AUDIT REPORT

Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office

For the Years Ended
June 30, 2005, and June 30, 2004

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Arthur A. Hayes, Jr., CPA, JD, CFE
Director

Charles K. Bridges, CPA
Assistant Director

Shirley A. Henry, CPA
Audit Manager

Michelle Earhart, CPA
In-Charge Auditor

Deborah Jenkins
Allan N. Leslie
Staff Auditors

Gerry Boaz, CPA
Technical Analyst

Amy Brack
Editor

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 401-7897

Financial/compliance audits of colleges and universities are available on-line at www.comptroller.state.tn.us/sa/reports/index.html.
For more information about the Comptroller of the Treasury, please visit our website at www.comptroller.state.tn.us.

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

John G. Morgan
Comptroller

July 11, 2006

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Charles W. Manning, Chancellor
Tennessee Board of Regents
1415 Murfreesboro Road, Suite 350
Nashville, Tennessee 37217

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the State University and Community College System of Tennessee – Central Office for the years ended June 30, 2005, and June 30, 2004. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

John G. Morgan

John G. Morgan
Comptroller of the Treasury

JGM/sah
06/055

State of Tennessee

Audit Highlights

Comptroller of the Treasury		Division of State Audit

Financial and Compliance Audit

State University and Community College
System of Tennessee – Central Office

For the Years Ended June 30, 2005, and June 30, 2004

AUDIT OBJECTIVES

The objectives of the audit were to consider the Central Office'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.

AUDIT FINDINGS

The audit report contains no findings.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

Audit Report
Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
For the Years Ended June 30, 2005, and June 30, 2004

TABLE OF CONTENTS

TABLE OF CONTENTS (CONT.)

Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
For the Years Ended June 30, 2005, and June 30, 2004

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the State University and Community College System of Tennessee – Central Office. 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 State University and Community College System of Tennessee was created by the General Assembly in 1972. The system now includes 6 universities, 13 community colleges, and 26 technology centers. The Tennessee Board of Regents is vested with the responsibility of governing the system. The Central Office provides essential centralized services and uniform procedures for the institutions in the system. Among the Central Office's major responsibilities are prescribing curricula and requirements for diplomas, approving operating and capital budgets, and establishing policies and procedures regarding campus life.

ORGANIZATION

The governance of the State University and Community College System of Tennessee – Central Office is vested in the Tennessee Board of Regents. The Governor, the Commissioner of Education, the Commissioner of Agriculture, and the Director of the Tennessee Higher Education Commission serve *ex officio* on this board. The chief administrative officer of the system is the chancellor.

AUDIT SCOPE

The audit was limited to the period July 1, 2003, 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 years ended June 30, 2005, and June 30, 2004. The State University and Community College System of Tennessee – Central Office is a part of the Tennessee Board of Regents, which is an integral part of state government. As such, the Tennessee Board of Regents 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 Central Office's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

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 Central Office. 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 Central Office 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 Central Office.

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 Central Office. 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 Central Office's financial statements for the years ended June 30, 2005, and June 30, 2004, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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*.

Fairness of Financial Statement Presentation

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

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 401-7897
FAX (615) 532-2765

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*

April 21, 2006

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 State University and Community College System of Tennessee – Central Office, a part of the Tennessee Board of Regents, which is a component unit of the State of Tennessee, as of and for the years ended June 30, 2005, and June 30, 2004, and have issued our report thereon dated April 21, 2006. 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 Central Office implemented GASB Statement 40, *Deposit and Investment Risk Disclosures*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Central Office's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide 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 over financial reporting 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.

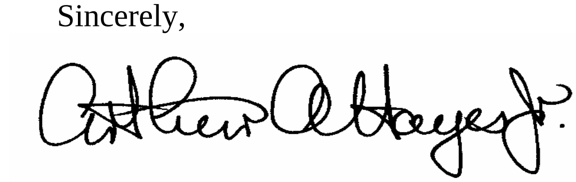
However, we noted certain matters involving the internal control over financial reporting, which we have reported to the Central Office's management in a separate letter.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Central Office's financial statements are free of material misstatement, we performed tests of the Central Office'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*.

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

Sincerely,



Arthur A. Hayes, Jr., CPA
Director

AAH/sah

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 401-7897
FAX (615) 532-2765

Independent Auditor's Report

April 21, 2006

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 State University and Community College System of Tennessee – Central Office, a part of the Tennessee Board of Regents, which is a component unit of the State of Tennessee, as of and for the years ended June 30, 2005, and June 30, 2004, as listed in the table of contents. These financial statements are the responsibility of the Central Office's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

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 provides a reasonable basis for our opinion. 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 of 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, the financial statements referred to above present fairly, in all material respects, the financial position of the State University and Community College System of Tennessee – Central Office, as of June 30, 2005, and June 30, 2004, and the changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

During the year ended June 30, 2005, the Central Office implemented GASB Statement 40, *Deposit and Investment Risk Disclosures.*

The management's discussion and analysis on pages 9 through 17 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 April 21, 2006, on our consideration of the Central Office'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/sah

Tennessee Board of Regents - Central Office
Management's Discussion and Analysis

This section of the Central Office's report presents a discussion and analysis of the financial performance of the Central Office during the fiscal years ended June 30, 2005, and June 30, 2004, with comparative information presented for the fiscal year ended June 30, 2003. This discussion has been prepared by management along with the financial statements and related note disclosures and should be read in conjunction with the financial statements and notes. The financial statements, notes, and this discussion are the responsibility of management.

Using This 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 Central Office as a whole and present a long-term view of the Central Office's finances.

The Statement of Net Assets

The Statement of Net Assets presents the financial position of the Central Office at the end of the fiscal year and includes all assets and liabilities of the Central Office. The difference between total assets and total liabilities—net assets—is an indicator of the current financial condition of the Central Office. Assets and liabilities are generally measured using current values. One notable exception is capital assets, which are stated at historical cost less an allowance for depreciation.

