The University of Tennessee is one of the nation’s oldest institutions of higher education, in operation since 1794. Two years before Tennessee achieved statehood in 1796, the legislature of the Southwest Territory—which later became Tennessee—granted a charter to Blount College, named in honor of the territorial governor, William Blount. Located in Knoxville near today's downtown area, Blount College was nonsectarian, which was unusual for an institution of higher education at that time. The university has remained nondenominational and is believed to be the oldest such institution west of the Appalachian Divide. Blount College was all male, typical for colleges of the late 18th century, a restriction that remained in force for almost a century until the first women students were admitted in 1892.

In 1807 the state legislature changed the name of Blount College to East Tennessee College, and in 1826 the 40-acre tract known as “the Hill” became part of its campus. The name of the school changed again in 1840 to East Tennessee University. But 21 years later, the Civil War forced the university to close, and its buildings were used as a hospital for Confederate troops, then later occupied by Union soldiers.

When the war ended, East Tennessee University reopened, and in 1869 the state legislature selected the university as the state’s federal land-grant institution under the Morrill Act of 1862. To comply with the terms of the act, ETU broadened its offerings to include agricultural, engineering, and military-science courses.

Ten years later, East Tennessee University was chosen by the legislature to be the state university of Tennessee, and its name was changed to the University of Tennessee. The university pledged itself to the service and interest of the entire state, and the state pledged its name and reputation to the university, promising the institution a vital role in the progress of the state.

Today, the university serves the people of Tennessee from locations across the state. The medical campus, founded in Nashville and acquired by the university in 1879, was moved to Memphis in 1911. The Martin campus, established in 1900 as a private institution, became part of the University of Tennessee in 1927. In 1969 the private University of Chattanooga merged with the public university to become its fourth primary campus. The University of Tennessee Space Institute, a graduate education and research center near Tullahoma, was established in 1964.

Three statewide units of the university—the Institute of Agriculture, the Institute for Public Service, and the Division of Continuing Education—extend the university beyond its various campuses to serve the entire state.

The administration of the university is headquartered in Knoxville, where the offices of the president and the central staff are located. Resident chancellors are the chief administrators of the Chattanooga and Martin campuses.

Traditionally, Tennessee’s governors and members of the state legislature have shown active interest in the development of the University of Tennessee by providing the support it needs to meet the increasing educational, research, and service needs of the people of Tennessee. As a result, many university programs have earned both national and global recognition.
Letter from the Treasurer

The financial statements on the following pages have been prepared in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. The management of the University of Tennessee is responsible for the integrity and objectivity of these financial statements.

Management believes that the university’s highly developed system of internal accounting controls provides reasonable assurance that assets are protected and that transactions and events are properly recorded. Establishing sound fiscal policies and procedures and communicating them clearly, carefully selecting qualified financial staff, and implementing an extensive program of internal audits and management reviews ensure that the system of internal controls is maintained.

The financial statements herein have been audited by the State of Tennessee, Comptroller of the Treasury, Division of State Audit. The auditor’s opinion is based on audit procedures described in their letter on page 3, which include understanding university systems, procedures, and internal controls and performing tests and other auditing procedures sufficient to provide reasonable assurance that the financial statements are not materially misleading nor do they contain material errors.

The statements contained in this report describe the university’s overall financial condition and the financial performance for the year ended June 30, 2004. A separate publication, “Report of the Treasurer 2004 Supplemental Schedules and Appendices,” contains detailed supporting schedules and appendices and is available for those who wish to make a more extensive analysis of university operations. The supporting schedules and appendices are designed to enable analysis of important items summarized or consolidated in the financial statements of this report.

Respectfully submitted,

Charles M. Peccolo
Vice President and Treasurer
The Honorable John G. Morgan  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243  

Dear Mr. Morgan:  

We have audited the accompanying basic financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, and its aggregate discretely presented component units as of and for the year ended June 30, 2004, 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., which represent 71% and 48%, respectively, of the assets and revenues of the aggregate discretely presented component units of the university. We also did not audit the financial statements of the University of Tennessee Foundation, Inc., which represent 29% and 52%, respectively, of the assets and revenues of the aggregate discretely presented component units of the university. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., is based on the reports of the other auditors.  

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., were not audited in compliance with Government Auditing Standards. 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 the management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of the other auditors provide a reasonable basis for our opinions.  

Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the board of directors of many agencies, commissions, and component units of the State of Tennessee; managing the state's debt; and making loan to the state's colleges and universities from debt proceeds. Some of the boards on which the Comptroller of the Treasury serves as a member per state statutes include State building Commission and Tennessee Higher Education Commission.  

In our opinion, based on our audit and the reports of 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 aggregate discretely presented component units as of June 30, 2004, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.  

During the year ended June 30, 2004, the university implemented GASB Statement 39, Determining Whether Certain Organizations are Component Units. The management’s discussion and analysis is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.  

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the University of Tennessee's basic financial statements. The schedules and charts presented outside of the basic financial statements are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.  

In accordance with Government Auditing Standards, we have also issued our report dated November 12, 2004, 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 Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.  

Sincerely,  

Arthur A. Hayes, Jr., CPA  
Director  
AAH/sds
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, 2004, with comparative information presented for the fiscal year ended June 30, 2003. This discussion has been prepared by management along with the financial statements and related note disclosures and should be read in conjunction with them. The financial statements, notes, and this discussion are the responsibility of management.

The university has two discretely presented component units, the University of Chattanooga Foundation and the University of Tennessee Foundation. More detailed information about the university’s component units is presented in Notes 19 and 20 of the financial statements. Information and analysis regarding the component units is also included in this section.

Using This Annual Report

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

The Statement of Net Assets

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

Net assets are divided into three major categories. The first category, invested in capital assets, net of related debt, provides the university’s equity in property, plant, and equipment owned by the university. The next asset category is restricted net assets, which is divided into two categories, nonexpendable and expendable. The corpus of nonexpendable restricted resources is only available for investment purposes. Expendable restricted net assets are available for expenditure by the university but must be spent for purposes as determined by donors and/or external entities that have placed time or purpose restrictions on the use of the assets. The final category is unrestricted net assets. Unrestricted net assets are available to the university for any lawful purpose of the institution. See Table 1 below.

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

Table 1. Statements of Net Assets (in thousands of dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>$320,301</td>
<td>$311,931</td>
<td>$11,668</td>
<td>$12,858</td>
<td>$12,596</td>
<td>$43,772</td>
</tr>
<tr>
<td>Capital assets, net</td>
<td>960,103</td>
<td>943,877</td>
<td>75,730</td>
<td>59,752</td>
<td>48,296</td>
<td>14,915</td>
</tr>
<tr>
<td>Other assets</td>
<td>881,699</td>
<td>828,919</td>
<td>117,068</td>
<td>132,470</td>
<td>21,626</td>
<td>9,148</td>
</tr>
<tr>
<td>Total Assets</td>
<td>2,162,103</td>
<td>2,084,727</td>
<td>204,466</td>
<td>205,080</td>
<td>82,518</td>
<td>67,835</td>
</tr>
<tr>
<td>Liabilities:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>238,258</td>
<td>233,459</td>
<td>11,668</td>
<td>12,859</td>
<td>5,171</td>
<td>1,415</td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td>298,596</td>
<td>289,881</td>
<td>86,222</td>
<td>87,864</td>
<td>58,593</td>
<td>60,629</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>536,854</td>
<td>523,340</td>
<td>97,890</td>
<td>100,723</td>
<td>63,764</td>
<td>62,044</td>
</tr>
<tr>
<td>Net Assets:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested in capital assets, net of related debt</td>
<td>730,786</td>
<td>730,451</td>
<td>6,786</td>
<td>7,442</td>
<td>15,494</td>
<td>4,334</td>
</tr>
<tr>
<td>Restricted-expendable</td>
<td>356,646</td>
<td>298,644</td>
<td>39,609</td>
<td>36,397</td>
<td>2,755</td>
<td>1,196</td>
</tr>
<tr>
<td>Restricted-nonexpendable</td>
<td>323,475</td>
<td>316,191</td>
<td>60,181</td>
<td>60,518</td>
<td>505</td>
<td>261</td>
</tr>
<tr>
<td>Unrestricted</td>
<td>214,342</td>
<td>216,101</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Net Assets</td>
<td>$1,625,249</td>
<td>$1,561,387</td>
<td>$106,576</td>
<td>$104,357</td>
<td>$18,754</td>
<td>$5,791</td>
</tr>
</tbody>
</table>
Material liabilities include long-term bonded debt, compensated absences, accounts payable, accrued liabilities, and deferred revenue. The current portion of compensated absences increased, shifting the liability from noncurrent to current.

Many of the university’s unrestricted net assets have been designated or reserved for specific purposes such as repairs and replacement of capital assets, future debt service, quasi-endowments, and capital projects. The following graph shows the allocations. See Graph A Unrestricted Net Assets bar graph page 6).

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 generally accepted accounting principles.

The increase in tuition and fees is primarily due to a 9% increase in fees for the 2004 academic year. Operating grants and contracts increased by $25 million due to a general increase in federal, state, and private grants and contracts. The largest increases were in grants from the Department of Health and Human Services and the Department of Energy. Other operating income decreased due to the transfer of the Bowld Hospital operations to Methodist Healthcare – Memphis Hospitals.

In fiscal year 2004, state appropriations decreased $3 million. Nonoperating gifts decreased $27 million. The gain on investments was due to an increase of endowment income and a significant reversal of the previous year’s capital market decline.

The decrease in capital grants and gifts for 2004 consisted of the donation of several buildings at the Memphis campus recognized last year. Additions to permanent endowments increased due to higher levels of new gifts to endowments for the 2004 fiscal year.

