AUDIT REPORT

The University of Tennessee

For the Year Ended
June 30, 2008

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee
Comptroller
of the Treasury

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March 26, 2009

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Mr. James E. Hall, Chairman
Audit Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180
and
Dr. Jan Simek, Acting 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, 2008. 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,

Arthur A. Hayes, Jr., CPA
Director

AAH/sds
08/080

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, 2008

AUDIT OBJECTIVES

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

INTERNAL CONTROL FINDING

Advancement Services and Athletic Department Personnel Failed to Address Risks Associated With Improper Accounting for Pledges Receivable, Resulting in a $6.4 Million Overstatement of Pledges Receivable on the University's June 30, 2008, Financial Statements
The University of Tennessee uses two separate systems to process and account for donor pledges made to the university. Personnel in the Advancement Services office use the Alumni and Development Information System (ANDI) to maintain the official record of all gifts and pledges made to the university. Personnel in Athletic Development at Knoxville use the ADvantage system to account for gifts and pledges made to the UT Knoxville Athletic Department. Pledges and gifts are initially entered into the ADvantage system and then are subsequently entered into the ANDI system through a multi-step data transfer process. The Assistant Vice President for Advancement Services and his staff are responsible for reporting accurate gift and pledges receivable balances at each June 30 year-end to the Controller for proper financial statement reporting. However, the Assistant Vice President did not provide accurate pledges receivable balances at June 30, 2008, to the Controller because of uncorrected data integrity issues on the ANDI accounting system and because of the staff's failure to establish an Advancement Services policy for the write-off of delinquent, uncollected pledges, ultimately affecting the June 30 balances. We also found that neither Advancement Services personnel nor Athletic Department personnel performed monthly reconciliations between ANDI and ADvantage (page 9).

COMPLIANCE FINDING

The Principal Investigator and the Grant Accountant at the University's Institute of Agriculture Failed to Ensure That Obligations Charged to Federal Awards Occurred During the Award's Period of Availability, Resulting in Federal Questioned Costs of $569.21

The university personnel did not comply with federal regulations governing the federal research and development award period of availability. The principal investigator and the responsible grant accountant at the university's Institute of Agriculture did not detect direct payroll costs incorrectly charged to a federal grant after the grant's funding period of availability, resulting in federal questioned costs totaling $569.21. According to the *Code of Federal Regulations*, Title 7, Part 3019, Section 28, "Where a funding period is specified, a recipient may charge to the grant only allowable costs resulting from obligations incurred during the funding period and any pre-award costs authorized by the Federal awarding agency" (page 13).

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, 2008

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The University of Tennessee
For the Year Ended June 30, 2008

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, 2007, through June 30, 2008, 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 year ended June 30, 2008. The University of Tennessee is an integral part of state government. As such, it has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report.*

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the university's internal control over financial reporting to determine auditing procedures for the purpose of expressing opinions on the financial statements;

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

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

4. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The university filed its report with the Department of Audit on June 3, 2008. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the university has corrected previous audit findings concerning the overawarding of financial aid at the university's Health Science Center in Memphis and inadequate controls over the Banner computer systems at the Martin campus.

The university is in the process of resolving a finding regarding overhead fees due from the UT Medical Group (UTMG) in Memphis. UTMG has paid all overhead fees since 2005, and the university has hired a consultant to examine the relationship between the Health Science Center and UTMG.

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, 2008, 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 a recommendation and management's response, is 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 generally accepted 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.

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*

December 12, 2008

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Mr. James E. Hall, 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:

We have audited the financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, and its discretely presented component units as of and for the year ended June 30, 2008, and have issued our report thereon dated December 12, 2008. Our report was modified to include a reference to other auditors. During the year ended June 30, 2008, the university implemented GASB Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. 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 university's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the university's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the university'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 a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

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 deficiency was noted:

- Advancement Services and Athletic Department personnel failed to address risks associated with improper accounting for pledges receivable, resulting in a $6.4 million overstatement of pledges receivable on the university's June 30, 2008, financial statements.

This deficiency is 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 that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we do not believe the significant deficiency 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 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.

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.

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

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/sds

FINDINGS AND RECOMMENDATIONS

1. <u>Advancement Services and Athletic Department personnel failed to address risks associated with improper accounting for pledges receivable, resulting in a $6.4 million overstatement of pledges receivable on the university's June 30, 2008, financial statements</u>

Finding

The University of Tennessee uses two separate systems to process and account for donor pledges made to the university. Personnel in the Advancement Services office use the Alumni and Development Information System (ANDI) to maintain the official record of all gifts and pledges made to the university. Personnel in Athletic Development at Knoxville use the ADvantage system to account for gifts and pledges made to the UT Knoxville Athletic Department. Pledges and gifts are initially entered into the ADvantage system and then are subsequently entered into the ANDI system through a multi-step data transfer process.

University personnel failed to appropriately respond to data integrity issues discovered within the ANDI system, failed to establish a pledges receivable write-off policy, and failed to mitigate other internal control weaknesses involving the pledges receivable process. The Assistant Vice President for Advancement Services and his staff are responsible for reporting accurate gift and pledges receivable balances at each June 30 year-end to the Controller for proper financial statement reporting. However, the Assistant Vice President did not provide accurate pledges receivable balances at June 30, 2008, to the Controller because of uncorrected data integrity issues on the ANDI accounting system and because of the staff's failure to establish an Advancement Services policy for the write-off of delinquent, uncollected pledges, ultimately affecting the June 30 balances. Also, based on our audit work, we identified certain other internal control weaknesses. The specific discrepancies are described as follows:

Data Integrity Issues – ANDI

In our discussions with the Assistant Vice President for Advancement Services and his staff, they informed us that the total pledges receivable balance from the ANDI subsidiary ledger is based on donors' scheduled pledge payments reduced by pledge payments already made. However, after they became aware of several calculation errors within the system, Advancement Services personnel generated a data integrity report which indicated that for 58 pledges, ANDI had not correctly calculated the June 30, 2008, pledge receivable balances. Management relies on the amounts from the ANDI system for financial statement reporting. Because of these uncorrected calculation errors, net pledges receivable was understated by $275,242.39 on the university's June 30, 2008, statement of net assets.

According to personnel in Advancement Services, the ANDI calculation errors occur occasionally, and this problem has been reported to the developer of the software. To this date, the source of the problem has not been determined; therefore, the software vendor has not identified a solution to this problem. In an effort to address the calculation errors, a programmer from the university's Office of Information Technology developed a data integrity script to help identify the pledges affected by calculation errors. Beginning in November 2008, after our discussions with Advancement Services' staff, they initiated a weekly data integrity report to identify such pledge calculation errors. Since that time, Advancement Services' staff have performed maintenance efforts to keep pledge balances and scheduled payments in agreement.

Delinquent Pledges

We also found that for the audit period, the Advancement Services staff had not established a policy to write off uncollectible pledges when donors became delinquent in their scheduled pledge payments. The Advancement Services staff did enact a policy during the 2009 fiscal year which stated that staff should deem pledges uncollectible "when a scheduled payment becomes one year overdue."

We determined that, based on research done by Advancement Services' staff, delinquent pledges (no payments for one year or more) totaled approximately $7,944,600 and were included on the university's June 30, 2008, statement of net assets net of a 20 percent allowance for doubtful accounts and discounted to net present value. These pledges were deemed uncollectible and were scheduled for write-off on January 1, 2009. Since the entire amount was deemed uncollectible, the allowance account established for doubtful accounts was not sufficient to cover all uncollectible pledges. At June 30, 2008, net pledges receivable were overstated on the university's statement of net assets by at least $5,936,319.84.

Other Internal Control Weaknesses

Based on our testwork, we also found that neither Advancement Services personnel nor Athletic Department personnel performed monthly reconciliations between ANDI, the system-wide pledge accounting system; and ADvantage, the UT Knoxville Athletic Department pledge accounting system. University personnel rely on accurate ADvantage pledge data to ensure staff enter accurate data for the ANDI system. Therefore, it is imperative that a monthly reconciliation of these systems be performed to ensure that financial statement balances are properly reported. Based on our review of significant pledges, we found ten donors with pledges totaling $800,000 recorded in ADvantage that were missing in ANDI. Once we informed Advancement Services' staff of these discrepancies, they corrected the pledge information on ANDI prior to preparation of the fiscal year 2008 financial statements. Some of these pledges had been processed and transferred to Advancement Services by Athletic Department personnel but not recorded on ANDI, while other pledges had not been processed and transferred to Advancement Services. Explanations of these discrepancies as given by Advancement Services personnel and Athletic Development personnel were inconsistent.

We also found that Athletic Development staff did not perform formal reconciliations comparing pledge documents to batch reports listing pledges entered in the ADvantage system. Staff review the pledges for correctness when entering into the system, but no additional formal review process is in place to ensure pledges are accurate once entered. Without this review process, errors are likely to be made and not detected.

We found an unsupported pledge amount of $1,000,000 on the ADvantage and ANDI systems. To print an invoice to a potential donor, an Athletic Development staff member recorded a possible pledge on the ADvantage system, which the donor did not fulfill. The unfulfilled pledge was left on both systems as an actual pledge. Because of this error, net pledges receivable were overstated by $747,214.39 on the university's June 30, 2008, statement of net assets.

An Athletic Development staff member opens the mail and, with the help of additional workers, processes gift checks in ADvantage. A walkthrough revealed that student workers who assist in processing these checks were working in a different area, and therefore checks and receipts were transferred from one work area to another without adequate security safeguards. In addition, as checks were received in the mail, receipts for checks were not immediately written, nor were the checks immediately logged. The failure to establish immediate control over these unsecured checks could lead to their loss or misappropriation.

All of the problems identified above were caused by the failure of Advancement Services and Athletic Development personnel to understand the importance of their role in accounting for pledges and in financial reporting and to properly communicate to ensure coordination of recording and reporting on pledges. The staff members accounting for pledges apparently did not have adequate accounting knowledge to ensure accurate financial reporting, and supervisors did not provide adequate oversight by external accounting personnel to ensure accurate financial reporting. Without proper communication and proper oversight of accounting for pledges receivable, doubtful account estimates, write-off policies, and internal control procedures, errors can occur and not be detected timely.

Recommendation

The university's Senior Vice President and Chief Financial Officer should strongly consider that the university use a single, reliable accounting system to ensure the accurate reporting of pledges receivable on the university's financial statements. Top management should consider using only the ANDI system to account for pledges receivable with Athletic Department personnel having access to that system. Written control procedures should be developed for Advancement Services and Athletic Development at Knoxville to ensure proper accountability for pledges and gift receipts. Current policies should be revisited to ensure that estimates of allowances for doubtful accounts and write-off procedures are reasonable, and appropriate revisions should be made as necessary. University personnel with adequate accounting expertise should be assigned to aid Advancement Services and Athletic Development personnel in achieving these goals and to provide ongoing oversight.

The Assistant Vice President for Advancement Services and his staff should comply with the recently adopted policy to write off delinquent pledges. (Revisions should be made to the policy if research and conditions warrant.) In addition, they should perform a review of delinquent pledges and prepare a write-off of delinquent pledges on a quarterly basis.