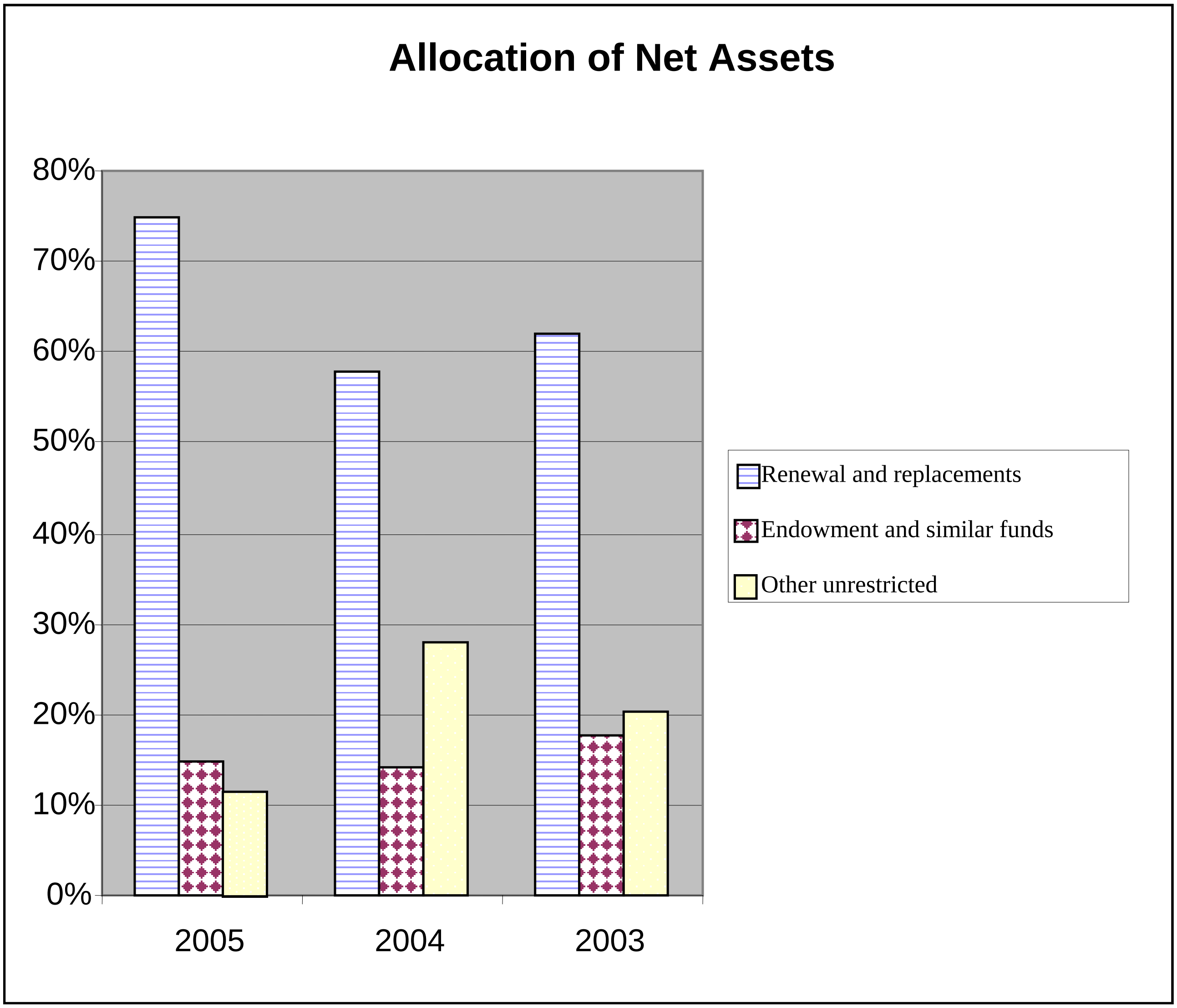
Net assets are divided into three major categories. The first category, invested in capital assets, provides the Central Office's equity in property, plant, and equipment owned by the Central Office. The next asset category is restricted net assets, which is divided into two categories, nonexpendable and expendable. The corpus of nonexpendable restricted resources is only available for investment purposes. Expendable restricted net assets are available for expenditure by the Central Office 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 Central Office for any lawful purpose of the Central Office.

Central Office
Statement of Net Assets (in thousands of dollars)

	2005	2004	2003
Assets:			
Current assets	3,349	4,211	3,758
Capital assets, net	457	243	259
Other assets	5,315	3,943	3,568
Total assets	**9,121**	**8,397**	**7,585**
Liabilities:			
Current liabilities	3,021	3,378	2,945
Noncurrent liabilities	556	532	530
Total liabilities	**3,577**	**3,910**	**3,475**
Net assets:			
Invested in capital assets	457	243	259
Restricted - nonexpendable	474	474	474
Restricted - expendable	1,290	326	576
Unrestricted	3,323	3,444	2,801
Total net assets	**5,544**	**4,487**	**4,110**

- Current assets decreased and other assets increased from 2004 to 2005 because of transfers of funds from unrestricted current funds to noncurrent renewals and replacements.
- The increase in capital assets from 2004 to 2005 resulted from equipment and automobile purchases during 2005.
- Restricted expendable net assets increased from 2004 to 2005 for unspent consent decree program funds carried from 2004 to 2005.
- Unrestricted net assets increased from 2003 to 2004 because of an increase in funds held for renewals and replacement of computer equipment.
- For 2004, current assets increased 12% over 2003 due to an increase in accounts and grants receivable. Grants receivable for the Tech Prep program increased ~$101,000 and for the TSBDC-ECD grants ~$120,000.
- Current liabilities increased 15% from 2003 to 2004 due to an increase in accounts payable for the Geier Consent decree program in restricted current funds.

