AUDIT REPORT

The University of Tennessee

For the Year Ended
June 30, 2005

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

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Division of State Audit

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STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

March 28, 2006

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, 2005. You will note from the independent auditor's report that unqualified opinions were 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
05/088

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, 2005

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.

COMPLIANCE FINDINGS

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

The Registrar's Offices in Knoxville and Memphis Failed to Properly Report Student Status Changes, Increasing the Risk of Not Initiating the Student Loan Repayment Process
At the University of Tennessee at Knoxville and at the University of Tennessee Center for the Health Sciences at Memphis, the university did not properly report enrollment changes for Federal Family Education Loan borrowers who dropped classes, withdrew, or graduated (page 9).

The Director and Staff of the University's Financial Aid Office in Memphis Failed to Maintain Required Letters to Perkins Loan Borrowers, Increasing the Risk of Inadequate Borrower Notification

At the University of Tennessee Center for the Health Sciences in Memphis, the financial aid staff was not able to document that necessary correspondence was sent to Perkins loan borrowers entering repayment. The *Code of Federal Regulations*, Section 34, Part 674.42(c), states that institutions must contact borrowers entering repayment three times during a nine-month grace period: 90 days, 150 days, and 240 days after the commencement of the grace period. The grace period is a prescribed period of time (nine months for these students) before the borrower must begin or resume paying a loan. The letters inform the borrower that he or she is responsible for repayment and describe repayment terms and amounts. For 12 of 25 Perkins borrowers tested who entered repayment, there was no documentation that any grace period letters had been sent. For another borrower, there was no documentation that the 90-day letter had been sent (page 11).

OPINIONS ON THE FINANCIAL STATEMENTS

The opinions on the financial statements are unqualified.

Audit Report
The University of Tennessee
For the Year Ended June 30, 2005

TABLE OF CONTENTS

TABLE OF CONTENTS (CONT.)

The University of Tennessee
For the Year Ended June 30, 2005

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, 2004, through June 30, 2005, 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, 2005. 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 June 16, 2005. 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 security over the UT Knoxville financial aid system, students at UT Martin that were not eligible for federal financial aid, the failure to properly report student status changes at UT Martin, the failure to report federal Pell Payment Data in compliance with federal regulations at UT Martin, and the failure to ensure that subrecipients of federal funds were properly audited.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the institution. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the institution is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the institution.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the institution. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, 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, 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, 2005, 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. 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 section.

Fairness of Financial Statement Presentation

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

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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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 30, 2005

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, a component unit of the State of Tennessee, and its aggregate discretely presented component units as of and for the year ended June 30, 2005, and have issued our report thereon dated November 30, 2005. 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. During the year ended June 30, 2005, the university implemented GASB Statement 40, *Deposit and Investment Risk Disclosures*.

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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

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

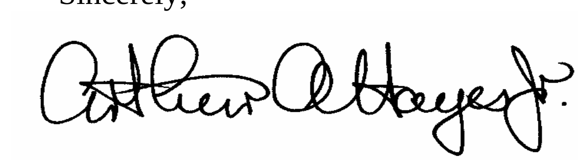
Compliance and Other Matters

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, the university's board of trustees, 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. As previously reported, departmental staff are still failing to properly record serial numbers and tag numbers for federal equipment, increasing the risk of misappropriation of equipment

Finding

The university's equipment records are maintained on its accounting system, the Integrated R/3 Information System (IRIS). As was reported in the 2003 audit, responsible staff of the university are not properly recording serial numbers and tag numbers on the university's equipment system. For 8 of 40 equipment items tested which were purchased with federal research and development funds during the year ended June 30, 2005 (20%), the serial number and the tag number of the item were not entered in the system.

The university's *Fiscal Policy* requires that departments "promptly tag equipment and record the tag (inventory) numbers into the accounting system." Such internal controls are essential to safeguard university assets from fraud, waste, or abuse.

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

Under the university's IRIS accounting system, equipment items are initially entered in the system during the requisition process by departmental personnel. Later, when assets are received, departmental personnel are to enter the serial number and the tag number for each asset. According to controller's office personnel at the university, departmental staff members are failing to enter this information. In December of 2003, the controller's office began sending quarterly notifications to department heads or departmental business managers (usually responsible for large departments or several, related departments) which list equipment items that do not have tag numbers and serial numbers entered on the IRIS system. During the last quarter of the fiscal year, an employee in the controller's office makes follow-up phone calls in cases where departmental employees have not entered the required information.

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

Recommendation

Responsible university management should make revisions to its IRIS accounting system, such as requiring the entry of a serial and tag number prior to payment, or take other steps to ensure that departmental personnel are consistently and promptly entering serial numbers and tag numbers on the university's equipment system. Controller's office personnel should continue to send periodic notifications to departmental personnel. Department heads and departmental business managers should be held accountable if serial numbers and tag numbers are not promptly entered. Campus chief business officers should also be sent periodic listings and be required to monitor their area of responsibility.

Management should ensure that risks such as these noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

Management's Comment

We concur. Once a quarter, the controller's office sends notification to all departments who fail to record serial numbers and tag numbers for federal equipment. Controller's office staff follow up until this information is entered on the asset record. All of the missing information was entered on the asset records before June 30. We believe the current controls are adequate.

2. **<u>The registrar's offices in Knoxville and Memphis failed to properly report student status changes, increasing the risk of not initiating the student loan repayment process</u>**

Finding

At the University of Tennessee at Knoxville and at the University of Tennessee Center for the Health Sciences in Memphis, the registrar's offices did not properly report student status changes for Federal Family Education Loan (FFEL) borrowers who withdrew from classes. According to the *Federal Student Aid Handbook*, volume 2, page 172:

> 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 [emphasis added].
>
> Changes in enrollment to less than half-time, graduated, or withdrawn must be reported to NSLDS within 30 days. However, if a scheduled Roster file report is expected within 60 days, the university may provide the information on this report.

Testwork at the University of Tennessee at Knoxville revealed that for 3 of 25 FFEL student borrowers tested (12%), enrollment status changes were not properly reported. Two students who unofficially withdrew (ceased attendance without providing official notification) in the spring 2005 semester were not reported. A third student who failed to enroll for the spring 2005 semester was reported 98 days late.

These exceptions occurred in the spring semester of 2005. The university used enrollment data through the 98th day of the semester. The registration data as of the 98th day did not indicate a withdrawal for these three students, and therefore, their withdrawal was not reported. The university instituted a new Student Information System (SIS) in the summer semester of 2005 that should resolve this problem.

Testwork at Memphis revealed that for 5 of 25 FFEL student borrowers tested (20%), enrollment status changes were not properly reported. The status change for the 5 students who had either withdrawn or graduated was reported up to 192 days late.

At Memphis, the registrar was absent during much of the fiscal year, and inadequate oversight appears to be the cause of the inadequate reporting.

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 registrars at Knoxville and Memphis should ensure that all student status changes for FFEL loan recipients are reported in compliance with federal regulations.

Management should ensure that risks such as these noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

Management’s Comment

We concur. In Knoxville, a withdrawal report is produced from the Student Information System for release to the Clearinghouse, which is the third-party entity that performs our enrollment verifications. Under the old Registration/Student Records process we loaded enrollment data through the 98th day of the term for this report. For Spring 2005, the 98th day was April 19. These students withdrew April 22 and April 27, which was after our last load for Spring 2005. The registration data as of the 98th day did not indicate a withdrawal for these three students, and therefore, their withdrawal was not reported.

Under the new SIS Registration System, we now have data that is real-time as opposed to point-in-time. Therefore, we will not have this timing problem with withdrawals.

In Memphis, the registrar's office will report student status changes within the scheduled 60-day NSLDS reporting period as required.

3. <u>The director and staff of the university's financial aid office in Memphis failed to maintain required letters to Perkins loan borrowers, increasing the risk of inadequate borrower notification</u>

Finding

At the University of Tennessee Center for the Health Sciences in Memphis, the financial aid staff was not able to document that necessary correspondence was sent to Perkins loan borrowers in the grace period prior to the borrower beginning repayment.

The *Code of Federal Regulations*, Section 34, Part 674.42(c), states that institutions must contact borrowers entering repayment three times during a nine-month grace period: 90 days, 150 days, and 240 days after the commencement of the grace period. The grace period is a prescribed period of time (nine months for these students) before the borrower must begin or resume paying a loan. The letters must inform the borrower that he or she is responsible for repayment and describe repayment terms and amounts.

