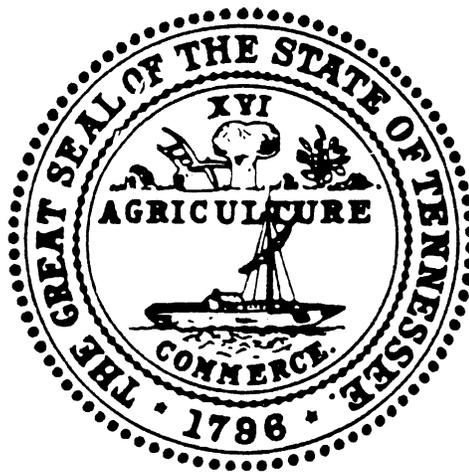


AUDIT REPORT

The University of Tennessee

For the Year Ended
June 30, 2007



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
(615) 741-2501

John G. Morgan
Comptroller

February 5, 2008

The Honorable Phil Bredesen, Governor
and

Members of the General Assembly
State Capitol
Nashville, Tennessee 37243

and

The Honorable James L. Murphy, III, Chairman
Audit Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180

and

Dr. John D. 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, 2007. 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
07/096

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, 2007

AUDIT OBJECTIVES

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

INTERNAL CONTROL FINDINGS

The Previous University of Tennessee Health Science Center Officials Failed to Properly Recognize and Account for Approximately \$9 Million in Overhead Fees Due From the UT Medical Group Over a Seven-Year Period, Resulting in a Failure to Comply With Statutory Requirements for Writing Off Uncollectible Receivables

From 2000 through 2005, previous University of Tennessee Health Science Center management allowed the UT Medical Group, a contractor, to retain funds which were due to the College of Medicine. Such actions were inconsistent with the terms of the affiliation agreement between the university and UT Medical Group, and resulted in university management's failure to recognize and record receivables from UT

Medical Group in the university's financial statements and management's failure to comply with statutory requirements for writing off uncollectible receivables (page 13).

The University Failed to Provide Adequate Access Controls and Program Change Management Over the Banner Computer Systems at Martin, Which Increased the Risk of Fraud or Error

At the University of Tennessee at Martin, management of the university's Information Technology Services (ITS) group did not provide for adequate internal controls over access to its Banner computer system and has not established and implemented effective policies and procedures over program changes to the Banner system (page 18).

COMPLIANCE FINDING

The Management and Staff of the University of Tennessee Health Science Center Did Not Understand How to Calculate Students' Financial Aid When Non-federal Resources Were Available to Students, Resulting in Numerous Overawards and Federal Questioned Costs Totaling \$120,419

The financial aid staff at the University of Tennessee's Health Science Center (UTHSC) at Memphis did not make themselves aware of critical federal requirements related to their responsibility to properly coordinate student aid programs and establish controls to preclude the awarding of assistance in excess of students' financial needs. As a result, the financial aid staff did not correctly calculate students' financial aid need and made overawards to students totaling \$120,419 (page 9).

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, 2007

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**The University of Tennessee
For the Year Ended June 30, 2007**

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 Science 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, 2006, through June 30, 2007, 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, 2007. 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 FINDING

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 11, 2007. A follow-up of a prior audit finding was conducted as part of the current audit.

RESOLVED AUDIT FINDING

The current audit disclosed that the university has corrected a previous audit finding concerning the failure to properly report student status changes at the Health Science Center in Memphis.

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, 2007, 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. Significant deficiencies, along with recommendations and management's responses, are detailed in the findings and recommendations section. 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*. An immaterial instance of noncompliance, along with our recommendation and management's response, is 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.



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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***

December 7, 2007

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 discretely presented component units as of and for the year ended June 30, 2007, and have issued our report thereon dated December 7, 2007. Our report was modified to include a reference to 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the university's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be significant deficiencies. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect

misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

The following significant deficiencies were noted:

- The previous University of Tennessee Health Science Center officials failed to properly recognize and account for approximately \$9 million in overhead fees due from the UT Medical Group over a seven-year period, resulting in a failure to comply with statutory requirements for writing off uncollectible receivables.
- The university failed to provide adequate access controls and program change management over the Banner computer systems at Martin, which increased the risk of fraud or error.

These conditions are described in the Findings and Recommendations section of this report.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. As discussed above, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies. However, we believe none of the significant deficiencies described above is a material weakness.

We also 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

The Honorable John G. Morgan
December 7, 2007
Page Three

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 an immaterial instance 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 dated December 21, 2007.

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,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." with a stylized, cursive script.

Arthur A. Hayes, Jr., CPA
Director

AAH/sds

FINDINGS AND RECOMMENDATIONS

1. **The management and staff of the University of Tennessee Health Science Center did not understand how to calculate students' financial aid when non-federal resources were available to students, resulting in numerous overawards and federal questioned costs totaling \$120,419**

Finding

The financial aid staff at the University of Tennessee's Health Science Center (UTHSC) at Memphis did not make themselves aware of critical federal requirements related to their responsibility to properly coordinate student aid programs and establish controls to preclude the awarding of assistance in excess of students' financial needs. As a result, the financial aid staff did not correctly calculate students' financial aid need and made overawards to students totaling \$120,419.

According to the *Federal Student Aid Handbook*, Volume 2, Chapter 10, page 169:

A participating school must designate a capable individual to administer the FSA programs and to coordinate aid from these programs with all other aid received by students attending the school. To properly package and most effectively use the various types of student assistance (federal, school, state, private, etc.), the coordinating official must be aware of all aid received by students attending the school, regardless of the source. When creating a student's financial aid package, in order to ensure that a student's aid does not exceed his or her need, an aid administrator must include aid the student is receiving from external sources as well as institutional aid and FSA program assistance. Therefore, a school's operations must be administered in a way that ensures all the information the school receives that might affect a student's FSA eligibility is communicated to the coordinating official and to the financial aid office.

Page 174 further states:

In addition to having a well-organized financial aid office staffed by qualified personnel, a school must ensure that its administrative procedures for the FSA programs include an adequate system of internal checks and balances.

Regarding "specific need" calculation requirements, the *Federal Student Aid Handbook*, Volume 3, Chapter 6, page 101, states:

Except for Pell Grants, Federal Student Aid award amounts are also constrained by the other aid that a student receives, known as resources under the Campus-Based programs or as estimated financial assistance for Stafford/Plus loans. The general rule in [financial aid] packaging is that the student's total financial aid and other resources may not exceed the student's financial need (Need = Cost minus the EFC).

As noted above, except for Pell Grants, total aid of all types (federal and non-federal) awarded to students who receive any federal financial aid may not exceed the students' need, as defined by the U.S. Department of Education. Financial need is simply defined as the difference between a student's cost of attendance and the family's ability to pay these costs, known as the expected family contribution (EFC). The only federal funds that are allowed to replace a student's EFC in calculating need are unsubsidized Stafford and PLUS loans.

During our audit field work, we observed the financial aid office's controls related to the FSA programs. We specifically observed the controls related to:

- segregation of responsibilities for authorizing FSA payments and for disbursing FSA funds;
- system processing of the students' needs calculation; and
- monitoring efforts by supervisory personnel of critical financial aid processes.

Although management had the above mentioned critical controls in place, our interviews with the UTHSC Assistant Financial Aid Director and initial sample testwork revealed that management had not gained a clear understanding of the federal requirement that total need-based financial aid must not exceed the students' need. Instead, management mistakenly thought that any financial aid that was non-federal "need-based" aid could be awarded up to the amount of the students' EFC, and that calculated need imposed a limit only on federal "need-based" aid. As a result of this misinterpretation, management designed, implemented, and utilized controls which allowed awards of financial aid in excess of need. Indeed, we observed that most resources other than federal "need-based" aid were designated in UTHSC's financial aid computer system as appropriate resources to replace the students' EFCs, when financial aid regulations allow only unsubsidized Stafford and/or PLUS loans as replacements for the Expected Family Contribution. In effect, because of a programming logic error made by the financial aid staff, the system was incorrectly calculating and allowing awards in excess of need when a student had received non-federal aid. We tested all students' aid calculations for the year ended June 30, 2007, and found that 35 of 1,809 students received overawards totaling \$120,419. This amount represents federal questioned costs.

In reaction to our testwork results, the Assistant Financial Aid Director met with all financial aid personnel and instructed them in the proper use of EFC substitution and proper calculation of need. In addition, we observed that management had corrected the programming logic in order to correct the control deficiency regarding EFC substitution.

Recommendation

The Assistant Vice Chancellor for Student Affairs for the Health Science Center and other management, including the Vice Chancellor for Academic, Faculty, and Student Affairs for the Health Science Center, should ensure that the financial aid personnel at Memphis have the knowledge and expertise to award federal financial aid in accordance with federal regulations. At a minimum, additional training of current staff should be provided. The Assistant Vice Chancellor for Student Affairs should develop a process for ongoing monitoring of the controls over financial aid need calculations and awards to ensure that overawards are prevented or, at a minimum, identified and corrected before being disbursed to students.

Financial aid personnel at Memphis should continue to review the federal requirements and make any necessary modifications to the system software used to make financial aid awards.

The Assistant Vice Chancellor for Student Affairs should contact the U.S. Department of Education about the possible return of any overawards and the need to perform prior-year reviews to detect similar overawards.

Any audit can only examine a limited part of the operations of an entity. In this case, the failure of top management to understand the basic requirements of federal financial aid calls into question the extent to which management and staff understand programs they administer and, importantly, the risk to those programs from fraud, waste, or abuse.

As a result, management should ensure that risks such as those identified in this finding related to the programs noted in this finding as well as all the other programs the Financial Aid Office is responsible for 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 in a timely manner. 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 recognizing the overall situation within the Health Science Center Financial Aid Office, the Vice Chancellor for Academic, Faculty, and Student Affairs recently hired a new Assistant Vice Chancellor for Student Affairs who, as part of his job duties, will oversee the rebuilding and restaffing of the Financial Aid Office. The new Assistant Vice Chancellor comes to UTHSC with over 12 years of financial aid experience. Since the Assistant Vice Chancellor's arrival, the Financial Aid Office has been in the process of hiring 4 additional full-time staff members. The Assistant Vice Chancellor is also working with regional loan guarantors to determine if in-house financial aid training can be provided. Along with in-house training, local and regional training events are being considered, ones that will enhance the knowledge base of Financial Aid staff members.

