STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

TENNESSEE BOARD OF REGENTS
CENTRAL OFFICE

Financial and Compliance Audit Report

For the Years Ended June 30, 2017, and June 30, 2016

Justin P. Wilson, Comptroller

Division of State Audit

Deborah V. Loveless, CPA, CGFM, CGMA
Director

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Assistant Director

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Audit Manager

Erica Pettway, CFE
In-Charge Auditor

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Comptroller of the Treasury, Division of State Audit
Cordell Hull Building
425 Fifth Avenue North
Nashville, TN 37243
(615) 401-7897

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TENNESSEE COMPTROLLER OF THE TREASURY

JUSTIN P. WILSON
Comptroller

JASON E. MUMPOWER
Chief of Staff

November 15, 2018

The Honorable Bill Haslam, Governor
Members of the General Assembly
The Honorable Flora W. Tydings, Chancellor

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Board of Regents – Central Office, for the years ended June 30, 2017, and June 30, 2016. You will note from the independent auditor's report that unmodified opinions were given on the fairness of the presentation of the financial statements.

Consideration of the internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Findings and Recommendations section of this report. The Central Office's management has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

Deborah V. Loveless

Deborah V. Loveless, CPA, Director
Division of State Audit

18/052

Audit Report

Tennessee Board of Regents – Central Office

For the Years Ended June 30, 2017, and June 30, 2016

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Tennessee Board of Regents – Central Office

For the Years Ended June 30, 2017, and June 30, 2016

Opinions on the Financial Statements

The opinions on the financial statements are unmodified.

Audit Findings

The Tennessee Board of Regents did not document consideration of outsourced information technology services in its risk assessments and did not proactively communicate its review of System and Organizational Controls reports for external information system service providers with other institutions using those services under the board's contract

Although the Tennessee Board of Regents management performed organizational risk assessments that considered certain Information Technology (IT) risks, management did not document and assess the risks associated with the use of external IT service providers. Furthermore, the board did not proactively communicate the result of its review of System and Organizational Controls (SOC) reports for external IT service providers to other board institutions that use those services under the board's contract (page 46).

The Tennessee Board of Regents did not provide adequate internal controls in two areas

Tennessee Board of Regents' management did not design and monitor effective internal controls in two areas. For both of these areas, we found internal control deficiencies related to one of the board's systems because management either did not implement controls or implemented controls that were not sufficient. The details of this finding are confidential pursuant to Section 10-7-504(i), *Tennessee Code Annotated* (page 49).

Tennessee Comptroller of the Treasury

Justin P. Wilson
Comptroller

Jason E. Mumpower
Chief of Staff

Independent Auditor's Report

The Honorable Bill Haslam, Governor
Members of the General Assembly
The Honorable Flora W. Tydings, Chancellor

Report on the Financial Statements

We have audited the accompanying financial statements of the Tennessee Board of Regents – Central Office, a part of the State University and Community College System of Tennessee, which is a component unit of the State of Tennessee, as of and for the years ended June 30, 2017, and June 30, 2016, and the related notes to the financial statements, which collectively comprise the basic financial statements as listed in the table of contents.

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 opinions 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

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relevant to the Central Office'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 policies used and the 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 opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Tennessee Board of Regents – Central Office, as of June 30, 2017, and June 30, 2016; and the respective changes in financial position and, where applicable, cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 1, the financial statements of the Tennessee Board of Regents – Central Office, a part of the State University and Community College System of Tennessee, are intended to present the financial position, the changes in financial position, and the cash flows of only the Central Office. They do not purport to, and do not, present fairly the financial position of the State University and Community College System of Tennessee as of June 30, 2017, and June 30, 2016, and the changes in financial position and cash flows thereof 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 Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 5 through 12; the schedule of the Central Office's proportionate share of the net pension liability – Closed State and Higher Education Employee Pension Plan within TCRS on page 38; the schedule of the Central Office's proportionate share of the net pension asset – State and Higher Education Employee Retirement Plan within TCRS on page 39; the schedule of the Central Office's contributions – Closed State and Higher Education Employee Pension Plan within TCRS on page 40; the schedule of the Central Office's contributions – State and Higher Education Employee Retirement Plan within TCRS on page 41; and the other postemployment benefits schedule of funding progress on page 42 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during the audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated September 25, 2018, on our consideration of the Central Office's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements 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 the 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 Central Office's internal control over financial reporting and compliance.

Deborah V. Loveless

Deborah V. Loveless, CPA, Director
Division of State Audit
September 25, 2018

TENNESSEE BOARD OF REGENTS – CENTRAL OFFICE
Management's Discussion and Analysis

Introduction

This section of the Central Office's annual financial report presents a discussion and analysis of the financial performance of the Central Office during the fiscal years ended June 30, 2017, and June 30, 2016, with comparative information presented for the fiscal year ended June 30, 2015. This discussion has been prepared by management along with the financial statements and related note disclosures and should be read in conjunction with the independent auditor's report, the audited financial statements, and the notes. The financial statements, notes, and this discussion are the responsibility of management.

Overview of the Financial Statements

The financial statements have been prepared in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB), which establishes standards for external financial reporting for public colleges and universities. The financial statements are presented on a consolidated basis to focus on the Central Office as a whole. The full scope of the Central Office's activities is considered to be a single business-type activity, and accordingly, is reported within a single column in the basic financial statements.

The Central Office's financial report includes the statement of net position; the statement of revenues, expenses, and changes in net position; and the statement of cash flows. Notes to the financial statements are also presented to provide additional information that is essential to a full understanding of the financial statements.

The Statement of Net Position

The statement of net position is a point-in-time financial statement. The statement of net position presents the financial position of the Central Office at the end of the fiscal year. To aid the reader in determining the Central Office's ability to meet immediate and future obligations, the statement includes all assets, liabilities, deferred outflows/inflows of resources, and net position of the Central Office and segregates the assets and liabilities into current and noncurrent components. Current assets are those that are available to satisfy current liabilities, inclusive of assets that will be converted to cash within one year. Current liabilities are those that will be paid within one year. The statement of net position is prepared under the accrual basis of accounting; assets and liabilities are recognized when goods or services are provided or received, despite when cash is actually exchanged.

From the data presented, readers of the statement are able to determine the assets available to continue the operations of the Central Office. They are also able to determine how much the Central Office owes vendors, lenders, and others. Net position represents the difference between the Central Office's assets and liabilities, along with the difference between deferred outflows and deferred inflows of resources, and is one indicator of the Central Office's current financial condition.

The statement of net position also indicates the availability of net position for expenditure by the Central Office. Net position is divided into three major categories. The first category, investment in capital assets, represents the Central Office's total investment in property, plant, and equipment. The next category is restricted net position, which is subdivided into two categories, nonexpendable and expendable. Nonexpendable restricted net position includes endowment and similar resources whose use is limited by donors or other outside sources and as a condition of the gift, the principal is to be maintained in perpetuity. Expendable restricted net position is available for expenditure by the Central Office but must be spent for purposes as determined by donors and/or external entities that have placed time or purpose restrictions on the use of the resources. The final category is unrestricted net position. Unrestricted net position is available to the Central Office for any lawful purpose of the Central Office.

The following table summarizes the Central Office's assets, liabilities, deferred outflows/inflows of resources, and net position at June 30, 2017; June 30, 2016; and June 30, 2015.

Summary of Net Position
(in thousands of dollars)

	2017	2016	2015
Assets:			
Current assets	$16,811	$12,447	$11,700
Capital assets, net	3,987	619	314
Other assets	64,469	44,187	38,604
Total Assets	85,267	57,253	50,618
Deferred Outflows of Resources:			
Deferred outflows related to pensions	2,633	1,561	993
Total Deferred Outflows of Resources	2,633	1,561	993
Liabilities:			
Current liabilities	6,044	3,573	3,582
Noncurrent liabilities	8,092	6,211	4,344
Total Liabilities	14,136	9,784	7,926

Deferred Inflows of Resources:			
Deferred inflows related to pensions	253	698	2,312
Total Liabilities	253	698	2,312
Net Position:			
Investment in capital assets	3,987	619	314
Restricted – expendable	11,112	10,332	8,523
Unrestricted	58,412	37,381	32,536
Total Net Position	$73,511	$48,332	$41,373

Comparison of Fiscal Year 2017 to Fiscal Year 2016

- The increase in current assets is due to an increase in prepaid expenses for some TN eCampus contracts and an increase in cash from unspent shared services initiative funds.
- The increase in capital assets and investment in capital assets is due to new equipment, leasehold improvements, and furnishings for the new office space acquired in fiscal year 2017.
- The increase in other assets is due to transfers of funds to renewal and replacement for shared services.
- The increase in deferred outflows of resources resulted from actual investment returns being below projections.
- The increase in current liabilities is due to an increase in vendors payable in fiscal year 2017 for shared services consultant invoices.
- The increase in noncurrent liabilities is due to increases in the net OPEB obligation, the net pension liability, and the noncurrent portion of the compensated absences liability.
- The decrease in deferred inflows of resources resulted from recording the amortization of the 2014 actuarial experience and investment gains.
- The increase in restricted-expendable net position is from unspent Access Diversity funds.
- The increase in unrestricted net position resulted from an increase in state appropriations for the shared services initiative.

Comparison of Fiscal Year 2016 to Fiscal Year 2015

- The increase in current assets was caused by an increase in due from primary government for the fee waiver funds due from the state.
- Capital assets increased due to the purchase of equipment and projects in progress.
- Other assets increased due to transfers of funds to renewal and replacement for Business Intelligence/Data Warehousing.

- The increase in deferred outflows of resources related to pensions resulted from recording the actuarial experience loss for fiscal year 2015 and the actual investment earnings for 2015 being less than assumed.
- The increase in non-current liabilities resulted from increases in the net OPEB obligation and the net pension liability.
- The decrease in deferred inflows of resources related to pensions resulted from recording amortization for the actuarial experience gain in 2014 and recording the amortization of investment earnings gain for 2014.
- The increase in investment in capital assets is due to the purchase of equipment and projects in progress in 2016.
- The increase in unrestricted net position resulted from transfers of funds to renewal and replacement funds for business intelligence/data warehousing.
- The increase in restricted expendable net position resulted from private grants from the Gates Foundation, AT&T, and EdX.