For 12 of 25 Perkins borrowers tested who entered repayment, there was no documentation that any grace period letters had been sent. For another borrower, there was no documentation that the 90-day letter had been sent.

Officials of the outside loan servicer whose contract ended on June 30, 2005, stated that all collection procedures were performed, including the correspondence in question, and the documentation was forwarded to the subsequent contractor on July, 1 2005. Officials of the subsequent contractor stated that all information received was posted to their computer system. However, neither the university's financial aid staff nor the staff of either contractor could provide adequate documentation of the required correspondence.

Without adequate documentation, university personnel cannot verify that the contractor properly contacted Perkins borrowers. Although the financial aid office may contract with outside parties to perform these functions, officials cannot delegate their responsibilities to those parties. When officials of the university elect to enter such agreements, it is essential that they take all necessary steps to ensure that these parties comply with all relevant requirements such as the need to maintain adequate documentation of the activities the parties undertake on behalf of the university.

Recommendation

The financial aid director should ensure that students entering repayment for Perkins loans are contacted at the required intervals as described in the *Code of Federal Regulations*. Financial aid personnel should ensure that documentation of all required correspondence is maintained.

The financial aid director should assess the risks of using outside contractors to perform these duties and establish effective mitigating internal controls. University-wide management should review the director's assessment and conclusions, and the mitigating controls as to adequacy. The financial aid director should assess the adequacy of all other services that were performed by the contractors and consider any possible ramifications.

Management should ensure that risks such as these noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

Management's Comment

We concur. The University of Tennessee – Student Loans Division had a contract with Affiliated Computer Services, Inc., (ACS), formerly AFSA, for five (5) years with no former audit findings due to lack of due diligence letters being produced. The History Screen for ACS provided due diligence history of bills and notices sent. Unfortunately after July 31, 2005, UT Student Loans Division no longer had access to the ACS system and these files were transmitted to our new servicers, Educational Computer Systems, Inc., (ECSI). No notes were recorded on the History screen for ECSI as that screen is used for payments and advances. It has not been the practice of the University of Tennessee Student Loans Division to make hard copies of every history file as this information was readily available on our student loan system.

The bursar's office has reviewed the contract with ECSI to insure compliance with the *Code of Federal Regulations*. The student loans coordinator has been designated to monitor compliance for all student loans. We will contact students entering repayment for Perkins loans at the required intervals.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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JAMES K. POLK STATE OFFICE BUILDING
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PHONE (615) 401-7897
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Independent Auditor's Report

November 30, 2005

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, as of and for the year ended June 30, 2005, 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., 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, 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. 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 the 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 discretely presented component units as of June 30, 2005, 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, 2005, the university implemented GASB Statement 40, *Deposit and Investment Risk Disclosures*.

The management's discussion and analysis on pages 15 through 24 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 30, 2005, 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, 2005, with comparative information presented for the fiscal year ended June 30, 2004. 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.

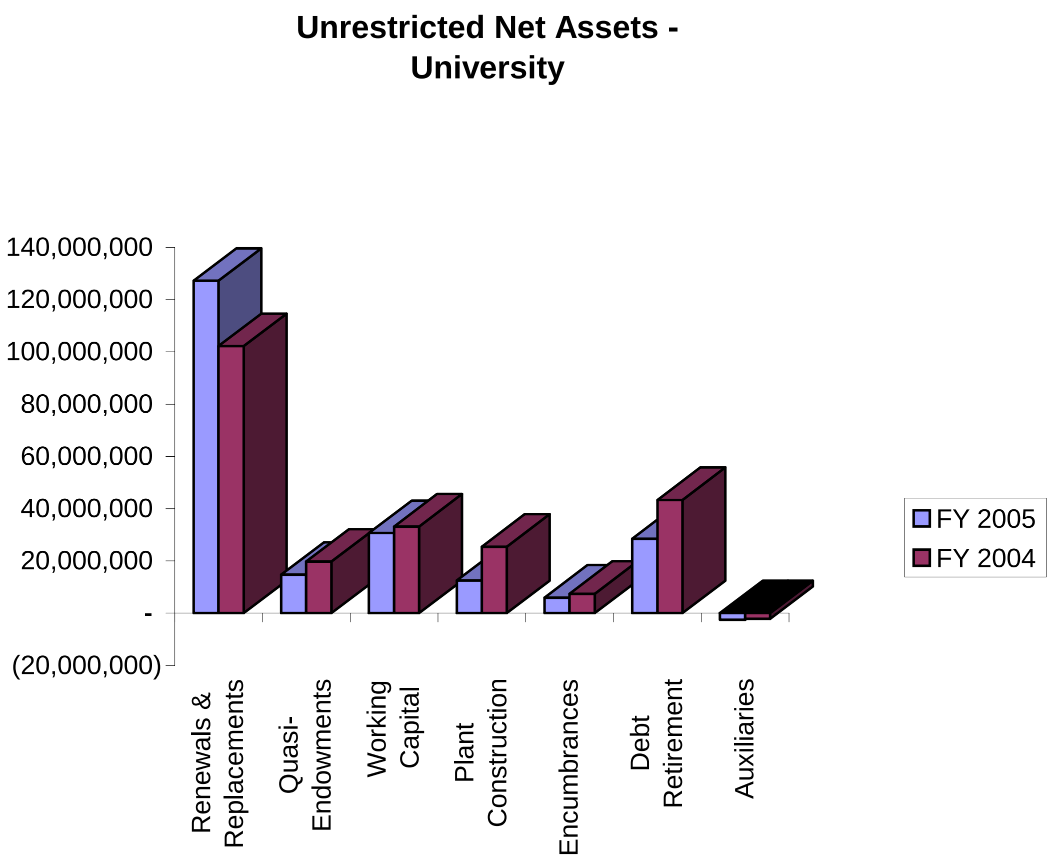
Statements of Net Assets
(in thousands of dollars)

	UT		UC Foundation		UT Foundation	
	2005	**2004**	**2005**	**2004**	**2005**	**2004**
Assets:						
Current assets	$ 332,130	$ 320,301	$ 9,243	$ 11,668	$ 7,929	$ 12,596
Capital assets, net	963,076	960,103	75,575	75,730	51,102	48,296
Other assets	869,742	881,699	112,554	117,068	26,152	21,626
Total Assets	2,164,948	2,162,103	197,372	204,466	85,183	82,518
Liabilities:						
Current liabilities	244,584	238,258	9,243	11,668	3,406	5,171
Noncurrent liabilities	328,655	298,596	89,033	86,222	59,233	58,593
Total Liabilities	573,239	536,854	98,276	97,890	62,639	63,764
Net Assets:						
Invested in capital assets, net of related debt	713,142	730,786	-	-	-	-
Restricted – expendable	348,315	356,646	7,805	6,786	16,399	15,494
Restricted – nonexpendable	335,859	323,475	39,255	39,609	5,460	2,755
Unrestricted	194,393	214,342	52,036	60,181	685	505
Total Net Assets	$ 1,591,709	$ 1,625,249	$ 99,096	$ 106,576	$ 22,544	$ 18,754

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

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

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



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

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

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

	UT		UC Foundation		UT Foundation	
	2005	2004	2005	2004	2005	2004
Operating revenues:						
Net tuition and fees	$210,613	$208,018	$ -	$ -	$ -	$ -
Grants and contracts	391,942	382,438	-	-	-	-
Auxiliary	129,304	123,314	-	-	-	-
Other	68,095	73,182	11,308	8,910	6,817	12,103
Total operating revenues	799,954	786,952	11,308	8,910	6,817	12,103
Operating expenses	1,400,362	1,340,677	10,511	8,647	6,543	1,735
Operating income (loss)	(600,408)	(553,725)	797	263	274	10,368
Nonoperating revenues and expenses:						
State appropriations	446,293	420,368	-	-	-	-
Gifts	24,104	40,486	-	-	-	-
Investment income	90,272	84,513	(863)	4,063	1,183	809
Other revenues and expenses	50,993	22,089	(8,380)	(2,857)	-	-
Total nonoperating revenues and expenses	611,662	567,456	(9,243)	1,206	1,183	809
Income (loss) before other revenues, expenses, gains, or losses	11,254	13,731	(8,446)	1,469	1,457	11,177
Other revenues, expenses, gains, or losses:						
Capital appropriations	15,137	21,725	-	-	-	-
Capital grants and gifts	12,556	15,253	-	-	-	-
Additions to permanent endowments	15,032	13,588	966	750	2,333	1,785
Other	(5,423)	(435)	-	-	-	-
Total other revenues, expenses, gains, or losses	37,302	50,131	966	750	2,333	1,785
Increase (decrease) in net assets	48,556	63,862	(7,480)	2,219	3,790	12,962
Net assets at beginning of period	1,625,249	1,561,387	106,576	104,357	18,754	5,792
Prior period adjustment	(82,096)	-	-	-	-	-
Net assets at beginning of period, as restated	1,543,153	-	-	-	-	-
Net assets at end of year	$1,591,709	$1,625,249	$99,096	$106,576	$22,544	$18,754

The increase in tuition and fees is primarily due to a 7% increase in fees for the 2005 academic year. Operating grants and contracts increased by $9 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 a decrease in revenue for the Knoxville Conference Center.

