

AUDIT REPORT

The University of Tennessee

For the Year Ended
June 30, 2013



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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February 3, 2014

The Honorable Bill Haslam, Governor
Members of the General Assembly
Dr. Joseph A. DiPietro, President

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the University of Tennessee, for the year ended June 30, 2013. You will note from the independent auditor's report that unmodified opinions were given on the fairness of the presentation of the financial statements.

Consideration of the internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Findings and Recommendations 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,

Deborah V. Loveless, CPA
Director

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Audit Report
The University of Tennessee
For the Year Ended June 30, 2013

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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, 2013

Opinions on the Financial Statements

The opinions on the financial statements are unmodified.

Audit Findings

As Reported in the Previous Audit, the Registrar's Office in Knoxville Did Not Properly Report Enrollment Data, Increasing the Risk of Not Initiating the Student Loan Repayment Process*

The Registrar's Office at the University of Tennessee in Knoxville did not properly report enrollment data for the Direct Loan borrowers who withdrew from classes or graduated (page 65).

Financial Aid Staff Awarded Aid to Students Who Were Not Making Satisfactory Academic Progress, Resulting in Federal Questioned Costs of \$18,527

The Office of Financial Aid and Scholarships at the Martin campus awarded aid to two students who were not making satisfactory academic progress as defined in the university's policies. Because the office did not ensure its automated programs to detect students not maintaining satisfactory academic progress were operating correctly, federal financial aid was awarded to the two ineligible students (page 67).

* This finding is repeated from the prior audit.



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Independent Auditor's Report

The Honorable Bill Haslam, Governor
Members of the General Assembly
Dr. Joseph A. DiPietro, President

Report on the Financial Statements

We have audited the accompanying 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, 2013, and the related notes to the financial statements, which collectively comprise the basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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.; the University of Tennessee Foundation, Inc.; and the University of Tennessee Research Foundation, Inc., discretely presented component units. Those statements were audited by other auditors, whose reports have been furnished to us. Our opinion, insofar as it relates to the amounts included for the foundations, is based solely on the reports of the other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial

statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

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, 2013, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 2, the financial statements of the university include investments valued at \$410,763,729.22 (15.2 percent of net position), 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. Our opinion is not modified with respect to this matter.

As discussed in Note 1, the university implemented GASB Statement 65, *Items Previously Reported as Assets and Liabilities*, during the year ended June 30, 2013. Our opinion is not modified with respect to this matter.

Other Matters

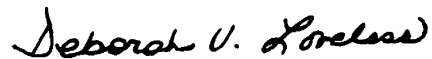
Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 5 through 13 and the schedule of funding progress on page 62 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during the audit of the basic financial statements. We do not express an opinion or provide any

assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 9, 2013, on our consideration of the university's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the university's internal control over financial reporting and compliance.



Deborah V. Loveless, CPA

Director

December 9, 2013

THE UNIVERSITY OF TENNESSEE

Management's Discussion and Analysis

Introduction

This section of the University of Tennessee's annual financial report presents a discussion and analysis of the financial performance of the university during the fiscal year ended June 30, 2013, with comparative information presented for the fiscal year ended June 30, 2012. 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 financial statements, and the notes to the financial statements.

The university is a component unit of the State of Tennessee and an integral part of the state's *Comprehensive Annual Financial Report (CAFR)*. The financial reporting entity for the financial statements is comprised of the university and three component units. The component units are discretely presented based on the nature and significance of their relationship to the university. The reader may refer to Note 1 for detailed information on the financial reporting entity. More detailed information about the foundations is presented in notes 21, 22, and 23 to the financial statements. This discussion focuses on the university and does not include the foundations.

Overview of the Financial Statements

The financial statements have been prepared in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB), which establishes standards for external financial reporting for public colleges and universities. The financial statements are presented on a consolidated basis to focus on the university as a whole. The full scope of the university's activities is considered to be a single business-type activity and, accordingly, is reported within a single column in the basic financial statements.

The university's financial report includes the statement of net position; the statement of revenues, expenses, and changes in net position; and the statement of cash flows. Notes to the financial statements are also presented to provide additional information that is essential to a full understanding of the financial statements.

The Statement of Net Position

The statement of net position is a point-in-time financial statement. The statement of net position presents the financial position of the university at the end of the fiscal year. To aid the reader in determining the university's ability to meet immediate and future obligations, the statement includes all assets, liabilities, deferred outflows/inflows, and net position of the university and segregates the assets and liabilities into current and noncurrent components.

Current assets are those that are available to satisfy current liabilities, inclusive of assets that will be converted to cash within one year. Current liabilities are those that will be paid within one year. The statement of net position is prepared under the accrual basis of accounting; assets and liabilities are recognized when goods or services are provided or received, despite when cash is actually exchanged.

From the data presented, readers of the statement are able to determine the assets available to continue the operations of the university. They are also able to determine how much the university owes vendors, lenders, and others. Net position represents the difference between the university's assets and liabilities, along with the difference between deferred outflows and deferred inflows, and is one indicator of the university's current financial condition.

The statement of net position also indicates the availability of net position for expenditure by the university. Net position is divided into three major categories. The first category, net investment in capital assets, represents the university's total investment in property, plant, and equipment, net of outstanding debt obligations and deferred outflows/inflows of resources related to these capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included. The next category is restricted net position, which is subdivided into two categories, nonexpendable and expendable. Nonexpendable restricted net position includes endowment and similar resources whose use is limited by donors or other outside sources and, as a condition of the gift, the principal is to be maintained in perpetuity. Expendable restricted net position is 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 resources. The final category is unrestricted net position. Unrestricted net position is available to the university for any lawful purpose of the institution.

The following table summarizes the university's assets, liabilities, deferred outflows/inflows, and net position at June 30, 2013, and June 30, 2012:

**Summary of Net Position
(in thousands of dollars)**

	<u>2013</u>	<u>2012</u>
Assets:		
Current assets	\$ 536,296	\$ 548,728
Capital assets, net	2,024,634	1,895,759
Other assets	1,317,715	1,300,352
Total assets	3,878,645	3,744,839
Deferred outflows:		
Deferred loss on debt refunding	6,449	-
Liabilities:		
Current liabilities	327,927	357,676

Noncurrent liabilities	855,033	777,133
Total liabilities	1,182,960	1,134,809
Net position:		
Net investment in capital assets	1,407,126	1,330,993
Restricted – nonexpendable	442,343	423,833
Restricted – expendable	429,668	409,920
Unrestricted	422,997	445,284
Total net position	\$ 2,702,134	\$ 2,610,030

Total net position increased by \$92.1 million, or 3.53%, during the 2013 fiscal year. The increases were in net investment in capital assets, restricted – nonexpendable, and restricted – expendable. Increases in investment income, state appropriations, and tuition and fees were the largest contributors to the increase in net position.

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

The statement of revenues, expenses, and changes in net position presents the results of operations for the fiscal year. Revenues and expenses are recognized when earned or incurred, regardless of when cash is received. The statement indicates whether the university’s financial condition has improved or deteriorated during the fiscal year. The statement presents the revenues received by the university, both operating and nonoperating; the expenses paid by the university, operating and nonoperating; and any other revenues, expenses, gains, or losses received or spent by the university.

Generally speaking, operating revenues are received for providing goods and services to the various customers and constituencies of the university. Operating expenses are those expenses paid to acquire or produce the goods and services provided in return for the operating revenues, and to carry out the mission of the university. Nonoperating revenues are revenues received for which goods and services are not provided directly to the payor. Although the University of Tennessee is dependent upon state appropriations and gifts to fund educational and general operations, under GASB standards these funding sources are reported as nonoperating revenues, as is investment income. As a result, the university has historically reported an excess of operating expenses over operating revenues, resulting in an operating loss. Therefore, the “increase in net position” is more indicative of overall financial results for the year.

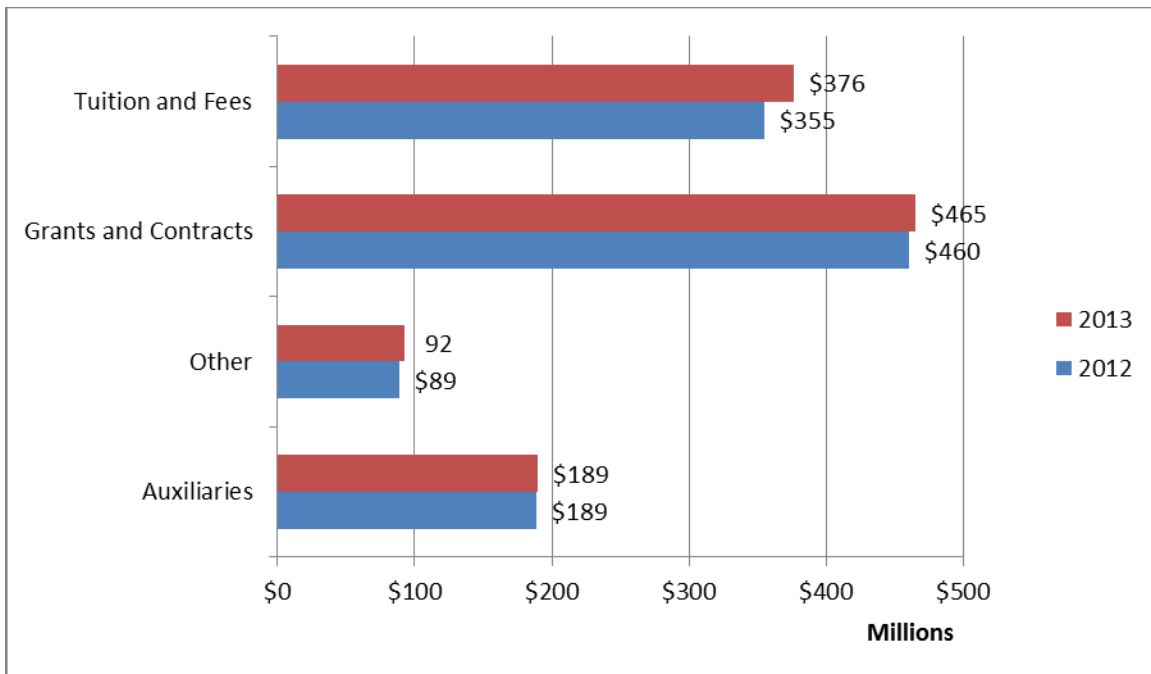
A summary of the university’s revenues, expenses, and changes in net position for the year ended June 30, 2013, and the previous year follows:

**Summary of Revenues, Expenses, and Changes in
Net Position (in thousands of dollars)**

	<u>2013</u>	<u>2012</u>
Operating revenues	\$1,122,879	\$1,092,934
Operating expenses	1,892,396	1,857,043
Operating loss	(769,517)	(764,109)
Nonoperating revenues and expenses	761,223	683,655
Income (loss) before other revenues, expenses, gains, or losses	(8,294)	(80,454)
Other revenues, expenses, gains, or losses	100,398	140,983
Increase in net position	92,104	60,529
Net position at beginning of year	2,610,030	2,561,937
Prior period adjustment	-	(12,436)
Net position at end of year	\$2,702,134	\$2,610,030

Operating Revenues

The following summarizes the operating revenues by source that were used to fund operating activities for the last two fiscal years:

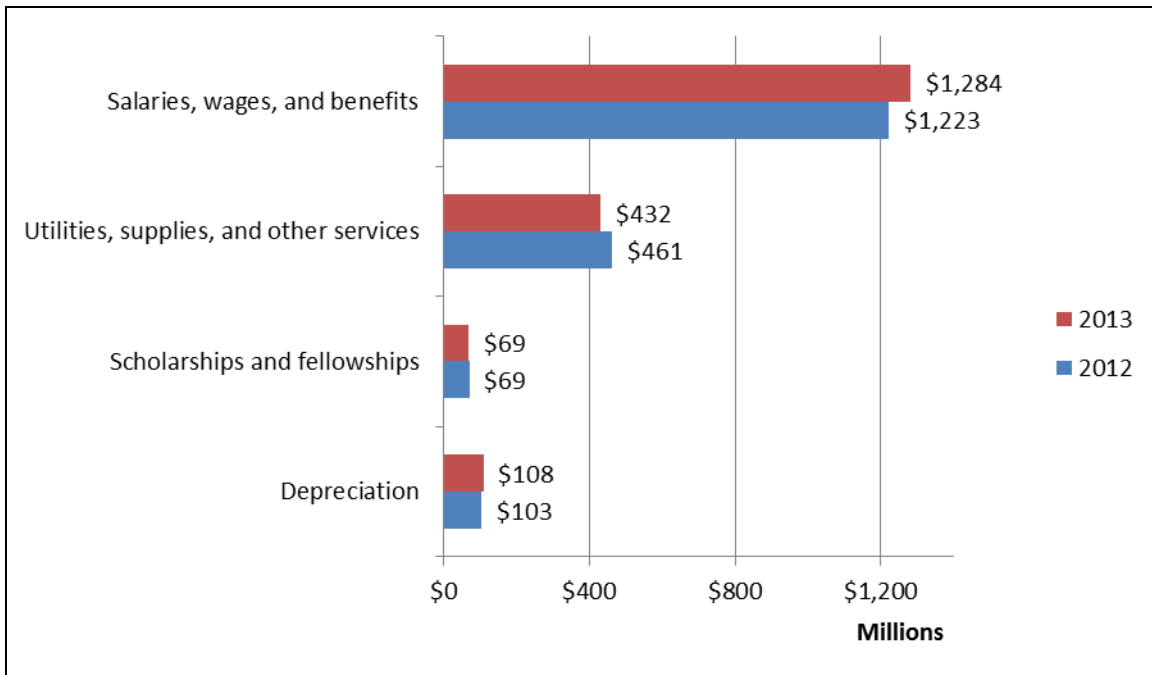


Comparison of Fiscal Year 2013 to Fiscal Year 2012

- Tuition and fees increased by \$21.5 million, or 6.1%, primarily due to a 4% to 10% increase in tuition rates.
- Operating grants and contracts increased by \$4.5 million, or 1%, due to a slight increase in sponsored projects.
- Other revenue increased \$3 million, or 3.3%, due to increases in sales and services of educational departments and other miscellaneous areas such as University Family Practice, the Knoxville Dairy Experiment Station, fees for student publications, and several new operations.