With the assistance of the university's Office of Information Technology staff, Advancement Services' staff should isolate and correct the data integrity issue. Until then, Advancement Services' staff should prepare a weekly data integrity report to identify and correct any errors identified in this process.

While university management continues to use two separate departments to enter pledge data into two separate systems (ANDI and ADvantage), Advancement Services' staff with the aid of Athletic Department personnel should perform monthly reconciliations between the two systems to ensure new pledges, pledge payments, and pledge balances are accurate, and any differences in the two systems should be resolved immediately.

The Athletic Development staff should perform reconciliations comparing pledge documents to batch reports listing pledges entered in the ADvantage system. The reconciliations should be documented and signed.

The staff responsible for opening the mail in Athletic Development should either immediately write receipts or keep a log of checks received which includes the donor's name, the amount, and check number. An employee not performing these cash receipting duties should reconcile the mail log with check deposits.

Although management identified the risks noted in this finding in the overall financial risk assessment, management did not properly mitigate the risks by ensuring adequate controls were in place. Management should promptly review the controls and make changes as needed to ensure proper pledge receipting, recording, and reporting.

Management's Comment

We concur. The university will use the ANDI system as the official record for gift pledges to the university to be recorded on the university's financial statements. The university will develop written control procedures for Advancement Services and the Athletic Development at Knoxville to ensure proper accountability for pledges and gift receipts. The Advancement Services policy on pledge write-offs will be revisited to ensure that estimates of allowances for doubtful accounts and write-off procedures are reasonable, and appropriate revisions will be made as necessary. Advancement Services staff will review delinquent pledges and prepare a write-off of delinquent pledges on a quarterly basis. Advancement Services' staff has identified the data integrity issue. Unfortunately, the vendor cannot replicate the issue and, thus, has not identified a solution. As a compensating control, Advancement Services' staff has created a weekly data integrity report to identify errors, has corrected all identified errors, and will continue to correct any errors as soon as they are identified. Advancement Services has implemented several other procedures to enhance pledge reporting.

While university management continues to use two separate departments to enter pledge data into two separate systems (ANDI and ADvantage), Advancement Services' staff with the aid of Athletic Department personnel will perform monthly reconciliations between the two systems to ensure new pledges, pledge payments, and pledge balances are accurate, and any differences in the two systems are resolved as soon as possible.

The Athletic Development staff responsible for recording pledges will perform monthly reconciliations comparing pledge documents to batch reports listing pledges entered in the ADvantage system. These reconciliations will be documented and signed.

Athletics will establish immediate control over all donor checks by preparing a daily log of mail receipts. An employee not performing cash receipting duties will reconcile the mail log with cash receipts and check deposits.

2. The principal investigator and the grant accountant at the university's Institute of Agriculture failed to ensure that obligations charged to federal awards occurred during the award's period of availability, resulting in federal questioned costs of $569.21

Finding

University personnel did not comply with federal regulations governing the federal research and development award period of availability. The principal investigator and the responsible grant accountant at the university's Institute of Agriculture did not detect direct payroll costs incorrectly charged to a federal grant after the grant's funding period of availability, resulting in federal questioned costs totaling $569.21.

According to the *Code of Federal Regulations*, Title 7, Part 3019, Section 28, "Where a funding period is specified, a recipient may charge to the grant only allowable costs resulting from obligations incurred during the funding period and any pre-award costs authorized by the Federal awarding agency."

We tested 40 randomly selected transactions charged to federal research and development grants and contracts for the period July 1, 2007, through May 31, 2008. We found that one of the 40 transactions occurred after the applicable grant's funding period of availability. Our interview with the responsible grant accountant determined that payroll charges for a student employee were incorrectly charged to the grant's general ledger account, which is used to draw down federal funds. However, when the grant account was closed out, neither the responsible bookkeeper, the responsible grant accountant, nor the principal investigator initiated an adjusting entry to ensure the student employee's time was charged to the appropriate account. Based on discussions with the responsible grant accountant, in accordance with university *Fiscal Policy* 115, although the responsible parties reviewed the monthly grant ledgers for errors, the errors were not detected. The bookkeeper for this grant was new to this position and was still in the process of learning his duties.

The university's *Fiscal Policy* 205 states, "All charges should be processed against such accounts within 60 days after the project end date so that final financial reports can be submitted and the [accounts] closed on a timely basis." This account was not properly closed within 60 days of the grant's July 31, 2007, project end date. The majority of these payroll charges ($308.62) were posted more than 60 days after the project end date. The grant accountant and the principal investigator should have ensured that the account was properly closed 60 days after the project end date.

Due to staffing changes and the staff's failure to comply with university policy, these expenses were inappropriately charged to the federal grant.

The total amount of questioned costs for the transaction noted above was $569.21 out of a total of $83,608.66 tested. The total amount of the population sampled was $108,270,735.33. Office of Management and Budget Circular A-133 requires us to report all known questioned costs when likely questioned costs exceed $10,000 for a federal compliance requirement. We believe likely questioned costs exceed $10,000 for this condition.

In response to our testwork, the responsible grant accountant met with the bookkeeper to further instruct him on the closing procedures at the end of a grant's funding period. In addition, the grant accountant began communication with the grantor and returned the costs in question to the grantor.

Recommendation

The Vice President for Agriculture and other management should ensure that the principal investigators, bookkeepers, and grant accountants have the knowledge and expertise to monitor and account for federal grant and contract awards in accordance with federal and university regulations.

Although the risks noted in this finding were identified and assessed in management's overall financial risk assessment, management should continue to assess risks of noncompliance with federal regulations and ensure controls are in place to mitigate those risks.

Management's Comment

We concur. As was mentioned in the finding, the questioned amount has been returned to the United States Department of Agriculture. The Institute of Agriculture will remind all principal investigators, department heads, and departmental financial staff of the necessity to place personnel on the proper accounts, and the Institute will provide training for all principal investigators, department heads, and departmental financial staff to be sure all of these persons have the knowledge and expertise to monitor and account for federal grant and contract awards in accordance with federal and university regulations.

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Independent Auditor's Report

December 12, 2008

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Mr. James E. Hall, 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:

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, 2008, 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 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 and the reports of the other auditors provide a reasonable basis for our opinions.

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, 2008, 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 $265,427,070.13 (12.7 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.

As discussed in Note 22, during the year ended June 30, 2008, the university implemented GASB Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

The management’s discussion and analysis on pages 18 through 29 and the OPEB schedule of funding progress on page 74 are not a required part of the basic financial statements but are 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 December 12, 2008, on our consideration of the university’s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with 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., CPA
Director

AAH/sds

The University of Tennessee
Management's Discussion and Analysis
June 30, 2008

This section of the University of Tennessee's report presents a discussion and analysis of the financial performance of the university during the fiscal year ended June 30, 2008, with comparative information presented for the fiscal year ended June 30, 2007. 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 20 and 21 of the financial statements. Information and analysis regarding the component units are also included in this section.

Using This Report

This report consists of three basic financial statements. The statement of net assets; the statement of revenues, expenses, and changes in net assets; and the statement of cash flows provide information on the 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.

Condensed Statements of Net Assets
(in thousands of dollars)

	UT		UC Foundation		UT Foundation	
	2008	**2007**	**2008**	**2007**	**2008**	**2007**
Assets:						
Current assets	$ 462,504	$ 453,049	$ 8,978	$ 8,521	$ 5,072	$ 7,254
Capital assets, net	1,335,610	1,128,100	69,160	69,731	-	50,588
Other assets	1,144,091	1,122,316	118,351	132,958	88,163	62,771
Total Assets	2,942,205	2,703,465	196,489	211,210	93,235	120,613
Liabilities:						
Current liabilities	282,804	275,524	9,924	8,521	1,764	1,012
Noncurrent liabilities	574,383	439,533	85,044	86,443	553	58,109
Total Liabilities	857,187	715,057	94,968	94,964	2,317	59,121
Net Assets:						
Invested in capital assets, net of related debt	868,014	773,979	-	-	-	-
Restricted – nonexpendable	391,038	379,343	46,469	50,993	15,408	9,401
Restricted – expendable	541,916	588,963	8,342	8,278	74,315	55,048
Unrestricted	284,050	246,123	46,710	56,975	1,195	(2,957)
Total Net Assets	$ 2,085,018	$ 1,988,408	$ 101,521	$ 116,246	$ 90,918	$ 61,492

The university had the following significant changes between fiscal years on the statement of net assets:

Currents assets increased between fiscal years due to increases in cash and cash equivalents and accounts, notes, and grants receivable. The most significant increase is attributable to moving assets from commercial paper and U.S. agency obligations to certificates of deposit.

Other noncurrent assets of cash and cash equivalents and lease payments receivable increased between the fiscal years. Cash and cash equivalents increased due to a changing investment mix to adjust to activity in the capital markets. Lease payments receivable increased with the addition of a new lease agreement with the Tennessee Department of Mental Health and Developmental Disabilities for the Memphis Mental Health Institute. Investments decreased due to losses in the capital markets, and accounts, notes, and grants receivable decreased due to a reduction in pledges of future gifts.

The increase in net capital assets between fiscal years is a result of additions to the university's capital assets. More detailed information about the university's capital assets is presented in the Capital Assets and Debt Administration section of this report.

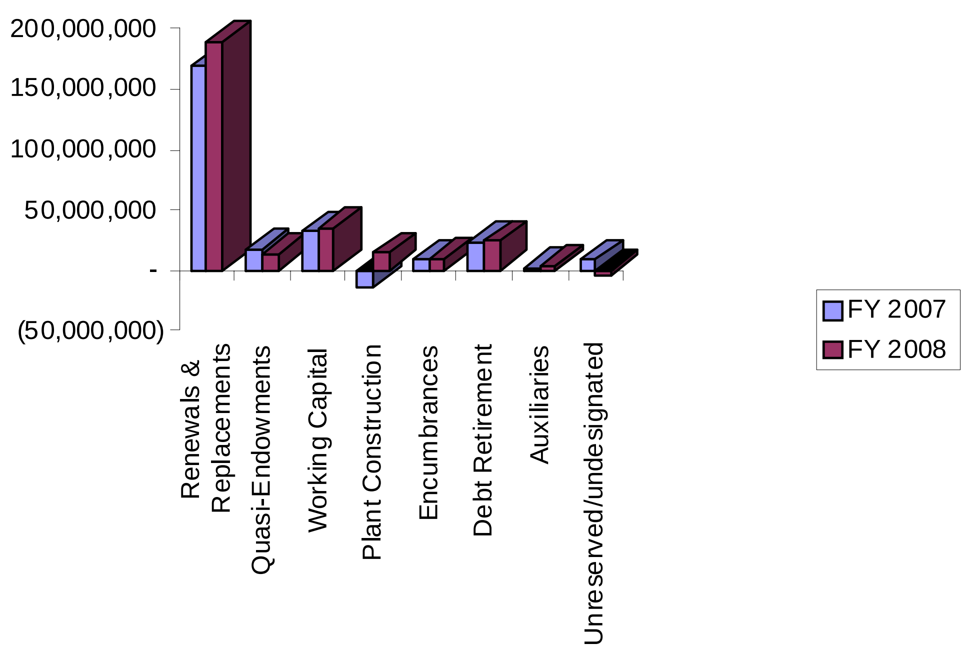
Noncurrent liabilities increased between fiscal years due to the issuance of bonds and/or commercial paper by the Tennessee State School Bond Authority on behalf of the university for various capital projects. More detailed information about the university's debt is presented in the Capital Assets and Debt Administration section of this report.