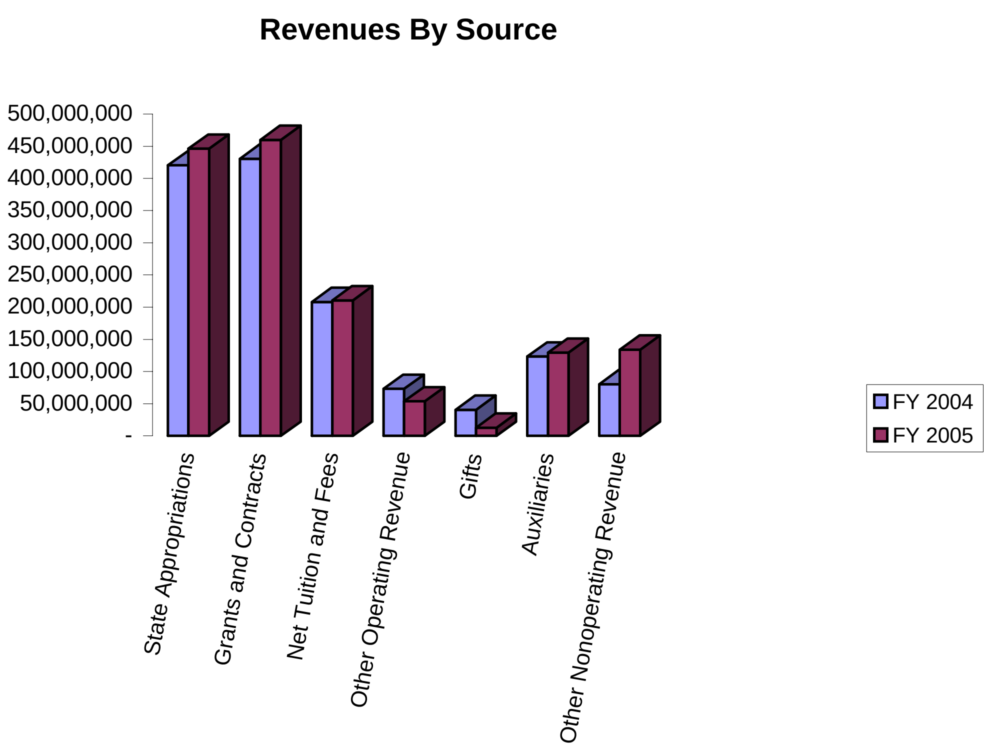
In fiscal year 2005, state appropriations increased $26 million. Nonoperating gifts decreased $16 million. The gain on investments was due to an increase of endowment income and continued modest gains in the capital market.

The decrease in capital appropriations for 2005 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 2005 fiscal year.

Total operating expenses increased approximately $60 million in fiscal year 2005 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.

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, 2005, and June 30, 2004.



For the year ended June 30, 2005, approximately 77 percent of UT's revenue was attributed to state appropriations, grants and contracts, and tuition and fees.

Expenses

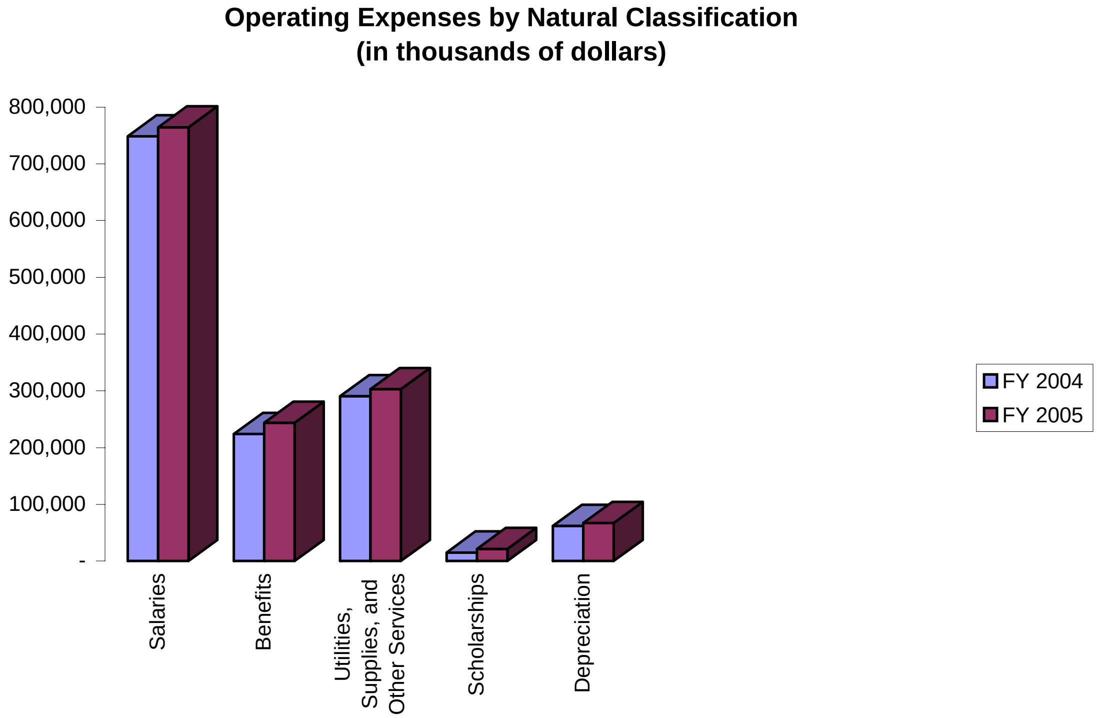
Operating expenses can be displayed in two formats, natural classification and functional classification. Both formats are displayed below (in thousands of dollars).

2005 Natural Classification

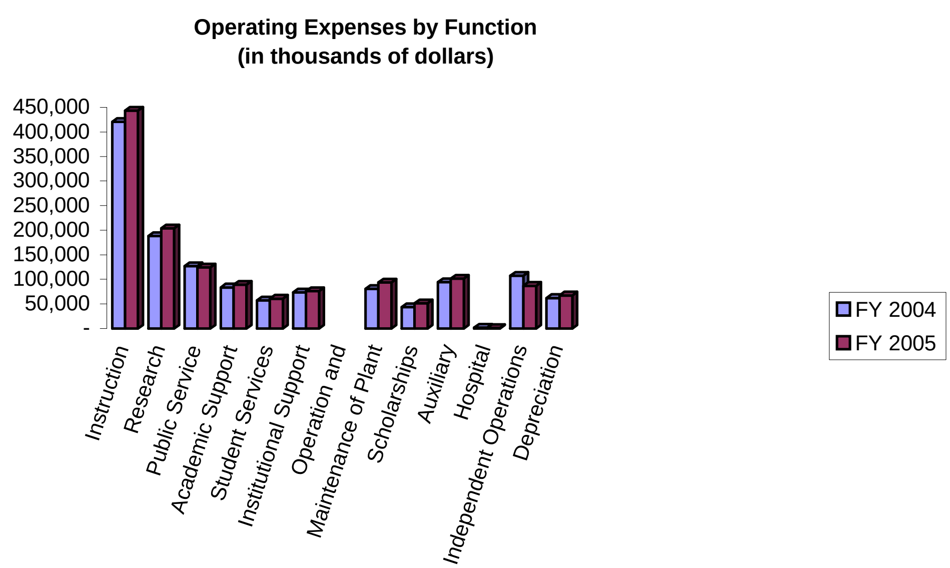
2005 Functional Classification	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$312,998	$84,344	$46,362	$ -	$ -	$443,704
Research	113,098	29,950	60,677	-	-	203,725
Public service	68,027	23,024	33,190	-	-	124,241
Academic support	56,856	18,700	13,694	-	-	89,250
Student services	30,134	9,928	20,839	-	-	60,901
Institutional support	57,063	19,030	-	-	-	76,093
Operation and maintenance of plant	27,874	11,475	54,167	-	-	93,516
Scholarships	2,825	15,362	11,526	21,833	-	51,546
Auxiliary	31,734	8,843	61,176	-	-	101,753
Hospital	-	-	1,447	-	-	1,447
Independent operations	63,513	23,352	-	-	-	86,865
Depreciation	-	-	-	-	67,321	67,321
Total expenses	$764,122	$244,008	$303,078	$21,833	$67,321	$1,400,362

2004 Natural Classification

2004 Functional Classification	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$298,233	$76,013	$46,539	$ -	$ -	$420,785
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	$290,582	$15,210	$62,167	$1,340,677



For the year ended June 30, 2005, approximately 71 percent of operating expenses are attributed to salaries and benefits. Utilities, supplies, and other services represent 21 percent of total operating expenses. Scholarships and depreciation represent the remaining 8 percent of operating expenses.