Many of the Central Office's unrestricted net assets have been designated or reserved for specific purposes such as repairs and replacement of equipment and quasi-endowments. The following graph shows the allocations:



- Other unrestricted net assets increased from 20% to 28% from 2003 to 2004 as funds were accumulated to cover the compensated absences liability.
- Other unrestricted net assets decreased from 28% to 11% from 2004 to 2005 because more funds were transferred to renewals and replacements for computer equipment, Regents Online Degree Program (RODP) equipment, and automobiles.

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

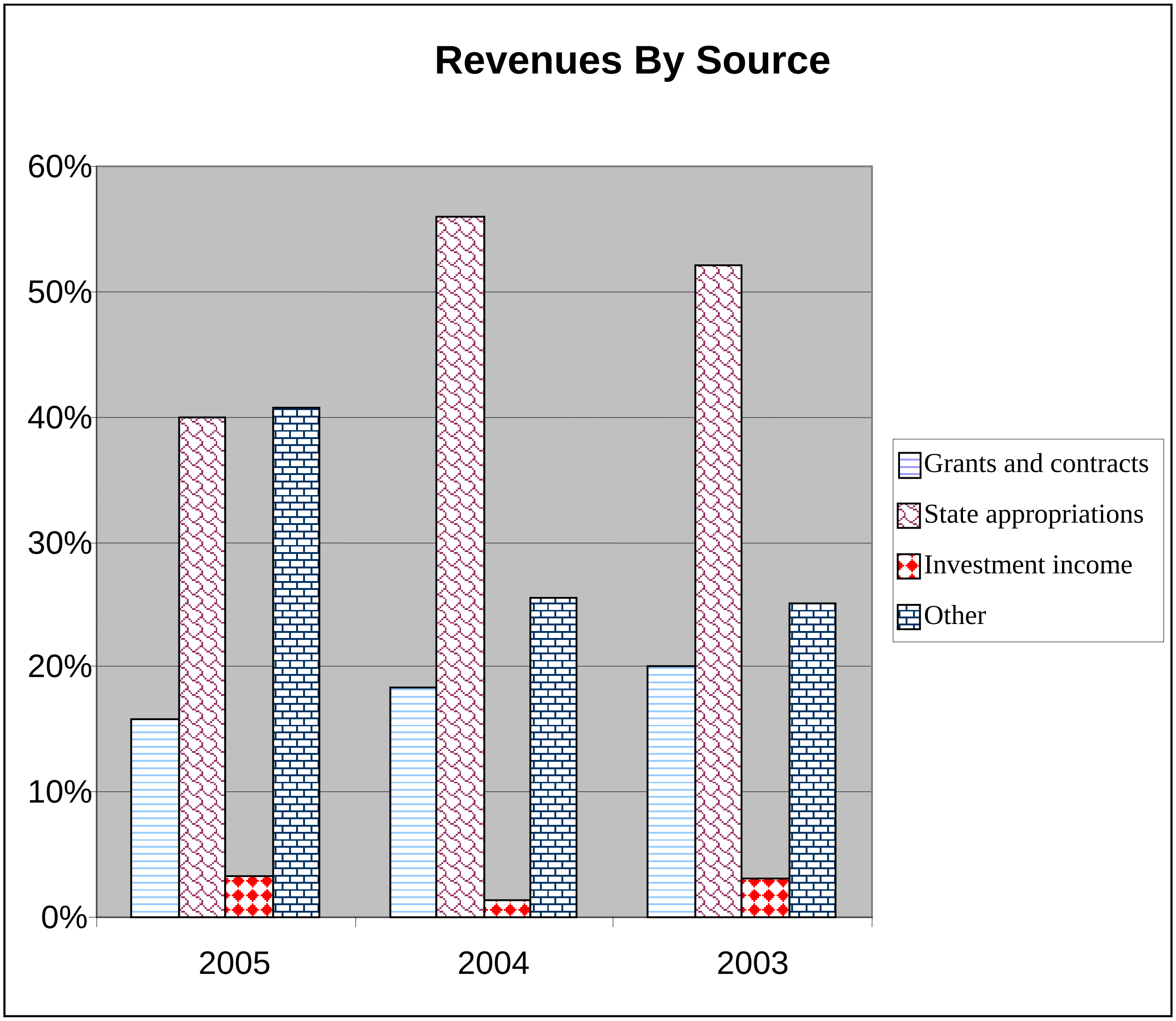
The Statement of Revenues, Expenses, and Changes in Net Assets presents the operating results of the Central Office, as well as the nonoperating revenues and expenses. Annual state appropriations, while budgeted for operations, are considered nonoperating revenues according to accounting principles generally accepted in the United States of America**.**

Central Office
Statement of Revenues, Expenses, and Changes in Net Assets (in thousands of dollars)

	2005	2004	2003
Operating revenues:			
Grants and contracts	2,825	2,689	2,950
Gifts and contributions	10	-	-
Other	7,239	3,874	3,655
Total operating revenues	**10,074**	**6,563**	**6,605**
Operating expenses	16,720	14,942	13,603
Operating loss	**(6,646)**	**(8,379)**	**(6,998)**
Nonoperating revenues and expenses:			
State appropriations	7,113	8,512	7,520
Investment income	590	244	374
Other nonoperating revenues (expenses)	-	-	(211)
Total nonoperating revenues and expenses	**7,703**	**8,756**	**7,683**
Increase in net assets	**1,057**	**377**	**685**
Net assets at beginning of year	**4,487**	**4,110**	**3,425**
Net assets at end of year	**5,544**	**4,487**	**4,110**

<u>Revenues</u>

The following is a graphic illustration of revenues by source (both operating and nonoperating), which were used to fund the Central Office's operating activities for the years ended June 30, 2005; June 30, 2004; and June 30, 2003.