Total operating expenses increased approximately $25 million in fiscal year 2004 primarily due to increased salaries and wages, staff benefits, and depreciation expense. The university intentionally attempted to bring faculty and staff salaries to a more competitive level. In addition to the staff benefits related to salary increases, health insurance premiums increased 10 percent in fiscal year 2004.

| Table 2. Statements of Revenues, Expenses, and Changes in Net Assets (in thousands of dollars) |
|-----------------------------------------------|-----------------|-----------------|-----------------|-----------------|
| Net tuition and fees                         | $208,018       | $192,977       | $ -              | $ -              | $ -              | $ -              |
| Grants and contracts                         | 382,438        | 356,451        | -                | -                | -                | -                |
| Auxiliary                                    | 123,314        | 123,724        | -                | -                | -                | -                |
| Other                                        | 73,182         | 81,214         | 8,910            | 5,410            | 12,103           | 6,768            |
| Total operating revenues                     | 786,952        | 754,366        | 8,910            | 5,410            | 12,103           | 6,768            |
| Operating expenses                           | 1,340,677      | 1,315,836      | 8,647            | 8,699            | 1,735            | 1,609            |
| Operating loss                               | (553,725)      | (561,470)      | 263              | (3,289)          | 10,368           | 5,159            |
| Nonoperating revenues and expenses:          |                |                |                  |                  |                  |                  |
| State appropriations                         | 420,368        | 423,816        | -                | -                | -                | -                |
| Gifts                                        | 40,486         | 67,281         | -                | -                | -                | -                |
| Investment income                            | 84,513         | 42,407         | 4,063            | 3,029            | 809              | 237              |
| Other revenues and expenses                  | 22,089         | 32,039         | (2,857)          | (2,787)          |                  |                  |
| Total nonoperating revenues and expenses      | 567,456        | 565,543        | 1,206            | 242              | 809              | 237              |
| Income (loss) before other revenues,         |                |                |                  |                  |                  |                  |
| expenses, gains, or losses                   | 13,731         | 4,073          | 1,469            | (3,047)          | 11,177           | 5,396            |
| Other revenues, expenses, gains, or losses   |                |                |                  |                  |                  |                  |
| Capital appropriations                       | 21,725         | 32,584         | -                | -                | -                | -                |
| Capital grants and gifts                     | 15,253         | 47,165         | -                | -                | -                | -                |
| Additions to permanent endowments            | 13,588         | 12,341         | 750              | 4,841            | 1,785            | -                |
| Other                                        | (435)          | (1,971)        | -                | -                | -                | -                |
| Total other revenues, gains, or losses       | 50,131         | 90,119         | 750              | 4,841            | 1,785            | -                |
| Increase (decrease) in net assets            | 63,862         | 94,192         | 2,219            | 1,794            | 12,962           | 5,396            |
| Net assets at beginning of period            | 1,561,387      | 1,467,195      | 104,357          | 102,563          | 5,791            | 395              |
| Net assets at end of year                    | $1,625,249     | $1,561,387     | $106,576         | $104,357         | $18,753          | $5,791           |
Table 3. Expenses Displaying Natural & Functional Classifications

<table>
<thead>
<tr>
<th>2004 Natural Classification</th>
<th>2004 Functional Classification</th>
<th>2003 Natural Classification</th>
<th>2003 Functional Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>SALARIES</td>
<td>BENEFITS</td>
<td>UTILITIES, SUPPLIES</td>
<td>SCHOLARSHIPS</td>
</tr>
<tr>
<td>$298,233</td>
<td>$76,013</td>
<td>$46,538</td>
<td>$420,784</td>
</tr>
<tr>
<td>Research</td>
<td>106,217</td>
<td>25,295</td>
<td>188,040</td>
</tr>
<tr>
<td>Public service</td>
<td>69,429</td>
<td>20,585</td>
<td>127,106</td>
</tr>
<tr>
<td>Academic support</td>
<td>53,776</td>
<td>16,132</td>
<td>83,584</td>
</tr>
<tr>
<td>Student services</td>
<td>28,300</td>
<td>8,323</td>
<td>57,098</td>
</tr>
<tr>
<td>Institutional support</td>
<td>55,736</td>
<td>16,108</td>
<td>73,616</td>
</tr>
<tr>
<td>Operation and maintenance of plant</td>
<td>26,453</td>
<td>9,706</td>
<td>44,606</td>
</tr>
<tr>
<td>Scholarships</td>
<td>2,872</td>
<td>14,855</td>
<td>43,774</td>
</tr>
<tr>
<td>Auxiliary</td>
<td>29,836</td>
<td>7,538</td>
<td>94,546</td>
</tr>
<tr>
<td>Hospital</td>
<td>1,885</td>
<td></td>
<td>107,311</td>
</tr>
<tr>
<td>Independent operations</td>
<td>77,543</td>
<td>29,768</td>
<td>$62,167</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$748,395</td>
<td>$224,323</td>
<td>$290,581</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$1,340,676</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2003 Natural Classification</th>
<th>2003 Functional Classification</th>
<th>2003 Natural Classification</th>
<th>2003 Functional Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>SALARIES</td>
<td>BENEFITS</td>
<td>UTILITIES, SUPPLIES</td>
<td>SCHOLARSHIPS</td>
</tr>
<tr>
<td>$289,078</td>
<td>$68,378</td>
<td>$51,741</td>
<td>$409,197</td>
</tr>
<tr>
<td>Research</td>
<td>101,628</td>
<td>27,803</td>
<td>185,819</td>
</tr>
<tr>
<td>Public service</td>
<td>67,284</td>
<td>22,443</td>
<td>123,614</td>
</tr>
<tr>
<td>Academic support</td>
<td>53,339</td>
<td>14,509</td>
<td>83,044</td>
</tr>
<tr>
<td>Student services</td>
<td>27,102</td>
<td>7,904</td>
<td>52,042</td>
</tr>
<tr>
<td>Institutional support</td>
<td>53,503</td>
<td>15,876</td>
<td>72,950</td>
</tr>
<tr>
<td>Operation and maintenance of plant</td>
<td>26,236</td>
<td>8,917</td>
<td>39,735</td>
</tr>
<tr>
<td>Scholarships</td>
<td>3,043</td>
<td>23,768</td>
<td>42,780</td>
</tr>
<tr>
<td>Auxiliary</td>
<td>30,235</td>
<td>7,240</td>
<td>96,991</td>
</tr>
<tr>
<td>Hospital</td>
<td>6,816</td>
<td>1,844</td>
<td>20,877</td>
</tr>
<tr>
<td>Independent operations</td>
<td>75,176</td>
<td>21,475</td>
<td>96,651</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$733,440</td>
<td>$220,157</td>
<td>$300,605</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$1,315,836</td>
</tr>
</tbody>
</table>
Revenues
On page 6 is the 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, 2004, and June 30, 2003.

For the year ended June 30, 2004, approximately seventy-four percent of UT’s revenue was attributed to state appropriations, grants and contracts, and tuition and fees.

Expenses
Operating expenses can be displayed in two formats, natural classification and functional classification. Both formats for fiscal years 2004 and 2003 are displayed in Table 3, page 6.

For the year ended June 30, 2004, approximately seventy-two percent of operating expenses are attributed to salaries and benefits. Utilities, supplies, and other services represent twenty-two percent of total operating expenses. Scholarships and depreciation represent the remaining six percent of operating expenses. Refer to Graph C above left.

For the year ended June 30, 2004, fifty-five percent of operating expenses by function is attributable to instruction, research, and public service. The percentages for the remaining functional areas range from one to eight percent of total operating expenses. Refer to Graph D. above right.

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

Table 4. Statements of Cash Flows (in thousands of dollars)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash provided (used) by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating activities</td>
<td>$(446,942)</td>
<td>$(487,276)</td>
</tr>
<tr>
<td>Noncapital financing activities</td>
<td>509,948</td>
<td>524,428</td>
</tr>
<tr>
<td>Investing activities</td>
<td>2,422</td>
<td>68,479</td>
</tr>
<tr>
<td>Capital and related financing activities</td>
<td>(52,723)</td>
<td>(65,550)</td>
</tr>
<tr>
<td>Net increase (decrease) in cash</td>
<td>$ 12,705</td>
<td>$ 40,081</td>
</tr>
<tr>
<td>Cash, beginning of year</td>
<td>$ 409,918</td>
<td>$ 369,837</td>
</tr>
<tr>
<td>Cash, end of year</td>
<td>$ 422,623</td>
<td>$ 409,918</td>
</tr>
</tbody>
</table>

Material sources of cash included state appropriations, tuition and fees, and grants and contracts. Material uses
of cash are reflected in payments to suppliers and vendors, payments to employees, payments for benefits, and the purchase of capital assets and construction.


Capital Assets and Debt Administration

Capital Assets

At June 30, 2004, The University of Tennessee had $960,103,308.64 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled $62,166,509.09 for the current fiscal year. Details of these assets are shown below.

| Table 5. Schedule of Capital Assets, Net of Depreciation (in thousands of dollars) |
|-----------------------------------------------|-------------------|
| 2004 | 2003 |
| Land ................................................ $ 47,912 ........... $ 48,358 |
| Land improvements & infrastructure ................. 29,021 ............ 30,314 |
| Buildings .......................................... 627,401 ............ 595,986 |
| Equipment ........................................ 94,158 ............ 99,158 |
| Software ........................................... 9,147 ............ 11,176 |
| Library holdings ................................... 52,453 ............ 49,666 |
| Projects in progress ................................ 100,011 ............ 109,219 |
| Total .................................................$ 960,103 ........... $ 943,877 |

Major capital additions for UT during 2003-2004 include the $19 million Student Recreation Center and the $17.3 million Cumberland Avenue Parking Garage in Knoxville, and the $3.3 million Boling Apartments Improvements in Chattanooga.

For the next fiscal year, the state has approved more than $68.6 million in capital outlay appropriations and $34 million in capital maintenance appropriations for UT. Some of these approved projects include the Glocker Business Building renovation and addition in Knoxville, the College of Pharmacy Building in Memphis, and the Grote Hall upgrades in Chattanooga. More detailed information about the university’s capital assets is presented in Note 5 to the financial statements.

Debt

At June 30, 2004, the university had $230,163,701.82 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

<table>
<thead>
<tr>
<th>Table 6. Outstanding Debt Schedule (in thousands of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
</tr>
<tr>
<td>Bonds-current portion ................................. $ 12,566 ........... $ 13,851</td>
</tr>
<tr>
<td>Bonds-noncurrent ...................................... 205,292 ........... 183,723</td>
</tr>
<tr>
<td>Commercial paper-noncurrent .......................... 12,231 ........... 18,160</td>
</tr>
<tr>
<td>Total TSSBA authorized debt .......................... $ 230,089 ........... $ 215,734</td>
</tr>
<tr>
<td>Notes-current portion .................................. 5</td>
</tr>
<tr>
<td>Notes-noncurrent portion ................................ 70</td>
</tr>
<tr>
<td>Total Debt .............................................$ 230,164 ........... $ 215,734</td>
</tr>
</tbody>
</table>

The university retired more than $18 million in bonds and notes in fiscal year 2003-2004. The Tennessee State School Bond Authority (TSSBA), in addition to its authority to issue bonds and notes to finance capital projects, has responsibility for approving all long-term debt of the university. TSSBA currently is rated as AA- by Standard & Poor. More detailed information about the university’s long-term liabilities is presented in Note 7 to the financial statements.

The university issued three new bond series in 2003-2004 in the net amount of $70.3 million. These are the 2004A series in the amount of $54.6 million (this series is a refunding of $50.7 million of the 1996A series); the 2004B tax exempt series in the amount of $30.4 million; and the 2004C taxable series in the amount of $36.0 million.

