AUDIT REPORT

The University of Tennessee

For the Year Ended
June 30, 2011

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

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March 8, 2012

The Honorable Bill Haslam, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Mr. James E. Hall, Chairman
Audit Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180
and
Dr. Joseph A. DiPietro, President
The University of Tennessee
800 Andy Holt Tower
Knoxville, Tennessee 37996-0180

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the University of Tennessee for the year ended June 30, 2011. You will note from the independent auditor's report that unqualified opinions were given on the fairness of the presentation of the financial statements.

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

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/sds
11/075

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, 2011

AUDIT OBJECTIVES

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

COMPLIANCE FINDINGS

Principal Investigators at the University of Tennessee Health Science Center and the University of Tennessee at Knoxville Did Not Ensure That Obligations Charged to Federal Awards Were Allowable Under Federal Research and Development Grants, Resulting in Federal Questioned Costs of $18,096.03
A principal investigator at the University of Tennessee Health Science Center did not obtain prior approval for equipment purchased under United States Public Health Service grant number R01DK067269. In a separate instance, a principal investigator at the University of Tennessee at Knoxville did not ensure that costs charged to Air Force grant number FA9550-09-1-0624 were allocable to the grant. These resulted in $18,096.03 of federal questioned costs (page 9).

Financial Aid Staff Did Not Properly Perform Title IV Return-of-Funds Calculations, Resulting in Federal Questioned Costs of $13,344.38
The financial aid office at the Knoxville campus did not properly calculate the amount of Title IV funds to be returned for students who withdrew during the fall 2010 semester. This resulted in $13,344.38 of federal questioned costs (page 12).

The Registrar's Office at the Health Science Center 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 Health Science Center in Memphis did not properly report enrollment data for the Direct Loan borrowers who withdrew from classes or graduated (page 14).

Directors of Financial Aid Did Not Properly Perform Direct Loan Reconciliations

The Directors of Financial Aid at the Knoxville and Martin campuses and the Health Science Center in Memphis did not properly reconcile the university's Direct Loan financial records with the federal Direct Loan Servicing System (page 17).

OPINIONS ON THE FINANCIAL STATEMENTS

The opinions on the financial statements are unqualified.

Audit Report
The University of Tennessee
For the Year Ended June 30, 2011

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The University of Tennessee
For the Year Ended June 30, 2011

INTRODUCTION

POST-AUDIT AUTHORITY

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

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

BACKGROUND

The University of Tennessee was first established as Blount College in 1794 by the legislature of the Federal Territory. In 1807, the General Assembly renamed the institution East Tennessee College, and in 1840, designated it a university. East Tennessee University was selected by the General Assembly to be Tennessee's land-grant institution under the terms of the Morrill Act of 1862. In 1879, the General Assembly chose the school to be Tennessee's state university and changed the name to the University of Tennessee.

Since its establishment, the university has grown into an institution with 20 different colleges and schools. With its campuses, various experiment stations, and extension services, the university provides services throughout the state. The university has three accredited units: the University of Tennessee (Knoxville campus, Health Science Center, Space Institute, Institute of Agriculture, and Institute for Public Service), the University of Tennessee at Chattanooga, and the University of Tennessee at Martin.

ORGANIZATION

The governance of the University of Tennessee is vested in the University of Tennessee Board of Trustees. In 1968, the board reorganized the institution into a university system, giving a central administrative staff the responsibility for the entire operation of the university. In 2000, the university was reorganized from a four-campus system into three accredited units: the

University of Tennessee, the University of Tennessee at Chattanooga, and the University of Tennessee at Martin.

AUDIT SCOPE

The audit was limited to the period July 1, 2010, through June 30, 2011, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 2011. The University of Tennessee is an integral part of state government. As such, it has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report.*

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the university's internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing opinions on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

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

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

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

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

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

FRAUD CONSIDERATIONS

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

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

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the university's financial statements for the year ended June 30, 2011, we considered internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing opinions on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance and Other Matters

The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under generally accepted government auditing standards. Immaterial instances of noncompliance, along with recommendations and management's responses, are included in the Findings and Recommendations section.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered unqualified opinions on the university's financial statements.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

December 9, 2011

The Honorable Bill Haslam, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Mr. James E. Hall, Chairman
Audit Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180
and
Dr. Joseph A. DiPietro, President
The University of Tennessee
800 Andy Holt Tower
Knoxville, Tennessee 37996-0180

Ladies and Gentlemen:

We have audited the financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, and its discretely presented component units as of and for the year ended June 30, 2011, and have issued our report thereon dated December 9, 2011. Our report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards.

Internal Control Over Financial Reporting

Management of the university is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the university's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the university's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the university's internal control over financial reporting.

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.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the university's financial statements are free of material misstatement, we performed tests of 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 generally accepted 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.

We also noted certain matters that we reported to the management of the University of Tennessee in a separate letter.

The University of Tennessee's responses to the findings identified in our audit are included in the Findings and Recommendations section of this report. We did not audit the university's responses, and accordingly, we express no opinion on them.

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

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/sds

FINDINGS AND RECOMMENDATIONS

1. **<u>Principal investigators at the University of Tennessee Health Science Center and the University of Tennessee at Knoxville did not ensure that obligations charged to federal awards were allowable under federal research and development grants, resulting in federal questioned costs of $18,096.03</u>**

Finding

We tested 65 randomly selected transactions charged to federal research and development grants and contracts for the period July 1, 2010, through May 31, 2011. We found that 2 of the 65 transactions (3%) were unallowable. In one case, the principal investigator did not obtain prior approval for equipment purchased, and in the second case, the principal investigator did not ensure that the charge was allocable to the federal grant.

A principal investigator at the University of Tennessee Health Science Center did not obtain prior approval for equipment purchased under United States Public Health Service grant number R01DK067269. An upright freezer was purchased under the award for $11,948.01 without obtaining prior approval for the purchase. Additionally, the purchase was posted to the incorrect general ledger account, resulting in $5,496.09 of related facilities and administration (F&A) costs also being charged to the grantor for the purchase. This resulted in a total of $17,444.10 of federal questioned costs. The expenses were charged to the grant's general ledger account, which is used to draw down federal funds.

According to the *Code of Federal Regulations*, Title 2, Part 220, Appendix A,

> Capital expenditures for special purpose equipment are allowable as direct costs, provided that items with a unit cost of $5,000 or more have the prior approval of the awarding agency.

University policy requires equipment of this nature to be charged to the Computers, Education, Scientific Equipment general ledger account; however, the departmental bookkeeper miscoded the equipment to the Other Expenditures general ledger account. F&A charges are automatically calculated in the university's accounting system based on charges posted to the general ledger accounts. Per the *Code of Federal Regulations*, equipment charges are not to incur F&A costs. Specifically, according to the *Code of Federal Regulations*, Title 2, Part 220, Appendix A,

> F&A costs shall be distributed to applicable sponsored agreements and other benefiting activities within each major function on the basis of modified total direct costs. . . Equipment, capital expenditures, charges for patient care and tuition remission, rental costs, scholarships, and fellowships as well as the portion of each subgrant and subcontract in excess of $25,000 shall be excluded from modified total direct costs.

The university's accounting system automatically excludes the equipment general ledger accounts from the calculation. If the purchase had been coded to the correct general ledger account, F&A costs of $5,496.09 would not have been charged for the equipment.

In a separate instance, a principal investigator at the University of Tennessee at Knoxville did not ensure that costs being charged to a federal grant were allocable to the grant. A portion of the costs for a laptop computer, $440.49, was charged to Air Force grant number FA9550-09-1-0624. F&A costs associated with this charge were $211.44. This resulted in $651.93 of federal questioned costs.

According to the *Code of Federal Regulations,* Title 2, Part 220, Appendix A,

> A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a sponsored agreement if it is incurred solely to advance the work under the sponsored agreement; it benefits both the sponsored agreement and other work of the institution, in proportions that can be approximated through use of reasonable methods, or it is necessary to the overall operation of the institution and, in light of the principles provided in this Appendix, is deemed to be assignable in part to sponsored projects. . . Only materials and supplies actually used for the performance of a sponsored agreement may be charged as direct costs.

The laptop was purchased as part of a Faculty Computer Upgrade Program. The Faculty Computer Upgrade Program is designed to upgrade the computer equipment for each tenured or tenure-track faculty member once every four years. This program is a university program and is not related to any federal programs. Approved faculty members may purchase any computer available under university contract, but the department will only be reimbursed for the cost of the computer up to the maximum reimbursement amount. The maximum for fiscal year 2011 was $1,444.26. The cost of the laptop was $1,884.75. Any amount over the maximum was to be charged to the appropriate departmental account. Instead, the amount over the maximum, $440.49, was charged to the Air Force grant.

The total amount of questioned costs for the transactions noted above is $18,096.03. Unallowable costs of $12,599.94 were noted in our testwork. We tested a sample of $1,118,029.70 from a total population of $127,118,814.62. Related unallowable F&A costs total $5,496.09. We tested F&A costs of $5,908,619.33 from a total population of $32,641,725.08.

Recommendation

Management should ensure that departmental bookkeepers, principal investigators, and grant accountants have the knowledge and expertise to monitor and account for federal grant and contract awards in accordance with award agreements and federal regulations.

Although the risks noted in this finding were identified and assessed in management's risk assessment activities, management should reassess these risks and ensure that adequate controls are implemented to prevent noncompliance.

Management's Comment

The university concurs.

<u>For the UTHSC campus:</u>

We concur that the purchase of the upright freezer, under United States Public Health Service grant number R01DK067269, was not in accordance with the grant award and/or federal guidelines. Steps have been taken to obtain the appropriate approval for the purchase of the freezer. The general ledger accounts for the freezer purchase were corrected with document number 100005300. The F&A costs were corrected in the month-end F&A posting. Reporting will be corrected in the regular quarterly reporting.

The following procedures exist to prevent such errors from occurring and will be reinforced to eliminate future errors of this type:

- The approved grant application and budget will be reviewed prior to initiating the purchase.
- If the proposed item is not in the approved application/budget, the award/contract document will be reviewed to determine the level of prior approval (local or agency) necessary for the purchase.
- The department will process the appropriate request for prior approval.
- Upon receipt of the necessary approval, the purchase will be initiated.
- The University General Ledger Codes will be reviewed for correctness when processing the invoice for payment.

For the Knoxville campus:

Upon notification by State Audit of this issue, the expenditure in question was removed and charged to the department's cost center, via document number 100003103, 9/30/2011. The final financial report was revised and a refund was issued to the Air Force.

The following are the actions to prevent this situation from reoccurring:

- Sponsored Projects Accounting discussed this finding at its staff meeting and implemented a periodic review of computers purchased on sponsored projects for allowability.

- Sponsored Projects Accounting will discuss the audit finding at the next Knoxville Campus Fiscal Officers Meeting.

- Sponsored Projects Accounting will publish an article in the next quarterly newsletter reminding the campus business offices that general-use computers are not an allowable cost. The article will also be published in the Sponsored Programs (Office of Research) bi-monthly newsletter which includes faculty in their circulation.

- The Budget Director for the College, the Associate Research Dean, and the Director of Material Science Engineering (the Department Head) were notified of this weakness. The Business Manager of this department has educated her staff to note the unallowability of general-purpose computers on sponsored projects.

2. Financial aid staff did not properly perform Title IV return-of-funds calculations, resulting in federal questioned costs of $13,344.38

Finding

The financial aid office at the Knoxville campus did not properly calculate the amount of Title IV funds to be returned for students who withdrew during the fall 2010 semester. According to the *Code of Federal Regulations*, Title 34, Part 668.22(f):

> . . . the percentage of the payment period or period of enrollment completed is determined. . . by dividing the total number of calendar days in the payment period or period of enrollment into the number of calendar days completed in that period as of the student's withdrawal date. . .

The *Federal Student Aid Handbook*, Volume 5, page 27, states that, "Up through the 60% point in each payment period or period of enrollment, a prorata schedule is used to determine the amount of Title IV funds the student has earned at the time of withdrawal."

For 2 of 13 students tested (15%) who received Title IV aid and withdrew during the award year, financial aid staff members did not properly calculate the prorata enrollment period when determining the amount of Title IV funds to return. For both students, the staff members used the incorrect start date of the fall 2010 semester in calculating the number of days in the period of enrollment. As a result, eight additional days were added to the beginning of the term, inflating the percentage of the period of enrollment completed and reducing the amount of Title IV aid to be returned. We also haphazardly selected six additional students who withdrew during the fall semester and found that the incorrect semester start date was also used for each of these students. In addition, for one of the six additional students tested, the student's Direct Subsidized Loan of $1,742.00 was omitted from the total aid disbursed.

The Assistant Director of Financial Aid stated these errors occurred because the Senior Financial Aid Specialist typed the wrong semester start date into the computerized return of Title IV aid worksheet. The Assistant Director agreed that, since term dates are saved in a computerized template to be used for all undergraduate withdrawals, the error would have extended to all undergraduate students who withdrew during the fall semester.

The Assistant Director determined that the return of funds calculations were incorrect for 85 students by reviewing the withdrawal worksheets for all students who received Title IV aid and withdrew during the fall semester. Financial Aid personnel recalculated the return of Title IV aid for each of the 85 affected students and determined that an additional $11,755.68 was due to the Department of Education. However, the Financial Aid Director did not ensure the omission of the student's Direct Subsidized Loan noted above was included in the recalculations, resulting in an additional error of $1,588.70. As a result, questioned costs totaled $13,344.38.