For the year ended June 30, 2005, 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 7 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)

	2005	2004
Cash provided (used) by:		
Operating activities	$(525,997)	$(446,942)
Noncapital financing activities	561,356	509,948
Investing activities	93,777	2,422
Capital and related financing activities	(56,989)	(52,723)
Net increase (decrease) in cash	72,147	12,705
Cash, beginning of year	422,623	409,918
Cash, end of year	$494,770	$422,623

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 $72,146,382.13 for the year ended June 30, 2005. The net increase in cash and cash equivalents amounted to $12,705,021.33 for the year ended June 30, 2004.

Capital Assets and Debt Administration

Capital Assets

At June 30, 2005, the University of Tennessee had $963,076,558.13 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled $67,320,593.15 for the current fiscal year. Details of these assets are shown below.

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

	2005	2004
Land	$50,994	$47,912
Land improvements & infrastructure	32,325	29,021
Buildings	618,446	627,401
Works of art/historical treasures	405	-
Equipment	96,158	94,158
Software	5,350	9,147
Library holdings	55,562	52,453
Projects in progress	103,837	100,011
Total	$963,077	$960,103

Major capital additions for UT during 2004-2005 include the $11.3 million Neyland–Thompson Sports Center Addition in Knoxville, the $9.3 million Eye Institute in Memphis, and the $1.6 million Electrical Distribution System Upgrade in Chattanooga.

For the next fiscal year, the state has approved more than $37 million in capital outlay appropriations and $18.5 million in capital maintenance appropriations for UT. Some of these approved projects include the Electrical and Computer Engineering Facility and Steam Plant Improvements in Knoxville and various improvement projects at the Martin and Chattanooga campuses. More detailed information about the university's capital assets is presented in Note 5 to the financial statements.

Debt

At June 30, 2005, the university had $248,122,385.03 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

Outstanding Debt Schedule
(in thousands of dollars)

	2005	**2004**
Bonds-current portion	$12,764	$12,566
Bonds-noncurrent	212,976	205,292
Commercial paper-noncurrent	22,317	12,231
Total TSSBA authorized debt	248,057	230,089
Notes-current portion	10	5
Notes-noncurrent portion	56	70
Total Debt	$ 248,123	$ 230,164

The university retired more than $13.3 million in bonds and notes in fiscal year 2004-2005. The Tennessee State School Bond Authority (TSSBA), in addition to its authority to issue bonds and notes to finance capital projects, has the responsibility for approving all long-term debt of the university. TSSBA currently is rated 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 two new bond series in 2004-2005 in the net amount of $3.1 million. These are the 2005A series in the amount of $27.4 million (this series is a refunding of the 1998C, 2000A, and 2002A series in the amount of $27.4 million); and the 2005B taxable series in the amount of $18.8 million (this series is a refunding of the 1998B and 2000B bonds in the amount of $15.7 million).

Economic Factors That Will Affect the Future

For fiscal year 2006, the University of Tennessee Board of Trustees has authorized an individual campus fee increase of from 9 to 13% that is expected to generate approximately $15 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 $16 million to fund employee increases. The university expects investment income to increase slightly as interest rates continue to slowly increase.

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.

Exhibit A

THE UNIVERSITY OF TENNESSEE
STATEMENT OF NET ASSETS
June 30, 2005

	THE UNIVERSITY OF TENNESSEE	UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.	THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.
ASSETS			
Current assets:			
Cash and cash equivalents (Note 2)	$ 169,633,793.82	$ 7,710,480.00	$ 7,342,270.91
Investments (Note 2)	69,810,482.89	-	-
Accounts, notes, and grants receivable (net) (Note 4)	81,197,921.84	959,908.00	525,329.48
Inventories	8,280,697.62	-	-
Prepaid expenses and deferred charges	3,207,594.53	573,160.00	61,375.15
Total current assets	332,130,490.70	9,243,548.00	7,928,975.54
Noncurrent assets:			
Cash and cash equivalents (Note 2)	325,136,322.13	4,794,983.00	4,027,761.33
Investments (Note 2)	403,614,616.26	107,686,370.00	14,121,618.96
Investment in UT - Battelle, LLC (Note 11)	2,517,991.00	-	-
Accounts, notes, and grants receivable (net) (Note 4)	110,273,524.13	72,729.00	2,824,267.96
Lease payments receivable (Note 15)	26,020,713.17	-	-
Capital assets (net) (Note 5)	963,076,558.13	75,574,971.00	51,101,791.81
Prepaid expenses and deferred charges	2,178,525.16	-	-
Assets held by the university	-	-	5,178,487.08
Total noncurrent assets	1,832,818,249.98	188,129,053.00	77,253,927.14
Total assets	2,164,948,740.68	197,372,601.00	85,182,902.68
LIABILITIES			
Current liabilities:			
Accounts payable	73,749,840.70	1,774,229.00	95,823.54
Accrued liabilities	40,605,375.66	-	-
Deferred revenue	65,916,569.11	1,303,000.00	98,116.49
Deposits payable	418,306.18	94,543.00	-
Annuities payable	1,303,987.55	-	-
Long-term liabilities, current portion (Note 7)	50,427,352.80	235,000.00	495,000.00
Deposits held in custody for others	6,983,882.29	2,714,217.25	-
Deposits held in custody for component units	5,178,487.08	-	-
Due to the university	-	3,122,558.75	2,716,863.60
Total current liabilities	244,583,801.37	9,243,548.00	3,405,803.63
Noncurrent liabilities:			
Deferred revenue (Note 7)	15,500,438.71	-	-
Long-term liabilities, noncurrent portion (Note 7)	268,644,448.25	89,033,050.00	59,232,545.39
Due to grantors (Note 7)	36,722,743.00	-	-
Annuities payable (Note 7)	7,787,941.02	-	-
Total noncurrent liabilities	328,655,570.98	89,033,050.00	59,232,545.39
Total liabilities	573,239,372.35	98,276,598.00	62,638,349.02
NET ASSETS			
Invested in capital assets, net of related debt	713,142,310.91	-	-
Restricted:			
Nonexpendable:			
Scholarships and fellowships	144,664,249.11	10,985,518.00	3,689,139.13
Libraries	13,199,441.59	-	88,285.74
Research	17,275,656.60	-	-
Instructional department uses	107,796,357.53	28,223,013.00	-
Academic support	25,973,741.93	46,885.00	1,426,394.23
Other	26,949,204.49	-	256,029.48
Expendable:			
Scholarships and fellowships	108,749,423.46	316,123.00	1,103,894.66
Libraries	7,457,248.94	-	-
Research	28,868,062.49	-	22,759.19
Instructional department uses	80,212,136.77	2,395,457.00	-
Academic support	43,842,847.64	11,779.00	15,183,412.37
Loans	8,942,885.20	-	-
Capital projects	19,760,332.15	5,000,000.00	-
Debt service	302,603.33	-	-
Other	50,179,555.17	80,780.00	88,923.02
Unrestricted (Note 18)	194,393,311.02	52,036,448.00	685,715.84
Total net assets	$ 1,591,709,368.33	$ 99,096,003.00	$ 22,544,553.66

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

Exhibit B

THE UNIVERSITY OF TENNESSEE
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Year Ended June 30, 2005