Operating Expenses

Operating expenses may be reported by nature or function. The university has chosen to report the expenses in their natural classification on the statement of revenues, expenses, and changes in net position and has displayed the functional classification in the notes to the financial statements. The following summarizes the operating expenses by natural classifications for the last two fiscal years:



Comparison of Fiscal Year 2013 to Fiscal Year 2012

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

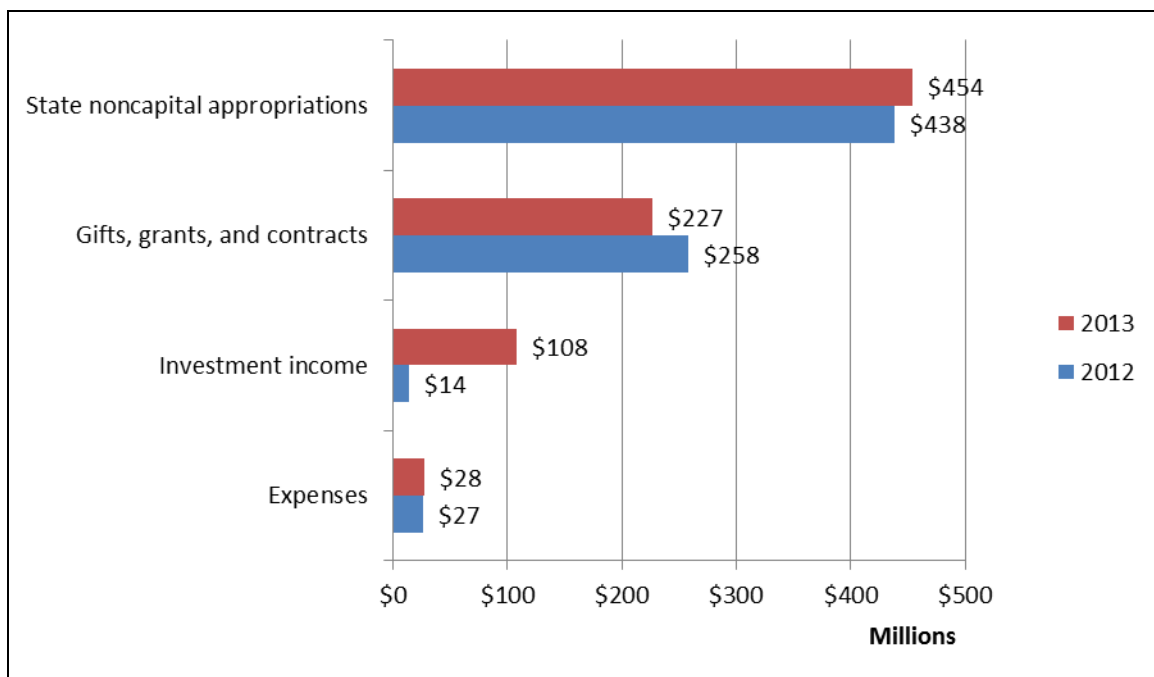
The increase in salary and benefit expenses from 2012 to 2013 is due to a 2.5% across-the-board salary increase, a 1% to 2.5% market/merit salary increase, and increases in staff in the instruction, research, academic support, institutional support, and operation and maintenance of plant functions.

Employee benefit expenses also increased between fiscal years as a result of increasing the number of employees and increases in health insurance premiums.

Utilities, supplies, and other services decreased between fiscal years due to use in fiscal year 2012 of available one-time funds for maintenance costs and equipment purchases.

Nonoperating Revenues and Expenses

Certain revenue sources that the university relies on to provide funding for operations, including state noncapital appropriations, certain gifts and grants, and investment income, are defined by the GASB as nonoperating. Nonoperating expenses include capital financing costs and other costs related to capital assets. The following summarizes the university's nonoperating revenues and expenses for the last two fiscal years:



Comparison of Fiscal Year 2013 to Fiscal Year 2012

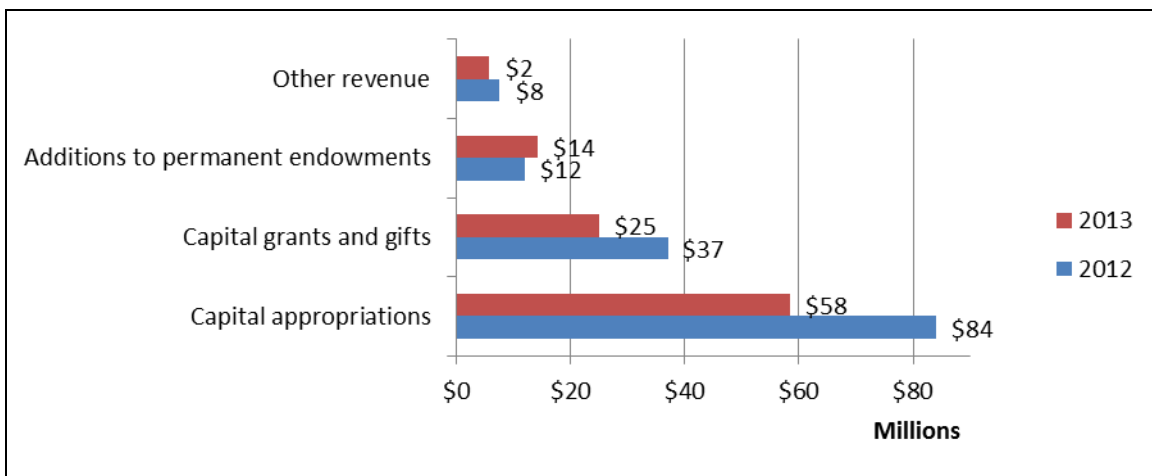
In fiscal year 2013, state and local appropriations increased \$15.7 million, which mainly represented a 4.4% increase in state appropriations, mostly due to the 2.5% salary increase and related benefits and new THEC formula outcomes productivity gains.

Nonoperating grants and contracts decreased \$37.4 million from 2012 to 2013 due to the end of American Recovery and Reinvestment Act (ARRA) funding and the end of the ARRA funded Solar Grant, while gifts increased \$6.5 million for the same time period.

The increase in investment income was due to an increase in endowment income and an overall increase in the capital markets.

Other Revenues

This category is composed of state appropriations for capital purposes, capital grants and gifts, additions to permanent endowments, and other revenue. These amounts were as follows for the last two fiscal years:



The decrease in capital appropriations was due to the completion of several state-appropriated 2012 projects and less capital construction and maintenance for 2013.

Capital grants and gifts decreased by \$12 million in 2013.

Additions to permanent endowments increased \$2 million.

Other revenue decreased \$2 million due to increased insurance recoveries in 2012.

Capital Asset and Debt Administration

Capital Assets

The University of Tennessee had \$2,024,634,489.54 invested in capital assets, net of accumulated depreciation at June 30, 2013; and \$1,895,759,159.32 invested in capital assets, net of accumulated depreciation at June 30, 2012. Depreciation charges totaled \$108,247,333.60 and \$103,198,969.58 for the years ended June 30, 2013, and June 30, 2012, respectively.

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

	<u>2013</u>	<u>2012</u>
Land	\$ 68,477	\$ 65,525
Land improvements & infrastructure	46,602	46,090
Buildings	1,236,118	1,157,653
Works of art/historical treasures	3,878	3,878
Equipment	136,098	143,391
Software	5,173	7,058
Library holdings	78,650	76,554
Projects in progress	449,638	395,610
Total	\$2,024,634	\$1,895,759

Major capital additions for UT during 2012-2013 include the \$24 million John D. Tickle Engineering Building, the \$13.7 million Hess Hall Renovation, and the \$7 million Dougherty Engineering Building Renovation in Knoxville; the \$8.3 million Grote Science & Engineering Building Renovation in Chattanooga; and the \$53.4 million Pharmacy Building in Memphis.

At June 30, 2013, outstanding commitments under construction contracts totaled \$164,679,210.49 for various renovations and repairs of buildings and infrastructure. Future state capital outlay appropriations will fund \$134,400,779.67 of these costs.

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

Debt

The university had \$633,013,930.88 and \$575,135,598.84 in debt outstanding at June 30, 2013, and June 30, 2012, respectively. The table below summarizes these amounts by type of debt instrument.

Outstanding Debt Schedule
(in thousands of dollars)

	<u>2013</u>	<u>2012</u>
Bonds-current portion	\$ 26,603	\$ 27,539
Bonds-noncurrent	477,409	446,033
Unamortized bond premium	26,541	7,377
Commercial paper-noncurrent	102,461	94,187
Total Debt	\$633,014	\$575,136

The Tennessee State School Bond Authority (TSSBA) issued bonds with interest rates ranging from .18% to 6.25% due to 2042 on behalf of the University of Tennessee. The university is responsible for the debt service of these bonds. The current portion of the \$504,012,490.16 outstanding at June 30, 2013, is \$26,603,121.58.

The ratings on debt issued by the Tennessee State School Bond Authority at June 30, 2013, were as follows:

Fitch	AA+
Moody's Investor Service	Aa1
Standard & Poor's	AA

More detailed information about the university's long-term liabilities is presented in Note 8 to the financial statements.

Economic Factors That Will Affect the Future

For fiscal year 2014, the University of Tennessee Board of Trustees has authorized individual campus fee increases of 6.0% that are expected to generate approximately \$32.4 million in new funding, net of related scholarships, with a continued projected enrollment increase. State appropriations will increase \$38.2 million with salary and benefit funds and new formula increases. The university continues to be successful in competing for grants and contracts. The capital markets remain unstable, which will affect the university's investment income.

Requests for Information

This financial report is designed to provide a general overview of the university's finances for all those with an interest in the university's finances. Questions concerning any of the information provided in the report or requests for additional information should be directed to Mr. Ron Maples, Controller, 201 Andy Holt Tower, Knoxville, Tennessee, 37996-0100.