The Statement of Revenues, Expenses, and Changes in Net Position

The statement of revenues, expenses, and changes in net position presents the results of operations for the fiscal year. Revenues and expenses are recognized when earned or incurred, regardless of when cash is received. The statement indicates whether the Central Office's financial condition has improved or deteriorated during the fiscal year. The statement presents the revenues received by the Central Office, both operating and nonoperating; the expenses paid by the Central Office, operating and nonoperating; and any other revenues, expenses, gains, or losses received or spent by the Central Office.

Generally speaking, operating revenues are received for providing goods and services to the various customers and constituencies of the Central Office. Operating expenses are those expenses paid to acquire or produce the goods and services provided in return for the operating revenues, and to carry out the mission of the Central Office. Nonoperating revenues are revenues received for which goods and services are not provided directly to the payor. Although the Central Office is dependent upon state appropriations and gifts to fund educational and general operations, under GASB standards these funding sources are reported as nonoperating revenues, as is investment income. As a result, the Central Office has historically reported an excess of operating expenses over operating revenues, resulting in an operating loss. Therefore, the "increase in net position" is more indicative of overall financial results for the year.

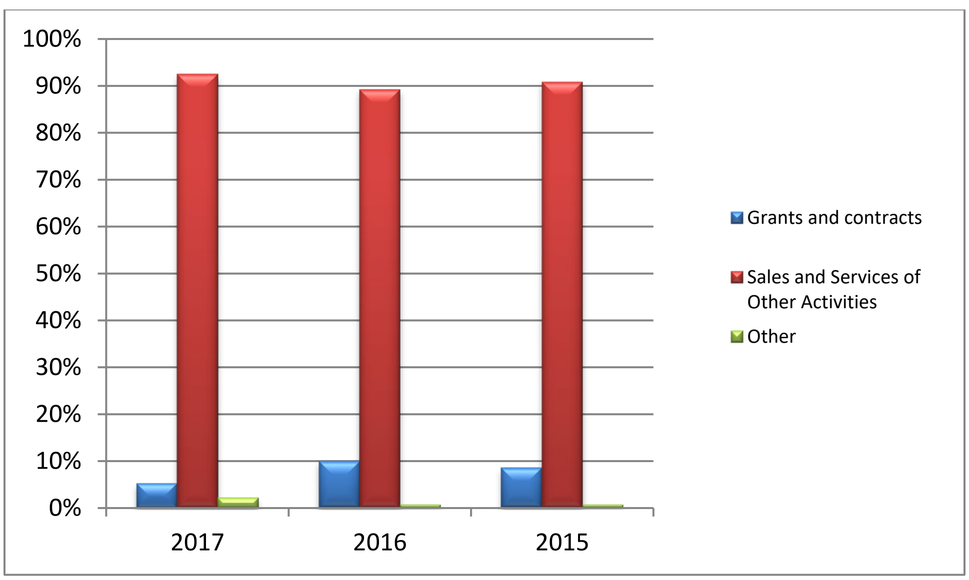
A summary of the Central Office's revenues, expenses, and changes in net position for the years ended June 30, 2017; June 30, 2016; and June 30, 2015, follows.

Summary of Revenues, Expenses, and Changes in Net Position
(in thousands of dollars)

	2017	2016	2015
Operating revenues	$20,427	$22,365	$20,810
Operating expenses	44,562	35,569	36,943
Operating loss	(24,135)	(13,204)	(16,133)
Total nonoperating revenues and expenses	49,314	20,163	19,730
Increase in net position	25,179	6,959	3,597
Net position at beginning of year as originally reported	48,332	41,373	41,453
Cumulative effect of change in accounting principle	-	-	(3,677)
Net position at beginning of year restated	48,332	41,373	37,776
Net position at end of year	$73,511	$48,332	$41,373

Operating Revenues

The following summarizes the operating revenues by source that were used to fund operating activities for the last three fiscal years.



Comparison of Fiscal Year 2017 to Fiscal Year 2016

- Grants and contracts decreased due to the timing of grant payments from Gates Foundation and the ending of the Lumina grant and Tennessee Higher Education Commission grants.

- Sales and services of other activities decreased due to a reduction in Data Warehousing/Business Initiative funding from the institutions. The increase in the percentage of the total resulted from the timing and decrease of the grant payments.
- Other operating revenues increased because of increased vendor rebates.

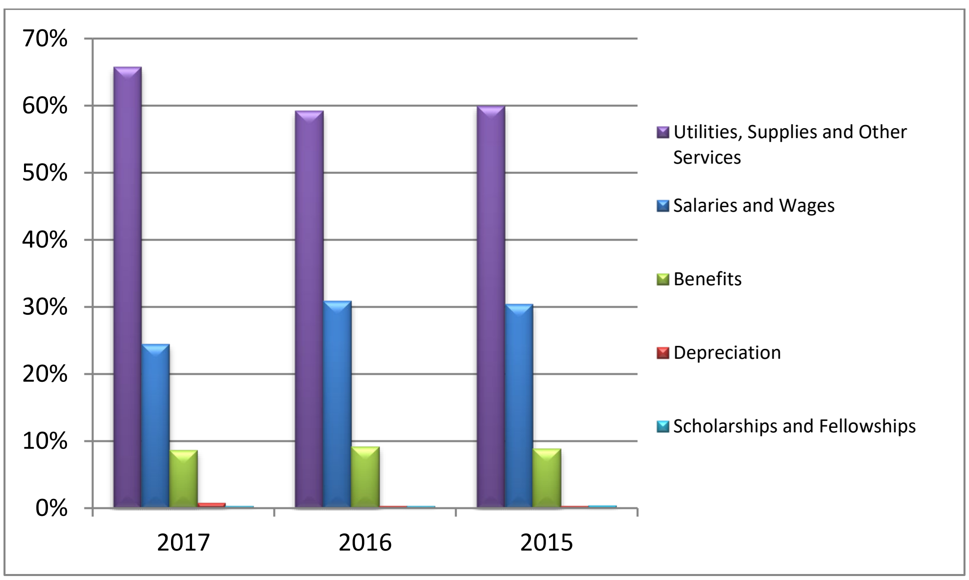
Comparison of Fiscal Year 2016 to Fiscal Year 2015

- Grants and contracts revenue increased in 2016 due to private grants from the Gates Foundation, AT&T, and EdX.
- Sales and services of other activities increased due to an increase in the system charge and the community college office implementation costs.

Operating Expenses

Operating expenses may be reported by nature or function. The Central Office has chosen to report the expenses in their natural classification on the statement of revenues, expenses, and changes in net position and has displayed the functional classification in the notes to the financial statements.

The following summarizes the operating expenses by natural classification for the last three fiscal years:



Comparison of Fiscal Year 2017 to Fiscal Year 2016

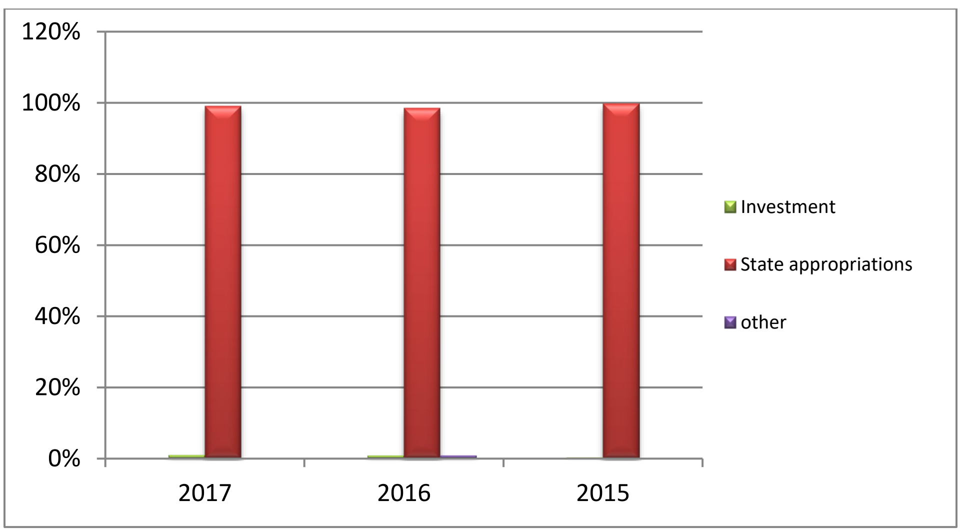
- Utilities, supplies, and other services increased as a percentage of total expenses due to increased consultant costs associated with the shared services initiative and an increase in TCAT Facilities Funds grants to the TCATs.

- Salaries and wages decreased less than 1% but decreased more significantly as a percentage of total expenses because of the increased utilities, supplies, and other services costs noted above.
- Depreciation increased in fiscal year 2017 due to capitalized leasehold improvements and purchases of new equipment for the new facility.

Nonoperating Revenues and Expenses

Certain revenue sources that the Central Office relies on to provide funding for operations, including state noncapital appropriations, certain gifts and grants, and investment income, are defined by the GASB as nonoperating. Nonoperating expenses include capital financing costs and other costs related to capital assets.

The following summarizes the Central Office's nonoperating revenues and expenses for the last three fiscal years:



Comparison of Fiscal Year 2017 to Fiscal Year 2016

- State appropriations increased due to additional funding for the shared services initiative in fiscal year 2017.
- Investment income increased due to an increase in funds deposited for the shared services initiative.

Comparison of Fiscal Year 2016 to Fiscal Year 2015

- Investment income increased due to private grant balances in restricted funds and higher R&R fund balances for business intelligence/data warehousing.

- Other nonoperating revenues/(expenses) increased because of changes in gains/losses on disposals of equipment.