Economic Factors That Will Affect the Future

For fiscal year 2005, the University of Tennessee Board of Trustees has authorized a fee increase of 7.9% that is expected to generate approximately $13 million in new funding, net of related scholarships. However, the influx of lottery scholarship freshmen may cause that number to increase. State appropriations are expected to increase by a modest $6.2 million to fund employee increases. The university expects investment income to decrease as higher yielding investments are replaced with ones earning much less. The university expects to complete the transfer of the Bowld Hospital to Methodist University Hospital at which time the university will cease to have any hospital operations under its direct oversight.
<table>
<thead>
<tr>
<th>Assets</th>
<th>THE UNIVERSITY OF TENNESSEE</th>
<th>UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.</th>
<th>THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets:</strong></td>
<td>$151,557,385.23</td>
<td>$8,702,699.00</td>
<td>$12,442,059.68</td>
</tr>
<tr>
<td>Cash and cash equivalents (Note 2)</td>
<td>62,491,232.26</td>
<td>943,927.00</td>
<td>140,821.62</td>
</tr>
<tr>
<td>Investments (Note 2)</td>
<td>90,620,866.25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts, notes, and grants receivable (net) (Note 4)</td>
<td>8,269,048.51</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid expenses and deferred charges</td>
<td>7,362,424.54</td>
<td>2,021,123.00</td>
<td>13,539.42</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>320,300,956.79</td>
<td>11,667,749.00</td>
<td>12,596,420.72</td>
</tr>
<tr>
<td><strong>Noncurrent assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents (Note 2)</td>
<td>271,066,348.59</td>
<td>19,381,001.00</td>
<td>3,504,377.50</td>
</tr>
<tr>
<td>Investments (Note 2)</td>
<td>444,049,858.74</td>
<td>97,536,676.00</td>
<td>13,552,736.90</td>
</tr>
<tr>
<td>Investment in UT - Battelle, LLC (Note 11)</td>
<td>2,378,253.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts, notes, and grants receivable (net) (Note 4)</td>
<td>142,798,126.01</td>
<td>150,708.00</td>
<td>1,793,022.60</td>
</tr>
<tr>
<td>Lease payments receivable (Note 15)</td>
<td>21,228,595.80</td>
<td></td>
<td></td>
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<tr>
<td>Capital assets (net) (Note 5)</td>
<td>960,103,308.64</td>
<td>75,729,835.00</td>
<td>48,296,250.93</td>
</tr>
<tr>
<td>Prepaid expenses and deferred charges</td>
<td>178,108.39</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total noncurrent assets</strong></td>
<td>1,841,802,599.17</td>
<td>192,798,220.00</td>
<td>69,921,815.98</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$2,162,103,555.96</td>
<td>$204,465,969.00</td>
<td>$82,518,236.70</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>THE UNIVERSITY OF TENNESSEE</th>
<th>UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.</th>
<th>THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$57,842,391.72</td>
<td>$514,827.00</td>
<td>$3,292,405.68</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>39,878,942.22</td>
<td>2,052,826.00</td>
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</tr>
<tr>
<td>Deferred revenue</td>
<td>68,298,253.34</td>
<td>311,235.00</td>
<td>6,440.00</td>
</tr>
<tr>
<td>Deposits payable</td>
<td>6,451,994.13</td>
<td>45,194.00</td>
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<tr>
<td>Annuities payable</td>
<td>1,304,992.59</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term liabilities, current portion (Note 7)</td>
<td>54,695,538.99</td>
<td>1,645,000.00</td>
<td>1,100,000.00</td>
</tr>
<tr>
<td>Deposits held in custody for others</td>
<td>7,010,359.02</td>
<td>1,951,177.68</td>
<td></td>
</tr>
<tr>
<td>Deposits held in custody for component units</td>
<td>2,775,428.05</td>
<td></td>
<td></td>
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<tr>
<td>Due to the university</td>
<td></td>
<td>5,147,489.32</td>
<td>772,219.61</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>238,257,900.06</td>
<td>11,667,749.00</td>
<td>5,171,065.29</td>
</tr>
<tr>
<td><strong>Noncurrent liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred revenue (Note 7)</td>
<td>15,500,438.71</td>
<td></td>
<td></td>
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<tr>
<td>Long-term liabilities, noncurrent portion (Note 7)</td>
<td>238,439,662.24</td>
<td>86,222,240.00</td>
<td>58,593,468.60</td>
</tr>
<tr>
<td>Due to grantors (Note 7)</td>
<td>36,603,050.86</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annuities payable (Note 7)</td>
<td>2,092,812.58</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total noncurrent liabilities</strong></td>
<td>298,595,964.39</td>
<td>86,222,240.00</td>
<td>58,593,468.60</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$536,853,864.45</td>
<td>$97,889,989.00</td>
<td>$63,764,533.89</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Assets</th>
<th>THE UNIVERSITY OF TENNESSEE</th>
<th>UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.</th>
<th>THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Invested in capital assets, net of related debt</strong></td>
<td>$730,786,146.56</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Nonexpendable:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scholarships and fellowships</td>
<td>135,745,016.26</td>
<td>$10,398,687.00</td>
<td>$2,451,597.37</td>
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<tr>
<td>Libraries</td>
<td>12,998,803.63</td>
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<td>57,600.12</td>
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<tr>
<td>Research</td>
<td>17,063,241.56</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Instructional department uses</td>
<td>104,694,450.50</td>
<td>29,178,161.00</td>
<td></td>
</tr>
<tr>
<td>Academic support</td>
<td>25,494,275.09</td>
<td>32,230.00</td>
<td>87,760.97</td>
</tr>
<tr>
<td>Other</td>
<td>27,479,348.74</td>
<td></td>
<td>156,964.84</td>
</tr>
<tr>
<td><strong>Expendable:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scholarships and fellowships</td>
<td>109,312,355.62</td>
<td>28,441.00</td>
<td>775,304.97</td>
</tr>
<tr>
<td>Libraries</td>
<td>6,402,559.23</td>
<td></td>
<td>21,741.21</td>
</tr>
<tr>
<td>Research</td>
<td>36,858,446.80</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Instructional department uses</td>
<td>75,761,529.35</td>
<td>1,586,926.00</td>
<td></td>
</tr>
<tr>
<td>Academic support</td>
<td>56,555,822.08</td>
<td>10,878.00</td>
<td>14,529,992.89</td>
</tr>
<tr>
<td>Loans</td>
<td>8,422,955.49</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital projects</td>
<td>18,904,230.27</td>
<td>5,000,000.00</td>
<td></td>
</tr>
<tr>
<td>Debt service</td>
<td>448,854.02</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>43,979,598.28</td>
<td>159,560.00</td>
<td>167,547.34</td>
</tr>
<tr>
<td>Unrestricted (Note 18)</td>
<td>214,342,038.03</td>
<td>60,181,097.00</td>
<td>505,193.10</td>
</tr>
<tr>
<td><strong>Total net assets</strong></td>
<td>$1,625,249,691.51</td>
<td>$106,575,980.00</td>
<td>$18,753,702.81</td>
</tr>
</tbody>
</table>

The notes to the financial statements are an integral part of this statement.
### Statement of Revenues, Expenses, and Changes in Net Assets

For the year ended June 30, 2004

#### REVENUES

<table>
<thead>
<tr>
<th></th>
<th>THE UNIVERSITY OF TENNESSEE</th>
<th>UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.</th>
<th>THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating revenues:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Student tuition and fees (net of scholarship allowances of $40,422,660.79 for the year ended June 30, 2004 )</td>
<td>$208,017,640.88</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td></td>
<td>$135,082.00</td>
<td>$11,970,475.30</td>
</tr>
<tr>
<td>Investment return designated for operations</td>
<td></td>
<td>4,021,619.00</td>
<td></td>
</tr>
<tr>
<td>Federal appropriations</td>
<td>15,409,299.47</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Governmental grants and contracts</td>
<td>215,350,044.32</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-governmental grants and contracts</td>
<td>167,087,973.69</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales and services of educational departments</td>
<td>41,105,855.86</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auxiliary enterprises:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residential life (net of scholarship allowances of $1,038,969.26 for the year ended June 30, 2004)</td>
<td>28,801,314.30</td>
<td>4,753,472.00</td>
<td>123,380.00</td>
</tr>
<tr>
<td>Food services</td>
<td>2,757,895.29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bookstore</td>
<td>18,734,178.03</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parking</td>
<td>8,254,783.66</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Athletics</td>
<td>58,858,223.59</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other auxiliaries</td>
<td>5,907,971.34</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest earned on loans to students</td>
<td>77,423.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other operating revenues</td>
<td>16,589,257.39</td>
<td></td>
<td>8,787.78</td>
</tr>
<tr>
<td>Total operating revenues</td>
<td>$786,951,860.82</td>
<td>$8,910,173.00</td>
<td>$12,102,643.08</td>
</tr>
</tbody>
</table>

#### EXPENSES

<table>
<thead>
<tr>
<th></th>
<th>THE UNIVERSITY OF TENNESSEE</th>
<th>UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.</th>
<th>THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>$748,396,484.77</td>
<td></td>
<td>$31,247.00</td>
</tr>
<tr>
<td>Fringe benefits</td>
<td>224,322,791.92</td>
<td></td>
<td>4,127.43</td>
</tr>
<tr>
<td>Utilities, supplies, and other services</td>
<td>290,580,915.19</td>
<td></td>
<td>$2,427,223.00</td>
</tr>
<tr>
<td>Scholarships and fellowships</td>
<td>15,210,798.07</td>
<td></td>
<td>531,640.57</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>62,166,509.09</td>
<td>2,229,680.00</td>
<td></td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>$1,340,677,499.04</td>
<td>8,647,553.00</td>
<td>1,735,283.64</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$(553,725,638.22)</td>
<td>$262,620.00</td>
<td>$10,367,359.44</td>
</tr>
</tbody>
</table>

#### NONOPERATING REVENUES (EXPENSES)

<table>
<thead>
<tr>
<th></th>
<th>THE UNIVERSITY OF TENNESSEE</th>
<th>UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.</th>
<th>THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td>State and local appropriations</td>
<td>$420,368,313.56</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gifts (includes $3,158,918.64 from the component units)</td>
<td>40,485,978.41</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grants and contracts</td>
<td>48,051,458.44</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income (loss)</td>
<td>$4,062,521.00</td>
<td>$809,257.24</td>
<td></td>
</tr>
<tr>
<td>Interest on capital asset-related debt</td>
<td>(9,634,578.34)</td>
<td>(2,147,948.00)</td>
<td></td>
</tr>
<tr>
<td>Other nonoperating expenses</td>
<td>(16,328,818.10)</td>
<td>(709,012.00)</td>
<td></td>
</tr>
<tr>
<td>Net nonoperating revenues</td>
<td>567,457,116.04</td>
<td>1,205,561.00</td>
<td>809,257.24</td>
</tr>
<tr>
<td>Income before other revenues, expenses, gains, or losses</td>
<td>13,731,477.82</td>
<td>1,468,181.00</td>
<td>11,176,616.68</td>
</tr>
<tr>
<td>Capital appropriations</td>
<td>21,725,484.60</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital grants and gifts</td>
<td>15,258,722.72</td>
<td>750,404.00</td>
<td>1,785,756.87</td>
</tr>
<tr>
<td>Additions to annuity and life income trusts</td>
<td>3,603,865.94</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>(4,038,918.91)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total other revenues</td>
<td>50,131,075.02</td>
<td>750,404.00</td>
<td>1,785,756.87</td>
</tr>
<tr>
<td>Increase in net assets</td>
<td>$63,862,552.84</td>
<td>$2,218,585.00</td>
<td>$12,962,373.55</td>
</tr>
</tbody>
</table>

#### NET ASSETS

<table>
<thead>
<tr>
<th></th>
<th>THE UNIVERSITY OF TENNESSEE</th>
<th>UNIVERSITY OF CHATTANOOGA FOUNDATION, INC.</th>
<th>THE UNIVERSITY OF TENNESSEE FOUNDATION, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets at beginning of year</td>
<td>$1,561,387,138.67</td>
<td>$104,357,395.00</td>
<td>5,791,329.26</td>
</tr>
<tr>
<td>Net assets at end of year</td>
<td>$1,625,249,691.51</td>
<td>$106,575,980.00</td>
<td>18,753,702.81</td>
</tr>
</tbody>
</table>