	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 $59,245,245,82 for the year ended June 30, 2005)	$ 210,613,440.13	$ -	$ -
Contributions	-	142,559.00	2,230,376.13
Investment return designated for operations	-	4,081,933.00	-
Federal appropriations	11,661,367.10	-	-
Governmental grants and contracts	199,172,107.04	-	-
Non-governmental grants and contracts	192,770,006.67	-	-
Sales and services of educational departments	42,051,237.67	-	-
Auxiliary enterprises:			
Residential life (net of scholarship allowances of $1,122,469.25 for the year ended June 30, 2005 ; all revenues are used as security for varying revenue bonds; see Note 7)	31,559,513.36	7,083,390.00	4,574,311.08
Food services	3,167,767.86	-	-
Bookstore	19,610,295.78	-	-
Parking	8,201,010.13	-	-
Athletics	61,311,111.32	-	-
Other auxiliaries	5,454,501.84	-	-
Hospital	1,513,398.81	-	-
Interest earned on loans to students	56,896.66	-	-
Other operating revenues	12,811,598.56	-	12,421.07
Total operating revenues	799,954,252.93	11,307,882.00	6,817,108.28
EXPENSES			
Operating expenses (Note 17):			
Salaries and wages	764,122,543.60	-	64,063.53
Fringe benefits	244,007,860.36	-	10,844.78
Utilities, supplies, and other services	303,078,714.74	3,495,738.00	3,948,331.23
Scholarships and fellowships	21,832,849.73	-	-
Depreciation expense	67,320,593.15	2,933,610.00	1,388,945.32
Payments to or on behalf of the university	-	4,081,933.00	1,130,551.88
Total operating expenses	1,400,362,561.58	10,511,281.00	6,542,736.74
Operating income (loss)	(600,408,308.65)	796,601.00	274,371.54
NONOPERATING REVENUES (EXPENSES)			
State and local appropriations	446,292,718.20	-	-
Gifts (include $5,212,484.88 from component units)	24,103,880.73	-	-
Grants and contracts	68,009,719.00	-	-
Investment income (loss)	90,272,711.94	(862,635.00)	1,183,066.40
Interest on capital asset - related debt	(14,007,335.89)	(3,557,759.00)	-
Bond issuance costs	-	(3,666,665.00)	-
Other nonoperating expenses	(3,008,842.74)	(1,155,660.00)	-
Net nonoperating revenues (expenses)	611,662,851.24	(9,242,719.00)	1,183,066.40
Income (loss) before other revenues, expenses, gains, or losses	11,254,542.59	(8,446,118.00)	1,457,437.94
Capital appropriations	15,136,525.14	-	-
Capital grants and gifts	12,556,463.89	-	-
Additions to permanent endowments	15,032,284.70	966,141.00	2,333,412.91
Additions to annuity and life income trusts	1,229,133.94	-	-
Other	(6,652,626.11)	-	-
Total other revenues	37,301,781.56	966,141.00	2,333,412.91
Increase in net assets	48,556,324.15	(7,479,977.00)	3,790,850.85
NET ASSETS			
Net assets at beginning of year, as restated for the university (Note 21)	1,543,153,044.18	106,575,980.00	18,753,702.81
Net assets at end of year	$ 1,591,709,368.33	$ 99,096,003.00	$ 22,544,553.66

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, 2005

CASH FLOWS FROM OPERATING ACTIVITIES		
Tuition and fees	$	209,939,379.47
Federal appropriations		11,661,367.10
Grants and contracts		391,519,488.57
Sales and services of educational activities		42,060,630.94
Payments to suppliers and vendors		(295,535,863.35)
Payments to employees		(763,505,075.18)
Payments for benefits		(235,920,978.73)
Payments for scholarships and fellowships		(21,832,849.73)
Loans issued to students		(6,663,093.60)
Collection of loans from students		5,878,505.96
Interest earned on loans to students		530,606.58
Auxiliary enterprise charges:		
Residence halls		31,559,513.36
Bookstore		19,610,295.78
Food service		3,167,767.86
Parking		8,201,010.13
Athletics		58,541,195.33
Other auxiliaries		5,483,876.08
Hospital		3,300,047.93
Other receipts (payments)		6,006,721.13
Net cash provided (used) by operating activities		(525,997,454.37)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations		442,491,470.38
Local appropriations		4,053,047.82
Gifts and grants for other than capital or endowment purposes		96,130,752.89
Private gifts for endowment purposes		16,261,418.64
Split-interest transactions receipts		1,323,440.02
Split-interest transactions disbursements		(3,033,180.24)
Federal student loan receipts		154,004,334.90
Federal student loan disbursements		(154,004,334.90)
Changes in deposits held for others		439,230.41
Net cash balance implicitly financed (repaid)		10,342,035.87
Other noncapital receipts (payments)		(6,652,626.11)
Net cash provided (used) by noncapital financing activities		561,355,589.68
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from capital debt		33,509,669.47
Capital appropriations		19,432,140.92
Capital grants and gifts received		12,556,463.89
Proceeds from sale of capital assets		826,858.90
Purchase of capital assets and construction		(93,914,237.64)
Principal paid on capital debt and leases		(12,572,643.55)
Interest paid on capital debt and leases		(16,007,752.66)
Other capital and related financing receipts (payments)		(819,512.33)
Net cash provided (used) by capital and related financing activities		(56,989,013.00)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments		150,913,403.01
Interest on investments		87,754,732.31
Purchase of investments		(144,890,875.50)
Net cash provided (used) by investing activities		93,777,259.82
Net increase (decrease) in cash and cash equivalents		72,146,382.13
Cash and cash equivalents at beginning of year		422,623,733.82
Cash and cash equivalents at end of year	$	494,770,115.95

Exhibit C (Cont.)

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2005

RECONCILIATION OF NET OPERATING LOSS TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating loss	$	(600,408,308.65)
Adjustments to reconcile operating loss to net cash provided (used) by operating activities:		
Depreciation expense		67,320,593.15
Changes in assets and liabilities:		
Receivables, net		(430,690.41)
Inventories		(11,649.11)
Prepaid expenses and deferred charges		4,154,830.01
Accrued interest receivable		473,709.92
Accounts payable		3,399,670.49
Accrued liabilities		726,433.44
Deferred revenue		(2,381,684.23)
Deposits		(6,033,687.95)
Compensated absences		7,977,916.61
Other additions:		
Loans to students		(784,587.64)
Net cash provided (used) by operations	$	(525,997,454.37)

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

The University of Tennessee
Notes to the Financial Statements
June 30, 2005

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The university is a component unit of the State of Tennessee because the state appoints the majority of the university's governing body and provides financial support. The university is discretely presented in the *Tennessee Comprehensive Annual Financial Report*.

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.

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 its component units', assets, liabilities, net assets, revenues, expenses, changes in net assets, and cash flows.

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) nonoperating 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

The university reports investments in commercial paper at amortized cost. The university had no investments in commercial paper at June 30, 2005. 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 $17,177,505.95 as of June 30, 2005. 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

Cash Management Investment Pool - 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.

University policy also requires that commercial paper not exceed 35% of the portfolio in total and that no more than 10% of the portfolio's value be in the commercial paper of a single issuer. In addition, banker's acceptances cannot exceed 20% of the portfolio's value and no one bank's acceptances may exceed 10%. Money market funds cannot exceed 10% of the portfolio's total value.

Investments - 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.

Deposits - University policy and state statute require that university funds be deposited into authorized commercial banks and savings and loan associations. State statutes also require that these financial institutions pledge securities as collateral to secure university time and demand deposits. To facilitate the pledge requirement, financial institutions can elect to either participate in the State of Tennessee Collateral Pool for Public Deposits administered by the State Treasurer or pledge securities with a third party.

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, 2005, cash and cash equivalents consisted of $100,568,780.13 in bank accounts, $1,281,045.35 of petty cash on hand, $32,000,000.00 of certificates of deposit, and $304,856,163.81 in the university's cash management investment pool.

The carrying amount of the university's deposits was $132,568,780.13 and the bank balance including accrued interest was $125,408,370.17.

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 agreements, First Tennessee Bank and Citigroup placed cash equivalents totaling $56,064,126.66 at June 30, 2005, in the banks' money market mutual funds.

Custodial Credit Risk – Deposits

The custodial credit risk for deposits is the risk that in the event of a bank failure, the university's deposits may not be recovered. As stated earlier, state statutes require that all university deposits be in a qualified depository and secured through direct collateralization or participation in the State Collateral Pool. As of June 30, 2005, all university deposits were adequately secured as required by state statute.