The restricted - expendable net assets decreased between fiscal years as a result of the use of accumulated private dollars on scholarships and fellowships, instructional department uses, and capital projects. These funds were received in prior years and were spent in the current year.

The decrease in capital assets for the UT Foundation was caused by the sale of Knoxville Place, an apartment complex, to the university. The complex was renamed Volunteer Hall.

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

Unrestricted Net Assets - University



The change in the designation for plant construction between fiscal years is attributable to an increase of gifts for capital construction.

Renewals and replacements increased from 2007 to 2008 due to unspent educational and general dollars with the expectation that fiscal year 2009 would be leaner.

The unreserved/undesignated amount decreased from 2007 to 2008 due to a new requirement issued by the Governmental Accounting Standards Board to recognize approximately $20 million in post-employment benefits.

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.

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

	UT		UC Foundation		UT Foundation	
	2008	2007	2008	2007	2008	2007
Operating revenues:						
Net tuition and fees	$ 239,567	$ 231,621	$ -	$ -	$ -	$ -
Grants and contracts	377,475	383,659	-	-	-	-
Auxiliary	157,543	160,502	-	-	-	-
Other	88,881	75,266	14,841	13,212	31,243	34,148
Total operating revenues	863,466	851,048	14,841	13,212	31,243	34,148
Operating expenses	1,587,279	1,508,826	11,620	11,860	15,173	7,312
Operating income (loss)	(723,813)	(657,778)	3,221	1,352	16,070	26,836
Nonoperating revenues and expenses:						
State and local appropriations	539,634	492,810	-	-	-	-
Gifts	21,108	65,725	-	-	-	-
Investment income	17,528	175,091	(6,653)	15,734	208	2,348
Other revenues and expenses	104,933	98,546	(5,659)	(4,801)	6,520	-
Total nonoperating revenues and expenses	683,203	832,172	(12,312)	10,933	6,728	2,348
Income (loss) before other revenues, expenses, gains, or losses	(40,610)	174,394	(9,091)	12,285	22,798	29,184
Other revenues, expenses, gains, or losses:						
Capital appropriations	69,592	32,834	-	-	-	-

Capital grants and gifts	41,044	22,875	-	-	-	-
Additions to permanent endowments	17,812	17,827	766	638	6,628	708
Other	8,772	905	-	-	-	-
Total other revenues, expenses, gains, or losses	137,220	74,441	766	638	6,628	708
Increase (decrease) in net assets	96,610	248,835	(8,325)	12,923	29,426	29,892
Net assets at beginning of period, as restated	1,988,408	1,739,573	109,846	103,323	61,492	31,600
Net assets at end of year	$2,085,018	$1,988,408	$101,521	$116,246	$90,918	$61,492

The university had the following significant changes in revenues between fiscal years:

Net tuition and fees increased from 2007 to 2008 as a result of a 6% fee increase. However, this increase in tuition and fee revenue was partially offset by current and new students receiving funds from the Tennessee Education Lottery Scholarship Program, which reduces tuition and fees and is shown as other nonoperating revenue.

Operating grants and contracts decreased by $6 million from 2007 to 2008 primarily in grants at Knoxville and Memphis.

Auxiliary revenues decreased $3 million, primarily in intercollegiate athletics at Knoxville due to changes in the video board contract.

In fiscal year 2008, state and local appropriations increased $47 million, which included funds for a 3% employee salary increase, new operating funds, access and diversity initiatives, and biofuels initiatives funds.

Nonoperating gifts decreased $45 million from 2007 to 2008 while capital gifts increased $18 million for the same time period.

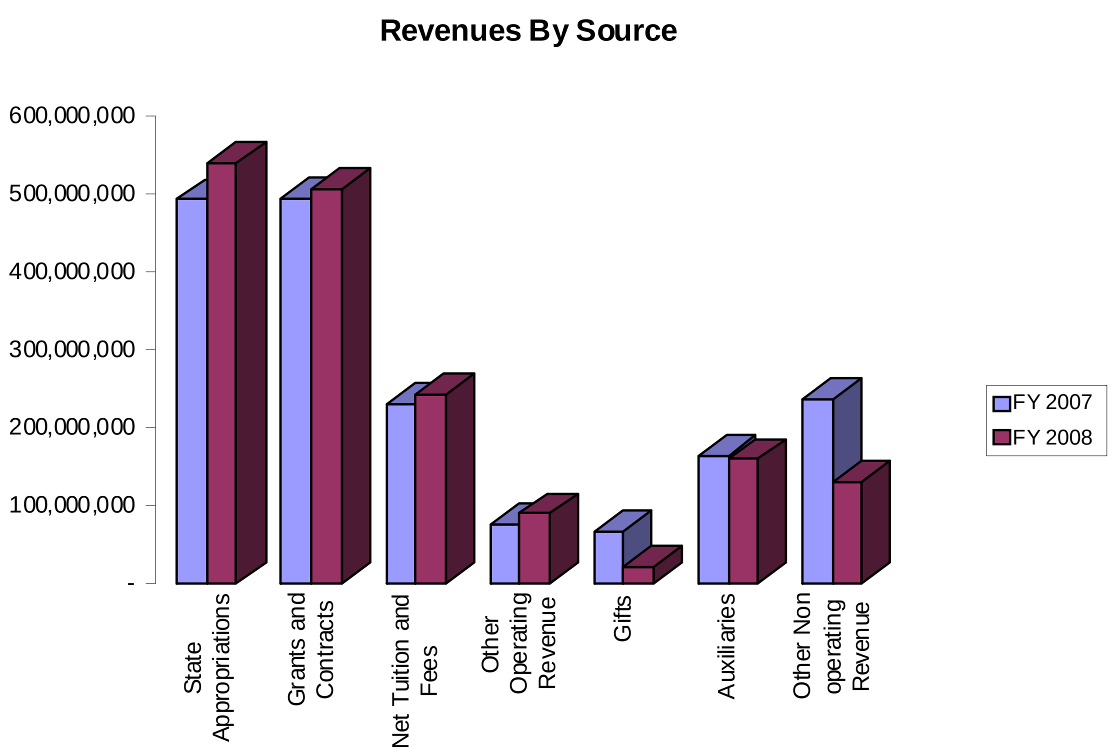
The decrease in investment income was due to a decrease in endowment income and a decline in the capital markets.

The increase in capital appropriations for 2008 consisted of an increase in state appropriations for new buildings and capital maintenance.

Additions to permanent endowments totaled $17.8 million for the 2008 fiscal year.

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, 2008, and June 30, 2007.



For the year ended June 30, 2008, approximately 76 percent of UT's revenue was attributed to state and local appropriations, grants and contracts, and tuition and fees.

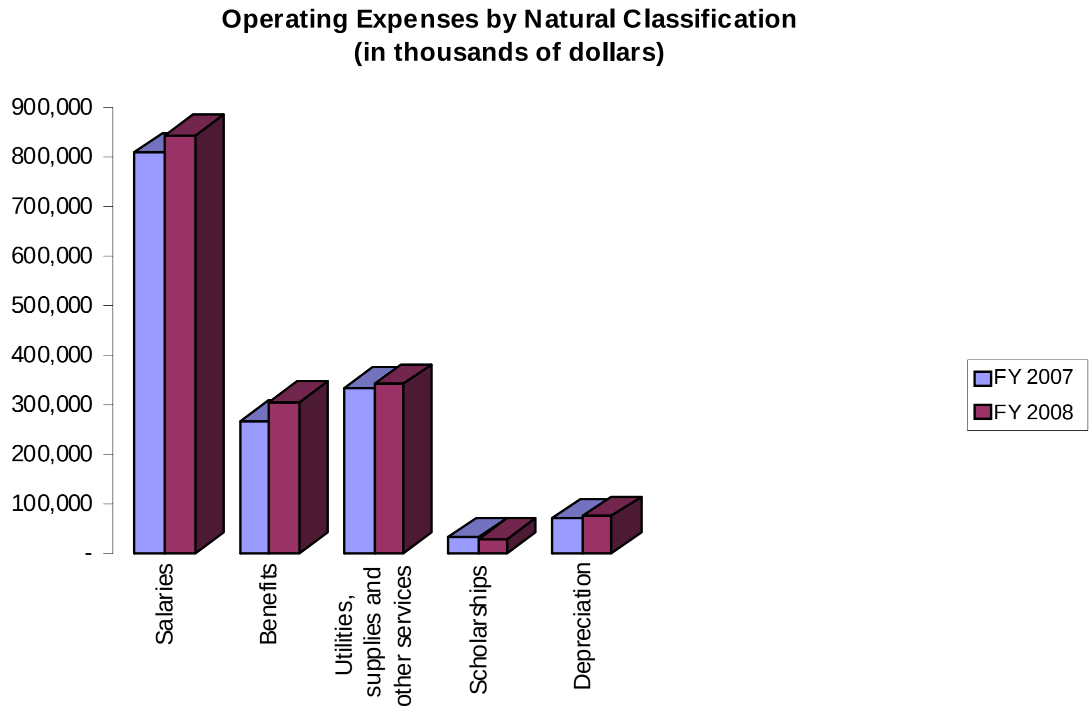
Expenses

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, 2008

2008 Functional Classification	2008 Natural Classification Salaries	Benefits	Utilities, supplies, and other services	Scholarships	Depreciation	Total
Instruction	$ 357,325	$ 108,863	$ 57,977	$ -	$ -	$ 524,165
Research	113,900	32,390	57,826	-	-	204,116
Public service	69,811	26,592	37,295	-	-	133,698
Academic support	67,657	25,391	18,265	-	-	111,313
Student services	35,884	13,632	23,055	-	-	72,571
Institutional support	69,774	26,689	4,085	-	-	100,548
Operation and maintenance of plant	32,248	15,863	51,462	-	-	99,573
Scholarships	3,078	18,057	16,597	28,304	-	66,036
Auxiliary	36,789	11,708	72,877	-	-	121,374
Independent operations	57,726	23,598	-	-	-	81,324
Depreciation	-	-	-	-	72,561	72,561
Total expenses	$ 844,192	$ 302,783	$ 339,439	$ 28,304	$ 72,561	$ 1,587,279

2007 Functional Classification	2007 Natural Classification Salaries	Benefits	Utilities, supplies, and other services	Scholarships	Depreciation	Total
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