Capital Assets

The Central Office had $3,987,023.45 invested in capital assets, net of accumulated depreciation of $569,068.14 at June 30, 2017; $619,104.12 invested in capital assets, net of accumulated depreciation of $713,046.70 at June 30, 2016; and $313,739.07 invested in capital assets, net of accumulated depreciation of $779,655.08 at June 30, 2015. Depreciation charges totaled $341,677.84; $92,626.13; and $115,541.54 for the years ended June 30, 2017; June 30, 2016; and June 30, 2015, respectively.

Schedule of Capital Assets, Net of Depreciation
(in thousands of dollars)

	2017	2016	2015
Leasehold improvements	$2,036	$ -	$ -
Equipment/furniture	1,951	452	314
Projects in progress	-	167	-
Total	$3,987	$619	$314

Significant additions to capital assets occurred in fiscal year 2017. These additions were from leasehold improvements and furniture for new office space.

More detailed information about the Central Office's capital assets is presented in Note 5 to the financial statements.

Economic Factors That Will Affect the Future

The Focus on College and University Success (FOCUS) Act became effective July 1, 2016. This Act removed the six universities from the governance of the Tennessee Board of Regents. The universities remain part of the State University and Community College System of Tennessee, but each has its own local board that provides governance, approves policies, sets tuition and fee rates, and hires presidents. The Act also enhanced the role of the Tennessee Higher Education Commission (THEC) by requiring THEC to provide greater coordination across the state, including capital project management, institutional mission approval, and higher education finance. The economic impact on the Central Office cannot be accurately measured at this time.

TENNESSEE BOARD OF REGENTS - CENTRAL OFFICE
Statements of Net Position
June 30, 2017, and June 30, 2016

	June 30, 2017	June 30, 2016
Assets		
Current assets:		
Cash (Notes 2 and 3)	$ 14,719,689.38	$ 10,075,871.16
Accounts, notes, and grants receivable (net) (Note 4)	1,236,383.55	600,164.90
Due from State of Tennessee	216,349.55	1,474,219.26
Prepaid expenses	639,040.80	297,046.98
Other assets	175.00	175.00
Total current assets	16,811,638.28	12,447,477.30
Noncurrent assets:		
Cash (Notes 2 and 3)	64,462,212.55	44,183,808.88
Net pension asset (Note 8)	7,624.00	3,265.00
Capital assets (net) (Note 5)	3,987,023.45	619,104.12
Total noncurrent assets	68,456,860.00	44,806,178.00
Total assets	85,268,498.28	57,253,655.30
Deferred outflows of resources		
Deferred outflows related to pensions (Note 8)	2,633,022.97	1,561,492.00
Total deferred outflows of resources	2,633,022.97	1,561,492.00
Liabilities		
Current liabilities:		
Accounts payable	3,191,525.40	916,456.65
Accrued liabilities	181,853.47	145,994.07
Due to primary government	93,208.71	91,642.62
Compensated absences (Note 6)	342,103.10	434,241.35
Deposits held in custody for others	2,235,566.17	1,985,200.88
Total current liabilities	6,044,256.85	3,573,535.57
Noncurrent liabilities:		
Net OPEB obligation (Note 9)	2,409,551.00	2,123,131.00
Net pension liability (Note 8)	4,745,375.00	3,240,530.00
Compensated absences (Note 6)	937,484.67	846,935.38
Total noncurrent liabilities	8,092,410.67	6,210,596.38
Total liabilities	14,136,667.52	9,784,131.95
Deferred inflows of resources		
Deferred inflows related to pensions (Note 8)	253,005.00	698,370.00
Total deferred inflows of resources	253,005.00	698,370.00
Net position		
Investment in capital assets	3,987,023.45	619,104.12
Restricted for:		
Expendable:		
Pensions	7,624.00	3,265.00
Other	11,104,758.05	10,329,591.93
Unrestricted	58,412,443.23	37,380,684.30
Total net position	$ 73,511,848.73	$ 48,332,645.35

The notes to the financial statements are an integral part of this statement.

TENNESSEE BOARD OF REGENTS - CENTRAL OFFICE
Statements of Revenues, Expenses, and Changes in Net Position
For the Years Ended June 30, 2017, and June 30, 2016

	Year Ended June 30, 2017	Year Ended June 30, 2016
Revenues		
Operating revenues:		
Governmental grants and contracts	$ 967,403.69	$ 1,283,517.33
Nongovernmental grants and contracts	117,701.53	960,100.00
Sales and services of other activities	18,886,944.00	19,957,629.34
Other operating revenues	455,354.23	163,674.73
Total operating revenues	20,427,403.45	22,364,921.40
Expenses		
Operating expenses (Note 12):		
Salaries and wages	10,899,926.02	10,996,939.70
Benefits	3,850,303.66	3,275,836.83
Utilities, supplies, and other services	29,342,671.52	21,084,596.18
Scholarships and fellowships	127,565.00	113,200.00
Depreciation expense	341,677.84	98,702.18
Total operating expenses	44,562,144.04	35,569,274.89
Operating income (loss)	(24,134,740.59)	(13,204,353.49)
Nonoperating revenues (expenses)		
State appropriations	48,838,612.50	19,847,250.00
Investment income (expense)	446,593.86	158,894.21
Other nonoperating revenues	28,737.61	157,473.27
Total nonoperating revenues (expenses)	49,313,943.97	20,163,617.48
Increase in net position	25,179,203.38	6,959,263.99
Net position		
Net position - beginning of year	48,332,645.35	41,373,381.36
Net position - end of year	$ 73,511,848.73	$ 48,332,645.35

The notes to the financial statements are an integral part of this statement.

TENNESSEE BOARD OF REGENTS - CENTRAL OFFICE
Statements of Cash Flows
For the Years Ended June 30, 2017, and June 30, 2016

	Year Ended June 30, 2017	Year Ended June 30, 2016
Cash flows from operating activities		
Grants and contracts	$ 1,166,408.27	$ 2,347,643.78
Sales and services of other activities	18,886,944.00	19,957,629.34
Payments to suppliers and vendors	(28,316,855.79)	(21,225,890.25)
Payments to employees	(10,901,272.60)	(11,049,379.77)
Payments for benefits	(3,535,497.06)	(3,544,134.57)
Payments for scholarships and fellowships	(127,565.00)	(113,200.00)
Other receipts	455,354.23	163,674.73
Net cash used for operating activities	(22,372,483.95)	(13,463,656.74)
Cash flows from noncapital financing activities		
State appropriations	48,828,600.01	19,806,600.00
Changes in deposits held for others	1,700,371.53	(1,065,078.33)
Other non-capital receipts	-	132,903.02
Net cash provided by noncapital financing activities	50,528,971.54	18,874,424.69
Cash flows from capital and related financing activities		
Proceeds from sale of capital assets	79,897.19	33,679.00
Purchase of capital assets and construction	(3,760,756.75)	(413,175.98)
Net cash used for capital and related financing activities	(3,680,859.56)	(379,496.98)
Cash flows from investing activities		
Income on investments	446,593.86	158,894.21
Net cash provided by investing activities	446,593.86	158,894.21
Net increase in cash	24,922,221.89	5,190,165.18
Cash - beginning of year	54,259,680.04	49,069,514.86
Cash - end of year	$ 79,181,901.93	$ 54,259,680.04
Reconciliation of operating loss to net cash used by operating activities:		
Operating loss	$ (24,134,740.59)	$ (13,204,353.49)
Adjustments to reconcile operating loss to net cash used by operating activities:		
Noncash operating expenses	1,171,934.34	457,813.18
Change in assets and liabilities:		
Receivables, net	(824,463.80)	109,739.95
Prepaid items	(341,994.79)	178,850.07
Net pension asset	(4,359.00)	(3,265.00)
Deferred outflows of resources - pensions	(1,071,531.00)	(568,601.97)
Net pension liability	1,504,845.95	1,636,144.05
Deferred inflows of resources - pensions	(445,365.60)	(1,613,299.41)
Accounts payable	2,273,577.37	(325,857.64)
Accrued liabilities	(786,783.96)	(453,354.82)
Compensated absences	(1,588.96)	(61,879.28)
Due to primary government	1,566.09	91,642.62
OPEB liability	286,420.00	292,765.00
Net cash used by operating activities	$ (22,372,483.95)	$ (13,463,656.74)
Noncash investing, capital, or financing transactions		
Gain on disposal of capital assets	$ 28,737.61	$ 18,494.20

The notes to the financial statements are an integral part of this statement.

Note 1. Summary of Significant Accounting Policies

Reporting Entity

The Central Office is a part of the State University and Community College System of Tennessee. This system is a component unit of the State of Tennessee because the state appoints a majority of the system's governing body and provides significant financial support; the system is discretely presented in the *Tennessee Comprehensive Annual Financial Report*.

The financial statements present only that portion of the system's activities that is attributable to the transactions of the Central Office.

Basis of Presentation

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America applicable to governmental colleges and universities engaged in business-type activities as prescribed by the Governmental Accounting Standards Board (GASB).

Basis of Accounting

For financial statement purposes, the Central Office is considered a special-purpose government engaged only in business-type activities. Accordingly, 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 when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all of the provider's eligibility requirements have been met. All significant internal activity has been eliminated.

The Central Office has classified its revenues and expenses as either operating or nonoperating according to the following criteria: Operating revenues and expenses are those that have the characteristics of exchange transactions. Operating revenues include 1) tuition and fees, net of scholarship discounts and allowances; 2) certain federal, state, local, and private grants and contracts; 3) sales and services of auxiliary enterprises, net of scholarship discounts and allowances; and 4) interest on institutional loans. Operating expenses include 1) salaries and wages; 2) employee benefits; 3) utilities, supplies, and other services; 4) scholarships and fellowships; and 5) depreciation.

Nonoperating revenues and expenses include activities that have the characteristics of nonexchange transactions, such as gifts, contributions, and other activities that are defined as nonoperating by GASB Statement 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, and GASB Statement 34, such as state appropriations and investment income.

When both restricted and unrestricted resources are available for use, it is the Central Office's policy to determine which to use first, depending upon existing facts and circumstances.