THE UNIVERSITY OF TENNESSEE
Statement of Net Position
June 30, 2013

	The University of Tennessee	University of Chattanooga Foundation, Inc.	The University of Tennessee Foundation, Inc.	The University of Tennessee Research Foundation, Inc.
ASSETS				
Current assets:				
Cash and cash equivalents (Note 2)	\$292,803,057.82	\$11,918,091.00	\$11,233,109.01	\$2,400,671.00
Investments (Notes 2, 21, 22, and 23)	103,182,332.33	-	56,319,509.56	-
Accounts, notes, and grants receivable (net) (Note 4)	130,579,455.29	1,381,775.00	6,649,749.58	611,577.00
Due from the university	-	-	-	3,969,417.00
Inventories	5,861,081.72	-	-	-
Prepaid expenses	3,869,764.41	58,577.00	-	132,037.00
Total current assets	536,295,691.57	13,358,443.00	74,202,368.15	7,113,702.00
Noncurrent assets:				
Cash and cash equivalents (Note 2)	553,498,526.98	-	584,083.11	1,546,670.00
Investments (Notes 2, 21, 22, and 23)	606,293,765.37	105,487,823.00	11,023,563.43	289,537.00
Investment in UT - Battelle, LLC (Note 13)	4,947,065.79	-	-	-
Accounts, notes, and grants receivable (net) (Note 4)	96,142,352.62	1,879,598.00	67,805,888.56	-
Lease payments receivable (Note 18)	46,994,450.42	-	-	-
Due from primary government	9,336,539.16	-	-	-
Capital assets (net) (Notes 5, 21, and 23)	2,024,634,489.54	57,284,491.00	-	58,369,556.00
Prepaid expenses	501,956.48	397,080.00	-	-
Assets held by the university	-	838,797.00	50,560,380.58	-
Total noncurrent assets	3,342,349,146.36	165,887,789.00	129,973,915.68	60,205,763.00
Total assets	3,878,644,837.93	179,246,232.00	204,176,283.83	67,319,465.00
DEFERRED OUTFLOWS OF RESOURCES				
Deferred loss on debt refunding	6,449,277.88	-	-	-
Total deferred outflows of resources	6,449,277.88	-	-	-
LIABILITIES				
Current liabilities:				
Accounts payable (Note 7)	101,085,174.40	1,736,027.00	755,582.34	989,866.00
Accrued liabilities	50,796,925.99	-	-	-
Unearned revenue	87,005,352.27	109,251.00	-	3,296,824.00
Due to component unit	1,214,198.10	-	-	-
Deposits payable	3,507,608.58	-	-	-
Annuities and life income payable (Note 8)	3,016,688.00	-	140,000.52	-
Long-term liabilities, current portion (Notes 8, 21, and 22)	67,833,515.66	1,895,000.00	706,492.95	-
Deposits held in custody for others	13,467,317.02	2,326,484.31	-	-
Due to the university	-	3,417,518.69	34,785,236.23	-
Total current liabilities	327,926,780.02	9,484,281.00	36,387,312.04	4,286,690.00
Noncurrent liabilities:				
Net OPEB obligation (Note 11)	87,696,118.55	-	-	-
Unearned revenue (Notes 8 and 23)	15,500,438.71	-	-	18,724,631.00
Long-term liabilities, noncurrent portion (Notes 8, 21, and 22)	647,809,744.44	76,829,244.00	824,909.38	-
Due to grantors (Note 8)	36,686,582.22	-	-	-
Annuities and life income payable (Note 8)	16,779,694.35	-	993,604.57	-
Deposits held in custody for component units	50,560,380.58	-	-	-
Total noncurrent liabilities	855,032,958.85	76,829,244.00	1,818,513.95	18,724,631.00
Total liabilities	1,182,959,738.87	86,313,525.00	38,205,825.99	23,011,321.00
NET POSITION				
Net investment in capital assets	1,407,126,575.63	-	-	38,743,841.00
Restricted for:				
Nonexpendable:				
Scholarships and fellowships	201,260,954.51	16,742,216.00	28,399,613.09	-
Libraries	15,193,240.26	-	317,999.93	-
Research	20,627,360.24	-	1,557,903.56	-
Instructional department uses	139,790,011.23	32,320,745.00	25,592,506.87	-
Academic support	28,703,271.96	147,123.00	16,349,060.40	-
Other	36,767,779.42	38,327.00	8,358,880.70	-
Expendable:				
Scholarships and fellowships	109,004,658.11	580,072.00	4,594,948.72	-
Libraries	10,270,909.26	-	17,905.06	-
Research	55,365,518.78	-	6,141,514.15	-
Instructional department uses	79,551,696.21	5,142,595.00	8,977,498.15	-
Academic support	47,115,186.42	12,107.00	17,808,740.33	-
Loans	10,607,583.69	-	-	-
Capital projects	32,475,298.12	5,000,000.00	22,082,721.34	-
Debt service	645,409.34	-	-	-
Other	84,631,421.83	1,972,133.00	18,659,177.81	-
Unrestricted	422,997,501.93	30,977,389.00	7,111,987.73	5,564,303.00
Total net position	\$2,702,134,376.94	\$92,932,707.00	\$165,970,457.84	\$44,308,144.00

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

THE UNIVERSITY OF TENNESSEE
Statement of Revenues, Expenses, and Changes in Net Position
For the Year Ended June 30, 2013

	The University of Tennessee	University of Chattanooga Foundation, Inc.	The University of Tennessee Foundation, Inc.	The University of Tennessee Research Foundation, Inc.
REVENUES				
Operating revenues:				
Student tuition and fees (net of scholarship allowances of \$169,402,418.26)	\$ 376,325,190.31	\$ -	\$ -	\$ -
Contributions	-	2,312,920.00	51,523,325.51	2,427,300.00
Investment return designated for operations	-	6,333,335.00	-	-
Federal appropriations	15,335,809.57	-	-	-
Governmental grants and contracts (Note 17)	248,121,444.04	-	22,936,152.00	-
Nongovernmental grants and contracts	216,677,764.57	-	-	2,411,979.00
Sales and services of educational departments and other activities	55,704,395.68	-	-	-
Auxiliary enterprises:				
Residential life (net of scholarship allowances of \$2,288,381.94; all revenues are used as security for varying revenue bonds; see Note 8)	55,888,877.60	11,085,149.00	-	-
Food services	5,798,685.75	-	-	-
Bookstore	19,575,763.45	-	-	-
Parking	9,992,746.31	-	-	-
Athletics (includes gifts of \$22,389,263.77 from component units)	92,196,454.27	-	-	-
Other auxiliaries	6,027,715.05	-	-	-
Interest earned on loans to students	49,524.94	-	-	-
Other operating revenues	21,184,217.34	-	203,268.40	-
Total operating revenues	1,122,878,588.88	19,731,404.00	74,662,745.91	4,839,279.00
EXPENSES				
Operating expenses (Note 19):				
Salaries and wages	949,627,886.42	-	-	-
Fringe benefits	334,184,068.71	-	-	-
Utilities, supplies, and other services	431,579,782.71	3,779,104.00	22,930,798.08	9,887,185.00
Scholarships and fellowships	68,756,707.97	-	-	-
Depreciation and amortization expense	108,247,333.60	3,180,937.00	-	3,734,852.00
Payments to or on behalf of the university (Notes 21 and 22)	-	6,333,335.00	46,936,450.91	-
Total operating expenses	1,892,395,779.41	13,293,376.00	69,867,248.99	13,622,037.00
Operating income (loss)	(769,517,190.53)	6,438,028.00	4,795,496.92	(8,782,758.00)
NONOPERATING REVENUES (EXPENSES)				
State and local appropriations	453,943,026.40	-	-	-
Gifts (include \$21,218,544.71 from component units)	40,799,672.13	-	-	10,000.00
Grants and contracts	186,313,638.75	-	-	6,997,841.00
Investment income (loss) (includes \$1,817,202.76 from component units)	107,895,351.72	6,533,252.00	4,362,595.31	5,636.00
Interest on capital asset - related debt	(24,229,438.68)	(4,246,377.00)	-	-
Other nonoperating revenues (expenses)	(3,499,750.52)	(19,821.00)	-	-
Net nonoperating revenues (expenses)	761,222,499.80	2,267,054.00	4,362,595.31	7,013,477.00
Income (loss) before other revenues, expenses, gains, or losses	(8,294,690.73)	8,705,082.00	9,158,092.23	(1,769,281.00)
Capital appropriations	58,461,922.92	-	-	-
Capital grants and gifts (include \$7,844,774.67 from component units)	25,089,458.82	-	-	-
Additions to permanent endowments	14,408,034.65	2,330,969.00	14,794,491.91	-
Other	2,439,389.72	-	-	903,040.00
Total other revenues	100,398,806.11	2,330,969.00	14,794,491.91	903,040.00
Increase (decrease) in net position	92,104,115.38	11,036,051.00	23,952,584.14	(866,241.00)
NET POSITION				
Net position at beginning of year	2,610,030,261.56	81,896,656.00	142,017,873.70	45,174,385.00
Net position at end of year	\$ 2,702,134,376.94	\$ 92,932,707.00	\$ 165,970,457.84	\$ 44,308,144.00

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

THE UNIVERSITY OF TENNESSEE
Statement of Cash Flows
For the Year Ended June 30, 2013

CASH FLOWS FROM OPERATING ACTIVITIES	
Tuition and fees	\$376,069,482.88
Federal appropriations	15,335,809.57
Grants and contracts	474,854,285.35
Sales and services of educational and other activities	52,708,205.63
Payments to suppliers and vendors	(434,833,599.94)
Payments to employees	(946,227,003.85)
Payments for benefits	(319,082,147.04)
Payments for scholarships and fellowships	(68,756,707.97)
Loans issued to students	(3,936,142.01)
Collection of loans from students	3,896,104.38
Interest earned on loans to students	584,658.44
Auxiliary enterprise charges:	
Residence halls	55,914,672.60
Bookstore	19,575,763.45
Food service	5,798,685.75
Parking	9,992,746.31
Athletics	90,185,994.46
Other auxiliaries	6,244,540.18
Other receipts (payments)	19,786,276.16
Net cash used by operating activities	(641,888,375.65)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State appropriations	448,259,216.43
Local appropriations	5,683,809.97
Gifts and grants for other than capital or endowment purposes	204,692,319.56
Private gifts for endowment purposes	14,408,034.65
Split-interest transactions receipts	5,990,036.84
Split-interest transactions disbursements	(5,168,331.41)
Federal student loan receipts	282,586,351.84
Federal student loan disbursements	(282,152,992.00)
Changes in deposits held for others	(19,419,191.81)
Net cash balance implicitly financed (repaid)	(6,422,592.14)
Other noncapital receipts (payments)	(11,302,958.37)
Net cash provided by noncapital financing activities	637,153,703.56
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Proceeds from capital debt	72,351,018.34
Capital appropriations	78,583,365.95
Capital grants and gifts received	17,244,684.15
Proceeds from sale of capital assets	1,078,130.59
Purchase of capital assets and construction	(242,879,596.94)
Principal paid on capital debt and leases	(32,952,767.73)
Interest paid on capital debt and leases	(24,241,872.40)
Other capital and related financing receipts (payments)	12,686,915.74
Net cash used by capital and related financing activities	(118,130,122.30)
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales and maturities of investments	166,315,764.21
Income on investments	56,835,243.93
Purchase of investments	(170,503,950.89)
Net cash provided by investing activities	52,647,057.25
Net decrease in cash and cash equivalents	(70,217,737.14)
Cash and cash equivalents at beginning of year	916,519,321.94
Cash and cash equivalents at end of year	\$846,301,584.80

THE UNIVERSITY OF TENNESSEE
Statement of Cash Flows (Continued)
For the Year Ended June 30, 2013

Reconciliation of operating loss to net cash used by operating activities:	
Operating loss	(\$769,517,190.53)
Adjustments to reconcile operating loss to net cash used by operating activities:	
Depreciation and amortization expense	108,247,333.60
Changes in assets and liabilities:	
Receivables, net	3,013,839.24
Inventories	679,665.01
Prepaid expenses	80,132.78
Accrued interest receivable	535,133.50
Accounts payable	(4,033,053.92)
Accrued liabilities	4,001,038.32
Unearned revenue	4,257,545.76
Deposits	(3,614,547.70)
Net OPEB obligation	11,188,748.44
Compensated absences	3,313,017.48
Other deductions:	
Loans to students	(40,037.63)
Net cash used by operations	(\$641,888,375.65)
Noncash investing, capital, or financing transactions	
Gifts of capital assets	\$593,317.07
Unrealized gain on investments	\$44,904,424.29
Loss on disposal of capital assets	(\$2,444,318.17)

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

THE UNIVERSITY OF TENNESSEE
Notes to the Financial Statements
June 30, 2013

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 significant 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, and 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 26 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. The University of Tennessee Research Foundation, Inc., is also considered a component unit of the university because the university's board of trustees approves the foundation's administrative budget and funds the foundation's administrative costs. It is also discretely presented in the university's financial statements. See Notes 21, 22, and 23 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).

Notes to the Financial Statements (Continued)

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.

Amounts reported as operating revenues include (1) tuition and fees, net of scholarship discounts and allowances; (2) federal appropriations; (3) certain federal, state, local, and private grants and contracts; (4) sales and services of educational departments and other activities; (5) sales and services of auxiliary enterprises, net of scholarship discounts and allowances; and (6) other sources of revenue. Operating expenses include (1) salaries and wages; (2) employee benefits; (3) scholarships and fellowships; (4) depreciation; and (5) utilities, supplies, and other services.

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

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

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. 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

Notes to the Financial Statements (Continued)

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 position at historical cost or at fair value at date of donation, less accumulated depreciation/amortization. The costs of normal maintenance and repairs that do not add to the value of the assets 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 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/amortized 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 \$13,425,438.81 as of June 30, 2013. 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 position. There is no liability for unpaid accumulated sick leave since the university's policy is to pay this only when an employee dies or is absent because of illness or injury.

Net Position

The university's net position is classified as follows:

Net investment in capital assets – This represents the institution's total investment in capital assets, net of accumulated depreciation and net of outstanding debt obligations and deferred outflows/inflows of resources related to those capital assets. To the extent debt has been

Notes to the Financial Statements (Continued)

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 position – Nonexpendable restricted net position consists 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 position – Expendable restricted net position includes resources in which the university is legally or contractually obligated to spend resources in accordance with restrictions imposed by external third parties.

Unrestricted net position – Unrestricted net position represents resources derived from student tuition and fees; state appropriations; the sales and services of educational departments and other activities; 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 position. 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*.

Accounting Change

The university implemented GASB Statement 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, during the year ended June 30, 2013. The effect on the university was the renaming of the residual of all other elements in the statement of financial position as net position, rather than net assets.

Notes to the Financial Statements (Continued)

Early Implementation of Accounting Pronouncement

In March 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*. This statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities; it also recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The provisions of this statement are effective for financial statements for periods beginning after December 15, 2012. However, the university has elected to early implement the provisions of this statement for fiscal year 2013.

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. At June 30, 2013, the university's cash management investment pool consisted of \$546,000,000.00 of certificates of deposit, \$38,425,000.00 of demand deposits yielding money market rates, \$129,842,472.68 of commercial paper, and \$92,551,323.96 of U.S. Government guaranteed securities.

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.