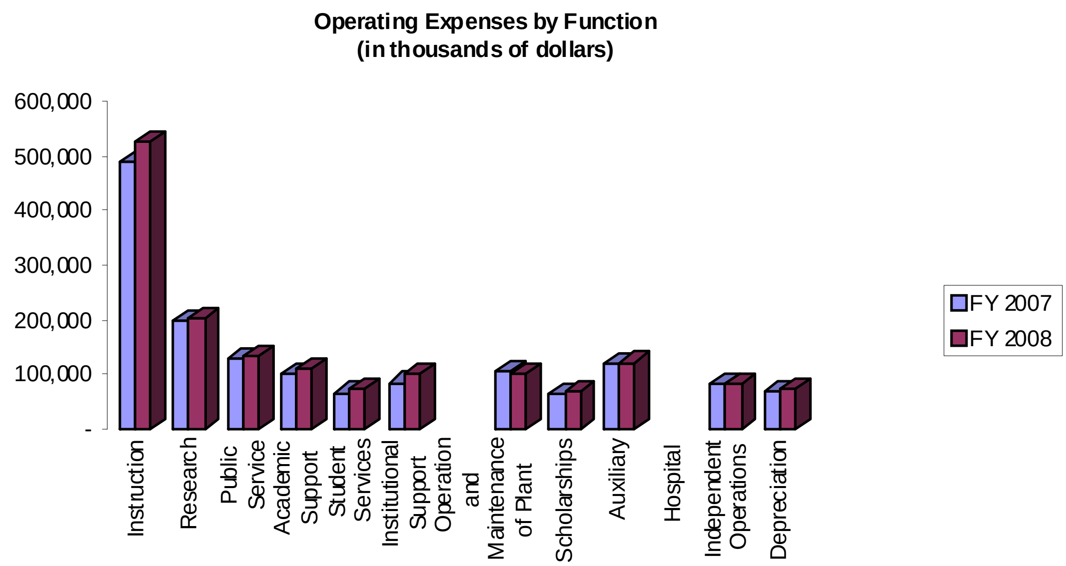
The university had the following significant changes in expenses between fiscal years:

The increase in salary expenses from 2007 to 2008 is due to a 3% across-the-board pay raise effective July 1, 2008, and university salary supplements of 2% to recognize performance, equity, retention, market, and other salary priorities.

Employee benefit expenses increased between fiscal years mainly as a result of increases in the state's group health insurance premiums, increases in Tennessee Consolidated Retirement System rates, and proportional benefits increases resulting from higher salaries.

Operating expenses increased between fiscal years due to increases in utility costs, maintenance, student awards, and equipment purchases.

Scholarship expenses decreased between fiscal years due to the required netting of increased Tennessee Education Lottery Scholarships. Scholarship expenses before discounting increased to $160 million.



The increases in all functional areas were due to the pay raises, pay supplements, benefit increases, and increased 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.

Condensed Statements of Cash Flows
(in thousands of dollars)

	2008	2007
Cash provided (used) by:		
Operating activities	$ (631,258)	$ (575,820)
Noncapital financing activities	724,201	647,644
Capital and related financing activities	(101,019)	(45,292)
Investing activities	71,433	49,003
Net increase (decrease) in cash	63,357	75,535
Cash, beginning of year	564,094	488,559
Cash, end of year	$ 627,451	$ 564,094

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 university's cash position increased by $63.3 million for FY 2007-2008 and $75.5 million for FY 2006-2007.

Capital Assets and Debt Administration

Capital Assets

At June 30, 2008, the University of Tennessee had $1,335,609,685.89 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled $72,561,012.36 for the current fiscal year. Details of these assets are shown below.

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

	2008	2007
Land	$ 53,866	$ 50,397
Land improvements & infrastructure	27,478	28,049
Buildings	815,018	666,417
Works of art/historical treasures	510	434
Equipment	112,323	94,898
Software	529	881
Library holdings	65,943	62,686
Projects in progress	259,942	224,338
Total	$ 1,335,609	$ 1,128,100

Major capital additions for UT during 2007-2008 include the $55.3 million purchase of Volunteer Hall, the $27.4 million Intercollegiate Swim Facility, the $15 million Basketball Practice Facility, the $6.5 million Soccer Stadium Improvements, the $2.9 million Walters Life Sciences Systems Improvements, the $800 thousand Library Commons and the $580 thousand Early Learning Center in Knoxville; the $16.7 million Student Housing and the $1.4 million Hall-Moody Fire Alarm System Upgrade in Martin; and the $25.2 million Basic/Clinical Sciences Building and the $2.4 million Coleman Building HVAC Improvements in Memphis.

For the next fiscal year, the state has approved $3 million in capital outlay appropriations and $6.744 million in capital maintenance appropriations for UT. These approved new projects are the Regional Biocontainment Lab Equipment and Humphreys General Education Building at the Health Sciences Center, Central Energy Plant Boiler Replacement – Phase II at Chattanooga, and the University-Wide Facilities Assessment. In addition, there are various construction and 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, 2008, the university had $462,000,152.38 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

Outstanding Debt Schedule
(in thousands of dollars)

	2008	2007
Bonds-current portion	$ 17,551	$ 15,385
Bonds-noncurrent	321,446	258,614
Commercial paper-noncurrent	122,968	77,582
Total TSSBA authorized debt	$ 461,965	$ 351,581
Notes-current portion	35	10
Notes-noncurrent portion	-	35
Total Debt	$ 462,000	$ 351,626

The university retired more than $16.3 million in bonds and notes in fiscal year 2007-2008. 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. More detailed information about the university's long-term liabilities is presented in Note 7 to the financial statements.

The Tennessee State School Bond Authority on behalf of the university issued the 2008A new bond series in 2007-2008 in the net amount of $80.8 million. There are four projects included in the 2008A bond series: UTK Intercollegiate Swim Facility – $ 20.5 million; UT Martin Elam Center Renovation – $ 2.6 million; UT Health Science Center Memphis Mental Health Institute - $ 3.9 million ($ 13.8 million was issued in the 2007A series); and UTK Knoxville Place Apartments - $ 53.8 million.

Economic Factors That Will Affect the Future

For fiscal year 2009, the University of Tennessee Board of Trustees has authorized an individual campus fee increase of 6% that is expected to generate approximately $21 million in new funding, net of related scholarships, with a continued projected enrollment increase. State appropriations have been reduced by $38 million. The capital markets are down significantly, which will affect the university's investment income. The university has won a $16 million

National Science Foundation award to begin the National Institute for Mathematical and Biological Synthesis.

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.

Exhibit A

THE UNIVERSITY OF TENNESSEE
STATEMENT OF NET ASSETS
June 30, 2008

	The University of Tennessee	University of Chattanooga Foundation, Inc.	The University of Tennessee Foundation, Inc.
ASSETS			
Current assets:			
Cash and cash equivalents (Note 2)	$ 250,275,820.84	$ 8,723,220.00	$ 3,290,087.97
Investments (Notes 2, 20, and 21)	111,229,218.09	-	597,097.40
Accounts, notes, and grants receivable (net) (Note 4)	89,280,470.48	233,654.00	975,662.34
Inventories	8,701,900.59	-	67,850.00
Prepaid expenses and deferred charges	3,017,170.54	21,183.00	141,683.25
Total current assets	462,504,580.54	8,978,057.00	5,072,380.96
Noncurrent assets:			
Cash and cash equivalents (Note 2)	377,175,373.91	-	3,224,553.99
Investments (Notes 2, 20, and 21)	607,433,651.00	117,553,876.00	17,581,835.97
Investment in UT - Battelle, LLC (Note 11)	4,075,076.00	-	-
Accounts, notes, and grants receivable (net) (Note 4)	107,588,956.33	241,172.00	52,523,589.74
Lease payments receivable (Note 15)	47,251,619.40	-	-
Capital assets (net) (Notes 5 and 20)	1,335,609,685.89	69,160,344.00	-
Prepaid expenses and deferred charges	565,933.69	555,427.00	-
Assets held by the university	-	-	14,833,349.04
Total noncurrent assets	2,479,700,296.22	187,510,819.00	88,163,328.74
Total assets	2,942,204,876.76	196,488,876.00	93,235,709.70
LIABILITIES			
Current liabilities:			
Accounts payable	90,656,197.85	4,771,840.00	289,269.61
Accrued liabilities	50,322,140.64	-	-
Deferred revenue	71,162,804.85	647,644.00	-
Deposits payable	3,723,492.74	-	-
Annuities payable	1,276,364.74	-	40,537.52
Long-term liabilities, current portion (Notes 7, 20, and 21)	58,974,074.85	1,475,000.00	13,729.99
Deposits held in custody for others	6,688,430.98	1,913,186.92	-
Due to the university	-	1,116,308.08	1,420,668.17
Total current liabilities	282,803,506.65	9,923,979.00	1,764,205.29
Noncurrent liabilities:			
Deferred revenue (Note 7)	15,500,438.71	-	-
Long-term liabilities, noncurrent portion (Notes 7, 20, and 21)	501,685,963.93	85,043,498.00	211,954.45
Due to grantors (Note 7)	35,367,779.86	-	-
Annuities payable (Note 7)	6,995,645.00	-	341,302.39
Deposits held in custody for component units	14,833,349.04	-	-
Total noncurrent liabilities	574,383,176.54	85,043,498.00	553,256.84
Total liabilities	857,186,683.19	94,967,477.00	2,317,462.13
NET ASSETS			
Invested in capital assets, net of related debt	868,014,437.29	-	-
Restricted:			
Nonexpendable:			
Scholarships and fellowships	171,836,450.58	14,775,981.00	6,706,229.29
Libraries	13,503,298.72	-	242,409.36
Research	18,401,773.32	-	172,997.57
Instructional department uses	126,217,784.38	31,641,721.00	1,837,462.30
Academic support	27,113,623.28	51,950.00	2,500,039.89
Other	33,965,332.58	-	3,949,494.74
Expendable:			
Scholarships and fellowships	141,473,080.29	575,304.00	27,089,970.79
Libraries	10,356,798.85	-	9,357.47
Research	59,811,284.12	-	641,483.40
Instructional department uses	106,358,992.21	2,643,049.00	118,808.61
Academic support	44,197,376.01	12,386.00	17,877,808.07
Loans	9,734,687.66	-	-
Capital projects	63,927,452.64	5,000,000.00	22,301,344.69
Debt service	565,933.69	-	-
Other	105,490,125.02	111,250.00	6,276,027.52
Unrestricted (Note 18)	284,049,762.93	46,709,758.00	1,194,813.87
Total net assets	$ 2,085,018,193.57	$ 101,521,399.00	$ 90,918,247.57

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

Exhibit B

THE UNIVERSITY OF TENNESSEE
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Year Ended June 30, 2008

