AUDIT REPORT

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

For the Years Ended
June 30, 2007, and June 30, 2006

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee Comptroller of the Treasury

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

Financial/compliance audits of colleges and universities are available on-line at www.comptroller.state.tn.us/sa/reports/index.html.
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STATE OF TENNESSEE
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December 11, 2008

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

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the State University and Community College System of Tennessee – Central Office for the years ended June 30, 2007, and June 30, 2006. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

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

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/cj
08/062

State of Tennessee

Audit Highlights

Comptroller of the Treasury   Division of State Audit

Financial and Compliance Audit
Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
For the Years Ended June 30, 2007, and June 30, 2006

AUDIT OBJECTIVES

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

INTERNAL CONTROL FINDING

TBR Management's Implementation of the Banner Application System's Security Structure Did Not Facilitate Adequate Documentation of Users' Access Authorities to the System and Did Not Properly Align User Access Privileges With Job Requirements, Resulting in Inadequate Segregation of Duties Which Increased the Risks of Compromised Information Security and Error or Fraud

The auditors noted significant conditions that violated best practices for information security controls during an examination of the Banner system implementation at the Central Office. In addition, user access privileges within the Banner application and duties outside the Banner application were not always compatible (page 8).

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

Audit Report
Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
For the Years Ended June 30, 2007, and June 30, 2006

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INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the State University and Community College System of Tennessee – Central Office. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated,* which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The State University and Community College System of Tennessee was created by the General Assembly in 1972. The system now includes 6 universities, 13 community colleges, and 27 technology centers. The Tennessee Board of Regents is vested with the responsibility of governing the system. The Central Office provides essential centralized services and uniform procedures for the institutions in the system. Among the Central Office's major responsibilities are prescribing curricula and requirements for diplomas, approving operating and capital budgets, and establishing policies and procedures regarding campus life.

ORGANIZATION

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

AUDIT SCOPE

The audit was limited to the period July 1, 2005, 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 generally accepted government auditing standards. Financial statements are presented for the years ended June 30, 2007, and June 30, 2006. The State University and Community College System of Tennessee – Central Office is a part of the Tennessee Board of Regents, which is an integral part of state government. As such, the Tennessee Board of Regents has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report.*

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Central Office's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;

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

3. to determine the fairness of the presentation of the financial statements; and

4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

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

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

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

FRAUD CONSIDERATIONS

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

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

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Central Office's financial statements for the years ended June 30, 2007, and June 30, 2006, we considered internal control over financial reporting as a basis for designing 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 generally accepted government auditing standards. A significant deficiency, along with the recommendation and management's response, is detailed in the finding and recommendation 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 generally accepted government auditing standards.

Fairness of Financial Statement Presentation

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

STATE OF TENNESSEE
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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*

September 29, 2008

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

Ladies and Gentlemen:

We have audited the financial statements of State University and Community College System of Tennessee – Central Office, a part of the Tennessee Board of Regents, which is a component unit of the State of Tennessee, as of and for the years ended June 30, 2007, and June 30, 2006, and have issued our report thereon dated September 29, 2008. 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 generally accepted government auditing standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Central Office's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Central Office's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the college's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting 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 Central Office's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Central Office's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

The following significant deficiency was noted:

- TBR management's implementation of the Banner application system's security structure did not facilitate adequate documentation of users' access authorities to the system and did not properly align user access privileges with job requirements, resulting in inadequate segregation of duties which increased the risks of compromised information security and error or fraud

This deficiency is described in the Finding and Recommendation 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 that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe the significant deficiency described above is not a material weakness.

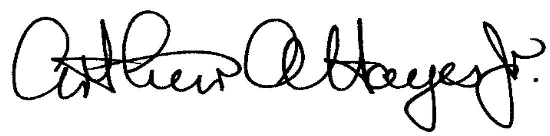
We also noted certain matters involving the internal control over financial reporting, which we have reported to the Central Office's management in a separate letter.

Compliance and Other Matters

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

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

Sincerely,



Arthur A. Hayes, Jr., CPA
Director

AAH/cj

FINDING AND RECOMMENDATION

TBR management's implementation of the Banner application system's security structure did not facilitate adequate documentation of users' access authorities to the system and did not properly align user access privileges with job requirements, resulting in inadequate segregation of duties which increased the risks of compromised information security and error or fraud

Finding

The Banner system provides a suite of administrative services for higher education including Finance and Human Resources, which are currently utilized by the Tennessee Board of Regents (TBR) Central Office. Banner Finance was implemented on July 1, 2005, and Banner Human Resources was implemented on January 1, 2006. Within the Banner application, users interface and perform tasks using objects such as menus, forms (screens), and processes. Over three thousand objects can be found within the Banner application. Access to each object can be assigned as "query" (read only) or "maintenance" (read/write) authority to an individual user, or to a group called a class. Any number of classes can be created as needed by the security administrator and can be made up of one (or more) object(s) with a specified access authority assigned to each object. Users can then be assigned to a class or classes, giving the user access to all of the objects found in that class.

Testwork revealed that user authorizations for 10 of 15 user accounts selected for review (67%) either could not be located or, when available, provided only minimal documentation of access authorities granted to the users. TBR Banner Systems Access Policy/Procedures state that the departments are to fill out a Banner Systems Access Request Form for any new user before access to the application is allowed, or to change access levels for an existing user. This form is used to list the reason for the access request, the security classes to be assigned to the user, the requestor, and management's authorization of the request. Failure to properly prepare and monitor user security authorizations increases the risk that access to sensitive systems and information may be granted to employees in excess of what they need for their job responsibilities. Also, best practice for information security and internal control is to implement an access control system based on users' actual job duties, and avoid granting permissions to individuals in excess of those required for the performance of their job duties.

When the Banner information system was implemented at the TBR Central Office, the Director of Fiscal Services established the security access within Banner Finance for each class of user in the Business and Finance office. During our audit, we reviewed these security classes to determine if staff duties related to accounts payable were adequately segregated. As a result of this review, we determined that the Director of Fiscal Services did not adequately segregate the duties over disbursements within the Banner information system. We noted that the Director of Fiscal Services and the Assistant Director of Fiscal Services had the ability to create new vendors, to post vendor invoices to the system, and to authorize ACH files to be sent to the bank. ACH, or "Automated Clearing House," payments are disbursements that do not require a physical check. These are electronic payments that conform to a standardized data format and can thus be processed and cleared much more quickly than payments by printed check. TBR transmits these payments via an electronic file directly to the bank upon which they will be drawn. In the absence of compensating manual controls, the ability to create vendors, post vendor invoices, and authorize ACH payments might provide an opportunity for fraud. An individual with these duties assigned could create a fictitious vendor, post a fictitious invoice along with the other (legitimate) invoices, and then authorize the ACH payment to an unauthorized or fictitious vendor, thus misappropriating board funds.

