The University of Tennessee

For the Year Ended
June 30, 2004

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
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John G. Morgan
Comptroller

March 22, 2005

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Waymon L. Hickman, Chairman
Audit Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180
and
Dr. John Petersen, President
The University of Tennessee
800 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, 2004. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

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

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/sds
04/094

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, 2004

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 grant agreements; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDING

Security Over the UT Knoxville Financial Aid System (BANNER) Needs Improvement
The University of Tennessee's Office of Information Technology has not implemented adequate security controls over the University of Tennessee at Knoxville's financial aid system (BANNER). The University of Tennessee Information Technology Acceptable Use Policy purpose states, "The University of Tennessee seeks to protect the confidentiality of data and privacy of its users, . . . [and] to safeguard the integrity of UTK data and IT resources." Improvements are needed to comply with this policy (page 8).

COMPLIANCE FINDINGS

Students Were Not Eligible for Federal Financial Aid
At the University of Tennessee at Martin, 2 of 42 federal financial aid recipients tested for eligibility did not meet the eligibility requirements for their assistance. One of the recipients was not a regular student enrolled for the purpose of obtaining a degree. Another student received financial assistance that exceeded the student's financial need (page 8).

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

Federal Pell Payment Data Was Not Reported in Compliance With Federal Regulations

At the University of Tennessee at Martin, the university credited student accounts with institutional funds more than 10 days before classes began. For these students, the reported disbursement date was more than 10 days prior to the first day of classes. This is not in compliance with the *Code of Federal Regulations*, which states that in this instance the official disbursement date is 10 days before the first day of classes. In addition, the *2003-2004 Federal Student Aid Handbook* states that schools can submit disbursement records up to 30 days before the actual disbursement date. However, 8 disbursement records in the sample were submitted more than 30 days before the disbursement date (page 11).

Failure to Ensure That Subrecipients of Federal Funds Were Properly Audited

For 5 of 34 federal research and development subrecipients tested for the fiscal year ended June 30, 2003, university personnel did not ensure that the subrecipient was properly audited in accordance with OMB Circular A-133. Each subrecipient was sent a letter inquiring about the subrecipient's need for a Circular A-133 audit. In each case, the letter was not returned or was not received timely (page 12).

PRIOR AUDIT FINDING

Special Investigation Report—Review of Issues Related to the Presidency of Dr. John Shumaker

In October 2003, the Division of State Audit released a special investigation report regarding the presidency of Dr. John Shumaker at the University of Tennessee. This report contained several recommendations for improving controls. The university's internal audit staff conducted a follow-up to ensure the implementation of those recommendations. The Board of Trustees has taken action to address the weaknesses identified by the university's internal auditor and has taken action to address most of the weaknesses identified by the Division of State Audit in its 2003 Special Report. However, the board has neither addressed nor formally discussed the finding concerning oversight of the UT Foundation. Correspondence from the Vice Chair of the Board of Trustees to this office states that at the March 2005 meeting the board will begin an examination of the issues concerning the Foundation.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

Audit Report
The University of Tennessee
For the Year Ended June 30, 2004

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The University of Tennessee
For the Year Ended June 30, 2004

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, 2003, through June 30, 2004, 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, 2004. 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 opinions on the financial statements;

2. to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements;

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 May 12, 2004. 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 failure to properly record serial numbers and tag numbers for federal equipment, the need to submit federal financial reports on a timely basis, the need to report student status changes on a timely basis (Memphis campus), the need to follow university collection policies for accounts receivable (Martin campus), and the need to follow procurement card procedures.

SPECIAL INVESTIGATION REPORT—REVIEW OF ISSUES RELATED TO THE PRESIDENCY OF DR. JOHN SHUMAKER

In October 2003, the Division of State Audit released a special investigation report regarding the presidency of Dr. John Shumaker at the University of Tennessee. This report contained several recommendations for improving controls. The university's internal audit staff conducted a follow-up to ensure the implementation of those recommendations. The Board of Trustees has taken action to address the weaknesses identified by the university's internal auditor and has taken action to address most of the weaknesses identified by the Division of State Audit in its 2003 Special Report. However, the board has neither addressed nor formally discussed the finding concerning oversight of the UT Foundation. Correspondence from the Vice Chair of the Board of Trustees to this office states that at the March 2005 meeting the board will begin an examination of the issues concerning the Foundation.

OBSERVATIONS AND COMMENTS

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, and not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

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, 2004, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing opinions 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. A reportable condition, along with a recommendation and management's response, is 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 Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

November 12, 2004

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, and its aggregate discretely presented component units as of and for the year ended June 30, 2004, and have issued our report thereon dated November 12, 2004. We did not audit the financial statements of the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., discretely presented component units of the university. Those financial statements were audited by other auditors whose reports thereon have been furnished to us. 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. The financial statements of the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., were not audited in compliance with *Government Auditing Standards*. During the year ended June 30, 2004, the university implemented GASB Statement 39, *Determining Whether Certain Organizations Are Component Units.*

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 opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the university's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable condition was noted:

- Security over the UT Knoxville financial aid system (BANNER) needs improvement.

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

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. 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 that the reportable condition described above is not a material weakness.

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

Compliance and Other Matters

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

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

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. <u>Security over the UT Knoxville financial aid system (BANNER) needs improvement</u>

Finding

Auditors observed that the University of Tennessee's Office of Information Technology has not implemented adequate security controls over the UT Knoxville financial aid system (BANNER). The University of Tennessee Information Technology Acceptable Use Policy purpose states, "The University of Tennessee seeks to protect the confidentiality of data and privacy of its users, . . . [and] to safeguard the integrity of UTK data and IT resources." Improvements are needed to comply with this policy. Failure to provide such controls increases the risk that unauthorized individuals could access confidential student financial aid information protected by federal privacy law.

The wording of this finding does not identify specific vulnerabilities that could allow someone to exploit the state's systems. Disclosing those vulnerabilities could present a potential security risk by providing readers with information that might be confidential pursuant to Section 10-7-504 (i), *Tennessee Code Annotated*. We provided the university with detailed information regarding the specific vulnerabilities we identified as well as our recommendations for improvement.

This finding is a reportable condition for purposes of the State of Tennessee Single Audit of federal financial assistance. This wording will also appear in that report, which will be provided to the federal government pursuant to the procedures developed for reporting of Single Audit findings.

Recommendation

UT management should improve security over the BANNER financial aid system.

Management's Comment

We concur. The university will take the necessary steps to comply with the recommendations to improve the security of the BANNER financial aid system.

2. <u>Students were not eligible for federal financial aid</u>

Finding

Two of 42 federal financial aid recipients tested for eligibility at the University of Tennessee at Martin (4.8%) did not meet the eligibility requirements for their assistance.

One of the students was not a regular student enrolled for the purpose of obtaining a degree.

According to the *Federal Student Aid Handbook*, volume 1, page 1:

> A person must be enrolled as a *regular student* in an eligible program in order to receive FSA funds . . . A regular student is someone who is enrolled or accepted for enrollment in an eligible institution for the purpose of obtaining a degree or certificate offered by the school.

This student was awarded a $2,750 unsubsidized Stafford Loan in the fall semester of 2003 after graduating in the spring semester of 2003. Financial aid personnel were not aware that the student was not seeking a degree.

Another student received financial assistance (a subsidized Stafford Loan) that exceeded the student's financial need. This resulted in an overaward of $1,378.50. The overaward occurred because other financial assistance received was not entered into the award calculation software in a timely manner.

According to the *Federal Student Aid Handbook*, volume 1, page 117:

> A student must have financial need to receive all FSA funds except for unsubsidized Stafford and PLUS loans under the Direct Loan and FFEL programs. Financial need is simply defined as the difference between the student's cost of attendance and the family's ability to pay these costs, the EFC [Expected Family Contribution]. Excepting the Pell Grant Program, other aid the student receives known as *resources* under the Campus-based programs or as *estimated financial assistance* under the Stafford programs, is also subtracted from the cost of attendance to determine financial need.

Since the two students described above were not eligible for this federal financial assistance, costs totaling $4,128.50 have been questioned. Stafford loans tested at Martin totaled $114,176.00, and Stafford loans awarded totaled $14,451,213.39.

Recommendation

Financial aid personnel at Martin should ensure that each financial aid recipient has met all eligibility criteria. Each recipient should be seeking a degree or certificate as offered by the institution. Controls should be implemented to monitor the awarding of aid to students who have already graduated. All sources of other financial assistance should be considered when calculating student awards.

Management's Comment

We concur. In the case of overawards, queries have been written and are run before the first disbursements of each term and on a weekly basis thereafter to catch any overawards. If an overaward occurs and cannot be resolved with a change in award or through other means, then aid is reduced and the student is notified. Loans are reduced first in resolving overawards. Consequently, a process is in place to monitor for overawards and care will be exercised to be in compliance with regulations.

In the case of eligibility, queries are now being run to check if changes are made in student status prior to disbursing aid. If a student's status has changed from an eligible to a non-eligible program, aid will be canceled. Our Academic Records Office is also placing holds on students once they graduate to keep them from registering for additional classes until they update their status to reflect either "senior seeking a second degree" or "post-baccalaureate."

3. Student status changes were not properly reported

Finding

At the University of Tennessee at Martin, 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 *Federal Student Aid Handbook*, volume 8, page 67:

> 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 Martin revealed that for 5 of 25 FFEL student borrowers tested (20%), enrollment status changes were not accurately reported. Three students who had officially withdrawn and two students identified as unofficially withdrawn were incorrectly reported as enrolled.