In addition, the Financial Aid Office has already made changes in PowerFails (the system software used to make financial aid awards) so that external funds are viewed appropriately in “need-based” calculations. The Financial Aid Office will also begin using an exception report in PowerFails that identifies overawards. Appropriate testing will be done at the beginning of each aid cycle to ensure that the PowerFails system is set up correctly and that automatic packaging is being performed accurately. For the 2007-2008 academic year, the Financial Aid Office staff has re-reviewed the packaging plans of the students who were associated with this audit to make sure that their financial aid packages were accurate. Also, the overaward exception report in PowerFails was run to determine if the system identified any students who had been overawarded.

The Assistant Vice Chancellor for Student Affairs will contact the Department of Education about the possible return of any overawards and the need to go back two fiscal years to determine whether similar overawards were made.

2. **The previous University of Tennessee Health Science Center officials failed to properly recognize and account for approximately \$9 million in overhead fees due from the UT Medical Group over a seven-year period, resulting in a failure to comply with statutory requirements for writing off uncollectible receivables**

Finding

From 2000 through 2005, previous University of Tennessee Health Science Center management allowed the UT Medical Group, a contractor, to retain funds which were due to the College of Medicine. Such actions were inconsistent with the terms of the affiliation agreement between the university and UT Medical Group, and resulted in university management's failure to recognize and record receivables from UT Medical Group in the university's financial statements and management's failure to comply with statutory requirements for writing off uncollectible receivables.

The University of Tennessee Medical Group

In July 1999, the University of Tennessee's Health Science Center (UTHSC) entered into an affiliation agreement with the UT Medical Group, Inc., (UTMG), a legally separate, non-profit corporation. UTMG's purpose included establishing a physicians' group practice organization for the benefit of the physicians/faculty on staff at the university's Health Science Center in Memphis; providing health services to the citizens of the State of Tennessee; supporting university research; and providing educational opportunities for students at UTHSC. Providing a practice organization for medical faculty is common at most health science centers, and most of the UTHSC faculty are required to perform their patient care activities through the UTMG. UTMG has the authority and responsibility through the affiliation agreement to enter into agreements with hospitals and other health care organizations to provide patient service opportunities and ongoing clinical skills for the university's physicians/faculty. UTMG also bills patients, collects patient revenue, and compensates the university's physicians/faculty for the patient care services which they provide to patients based on terms negotiated and agreed upon in writing by university and UTMG officials.

Requirement to Pay the University Overhead Fees

The university's affiliation agreement with UTMG also required UTMG to pay the UTHSC an overhead fee from patient collections (cash basis) equal to 2.5% of those collections. These funds are restricted for use by the College of Medicine at the Health Science Center. A 2005 amendment to the affiliation agreement further stipulated that either party could revise the fee payment by the written, mutual agreement of both parties.

The University's Internal Audit Report Criticized Previous UTHSC Officials' Handling of Affiliation Agreement With UTMG

According to an internal audit report recently issued by the university's Department of Audit and Consulting Services, the UTMG failed to remit the overhead fee to the university since 2000 and the Health Science Center management

- waived the contractual requirement without the authority to do so;
- failed to record the amounts due to the university in the accounting records;
- did not properly report accounts receivable in the university's financial statements; and
- did not pursue the write-off of uncollectible accounts in accordance with the State of Tennessee Department of Finance and Administration's policy.

UTHSC Failed to Waive Amounts Due From UTMG in Accordance With the Terms of the Affiliation Agreement

Beginning in 1999 UTMG advised university officials of their inability to pay the overhead amount. However, the agreement did not allow for the forgiveness of this fee, and to do so prior to 2005 would have required an amendment to the agreement. University management finally processed an amendment in 2005 which would have allowed UTMG to retain the overhead fee provided UTMG and the university agreed to these terms in writing. From 2000 through 2005, university officials allowed UTMG to forgo payments totaling \$7,509,338 because of its financial condition, but none of these waivers were processed in accordance with the terms of the affiliation agreement in effect for these fiscal years.

UTHSC Dean Lacked Authority to Approve Waivers

In 2005, the Dean of the College of Medicine signed a waiver allowing UTMG to retain the overhead fee due for the years ended June 30, 2004, and June 30, 2005, which totaled \$3,565,285. The internal audit report, however, noted that the dean was not authorized to sign financial agreements on behalf of the university.

UTMG Lender Stipulates Terms Adverse to the University

UT Internal Audit reported that beginning in 1999 UTMG began experiencing financial difficulties and was at risk of defaulting on a loan with its lending institution. As a result, in 2004, UTMG's lending institution stipulated in its loan agreement that UTMG was prohibited from making its contractual payments to the UTHSC without lender approval.

Improper Attempts to Write Off UTMG Debt by University and UTHSC officials

By waiving UTMG's overhead fees totaling \$7,509,338 from 2000 through 2005 without proper contractual provision, university management has in substance written off the unrecorded accounts receivable totaling \$7,509,338 without the proper approval of state officials. The *Rules of the Department of Finance and Administration*, Chapter 0620-1-9, Policy and Procedures Governing Write-Off of Accounts Receivable, require that all state agencies, departments, and institutions obtain written approval from the Commissioner of Finance and Administration and the Comptroller of the Treasury for the write-off of all accounts of \$5,000 or greater or accounts aggregating to \$25,000 or greater.

Despite Efforts to Collect the Amounts Due for 2006, the Debt Owed to the University Was Not Properly Recorded or Reported

Our current audit testwork revealed that the university made efforts to collect amounts for the 2006 and 2007 fiscal years, rather than waiving the overhead. For the 2006 fiscal year, the overhead fee was \$1,923,668, of which UTMG paid \$490,000. A written agreement signed by both parties in January 2007 allowed the remaining amounts owed to the university to be retained in UTMG reserve funds. This waiver was executed six months after the year ended June 30, 2006, and UTHSC officials again did not properly record the amount as a receivable on the university's financial statements for the year ended June 30, 2006. In exchange for being allowed to retain the remaining \$1,433,668, the UTMG director and the university entered into a second agreement, and UTMG promised to pay \$1,500,000 over a five-year period, which would allow the university to collect \$1,990,000 (\$1,500,000 plus \$490,000) instead of the \$1,923,668, which was due for fiscal year 2006 over the five-year period. However, UTMG's board of directors rejected this second agreement shortly after the UTMG director had negotiated and signed the agreement. The 2007 overhead fee estimated at \$2,625,000 has not been waived orally or in writing, and the UTHSC business office has properly accrued the amount in the university's general ledger at June 30, 2007. UTMG, however, has not paid any of this amount.

Conclusion

The university's and specifically UTHSC's inaction resulted in the university's failure to record and report overhead fees due to the university totaling \$8,943,006, for the past seven years. In addition, UTHSC management's decisions to waive amounts due resulted in violation of the state's policy governing the write-off of uncollectible accounts receivable. The total uncollected fees amount to \$11,568,006.

Recommendation

The President and the Board of Trustees should review the details of this finding and the university's internal auditor's report on these matters. The President and the Chief Financial Officer should take appropriate actions to ensure that the leadership of UTHSC understand their responsibilities to the university, including the need to promptly advise the President and the

Chief Financial Officer (who should in turn notify the audit committee of the board of trustees) whenever they are attempting to write off or waive significant funds, particularly from related parties.

Upper management of UTHSC should ensure that risks such as those identified 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 in a timely manner. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

The university's management and UTMG management should work together to resolve any issues related to the payment of these overhead fees. Since the university has not executed waivers in compliance with the affiliation agreement, the UT Controller's office should prepare any write-offs for uncollectible amounts in accordance with the Department of Finance and Administration's policy. The UT Controller's office should submit the write-offs for approval by the Commissioner of Finance and Administration and the State Comptroller.

In the future, if waivers become necessary due to UTMG's financial condition, they should be properly executed in writing on a timely basis in accordance with the affiliation agreement. Any waivers should be signed by both parties, designating the parties' mutual agreement.

The affiliation agreement should be amended to require the university's written approval before UTMG enters into any agreement which may have an impact on the UTMG's ability to meet its contractual obligations to the university.

UT Controller's office personnel and UTHSC accounting personnel should review UTMG's financial statements annually to ensure proper and consistent accounting for transactions between the two entities.

University management should also make UTMG officials aware of the state's requirements for writing off or waiving amounts due from UTMG.

University management should communicate to UTMG officials their fiduciary responsibilities to the university and the fact that they should act in good faith and in the best interests of the university. As such, they should be more careful in developing business plans that could negatively affect the university, particularly with regard to revenue projections and the ability to meet, on a timely basis, their full and complete legal and ethical obligations to the university. They should not enter into side agreements which attempt to, or may otherwise, place the interests of the university in an inferior position to other parties.

Management's Comment

We concur. The internal audit report detailing the concerns with UTMG was shared with the president, the audit committee, UTMG officials, and other pertinent university officials. This information has also been discussed in various Board committee meetings and copies of this report will be sent to all Board members. Furthermore, the current administration at the UT Health Science Center (UTHSC), including the chancellor, the chief business officer, the dean of the College of Medicine, and the interim executive vice chancellor and chief of staff have all been advised of the appropriate protocol and requirement for collecting, recording, and writing off amounts due from UTMG. Likewise, UTMG officials have also been made aware of these requirements. As noted above, the discrepancies noted occurred with a previous administration. Since this matter was brought to light by a UT internal audit report, UTHSC has properly accounted for funds due from UTMG.

The university is currently working with UTMG management to resolve the issues related to the past overhead amounts and to create a new memorandum of agreement, which should help prevent future occurrences and to address the remaining concerns outlined in your recommendations. Any write-offs will be prepared by the university's controller and submitted to appropriate state officials in accordance with applicable university policy and state statutes. The UT controller and UTHSC officials will review UTMG's financial statements annually.

The failure to record accounts receivable was identified in a recent risk assessment. To further strengthen controls over this risk, university management is currently reviewing UT's contract tracking system for a means of identifying contracts that may generate a receivable. This will assist in monitoring these contracts. The UTHSC contract office currently records and collects receivables, and a recent review by the Internal Audit department indicated the office was properly billing and collecting amounts due. Internal Audit is also conducting a system-wide review of accounts receivable and determining ways to further strengthen controls in this area.

3. **The university failed to provide adequate access controls and program change management over the Banner computer systems at Martin, which increased the risk of fraud or error**

Finding

The University of Tennessee at Martin uses the Banner system to maintain all student information, including accounts receivable and financial aid, at the Martin campus. Management of the university's Information Technology Services (ITS) group did not provide for adequate internal controls over access to its Banner computer system. Also, management has not established and implemented effective policies and procedures over program changes to the Banner system.