- Other revenues increased from 2004 to 2005 because of increased revenues for the Regents Online Degree Program which were recorded in unrestricted current funds in 2005 (previously recorded in agency funds).
- State appropriations decreased for the Geier Consent Decree program for 2005 and 2004.
- Investment income increased for 2005 due to a rise in interest rates and the timing of revenues and expenses.

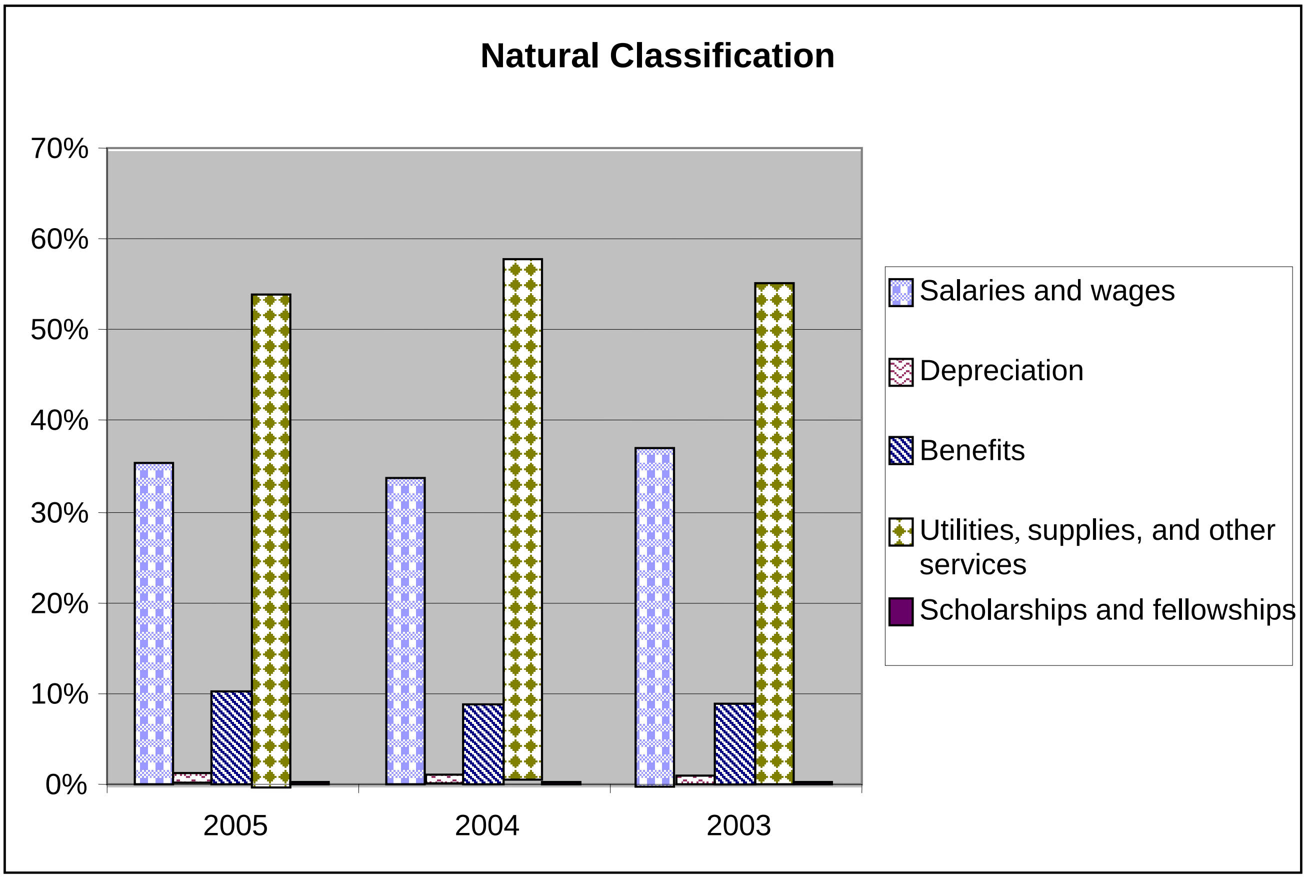
Expenses

Operating expenses can be displayed in two formats, natural classification and program classification. Both formats are displayed below.

Natural Classification

Operating Expenses (in thousands of dollars)