The status changes were incorrectly reported due to a computer programming error made during the Fall 2003 semester.

The failure to accurately report student status changes could result in the inappropriate granting of an in-school deferment or the failure to properly initiate the loan repayment process.

Recommendation

The director of academic records and registrar should ensure that all student status changes for FFEL loan recipients are reported in compliance with federal regulations. Any necessary computer programming changes should be made in order to ensure accurate reporting.

Management's Comment

We concur. An error in the program that reports to the Clearinghouse and NSLDS occurred with the Banner 6.1 upgrade. Once the problem was discovered, it was corrected. In the future, when system upgrades occur, there are procedures in place for testing the system to ensure that Clearinghouse reporting is working properly.

4. <u>Federal Pell Payment Data was not reported in compliance with federal regulations</u>

Finding

Federal Pell Payment Data is reported to the United States Department of Education through the Common Origination and Disbursement (COD) on-line system. Each Pell payment made to an eligible student is reported on a separate disbursement record. Disbursement records are submitted periodically via batch processing.

The *Code of Federal Regulations*, section 34, part 668.164 (a), states that a disbursement has occurred when an institution credits a student's account with institutional funds on behalf of Pell. The regulation also states that if the credit occurs more than 10 days before classes begin, the official disbursement date is 10 days before the first day of classes.

At the University of Tennessee at Martin, for the fall 2003 semester and the spring 2004 semester, the university credited student accounts with institutional funds more than 10 days before classes began. For these students, the reported disbursement date on the COD system was more than 10 days prior to the first day of classes. The reported disbursement date was therefore not in compliance with the *Code of Federal Regulations.*

The *2003-2004 Federal Student Aid Handbook*, volume 3, page 66, also states, "If your school uses Advance Funding, you can submit a disbursement record up to 30 days before the actual disbursement date."

Eight disbursement records in our sample were submitted more than 30 days before the disbursement date as properly determined by federal regulations.

The failure of the university to properly report Pell disbursements on the COD system limits the U.S. Department of Education's ability to properly monitor the university's cash needs.

Recommendation

Financial aid personnel should ensure proper reporting of Pell Payment Data. Pell disbursement dates reported should be no earlier than 10 days before the first day of classes. The submission of disbursement records should be no earlier than 30 days before the disbursement date.

Management's Comment

We concur. The university was disbursing university funds on behalf of Pell, but because we were using university funds, it was believed not to be true Pell funds. According to the FSA handbook, university funds can be disbursed to student accounts earlier than 10 days prior to the start of classes as long as the university funds are not called Pell Grant funds. This has been corrected and funds are disbursed no earlier than 10 days prior to the first day of classes for enrolled students (34 CFR 668.165[a][1]).

5. Failure to ensure that subrecipients of federal funds were properly audited

Finding

The University of Tennessee contracts with many subrecipients to accomplish the research described under its numerous federally funded research and development programs. The university therefore qualifies as a "pass-through entity" as described in Office of Management and Budget (OMB) Circular A-133.

According to OMB Circular A-133, pass-through entities are required to ensure that subrecipients expending more than $300,000 in federal awards have an audit performed in accordance with OMB Circular A-133 ($500,000 is the threshold for fiscal years ending after December 31, 2003). The required audits are to be completed within 9 months of the end of the subrecipient's audit period. The pass-through entity is to review audit findings, if any, and issue a management decision within 6 months after receipt of the audit report. The pass-through entity should ensure that the subrecipient takes timely and appropriate corrective action on all audit findings. In cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity should take appropriate action, including sanctions.

For 5 of 34 federal research and development subrecipients tested for the fiscal year ended June 30, 2003, (15%), controller's office personnel did not ensure that the subrecipient was properly audited in accordance with OMB Circular A-133. In these five cases, each subrecipient was sent a letter inquiring about the subrecipient's need for a Circular A-133 audit. In 4 of the cases, a letter was mailed and a follow-up letter was mailed, but a reply was never received. No additional follow-up action was taken. In the other case, an initial letter was sent in February 2004 and a follow-up letter was sent in May 2004, but a reply was not received until September 2004 (15 months after the subrecipient's June 30, 2003, year-end).

Controller's office personnel maintain a list of audit inquiry letters sent to the subrecipients. Inquiry letters are normally sent in the February following the subrecipient's year-end, with follow-up letters sent the following May. A record is kept on this checklist describing letters sent and responses received. The procedures currently in place do not ensure the timely receipt of subrecipient audit information.

The failure to ensure that subrecipients of federal funds are properly audited in accordance with OMB Circular A-133 omits an integral part of the monitoring process. Audit reports could indicate ongoing financial, compliance, or internal control problems at the subrecipient. In addition, the university must review subrecipient audit findings, if any, and ensure that the subrecipient takes appropriate corrective action.

Recommendation

Controller's office personnel should ensure that all of the university's federal subrecipients which are states, local governments, or non-profit entities receive audits in accordance with OMB Circular A-133 if they expend federal awards in excess of $500,000. The university should develop formal procedures to ensure that this information is obtained for each subrecipient in a timely manner. For subrecipient audits with findings, controller's office personnel should review the findings and perform any necessary follow-up procedures.

Management's Comment

We concur. The five subcontractors identified were five other universities. All of these universities had A-133 audits for this time period; however, they did not respond to our letters. Controller's office staff went to the university or state web sites and reviewed the 2003 audit reports. No instances of noncompliance related to the University of Tennessee subcontracts were noted in the audits. In the future, Controller's office staff will continue to send at least two letters to each subcontractor, and staff will review the audit reports of all subcontractors that do not return our letters prior to the state auditors coming on site.

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Independent Auditor's Report

November 12, 2004

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

Dear Mr. Morgan:

We have audited the accompanying basic financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, and its aggregate discretely presented component units as of and for the year ended June 30, 2004, as listed in the table of contents. These financial statements are the responsibility of the university's management. Our responsibility is to express opinions on these financial statements, based on our audit. We did not audit the financial statements of the University of Chattanooga Foundation, Inc., which represent 71% and 48%, respectively, of the assets and revenues of the aggregate discretely presented component units of the university. We also did not audit the financial statements of the University of Tennessee Foundation, Inc., which represent 29% and 52%, respectively, of the assets and revenues of the aggregate discretely presented component units of the university. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., were not audited in compliance with *Government Auditing Standards*. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of the other auditors provide a reasonable basis for our opinions. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the board of directors of many agencies, commissions, and component units of the State of Tennessee; managing the state's debt; and making loans to the state's colleges and universities from debt proceeds. Some of the boards on which the Comptroller of the Treasury serves as a member per state statutes include the State Building Commission and the Tennessee Higher Education Commission.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the University of Tennessee and its aggregate discretely presented component units as of June 30, 2004, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

During the year ended June 30, 2004, the university implemented GASB Statement 39, *Determining Whether Certain Organizations Are Component Units.*

The management's discussion and analysis on pages 17 through 26 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 12, 2004, 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

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, 2004, with comparative information presented for the fiscal year ended June 30, 2003. 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.

The university has two discretely presented component units, the University of Chattanooga Foundation and the University of Tennessee Foundation. More detailed information about the university's component units is presented in Notes 19 and 20 of the financial statements. Information and analysis regarding the component units is also included in this section.

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)

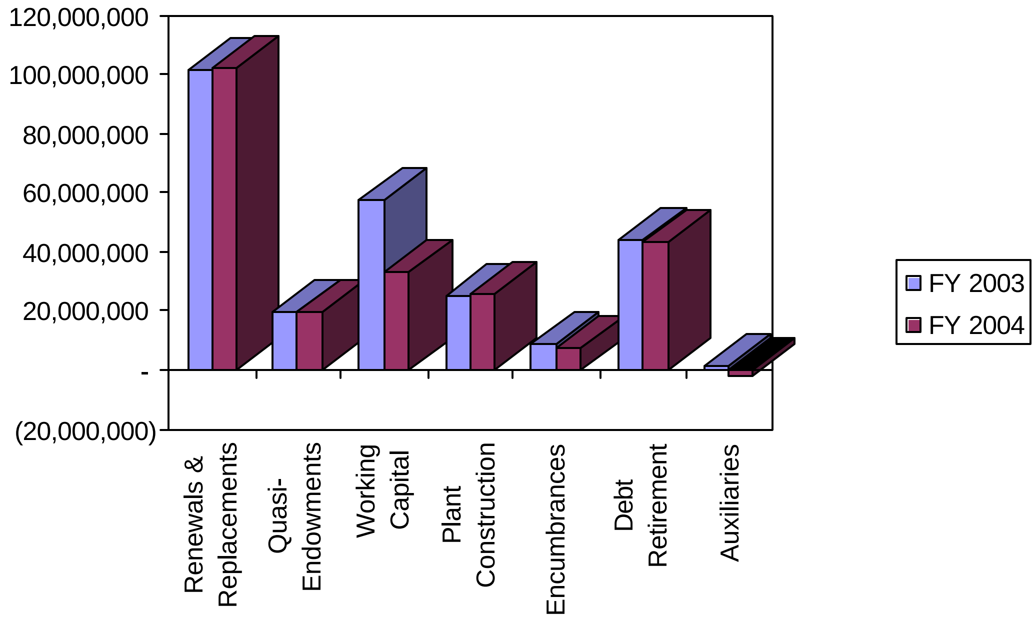
	UT		UC Foundation		UT Foundation	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Assets:						
Current assets	$ 320,301	$ 311,931	$ 11,668	$ 12,858	$ 12,596	$ 43,772
Capital assets, net	960,103	943,877	75,730	59,752	48,296	14,915
Other assets	881,699	828,919	117,068	132,470	21,626	9,148
Total assets	2,162,103	2,084,727	204,466	205,080	82,518	67,835
Liabilities:						
Current liabilities	238,258	233,459	11,668	12,859	5,171	1,415
Noncurrent liabilities	298,596	289,881	86,222	87,864	58,593	60,629
Total liabilities	536,854	523,340	97,890	100,723	63,764	62,044
Net Assets:						
Invested in capital assets, net of related debt	730,786	730,451	-	-	-	-
Restricted – expendable	356,646	298,644	6,786	7,442	15,494	4,334
Restricted – nonexpendable	323,475	316,191	39,609	36,397	2,755	1,196
Unrestricted	214,342	216,101	60,181	60,518	505	261
Total net assets	$ 1,625,249	$ 1,561,387	$ 106,576	$ 104,357	$ 18,754	$ 5,791