Notes to the Financial Statements (Continued)

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, 2013, cash and cash equivalents consisted of \$32,038,754.67 in bank accounts, \$1,568,315.80 of petty cash on hand, and \$806,818,796.64 in the university's cash management investment pool.

The carrying amount of the university's deposits was \$616,463,754.67, and the bank balance was \$621,382,292.20.

Additionally, the university maintains custodial accounts at First Tennessee Bank and Hilliard Lyons for funds contractually managed by independent investment counsel. In accordance with the custody agreements, First Tennessee Bank and Hilliard Lyons placed cash equivalents totaling \$5,875,717.69 at June 30, 2013, 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, 2013, all university deposits were adequately secured as required by state statute.

Investments

Investments in commercial paper are reported at amortized cost. All other investments are reported at fair value, including those securities with a maturity date of one year or less. As of June 30, 2013, the university had the following investments and maturities:

Investment Type	Fair Value	Less Than 1	Investment Maturities (In Years)				Unknown	Cost
			1 to 5	6 to 10	10+			
<u>Cash Management Pool</u>								
<u>Cash Equivalents</u>								
<u>Debt Securities</u>								
Commercial paper	\$129,842,472.68	\$129,842,472.68	\$ -	\$ -	\$ -	\$ -	\$ -	\$129,717,166.63
U.S. agencies	92,551,323.96	-	-	1,263,395.81	91,287,928.15	-	-	92,278,670.04
	<u>222,393,796.64</u>	<u>129,842,472.68</u>	<u>-</u>	<u>1,263,395.81</u>	<u>91,287,928.15</u>	<u>-</u>	<u>-</u>	<u>221,995,836.67</u>
<u>Investments</u>								
<u>Debt Securities</u>								
U.S. Treasury	3,480,926.90	85,286.21	2,453,726.71	245,478.26	696,435.72	-	-	3,104,271.30
U.S. agencies	8,931,795.34	1,162,112.09	5,809,728.25	888,381.60	1,071,573.40	-	-	8,499,971.60
Corporate bonds	15,067,672.82	1,343,291.50	10,157,297.97	3,440,556.35	126,527.00	-	-	14,557,485.91
Municipal bonds	4,719,985.10	115,008.05	2,870,028.10	-	1,734,948.95	-	-	4,746,052.53

Notes to the Financial Statements (Continued)

Mortgages and notes	15,246.23	-	15,246.23	-	-	-	15,246.23
Bond mutual funds	28,807,399.83	-	2,006,404.58	22,763,484.96	1,588,829.65	2,448,680.64	29,203,934.05
	<u>61,023,026.22</u>	<u>2,705,697.85</u>	<u>23,312,431.84</u>	<u>27,337,901.17</u>	<u>5,218,314.72</u>	<u>2,448,680.64</u>	<u>60,126,961.62</u>
		<u>\$132,548,170.53</u>	<u>\$23,312,431.84</u>	<u>\$28,601,296.98</u>	<u>\$96,506,242.87</u>	<u>\$2,448,680.64</u>	
Other Investments							
Corporate stocks:							
Domestic	27,049,461.38						19,183,376.94
International	4,081,729.09						4,517,125.80
Mutual funds – equity	195,594,010.01						202,075,322.83
Alternative investments:							
Private equity	107,633,197.45						94,976,843.38
Natural resources	113,094,684.54						94,448,208.86
Hedge funds	170,122,902.66						133,240,535.20
Real estate investments	19,912,944.57						13,953,551.76
Real estate gifts	3,938,450.87						5,459,352.37
Assets with trustees	7,025,690.91						7,811,905.15
Total investments and cash equivalents	<u>931,869,894.34</u>						<u>857,789,020.58</u>
Less: cash equivalents	222,393,796.64						221,995,836.67
Total investments	<u>\$709,476,097.70</u>						<u>\$635,793,183.91</u>

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, 2013, 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, and 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, 2013, the institution's investments were rated as follows:

Notes to the Financial Statements (Continued)

Rated Debt Instruments	Fair Value	Aaa	Aa1	Aa2	Aa3	A1
<u>Cash management pool</u>						
Commercial paper	\$129,842,472.68	\$ -	\$ -	\$ -	\$ -	\$129,842,472.68
U.S. agencies	92,551,323.96	92,551,323.96	-	-	-	-
<u>Investments</u>						
U.S. agencies	8,931,795.34	8,931,795.34	-	-	-	-
Corporate bonds	15,067,672.82	-	-	488,218.75	377,507.30	1,126,460.25
Municipal bonds	4,719,985.10	-	941,644.25	900,313.75	741,343.25	408,196.00
Mutual funds – bonds	28,807,399.83	1,907,444.51	-	-	-	-
Mortgages and notes	15,246.23	-	-	-	-	-
Money market funds in custodial accounts	5,875,717.69	-	-	-	-	-

Rated Debt Instruments	A2	A3	Baa1	Baa2	Baa3	Ba1
<u>Investments</u>						
U.S. agencies	-	-	-	-	-	-
Corporate bonds	1,201,902.25	3,126,636.75	3,947,253.00	4,130,053.95	158,517.15	435,323.25
Municipal bonds	204,168.00	198,453.45	-	-	-	-
Mutual funds – bonds	1,543,581.07	-	-	123,036.09	-	-
Mortgages and notes	-	-	-	-	-	-
Money market funds in custodial accounts	-	-	-	-	-	-

Rated Debt Instruments	Ba2	B2	Unrated
<u>Investments</u>			
U.S. agencies	-	-	-
Corporate bonds	-	-	75,800.17
Municipal bonds	-	-	1,325,866.40
Mutual funds – bonds	4,372,948.16	73,612.22	20,786,777.78
Mortgages and notes	-	-	15,246.23
Money market funds in custodial accounts	-	-	5,875,717.69

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 20, 2013, the university had \$7,025,690.91 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.

Notes to the Financial Statements (Continued)

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 \$4,081,729.09 invested in foreign corporate equities and \$428,667.75 invested in foreign corporate bonds at June 30, 2013.

Alternative Investments

In its Consolidated Investment Pool, as part of its endowment assets, the university has investments in 90 limited partnerships, limited companies, corporations, and limited liability corporations (LLCs).

These investments include 42 private equity funds, 3 real estate funds, 19 natural resource funds, and 26 hedge funds. The estimated fair value of these assets is \$410,763,729.22 at June 30, 2013.

Total capital contributions less returns of capital equal \$336,619,139.20 at June 30, 2013.

The university believes that the carrying amount of its alternative investments is a reasonable estimate of fair value as of June 30, 2013. 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 estate 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 estate 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.

Notes to the Financial Statements (Continued)

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 their contributions 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, 4.5% 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, 2013, net appreciation of \$124,236,860.03 is available to be spent, of which \$121,691,022.31 is restricted for scholarships and fellowships, libraries, instructional department uses, academic support, research, and other purposes. The per-unit fair value for participating endowments was \$3.272283 at June 30, 2013. Income distributed was \$.14050 per share in 2013, or \$28,044,905.52.

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 2013 and the three and five years then ended was 12.1%, 10.0%, and 2.7%, 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 \$155,802.37 for 2013.

Annuity and life income amounts held in trust are separately invested entities requiring detailed accounting to reflect specific compliance with the 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 2013 amounted to \$1,697,679.01.

Notes to the Financial Statements (Continued)

Note 4. Accounts, Notes, and Grants Receivable

Accounts, notes, and grants receivable included the following at June 30, 2013:

Student accounts receivable	\$ 15,874,063.83
Grants receivable	76,906,232.85
Notes receivable	3,275,014.31
Pledges receivable	29,880,123.50
TSSBA debt service reserve receivable	12,509,416.89
Due from component units	38,202,754.92
Other receivables	38,331,478.94
<hr/>	
Subtotal	214,979,085.24
Less allowance for doubtful accounts	(17,176,542.60)
<hr/>	
Total	\$197,802,542.64

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of \$5,976,024.69.

Federal Perkins Loan Program funds included the following at June 30, 2013:

Perkins Loans receivable	\$28,919,265.27
Less allowance for doubtful accounts	-
<hr/>	
Total	\$28,919,265.27

Note 5. Capital Assets

Capital asset activity for the year ended June 30, 2013, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Transfers</u>	<u>Reductions</u>	<u>Ending Balance</u>
Land	\$ 65,525,014.66	\$ 3,469,115.77	\$ -	\$ (517,009.37)	\$ 68,477,121.06
Land improvements & infrastructure	98,225,982.15	2,597.44	4,507,408.55	-	102,735,988.14
Buildings	1,946,418,801.31	16,439,432.09	113,948,565.33	-	2,076,806,798.73
Works of art/ historical treasures	3,878,450.77	-	-	-	3,878,450.77

Notes to the Financial Statements (Continued)

Equipment	386,465,937.90	31,502,647.49	-	(12,756,712.20)	405,211,873.19
Software	29,477,521.19	643,214.03	-	(20,527.10)	30,100,208.12
Library holdings	134,295,318.43	15,560,367.33	-	(11,372,033.79)	138,483,651.97
Projects in progress	395,610,457.11	172,966,376.60	(118,455,973.88)	(483,193.87)	449,637,665.96
Total	3,059,897,483.52	240,583,750.75	-	(25,149,476.33)	3,275,331,757.94
Less accumulated depreciation/amortization:					
Land improvements & infrastructure	(52,136,137.56)	(3,997,614.58)	-	-	(56,133,752.14)
Buildings	(788,765,947.28)	(51,922,824.23)	-	-	(840,688,771.51)
Equipment	(243,074,877.03)	(36,340,439.13)	-	10,301,720.51	(269,113,595.65)
Software	(22,419,785.81)	(2,522,021.04)	-	14,635.10	(24,927,171.75)
Library holdings	(57,741,576.52)	(13,464,434.62)	-	11,372,033.79	(59,833,977.35)
Total	(1,164,138,324.20)	(108,247,333.60)	-	21,688,389.40	(1,250,697,268.40)
Capital assets, net	\$1,895,759,159.32	\$132,336,417.15	\$ -	\$(3,461,086.93)	\$2,024,634,489.54

Note 6. Operating Leases

The university has entered into various operating leases for buildings and equipment. It is expected that in the normal course of business, such leases will continue to be required. Net expenses for rentals under leases were \$9,219,618.00 for the year ended June 30, 2013. All operating leases are cancelable at the lessee's option.

Note 7. Accounts Payable

Accounts payable included the following:

	<u>June 30, 2013</u>
Vendors payable	\$ 77,011,837.82
Payroll deductions payable	24,073,336.58
<hr/>	
Total	<u>\$101,085,174.40</u>

Note 8. Long-term Liabilities

Long-term liability activity for the year ended June 30, 2013, was as follows:

Notes to the Financial Statements (Continued)

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term liabilities:					
Bonds	\$473,571,593.78	\$253,480,390.63	\$223,039,494.25	\$504,012,490.16	\$26,603,121.58
Unamortized bond premium	7,377,058.91	20,829,431.11	1,665,590.48	26,540,899.54	-
Commercial paper	94,186,946.15	48,451,053.55	40,177,458.52	102,460,541.18	-
Total TSSBA indebtedness	575,135,598.84	322,760,875.29	264,882,543.25	633,013,930.88	26,603,121.58
Compensated absences	79,316,311.40	44,543,411.90	41,230,394.08	82,629,329.22	41,230,394.08
Total long-term liabilities	654,451,910.24	367,304,287.19	306,112,937.33	715,643,260.10	\$67,833,515.66
Other noncurrent liabilities:					
Unearned revenue	15,500,438.71	-	-	15,500,438.71	
Due to grantors	36,403,548.94	914,681.14	631,647.86	36,686,582.22	
Annuities payable and life income payable	15,227,976.83	2,465,153.76	913,436.24	16,779,694.35	
Totals	\$721,583,874.72	\$370,684,122.09	\$307,658,021.43	\$784,609,975.38	

TSSBA Debt – Bonds

Bonds, with interest rates ranging from .18% to 6.25%, were issued by the Tennessee State School Bond Authority (TSSBA). The bonds are due serially to 2042 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. (See Note 9 for further details.) The bonded indebtedness with the Tennessee State School Bond Authority included in long-term liabilities on the statement of net position is shown net of assets held by the authority in the debt service reserve, capitalized interest, and unexpended debt proceeds. The total bonded indebtedness at June 30, 2013, was \$602,118,570.36. The debt service reserve amount at June 30, 2013, was \$20,895,329.03, capitalized interest was \$3,436,026.79, and unspent debt proceeds were \$73,774,724.38.

The university's debt service requirements to maturity for all bonds payable at June 30, 2013, are as follows:

Year Ending June 30	Principal	Interest
2014	\$ 29,271,877.44	\$ 25,271,227.49
2015	27,191,583.56	24,248,519.05
2016	27,812,307.92	23,146,032.35
2017	27,619,368.37	22,056,972.50
2018	28,504,023.70	20,984,706.48
2019-2023	137,479,002.21	87,116,379.90
2024-2028	125,119,405.51	59,362,770.02
2029-2033	99,915,057.34	33,939,863.92
2034-2038	65,055,548.31	15,346,905.23
2039-2042	34,150,396.00	2,996,928.90
	<u>\$602,118,570.36</u>	<u>\$314,470,305.84</u>

Notes to the Financial Statements (Continued)

Less:	
Debt service reserve fund	(20,895,329.03)
Unspent bond proceeds	(73,774,724.38)
Capitalized interest	<u>(3,436,026.79)</u>
TSSBA debt - bonds	<u>\$504,012,490.16</u>

TSSBA Debt – Commercial Paper

The TSSBA issues commercial paper to finance the costs of various capital projects during the 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 \$102,460,541.18 at June 30, 2013.