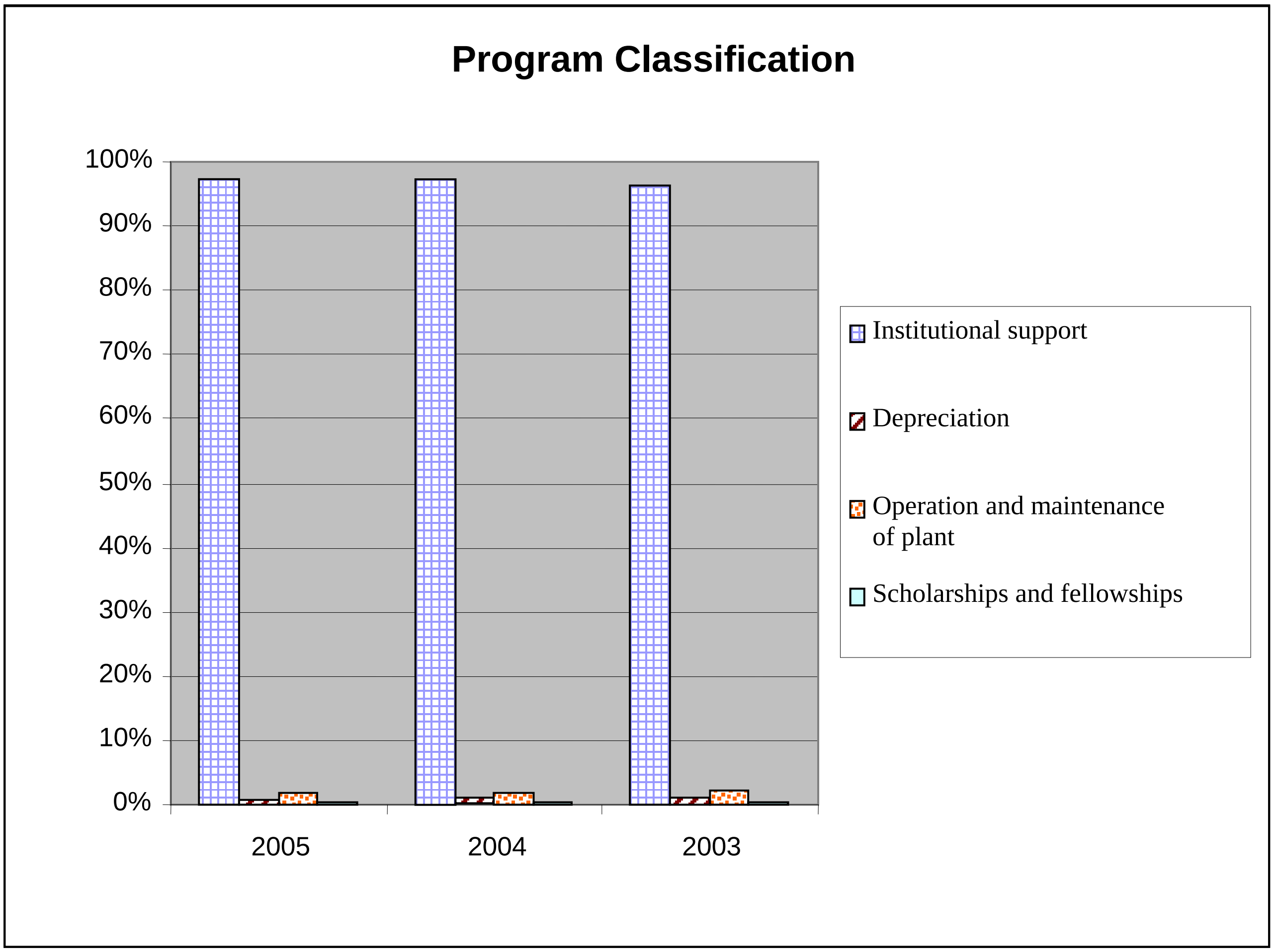
	2005	**2004**	**2003**
Salaries and wages	6,073	5,022	5,056
Benefits	1,666	1,318	1,279
Utilities, supplies, and other services	8,815	8,420	7,070
Scholarships and fellowships	44	48	37
Depreciation	122	134	161
Total operating expenses	**16,720**	**14,942**	**13,603**



Program Classification

Operating Expenses (in thousands of dollars)

	2005	2004	2003
Institutional support	16,248	14,466	13,111
Operation of maintenance and plant	306	294	294
Scholarships and fellowships	44	48	37
Depreciation	122	134	161
Total operating expenses	**16,720**	**14,942**	**13,603**



Increases in operating expenses from 2004 to 2005 resulted from RODP being recorded in unrestricted current funds in 2005 (previously in agency funds). Increases in operating expenses from 2003 to 2004 resulted from an increase in Geier Consent Decree funds recorded as grants to TBR Institutions.

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 Central Office's ability to generate net cash flows, its ability to meet its obligations as they come due, and its need for external financing.

Central Office
Statement of Cash Flows (in thousands of dollars)

	2005	2004	2003
Cash provided (used) by:			
Operating activities	(6,542)	(7,906)	(5,948)
Noncapital financing activities	6,701	8,361	7,180
Capital and related financing activities	(354)	(43)	(44)
Investing activities	590	244	374
Net increase in cash	**395**	**656**	**1,562**
Cash, beginning of year	**7,556**	**6,900**	**5,338**
Cash, end of year	**7,951**	**7,556**	**6,900**

- The net decrease in cash used by operations from 2004 to 2005 resulted from increased revenue from the RODP.
- Cash provided by noncapital financing activities decreased from 2004 to 2005 because of a decrease in state appropriations for the Geier Consent Decree program and a lesser increase in deposits held in custody for others.
- Cash used by capital and related financing activities increased from 2004 to 2005 for computer equipment and automobile purchases.
- Cash provided by investing activities increased from 2004 to 2005 due to an increase in interest rates.
- Cash used by operating activities increased from 2003 to 2004 because of increased employee benefit costs and increased payments to vendors.
- From 2003 to 2004, a significant increase in cash provided by noncapital financing activities included state appropriations for desegregation funding under the Geier Consent Decree.
- Cash provided by investing activities decreased in 2004 over 2003 as a result of lower interest earnings.
- The Central Office's liquidity improved during 2005 and 2004.

Capital Assets

At June 30, 2005, the Central Office had $456,898.03 invested in capital assets, net of accumulated depreciation of $647,341.87. At June 30, 2004, the Central Office had $242,728.31 invested in capital assets, net of accumulated depreciation of $635,116.11. At June 30, 2003, the Central Office had $259,260.79 invested in capital assets, net of accumulated depreciation of $732,557.12. Depreciation charges totaled $121,944.51 for the current fiscal year; $134,047.42 for the year ended June 30, 2004; and $160,645.62 for the year ended June 30, 2003. Details of these assets are shown below.

Central Office

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

	2005	2004	2003
Equipment	457	243	259

- Equipment increased in 2005 due to computer equipment and automobile purchases.
- There were no major capital additions during 2004.

More detailed information about the Central Office's capital assets is presented in Note 5 to the financial statements.