Based on our review of the period July 1, 2005, through June 30, 2007, we determined that the Director of Fiscal Services did not segregate duties over accounts payable because of the small size of the Central Office's accounting staff and the complexity of the Banner information system. The Director stated that she felt that a certain amount of broad access was necessary due to the limited number of staff members. However, when we discussed this specific lack of segregation of duties with the Director of Fiscal Services, she agreed it was a problem and stated that it occurred largely due to the short time in which the Banner security features were implemented.

In the absence of compensating manual controls, poorly segregated duties over ACH disbursements might provide an opportunity for fraud, waste, or abuse. In order to determine that no questionable ACH payments were made during the time in which there were no compensating controls, we reviewed a report from the Banner information system showing all ACH transactions that had been voided from July 1, 2005, through April 9, 2008. We selected 25 of the largest dollar transactions (representing 89% of the total dollar population) for review. We noted no evidence of fraud within these transactions.

Since these initial discussions, the Director of Fiscal Services implemented a new control procedure over ACH payments on April 1, 2008, which requires two employees, the Accounts Payable Supervisor and the Director of Fiscal Services, to approve a listing each day of the authorized ACH payments. These employees, by adding their signatures to the listing, are attesting that they have reviewed the properly approved supporting documentation and that they have verified that the current day's first ACH payment number (a number automatically assigned by the Banner information system) continues sequentially from the previous day's ACH listing to ensure that there are no unidentified ACH payments. We were able to observe this new procedure in practice during our fieldwork. With this additional control procedure, the Accounts Payable Supervisor and the Director of Fiscal Services should detect any attempt to make a fraudulent ACH payment.

In May 2006, Central Office management submitted the overall risk assessment prepared for the finance processes which included the risk of fraudulent transactions. Management then assessed the level of the risk as "Moderate Impact, Moderate Probability," which requires management to perform the oversight function to ensure that the controls over transactions are working properly. In May 2008, Central Office management submitted a more detailed risk assessment of Business and Finance activities. Management responsible for these processes identified the risks more specifically as payments for vendor billings that are fake, duplicate, or inaccurate and theft of cash or other assets. Management then assessed the level of these risks as

"Low Impact, Moderate Probability" and "Low Impact, Low Probability," respectively. For both of these levels of risk, management has decided to accept the risk and have no controls other than relying on supervisors to monitor the execution of controls in their particular areas. However, management did not ensure that duties in processing transactions were segregated.

During our audit, additional vulnerabilities were noted that increased the risk of compromised information security. The wording of this finding does not identify specific vulnerabilities that could allow someone to exploit the board'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 board with detailed information regarding the specific vulnerabilities we identified as well as our recommendations for improvement.

Recommendation

The Vice Chancellor for Business and Finance and the Chief Information Officer should review the current population of all Banner user accounts and ensure that employees' access levels are properly authorized and documented. In doing so, TBR should conduct a review of all business and security processes, assess the risks associated with each process, and create logical Banner classes that are consistent with those processes. Banner users should be given access only to those classes that are within the scope of their job functions. To the extent possible, automated controls should enforce a proper separation of incompatible job functions. In the event that a lack of staff resources makes a proper separation of duties impractical, an effective system of compensating controls (e.g., manual controls, reconciliations, and monitoring) should be implemented.

The Vice Chancellor for Business and Finance and the Director of Fiscal Services should also ensure that the new control procedure over ACH payments recently implemented during the audit fieldwork is followed. The Director of Fiscal Services should carefully review the system and determine that all access which has been granted is appropriate. Where segregation of duties is not possible, the Director of Fiscal Services should establish and document any additional manual controls. The Vice Chancellor for Business and Finance and the Director of Fiscal Services should ensure specific staff who are assigned the responsibility for monitoring these processes are indeed performing those functions to mitigate the risks of error or fraud.

Management should continue to evaluate risks and include them in documented risk assessment activities. Management should ensure staff who are responsible for the design and implementation of internal controls to adequately mitigate those risks and to prevent and detect exceptions timely are continually evaluating those controls. Management should ensure staff who are responsible for ongoing monitoring for compliance with all requirements are indeed monitoring and taking prompt action should exceptions occur. All controls and control activities, including monitoring, should be adequately documented.

Management's Comment

We concur with the finding. The Vice Chancellor for Business and Finance and the Chief Information Officer working with their respective staff will take a three-step approach in addressing this finding. First, surveying best practices in use in the Banner user community the TBR will identify the security classes, tasks, and roles that are most appropriate to the TBR in proper Banner security. Working by module, role descriptions will be created and the proper security classes assigned to each. Once completed, the second phase will be to work with the staff and to identify the roles that each staff member needs to perform his/her job, along with any exceptions, and then to document them in a security matrix. Finally, the currently assigned security permissions in the Banner application will be examined on an employee by employee basis and adjusted to reflect the employee's needed security access as detailed in the security matrix documentation. Additionally, the Vice Chancellor for Business and Finance and the Director of Fiscal Services will ensure that the new control procedure over ACH payments implemented during the audit field work is followed. Management will also continue to evaluate risks and include them in documented risk assessment activities.

STATE OF TENNESSEE
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Independent Auditor's Report
September 29, 2008

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

Ladies and Gentlemen:

We have audited the accompanying basic financial statements of the State University and Community College System of Tennessee – Central Office, a part of the Tennessee Board of Regents, which is a component unit of the State of Tennessee, as of and for the years ended June 30, 2007, and June 30, 2006, as listed in the table of contents. These financial statements are the responsibility of the Central Office's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of the State University and Community College System of Tennessee – Central Office, a part of the Tennessee Board of Regents, are intended to present the financial position, the changes in financial position, and the cash flows of only the Central Office. They do not purport to and do not present fairly the financial position of the Tennessee Board of Regents as of June 30, 2007, and June 30, 2006, the changes in its financial position, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the State University and Community College System of Tennessee – Central Office, as of June 30, 2007, and June 30, 2006, and the respective changes in financial position and cash flows thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 14 through 26 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with generally accepted government auditing standards, we have also issued our report dated September 29, 2008, on our consideration of the Central Office's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with generally accepted government auditing standards and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr.

