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MEMBERS
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To the Board of Directors of
The University of Tennessee Foundation, Inc.
Knoxville, Tennessee

We have audited the accompanying consolidated statement of financial position of The University of Tennessee Foundation, Inc. (a non-profit organization) as of June 30, 2003, and the related statements of activities and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The University of Tennessee Foundation, Inc. as of June 30, 2003, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Brown Jake & McDaniel, PC

September 26, 2003

The University of Tennessee Foundation, Inc.

Consolidated Statement of Financial Position

June 30, 2003

	Unrestricted	Temporarily Restricted	Total
Assets:			
Cash and cash equivalents	$ 628,770.15	$ 403,426.62	$ 1,032,196.77
Cash with trustee (Note 9)	46,021,127.23	-	46,021,127.23
Accounts and interest receivable	69,617.76	-	69,617.76
Prepaid expenses	98,712.32	34,180.43	132,892.75
Investments (Note 3)	248,696.64	-	248,696.64
Pledges receivable (Note 2)	323,246.05	212,802.27	536,048.32
Construction in progress (Note 9)	14,135,535.79	-	14,135,535.79
Other project costs (Note 9)	779,852.99	-	779,852.99
Remainder interest (Note 11)	-	3,896,346.06	3,896,346.06
Assets held by the University of Tennessee (Note 4)	-	983,346.01	983,346.01
Total assets	$ 62,305,558.93	$ 5,530,101.39	$ 67,835,660.32
Liabilities and net assets:			
Liabilities:			
Accounts payable	$ 1,415,836.44	$ -	$ 1,415,836.44
Due to the University of Tennessee	948,170.71	-	948,170.71
Bonds payable (Note 9)	60,090,000.00	-	60,090,000.00
Underwriter's discount (Note 9)	(409,676.09)	-	(409,676.09)
Total liabilities	62,044,331.06	-	62,044,331.06
Net assets:			
Unrestricted	261,227.87	-	261,227.87
Temporarily restricted	-	5,530,101.39	5,530,101.39
Total net assets	261,227.87	5,530,101.39	5,791,329.26
Total liabilities and net assets	$ 62,305,558.93	$ 5,530,101.39	$ 67,835,660.32

The accompanying notes are an integral part of these financial statements.

The University of Tennessee Foundation, Inc.

Consolidated Statement of Activities

Year Ended June 30, 2003

	Unrestricted	Temporarily Restricted	Total
Revenues:			
Contributions	$ 1,349,095.49	$ 1,652,544.25	$ 3,001,639.74
Contributions - remainder interest (Note 11)	-	3,759,444.61	3,759,444.61
Interest and Investment income	74,339.92	9,546.41	83,886.33
Net realized/unrealized gains and losses	6,471.04	9,960.88	16,431.92
Change in actuarial value of split interest	-	136,901.45	136,901.45
Other	6,586.83	-	6,586.83
Net assets released from restrictions	408,626.83	(408,626.83)	-
Total revenue	1,845,120.11	5,159,770.77	7,004,890.88
Expenses:			
Grants and Scholarships	978,309.35	-	978,309.35
General and administrative	630,635.12	-	630,635.12
Total expenses	1,608,944.47	-	1,608,944.47
Change in net assets	236,175.64	5,159,770.77	5,395,946.41
Net assets at beginning of year	25,052.23	370,330.62	395,382.85
Net assets at end of year	$ 261,227.87	$ 5,530,101.39	$ 5,791,329.26

The accompanying notes are an integral part of these financial statements.

The University of Tennessee Foundation, Inc.

Consolidated Statement of Cash Flows

Year Ended June 30, 2003

Cash flows from operating activities:	
Change in net assets	$ 5,395,946.41
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Non-cash contributions	(3,759,444.61)
Net realized/unrealized gains	(16,431.92)
Change in actuarial value of donated asset	(136,901.45)
Amortization of project costs and underwriter's discount	62,783.96
Increase in receivable	(69,151.09)
Increase in prepaid expenses	(128,127.35)
Increase in pledge receivable	(536,048.32)
Increase in accounts payable	2,333,443.11
Net cash provided by operating activities	3,146,068.74
Cash flows from investing activities:	
Sale of stock	7,517.36
Purchase of shares in the university's investment pool	(973,385.13)
Payment on construction project	(14,135,535.79)
Other project costs	(831,683.04)
Purchase of investments	(75,000.00)
Net cash used for investing activities	(16,008,086.60)
Cash flows from financing activities:	
Proceeds from bonds	60,090,000.00
Payment of underwriter discount	(420,630.00)
Net cash provided by financing activities	59,669,370.00
Net increase in cash and cash equivalents	46,807,352.14
Cash and cash equivalents at beginning of year	245,971.86
Cash and cash equivalents at end of year	$ 47,053,324.00

Supplemental disclosures of cash flow information:	
Cash paid during the year for interest	$ 1,153,563.38

The accompanying notes are an integral part of these financial statements.

The University of Tennessee Foundation, Inc.