We observed conditions that were in violation of industry-accepted information security practices, proper segregation of duties, and university policy. Failure to consistently apply proper access and change management controls across the university's computing environment increases the risk of fraud, error, and inappropriate access to sensitive data and equipment.

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

Recommendation

The Chief Information Officer (CIO) should ensure that these conditions are remedied by the prompt development and implementation of effective access controls and program change management. The CIO should ensure that risks associated with this finding are adequately identified and assessed in the university's documented risk assessment. The CIO should implement effective controls to ensure compliance with applicable requirements, assign staff to be responsible for ongoing monitoring of the risks and mitigating controls, and take action if deficiencies occur.

Management's Comment

We concur. The CIO has already implemented various controls, formalization of documentation, and processes for access and program change management. The CIO and her staff are monitoring and documenting risks, formalizing additional processes, and researching additional improvements with the intent to implement those elements necessary to minimize the risk of fraud or error.



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

December 7, 2007

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, 2007, 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, 2007, 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.

As explained in Note 2, the financial statements include investments valued at \$203,147,466.77 (10.2 percent of net assets), whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners.

The management's discussion and analysis on pages 22 through 34 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 December 7, 2007, 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

The Honorable John G. Morgan
December 7, 2007
Page Three

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,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." The signature is written in a cursive style with a large, prominent initial "A".

Arthur A. Hayes, Jr., CPA
Director

AAH/sds

The University of Tennessee
Management's Discussion and Analysis
June 30, 2007

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, 2007, with comparative information presented for the fiscal year ended June 30, 2006. This discussion has been prepared by management along with the financial statements and related note disclosures and should be read in conjunction with the Independent Auditor's Report, the audited financial statements, and the accompanying notes. 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.

The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007

Condensed Statements of Net Assets
(in thousands of dollars)

	<u>UT</u>		<u>UC Foundation</u>		<u>UT Foundation</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Assets:						
Current assets	\$ 453,049	\$ 399,030	\$ 8,521	\$ 9,318	\$ 7,254	\$ 3,899
Capital assets, net	1,128,100	1,031,458	69,731	72,586	50,588	52,422
Other assets	1,122,316	936,033	132,958	118,511	62,771	35,238
Total Assets	2,703,465	2,366,521	211,210	200,415	120,613	91,559
Liabilities:						
Current liabilities	275,524	264,435	8,521	9,319	1,012	1,110
Noncurrent liabilities	439,533	362,513	86,443	87,773	58,109	58,849
Total Liabilities	715,057	626,948	94,964	97,092	59,121	59,959
Net Assets:						
Invested in capital assets, net of related debt	773,979	750,758	-	-	-	-
Restricted – nonexpendable	379,343	358,337	50,993	43,560	9,401	7,464
Restricted – expendable	588,963	432,797	8,278	7,763	55,048	25,483
Unrestricted	246,123	197,681	56,975	52,000	(2,957)	(1,347)
Total Net Assets	\$ 1,988,408	\$ 1,739,573	\$ 116,246	\$ 103,323	\$ 61,492	\$ 31,600

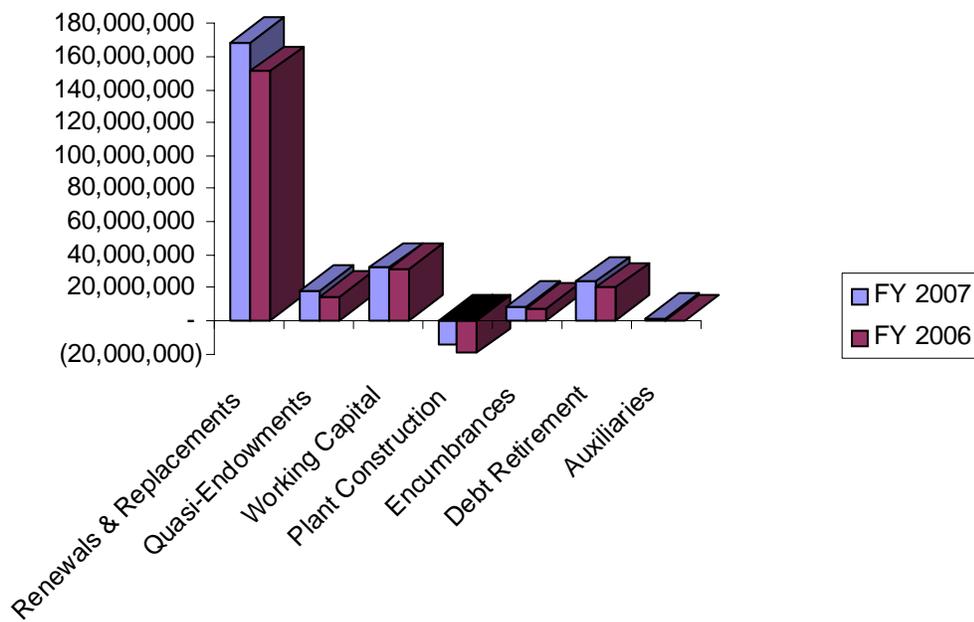
Material assets consist of cash and cash equivalents; investments; accounts, notes, and grants receivable; and capital assets. Increases in current assets are in cash and cash equivalents; investments; and accounts, notes, and grants receivable. Increases in noncurrent assets can be found in cash and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

Material liabilities include long-term bonded debt, compensated absences, accounts payable, accrued liabilities, and deferred revenue. The increase in current liabilities is due to increases in accounts payable and deferred revenue. The increase in noncurrent liabilities is due mainly to an increase in Tennessee State School Bond Authority indebtedness.

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 University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007**

**Unrestricted Net Assets -
University**



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

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

The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007

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

	<u>UT</u>		<u>UC Foundation</u>		<u>UT Foundation</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Operating revenues:						
Net tuition and fees	\$231,621	\$232,960	\$ -	\$ -	\$ -	\$ -
Grants and contracts	383,659	377,289	-	-	-	-
Auxiliary	160,502	134,466	-	-	-	-
Other	75,266	70,797	13,212	12,949	34,148	14,182
Total operating revenues	851,048	815,512	13,212	12,949	34,148	14,182
Operating expenses	1,508,826	1,425,134	11,860	11,295	7,312	8,323
Operating income (loss)	(657,778)	(609,622)	1,352	1,654	26,836	5,859
Nonoperating revenues and expenses:						
State and local appropriations	492,810	459,279	-	-	-	-
Gifts	65,725	36,339	-	-	-	-
Investment income	175,091	110,939	15,734	5,766	2,348	1,536
Other revenues and expenses	98,546	61,830	(4,801)	(4,968)	-	-
Total nonoperating revenues and expenses	832,172	668,387	10,933	798	2,348	1,536
Income (loss) before other revenues, expenses, gains, or losses	174,394	58,765	12,285	2,452	29,184	7,395
Other revenues, expenses, gains, or losses:						
Capital appropriations	32,834	24,579	-	-	-	-
Capital grants and gifts	22,875	18,284	-	-	-	-
Additions to permanent endowments	17,827	36,030	638	1,775	708	1,661
Other	905	10,206	-	-	-	-
Total other revenues, expenses, gains, or losses	74,441	89,099	638	1,775	708	1,661
Increase (decrease) in net assets	248,835	147,864	12,923	4,227	29,892	9,056
Net assets at beginning of year	1,739,573	1,591,709	103,323	99,096	31,600	22,544
Net assets at end of year	\$1,988,408	\$1,739,573	\$116,246	\$103,323	\$61,492	\$31,600

The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007

The increase in tuition and fees is primarily due to an approximate 4 percent increase in fees for the 2007 academic year. Operating grants and contracts increased by \$6 million. Auxiliary revenues increased \$26 million, primarily in Men's Athletics at Knoxville.

In fiscal year 2007, state and local appropriations increased \$33 million. Nonoperating gifts increased \$30 million. The increase in investment income was due to an increase in endowment income and continued modest gains in the capital market.

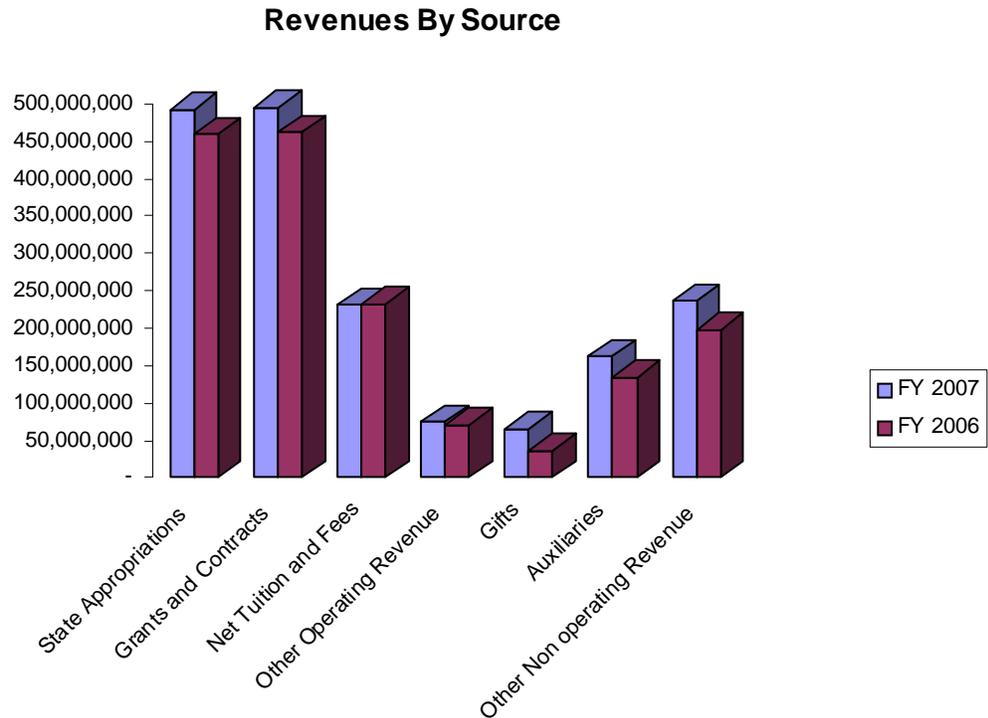
The increase in capital appropriations for 2007 consisted of an increase in state appropriations for new buildings and capital maintenance. Additions to permanent endowments decreased for the 2007 fiscal year.

Total operating expenses increased approximately \$83 million in fiscal year 2007 with increases in salaries and wages; fringe benefits; and utilities, supplies, and other services. 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, 2007, and June 30, 2006.

**The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007**



For the year ended June 30, 2007, approximately 69 percent of UT's revenue was attributed to state and local 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).