Because the Office of Financial Aid & Scholarships at the Knoxville campus did not properly calculate the amount of Title IV funds to be returned for students who withdrew during the fall 2010 semester, additional funds are due to the U.S. Department of Education.

Recommendation

The Director of Financial Aid should implement additional review procedures to ensure the accuracy of the return-of-funds calculations. Any templates used in the return calculations should be properly reviewed by the Director of Financial Aid or Assistant Director of Financial Aid for accuracy.

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 of Financial Aid should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. The Director 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

The university concurs. The date-related calculation errors resulted from a single, clerical error in the semester date parameter during the setup of the Return of Title IV Funds software, which is provided by the U.S. Department of Education. The semester start date was entered incorrectly, resulting in a minor miscalculation of the percentage of funds that students had earned prior to withdrawal from classes - a percentage that was not significantly out of line compared with other semesters. This is not an indication of a systemic problem, but of an isolated instance affecting a limited number of students who withdrew during a small window of time in a single semester. With the exception of the date-related calculation errors and the omission of one student's Direct Subsidized Loan, all other calculations were correct. The identified errors have been corrected, and funds have been returned to the Department. The institution did not benefit from the errors, and the students were held harmless in their resolution.

Appropriate staff training has been added to ensure future compliance. In addition to current practices, the Assistant Director for Grants and Loans will monitor compliance through review of system reporting templates and individual withdrawal calculations as completed by the Withdrawal Processor.

Proper policies and procedures are in place to ensure compliance regarding the Return of Title IV Funds resulting from a student withdrawal from classes. Additional training and review will assist with error prevention and detection.

3. <u>The Registrar's Office at the Health Science Center did not properly report enrollment data, increasing the risk of not initiating the student loan repayment process</u>

Finding

The Registrar's Office at the University of Tennessee Health Science Center in Memphis did not properly report enrollment data for the Direct Loan borrowers who withdrew from classes or graduated. *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 Service] (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 42:

> 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].

The Health Science Center received the Enrollment Reporting Roster File from the Department of Education every 60 days during the year ended June 30, 2011. The Enrollment Reporting Summary Schedule (SCHER1) obtained from NSLDS indicated that the Registrar's Office did not complete and return three of six Enrollment Reporting Roster Files within 30 days of receipt from the U.S. Department of Education. The Registrar's Office did not complete and return one roster file because the next one was sent by the Department of Education prior to the registrar's office completing the file. The Registrar's Office returned the other two completed reports 43 and 45 days after they were received from the Department of Education.

In addition, we selected a sample of all Direct Loan borrowers who withdrew from classes or graduated during the year ended June 30, 2011. The Registrar's Office did not properly report the enrollment data to the Department of Education for any of the 25 borrowers tested.

- One student withdrew on December 6, 2010; however, the Registrar's Office did not report the student as having withdrawn until May 10, 2011, 125 days late.

- As of August 2, 2011, two students who withdrew from classes during the spring semester had not been reported as withdrawn. One student withdrew on May 19, 2011, and was reported to NSLDS as being enrolled full-time on May 26, 2011, and again on July 30, 2011. The other student, who withdrew on March 14, 2011, was reported as being enrolled full-time on May 26, 2011, and August 1, 2011.

- Thirteen students tested who graduated during the spring semester on May 27, 2011, were not reported as having graduated until July 29, 2011, through August 1, 2011, 33 to 36 days late.

- As of August 2, 2011, the Registrar's Office had not reported the graduation of nine students who graduated during the spring semester.

The Academic Records Coordinator II stated enrollment status changes were not reported timely because the institution had recently implemented a new student information system; the institution was negotiating a contract with the National Student Clearinghouse to report status changes; and the employee assigned the task of reporting did not perform his duties. It was also noted that there was no written policy about reporting enrollment status changes for student borrowers.

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.

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. In response, the University of Tennessee Health Science Center (HSC) has designed a comprehensive action plan to ensure enrollment student status changes are made within the scheduled 30 day time frame to NSLDS. First, the HSC is in the process of partnering with the National Student Clearinghouse (NSC). This partnership will allow an automatic upload by NSC of enrollment data and ensure timely reporting. Therefore, the daily submission of and changes to student status changes should eliminate future errors.

Additionally, the HSC Registrar has assigned duties and responsibilities to ensure the accuracy and timeliness of the report. Included in the plan are persons responsible for the implementation, quality control, and on-going monitoring of the plan.

- The employee responsible for entering changes (half-time, graduate, or withdrawn) in Banner was assigned the NSLDS report, improving accuracy and efficiency. Student status changes are entered in Banner and NSLDS upon receipt in the Registrar's office. The Registrar monitors and reviews the bi-monthly upload to the NSLDS website and receives a written report from the assigned employee confirming completion of each report. The Coordinator for Academic Records is trained and authorized to update student enrollment status information via the NSLDS website. She serves as the back-up for reporting purposes.

- Another staff person populates the Banner graduation fields. The two employees collaborate to ensure graduates are entered into NSLDS within six business days after graduation. The Registrar, Coordinator, and other assistants in the office are trained to enter data in the Banner graduation fields. Weekly staff meetings alert the Registrar to problems, providing time to adjust and modify for accurate reporting.

4. Directors of Financial Aid did not properly perform Direct Loan reconciliations

Finding

The Directors of Financial Aid at the Knoxville and Martin campuses and the Health Science Center in Memphis did not properly reconcile the university's Direct Loan financial records with the federal Direct Loan Servicing System.

The U.S. Department of Education's *Direct Loan School Guide*, Chapter 6, states:

> A school that participates in the Direct Loan Program is required to reconcile the funds that it has received (from the G5 system) to pay its students with the actual disbursement records that it has forwarded to the Common Origination and Disbursement (COD) system. Reconciliation takes place on a monthly basis, with a final reconciliation that is conducted after the award year ends on June 30.
>
> The starting point for reconciliation is the School Account Statement that COD sends to the school each month. A school reconciles its Direct Loan account by comparing the Ending Cash Balance on the School Account Statement with its internal records, ensuring that any discrepancies are resolved, and documents any reasons for a positive or negative balance.
>
> The Ending Cash Balance is simply the difference between the actual disbursement information that [the school has] reported to COD (and COD has accepted) for individual students and parents, compared to the net Drawdowns/Payments that [the] school has received from the G5 Payment System, as reported on the School Account Statement.

To properly perform this reconciliation, the school is required to reconcile net booked disbursements and net cash drawdowns on the School Account Statement to its internal financial records on a monthly basis, and any differences should be investigated.

Based on our interviews with the Directors of Financial Aid, the Directors did not fully perform these reconciliations, nor did they ensure that other staff members performed these reconciliations completely.

The Sponsored Projects Accounting Office in Knoxville performs the Direct Loan drawdowns for all campuses and also performs monthly reconciliations between the Department of Education's Grants Management (G5) system and the business office records. The Directors of Financial Aid each disclosed that they did not reconcile net drawdowns because they thought the reconciliations performed by the Sponsored Projects Accounting Office staff were sufficient to meet federal regulations.

This G5 reconciliation alone was not sufficient since the net cash drawdowns per the G5 system and ledger were not compared to the net cash drawdowns on the School Account Statement as provided by the COD system. The staff of the Financial Aid and Sponsored Project Accounting Offices should both be involved in validating the drawdown number on the School Account Statement.

None of the three campuses performed reconciliations of the ending cash balance to the school's financial records. In addition, they either did not reconcile or did not fully reconcile total net booked disbursements each month to the school's financial records. The Director of Financial Aid at the Knoxville campus did not reconcile disbursements for any of the 12 months in the fiscal year. The Assistant Director of Financial Aid at Martin did not reconcile disbursements for 3 of the 9 months tested. The Director of Financial Aid at the Health Science Center attempted to reconcile cash disbursements for 3 of the 12 months tested. However, these reconciliations were not complete and were not adequately documented.

The Director of Financial Aid at the Health Science Center also disclosed that the Sponsored Projects Accounting staff incorrectly used the Knoxville G5 number when requesting the Health Science Center's Direct Loan reimbursements from the Department of Education for July through November 2010. This error was not discovered until November. Because the incorrect G5 number was used when requesting reimbursements, the net drawdowns reported on the School Account Statement Cash Summary were overstated for the Knoxville campus and understated for the Health Science Center. If the Directors of Financial Aid at Knoxville and the Health Science Center had performed monthly reconciliations of all required data elements (ending cash, net drawdowns, and net booked disbursements) on the Cash Summary, the reimbursement request error would have been detected earlier.

The absence of reconciliations of net cash drawdowns and net booked disbursements as reported to the federal government and to the financial records of the university could lead to unresolved errors. Excess amounts could be received from the federal government, resulting in questioned costs, or amounts due to the university might not be drawn down. Without performing monthly reconciliations and retaining all supporting documentation, financial aid staff cannot ensure that all Direct Loan funds are received and that disbursements to students are made timely and for the correct amounts.

Recommendation

The Director of Financial Aid at each campus should ensure that staff members are aware of federal regulations and are adequately trained to perform the Direct Loan reconciliations as outlined in the *Direct Loans School Guide*, Chapter 6. If any items on these reconciliations do not agree, financial aid staff should then investigate and resolve the differences.

The Director of Financial Aid at each campus should ensure that risks such as those noted in this finding are adequately identified and assessed in management's risk assessment activities. The Director of Financial Aid at each campus should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Each Director 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

The university concurs. This was the first year that UT fully participated in the Direct Loan program, having converted from the lender-based FFEL program. The university is aware of the Federal requirement that all Federal Direct Loan (DL) transactions be reconciled monthly and believed it had the appropriate procedures in place for full compliance.

<u>For the Knoxville campus:</u>

Corrective action has taken place with the creation of a new taskforce that includes all key areas involved in the processing, disbursing, and reconciling of the DL program. The taskforce has reviewed all aspects of the process and made the necessary revisions to the written procedures and has trained all staff to ensure future compliance. Manual monthly reconciliation of the federal loan disbursements now includes the School Account Statement and COD components in the process.

<u>For the Martin campus:</u>

The Assistant Director of Financial Aid is now reconciling Direct Loan disbursements on a monthly basis. The reconciliation is reviewed monthly by the Financial Aid Director. An e-mail is sent to the Knoxville Sponsored Project Accounting staff after each reconciliation to report the cash receipts per COD and the school expenditures.

For the UTHSC campus:

The HSC concurs with the finding and has taken necessary actions to reconcile the university's Direct Loan financial records with the federal Direct Loan Servicing System. We have ensured that we are receiving the proper files from the Direct Loan Servicing System along with the correct information from the G5 system. Specifically, the HSC reconciles the School Account Statement from the Department of Education with DL funds that show as paid in the Banner Student Information System and with the Departmental Ledger Report produced out of IRIS.

The Direct Loans at the HSC were properly reconciled with the Direct Loan Servicing System for the 2010-2011 Program Year and are current for the 2011-2012 Program Year.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7897
FAX (615) 532-2765

Independent Auditor's Report

December 9, 2011

The Honorable Bill Haslam, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Mr. James E. Hall, Chairman
Audit Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180
and
Dr. Joseph A. DiPietro, President
The University of Tennessee
800 Andy Holt Tower
Knoxville, Tennessee 37996-0180

Ladies and Gentlemen:

We have audited the accompanying basic financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, as of and for the year ended June 30, 2011, as listed in the table of contents. These financial statements are the responsibility of the university's management. Our responsibility is to express opinions on these financial statements, based on our audit. We did not audit the financial statements of the University of Chattanooga Foundation, Inc.; the University of Tennessee Foundation, Inc.; and the University of Tennessee Research Foundation, Inc., discretely presented component units of the university. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of Chattanooga Foundation, Inc.; the University of Tennessee Foundation, Inc.; and the University of Tennessee Research Foundation, Inc., is based on the reports of the other auditors.

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

In our opinion, based on our audit and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the University of Tennessee, and its discretely presented component units as of June 30, 2011, and the respective changes in financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As explained in Note 2, the financial statements include investments valued at $361,231,003.85 (14.1 percent of net assets), whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners.

The management's discussion and analysis on pages 24 through 35 and the schedule of funding progress on page 95 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with generally accepted government auditing standards, we have also issued our report dated December 9, 2011, on our consideration of the university's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with generally accepted government auditing standards and should be considered in assessing the results of our audit.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/sds

The University of Tennessee
Management's Discussion and Analysis

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, 2011, with comparative information presented for the fiscal year ended June 30, 2010. This discussion has been prepared by management along with the financial statements and related note disclosures and should be read in conjunction with the Independent Auditor's Report, the audited financial statements, and the accompanying notes. The financial statements, notes, and this discussion are the responsibility of management.

The university 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.

Using This Annual Report

This report consists of three basic financial statements. The statement of net assets; the statement of revenues, expenses, and changes in net assets; and the statement of cash flows provide information on the University of Tennessee as a whole and present a long-term view of the university's finances.

The Statement of Net Assets

The statement of net assets presents the financial position of the university at the end of the fiscal year and includes all assets and liabilities of the university. The difference between total assets and total liabilities—net assets—is an indicator of the current financial condition of the university. Assets and liabilities are generally measured using current values. Capital assets, however, are stated at historical cost less an allowance for depreciation.