The notes to the financial statements are an integral part of this statement.
CASH FLOWS FROM OPERATING ACTIVITIES
Tuition and fees ........................................ $ 213,016,004.81
Federal appropriations ............................... 16,659,299.47
Grants and contracts ................................. 412,993,309.22
Sales and services of educational activities .... 49,576,898.92
Payments to suppliers and vendors ............. (298,224,555.91)
Payments to employees ............................. (743,351,402.89)
Payments for benefits ............................... (224,218,368.37)
Payments for scholarships and fellowships .... (15,210,798.07)
Loans issued to students ............................ (4,241,404.77)
Collection of loans from students ..............  6,374,877.96
Interest earned on loans to students ..........  607,729.03

Auxiliary enterprise charges:
Residence halls ...................................... 28,801,314.30
Bookstore ............................................ 18,734,178.03
Food service ........................................ 2,757,895.29
Parking .............................................. 8,254,783.66
Athletics ............................................ 58,318,635.67
Other auxiliaries .................................. 6,513,457.78
Hospital ............................................ (1,226,098.60)
Other receipts (payments) ......................... 16,922,677.14

Net cash provided (used) by operating activities $ (446,941,567.33)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES
State appropriations ............................... 416,039,681.40
Local appropriations ................................ 3,946,132.16
Gifts and grants for other than capital or endowment purposes......... 83,316,592.26
Private gifts for endowment purposes ........ 13,587,722.72
Split-interest transactions receipts ........... 3,742,931.34
Split-interest transactions disbursements .. (2,646,216.33)
Federal student loan receipts .................... 143,892,189.93
Federal student loan disbursements .......... (143,892,189.93)
Changes in deposits held for others ..........  73,912.17
Net cash balance implicitly financed (repaid) (7,677,533.43)
Other noncapital receipts (payments) ........ (435,052.97)

Net cash provided (used) by noncapital financing activities $ 509,948,169.32

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES
Proceeds from capital debt ....................... 33,596,076.27
Capital appropriations ........................... 21,459,704.28
Capital grants and gifts received .............. 15,252,920.67
Proceeds from sale of capital assets .......... 5,443,527.13
Purchase of capital assets and construction .... (98,999,758.26)
Principal paid on capital debt and leases .... (18,060,536.01)
Interest paid on capital debt and leases ...... (9,723,883.32)
Other capital and related financing receipts (payments) .. (1,691,126.01)

Net cash provided (used) by capital and related financing activities $ (52,723,075.25)

RECONCILIATION OF NET OPERATING LOSS TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES
Operating loss ...................................... $ (553,725,638.22)
Adjustments to reconcile operating loss to net cash provided (used) by operating activities:
Depreciation expense .............................. 62,166,509.09
Changes in assets and liabilities:
Receivables, net ................................. 40,036,718.06
Inventories ......................................... (217,881.30)
Prepaid expenses and deferred charges ....... (3,615,618.53)
Accrued interest receivable .....................  530,306.03
Accounts payable ................................. (3,830,763.20)
Accrued liabilities .................................  5,935,390.45
Deferred revenue .................................  4,078,363.70
Deposits ...........................................  353,458.42
Compensated absences ......................... (785,885.02)
Other additions:
Loans to students ................................ 2,133,473.19

Net cash provided (used) by operations $ (446,941,567.33)
Note 1: Summary of Significant Accounting Policies

A. Reporting Entity

The financial reporting entity, as defined by Governmental Accounting Standards Board (GASB) Statement No. 14, The Financial Reporting Entity, consists of the primary government and all of its component units. Component units are legally separate organizations for which the primary government is financially accountable and other organizations for which the significance of their relationship with the primary government are such that exclusion would cause the financial statements to be misleading or incomplete.

For the year ended June 30, 2004, the university adopted GASB Statement No. 39, Determining Whether Certain Organizations Are Component Units which provides criteria for determining whether certain organizations should be reported as component units based on the nature and significance of their relationship with a primary government and clarifies reporting requirements for those organizations. Based on these criteria, the financial statements now include the accounts of the university, as the primary government, and the accounts of the University of Chattanooga Foundation, Inc., and the University of Tennessee Foundation, Inc., as discretely presented component units.

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 - Center for the Health Sciences, including the Memphis campus, the Memorial Research Center at Knoxville, Clinical Education Centers at Chattanooga and Knoxville, Family Practice Centers at Jackson, Knoxville, and Memphis, and a hospital in 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 University-Wide Administration. The university is governed by a board of 23 members, including one student and one faculty member, all either ex officio or appointed by the governor, who also serves as chairman. The president is the chief executive officer of the university system.

The university is a component unit of the State of Tennessee, and is discretely presented in the Tennessee Comprehensive Annual Financial Report. Although the university is a separate legal entity, the state is financially accountable for the university because the state appoints a majority of its governing body and provides financial support.

B. Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). In June 1999, the GASB issued Statement No. 34, Basic Financial Statements and Management’s Discussion and Analysis for State and Local Governments. This was followed in November 1999 by GASB Statement No. 35, Basic Financial Statements and Management’s Discussion and Analysis for Public Colleges and Universities and in May 2002 by GASB Statement No. 39, Determining Whether Certain Organizations are Component Units. The financial statement presentation required by those statements provides a comprehensive, entity-wide perspective of the university’s, including component units, assets, liabilities, net assets, revenues, expenses, changes in net assets, and cash flows, and replaces the fund-group perspective previously required.

A significant accounting change, adoption of depreciation on capital assets, was made in order to comply with the new requirements.

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

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

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

D. 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.

E. Investments

Investments in commercial paper are reported at amortized cost at June 30, 2004. All other investments are reported at fair value.

F. Capital Assets

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

A capitalization threshold of $100,000 is used for buildings, land improvements, and infrastructure. Equipment and software are capitalized when the unit acquisition cost is $5,000 or greater and the estimated useful life is one year or more. The capitalization threshold for additions and improvements to buildings, infrastructure, and land improvements is also $100,000. The capitalization threshold for additions and improvements to buildings is $100,000 provided that amount exceeds 20 percent of the book value of the building.

These assets, with the exception of land, are depreciated using the straight-line method over the estimated useful lives of the assets, which range from 5 to 40 years.

G. Accounts Payable

Included in accounts payable are checks payable in the amount of $6,855,470.08 as of June 30, 2004. 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.

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

I. Net Assets
The institution’s net assets are classified as follows:

INVESTED IN CAPITAL ASSETS, NET OF RELATED DEBT: This represents the institution’s total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

EXPENDABLE RESTRICTED NET ASSETS: Expendable restricted net assets include resources in which the university is legally or contractually obligated to spend resources in accordance with restrictions imposed by external third parties.

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

UNRESTRICTED NET ASSETS: Unrestricted net assets represent resources derived from student tuition and fees, state appropriations, and the sales and services of educational departments, and auxiliary enterprises. These resources are used for transactions 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.

J. 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.

K. 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. 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.

In accordance with state statutes, commercial banks and savings and loan associations that do not participate in the State of Tennessee Collateral Pool for Public Deposits must pledge securities with third parties as collateral to secure university time and demand deposits. Market values of these securities are regularly monitored to ascertain that 105 percent of university deposits, less the amounts protected by the Federal Deposit Insurance Corporation, are secured.

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, 2004, cash and cash equivalents consisted of $119,172,009.98 in bank accounts, $1,398,143.87 of petty cash on hand, $54,980,000.00 of certificates of deposit, and $244,280,505.02 in the university’s cash management investment pool.

Additionally, the university maintains custodial accounts at First Tennessee Bank and Citigroup for funds contractually managed by independent investment counsel. In accordance with the custody agreement, First Tennessee Bank and Citigroup placed cash equivalents totaling $2,793,074.95 at June 30, 2004, in the banks’ money market mutual funds.

Deposits. Deposits with financial institutions are required to be categorized to indicate the level of custodial risk assumed by the university. Category 1 consists of deposits that are insured or collateralized with securities held by the university or by its agent in the university’s name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution’s trust department or agent in the university’s name. Category 3 deposits are uncollateralized. This category includes any bank balance that is collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the university’s name.

Some of the university’s bank accounts are in financial institutions which participate in the bank collateral pool administered by the Treasurer of the State of Tennessee. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure.

At June 30, 2004, the carrying amount of the university’s deposits was $174,152,009.98, and the bank balance including accrued interest was $170,167,531.38. The entire bank balance was category 1.

During the year ended June 30, 2004, the university had uncollateralized deposits on several days, ranging from $466,805.03 to $5,874,256.82.

The laws of the State of Tennessee require that collateral be pledged to secure all uninsured deposits.

Cash Management Investment Pool. The cash management investment pool consists of marketable securities and government repurchase agreements as previously described. The reported amount of the cash management pool at June 30, 2004, was $244,280,505.02. The cost of the cash management pool at June 30, 2004, was $245,727,702.73. Management has elected to classify all securities in the cash
management investment pool as cash and cash equivalents. The reported amount of securities in the pool with a maturity date of three months or less from the date of purchase at June 30, 2004, was $60,954,686.12. The cost of these same securities at June 30, 2004, was $60,929,067.79. The securities in the pool are categorized on the following schedule, listed as cash and cash equivalents, to indicate the level of risk assumed by the university. The university’s standard “Master Repurchase Agreements” require that the securities underlying repurchase agreements have fair value equal to or exceeding 100 percent of the cost of the repurchase agreement and that the securities be delivered to its agent’s trust account at the Federal Reserve Bank - Memphis. The university invested in repurchase agreements during the year, but there were no repurchase agreements at June 30, 2004.

**Investments.** The university’s investments are categorized below to indicate the level of custodial risk assumed by the university at year end. Category 1 consists of insured or registered investments or investments for which the securities are held by the university or its agent in the university’s name. Category 2 consists of uninsured or unregistered investments for which the securities are held by the counterparty’s trust department or agent in the university’s name. Category 3 consists of uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the university’s name.