**The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007**

2007 Natural Classification

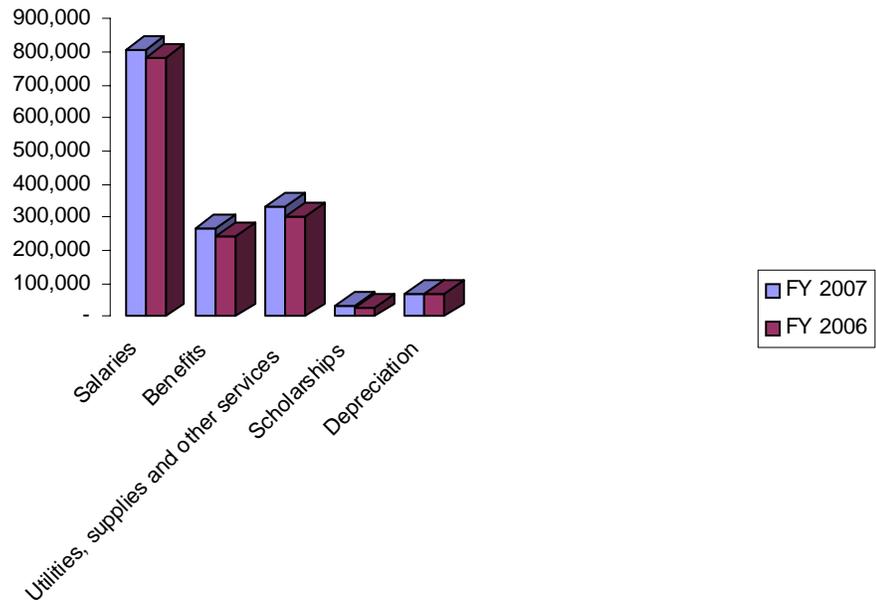
<u>2007 Functional Classification</u>	<u>Salaries</u>	<u>Benefits</u>	<u>Utilities, supplies, and other services</u>	<u>Scholarships</u>	<u>Depreciation</u>	<u>Total</u>
Instruction	\$341,104	\$94,679	\$54,107	\$ -	\$ -	\$489,890
Research	111,346	29,507	57,252	-	-	198,105
Public service	68,428	24,204	35,370	-	-	128,002
Academic support	64,174	22,759	14,882	-	-	101,815
Student services	33,219	11,522	21,541	-	-	66,282
Institutional support	63,708	22,482	-	-	-	86,190
Operation and maintenance of plant	29,312	13,125	60,618	-	-	103,055
Scholarships	2,781	17,065	14,514	30,400	-	64,760
Auxiliary	33,178	10,168	75,890	-	-	119,236
Independent operations	60,439	22,583	-	-	-	83,022
Depreciation	-	-	-	-	68,469	68,469
Total expenses	\$807,689	\$268,094	\$334,174	\$30,400	\$68,469	\$1,508,826

2006 Natural Classification

<u>2006 Functional Classification</u>	<u>Salaries</u>	<u>Benefits</u>	<u>Utilities, supplies, and other services</u>	<u>Scholarships</u>	<u>Depreciation</u>	<u>Total</u>
Instruction	\$325,039	\$86,249	\$51,543	\$ -	\$ -	\$462,831
Research	111,668	27,824	57,639	-	-	197,131
Public service	69,920	22,769	33,765	-	-	126,454
Academic support	58,914	19,155	16,319	-	-	94,388
Student services	31,356	9,926	20,984	-	-	62,266
Institutional support	60,434	19,764	449	-	-	80,647
Operation and maintenance of plant	27,826	11,351	51,048	-	-	90,225
Scholarships	2,714	17,587	14,882	24,534	-	59,717
Auxiliary	31,864	8,842	59,004	-	-	99,710
Hospital	-	6	191	-	-	197
Independent operations	62,485	20,925	-	-	-	83,410
Depreciation	-	-	-	-	68,158	68,158
Total expenses	\$782,220	\$244,398	\$305,824	\$24,534	\$68,158	\$1,425,134

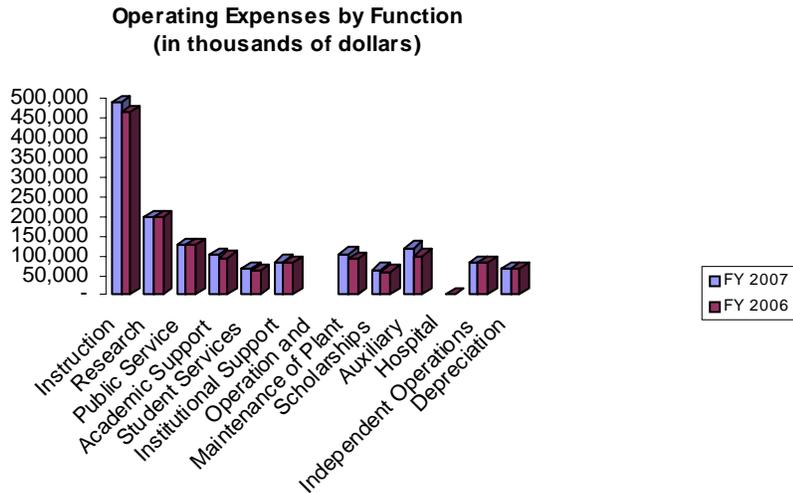
**The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007**

**Operating Expenses by Natural Classification
(in thousands of dollars)**



For the year ended June 30, 2007, approximately 71 percent of operating expenses are attributed to salaries and benefits. Utilities, supplies, and other services represent 22 percent of total operating expenses. Scholarships and depreciation represent the remaining 7 percent of operating expenses.

**The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007**



For the year ended June 30, 2007, 54 percent of operating expenses by function is attributable to instruction, research, and public service. The percentages for the remaining functional areas range from 4 to 8 percent of total operating expenses.

The Statement of Cash Flows

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

The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007

Condensed Statements of Cash Flows
(in thousands of dollars)

	<u>2007</u>	<u>2006</u>
Cash provided (used) by:		
Operating activities	\$(575,820)	\$(531,695)
Noncapital financing activities	647,644	620,470
Capital and related financing activities	(45,292)	(73,461)
Investing activities	49,003	(21,525)
Net increase (decrease) in cash	75,535	(6,211)
Cash, beginning of year	488,559	494,770
Cash, end of year	\$564,094	\$488,559

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 \$75,535,186.67 for the year ended June 30, 2007. The net decrease in cash and cash equivalents amounted to \$6,211,441.08 for the year ended June 30, 2006.

Capital Assets and Debt Administration

Capital Assets

At June 30, 2007, the University of Tennessee had \$1,128,100,153.24 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled \$68,469,191.36 for the current fiscal year. Details of these assets are shown below.

**The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007**

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

	<u>2007</u>	<u>2006</u>
Land	\$50,397	\$50,071
Land improvements & infrastructure	28,049	29,542
Buildings	666,417	655,176
Works of art/historical treasures	434	405
Equipment	94,898	96,945
Software	881	1,458
Library holdings	62,686	59,179
Projects in progress	224,338	138,682
Total	<u>\$1,128,100</u>	<u>\$1,031,458</u>

Major capital additions for UT during 2006-2007 include a \$23.7 million Hesler Biology Building Renovation, the \$10.5 million Clement Hall Renovation, the \$2.6 million Business Incubator Building, and the \$750 thousand Hill Area Site Improvements in Knoxville; the \$2.6 million Elam Center Renovation and the \$1.6 million Humanities HVAC in Martin; and the \$2.0 million Coleman Building Chiller Replacement in Memphis.

For the next fiscal year, the state has approved more than \$153 million in capital outlay appropriations and \$22 million in capital maintenance appropriations for UT. Some of these approved new projects include Infrastructure Improvements to the UT Cherokee Campus, UT Biofuels Center, UTK Music Center, UTC Library, and equipment for the UT Joint Institute for Biological Sciences. In addition, there are various improvement projects at all campuses. More detailed information about the university's capital assets is presented in Note 5 to the financial statements.

Debt

At June 30, 2007, the university had \$351,626,390.67 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

**The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007**

**Outstanding Debt Schedule
(in thousands of dollars)**

	<u>2007</u>	<u>2006</u>
Bonds-current portion	\$15,385	\$14,150
Bonds-noncurrent	258,614	235,454
Commercial paper-noncurrent	77,582	28,598
Total TSSBA authorized debt	<u>351,581</u>	<u>278,202</u>
Notes-current portion	10	10
Notes-noncurrent portion	35	45
Total Debt	<u>\$ 351,626</u>	<u>\$ 278,257</u>

The university retired more than \$16.3 million in bonds and notes in fiscal year 2006-2007. 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 debt currently is rated AA by Standard & Poor's. More detailed information about the university's long-term liabilities is presented in Note 7 to the financial statements.

To fund university projects, the TSSBA issued two new bond series in 2006-2007 in the net amount of \$23.5 million. These are the 2007A series in the amount of \$21.3 million and the 2007B series in the amount of \$2.2 million. TSSBA bonds related to university projects totaling \$34.6 million were also refunded. The new 2007C series refunded the 1996B, 1996C, 1998A, and 2002A series.

Economic Factors That Will Affect the Future

For fiscal year 2008, the University of Tennessee Board of Trustees has authorized an individual campus fee increase of from 4 to 5 percent that is expected to generate approximately \$16 million in new funding, net of related scholarships, with a continued projected enrollment increase. State appropriations are expected to increase by \$40 million to fund employee increases, and include an \$8.5 million biofuels project and \$6.5 million for Governor's chairs. The university has won a \$65 million National Science Foundation award to build a super computer.

The University of Tennessee
Management's Discussion and Analysis (Cont.)
June 30, 2007

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, Assistant Vice President and Controller, 201 Andy Holt Tower, Knoxville, Tennessee, 37996-0100.