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

Condensed Statements of Net Assets
(in thousands of dollars)

	2011	2010
Assets:		
Current assets	$ 538,602	$ 497,916
Capital assets, net	1,728,408	1,609,656
Other assets	1,330,550	1,154,605
Total assets	3,597,560	3,262,177
Liabilities:		
Current liabilities	331,767	301,910
Noncurrent liabilities	703,856	694,863
Total liabilities	1,035,623	996,773
Net assets:		
Invested in capital assets, net of related debt	1,198,045	1,075,557
Restricted – nonexpendable	426,959	408,475
Restricted – expendable	479,175	419,862
Unrestricted	457,758	361,510
Total net assets	$2,561,937	$2,265,404

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

Current assets increased between fiscal years due to increases in investments and the current portion of accounts, notes, and grants receivable. The most significant increase is attributable to the portion of grants receivable deemed current.

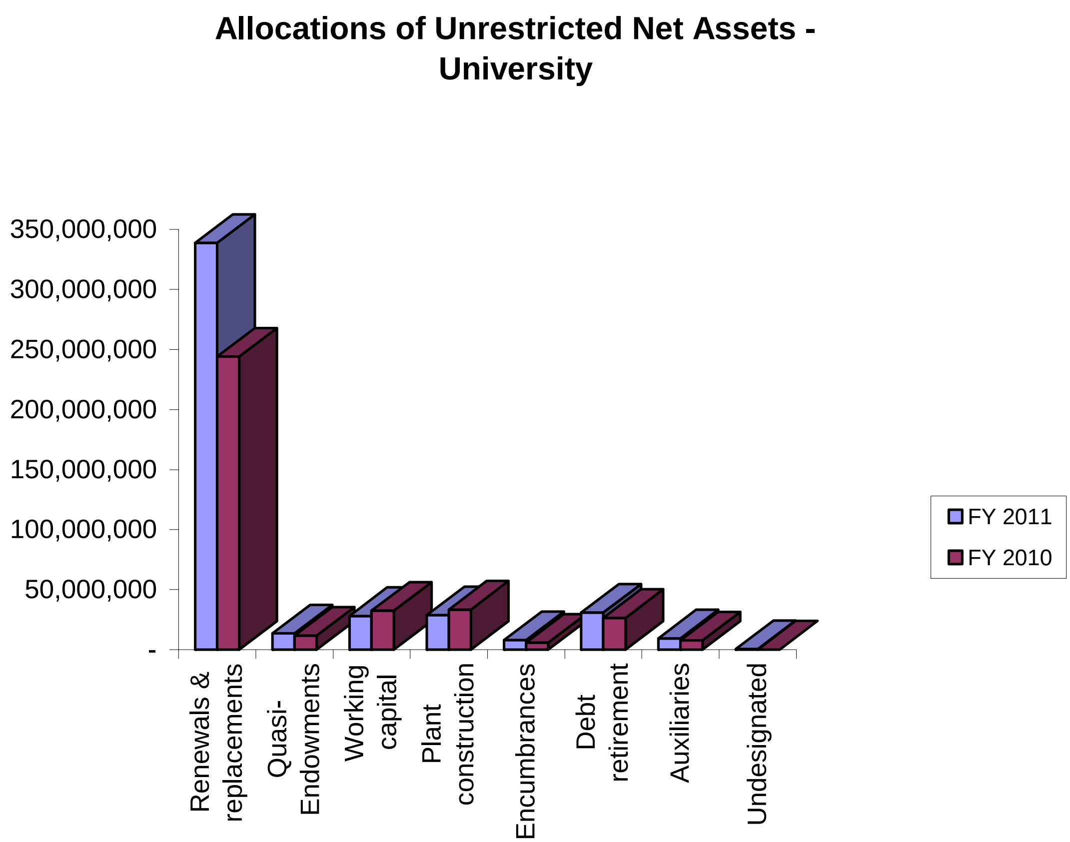
Noncurrent assets of cash and cash equivalents, investments, and capital assets increased between the fiscal years. Cash and cash equivalents increased due to a changing investment mix to adjust to activity in the capital markets. Investments increased due to increases in the book value of investments as well as increases in the market value and increased deposits for investing from a component unit, the University of Tennessee Foundation.

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

Current liabilities increased due to an increase in deferred revenue associated with the Tennessee Solar Institute even though accounts payable decreased. Noncurrent liabilities increased slightly between fiscal years due to increased deposits held in custody for component units, even though long-term liabilities decreased due to the retirement of Tennessee State School Bond Authority debt by the university. More detailed information about the university's debt is presented in the Capital Asset and Debt Administration section of this report.

The restricted - expendable net assets increased between fiscal years as a result of accumulated private dollars for scholarships and fellowships, instructional department uses, and other restricted purposes and market increases. These funds will be spent in future years.

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



Renewals and replacements increased from 2010 to 2011 due to unspent educational and general dollars with the expectation that fiscal years 2012 and 2013 would be leaner.

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

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

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

	2011	2010
Operating revenues:		
Net tuition and fees	$ 316,045	$ 279,638
Grants and contracts	448,903	395,316
Auxiliary	184,113	178,845
Other	85,201	85,009
Total operating revenues	1,034,262	938,808
Operating expenses	1,782,288	1,683,195
Operating loss	(748,026)	(744,387)
Nonoperating revenues and expenses:		
State and local appropriations	540,013	477,120
Gifts	32,487	41,844
Investment income	129,975	117,281
Other	220,790	182,409
Total nonoperating revenues	923,265	818,654
Income (loss) before other revenues, expenses, gains, or losses	175,239	74,267
Other revenues, expenses, gains, or losses:		
Capital appropriations	66,223	91,550
Capital grants and gifts	32,220	23,266
Additions to permanent endowments	15,135	16,758
Other	7,716	883
Total other revenues, expenses, gains, or losses	121,294	132,457
Increase (decrease) in net assets	296,533	206,724
Net assets at beginning of year	2,265,404	2,058,680
Net assets at end of year	$ 2,561,937	$ 2,265,404

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

Net tuition and fees increased from 2010 to 2011 as a result of a 9% fee increase. However, this increase in tuition and fee revenue was partially offset by current and new students receiving funds from the Tennessee Education Lottery Scholarship Program, which reduces tuition and fees and is shown as grants and contracts revenue.

Operating grants and contracts increased $54 million from 2010 to 2011 with the addition of American Recovery and Reinvestment Act of 2009 (ARRA) competitive awards and other large awards.

Auxiliary revenues increased $5.3 million, primarily in residence halls and athletics.

In fiscal year 2011, state appropriations increased $63 million which represented a 14% increase in state appropriations mostly due to the state giving the university one-time appropriations in lieu of ARRA - State Fiscal Stabilization Funds.

Nonoperating gifts decreased $9.3 million from 2010 to 2011 while capital grants and gifts increased $9 million for the same time period.

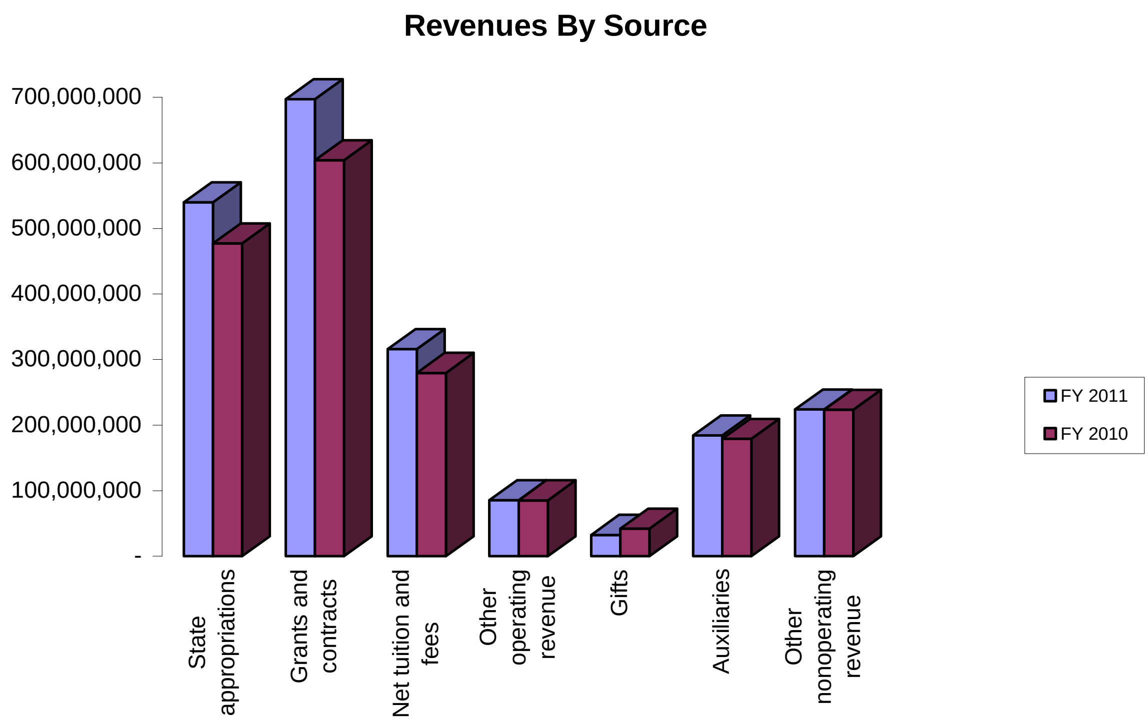
The increase in investment income was due to an increase in endowment income and an overall increase in the capital markets.

The decrease in capital appropriations for 2011 consisted of another year of no state appropriations for new buildings and limited dollars for capital maintenance.

Additions to permanent endowments remained almost the same from 2010 to the 2011 fiscal year.

<u>Revenues</u>

The following is a graphic illustration of revenues by source (both operating and nonoperating), which were used to fund the university's activities for the years ended June 30, 2011, and June 30, 2010.



For the year ended June 30, 2011, approximately 75% of UT's revenue was attributed to state and local appropriations, grants and contracts, and tuition and fees.

<u>Expenses</u>

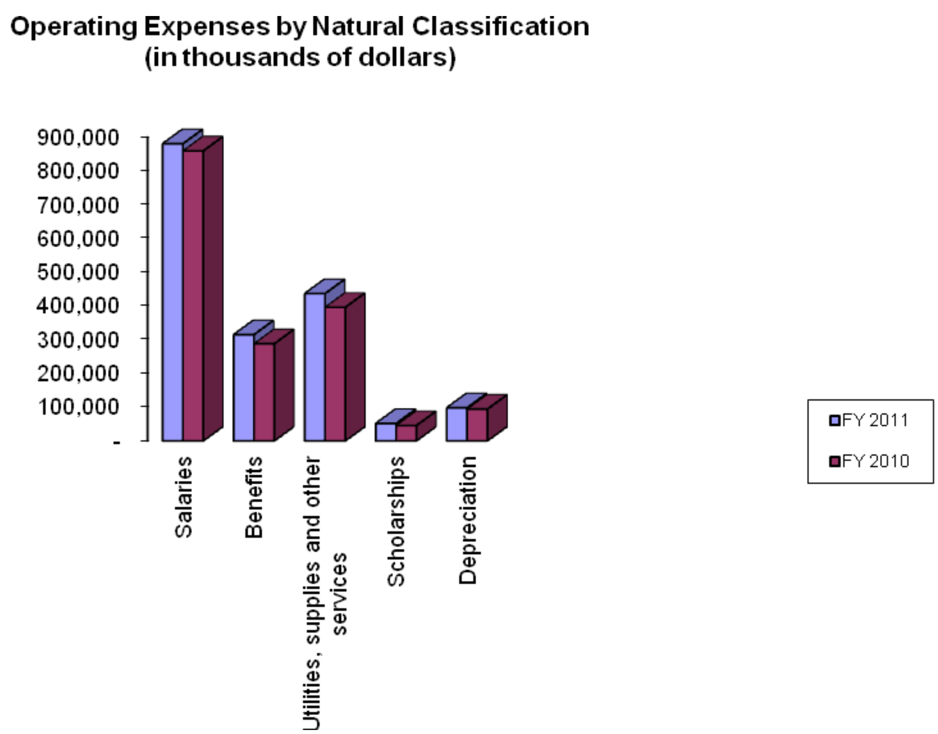
Operating expenses can be displayed in two formats, natural classification and functional classification. Both formats are displayed below (in thousands of dollars).