Notes to Consolidated Financial Statements

June 30, 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Nature of Activities

The University of Tennessee Foundation, Inc. (the "Foundation") is a not-for-profit organization exempt from federal income tax under Section 501 (c) (3) of the Internal Revenue Code. The Foundation was formed to support The University of Tennessee (the "University"). The Foundation was established to provide flexibility for the University in carrying out its mission of teaching, research, and public research. The Foundation receives contributions from individuals, corporations, alumni, and other donors.

Financial Statement Presentation

The Foundation has adopted Statement of Financial Accounting Standards (SFAS) No. 117, "Financial Statements of Not-for-Profit Organizations." Under SFAS No. 117, the Foundation is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

The Foundation has no permanently restricted net assets.

Principles of Consolidation

The consolidated financial statements include the accounts of the Foundation and two single member limited liability companies created by the Foundation. The names of the limited liability companies are Volunteer Student Housing, LLC and Martin Student Housing, LLC. The limited liability companies were created to own student housing facilities adjacent to the University of Tennessee at Knoxville campus and University of Tennessee at Martin campus. All significant intercompany balances and transactions have been eliminated in the consolidation.

Basis of Presentation

The financial statements have been prepared on the accrual basis of accounting, and accordingly, reflect all significant receivables, payables, and other liabilities.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposit accounts and money market funds with financial institutions.

Investments

Investments are recorded on the date of contribution and are stated at market value. Market values are determined by national securities exchanges. Unrealized gains and losses are determined by the difference between market values at the beginning and end of the year. These amounts are included in the change in net assets in the accompanying statement of activities.

The Foundation's policy regarding investment income and realized and unrealized gains and losses for temporarily and permanently restricted assets is to record such revenues as unrestricted support to the extent that restrictions are met in the same reporting period.

Pledges Receivable

Unconditional pledges, less an allowance for doubtful accounts, are recognized as contribution revenue in the period received and as an asset. Conditional pledges are recognized when the conditions on which they depend are substantially met. Unconditional pledges that are expected to be collected within one year are recorded at net realizable value. Unconditional pledges that are expected to be collected in future years are recorded at the present value of their estimated future cash flow.

Construction in Progress

Construction in progress is recorded at cost. Interest expense on tax-exempt bonds financing the project, offset by interest earned on the proceeds of the bonds, during the construction phase is capitalized. At the completion of construction, the resulting assets will be depreciated over their estimated useful lives.

Contributions

Contributions received are recorded as unrestricted or temporarily restricted support depending on the existence or nature of any donor restrictions.

The Foundation reports gifts of cash, donated property, and all other assets as unrestricted support unless explicit donor stipulations limit the use of the donated assets. When a donor restriction expires, that is, when the stipulated time restriction ends or purpose restriction is

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions.

Donated gifts are recorded at fair market value at the time of donation and are reported as restricted support if it is received with donor imposed restrictions.

2. PLEDGES RECEIVABLE

Pledges receivable are summarized below net of the allowance for doubtful accounts:

	Unrestricted	Temporarily Restricted
Current pledges	$ 25,753.55	$ 23,544.00
Pledges due in one to five years	156,171.70	149,646.43
Pledges due after five years	164,102.43	50,044.32
	346,027.68	223,234.75
Less discounts to net present value	(22,781.63)	(10,432.48)
Total pledges receivable, net	$ 323,246.05	$ 212,802.27

3. INVESTMENTS

Investment securities held at June 30, 2003, were as follows:

	Market Value	Cost Basis
Mutual funds	$ 248,696.64	$ 242,000.00

4. ASSETS HELD BY THE UNIVERSITY OF TENNESSEE

All Foundation endowments are invested in the University of Tennessee Consolidated Investment Pool. The endowments are invested according to the policies of the University. Investment pool earnings for the Foundation endowments are provided to the University as stipulated in the endowment agreements. The book value and market value for the endowments invested were $973,385.13 and $983,346.01, which resulted in an unrealized gain of $9,960.88. Endowment pool earnings transferred to the University were $7,369.90 for fiscal year 2003.

5. OPERATING LEASES

The Foundation has entered into a five-year lease for farm land in Martin, Tennessee. The lease terminates in April 2007. Minimum lease payments are $30,000.00 per year over the term of the lease. Total accrued lease expense was $30,000.00 for the year ended June 30, 2003. The Foundation has subleased the land to the University. The sublease is a five-year term and terminates in April 2007. The Foundation will receive $2,800.00 per year as compensation for the lease. Total accrued lease revenue at June 30, 2003, was $466.67.

The Foundation has also entered into an agreement to lease office space in Nashville, Tennessee for 3 years. The minimum lease payments are $63,198.00 per year over the term of the lease. Total accrued lease expense was $26,332.50 at June 30, 2003.

Minimum lease payments for future years are as follows:

2004	$ 93,198.00
2005	93,198.00
2006	66,865.50
2007	25,000.00
	$ 278,261.50

6. TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets consist of endowments for scholarships or other academic purposes, a housing project, administrative funding provided by the University, and contributions for the farm lease payment. Total temporarily restricted net assets at June 30, 2003, were $5,530,101.39.