Arthur A. Hayes, Jr., CPA
Director

AAH/cj

Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
Management's Discussion and Analysis
June 30, 2007, and June 30, 2006

This section of the Central Office's report presents a discussion and analysis of the financial performance of the Central Office during the fiscal years ended June 30, 2007, and June 30, 2006, with comparative information presented for the fiscal year ended June 30, 2005. 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.

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

The Statement of Net Assets

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

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

Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
Management's Discussion and Analysis (Cont.)
June 30, 2007, and June 30, 2006

Central Office's Net Assets (in thousands of dollars)

	2007	2006	2005
Assets:			
Current assets	4,383	5,148	3,349
Capital assets, net	713	581	457
Other assets	5,130	3,078	5,315
Total Assets	**10,226**	**8,807**	**9,121**
Liabilities:			
Current liabilities	2,298	3,222	3,021
Noncurrent liabilities	698	626	556
Total Liabilities	**2,996**	**3,848**	**3,577**
Net Assets:			
Invested in capital assets	713	581	457
Restricted – nonexpendable	474	474	474
Restricted – expendable	1,330	787	1,290
Unrestricted	4,713	3,117	3,323
Total Net Assets	**7,230**	**4,959**	**5,544**

Comparison of FY 2007 to FY 2006

- Current assets decreased due to a decrease in accounts receivable related to the Banner implementation in 2007. Other assets increased due to an increase in noncurrent cash resulting from an increase in renewals & replacements funds for computer equipment, Regents Online Degree Program (RODP) equipment, and facilities renewals. Also, there was an increase in agency funds for the Tennessee Foreign Language Institute (TFLI).

- The increase in capital assets from 2006 to 2007 resulted from equipment purchased in 2007.

- The decrease in current liabilities is due to a reduction in accounts payable, accrued liabilities, and due to grantor in 2007. These decreases were due to reductions in the Geier Consent Decree and Tech Prep programs.

- Restricted, expendable net assets increased from 2006 to 2007 for the Geier desegregation and consent decree programs.

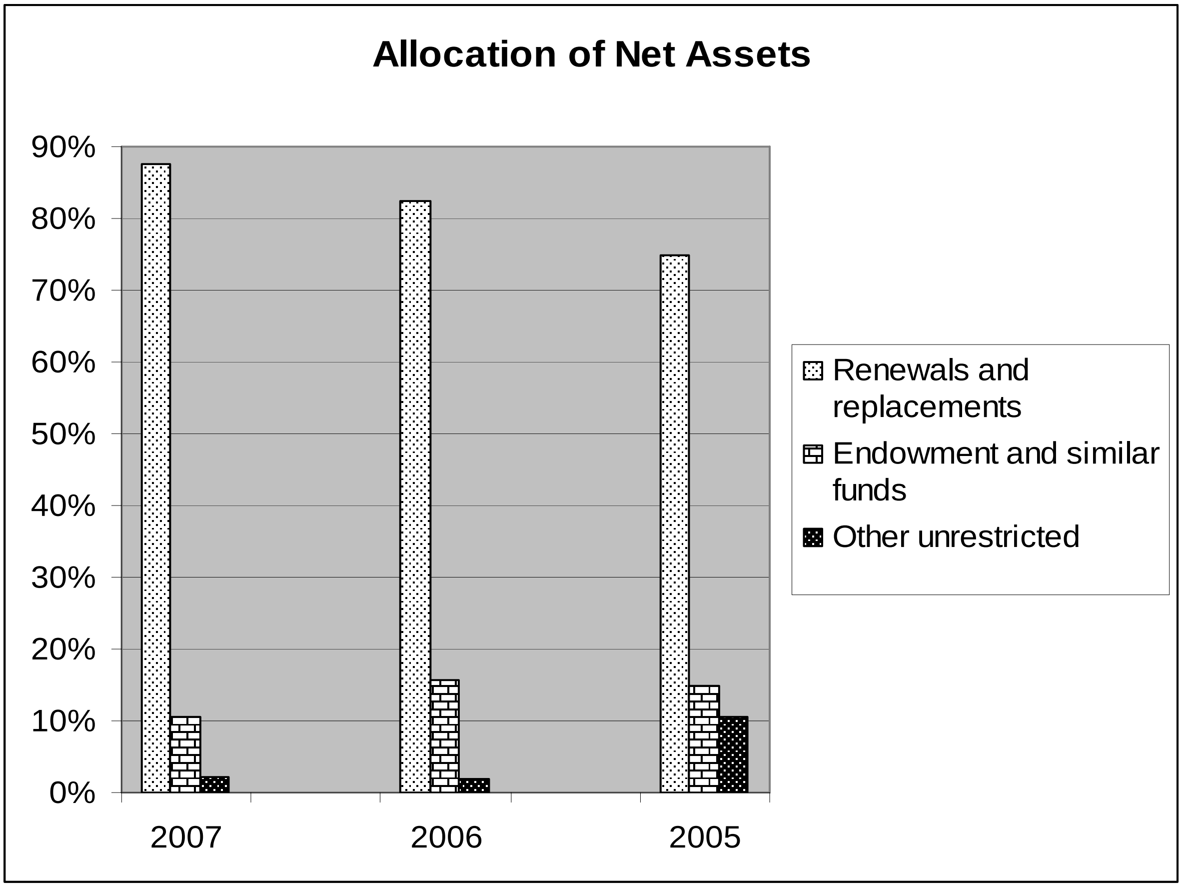
- Unrestricted net assets increased from 2006 to 2007 because of increases in renewals & replacements funds for computer equipment, telephone system, automobiles, Regents Online Degree Program (RODP) equipment, and facilities/equipment renewals.

Comparison of FY 2006 to FY 2005

- Current assets increased and other assets decreased from 2005 to 2006 because of an increase in receivables for Families First and Food Stamp Employment Programs and an increase in agency fund receivables due from institutions to pay a large vendor invoice.

- The increase in capital assets from 2005 to 2006 resulted from equipment and automobile purchases during 2006.

- Restricted expendable net assets decreased from 2005 to 2006 for the Geier desegregation and consent decree programs.



Comparison of FY 2007 to FY 2006

Other unrestricted net assets increased because of increases in discretionary allocations for the Regents Online Degree Program, the Floyd Scholarship, and unspent funds for Academic Programs.

Comparison of FY 2006 to FY 2005

Other unrestricted net assets decreased from 11% to 2% from 2005 to 2006 as funds were accumulated to cover the compensated absences liability and to transfer more funds to renewals and replacements for computer equipment.