THE UNIVERSITY OF TENNESSEE
STATEMENT OF NET ASSETS
June 30, 2007

	The University of Tennessee	University of Chattanooga Foundation, Inc.	The University of Tennessee Foundation, Inc.
ASSETS			
Current assets:			
Cash and cash equivalents (Note 2)	\$ 237,030,864.86	\$ 8,166,911.00	\$ 3,047,065.43
Investments (Notes 2, 19, and 20)	119,881,255.16	-	2,946,924.62
Accounts, notes, and grants receivable (net) (Note 4)	85,912,094.94	334,039.00	1,172,966.51
Inventories	7,724,395.44	-	67,850.00
Prepaid expenses and deferred charges	2,499,975.80	20,106.00	19,556.25
Total current assets	<u>453,048,586.20</u>	<u>8,521,056.00</u>	<u>7,254,362.81</u>
Noncurrent assets:			
Cash and cash equivalents (Note 2)	327,062,996.68	12,768,821.00	3,491,461.52
Investments (Notes 2, 19, and 20)	647,416,124.96	119,602,117.00	15,332,093.12
Investment in UT - Battelle, LLC (Note 11)	4,589,975.00	-	-
Accounts, notes, and grants receivable (net) (Note 4)	113,381,487.07	101,270.00	34,035,532.80
Lease payments receivable (Note 15)	29,511,828.24	-	-
Capital assets (net) (Notes 5, 19, and 20)	1,128,100,153.24	69,731,368.00	50,587,501.24
Prepaid expenses and deferred charges	353,825.22	486,378.00	-
Assets held by the university	-	-	9,911,884.71
Total noncurrent assets	<u>2,250,416,390.41</u>	<u>202,689,954.00</u>	<u>113,358,473.39</u>
Total assets	<u>2,703,464,976.61</u>	<u>211,211,010.00</u>	<u>120,612,836.20</u>
LIABILITIES			
Current liabilities:			
Accounts payable	77,188,943.84	2,775,071.00	99,216.81
Accrued liabilities	45,032,738.43	-	-
Deferred revenue	85,415,864.06	814,280.00	160,137.94
Deposits payable	4,588,553.37	-	-
Annuities payable	1,398,136.35	-	-
Long-term liabilities, current portion (Notes 7, 19, and 20)	54,099,948.85	1,405,000.00	753,103.42
Deposits held in custody for others	7,800,260.38	1,970,687.20	-
Due to the university	-	1,556,017.80	-
Total current liabilities	<u>275,524,445.28</u>	<u>8,521,056.00</u>	<u>1,012,458.17</u>
Noncurrent liabilities:			
Deferred revenue (Note 7)	15,500,438.71	-	-
Long-term liabilities, noncurrent portion (Notes 7, 19, and 20)	371,370,940.72	86,443,349.00	58,108,587.12
Due to grantors (Note 7)	35,076,074.86	-	-
Annuities payable (Note 7)	7,673,562.43	-	-
Deposits held in custody for component units	9,911,884.71	-	-
Total noncurrent liabilities	<u>439,532,901.43</u>	<u>86,443,349.00</u>	<u>58,108,587.12</u>
Total liabilities	<u>715,057,346.71</u>	<u>94,964,405.00</u>	<u>59,121,045.29</u>
NET ASSETS			
Invested in capital assets, net of related debt	773,979,056.58	-	-
Restricted:			
Nonexpendable:			
Scholarships and fellowships	165,073,443.16	15,293,567.00	5,769,209.16
Libraries	13,641,788.71	-	155,584.45
Research	18,285,955.57	-	269,535.15
Instructional department uses	119,529,697.71	35,640,947.00	-
Academic support	26,897,637.28	58,827.00	2,499,250.45
Other	35,914,703.57	-	707,434.06
Expendable:			
Scholarships and fellowships	166,859,467.80	354,288.00	4,010,605.93
Libraries	12,419,447.21	-	-
Research	51,920,317.36	-	267,535.86
Instructional department uses	119,010,584.75	2,677,805.00	-
Academic support	47,236,628.85	14,113.00	24,587,910.43
Loans	9,410,736.70	-	-
Capital projects	87,543,602.65	5,000,000.00	-
Debt service	353,825.22	-	-
Other	94,208,242.40	231,779.00	26,182,155.16
Unrestricted (Note 18)	246,122,494.38	56,975,279.00	(2,957,429.74)
Total net assets	<u>\$ 1,988,407,629.90</u>	<u>\$ 116,246,605.00</u>	<u>\$ 61,491,790.91</u>

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

THE UNIVERSITY OF TENNESSEE
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Year Ended June 30, 2007

	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 \$92,239,698.23 for the year ended June 30, 2007)	\$ 231,621,035.54	\$ -	\$ -
Contributions	-	244,190.00	29,659,169.15
Investment return designated for operations	-	4,289,174.00	-
Federal appropriations	12,595,931.11	-	-
Governmental grants and contracts	218,899,431.20	-	-
Non-governmental grants and contracts	164,759,394.61	-	-
Sales and services of educational departments	44,210,547.09	-	-
Auxiliary enterprises:			
Residential life (net of scholarship allowances of \$1,222,298.96 for the year ended June 30, 2007; all revenues are used as security for varying revenue bonds; see Note 7)	35,922,859.08	8,678,927.00	4,480,132.34
Food services	3,772,023.64	-	-
Bookstore	21,657,120.65	-	-
Parking	8,885,562.27	-	-
Athletics	83,995,469.27	-	-
Other auxiliaries	6,269,702.08	-	-
Interest earned on loans to students	27,907.64	-	-
Other operating revenues	18,431,175.31	-	8,297.36
Total operating revenues	<u>851,048,159.49</u>	<u>13,212,291.00</u>	<u>34,147,598.85</u>
EXPENSES			
Operating expenses (Note 17):			
Salaries and wages	807,688,567.75	-	-
Fringe benefits	268,093,818.61	-	-
Utilities, supplies, and other services	334,173,835.34	4,349,474.00	5,042,463.93
Scholarships and fellowships	30,400,415.29	-	-
Depreciation expense	68,469,191.36	3,221,413.00	1,869,426.98
Payments to or on behalf of the university (Notes 19 and 20)	-	4,289,173.00	399,927.40
Total operating expenses	<u>1,508,825,828.35</u>	<u>11,860,060.00</u>	<u>7,311,818.31</u>
Operating income (loss)	<u>(657,777,668.86)</u>	<u>1,352,231.00</u>	<u>26,835,780.54</u>
NONOPERATING REVENUES (EXPENSES)			
State and local appropriations	492,809,851.56	-	-
Gifts (include \$4,689,100.40 from component units)	65,724,792.77	-	-
Grants and contracts	111,130,861.40	-	-
Investment income	175,090,831.90	15,734,308.00	2,348,471.46
Interest on capital asset - related debt	(14,443,292.57)	(4,736,721.00)	-
Other nonoperating revenues (expenses)	1,858,166.03	(64,775.00)	-
Net nonoperating revenues (expenses)	<u>832,171,211.09</u>	<u>10,932,812.00</u>	<u>2,348,471.46</u>
Income (loss) before other revenues, expenses, gains, or losses	<u>174,393,542.23</u>	<u>12,285,043.00</u>	<u>29,184,252.00</u>
Capital appropriations	32,834,155.19	-	-
Capital grants and gifts	22,874,770.05	-	-
Additions to permanent endowments	17,827,065.30	637,944.00	707,717.10
Additions to annuity and life income trusts	4,910,502.35	-	-
Other	(4,005,135.53)	-	-
Total other revenues	<u>74,441,357.36</u>	<u>637,944.00</u>	<u>707,717.10</u>
Increase in net assets	<u>248,834,899.59</u>	<u>12,922,987.00</u>	<u>29,891,969.10</u>
NET ASSETS			
Net assets at beginning of year	1,739,572,730.31	103,323,618.00	31,599,821.81
Net assets at end of year	<u>\$ 1,988,407,629.90</u>	<u>\$ 116,246,605.00</u>	<u>\$ 61,491,790.91</u>

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

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2007

CASH FLOWS FROM OPERATING ACTIVITIES	
Tuition and fees	\$ 235,665,400.67
Federal appropriations	15,613,931.11
Grants and contracts	389,017,339.87
Sales and services of educational activities	42,890,398.78
Payments to suppliers and vendors	(329,571,246.58)
Payments to employees	(806,237,496.26)
Payments for benefits	(264,805,921.58)
Payments for scholarships and fellowships	(30,400,415.29)
Loans issued to students	(5,758,043.15)
Collection of loans from students	6,033,161.04
Interest earned on loans to students	457,772.30
Auxiliary enterprise charges:	
Residence halls	35,922,859.08
Bookstore	21,657,120.65
Food service	3,772,023.64
Parking	8,885,562.27
Athletics	83,836,541.57
Other auxiliaries	6,004,646.81
Hospital	(494,201.48)
Other receipts (payments)	11,690,218.76
Net cash provided (used) by operating activities	<u>(575,820,347.79)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State appropriations	489,602,510.71
Local appropriations	4,749,140.85
Gifts and grants for other than capital or endowment purposes	136,807,506.25
Private gifts for endowment purposes	22,737,567.65
Split-interest transactions receipts	5,540,434.41
Split-interest transactions disbursements	(3,421,198.54)
Federal student loan receipts	174,971,593.00
Federal student loan disbursements	(174,971,593.00)
Changes in deposits held for others	225,379.21
Net cash balance implicitly financed (repaid)	(4,591,944.44)
Other noncapital receipts (payments)	(4,005,135.53)
Net cash provided (used) by noncapital financing activities	<u>647,644,260.57</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Proceeds from capital debt	94,690,063.21
Capital appropriations	27,684,704.04
Capital grants and gifts received	22,874,770.05
Proceeds from sale of capital assets	879,025.20
Purchase of capital assets and construction	(162,613,760.65)
Principal paid on capital debt and leases	(15,284,958.42)
Interest paid on capital debt and leases	(14,585,999.53)
Other capital and related financing receipts (payments)	1,063,924.83
Net cash provided (used) by capital and related financing activities	<u>(45,292,231.27)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales and maturities of investments	297,657,595.29
Income on investments	175,862,274.25
Purchase of investments	(424,516,364.38)
Net cash provided (used) by investing activities	<u>49,003,505.16</u>
Net increase (decrease) in cash and cash equivalents	75,535,186.67
Cash and cash equivalents at beginning of year	488,558,674.87
Cash and cash equivalents at end of year	<u>\$ 564,093,861.54</u>

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2007

**RECONCILIATION OF NET OPERATING LOSS TO NET CASH
PROVIDED (USED) BY OPERATING ACTIVITIES**

Operating loss	\$ (657,777,668.86)
Adjustments to reconcile operating loss to net cash provided (used) by operating activities:	
Depreciation expense	68,469,191.36
Changes in assets and liabilities:	
Receivables, net	(867,929.62)
Inventories	272,981.44
Prepaid expenses and deferred charges	(213,116.57)
Accrued interest receivable	429,864.66
Accounts payable	4,542,723.89
Accrued liabilities	1,707,142.93
Deferred revenue	8,304,823.39
Deposits	(3,995,303.89)
Compensated absences	3,031,825.59
Other additions:	
Loans to students	275,117.89
Net cash provided (used) by operations	<u>\$ (575,820,347.79)</u>
Noncash transactions	
Gifts of capital assets	\$ 679,957.00
Unrealized gains on investments	63,454,315.67
Loss on disposal of capital assets	(5,408,080.88)

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

The University of Tennessee
Notes to the Financial Statements
June 30, 2007

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 Health Science Center, 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; the University of Tennessee Space Institute at Tullahoma; the University of Tennessee Institute of Agriculture, including the College of Agriculture at Knoxville, the Agricultural Experiment Stations, the Agricultural Extension Service, and the College of Veterinary Medicine at Knoxville; the Institute for Public Service, which includes the County Technical Assistance Service and the Municipal Technical Advisory Service; and the University-Wide Administration. The university is governed by a board of 23 members, including one student and one faculty member, all either *ex officio* or appointed by the Governor, who also serves as chairman. The president is the chief executive officer of the university system.

