



JUSTIN P. WILSON
Comptroller

JASON E. MUMPOWER
Chief of Staff

Independent Auditor's Report

Members of the General Assembly
Members of the Board of Trustees
The Honorable David H. Lillard, Jr., Treasurer

Report on the Financial Statements

We have audited the accompanying balance sheet of the Chairs of Excellence, a permanent fund of the State of Tennessee, as of June 30, 2017, the related statement of revenues, expenditures, and changes in fund balance for the year then ended, and the related notes to the financial statements, which collectively comprise the Chairs of Excellence's basic financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting principles

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used and reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion. 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 the Chairs of Excellence. We do not believe that the Comptroller's service in this capacity affected our ability to conduct an independent audit of the Chairs of Excellence.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Charis of Excellence, a permanent fund of the State of Tennessee as of June 30, 2017, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note A.1., the financial statements present only the Chairs of Excellence, a permanent fund, and do not purport to, and do not, present fairly the financial position of the State of Tennessee, as of June 30, 2017, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 8, 2018, on our consideration of the Chairs of Excellence's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts, 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Chairs of Excellence's internal control over financial reporting and compliance.



Deborah V. Loveless, CPA, Director
Division of State Audit
March 8, 2018

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Chairs of Excellence Balance Sheet June 30, 2017

ASSETS

Cash and Cash Equivalents	\$	12,665,878
Investments, at fair value		
Government securities		88,604,775
Corporate securities		31,854,217
Investment in exchange traded equity fund		194,432,538
Total investments		<u>314,891,530</u>
Receivables		
Due from colleges and universities		803,959
Investment income receivable		706,731
Total receivables		<u>1,510,690</u>
TOTAL ASSETS	\$	<u><u>329,068,098</u></u>
LIABILITIES AND FUND BALANCES		
LIABILITIES		
Due to colleges and universities	\$	2,335,782
Due to the Academic Scholars fund		3,762,421
Due to the general fund		49,246
Investments purchased		1,475,954
TOTAL LIABILITIES		<u>7,623,403</u>
FUND BALANCES		
Nonspendable corpus		104,358,388
Restricted		217,086,307
TOTAL FUND BALANCES		<u>321,444,695</u>
TOTAL LIABILITIES AND FUND BALANCES	\$	<u><u>329,068,098</u></u>

See accompanying Notes to the Financial Statements

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Chairs of Excellence Statements of Revenue, Expenditures, and Changes in Fund Balances For Fiscal Year Ended June 30, 2017

REVENUES

Investment income	\$	30,008,209
Contributions from private sources		<u>2,500,000</u>

TOTAL REVENUES		<u>32,508,209</u>
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EXPENDITURES

University of Tennessee		4,189,360
State University and Community College System		4,209,380
Administrative cost		<u>253,228</u>

TOTAL EXPENDITURES		<u>8,651,968</u>
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EXCESS OF REVENUE OVER EXPENDITURES		23,856,241
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OTHER FINANCING SOURCES

Transfer in from the General Fund		<u>1,500,000</u>
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TOTAL OTHER FINANCING SOURCES		<u>1,500,000</u>
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NET CHANGE IN FUND BALANCE		25,356,241
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FUND BALANCES, BEGINNING OF YEAR		<u>296,088,454</u>
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FUND BALANCES, END OF YEAR	\$	<u><u>321,444,695</u></u>
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See accompanying Notes to the Financial Statements

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Chairs of Excellence Notes to the Financial Statements June 30, 2017

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Reporting Entity

The Chairs of Excellence (COE) Trust forms an integral part of the primary government and has been included as a permanent fund in the Tennessee Comprehensive Annual Financial Report.

2. Measurement Focus and Basis of Accounting

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB), using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recorded when they become both measurable and available, and expenditures are recognized when the related fund liability is incurred. Interest associated with the current fiscal year is considered to be available if received in six months.

3. Cash and Cash Equivalents

Cash and cash equivalents includes cash and short term investments with a maturity date within three months of the acquisition date. Cash management pools are included as cash. Cash received that cannot be immediately invested in securities, or that is needed for operations, is invested in either the State Pooled Investment Fund sponsored by the State of Tennessee and administered by the State Treasurer or a short-term, open-end mutual fund under the contractual arrangement for master custody services and invested in the State Street Government Money Market Fund.

4. Method Used to Value Investments

Investments are reported at fair value. Securities traded on a national exchange are valued at the last reported sales price. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments and interest and dividend income. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.