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

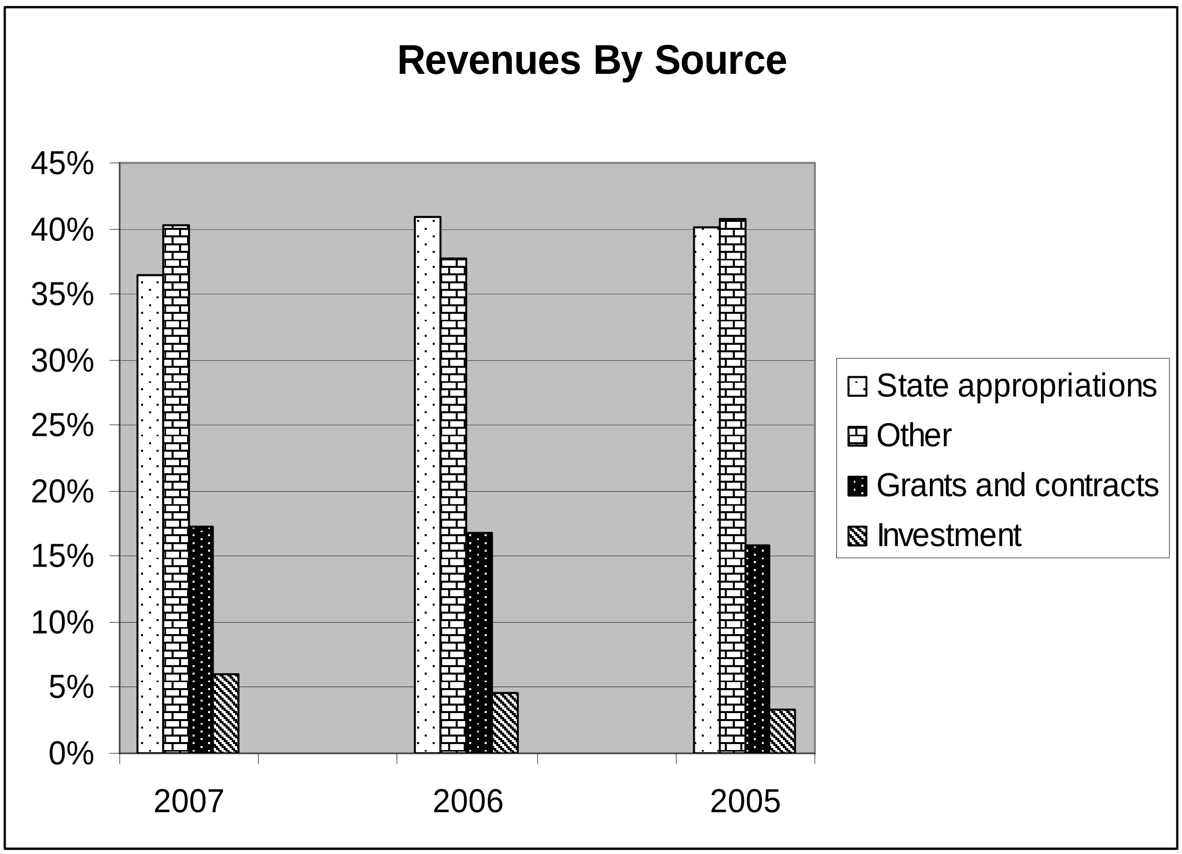
The Statement of Revenues, Expenses, and Changes in Net Assets presents the operating results of the Central Office, as well as the nonoperating revenues and expenses. Annual state appropriations, while budgeted for operations, are considered non-operating revenues according to accounting principles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

Central Office's Changes in Net Assets (in thousands of dollars)

	2007	2006	2005
Operating revenues:			
Grants and contracts	3,839	3,557	2,825
Gifts	-	-	10
Other	8,959	7,983	7,239
Total operating revenues	**12,798**	**11,540**	**10,074**
Operating expenses	19,966	21,791	16,720
Operating loss	**(7,168)**	**(10,251)**	**(6,646)**
Nonoperating revenues and expenses:			
State appropriations	8,101	8,679	7,113
Investment income	1,330	987	590
Other nonoperating revenues (expenses)	8	-	-
Total nonoperating revenues and expenses	**9,439**	**9,666**	**7,703**
Increase (decrease) in net assets	**2,271**	**(585)**	**1,057**
Net asset at beginning of period	**4,959**	**5,544**	**4,487**
Net assets at end of year	**7,230**	**4,959**	**5,544**

Revenues

The following is a graphic illustration of revenues by source (both operating and nonoperating), which are used to fund the Central Office's operating activities for the years ended June 30, 2007; June 30, 2006; and June 30, 2005.



Comparison of FY 2007 to FY 2006

- State appropriations decreased due to reduced appropriations for the Geier Consent Decree program.
- Other income increased largely due to an increase in Regents Online Degree Program revenues.

- Investment income increased due to a rise in interest rates and the timing of revenues and expenses.

Comparison of FY 2006 to FY 2005

- State appropriations increased for the Geier Consent Decree program.

- Investment income increased due to a rise in interest rates and the timing of revenues and expenses.