The University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., are considered component units of the university. Although the university does not control the timing or amount of receipts from the foundations, the majority of resources, or income thereon, that the foundations hold and invest are restricted to the activities of the university by the donors. Because these restricted resources held by the foundations can only be used by, or for the benefit of, the university, the foundations are considered component units of the university and are discretely presented in the university's financial statements. See Notes 19 and 20 for more detailed information about the component units and how to obtain their reports.

Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) applicable to

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

governmental colleges and universities engaged in business-type activities as prescribed by the Governmental Accounting Standards Board (GASB).

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) certain federal, state, local, and private grants and contracts; 4) sales and services of educational departments; 5) sales and services of auxiliary enterprises; and 6) other sources of revenue. Operating expenses for the institution include: 1) salaries and wages; 2) employee benefits; 3) scholarships and fellowships; 4) depreciation; and 5) utilities, supplies, and other services.

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

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

Cash Equivalents

This classification includes instruments which are readily convertible to known amounts of cash.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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. All other investments are reported at fair value or estimated fair value.

The university holds investments in limited partnerships, limited companies, corporations, and limited liability corporations which are carried at estimated fair value provided by the management of these funds. The purpose of this alternative investment class is to increase portfolio diversification and reduce risk due to the low correlation with other asset classes. Methods for determining estimated fair values include discounted cash flows and estimates provided by general partners and fund managers. Because these investments are not readily marketable, the estimated fair value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investments existed, and such differences could be material. The estimated fair values are reviewed and evaluated by the university.

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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

Accounts Payable

Included in accounts payable are checks payable in the amount of \$8,239,999.52 as of June 30, 2007. 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.

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 in which the university is legally or contractually obligated to spend resources in accordance with restrictions imposed by external third parties.

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

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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, 2007, cash and cash equivalents consisted of \$49,096,893.01 in bank accounts, \$1,479,839.74 of petty cash on hand, \$19,300,000.00 of certificates of deposit, \$489,970,619.96 in the university’s cash management investment pool, and \$2,287,582.93 on deposit with the State of Tennessee.

The carrying amount of the university’s deposits was \$68,396,893.01 and the bank balance including accrued interest was \$69,912,466.16.

Additionally, the university maintains custodial accounts at First Tennessee Bank, Citigroup, and Morgan Keegan for funds contractually managed by independent investment counsel. In accordance with the custody agreements, First Tennessee Bank, Citigroup, and Morgan Keegan placed cash equivalents totaling \$1,958,925.90 at June 30, 2007, in 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, 2007, all university deposits were adequately secured as required by state statute.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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, 2007, 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
<u>Cash Management Pool</u>						
<u>Cash Equivalents</u>						
<u>Debt Securities</u>						
Commercial paper	\$ 166,877,681.88	\$166,877,681.88	\$ -	\$ -	\$ -	\$ 165,880,416.24
U.S. Treasury	61,098,070.00	5,948,670.00	55,149,400.00	-	-	61,368,734.68
U.S. Agencies	<u>261,994,868.08</u>	<u>126,362,187.78</u>	<u>135,632,680.30</u>	-	-	<u>263,474,510.96</u>
	<u>489,970,619.96</u>	<u>299,188,539.66</u>	<u>190,782,080.30</u>	-	-	<u>490,723,661.88</u>

Investments

<u>Debt Securities</u>						
U.S. Treasury	12,322,280.65	72,091.24	6,094,729.89	4,782,060.47	1,373,399.05	12,289,333.94
U.S. Agencies	19,141,914.52	179,390.70	12,362,086.22	4,897,159.35	1,703,278.25	18,972,754.18
Corporate bonds	24,150,751.43	2,176,072.25	20,159,711.75	1,814,967.43	-	24,612,286.18
Municipal bonds	1,386,398.90	151,341.00	-	-	1,235,057.90	1,407,432.02
Mortgages and notes	432,858.31	-	31,018.50	401,839.81	-	443,088.35
Bond mutual funds	<u>54,615,139.04</u>	<u>2,002,881.41</u>	<u>1,544,958.60</u>	<u>48,525,058.99</u>	<u>2,542,240.04</u>	<u>56,631,931.38</u>
	<u>112,049,342.85</u>	<u>4,581,776.60</u>	<u>40,192,504.96</u>	<u>60,421,086.05</u>	<u>6,853,975.24</u>	<u>114,356,826.05</u>
		<u>\$303,770,316.26</u>	<u>\$230,974,585.26</u>	<u>\$60,421,086.05</u>	<u>\$ 6,853,975.54</u>	

Other investments

<u>Corporate stocks:</u>						
Domestic	132,347,591.36					107,772,372.09
International	5,627,344.91					4,819,318.48
Mutual funds – equity	288,050,116.47					199,062,938.14
<u>Alternative investments:</u>						
Real estate equity funds	42,211,057.99					33,557,177.95
Venture capital funds	46,438,149.88					61,100,072.04
Hedge funds	99,445,261.47					69,997,219.18
Natural resources	15,052,997.43					13,220,763.78
Real estate gifts	3,251,979.13					4,705,220.67
Assets with trustees	5,806,042.66					5,709,884.58
Mutual funds – bonds	16,304,334.74					9,513,405.51
Other investments	<u>713,161.23</u>					<u>885,623.10</u>
Total investments and cash equivalents	<u>1,257,268,000.08</u>					<u>1,115,424,483.45</u>
Less: cash equivalents	<u>489,970,619.96</u>					<u>490,723,661.88</u>
Total investments	<u>\$ 767,297,380.12</u>					<u>\$ 624,700,821.57</u>

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of a debt investment. The university does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

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, 2007, 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 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, 2007, the institution's investments were rated as follows:

Rated Debt Instruments	<u>Fair Value</u>	<u>Aaa</u>	<u>Aa1</u>	<u>Aa2</u>	<u>Aa3</u>	<u>A1</u>
<u>Cash Management Pool</u>						
U.S. Treasury	\$ 61,098,070.00	\$ 61,098,070.00	\$ -	\$ -	\$ -	\$ -
U.S. Agencies	261,994,868.08	236,023,517.58	-	25,971,350.50	-	-
Commercial paper	166,877,681.88	-	-	-	-	166,877,681.88
<u>Investments</u>						
U.S. Treasury	12,322,280.65	12,268,353.11	-	-	-	-
U.S. Agencies	19,141,914.52	17,116,914.52	-	2,025,000.00	-	-
Corporate bonds	24,150,751.43	1,830,957.00	2,181,538.75	2,936,505.75	5,553,738.65	2,671,993.10
Municipal bonds	1,386,398.90	848,687.20	-	191,788.20	-	-
Mutual funds—bonds	70,919,473.78	32,280,389.04	10,837,253.05	7,389,009.09	-	-
Mortgages and notes	432,858.31	-	-	-	-	-

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

Rated Debt Instruments	<u>A2</u>	<u>A3</u>	<u>Baa1</u>	<u>Baa2</u>	<u>Ba2</u>	<u>B2</u>
<u>Cash Management Pool</u>						
U.S. Treasury	-	-	-	-	-	-
U.S. Agencies	-	-	-	-	-	-
Commercial paper	-	-	-	-	-	-
<u>Investments</u>						
U.S. Treasury	-	-	-	-	-	-
U.S. Agencies	-	-	-	-	-	-
Corporate bonds	5,436,650.65	1,541,475.75	580,910.55	569,318.10	-	-
Municipal bonds	-	-	-	-	-	-
Mutual funds—bonds	-	-	-	-	2,105,606.45	2,002,881.41
Mortgages and notes	-	-	-	-	-	-

Rated Debt Instruments	<u>Caa</u>	<u>Unrated</u>
<u>Cash Management Pool</u>		
U.S. Treasury	-	-
U.S. Agencies	-	-
Commercial paper	-	-
<u>Investments</u>		
U.S. Treasury	-	53,927.54
U.S. Agencies	-	-
Corporate bonds	-	847,663.13
Municipal bonds	201,040.00	144,883.50
Mutual funds—bonds	-	16,304,334.74
Mortgages and notes	-	432,858.31

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, 2007, the university had \$5,806,042.66 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:

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

<u>Issuer</u>	<u>Fair Value</u>	<u>Percent of Total Investments</u>
Federal Home Loan Bank	\$163,892,611.80	13.04%
Federal National Mortgage Association	\$84,063,868.94	6.69%

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 \$5,627,344.91 invested in foreign corporate equities at June 30, 2007.

Alternative Investments

In its Consolidated Investment Pool, as part of its endowment assets, the university has investments in fifty-four limited partnerships, limited companies, corporations, and limited liability corporations (LLCs). These investments include thirty-three private equity (venture capital) funds, four real estate funds, eight natural resource funds, and nine hedge funds. The estimated fair value of these assets is \$203,147,466.77 at June 30, 2007. Total capital contributions less returns of capital equal \$177,875,232.95 at June 30, 2007.

The university believes that the carrying amount of its alternative investments is a reasonable estimate of fair value as of June 30, 2007. Because these investments are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investments existed, and such differences could be material. These investments are made in accordance with the university's investment policy that approves the allocation of funds to various asset classes in order to ensure the proper level of diversification within the endowment pool. These investments (private equity, real assets, natural resources, and hedge funds) are designed to enhance diversification and provide reductions in overall portfolio volatility. These fair values are estimated by the general partner of each limited partnership or manager of each corporate entity using various valuation techniques.

The methods and assumptions used in estimating fair value varies based upon the asset class, but uniformly all start with the latest audited financial statements for the funds. Most funds issue audited financial statements on a calendar year basis. Using those audited fair values as a beginning point, valuations are adjusted for net capital activity and marketplace considerations to ascertain the reasonableness of estimated fair values

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

provided by the fund managers. Marketplace activity includes subsequent independent appraisals for real assets, subsequent rounds of capital financings that include new investors for private/venture equity, and asset confirmations from brokers and fund administrators for hedge funds.