Compensated Absences

The Central Office's employees accrue annual and sick leave at varying rates, depending on length of service or classification. Some employees also earn compensatory time.

The amount of the liabilities for annual leave and compensatory time and their related benefits are reported in the statement of net position. There is no liability for unpaid accumulated sick leave since the Central Office's policy is to pay this only if the employee dies or is absent because of illness, injury, or related family death.

Capital Assets

Capital assets, which include equipment, projects in process, and leasehold improvements, are reported in the statement of net position at historical cost or at acquisition value at date of donation, less accumulated depreciation/amortization. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend the asset's useful life are not capitalized.

Equipment is capitalized when the unit acquisition cost is $5,000 or greater. The capitalization threshold for leasehold improvements is set at $50,000.

These assets are depreciated/amortized using the straight-line method over their estimated useful lives, which range from 5 to 20 years.

Pensions

For purposes of measuring the net pension liability (asset), deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the fiduciary net position of the Closed State and Higher Education Employee Pension Plan and the State and Higher Education Employee Retirement Plan in the Tennessee Consolidated Retirement System (TCRS) and additions to/deductions from the plans' fiduciary net positions have been determined on the same basis as they are reported by the TCRS. For this purpose, benefits (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms of the Closed State and Higher Education Employee Pension Plan and the State and Higher Education Employee Retirement Plan. Investments are reported at fair value.

Net Position

The Central Office's net position is classified as follows:

<u>Investment in capital assets</u> – This represents the Central Office's total investment in capital assets, net of accumulated depreciation related to those capital assets.

Expendable restricted net position – Expendable restricted net position includes resources that the Central Office is legally or contractually obligated to spend in accordance with restrictions imposed by external third parties.

Unrestricted net position – Unrestricted net position represents resources derived from state appropriations and system charges to the institutions. These resources are used for transactions relating to the educational and general operations of the Central Office and may be used at the discretion of the Central Office to meet current expenses for any purpose.

Note 2. Cash

This classification includes demand deposits and petty cash on hand. At June 30, 2017, cash consisted of $2,177,373.26 in bank accounts; $100.00 of petty cash on hand; and $77,004,428.67 in the Local Government Investment Pool (LGIP) administered by the State Treasurer. At June 30, 2016, cash consisted of $2,335,072.13 in bank accounts; $100.00 of petty cash on hand; and $51,924,507.91 in the LGIP.

The LGIP, which is part of the State Pooled Investment Fund, is administered by the State Treasurer and is measured at amortized cost. There are no minimum or maximum limitations on withdrawals with the exception of a 24-hour notification period for withdrawals of $5 million or more. The fund's required risk disclosures are presented in the *State of Tennessee Treasurer's Report*. That report is available on the state's website at www.treasury.tn.gov.

Note 3. Investments

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Central Office is authorized by statute to invest funds in accordance with Tennessee Board of Regents policies. Under the current policy, funds other than endowments may be invested only in obligations of the United States or its agencies which are backed by the full faith and credit of the United States; repurchase agreements for United States securities; certificates of deposit in banks and savings and loan associations; bankers' acceptances; commercial paper; money market mutual funds; and the State of Tennessee Local Government Investment Pool. The policy requires that investments of endowments in equity securities be limited to funds from private gifts or other sources external to the Central Office and that endowment investments be prudently diversified.

Tennessee Board of Regents policy restricts investments in bankers' acceptances and commercial paper. The policy requires that prime bankers' acceptances must be issued by domestic banks with a minimum AA rating or foreign banks with a AAA long-term debt rating by a majority of the rating services that have rated the issuer. Prime bankers' acceptances are required to be eligible for purchase by the Federal Reserve System. To be eligible, the original maturity must not be more than 270 days, and it must 1) arise out of the current shipment of goods between countries or with the United States or 2) arise out of storage within the United States of goods that are under contract of sale or are expected to move into the channel of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods.

Tennessee Board of Regents policy requires that prime commercial paper be limited to that of corporations that meet the following criteria: 1) Senior long-term debt, if any, should have a minimum rating of A1 or equivalent, and short-term debt should have a minimum rating of A1 or equivalent, as provided by a majority of the rating services that rate the issuer. If there is no long-term debt rating, the short-term debt rating must be A1 by all rating services (minimum of two). 2) The rating should be based on the merits of the issuer or guarantee by a nonbank. 3) A financial review should be made to ascertain the issuer's financial strength to cover the debt. 4) Commercial paper of a banking institution should not be purchased. Prime commercial paper shall not have a maturity that exceeds 270 days.

As of June 30, 2017, and June 30, 2016, the Central Office's investments consisted entirely of investments in the Local Government Investment Pool, which are valued at amortized cost. The value of these investments was $77,004,428.67 at June 30, 2017, and $51,924,507.91 at June 30, 2016. LGIP investments are not rated by nationally recognized statistical ratings organizations.

Note 4. Receivables

Receivables included the following:

	June 30, 2017	June 30, 2016
Grants and contracts receivable	$ -	$ 3,433.34
TFLI receivables	257,090.27	246,658.41
Shared hosting receivables	59,060.85	340,828.47
Northeast State Community College	900,000.00	-
Other receivables	20,232.43	9,244.68
Total receivables	$1,236,383.55	$600,164.90

Note 5. Capital Assets

Capital asset activity for the year ended June 30, 2017, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Leasehold improvements	$ -	$1,988,637.57	$ 167,339.18	$ -	$2,155,976.75
Equipment	1,164,811.64	1,772,119.18	-	536,815.98	2,400,114.84
Projects in progress	167,339.18	-	(167,339.18)	-	-
Total	1,332,150.82	3,760,756.75	-	536,815.98	4,556,091.59
Less accumulated depreciation					
Leasehold improvements	-	119,776.49	-	-	119,776.49
Equipment	713,046.70	221,901.35	-	485,656.40	449,291.65
Total	713,046.70	341,677.84	-	485,656.40	569,068.14
Capital assets, net	$ 619,104.12	$3,419,078.91	$ -	$ 51,159.58	$3,987,023.45

Capital asset activity for the year ended June 30, 2016, was as follows:

	Beginning Balance	Additions	Transfers	Reductions	Ending Balance
Projects in progress	$ -	$167,339.18	$ -	$ -	$ 167,339.18
Equipment	1,093,394.15	245,836.80	-	174,419.31	1,164,811.64
Total	1,093,394.15	413,175.98	-	174,419.31	1,332,150.82
Less accumulated depreciation					
Equipment	779,655.08	92,626.13	-	159,234.51	713,046.70
Total	779,655.08	92,626.13	-	159,234.51	713,046.70
Capital assets, net	$ 313,739.07	$320,549.85	$ -	$ 15,184.80	$ 619,104.12

Note 6. Long-term Liabilities

Long-term liabilities activity for the year ended June 30, 2017, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Compensated absences	$1,281,176.73	$651,945.63	$653,534.59	$1,279,587.77	$342,103.10

Long-term liabilities activity for the year ended June 30, 2016, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Compensated absences	$1,343,056.01	$722,992.43	$784,871.71	$1,281,176.73	$434,241.35

Note 7. Endowments

If a donor has not provided specific instructions to the Central Office, state law permits the Central Office to authorize for expenditure the earnings of the investments of endowment funds. When administering its power to spend the earnings, the Central Office is required to consider its long-term and short-term needs; present and anticipated financial requirements; expected return on its investments; price-level trends; and general economic conditions. Any earnings spent are required to be spent for the purposes for which the endowment was established.

For the Floyd Endowment, the Central Office chooses to spend only a portion of the investment income each year. Under the spending plan established by the Board in March 2015, expenditures are limited to one new renewable $500.00 scholarship awarded each year, and funding any previously awarded scholarships. The remaining amount, if any, is retained to be used in future years. At June 30, 2017, investment income of $18,729.42 is available to be spent and is included in unrestricted net position. At June 30, 2016, investment income of $16,608.56 is available to be spent and is included in unrestricted net position.

Note 8. Pension Plans

Defined Benefit Plans

Closed State and Higher Education Employee Pension Plan

General Information About the Pension Plan

Plan description – State employees and higher education employees with membership in the Tennessee Consolidated Retirement System (TCRS) before July 1, 2014, are provided with pensions through the Closed State and Higher Education Employee Pension Plan. This plan is a component of the Public Employee Retirement Plan, an agent, multiple-employer defined benefit pension plan. The Closed State and Higher Education Employee Pension Plan stopped accepting new membership on June 30, 2014, but will continue providing benefits to existing members and retirees. Beginning July 1, 2014, a new agent defined benefit retirement plan, the State and Higher Education Employee Retirement Plan, became effective for state employees and higher education employees hired on or after July 1, 2014.

The TCRS was created by state statute under Title 8, Chapters 34-37, *Tennessee Code Annotated*. The TCRS Board of Trustees is responsible for the proper operation and administration of all employer pension plans in the TCRS. The Tennessee Treasury Department, an agency in the legislative branch of state government, administers the plans of the TCRS. The TCRS issues a publicly available financial report that can be obtained at http://www.treasury.state.tn.us/.

Benefits provided – Title 8, Chapters 34-37, *Tennessee Code Annotated*, establishes the benefit terms and can be amended only by the Tennessee General Assembly. Members of the Closed State and Higher Education Employee Pension Plan are eligible to retire with an unreduced benefit at age 60 with 5 years of service credit or after 30 years of service credit regardless of age. Benefits are determined using the following formula:

Average of member's highest compensation for 5 consecutive years (up to Social Security integration level)	x	1.50%	x	Years of Service Credit	x	105%

Plus:

Average of member's highest compensation for 5 consecutive years (over the Social Security integration level)	x	1.75%	x	Years of Service Credit	x	105%

A reduced early retirement benefit is available at age 55 and vested. Members are vested with 5 years of service credit. Service-related disability benefits are provided regardless of length of service. Five years of service is required for non-service-related disability eligibility. The service-related and non-service-related disability benefits are determined in the same manner as a service retirement benefit but are reduced 10% and include projected service credits. A variety of death benefits are available under various eligibility criteria. Member and beneficiary annuitants are entitled to automatic cost-of-living adjustments (COLAs) after retirement. A COLA is granted each July for annuitants retired prior to July 2 of the previous year. The COLA is based on the change in the consumer price index (CPI) during the prior calendar year, capped at 3%, and applied to the current benefit. No COLA is granted if the change in the CPI is less than 0.5%. A 1% COLA is granted if the CPI change is between 0.5% and 1%. A member who leaves employment may withdraw employee contributions, plus any accumulated interest.