2011 Natural Classification

2011 Functional Classification	Salaries	Benefits	Utilities, supplies, and other services	Scholarships	Depreciation	Total
Instruction	$ 373,984	$ 112,177	$ 64,835	$ -	$ -	$ 550,996
Research	131,435	35,726	81,925	-	-	249,086
Public service	68,496	25,376	62,190	-	-	156,062
Academic support	67,118	24,524	26,907	-	-	118,549
Student services	40,086	14,584	21,820	-	-	76,490
Institutional support	71,851	27,858	4,655	-	-	104,364
Operation and maintenance of plant	33,333	16,485	79,733	-	-	129,551
Scholarships	3,435	26,060	20,243	51,542	-	101,280
Auxiliary	43,173	12,920	73,969	-	-	130,062
Independent operations	48,069	19,230	-	-	-	67,299
Depreciation	-	-	-	-	98,549	98,549
Total expenses	$ 880,980	$ 314,940	$ 436,277	$ 51,542	$ 98,549	$ 1,782,288

2010 Natural Classification

2010 Functional Classification	Salaries	Benefits	Utilities, supplies, and other services	Scholarships	Depreciation	Total
Instruction	$ 362,847	$ 103,476	$ 59,659	$ -	$ -	$ 525,982
Research	125,759	32,926	76,364	-	-	235,049
Public service	67,506	23,849	33,519	-	-	124,874
Academic support	65,812	23,082	18,435	-	-	107,329
Student services	39,129	13,393	23,265	-	-	75,787
Institutional support	71,514	25,226	-	-	-	96,740
Operation and maintenance of plant	32,789	14,976	93,702	-	-	141,467
Scholarships	3,857	19,903	18,846	45,389	-	87,995
Auxiliary	40,075	12,197	72,179	-	-	124,451
Independent operations	50,418	18,945	-	-	-	69,363
Depreciation	-	-	-	-	94,158	94,158
Total expenses	$ 859,706	$ 287,973	$ 395,969	$ 45,389	$ 94,158	$ 1,683,195



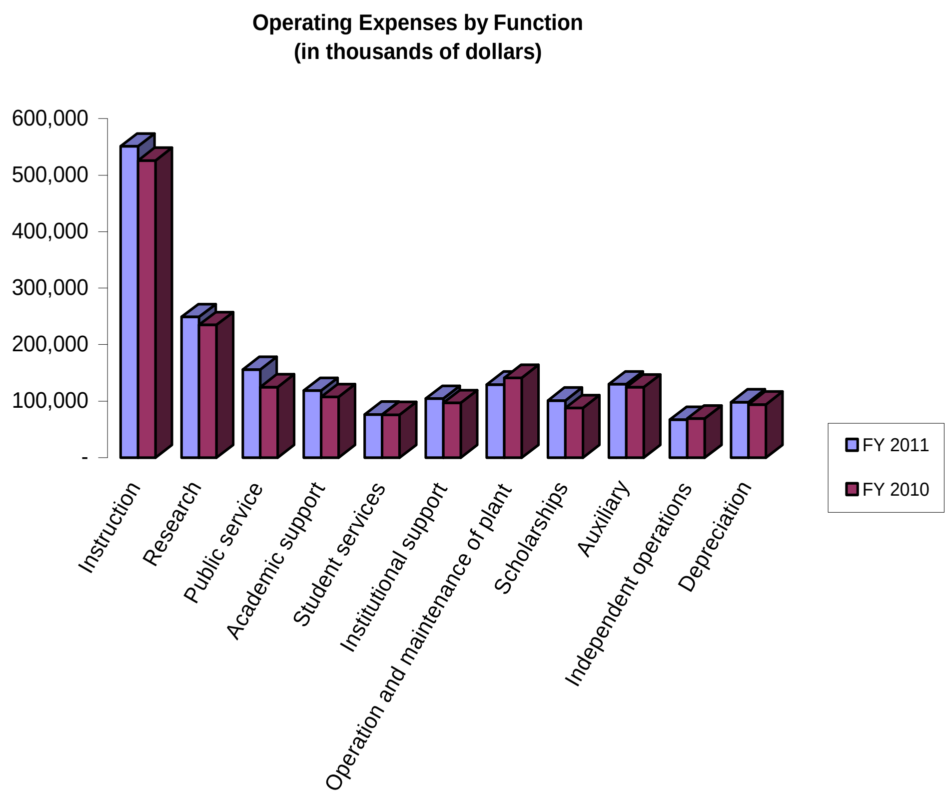
The university had the following significant changes in expenses between fiscal years:

The increase in salary and benefit expenses from 2011 to 2010 is due to the increases in staff in the instruction, research, and auxiliary functions.

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

Other operating expenses increased between fiscal years due to availability of one-time funds to fund maintenance costs and equipment purchases and the Solar Institute.

Scholarship expenses increased due to departments awarding more aid to students compared to the previous fiscal year.



Functional increases in instruction and research were due to the addition of ARRA stimulus and one-time state funds.

Capital Asset and Debt Administration

Capital Assets

At June 30, 2011, the University of Tennessee had $1,728,407,603.85 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled $98,549,195.45 for the current fiscal year. Details of these assets are shown below.

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

	2011	2010
Land	$ 64,320	$ 60,121
Land improvements & infrastructure	26,833	25,255
Buildings	1,147,698	1,093,497
Works of art/historical treasures	3,493	528
Equipment	149,576	145,876
Software	9,170	8,168
Library holdings	75,378	70,692
Projects in progress	251,940	205,519
Total	$1,728,408	$1,609,656

Major capital additions for UT during 2010-2011 include the $23 million Ayres Hall Renovation, the $10.7 million Joint Institute for Neutron Sciences Building, the $4.8 million purchase of Shelbourne Towers, and a $21 million phase of Neyland Stadium Improvements in Knoxville; the $1.1 million Boling HVAC Improvements and a $1.2 million phase of the Dunn Dental Building - 4th Floor in Memphis; the $1 million Boling Center Ballroom Renovation at Martin; and the $8.2 million Grote Hall Improvements at Chattanooga.

For the next fiscal year, the state has approved $23.92 million in capital maintenance and $4.5 million in capital outlay appropriations for UT. These approved new projects are the Alexander Building Improvements and Completion of Pharmacy Building - 6th Floor in Memphis; the Electrical Distribution System Improvements Phase IV, Utilities Infrastructure Study, and College of Veterinary Medicine Building Improvements in Knoxville; Campus Elevator Upgrades in Martin; and Holt Hall Improvements in Chattanooga. In addition, there are various construction and improvement projects at all campuses. More detailed information about the university's capital assets is presented in Note 5 to the financial statements.

Debt

At June 30, 2011, the university had $540,222,243.51 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

Outstanding Debt Schedule
(in thousands of dollars)

	2011	2010
Bonds - current portion	$ 27,703	$ 22,299
Bonds - noncurrent	468,044	359,731
Unamortized bond premium	7,787	-
Commercial paper - noncurrent	36,688	163,126
Total TSSBA authorized debt	540,222	545,156
Notes - current portion	-	12
Total debt	$ 540,222	$ 545,168

The university retired more than $162.9 million in bonds and commercial paper in fiscal year 2010-2011. The Tennessee State School Bond Authority (TSSBA), in addition to its authority to issue bonds and notes to finance capital projects, has the responsibility for approving all long-term debt of the university. TSSBA currently is rated AA by Standard & Poor's. To fund university projects, the TSSBA issued the 2010 Series A bonds in the amount of $131.2 million and the 2010 Series B bonds in the amount of $15.9 million. 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 2012, the University of Tennessee Board of Trustees has authorized individual campus fee increases of 9.9% to 12% that are expected to generate approximately $53 million in new funding, net of related scholarships, with a continued projected enrollment increase. State appropriations will continue to be reduced. The university continues to be successful in competing for grants and contracts. The capital markets remain unstable, which may adversely 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.

Exhibit A

THE UNIVERSITY OF TENNESSEE
STATEMENT OF NET ASSETS
JUNE 30, 2011

	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)	$ 295,147,284.75	$ 8,646,928.00	$ 2,875,094.28	$ 4,925,360.00
Investments (Notes 2, 22, 23, and 24)	96,924,156.88	-	1,439,150.00	-
Accounts, notes, and grants receivable (net) (Note 4)	125,699,132.11	525,334.00	3,297,756.27	3,351,769.73
Due from primary government	10,330,283.15	-	-	2,123,562.27
Inventories	7,264,575.31	-	67,850.00	-
Prepaid expenses and deferred charges	3,236,758.36	44,722.00	13,428.16	136,509.00
Total current assets	538,602,190.56	9,216,984.00	7,693,278.71	10,537,201.00
Noncurrent assets:				
Cash and cash equivalents (Note 2)	617,470,041.75	-	3,193,081.04	376,901.00
Investments (Notes 2, 22, 23, and 24)	571,715,626.89	100,200,293.00	26,102,830.67	328,835.00
Investment in UT - Battelle, LLC (Note 14)	4,632,313.18	-	-	-
Accounts, notes, and grants receivable (net) (Note 4)	88,621,344.83	421,836.00	49,053,379.95	-
Lease payments receivable (Note 18)	47,907,768.02	-	-	-
Capital assets (net) (Notes 5, 22, and 24)	1,728,407,603.85	61,579,319.00	-	60,606,479.00
Prepaid expenses and deferred charges	202,461.22	415,261.00	-	-
Assets held by the university	-	485,519.00	34,998,088.42	-
Total noncurrent assets	3,058,957,159.74	163,102,228.00	113,347,380.08	61,312,215.00
Total assets	3,597,559,350.30	172,319,212.00	121,040,658.79	71,849,416.00
LIABILITIES				
Current liabilities:				
Accounts payable (Note 7)	88,686,791.59	731,775.25	2,565.45	7,070,404.00
Accrued liabilities	44,299,173.78	-	-	-
Deferred revenue	114,399,613.39	143,440.00	-	901,084.00
Due to component unit	2,123,562.27	-	-	-
Deposits payable	4,973,544.90	-	-	-
Annuities payable	1,213,584.49	-	63,979.20	-
Long-term liabilities, current portion (Notes 8, 22, 23, and 24)	71,797,463.73	1,715,000.00	15,733.89	-
Deposits held in custody for others	4,273,071.68	2,153,743.00	-	-
Due to the university	-	963,229.75	2,182.62	-
Total current liabilities	331,766,805.83	5,707,188.00	84,461.16	7,971,488.00
Noncurrent liabilities:				
Deferred revenue (Notes 8 and 24)	15,500,438.71	-	-	20,349,480.00
Long-term liabilities, noncurrent portion (Notes 8, 22, 23, and 24)	611,649,165.01	80,373,946.00	168,042.86	654,922.00
Due to grantors (Note 8)	36,201,013.40	-	-	-
Annuities payable (Note 8)	5,507,214.65	-	689,451.68	-
Deposits held in custody for component units	34,998,088.42	-	-	-
Total noncurrent liabilities	703,855,920.19	80,373,946.00	857,494.54	21,004,402.00
Total liabilities	1,035,622,726.02	86,081,134.00	941,955.70	28,975,890.00
NET ASSETS				
Invested in capital assets, net of related debt	1,198,044,555.13	-	-	39,355,915.00
Restricted:				
Nonexpendable:				
Scholarships and fellowships	192,851,899.16	14,358,894.00	15,990,406.01	-
Libraries	13,807,689.65	-	257,237.83	-
Research	18,800,105.71	-	1,314,915.85	-
Instructional department uses	135,559,160.04	29,034,524.00	28,236,241.78	-
Academic support	28,228,315.11	106,525.00	4,281,260.85	-
Other	37,711,942.17	134,258.00	7,061,103.56	-
Expendable:				
Scholarships and fellowships	113,152,363.51	510,663.00	1,225,003.26	-
Libraries	10,636,094.07	-	-	-
Research	65,878,872.76	-	1,404,591.06	-
Instructional department uses	83,638,904.39	2,794,392.00	6,880.31	-
Academic support	36,168,310.89	11,141.00	31,246,018.36	-
Loans	10,276,236.93	-	-	-
Capital projects	65,722,475.83	5,000,000.00	13,448,139.20	-
Debt service	536,521.17	-	-	-
Other	93,164,836.83	1,973,015.00	14,756,785.49	-
Unrestricted (Note 9)	457,758,340.93	32,314,666.00	870,119.53	3,517,611.00
Total net assets	$ 2,561,936,624.28	$ 86,238,078.00	$ 120,098,703.09	$ 42,873,526.00

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

Exhibit B

THE UNIVERSITY OF TENNESSEE
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2011

	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 $143,740,592.27)	$ 316,045,145.61	$ -	$ -	$ -
Contributions	-	147,837.00	2,240,720.22	1,724,081.00
Investment return designated for operations	-	5,767,282.00	-	-
Federal appropriations	13,817,123.16	-	-	-
Governmental grants and contracts	258,601,583.71	-	-	-
Nongovernmental grants and contracts	190,301,441.71	-	-	3,428,673.00
Sales and services of educational departments	51,904,262.17	-	-	-
Auxiliary enterprises:				
Residential life (net of scholarship allowances of $1,685,828.40; all revenues are used as security for varying revenue bonds; see Note 8)	51,554,789.48	10,227,569.00	-	-
Food services	4,880,433.37	-	-	-
Bookstore	18,364,890.55	-	-	-
Parking	10,236,047.42	-	-	-
Athletics	93,455,719.61	-	-	-
Other auxiliaries	5,621,303.46	-	-	-
Interest earned on loans to students	44,057.28	-	-	-
Other operating revenues	19,435,489.89	-	153,987.04	-
Total operating revenues	1,034,262,287.42	16,142,688.00	2,394,707.26	5,152,754.00
EXPENSES				
Operating expenses (Note 19):				
Salaries and wages	880,979,955.85	-	-	2,948,881.10
Fringe benefits	314,939,808.31	-	-	324,016.90
Utilities, supplies, and other services	436,277,650.44	3,598,474.00	1,029,350.22	32,283,649.00
Scholarships and fellowships	51,541,662.44	-	-	-
Depreciation expense	98,549,195.45	3,206,007.00	-	3,000,448.00
Payments to or on behalf of the university (Notes 22 and 23)	-	5,767,282.00	13,768,772.09	-
Total operating expenses	1,782,288,272.49	12,571,763.00	14,798,122.31	38,556,995.00
Operating income (loss)	(748,025,985.07)	3,570,925.00	(12,403,415.05)	(33,404,241.00)
NONOPERATING REVENUES (EXPENSES)				
State and local appropriations	540,013,070.87	-	-	-
Gifts (include $19,536,054.09 from component units)	32,487,318.78	-	-	-
Grants and contracts	248,366,586.60	-	-	33,257,203.00
Investment income (loss)	129,974,829.36	10,570,783.00	5,867,099.71	25,992.00
Interest on capital asset - related debt	(23,234,431.20)	(4,430,265.00)	-	-
Bond issuance costs	(1,528,116.13)	-	-	-
Other nonoperating revenues (expenses)	(2,813,938.63)	(32,476.00)	-	1,471.00
Net nonoperating revenues (expenses)	923,265,319.65	6,108,042.00	5,867,099.71	33,284,666.00
Income (loss) before other revenues, expenses, gains, or losses	175,239,334.58	9,678,967.00	(6,536,315.34)	(119,575.00)
Capital appropriations	66,222,831.29	-	-	-
Capital grants and gifts	32,220,023.00	-	-	2,010,226.00
Additions to permanent endowments	15,134,618.42	221,366.00	13,575,321.01	-
Additions to annuity and life income trusts	1,553,887.63	-	-	-
Other	6,162,010.51	-	-	910,039.00
Total other revenues	121,293,370.85	221,366.00	13,575,321.01	2,920,265.00
Increase (decrease) in net assets	296,532,705.43	9,900,333.00	7,039,005.67	2,800,690.00
NET ASSETS				
Net assets at beginning of year	2,265,403,918.85	76,337,745.00	113,059,697.42	40,072,836.00
Net assets at end of year	$ 2,561,936,624.28	$ 86,238,078.00	$ 120,098,703.09	$ 42,873,526.00

