

# Tennessee Promise Scholarship Endowment



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## 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 Tennessee Promise Scholarship Endowment, a part of the State of Tennessee's education fund, a special revenue fund, 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 Tennessee Promise Scholarship Endowment'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 audit. 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 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 trustees of the Tennessee Promise Scholarship Endowment Trust. We do not believe that the Comptroller's service in this capacity affected our ability to conduct an independent audit of the Tennessee Promise Scholarship Endowment.

## ***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Promise Scholarship Endowment 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 Tennessee Promise Scholarship Endowment, a part of the State of Tennessee's education fund, a special revenue fund, and do not purport to, and do not, present fairly the financial position of the State of Tennessee or of the State of Tennessee's education fund, a special revenue fund, 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 December 14, 2017, on our consideration of the Tennessee Promise Scholarship Endowment'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 Tennessee Promise Scholarship Endowment's internal control over financial reporting and compliance.



Deborah V. Loveless, CPA  
Director  
December 14, 2017

# Tennessee Promise Scholarship Endowment

## Tennessee Promise Scholarship Endowment Balance Sheet June 30, 2017

### ASSETS

Cash and cash equivalents	\$ 5,912,799
Investments, at fair value	
Government securities	31,006,658
Corporate securities	59,984,984
Investment in exchange traded equity fund	365,235,438
Total investments	<u>456,227,080</u>
Receivables	
Receivable for tuition refunds	74,259
Investment income receivable	965,933
Total receivables	<u>1,040,192</u>
<b>TOTAL ASSETS</b>	<b><u>\$ 463,180,071</u></b>

### LIABILITIES AND FUND BALANCE

#### LIABILITIES

Due to general fund	350,308
Due to colleges and universities	509,955
<b>TOTAL LIABILITIES</b>	<b><u>860,263</u></b>

#### FUND BALANCE

Nonspendable corpus	361,381,325
Restricted for Scholarships	100,938,483
<b>TOTAL FUND BALANCE</b>	<b><u>462,319,808</u></b>
<b>TOTAL LIABILITIES AND FUND BALANCE</b>	<b><u>\$ 463,180,071</u></b>

*See accompanying Notes to the Financial Statements.*

# Tennessee Promise Scholarship Endowment

## Tennessee Promise Scholarship Endowment Statement of Revenues, Expenditures, and Change in Fund Balance For Fiscal Year Ended June 30, 2017

### REVENUES

Investment income	\$ 21,072,343
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<b>TOTAL REVENUES</b>	<u>21,072,343</u>
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### EXPENDITURES

Scholarship payments	25,155,715
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Administrative cost	<u>350,308</u>
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<b>TOTAL EXPENDITURES</b>	<u>25,506,023</u>
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<b>EXCESS OF REVENUES OVER EXPENDITURES</b>	(4,433,680)
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### OTHER FINANCING SOURCE

Transfer in from education fund	<u>59,745,794</u>
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<b>TOTAL OTHER FINANCING SOURCE</b>	<u>59,745,794</u>
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<b>NET CHANGE IN FUND BALANCE</b>	55,312,114
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<b>FUND BALANCE, BEGINNING OF YEAR</b>	<u>407,007,694</u>
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<b>FUND BALANCE, END OF YEAR</b>	<u><u>\$ 462,319,808</u></u>
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*See accompanying Notes to the Financial Statements.*

# Tennessee Promise Scholarship Endowment

## Tennessee Promise Scholarship Endowment Notes to the Financial Statements June 30, 2017

### A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### **1. Reporting Entity**

The Tennessee Promise Scholarship Endowment (TN Promise) is a part of the State of Tennessee's Education Fund which forms an integral part of the primary government and has been included as a special revenue fund in the *Tennessee Comprehensive Annual Financial Report*. The financial statements present only that portion of the Education Fund's activities that is attributable to the transactions of the Tennessee Promise Scholarship Endowment.

#### **2. Measurement Focus and Basis of Accounting**

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) 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, 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 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.

## Investments Measured at Fair Value

For Fiscal Year Ended June 30, 2017

*Expressed in Thousands*

Investments at Fair Value Level	GAAP Hierarchy Level 1	GAAP Hierarchy Level 2	Total Investments
Mutual Funds	\$ 365,235	\$ 0	\$ 365,235
Government Issues	9,951	0	9,951
Agency Securities	0	21,056	21,056
Corporate	0	51,368	51,368
Other Asset Backed Securities	0	8,617	8,617
<b>TOTAL INVESTMENTS AT FAIR VALUE</b>	<b>\$ 375,186</b>	<b>\$ 81,041</b>	<b>\$ 456,227</b>
Cash and Cash Equivalents			5,913
Other Receivables			74
Investment Income Receivable			966
<b>TOTAL FINANCIAL STATEMENT ASSETS</b>			<b>\$ 463,180</b>