	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 $113,193,325.79)	$ 239,567,345.60	$ -	$ -
Contributions	-	1,114,244.00	28,718,196.33
Investment return designated for operations	-	4,625,974.00	-
Federal appropriations	19,776,233.56	-	-
Governmental grants and contracts	213,698,468.07	-	-
Non-governmental grants and contracts	163,776,521.41	-	-
Sales and services of educational departments	51,643,040.18	-	-
Auxiliary enterprises:			
Residential life (net of scholarship allowances of $1,304,511.11; all revenues are used as security for varying revenue bonds; see Note 7)	37,490,259.36	9,101,044.00	2,522,094.20
Food services	4,362,591.84	-	-
Bookstore	22,022,305.99	-	-
Parking	8,900,470.75	-	-
Athletics	78,349,051.55	-	-
Other auxiliaries	6,418,868.71	-	-
Interest earned on loans to students	59,498.57	-	-
Other operating revenues	17,401,609.77	-	2,800.00
Total operating revenues	863,466,265.36	14,841,262.00	31,243,090.53
EXPENSES			
Operating expenses (Note 17):			
Salaries and wages	844,192,605.86	-	-
Fringe benefits	302,782,803.91	-	-
Utilities, supplies, and other services	339,438,837.62	3,783,139.00	5,515,661.90
Scholarships and fellowships	28,304,421.26	-	-
Depreciation expense	72,561,012.36	3,210,842.00	1,876,280.51
Payments to or on behalf of the university (Notes 20 and 21)	-	4,625,974.00	7,781,165.66
Total operating expenses	1,587,279,681.01	11,619,955.00	15,173,108.07
Operating income (loss)	(723,813,415.65)	3,221,307.00	16,069,982.46
NONOPERATING REVENUES (EXPENSES)			
State and local appropriations	539,634,239.99	-	-
Gifts (include $12,407,139.66 from component units)	21,108,077.33	-	-
Grants and contracts	130,236,764.87	-	-
Investment income (loss)	17,528,417.84	(6,652,586.00)	207,921.36
Interest on capital asset - related debt	(17,607,736.56)	(5,360,165.00)	-
Other nonoperating revenues (expenses)	(7,696,291.41)	(299,803.00)	6,520,579.50
Net nonoperating revenues (expenses)	683,203,472.06	(12,312,554.00)	6,728,500.86
Income (loss) before other revenues, expenses, gains, or losses	(40,609,943.59)	(9,091,247.00)	22,798,483.32
Capital appropriations	69,592,137.36	-	-
Capital grants and gifts	41,044,392.51	-	-
Additions to permanent endowments	17,812,253.53	766,051.00	6,627,973.34
Additions to annuity and life income trusts	2,737,853.26	-	-
Other	6,033,870.60	-	-
Total other revenues	137,220,507.26	766,051.00	6,627,973.34
Increase (decrease) in net assets	96,610,563.67	(8,325,196.00)	29,426,456.66
NET ASSETS			
Net assets at beginning of year, restated as disclosed in Note 20	1,988,407,629.90	109,846,595.00	61,491,790.91
Net assets at end of year	$ 2,085,018,193.57	$ 101,521,399.00	$ 90,918,247.57

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

Exhibit C

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2008

CASH FLOWS FROM OPERATING ACTIVITIES		
Tuition and fees	$	241,197,151.49
Federal appropriations		16,758,233.56
Grants and contracts		378,291,531.66
Sales and services of educational activities		36,412,823.12
Payments to suppliers and vendors		(331,018,037.56)
Payments to employees		(839,696,613.98)
Payments for benefits		(279,884,126.22)
Payments for scholarships and fellowships		(28,304,421.26)
Loans issued to students		(5,603,470.54)
Collection of loans from students		3,743,959.21
Interest earned on loans to students		457,814.18
Auxiliary enterprise charges:		
Residence halls		37,490,259.36
Bookstore		22,022,305.99
Food service		4,362,591.84
Parking		8,900,470.75
Athletics		81,179,999.33
Other auxiliaries		7,010,122.79
Hospital		(150,745.86)
Other receipts (payments)		15,571,875.51
Net cash provided (used) by operating activities		(631,258,276.63)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State appropriations		534,670,091.63
Local appropriations		5,019,358.36
Gifts and grants for other than capital or endowment purposes		156,634,431.52
Private gifts for endowment purposes		20,550,106.79
Split-interest transactions receipts		3,239,944.95
Split-interest transactions disbursements		(2,954,744.62)
Federal student loan receipts		194,055,576.00
Federal student loan disbursements		(194,055,576.00)
Changes in deposits held for others		679,640.12
Net cash balance implicitly financed (repaid)		328,086.07
Other noncapital receipts (payments)		6,033,870.60
Net cash provided (used) by noncapital financing activities		724,200,785.42
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from capital debt		125,658,720.14
Capital appropriations		64,127,377.21
Capital grants and gifts received		41,044,392.51
Proceeds from sale of capital assets		916,765.43
Purchase of capital assets and construction		(286,602,029.41)
Principal paid on capital debt and leases		(12,574,838.29)
Interest paid on capital debt and leases		(17,819,845.03)
Other capital and related financing receipts (payments)		(15,769,282.87)
Net cash provided (used) by capital and related financing activities		(101,018,740.31)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments		139,989,408.39
Income on investments		112,896,825.28
Purchase of investments		(181,452,668.94)
Net cash provided (used) by investing activities		71,433,564.73
Net increase in cash and cash equivalents		63,357,333.21
Cash and cash equivalents at beginning of year		564,093,861.54
Cash and cash equivalents at end of year	$	627,451,194.75

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2008

RECONCILIATION OF NET OPERATING LOSS TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating loss	$	(723,813,415.65)
Adjustments to reconcile operating loss to net cash provided (used) by operating activities:		
Depreciation expense		72,561,012.36
Changes in assets and liabilities:		
Receivables, net		570,250.06
Inventories		(977,505.15)
Prepaid expenses and deferred charges		(517,194.74)
Accrued interest receivable		398,315.61
Accounts payable		10,103,222.48
Accrued liabilities		25,212,650.45
Deferred revenue		(14,253,059.21)
Deposits		(865,060.63)
Compensated absences		2,182,019.12
Other deductions:		
Loans to students		(1,859,511.33)
Net cash provided (used) by operations	$	(631,258,276.63)

Noncash transactions		
Gifts of capital assets	$	212,500.00
Unrealized loss on investments	$	(90,355,239.79)
Loss on disposal of capital assets	$	(38,727,975.13)

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

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 20 and 21 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 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.

Inventories

Inventories are valued at the lower of cost or market, based on the retail, specific identification, average cost, or first-in, first-out basis.

Investments

The university reports investments in commercial paper at amortized cost. The university had no investments in commercial paper at June 30, 2008. 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.

Accounts Payable

Included in accounts payable are checks payable in the amount of $8,568,085.59 as of June 30, 2008. 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 of 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 sales and services of educational departments and auxiliary enterprises. These resources are used for transactions relating to the educational and general operations of the institution, and may be used at the discretion of the institution to meet current expenses for any purpose.

Scholarship Discounts and Allowances

Student tuition and fee revenues, and certain other revenues from students, are reported net of scholarship discounts and allowances in the statement of revenues, expenses, and changes in net assets. Scholarship discounts and allowances are the difference between the stated charge for goods and services provided by the university and the amount that is paid by the student and/or third parties making payments on the student's behalf. Certain governmental grants, such as Pell grants, and other federal, state, or nongovernmental programs, are recorded as either operating or nonoperating revenues in the institution's financial statements. To the extent that revenues from such programs are used to satisfy tuition and fees and other student charges, the institution has recorded a scholarship discount and allowance.

Income Taxes

The university, as a public corporation and an instrumentality of the State of Tennessee, is exempt from federal income taxes under Section 115 of the *Internal Revenue Code*. Contributions to the university are deductible by donors as provided under Section 170 of the *Internal Revenue Code*.

NOTE 2. DEPOSITS AND INVESTMENTS

Investment Policy

Cash Management Investment Pool - The University of Tennessee maintains a cash management investment pool that is available for use by all fund groups. State statutes and university investment policies authorize the university's cash management pool to invest in collateralized Tennessee bank or savings and loan association certificates of deposit, U.S. Treasury obligations, U.S. government agency obligations, repurchase agreements of those securities, highest quality commercial paper, prime bankers' acceptances, and money market mutual funds meeting certain criteria.

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

Investments - The university's assets subject to long-term investment (endowments and annuity and life income assets) use various external managers and funds consistent with investment objectives for those invested assets. A significant part of these assets is the university's Consolidated Investment Pool which is a carefully crafted portfolio of broadly diversified asset classes.

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

Cash and Cash Equivalents

In addition to petty cash and demand deposits, this classification includes instruments which are readily convertible to known amounts of cash. At June 30, 2008, cash and cash equivalents consisted of $38,129,456.52 in bank accounts, $1,514,585.46 of petty cash on hand, $390,300,000.00 of certificates of deposit, $195,479,355.10 in the university's cash management investment pool, and $522,060.58 on deposit with the State of Tennessee.

The carrying amount of the university's deposits was $428,429,456.52, and the bank balance including accrued interest was $428,814,033.35.

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 $1,505,737.09 at June 30, 2008, 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, 2008, university deposits in the amount of $22,156.26 were uncollateralized.

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, 2008, the university had the following investments and maturities.

Investment Type	Fair Value	Investment Maturities (In Years) Less Than 1	1 to 5	6 to 10	10+	Cost
Cash Management Pool						
Cash Equivalents						
Debt Securities						
U.S. Treasury	$ 56,818,470.00	$ 16,153,550.00	$ 40,664,920.00	$ -	$ -	$ 55,489,106.02
U.S. Agencies	138,660,885.10	75,086,143.90	63,574,741.20	-	-	135,814,157.52
	195,479,355.10	91,239,693.90	104,239,661.20	-	-	191,303,263.54
Investments						
Debt Securities						
U.S. Treasury	9,161,992.10	-	7,096,022.50	1,039,297.15	1,026,672.45	8,589,657.86
U.S. Agencies	15,397,099.31	1,727,562.50	7,749,551.31	4,157,193.50	1,762,792.00	14,602,267.88
Corporate bonds	20,580,422.15	1,836,310.00	16,267,892.50	2,476,219.65	-	20,780,518.55
Municipal bonds	2,833,582.52	-	1,488,835.50	-	1,344,747.02	2,951,904.86
Mortgages and notes	403,386.87	6,508.01	11,151.39	385,727.47	-	385,948.60
Bond mutual funds	47,575,178.68	-	1,880,425.02	43,259,444.99	2,435,308.67	50,134,358.52
	95,951,661.63	3,570,380.51	34,493,878.22	51,317,882.76	6,569,520.14	97,444,656.27
		$94,810,074.41	$ 138,733,539.42	$ 51,317,882.76	$ 6,569,520.14	
Other Investments						
Corporate Stocks:						
Domestic	80,647,660.31					80,665,617.87
International	4,715,950.46					4,705,455.54
Mutual funds – equity	259,795,594.60					232,909,378.73
Alternative investments						
Private equity	83,566,917.00					89,426,404.28
Real estate investments	38,025,665.33					34,322,396.98
Natural resources	33,217,510.67					32,157,014.58
Hedge funds	110,616,977.13					87,577,587.70
Real estate gifts	4,699,610.87					5,548,220.67
Assets with trustees	7,425,321.09					6,593,951.19
Total investments and cash equivalents	914,142,224.19					862,653,947.35
Less: cash equivalents	195,479,355.10					191,303,263.54
Total investments	$ 718,662,869.09					$ 671,350,683.81