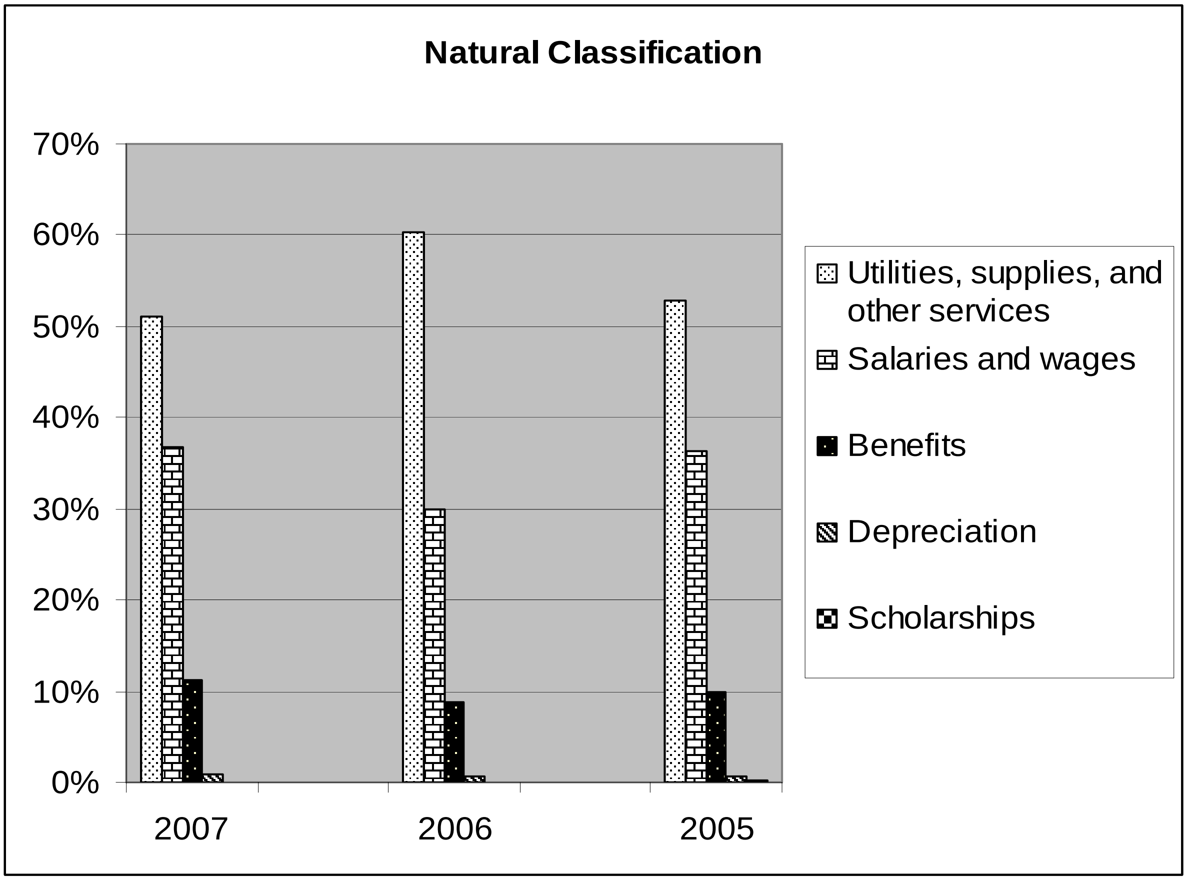
Expenses

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

Natural Classification

Operating Expenses (in thousands of dollars)
Central Office

	2007	2006	2005
Salaries and Wages	7,326	6,519	6,073
Benefits	2,260	1,932	1,666
Utilities, Supplies, and Other Services	10,179	13,160	8,815
Scholarships and Fellowships	17	20	44
Depreciation	184	160	122
Total Operating Expenses	**19,966**	**21,791**	**16,720**



Comparison of FY 2007 to FY 2006

- A decrease in operating expenses from 2006 to 2007 resulted from decreased grant expenses for the Geier Consent decree program.
- Increased salary and benefit costs resulted from additional positions and general salary increases.

Comparison of FY 2006 to FY 2005

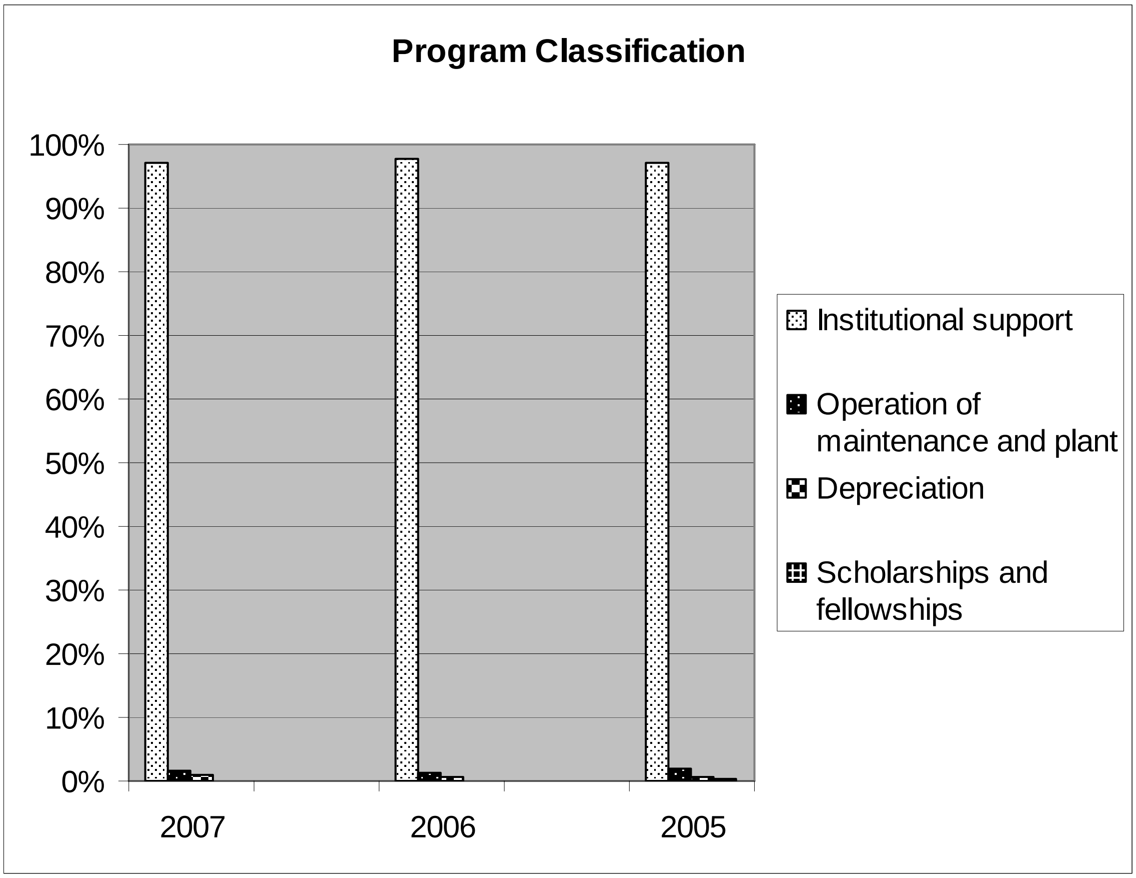
- Increases in operating expenses from 2005 to 2006 resulted from increased grant expenses for the Geier Consent Decree program.

- Increased salary and benefit costs resulted from additional RODP positions and general salary increases.

Program Classification

Operating Expenses (in thousands of dollars)
Central Office

	2007	2006	2005
Institutional Support	19,411	21,302	16,248
Operation of Maintenance and Plant	354	309	306
Scholarships and Fellowships	17	20	44
Depreciation	184	160	122
Total Operating Expenses	**19,966**	**21,791**	**16,720**



Comparison of FY 2007 to FY 2006

Decreases in institutional support from 2006 to 2007 resulted mostly from decreased grant expenses for the Geier Consent Decree.