The fair value of assets held at June 30, 2017 represents the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Assets held are categorized for fair value measurement within the fair value hierarchy established by Generally Accepted Accounting Principles (GAAP). The hierarchy is based on the valuation inputs used to measure the fair value of the asset and give the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

- Level 1 - Unadjusted quoted prices for identical assets or liabilities in active markets that can be accessed at the measurement date.
- Level 2 - Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; assets or liabilities that have a bid-ask spread price in an inactive dealer market, brokered market and principal-to-principal market; and Level 1 assets or liabilities that are adjusted.
- Level 3 - Valuations derived from valuation techniques in which significant inputs are unobservable.

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Investments where fair value is measured using the Net Asset Value (“NAV”) per share have no readily determinable fair value and have been determined to be calculated consistent with FASB principles for investment companies.

Where inputs used in the measurement of fair value fall into different levels of the hierarchy, fair value of the instrument in its entirety are categorized based on the lowest level input that is significant to the valuation. This assessment requires professional judgement and as such management developed a fair value committee that worked in conjunction with our custodian and investment professionals to make these valuations. All assets held were valued individually and aggregated into classes so to be represented in the table below.

Short-term securities generally include investments in money market-type securities reported at cost plus accrued interest.

Equity and equity derivative securities classified in Level 1 are valued using last reported sales prices quoted in active markets that can be accessed at the measurement date.

US Treasury Bills, Bonds, Notes and Futures classified in Level 1 are valued using last reported sales prices quoted in active markets that can be accessed at the measurement date. Debt and debt derivative securities classified in Level 2 are valued using a bid-ask spread price from multiple independent brokers, dealers, or market principals, which are known to be actively involved in the market. Level 3 debt securities are valued using proprietary information, a single pricing source, or other unobservable inputs related to similar assets or liabilities.

Investments Measured at Fair Value

June 30, 2017

Expressed in Thousands

Investments at Fair Value Level	GAAP Hierarchy Level 1	GAAP Hierarchy Level 2	Total Assets
Domestic Passive Mutual Fund	\$ 149,513	\$ -	\$ 149,513
International Passive Mutual Fund	44,919	-	44,919
Total Exchange Traded Funds	194,432	-	194,432
Government Issues	60,696	3,937	64,633
Corporate Bonds	-	26,233	26,233
Agency Securities	-	18,837	18,837
Municipals	-	5,135	5,135
Other Asset Backed	-	5,621	5,621
	60,696	59,763	120,459
TOTAL INVESTMENTS AT FAIR VALUE	\$ 255,128	\$ 59,763	\$ 314,891
Cash and Cash Equivalents			12,666
Other Receivables			804
Investment Income Receivable			707
TOTAL FINANCIAL STATEMENT ASSETS			\$ 329,068

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5. Fund Balances

Nonspendable fund balance includes amounts that cannot be spent because they are legally or contractually required to be maintained intact. The COE Trust's nonspendable corpus consists of funds provided by contributions from the state, colleges and universities, and private sources. Restricted fund balance includes amounts that are restricted for specific purposes stipulated by external resource providers, constitutionally, or through enabling legislation. The COE Trust's restricted fund balance consists of investment income that must be used for funding the Chairs of Excellence program.

B. DEPOSITS AND INVESTMENTS

State statute authorizes the funds of the COE Trust to be commingled for investment with other trust funds and other funds subject to investment by the State Treasurer. The COE Trust does not maintain its own bank accounts but utilizes the State Pooled Investment Fund for its operating cash needs. The State Pooled Investment Fund is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee. The current resolution of that board gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements and various U.S. Treasury and Agency obligations. The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities.

State statute also authorizes the Board of Trustees of the COE Trust to adopt an investment policy for the trust in accordance with the laws, guidelines and policies that govern investments by the Tennessee Consolidated Retirement System. The State Treasurer is responsible for the investment of trust funds in accordance with the policy established by the trustees. The investment policy of the COE Trust requires that public funds, capital gains on public funds, and all current income exceeding withdrawals be invested in fixed income securities. Private contributions may be invested in equity securities, including domestic and foreign common stocks, preferred stocks and convertible bonds. Subsequent to the initial funding of a chair, funds may be transferred from the equity corpus to the fixed income corpus but not from the fixed income corpus to the equity corpus. During the year ended June 30, 2017, the COE Trust's equity investments were within the overall limits on equity securities per statutory and policy provisions.

See GASB 40A Table on next page.

