 2002, beginning net assets were reduced by $33,764,402.98.