## 5. Fund Balances

Nonspendable fund balance includes amounts that cannot be spent because they are legally or contractually required to be maintained intact. TN Promise’s nonspendable corpus consists of the initial deposit of (i) the program-generated revenues plus the earnings as of June 30, 2014 of the Tennessee Student Assistance Corporation (TSAC) invested as part of the Chairs of Excellence Endowment Fund established by *Tennessee Code Annotated* Section 49-7-501 and pursuant to Chapter 98 of the *Public Acts of 2013*; and (ii) the June 30, 2014 balance of the

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lottery for education account established in accordance with *Tennessee Code Annotated* Section 4-51-111(b), but excluding the general shortfall reserve subaccount provided in *Tennessee Code Annotated* Section 4-51-111(b)(3) and the sum of ten million dollars (\$10,000,000). TN Promise's restricted fund balance, which may be subject to future allocation and/or distribution in accordance with the Tennessee Promise Scholarship Endowment agreement, includes all amounts that are transferred to TN Promise, except the initial deposit constituting the corpus, and all investment income of TN Promise.

## **B. DEPOSITS AND INVESTMENTS**

State statute authorizes the trustees of TN Promise to adopt an investment policy for the trust in accordance with the laws, policies and guidelines that govern investments by the Tennessee Consolidated Retirement System. The State Treasurer is responsible for the investments of TN Promise in accordance with the policy established by the trustees. The current policy of the trustees for TN Promise gives the Treasurer approval to invest and reinvest TN Promise assets in the same securities or investments in which the Tennessee Consolidated Retirement System is permitted to invest. The policy also allows assets to be invested in shares of publicly traded investment companies, including Unit Investment Trusts (UIT's), Exchange Traded Funds (ETF's) and open-end and closed-end mutual funds. In addition, it permits investment in publicly traded foreign securities that are the same kinds, classes and investment grades otherwise eligible for investment, and in non-investment grade, fixed income securities, including but not limited to, high yield bonds.

State statute also authorizes TN Promise investments to be commingled for investment purposes with other trust funds and other funds subject to investment by the State Treasurer. TN Promise does not maintain its own bank accounts but utilizes the State Pooled Investment Fund (SPIF) for its operating cash needs. The SPIF 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 SPIF 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.

### **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 TN Promise's investments in fixed income securities as of June 30, 2017 are included in the schedule below (expressed in thousands). Securities are rated using Standard and Poor's and/or Moody's and are presented below 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 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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## Credit Quality Distribution for Securities with Credit Exposure as a Percentage of Total Investments

June 30, 2017

Expressed in Thousands

Rating	Fair Value	Percentage of Total Investments
AAA	\$ 1,592	0.35%
A	23,761	5.21%
BBB	26,537	5.82%
Not Rated	22,677	4.97%
Total Debt Investments	<u>74,567</u>	
Government Agencies and Obligations*	<u>16,425</u>	
Total Fixed Income Securities	90,992	
Equity	<u>365,235</u>	
Total Investments as shown on statements	<u>\$ 456,227</u>	

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

### 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 TN Promise Fund 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.

TN Promise'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 TN Promise does not specifically address limits on investment maturities. TN Promise had the following investments (expressed in thousands) and effective duration at June 30, 2017:

Investment Type	Fair Value as of June 30, 2017	Effective Duration (Years)
U.S. Government Treasuries	\$ 9,951	6.50
Government Asset Backed	4,882	3.84
Government Mortgage Backed	21,056	4.60
Corporate Bonds	51,368	2.70
Corporate Mortgage Backed	3,735	2.78
Total Debt Investments	<u>\$ 90,992</u>	3.62

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## **Asset Backed Securities**

TN Promise 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 \$3,734,552 of which none were CMOs that are generally more sensitive interest rate changes.

## **C. OTHER ACCOUNTING DISCLOSURES**

### **The Tennessee Promise Scholarship Endowment**

TN Promise was established by Chapter No. 900 of the *Public Acts of 2014* for the purpose of funding the Tennessee Promise Scholarship Program, a scholarship program for Tennessee residents seeking an associate's degree, certificate or diploma from an eligible postsecondary institution. TN Promise consists of the Tennessee Promise Endowment Account and the Tennessee Promise Scholarship Special Reserve Account. The Tennessee Promise Endowment Account is comprised of the initial deposit of \$361,381,325 and is the nonspendable corpus amount of TN Promise. All income and subsequent deposits and transfers to TN Promise will be credited to the Tennessee Promise Scholarship Special Reserve Account, to be used only for the payment of scholarships and expenses relative to the administration and investment of assets.