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

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:

Unrestricted Net Assets - University



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)

	UT		UC Foundation		UT Foundation	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Operating revenues:						
Net tuition and fees	$208,018	$192,977	$ -	$ -	$ -	$ -
Grants and contracts	382,438	356,451	-	-	-	-
Auxiliary	123,314	123,724	-	-	-	-
Other	73,182	81,214	8,910	5,410	12,103	6,768
Total operating revenues	786,952	754,366	8,910	5,410	12,103	6,768
Operating expenses	1,340,677	1,315,836	8,647	8,699	1,735	1,609
Operating loss	(553,725)	(561,470)	263	(3,289)	10,368	5,159
Nonoperating revenues and expenses:						
State appropriations	420,368	423,816	-	-	-	-
Gifts	40,486	67,281	-	-	-	-
Investment income	84,513	42,407	4,063	3,029	809	237
Other revenues and expenses	22,089	32,039	(2,857)	(2,787)	-	-
Total nonoperating revenues and expenses	567,456	565,543	1,206	242	809	237
Income (loss) before other revenues, expenses, gains, or losses	13,731	4,073	1,469	(3,047)	11,177	5,396
Other revenues, expenses, gains, or losses:						
Capital appropriations	21,725	32,584	-	-	-	-
Capital grants and gifts	15,253	47,165	-	-	-	-
Additions to permanent endowments	13,588	12,341	750	4,841	1,785	-
Other	(435)	(1,971)	-	-	-	-
Total other revenues, expenses, gains, or losses	50,131	90,119	750	4,841	1,785	-
Increase (decrease) in net assets	63,862	94,192	2,219	1,794	12,962	5,396
Net assets at beginning of year	1,561,387	1,467,195	104,357	102,563	5,791	395
Net assets at end of year	$1,625,249	$1,561,387	$106,576	$104,357	$18,753	$ 5,791

The increase in tuition and fees is primarily due to a 9 percent increase in fees for the 2004 academic year. Operating grants and contracts increased by $25 million due to a general increase in federal, state, and private grants and contracts. The largest increases were in grants from the Department of Health and Human Services and the Department of Energy. Other operating income decreased due to the transfer of the Bowld Hospital operations to Methodist Healthcare – Memphis Hospitals.

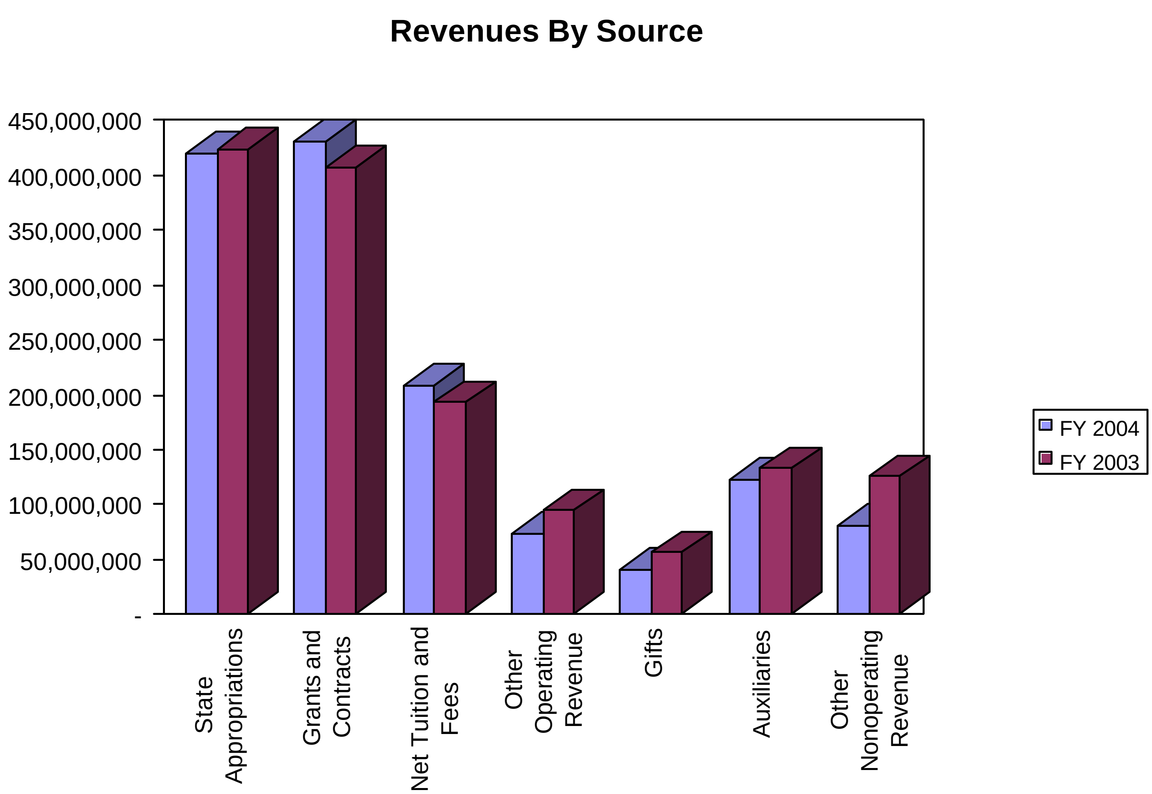
In fiscal year 2004, state appropriations decreased $3 million. Nonoperating gifts decreased $27 million. The gain on investments was due to an increase of endowment income and a significant reversal of the previous year's capital market decline.

The decrease in capital grants and gifts for 2004 consisted of the donation of several buildings at the Memphis campus recognized last year. Additions to permanent endowments increased due to higher levels of new gifts to endowments for the 2004 fiscal year.

Total operating expenses increased approximately $25 million in fiscal year 2004 primarily due to increased salaries and wages, staff benefits, and depreciation expense. 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 10 percent in fiscal year 2004.

Revenues

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, 2004, and June 30, 2003.



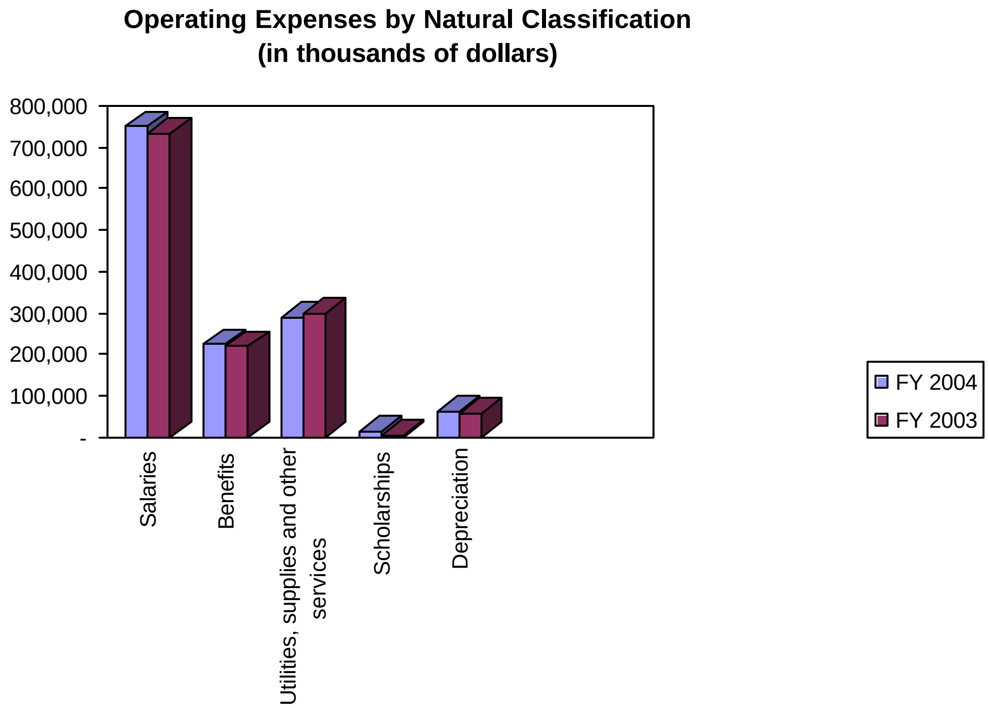
For the year ended June 30, 2004, approximately 74 percent of UT's revenue was attributed to state appropriations, grants and contracts, and tuition and fees.