**JUNE 30, 2004**

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>Reported Amount</th>
<th>Cost</th>
</tr>
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<tbody>
<tr>
<td>Cash equivalents</td>
<td></td>
<td></td>
<td></td>
<td>$183,325,818.90</td>
<td>$184,798,634.94</td>
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<tr>
<td>Government securities</td>
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<td>$24,115,473.22</td>
<td>$32,863,454.22</td>
<td>$31,778,326.27</td>
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<td>Commercial paper</td>
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<td>20,140,379.37</td>
<td>19,892,959.57</td>
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<tr>
<td>Corporate stocks</td>
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<td>7,047,277.12</td>
<td>123,926,098.71</td>
<td>105,134,902.69</td>
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</tr>
<tr>
<td>Mortgages and notes</td>
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<td>1,484,068.99</td>
<td>1,477,025.00</td>
<td>1,477,025.00</td>
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<tr>
<td>Other investments</td>
<td>23,349.53</td>
<td></td>
<td>23,349.53</td>
<td>29,054.00</td>
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<tr>
<td>Assets with trustees</td>
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<td>$4,416,368.72</td>
<td></td>
<td>$4,371,255.82</td>
<td></td>
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<tr>
<td>International securities</td>
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<td>166,375.31</td>
<td>2,461,066.31</td>
<td>1,497,581.60</td>
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<tr>
<td>Corporate stocks</td>
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<td>$50,910,507.65</td>
<td>$4,416,368.72</td>
<td>$4,416,368.72</td>
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</tr>
<tr>
<td>Cash equivalents - assets</td>
<td></td>
<td></td>
<td></td>
<td>$164,181,104.95</td>
<td></td>
</tr>
<tr>
<td>First</td>
<td></td>
<td></td>
<td></td>
<td>$185,314,785.85</td>
<td></td>
</tr>
<tr>
<td>Domestic securities</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>Government securities</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>Corporate bonds</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>Corporate stocks</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>Mortgages and notes</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>Other investments</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>Assets with trustees</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>International securities</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>Corporate stocks</td>
<td></td>
<td></td>
<td></td>
<td>$244,280,505.02</td>
<td></td>
</tr>
<tr>
<td>University cash equivalents and investments not susceptible to categorization:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash equivalents - assets</td>
<td></td>
<td></td>
<td></td>
<td>$4,416,368.72</td>
<td></td>
</tr>
<tr>
<td>First</td>
<td></td>
<td></td>
<td></td>
<td>$4,416,368.72</td>
<td></td>
</tr>
<tr>
<td>Limited partnership-venture capital funds</td>
<td>2,793,074.95</td>
<td>4,793,074.95</td>
<td>4,793,074.95</td>
<td>4,793,074.95</td>
<td></td>
</tr>
<tr>
<td>Mutual funds</td>
<td>27,420,705.00</td>
<td>45,908,525.93</td>
<td>45,908,525.93</td>
<td>45,908,525.93</td>
<td></td>
</tr>
<tr>
<td>Investments in hedge funds</td>
<td>204,937,204.95</td>
<td>172,838,513.28</td>
<td>172,838,513.28</td>
<td>172,838,513.28</td>
<td></td>
</tr>
<tr>
<td>Real estate equity funds</td>
<td>59,418,180.00</td>
<td>60,000,000.00</td>
<td>60,000,000.00</td>
<td>60,000,000.00</td>
<td></td>
</tr>
<tr>
<td>Real estate gifts</td>
<td>26,030,806.03</td>
<td>20,598,111.61</td>
<td>20,598,111.61</td>
<td>20,598,111.61</td>
<td></td>
</tr>
<tr>
<td>Total investments and cash equivalents</td>
<td>$735,641,670.97</td>
<td>$716,551,245.12</td>
<td>$716,551,245.12</td>
<td>$716,551,245.12</td>
<td></td>
</tr>
<tr>
<td>Total investments</td>
<td>$506,541,291.00</td>
<td>$468,030,476.44</td>
<td>$468,030,476.44</td>
<td>$468,030,476.44</td>
<td></td>
</tr>
</tbody>
</table>

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 including an alternative asset class comprised of hedge funds. Currently, the Consolidated Investment Pool invests in five hedge funds: the Commonfund Global Hedged Partners, the Balentine Hedge Fund Select, the Gerber/Taylor Offshore Fund, Ltd, the Maplewood Associates II, L.P, and the Pointer Offshore, Ltd. Fund. The hedge fund investments expose the university to significant amounts of credit risk and market risk by trading or holding derivative securities and by leveraging the securities in the fund. These investments are briefly described as follows.

Commonfund Global Hedged Partners, LLC, was created in 2000 as a multi-manager fund investing in a diversified group of 17 primarily equity hedge fund managers operating and investing in the United States, Europe, and Asia. Investment strategies are predominantly long/short but also include international and event-driven arbitrage. The university’s investment of $20,000,000 was valued at $21,630,400 at June 30, 2004.

Balentine Hedge Fund, L.P., was created in 2000 as a multi-manager partnership. Currently, portfolio assets are allocated among 12 managers with 40 percent of the managers biased toward net long positions in U.S. large capitalization companies and 60 percent using widely diverse strategies to moderate overall volatility. These strategies include long equity positions, distressed securities, mortgage-backed securities, and private equity. Effective January 1, 2001, the partnership changed its name to Balentine Hedge Fund Select, L.P. The university’s investment of $20,000,000 was valued at $15,281,620 at June 30, 2004.

Gerber/Taylor Offshore Fund, Ltd., was created in 2000 as a multi-manager fund that conducts its activities through Gerber/Taylor Partners, L.P. Utilizing the “fund of funds” approach, the fund seeks to identify investment managers or investment pools which implement hedged or market neutral strategies. The university’s investment of $5,000,000 was valued at $5,944,980 at June 30, 2004.

Maplewood Associates II, L.P., created in 2001, is a limited partnership managed by Ivy Asset Management Corporation. The partnership seeks above average capital appreciation on portfolio assets while attempting to minimize risk without incurring any unrelated business taxable income. The partnership seeks to achieve this objective with diversified asset management utilizing independent investment managers through non-U.S. investment corporations. Investment strategies include value-oriented equities investing, special situations investing, and relative value trading. The university’s investment of $10,000,000 was valued at $11,008,120 at June 30, 2004.

Pointer Offshore, Ltd. Fund was created in 2002 and is managed by Pointer Offshore, LLC. By allocating its assets to a select number of long/short equity-based managers, the fund seeks capital appreciation through a balanced level of risk. The fund is a “fund of funds” that utilizes diversified strategies to achieve its objective. The university’s investment of $5,000,000 was valued at $5,553,060 at June 30, 2004.
Note 3: Endowment, Annuity, and Life Income Agreements

There are two categories of university assets which are subject to long-term investment: endowments and amounts held in trust under annuity and life income agreements. The investment of these funds is governed by the gift instrument and the investment policies established by the Board of Trustees.

Effective July 1, 1954, the university adopted the policy of investing endowment assets over which it had full investment discretion (and on which the donor or governing gift instrument does not require separate investment) in a Consolidated Investment Pool. This pooling of investments affords closer supervision of the investment portfolio and provides, regardless of size, the advantages of participation in a well-diversified portfolio of domestic and international equities, private equity, bonds, real estate, and hedge funds. All contributing endowments participate in the income and capital appreciation of the Pool on a per-share basis commensurate with its contribution to the Pool. New endowments purchase shares in the Pool at the end of each month at the then current fair value per share, determined by valuing the Pool at month end fair value and dividing by the number of pool units outstanding.

If a donor has not provided specific instructions, state law permits the university to authorize for spending the net appreciation (realized and unrealized) of the investments of endowment funds. When administering its power to spend net appreciation, the university is required to consider the university’s long-term and short-term needs, present and anticipated financial requirements, expected total return on its investments, price-level trends, and general economic conditions. Any net appreciation that is spent is required to be spent for the purposes for which the endowment was established.

The university chooses to spend only a portion of the investment income (including changes in the value of investments) each year. Under the spending plan established by the university, five percent of a three-year moving average of the fair value of endowment investments has been authorized for expenditure. The remaining amount, if any, is retained to be used in future years when the amount computed using the spending plan exceeds the investment income. At June 30, 2004, net appreciation of $135,257,589.26 is available to be spent, of which $130,516,070.47 is restricted to specific purposes. The per unit fair value for participating endowments was $3.327952 at June 30, 2004. Income distributed was $1.7209 per share in 2004, or $19,217,075.32.

The university’s consolidated investment pool is invested to maximize total return rather than current income consistent with provisions of the Uniform Management of Institutional Funds Act adopted by the State of Tennessee in 1973. During the past three years, the total return for the consolidated investment pool has been negative or below the defined spending plan for the participating endowments. As a result, there were 445 true endowments at June 30, 2004, that had a market value of $55,359,201.05 and historic gift value of $58,675,266.74, yielding a net “underwater” position of $3,316,065.69. Since the principal amount of a true endowment is categorized as a restricted non-expendable net asset, this depreciation of market value has been charged to unrestricted net assets for financial statement presentation.

All endowments not invested as part of the Consolidated Investment Pool are separately invested to observe requirements or limitations imposed by donors. Income earned and distributed on separately invested endowments amounted to $733,552.63 for 2004.

Annuity and life income amounts held in trust are separately invested entities requiring detailed accounting to reflect specific compliance with terms of each trust and applicable federal regulations. The investment objectives as reflected in each agreement vary widely since they are affected by the age, income level, and needs of the beneficiaries as well as motives and objectives of the donors. Interest, dividend, rent, and royalty income realized on these funds for 2004 amounted to $1,696,490.57.

Note 4: Accounts, Notes, and Grants Receivable

Accounts, notes, and grants receivable included the following at June 30, 2004:

- Student accounts receivable $ 6,717,928.73
- Grants receivable 70,607,698.94
- Notes receivable 5,408,302.98
- Pledges receivable 79,469,716.44
- State capital outlay receivable 4,295,615.78
- TSSBA debt proceeds receivable 2,978,342.71
- Due from component units 5,919,708.93
- Other receivables 40,364,266.38

Total $215,961,380.89
Less allowance for doubtful accounts (11,718,296.10)
Total $204,243,084.79

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of $1,048,575.19.

Federal Perkins Loan Program funds included the following at June 30, 2004:
- Perkins loans receivable $ 29,175,907.47
- Less allowance for doubtful accounts (11,718,296.10)
Total $29,175,907.47

Note 5: Capital Assets

Capital asset activity for the year ended June 30, 2004, was as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Beginning Balance</th>
<th>Additions</th>
<th>Transfers</th>
<th>Reductions</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$48,357,545.18</td>
<td>$108,387.00</td>
<td></td>
<td></td>
<td>$47,912,078.18</td>
</tr>
<tr>
<td>Land improvements &amp; infrastructure</td>
<td>56,379,379.34</td>
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<td></td>
<td></td>
<td>57,832,146.84</td>
</tr>
<tr>
<td>Buildings</td>
<td>1,044,474,442.22</td>
<td>6,625,606.96</td>
<td>51,978,214.24</td>
<td>(2,858,963.94)</td>
<td>1,100,219,299.48</td>
</tr>
<tr>
<td>Equipment</td>
<td>250,711,019.50</td>
<td>21,518,589.50</td>
<td></td>
<td>(23,694,085.57)</td>
<td>248,535,523.43</td>
</tr>
<tr>
<td>Software</td>
<td>18,850,451.93</td>
<td>285,380.92</td>
<td></td>
<td></td>
<td>19,135,832.85</td>
</tr>
<tr>
<td>Library holdings</td>
<td>84,808,936.47</td>
<td>11,309,104.23</td>
<td>(23,694,085.57)</td>
<td>73,424,951.12</td>
<td></td>
</tr>
<tr>
<td>Projects in progress</td>
<td>109,218,940.49</td>
<td>44,730,357.93</td>
<td>(53,530,159.44)</td>
<td>(27,320,871.88)</td>
<td>81,886,117.67</td>
</tr>
<tr>
<td>Total</td>
<td>$1,612,800,715.13</td>
<td>$84,577,428.34</td>
<td>(53,530,159.44)</td>
<td>(27,320,871.88)</td>
<td>$1,663,445,470.49</td>
</tr>
<tr>
<td>Less accumulated depreciation:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land improvements &amp; infrastructure</td>
<td>(26,064,995.11)</td>
<td>(2,751,162.62)</td>
<td>-</td>
<td>4,958.91</td>
<td>(28,811,242.82)</td>
</tr>
<tr>
<td>Buildings</td>
<td>(448,488,025.49)</td>
<td>(26,943,655.83)</td>
<td>-</td>
<td>2,613,259.30</td>
<td>(472,818,422.02)</td>
</tr>
<tr>
<td>Equipment</td>
<td>(151,553,419.28)</td>
<td>(19,955,943.72)</td>
<td>-</td>
<td>17,132,222.21</td>
<td>(154,717,140.79)</td>
</tr>
<tr>
<td>Software</td>
<td>(7,674,286.72)</td>
<td>(3,993,267.64)</td>
<td>-</td>
<td>1,678,564.45</td>
<td>(9,988,998.91)</td>
</tr>
<tr>
<td>Library holdings</td>
<td>(35,142,759.91)</td>
<td>(6,522,479.28)</td>
<td>-</td>
<td>6,318,827.88</td>
<td>(37,340,110.31)</td>
</tr>
<tr>
<td>Total accumulated depreciation</td>
<td>($668,923,485.51)</td>
<td>($62,166,509.29)</td>
<td>-</td>
<td>$27,747,832.75</td>
<td>($703,342,161.85)</td>
</tr>
<tr>
<td>Capital assets, net</td>
<td>$943,877,229.62</td>
<td>$22,410,919.25</td>
<td>-</td>
<td>(6,184,840.23)</td>
<td>$960,103,308.64</td>
</tr>
</tbody>
</table>
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 $6,988,650.08 for the year ended June 30, 2004.