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, 2008, 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, 2008, the institution's investments were rated as follows:

Rated Debt Instruments	Fair Value	Aaa	Aa1	Aa2	Aa3	A1
Cash Management Pool						
U.S. Treasury	$ 56,818,470.00	$ 56,818,470.00	$ -	$ -	$ -	$ -
U.S. Agencies	138,660,885.10	138,660,885.10	-	-	-	-
Investments						
U.S. Treasury	9,161,992.10	9,116,285.10	-	-	-	-
U.S. Agencies	15,397,099.31	13,336,779.31	-	2,060,320.00	-	-
Corporate bonds	20,580,422.15	1,209,540.00	628,728.50	1,955,135.00	4,311,531.20	2,477,515.00
Municipal bonds	2,833,582.52	201,364.00	-	757,320.42	963,667.00	192,350.00
Mutual funds–bonds	47,575,178.68	35,101,562.15	-	12,081,148.91	-	-
Mortgages and notes	403,386.87	-	-	-	-	-

Rated Debt Instruments	A2	A3	Baa1	Baa2	Ba2	B1
Cash Management Pool						
U.S. Treasury	-	-	-	-	-	-
U.S. Agencies	-	-	-	-	-	-
Investments						
U.S. Treasury	-	-	-	-	-	-
U.S. Agencies	-	-	-	-	-	-
Corporate bonds	4,039,066.00	2,082,350.00	2,001,749.00	1,786,255.95	-	-
Municipal bonds	420,187.60	-	-	-	-	-
Mutual funds–bonds	-	-	-	-	392,467.62	-
Mortgages and notes	-	-	-	-	-	-

Rated Debt Instruments	B2	Caa	Unrated
Cash Management Pool			
U.S. Treasury	-	-	-
U.S. Agencies	-	-	-
Investments			
U.S. Treasury	-	-	45,707.00
U.S. Agencies	-	-	-
Corporate bonds	-	-	88,551.50
Municipal bonds	-	160,390.00	138,303.50
Mutual funds–bonds	-	-	-
Mortgages and notes	-	-	403,386.87

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, 2008, the university had $7,425,321.09 of uninsured and unregistered investments held by a counterparty but not in the school's name.

Concentration of Credit Risk

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

Issuer	Fair Value	Percent of Total Investments/ Cash Equivalents
Federal Home Loan Bank	$114,978,032.25	12.58%

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of a deposit or investment. The university has $4,715,950.46 invested in foreign corporate equities at June 30, 2008.

Alternative Investments

In its Consolidated Investment Pool, as part of its endowment assets, the university has investments in 63 limited partnerships, limited companies, corporations, and limited liability corporations (LLCs).

These investments include 36 private equity funds, 3 real estate funds, 12 natural resource funds, and 12 hedge funds. The estimated fair value of these assets is $265,427,070.13 at June 30, 2008.

Total capital contributions less returns of capital equal $243,483,403.54 at June 30, 2008.

The university believes that the carrying amount of its alternative investments is a reasonable estimate of fair value as of June 30, 2008. 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 vary 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 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, 2008, net appreciation of $216,819,781.09 is available to be spent, of which $212,552,799.86 is restricted to specific purposes. The per-unit fair value for participating endowments was $3.889488 at June 30, 2008. Income distributed was $.18854 per share in 2008, or $30,760,052.59.

The university's consolidated investment pool is invested to maximize total return rather than current income consistent with provisions of the Uniform Prudent Management of Institutional Funds Act adopted by the State of Tennessee in 2007. The total return for fiscal year 2008 and the three and five years then ended was (6.6%), 8.7%, and 10.8%, respectively.

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 $710,043.94 for 2008.

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 2008 amounted to $2,446,226.89.

NOTE 4. ACCOUNTS, NOTES, AND GRANTS RECEIVABLE

Accounts, notes, and grants receivable included the following at June 30, 2008:

Student accounts receivable	$ 8,475,259.79
Grants receivable	61,699,047.82
Notes receivable	3,889,941.28
Pledges receivable	48,425,065.20
State capital outlay and maintenance receivable	10,614,211.30
Due from component units	2,536,976.25
Other receivables	52,399,662.65
Subtotal	188,040,164.29
Less allowance for doubtful accounts	(23,619,048.75)
Total	$164,421,115.54

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of $9,685,013.04.

Federal Perkins Loan Program funds included the following at June 30, 2008:

Perkins loans receivable	$32,448,311.27
Less allowance for doubtful accounts	-
Total	$32,448,311.27

NOTE 5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2008, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Land	$ 50,397,381.27	$ 3,911,547.60	$ -	$ (442,500.00)	$ 53,866,428.87
Land improvements & infrastructure	65,501,326.29	180,927.38	2,193,190.98	-	67,875,444.65
Buildings	1,249,125,055.46	82,518,713.11	107,291,839.97	(12,663,002.68)	1,426,272,605.86
Works of art/ historical treasures	434,498.72	75,011.52	-	-	509,510.24
Equipment	246,254,921.85	41,283,807.87	-	(12,550,169.07)	274,988,560.65
Software	19,865,576.73	185,482.49	-	(18,509.00)	20,032,550.22
Library holdings	105,983,850.38	13,905,141.56	-	(7,916,097.27)	111,972,894.67
Projects in progress	224,338,041.56	176,737,888.61	(109,485,030.95)	(31,648,914.81)	259,941,984.41
Total	1,961,900,652.26	318,798,520.14	-	(65,239,192.83)	2,215,459,979.57
Less accumulated depreciation:					
Land improvements & infrastructure	(37,452,778.39)	(2,944,179.48)	-	-	(40,396,957.87)
Buildings	(582,708,030.93)	(35,941,759.43)	-	7,395,513.72	(611,254,276.64)
Equipment	(151,357,156.75)	(22,495,105.76)	-	11,187,384.93	(162,664,877.58)
Software	(18,984,477.23)	(531,673.95)	-	12,221.78	(19,503,929.40)
Library holdings	(43,298,055.72)	(10,648,293.74)	-	7,916,097.27	(46,030,252.19)
Total accumulated depreciation	(833,800,499.02)	(72,561,012.36)	-	26,511,217.70	(879,850,293.68)
Capital assets, net	$1,128,100,153.24	$246,237,507.78	$ -	$(38,727,975.13)	$ 1,335,609,685.89

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 $8,590,553.57 for the year ended June 30, 2008.

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, 2008. 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 2008 Consumer Price Index (214.82).

Year Ending June 30	
2009	$ 13,300.00
2010	13,300.00
2011	13,300.00
2012	13,300.00
Total minimum payments required	$ 53,200.00

NOTE 7. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2008, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term liabilities:					
Bonds	$273,999,098.54	$ 81,189,164.36	$ 16,190,935.79	$ 338,997,327.11	$ 17,551,037.35
Commercial paper	77,581,836.71	67,388,170.33	22,001,883.76	122,968,123.28	-
Total TSSBA indebtedness	351,580,935.25	148,577,334.69	38,192,819.55	461,965,450.39	17,551,037.35
Notes	45,455.42	-	10,753.43	34,701.99	34,701.99
Capital lease obligations	-	3,126,282.87	416,162.73	2,710,120.14	824,327.12
Net OPEB obligation	-	19,923,248.24	-	19,923,248.24	-
Compensated absences	73,844,498.90	42,746,027.51	40,564,008.39	76,026,518.02	40,564,008.39
Total long-term liabilities	425,470,889.57	214,372,893.31	79,183,744.10	560,660,038.78	$ 58,974,074.85
Other noncurrent liabilities:					
Deferred revenue	15,500,438.71	-	-	15,500,438.71	
Due to grantors	35,076,074.86	736,138.97	444,433.97	35,367,779.86	

Annuities payable	7,673,562.43	598,447.31	1,276,364.74	6,995,645.00
Totals	$483,720,965.57	$215,707,479.59	$ 80,904,542.81	$ 618,523,902.35

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 2037 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, 2008, was $346,503,798.99. The reserve amount at June 30, 2008, was $2,563,506.12, and unspent debt proceeds were $4,516,374.10. Unaccreted bonds payable at June 30, 2008, were $426,591.66.

Included in the total outstanding indebtedness is a $75,093 note with Chattanooga Agricultural Credit Association. The five-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, 2008, is $34,701.99.

The university's debt service requirements (TSSBA and the five-year note) to maturity for all bonds and notes payable at June 30, 2008, are as follows:

Year Ending June 30	Principal	Interest and Administrative Fees
2009	$ 17,585,739.34	$ 16,188,634.30
2010	18,031,193.52	15,715,283.22
2011	15,776,613.07	14,697,441.04
2012	15,386,511.14	14,009,886.23
2013	14,888,673.77	13,348,391.31
2014-2018	75,053,262.95	56,382,849.36
2019-2023	76,257,272.61	38,297,455.03
2024-2028	59,893,749.18	21,129,282.62
2029-2033	43,921,442.15	8,718,205.70
2034-2037	9,317,452.19	934,570.75
	$ 346,111,909.92	$ 199,421,999.56

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 $122,968,123.28 at June 30, 2008.

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 37243-1402, or by calling (615) 401-7872.

Capital Lease Obligations

The university leases certain items of equipment accounted for as capital leases. The capitalized cost of the assets under lease at June 30, 2008, was $3,126,282.87. Accumulated amortization of the leased assets at June 30, 2008, was $416,162.74.

Future minimum lease payments under capital leases at June 30, 2008, are as follows:

Year Ending June 30	
2009	$824,327.12
2010	824,327.12
2011	679,628.71
2012	679,628.71
Total	3,007,911.66
Less: amount representing interest	(297,791.52)
Present value of minimum lease payments	$2,710,120.14

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 accessing 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 13.62% 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, 2008, 2007, and 2006, were $39,356,714.98, $37,574,415.22, and $27,746,496.78, respectively. Contributions met the requirements for each year.

Federal Retirement Program

Plan Description

The University of Tennessee contributes to the Federal Retirement Program, a cost-sharing multiple-employer defined benefit pension plan administered by the Civil Service Retirement System (CSRS) for participants employed prior to January 1, 1984, and the Federal Employees Retirement System (FERS) for participants employed after December 31, 1983. Both systems provide retirement, death, and disability benefits, as well as annual cost-of-living adjustments, to plan members and their beneficiaries. All regular full-time employees of the University of Tennessee Agricultural Extension Service who hold federal appointments for 51% or more of their time are required to participate in either one of the two Federal Retirement

Programs. For both systems, benefit provisions are established in federal statutes. Federal statutes are amended by the U.S. Congress.

CSRS and FERS issue publicly available financial reports that include financial statements and required supplementary information. These reports may be obtained by writing to the Office of Personnel Management, Retirement Information Office, P.O. Box 45, Boyers, PA 16017-0045, or by calling (202) 606-0500.