Contributions – Contributions for state employees and higher education employees are established in the statutes governing the TCRS and may only be changed by the Tennessee General Assembly. The Central Office's employees are non-contributory, as are most members in the Closed State and Higher Education Employee Pension Plan. State and higher education agencies make employer contributions at the rate set by the Board of Trustees as determined by an actuarial valuation. By law, employer contributions for the Closed State and Higher Education Employee Pension Plan are required to be paid. Employer contributions by the Central Office for the years ended June 30, 2017, and June 30, 2016, to the Closed State and Higher Education Employee Pension Plan were $903,080 and $954,412, respectively, which is 15.02% and 15.03% of covered payroll, respectively. The employer rate is expected to finance the costs of benefits earned by members during the year and the cost of administration, as well as an amortized portion of any unfunded liability.

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions

Pension liability – At June 30, 2017, the Central Office reported a liability of $4,745,375 for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2016, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of that date. The Central Office's proportion of the net pension liability was based on a projection of the Central Office's contributions during the year ended June 30, 2016, to the pension plan relative to the contributions of all participating state and higher education agencies. At the June 30, 2016, measurement date, the Central Office's proportion was 0.26008%.

At June 30, 2016, the Central Office reported a liability of $3,240,530 for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2015, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of that date. The Central Office's proportion of the net pension liability was based on a projection of the Central Office's contributions during the year ended June 30, 2015, to the pension plan relative to the contributions of all participating state and higher education agencies. At the June 30, 2015, measurement date, the Central Office's proportion was 0.25134%. At the June 30, 2014, measurement date, the Central Office's proportion was 0.232537%.

Pension expense – For the years ended June 30, 2017, and June 30, 2016, the Central Office recognized pension expense of $912,989 and $411,796, respectively.

Deferred outflows of resources and deferred inflows of resources – For the years ended June 30, 2017, and June 30, 2016, the Central Office reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

Fiscal Year 2017	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	$ 266,120	$252,186
Net difference between projected and actual earnings on pension plan investments	1,147,667	-
Changes in proportion of net pension liability	283,796	-

The Central Office's contributions subsequent to the measurement date of June 30, 2016	903,080	-
Total	$2,600,663	$252,186

Fiscal Year 2016	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	$ 342,901	$ 280,577
Net difference between projected and actual earnings on pension plan investments	-	416,579
Changes in proportion of net pension liability	253,373	-
The Central Office's contributions subsequent to the measurement date of June 30, 2015	954,412	-
Total	$ 1,550,686	$ 697,156

Deferred outflows of resources, resulting from the Central Office's employer contributions of $903,080 subsequent to the measurement date, will be recognized as a decrease in net pension liability in the year ending June 30, 2018. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

Year Ending June 30	
2018	$155,218
2019	$155,218
2020	$801,587
2021	$333,374
2022	-
Thereafter	-

In the table above, positive amounts will increase pension expense, while negative amounts will decrease pension expense.

Actuarial assumptions – The total pension liability was determined by actuarial valuations using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.0%
Salary increases	Graded salary ranges from 8.97% to 3.71% based on age, including inflation, averaging 4.25%

Investment rate of return	7.5%, net of pension plan investment expenses, including inflation
Cost-of-living adjustment	2.5%

Mortality rates were based on actual experience from the June 30, 2012, actuarial experience study adjusted for some of the expected future improvement in life expectancy.

The actuarial assumptions used in the actuarial valuations were based on the results of an actuarial experience study performed for the period July 1, 2008, through June 30, 2012. The demographic assumptions were adjusted to more closely reflect actual and expected future experience.

The long-term expected rate of return on pension plan investments was established by the TCRS Board of Trustees in conjunction with the June 30, 2012, actuarial experience study by considering the following three techniques: 1) the 25-year historical return of the TCRS at June 30, 2012; 2) the historical market returns of asset classes from 1926 to 2012 using the TCRS investment policy asset allocation; and 3) capital market projections that were utilized as a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. Four sources of capital market projections were blended and utilized in the third technique. The blended capital market projection established the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding inflation of 3%. The target allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

Asset Class	Long-term Expected Real Rate of Return	Target Allocation
U.S. equity	6.46%	33%
Developed market international equity	6.26%	17%
Emerging market international equity	6.40%	5%
Private equity and strategic lending	4.61%	8%
U.S. fixed income	0.98%	29%
Real estate	4.73%	7%
Short-term securities	0.00%	1%
		100%

The long-term expected rate of return on pension plan investments was established by the TCRS Board of Trustees as 7.5% based on a blending of the three factors described above.

Discount rate – The discount rate used to measure the total pension liability was 7.5%. The projection of cash flows used to determine the discount rate assumed that employee contributions will be made at the current rate and that contributions from all state and higher education agencies will be made at the actuarially determined contribution rate in accordance with the funding policy of the TCRS Board of Trustees and as required to be paid by state statute. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make projected future benefit payments of current active and inactive members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of the proportionate share of net pension liability to changes in the discount rate – The following presents the Central Office's proportionate share of the net pension liability calculated using the discount rate of 7.5%, as well as what the Central Office's proportionate share of the net pension liability would be if it were calculated using a discount rate that is 1 percentage point lower (6.5%) or 1 percentage point higher (8.5%) than the current rate:

	1% Decrease (6.5%)	Current Discount Rate (7.5%)	1% Increase (8.5%)
Central Office's proportionate share of net pension liability	$9,325,530	$4,745,375	$883,168

Pension plan fiduciary net position – Detailed information about the pension plan's fiduciary net position is available in a separately issued TCRS financial report at http://www.treasury.state.tn.us/.

Payable to the Pension Plan

At June 30, 2017, and June 30, 2016, the Central Office reported a payable of $76,586 and $78,317.72, respectively, for the outstanding amount of legally required contributions to the pension plan required for the years then ended.

State and Higher Education Employee Retirement Plan

General Information About the Pension Plan

Plan description – State employees and higher education employees with membership in the Tennessee Consolidated Retirement System (TCRS) before July 1, 2014, are provided with pensions through the Closed State and Higher Education Employee Pension Plan, an agent plan within the Public Employee Retirement Plan administered by the TCRS. TCRS is a multiple-employer pension plan. The Closed State and Higher Education Pension Plan was closed effective June 30, 2014, and covers employees hired before July 1, 2014. Employees hired after June 30, 2014, are provided with pensions through a legally separate plan referred to as the State and Higher Education Employee Retirement Plan, an agent plan within the Public Employee Retirement Plan administered by the TCRS. The TCRS was created by state statute under Title 8, Chapters 34-37, *Tennessee Code Annotated*.

Benefits provided – Title 8, Chapters 34-37, *Tennessee Code Annotated,* establishes the benefit terms and can be amended only by the Tennessee General Assembly. Members of the State and

Higher Education Employee Retirement Plan are eligible to retire at age 65 with 5 years of service credit or pursuant to the rule of 90 in which the member's age and service credit total 90. Members are entitled to receive unreduced service retirement benefits, which are determined by a formula multiplying the member's highest 5 consecutive year average compensation by 1% multiplied by the member's years of service credit. A reduced early retirement is available at age 60 with 5 years of service credit or pursuant to the rule of 80 in which a member's age and service credit total 80. Service-related disability benefits are provided regardless of length of service. Five years of service is required for non-service-related disability eligibility. The service-related and non-service-related disability benefits are determined in the same manner as a service retirement benefit but are reduced 10% and include projected service credit. A variety of death benefits are available under various eligibility criteria.

Member and beneficiary annuitants are entitled to automatic cost-of-living adjustments (COLAs) after retirement. A COLA is granted each July for annuitants retired prior to July 2 of the previous year. The COLA is based on the change in the consumer price index (CPI) during the prior calendar year, capped at 3%, and applied to the current benefit. No COLA is granted if the change in the CPI is less than 0.5%. A 1% COLA is granted if the CPI change is between 0.5% and 1%. A member who leaves employment may withdraw employee contributions, plus any accumulated interest.

<u>Contributions</u> – Contributions for state and higher education employees are established in the statutes governing the TCRS and may only be changed by the Tennessee General Assembly. Employees contribute 5% of their salary to the State and Higher Education Employee Retirement Plan. By law, employer contributions for the State and Higher Education Employee Retirement Plan are required to be paid. Employer contributions by the Central Office for the years ended June 30, 2017, and June 30, 2016, to the State and Higher Education Employee Retirement Plan were \$30,460 and \$10,617, respectively, which is 3.94% and 3.81% of covered payroll, respectively. The employer rate, when combined with member contributions, is expected to finance the costs of benefits earned by members during the year and the cost of administration, as well as an amortized portion of any unfunded liability.

Pension Assets, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions

<u>Pension asset</u> – At June 30, 2017, the Central Office reported an asset of \$7,624 for its proportionate share of the net pension asset. The net pension asset was measured as of June 30, 2016, and the total pension asset used to calculate the net pension asset was determined by an actuarial valuation as of that date. The Central Office's proportion of the net pension asset was based on a projection of the Central Office's contributions during the year ended June 30, 2016, to the pension plan relative to the contributions of all participating state and higher education agencies. At the June 30, 2016, measurement date, the Central Office's proportion was 0.090505%.

At June 30, 2016, the Central Office reported an asset of \$3,265 for its proportionate share of the net pension asset. The net pension asset was measured as of June 30, 2015, and the total pension asset used to calculate the net pension asset was determined by an actuarial valuation as of that date. The Central Office's proportion of the net pension asset was based on a projection of the Central Office's contributions during the year ended June 30, 2015, to the pension plan relative to the contributions of all participating state and higher education agencies. At the June 30, 2015, measurement date, the Central Office's proportion was 0.117401%, representing the first-time presentation of this proportion.