Expenses

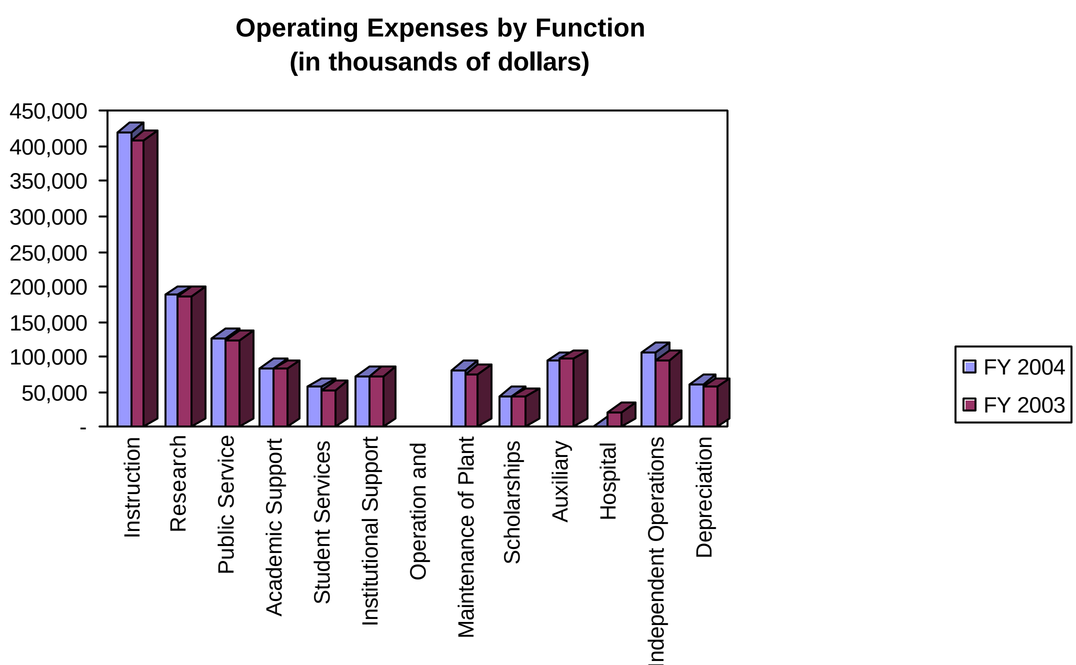
Operating expenses can be displayed in two formats, natural classification and functional classification. Both formats are displayed below (in thousands of dollars).

2004 Functional Classification	2004 Natural Classification					
	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$298,233	$76,013	$46,538	$ -	$ -	$420,784
Research	106,217	25,295	56,528	-	-	188,040
Public service	69,429	20,585	37,092	-	-	127,106
Academic support	53,776	16,132	13,676	-	-	83,584
Student services	28,300	8,323	20,475	-	-	57,098
Institutional support	55,736	16,108	1,772	-	-	73,616
Operation and maintenance of plant	26,453	9,706	44,606	-	-	80,765
Scholarships	2,872	14,855	10,837	15,210	-	43,774
Auxiliary	29,836	7,538	57,172	-	-	94,546
Hospital	-	-	1,885	-	-	1,885
Independent operations	77,543	29,768	-	-	-	107,311
Depreciation	-	-	-	-	62,167	62,167
Total expenses	$748,395	$224,323	$290,581	$15,210	$62,167	$1,340,676

2003 Functional Classification	2003 Natural 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



For the year ended June 30, 2004, approximately 72 percent of operating expenses are attributed to salaries and benefits. Utilities, supplies, and other services represent 22 percent of total operating expenses. Scholarships and depreciation represent the remaining 6 percent of operating expenses.



For the year ended June 30, 2004, 55 percent of operating expenses by function is attributable to instruction, research, and public service. The percentages for the remaining functional areas range from 1 to 8 percent 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)

	2004	2003
Cash provided (used) by:		
Operating activities	$(446,942)	$(487,276)
Noncapital financing activities	509,948	524,428
Capital and related financing activities	(52,723)	(65,550)
Investing activities	2,422	68,479
Net increase (decrease) in cash	12,705	40,081
Cash, beginning of year	409,918	369,837
Cash, end of year	$422,623	$409,918

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 $12,705,021.33 for the year ended June 30, 2004. The net increase in cash and cash equivalents amounted to $40,081,653.55 for the year ended June 30, 2003.

Capital Assets and Debt Administration

Capital Assets

At June 30, 2004, the University of Tennessee had $960,103,308.64 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled $62,166,509.09 for the current fiscal year. Details of these assets are shown below.

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

	2004	2003
Land	$47,912	$48,358
Land improvements & infrastructure	29,021	30,314
Buildings	627,401	595,986
Equipment	94,158	99,158
Software	9,147	11,176
Library holdings	52,453	49,666
Projects in progress	100,011	109,219
Total	$960,103	$943,877

Major capital additions for UT during 2003-2004 include the $19 million Student Recreation Center and the $17.3 million Cumberland Avenue Parking Garage in Knoxville, and the $3.3 million Boling Apartments Improvements in Chattanooga.

For the next fiscal year, the state has approved more than $68.6 million in capital outlay appropriations and $34 million in capital maintenance appropriations for UT. Some of these approved projects include the Glocker Business Building renovation and addition in Knoxville, the College of Pharmacy Building in Memphis, and the Grote Hall upgrades in Chattanooga. More detailed information about the university's capital assets is presented in Note 5 to the financial statements.

Debt

At June 30, 2004, the university had $230,163,701.82 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

Outstanding Debt Schedule
(in thousands of dollars)

	2004	2003
Bonds-current portion	$ 12,566	$ 13,851
Bonds-noncurrent	205,292	183,723
Commercial paper-noncurrent	12,231	18,160
Total TSSBA authorized debt	230,089	215,734
Notes-current portion	5	-
Notes-noncurrent portion	70	-
Total Debt	$230,164	$215,734

The university retired more than $18 million in bonds and notes in fiscal year 2003-2004. 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. More detailed information about the university's long-term liabilities is presented in Note 7 to the financial statements.

The university issued three new bond series in 2003-2004 in the net amount of $70.3 million. These are the 2004A series in the amount of $54.6 million (this series is a refunding of $50.7 million of the 1996A series); the 2004B tax exempt series in the amount of $30.4 million; and the 2004C taxable series in the amount of $36.0 million.

Economic Factors That Will Affect the Future

For fiscal year 2005, the University of Tennessee Board of Trustees has authorized a fee increase of 7.9% that is expected to generate approximately $13 million in new funding, net of related scholarships. However, the influx of lottery scholarship freshmen may cause that number to increase. State appropriations are expected to increase by a modest $6.2 million to fund employee increases. The university expects investment income to decrease as higher yielding investments are replaced with ones earning much less. The university expects to complete the transfer of the Bowld Hospital to Methodist University Hospital at which time the university will cease to have any hospital operations under its direct oversight.

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 the report or requests for additional information should be directed to Mr. Ron Maples, Controller, 201 Andy Holt Tower, Knoxville, Tennessee, 37996-0100.

THE UNIVERSITY OF TENNESSEE
STATEMENT OF NET ASSETS
June 30, 2004

	The University of Tennessee	University of Chattanooga Foundation, Inc.	The University of Tennessee Foundation, Inc.
ASSETS			
Current assets:			
Cash and cash equivalents (Note 2)	$ 151,557,385.23	$ 8,702,699.00	$ 12,442,059.68
Investments (Note 2)	62,491,232.26	-	-
Accounts, notes, and grants receivable (net) (Note 4)	90,620,866.25	943,927.00	140,821.62
Inventories	8,269,048.51	-	-
Prepaid expenses and deferred charges	7,362,424.54	2,021,123.00	13,539.42
Total current assets	320,300,956.79	11,667,749.00	12,596,420.72
Noncurrent assets:			
Cash and cash equivalents (Note 2)	271,066,348.59	19,381,001.00	3,504,377.50
Investments (Note 2)	444,049,858.74	97,536,676.00	13,552,736.90
Investment in UT - Battelle, LLC (Note 11)	2,378,253.00	-	-
Accounts, notes, and grants receivable (net) (Note 4)	142,798,126.01	150,708.00	1,793,022.60
Lease payments receivable (Note 15)	21,228,595.80	-	-
Capital assets (net) (Note 5)	960,103,308.64	75,729,835.00	48,296,250.93
Prepaid expenses and deferred charges	178,108.39	-	-
Assets held by the university	-	-	2,775,428.05
Total noncurrent assets	1,841,802,599.17	192,798,220.00	69,921,815.98
Total assets	2,162,103,555.96	204,465,969.00	82,518,236.70
LIABILITIES			
Current liabilities:			
Accounts payable	57,842,391.72	514,827.00	3,292,405.68
Accrued liabilities	39,878,942.22	2,052,826.00	-
Deferred revenue	68,298,253.34	311,235.00	6,440.00
Deposits payable	6,451,994.13	45,194.00	-
Annuities payable	1,304,992.59	-	-
Long-term liabilities, current portion (Note 7)	54,695,538.99	1,645,000.00	1,100,000.00
Deposits held in custody for others	7,010,359.02	1,951,177.68	-
Deposits held in custody for component units	2,775,428.05	-	-
Due to the university	-	5,147,489.32	772,219.61
Total current liabilities	238,257,900.06	11,667,749.00	5,171,065.29
Noncurrent liabilities:			
Deferred revenue (Note 7)	15,500,438.71	-	-
Long-term liabilities, noncurrent portion (Note 7)	238,439,662.24	86,222,240.00	58,593,468.60
Due to grantors (Note 7)	36,603,050.86	-	-
Annuities payable (Note 7)	8,052,812.58	-	-
Total noncurrent liabilities	298,595,964.39	86,222,240.00	58,593,468.60
Total liabilities	536,853,864.45	97,889,989.00	63,764,533.89
NET ASSETS			
Invested in capital assets, net of related debt	730,786,146.56	-	-
Restricted:			
Nonexpendable:			
Scholarships and fellowships	135,745,016.26	10,398,687.00	2,451,597.37
Libraries	12,998,803.63	-	57,600.12
Research	17,063,241.56	-	-
Instructional department uses	104,694,450.50	29,178,161.00	-
Academic support	25,494,275.09	32,230.00	87,760.97
Other	27,479,348.74	-	156,964.84
Expendable:			
Scholarships and fellowships	109,312,355.62	28,441.00	775,304.97
Libraries	6,402,559.23	-	21,741.21
Research	36,858,446.80	-	-
Instructional department uses	75,761,529.35	1,586,926.00	-
Academic support	56,555,822.08	10,878.00	14,529,992.89
Loans	8,422,955.49	-	-
Capital projects	18,904,250.27	5,000,000.00	-
Debt service	448,854.02	-	-
Other	43,979,598.28	159,560.00	167,547.34
Unrestricted (Note 18)	214,342,038.03	60,181,097.00	505,193.10
Total net assets	$ 1,625,249,691.51	$ 106,575,980.00	$ 18,753,702.81