Economic Factors That Will Affect the Future

We are not aware of economic factors that are expected to have a significant impact on the financial position or results of operations in the future. Economic factors will continue to affect investment income earnings.

Requests for Information

This financial report is designed to provide a general overview of the Central Office's finances for all those with an interest in the Central Office's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be directed to Dr. Robert H. Adams, Vice Chancellor for Business and Finance, Tennessee Board of Regents, 1415 Murfreesboro Road, Suite 350, Nashville, Tennessee 37217.

TENNESSEE BOARD OF REGENTS
STATE UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF TENNESSEE - CENTRAL OFFICE
STATEMENTS OF NET ASSETS
JUNE 30, 2005, AND JUNE 30, 2004

	June 30, 2005	June 30, 2004
ASSETS		
Current assets:		
Cash (Notes 2 and 3)	$ 2,635,337.75	$ 3,612,091.28
Accounts and grants receivable (net) (Note 4)	713,395.67	598,325.06
Prepaid expenses and deferred charges	92.10	172.33
Other assets	175.00	175.00
Total current assets	3,349,000.52	4,210,763.67
Noncurrent assets:		
Cash (Notes 2 and 3)	5,315,322.00	3,943,450.76
Capital assets (net) (Note 5)	456,898.03	242,728.31
Total noncurrent assets	5,772,220.03	4,186,179.07
Total assets	9,121,220.55	8,396,942.74
LIABILITIES		
Current liabilities:		
Accounts payable	1,755,482.72	1,750,495.84
Accrued liabilities	69,393.38	108,866.68
Deferred revenue	875.00	875.00
Compensated absences (Note 6)	185,460.77	177,403.62
Deposits held in custody for others	1,009,778.59	1,340,043.40
Total current liabilities	3,020,990.46	3,377,684.54
Noncurrent liabilities:		
Compensated absences (Note 6)	556,382.32	532,210.86
Total noncurrent liabilities	556,382.32	532,210.86
Total liabilities	3,577,372.78	3,909,895.40
NET ASSETS		
Invested in capital assets	456,898.03	242,728.31
Restricted for:		
Nonexpendable:		
Scholarships and fellowships	474,295.88	474,295.88
Expendable:		
Scholarships and fellowships	9,578.01	7,546.15
Other	1,280,687.79	318,182.34
Unrestricted (Notes 7 and 8)	3,322,388.06	3,444,294.66
Total net assets	$ 5,543,847.77	$ 4,487,047.34

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

Exhibit B

TENNESSEE BOARD OF REGENTS
STATE UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF TENNNESSEE - CENTRAL OFFICE
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2005, AND JUNE 30, 2004

	Year Ended June 30, 2005	Year Ended June 30, 2004
REVENUES		
Operating revenues:		
Gifts and contributions	$ 10,000.00	$ -
Governmental grants and contracts	2,824,637.94	2,688,379.36
Other operating revenues	7,239,565.13	3,874,303.88
Total operating revenues	10,074,203.07	6,562,683.24
EXPENSES		
Operating expenses (Note 13):		
Salaries and wages	6,073,143.86	5,022,170.07
Benefits	1,665,880.11	1,317,575.29
Utilities, supplies, and other services	8,815,301.85	8,419,689.43
Scholarships and fellowships	44,405.50	48,389.50
Depreciation expense	121,944.51	134,047.42
Total operating expenses	16,720,675.83	14,941,871.71
Operating loss	(6,646,472.76)	(8,379,188.47)
NONOPERATING REVENUES (EXPENSES)		
State appropriations	7,113,483.84	8,512,107.00
Investment income	589,789.35	243,952.90
Net nonoperating revenues	7,703,273.19	8,756,059.90
Increase in net assets	1,056,800.43	376,871.43
NET ASSETS		
Net assets - beginning of year	4,487,047.34	4,110,175.91
Net assets - end of year	$ 5,543,847.77	$ 4,487,047.34

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

Exhibit C

TENNESSEE BOARD OF REGENTS
STATE UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF TENNESSEE - CENTRAL OFFICE
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2005, AND JUNE 30, 2004

	Year Ended June 30, 2005	Year Ended June 30, 2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Gifts and contributions	$ 10,000.00	$ -
Grants and contracts	2,736,063.85	2,523,711.64
Payments to suppliers and vendors	(8,728,274.81)	(7,892,851.04)
Payments to employees	(6,056,199.90)	(4,989,150.34)
Payments for benefits	(1,690,068.76)	(1,285,778.56)
Payments for scholarships and fellowships	(44,405.50)	(48,389.50)
Other receipts (payments)	7,231,221.97	3,786,293.51
Net cash used by operating activities	(6,541,663.15)	(7,906,164.29)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations	7,120,683.84	8,505,907.00
Other noncapital financing receipts (payments)	(419,300.41)	(144,827.90)
Net cash provided by noncapital financing activities	6,701,383.43	8,361,079.10
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchases of capital assets	(354,391.92)	(42,908.00)
Net cash used by capital and related financing activities	(354,391.92)	(42,908.00)
CASH FLOWS FROM INVESTING ACTIVITIES		
Income on investments	589,789.35	243,952.90
Net cash provided by investing activities	589,789.35	243,952.90
Net increase in cash	395,117.71	655,959.71
Cash - beginning of year	7,555,542.04	6,899,582.33
Cash - end of year	$ 7,950,659.75	$ 7,555,542.04
Reconciliation of operating loss to net cash used by operating activities:		
Operating loss	$ (6,646,472.76)	$ (8,379,188.47)
Adjustments to reconcile operating loss to net cash used by operating activities:		
Depreciation expense	121,944.51	134,047.42
Other adjustments	(378,786.15)	13,403.43
Change in assets and liabilities:		
Receivables, net	(88,149.80)	(107,136.46)
Prepaid/deferred items	80.23	4,078.84
Accounts payable	465,308.67	511,200.04
Accrued liabilities	(39,473.30)	26,513.57
Deferred revenue	-	(59,375.18)
Compensated absences	32,228.61	38,302.89
Other	(8,343.16)	(88,010.37)
Net cash used by operating activities	$ (6,541,663.15)	$ (7,906,164.29)

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

Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
Notes to the Financial Statements
June 30, 2005, and June 30, 2004

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Central Office is a part of the State University and Community College System of Tennessee (Tennessee Board of Regents). This system is a component unit of the State of Tennessee because the state appoints a majority of the system's governing body and provides financial support; the system is discretely presented in the *Tennessee Comprehensive Annual Financial Report*.