Investments

Investments in commercial paper are reported at amortized cost. All other investments are reported at fair value, including those securities with a maturity date of one year or less. As of June 30, 2005, the university had the following investments and maturities.

Investment Maturities (In Years)

Investment Type	Fair Value	Less Than 1	1 to 5	6 to 10	10+	Cost
Cash Management Pool						
Cash Equivalents						
Debt Securities						
U.S. Treasury	$ 66,007,433.61	$ 10,510,778.13	$ 55,496,655.48	$ -	$ -	$ 66,764,945.63
U.S. Agencies	238,848,730.20	50,796,234.86	188,052,495.34	-	-	240,833,121.03
	304,856,163.81	61,307,012.99	243,549,150.82	-	-	307,598,066.66
Investments						
Debt Securities						
U.S. Treasury	7,688,378.19	1,193,423.40	3,614,544.48	1,202,883.30	1,677,527.01	7,286,284.07
U.S. Agencies	21,389,834.39	2,663,413.39	8,961,425.35	6,478,769.25	3,286,226.40	20,564,248.14
Corporate bonds	20,378,487.90	2,689,191.20	8,749,807.50	8,939,489.20	-	20,343,305.91
Municipal bonds	2,768,726.70	162,091.65	533,693.55	-	2,072,941.50	2,718,136.98
Mortgages and notes	1,176,075.17	25,000.00	608,200.28	542,874.89	-	1,170,707.29
Bond mutual funds	15,926,225.42	-	13,297,891.54	2,628,333.88	-	15,857,492.19
	69,327,727.77	6,733,119.64	35,765,562.70	19,792,350.52	7,036,694.91	67,940,174.58
		$68,040,132.63	$279,314,713.52	$ 19,792,350.52	$ 7,036,694.91	
Other investments						
Corporate stocks:						
Domestic	114,627,335.00					100,322,808.20
International	4,738,231.82					4,292,248.91
Mutual funds – equity	117,002,350.14					91,524,357.38
Real estate:						
Equity funds	31,395,980.76					21,775,814.61
Gifts	1,417,659.18					2,096,180.67
Venture capital funds	31,553,007.86					48,426,485.91
Hedge funds	64,355,415.00					60,000,000.00
Assets with trustees	4,581,049.24					4,535,111.08
Other investments	4,169.00					4,169.00
Mutual funds – bonds	34,422,173.38					28,583,234.97
Total investments and cash equivalents	778,281,262.96					737,098,651.97
Less: Cash equivalents	304,856,163.81					307,598,066.66
Total investments	$ 473,425,099.15					$ 429,500,585.31

Interest Rate Risk

Interest rate risk is defined as the risk the university may face should changes in interest rates affect the fair value of investments. The university does not have a formal policy that addresses interest rate risk.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The university's debt investments as of June 30, 2005, were rated by Moody's.

The university is authorized by statute to invest funds in accordance with University of Tennessee investment policies. Funds, other than endowment and annuity and life income funds, may be invested 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. Endowment and annuity and life income funds can be invested in equity securities and various other securities given prudent diversification. The university has no investment policy limiting its investment choice based on ratings issued by nationally recognized statistical rating agencies. As of June 30, 2005, the institution's investments were rated as follows:

Rated Debt Instruments	Fair Value	Aaa	Aa1	Aa2	Aa3	A1
Cash Management Pool						
U. S. Treasury	$ 66,007,433.61	$ 66,007,433.61	$ -	$ -	$ -	$ -
U.S. Agencies	238,848,730.20	238,848,730.20	-	-	-	-
Investments						
U.S. Treasury	7,688,378.19	7,637,355.76	-	-	-	-
U.S. Agencies	21,389,834.39	19,240,414.39	-	2,149,420.00	-	-
Corporate bonds	20,378,487.90	1,028,167.75	639,275.00	724,188.95	4,225,482.50	5,997,223.50
Municipal bonds	2,768,726.70	1,023,172.40	-	522,985.40	-	-
Mutual funds–bonds	50,348,398.80	-	2,577,384.29	50,949.59	13,297,891.54	-
Mortgages and notes	1,176,075.17	-	-	-	-	-

Rated Debt Instruments	A2	A3	Baa1	Baa2	Baa3	Unrated
Cash Management Pool						
U. S. Treasury	-	-	-	-	-	-
U.S. Agencies	-	-	-	-	-	-
Investments						
U.S. Treasury	-	-	-	-	-	51,022.43
U.S. Agencies	-	-	-	-	-	-
Corporate bonds	2,204,786.00	2,808,149.40	718,822.00	1,948,162.80	-	84,230.00
Municipal bonds	-	-	-	-	65,231.40	1,157,337.50
Mutual funds–bonds	-	-	-	-	-	34,422,173.38
Mortgages and notes	-	-	-	-	-	1,176,075.17

Custodial Credit Risk – Investments

Custodial credit risk is the risk that, in the event of a failure of the counterparty, the university will not be able to recover the value of the investment or collateral securities that are in possession of an outside party. At June 30, 2005, the university had $4,581,049.24 of uninsured and unregistered investments held by a counterparty but not in the school's name.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of the university's investment in a single issuer. Other than the restrictions placed on the cash management investment pool described in the investment policies above, the university places no limit on the amount the university may invest in any one issuer. More than five percent of the university's investments are invested in the following single issuers:

Issuer	Fair Value	Percent of Total Investments
U. S. Treasury obligations	$ 73,695,811.80	9.47%
Federal Home Loan Bank	$134,109,130.05	17.23%
Federal National Mortgage Association	$ 67,679,759.57	8.70%

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of a deposit or investment. The university has $4,738,231.82 invested in foreign corporate equities at June 30, 2005.

Investments in Hedge Funds

In its Consolidated Investment Pool, as part of its endowment assets, the university has investments in hedge funds whose fair value is $64,355,415. Currently, the Consolidated Investment Pool invests in five hedge funds: the Commonfund Global Hedged Partners; the Balentine Global Hedge Fund Select; the G/T Offshore Fund, Ltd.; the Maplewood Associates II; and Pointer Offshore, Ltd. The hedge fund investments are all fund-of-funds and accordingly due to that structure, flexibility, and lower levels of regulatory oversight expose the university to magnified amounts of investment risk. Since the fund-of-fund managers hold the university's unrated investments consisting of specific hedging strategies that deal with derivative securities and leveraging those portfolio securities, a significant amount of credit, custodial credit, and market risk exists. These investments are briefly described below.

Commonfund Global Hedged Partners, L.L.C., 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 $23,397,740 at June 30, 2005.

Balentine Global Hedge Fund Select 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. The university's investment of $20,000,000 was valued at $16,919,400 at June 30, 2005.

G/T Offshore Fund, Ltd., was created in 2000 as a multi-manager fund that conducts its activities through GT 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 $6,550,095 at June 30, 2005.

Maplewood Associates II, 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 $11,417,510 at June 30, 2005.

Pointer Offshore, Ltd., was created in 2002 and is managed by Pointer Offshore, L.L.C. By allocating its assets to a select number of long/short equity-based managers, the fund seeks capital appreciation through a balanced level of risk. The fund is a "fund of funds" that utilizes diversified strategies to achieve its objective. The university's investment of $5,000,000 was valued at $6,070,670 at June 30, 2005.

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 spending 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, 2005, net appreciation of $162,736,383.51 is available to be spent, of which $160,040,394.38 is restricted to specific purposes. The per unit fair value for participating endowments was $3.507638 at June 30, 2005. Income distributed was $.16300 per share in 2005, or $20,615,858.44.

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. The total return for fiscal year 2005 and the three and five years then ended was 11.2%, 9.2%, and 3.2%, respectively. Longer-term average returns continue to be impacted by the negative return years of 2001 and 2002. Due to these two negative numbers, there were 86 true endowments at June 30, 2005, that had a market value of $17,756,972.76 and historic gift value of $18,427,783.05, yielding a net "underwater" position of $670,810.29. 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 $897,747.30 for 2005.

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 2005 amounted to $1,916,289.29.

NOTE 4. ACCOUNTS, NOTES, AND GRANTS RECEIVABLE

Accounts, notes, and grants receivable included the following at June 30, 2005:

Student accounts receivable	$ 7,038,360.83
Grants receivable	65,941,041.98
Notes receivable	5,006,853.12
Pledges receivable	16,907,989.02
Due from component units	5,839,422.35
Other receivables	70,645,430.36
Subtotal	171,379,097.66
Less allowance for doubtful accounts	(10,269,596.66)
Total	$161,109,501.00

Pledges receivable are promises of private donations that are reported as accounts receivable, net of an estimated uncollectible allowance of $2,874,358.13.