Funding Policy

Participating employees, with some exceptions, are required by federal statute to contribute 7.0% of covered salaries to the CSRS plan. The university is currently required to contribute 7.0%. Contributions to CSRS for the year ended June 30, 2008, were $1,157,970.84, which consisted of $597,028.11 from the university and $560,942.73 from the employees; contributions 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; and 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.

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 $1,049,011.37 for the year ended June 30, 2008, which consisted of $69,934.30 from employees and $979,077.07 from the university; $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; and $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. Contributions for the Thrift Savings Plan were $1,083,359.00 for the year ended June 30, 2008, which consisted of $671,460.00 from employees and $411,899.00 from the university; $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; and $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. Contributions met the requirements for each year.

Defined Contribution Plans

Optional Retirement Plans (ORP)

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

Plan members are noncontributory. The university contributes an amount equal to 10% of the employee's base salary below the social security wage base and 11% above the social security wage base. Contribution requirements are established and amended by state statute. The contribution made by the university to the plans for the year ended June 30, 2008, was $40,350,986.48 and for the year ended June 30, 2007, was $38,781,695.20. Contributions met the requirements for each year.

Joint Contributory Retirement System Plan A (JCRS-A)

The Joint Contributory Retirement System Plan A (JCRS-A) is a defined contribution plan with minimum benefits and is administered by the Tennessee Consolidated Retirement System and TIAA-CREF. Employees who were enrolled in the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) before July 1977 are members of JCRS-A. Enrollment in this plan for new employees has been closed since July 1977. Although JCRS-A members participate in Aetna, TIAA-CREF, or VALIC, they may also, under certain circumstances, receive a supplementary benefit from the State of Tennessee. Plan provisions are established by *Tennessee Code Annotated,* Chapter 35, Part 4.

State statutes are amended by the Tennessee General Assembly. Plan members are noncontributory. The university's contributions for JCRS-A members were calculated using the base salary amounts of $35,357,200.98 for fiscal year 2008, and $38,536,482.05 for fiscal year 2007. Contribution requirements are established and amended by state statute. The contributions are included in the ORP amounts. University contributions to fund the state supplemental benefit totaled $4,817,586.81 in fiscal year 2008, and $5,247,137.08 in fiscal year 2007. Contributions met the requirements for each year.

Deferred Compensation Plans

The University of Tennessee offers its employees three deferred compensation plans. The university, through the State of Tennessee, provides two plans, one established pursuant to *Internal Revenue Code* (IRC), Section 457, and the other pursuant to IRC, Section 401(k). The third plan is administered by the university and was established in accordance with IRC, Section 403(b). These plans, available to all university employees, permit them to defer a portion of their salaries to future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All costs of administering and funding these plans, with the exclusion of the $50 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 2008, the university provided a $50 monthly match from unrestricted funds for employees making a minimum monthly contribution of $50 to the Section 401(k) plan. During the year ended June 30, 2008, contributions totaling $17,711,558.01 were made by employees participating in the plan, with a related match of $5,562,078.86 made by the university. 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. In accordance with the *IRC*, employee contributions through the 403(b) plan remain the assets of the employee. In addition, the amounts withheld from employees are remitted directly to third-party administrators. Therefore, these employee contributions are not reflected in the university's financial statements.

NOTE 9. OTHER POST-EMPLOYMENT BENEFITS

Healthcare is the only "other post-employment benefit" (OPEB) provided to employees. The State of Tennessee administers a group health insurance program which provides post-employment health insurance benefits to eligible university retirees. This program includes two plans available to higher education employees—the State Employee Group Plan and the Medicare Supplement Plan. Both plans are agent multiple-employer defined benefit OPEB plans. Benefits are established and amended by an insurance committee created by *Tennessee Code Annotated* (TCA), Section 8-27-101. Prior to reaching age 65, all members have the option of choosing a preferred provider organization (PPO), point of service (POS), or health maintenance organization (HMO) plan for healthcare benefits. Subsequent to age 65, members who are also in the state's retirement system may participate in a state-administered Medicare Supplement that does not include pharmacy. The state makes on-behalf payments to the Medicare Supplement Plan for the university's eligible retirees; see Note 19. The plans are reported in the *Tennessee Comprehensive Annual Financial Report* (CAFR). The CAFR is available on the state's website at http://tennessee.gov/finance/act/cafr.html.

Funding Policy

The premium requirements of plan members are established and may be amended by the insurance committee. The plans are self-insured and financed on a pay-as-you-go basis with the risk shared equally among the participants. Claims liabilities of the plan are periodically computed using actuarial and statistical techniques to establish premium rates. In accordance with TCA 8-27-205(b), retirees not eligible for Medicare pay a percentage of the total state premium under the state plan based on years of service, leaving a portion of retiree premiums effectively subsidized by contributions to the state plan for active employees. Retirees with 30 years of service pay 20% of the total premium under the state plan. Retirees with 20 but less than 30 years of service pay 30% of the total premium under the state plan. Retirees 55 and older with less than 20 but more than 10 years of service pay 40% of the total premium under the state plan. Contributions for the state plan for the year ended June 30, 2008, were $119,129,947.60, which consisted of $98,069,345.85 from the university and $21,060,601.75 from the employees.

Annual OPEB Cost and Net OPEB Obligation

	State Plan
Annual required contribution (ARC)	$30,603,000.00
Interest on net OPEB obligation	-
Adjustment to the ARC	-
Annual OPEB cost	30,603,000.00
Amount of contribution	(10,679,751.76)
Increase/decrease in net OPEB obligation	19,923,248.24
Net OPEB obligation – beginning of year	-
Net OPEB obligation – end of year	$19,923,248.24

Year End	Plan	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation at Year-end
6/30/2008	State Plan	$30,603,000.00	34.90%	$19,923,248.24

Funded Status and Funding Progress

The funded status of the plan as of June 30, 2008, was as follows:

	State Plan
Actuarial valuation date	July 1, 2007
Actuarial accrued liability (AAL)	$294,669,000.00
Actuarial value of plan assets	-
Unfunded actuarial accrued liability (UAAL)	294,669,000.00
Actuarial value of assets as a % of the AAL	0%
Covered payroll (active plan members)	616,687,517.00
UAAL as percentage of covered payroll	47.8%

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future, and actuarially determined amounts are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future. The schedule of funding progress, presented as RSI following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

Actuarial Methods and Assumptions

Calculations are based on the types of benefits provided under the terms of the substantive plan at the time of each valuation and on the pattern of sharing of costs between the employer and plan members to that point. Actuarial calculations reflect a long-term perspective. Consistent with that perspective, actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets.

In the July 1, 2007, actuarial valuation, the Projected Unit Credit actuarial cost method was used. The actuarial assumptions included a 4.5% investment rate of return (net of administrative expenses) and an annual healthcare cost trend rate of 7% initially, increased to 11% in the second year and then reduced by decrements to an ultimate rate of 5% after 12 years. Both rates include a 3% inflation assumption. The unfunded actuarial accrued liability is being amortized as a level percentage of payroll on a closed basis over a 30-year period beginning with July 1, 2007.

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, 2008. 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, 2008, the amounts held in trust totaled $111,742,334.24 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 $4,075,076.00 at June 30, 2008. 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, 2007, to the university was $2,957,684.79.

During the year ended June 30, 2008, the university had expenses of $16,881,799.00 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled $2,819,470.00 at June 30, 2008. 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 amount of settlements has not exceeded insurance coverage for each 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 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, 2008, and June 30, 2007, 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 Rosa L. Parks Avenue, Nashville, TN 37243-1102 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, 2008, the Risk Management Fund held $123.9 million in cash and cash equivalents designated for payment of claims. At June 30, 2008, the scheduled coverage for the university was $4,285,931,900 for buildings and $1,088,887,500 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, 2008, were $102,128,505.90.

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, 2008. The amount of unused sick leave was $272,370,755.69 at June 30, 2008.

Grants and Contracts

The university receives grants and contracts from various federal and state agencies to fund research and other activities. The costs, both direct and indirect, charged to these grants and contracts are subject to audit and disallowance by the granting agency. The university administration believes that any disallowance or adjustments would not have a material effect on the university's financial position.

Nonvested Equipment

Equipment in the possession of the university valued at $4,452,570.52 as of June 30, 2008, 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 20 years. UHS assumed all prior hospital liabilities, known or unknown. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease.

Employee Services Agreement

UHS has leased from the university all hospital employees as of the date of closing. UHS has paid to the university the amounts incurred by the university to pay the direct expenses relating to the hospital employees, including wages, salaries, and fringe benefits. These payroll expenses on behalf of UHS, totaling $79,248,246.42 in 2008, 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 LEASES OF REAL PROPERTY

Capital Lease of Real Property to University Health Systems, Inc.

The university has leased the real property of the UT Memorial Research Center and Hospital to UHS for a term of 50 years. This lease is pursuant to the Lease and Transfer Agreement described in Note 14. This lease is classified as a direct financing lease. The guaranteed lease payment of $50 million will be paid by UHS in annual payments through 2019. The amount of the annual payments will equal the lesser of (1) 20% of the hospital's net operating profit for the applicable calendar year; or (2) $3 million or the greater amount resulting from the application of an index, as specified in the agreement. The payment of $50 million is guaranteed by December 31, 2019. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease. An annual lease payment to the university during the year ended June 30, 2008, totaled $3,537,047.00.

The university recorded a lease payment receivable in the amount of $30,527,963.51 at June 30, 2008, which represents the net present value of the guaranteed $50 million discounted at 5.75%. The minimum lease payments to be received amount has been adjusted upward to reflect a contractually required adjustment to the final required lease payment.

	June 30, 2008
Total minimum lease payments to be received	$54,676,887.96
Less: unearned income	(24,148,924.45)
Net investment in direct financing lease	$30,527,963.51

Capital Lease of Real Property to Memphis Mental Health Institute

On November 5, 2005, the university entered into a facility lease agreement with the Tennessee Department of Mental Health and Developmental Disabilities (TDMHDD) to provide a new building to house the Memphis Mental Health Institute. The building is a joint project of the university, Methodist Healthcare, Shelby County Health Care Authority (the MED), the State of Tennessee, and Shelby County. This lease is classified as a direct financing lease. The guaranteed lease payments will be paid by TDMHDD in semiannual payments through 2027. The amount of the semiannual payments will equal the amount to retire the debt from the construction project and any other project costs incurred by the university in excess of the funds contributed by Methodist Healthcare and the MED. During the term of the lease, TDMHDD will be responsible for all operational and maintenance costs associated with the facility.

The university recorded a lease payment receivable in the amount of $16,723,655.89 at June 30, 2008:

Total minimum lease payments to be received	$24,854,331.76
Less: unearned income	(8,130,675.87)
Net investment in direct financing lease	$16,723,655.89

Year Ended June 30	Minimum Lease Payments to Be Received	Interest	Principal
2009	$ 1,350,281.46	$ 748,601.39	$ 601,680.07
2010	1,351,551.38	721,668.37	629,883.01
2011	1,352,874.66	693,472.90	659,401.76
2012	1,354,253.50	663,956.08	690,297.42
2013	1,355,690.26	633,056.29	722,633.97
2014-2018	6,802,150.96	2,648,696.43	4,153,454.53
2019-2023	6,848,239.84	1,627,927.84	5,220,312.00
2024-2027	4,439,289.70	393,296.57	4,045,993.13
	$24,854,331.76	$8,130,675.87	$16,723,655.89

NOTE 16. AGREEMENTS WITH METHODIST HEALTHCARE

On November 1, 2002, the university transferred management and operations of its hospital located in Memphis to Methodist Healthcare (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.