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

Exhibit C

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2011

CASH FLOWS FROM OPERATING ACTIVITIES	
Tuition and fees	$ 317,491,579.41
Federal appropriations	13,817,123.16
Grants and contracts	470,478,961.73
Sales and services of educational activities	52,656,090.08
Payments to suppliers and vendors	(432,829,691.33)
Payments to employees	(879,917,688.10)
Payments for benefits	(302,936,968.02)
Payments for scholarships and fellowships	(51,541,662.44)
Loans issued to students	(2,595,269.58)
Collection of loans from students	4,106,207.40
Interest earned on loans to students	605,616.88
Auxiliary enterprise charges:	
Residence halls	51,554,789.48
Bookstore	18,364,890.55
Food service	4,880,433.37
Parking	10,236,047.42
Athletics	95,184,898.11
Other auxiliaries	7,226,454.54
Hospital	458,525.35
Other receipts (payments)	19,158,997.01
Net cash used by operating activities	(603,600,664.98)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
State appropriations	533,814,990.55
Local appropriations	5,326,880.32
Gifts and grants for other than capital or endowment purposes	278,831,358.78
Private gifts for endowment purposes	15,134,618.42
Split-interest transactions receipts	1,553,887.63
Split-interest transactions disbursements	(3,278,441.73)
Federal student loan receipts	257,476,480.50
Federal student loan disbursements	(266,142,054.00)
Changes in deposits held for others	(288,273.37)
Net cash balance implicitly financed (repaid)	(6,242,342.80)
Other noncapital receipts (payments)	7,715,898.14
Net cash provided by noncapital financing activities	823,903,002.44
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Proceeds from capital debt	32,707,647.89
Capital appropriations	62,102,954.39
Capital grants and gifts received	32,220,023.00
Proceeds from sale of capital assets	386,561.11
Purchase of capital assets and construction	(223,041,746.26)
Principal paid on capital debt and leases	(28,349,273.83)
Interest paid on capital debt and leases	(22,558,515.95)
Other capital and related financing receipts (payments)	(2,034,517.03)
Net cash used by capital and related financing activities	(148,566,866.68)
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales and maturities of investments	268,036,369.34
Income on investments	27,564,544.71
Purchase of investments	(246,781,677.84)
Net cash provided by investing activities	48,819,236.21
Net increase in cash and cash equivalents	120,554,706.99
Cash and cash equivalents at beginning of year	792,062,619.51
Cash and cash equivalents at end of year	$ 912,617,326.50

Exhibit C (Cont.)

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2011

RECONCILIATION OF NET OPERATING LOSS TO NET CASH USED BY OPERATING ACTIVITIES		
Operating loss	$	(748,025,985.07)
Adjustments to reconcile operating loss to net cash used by operating activities:		
Depreciation expense		98,549,195.45
Changes in assets and liabilities:		
Receivables, net		(4,978,220.53)
Inventories		140,129.85
Prepaid expenses and deferred charges		(574,003.43)
Accrued interest receivable		561,559.60
Accounts payable		3,876,505.81
Accrued liabilities		1,249,726.76
Deferred revenue		31,994,892.05
Deposits		279,215.43
Other postemployment benefits		11,302,669.74
Compensated absences		512,711.54
Other additions:		
Loans to students		1,510,937.82
Net cash used by operations	$	(603,600,664.98)
Noncash investing, capital, or financing transactions		
Gifts of capital assets	$	9,544,582.03
Unrealized gain on investments	$	102,840,928.01
Loss on disposal of capital assets	$	(1,648,135.97)

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

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The university is a component unit of the State of Tennessee because the state appoints the majority of the university's governing body and provides 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. It is also discretely presented in the university's financial statements. See Notes 22, 23, and 24 for more detailed information about the component units and how to obtain their reports.

Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) applicable to governmental colleges and universities engaged in business-type activities as prescribed by the Governmental Accounting Standards Board (GASB).

Basis of Accounting

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

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

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

All other activity is nonoperating in nature. This activity includes (1) state and local appropriations for operations; (2) investment income; (3) interest on capital asset-related debt; (4) 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. The university had no investments in commercial paper at June 30, 2011. All other investments are reported at fair value or estimated fair value.

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

Capital Assets

Capital assets, which include property, plant, equipment, software, and library holdings, are reported in the statement of net assets at historical cost or at fair value at date of donation, less accumulated depreciation. The costs of normal maintenance and repairs that do not add to the value of the 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 buildings, infrastructure, and land improvements is also $100,000. The capitalization threshold for additions and improvements to buildings is $100,000 provided that amount exceeds 20% of the book value of the building.

These assets, with the exception of land, are depreciated/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 $683,487.86 as of June 30, 2011. These amounts represent the sum of checks written in excess of the university's checking account balance because of the use of a controlled disbursement account. In this way, the university maximizes interest income by transferring from an investment account only funds necessary to cover the checks that clear the bank daily.

Compensated Absences

The university's employees accrue annual leave at varying rates, depending on length of service or classification. Some employees also earn compensatory time. Generally, all permanent full-time employees and certain part-time employees are entitled to accrue and carry forward calendar year maximums of 42 days of annual vacation leave, except nine-month faculty members, who do not accrue annual leave. The amount of these liabilities and their related benefits are reported in the statement of net assets.

Net Assets

The institution's net assets are classified as follows:

<u>Invested in capital assets, net of related debt</u> - This represents the institution's total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

<u>Nonexpendable restricted net assets</u> - Nonexpendable restricted net assets consist of endowment and similar type funds in which donors or other outside sources have stipulated, as a condition of the gift instrument, that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may be expendable or added to principal.

<u>Expendable restricted net assets</u> - Expendable restricted net assets include resources in which the university is legally or contractually obligated to spend resources in accordance with restrictions imposed by external third parties.

Unrestricted net assets - Unrestricted net assets represent resources derived from student tuition and fees, state appropriations, sales and services of educational departments, and auxiliary enterprises. These resources are used for transactions relating to the educational and general operations of the institution, and may be used at the discretion of the institution to meet current expenses for any purpose.

Scholarship Discounts and Allowances

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

Income Taxes

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

NOTE 2. DEPOSITS AND INVESTMENTS

Investment Policy

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

University policy also requires that commercial paper not exceed 35% of the portfolio in total and that no more than 10% of the portfolio's value be in the commercial paper of a single issuer. In addition, banker's acceptances cannot exceed 20% of the portfolio's value and no one bank's acceptances may exceed 10%. Money market funds cannot exceed 10% of the portfolio's total value. At June 30, 2011, the university's cash management investment pool consisted of $718,250,000.00 of certificates of deposit and $159,400,000.00 of demand deposits yielding money market rates.

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

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

Cash and Cash Equivalents

In addition to petty cash and demand deposits, this classification includes instruments which are readily convertible to known amounts of cash.

At June 30, 2011, cash and cash equivalents consisted of $191,101,822.84 in bank accounts, $1,504,429.36 of petty cash on hand, and $718,250,000.00 of certificates of deposit.

The carrying amount of the university's deposits was $909,351,822.84, and the bank balance was $936,870,504.26.

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 $1,761,074.30 at June 30, 2011, 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, 2011, 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, 2011, the university had the following investments and maturities:

Investment Type	Fair Value	Investment Maturities (In Years) Less Than 1	1 to 5	6 to 10	10+	Unknown	Cost
Investments							
Debt Securities							
U.S. Treasury	$ 3,663,740.28	$ 49,982.50	$ 2,157,132.68	$ 757,595.49	$ 699,029.61	$ -	$ 3,221,606.18
U.S. agencies	10,901,688.66	173,977.34	6,584,372.12	2,248,096.20	1,895,243.00	-	10,206,068.46
Corporate bonds	16,071,076.91	4,888,915.22	5,070,408.09	6,087,400.10	24,353.50	-	15,485,779.89
Municipal bonds	3,394,524.70	974,064.60	699,275.00	2,000.00	1,719,185.10	-	3,397,986.95
Mortgages and notes	236,273.83	14,108.70	222,165.13	-	-	-	225,374.55
Bond mutual funds	27,388,676.35	-	6,309,908.28	17,233,540.12	3,171,944.33	673,283.62	26,712,519.29
	61,655,980.73	$6,101,048.36	$21,043,261.30	$26,328,631.91	$7,509,755.54	$673,283.62	59,249,335.32
Other Investments							
Corporate stocks:							
Domestic	35,856,049.39						32,215,907.42
International	1,267,196.84						1,160,969.52
Mutual funds – equity	197,769,146.04						193,548,179.83
Alternative investments:							
Private equity	107,880,830.45						115,535,959.35
Real estate investments	30,749,317.15						38,572,396.98
Natural resources	77,214,878.03						70,103,526.33
Hedge funds	145,385,978.22						120,481,257.96
Real estate gifts	4,405,950.87						5,944,720.67
Assets with trustees	6,454,456.05						7,149,344.02
Total investments	$668,639,783.77						$643,961,597.40

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, 2011, were rated by Moody's.

The university is authorized by statute to invest funds in accordance with University of Tennessee investment policies. Funds, other than endowment and annuity and life income funds, may be invested in collateralized Tennessee bank or savings and loan association certificates of deposit, U.S. Treasury obligations, U.S. government agency obligations, repurchase agreements of those securities, highest quality commercial paper, prime bankers' acceptances, and money market mutual funds meeting certain criteria. Endowment and life income funds can be invested in equity securities and various other securities given prudent diversification. The university has no investment policy limiting its investment choice based on ratings issued by nationally recognized statistical rating agencies. As of June 30, 2011, the institution's investments were rated as follows:

Rated Debt Instruments	Fair Value	Aaa	Aa1	Aa2	Aa3	A1
Investments						
U.S. agencies	$ 10,901,688.66	$ 9,756,760.16	$ -	$ -	$ -	$ -
Corporate bonds	16,071,076.91	2,039,390.00	-	954,957.25	305,520.00	1,394,182.25
Municipal bonds	3,394,524.70	-	223,369.95	1,285,511.25	762,126.40	183,692.00
Mutual funds – bonds	27,388,676.35	1,152,873.11	-	1,498,571.17	-	-
Mortgages and notes	236,273.83	-	-	-	-	-
Money market funds in custodial accounts	1,761,074.30	1,761,074.30	-	-	-	-

Rated Debt Instruments	A2	A3	Baa1	Baa2	Ba2	B1
Investments						
U.S. agencies	-	-	-	-	-	-
Corporate bonds	3,022,194.25	1,607,138.25	3,415,110.83	2,823,170.36	-	-
Municipal bonds	-	-	425,987.60	-	-	-
Mutual funds – bonds	1,628,637.56	-	-	1,476,129.30	1,281,213.53	87,275.61
Mortgages and notes	-	-	-	-	-	-
Money market funds in custodial accounts	-	-	-	-	-	-

Rated Debt Instruments	B2	Unrated
Investments		
U.S. agencies	-	1,144,928.50
Corporate bonds	-	509,413.72
Municipal bonds	-	513,837.50

Mutual funds – bonds	39,613.78	20,224,362.29
Mortgages and notes	-	236,273.83
Money market funds in custodial accounts	-	-

Custodial Credit Risk – Investments

Custodial credit risk is the risk that, in the event of a failure of the counterparty, the university will not be able to recover the value of the investment or collateral securities that are in possession of an outside party. At June 30, 2011, the university had $6,454,456.05 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. At June 30, 2011, there was no single issuer with whom the university had more than 5 percent of its invested funds.

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 $1,267,196.84 invested in foreign corporate equities and $305,520.00 invested in foreign corporate bonds at June 30, 2011.

Alternative Investments

In its Consolidated Investment Pool, as part of its endowment assets, the university has investments in 86 limited partnerships, limited companies, corporations, and limited liability corporations (LLCs).

These investments include 42 private equity funds, 4 real estate funds, 18 natural resource funds, and 22 hedge funds. The estimated fair value of these assets is $361,231,003.85 at June 30, 2011.

Total capital contributions less returns of capital equal $344,693,140.62 at June 30, 2011.

The university believes that the carrying amount of its alternative investments is a reasonable estimate of fair value as of June 30, 2011. 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.

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, 5 percent of a three-year moving average of the fair value of endowment investments has been authorized for expenditure. The remaining amount, if any, is retained to be used in future years when the amount computed using the spending plan exceeds the investment income. At June 30, 2011, net appreciation of $122,264,592.80 is available to be spent, of which $119,700,974.54 is restricted for scholarships and fellowships, libraries, instructional department uses, academic support, and other purposes. The per-unit fair value for participating endowments was $3.276602 at June 30, 2011. Income distributed was $.17112 per share in 2011, or $32,006,067.50.