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

THE UNIVERSITY OF TENNESSEE
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Year Ended June 30, 2004

	The University of Tennessee	University of Chattanooga Foundation, Inc.	The University of Tennessee Foundation, Inc.
REVENUES			
Operating revenues:			
Student tuition and fees (net of scholarship allowances of $40,422,660.79 for the year ended June 30, 2004)	$ 208,017,640.88	$ -	$ -
Contributions	-	135,082.00	11,970,475.30
Investment return designated for operations	-	4,021,619.00	-
Federal appropriations	15,409,299.47	-	-
Governmental grants and contracts	215,350,044.32	-	-
Non-governmental grants and contracts	167,087,973.69	-	-
Sales and services of educational departments	41,105,855.86	-	-
Auxiliary enterprises:			
Residential life (net of scholarship allowances of $1,038,969.26 for the year ended June 30, 2004; all revenues are used as security for varying revenue bonds; see Note 7)	28,801,314.30	4,753,472.00	123,380.00
Food services	2,757,895.29	-	-
Bookstore	18,734,178.03	-	-
Parking	8,254,783.66	-	-
Athletics	58,858,223.59	-	-
Other auxiliaries	5,907,971.34	-	-
Interest earned on loans to students	77,423.00	-	-
Other operating revenues	16,589,257.39	-	8,787.78
Total operating revenues	786,951,860.82	8,910,173.00	12,102,643.08
EXPENSES (Note 17)			
Operating expenses:			
Salaries and wages	748,396,484.77	-	31,247.00
Fringe benefits	224,322,791.92	-	4,127.43
Utilities, supplies, and other services	290,580,915.19	2,427,223.00	531,640.57
Scholarships and fellowships	15,210,798.07	-	-
Depreciation expense	62,166,509.09	2,229,680.00	-
Payments to or on behalf of the university	-	3,990,650.00	1,168,268.64
Total operating expenses	1,340,677,499.04	8,647,553.00	1,735,283.64
Operating income (loss)	(553,725,638.22)	262,620.00	10,367,359.44
NONOPERATING REVENUES (EXPENSES)			
State and local appropriations	420,368,313.56	-	-
Gifts (includes $5,158,918.64 from component units)	40,485,978.41	-	-
Grants and contracts	48,051,458.44	-	-
Investment income (loss)	84,514,762.07	4,062,521.00	809,257.24
Interest on capital asset - related debt	(9,634,578.34)	(2,147,948.00)	-
Other nonoperating expenses	(16,328,818.10)	(709,012.00)	-
Net nonoperating revenues	567,457,116.04	1,205,561.00	809,257.24
Income before other revenues, expenses, gains, or losses	13,731,477.82	1,468,181.00	11,176,616.68
Capital appropriations	21,725,484.60	-	-
Capital grants and gifts	15,252,920.67	-	-
Additions to permanent endowments	13,587,722.72	750,404.00	1,785,756.87
Additions to annuity and life income trusts	3,603,865.94	-	-
Other	(4,038,918.91)	-	-
Total other revenues	50,131,075.02	750,404.00	1,785,756.87
Increase in net assets	63,862,552.84	2,218,585.00	12,962,373.55
NET ASSETS			
Net assets at beginning of year	1,561,387,138.67	104,357,395.00	5,791,329.26
Net assets at end of year	$ 1,625,249,691.51	$ 106,575,980.00	$ 18,753,702.81

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

Exhibit C

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2004

CASH FLOWS FROM OPERATING ACTIVITIES	
Tuition and fees	$ 213,016,004.81
Federal appropriations	16,659,299.47
Grants and contracts	412,993,309.22
Sales and services of educational activities	49,576,898.92
Payments to suppliers and vendors	(298,224,555.91)
Payments to employees	(743,351,402.89)
Payments for benefits	(224,218,368.37)
Payments for scholarships and fellowships	(15,210,798.07)
Loans issued to students	(4,241,404.77)
Collection of loans from students	6,374,877.96
Interest earned on loans to students	607,729.03
Auxiliary enterprise charges:	
Residence halls	28,801,314.30
Bookstore	18,734,178.03
Food service	2,757,895.29
Parking	8,254,783.66
Athletics	58,318,635.67
Other auxiliaries	6,513,457.78
Hospital	(1,226,098.60)
Other receipts (payments)	16,922,677.14
Net cash provided (used) by operating activities	(446,941,567.33)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State appropriations	416,039,681.40
Local appropriations	3,946,132.16
Gifts and grants for other than capital or endowment purposes	83,316,592.26
Private gifts for endowment purposes	13,587,722.72
Split-interest transactions receipts	3,742,931.34
Split-interest transactions disbursements	(2,646,216.33)
Federal student loan receipts	143,892,189.93
Federal student loan disbursements	(143,892,189.93)
Changes in deposits held for others	73,912.17
Net cash balance implicitly financed (repaid)	(7,677,533.43)
Other noncapital receipts (payments)	(435,052.97)
Net cash provided (used) by noncapital financing activities	509,948,169.32
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Proceeds from capital debt	33,596,076.27
Capital appropriations	21,459,704.28
Capital grants and gifts received	15,252,920.67
Proceeds from sale of capital assets	5,443,527.13
Purchase of capital assets and construction	(98,999,758.26)
Principal paid on capital debt and leases	(18,060,536.01)
Interest paid on capital debt and leases	(9,723,883.32)
Other capital and related financing receipts (payments)	(1,691,126.01)
Net cash provided (used) by capital and related financing activities	(52,723,075.25)
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales and maturities of investments	114,262,276.23
Interest on investments	84,815,505.91
Purchase of investments	(196,656,287.55)
Net cash provided (used) by investing activities	2,421,494.59
Net increase (decrease) in cash and cash equivalents	12,705,021.33
Cash and cash equivalents at beginning of year	409,918,712.49
Cash and cash equivalents at end of year	$ 422,623,733.82

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2004

RECONCILIATION OF NET OPERATING LOSS TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating loss	$	(553,725,638.22)
Adjustments to reconcile operating loss to net cash provided (used) by operating activities:		
Depreciation expense		62,166,509.09
Changes in assets and liabilities:		
Receivables, net		40,036,718.06
Inventories		(217,881.30)
Prepaid expenses and deferred charges		(3,615,618.53)
Accrued interest receivable		530,306.03
Accounts payable		(3,830,763.20)
Accrued liabilities		5,935,390.45
Deferred revenue		4,078,363.70
Deposits		353,458.42
Compensated absences		(785,885.02)
Other additions:		
Loans to students		2,133,473.19
Net cash provided (used) by operations	$	(446,941,567.33)

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

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The financial reporting entity, as defined by Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity,* consists of the primary government and all of its component units. Component units are legally separate organizations for which the primary government is financially accountable and other organizations for which the significance of their relationship with the primary government are such that exclusion would cause the financial statements to be misleading or incomplete.

For the year ended June 30, 2004, the university adopted GASB Statement No. 39, *Determining Whether Certain Organizations Are Component* Units, which provides criteria for determining whether certain organizations should be reported as component units based on the nature and significance of their relationship with a primary government and clarifies reporting requirements for those organizations. Based on these criteria, the financial statements now include the accounts of the university, as the primary government, and the accounts of the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., as discretely presented component units.

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 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.

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 in November 1999 by GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities* and in May 2002 by GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*. The financial statement presentation required by those statements provides a comprehensive, entity-wide perspective of the university's, including component units, 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 educational departments; 5) sales and services of auxiliary enterprises; 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) interest on capital asset-related debt; 4) non-operating grants and contracts; and 5) 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, 2004. 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. The capitalization threshold for additions and improvements to buildings is $100,000 provided that amount exceeds 20% of the book value of the building.

