



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 statement of fiduciary net position of the TNStars College Savings 529 Program, a private-purpose trust fund of the State of Tennessee, as of June 30, 2017, the related statement of changes in fiduciary net position for the year then ended, and the related notes to the financial statements, which collectively comprise the TNStars College Savings 529 Program'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

# TNStars College Savings 529 Program

no such opinion. An audit also includes evaluating the appropriateness of accounting principles 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 TNStars College Savings 529 Program. We do not believe that the Comptroller's service in this capacity affected our ability to conduct an independent audit of the TNStars College Savings 529 Program.

## ***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net position of the TNStars College Savings 529 Program of the State of Tennessee as of June 30, 2017, and the changes in fiduciary net 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 TNStars College Savings 529 Program, a private-purpose trust fund of the State of Tennessee, 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 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 TNStars College Savings 529 Program'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 TNStars College Savings 529 Program's internal control over financial reporting and compliance.



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

# TNStars College Savings 529 Program

## TNStars College Savings 529 Program Statement of Fiduciary Net Position June 30, 2017

### ASSETS

Cash and Cash Equivalents	\$ 7,235,322
Receivables	
Contributions receivable	51,957
Investments, at fair value	
Investment in mutual funds (fixed income)	8,449,138
Investment in mutual funds (blended)	36,196,410
Investment in mutual funds (equity)	46,523,632
<b>TOTAL ASSETS</b>	<u>98,456,459</u>

### LIABILITIES

Accounts payable	76,570
Due to the University of Tennessee	1,101
<b>TOTAL LIABILITIES</b>	<u>77,671</u>

<b>NET POSITION - RESTRICTED FOR PLAN PARTICIPANTS</b>	<u>\$ 98,378,788</u>
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See accompanying Notes to the Financial Statements

## TNStars College Savings 529 Program Statement of Changes in Fiduciary Net Position For Fiscal Year Ended June 30, 2017

### ADDITIONS

Contributions	\$ 25,789,454
Investment income	
Net increase (decrease) in fair value of investments	7,309,639
Interest and dividend income	2,750,945
Total investment income	10,060,584
Transfers from General Fund	829,019
<b>TOTAL ADDITIONS</b>	<u>36,679,057</u>

### DEDUCTIONS

Withdrawals	4,839,290
Administrative cost	120,307
<b>TOTAL DEDUCTIONS</b>	<u>4,959,597</u>

<b>CHANGE IN NET POSITION</b>	31,719,460
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### NET POSITION - RESTRICTED FOR PLAN PARTICIPANTS

<b>BEGINNING OF YEAR</b>	66,659,328
<b>END OF YEAR</b>	<u>\$ 98,378,787</u>

See accompanying Notes to the Financial Statements

# TNStars College Savings 529 Program

## TNStars College Savings 529 Program Notes to the Financial Statements June 30, 2017

### A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The TN Stars College Savings 529 Program, Educational Savings Plan (ESP) is included in the State of Tennessee financial reporting entity. Because of the state's fiduciary responsibility, the ESP has been included in the Tennessee Comprehensive Annual Financial Report as a private-purpose trust fund.

#### **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). 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 at the time liabilities are incurred regardless of the timing of related cash flows.

#### **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 the State Pooled Investment Fund sponsored by the State of Tennessee and administered by the State Treasurer.

#### **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. The fair value of investments in open-end mutual funds is based on the share 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.

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.

# TNStars College Savings 529 Program

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.

## Investments Measured at Fair Value For Fiscal Year Ended June 30, 2017 (Expressed in Thousands)

Investments at Fair Value Level	GAAP Hierarchy Level 1	Total Assets
<b>EQUITY INVESTMENTS</b>		
Vanguard Institutional Index I	\$ 11,127	\$ 11,127
PRIMECAP Odyssey Aggressive Growth	11,660	11,660
Vanguard Mid-Cap Growth Inv	6,699	6,699
DFA Large Cap International I	2,638	2,638
DFA US Large Cap Value I	13,450	13,450
DFA US Small Cap I	949	949
	46,523	46,523
<b>BLENDED INVESTMENTS</b>		
Vanguard Wellington Admiral	17,498	17,498
Vanguard LifeStrategy Conservative Growth Inv	11,455	11,455
Vanguard Life Strategy Income Inv	7,244	7,244
	36,197	36,197
<b>FIXED INCOME INVESTMENTS</b>		
DFA Inflation-Protected Securities I	572	572
Vanguard Total Bond Market Index I	6,148	6,148
Vanguard Intermediate-Term Investment-Grade Adm	1,263	1,263
Vanguard Intermediate-Term Treasury Adm	466	466
	8,449	8,449
<b>TOTAL INVESTMENTS AT FAIR VALUE</b>		91,169
Cash and Cash Equivalents		7,235
Other Receivables		52
<b>TOTAL FINANCIAL STATEMENT ASSETS</b>		\$ 98,456

# TNStars College Savings 529 Program

## **B. DEPOSITS AND INVESTMENTS**

In accordance with State statute, the ESP assets may be invested in any instrument, obligation, security or property that constitutes a legal investment for assets of the Tennessee Consolidated Retirement System (TCRS) or any other investment deemed appropriate by the Board. The authority for investing the assets of the ESP is vested in the Baccalaureate Education System Trust (BEST) Board of Trustees (the “Board”) and the responsibility for implementing the investment policy established by the Board is delegated to the State Treasurer.