Federal Perkins Loan Program funds included the following at June 30, 2005:

Perkins loans receivable	$30,361,944.97
Less allowance for doubtful accounts	-
Total	$30,361,944.97

NOTE 5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2005, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Land	$ 47,912,078.18	$3,493,961.00	$ -	$ (411,428.10)	$ 50,994,611.08
Land improvements & infrastructure	57,832,146.84	1,475,082.08	4,910,661.89	(10,239.57)	64,207,651.24
Buildings	1,100,219,299.48	16,737,458.16	28,990,238.47	(5,060,444.55)	1,140,886,551.56
Works of art/ historical treasures	405,098.72	-	-	-	405,098.72
Equipment	248,130,424.71	25,385,158.12	-	(14,726,824.86)	258,788,757.97
Software	19,135,832.85	265,493.00	-	-	19,401,325.85
Library holdings	89,799,212.82	12,129,031.28	-	(7,294,000.53)	94,634,243.57
Projects in progress	100,011,376.89	37,726,465.86	(33,900,900.36)	-	103,836,942.39
Total	1,663,445,470.49	97,212,649.50	-	(27,502,937.61)	1,733,155,182.38
Less accumulated depreciation:					
Land improvements & infrastructure	(28,811,198.82)	(3,072,291.20)	-	703.98	(31,882,786.04)
Buildings	(495,588,370.53)	(31,123,207.31)	-	4,270,675.21	(522,440,902.63)
Equipment	(154,377,140.69)	(20,042,667.78)	-	11,788,699.34	(162,631,109.13)
Software	(9,988,989.81)	(4,062,213.66)	-	-	(14,051,203.47)
Library holdings	(37,346,410.31)	(9,020,213.20)	-	7,294,000.53	(39,072,622.98)
Total accumulated depreciation	(726,112,110.16)	(67,320,593.15)	-	23,354,079.06	(770,078,624.25)
Capital assets, net	$937,333,360.33	$29,892,056.35	$ -	$(4,148,858.55)	$963,076,558.13

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 $7,442,770.40 for the year ended June 30, 2005.

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, 2005. 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:	
2006	$11,970.00
2007	11,970.00
2008	11,970.00
2009	11,970.00
2010	11,970.00
2011-2012	23,940.00
Total minimum payments required	$83,790.00

NOTE 7. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2005, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term liabilities:					
Bonds	$217,857,968.44	$50,085,595.72	$42,203,416.04	$225,740,148.12	$12,763,659.09
Commercial paper	12,230,640.38	10,895,870.74	810,000.00	22,316,511.12	-
Total TSSBA indebtedness	230,088,608.82	60,981,466.46	43,013,416.04	248,056,659.24	12,763,659.09
Notes	75,093.00	-	9,367.21	65,725.79	9,934.51
Compensated absences	62,971,499.41	45,631,675.81	37,653,759.20	70,949,416.02	37,653,759.20
Total long-term liabilities	293,135,201.23	106,613,142.27	80,676,542.45	319,071,801.05	$50,427,352.80
Other noncurrent liabilities:					
Deferred revenue	15,500,438.71	-	-	15,500,438.71	
Due to grantors	36,603,050.86	933,998.87	814,306.73	36,722,743.00	
Annuities payable	8,052,812.58	1,039,115.99	1,303,987.55	7,787,941.02	
Totals	$353,291,503.38	$108,586,257.13	$82,794,836.73	$379,082,923.78	

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 $258,798,802.65 as of June 30, 2005. The total bonded indebtedness reported on the statement of net assets at June 30, 2005, is shown net of unaccreted bonds payable of $2,121,352.27, assets of $5,911,353.81 held by the Tennessee State School Bond Authority, and unspent bond proceeds of $25,025,948.45.

Included in the total outstanding indebtedness is a $75,093.00 note with the 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, 2005, is $65,725.79.

The university's debt service requirements (TSSBA and the 5-year note) to maturity for all bonds and notes payable at June 30, 2005, are as follows:

Year Ending June 30	Principal	Interest and Administrative Fees
2006	$ 12,773,593.60	$ 11,638,511.56
2007	13,196,961.31	11,335,370.10
2008	13,629,243.06	10,902,034.40
2009	14,129,322.54	10,435,603.66
2010	14,587,998.69	9,951,681.84
2011-2015	56,092,801.37	41,636,129.07
2016-2020	53,468,683.71	28,686,865.95
2021-2025	43,504,536.27	16,091,097.24
2026-2030	25,564,160.35	7,116,595.99
2031-2034	11,917,227.54	1,376,007.28
	$ 258,864,528.44	$ 149,169,897.09

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, 2005, $22,316,511.12 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 10.54% 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, 2005, 2004, and 2003, were $26,506,950.91, $17,904,045.80, and $18,125,448.74, 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, 2005, were $1,181,636.69, which consisted of $607,533.23 from the university and $574,103.46 from the employees; contributions 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; and 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.

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 11.2%. 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 $1,018,002.60 for the year ended June 30, 2005, which consisted of $68,585.93 from employees and $949,416.67 from the university; $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; and $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. Contributions for the Thrift Savings Plan were $1,038,288.00 for the year ended June 30, 2005, which consisted of $639,649.00 from employees and $398,639.00 from the university; $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; and $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. 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, 2005, was $38,198,999.23 and for the year ended June 30, 2004, was $36,873,939.85. 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 $46,624,583.43 for fiscal year 2005, and $47,738,857.63 for fiscal year 2004. 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 $4,910,723.14

in fiscal year 2005, and $3,478,915.92 in fiscal year 2004. 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, 2005, contributions totaling $11,271,296.71 were made by employees participating in the plan, with a related match of $1,912,499.17 made by the university. 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. 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, 2005. 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, 2005, the amounts held in trust totaled $103,956,121.30 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 $2,517,991.00 at June 30, 2005. 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, 2004, to the university was $1,392,992.01.

During the year ended June 30, 2005, the university had expenses of $19,455,974.41 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled $7,493,212.32 at June 30, 2005. 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 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. Information regarding the determination of the claims liabilities and the changes in the balances of the claims liabilities for the years ended June 30, 2005, and June 30, 2004, are presented 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, 14th Floor, William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, TN 37243-0298 or by calling (615) 741-2140. 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, 2005, the Risk Management Fund held $114.4 million in cash and cash equivalents designated for payment of claims.

At June 30, 2005, the scheduled coverage for the university was $2,914,838,655 for buildings and $899,458,971 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, 2005, were $48,468,676.80.

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, 2005. The amount of unused sick leave was $236,102,493.43 at June 30, 2005.

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 $2,853,841.02 as of June 30, 2005, 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 $83,995,338.63 in 2005, 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, 2005, totaled $1,108,651.00.

The university recorded a lease payment receivable in the amount of $26,020,713.17 at June 30, 2005, 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.

	June 30, 2005
Total minimum lease payments to be received	$54,256,562.02
Less: Unearned income	(28,235,848.85)
Net investment in direct financing lease	$26,020,713.17

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

The university and Methodist entered into a management agreement whereby Methodist managed the operations of William F. Bowld Hospital. The term of the agreement was from November 1, 2002, until July 24, 2004, the date all services comprising the hospital were relocated to Methodist University Hospital. As consideration for managing the hospital in the first two years, Methodist retained the net margins or deficits from hospital operations as defined in the agreement. The university 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

Methodist leased from the university all hospital employees as of the date of closing. 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 $2,869,779.71, 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 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, 2005, are as follows:

	Natural Classification					
Functional Classification	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$312,998,319.66	$84,343,659.56	$46,362,413.23	$ -	$ -	$443,704,392.45
Research	113,098,366.04	29,949,953.00	60,676,707.24	-	-	203,725,026.28
Public service	68,027,018.51	23,023,980.80	33,190,008.25	-	-	124,241,007.56
Academic support	56,855,482.28	18,699,535.52	13,694,122.73	-	-	89,249,140.53
Student services	30,134,450.78	9,928,018.42	20,839,278.73	-	-	60,901,747.93
Institutional support	57,062,648.79	19,030,265.35	-	-	-	76,092,914.14
Operation & maintenance of plant	27,874,194.70	11,475,223.82	54,166,833.71	-	-	93,516,252.23
Scholarships & fellowships	2,825,015.37	15,362,090.56	11,526,680.90	21,832,849.73	-	51,546,636.56
Auxiliary	31,734,103.47	8,842,958.99	61,175,721.67	-	-	101,752,784.13
Hospital	-	-	1,446,948.28	-	-	1,446,948.28
Independent operations	63,512,944.00	23,352,174.34	-	-	-	86,865,118.34
Depreciation	-	-	-	-	67,320,593.15	67,320,593.15
Total expenses	$764,122,543.60	$244,007,860.36	$303,078,714.74	$21,832,849.73	$67,320,593.15	$1,400,362,561.58

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, 2005
Working capital	$30,667,883.03
Encumbrances	5,957,541.65
Auxiliaries	(2,556,068.48)
Quasi-endowments	14,690,476.30
Plant construction	12,506,412.37
Renewal and replacement of capital assets	127,233,811.14
Debt retirement	28,494,512.78
Unreserved/undesignated	(22,601,257.77)
Total	$194,393,311.02

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 friends 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, 2005, the foundation expended $4,081,933.00 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

The 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 on 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. The third and final phase of the student housing, consisting of 576 bedrooms in 144 units, was completed and leased to students in October 2004.