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

Accounts Payable

Included in accounts payable are checks payable in the amount of $6,835,470.08 as of June 30, 2004. 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, and auxiliary enterprises. 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, 2004, cash and cash equivalents consisted of $119,172,009.98 in bank accounts, $1,398,143.87 of petty cash on hand, $54,980,000.00 of certificates of deposit, and $244,280,505.02 in the university's cash management investment pool.

Additionally, the university maintains custodial accounts at First Tennessee Bank and Citigroup for funds contractually managed by independent investment counsel. In accordance with the custody agreement, First Tennessee Bank and Citigroup placed cash equivalents totaling $2,793,074.95 at June 30, 2004, in the banks' money market mutual funds.

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, 2004, the carrying amount of the university's deposits was $174,152,009.98, and the bank balance including accrued interest was $170,167,531.38. The entire bank balance was category 1.

During the year ended June 30, 2004, the university had uncollateralized deposits on several days, ranging from $466,805.03 to $5,874,256.82.

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, 2004, was $244,280,505.02. The cost of the cash management pool at June 30, 2004, was $245,727,702.73. Management has elected to classify all securities in the cash management investment pool as cash and 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, 2004, was $60,954,686.12. The cost of these same securities at June 30, 2004, was $60,929,067.79. The securities in the pool are categorized on the following schedule, listed as cash and 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 university invested in repurchase agreements during the year, but there were no repurchase agreements at June 30, 2004.

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, 2004

	Category 1	Category 2	Category 3	Reported Amount	Cost
Cash and cash equivalents					
Government securities	$ 183,325,818.90	$ -	$ -	$ 183,325,818.90	$ 184,798,634.94
Commercial paper	60,954,686.12	-	-	60,954,686.12	60,929,067.79
	244,280,505.02	-	-	244,280,505.02	245,727,702.73
Investments					
Domestic securities					
Government securities	8,747,981.00	24,115,473.22	-	32,863,454.22	31,778,326.27
Corporate bonds	558,997.37	19,581,382.00	-	20,140,379.37	19,892,959.57
Corporate stocks	116,878,821.59	7,047,277.12	-	123,926,098.71	105,134,902.69
Mortgages and notes	1,484,068.99	-	-	1,484,068.99	1,477,025.00
Other investments	23,349.53	-	-	23,349.53	29,054.00
International securities					
Corporate stocks	2,294,691.00	166,375.31	-	2,461,066.31	1,497,581.60
Assets with trustees	-	-	4,416,368.72	4,416,368.72	4,371,255.82
	129,987,909.48	50,910,507.65	4,416,368.72	185,314,785.85	164,181,104.95
	$ 374,268,414.50	$ 50,910,507.65	$ 4,416,368.72		
University cash equivalents and investments not susceptible to categorization:					
Cash equivalents - assets with First Tennessee Bank and Citigroup as custodians				2,793,074.95	2,793,074.95
Limited partnership - venture capital funds				27,420,705.00	45,908,525.93
Mutual funds				204,937,204.95	172,838,513.28
Investments in hedge funds				59,418,180.00	60,000,000.00
Real estate equity funds				26,030,806.03	20,598,111.61
Real estate gifts				3,419,409.17	4,504,220.67
Total investments, cash and cash equivalents				753,614,670.97	716,551,254.12
Less: Cash and cash equivalents				247,073,579.97	248,520,777.68
Total investments				$ 506,541,091.00	$ 468,030,476.44

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 $21,630,400 at June 30, 2004.

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 Balentine Hedge Fund Select, L.P. The university's investment of $20,000,000 was valued at $15,281,620 at June 30, 2004.

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 $5,944,980 at June 30, 2004.

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 $11,008,120 at June 30, 2004.

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 objectives. The university's investment of $5,000,000 was valued at $5,553,060 at June 30, 2004.

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, 2004, net appreciation of $135,257,589.26 is available to be spent, of which $130,516,070.47 is restricted to specific purposes. The per unit fair value for participating endowments was $3.327952 at June 30, 2004. Income distributed was $.17209 per share in 2004, or $19,217,075.32.

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 445 true endowments at June 30, 2004, that had a market value of $55,359,201.05 and historic gift value of $58,675,266.74, yielding a net "underwater" position of $3,316,065.69. 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.

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 $733,552.63 for 2004.

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 2004 amounted to $1,696,490.57.

NOTE 4. ACCOUNTS, NOTES, AND GRANTS RECEIVABLE

Accounts, notes, and grants receivable included the following at June 30, 2004:

Student accounts receivable	$6,717,928.73
Grants receivable	70,607,698.94
Notes receivable	5,408,302.98
Pledges receivable	79,469,716.44
State capital outlay receivable	4,295,615.78
TSSBA debt proceeds receivable	2,978,342.71
Due from component units	5,919,708.93
Other receivables	40,564,066.38

Subtotal	215,961,380.89
Less allowance for doubtful accounts	(11,718,296.10)
Total	$204,243,084.79

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of $1,048,575.19.

Federal Perkins Loan Program funds included the following at June 30, 2004:

Perkins loans receivable	$29,175,907.47
Less allowance for doubtful accounts	-
Total	$29,175,907.47

NOTE 5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2004, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Land	$48,357,545.18	$108,387.00	$ -	$(553,854.00)	$47,912,078.18
Land improvements & infrastructure	56,379,379.34	-	1,551,945.70	(99,178.20)	57,832,146.84
Buildings	1,044,474,442.22	6,625,606.96	51,978,214.24	(2,858,963.94)	1,100,219,299.48
Equipment	250,711,019.50	21,518,589.50	-	(23,694,085.57)	248,535,523.43
Software	18,850,451.93	285,380.92	-	-	19,135,832.85
Library holdings	84,808,936.47	11,309,104.23	-	(6,318,827.88)	89,799,212.82
Projects in progress	109,218,940.49	44,730,359.73	(53,530,159.94)	(407,763.39)	100,011,376.89
Total	1,612,800,715.13	84,577,428.34	-	(33,932,672.98)	1,663,445,470.49
Less accumulated depreciation:					
Land improvements & infrastructure	(26,064,995.11)	(2,751,162.62)	-	4,958.91	(28,811,198.82)
Buildings	(448,488,025.49)	(26,943,655.83)	-	2,613,259.30	(472,818,422.02)
Equipment	(151,553,419.28)	(19,955,943.72)	-	17,132,222.21	(154,377,140.79)
Software	(7,674,286.72)	(3,993,267.64)	-	1,678,564.45	(9,988,989.91)
Library holdings	(35,142,758.91)	(8,522,479.28)		6,318,827.88	(37,346,410.31)
Total accumulated depreciation	(668,923,485.51)	(62,166,509.09)	-	27,747,832.75	(703,342,161.85)
Capital assets, net	$943,877,229.62	$22,410,919.25	$ -	$(6,184,840.23)	$ 960,103,308.64

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 $6,988,650.08 for the year ended June 30, 2004.

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, 2004. 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	
2005	$11,620.00
2006	11,620.00
2007	11,620.00
2008	11,620.00
2009	11,620.00
2010 – 2012	34,860.00
Total Minimum Payments Required	$92,960.00

NOTE 7. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2004, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term liabilities:					
Bonds	$197,574,193.33	$122,932,412.05	$102,648,636.94	$217,857,968.44	$12,566,284.96
Commercial paper	18,160,003.52	19,516,814.11	25,446,177.25	12,230,640.38	-
Total TSSBA indebtedness	215,734,196.85	142,449,226.16	128,094,814.19	230,088,608.82	12,566,284.96
Notes	-	75,093.00	-	75,093.00	4,545.57
Compensated absences	63,757,384.43	41,338,823.44	42,124,708.46	62,971,499.41	42,124,708.46
Total long-term liabilities	279,491,581.28	183,863,142.60	170,219,522.65	293,135,201.23	$54,695,538.99

Other noncurrent liabilities:				
Deferred revenue	15,500,438.71	-	-	15,500,438.71
Due to grantors	36,320,989.59	740,753.67	458,692.40	36,603,050.86
Annuities payable	8,580,703.69	777,101.48	1,304,992.59	8,052,812.58
Totals	$339,893,713.27	$185,380,997.75	$ 171,983,207.64	$353,291,503.38

Tennessee State School Bond Authority (TSSBA) bonds, with interest rates ranging from 1.3% to 7.75%, are due serially to 2034 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 $268,210,704.81 as of June 30, 2004. The total bonded indebtedness reported on the statement of net assets at June 30, 2004, is shown net of unaccreted bonds payable of $2,929,815.34, assets of $8,947,429.50 held by the Tennessee State School Bond Authority, and unspent bond proceeds of $38,475,491.53.

Included in the total outstanding indebtedness is a $75,093.00 note with Chattanooga Agricultural Credit Association. The 5-year note is for the construction of a farm building at UT – Martin. This note carries an interest rate of 4% and is due semi-annually to July 1, 2009. The outstanding balance at June 30, 2004, is $75,093.00.