For the commercial paper program, TSSBA 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 is available on the state's website at www.comptroller.tn.gov/tssba/cafr.asp.

Refunding of Debt

On August 1, 2012, the Tennessee State School Bond Authority issued \$117,958,382 in revenue bonds with interest rates ranging from .18% to 5% to advance refund \$121,728,863.06 of outstanding Series 1998D, 2004A, 2004B, 2004C, 2005B, and 2006A bonds with interest rates ranging from 1.3% to 6.25%. The net proceeds of \$128,716,787.33 (after payment of \$381,240.57 in underwriter's fees and issuance costs) were deposited with an escrow agent to provide for all future debt service payments on the Series 1998D, 2004A, 2004B, 2004C, 2005B, and 2006A bonds. As a result, the Series 1998D, 2004A, 2004B, 2004C, 2005B, and 2006A bonds are considered to be defeased, and the liability for those bonds has been removed from the university's long-term liabilities.

Note 9. Pledged Revenues

The University of Tennessee has pledged certain revenues and fees, including state appropriations, to repay \$504,012,490.16 in revenue bonds issued from May 2004 to September 2012. Proceeds from the bonds provided financing for construction and renovation projects. The bonds are payable through 2042. (See Note 8 for further details.) Annual principal and interest payments on the bonds are expected to require 4.27% of available revenues. The total principal and interest

Notes to the Financial Statements (Continued)

remaining to be paid on the bonds is \$818,482,796.00. Principal and interest paid for the current year and total available revenues were \$52,859,292.16 and \$1,236,827,720.97, respectively.

Note 10. 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 is available on the state's website at www.treasury.tn.gov/tcrs.

Funding Policy - Plan members are noncontributory. The university is required to contribute at an actuarially determined rate. The current rate is 15.03% 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, 2013; June 30, 2012; and June 30, 2011, were \$47,508,570.55, \$44,814,905.55, and \$43,343,861.11, 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

Notes to the Financial Statements (Continued)

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, 2013, were \$582,486.86, which consisted of \$302,615.78 from the university and \$279,871.08 from the employees; contributions for the year ended June 30, 2012, were \$618,678.32, which consisted of \$321,988.78 from the university and \$296,689.54 from the employees; and contributions for the year ended June 30, 2011, were \$655,375.40, which consisted of \$339,588.48 from the university and \$315,786.92 from the employees. Contributions met the requirements for each year.

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 11.9%. 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 \$1,131,626.95 for the year ended June 30, 2013, which consisted of \$71,372.55 from employees and \$1,060,254.40 from the university; \$1,101,753.98 for the year ended June 30, 2012, which consisted of \$69,636.70 from employees and \$1,032,117.28 from the university; and \$1,050,369.80 for the year ended June 30, 2011, which consisted of \$67,950.44 from employees and \$982,419.36 from the university. Contributions for the Thrift Savings Plan were \$1,031,993.00 for the year ended June 30, 2013, which consisted of \$613,673.00 from employees and \$418,320.00 from the university; \$1,018,610.96 for the year ended June 30, 2012, which consisted of \$611,154.96 from employees and \$407,456.00 from the university; and \$984,569.00 for the year ended June 30, 2011, which consisted of \$586,628.00 from employees and \$397,941.00 from the university. Contributions met the requirements for each year.

Defined Contribution Plans

Optional Retirement Plans

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

Notes to the Financial Statements (Continued)

Funding Policy - 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 contributions made by the university to the plans for the year ended June 30, 2013, were \$44,795,482.61 and for the year ended June 30, 2012, were \$42,961,063.63. Contributions met the requirements for each year.

Joint Contributory Retirement System Plan A (JCRS-A)

Plan Description - 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 ING, 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.

Funding Policy - Plan members are noncontributory. The university's contributions for JCRS-A members were calculated using the base salary amounts of \$18,268,301.01 for fiscal year 2013, and \$23,563,246.91 for fiscal year 2012. 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 \$3,003,878.67 in fiscal year 2013, and \$3,511,390.91 in fiscal year 2012. 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 2013, the university provided a \$50 monthly match from unrestricted funds for employees making a minimum monthly contribution

Notes to the Financial Statements (Continued)

of \$50 to the Section 401(k) plan. During the year ended June 30, 2013, contributions totaling \$20,166,810.55 were made by employees participating in the plan, with a related match of \$5,438,830.45 made by the university. During the year ended June 30, 2012, contributions totaling \$19,367,197.98 were made by employees participating in the plan, with a related match of \$5,456,652.02 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 11. Other Postemployment Benefits

Healthcare is the only "other postemployment benefit" (OPEB) provided to employees. The State of Tennessee administers a group health insurance program which provides postemployment 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. For accounting purposes, the plans are agent multiple-employer defined benefit OPEB plans. Benefits are established and amended by an insurance committee created by Section 8-27-201, *Tennessee Code Annotated*. Prior to reaching the age of 65, all members have the option of choosing between the standard or partnership preferred provider organization (PPO) plan for healthcare benefits. Subsequent to age 65, retirees 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 20. The plans are reported in the State of Tennessee's *Comprehensive Annual Financial Report* (CAFR). The CAFR is available on the state's website at www.tn.gov/finance/act/cafr.shtml.

Special Funding Situation

The State of Tennessee is legally responsible for contributions to the Medicare Supplement Plan that covers the retirees of other governmental entities, including the University of Tennessee. The state is the sole contributor for the university retirees that participate in the Medicare Supplement Plan and, therefore, is acting as the employer.

Funding Policy

The premium requirements of members of the State Employee Group Plan are established and may be amended by the insurance committee. The plan is self-insured and financed on a pay-as-you-go basis with the risk shared equally among the participants. Claims liabilities of the State Employee Group Plan are periodically computed using actuarial and statistical techniques to establish premium rates. Administrative costs of the plan are allocated to plan participants. In accordance with Section 8-27-205(b), *Tennessee Code Annotated*, retirees in the State Employee Group Plan pay the same base premium as active employees in the plan adjusted for years of

Notes to the Financial Statements (Continued)

service. Retirees with 30 years of service are subsidized 80%; retirees with 20 years of service but less than 30 years of service, 70%; and retirees with less than 20 years of service, 60%.

Retirees in the Medicare Supplement Plan have flat-rate premium subsidies based on years of service. Retirees with 30 years of service received \$50 per month; retirees with 20 years of service but less than 30 years of service, \$37.50; and retirees with 15 years of service but less than 20 years of service, \$25.

University's Annual OPEB Cost and Net OPEB Obligation State Employee Group Plan

Annual required contribution (ARC)	\$25,100,000.00
Interest on the net OPEB obligation	3,060,000.00
Adjustment to the ARC	(3,248,000.00)
Annual OPEB cost	24,912,000.00
Amount of contribution	(13,723,251.56)
Increase in net OPEB obligation	11,188,748.44
Net OPEB obligation – beginning of year	76,507,370.11
Net OPEB obligation – end of year	\$87,696,118.55

<u>Year-end</u>	<u>Plan</u>	<u>Annual OPEB Cost</u>	<u>Percentage of Annual OPEB Cost Contributed</u>	<u>Net OPEB Obligation at Year-end</u>
June 30, 2011	State Employee Group Plan	\$24,105,000.00	53.11%	\$66,561,306.04
June 30, 2012	State Employee Group Plan	\$24,642,000.00	59.64%	\$76,507,370.11
June 30, 2013	State Employee Group Plan	\$24,912,000.00	55.09%	\$87,696,118.55

Funded Status and Funding Progress

The funded status of the university's portion of the State Employee Group Plan as of July 1, 2011, was as follows:

State Employee Group Plan

Actuarial valuation date	July 1, 2011
Actuarial accrued liability (AAL)	\$242,451,000.00

Notes to the Financial Statements (Continued)

Actuarial value of plan assets	-
Unfunded actuarial accrued liability (UAAL)	\$242,451,000.00
Actuarial value of assets as a percentage of the AAL	0%
Covered payroll (active plan members)	\$685,300,649.00
UAAL as percentage of covered payroll	35.4%

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 Required Supplementary Information 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, 2011, actuarial valuation for each plan, the Projected Unit Credit actuarial cost method was used. The actuarial assumptions included a 4% investment rate of return (net of administrative expenses) and an annual healthcare cost trend rate of 9.25% initially, decreased to 8.75% in fiscal year 2013, and then reduced by decrements to an ultimate rate of 5% in fiscal year 2021. All rates include a 2.5% inflation assumption, which also represents the projected salary increase. 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 12. 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, 2013. 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 position does not include the amounts held in trust by the State Treasurer. At June 30, 2013, the amounts held in trust totaled \$123,382,565.76 at fair value.

Notes to the Financial Statements (Continued)

Note 13. Joint Ventures

UT-Battelle

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 \$4,947,065.79 at June 30, 2013. The university and Battelle each receive a 50% distribution of the ORNL management fee after shared expenses are deducted. The fee distribution to the university for the year ended September 30, 2012, was \$3,822,065.79.

During the year ended June 30, 2013, the university had expenses of \$21,595,905.17 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled \$3,727,294.36 at June 30, 2013. 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.

UT Le Bonheur Pediatric Specialists

The university is a participant in a joint venture with Methodist Healthcare - Memphis Hospitals, Le Bonheur Children's Hospital, for the sole purpose of governance, management, and support of the UT Le Bonheur Pediatric Specialists, Inc. (ULPS), a nonprofit faculty group practice comprised of pediatric physicians holding hospital privileges at Le Bonheur who are employed as UT Health Science Center faculty members. The practice group was incorporated on September 9, 2010, and began operations in January 2011.

Both the university and Methodist Healthcare provided an advance to the joint venture in the 2011 fiscal year so that the faculty practice group could begin its operations. In addition, the university and Methodist Healthcare have agreed to guarantee the losses of ULPS equally and provide cash on a monthly basis to meet the operating needs of ULPS. During the 2013 fiscal year, the university remitted another \$5,414,000.00 for these purposes.

To review the audit report of UT Le Bonheur Pediatric Specialists, Inc., please contact the Controller's Office, The University of Tennessee, 201 Andy Holt Tower, Knoxville, Tennessee 37996-0100.

Note 14. Insurance-Related Activities

It is the policy of the state not to purchase commercial insurance for the risks associated with casualty losses for general liability, automobile liability, professional medical 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

Notes to the Financial Statements (Continued)

Management Fund. The state purchases commercial insurance for real property, builder's risk (for construction projects starting prior to July 1, 2012), and crime and fidelity coverage on the state's officials and employees. The contractor is responsible for acquiring builder's risk insurance for all construction projects after June 30, 2012; thus, builder's risk is no longer covered by the Risk Management Fund. For property coverage, the deductible for an individual state agency is the first \$25,000 of losses. The Risk Management Fund is responsible for property losses for the annual aggregate deductible of \$10 million for perils other than earthquakes and flood. Purchased insurance coverage is responsible for losses exceeding the \$10 million annual aggregate deductible. For earthquake and flood, there is a deductible of \$10 million per occurrence. The maximum insurance coverage is \$750 million per year for perils other than earthquake and flood. The maximum flood insurance coverage is \$50 million per occurrence, except there is only \$25 million of coverage in flood zones A and V. The maximum earthquake insurance coverage is \$50 million per occurrence. The amounts of settlements have not exceeded insurance coverage for each of the three past fiscal years.

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 year ended June 30, 2013, is presented in the *Tennessee Comprehensive Annual Financial Report (CAFR)*. The CAFR is available on the state's website at www.tn.gov/finance/act/cafr.shtml. 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, 2013, the Risk Management Fund held \$108.5 million in cash designated for payment of claims.

At June 30, 2013, the scheduled coverage for the university was \$4,451,043,200 for buildings and \$1,158,752,500 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

Notes to the Financial Statements (Continued)

university based on estimates of the ultimate cost of claims, including the 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 15. 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, 2013, were \$164,679,210.49, of which \$134,400,779.67 of these costs will be funded by future state capital outlay appropriations.

Sick Leave

The university records the cost of sick leave when paid. The dollar amount of unused sick leave was \$294,444,771.10 at June 30, 2013.

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 \$1,578,290.17 as of June 30, 2013, 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 16. 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

Notes to the Financial Statements (Continued)

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 18.) 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 \$59,111,002.54 in 2013, are reported as operating expenses in the statement of revenues, expenses, and changes in net position. An equal amount of operating revenue is reported in the nongovernmental 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.

