



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 Baccalaureate Education System Trust, Educational Services Plan, a private-purpose trust fund of the State of Tennessee, as of June 30, 2018, 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 Baccalaureate Education System Trust, Educational Services Plan'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 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 Baccalaureate Education System Trust. We do not believe that the Comptroller's service in this capacity affected our ability to conduct an independent audit of the Baccalaureate Education System Trust, Educational Services Plan.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net position of the Baccalaureate Education System Trust, Educational Services Plan of the State of Tennessee as of June 30, 2018, 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 Baccalaureate Education System Trust, Educational Services Plan, 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, 2018, 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 20, 2018, on our consideration of the Baccalaureate Education System Trust, Educational Services Plan'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 Baccalaureate Education System Trust, Educational Services Plan's internal control over financial reporting and compliance.



Deborah V. Loveless, CPA, Director
Division of State Audit
December 20, 2018

Baccalaureate Education System Trust
Educational Services Plan
Statement of Fiduciary Net Position
June 30, 2018

ASSETS

Cash and cash equivalents	\$	591,101
Receivables		
Due from Board of Regents Schools		7,752
Investment income receivable		904
Investments, at fair value		
Investment in fixed income index fund		24,293,908
		24,293,908
 TOTAL ASSETS		 24,893,665
 LIABILITIES		
Accounts payable		35,644
		35,644
 TOTAL LIABILITIES		 35,644
 NET POSITION - RESTRICTED FOR PLAN PARTICIPANTS	 \$	 24,858,021

See accompanying Notes to the Financial Statements

**Baccalaureate Education System Trust
Educational Services Plan
Statement of Changes in Fiduciary Net Position
For Fiscal Year Ended June 30, 2018**

ADDITIONS

Investment income		
Net increase (decrease) in fair value of investments	\$	(867,092)
Interest and dividend income		725,547
Net investment income		<u>(141,545)</u>
 TOTAL ADDITIONS		 <u>(141,545)</u>
 DEDUCTIONS		
Withdrawals		7,637,108
Administrative cost		<u>369,179</u>
 TOTAL DEDUCTIONS		 <u>8,006,287</u>
 CHANGE IN NET POSITION		 (8,147,832)
 NET POSITION, BEGINNING OF YEAR		 <u>33,005,853</u>
NET POSITION, END OF YEAR	\$	<u><u>24,858,021</u></u>

See accompanying Notes to the Financial Statements

**Baccalaureate Education System Trust
Educational Services Plan
Notes to the Financial Statements
For Fiscal Year Ended June 30, 2018**

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Reporting Entity

The Tennessee Baccalaureate Education System Trust Fund (BEST), Educational Services Plan (ESEP) is included in the State of Tennessee financial reporting entity. Because of the state's fiduciary responsibility, the BEST 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 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 has been 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, 2018 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.

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, 2018
Expressed in Thousands

Investments at Fair Value Level	GAAP Hierarchy Level 1
Fixed Income Passive Mutual Fund	\$ 24,294
TOTAL INVESTMENTS AT FAIR VALUE	<u>24,294</u>
Cash and Cash Equivalents	591
Due from Board of Regents	8
Investment Income Receivable	1
TOTAL ASSETS	<u><u>\$ 24,894</u></u>

B. DEPOSITS AND INVESTMENTS

In accordance with State statute, the board shall cause the amount on deposit in the ESEP to be invested in any instrument or investment vehicle that the board deems reasonable and appropriate to achieve the objectives of the trust. The statutes also require the board establish an investment policy for the trust fund. The board has authorized assets of the trust fund to be invested in instruments, obligations, securities or other properties that constitute a legal investment for assets of the Tennessee Consolidated Retirement System (TCRS). State statute authorizes the TCRS to invest in bonds, debentures, preferred stock and common stock, real estate and in other good and solvent securities subject to the approval of the Board of Trustees. In addition, the assets of the ESEP may be pooled for investment purposes with the assets of the TCRS or any other assets under the custody of the State Treasurer. The authority for investing the assets of the ESEP is vested in its Board of Trustees and the responsibility for implementing the investment policy established by the Board is delegated to the State Treasurer.

The ESEP 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 (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. The investment policy and required risk disclosures relative to the State Pooled Investment Fund are presented in the State Pooled Investment Fund Report.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The ESEP does not currently own specific fixed income securities, but chooses to invest in exchange traded funds (ETFs) that replicate the Vanguard Total Bond Market Index Fund. The underlying securities of the ETF have an average credit quality rating of BBB or higher. The State Pooled Investment Fund has not obtained a credit quality rating from a nationally recognized credit ratings agency. Funds are held at the bank in accordance with the contract for master custodian services with State Street. The SSGA Government Money Market Fund was not rated by a nationally recognized credit rating agency at June 30, 2018.

The ESEP's investment policy states that the trust may acquire securities which are rated within the four highest grades at the time of acquisition by any of the recognized rating agencies. In addition, the policy requires that only the highest quality short-term debt issues, including commercial paper with ratings of A1 or P1, may be purchased. The policy further states that index funds may be utilized as an alternative to selecting individual securities.

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 ESEP states that bonds generally will be purchased and held to maturity, but when necessary, the portfolio will be actively managed in times of volatile interest rate swings to shorten the average maturity and protect principal value. The average duration for the Vanguard Total Bond Market Index Fund was 6.1 years at June 30, 2018. 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.

C. DESCRIPTION OF THE EDUCATIONAL SERVICES PLAN

The Tennessee Baccalaureate Education System Trust, Educational Services Plan, administered by the State Treasurer, was created under Tennessee Code Annotated, Title 49, Chapter 7, Part 8 for the purpose of improving higher education in the State of Tennessee by assisting students or their families to pay in advance, a portion of the tuition and other costs of attending colleges and universities. Under the program, a purchaser entered into a contract with the BEST Board of Trustees to purchase tuition units on behalf of a beneficiary. Each tuition unit purchased entitled the beneficiary to an amount no greater than one percent of the weighted average tuition of Tennessee's four-year public universities during the academic term in which it is used; however, the tuition unit or equivalent funds may be used at any accredited public or private, in-state or out-of-state institution. The purchase price of the tuition unit was determined annually by the BEST Board of Trustees with the assistance of an actuary to maintain the plan's financial soundness. The BEST Board of Trustees voted to discontinue selling new prepaid units of tuition as of November 22, 2010 due to the rising cost of tuition. This action had no effect on units purchased prior to that date. Refunds and tuition payments are guaranteed only to the extent that ESEP program funds are available and neither the State of Tennessee nor the BEST Board of Trustees is liable for any amount in excess of available program funds. The net position restricted for plan participants was \$4,376,298 more at June 30, 2018, than the amounts needed to fund the outstanding tuition units at their weighted average tuition unit prices in effect at that date.



JUSTIN P. WILSON
Comptroller

JASON E. MUMPOWER
Chief of Staff

**Independent Auditor's Report on Internal Control Over
Financial Reporting and on Compliance and Other Matters
Based on an Audit of Financial Statements Performed in
Accordance With *Government Auditing Standards***

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

We have audited the financial statements of the Baccalaureate Education System Trust, Educational Services Plan, as of and for the year ended June 30, 2018, and the related notes to the financial statements, and have issued our report thereon dated December 20, 2018. 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.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Department of the Treasury's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control. Accordingly, we do not express an opinion on the effectiveness of the department's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did

not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Baccalaureate Education System Trust, Educational Services Plan's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Deborah V. Loveless, CPA, Director
Division of State Audit
December 20, 2018