Pension expense – For the years ended June 30, 2017, and June 30, 2016, the Central Office recognized a pension expense of $4,326 and $2,708, respectively.

Deferred outflows of resources and deferred inflows of resources – For the years ended June 30, 2017, and June 30, 2016, the Central Office reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

Fiscal Year 2017	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	$ 555	$819
Net difference between projected and actual earnings on pension plan investments	889	-
Changes in proportion of net pension asset	456	-
The Central Office's contributions subsequent to the measurement date of June 30, 2016	30,460	-
Total	$32,360	$819

Fiscal Year 2016	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	$ -	$1,214
Net difference between projected and actual earnings on pension plan investments	189	-
The Central Office's contributions subsequent to the measurement date of June 30, 2015	10,617	-
Total	$10,806	$1,214

Deferred outflows of resources, resulting from the Central Office's employer contributions of $30,460 subsequent to the measurement date, will be recognized as a decrease in net pension liability in the year ending June 30, 2018. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

Year Ending June 30	
2018	$241
2019	$241
2020	$241
2021	$204
2022	$ 9
Thereafter	$145

In the table above, positive amounts will increase pension expense, while negative amounts will decrease pension expense.

Actuarial assumptions – The total pension asset was determined by actuarial valuations using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.0%
Salary increases	Graded salary ranges from 8.97% to 3.71% based on age, including inflation, averaging 4.25%
Investment rate of return	7.5%, net of pension plan investment expenses, including inflation
Cost-of-living adjustment	2.5%

Mortality rates were based on actual experience from the June 30, 2012, actuarial experience study adjusted for some of the expected future improvement in life expectancy.

The actuarial assumptions used in the actuarial valuations were based on the results of an actuarial experience study performed for the period July 1, 2008, through June 30, 2012. The demographic assumptions were adjusted to more closely reflect actual and expected future experience.

The long-term expected rate of return on pension plan investments was established by the TCRS Board of Trustees in conjunction with the June 30, 2012, actuarial experience study by considering the following three techniques: 1) the 25-year historical return of the TCRS at June 30, 2012; 2) the historical market returns of asset classes from 1926 to 2012 using the TCRS investment policy asset allocation; and 3) capital market projections that were utilized as a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. Four sources of capital market projections were blended and utilized in the third technique. The blended capital market projection established the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding inflation of 3%. The target allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

Asset Class	Long-term Expected Real Rate of Return	Target Allocation
U.S. equity	6.46%	33%
Developed market international equity	6.26%	17%
Emerging market international equity	6.40%	5%
Private equity and strategic lending	4.61%	8%
U.S. fixed income	0.98%	29%
Real estate	4.73%	7%
Short-term securities	0.00%	1%
		100%

The long-term expected rate of return on pension plan investments was established by the TCRS Board of Trustees as 7.5% based on a blending of the three factors described above.

Discount rate – The discount rate used to measure the total pension liability (asset) was 7.5%. The projection of cash flows used to determine the discount rate assumed that employee contributions will be made at the current rate and that contributions from all state and higher education agencies will be made at the actuarially determined contribution rate in accordance with the funding policy of the TCRS Board of Trustees and as required to be paid by state statute. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make projected future benefit payments of current active and inactive members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability (asset).

Sensitivity of the proportionate share of net pension asset to changes in the discount rate – The following presents the Central Office's proportionate share of the net pension asset calculated using the discount rate of 7.5%, as well as what the Central Office's proportionate share of the net pension asset would be if it were calculated using a discount rate that is 1 percentage point lower (6.5%) or 1 percentage point higher (8.5%) than the current rate:

	1% Decrease (6.5%)	Current Discount Rate (7.5%)	1% Increase (8.5%)
Central Office's proportionate share of net pension asset	\$912	\$7,624	\$12,653

Pension plan fiduciary net position – Detailed information about the pension plan's fiduciary net position is available in a separately issued TCRS financial report at www.treasury.tn.gov/tcrs.

Payable to the Pension Plan

At June 30, 2017, and June 30, 2016, the Central Office reported a payable of \$3,807 and \$1,588.57, respectively, for the outstanding amount of legally required contributions to the pension plan required for the years then ended.

Total Defined Benefit Pension Expense

The total pension expense for the year ended June 30, 2017, for all state and local government defined benefit pension plans was $917,315. The total pension expense for the year ended June 30, 2016, for all state and local government defined benefit pension plans was $414,504.

Defined Contribution Plans

Optional Retirement Plans

Plan description – The Central Office contributes to the Optional Retirement Plan (ORP). The ORP, administered by the Tennessee Treasury Department, is a defined contribution plan. The ORP was established by state statute in Title 8, Chapter 35, Part 4, *Tennessee Code Annotated*. This statute also sets out the plan provisions. The plan provisions are amended by the Tennessee General Assembly. The ORP was designed to provide benefits at retirement to faculty and staff who are exempt from the overtime provision of the Fair Labor Standards Act and who waive membership in the TCRS. In a defined contribution plan, benefits depend solely on amounts contributed to the plan plus investment earnings.

Funding policy – For employees employed prior to July 1, 2014, plan members are noncontributory. The Central Office contributes an amount equal to 10% of the employee's base salary up to the social security wage base and 11% above the social security wage base. For employees hired after June 30, 2014, plan members will contribute 5% to the ORP and the Central Office will contribute 9% of the employee's base salary. Pension expense equaled the required contributions made to the ORP and was $403,296.11 for the year ended June 30, 2017; $421,552.49 for the year ended June 30, 2016; and $433,013.30 for the year ended June 30, 2015. Contributions met the requirements for each year.

Members are immediately 100% vested in the employer contributions made pursuant to the ORP. The Treasury Department has selected three investment vendors who offer a variety of investment products, and members are responsible for selecting how the contributions are invested. Each member makes the decision when to reallocate future contributions or when to transfer funds from one investment product to another. Funds are held by the investment vendor in the name of the member, not in the name of the State of Tennessee. The State of Tennessee has no discretion over these funds other than to make the initial contributions. Accordingly, the State of Tennessee is not acting in a trustee capacity, nor does it have a fiduciary responsibility for the funds held by the investment vendors.

Deferred Compensation Plans

Employees are offered three deferred compensation plans. The Central Office, through the State of Tennessee, provides two plans, one established pursuant to the Internal Revenue Code (IRC), Section 457, and the other pursuant to IRC, Section 401(k). The third plan is administered by the Central Office and was established in accordance with IRC, Section 403(b). The plans are outsourced to third-party vendors, and the administrative costs assessed by the vendors of these plans are the responsibility of plan participants. Section 401(k), Section 403(b), and Section 457 plan assets remain the property of the contributing employees; therefore, they are not presented in the accompanying financial statements. Sections 401(k), 403(b), and 457 establish participation, contribution, and withdrawal provisions for the plans. Participation in the 403(b) and the 457 plans is voluntary for employees. The Central Office provides up to a $50 monthly employer match for employees who participate in the state's 401(k) plan. Employees hired before July 1, 2014, voluntarily participate in the state's 401(k) plan. Pursuant to Public Chapter No. 259 of Public Acts of 2013*,* employees hired after June 30, 2014, are automatically enrolled in the state's 401(k) plan and contribute 2% of their salary, with the employer contributing an additional non-matching 5%. Employees may opt out of the 2% auto enrollment. Such contribution rates may only be amended by the Tennessee General Assembly. There are certain automatic cost controls and unfunded liability controls in the defined benefit plan where the employees participate that may impact the non-matching 5% employer contribution to the 401(k) plan.

Employees are immediately vested in both the employee and employer contributions in all plans. The IRC establishes maximum limits that an employee can contribute to these plans. The employee may increase, decrease, or stop contributions at any time for all three plans.

During the year ended June 30, 2017, contributions totaling $518,296.34 were made by employees participating in the 401(k) plan, and the Central Office recognized pension expense of $105,492.87 for employer contributions. During the year ended June 30, 2016, contributions totaling $598,777.98 were made by employees participating in the 401(k) plan, with contributions of $86,057.16 made by the Central Office. During the year ended June 30, 2015, contributions totaling $594,863.75 were made by employees participating in the 401(k) plan, with contributions of $76,670.57 made by the Central Office.

Note 9. Other Postemployment Benefits

Healthcare is the only "other postemployment benefit" (OPEB) provided to employees. The State of Tennessee administers a group health insurance program that provides postemployment health insurance benefits to eligible retirees. This program includes two plans available to higher education employees—the State Employee Group Plan and the Medicare Supplement Plan. For accounting purposes, the plans are agent multiple-employer defined benefit OPEB plans. Benefits are established and amended by an insurance committee created by Section 8-27-201, *Tennessee Code Annotated,* for the State Employee Group Plan and for the Medicare Supplement Plan. The State Employee Group Plan covers retirees until they reach the age of 65. Members have the option of choosing between the standard or partnership preferred provider organization plan for healthcare benefits. Subsequent to age 65, members who are also in the state's retirement system may participate in a state-administered Medicare supplement that does not include pharmacy. Employees hired on or after July 1, 2015, are not eligible to continue insurance coverage at retirement in either the State Employee Group Plan or the Medicare Supplement Plan. The state makes on-behalf payments to the Medicare Supplement Plan for the Central Office's eligible retirees; see Note 13. The plans are reported in the *Tennessee Comprehensive Annual Financial*

Report (CAFR). The CAFR is available on the state's website at www.tn.gov/finance/fa/fa-accounting-financial/fa-accfin-cafr.html.

Special Funding Situation

The State of Tennessee is legally responsible for contributions to the Medicare Supplement Plan, which covers the retirees of other governmental entities, including the Central Office. The state is the sole contributor for the Central Office retirees who participate in the Medicare Supplement Plan and, therefore, is acting as the employer.