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 2011 and the three and five years then ended was 20.6%, 1.2%, and 3.1%, 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 $634,459.23 for 2011.

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 2011 amounted to $1,615,696.83.

NOTE 4. ACCOUNTS, NOTES, AND GRANTS RECEIVABLE

Accounts, notes, and grants receivable included the following at June 30, 2011:

Student accounts receivable	$ 11,543,681.64
Grants receivable	75,270,585.90
Notes receivable	2,955,447.64
Pledges receivable	54,887,263.40
State capital outlay and maintenance receivable	16,782,508.78
TSSBA debt proceeds receivable	949,587.92
Due from component units	1,620,334.37
Other receivables	41,382,692.20
Subtotal	205,392,101.85
Less allowance for doubtful accounts	(20,869,964.68)
Total	$184,522,137.17

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of $10,977,452.68.

Federal Perkins Loan Program funds included the following at June 30, 2011:

Perkins Loans receivable	$29,798,339.77
Less allowance for doubtful accounts	-
Total	$29,798,339.77

NOTE 5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2011, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Land	$ 60,120,811.67	$ 4,199,095.96	$ -	$ -	$ 64,319,907.63
Land improvements & infrastructure	71,533,558.06	608,298.60	3,770,535.59	-	75,912,392.25
Buildings	1,787,039,023.03	40,757,462.52	60,259,670.96	-	1,888,056,156.51
Works of art/ historical treasures	527,510.24	2,965,940.53	-	-	3,493,450.77
Equipment	349,149,719.13	39,787,801.64	-	(14,780,804.78)	374,156,715.99
Software	28,522,578.31	2,943,786.86	-	(2,371,450.40)	29,094,914.77
Library holdings	121,628,350.68	17,018,978.78	-	(8,888,920.87)	129,758,408.59
Projects in progress	205,518,804.90	110,570,807.16	(64,030,206.55)	(119,374.70)	251,940,030.81
Total	2,624,040,356.02	218,852,172.05	-	(26,160,550.75)	2,816,731,977.32
Less accumulated depreciation:					
Land improvements & infrastructure	(46,278,418.02)	(2,801,837.36)	-	-	(49,080,255.38)
Buildings	(693,541,379.66)	(46,816,422.87)	-	-	(740,357,802.53)
Equipment	(203,273,422.43)	(34,656,310.78)	-	13,348,528.81	(224,581,204.40)
Software	(20,354,486.29)	(1,941,866.40)	-	2,371,450.40	(19,924,902.29)
Library holdings	(50,936,371.70)	(12,332,758.04)	-	8,888,920.87	(54,380,208.87)
Total accumulated depreciation	(1,014,384,078.10)	(98,549,195.45)	-	24,608,900.08	(1,088,324,373.47)
Capital assets, net	$1,609,656,277.92	$120,302,976.60	$ -	$(1,551,650.67)	$ 1,728,407,603.85

NOTE 6. OPERATING LEASES

The university has entered into various operating leases for buildings and equipment. It is expected that in the normal course of business, such leases will continue to be required. Net expenses for rentals under leases were $8,325,216.92 for the year ended June 30, 2011.

The following is a schedule of future minimum rental payments required under noncancelable operating leases that have initial or remaining lease terms of more than one year at June 30, 2011. Only one such lease is currently in effect. Annual payments on this particular lease fluctuate in direct proportion to changes in the Consumer Price Index as required by contractual agreement. The schedule below is calculated based on the April 2011 Consumer Price Index (224.91).

Year Ending June 30	
2012	$13,924.00
Total minimum payments required	$13,924.00

NOTE 7. ACCOUNTS PAYABLE

Accounts payable included the following:

	June 30, 2011
Vendors payable	$67,735,337.03
Payroll deductions payable	20,951,454.56
Total	$88,686,791.59

NOTE 8. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2011, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term liabilities:					
Bonds	$382,029,749.85	$136,087,007.66	$ 22,369,911.56	$495,746,845.95	$ 27,703,501.00
Unamortized bond premium	-	8,196,732.11	409,836.60	7,786,895.51	-
Commercial paper	163,126,243.72	14,070,575.94	140,508,317.61	36,688,502.05	-
Total TSSBA indebtedness	545,155,993.57	158,354,315.71	163,288,065.77	540,222,243.51	27,703,501.00
Notes	12,027.59	-	12,027.59	-	-
Capital lease obligations	1,273,005.35	-	622,544.60	650,460.75	650,460.75
Net OPEB obligation	55,258,636.30	24,105,000.00	12,802,330.26	66,561,306.04	-
Compensated absences	75,499,906.90	43,956,213.52	43,443,501.98	76,012,618.44	43,443,501.98
Total long-term liabilities	677,199,569.71	226,415,529.23	220,168,470.20	683,446,628.74	$ 71,797,463.73
Other noncurrent liabilities:					
Deferred revenue	15,500,438.71	-	-	15,500,438.71	
Due to grantors	36,066,487.07	835,494.00	700,967.67	36,201,013.40	
Annuities payable	5,784,480.00	936,319.14	1,213,584.49	5,507,214.65	
Totals	$734,550,975.49	$228,187,342.37	$222,083,022.36	$740,655,295.50	

TSSBA Debt – Bonds

Bonds, with interest rates ranging from 1.3% to 7.15%, were issued by the Tennessee State School Bond Authority (TSSBA). The bonds are due serially to 2040 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 10 for further details.) The bonded indebtedness with the Tennessee State School Bond Authority included in long-term liabilities on the statement of net assets is shown net of assets held by the authority in the debt service reserve and unexpended debt proceeds. The total bonded indebtedness at June 30, 2011, was $523,670,798.23. The debt service reserve amount at June 30, 2011, was $21,373,942.45, and unspent debt proceeds were $6,550,009.83.

The university's debt service requirements to maturity for all bonds payable at June 30, 2011, are as follows:

Year Ending June 30	Principal	Interest
2012	$ 27,703,501.00	$ 23,244,534.60
2013	27,537,355.73	22,296,418.92
2014	28,251,840.23	21,163,773.07
2015	24,317,636.89	20,014,141.86
2016	24,942,964.77	18,980,565.86
2017-2021	126,548,790.43	78,114,096.25
2022-2026	113,173,671.94	50,878,128.92
2027-2031	85,290,591.39	27,545,848.58
2032-2036	48,050,361.33	10,394,822.75
2037-2040	17,854,084.52	1,725,237.26
	$523,670,798.23	$274,357,568.07

TSSBA Debt - Commercial Paper

The Tennessee State School Bond Authority issues commercial paper to finance the costs of various capital projects during their construction phase. When projects are placed in service, long-term, fixed-rate debt is issued by TSSBA to finance the project over its useful payback period and the commercial paper is redeemed. The amount issued for projects at the university was $36,688,502.05 at June 30, 2011.

For the commercial paper program, the Tennessee State School Bond Authority maintains an interest rate reserve fund. The university contributes amounts to the reserve fund based on the amounts drawn. The principal of the reserve will be contributed to pay off notes or credited back to the university when the notes are converted to bonds. The interest earned on the reserve is used to pay interest due during the month.

More detailed information regarding the bonds and commercial paper can be found in the notes to the financial statements in the financial report for the Tennessee State School Bond Authority. That report is available on the state's website at www.comptroller1.state.tn.us/tssba/cafr.asp.

Capital Lease Obligations

The university leases certain items of equipment accounted for as capital leases. The capitalized cost of the assets under lease at June 30, 2011, was $3,126,282.87. Accumulated amortization of the leased assets at June 30, 2011, was $2,344,712.15.

Future minimum lease payments under capital leases at June 30, 2011, are as follows:

Year Ending June 30	
2012	$679,628.71
Total	679,628.71
Less: amount representing interest	(29,167.96)
Present value of minimum lease payments	$650,460.75

NOTE 9. UNRESTRICTED NET ASSETS

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

	June 30, 2011
Working capital	$ 28,005,121.33
Encumbrances	7,872,103.02
Auxiliaries	9,414,441.78
Quasi-endowments	13,529,273.54
Plant construction	28,718,730.20
Renewal and replacement of capital assets	338,897,897.43
Debt retirement	30,786,597.20
Undesignated	534,176.43
Total	$457,758,340.93

NOTE 10. PLEDGED REVENUES

The University of Tennessee has pledged certain revenues and fees, including state appropriations, to repay $495,746,845.95 in revenue bonds issued from September 1998 to September 2010. Proceeds from the bonds provided financing for construction and renovation projects. The bonds are payable through 2040. (See Note 8 for further details.) Annual principal and interest payments on the bonds are expected to require 3.83% of available revenues. The total principal and interest remaining to be paid on the bonds is $798,028,366.30. Principal and interest paid for the current year and total available revenues were $48,125,873.82 and $1,257,890,028.77, respectively.

NOTE 11. 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 http://www.state.tn.us/treasury/tcrs/index.html.

Funding Policy

Plan members are noncontributory. The university is required to contribute at an actuarially determined rate. The current rate is 14.91% 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, 2011, 2010, and 2009, were $43,343,861.11, $37,266,850.27, and $37,963,757.88, respectively. Contributions met the requirements for each year.

Federal Retirement Program

Plan Description

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

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

Funding Policy

Participating employees, with some exceptions, are required by federal statute to contribute 7.0% of covered salaries to the CSRS plan. The university is currently required to contribute 7.0%. Contributions to CSRS for the year ended June 30, 2011, were $655,375.40, which consisted of $339,588.48 from the university and $315,786.92 from the employees; contributions for the year ended June 30, 2010, were $795,846.34, which consisted of $411,178.79 from the university and $384,667.55 from the employees; and contributions for the year ended June 30, 2009, were $1,050,294.31, which consisted of $540,493.79 from the university and $509,800.52 from the employees.

Federal statute requires employees participating in FERS to contribute 0.8% of their salaries to the Basic Benefit Plan. The university is required to contribute 11.7%. 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 $1,050,369.80 for the year ended June 30, 2011, which consisted of $67,950.44 from employees and $982,419.36 from the university; $1,027,500.74 for the year ended June 30, 2010, which consisted of $68,500.09 from employees and $959,000.65 from the university; and $1,050,561.11 for the year ended June 30, 2009, which consisted of $70,037.34 from employees and $980,523.77 from the university. Contributions for the Thrift Savings Plan were $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; $994,264.00 for the year ended June 30, 2010, which consisted of $592,984.00 from employees and $401,280.00 from the university; and $1,065,023.00 for the year ended June 30, 2009, which consisted of $653,541.00 from employees and $411,482.00 from the university. Contributions met the requirements for each year.

Defined Contribution Plans

Optional Retirement Plans (ORP)

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.

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, 2011, were $41,479,557.03 and for the year ended June 30, 2010, were $40,627,517.44. 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 $26,209,414.76 for fiscal year 2011, and $28,923,540.87 for fiscal year 2010. 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 $3,907,605.09 in fiscal year 2011, and $3,765,844.24 in fiscal year 2010. 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 2011, the university provided a $50 monthly match from unrestricted funds for employees making a minimum monthly contribution of $50 to the Section 401(k) plan. During the year ended June 30, 2011, contributions totaling $18,503,853.21 were made by employees participating in the plan, with a related match of $5,508,820.48 made by the university. During the year ended June 30, 2010, contributions totaling $17,928,489.64 were made by employees participating in the plan, with a related match of $5,499,232.59 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 12. 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 8-27-101, *Tennessee Code Annotated.* Prior to reaching age 65, retirees may participate in the State Employee Group Plan. In previous fiscal years, prior to reaching the age of 65, all members had the option of choosing a preferred provider organization (PPO), point of service (POS), or health maintenance organization (HMO) plan for healthcare benefits. However, as of January 1, 2011, the insurance plan structure was changed and as a result, all members now have the option of choosing between the standard or partnership preferred provider organization 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 http://tennessee.gov/finance/act/cafr.html.

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 service. Retirees with 30 years of service are subsidized 80%; 25 years, 70%; and 20 years, 60%. Retirees in the Medicare Supplement Plan have flat-rate premium subsidies based on years of service. For 30 years of service, the subsidy is $50 per month; 25 years, $37.50; and 20 years, $25.

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

Annual required contribution (ARC)	$23,973,000.00
Interest on the net OPEB obligation	2,487,000.00
Adjustment to the ARC	(2,355,000.00)
Annual OPEB cost	24,105,000.00
Amount of contribution	(12,802,330.26)
Increase (decrease) in net OPEB obligation	11,302,669.74
Net OPEB obligation – beginning of year	55,258,636.30
Net OPEB obligation – end of year	$66,561,306.04

Year-end	Plan	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation at Year-end
June 30, 2009	State Employee Group Plan	$31,004,000.00	39.09%	$38,808,987.38
June 30, 2010	State Employee Group Plan	$26,523,000.00	37.98%	$55,258,636.30
June 30, 2011	State Employee Group Plan	$24,105,000.00	53.11%	$66,561,306.04

Funded Status and Funding Progress

The funded status of the university's portion of the State Employee Group Plan as of July 1, 2010, was as follows:

	State Employee Group Plan
Actuarial valuation date	July 1, 2010
Actuarial accrued liability (AAL)	$240,150,000.00
Actuarial value of plan assets	-
Unfunded actuarial accrued liability (UAAL)	$240,150,000.00
Actuarial value of assets as a percentage of the AAL	0%
Covered payroll (active plan members)	$628,383,463.00
UAAL as percentage of covered payroll	38.2%

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, 2010, actuarial valuation, the Projected Unit Credit actuarial cost method was used. The actuarial assumptions included a 4.5% investment rate of return (net of administrative expenses) and an annual healthcare cost trend rate of 10% in fiscal year 2011. The rate decreases to 9.5% in fiscal year 2012, and is then reduced by decrements of 0.5% per year to an ultimate rate of 5% in fiscal year 2021. All rates include a 3% inflation assumption. The unfunded actuarial accrued liability is being amortized as a level percentage of payroll on a closed basis over a 30-year period beginning with July 1, 2007.