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As of June 30, 2017, the COE Trust had the following investments (expressed in thousands):

Credit Quality distribution for securities with credit Exposure as a percentage of Total Investments June 30, 2017

Rating	Fair Value (in thousands)	Percentage of Total Investments
AAA	\$ 8,364	2.66%
AA	8,132	2.58%
A	9,137	2.90%
BBB	10,448	3.32%
BB	244	0.08%
CCC	266	0.08%
Not Rated	20,549	6.53%
Total Debt Investments	57,140	
Government Agencies and Obligations*	63,319	
Total Fixed Income Securities	120,459	
Equity	194,433	
Total Investments as shown on statements	\$ 314,892	

* Includes obligations of the US Government or obligations explicitly guaranteed by the US Government which are not rated by credit rating agencies.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Credit quality ratings for the COE Trust's investments in fixed income securities as of June 30, 2017 are included in the above schedule. Securities are rated using Standard and Poor's and/or Moody's and are presented above using the Standard and Poor's rating scale. The State Pooled Investment Fund has not obtained a credit quality rating from a nationally recognized credit ratings agency. The State Street Government Money Market Fund is not rated at June 30, 2017.

The COE Trust's investment policy states that the majority of investments should be placed in high quality debt securities to produce adequate income with minimal risk. In addition, for short-term investments, the investment policy states that only the highest quality short-term debt issues should be purchased.

As noted above, the COE Trust does not maintain its own bank accounts but utilizes the State Pooled Investment Fund for its operating cash purposes. The investment policy and required risk disclosures relative to the State Pooled Investment Fund are presented in the State Pooled Investment Fund Report.

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Concentration of Credit Risk

A concentration of investments in any one single issuer of debt securities presents a greater risk for loss in the event that the issuer fails on its obligations. The COE Trust had no investments at June 30, 2017, in organizations representing five percent or more of total investments, excluding those organizations whose issues are explicitly guaranteed by the United States government, and investments in mutual funds, external investment pools, and other pooled investments.

The COE Trust's investment policy does not specifically address limitations on investing in any one issuer.

Interest Rate Risk

Interest rate risk is the risk that future changes in prevailing market rates of interest will have an adverse effect on the fair value of debt investments. The fair values of securities with long terms to maturity may be highly sensitive to interest rate changes. The investment policy for the COE Trust states that the maturity of its debt securities may range from short-term instruments, including investments in the State Pooled Investment Fund, to long-term bonds, with consideration of liquidity needs. However, the policy does not specifically address limits on investment maturities. The fixed income portfolio is benchmarked against the Barclays Aggregate Index and tends to have a duration within a tight range around that index. Duration is a measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows weighted for those cash flows as a percentage of the investment's full price.

The COE Trust had the following investments and effective duration at June 30, 2017 (expressed in thousands).

<u>Investment Type</u>	<u>Fair Value as of June 30, 2017</u>	<u>Effective Duration (years)</u>
U.S. Government Agencies	\$ 3,937	2.95
U.S. Government TIPS	32,298	8.13
U.S. Government Treasuries	28,398	7.82
Municipal Bonds	5,135	3.49
Government Asset Backed	1,353	4.27
Government Mortgage Backed	18,874	4.30
Corporate Asset Backed	1,980	1.91
Corporate Bonds	26,233	6.26
Corporate Mortgage Backed	2,251	0.24
Total Debt Investments	<u>\$ 120,459</u>	<u>6.39</u>

Asset Backed Securities

The COE Trust invests in collateralized mortgage obligations (CMOs) which are mortgage backed securities. These securities are based on cash flows from interest and principal payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. The fair value of CMOs at June 30, 2017 was \$2,251,446 of which \$2,105,193 were CMOs that are generally more sensitive to interest rate changes.

C. OTHER ACCOUNTING DISCLOSURES

1. Chairs of Excellence Endowment Trust

The COE Trust is authorized by the 94th General Assembly to further the cause of education in Tennessee. The COE Trust is administered by the State Treasurer. The Trust is set up into two general accounts which equally divide any state appropriations: one for the University of Tennessee and one for the State University and Community College System. As each Chair is designated, a portion of the appropriation is transferred to a sub account for that Chair. The awarding college or university must provide matching contributions, of which at least 50 percent of the funds are from private contributions.

One hundred Chairs have been established with matching contributions received totaling \$58,458,388 as of June 30, 2017. Total contributions to the COE Trust totaled \$104,358,388 as of June 30, 2017. This includes \$45,900,000 from the State, \$10,321,300 from Colleges and Universities, and \$48,137,088 from private contributions as of June 30, 2017.

2. Other Funds

Funds from the Academic Scholars Fund are combined with the COE Trust for investment purposes only. This fund's general account receives only the income earned on its principal and does not receive any COE Trust state contributions or appropriations. The fund is invested in domestic fixed income securities.