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, 2007, net appreciation of

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

\$290,575,824.17 is available to be spent, of which \$284,642,339.56 is restricted to specific purposes. The per unit fair value for participating endowments was \$4.346110 at June 30, 2007. Income distributed was \$.17601 per share in 2007, or \$27,481,959.24.

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 2007 and the three and five years then ended was 7.9%, 15.1%, and 12.3%, respectively. Longer-term average returns continue to be impacted by the negative return years of 2001 and 2002. Due to these two negative return years, there were 12 true endowments at June 30, 2007, that had a fair market value of \$678,179.00 and historic gift value of \$682,144.32, yielding a net "underwater" position of \$3,965.32. 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 \$657,694.95 for 2007.

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 2007 amounted to \$2,365,945.81.

NOTE 4. ACCOUNTS, NOTES, AND GRANTS RECEIVABLE

Accounts, notes, and grants receivable included the following at June 30, 2007:

Student accounts receivable	\$ 8,050,969.70
Grants receivable	66,188,034.13
Notes receivable	3,650,088.03
Pledges receivable	60,711,160.67
State capital outlay and maintenance receivable	5,149,451.15
Due from component units	1,556,017.80

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

Less accumulated depreciation:

Land improvements & infrastructure	(34,665,630.87)	(2,787,147.52)	-	-	(37,452,778.39)
Buildings	(550,577,843.33)	(34,061,709.73)	-	1,931,522.13	(582,708,030.93)
Equipment	(145,228,976.18)	(20,728,710.28)	-	14,600,529.71	(151,357,156.75)
Software	(18,165,883.97)	(823,551.60)	-	4,958.34	(18,984,477.23)
Library holdings	<u>(41,019,769.19)</u>	<u>(10,068,072.23)</u>	-	<u>7,789,785.70</u>	<u>(43,298,055.72)</u>
Total accumulated depreciation	<u>(789,658,103.54)</u>	<u>(68,469,191.36)</u>	-	<u>24,326,795.88</u>	<u>(833,800,499.02)</u>
Capital assets, net	<u>\$1,031,458,280.42</u>	<u>\$ 102,049,953.70</u>	<u>\$ -</u>	<u>\$ (5,408,080.88)</u>	<u>\$1,128,100,153.24</u>

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 \$9,678,450.38 for the year ended June 30, 2007.

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, 2007. 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 April 2007 Consumer Price Index (206.69).

Year Ending June 30:

2008	\$12,810.00
2009	12,810.00
2010	12,810.00
2011	12,810.00
2012	<u>12,810.00</u>
 Total minimum payments required	 <u>\$64,050.00</u>

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

NOTE 7. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2007, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Current Portion</u>
Long-term liabilities:					
Bonds	\$249,603,966.28	\$59,877,803.67	\$35,482,671.41	\$273,999,098.54	\$15,384,675.93
Commercial paper	<u>28,597,532.93</u>	<u>53,961,577.97</u>	<u>4,977,274.19</u>	<u>77,581,836.71</u>	<u>-</u>
Total TSSBA indebtedness	<u>278,201,499.21</u>	<u>113,839,381.64</u>	<u>40,459,945.60</u>	<u>351,580,935.25</u>	<u>15,384,675.93</u>
Notes	55,791.28	-	10,335.86	45,455.42	10,753.43
Compensated absences	<u>70,812,673.31</u>	<u>41,736,345.08</u>	<u>38,704,519.49</u>	<u>73,844,498.90</u>	<u>38,704,519.49</u>
Total long-term liabilities	349,069,963.80	155,575,726.72	79,174,800.95	425,470,889.57	<u>\$54,099,948.85</u>
Other noncurrent liabilities:					
Deferred revenue	15,500,438.71	-	-	15,500,438.71	
Due to grantors	35,490,145.57	622,206.36	1,036,277.07	35,076,074.86	
Annuities payable	<u>8,140,122.12</u>	<u>931,576.66</u>	<u>1,398,136.35</u>	<u>7,673,562.43</u>	
Totals	<u>\$408,200,670.20</u>	<u>\$157,129,509.74</u>	<u>\$81,609,214.37</u>	<u>\$483,720,965.57</u>	

TSSBA Debt - Bonds

Bonds, with interest rates ranging from 1.3% to 7.15%, were issued by the Tennessee State School Bond Authority (TSSBA). The bonds are due serially to 2036 and are secured by pledges of the facilities' revenues to which they relate and certain other revenues and fees of the university, including state appropriations. The bonded indebtedness with the Tennessee State School Bond Authority included in long-term liabilities on the statement of net assets is shown net of assets held by the authority in the debt service reserve, unexpended debt proceeds, and unaccreted bonds payable. The total bonded indebtedness at June 30, 2007, was \$282,088,048.54. The reserve amount at June 30, 2007, was \$2,563,506.12, and unexpended debt proceeds were \$4,664,606.76. Unaccreted bonds payable at June 30, 2007, were \$860,837.12.

Included in the total outstanding indebtedness is a \$75,093 note with Chattanooga Agricultural Credit Association. The 5-year note is for the construction of a farm building at UT – Martin. This note carries an interest rate of 4% and is due semi-annually to July 1, 2009. The outstanding balance at June 30, 2007, is \$45,455.42.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

The university's debt service requirements (TSSBA and the 5-year note) to maturity for all bonds and notes payable at June 30, 2007, are as follows:

Year Ending <u>June 30</u>	<u>Principal</u>	Interest and <u>Administrative Fees</u>
2008	\$ 15,395,429.36	\$ 13,043,939.45
2009	15,964,846.52	12,511,537.70
2010	16,487,244.61	11,959,452.07
2011	13,868,639.66	11,309,069.94
2012	13,396,993.70	10,701,450.33
2013-2017	63,513,498.17	44,516,920.76
2018-2022	62,311,415.62	29,244,005.90
2023-2027	47,768,220.68	14,993,464.78
2028-2032	26,100,242.67	5,891,316.96
2033-2036	<u>7,326,972.97</u>	<u>747,324.57</u>
	<u>\$ 282,133,503.96</u>	<u>\$ 154,918,482.46</u>

TSSBA Debt - Commercial Paper

The Tennessee State School Bond Authority issues commercial paper to finance the costs of various capital projects during their construction phase. When projects are placed in service, long-term, fixed-rate debt is issued by TSSBA to finance the project over its useful payback period and the commercial paper is redeemed. The amount issued for projects at the university was \$77,581,836.71 at June 30, 2007.

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.

More detailed information regarding the bonds and commercial paper can be found in the notes to the financial statements in the financial report for the Tennessee State School Bond Authority. That report may be obtained by writing to the Director of Bond Finance, Suite 1600, James K. Polk Building, Nashville, Tennessee 37243-0273, or by calling (615) 401-7872.

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Notes to the Financial Statements (Cont.)
June 30, 2007

NOTE 8. PENSION PLANS

Defined Benefit Plans

Tennessee Consolidated Retirement System

Plan Description

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

Funding Policy

Plan members are noncontributory. The university is required to contribute at an actuarially determined rate. The current rate is 13.66% 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, 2007, 2006, and 2005, were \$37,574,415.22, \$27,746,496.78, and \$26,506,950.91, 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

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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, 2007, were \$1,184,643.44, which consisted of \$610,128.50 from the university and \$574,514.94 from the employees; contributions for the year ended June 30, 2006, were \$1,168,135.78, which consisted of \$601,347.97 from the university and \$566,787.81 from the employees; and contributions 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.

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 \$1,013,260.65 for the year ended June 30, 2007, which consisted of \$67,551.28 from employees and \$945,709.37 from the university; \$1,009,788.22 for the year ended June 30, 2006, which consisted of \$67,319.22 from employees and \$942,469.00 from the university; and \$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. Contributions for the Thrift Savings Plan were \$1,052,295.00 for the year ended June 30, 2007, which consisted of \$655,004.00 from employees and \$397,291.00 from the university; \$1,032,856.00 for the year ended June 30, 2006, which consisted of \$639,716.00 from employees and \$393,140.00 from the university; and \$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. Contributions met the requirements for each year.

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Notes to the Financial Statements (Cont.)
June 30, 2007

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, 2007, was \$38,781,695.20 and for the year ended June 30, 2006, was \$37,616,309.09. 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 \$38,536,482.05 for fiscal year 2007, and \$41,790,586.90 for fiscal year 2006. 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 \$5,247,137.08 in fiscal year 2007, and \$4,309,070.99 in fiscal year 2006. Contributions met the requirements for each year.

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Notes to the Financial Statements (Cont.)
June 30, 2007

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 \$40 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. In fiscal year 2007, the university provided a \$40 monthly match from unrestricted funds for employees making a minimum monthly contribution of \$40 to the Section 401(k) plan. During the year ended June 30, 2007, contributions totaling \$15,487,006.53 were made by employees participating in the plan, with a related match of \$4,338,361.62 made by the university. During the year ended June 30, 2006, contributions totaling \$13,088,410.01 were made by employees participating in the plan, with a related match of \$3,012,141.83 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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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, 2007. 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, 2007, the amounts held in trust totaled \$119,550,090.48 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 \$4,589,975.00 at June 30, 2007. 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, 2006, to the university was \$3,472,583.60.

During the year ended June 30, 2007, the university had expenses of \$16,460,719.08 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

contracts totaled \$2,657,231.73 at June 30, 2007. To review the audit report of UT-Battelle, please contact the Controller's Office, The University of Tennessee, 201 Andy Holt Tower, Knoxville, Tennessee 37996-0100.

NOTE 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, 2007, and June 30, 2006, 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, 2007, the Risk Management Fund held \$116.7 million in cash and cash equivalents designated for payment of claims.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

At June 30, 2007, the scheduled coverage for the university was \$3,136,509,317 for buildings and \$984,027,312 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 six 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, 2007, were \$142,442,093.82.

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, 2007. The amount of unused sick leave was \$260,907,956.65 at June 30, 2007.

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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

Nonvested Equipment

Equipment in the possession of the university valued at \$4,608,343.51 as of June 30, 2007, 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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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 \$82,117,174.87 in 2007, 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

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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, 2007, totaled \$2,385,268.00.

The university recorded a lease payment receivable in the amount of \$29,511,828.24 at June 30, 2007, 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.