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 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This was followed in November 1999 by GASB Statement 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities,* and in May 2002 by GASB Statement 39, *Determining Whether Certain Organizations Are Component Units*. The financial statement presentation required by those statements provides a comprehensive, entity-wide perspective of the Central Office's assets, liabilities, net assets, revenues, expenses, changes in net assets, and cash flows.

Basis of Accounting

For financial statement purposes, the Central Office 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. The Central Office has the option of following private-sector guidance issued subsequent to November 30, 1989, subject to the above limitation. The Central

Office has elected not to follow private-sector guidance issued subsequent to November 30, 1989.

Amounts reported as operating revenues include federal, state, local, and private grants and contracts and other sources of revenue. Operating expenses for the Central Office include (1) salaries and wages; (2) employee benefits; (3) depreciation; and (4) supplies and other services.

All other activity is nonoperating in nature and includes state appropriations for operations and investment income.

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

Compensated Absences

The Central Office's employees accrue annual leave at varying rates, depending on length of service or classification. Some employees also earn compensatory time. The amount of these liabilities and their related benefits are reported in the statement of net assets.

Capital Assets

Capital assets, which include equipment, 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 asset's useful life are not capitalized.

Equipment is capitalized when the unit acquisition cost is $5,000 or greater. Equipment is depreciated using the straight-line method over the estimated useful lives, which range from 5 to 10 years.

Net Assets

The Central Office's net assets are classified as follows:

Invested in capital assets - This represents the Central Office's total investment in capital assets.

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.

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

Unrestricted net assets - Unrestricted net assets represent resources derived from state appropriations, investment income, and other revenue sources. These resources are used for transactions relating to the general operations of the Central Office, and may be used at the discretion of the Central Office to meet current expenses for any purpose.

NOTE 2. CASH

This classification includes demand deposits and petty cash on hand. At June 30, 2005, cash consisted of $670,396.97 in bank accounts, $100.00 of petty cash on hand, and $7,280,162.78 in the State of Tennessee Local Government Investment Pool administered by the State Treasurer. At June 30, 2004, cash consisted of $1,364,334.77 in bank accounts, $100.00 of petty cash on hand, and $6,191,107.27 in the State of Tennessee Local Government Investment Pool administered by the State Treasurer.

NOTE 3. DEPOSITS

During the year ended June 30, 2005, the Central Office implemented GASB Statement 40, *Deposit and Investment Risk Disclosures*. That statement modified the custodial credit risk disclosures of GASB Statement 3 to limit required disclosures to deposits that are not covered by depository insurance and are (a) uncollateralized, (b) collateralized with securities held by the pledging financial institution, or (c) collateralized with securities held by the pledging financial institution’s trust department or agent but not in the university’s name.

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

At June 30, 2005, the carrying amount of the Central Office's deposits was $670,396.97, and the bank balance was $831,589.66. The bank balance was insured. At June 30, 2004, the carrying amount of the Central Office's deposits was $1,364,334.77, and the bank balance was $1,557,520.28. The bank balance was insured.

The laws of the State of Tennessee require that collateral be pledged to secure all uninsured deposits. Tennessee Board of Regents policies require that the market value of collateral pledged equal 115%, 100%, or 90% of the uninsured deposits at financial institutions participating in the collateral pool. The pledge level is based on financial criteria set by the Collateral Pool Board with the financially strongest institutions being eligible for the lowest pledge level.

The Central Office also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. The LGIP is part of the Pooled Investment Fund. The fund's required risks disclosures 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, Tennessee 37243-0298, or by calling (615) 741-2140.

NOTE 4. RECEIVABLES

Receivables included the following:

	June 30, 2005	June 30, 2004
Grants and contracts receivable	$588,004.53	$499,430.44
State appropriation receivable	12,800.00	20,000.00

Other receivables	112,591.14	78,894.62
Total receivables	$713,395.67	$598,325.06

NOTE 5. CAPITAL ASSETS

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

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Equipment	$877,844.42	$362,735.08	$ -	$136,339.60	$1,104,239.90
Less accum. depreciation	635,116.11	121,944.51	-	109,718.75	647,341.87
Capital assets, net	$242,728.31	$240,790.57	$ -	$ 26,620.85	$ 456,898.03

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

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Equipment	$991,817.91	$130,918.37	$ -	$244,891.86	$877,844.42
Less accum. depreciation	732,557.12	134,047.42	-	231,488.43	635,116.11
Capital assets, net	$259,260.79	$ (3,129.05)	$ -	$ 13,403.43	$242,728.31

NOTE 6. LONG-TERM LIABILITIES

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

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Compensated absences	$709,614.48	$491,739.77	$459,511.16	$741,843.09	$185,460.77

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

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Compensated absences	$671,311.59	$439,645.36	$401,342.47	$709,614.48	$177,403.62

NOTE 7. ENDOWMENTS

If a donor has not provided specific instructions to the Central Office, state law permits the office to authorize for expenditure the earnings of the investments of endowment funds. When administering its power to spend these earnings, the Central Office is required to consider the office's long-term and short-term needs, present and anticipated financial requirements, expected return on its investments, price-level trends, and general economic conditions. Any earnings spent are required to be spent for the purposes for which the endowment was established.