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 $398,885.76 in 2008, are reported as operating expenses in the statement of revenues, expenses, and changes in net assets. An equal amount of operating revenue is reported in the non-governmental grants and contracts category. The term of the Employee Services Agreement is from the effective date until there are no longer leased employees.

All persons who began service at the hospital after the date the employee service agreement was signed are employees of Methodist and not university employees.

Affiliation Agreement

The university and Methodist entered into a Master Affiliation Agreement dated March 18, 2002, wherein Methodist agreed to support the continuous development and improvement of the medical education, research, and public service programs of the university. The university and Methodist agreed that Methodist Central Hospital (renamed Methodist University Hospital) and LeBonheur Children's Medical Center (also a Methodist Hospital) will be the principal private teaching hospitals for the university in the Shelby County area.

The university shall be entitled to reimbursement for its expenses associated with the graduate medical education program rendered under this agreement including the costs of coverage under the Tennessee Claims Commission Act and defense costs. The university will cooperate, support, and assist in seeking adequate reimbursement from Medicare and the State of Tennessee for graduate medical education. The costs of providing residents and medical faculty supervision at Methodist will be paid by the university, and the pro rata costs will be reimbursed by Methodist based upon the actual costs associated with the program at Methodist. Specific financial arrangements for residents and faculty will be negotiated annually and incorporated annually by addendum into this Master Affiliation Agreement as part of the Methodist annual budgeting process. The annual addendum will specify the numbers of faculty and residents to be provided along with the costs to be annually reimbursed under this agreement.

NOTE 17. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATIONS

The university's operating expenses by functional classification for the year ended June 30, 2008, are as follows:

Functional Classification	Natural Classification					
	Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$357,325,303.57	$108,863,291.61	$ 57,976,683.29	$ -	$ -	$524,165,278.47
Research	113,899,734.26	32,389,827.54	57,825,986.69	-	-	204,115,548.49
Public service	69,811,282.55	26,591,901.21	37,295,230.06	-	-	133,698,413.82
Academic support	67,657,460.56	25,390,857.48	18,264,770.38	-	-	111,313,088.42
Student services	35,883,891.00	13,631,974.30	23,054,692.80	-	-	72,570,558.10
Institutional support	69,774,167.29	26,688,833.31	4,085,055.70	-	-	100,548,056.30
Operation & maintenance of plant	32,248,331.70	15,862,996.69	51,462,080.52	-	-	99,573,408.91
Scholarships & fellowships	3,077,660.51	18,056,934.04	16,597,014.51	28,304,421.26	-	66,036,030.32
Auxiliary	36,788,720.09	11,708,166.21	72,877,323.67	-	-	121,374,209.97
Independent operations	57,726,054.33	23,598,021.52	-	-	-	81,324,075.85
Depreciation	-	-	-	-	72,561,012.36	72,561,012.36
Total expenses	$844,192,605.86	$302,782,803.91	$339,438,837.62	$28,304,421.26	$72,561,012.36	$1,587,279,681.01

NOTE 18. UNRESTRICTED NET ASSETS

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

	June 30, 2008
Working capital	$34,595,021.18
Encumbrances	8,925,226.64
Auxiliaries	3,332,922.45
Quasi-endowments	12,973,238.85
Plant construction	14,121,129.03
Renewal and replacement of capital assets	189,518,657.50
Debt retirement	24,195,497.12
Unreserved/undesignated	(3,611,929.84)
Total	$284,049,762.93

NOTE 19. ON-BEHALF PAYMENTS

During the year ended June 30, 2008, the State of Tennessee made payments of $856,792.81 on behalf of the university for retirees participating in the Medicare Supplement Plan. The Medicare Supplement Plan is a post-employment benefit healthcare plan and is discussed further in Note 9. The plan is reported in the *Tennessee Comprehensive Annual Financial Report* (CAFR). The CAFR is available on the state's website at http://tennessee.gov/finance/act/cafr.html.

NOTE 20. COMPONENT UNIT – UNIVERSITY OF CHATTANOOGA FOUNDATION

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

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

During the year ended June 30, 2008, the foundation expended $4,625,974.00 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.

Investments

A summary of foundation investments at June 30, 2008, is as follows:

Equity securities (cost of $58,257,079)	$60,961,935
Debt securities (cost of $13,099,475)	13,195,578
Real estate	1,817,026
Limited partnerships	33,134,127
Other	54,713
Total	$109,163,379

The foundation also has investments restricted by the terms of the revenue bonds described below totaling $8,390,497.

Property and Equipment

A summary of foundation property and equipment at June 30, 2008, is as follows:

Land	$ 8,241,032
Buildings	74,619,445
Furniture, fixtures, and equipment	3,529,907
	86,390,384
Accumulated depreciation	(17,230,040)
Total	$69,160,344

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, 2008, 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	$67,225,000
Series 2005B revenue refunding bonds, interest rates fixed at 5.5% to 6.0% payable semi-annually, annual redemption payments due through October 1, 2035	21,310,000
	88,535,000
Less: unamortized discount	(2,016,502)
Total	$86,518,498

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

Year Ended June 30	
2009	$ 1,475,000
2010	1,550,000
2011	1,630,000
2012	1,715,000
2013	1,800,000
Thereafter	80,365,000
	$88,535,000

Restricted Cash and Cash Equivalents

The revenue bonds described above restrict the use of certain cash and cash equivalents at June 30, 2008, as follows:

Renewal and replacement reserves	$ 607,003
Restricted for debt service payments	3,147,115
Total	$3,754,118

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2008, are as follows:

	Natural Classification			
Functional Classification	Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Depreciation	Total
Academic programs	$ -	$1,217,937	$ -	$ 1,217,937
Professorships	-	556,718	-	556,718
Faculty development	-	309,272	-	309,272
Scholarships	-	2,058,020	-	2,058,020
Chancellor's discretionary	-	231,661	-	231,661
Other	-	252,366	-	252,366
Rental expenses	3,282,770	-	-	3,282,770
Administrative and investment fees	428,398	-	-	428,398
Legal	25,915	-	-	25,915
Tax and audit	46,056	-	-	46,056
Depreciation	-	-	3,210,842	3,210,842
Total expenses	$3,783,139	$4,625,974	$3,210,842	$11,619,955

Restatement of Prior-Year Net Assets

During 2008, management determined that the values of non-traditional investments were incorrectly reported in 2006 and 2007 due to errors in information obtained from third parties. As a result, the beginning net assets in the accompanying 2008 foundation statement of revenues, expenses, and changes in net assets have been restated to reflect a reduction in cumulative unrealized gains on these investments of $6,400,010.00.

NOTE 21. COMPONENT UNIT – UNIVERSITY OF TENNESSEE FOUNDATION

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

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

During the year ended June 30, 2008, the foundation expended $7,781,165.66 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:

	Temporarily Restricted	Permanently Restricted
Current pledges	$ 643,349.50	$ 97,986.83
Pledges due in one to five years	39,136,570.46	1,310,828.58
Pledges due after five years	19,189,458.11	121,320.00
	58,969,378.07	1,530,135.41
Less discounts to net present value	(7,121,238.88)	(113,348.53)
Total pledges receivable, net	$51,848,139.19	$1,416,786.88

The allowance for doubtful accounts at June 30, 2008, was $64,849.17.

Knoxville Place

On January 30, 2008, Knoxville Place was sold by Volunteer Student Housing, LLC, to the University of Tennessee for the bonds outstanding less funds held in reserve by the trustee. As a result of the sale, the bonds issued by the Health, Educational, and Housing Facility Board of the County of Knox, Tennessee, to fund the acquisition, construction, and equipping of Knoxville Place were paid in full. The housing facility will be owned and operated by the university as part of its Knoxville campus student housing. The foundation's gain on this sale of $6,250,579.50 is reported as other nonoperating revenue on the statement of revenues, expenses, and changes in net assets. The gain is due to the sale of the depreciated assets and expense recognition of the remaining underwriter's discount, bond costs, and letter of credit costs.

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, 2008, the note principal was reduced by $13,103.44 with an additional $10,896.56 of interest being paid. The balance of the note payable at June 30, 2008, was $225,684.44. Future maturities of this note are as follows:

Year Ended June 30	
2009	$13,729.99
2010	14,386.52
2011	15,074.44
2012	15,795.25
2013	16,550.54
2014-2018	95,408.14
2019-2021	54,739.56
Total	$225,684.44

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, 2008, was $12,619.47. The foundation has not experienced any such losses in this account and believes it is not exposed to any significant credit risk to cash.

Remainder Interest

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

In December 2002, a donor conveyed to the foundation a remainder interest in a limited liability company. The asset of the limited liability company is a fee simple interest in a warehouse in South Carolina. The remainder interest was appraised at $7,740,000.00 with the interest vesting on January 1, 2021. The value on the foundation's Consolidated Statement of Financial Position will be the present value calculation until the vesting date. The IRS discount rate for December 2002 used in determining the present value was 4%. The present value of the remainder interest at June 30, 2008, was $4,740,500.75.

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, 2008, was $11,235,237.08.

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2008, are as follows:

Functional Classification	Natural Classification: Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Depreciation	Total
Grants and scholarships	$ -	$ 471,656.16	$ -	$471,656.16
General and administrative	2,379,942.18	7,309,509.50	-	9,689,451.68
Student housing	3,135,719.72	-	1,876,280.51	5,012,000.23
Total expenses	$5,515,661.90	$7,781,165.66	$1,876,280.51	$15,173,108.07

NOTE 22. CHANGE IN ACCOUNTING PRINCIPLE

The university has implemented the Governmental Accounting Standards Board's Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This statement establishes standards for the measurement, recognition, and display of OPEB expense and related liabilities, note disclosures, and required supplementary information. The statement was implemented prospectively with a zero net OPEB obligation at transition.

NOTE 23. SUBSEQUENT EVENTS

Investments

Further disruption in the credit markets and overall declines in economic conditions in markets in the United States of America and internationally have resulted in significant declines in the fair value of the university's investments subsequent to June 30, 2008. Based on information available from fund managers, the university estimates that the fair value of its investments as of September 30, 2008, has declined approximately $72.4 million compared to the fair value as of June 30, 2008. Cash equivalents in the university's cash management investment pool have also declined approximately $5.9 million in fair value during this period.

THE UNIVERSITY OF TENNESSEE
REQUIRED SUPPLEMENTARY INFORMATION
OPEB SCHEDULE OF FUNDING PROGRESS
UNAUDITED

Actuarial Valuation Date	Plan	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
July 1, 2007	State Employee Group Plan	$ -	$ 294,669,000.00	$ 294,669,000.00	0%	$ 616,687,517.00	47.8%