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, 2004. 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 current Consumer Price Index.

<table>
<thead>
<tr>
<th>Year Ending June 30:</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010-2012</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total minimum payments required</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$92,960.00</td>
<td></td>
</tr>
</tbody>
</table>

Note 7: Long-term Liabilities

Long-term liability activity for the year ended June 30, 2003, was as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>$197,574,193.33</td>
<td>$122,932,412.05</td>
<td>$127,857,968.44</td>
<td>$12,566,284.96</td>
<td>12,566,284.96</td>
</tr>
<tr>
<td>Commercial paper</td>
<td>18,160,033.52</td>
<td>19,516,814.11</td>
<td>25,446,177.25</td>
<td>12,230,640.38</td>
<td></td>
</tr>
<tr>
<td>Total TSSBA indebtedness</td>
<td>$215,734,196.85</td>
<td>$142,449,226.16</td>
<td>$153,304,145.70</td>
<td>$12,566,284.96</td>
<td>12,566,284.96</td>
</tr>
<tr>
<td>Notes</td>
<td>75,093.00</td>
<td>75,093.00</td>
<td>75,093.00</td>
<td>75,093.00</td>
<td></td>
</tr>
<tr>
<td>Compensated absences</td>
<td>63,257,384.43</td>
<td>41,388,823.44</td>
<td>42,124,708.46</td>
<td>42,124,708.46</td>
<td></td>
</tr>
<tr>
<td>Total long-term liabilities</td>
<td>$279,491,518.28</td>
<td>$183,863,142.60</td>
<td>$170,219,522.65</td>
<td>$239,135,201.23</td>
<td>$239,135,201.23</td>
</tr>
</tbody>
</table>

Other noncurrent liabilities:

| Deferred revenue | 15,500,438.71 |
| Due to grantees  | 36,320,989.59 |
| Annuities payable | 8,580,703.69 |
| Totals           | $339,893,713.27 |

Tennessee State School Bond Authority (TSSBA) bonds, with interest rates ranging from 1.3 percent to 7.75 percent, are due serially to 2034 and are secured by pledges of the facilities’ revenue to which they relate and certain other revenues and fees of the university, including state appropriations. The total outstanding bonded indebtedness for the university was $268,210,704.81 as of June 30, 2004. The total bonded indebtedness reported on the statement of net assets at June 30, 2004, is shown net of unaccrued bonds payable of $2,929,815.34, assets of $8,947,429.50 held by the Tennessee State School Bond Authority, and unspent bond proceeds of $38,475,491.53.

Included in the total outstanding indebtedness is a $75,093 note with Chattanooga Agricultural Credit Association. The 5-year note is for the construction of a farm building at UT – Martin. This note carries an interest rate of 4 percent and is due semi-annually to July 1, 2009. The outstanding balance at 6/30/2004 is $75,093.00.

Commercial Paper Program

The Tennessee State School Bond Authority also authorized the issuance of commercial paper to finance costs of various capital projects. At June 30, 2004, $12,230,640.38 was issued for projects at the University of Tennessee.

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.

Note 8: Pension Plans

A. Defined Benefit Plans

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

Funding Policy

Plan members are noncontributory. The university is required to contribute at an actuarially determined rate. The current rate is 7.3 percent 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, 2004, 2003, and 2002, were $17,904,045.80, $18,125,448.74, and $14,844,243.45, respectively. Contributions met the requirements for each year.

2. 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 percent 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 percent of covered salaries to the CSRS plan. The university is currently required to contribute 7.0 percent. Contributions to CSRS for the year ended June 30, 2004, were $1,347,469.22, which consisted of $691,176.31 from the university and $656,292.91 from the employees; contributions for the year ended June 30, 2003, were $1,435,605.13, which consisted of $761,592.31 from the university and $674,012.82 from the employees; and contributions for the year ended June 30, 2002, were $1,368,041.75, which consisted of $706,073.01 from the university and $661,968.74 from the employees.

Federal statute requires employees participating in FERS to contribute 0.8 percent of their salaries to the Basic Benefit Plan. The university is required to contribute 10.7 percent. In addition, the university is required to contribute 1 percent of each participant's salary to the Thrift Savings Plan plus up to an additional 4 percent depending upon employees' contributions, which can range from 0 to 10 percent of their salaries. Contributions for the Basic Benefit Plan were $976,298.51 for the year ended June 30, 2004, which consisted of $67,915.82 from employees and $908,382.69 from the university; and $975,623.14 for the year ended June 30, 2003, which consisted of $67,869.03 from employees and $908,382.69 from the university; and $995,187.77 for the year ended June 30, 2002, which consisted of $69,230.98 from employees and $925,956.79 from the university.

Contributions for the Thrift Savings Plan were $1,011,982.00 for the year ended June 30, 2004, which consisted of $691,753.00 from employees and $392,229.00 from the university; $980,054.00 for the year ended June 30, 2003, which consisted of $595,517.00 from employees and $384,537.00 from the university; and $953,719.31 for the year ended June 30, 2002, which consisted of $572,187.00 from employees and $381,532.31 from the university.

C. 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 $20 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. Effective January 1996, the university began providing a $20 monthly match from unrestricted funds for employees making a minimum monthly contribution of $20 to the Section 401(k) plan. During the year ended June 30, 2004, contributions totaling $10,160,726.26 were made by employees participating in the plan, with a related match of $1,883,085.11 made by the university. During the year ended June 30, 2003, contributions totaling $9,710,479.63 were made by employees participating in the plan, with a related match of $1,883,085.11 made by the university. In accordance with the IRC, employee contributions through the 403(b) plan remain the assets of the employee. In addition, the amounts withheld from employees are remitted directly to third-party administrators. Therefore, these employee contributions are not reflected in the university's financial statements.
Note 9: Other Post-employment Benefits

The State of Tennessee administers a group health insurance program which provides post-employment health insurance benefits to eligible university retirees. This benefit is provided by and administered by the State of Tennessee. The university assumes no liability for retiree health care programs. Information related to this plan is available at the statewide level in the Tennessee Comprehensive Annual Financial Report. That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 312 Eighth Avenue North, 14TH Floor, William R. Snodgrass Tennessee Tower, Nashville, TN 37243-0298 or by calling (615) 741-2140.

Note 10: Chairs of Excellence

Since fiscal year 1985, the Tennessee General Assembly has appropriated $22 million to a Chairs of Excellence Endowment for the University of Tennessee. The appropriations provided that the Chairs of Excellence Endowment be established as an irrevocable trust with the State Treasurer and required the university to match the appropriation on a dollar-for-dollar basis. The university has fully matched 50 chairs as of June 30, 2004. 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, 2004, the amounts held in trust totaled $101,942,448.27 at fair value.

Note 11: Joint Venture

The university is a participant in a joint venture with Battelle Memorial Institute for the sole purpose of management and operation of the Oak Ridge National Laboratory (ORNL) for the U.S. Department of Energy. Each entity has a 50 percent interest in the venture, each having provided an initial investment of $125,000,000. The university’s equity interest was $2,378,253.00 at June 30, 2004. The university and Battelle each receive a 50 percent distribution of the ORNL management fee after shared expenses are deducted. The fee distribution for the year ended September 30, 2003, to the university was $1,253,252.81.

During the year ended June 30, 2004, the university had expenses of $17,199,910.33 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled $5,616,550.49 as of June 30, 2004. To review the audit report of UT-Battelle, please contact the Controller’s Office, The University of Tennessee, 201 Andy Holt Tower, Knoxville, Tennessee 37996-0100.

Note 12: Insurance-related Activities

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 insurance policy deductibles vary from $1 million to $7.5 million by type of risk coverage. A designation has been made for incurred losses at June 30, 2004, in the state’s Risk Management Fund.

At June 30, 2004, the scheduled coverage for the university was $2,734,476,100 for buildings and $903,426,700 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 ten university-owned aircraft. The university also 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 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. 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.

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

Note 13: Contingencies and Commitments

A. 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, 2004, were $33,126,375.83.

B. 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, 2004. The amount of unused sick leave was $218,969,953.86 at June 30, 2004.

C. 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.

D. Nonvested Equipment

Equipment in the possession of the university valued at $3,053,247.43 as of June 30, 2004 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.

E. Litigation

The university is involved in several lawsuits, none of which are expected to have a material effect on the financial position of the university.

Note 14: Lease and Transfer of UT Memorial Research Center and Hospital

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

Lease and Transfer Agreement – pursuant to the enabling legislation, Tennessee Code Annotated, Section 49-9-112 and Section 49-9-1301 et seq., UHS leased from the university the real property of the existing hospital and the
Graduate School of Medicine. (See also Note 15.) The term of the lease is 50 years. The university also transferred to UHS all operating assets of the hospital. The consideration for the lease of the real property and transfer of the operating assets was payment by UHS of a) a sum sufficient to economically defease all of the debt issued by the Tennessee State Bond Authority in the amount of $149,080,353.69, b) $25,000,000.00 paid to the university at closing, and c) a variable lease obligation of $50,000,000.00 to be paid to the university over twenty years. UHS assumed all prior hospital liabilities, known or unknown. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease.

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 $96,631,069.30 in 2004, are reported as operating expenses in the statement of revenues, expenses, and changes in net assets. An equal amount of operating revenue is reported in the non-governmental grants and contracts category. The term of the Employee Services Agreement is 50 years. All persons who began service at the hospital after the date the employee service agreement was signed are employees of UHS and not university employees.

Affiliation Agreement – the university and UHS agreed that UHS will continue to support the Graduate School of Medicine by providing appropriate facilities and resources of the hospital to the faculty and students at the Graduate School of Medicine. UHS agreed to pay the university $1,500,000 at closing for the benefit of the Graduate School of Medicine. In addition, UHS must pay monthly to the university, for the benefit of the Graduate School of Medicine, the government funding, direct and indirect medical education funds, TennCare medical education funds, and other medical education funds received by UHS for the benefit of the Graduate School of Medicine. The amount payable by UHS shall be reduced by a) the fair market rental value of the space provided to the Graduate School of Medicine; b) the fair market value of the information system, telecommunication, network infrastructure, and human resource services provided by UHS to the Graduate School of Medicine; and c) retroactive adjustments made by payers to the graduate medical education payments.