Notes to the Financial Statements (Continued)

Note 17. Transfer of Development Operations to the University of Tennessee Foundation

On July 1, 2011, the university transferred its Development and Alumni Affairs operations to the University of Tennessee Foundation, Inc., a not-for-profit component unit created in 2001 to support the University of Tennessee. The foundation supports the university's educational, research, and public activities by securing and administering private funds to support programs beyond the scope of the university's general budget. (See also Note 22.) Pursuant to the University of Tennessee Board of Trustees' approval and the enabling legislation, *Tennessee Code Annotated*, Section 49-9-113, the university and the foundation signed an Affiliation and Services Agreement and an Employee Services Agreement to effect the transfer.

Affiliation and Services Agreement

The university and the foundation agreed that all gifts, unless directed otherwise by the donor, be deposited into the foundation bank account and that the university pay the foundation direct support and a 100 basis point endowment assessment fee as compensation for performing the fundraising function. The direct support amount is to be reviewed every two years, and the foundation President and Chief Executive Officer, who is also the university's Vice President for Development and Alumni Affairs, coordinates fundraising goals and objectives of the foundation with the university. For fiscal year 2013, the university provided the foundation direct support of \$17,623,512.00 and endowment assessment fees of \$5,312,637.00.

Employee Services Agreement

The foundation has paid to the university the amounts incurred by the university to pay the direct expenses relating to the Development and Alumni Affairs employees, including wages, salaries, and fringe benefits. These payroll expenses on behalf of the foundation, totaling \$18,146,150.86 in fiscal year 2013, are reported as operating expenses in the statement of revenues, expenses, and changes in net position. An equal amount of operating revenue is reported in the nongovernmental grants and contracts category.

Note 18. 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 16. 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 2020. 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 March 15, 2021. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the

Notes to the Financial Statements (Continued)

remaining 30 years of the lease. An annual lease payment to the university during the year ended June 30, 2013, totaled \$2,871,767.00.

The university recorded a lease payment receivable in the amount of \$33,574,690.76 at June 30, 2013, which represents the net present value of the guaranteed \$50 million discounted at 5.75%. The minimum lease payments to be received amount has been adjusted upward to reflect a contractually required adjustment to the final required lease payment.

	<u>June 30, 2013</u>
Total minimum lease payments to be received	\$49,136,518.83
Less: unearned income	(15,561,828.07)
<hr/>	
Net investment in direct financing lease	\$33,574,690.76

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 Substance Abuse Services (TDMHSAS) to provide a new building to house the Memphis Mental Health Institute. The building is a joint project of the university, Methodist Healthcare, the 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 TDMHSAS 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, TDMHSAS will be responsible for all operational and maintenance costs associated with the facility.

The university recorded a lease payment receivable in the amount of \$13,419,759.66 at June 30, 2013:

Total minimum lease payments to be received	\$18,089,680.51
Less: unearned income	(4,669,920.85)
<hr/>	
Net investment in direct financing lease	\$13,419,759.66

Notes to the Financial Statements (Continued)

Year Ending June 30	Minimum Lease Payments to Be Received	Interest	Principal
2014	\$ 1,357,185.03	\$ 600,709.01	\$ 756,476.02
2015	1,358,740.88	566,846.85	791,894.03
2016	1,360,362.08	531,399.28	828,962.80
2017	1,362,051.36	494,292.40	867,758.96
2018	1,363,811.62	455,448.89	908,362.73
2019-2023	6,848,239.84	1,627,927.83	5,220,312.01
2024-2027	4,439,289.70	393,296.59	4,045,993.11
	<u>\$18,089,680.51</u>	<u>\$4,669,920.85</u>	<u>\$13,419,759.66</u>

Note 19. Natural Classifications With Functional Classifications

The university's operating expenses by functional classification for the year ended June 30, 2013, are as follows:

Functional Classification	Salaries	Benefits	Natural Classification Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	\$416,477,272.31	\$124,424,985.77	\$ 67,499,828.13	-	-	\$ 608,402,086.21
Research	138,774,710.78	36,911,189.59	81,199,218.92	-	-	256,885,119.29
Public service	66,714,328.48	25,150,256.34	35,315,901.04	-	-	127,180,485.86
Academic support	77,471,405.70	27,835,411.61	32,880,969.21	-	-	138,187,786.52
Student services	44,266,452.10	15,738,686.21	24,198,160.03	-	-	84,203,298.34
Institutional support	56,362,601.49	23,015,896.74	37,518,194.08	-	-	116,896,692.31
Operation & maint. of plant	38,103,234.70	18,408,942.39	78,386,231.36	-	-	134,898,408.45
Scholarships & fellowships	3,726,667.21	27,040,623.43	1,102,451.12	68,756,707.97	-	100,626,449.73
Auxiliary	51,659,275.54	13,949,283.45	73,478,828.82	-	-	139,087,387.81
Independent operations	56,071,938.11	21,708,793.18	-	-	-	77,780,731.29
Depreciation	-	-	-	-	108,247,333.60	108,247,333.60
Total expenses	\$949,627,886.42	\$334,184,068.71	\$431,579,782.71	\$68,756,707.97	\$108,247,333.60	\$1,892,395,779.41

Note 20. On-behalf Payments

During the year ended June 30, 2013, the State of Tennessee made payments of \$785,920.00 on behalf of the university for retirees participating in the Medicare Supplement Plan. The Medicare Supplement Plan is a postemployment benefit health care plan and is discussed further

Notes to the Financial Statements (Continued)

in Note 11. The plan is reported in the *Tennessee Comprehensive Annual Financial Report* (CAFR). That report is available on the state's website at www.tn.gov/finance/act/cafr.shtml.

Note 21. 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. 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, 2013, the foundation expended \$6,333,335.00 to or on behalf of the university for both restricted and unrestricted purposes. Complete financial statements for the foundation can be obtained from the University of Chattanooga Foundation, Development Office, Department 6806, 615 McCallie Avenue, Chattanooga, TN 37403-2598.

Organization and Nature of Activities

The foundation is a tax-exempt organization under the provisions of Section 509(a)(1) 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

Notes to the Financial Statements (Continued)

transactions during the one-month period between fiscal year ends is not significant.

CDFI was formed by the foundation 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 student housing consists of 1,701 bedrooms in 451 units and 666 parking spaces.

Investments

A summary of foundation investments at June 30, 2013, is as follows:

Mutual funds	\$58,267,073
Real estate	270,300
Limited partnerships	35,654,769
Other	14,381
<hr/> Total	<hr/> \$94,206,523

The foundation also has investments, restricted by the terms of the revenue bonds described below, totaling \$11,281,300.

Property and Equipment

A summary of foundation property and equipment at June 30, 2013, is as follows:

Land	\$ 8,271,432
Buildings	76,566,506
Furniture, fixtures, and equipment	5,189,346
	<hr/> 90,027,284
Accumulated depreciation	(32,742,793)
	<hr/>
Total	<hr/> \$57,284,491

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, 2013, consist of the following:

Notes to the Financial Statements (Continued)

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	\$60,885,000
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	19,480,000
	80,365,000
Less: unamortized discount	(1,640,756)
Total	\$78,724,244

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

Year Ending <u>June 30</u>	
2014	\$ 1,895,000
2015	1,990,000
2016	2,090,000
2017	2,200,000
2018	2,310,000
Thereafter	69,880,000
Total	\$80,365,000

Fair Value Measurements

The foundation reports under FASB Accounting Standards Codification (ASC) Topic 820, which defines fair value, establishes a framework for measuring fair value under accounting principles generally accepted in the United States, and prescribes disclosures about fair value measurements.

FASB ASC Topic 820 requires the categorization of assets and liabilities into three levels based upon the assumptions (inputs) used to value the assets or liabilities. Level 1 provides the most reliable measure of fair value, whereas Level 3 generally requires significant management judgment. The three levels are defined as follows:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the foundation has the ability to access.

Notes to the Financial Statements (Continued)

Level 2 - Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3 - Significant unobservable inputs that reflect management's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis:

	Balance as of June 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets:				
Mutual funds	\$58,267,073	\$56,645,393	\$1,621,680	\$ -
Guaranteed investment contracts	4,554,675	-	4,554,675	-
Commercial paper	1,528,000	1,528,000	-	-
Treasury obligations fund	5,198,625	5,198,625	-	-
Real estate	270,300	-	270,300	-
Limited partnerships	35,654,769	-	-	35,654,769
Other	14,381	14,381	-	-
Total assets	105,487,823	63,386,399	6,446,655	35,654,769
Liabilities:				
Deposits received for the benefit of others	5,744,003	-	5,744,003	-
Total liabilities	\$ 5,744,003	\$ -	\$ 5,744,003	\$ -

The table below presents additional information about assets measured at fair value on a recurring basis by reliance on Level 3 inputs to determine fair value:

	<u>Limited Partnerships</u>
Beginning balance	\$33,227,384
Total realized and unrealized gains and losses included in earnings	1,872,205
Purchases, sales, and other	555,180
Ending balance	\$35,654,769

Notes to the Financial Statements (Continued)

Endowments

The foundation's endowment consists of approximately 300 individual funds established for a variety of purposes. Its endowment includes both donor-restricted endowment funds and funds designated by the board of trustees to function as endowments. As required by accounting principles generally accepted in the United States of America (GAAP), net assets associated with endowment funds, including funds designated by the board of trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

Interpretation of Relevant Law

The board of trustees of the foundation has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the foundation classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the organization considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

1. The duration and preservation of the fund.
2. The purposes of the foundation and the donor-restricted endowment fund.
3. General economic conditions.
4. The possible effect of inflation and deflation.
5. The expected total return from income and the appreciation of investments.
6. Other resources of the foundation.
7. The investment policies of the foundation.

Endowment net assets by type of fund consist of the following at June 30, 2013. Due to GASB reformatting, temporarily restricted net assets are reported as expendable restricted net position, and permanently restricted net assets are reported as nonexpendable restricted net position on the statement of net position.

Notes to the Financial Statements (Continued)

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted funds	\$ (80,460)	\$1,593,421	\$49,248,411	\$ 50,761,372
Board-designated funds	52,287,156	-	-	52,287,156
	<u>\$52,206,696</u>	<u>\$1,593,421</u>	<u>\$49,248,411</u>	<u>\$103,048,528</u>

Changes in endowment net assets for the fiscal year ended June 30, 2013:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$48,900,884	\$1,514,123	\$43,107,598	\$ 93,522,605
Investment income	1,719,712	670,160	-	2,389,872
Net appreciation	5,536,626	-	5,816,403	11,353,029
Contributions	16,198	-	2,330,969	2,347,167
Appropriations	(4,613,027)	(1,922,858)	-	(6,535,885)
Transfers	646,303	1,331,996	(2,006,559)	(28,260)
Endowment net assets, end of year	<u>\$52,206,696</u>	<u>\$1,593,421</u>	<u>\$49,248,411</u>	<u>\$103,048,528</u>

At June 30, 2013, permanently restricted net assets consist of the portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by UPMIFA. Temporarily restricted net assets consist of the portion of perpetual endowment funds subject to a time restriction under UPMIFA. The temporarily restricted net assets also have purpose restrictions.

Funds With Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires the foundation to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature that are reported in unrestricted net assets were \$80,460 as of June 30, 2013. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions and continued appropriation for certain programs that was deemed prudent by the board of trustees.

Return Objectives and Risk Parameters

The foundation has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets.

Endowment assets include those assets of donor-restricted funds that the foundation must hold in perpetuity or for donor-specified periods as well as board-designated funds. Under this policy, as approved by the board of trustees, the endowment assets are invested in a manner that is intended to produce results that exceed the price and yield results of the consumer price index

Notes to the Financial Statements (Continued)

while assuming a moderate level of investment risk. The foundation expects its endowment funds, over time, to provide an average annual rate of return of approximately 6% above the rate of inflation. Actual returns in any given year may vary from this amount.

Strategies Employed for Achieving Objectives

To satisfy its long-term rate-of-return objectives, the foundation relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The foundation targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

The foundation has a policy of appropriating for distribution each year 4.5% of each endowment fund's average balance for the last 12 quarters. In establishing this policy, the foundation considered the long-term expected return on its endowment. Accordingly, over the long term, the foundation expects the current spending policy to allow its endowment to grow. This is consistent with the foundation's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

Related Party Transactions

CDFI, the LLC, and the university have executed a management agreement which allows the university to assume management responsibilities related to the LLC's student housing. The LLC paid management fees of \$200,000 to the university during the LLC's fiscal year ended July 31, 2013. As a matter of convenience, cash balances needed for student housing operations are held at the university, and operating expenses are paid from these funds. At June 30, 2013, deposits held at the university on behalf of the LLC were \$838,797.

During the year ended June 30, 2013, the foundation contributed property to CDFI consisting of a residence and two vacant lots with fair market values totaling \$1,530,400.

Contingencies

CDFI is involved in certain claims arising from normal business activities. Management believes that the financial position of CDFI will not be materially affected by the outcome of these proceedings.

Notes to the Financial Statements (Continued)

Note 22. 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. 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, 2013, the foundation expended \$46,936,450.91 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 fund raising support 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. The foundation also conducts the development and alumni affairs operations for the university. See also Note 17.