The university's debt service requirements to maturity for all bonds and notes payable at June 30, 2004, are as follows:

Year Ending June 30	Principal	Interest
2005	$12,566,284.96	$13,271,522.67
2006	12,773,398.25	12,232,115.08
2007	13,196,758.65	11,736,181.02
2008	13,629,032.21	11,310,014.38
2009	14,084,180.90	10,850,851.87
2010-2014	58,496,981.85	46,145,915.36
2015-2019	51,467,081.50	32,376,379.93
2020-2024	47,666,613.22	18,811,834.65
2025-2029	27,583,039.21	8,699,572.81
2030-2034	16,822,427.06	2,298,425.14
	$268,285,797.81	$167,732,812.91

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, 2004, $12,230,640.38 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, TN 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 7.3% 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, 2004, 2003, and 2002, were $17,904,045.80, $18,125,448.74, and $14,844,243.45, 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, 2004, were $1,347,469.22, which consisted of $691,176.31 from the university and $656,292.91 from the employees; contributions 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;

and 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.

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 $976,298.51 for the year ended June 30, 2004, which consisted of $67,915.82 from employees and $908,382.69 from the university; $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; and $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. Contributions for the Thrift Savings Plan were $1,011,982.00 for the year ended June 30, 2004, which consisted of $619,753.00 from employees and $392,229.00 from the university; $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; and $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. 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, 2004, was $36,873,939.85 and for the year ended June 30, 2003, was $35,777,441.20. 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 $47,738,857.63 for fiscal year 2004, and $50,242,761.15 for fiscal year 2003. 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 $3,478,915.92 in fiscal year 2004, and $3,662,932.19 in fiscal year 2003. 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, 2004, contributions totaling $10,160,726.26 were made by employees participating in the plan, with a related match of $1,883,085.11 made by the university. 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. 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. 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, 2004. 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, 2004, the amounts held in trust totaled $101,942,448.27 at fair value.

NOTE 11. 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 $2,378,253.00 at June 30, 2004. 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, 2003, to the university was $1,253,252.81. During the year ended June 30, 2004, the university had expenses of $17,199,910.33 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled $5,616,550.49 at June 30, 2004. To review the audit report of UT-Battelle, please contact the Controller's Office, The University of Tennessee, 201 Andy Holt Tower, Knoxville, TN 37996-0100.

NOTE 12. INSURANCE-RELATED ACTIVITIES

It is the policy of the state not to purchase commercial insurance for the risks of casualty losses for general liability, automobile liability, professional malpractice, and workers' compensation. The state's management believes it is more economical to manage these risks internally and set aside assets for claim settlement in its internal service fund, the Risk Management Fund. The state purchases commercial insurance for real property, flood, earthquake, and builder's risk losses and surety bond coverage on the state's officials and employees. The Risk Management Fund is also responsible for claims for damages to state owned property up to the amount of the property insurance aggregate deductible amount. The insurance policy deductibles vary from $25,000 per occurrence, depending on the type of coverage, to an aggregate of $7.5 million. The university participates in the Risk Management 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 Risk Management 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 Risk Management Fund. At June 30, 2004, the Risk Management Fund held $101.1 million in cash designated for payment of claims.

During the year ended June 30, 2003, the State of Tennessee as a whole incurred 13 property claims which exceeded the per occurrence deductible. The gross amount of claims for the period was approximately $7.2 million, of which the state's property insurance carrier will ultimately assume approximately $2.2 million.

At June 30, 2004, the scheduled coverage for the university was $2,734,476,100 for buildings and $903,426,700 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 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 13. 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, 2004, were $33,126,375.83.

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, 2004. The amount of unused sick leave was $218,969,953.86 at June 30, 2004.

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 $3,053,247.43 as of June 30, 2004, 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 14. LEASE AND TRANSFER OF UT MEMORIAL RESEARCH CENTER AND HOSPITAL

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

Employee Services Agreement, and the Affiliation Agreement. Each of these agreements is summarized below.

Lease and Transfer Agreement

Pursuant to the enabling legislation, *Tennessee Code Annotated*, Section 49-9-112 and Section 49-9-1301 et. seq., UHS leased from the university the real property of the existing hospital and the Graduate School of Medicine. (See also Note 15.) The term of the lease is 50 years. The university also transferred to UHS all operating assets of the hospital. The consideration for the lease of the real property and transfer of the operating assets was payment by UHS of a) a sum sufficient to economically defease all of the debt issued by the Tennessee State School Bond Authority in the amount of $149,080,353.69, b) $25,000,000.00 paid to the university at closing, and c) a variable lease obligation of $50,000,000.00 to be paid to the university over twenty years. UHS assumed all prior hospital liabilities, known or unknown. 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 $96,631,069.30 in 2004, 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 15. 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 14. This lease is classified as a direct financing lease. The guaranteed lease payment of $50 million will be paid by UHS in annual payments through 2019. The amount of the annual payments will equal the lesser of 1) 20% of the hospital's net operating profit for the applicable calendar year; or 2) $3 million or the greater amount resulting from the application of an index, as specified in the agreement. The payment of $50 million is guaranteed by December 31, 2019. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease. An annual lease payment to the university during the year ended June 30, 2004, totaled $2,070,344.00.

The university recorded a lease payment receivable in the amount of $21,228,595.80 at June 30, 2004, which represents 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.

	2004
Total minimum lease payments to be received	$50,677,762.37
Less: Unearned income	(29,449,166.57)
Net investment in direct financing lease	$21,228,595.80

NOTE 16. 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 $10,722,263.68, 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 17. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATIONS

The university's operating expenses by functional classification for the year ended June 30, 2004, are as follows:

Natural Classification

Functional Classification	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$298,233,114.42	$76,012,780.33	$46,537,919.06	$ -	$ -	$420,783,813.81
Research	106,217,440.26	25,295,421.94	56,527,755.92	-	-	188,040,618.12
Public service	69,429,137.20	20,585,486.35	37,091,572.32	-	-	127,106,195.87
Academic support	53,776,447.81	16,131,545.59	13,676,410.92	-	-	83,584,404.32
Student services	28,300,196.00	8,323,169.76	20,474,765.73	-	-	57,098,131.49
Institutional support	55,735,929.92	16,107,539.85	1,772,475.08	-	-	73,615,944.85
Operation & maintenance of plant	26,453,435.67	9,706,418.64	44,605,869.66	-	-	80,765,723.97
Scholarships & fellowships	2,871,896.45	14,855,095.51	10,837,091.02	15,210,798.07	-	43,774,881.05
Auxiliary	29,836,304.54	7,537,812.50	57,172,112.32	-	-	94,546,229.36
Hospital	-	-	1,884,943.16	-	-	1,884,943.16
Independent operations	77,542,582.50	29,767,521.45	-	-	-	107,310,103.95
Depreciation	-	-	-	-	62,166,509.09	62,166,509.09
Total expenses	$748,396,484.77	$224,322,791.92	$290,580,915.19	$15,210,798.07	$62,166,509.09	$1,340,677,499.04

NOTE 18. UNRESTRICTED NET ASSETS

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

	June 30, 2004
Working capital	$33,185,711.25
Encumbrances	7,416,519.09
Auxiliaries	(2,163,169.93)
Quasi-endowments	19,746,967.82
Plant construction	25,458,621.55
Renewal and replacement of capital assets	102,245,342.16
Debt retirement	43,343,103.45
Unreserved/undesignated	(14,891,057.36)
Total	$214,342,038.03

NOTE 19. COMPONENT UNIT – UNIVERSITY OF CHATTANOOGA FOUNDATION

The University of Chattanooga Foundation, Inc., is a private nonprofit organization that reports under Financial Accounting Standards Board (FASB) standards, including FASB Statement No. 117, *Financial Reporting for Non-Profit Organizations*. As such, certain revenue recognition criteria and presentation features are different from revenue recognition criteria and presentation features as prescribed by the Governmental Accounting Standards Board (GASB). The financial statements of this foundation have been reformatted into a GASB format and are reported in a separate column to the right of the university's statements.

The University of Chattanooga Foundation, Inc., is a legally separate, tax-exempt organization supporting the University of Tennessee at Chattanooga. The foundation acts primarily as a fund-raising organization to supplement the resources that are available to the university in support of the University of Tennessee at Chattanooga. The 48 member board of trustees of the foundation is self-perpetuating and consists of fiends of the University of Tennessee at Chattanooga. Although the university does not control the timing or amount of receipts from the foundation, the majority of resources, or income thereon, that the foundation holds and invests are restricted to the activities of the university by the donors. Because these restricted resources held by the foundation can only be used by, or for the benefit of, the University of Tennessee at Chattanooga, the foundation is considered a component unit of the university and is discretely presented in the university's financial statements.

During the year ended June 30, 2004, the foundation expended $3,990,650.00 to or on behalf of the university for both restricted and unrestricted purposes. Complete financial statements for the foundation can be obtained from the University of Chattanooga Foundation, Development Office, Department 6806, 615 McCallie Avenue, Chattanooga, TN 37403-2598.

Organization and Nature of Activities

University of Chattanooga Foundation, Inc., is a supporting organization under the provisions of Section 509(a)(3) of the *Internal Revenue Code,* dedicated to supporting excellence in higher education through special projects for the University of Tennessee at Chattanooga. Proposals for special projects are submitted by the chancellor of the university and approved by the foundation's Board of Trustees and the University of Tennessee Board of Trustees.

Principles of Consolidation

The consolidated financial statements of the foundation include the accounts of the foundation and its subsidiaries, Campus Development Foundation, Inc., (CDFI) and CDFI Phase I, LLC, (the LLC). All material intercompany accounts and transactions have been eliminated in consolidation. The foundation and CDFI have fiscal years that end June 30. The LLC's fiscal year ends on July 31 in order to reflect the operating cycle of collegiate student housing. The impact of any intervening transactions during the one month period between fiscal year ends is not significant.