Recognizing that plan participants may have an investment horizon ranging from a few months to more than twenty years, the ESP has selected a group of investment products that have an investment risk profile ranging from conservative to aggressive. The investment products selected are evaluated based on a number of factors including but not limited to fees, investment performance, investment strategy, any available ratings of the products, and suitability of products for participants. It is the responsibility of the ESP to provide products to plan participants; however it is the participants who select the options that suit their individual investment needs.

### **Credit Risk**

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations with regard to debt. The ESP does not currently own specific fixed income securities, but provided options to plan participants to invest in mutual funds that invest in fixed income securities. Mutual funds with 100% allocations in fixed income securities are considered to be fixed income investments while mutual funds with some portion of their assets invested in fixed income securities are considered blended investments. At June 30, 2017, these funds were not specifically rated by any rating agency; however the underlying securities of the funds had an average credit quality rating of Baa (4th highest) or better. At June 30, 2017, 26.6% of all the plan investments, including \$7,035,367.48 in a money market account classified as cash equivalents, was invested in fixed income securities. Those plan investments in the money market account are FDIC insured and are not considered to be exposed to credit risk.

### **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 ESP provides investment products for participants to select, however it is the participant that is responsible for selecting an option(s) that best suit their investment needs. As such, the ESP does not have a policy regarding the management of interest rate risk in periods of volatile interest rates. 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. Presented below is a statement of Effective Duration as of June, 30, 2017.

<b>Fund Name</b>	<b>Ending Balance</b>	<b>Effective Duration</b>
<b>Blended</b>		
Vanguard Wellington Admiral	\$ 17,497,953.02	6.55
Vanguard LifeStrategy Conservative Growth Inv	11,454,750.17	6.60
Vanguard Life Strategy Income Inv	7,243,706.30	6.60
<b>Fixed Income</b>		
DFA Inflation-Protected Securities I	571,720.43	7.85
Vanguard Total Bond Market Index I	6,148,441.11	6.09
Vanguard Intermediate-Term Investment-Grade Adm	1,263,341.38	5.50
Vanguard Intermediate-Term Treasury Adm	465,634.86	5.26

# TNStars College Savings 529 Program

## C. DESCRIPTION OF THE EDUCATIONAL SAVINGS PLAN

The TNStars College Savings 529 Program, Educational Savings Plan (ESP), administered by the State Treasurer, was created under *Tennessee Code Annotated*, Title 49, Chapter 7, Part 8 and is designed to help people save for the costs of education after high school. The ESP is administered by the Baccalaureate Education System Trust (BEST) Board of Trustees (the “Board”). The Board has the authority to appoint an ESP manager, adopt rules to implement and administer the ESP and establish investment policies for the ESP, to invest moneys of the trust in investments determined by the Board to be appropriate and to administer the funds of the Trust Fund. The ESP called TNStars began operations on September 18, 2012.

When opening an account, the owner may select two types of investment options, the Aged-Based Option and the Self Selected Investment Option. Within the Aged-Based Option, contributions are allocated among five age bands, based on the age of the beneficiary. Each Age Band is invested in specific Dimensional Fund Advisors (DFA) or Vanguard mutual funds from our slate of investment options (“an Underlying Fund”). The Age Bands become more conservatively invested as the beneficiary ages. The Self Selected Investment Option allows owners to invest in any underlying Fund. The list of investment options or underlying funds is listed below:

Type	Fund Name	Ticker Symbol
<b>Equity</b>	Vanguard Institutional Index I	VINIX
	PRIMECAP Odyssey Aggressive Growth	POAGX
	Vanguard Mid-Cap Growth Inv	VMGRX
	DFA Large Cap International I	DFALX
	DFA US Large Cap Value I	DFLVX
	DFA US Small Cap I	DFSTX
<b>Blended</b>	Vanguard Wellington Admiral	VWENX
	Vanguard LifeStrategy Conservative Growth Inv	VSCGX
	Vanguard Life Strategy Income Inv	VASIX
<b>Fixed Inc</b>	DFA Inflation-Protected Securities I	DIPSX
	Vanguard Total Bond Market Index I	VBPIX
	Vanguard Intermediate-Term Investment-Grade Adm	VFIDX
	Vanguard Intermediate-Term Treasury Adm	VFIUX

Participants in the ESP can make withdrawals at any time after contributions have been invested for 21 days. Withdrawals used for qualifying higher educational expenses receive certain tax incentives; additionally those not used for qualifying higher educational expenses receive certain tax penalties based on the participant’s individual circumstances.

Pursuant to state statute, the Board may establish an incentive plan or plans to encourage Tennessee residents to participate in TNStars. Such plans may include, but are not limited to, matching contributions using state funds and shall be restricted to Tennessee residents only. In addition, for fiscal year ended June 30, 2017, the Board authorized the program to subsidize, using state appropriations, the program management fee and the estimated underlying mutual fund expense so that the total annual asset-based fee, after subsidy, for any account does not exceed 35 basis points. The resulting transfers from the General Fund to cover the incentives and subsidy from state appropriations amounted to \$663,979 for the year ended June 30, 2017.

# TNStars College Savings 529 Program

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## D. OTHER ACCOUNTING DISCLOSURES

### **Cash Transfer**

At June 30, 2017 the ESP had a surplus in cash of \$199,955. On June 30, 2017, TNStars sent, via EFT, \$47,157 to the investment custodian. Also on this day, TNStars issued debit EFT transactions to plan participant's financial institutions for \$47,157. The debit EFT transactions would settle with the State on July 1, 2017 or the next business day. In addition, \$165,040 was transferred from the General Fund to TNStars to be used to fund the Tennessee Investments Preparing Scholars (TIPS) program. The TIPS funding was invested in July 2017.