Pledges Receivable

Pledges receivable (reported as accounts, notes, and grants receivable on the statement of net position) are summarized below net of the allowance for doubtful accounts:

	Temporarily Restricted	Permanently Restricted
Current pledges	\$ 7,034,644.51	\$ 2,477,625.67
Pledges due in one to five years	25,677,315.27	21,542,777.54

Notes to the Financial Statements (Continued)

Pledges due after five years	13,891,346.54	6,448,013.40
	46,603,306.32	30,468,416.61
Less discounts to net present value	(1,451,651.81)	(1,166,832.98)
Total pledges receivable, net	\$45,151,654.51	\$29,301,583.63

The allowance for doubtful accounts at June 30, 2013, was \$594,236.20.

Investments and Assets Held by the University of Tennessee

Investments held at June 30, 2013, were as follows:

	<u>Fair Value</u>	<u>Book Value</u>
Endowment assets held by the University of Tennessee:		
Cash	\$ 1,612,261.28	\$ 1,612,261.28
U.S. equity	4,472,689.80	3,606,762.51
International equity	10,612,361.08	13,312,191.78
Fixed income	3,118,818.06	3,457,518.55
Alternative investments:		
Private equity	8,100,731.22	7,995,221.91
Natural resources	8,511,775.77	7,950,721.06
Real estate investments	1,498,695.71	1,174,620.45
Hedge funds	12,633,047.66	11,216,288.19
Total endowment assets held by university	50,560,380.58	50,325,585.73
Endowment assets held by the foundation:		
Cash	168,575.51	168,575.51
Equities	615,264.40	538,816.55
Mutual funds	74,360.40	63,703.13
Total endowment assets held by the foundation	858,200.31	771,095.19
Gift annuity program:		
Cash	15,062.83	15,062.83
Equities	1,567,120.51	1,349,186.95
Fixed income	1,226,716.78	1,220,265.12
Total gift annuity program	2,808,900.12	2,584,514.90
Managed funds:		
Cash	2,543,720.33	2,543,720.33
Mutual funds	53,775,789.23	54,049,541.10
Total managed funds	56,319,509.56	56,593,261.43
Total investments	\$110,546,990.57	\$110,274,457.25

Also reported as investments on the statement of net position are other gift assets totaling \$7,356,463.00.

Notes to the Financial Statements (Continued)

At June 30, 2013, the fair values of alternative investments are based on valuations for which a readily determinable fair value does not exist. These investments are not listed on national exchanges or over-the-counter markets, and quoted market prices are not available. The fair value of these investments is estimated based on a review of all available information provided by fund managers and general partners. These estimates are evaluated on a regular basis and are susceptible to revisions as more information becomes available.

Endowments

The foundation's endowment funds consist of investments held by the university, investments held by the foundation, and permanently restricted unconditional promises to give. The majority of the foundation's invested endowment funds are invested in the University of Tennessee Consolidated Investment Pool. These funds are invested according to the policies of the university. A portion of the earnings from these funds are provided to the university to be used as stipulated in the endowment agreements. The book value and fair value for these endowments invested were \$50,325,585.73 and \$50,560,380.58, which resulted in a cumulative unrealized gain of \$234,794.85. One endowment with a market value of \$858,200.31 is separately invested. All endowments at the foundation are donor-restricted. Endowment earnings transferred to the university were \$1,817,202.76 for fiscal year 2013.

The foundation has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result, the foundation classifies permanently restricted net assets as (1) the original value of gifts to the endowment, (2) the original value of subsequent gifts to the endowment, (3) accumulations to the endowment made in accordance with the gift instrument, and (4) vesting of the endowment in the university's Consolidated Investment Pool. Below is a schedule of endowments by fund type. Due to the GASB reformatting, temporarily restricted net assets are reported as expendable restricted net position, and permanently restricted net assets are reported as nonexpendable restricted net position on the statement of net position.

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Beginning balance	\$(2,340,611.94)	\$31,466.05	\$65,396,204.56	\$63,087,058.67
Contributions received	-	-	14,794,491.91	14,794,491.91
Transfers to endowments	-	-	116,741.28	116,741.28
Investment earnings	3,376.48	1,830,706.27	90,826.81	1,924,909.56
Market value adjustment	2,340,611.94	342,831.90	-	2,683,443.84
Disbursements	(3,376.48)	(1,872,636.67)	-	(1,876,013.15)
Ending balance	\$ -	\$332,367.55	\$80,398,264.56	\$80,730,632.11

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires the foundation to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature are reported in

Notes to the Financial Statements (Continued)

unrestricted net assets. During the year, these deficiencies were covered by an increase in the market value of endowment funds.

The foundation uses the university's spending policy. The university calculates its spending policy by taking 4.5% of a three-year fair value average each December 31.

The university's overall, long-term investment objective of the Consolidated Investment Pool is to achieve an annualized total return (net of fees and expenses), through appreciation and income, greater than the rate of inflation (as measured by the broad, domestic Consumer Price Index) plus any spending, thus protecting the assets against inflation.

The assets are to be managed in a manner that will meet the long-term investment objective, while at the same time attempting to limit the volatility in year-to-year spending.

The university's Investment Advisory Committee believes that investing in securities with higher return expectations outweighs their short-term volatility risk. As a result, the majority of assets will be invested in equity or equity-like securities. Fixed income securities and other low volatility strategies (e.g., absolute return hedge funds) will be used to lower the short-term volatility of the portfolio and to provide stability, especially during periods of negative equity markets. Cash is not a strategic asset of the portfolio, but is a residual to the investment process and used to meet short-term liquidity needs.

Disciplined management of the asset allocation is necessary and desirable. Diversification of investments among assets that are not similarly affected by economic, political, or social developments is highly desirable. The general policy shall be to diversify investments so as to provide a balance that will enhance total return, while avoiding undue risk concentrations in any single asset or investment category. Actual allocations (excluding separately invested assets) were as follows at June 30, 2013:

Cash	3.2%
U.S. equity	8.9%
International equity	21.0%
Fixed income	6.2%
Alternative investments	
Private equity	16.0%
Natural resources	16.8%
Real estate investments	3.0%
Hedge funds	24.9%

Notes to the Financial Statements (Continued)

Fair Value Measurements

The foundation reports under FASB Accounting Standards Codification (ASC) Topic 820, which defines fair value, establishes a framework for measuring fair value under accounting principles generally accepted in the United States, and prescribes disclosures about fair value measurements.

FASB ASC Topic 820 requires the categorization of assets and liabilities into three levels based upon assumptions (inputs) used to value the assets or liabilities. Level 1 provides the most reliable measure of fair value, whereas Level 3 generally requires significant management judgment. The three levels are defined as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the foundation has the ability to access.

Level 2 – Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3 – Significant unobservable inputs that reflect management’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The table below presents the recorded amount of assets measured at fair value on a recurring basis:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Investments	\$75,457,205.37	\$4,345,534.84	\$30,744,250.36	\$110,546,990.57

The table below presents additional information about assets measured at fair value on a recurring basis by reliance on Level 3 inputs to determine fair value:

Beginning balance	\$22,913,810.52
Total realized and unrealized gains and losses included in earnings	8,508,399.45
Purchases, issuances, and settlements	(677,959.61)
Ending balance	<u>\$30,744,250.36</u>

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. The note has a 4.68% interest

Notes to the Financial Statements (Continued)

rate. The balance of the note payable at June 30, 2013, was \$150,147.68. Future maturities of this note are as follows:

<u>Year ending June 30:</u>	
2014	\$ 15,865.58
2015	18,100.58
2016	18,966.10
2017	19,873.00
<u>2018-2021</u>	<u>77,342.42</u>
 <u>Total</u>	 <u>\$150,147.68</u>

Concentration of Credit Risk

The foundation has concentrated its credit risk for cash by maintaining deposits at a bank, which may at times exceed amounts covered by insurance provided by the U.S. Federal Deposit Insurance Corporation (FDIC). The foundation has not experienced any losses in this account and believes it is not exposed to any significant credit risk to cash.

Note 23. Component Unit – University of Tennessee Research Foundation

The University of Tennessee Research Foundation, Inc., is a private nonprofit organization that reports under Financial Accounting Standards Board (FASB) standards. 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 Research Foundation is a legally separate, tax-exempt organization supporting the University of Tennessee. The foundation was created as the UT Research Corporation (UTRC) in 1934 and incorporated in January 1935. The foundation's stated purpose is, in conjunction with the university, to grow the University of Tennessee research enterprise; harvest, manage, and market University of Tennessee intellectual property; encourage and support entrepreneurial education and ventures by faculty, staff, students, and commercial partners/affiliates of the University of Tennessee; and to contribute to the well-being of the State of Tennessee through economic development. In April 2003, UTRC was renamed and reorganized to the University of Tennessee Research Foundation (UTRF). Roles were redefined, and the scope was expanded to include a new emphasis on entrepreneurship and economic development for technology transfer activities. A new set of bylaws and board of directors were established. The foundation has seven voting directors and three nonvoting directors. Because the university's board of trustees approves and funds the foundation's administrative budget, the foundation is considered fiscally dependent on the university, and there is a financial

Notes to the Financial Statements (Continued)

benefit/burden relationship between the two entities. Therefore, the research foundation is considered a component unit of the university and is discretely presented in the university's financial statements.

Complete financial statements for the research foundation can be obtained from the University of Tennessee Research Foundation, Suite 211, UT Conference Center Building, 600 Henley Street, Knoxville, TN 37996-4122.

Organization and Nature of Activities

The University of Tennessee Research 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 promote research and hold and manage the university's intellectual property. The foundation was established to protect, manage, and commercialize university inventions and intellectual property; grow the university research enterprise; develop and support an entrepreneurial culture; and contribute to state and regional economic development.

TennEra, LLC (the subsidiary), a wholly owned subsidiary of the University of Tennessee Research Foundation, is in the business of developing and operating a pilot-scale biorefinery and state-of-the-art research and development facility, in collaboration with DuPont Danisco Cellulosic Ethanol, LLC (DDCE), for cellulosic ethanol using non-food biomass feedstocks to prove the technology and commercial viability of producing cellulosic ethanol, primarily in the State of Tennessee. The project utilizes the University of Tennessee's expertise in cellulosic feedstock production and research, as well as its work with Tennessee farmers, to develop the first dedicated cellulosic energy crop supply chain utilizing switchgrass. The subsidiary also promotes, supports, and carries out the commercialization of research outcomes and the transfer of research-generated products, ideas, processes, and other technology related to renewable energies to agricultural, commercial, and industrial enterprises.

TennEra LLC's financial statements include the activity of two subsidiaries, Genera Energy, Inc., and Genera Energy Crops, LLC. TennEra, LLC, contracts with Genera Energy, Inc., for the overall management authority and responsibility to operate the Biomass Innovation Park and to complete TennEra, LLC's contractual obligations toward the University of Tennessee Research Foundation's State Biofuel Initiative.

The Center for Advanced Scientific Support and Engineering Technology (ASSET.TN) is also a wholly owned nonprofit subsidiary of the University of Tennessee Research Foundation. The management of the property, activities, and affairs of ASSET.TN is vested in its board of directors. The board is composed of nine individuals, seven of whom are voting directors and two that are nonvoting directors. As of June 30, 2013, ASSET.TN had total assets of \$175,317 and total revenues of \$198,829.

The Cherokee Farm Development Corporation (CFDC) is another wholly owned nonprofit subsidiary of the University of Tennessee Research Foundation. The management of the

Notes to the Financial Statements (Continued)

property, activities, and affairs of CFDC are vested in its board of directors. The board is composed of five voting directors. As of June 30, 2013, CFDC had total assets of \$142,315 and total revenue of \$240,648.

Principles of Consolidation

The foundation has entered into related agreements with the university and TennEra, LLC, whereby the foundation has undertaken to provide the subsidiary with working capital advances for its operational needs. The extent of the foundation's commitment is contingent upon its own ability to obtain additional funding from existing sources from which to make these advances. According to terms of the agreements, repayment of the operational funding by the subsidiary to the foundation is required only upon the occurrence of, and in preference to, other capital distributions. No interest accrues on the advances. Because the parties contemplate capital distributions only as the consequence of a general liquidation of the subsidiary, these advances have been treated as investments in the subsidiary on the books of the foundation and as equity capital on the books of the subsidiary. These amounts eliminate upon consolidation. The foundation's consolidated financial statements include the foundation's accounts and the accounts of its wholly owned subsidiaries. All intercompany balances and transactions were eliminated in consolidation, and the increase in net assets was reduced by the portion of earnings attributable to noncontrolling interests.

Property and Equipment

Property and equipment consist of the following major classifications at June 30, 2013:

Office furniture and equipment	\$ 177,415
Less accumulated depreciation	(106,463)
<hr/> Total	<hr/> 70,952
<u>TennEra</u>	
Land	1,775,505
Buildings	40,033,771
Leasehold improvements	123,273
Machinery and equipment	26,353,623
Furniture and fixtures	275,484
Vehicles	170,391
Less accumulated depreciation	(10,453,072)
<hr/> Total TennEra	<hr/> 58,278,975
<u>Cherokee Farm</u>	
Office furniture and equipment	\$ 1,739
Less accumulated depreciation	(100)

Notes to the Financial Statements (Continued)

Total Cherokee Farm	1,639
Total	\$58,351,566

Depreciation expense for the foundation and its subsidiaries totaled \$3,734,852 for the year ended June 30, 2013. Intangible assets totaling \$17,990 are also reported as capital assets on the statement of net position.