Comparison of FY 2006 to FY 2005

Increases in institutional support from 2005 to 2006 resulted from increased grant expenses for the Geier Consent Decree, Families First, and Food Stamp Employment programs.

The Statement of Cash Flows

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

Central Office's Cash Flows (in thousands of dollars)

	2007	2006	2005
Cash provided (used) by:			
Operating activities	(8,015)	(10,060)	(6,542)
Non-capital financing activities	8,671	8,282	6,701
Capital and related financing activities	(308)	(284)	(354)
Investing activities	1,330	987	590
Net increase (decrease) in cash	**1,678**	**(1,075)**	**395**
Cash, beginning of year	**6,876**	**7,951**	**7,556**
Cash, end of year	**8,554**	**6,876**	**7,951**

Comparison of FY 2007 to FY 2006

- The increase in cash provided (used) by operating activities resulted from an increase in grants and contracts and a decrease in restricted accounts payable.
- The increase in non-capital financing activities resulted from an increase in deposits held for others. The increase in deposits held for others was due to the timing of new Tennessee Technology Center (TTC) startup programs and an increase in Tennessee Foreign Language Institute (TFLI) funds, which are included in TBR's agency funds.
- Cash provided by investing activities increased due to an increase in interest rates and the timing of revenues and expenses.

- The Central Office's liquidity improved during 2007.

Comparison of FY 2006 to FY 2005

- The increase in cash provided (used) by operating activities resulted from an increase in grant payments from the Geier Consent Decree, Families First, and Food Stamp Employment programs, and an increase in RODP program expenses.

- The increase in cash provided by non-capital financing activities resulted from an increase in state appropriations for the Geier Consent Decree program.

- Cash provided by investing activities increased due to an increase in interest rates and the timing of revenues and expenses.

- The Central Office's liquidity declined during the 2006 year.

Capital Assets and Debt Administration

Capital Assets

The Central Office had $713,023.51 invested in capital assets, net of accumulated depreciation of $794,658.38 at June 30, 2007; $580,861.12 invested in capital assets, net of accumulated depreciation of $806,914.56 at June 30, 2006; and $456,898.03 invested in capital assets, net of accumulated depreciation of $647,341.87 at June 30, 2005. Depreciation charges totaled $183,608.81, $159,572.69, and $121,944.51 for the years ended June 30, 2007; June 30, 2006; and June 30, 2005, respectively. Details of these assets are shown below.

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

	2007	2006	2005
Equipment	713	581	457

The Central Office installed a new phone system to replace aging equipment, which caused most of the increase in capital assets for fiscal year 2007.

The Central Office has no immediate plans for significant capital expenditures for fiscal year 2008.

More detailed information about the Central Office's capital assets is presented in Note 4 to the financial statements.

Economic Factors That Will Affect the Future

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

Requests for Information

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

Exhibit A

TENNESSEE BOARD OF REGENTS
STATE UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF TENNESSEE - CENTRAL OFFICE
STATEMENTS OF NET ASSETS
JUNE 30, 2007, AND JUNE 30, 2006

	June 30, 2007	June 30, 2006
ASSETS		
Current assets:		
Cash (Note 2)	$ 3,423,576.22	$ 3,797,434.86
Accounts and grants receivable (net) (Note 3)	954,179.49	1,348,981.24
Prepaid expenses and deferred charges	4,956.12	1,620.92
Other assets	175.00	175.00
Total current assets	4,382,886.83	5,148,212.02
Noncurrent assets:		
Cash (Note 2)	5,130,477.04	3,078,698.40
Capital assets (net) (Note 4)	713,023.51	580,861.12
Total noncurrent assets	5,843,500.55	3,659,559.52
Total assets	10,226,387.38	8,807,771.54
LIABILITIES		
Current liabilities:		
Accounts payable	724,098.42	1,754,733.45
Accrued liabilities	91,090.70	121,399.49
Due to grantors (Note 5)	-	5,000.00
Deferred revenue	875.00	875.00
Compensated absences (Note 5)	270,311.08	268,739.04
Deposits held in custody for others	1,211,603.12	1,071,602.01
Total current liabilities	2,297,978.32	3,222,348.99
Noncurrent liabilities:		
Compensated absences (Note 5)	698,261.14	626,339.18
Total noncurrent liabilities	698,261.14	626,339.18
Total liabilities	2,996,239.46	3,848,688.17
NET ASSETS		
Invested in capital assets	713,023.51	580,861.12
Restricted for:		
Nonexpendable:		
Scholarships and fellowships	474,295.88	474,295.88
Expendable:		
Scholarships and fellowships (Note 6)	47,860.41	24,251.08
Other	1,282,228.81	762,717.05
Unrestricted (Notes 6 and 7)	4,712,739.31	3,116,958.24
Total net assets	$ 7,230,147.92	$ 4,959,083.37

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

Exhibit B

TENNESSEE BOARD OF REGENTS
STATE UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF TENNESSEE - CENTRAL OFFICE
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2007, AND JUNE 30, 2006

	Year Ended June 30, 2007	Year Ended June 30, 2006
REVENUES		
Operating revenues:		
Governmental grants and contracts	$ 3,824,257.56	$ 3,556,741.99
Non-governmental grants and contracts	15,000.00	-
Other operating revenues	8,959,026.68	7,983,007.51
Total operating revenues	12,798,284.24	11,539,749.50
EXPENSES		
Operating expenses (Note 12):		
Salaries and wages	7,325,701.83	6,518,882.69
Benefits	2,260,294.15	1,932,236.36
Utilities, supplies, and other services	10,178,558.73	13,160,309.17
Scholarships and fellowships	17,432.00	20,228.91
Depreciation expense	183,608.81	159,572.69
Total operating expenses	19,965,595.52	21,791,229.82
Operating loss	(7,167,311.28)	(10,251,480.32)
NONOPERATING REVENUES (EXPENSES)		
State appropriations	8,100,500.00	8,679,845.00
Investment income	1,330,076.83	986,870.92
Net nonoperating revenues	9,430,576.83	9,666,715.92
Income (loss) before other revenues, expenses, gains, or losses	2,263,265.55	(584,764.40)
Gain on disposal of capital assets	7,799.00	-
Total other revenues	7,799.00	-
Increase (decrease) in net assets	2,271,064.55	(584,764.40)
NET ASSETS		
Net assets - beginning of year	4,959,083.37	5,543,847.77
Net assets - end of year	$ 7,230,147.92	$ 4,959,083.37