Funding Policy

The premium requirements of plan members are established and may be amended by the insurance committee. The plans are self-insured and financed on a pay-as-you-go basis with the risk shared equally among the participants. The plan's claims liabilities are periodically computed using actuarial and statistical techniques to establish premium rates. The plan's administrative costs are allocated to plan participants. Retired members pay the same base premium, adjusted for years of service, as active employees. Retirees with 30 years of service are subsidized 80%; retirees with 20 years of service but less than 30 years of service, 70%; and retirees with less than 20 years of service, 60%. Retirees in the Medicare Supplement Plan have flat-rate premium subsidies based on years of service. Retirees with 30 years of service receive $50 per month; retirees with 20 years of service but less than 30 years of service, $37.50; and retirees with 15 years of service but less than 20 years of service, $25.

Central Office's Annual OPEB Cost and Net OPEB Obligation
State Employee Group Plan

	2017	2016
Annual required contribution (ARC)	$ 479,000	$ 465,000
Interest on the net OPEB obligation	79,617	68,638
Adjustment to the ARC	(79,937)	(68,914)
Annual OPEB cost	478,680	464,724
Amount of contribution	(192,260)	(171,959)
Increase in net OPEB obligation	286,420	292,765
Net OPEB obligation – beginning of year	2,123,131	1,830,366
Net OPEB obligation – end of year	$2,409,551	$2,123,131

Year-end	Plan	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation at Year-end
June 30, 2017	State Employee Group Plan	$478,680	40.2%	$2,409,551

June 30, 2016	State Employee Group Plan	$464,724	37.0%	$2,123,131
June 30, 2015	State Employee Group Plan	$280,778	62.6%	$1,830,366

Funded Status and Funding Progress

The funded status of the Central Office's portion of the State Employee Group Plan was as follows:

State Employee Group Plan

Actuarial valuation date	July 1, 2015
Actuarial accrued liability (AAL)	$ 6,779,000
Actuarial value of plan assets	-
Unfunded actuarial accrued liability (UAAL)	$ 6,779,000
Actuarial value of assets as a percentage of the AAL	0.00%
Covered payroll (active plan members)	$10,565,847
UAAL as percentage of covered payroll	64.2%

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future, and actuarially determined amounts are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future. The schedule of funding progress, presented as Required Supplementary Information following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

Actuarial Methods and Assumptions

Calculations are based on the types of benefits provided under the terms of the substantive plan at the time of each valuation and on the pattern of sharing of costs between the employer and plan members to that point. Actuarial calculations reflect a long-term perspective. Consistent with that perspective, actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets.

In the July 1, 2015, actuarial valuation, the Projected Unit Credit actuarial cost method was used. The actuarial assumptions included a 3.75% investment rate of return (net of administrative expenses) and an annual healthcare cost trend rate of 6.5% initially. The rate decreased to 6% in fiscal year 2016 and then reduces by decrements to an ultimate rate of 4.7% in fiscal year 2050. All rates include a 2.5% inflation assumption. Premium subsidies in the Medicare Supplement Plan are projected to remain unchanged, and, consequently, trend rates are not applicable. The unfunded actuarial accrued liability is being amortized as a level percentage of payroll on a closed basis over a 30-year period beginning with July 1, 2007. Payroll is assumed to grow at a rate of 3%.

Note 10. Insurance-related Activities

It is the policy of the state not to purchase commercial insurance for the risks associated with casualty losses for general liability, automobile liability, professional medical malpractice liability, and workers' compensation. By statute, the maximum liability for general liability, automobile liability, and professional medical malpractice liability is $300,000 per person and $1,000,000 per occurrence. The state's management believes it is more economical to manage these risks internally and set aside assets for claim settlement in its internal service fund, the Risk Management Fund (RMF). The state purchases commercial insurance for real property; crime and fidelity coverage on the state's officials and employees; and cyber liability coverage. For property coverage, the deductible for an individual state agency is the first $25,000 of losses. The RMF is responsible for property losses for the annual aggregate deductible of $7.5 million for perils other than earthquake and flood. Purchased insurance coverage is responsible for losses exceeding the $7.5 million annual aggregate deductible. For earthquake and flood, there is a deductible of $10 million per occurrence. The maximum insurance coverage is $750 million per year for perils other than earthquake and flood. The maximum flood insurance coverage is $50 million per occurrence, except there is only $25 million of coverage in flood zones A and V. The maximum earthquake insurance coverage is $50 million per occurrence. The amounts of settlements have not exceeded insurance coverage for each of the three past fiscal years.

The Central Office participates in the RMF. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the Central Office based on a percentage of the Central Office's expected loss costs, which include both experience and exposures. This charge considers recent trends in actual claims experience of the state as a whole. Information regarding the determination of the claims liabilities and the changes in the balances of the claims liabilities for the year ended June 30, 2017, is presented in the *Tennessee Comprehensive Annual Financial Report* (CAFR). The CAFR is available on the state's website at www.tn.gov/finance/fa/fa-accounting-financial/fa-accfin-cafr.html. At June 30, 2017, the Risk Management Fund held $167 million in cash designated for payment of claims. At June 30, 2016, the Risk Management Fund held $142.9 million in cash designated for payment of claims.

At June 30, 2017, the scheduled coverage for the Central Office was $2,000,000 for contents. At June 30, 2016, the scheduled coverage for the Central Office was $2,000,000 for contents.

The state has also set aside assets in the Employee Group Insurance Fund, an internal service fund, to provide a program of health insurance coverage for the employees of the state, with the risk retained by the state. The Central Office participates in the Employee Group Insurance Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the Central Office based on estimates of the ultimate cost of claims, including the cost of claims that have been reported but not settled and of claims that have been incurred but not reported. Employees and providers have 13 months to file medical claims.

Note 11. Commitments and Contingencies

Sick Leave

The Central Office records the cost of sick leave when paid. The dollar amount of unused sick leave was $3,384,808.20 at June 30, 2017, and $3,923,382.21 at June 30, 2016.

Operating Leases

The Central Office has entered into various operating leases for buildings and equipment. Such leases will probably continue to be required. Expenses under operating leases for real property were $989,507.04 and expenses for personal property were $34,745.95 for the year ended June 30, 2017. The amounts for the year ended June 30, 2016, were $568,096.73 and $1,877.69. All operating leases are cancelable at the lessee's option. The Central Office has entered a new operating lease with DES-TECH TN Limited Partnership for office space. The 15-year lease commenced on September 26, 2016, with the first year annual base rent of $789,543.00. Annual rent costs will increase approximately 2% per year thereafter.

Litigation

The Central Office is involved in several lawsuits, none of which are expected to have a material effect on the accompanying financial statements.

Note 12. Natural Classification With Functional Classifications

The Central Office's operating expenses for the year ended June 30, 2017, are as follows:

	Natural Classification					
Functional Classification	Salaries	Benefits	Other Operating	Scholarships	Depreciation	Total
Institutional support	$10,899,926.02	$3,850,303.66	$28,652,327.70	$ -	$ -	$43,402,557.38
Maintenance & operation	-	-	690,343.82	-	-	690,343.82
Scholarships & fellowships	-	-	-	127,565.00	-	127,565.00
Depreciation	-	-	-	-	341,677.84	341,677.84
Total	$10,899,926.02	$3,850,303.66	$29,342,671.52	$127,565.00	$341,677.84	$44,562,144.04

The Central Office's operating expenses for the year ended June 30, 2016, are as follows:

Functional Classification	Natural Classification Salaries	Benefits	Other Operating	Scholarships	Depreciation	Total
Institutional support	$10,996,939.70	$3,275,836.83	$20,694,084.14	$ -	$ -	$34,966,860.67
Maintenance & operation	-	-	390,512.04	-	-	390,512.04
Scholarships & fellowships	-	-	-	113,200.00	-	113,200.00
Depreciation	-	-	-	-	98,702.18	98,702.18
Total	$10,996,939.70	$3,275,836.83	$21,084,596.18	$113,200.00	$98,702.18	$35,569,274.89

Note 13. On-behalf Payments

During the year ended June 30, 2017, the State of Tennessee made payments of $7,612.50 on behalf of the Central Office for retirees participating in the Medicare Supplement Plan. The amount for the year ended June 30, 2016, was $7,950.00. The Medicare Supplement Plan is a postemployment benefit healthcare plan and is discussed further in Note 9.

Tennessee Board of Regents – Central Office

Required Supplementary Information
Schedule of the Central Office's Proportionate Share of the Net Pension Liability
Closed State and Higher Education Employee Pension Plan Within TCRS

	Proportion of the Net Pension Liability	Proportionate Share of the Net Pension Liability	Covered Payroll	Proportionate Share of the Net Pension Liability as a Percentage of Its Covered Payroll	Plan Fiduciary Net Position as a Percentage of the Total Pension Liability
2017	0.260080%	$4,745,375	$6,350,044	74.73%	87.96%
2016	0.251344%	3,240,530	6,563,138	49.37	91.26%
2015	0.232537%	1,604,385	6,352,719	25.26	95.11%

1) To correspond with the measurement date, the amounts presented were determined as of June 30 of the prior fiscal year.

2) This is a 10-year schedule; however, the information in this schedule is not required to be presented retroactively. Years will be added to this schedule in future years until 10 years of information are available.

Tennessee Board of Regents – Central Office

Required Supplementary Information
Schedule of the Central Office's
Proportionate Share of the Net Pension Asset
State and Higher Education Employee Retirement Plan Within TCRS

	2017	2016
Central Office's proportion of the net pension asset	0.090505%	0.117401%
Central Office's proportionate share of the net pension asset	$ 7,624	$ 3,265
Central Office's covered payroll	$278,841	$127,844
Central Office's proportionate share of the net pension asset as a percentage of its covered payroll	2.73%	2.55%
Plan fiduciary net position as a percentage of the total pension liability	130.56%	142.55%

1) To correspond with the measurement date, the amounts presented were determined as of June 30 of the prior fiscal year.

2) This is a 10-year schedule; however, the information in this schedule is not required to be presented retroactively. Years will be added to this schedule in future years until 10 years of information are available.