	<u>June 30, 2007</u>
Total minimum lease payments to be received	\$55,101,910.13
Less: unearned income	<u>(25,590,081.89)</u>
Net investment in direct financing lease	<u>\$29,511,828.24</u>

NOTE 16. AGREEMENTS WITH METHODIST HEALTHCARE – MEMPHIS HOSPITALS

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 from November 1, 2002, until July 24, 2004, the date all services comprising the hospital were relocated to Methodist University Hospital. The William F. Bowld Hospital was closed and the building was demolished.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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 \$779,076.64, 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.

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Notes to the Financial Statements (Cont.)
June 30, 2007

NOTE 17. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATIONS

The university's operating expenses by functional classification for the year ended June 30, 2007, are as follows:

<u>Functional Classification</u>	<u>Natural Classification</u>					
	<u>Salaries</u>	<u>Benefits</u>	<u>Utilities, Supplies, and Other Services</u>	<u>Scholarships</u>	<u>Depreciation</u>	<u>Total</u>
Instruction	\$341,104,307.61	\$94,678,764.97	\$ 54,106,616.84	\$ -	\$ -	\$489,889,689.42
Research	111,346,171.82	29,507,238.28	57,251,582.33	-	-	198,104,992.43
Public service	68,428,111.15	24,204,419.01	35,369,803.14	-	-	128,002,333.30
Academic support	64,173,866.01	22,758,560.43	14,882,542.78	-	-	101,814,969.22
Student services	33,218,881.75	11,522,383.47	21,540,818.04	-	-	66,282,083.26
Institutional support	63,708,380.53	22,482,292.47	-	-	-	86,190,673.00
Operation & maintenance of plant	29,311,985.28	13,125,131.43	60,618,076.15	-	-	103,055,192.86
Scholarships & fellowships	2,781,182.94	17,065,625.47	14,513,614.50	30,400,415.29	-	64,760,838.20
Auxiliary	33,177,652.32	10,167,784.50	75,890,781.56	-	-	119,236,218.38
Independent operations	60,438,028.34	22,581,618.58	-	-	-	83,019,646.92
Depreciation	-	-	-	-	68,469,191.36	68,469,191.36
Total expenses	<u>\$807,688,567.75</u>	<u>\$268,093,818.61</u>	<u>\$334,173,835.34</u>	<u>\$30,400,415.29</u>	<u>\$68,469,191.36</u>	<u>\$1,508,825,828.35</u>

NOTE 18. UNRESTRICTED NET ASSETS

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

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

	<u>June 30, 2007</u>
Working capital	\$31,795,030.35
Encumbrances	8,521,275.50
Auxiliaries	1,588,617.49
Quasi-endowments	17,598,781.41
Plant construction	(14,032,796.61)
Renewal and replacement of capital assets	168,825,958.02
Debt retirement	23,365,362.92
Unreserved/undesignated	<u>8,460,265.30</u>
Total	<u>\$246,122,494.38</u>

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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

During the year ended June 30, 2007, the foundation expended \$4,289,173.00 to or on behalf of the university for both restricted and unrestricted purposes. Complete financial statements for the foundation can be obtained from the University of Chattanooga Foundation, Development Office, Department 6806, 615 McCallie Avenue, Chattanooga, TN 37403-2598.

Organization and Nature of Activities

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

Principles of Consolidation

The consolidated financial statements of the foundation include the accounts of the foundation and its subsidiaries, Campus Development Foundation, Inc. (CDFI) and CDFI Phase I, LLC (the LLC). All material intercompany accounts and transactions have been eliminated in consolidation. The foundation and CDFI have fiscal years that end 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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

Investments

A summary of foundation investments at June 30, 2007, is as follows:

Equity securities (cost of \$66,530,593)	\$81,371,223
Debt securities (cost of \$12,208,195)	12,129,491
Real estate	1,367,026
Limited partnerships	15,317,743
Other	<u>75,794</u>
 Total	 <u>\$110,261,277</u>

The foundation also has investments restricted by the terms of the revenue bonds described below totaling \$9,340,840.

Property and Equipment

A summary of foundation property and equipment at June 30, 2007, is as follows:

Land	\$ 8,241,032
Buildings	72,337,547
Furniture, fixtures, and equipment	<u>3,266,114</u>
	83,844,693
 Accumulated depreciation	 <u>(14,113,325)</u>
 Total	 <u>\$69,731,368</u>

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, 2007, 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	\$68,320,000
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The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

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	<u>21,620,000</u>
	89,940,000
Less: unamortized discount	<u>(2,091,651)</u>
Total	<u>\$87,848,349</u>

Sinking fund requirements for scheduled redemptions of the revenue bonds for the next five years and thereafter are as follows:

Year Ended <u>June 30</u>	
2008	\$ 1,405,000
2009	1,475,000
2010	1,550,000
2011	1,630,000
2012	1,715,000
Thereafter	<u>82,165,000</u>
	<u>\$89,940,000</u>

Restricted Cash and Cash Equivalents

The revenue bonds described above restrict the use of certain cash and cash equivalents at June 30, 2007, as follows:

Renewal and replacement reserves	\$1,352,268
Restricted for debt service payments	<u>2,044,355</u>
Total	<u>\$3,396,623</u>

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2007, are as follows:

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

<u>Functional Classification</u>	<u>Natural Classification</u>			<u>Total</u>
	<u>Utilities, Supplies, and Other Services</u>	<u>Payments to or on Behalf of UT</u>	<u>Depreciation</u>	
Academic programs	\$ -	\$1,138,948	\$ -	\$ 1,138,948
Professorships	-	582,633	-	582,633
Faculty development	-	309,159	-	309,159
Scholarships	-	2,051,863	-	2,051,863
Chancellor's discretionary	-	107,874	-	107,874
Other	-	98,696	-	98,696
Rental expenses	3,777,670	-	-	3,777,670
Administrative and investment fees	467,089	-	-	467,089
Legal	34,805	-	-	34,805
Tax and audit	69,910	-	-	69,910
Depreciation	-	-	<u>3,221,413</u>	<u>3,221,413</u>
Total expenses	<u>\$4,349,474</u>	<u>\$4,289,173</u>	<u>\$3,221,413</u>	<u>\$11,860,060</u>

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

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

considered a component unit of the university and is discretely presented in the university's financial statements.

During the year ended June 30, 2007, the foundation expended \$399,927.40 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 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:

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>
Current pledges	\$51,128.96	\$148,579.70
Pledges due in one to five years	28,539,945.25	669,658.28
Pledges due after five years	<u>11,493,867.69</u>	<u>196,049.92</u>
	40,084,941.90	1,014,287.90
Less discounts to net present value	<u>(6,728,645.89)</u>	<u>(135,342.45)</u>
Total pledges receivable, net	<u>\$33,356,296.01</u>	<u>\$878,945.45</u>

The allowance for doubtful accounts at June 30, 2007, was \$75,779.41.

Capital Assets

Capital assets at June 30, 2007, consist of the following:

Land	\$ 3,249,152.73
Building	50,592,833.66
Furniture and equipment	<u>1,350,614.22</u>
	55,192,600.61
Accumulated depreciation	<u>(5,203,473.51)</u>
Net capital assets	<u>\$49,989,127.10</u>

Depreciation expense for the year ended June 30, 2007, was \$1,869,426.98.

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 32 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.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

At the beginning of the project, Volunteer Student Housing, LLC, entered into a seven-year 75% hedge on the project with the hedge rate being 3.25%. During the fiscal year, \$2,049,212.98 of interest expense and \$197,772.12 of interest income was accrued. The next principal payment of \$740,000 is due October 1, 2007. All income generated by the facility is held by U.S. Bank, the trustee. The cash and cash equivalents with trustee at fiscal year end is \$4,162,859.35.

Intangible assets consist of bond issuance costs, letter of credit issuance costs, and computer software. The bond issuance costs are amortized over the life of the bonds, and the letter of credit costs are amortized over the seven-year letter of credit term. The software costs are amortized over four years. The total intangible assets cost was \$744,138.25. Total amount of intangible assets charged to amortization expense during the year was \$54,138.47. Remaining unamortized cost of intangible assets at June 30, 2007, was \$598,374.14.

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 four-year 75% hedge with the hedge rate being 3.31%.

Future maturities of bonds payable commencing in 2008 are as follows:

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2007

Year Ended <u>June 30</u>	
2008	\$740,000
2009	885,000
2010	1,025,000
2011	1,185,000
2012	1,350,000
2013-2017	7,850,000
2018-2022	9,230,000
2023-2027	11,610,000
2028-2032	14,595,000
2033-2035	<u>10,510,000</u>
	<u>\$58,980,000</u>

These bonds were reported net of unamortized discount of \$357,097.34.

Mortgage Note Payable

The foundation was gifted property in Weakley and Obion counties in Tennessee. The property and its contents were appraised at \$376,000.00 with an attached mortgage note of \$259,330.41. The property will be used and overseen by the University of Tennessee at Martin. Payment on the note, which began in January 2006, is \$2,000.00 per month with the note maturing in December 2020. The note has a 4.68% interest rate. For the fiscal year ended June 30, 2007, the note principal was reduced by \$12,505.47 with an additional \$11,494.53 of interest being paid. The balance of the note payable at June 30, 2007, was \$238,787.88. Future maturities of this note are as follows:

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Year Ended <u>June 30</u>	
2008	\$13,103.42
2009	13,729.99
2010	14,386.52
2011	15,074.44
2012	15,795.25
2013-2017	91,054.20
2018-2021	<u>75,644.06</u>
Total	<u>\$238,787.88</u>

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, 2007.

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 amount at risk at June 30, 2007, was \$792. 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

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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, 2007, was \$4,558,173.80.

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, 2007, was \$10,773,919.32.

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2007, are as follows:

<u>Functional Classification</u>	Utilities, Supplies, and Other <u>Services</u>	<u>Natural Classification</u>		
		Payments to or on Behalf of <u>UT</u>	<u>Depreciation</u>	<u>Total</u>
Grants and scholarships	\$ -	\$305,227.04	\$ -	\$305,227.04
General and administrative	901,944.31	94,700.36	-	996,644.67
Student housing	<u>4,140,519.62</u>	<u>-</u>	<u>1,869,426.98</u>	<u>6,009,946.60</u>
Total expenses	<u>\$5,042,463.93</u>	<u>\$399,927.40</u>	<u>\$1,869,426.98</u>	<u>\$7,311,818.31</u>

Subsequent Event

Subsequent to year end, the University of Tennessee Foundation, Inc., entered into an agreement with the University of Tennessee for the sale of Knoxville Place. The university will become the owner of the facility with all assets related to the project. The debt will be removed from the foundation's records. This transaction is expected to be completed by January 31, 2008.