NOTE 13. 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, 2011. The financial statements of the university include as expenditures the amounts expended in the current year to match the state appropriations. The university's statement of net assets does not include the amounts held in trust by the State Treasurer. At June 30, 2011, the amounts held in trust totaled $113,738,940.22 at fair value.

NOTE 14. 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 $4,632,313.18 at June 30, 2011. The university and Battelle each receive a 50% distribution of the ORNL management fee after shared expenses are deducted. The fee distribution for the year ended September 30, 2010, to the university was $3,507,313.18.

During the year ended June 30, 2011, the university had expenses of $23,322,148.20 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled $2,180,412.18 at June 30, 2011. 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 of $900,000 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 2011 fiscal year, the university remitted another $2,200,000.00 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 15. INSURANCE-RELATED ACTIVITIES

It is the policy of the state not to purchase commercial insurance for the risks of losses for general liability, automobile liability, professional malpractice, and workers' compensation. The state's management believes it is more economical to manage these risks internally and set aside assets for claim settlement in its internal service fund, the Risk Management Fund. The state purchases commercial insurance for real property, flood, earthquake, and builder's risk losses and surety bond coverage on the state's officials and employees. The amounts of settlements have not exceeded insurance coverage for each of the past three fiscal years. The Risk Management Fund is also responsible for claims for damages to state-owned property up to the amount of the property insurance aggregate deductible amount. The insurance policy deductibles vary from $25,000 per occurrence, depending on the type of coverage, to an aggregate of $5 million.

The university participates in the Risk Management Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on a percentage of the university's expected loss costs, which include both experience and exposures. This charge considers recent trends in actual claims experience of the state as a whole. An actuarial valuation is performed as of fiscal year-end to determine the fund liability and premium allocation. Information regarding the determination of the claims liabilities and the changes in the balances of the claims liabilities for the years ended June 30, 2011, and June 30, 2010, are presented in the *Tennessee Comprehensive Annual Financial Report*. The CAFR is available on the state's website at http://tennessee.gov/finance/act/cafr.html. 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. Information regarding the cash and cash equivalents designated for payments of claims at June 30, 2011, is presented in the *Tennessee Comprehensive Annual Financial Report,* which is available at http://tennessee.gov/finance/act/cafr.html.

At June 30, 2011, the scheduled coverage for the university was $4,371,025,600 for buildings and $1,139,921,000 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 seven university-owned aircraft. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

The state has also set aside assets in the Employee Group Insurance Fund, an internal service fund, to provide a program of health insurance coverage for the employees of the state with the risk retained by the state. The university participates in the Employee

Group Insurance Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on estimates of the ultimate cost of claims, 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 16. 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, 2011, were $144,331,680.65.

Sick Leave

The university records the cost of sick leave when paid. Generally, since sick leave (earned one day per month with unlimited accumulation) is paid only when an employee dies or is absent due to illness or injury, there is no liability for sick leave at June 30, 2011. The amount of unused sick leave was $262,494,416.18 at June 30, 2011.

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 $2,909,713.19 as of June 30, 2011, 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 17. LEASE AND TRANSFER OF UT MEMORIAL RESEARCH CENTER AND HOSPITAL

On July 29, 1999, the university transferred ownership and control of its hospital located in Knoxville to University Health Systems, Inc., (UHS), an independent, private, not-for-profit organization operating under its own *Internal Revenue Code*, Section 501(c)(3) designation. The lease and transfer of the hospital from the university to UHS was accomplished through three main agreements: the Lease and Transfer Agreement, the Employee Services Agreement, and the Affiliation Agreement. Each of these agreements is summarized below.

Lease and Transfer Agreement

Pursuant to the enabling legislation, *Tennessee Code Annotated*, Section 49-9-112 and Section 49-9-1301 et seq., UHS leased from the university the real property of the existing hospital and the Graduate School of Medicine. (See also Note 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 $66,750,026.92 in 2011, are reported as operating expenses in the statement of revenues, expenses, and changes in net assets. An equal amount of operating revenue is reported in the 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.

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 17. This lease is classified as a direct financing lease. The guaranteed lease payment of $50 million will be paid by UHS in annual payments through 2019. The amount of the annual payments will equal the lesser of (1) 20% of the hospital's net operating profit for the applicable calendar year; or (2) $3 million or the greater amount resulting from the application of an index, as specified in the agreement. The payment of $50 million is guaranteed by December 31, 2019. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease. An annual lease payment to the university during the year ended June 30, 2011, totaled $1,791,627.00.

The university recorded a lease payment receivable in the amount of $33,075,076.99 at June 30, 2011, which represents the net present value of the guaranteed $50 million discounted at 5.75%. The minimum lease payments to be received amount has been adjusted upward to reflect a contractually required adjustment to the final required lease payment.

	June 30, 2011
Total minimum lease payments to be received	$52,369,624.54
Less: unearned income	(19,294,547.55)
Net investment in direct financing lease	$33,075,076.99

Capital Lease of Real Property to Memphis Mental Health Institute

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

The university recorded a lease payment receivable in the amount of $14,832,691.03 at June 30, 2011:

Total minimum lease payments to be received	$20,799,624.26
Less: unearned income	(5,966,933.23)
Net investment in direct financing lease	$14,832,691.03

Year Ending June 30	Minimum Lease Payments to Be Received	Interest	Principal
2012	$ 1,354,253.50	$ 663,956.08	$ 690,297.42
2013	1,355,690.26	633,056.29	722,633.97
2014	1,357,185.02	600,709.01	756,476.01
2015	1,358,740.88	566,846.85	791,894.03
2016	1,360,362.08	531,399.28	828,962.80

2017-2021	6,828,629.12	2,064,423.96	4,764,205.16
2022-2026	6,881,081.70	893,600.98	5,987,480.72
2027	303,681.70	12,940.78	290,740.92
	$20,799,624.26	$5,966,933.23	$14,832,691.03

NOTE 19. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATIONS

The university's operating expenses by functional classification for the year ended June 30, 2011, are as follows:

Functional Classification	Natural Classification Salaries	Benefits	Utilities, Supplies, and Other Services	Scholarships	Depreciation	Total
Instruction	$373,984,386.82	$112,177,018.79	$ 64,834,441.61	$ -	$ -	$ 550,995,847.22
Research	131,434,539.87	35,725,973.52	81,925,140.22	-	-	249,085,653.61
Public service	68,496,351.79	25,376,421.44	62,189,480.83	-	-	156,062,254.06
Academic support	67,118,340.47	24,523,317.97	26,907,464.86	-	-	118,549,123.30
Student services	40,085,810.32	14,584,438.32	21,820,178.55	-	-	76,490,427.19
Institutional support	71,850,982.74	27,858,165.12	4,655,395.76	-	-	104,364,543.62
Operation & maintenance of plant	33,332,483.50	16,484,990.54	79,733,303.36	-	-	129,550,777.40
Scholarships & fellowships	3,435,395.24	26,059,683.11	20,243,146.82	51,541,662.44	-	101,279,887.61
Auxiliary	43,173,201.49	12,919,455.29	73,969,098.43	-	-	130,061,755.21
Independent operations	48,068,463.61	19,230,344.21	-	-	-	67,298,807.82
Depreciation	-	-	-	-	98,549,195.45	98,549,195.45
Total expenses	$880,979,955.85	$314,939,808.31	$436,277,650.44	$51,541,662.44	$98,549,195.45	$1,782,288,272.49

NOTE 20. ON-BEHALF PAYMENTS

During the year ended June 30, 2011, the State of Tennessee made payments of $882,780.00 on behalf of the university for retirees participating in the Medicare Supplement Plan. The Medicare Supplement Plan is a postemployment benefit healthcare plan and is discussed further in Note 12. The plan is reported in the *Tennessee Comprehensive Annual Financial Report*. That report is available on the state's website at http://tennessee.gov/finance/act/cafr.html.

NOTE 21. VOLUNTARY RETIREMENT INCENTIVE PROGRAM

The University of Tennessee's Institute of Agriculture (UTIA) offered the UTIA Voluntary Retirement Incentive Program for staff in fiscal year 2011 as a strategy to assist the university in addressing budgetary constraints due to state appropriation reversions and potential budget reductions in the forthcoming fiscal year. Twenty-five approved staff participated in the program. Severance pay was paid the month following the employee's separation date.

The incentive pay offered was four months' base salary, paid in a lump sum after the effective retirement date. Participants had the option to request a temporary part-time, post-retirement appointment pursuant to *Tennessee Code Annotated,* Section 8-36-805.

For the fiscal year ended June 30, 2011, expenses for the program and other retirement incentive lump sum payments were $1,417,501.14.

NOTE 22. 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, 2011, the foundation expended $5,767,282.00 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 supporting 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 transactions during the one-month period between fiscal year ends is not significant. At June 30, 2011, the foundation's statement of net assets reflects $485,519 of LLC deposits held at the university which were not actually transferred to the university until July 2011.

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 1,649 bedrooms in 451 units and 666 parking spaces.

Investments

A summary of foundation investments at June 30, 2011, is as follows:

Equity securities (cost of $14,532,742)	$16,882,172
Mutual funds (cost of $41,130,271)	45,152,591
Real estate	1,800,700
Limited partnerships	29,761,154
Other	9,998
Total	$93,606,615

The foundation also has investments, restricted by the terms of the revenue bonds described below, totaling $6,593,678.

Property and Equipment

A summary of foundation property and equipment at June 30, 2011, is as follows:

Land	$ 8,241,032
Buildings	74,915,812
Furniture, fixtures, and equipment	4,924,273
	88,081,117
Accumulated depreciation	(26,501,798)
Total	$61,579,319

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, 2011, consist of the following:

Series 2005A revenue refunding bonds, interest rates fixed at 5.0% to 5.125% payable semi-annually, annual redemption payments due through October 1, 2035	$63,610,000

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	20,270,000
	83,880,000
Less: unamortized discount	(1,791,054)
Total	$82,088,946

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

Year Ending June 30	
2012	$ 1,715,000
2013	1,800,000
2014	1,895,000
2015	1,990,000
2016	2,090,000
Thereafter	74,390,000
Total	$83,880,000

Restricted Cash and Cash Equivalents

The revenue bonds described above restrict the use of certain cash and cash equivalents at June 30, 2011, as follows:

Renewal and replacement reserves	$ 315,326
Restricted for debt service payments	3,130,765
Surplus	936,259
Total	$4,382,350

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 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new 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.

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

	Balance as of June 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets:				
Equity securities	$16,882,172	$16,882,172	$ -	$ -
Mutual funds	45,152,591	35,016,020	10,136,571	-
Guaranteed investment contracts	5,011,430	-	5,011,430	-
Money market accounts	1,582,248	1,582,248	-	-
Real estate	1,800,700	-	1,800,700	-
Limited partnerships	29,761,154	-	-	29,761,154
Other	9,998	9,998	-	-
Total assets	100,200,293	53,490,438	16,948,701	29,761,154
Liabilities:				
Deposits received for the benefit of University of Tennessee at Chattanooga	2,153,743	-	2,153,743	-
Total liabilities	$ 2,153,743	$ -	$ 2,153,743	$ -

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.

	Limited Partnerships
Beginning balance	$29,659,592
Total realized and unrealized gains and losses included in earnings	3,047,713
Purchases, issuances, and settlements	(2,946,151)
Ending balance	$29,761,154

Endowments

The foundation's endowment consists of approximately 280 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 have 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, 2011. Due to GASB reformatting, temporarily restricted net assets are reported as expendable restricted net assets, and permanently restricted net assets are reported as nonexpendable restricted net assets on the statement of net assets.

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	$ (141,276)	$1,391,878	$43,634,201	$44,884,803
Board-designated funds	54,285,300	-	-	54,285,300
	$54,144,024	$1,391,878	$43,634,201	$99,170,103

Changes in endowment net assets for the fiscal year ended June 30, 2011:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$45,530,294	$1,285,017	$37,403,233	$84,218,544

Investment income (loss)	4,383,414	524,529	3,812,357	8,720,300
Net appreciation	3,432,106	-	3,831,988	7,264,094
Contributions	3,035,217	-	221,366	3,256,583
Appropriations	(2,695,239)	(1,764,109)	-	(4,459,348)
Transfers	458,232	1,346,441	(1,634,743)	169,930
Endowment net assets, end of year	$54,144,024	$1,391,878	$43,634,201	$99,170,103

Descriptions of endowment amounts classified as permanently restricted net assets and temporarily restricted net assets:

Permanently restricted net assets:

The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by UPMIFA	$43,634,201
Total endowment funds classified as permanently restricted net assets	$43,634,201

Temporarily restricted net assets:

The portion of perpetual endowment funds subject to a time restriction under UPMIFA	$ 1,391,878
Total endowment funds classified as temporarily restricted net assets	$ 1,391,878

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 $141,276 as of June 30, 2011. 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 a donor-specified period(s) 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 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 percent 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 percent 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 executed a management agreement which became effective January 1, 2009. This agreement allowed the university to assume management responsibilities related to the student housing. 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.