CDFI was formed by the foundation during 2001 to engage in charitable, scientific, and educational projects within the meaning of Section 501 (c)(3) of the *Internal Revenue Code*. The projects include, but are not limited to, the acquisition of real property and the construction, management, and operation of dormitories for students of the university. The Directors of CDFI are appointed by the Executive Committee of the Foundation.

CDFI is the sole member of its subsidiary, the LLC. The LLC was formed to own and develop an elementary school in downtown Chattanooga and student housing at the university. The first phase of the student housing, consisting of 455 bedrooms in 149 units, was completed and leased to students in August 2001. The second phase of the student housing, consisting of 584 bedrooms in 158 units, was completed and leased to students in August 2002.

Investments

A summary of foundation investments at June 30, 2004, is as follows:

Equity securities (cost of $54,808,056 in 2004)	$59,417,853
Debt securities (cost of $30,450,180 in 2004)	30,272,164
Real estate	1,360,426
Limited partnerships	6,379,147
Other	107,086
Total	$97,536,676

Property and Equipment

A summary of foundation property and equipment at June 30, 2004, is as follows:

Land	$8,241,032
Buildings	51,526,323
Furniture, fixtures, and equipment	2,225,429
Construction in progress	18,695,883
	80,688,667
Accumulated depreciation	(4,958,832)
Total	$75,729,835

Revenue Bonds Payable

During 2000 and 2001, the Health, Educational, and Housing Facility Board of the City of Chattanooga issued three series of tax-exempt revenue bonds to develop the elementary school and the student housing. The LLC is the borrower on the bonds. The Series 2000 revenue bonds totaled $18,000,000 and were used to acquire land and fund construction of the student housing. The Series 2001A revenue bonds totaled $10,440,000 and were used to fund construction of the elementary school. The Series 2001B revenue bonds totaled $60,140,000 and were used to acquire land and fund construction of additional student housing.

Revenue bonds payable at June 30, 2004, consist of the following:

Series 2000 revenue bonds, interest payable monthly, annual redemption payments due through October 1, 2032	$17,805,000
Series 2001A revenue bonds, interest payable monthly, annual redemption payments due through October 1, 2021	10,075,000
Series 2001B revenue bonds, interest payable monthly, annual redemption payments due October 1, 2004 through 2032	60,140,000
	88,020,000
Less: unamortized discount	(152,760)
Total	$87,867,240

Restricted Cash and Cash Equivalents

The revenue bonds described above restrict the use of certain cash and cash equivalents at June 30, 2004, as follows:

Debt service reserves	$5,069,140
Renewal and replacement reserves	75,440
Cash collateral account	-
Restricted for principal payments	1,240,888
Total	$6,385,468

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2004, are as follows:

	Natural Classification			
Functional Classification	Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Depreciation	Total
Academic programs	$ -	$1,276,073	$ -	$1,276,073
Professorships	-	371,440	-	371,440
Faculty development	-	279,883	-	279,883
Scholarships	-	1,915,014	-	1,915,014
Chancellor's discretionary	-	112,584	-	112,584
Other	-	35,656	-	35,656
Rental expenses	1,974,899	-	-	1,974,899
Administrative and investment fees	429,968	-	-	429,968
Legal	4,029	-	-	4,029
Tax and audit	18,327	-	-	18,327
Depreciation	-	-	2,229,680	2,229,680
Total expenses	$2,427,223	$3,990,650	$2,229,680	$8,647,553

NOTE 20. COMPONENT UNIT – UNIVERSITY OF TENNESSEE FOUNDATION

The University of Tennessee Foundation, Inc., is a private nonprofit organization that reports under Financial Accounting Standards Board (FASB) standards, including FASB Statement No. 117, *Financial Reporting for Non-Profit Organizations*. As such, certain revenue recognition criteria and presentation features are different from revenue recognition criteria and presentation features as prescribed by the Governmental Accounting Standards Board (GASB). The financial statements of this foundation have been reformatted into a GASB format and are reported in a separate column to the right of the university's statements.

The University of Tennessee Foundation is a legally separate, tax-exempt organization supporting the University of Tennessee. The foundation acts primarily as a fund-raising organization to supplement the resources that are available to the university in support of its programs. The foundation has 13 active board members and two ex-officio members. The board of the foundation is self-perpetuating and consists of graduates and friends of the university. Although the university does not control the timing or amount of receipts from the foundation, the majority of resources, or income thereon, that the foundation holds and invests are restricted to the activities of the university by the donors. Because these restricted resources held by the foundation can only be used by, or for the benefit of, the university, the foundation is considered a component unit of the university and is discretely presented in the university's financial statements.

During the year ended June 30, 2004, the foundation distributed $1,168,268.64 to or on behalf of the university for both restricted and unrestricted purposes. Complete financial statements for the foundation can be obtained from the University of Tennessee Foundation, Suite 100, UT Conference Center Building, 600 Henley Street, Knoxville, TN 37996.

Pledges Receivable

Pledges receivable (reported as accounts, notes, and grants receivable on the statement of net assets) are summarized below net of the allowance for doubtful accounts:

	Unrestricted	Temporarily Restricted	Permanently Restricted
Current pledges	$ 43,621.10	$ 5,092.43	$ 49,216.27
Pledges due in one to five years	178,871.31	1,030,959.15	189,291.10
Pledges due after five years	138,627.57	170,076.00	294,554.69
	361,119.98	1,206,127.58	533,062.06
Less discounts to net present value	(38,271.26)	(102,926.52)	(68,159.44)
Total pledges receivable, net	$322,848.72	$1,103,201.06	$464,902.62

The allowance for doubtful accounts at June 30, 2004, was $435,100.91.

Construction In Progress - Knoxville Place

In September 2002, the Health, Educational, and Housing Facility Board of the County of Knox, Tennessee issued $60,090,000.00 of variable rate, tax-exempt bonds to fund the acquisition, construction, and equipping of a student housing facility adjacent to the Knoxville campus. The facility will be a 12-story complex with five levels for parking and seven levels for housing. The facility is scheduled for completion in August 2004.

Volunteer Student Housing, LLC, entered into a 7 year 75% hedge on the project with the hedge rate being 3.25%. During the fiscal year, $1,619,875.91 of interest expense and $531,558.87 of interest income was accrued. The first principal payment is due September 1, 2005. The bond proceeds are held in trust and invested. The book value of the bond proceeds remaining at June 30, 2004, is $14,648,022.36, which approximates market value. Also, residents at the student housing complex have paid fees as part of their lease agreement. $90,000 of the rental fees have been transferred to the revenue fund at Wachovia Bank, the trustee.

Other project costs represent issuance costs and letter of credit costs paid from the bond proceeds at closing. The issuance costs will be amortized over the life of the bonds, and the letter of credit cost will be amortized over the 7 year letter of credit term. The total other project costs was $831,683.04, and the amortized cost for the fiscal year was $68,334.46. The underwriter's discount was also paid from bond proceeds at closing and will be amortized over the life of the bonds. The underwriter's discount was $420,630.00 and the amortized cost for the fiscal year was $13,144.69.

Future maturities of bonds payable commencing 2005 are as follows:

Year Ending June 30:	
2005	$ 1,100,000
2006	1,090,000
2007	1,130,000
2008	1,185,000
Thereafter	55,585,000
	$60,090,000

Letter of Credit

In association with the issuance of the bonds mentioned above, the foundation was granted an irrevocable letter of credit in the amount of $60,979,003.00. Of this amount, $60,090,000 is available for the payment of the principal of the bonds or a portion of the purchase price corresponding to the principal of the bonds and $889,003.00 is available for the payment of up to 45 days' interest on the bonds. There is no outstanding balance drawn on this letter of credit at June 30, 2004.

Concentration of Credit Risk

The foundation had concentrated its credit risk for cash by maintaining deposits at a bank, which may at times exceed amounts covered by insurance provided by the U. S. Federal Deposit Insurance Corporation (FDIC). The foundation has not experienced any such losses in this account and believes it is not exposed to any significant credit risk to cash.

Remainder Interest

The amounts described below are reported as investments on the statement of net assets.

In December 2002, a donor conveyed to the foundation a remainder interest in a limited liability company. The asset of the limited liability company is a fee simple interest in a warehouse in South Carolina. The remainder interest was appraised at $7,740,000.00 with the interest vesting on January 1, 2021. The value on the statement of net assets will be the present value calculation until the vesting date. The IRS discount rate for December 2002 used in determining the present value was 4%. The present value of the remainder interest at June 30 was $4,052,199.90.

In September 2003, a donor conveyed to the foundation another remainder interest in a limited liability company. The asset of this limited liability company is an office building in Connecticut. The remainder interest was appraised at $22,440,000.00 with the interest vesting on January 1, 2025. The value on the statement of net assets will be the present value calculation until the vesting date. The IRS discount rate for September 2003 was 4.20%. The present value at June 30 was $9,500,537.00.

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2004, are as follows:

	Natural Classification				
Functional Classification	Salaries	Benefits	Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Total
Grants and scholarships	$ -	$ -	$ -	$1,072,341.26	$1,072,341.26
General and administrative	31,247.00	4,127.43	530,636.68	95,927.38	661,938.49
Student housing	-	-	1,003.89	-	1,003.89
Total expenses	$31,247.00	$4,127.43	$531,640.57	$1,168,268.64	$1,735,283.64