The Central Office chooses to spend only a portion of the investment income each year. Under the spending plan established by the board, expenditures are limited to the one new four-year scholarship awarded each year and funding three previously awarded scholarships. Allowable scholarship expenditures are limited to the following: the cost of in-state tuition and fees, room and board (or a commuting allowance), a stipend of $500 per year, and a $500 annual book allowance. The remaining amount of investment income, if any, is retained for use in future years. At June 30, 2005, investment income of $70,902.48 is available to be spent. At June 30, 2004, investment income of $85,468.88 is available to be spent. These amounts are included in unrestricted net assets.

NOTE 8. UNRESTRICTED NET ASSETS

Unrestricted net assets include funds that have been designated or reserved for specific purposes. The unrestricted net assets are composed of the following:

	June 30, 2005	June 30, 2004
Working capital	$ 32,944.90	$ 23,641.54

Encumbrances	54,939.24	6,786.73
Quasi-endowment	491,179.20	491,179.20
Renewal and replacement of equipment	2,484,696.11	1,992,648.23
Unreserved/undesignated	258,628.61	930,038.96
Total	$3,322,388.06	$3,444,294.66

NOTE 9. PENSION PLANS

A. Defined Benefit Plan

Tennessee Consolidated Retirement System

Plan Description - The Central Office contributes to the State Employees, Teachers, and Higher Education Employees Pension Plan (SETHEEPP), a cost-sharing, multiple-employer, defined benefit pension plan administered by the Tennessee Consolidated Retirement System (TCRS). TCRS provides retirement, death, and disability benefits as well as annual cost-of-living adjustments to plan members and their beneficiaries. Title 8, Chapters 34-37, *Tennessee Code Annotated*, establishes benefit provisions. State statutes are amended by the Tennessee General Assembly.

The TCRS issues a publicly available financial report that includes financial statements and required supplementary information for SETHEEPP. That report may be obtained by writing to the Tennessee Department of the Treasury, Consolidated Retirement System, 10th Floor Andrew Jackson Building, Nashville, Tennessee 37243-0230, or by calling (615) 741-8202.

Funding Policy - Plan members are noncontributory. The Central Office is required to contribute an actuarially determined rate. The current rate is 10.54% of annual covered payroll. Contribution requirements for the Central Office are established and may be amended by the TCRS' Board of Trustees. The Central Office's contributions to TCRS for the years ended June 30, 2005, 2004, and 2003, were $406,549.58, $253,605.46, and $264,344.78. Contributions met the requirements for each year.

B. Defined Contribution Plans

Optional Retirement Plans (ORP)

Plan Description - The Central Office 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 the 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.

Funding Policy - Plan members are noncontributory. The Central Office contributes an amount equal to 10% of the employee's base salary up to 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 Central Office to the plans was $207,212.09 for the year ended June 30, 2005, and $191,738.66 for the year ended June 30, 2004. Contributions met the requirements for each year.

NOTE 10. OTHER POST-EMPLOYMENT BENEFITS

The State of Tennessee administers a group health insurance program which provides post-employment health insurance benefits to eligible Central Office retirees. This benefit is provided and administered by the State of Tennessee. The Central Office 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, 14th Floor William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, Tennessee 37243-0298, or by calling (615) 741-2140.

NOTE 11. 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 damage 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 Central Office participates in the Risk Management Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the Central Office based on a percentage of the Central Office'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, Tennessee 37243-0298, or by calling (615) 741-2140. Since the Central Office 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 Central Office 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, 2004, the Risk Management Fund held $101.1 million in cash and cash equivalents designated for payment of claims.

At June 30, 2005, the scheduled coverage for the Central Office was $2,000,000 for contents. At June 30, 2004, the scheduled coverage for the Central Office was $2,000,000 for contents.

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 Central Office 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 Central Office 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 12. COMMITMENTS AND CONTINGENCIES

Sick Leave - The Central Office 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 because of illness, injury, or related family death, there is no liability for sick leave at June 30. The dollar amount of unused sick leave was $2,509,637.96 at June 30, 2005, and $2,523,499.62 at June 30, 2004.

Operating Leases - The Central Office has entered into various operating leases for office and storage space. Such leases will probably continue to be required. Expenses under operating leases were $426,764.72 for the year ended June 30, 2005, and $408,987.47 for the year ended June 30, 2004. All operating leases are cancelable at the lessee's option.

Litigation - The Central Office is involved in one lawsuit, which is not expected to have a material effect on the accompanying financial statements.

NOTE 13. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATIONS

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

Functional Classification	Salaries	Benefits	Natural Classification Other Operating	Scholarships	Depreciation	Total
Institutional support	$6,073,143.86	$1,665,880.11	$8,509,258.68	$ -	$ -	$16,248,282.65
Operation & maintenance	-	-	306,043.17	-	-	306,043.17
Scholar. & fellow.	-	-	-	44,405.50	-	44,405.50
Depreciation	-	-	-	-	121,944.51	121,944.51
Total	$6,073,143.86	$1,665,880.11	$8,815,301.85	$44,405.50	$121,944.51	$16,720,675.83

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

Functional Classification	Salaries	Benefits	Natural Classification Other Operating	Scholarships	Depreciation	Total
Institutional support	$5,022,170.07	$1,317,575.29	$8,125,358.47	$ -	$ -	$14,465,103.83
Operation & maintenance	-	-	294,330.96	-	-	294,330.96
Scholar. & fellow.	-	-	-	48,389.50	-	48,389.50
Depreciation	-	-	-	-	134,047.42	134,047.42
Total	$5,022,170.07	$1,317,575.29	$8,419,689.43	$48,389.50	$134,047.42	$14,941,871.71