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.

During the year ended June 30, 2010, CDFI settled a 2005 lawsuit related to the construction of student housing at the university. This litigation was settled with total payments to the plaintiff of $2,976,630, which included $107,000 paid from the LLC's cash balances. The remainder of the settlement was contributed to CDFI by the foundation. During the 2011 fiscal year, CDFI's board committed to reimburse the foundation for contributions of $2,975,000 and related legal fees of $497,037.

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2011, are as follows:

	Natural Classification			
Functional Classification	Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Depreciation	Total
Academic programs	$ -	$1,006,937	$ -	$ 1,006,937
Professorships	-	548,891	-	548,891
Faculty development	-	125,515	-	125,515
Scholarships	-	1,987,232	-	1,987,232
Chancellor's discretionary	-	255,424	-	255,424
Other	-	1,843,283	-	1,843,283
Rental expenses	3,215,928	-	-	3,215,928
Administrative and investment fees	270,175	-	-	270,175
Legal	85,323	-	-	85,323
Tax, bad debt, and audit	27,048	-	-	27,048
Depreciation	-	-	3,206,007	3,206,007
Total expenses	$3,598,474	$5,767,282	$3,206,007	$12,571,763

NOTE 23. 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, 2011, the foundation expended $13,768,772.09 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.

Pledges Receivable

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

	Temporarily Restricted	Permanently Restricted
Current pledges	$ 2,466,759.29	$ 829,806.98
Pledges due in one to five years	19,412,815.55	18,829,431.13
Pledges due after five years	7,000,457.96	6,831,609.09
	28,880,032.80	26,490,847.20
Less discounts to net present value	(1,529,808.85)	(1,491,124.93)
Total pledges receivable, net	$27,350,223.95	$24,999,722.27

The allowance for doubtful accounts at June 30, 2011, was $258,263.05.

Investments and Assets Held by the University of Tennessee

Investments held at June 30, 2011, were as follows:

	Market Value	Cost Basis
Assets Held by the University of Tennessee		
Cash	$ 268,894.29	$ 268,894.29
U.S. equity	4,622,715.53	4,189,083.92
International equity	5,990,676.96	6,622,472.03
Fixed income	2,128,143.46	2,165,463.24
Certificates of deposit	3,750,000.00	3,750,000.00
Alternative investments:		
Private equity	5,446,922.24	6,124,446.99
Natural resources	3,896,908.80	3,716,275.35
Real estate	1,553,138.47	2,045,685.07
Other alternative investments	7,340,688.67	6,386,067.73
Total assets held by university	34,998,008.42	35,268,388.62
Gift Annuity		
Cash	63,024.61	63,024.61
Equities	1,252,018.35	1,137,937.46
Fixed income	586,020.18	535,124.19
Total gift annuity	1,901,063.14	1,736,086.26
Fidelity investments	440,732.38	437,672.37
Total	$37,339,883.94	$37,442,147.25

Also reported as investments on the statement of net assets are other gift assets totaling $7,126,640.62 and remainder interests of $18,073,544.53 as described herein.

At June 30, 2011, 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

Most foundation endowments are invested in the University of Tennessee Consolidated Investment Pool. The endowments are invested according to the policies of the university. Investment pool earnings for the foundation endowments are provided to the university to be used as stipulated in the endowment agreements. The book value and market value for the endowments invested were $31,520,571.24 and $31,250,271.04, which resulted in a cumulative unrealized loss of $270,300.20. One endowment with a market value of $440,732.38 is separately invested. All endowments at the foundation are donor restricted. Endowment pool earnings transferred to the university were $1,323,528.46 for fiscal year 2011.

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) the endowment is vested in the university's Consolidated Investment Pool. Other endowments that are not classified as permanently restricted are classified as temporarily restricted net assets. Below is a schedule of endowments by fund type. Due to the GASB reformatting, temporarily restricted net assets are reported as expendable restricted net assets, and permanently restricted net assets are reported as nonexpendable restricted net assets on the statement of net assets.

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Beginning balance	$(3,276,921.52)	$1,510,466.08	$22,995,350.86	$21,228,895.42
Contributions pooled	-	-	6,936,038.13	6,936,038.13
Investment earnings	-	-	1,407,744.63	1,407,744.63

Market value adjustment	3,009,681.33	-	-	3,009,681.33
Endowment held at Fidelity	-	-	437,672.37	437,672.37
Contributions not pooled	-	-	(5,500.00)	(5,500.00)
Disbursements	-	-	(1,323,528.46)	(1,323,528.46)
Transfer	-	(1,510,466.08)	1,510,466.08	-
Ending balance	$(267,240.19)	$ -	$31,958,243.61	$31,691,003.42

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 $267,240.19 at June 30, 2011. 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 were deemed prudent.

The foundation uses the university's spending policy. The university calculates its spending policy by taking 4.5% of a three-year market 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. Asset allocations (excluding separately invested assets) were as follows at June 30, 2011:

U.S. equity	14.8%
International equity	19.2%
Fixed income	6.8%
Private equity	17.4%
Natural resources	12.5%
Real estate	5.0%
Cash	.8%
Other alternative investments	23.5%

Fair Value Measures

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 establishes a framework for measuring fair value and a three-level hierarchy for fair value measurements based upon the inputs to value the assets and liabilities. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used for measurement are observable or unobservable. Observable inputs reflect market-derived or market-based information obtained from independent sources while unobservable inputs reflect estimates about market data based on the best available information in the circumstances. 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 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:

	Level 1	Level 2	Level 3	Total
Investments	$16,388,062.12	$2,714,163.64	$18,237,658.18	$37,339,883.94

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	$11,745,148.64
Total realized and unrealized gains and losses included in earnings	2,890,083.90
Purchases, issuances, and settlements	3,602,425.63
Ending balance	$18,237,658.17

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 rate. The balance of the note payable at June 30, 2011, was $183,776.75. Future maturities of this note are as follows:

Year ending June 30:	
2012	$ 15,733.89
2013	16,486.24
2014	17,274.56
2015	18,100.56
2016	18,966.10
2017-2021	97,215.40
Total	$ 183,776.75

Concentration of Credit Risk

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

Remainder Interest

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

In December 2002, a donor conveyed to the foundation a remainder interest in a limited liability company. The asset of the limited liability company is a fee simple interest in a warehouse in South Carolina. The remainder interest was appraised at $7,740,000.00 with the interest vesting on January 1, 2021. The value on the foundation's statement of financial position will be the present value calculation until the vesting date. The IRS discount rate for December 2002 used in determining the present value was 4%. The present value of the remainder interest at June 30, 2011, was $5,332,418.63.

In September 2003, a donor conveyed to the foundation another remainder interest in a limited liability company. The asset of this limited liability company is an office building in Connecticut. The remainder interest was appraised at $22,440,000.00 with the interest vesting on January 1, 2025. The value on the foundation's statement of financial position will be the present value calculation until the vesting date. The IRS discount rate for September 2003 was 4.20%. The present value at June 30, 2011, was $12,741,125.90.

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2011, are as follows:

	Natural Classification		
Functional Classification	Utilities, Supplies, and Other Services	Payments to or on Behalf of UT	Total
Program expenses	$ 799,047.16	$13,634,607.59	$14,433,654.75
General and administrative	230,303.06	134,164.50	364,467.56
Total expenses	$1,029,350.22	$13,768,772.09	$14,798,122.31

NOTE 24. 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 the foundation's administrative budget, the foundation is considered fiscally dependent on the university. 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.

Genera Energy, LLC (the subsidiary), a wholly owned subsidiary of the University of Tennessee Research Foundation, was formed on February 28, 2008. The subsidiary includes, in turn, four wholly owned subsidiaries and one subsidiary in which Genera owns 51%. The subsidiary is in the business of developing 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. The State of Tennessee has provided $40.7 million toward the construction of the pilot-scale biorefinery and related switchgrass utilization and demonstration facilities.

During the fiscal year ended June 30, 2010, the subsidiary (Genera Energy, LLC) changed its name to Genera Biofuels, LLC, and elected to be treated as a member-managed LLC. The member (UTRF) established a new director-managed LLC, Genera Energy, LLC, and contributed its equity of Genera Biofuels, LLC, to Genera Energy, LLC. As a result, Genera Biofuels, LLC, became a wholly owned subsidiary of Genera Energy, LLC. Genera Energy, LLC, formed three additional wholly owned subsidiaries, which are member-managed LLCs: Genera Solar Solutions, LLC; Genera Biomass, LLC; and Genera Capital, LLC.

Principles of Consolidation

The foundation has entered into related agreements with the university and Genera 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 consolidated financial statements include the accounts of the foundation, Genera, and its consolidated subsidiaries named above. All significant intercompany balances and transactions have been eliminated in consolidation.

Property and Equipment

Property and equipment consist of the following major classifications at June 30, 2011:

Research Foundation	
Office furniture and equipment	$ 164,467
Less accumulated depreciation	(74,971)
	89,496
Genera	
Land	182,549
Buildings	37,900,469
Leasehold improvements	61,314
Machinery and equipment	20,754,566
Furniture and fixtures	146,227
Vehicles	141,427
Construction in progress	4,776,066
	63,962,618

Less accumulated depreciation	(3,452,231)
	60,510,387
Total	$60,599,883

Depreciation expense for the foundation and its subsidiary totaled $3,000,448 for the year ended June 30, 2011. Intangible assets totaling $6,596 are also reported as capital assets on the statement of net assets.

Notes Payable

The foundation had an outstanding note payable to the university of $654,922 at June 30, 2011.

Deferred Revenue

During the years ended June 30, 2011, and June 30, 2010, the foundation capitalized $584,629 and $19,309,711 of costs related to the construction of a pilot-scale biorefinery, which were incurred by DDCE. Based on an agreement with DDCE, these and future unreimbursed costs incurred by DDCE on this project were capitalized in exchange for DDCE's future use of a portion of the biorefinery facility. An amount equal to DDCE's total construction cost was recorded as deferred revenue through completion of the biorefinery. The total amount of deferred revenue is expected to be recognized over the life of a proposed lease between the subsidiary and DDCE. As of June 30, 2011, the proposed lease was to be for ten years with three possible five-year extensions. Accordingly, deferred revenue is amortized to revenue over the 25 years beginning January 28, 2010, the date when DDCE first occupied its portion of the facility. Revenue of $901,084 was recognized in fiscal year 2011.

Fair Value Measurements

The foundation reports under FASB Accounting Standards Codification (ASC) Topic 820 which defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A valuation hierarchy has been established for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on management's assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

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

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, 2011.

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, 2011.

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 different fair value measurement at the reporting date.

At June 30, 2011, 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, 2011:

Assets at Fair Value	Level 1	Level 2	Level 3	Total
Registered investment companies	$ 7,516	$ -	$ -	$ 7,516
Marketable equity securities	106,142	-	-	106,142
Total	$113,658	$ -	$ -	$113,658

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.

Natural Classifications With Functional Classifications

The foundation's operating expenses by functional classification for the year ended June 30, 2011, are as follows:

	Natural Classification			
Functional Classification	Salary and Benefits	Utilities, Supplies, and Other Services	Depreciation	Total
Research support	$1,274,256	$ 3,924,435	$ -	$ 5,198,691
Research	1,105,467	2,357,738	-	3,463,205
Public service	893,175	26,001,476	-	26,894,651
Depreciation	-	-	3,000,448	3,000,448
Total expenses	$3,272,898	$32,283,649	$3,000,448	$38,556,995

NOTE 25. SUBSEQUENT EVENTS

The University of Tennessee Foundation, Inc., is a not-for-profit component unit created in 2001 to support the University of Tennessee'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 23.)

Over the past decade, the foundation has been very passive in fundraising efforts. In 2009, the University of Tennessee Board of Trustees appointed a Foundation Study

Committee to research the structure and impact of foundations at peer institutions. During that process, the committee learned that most of the university's peer and aspirational institutions operate their development function as part of a foundation and have nearly double the number of development staff as does the University of Tennessee. This structure has allowed peer institutions to secure considerably more in private donations, thereby providing additional resources especially needed to offset state funding reductions. This fundraising structure has enabled these institutions to grow and excel academically despite tough economic conditions.

In October 2010, the Foundation Study Committee presented its findings to the University of Tennessee Board of Trustees, which approved the UT Foundation plan, its new affiliation agreement, and a projected foundation budget pending legislative approval.

In April 2011, the Tennessee General Assembly passed legislation that would allow for the expansion of the UT Foundation.

On July 1, 2011, the university and the foundation signed an Affiliation and Services Agreement and an Employee Services Agreement. The agreements move the Development and Alumni Affairs function from the university to the foundation. All gifts unless directed by the donor will be deposited into the foundation bank account. The foundation will create new restricted gift accounts for funds received after July 1. For fiscal year 2012, the university will pay the foundation direct support and a 100 basis point endowment assessment fee as compensation for performing the fundraising function. The direct support amount will 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, shall coordinate with the university on the fundraising goals and objectives of the foundation. All current Development and Alumni Affairs employees will be leased from the university to the foundation beginning July 1, 2011.

For fiscal year 2012, direct support is expected to be $17,749,068.00.

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, 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%
July 1, 2007	State Employee Group Plan	$ -	$294,669,000.00	$294,669,000.00	0%	$616,687,517.00	47.8%

An additional year will be reported as the data becomes available. The amount reported here for covered payroll relates to the fiscal year in which the valuations were performed.