7. UT NATIONAL ALUMNI ASSOCIATION

The Foundation granted $970,939.45 to the University of Tennessee National Alumni Association to provide funds for the Association's budget. The Association funds various scholarships, faculty awards, and other programs which benefit the University. The funds provided came from unrestricted contributions.

8. 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 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.

8. CONSTRUCTION IN PROGRESS - KNOXVILLE PLACE (continued)

Volunteer Student Housing, LLC entered into a 7 year 75% hedge on the project with the hedge rate being 3.25%. During the fiscal year, $1,283,460.67 of interest expense and $572,583.32 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 at June 30, 2003 is $46,021,127.23, which approximates market value.

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 bond, 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 $51,830.05. The underwriter's discount was also paid from bond proceeds at closing and will be amortized over the life of the bond. The underwriter's discount was $420,630.00 and the amortized cost for the fiscal year was $10,953.91.

Future maturities of bonds payable commencing 2005 are as follows:

Year Ended June 30,	
2005	$ 1,100,000
2006	1,090,000
2007	1,130,000
2008	1,185,000
Thereafter	55,585,000
	$ 60,090,000

9. LETTER OF CREDIT

In association with the issuance of the bonds mentioned in Note 9, 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, 2003.

10. REMAINDER INTEREST

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

10. REMAINDER INTEREST (continued)

the interest vesting on January 1, 2021. The value on the Statement of Position will be the present value calculation until the vesting date. The IRS discount rate for December 2002 used in determining the present value was 4%. The present value of the remainder interest at June 30 was $3,896,346.06.

11. GIFT ANNUITIES

The Foundation has entered into an agreement with The Benefits Group (TBG) for gift annuities. Under the agreement, a donor can provide funds to the Foundation for a gift annuity and an annuity agreement would be signed between the donor and the Foundation. TBG is then contacted and completes the annuity contract with an insurance company (commercial annuity) with the contract also signed by the Foundation. The insurance company makes the annuity payments to the donor not the Foundation. Part of the gift annuity donation is sent to the insurance company to fund the annuity payments. The remaining annuity gift amount is sent to the University for the purpose specified in the annuity agreement. The commercial annuity purchased by the Foundation is insurance and is subject to regulation by the Tennessee Commissioner of Commerce and Insurance and is protected by an insurance guaranty association. The Foundation has no liability under this arrangement since the commercial annuity is purchased. During the fiscal year, three gift annuities were performed with the total gift value being $169,916.56.

12. RETIREMENT PLAN

The Foundation has a defined contribution plan (the Plan) covering all employees who agree to make contributions to the Plan equal to 10% of the participant's compensation. The Foundation matches participants' contributions to the Plan equal to 10% of participants' compensation. Total expense for the year ended June 30, 2003 was $15,000.00.

13. 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.

14. DR. SHUMAKER'S CONTRACT WITH THE FOUNDATION

At June 30, 2003, the Foundation had a contract with Dr. John Shumaker, President of the University, which was entered into in May 2002. Under the terms of the contract, the Foundation is to provide long term care insurance and life and disability insurance over and

14. DR. SHUMAKER'S CONTRACT WITH THE FOUNDATION (continued)

above the University's plan. The Foundation is to reimburse Dr. Shumaker up to $10,000.00 per fiscal year for incurred attorney and financial planning fees. The Foundation is also to provide target bonuses as an incentive to accomplish specific goals for the benefit of the University. No bonuses were provided during fiscal year 2003. The Foundation is to purchase $75,000.00 of investments on each June 30 as an Executive Option. The Foundation purchased $92,000.00 of additional executive option investments at June 30, 2002, since Dr. Shumaker gave up approximately this amount in options by leaving the University of Louisville, Kentucky. Purchased investments at June 30, 2003 total $242,000.00. The Foundation is to pay a supplemental retirement benefit of $150,000.00 per year for 10 years when Dr. Shumaker ceases to be President. Dr. Shumaker must remain as President until June 30, 2008, for the obligation to remain in effect except in the event of his death or permanent disability. The Foundation has not funded this benefit as of June 30, 2003. Finally, Dr. Shumaker has a $25,000.00 business expense allowance. During the fiscal year ended June 30, 2003, the Foundation incurred $117,761.17 of expenses for insurance premiums, attorney and financial consulting, executive options, and the expense allowance.

15. SUBSEQUENT EVENTS

Dr. Shumaker resigned August 8, 2003 as President of the University after less than two years of continuous service. According to the original agreement with Dr. Shumaker as described in Note 14, the $242,000.00 of purchased investments do not vest unless there was 8 years of continuous service to the University. Since this requirement was not met, the board will determine the disposition of these assets.

In addition, the Foundation sent a 90-day notice to terminate the Nashville, Tennessee office space lease described in Note 5 on August 8, 2003. As a result of this termination, future minimum lease payments for future years were reduced to the following:

2004	$ 52,277.52
2005	30,000.00
2006	30,000.00
2007	25,000.00
	$ 137,277.52