Note 15: Capital Lease of Real Property to University Health Systems, Inc.

The university’s leasing operations consist exclusively of leasing the real property of the UT Memorial Research Center and Hospital to UHS for a term of 50 years. This lease is pursuant to the Lease and Transfer Agreement described in Note 14. This lease is classified as a direct financing lease. The guaranteed lease payment of $50 million will be paid by UHS in annual payments through 2019. The amount of the annual payments will equal the lesser of 1) 20 percent 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, 2004, totaled $2,070,344.00.

The university recorded a lease payment receivable in the amount of $21,228,595.80 at June 30, 2004, which represents the net present value of the guaranteed $50 million discounted at 5.75 percent. The minimum lease payments to be received amount has been adjusted upward to reflect a contractually required adjustment to the final required lease payment.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment Receivable</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$21,228,595.80</td>
</tr>
</tbody>
</table>

Note 16: Management Agreement for William F. Bowld Hospital

On November 1, 2002, the university transferred management and operations of its hospital located in Memphis to Methodist Healthcare-Memphis Hospitals (Methodist), a Tennessee non-profit corporation. The transfer of the hospital management and operations from the university to Methodist was accomplished through three main agreements: the Management Agreement, the Employee Services Agreement, and the Affiliation Agreement. Each of these agreements is summarized below.

Management Agreement – Effective November 1, 2002, the university and Methodist entered into a management agreement whereby Methodist will manage the operations of William F. Bowld Hospital. Bowld Hospital will operate programs for patients with complex chronic diseases, which will include transplant patients. The term of the agreement is from the effective date until the date all services comprising the hospital are relocated to Methodist University Hospital. As consideration for managing the hospital in the first two years, Methodist will retain the net margins or deficits from hospital operations as defined in the agreement. After the first two years, Methodist will distribute 50 percent of the cumulative net margins in excess of a minimum threshold, as defined in the agreement, if any, to the university. The university has agreed to allow Methodist to use, without limitation, all hospital assets. Methodist purchased the supplies inventories from the university. The university retained the patient accounts receivable as of the effective date.

Employee Services Agreement – Pursuant to the enabling legislation, Tennessee Code Annotated, Section 49-9-112, et seq., Methodist has leased from the university all hospital employees as of the effective date (November 1, 2002). Methodist has paid to the university the amounts incurred by the university to pay the direct expenses relating to the hospital employees, including wages, salaries, and fringe benefits. These payroll expenses on behalf of Methodist, totaling $10,722,263.68, are reported as operating expenses in the statement of revenues, expenses, and changes in net assets. An equal amount of operating revenue is reported in the non-governmental grants and contracts category. The term of the Employee Services Agreement is from the effective date until the date all services comprising the hospital are relocated from William F. Bowld Hospital to Methodist University Hospital. (There are certain provisions under which a limited number of leased employees could continue after this date. Under these circumstances, the agreement will terminate when there are no longer leased employees.) All persons who began service at the hospital after the date the employee service agreement was signed are employees of Methodist and not university employees.

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

The university shall be entitled to reimbursement for its expenses associated with the graduate medical education program rendered under this agreement including the costs of coverage under the Tennessee Claims Commission Act and defense costs. The university will cooperate, support, and assist in seeking adequate reimbursement from Medicare and the State of Tennessee for graduate medical education. The costs of providing residents and medical faculty supervision at Methodist will be paid by the university and the pro rata costs will be reimbursed by Methodist based upon the actual costs associated with the program at Methodist. Specific financial arrangements for residents an faculty will be negotiated annually and incorporated annually by addendum into this Master Affiliation Agreement as part of the Methodist annual budgeting process. The annual addendum will specify the numbers of faculty and residents to be provided along with the costs to be annually reimbursed under this agreement.
Note 17: Natural Classifications with Functional Classifications

The university's operating expenses by functional classification for the year ended June 30, 2004, are as follows:

<table>
<thead>
<tr>
<th>Natural Classification</th>
<th>Salaries</th>
<th>Benefits</th>
<th>Utilities, Supplies &amp; Other Services</th>
<th>Scholarships</th>
<th>Depreciation</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instruction</td>
<td>$258,233,114.42</td>
<td>$76,012,780.33</td>
<td>$46,537,919.06</td>
<td>-</td>
<td>-</td>
<td>$420,783,813.81</td>
</tr>
<tr>
<td>Public service</td>
<td>69,429,137.20</td>
<td>20,585,466.35</td>
<td>37,092,572.32</td>
<td>-</td>
<td>-</td>
<td>127,106,195.87</td>
</tr>
<tr>
<td>Academic support</td>
<td>53,776,447.81</td>
<td>16,131,545.59</td>
<td>13,676,410.92</td>
<td>-</td>
<td>-</td>
<td>83,584,404.32</td>
</tr>
<tr>
<td>Student services</td>
<td>28,300,196.00</td>
<td>8,323,169.76</td>
<td>20,474,765.73</td>
<td>-</td>
<td>-</td>
<td>57,098,131.49</td>
</tr>
<tr>
<td>Institutional support</td>
<td>55,735,929.92</td>
<td>16,107,539.85</td>
<td>1,772,475.08</td>
<td>-</td>
<td>-</td>
<td>73,616,944.85</td>
</tr>
<tr>
<td>Operation and maintenance of plant</td>
<td>26,453,455.67</td>
<td>9,706,418.64</td>
<td>44,606,869.66</td>
<td>-</td>
<td>-</td>
<td>80,765,723.97</td>
</tr>
<tr>
<td>Scholarships and fellowships</td>
<td>2,871,896.45</td>
<td>14,855,095.51</td>
<td>10,837,091.02</td>
<td>$15,210,798.07</td>
<td>-</td>
<td>43,774,881.05</td>
</tr>
<tr>
<td>Auxiliary</td>
<td>29,836,304.54</td>
<td>7,537,812.50</td>
<td>1,884,943.16</td>
<td>-</td>
<td>-</td>
<td>94,546,229.36</td>
</tr>
<tr>
<td>Hospital</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Independent operations</td>
<td>77,542,582.50</td>
<td>29,767,521.45</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>107,310,103.95</td>
</tr>
<tr>
<td>Depreciation</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$748,396,484.77</td>
<td>$224,322,791.92</td>
<td>$290,580,915.19</td>
<td>$15,210,798.07</td>
<td>$62,166,509.09</td>
<td>$1,340,677,499.04</td>
</tr>
</tbody>
</table>

Note 18: Unrestricted Net Assets

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

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital</td>
<td>$33,185,711.25</td>
</tr>
<tr>
<td>Encumbrances</td>
<td>$7,416,519.09</td>
</tr>
<tr>
<td>Quasi-endowments</td>
<td>$(2,163,169.93)</td>
</tr>
<tr>
<td>Plant construction</td>
<td>$19,746,967.82</td>
</tr>
<tr>
<td>Renewal and replacement of capital assets</td>
<td>$102,245,342.16</td>
</tr>
<tr>
<td>Debt retirement</td>
<td>$43,343,103.45</td>
</tr>
<tr>
<td>Total</td>
<td>$214,342,038.03</td>
</tr>
</tbody>
</table>

Note 19: Component Unit—University of Chattanooga Foundation

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

The University of Chattanooga Foundation, Inc., is a legally separate, tax-exempt organization supporting the University of Tennessee at Chattanooga. The foundation acts primarily as a fund-raising organization to supplement the university's operating expenses. The foundation is self-perpetuating and consists of friends of the University of Tennessee at Chattanooga. The 48 member board of trustees of the foundation has 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 separately incorporated, tax-exempt organization supporting the University of Tennessee at Chattanooga. 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 discreetly presented in the university's financial statements.

During the year ended June 30, 2004, the foundation expended $3,990,650.00 to or on behalf of the university for both restricted and unrestricted purposes. Complete financial statements for the foundation can be obtained from the University of Chattanooga Foundation, Development Office, Department 6806, 615 McCallie Avenue, Chattanooga, TN 37403-2598.

Organization and Nature of Activities

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

Principles of Consolidation

The consolidated financial statements of the foundation include the accounts of the foundation and its subsidiaries, Campus Development Foundation, Inc., (CDFI) and CDFI Phase I, LLC (the LLC). All material intercompany accounts and transactions have been eliminated in consolidation. The foundation and CDFI have fiscal years that end June 30. The LLC's fiscal year ends on July 31 in order to reflect the operating cycle of collegiate student housing. The impact of any intervening transactions during the one month period between fiscal year ends is not significant.

CDFI was formed by the foundation during 2001 to engage in charitable, scientific, and educational projects within the meaning of Section 501(c)(3) of the Internal Revenue Code. The projects include, but are not limited to, the acquisition of real property and the construction, management, and operation of dormitories for students of the university. The Directors of CDFI are appointed by the Executive Committee of the Foundation.

CDFI is the sole member of its subsidiary, the LLC. The LLC was formed to own and develop an elementary school in downtown Chattanooga and student housing at the university. The first phase of the student housing, consisting of 455 bedrooms in 149 units, was completed and leased to students in August 2001. The second phase of the student housing, consisting of 584 bedrooms in 158 units, was completed and leased to students in August 2002.

Investments

A summary of foundation investments at June 30, 2004, is as follows:

<table>
<thead>
<tr>
<th>Type of Investment</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity securities (cost of $54,808,056 in 2004)</td>
<td>$59,417,853</td>
</tr>
<tr>
<td>Debt securities (cost of $30,450,180 in 2004)</td>
<td>$30,272,164</td>
</tr>
<tr>
<td>Real estate</td>
<td>$1,360,426</td>
</tr>
<tr>
<td>Limited partnerships</td>
<td>$6,379,147</td>
</tr>
<tr>
<td>Other</td>
<td>$107,286</td>
</tr>
<tr>
<td>Total</td>
<td>$97,336,676</td>
</tr>
</tbody>
</table>
Revenue Bonds Payable

During 2000 and 2001, the Health, Educational, and Housing Facility Board of the City of Chattanooga issued three series of tax-exempt revenue bonds to develop the elementary school and the student housing. The LLC is the borrower on the bonds. The Series 2000 revenue bonds totaled $18,000,000 and were used to acquire land and fund construction of the student housing. The Series 2001A revenue bonds totaled $10,440,000 and were used to fund construction of the elementary school. The Series 2001B revenue bonds totaled $60,140,000 and were used to acquire land and fund construction of additional student housing.