Unearned Revenue

Based on an agreement with DDCE, all unreimbursed costs incurred by DDCE on the construction of the pilot-scale biorefinery were recorded as unearned revenue. The total amount of unearned revenue is expected to be recognized over the life of a lease between the company and DDCE, by which DDCE will be granted the use of a portion of the biorefinery facility. As of June 30, 2010, the lease was to be for ten years with three possible five-year extensions. Accordingly, revenue will be recognized over a period of 25 years beginning January 28, 2010, the date which DDCE first occupied its portion of the facility. Unearned revenue in conjunction with this lease was \$19,448,399 at June 30, 2013. Revenue of \$901,084 was recognized in fiscal year 2013.

Fair Value Measurements

The foundation reports under FASB Accounting Standards Codification (ASC) Topic 820, which defines fair value, establishes a framework for measuring fair value under accounting principles generally accepted in the United States, and prescribes disclosures about fair value measurements.

FASB ASC Topic 820 requires the categorization of assets and liabilities into three levels based upon the assumptions (inputs) used to value the assets or liabilities. Level 1 provides the most reliable measure of fair value, whereas Level 3 generally requires significant management judgment. The three levels are defined as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the foundation has the ability to access.

Level 2 – Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3 – Significant unobservable inputs that reflect management’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Following is a description of the valuation methodologies used for assets measured at fair value.

Notes to the Financial Statements (Continued)

Registered Investment Companies

The fair value of registered investment companies (mutual funds) is based on quoted net asset values of the shares held by the foundation at June 30, 2013.

Marketable Equity Securities

The fair value of marketable equity securities is based on quoted prices times the number of the shares held by the foundation at June 30, 2013.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the foundation believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

At June 30, 2013, the foundation had no liabilities carried at fair value subject to remeasurement on a recurring basis. The following table provides the assets carried at fair value measured on a recurring basis as of June 30, 2013:

Assets:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Registered investment companies	\$ 8,549	\$ -	\$ -	\$ 8,549
Marketable equity securities	65,811	-	-	65,811
Total	\$74,360	\$ -	\$ -	\$74,360

The foundation also has \$215,177 of investments (equity securities) for which there is no readily determinable market value. These investments are valued at cost, as management believes that any variance in valuation from historical cost would not be material to the operations of the foundation.

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, 2011	State Employee Group Plan	\$ -	\$242,451,000.00	\$242,451,000.00	0%	\$685,300,649.00	35.4%
July 1, 2010	State Employee Group Plan	\$ -	\$240,150,000.00	\$240,150,000.00	0%	\$628,383,463.00	38.2%
July 1, 2009	State Employee Group Plan	\$ -	\$269,772,000.00	\$269,772,000.00	0%	\$620,716,467.00	43.5%

The amount reported here for covered payroll relates to the fiscal year in which the valuations were performed.



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COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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**Independent Auditor's 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***

The Honorable Bill Haslam, Governor
Members of the General Assembly
Dr. Joseph A. DiPietro, President

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, 2013, and the related notes to the financial statements, which collectively comprise the university's basic financial statements, and have issued our report thereon dated December 9, 2013. We conducted our audit in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Our report includes a reference to other auditors who audited the financial statements of the University of Chattanooga Foundation, Inc.; the University of Tennessee Foundation, Inc.; and the University of Tennessee Research Foundation, Inc.; as described in our report on the University of Tennessee's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the university's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of the university's internal control.

A deficiency in internal control 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 and correct misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

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

We did, however, note certain immaterial instances of noncompliance that we have included in the Findings and Recommendations section of this report.

The University of Tennessee's Responses to Findings

The university's responses to the findings identified in our audit are included in the Findings and Recommendations section of this report. The university's responses were not subjected to the auditing procedures applied in the audit of the financial statements, and, accordingly, we express no opinion on them.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Deborah V. Loveless, CPA
Director
December 9, 2013

Findings and Recommendations

1. **As reported in the previous audit, the Registrar's Office in Knoxville did not properly report enrollment data, increasing the risk of not initiating the student loan repayment process**

Finding

The Registrar's Office at the University of Tennessee in Knoxville did not properly report enrollment data for the Direct Loan borrowers who withdrew from classes or graduated. A similar finding was reported in the previous audit. *Office of Management and Budget Circular A-133 Compliance Supplement*, Part 5, states,

Schools must complete and return within 30 days the Enrollment Reporting Roster File [formerly the Student Status Confirmation Report (SSCR)] placed in their Student Aid Internet Gateway (SAIG) mailboxes sent by ED [Department of Education] via NSLDS [National Student Loan Data System] (OMB No. 1845-0035) . . . Once received, the institution must update for changes in student status, report the date the enrollment status was effective, enter the new anticipated completion date, and submit the changes electronically through the batch method or the NSLDS web site.

Unless the school expects to complete its next roster within 60 days, the school must notify the lender or the guaranty agency within 30 days, if it discovers that a student who received a loan either did not enroll or ceased to be enrolled on at least a half-time basis (Direct Loan, 34CFR section 685.309).

According to the *Federal Student Aid Handbook*, volume 2, page 45:

Student enrollment information is *extremely important*, because it is used to determine if the student is still considered in school, must be moved into repayment, or is eligible for an in-school deferment. For students moving into repayment, the out of school status effective date determines when the grace period begins and how soon a student must begin repaying loan funds [emphasis added].

We selected a sample from Direct Loan borrowers who dropped below half-time, withdrew from classes, or graduated during the year ended June 30, 2013. The Registrar's Office did not properly report the enrollment data to the Department of Education for 5 of the 40 borrowers tested.

- Three students unofficially withdrew during the spring 2013 semester; however, the Registrar's Office had not reported the students as having withdrawn as of August 20, 2013 (the date our testwork was completed).

- One student graduated on May 11, 2013; however, the Registrar's Office had not reported the student's enrollment status as graduated, instead of full-time, as of August 20, 2013.
- One student dropped to less than half-time on April 2, 2013; however, the Registrar's Office had not reported the student as having dropped to less than half-time as of August 20, 2013.

The Assistant Registrar stated that the first three enrollment status changes were not reported timely because unofficial withdrawals are not being reported at the Knoxville campus. The fourth and fifth students were not reported because the Admissions Office did not remove a special flag from the student's account, which prevented reporting.

Not accurately reporting enrollment status changes could result in the inappropriate granting of an in-school deferment or the failure to properly initiate the loan repayment process.

Recommendation

The Registrar should ensure that all enrollment status changes for Direct Loan borrowers are reported timely in compliance with federal regulations. She should develop a process to perform ongoing reviews and implement written procedures to ensure proper reporting. Students who do not attend classes and unofficially withdraw should be reported to the Registrar's Office by the Office of Financial Aid and Scholarships, which monitors unofficial withdrawals. The Registrar's Office should report these enrollment status changes.

The Registrar should ensure that risks such as those noted in this finding are adequately identified and assessed in management's risk assessment activities. The Registrar should also identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. She should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and take prompt action should exceptions occur.

Management's Comment

We concur with the finding. Each of the three instances is addressed below.

- *Three students unofficially withdrew during the spring 2013 semester; however, the Registrar's Office had not reported the students as having withdrawn as of August 20, 2013 (the date our testwork was completed).* The Registrar's Office in conjunction with the Office of Financial Aid and Scholarships will follow the prescribed rule set forth in the *Federal Student Aid Handbook*, volume 5, page 22, that states: "For a student who withdraws from a school that is not required to take attendance without providing notification, the school must determine the withdrawal

date no later than 30 days after the end of the earlier of (1) the payment period or the period of enrollment (as applicable), (2) the academic year, or (3) the student's educational program." Therefore, the Office of Financial Aid and Scholarships will, at the completion of the term, when final grades are posted, identify those students who unofficially withdrew from the preceding term without benefit of a university official withdrawal. Within thirty (30) days of the determination of the unofficial withdrawal effective date, the Office of Financial Aid and Scholarships will notify the Registrar's Office, and these student records will be updated on the National Student Clearinghouse files to indicate the unofficial withdrawal and the appropriate date.

- *One student graduated on May 11, 2013; however, the Registrar's Office had not reported the student's enrollment status as graduated, instead of full-time, as of August 20, 2013. The graduation and degree awarded were reported on time to the Clearinghouse. However, this student's change in **enrollment** status to "graduated" was not reported because she was assigned a student attribute which excluded her enrollment information from the Clearinghouse report. The practice of excluding this student attribute has been suspended effective immediately, which will allow reporting of all categories of student enrollment.*
- *One student dropped to less than half-time on April 2, 2013; however, the Registrar's Office had not reported the student as having dropped to less than half-time as of August 20, 2013. This student's enrollment was not reported because he was assigned a student attribute which excluded his enrollment information from the Clearinghouse report. The practice of excluding this student attribute has been suspended effective immediately, which will allow reporting of all categories of student enrollment.*

2. Financial Aid staff awarded aid to students who were not making satisfactory academic progress, resulting in federal questioned costs of \$18,527

Finding

The Office of Financial Aid and Scholarships at the University of Tennessee's Martin Campus awarded aid to two students who were not making satisfactory academic progress as defined in the university's policies.

According to the *Federal Student Aid Handbook*, Volume 1, page 8:

To be eligible for FSA funds, a student must make satisfactory academic progress, and [the] school must have a reasonable policy for monitoring that progress.

At the University of Tennessee at Martin, the *Policy and Procedures Manual* states that a student must meet the following standards to maintain satisfactory academic progress:

Academic progress for federal and state financial aid programs is based on three measures: Cumulative grade point average, course-completion rate based on hours earned compared to hours attempted, and a maximum timeframe for degree completion. Satisfactory academic progress status is based on the entire academic record at all schools attended, regardless of whether financial aid was received. The following describes the university's standards for each of these three measures.

Cumulative Grade Point Average (GPA) - Undergraduate students must maintain a minimum cumulative GPA of 2.0 to be making satisfactory academic progress for financial aid. Graduate students must maintain a minimum cumulative GPA of 3.0.

Course Completion Rate (CCR) - Students must earn (pass) a cumulative 67% of all hours attempted to remain eligible for Financial Aid. Grades of A, B, C, D, & P count as attempted and earned credit hours. Grades of F, I, W, WP & WF count as attempted but not earned credit hours.

Maximum Time Frame - The maximum time limit for a student to receive financial aid is 150% of the published program length. Most undergraduate degree programs at UTM require 120 credit hours to complete. To be placed on unsatisfactory progress due to maximum time frame, a student would either meet or exceed 180 attempted hours. All grades, A, B, C, D, F, I, P, W, WP & WF count as attempted hours. For Graduate programs, the maximum time frame is determined as 150% of the required hours for the degree as published in the Graduate Catalog.

At the beginning of the fall 2012 semester, the first student was placed on an "Academic Plan" due to having a financial aid appeal approved. He was required to "earn 80% of courses taken and earn a GPA of 2.0 each semester." He did not meet these goals but, due to a programming error, was not deemed ineligible for aid in the spring 2013 semester. As a result, he received \$7,478 of federal student financial aid in error for the spring 2013 semester. These costs will be questioned.

At the end of the spring 2012 semester, the second student had only earned 91 hours of the 153 cumulative hours he had attempted at that time. He should have been suspended for not earning two-thirds of his attempted hours. However, there was a programming error, and he was not suspended at that time. As a result, he received \$11,049 of federal student financial aid in error for the fall 2012 and spring 2013 semesters. These costs will be questioned.

Because the Office of Financial Aid and Scholarships at the Martin campus did not ensure its automated programs to detect students not maintaining satisfactory academic progress were operating correctly, federal financial aid was awarded to the two ineligible students.

The total amount of questioned costs for the transactions noted above is \$18,527. We tested a sample of \$392,582 from a total population of \$51,688,155.

Recommendation

The Director of Financial Aid should implement additional review procedures to ensure financial aid recipients are maintaining satisfactory academic progress. Programming should be adequately reviewed and tested to prevent errors of this type.

The Director of Financial Aid should ensure that risks such as those noted in this finding are adequately identified and assessed in management's risk assessment activities. The Director should also identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. She should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and take prompt action should exceptions occur.

Management's Comment

We concur with the finding. The two students identified in the audit were the only students with this issue. The questioned costs have been returned to the U.S. Department of Education.

Martin's Satisfactory Academic Progress (SAP) Policy, driven by the new federal guidelines, requires that all students are checked at the end of spring each year and those who are on Academic Plans or Graduation Plans are checked each semester until they are in compliance. After revamping our internal controls that are used to identify students who fail SAP, the financial aid office is confident that they are now accurately identifying those students who are not meeting our policy requirements.

The Director of Financial Aid will implement additional review procedures to ensure financial aid recipients are maintaining satisfactory academic progress. These will include people who have had continuous enrollment from the prior semester and those who are transferring hours in from prior semesters. Programming will be reviewed and tested to prevent future errors of this type.

The Director of Financial Aid will ensure that risks such as those noted in this finding are adequately identified and assessed in management's risk assessment activities. The Director has specific staff members who are responsible for the design and implementation of internal controls to prevent and detect exceptions timely. This staff member is also responsible for ongoing monitoring for compliance with all requirements and will take prompt action should exceptions occur.