Investments

A summary of foundation investments at June 30, 2005, is as follows:

Equity securities (cost of $60,179,310 in 2005)	$63,484,444
Debt securities (cost of $25,088,291 in 2005)	25,034,402
Real estate	1,367,026
Limited partnerships	6,944,947
Other	53,624
Total	$96,884,443

The foundation also has investments restricted by the terms of the revenue bonds described below totaling $10,801,927.

Property and Equipment

A summary of foundation property and equipment at June 30, 2005, is as follows:

Land	$ 8,241,032
Buildings	72,301,570
Furniture, fixtures, and equipment	2,924,812
	83,467,414
Accumulated depreciation	(7,892,443)
Total	$75,574,971

Revenue Bonds Payable

During May 2005, the Health, Educational, and Housing Facility Board of the City of Chattanooga issued two series of tax-exempt revenue refunding bonds totaling $91,510,000. The LLC is the borrower on the bonds. The proceeds of the refunding bonds were primarily used to retire early the three series of tax-exempt revenue bonds issued in 2000 and 2001. The 2000 and 2001 bonds were used to acquire land, fund construction of the student housing, and develop an elementary school near the student housing.

Revenue bonds payable at June 30, 2005, consist of the following:

Series 2005A revenue refunding bonds, interest rates fixed at 5.0% to 5.125% payable semi-annually, annual redemption payments due through October 1, 2035	$69,490,000
Series 2005B revenue refunding bonds, interest rates fixed at 5.5% to 6.0% payable semi-annually, annual redemption payments due through October 1, 2035	22,020,000
	91,510,000
Less: unamortized discount	(2,241,950)
Total	$89,268,050

Restricted Cash and Cash Equivalents

The revenue bonds described above restrict the use of certain cash and cash equivalents at June 30, 2005, as follows:

Renewal and replacement reserves	$ 674,399
Restricted for debt issuance costs	9,903
Restricted for debt service payments	774,365
Total	$1,458,667

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2005, are as follows:

Functional Classification	Natural Classification: Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Depreciation	Total
Academic programs	$ -	$1,138,619	$ -	$1,138,619
Professorships	-	489,762	-	489,762
Faculty development	-	285,285	-	285,285
Scholarships	-	1,691,194	-	1,691,194
Chancellor's discretionary	-	220,777	-	220,777
Other	-	256,296	-	256,296
Rental expenses	2,991,623	-	-	2,991,623
Administrative and investment fees	478,726	-	-	478,726
Legal	6,429	-	-	6,429
Tax and audit	18,960	-	-	18,960
Depreciation	-	-	2,933,610	2,933,610
Total expenses	$3,495,738	$4,081,933	$2,933,610	$10,511,281

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 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, 2005, the foundation distributed $1,130,551.88 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.

Organization and Nature of Activities

The University of Tennessee Foundation, Inc., is a not-for-profit organization exempt from federal income tax under Section 501 (c)(3) of the *Internal Revenue Code*. The foundation was formed to support the University of Tennessee. The foundation was established to provide flexibility for the university in carrying out its mission of teaching, research, and public service. The foundation receives contributions from individuals, corporations, alumni, and other donors.

Principles of Consolidation

The consolidated financial statements include the accounts of the foundation and two single member limited liability companies created by the foundation. The names of the limited liability companies are Volunteer Student Housing, LLC, and Martin Student Housing, LLC. The limited liability companies were created to own student housing facilities adjacent to the University of Tennessee at Knoxville campus and the University of Tennessee at Martin campus. All significant intercompany balances and transactions have been eliminated in the consolidation.

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	$85,487.60	$224,053.10	$ 64,122.88
Pledges due in one to five years	622,683.26	990,504.49	814,215.02
Pledges due after five years	160,674.38	390,819.98	248,583.72
	868,845.24	1,605,377.57	1,126,921.62
Less discounts to net present value	(92,535.15)	(180,267.55)	(130,410.19)
Total pledges receivable, net	$776,310.09	$1,425,110.02	$996,511.43

The allowance for doubtful accounts at June 30, 2005, was $243,598.31.

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 is a 12-story complex with five levels for parking and seven levels for housing. The facility was completed and opened in August 2004. The building and furniture, fixtures, and equipment will be depreciated over 39 and 5 years, respectively. The depreciation method used is straight-line. The management group which operates the housing has a fiscal year-end on July 31. The financial activity presented in the financial statements for the student housing only reflects that fiscal year-end.

At the beginning of the project, 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, $1,876,118.43 of interest expense and $226,722.19 of interest income was accrued. The first principal payment of $495,000 is due November 1, 2005. All income generated by the facility is held by Wachovia Bank, the trustee. The trust value at fiscal year end is $6,367,401.76.

Other project costs represent software costs and issuance costs and letter of credit costs paid from the bond proceeds at closing. The issuance cost is being amortized over the life of the bonds, and the letter of credit cost is being amortized over the 7 year letter of credit term. The total other project costs were $831,683.04, and the amortized cost for the fiscal year was $25,866.67. 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 $34,076.79. The software costs were $5,778.00 and will be amortized over 4 years. The amount amortized this fiscal year was $1,444.50.

On September 9, 2005, the Volunteer Student Housing, LLC, entered into a new Letter of Credit agreement with Allied Irish Bank (AIB). As part of this new arrangement, the bonds payable amortization schedule was changed. The future maturities of the bonds reflect the new arrangement with AIB. Also, as a result of this new arrangement, the existing hedge was eliminated and replaced with a new 4 year 75% hedge with the hedge rate being 3.31%.

Future maturities of bonds payable commencing in 2006 are as follows:

Year Ending June 30:	
2006	$495,000
2007	615,000
2008	740,000
2009	885,000
Thereafter	57,355,000
	$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. 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 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, 2005.

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 foundation's Consolidated Statement of Financial Position 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, 2005, was $4,214,287.90.

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 foundation's Consolidated Statement of Financial Position 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, 2005, was $9,907,331.06.

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2005, are as follows:

	Natural Classification					
Functional Classification	Salaries	Benefits	Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Depreciation	Total
Grants and scholarships	$ -	$ -	$ -	$1,036,036.68	$ -	$1,036,036.68
General and administrative	64,063.53	10,844.78	479,525.57	94,515.20	-	648,949.08
Student housing	-	-	3,468,805.66	-	1,388,945.32	4,857,750.98
Total expenses	$64,063.53	$10,844.78	$3,948,331.23	$1,130,551.88	$1,388,945.32	$6,542,736.74

NOTE 21. PRIOR-YEAR ADJUSTMENT

As of June 30, 2004, the university overstated its pledges receivable by $59,326,699.02. The university incorrectly reported pledges which were based on wills, life insurance policies, and retirement benefits. These amounts should not have been recognized as the possibility exists that the university may not remain the primary beneficiary. As a result, for the year ended June 30, 2005, beginning net assets have been decreased by $59,326,699.02.

As of June 30, 2004, the university understated its accumulated depreciation by $22,769,948.31. In the 2004 fiscal year, the university reassessed the estimated useful lives of certain buildings based on componentization studies (a change in accounting estimate). The university failed to record $22,769,948.31 of accumulated depreciation at June 30, 2004, as indicated by these studies. As a result, for the year ended June 30, 2005, beginning net assets have been decreased by $22,769,948.31.