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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 statements 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, 2014, and June 30, 2013, the related statements of changes in fiduciary net position for the years 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.

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**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN
INDEPENDENT AUDITOR'S REPORT (CONTINUED)**

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, 2014, and June 30, 2013, and the changes in fiduciary net position thereof for the years 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, 2014, and June 30, 2013, and the changes in its financial position for the years 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 19, 2014, 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
December 19, 2014

**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN
STATEMENTS OF FIDUCIARY NET POSITION
JUNE 30, 2014 AND JUNE 30, 2013**

	June 30, 2014	June 30, 2013
ASSETS		
Cash and cash equivalents	\$ 3,432,278	\$ 1,821,912
Receivables		
Investment income receivable	230,420	172,914
Investments sold	0	1,530,073
Investments, at fair value		
Investment in fixed income index fund	50,557,078	51,132,336
Investment in equity index fund	33,383,633	33,219,287
TOTAL ASSETS	<u>87,603,409</u>	<u>87,876,522</u>
LIABILITIES		
Accounts payable	90,149	103,936
Due to General Fund	86,226	0
TOTAL LIABILITIES	<u>176,375</u>	<u>103,936</u>
NET POSITION RESTRICTED FOR PLAN PARTICIPANTS	<u>\$ 87,427,034</u>	<u>\$ 87,772,586</u>

See accompanying Notes to the Financial Statements.

**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
FOR THE YEARS ENDED JUNE 30, 2014 AND JUNE 30, 2013**

	For the Year Ended June 30, 2014	For the Year Ended June 30, 2013
ADDITIONS		
Investment income		
Net increase in fair value of investments	\$ 7,506,890	\$ 4,239,455
Interest and dividend income	2,096,817	1,340,818
Less: Investment expense	0	(15,854)
Net investment income	<u>9,603,707</u>	<u>5,564,419</u>
TOTAL ADDITIONS	<u>9,603,707</u>	<u>5,564,419</u>
DEDUCTIONS		
Withdrawals	9,603,718	10,189,587
Administrative cost	345,541	276,061
TOTAL DEDUCTIONS	<u>9,949,259</u>	<u>10,465,648</u>
CHANGE IN NET POSITION	(345,552)	(4,901,229)
NET POSITION, BEGINNING OF YEAR	87,772,586	92,673,815
NET POSITION, END OF YEAR	<u>\$ 87,427,034</u>	<u>\$ 87,772,586</u>

See accompanying Notes to the Financial Statements.

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 by the ESEP that cannot be invested immediately in securities, or that is needed for operations, is invested in the State Pooled Investment Fund administered by the State Treasurer or a short-term, open-end mutual fund, Northern Institutional Government Portfolio, under the contractual arrangements for master custody services.
- 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.

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 on pages 104 - 110 of this report.

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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. This ETF has been given a two-star rating by MorningStar and the underlying securities of the fund 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. The Northern Institutional Government Portfolio had a credit quality rating of AAA at June 30, 2014 and June 30, 2013.

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 5.60 years and 5.49 years at June 30, 2014 and June 30, 2013, respectively. 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 \$10,014,407 more at June 30, 2014, and \$4,790,417 more at June 30, 2013, than the amounts needed to fund the outstanding tuition units at their weighted average tuition unit prices in effect at the respective dates.