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

TENNESSEE BOARD OF REGENTS
STATE UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF TENNESSEE - CENTRAL OFFICE
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2007, AND JUNE 30, 2006

	Year Ended June 30, 2007	Year Ended June 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Grants and contracts	$ 3,808,128.19	$ 3,358,003.07
Payments to suppliers and vendors	(11,221,673.01)	(13,135,149.53)
Payments to employees	(7,263,418.78)	(6,389,022.42)
Payments for benefits	(2,279,391.99)	(1,856,855.39)
Payments for scholarships and fellowships	(17,432.00)	(20,228.91)
Other receipts (payments)	8,959,026.68	7,983,007.51
Net cash used by operating activities	(8,014,760.91)	(10,060,245.67)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations	8,099,100.00	8,680,345.00
Change in deposits held for others	571,476.28	(397,960.96)
Net cash provided by noncapital financing activities	8,670,576.28	8,282,384.04
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchases of capital assets	(315,771.20)	(283,535.78)
Proceeds from sale of capital assets	7,799.00	-
Net cash used by capital and related financing activities	(307,972.20)	(283,535.78)
CASH FLOWS FROM INVESTING ACTIVITIES		
Income on investments	1,330,076.83	986,870.92
Net cash provided by investing activities	1,330,076.83	986,870.92
Net increase (decrease) in cash	1,677,920.00	(1,074,526.49)
Cash - beginning of year	6,876,133.26	7,950,659.75
Cash - end of year	$ 8,554,053.26	$ 6,876,133.26
Reconciliation of operating loss to net cash used by operating activities:		
Operating loss	$ (7,167,311.28)	$ (10,251,480.32)
Adjustments to reconcile operating loss to net cash used by operating activities:		
Depreciation expense	183,608.81	159,572.69
Change in assets and liabilities:		
Receivables, net	(26,129.37)	(200,969.00)
Prepaid/deferred items	(3,335.20)	(1,528.82)
Accounts payable	(1,039,779.08)	23,918.54
Accrued liabilities	(30,308.79)	52,006.11
Compensated absences	73,494.00	153,235.13
Other	(5,000.00)	5,000.00
Net cash used by operating activities	$ (8,014,760.91)	$ (10,060,245.67)
Noncash transactions		
Gain on disposal of capital assets	$ 7,799.00	$ -

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

Tennessee Board of Regents
State University and Community College
System of Tennessee – Central Office
Notes to the Financial Statements
June 30, 2007, and June 30, 2006

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

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

Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The financial statement presentation required by those statements provides a comprehensive, entity-wide perspective of the Central Office's assets, liabilities, net assets, revenues, expenses, changes in net assets, and cash flows.

Basis of Accounting

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

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

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

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

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

Compensated Absences

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

Capital Assets

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

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

Net Assets

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

<u>Invested in capital assets</u> - This represents the Central Office's total investment in capital assets.

<u>Nonexpendable restricted net assets</u> - Nonexpendable restricted net assets consist of endowment and similar type funds in which donors or other outside sources have stipulated, as a condition of the gift instrument, that the principal is to be maintained

inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may be expendable or added to principal.

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

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

NOTE 2. CASH

This classification includes demand deposits and petty cash on hand. At June 30, 2007, cash consisted of $603,596.63 in bank accounts, $100.00 of petty cash on hand, and $7,950,356.63 in the State of Tennessee Local Government Investment Pool administered by the State Treasurer. At June 30, 2006, cash consisted of $576,458.01 in bank accounts, $100.00 of petty cash on hand, $6,299,575.25 in the State of Tennessee Local Government Investment Pool administered by the State Treasurer.

The Central Office also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. The LGIP is part of the Pooled Investment Fund. The fund's required risks disclosures are presented in the *Tennessee Comprehensive Annual Financial Report.* That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 14th Floor William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, Tennessee 37243-0298, or by calling (615) 741-2140.

Tennessee Board of Regents
State University and Community College System of Tennessee – Central Office
Notes to the Financial Statements (Cont.)
June 30, 2007, and June 30, 2006

NOTE 3. RECEIVABLES

Receivables included the following:

	June 30, 2007	June 30, 2006
Grants receivable	$ 815,128.22	$ 791,743.45
State appropriation receivable	13,700.00	12,300.00
Other receivables	125,351.27	544,937.79
Total receivables	$ 954,179.49	$ 1,348,981.24

NOTE 4. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2007, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance
Equipment	$ 1,387,775.68	$ 315,771.20	$195,864.99	$ 1,507,681.89
Less accumulated depreciation	806,914.56	183,608.81	195,864.99	794,658.38
Capital assets, net	$ 580,861.12	$ 132,162.39	$ -	$ 713,023.51

Capital asset activity for the year ended June 30, 2006, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance
Equipment	$ 1,104,239.90	$ 283,535.78	$ -	$ 1,387,775.68
Less accumulated depreciation	647,341.87	159,572.69	-	806,914.56
Capital assets, net	$ 456,898.03	$ 123,963.09	$ -	$ 580,861.12

NOTE 5. LONG-TERM LIABILITIES

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

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Compensated absences	$ 895,078.22	$ 602,628.19	$ 529,134.19	$ 968,572.22	$ 270,311.08
Due to grantors	5,000.00	-	5,000.00	-	-
Total long-term liabilities	$ 900,078.22	$ 602,628.19	$ 534,134.19	$ 968,572.22	$ 270,311.08

Long-term liabilities activity for the year ended June 30, 2006, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Compensated absences	$ 741,843.09	$ 625,106.49	$ 471,871.36	$ 895,078.22	$ 268,739.04
Due to grantors	-	5,000.00	-	5,000.00	5,000.00
Total long-term liabilities	$ 741,843.09	$ 630,106.49	$ 471,871.36	$ 900,078.22	$ 273,739.04

NOTE 6. ENDOWMENTS

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

The Central Office chooses to spend only a portion of the investment income each year. Under the spending plan established by the board, expenditures are limited to the one new four year scholarship awarded each year, and funding three previously awarded scholarships. Allowable scholarship expenditures are limited to the following: the cost of in-state tuition and fees, room and board (or a commuting allowance), a stipend of $500 per year, and a $500 annual book allowance. The remaining amount, if any, is retained for use in future years. At June 30, 2007, net appreciation of $143,804.48 is available to be spent, of which $47,860.41 is included in restricted net assets expendable for scholarships and fellowships and $95,944.07 is included in unrestricted net assets. At June 30, 2006, net appreciation of $106,276.57 is available to be spent, of which $24,251.08 is included in restricted net assets expendable for scholarships and fellowships and $82,025.49 is included in unrestricted net assets.