Tennessee Board of Regents – Central Office

Required Supplementary Information

Schedule of the Central Office's Contributions

Closed State and Higher Education Employee Pension Plan Within TCRS

	Contractually Determined Contributions	Contributions in Relation to Contractually Determined Contributions	Contribution Deficiency (Excess)	Covered Payroll	Contributions as a Percentage of Covered Payroll
2017	$903,080.00	$903,080.00	$ -	$6,011,473.76	15.02%
2016	954,412.00	954,412.00	-	6,350,043.97	15.03%
2015	987,942.00	987,942.00	-	6,573,134.00	15.03%
2014	954,814.00	954,814.00	-	6,352,719.00	15.03%
2013	892,513.77	892,513.77	-	5,938,215.37	15.03%
2012	805,600.10	805,600.10	-	5,403,085.85	14.91%
2011	739,318.12	739,318.12	-	4,958,538.70	14.91%
2010	689,526.40	689,526.40	-	5,295,901.69	13.02%
2009	635,332.47	635,332.47	-	4,879,665.67	13.02%
2008	698,339.27	698,339.27	-	5,127,307.42	13.62%

Tennessee Board of Regents – Central Office
Required Supplementary Information
Schedule of the Central Office's Contributions
State and Higher Education Employee Retirement Plan Within TCRS

	2017	2016	2015
Contractually determined contributions	$ 30,460	$ 10,617	$ 4,948
Contributions in relation to the contractually determined contributions	30,460	10,617	4,948
Contribution deficiency (excess)	$ -	$ -	$ -
Covered payroll	$773,096	$278,841	$127,844
Contributions as a percentage of covered payroll	3.94%	3.81%	3.87%

This is a 10-year schedule; however, contributions to this plan began in 2015. Years will be added to this schedule in future years until 10 years of information are available.

Tennessee Board of Regents – Central Office
Required Supplementary Information
OPEB Schedule of Funding Progress

Actuarial Valuation Date	Plan	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll [(b-a)/c)]
July 1, 2015	State Employee Group Plan	$ -	$6,779,000	$6,779,000	0%	$10,565,847	64.16%
July 1, 2013	State Employee Group Plan	$ -	$3,309,000	$3,309,000	0%	$10,356,633	31.95%
July 1, 2011	State Employee Group Plan	$ -	$2,797,000	$2,797,000	0%	$9,098,824	30.74%

The amount reported here for covered payroll relates to the fiscal year in which the valuations were performed.

Tennessee Comptroller of the Treasury

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*

The Honorable Bill Haslam, Governor
Members of the General Assembly
The Honorable Flora W. Tydings, Chancellor

We have audited the financial statements of the Tennessee Board of Regents – Central Office, a part of the State University and Community College System of Tennessee, which is a component unit of the State of Tennessee, as of and for the years ended June 30, 2017, and June 30, 2016, and the related notes to the financial statements, which collectively comprise the Central Office's basic financial statements, and have issued our report thereon dated September 25, 2018. We conducted our audit in accordance with the 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 Central Office'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 opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Central Office's internal control. Accordingly, we do not express an opinion on the effectiveness of the Central Office'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 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; therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, as described below, that we consider to be significant deficiencies.

- The Tennessee Board of Regents did not document consideration of outsourced information technology services in its risk assessments and did not proactively communicate its review of System and Organizational Controls reports for external information system service providers with other institutions using those services under the board's contract.
- The Tennessee Board of Regents did not provide adequate controls in two areas.

These deficiencies are described in the Findings and Recommendations section of this report.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Central Office's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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*.

The Central Office's Responses to the Findings

The Central Office's responses to the findings identified in our audit are included in the Findings and Recommendations section of this report. The Central Office's responses were not subjected to the auditing procedures applied in the audit of the financial statements, and, accordingly, we express no opinion on them.

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

Deborah V. Loveless, CPA, Director
Division of State Audit
September 25, 2018

Findings and Recommendations

1. **<u>The Tennessee Board of Regents did not document consideration of outsourced information technology services in its risk assessments and did not proactively communicate its review of System and Organizational Controls reports for external information system service providers with other institutions using those services under the board's contract</u>**

Background

The Tennessee Board of Regents (TBR) contracted with two information technology (IT) vendors to establish important business applications used by TBR and the community colleges that TBR supports. One application supports procurement and supplier management business processes while the other application supports cashiering functions and the processing of electronic payments. TBR comprises 13 community colleges who have the option of using these applications through the TBR contract.

The IT contractors developed and currently maintain these applications and provide access to both through web-based solutions on the Internet. The application software and data are stored and processed in the cloud at data centers that the IT contractors' vendors manage.

Additionally, after the audit period, TBR contracted with a data center vendor to host application and data from a key application used at TBR. TBR uses this application for financial reporting and for managing human resource functions such as payroll.

Condition

Although TBR management performed organizational risk assessments that included consideration of certain IT risks, management did not document and assess the risks associated with the use of external IT service providers. While TBR management reportedly reviewed independent System and Organization Controls (SOC)[1] audit reports for each of these three IT contractors, management did not document its review of these audits as part of TBR's risk assessments and did not document its own evaluation of internal controls that the IT contractors implemented.

Furthermore, TBR did not proactively communicate the result of its review of SOC reports for external IT service providers to other TBR institutions that use those services under the TBR contract. TBR's Chief Information Officer stated that, moving forward, TBR would include its assessment of risks associated with IT contractors, including TBR's review of SOC reports, in TBR's annual risk assessment.

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[1] SOC audits are completed by Certified Public Accountants in accordance with American Institute of Certified Public Accountants standards and are applicable to service organizations such as the IT contractors and data center hosting vendor. The SOC 1 Type 2 and the SOC 2 Type 2 reports provide the most information to management and other auditors regarding the design and effectiveness of internal controls. The former focuses on internal control over financial reporting, and the latter focuses on data security, availability, processing integrity, confidentiality, and/or privacy.

Criteria

The U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* (Green Book) provides a comprehensive framework for internal control practices in federal agencies and serves as a best practice for other government agencies, including TBR. According to Sections 3.09 through 3.11 of the Green Book,

> Management develops and maintains documentation of its internal control system.
>
> Effective documentation assists in management's design of internal control by establishing and communicating the who, what, when, where, and why of internal control execution to personnel. . . .
>
> Management documents internal control to meet operational needs. Documentation of controls, including changes to controls, is evidence that controls are identified, capable of being communicated to those responsible for their performance, and capable of being monitored and evaluated by the entity.

Best practices in the National Institute of Standards and Technology's Special Publication 800-53 (Rev. 4), *Security and Privacy Controls for Federal Information Systems and Organizations,* Chapter 2.5, "External Service Providers," explains that "organizations are responsible and accountable for the information security risk incurred by the use of information system services provided by external providers." Additionally, section RA-3 "Risk Assessment" states that, "risk assessments also take into account risk from external parties (e.g., service providers, contractors operating information systems on behalf of the organization, individuals accessing organizational information systems, outsourcing entities)."

Furthermore, section 3.1, "Security Management," of the *Federal Information System Controls Audit Manual* states that "appropriate policies and procedures should be developed, implemented, and monitored to ensure that the activities performed by external third parties (for example, service bureaus, contractors, other service providers such as system development, network management, and security management) are documented, agreed to, implemented, and monitored for compliance."

According to TBR's bylaws, as summarized on TBR's website, one of TBR's purposes is to "provide essential centralized services and uniform procedures which will increase the individual effectiveness and improve operations of each of the institutions and schools of the system." Therefore, while the community colleges have a responsibility to assess their own risk of using these administrative systems, TBR does have oversight responsibility for these schools, which would include communicating with them about risks.

Cause

The Chief Information Officer described a process where TBR management evaluated the risks of using these IT contractors, which included a review of SOC audit reports. However, this evaluation was never formally documented and was not communicated to the community colleges.

Effect

By not considering the risk of outsourced information technology services in its formal risk assessment process, TBR may not design and implement appropriate internal controls to address those risks. Furthermore, if TBR does not provide relevant information about third-party IT service providers' SOC reports to the community colleges that use those services under the TBR contract, those colleges would need to independently obtain and review those vendors' SOC reports to adequately assess the risk of using the third-party IT services. SOC reports will also identify any complementary user entity controls that a service organization expects its customers to implement to achieve the control objectives specified in the SOC report. Consequently, colleges using the services offered by the IT contractors may not have adequate internal controls implemented over their business processes if they are not made aware of complementary user entity controls.

Recommendation

The Tennessee Board of Regents should include in its organizational risk assessment the consideration of using the information system services of third parties to support key business processes. TBR should also ensure that all community colleges that use third-party information system services under TBR contracts are provided with relevant information from SOC reports issued for those third-party services.

Management's Comment

We concur with the finding and recommendations. The Tennessee Board of Regents Office of Information Technology Management will take corrective action to ensure internal controls are strengthened.

The SOC reports will be gathered in a single secure location (repository) for every vendor whose contract is supported by TBR for the College System of Tennessee. These will be reviewed initially when contracting with a third-party provider and annually thereafter. The review will also be included in the annual risk assessment. Additionally, the SOC report repository will be shared securely with the College System of Tennessee institutions for their review with a reminder for them once the annual review is done.

2. <u>The Tennessee Board of Regents did not provide adequate internal controls in two areas</u>

Tennessee Board of Regents' management did not design and monitor effective internal controls in two areas. For both of these areas, we found internal control deficiencies related to one of the board's systems because management either did not implement controls or implemented controls that were not sufficient.

Ineffective implementation of internal controls increases the likelihood of errors, data loss, and unauthorized access to college information. The details of this finding are confidential pursuant to Section 10-7-504(i), *Tennessee Code Annotated.* We provided the board with detailed information regarding the specific conditions we identified, as well as the related criteria, causes, and our specific recommendations for improvement.

Recommendation

Management should ensure that these conditions are corrected by promptly developing and consistently implementing internal controls in these areas.

Management's Comment

We concur with the finding and recommendations. The Tennessee Board of Regents management will take corrective action to ensure internal controls are strengthened.