Restricted Cash and Cash Equivalents

The revenue bonds described above restrict the use of certain cash and cash equivalents at June 30, 2004, as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Service Reserves</td>
<td>$ 5,069,140</td>
</tr>
<tr>
<td>Renewal and Replacement Reserves</td>
<td>75,440</td>
</tr>
<tr>
<td>Cash Collateral Account</td>
<td>-</td>
</tr>
<tr>
<td>Restricted for Principal Payments</td>
<td>1,240,888</td>
</tr>
<tr>
<td>Total</td>
<td>$ 6,385,468</td>
</tr>
</tbody>
</table>

Natural Classifications with Functional Classification

The foundation's operating expenses by functional classification for the year ended June 30, 2004, are as follows:

<table>
<thead>
<tr>
<th>Natural Classification</th>
<th>SALARIES</th>
<th>BENEFITS</th>
<th>UTILITIES, SUPPLIES &amp; OTHER SERVICES</th>
<th>PAYMENTS TO OR ON BEHALF OF UT</th>
<th>DEPRECIATION</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Functional Classification</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Academic programs</td>
<td>$ 1,276,073</td>
<td>$ 1,276,073</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professorships</td>
<td>371,440</td>
<td>371,440</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Faculty development</td>
<td>279,883</td>
<td>279,883</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scholarships</td>
<td>1,915,014</td>
<td>1,915,014</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chancellor’s discretionary</td>
<td>112,584</td>
<td>112,584</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>35,656</td>
<td>35,656</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rental expenses</td>
<td>1,974,899</td>
<td>1,974,899</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Administrative and investment fees</td>
<td>429,968</td>
<td>429,968</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal</td>
<td>4,029</td>
<td>4,029</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax and audit</td>
<td>18,327</td>
<td>18,327</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>$2,229,680</td>
<td>2,229,680</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$ 2,427,223</td>
<td>$ 3,990,650</td>
<td>$ 2,229,680</td>
<td></td>
<td></td>
<td>$ 6,457,553</td>
</tr>
</tbody>
</table>

Note 20: Component Unit—University of Tennessee Foundation

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

The University of Tennessee Foundation is a legally separate, tax-exempt organization supporting the University of Tennessee. The foundation acts primarily 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, 2004, the foundation distributed $1,168,268.64 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.

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:

<table>
<thead>
<tr>
<th>Category</th>
<th>Unrestricted</th>
<th>Temporarily Restricted</th>
<th>Permanently Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current pledges</td>
<td>$ 43,621.10</td>
<td>$ 5,092.43</td>
<td>$ 49,213.57</td>
</tr>
<tr>
<td>Pledges due in one to five years</td>
<td>178,871.31</td>
<td>1,030,959.15</td>
<td>189,291.10</td>
</tr>
<tr>
<td>Pledges due after five years</td>
<td>138,627.57</td>
<td>170,076.00</td>
<td>294,554.69</td>
</tr>
<tr>
<td>Less discounts to net present value</td>
<td>361,119.98</td>
<td>1,206,127.58</td>
<td>533,062.06</td>
</tr>
<tr>
<td>Total pledges receivable, net</td>
<td>$ 322,848.72</td>
<td>$1,103,201.06</td>
<td>$ 464,902.62</td>
</tr>
</tbody>
</table>

The allowance for doubtful accounts at June 30, 2004, was $435,100.91.
Construction in Progress—Knoxville Place

In September 2002, the Health, Educational and Housing Facility Board of the County of Knox, Tennessee, issued $60,090,000.00 of variable rate, tax-exempt bonds to fund the acquisition, construction, and equipping of a student housing facility adjacent to the Knoxville campus. The facility will be a 12-story complex with five levels for parking and seven levels for housing. The facility is scheduled for completion in August 2004.

Volunteer Student Housing, LLC, entered into a 7 year 75 percent hedge on the project with the hedge rate being 3.25 percent. During the fiscal year, $1,619,875.91 of interest expense and $531,558.87 of interest income was accrued. The first principal payment is due September 1, 2005. The bond proceeds are held in trust and invested. The book value of the bond proceeds remaining at June 30, 2004, is $14,648,022.36, which approximates market value. Also, residents at the student housing complex have paid fees as part of their lease agreement. $90,000 of the rental fees have been transferred to the revenue fund at Wachovia Bank, the trustee.

Other project costs represent issuance costs and letter of credit costs paid from the bond proceeds at closing. The issuance costs will be amortized over the life of the bonds, and the letter of credit cost will be amortized over the 7-year letter of credit term. The total other project costs was $831,683.04, and the amortized cost for the fiscal year was $68,334.46. The underwriter’s discount was also paid from bond proceeds at closing and will be amortized over the life of the bonds. The underwriter’s discount was $420,630.00 and the amortized cost for the fiscal year was $13,144.69.

Future maturities of bonds payable commencing 2005 are as follows:

<table>
<thead>
<tr>
<th>Year Ended June 30:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2005..........................</td>
<td>$ 1,100,000</td>
</tr>
<tr>
<td>2006..........................</td>
<td>$ 1,090,000</td>
</tr>
<tr>
<td>2007..........................</td>
<td>$ 1,130,000</td>
</tr>
<tr>
<td>2008..........................</td>
<td>$ 1,185,000</td>
</tr>
<tr>
<td>Thereafter ..................</td>
<td>$ 55,585,000</td>
</tr>
<tr>
<td>--------------------------</td>
<td>$ 60,090,000</td>
</tr>
</tbody>
</table>

Natural Classifications with Functional Classification

The foundation’s operating expenses by functional classification for the year ended June 30, 2004, are as follows:

<table>
<thead>
<tr>
<th>Natural Classification</th>
<th>SALARIES</th>
<th>BENEFITS</th>
<th>UTILITIES, SUPPLIES &amp; OTHER SERVICES</th>
<th>PAYMENTS TO OR ON BEHALF OF UT</th>
<th>DEPRECIATION</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grants and Scholarships</td>
<td>$31,247.00</td>
<td>$4,127.43</td>
<td>$531,636.68</td>
<td>$1,072,341.26</td>
<td></td>
<td>$1,072,341.26</td>
</tr>
<tr>
<td>General and Administrative</td>
<td>$31,247.00</td>
<td>$4,127.43</td>
<td>$531,636.68</td>
<td></td>
<td>$95,927.38</td>
<td>$661,938.49</td>
</tr>
<tr>
<td>Student Housing</td>
<td>-</td>
<td>-</td>
<td>1,003.89</td>
<td></td>
<td>-</td>
<td>1,003.89</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$31,247.00</td>
<td>$4,127.43</td>
<td>$531,640.57</td>
<td>$1,168,268.64</td>
<td></td>
<td>$1,735,283.64</td>
</tr>
</tbody>
</table>

Letter of Credit

In association with the issuance of the bonds mentioned above, the foundation was granted an irrevocable letter of credit in the amount of $60,979,003.00. Of this amount, $60,090,000 is available for the payment of the principal of the bonds or a portion of the purchase price corresponding to the principal of the bonds and $889,003.00 is available for the payment of up to 45 days’ interest on the bonds. There is no outstanding balance drawn on this letter of credit at June 30, 2004.

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 such losses in this account and believes it is not exposed to any significant credit risk to cash.

Remainder Interest

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

In December 2002, a donor conveyed to the foundation a remainder interest in a limited liability company. The asset of the limited liability company is a fee simple interest in a warehouse in South Carolina. The remainder interest was appraised at $7,740,000.00 with the interest vesting on January 1, 2021. The value on the statement of net assets 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 percent. The present value of the remainder interest at June 30 was $4,052,199.90.

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 statement of net assets will be the present value calculation until the vesting date. The IRS discount rate for September 2003 was 4.20 percent. The present value at June 30 was $9,500,537.00.
### Ten-Year Summary of University of Tennessee Operations, Fiscal Years 1994–2004

#### SOURCES OF OPERATING REVENUES (,000)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>State Appropriations</td>
<td>$416,422</td>
<td>$419,927</td>
<td>$415,921</td>
</tr>
<tr>
<td>Student Fees</td>
<td>243,661</td>
<td>227,582</td>
<td>217,000</td>
</tr>
<tr>
<td>Federal Appropriations</td>
<td>15,409</td>
<td>11,839</td>
<td>13,761</td>
</tr>
<tr>
<td>Other (Gifts, Grants, Sales and Services, etc.)</td>
<td>465,271</td>
<td>482,156</td>
<td>431,677</td>
</tr>
<tr>
<td>Total General Funds</td>
<td>$1,140,763</td>
<td>$1,141,504</td>
<td>$1,078,359</td>
</tr>
<tr>
<td>Auxiliary Enterprise</td>
<td>132,954</td>
<td>132,818</td>
<td>130,084</td>
</tr>
<tr>
<td>Hospitals</td>
<td>(871)</td>
<td>16,466</td>
<td>51,533</td>
</tr>
<tr>
<td>Independent Operations</td>
<td>107,372</td>
<td>97,751</td>
<td>91,147</td>
</tr>
<tr>
<td>Total Revenues-Current Funds</td>
<td>$1,380,218</td>
<td>$1,388,539</td>
<td>$1,351,123</td>
</tr>
</tbody>
</table>

#### CURRENT EXPENDITURES AND TRANSFERS (,000)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Instruction</td>
<td>$427,422</td>
<td>$417,388</td>
<td>$398,298</td>
</tr>
<tr>
<td>Research</td>
<td>195,999</td>
<td>195,226</td>
<td>168,457</td>
</tr>
<tr>
<td>Public Service</td>
<td>131,952</td>
<td>127,154</td>
<td>120,807</td>
</tr>
<tr>
<td>Academic Support</td>
<td>96,809</td>
<td>97,922</td>
<td>86,647</td>
</tr>
<tr>
<td>Student Services</td>
<td>59,554</td>
<td>54,644</td>
<td>50,675</td>
</tr>
<tr>
<td>Institutional Support</td>
<td>77,500</td>
<td>78,880</td>
<td>70,086</td>
</tr>
<tr>
<td>Operation and Maintenance of Physical Plant</td>
<td>81,316</td>
<td>75,626</td>
<td>69,469</td>
</tr>
<tr>
<td>Scholarships and Fellowships</td>
<td>76,777</td>
<td>74,960</td>
<td>68,059</td>
</tr>
<tr>
<td>Transfers (1,099)</td>
<td>3,404</td>
<td></td>
<td>24,950</td>
</tr>
<tr>
<td>Total General Funds-Expenditures and Transfers</td>
<td>$1,146,230</td>
<td>$1,125,204</td>
<td>$1,057,448</td>
</tr>
<tr>
<td>Auxiliary Expenditures and Transfers</td>
<td>133,322</td>
<td>133,142</td>
<td>129,029</td>
</tr>
<tr>
<td>Hospital Expenditures and Transfers</td>
<td>2,076</td>
<td>21,094</td>
<td>66,782</td>
</tr>
<tr>
<td>Ind Operations Expenditures and Transfers</td>
<td>107,310</td>
<td>96,651</td>
<td>91,147</td>
</tr>
<tr>
<td>Total Current Expenditures and Transfers</td>
<td>$1,388,938</td>
<td>$1,376,091</td>
<td>$1,344,406</td>
</tr>
<tr>
<td>Expenditures Converted to 2003</td>
<td>1</td>
<td>1.022</td>
<td>1.045</td>
</tr>
<tr>
<td>Equivalent by Consumer Price Index Factor</td>
<td>$1,388,938</td>
<td>$1,406,365</td>
<td>$1,404,904</td>
</tr>
</tbody>
</table>

#### CURRENT UNRESTRICTED FUND ASSETS (,000)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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#### STUDENT LOAN FUNDS

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#### ENDOWMENT FUNDS (,000)

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#### LIFE INCOME FUNDS (,000)

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<td>Market Value</td>
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#### PLANT FUNDS (,000)

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#### GENERAL DATA

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**24**
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Administration of the University of Tennessee
From July 1, 2003, to June 30, 2004

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