NOTE 7. UNRESTRICTED NET ASSETS

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

	June 30, 2007	June 30, 2006
Working capital	$ 40,699.87	$ 51,869.87
Encumbrances	34,791.97	104,966.26
Quasi-endowment	491,179.20	491,179.20
Renewal and replacement of equipment	4,121,321.01	2,565,563.85
Undesignated	24,747.26	(96,620.94)
Total	$ 4,712,739.31	$ 3,116,958.24

NOTE 8. PENSION PLANS

A. Defined Benefit Plans

Tennessee Consolidated Retirement System

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

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

Funding Policy - Plan members are noncontributory. The Central Office is required to contribute an actuarially determined rate. The current rate is 13.66% of annual covered payroll. Contribution requirements for the Central Office are established and may be amended by the TCRS' Board of Trustees. The Central Office's contributions to TCRS for the years ended June 30, 2007, 2006, and 2005 were $618,431.98, $533,383.17, and $406,549.58. Contributions met the requirements for each year.

B. Defined Contribution Plans

Optional Retirement Plans (ORP)

Plan Description - The Central Office contributes to three defined contribution plans: Teachers Insurance and Annuity Association–Central Office Retirement Equities Fund (TIAA-CREF), Aetna Life Insurance and Annuity Company, and Variable Annuity Life Insurance Company (VALIC). These plans are administered by the Tennessee Department of the Treasury. Each plan provides retirement benefits to faculty and staff who are exempt from the overtime provisions of the Fair Labor Standards Act and who waive membership in the TCRS. Benefits depend solely on amounts contributed to the plan plus investment earnings. Plan provisions are established by state statute in Title 8, Chapter 35, Part 4, *Tennessee Code Annotated.* State statutes are amended by the Tennessee General Assembly.

Funding Policy - Plan members are noncontributory. The Central Office contributes an amount equal to 10% of the employee's base salary up to the social security wage base and 11% above the social security wage base. Contribution requirements are established and amended by state statute. The contribution made by the Central Office to the plans was $255,846.56 for the year ended June 30, 2007, and $115,448.47 for the year ended June 30, 2006. Contributions met the requirements for each year.

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 Central Office retirees. This benefit is provided and administered by the State of Tennessee. The Central Office assumes no liability for retiree health care programs. Information related to this plan is available at the statewide level in the *Tennessee Comprehensive Annual Financial Report*. That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 14th Floor William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, Tennessee 37243-0298, or by calling (615) 741-2140.

NOTE 10. 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. Settled claims have not exceeded this commercial coverage in any of the past three fiscal years. 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 $5 million.

The Central Office participates in the Risk Management Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the Central Office based on a percentage of the Central Office's expected loss costs, which include both experience and exposures. This charge considers recent trends in actual claims experience of the state as a whole. An actuarial valuation is performed as of fiscal year-end to determine the fund liability and premium allocation. Information regarding the determination of the claims liabilities and the changes in the balances of the claims liabilities for the years ended June 30, 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, Tennessee 37243-0298, or by calling (615) 741-2140. Since the Central Office participates in the Risk Management Fund, it is subject to the liability limitations under the provisions of the Tennessee Claims Commission Act, *Tennessee Code Annotated*, Section 9-8-101 et seq. Liability for negligence of the Central Office for bodily injury and property damage is limited to $300,000 per person and $1,000,000 per occurrence. The limits of liability under workers' compensation are set forth in *Tennessee Code Annotated*, Section 50-6-101 et seq. Claims are paid through the state's Risk Management Fund. At June 30, 2007, the Risk Management Fund held $116.7 million in cash and cash equivalents designated for payment of claims. At June 30, 2006, the Risk Management fund held $133.2 million in cash and cash equivalents designated for payment of claims.

At June 30, 2007, the scheduled coverage for the Central Office was $2,000,000 for contents. At June 30, 2006, the scheduled coverage for the Central Office was $2,000,000 for contents.

The state has also set aside assets in the Employee Group Insurance Fund, an internal service fund, to provide a program of health insurance coverage for the employees of the state with the risk retained by the state. The Central Office participates in the Employee Group Insurance Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the Central Office based on estimates of the ultimate cost of claims that have been reported but not settled and of claims that have been incurred but not reported. Employees and providers have 13 months to file medical claims.

NOTE 11. COMMITMENTS AND CONTINGENCIES

Sick Leave - The Central Office records the cost of sick leave when paid. Generally, since sick leave (earned one day per month with unlimited accumulation) is paid only when an employee dies or is absent because of illness, injury, or related family death, there is no liability for sick leave at June 30. The dollar amount of unused sick leave was $3,252,698.73 at June 30, 2007, and $2,775,816.15 at June 30, 2006.

Operating Leases - The Central Office has entered into various operating leases for office and storage space. Such leases will probably continue to be required. Expenses under operating leases were $605,226.80 for the year ended June 30, 2007, and $539,959.92 for the year ended June 30, 2006. All operating leases are cancelable at the lessee's option.

Litigation - The Central Office is involved in several lawsuits, none of which are expected to have a material effect on the accompanying financial statements.

NOTE 12. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATIONS

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

			Natural Classification			
Functional Classification	Salaries	Benefits	Other Operating	Scholarships	Depreciation	Total
Institutional support	$ 7,325,701.83	$2,260,294.15	$ 9,824,467.41	$ -	$ -	$ 19,410,463.39
Operation & maintenance	-	-	354,091.32	-	-	354,091.32
Scholar. & fellow.	-	-	-	17,432.00	-	17,432.00
Depreciation	-	-	-	-	183,608.81	183,608.81
Total	$ 7,325,701.83	$2,260,294.15	$ 10,178,558.73	$ 17,432.00	$ 183,608.81	$ 19,965,595.52

The Central Office's operating expenses by functional classification for the year ended June 30, 2006, are as follows:

			Natural Classification			
Functional Classification	Salaries	Benefits	Other Operating	Scholarships	Depreciation	Total
Institutional support	$ 6,518,882.69	$ 1,932,236.36	$ 12,850,864.49	$ -	$ -	$ 21,301,983.54
Operation & maintenance	-	-	309,444.68	-	-	309,444.68
Scholar. & fellow.	-	-	-	20,228.91	-	20,228.91
Depreciation	-	-	-	-	159,572.69	159,572.69
Total	$ 6,518,882.69	$ 1,932,236.36	$ 13,160,309.17	$ 20,228.91	$ 159,572.69	$ 21,791,229.82