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

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STATE OF TENNESSEE  
**COMPTROLLER OF THE TREASURY**  
 DEPARTMENT OF AUDIT / DIVISION OF STATE AUDIT  
 SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING  
 NASHVILLE, TENNESSEE 37243-0264  
 PHONE (615) 401-7897 / FAX (615) 532-2765

December 4, 2008

Members of the General Assembly  
 and  
 Members of the Board of Trustees  
 Baccalaureate Education System Trust  
 and  
 The Honorable Dale Sims, Treasurer  
 State Capitol  
 Nashville, Tennessee 37243

Ladies and Gentlemen:

We have audited the accompanying fiduciary net assets of the Baccalaureate Education System Trust, Educational Services Plan, a private-purpose trust fund of the State of Tennessee, as of June 30, 2008, and June 30, 2007, and the related statements of changes in fiduciary net assets for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements, based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the board of the Baccalaureate Education System Trust.

As discussed in Note A.1., the financial statements referred to above present only the Baccalaureate Education System Trust, Educational Services Plan, a private-purpose trust fund, and do not purport to, and do not, present fairly the financial position of the State of Tennessee as of June 30, 2008, and June 30, 2007, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net assets of the Baccalaureate Education System Trust, Educational Services Plan, of the State of Tennessee as of June 30, 2008, and June 30, 2007, and the changes in its fiduciary net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with generally accepted government auditing standards, we have also issued our report dated December 4, 2008, on our consideration of the Baccalaureate Education System Trust, Educational Services Plan's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with generally accepted government auditing standards and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr., CPA  
 Director

**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN  
COMPARATIVE STATEMENTS OF FIDUCIARY NET ASSETS  
JUNE 30, 2008 AND JUNE 30, 2007**

ASSETS	June 30, 2008	June 30, 2007
Cash and cash equivalents	\$ 1,756,131	\$ 27,312,565
Receivables		
Contributions receivable	8,651	8,362
Investment income receivable	855,069	5,297
Investments, at fair value		
Investment in fixed income index fund	41,233,334	30,727,757
Investment in equity index fund	47,064,196	37,505,487
<b>TOTAL ASSETS</b>	<u>90,917,381</u>	<u>95,559,468</u>
<b>LIABILITIES</b>		
Investments purchased	852,163	0
Other investment payable	10,269	7,810
<b>TOTAL LIABILITIES</b>	<u>862,432</u>	<u>7,810</u>
<b>NET ASSETS HELD IN TRUST FOR PLAN PARTICIPANTS</b>	<u>\$ 90,054,949</u>	<u>\$ 95,551,658</u>

*See accompanying Notes to the Financial Statements*

**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN  
COMPARATIVE STATEMENTS OF CHANGES IN FIDUCIARY NET ASSETS  
FOR THE YEARS ENDED JUNE 30, 2008 AND JUNE 30, 2007**

ADDITIONS	For the Year Ended June 30, 2008	For the Year Ended June 30, 2007
Contributions	\$ 4,933,806	\$ 5,578,640
Investment income		
Net increase (decrease) in fair value of investments	(7,464,949)	6,559,337
Interest and dividend income	3,559,556	2,398,731
Less: Investment expense	(38,507)	(27,420)
Net investment income	<u>(3,943,900)</u>	<u>8,930,648</u>
Administrative fees	322,684	351,988
Transfer from general fund	0	25,950,000
<b>TOTAL ADDITIONS</b>	<u>1,312,590</u>	<u>40,811,276</u>
<b>DEDUCTIONS</b>		
Refunds	832,858	731,244
Payments	5,551,813	4,939,836
Administrative cost	424,628	372,041
<b>TOTAL DEDUCTIONS</b>	<u>6,809,299</u>	<u>6,043,121</u>
<b>CHANGE IN NET ASSETS</b>	(5,496,709)	34,768,155
<b>NET ASSETS HELD IN TRUST FOR PLAN PARTICIPANTS</b>		
<b>BEGINNING OF YEAR</b>	<u>95,551,658</u>	<u>60,783,503</u>
<b>END OF YEAR</b>	<u>\$ 90,054,949</u>	<u>\$ 95,551,658</u>

*See accompanying Notes to the Financial Statements*

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**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2008 AND JUNE 30, 2007**

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**A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**1. Reporting Entity**

The Tennessee Baccalaureate Education System Trust Fund (BEST), Educational Services Plan (ESEP) is an integral part of the primary government and has been included in the *Tennessee Comprehensive Annual Financial Report* as a private-purpose trust fund.

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

The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The financial statements have been prepared using the flow of economic resources measurement focus and the accrual basis of accounting. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

**3. Cash and Cash Equivalents**

Cash and Cash Equivalents, by definition, includes cash and short-term investments with a maturity date within three months of the acquisition date. The state's accounting policy regarding the definition of cash and cash equivalents includes cash management pools as cash. Cash received by the ESEP that cannot be invested immediately in securities, or that is needed for operations, is invested in the State Pooled Investment Fund administered by the State Treasurer or a short-term, open-end mutual fund, Northern Institutional Government Portfolio, under the contractual arrangements for master custody services during the fiscal year ended June 30, 2008. During the fiscal year ended June 30, 2007, cash that could not be invested immediately in securities, or that was needed for operations, was invested in the State Pooled Investment Fund administered by the State Treasurer or a short-term, open-end mutual fund, J P Morgan Prime Money Market fund, under the contractual arrangements for master custody services at that time.

**4. Method Used to Value Investments**

Investments are reported at fair value. Securities traded on a national exchange are valued at the last reported sales price. The fair value of investments in open-end mutual funds is based on the share price. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments and interest and dividend income. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.

**B. DEPOSITS AND INVESTMENTS**

In accordance with State statute, the ESEP assets may be invested in any instrument, obligation, security or property that constitutes a legal investment for assets of the Tennessee Consolidated Retirement System (TCRS). In addition, the assets of the ESEP may be pooled for investment purposes with the assets of the TCRS or any other assets under the custody of the State Treasurer.

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**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2008 AND JUNE 30, 2007**

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The authority for investing the assets of the ESEP is vested in its Board of Trustees and the responsibility for implementing the investment policy established by the Board is delegated to the State Treasurer. The ESEP does not maintain its own bank accounts but utilizes the State Pooled Investment Fund for its operating cash needs. The State Pooled Investment Fund is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee. The current resolution of that board gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, and various U.S. Treasury and Agency obligations. The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. Required risk disclosures relative to the State Pooled Investment Fund are presented in the *Tennessee Comprehensive Annual Financial Report*. That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 14th Floor William R. Snodgrass Tennessee Tower, 312 Rosa L. Parks Avenue, Nashville, Tennessee 37243-0298.

**Credit Risk**

The ESEP does not currently own specific fixed income securities, but chooses to invest in a Lehman Government Aggregate Index Fund. At June 30, 2008 and June 30, 2007, the ESEP had \$41,233,334 and \$30,727,757 respectively, invested in the Lehman Government Aggregate Index Fund.

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Credit quality ratings for the ESEP's investments in fixed income securities as of June 30, 2008 and June 30, 2007 are not available since the Lehman Government Aggregate Index Fund is not traded on an exchange and is unrated; however the average rating for the securities in the fund is AA1/AA2 for June 30, 2008 and AA2 for June 30, 2007. Neither the State Pooled Investment Fund nor the J P Morgan Prime Money Market Fund has obtained a credit quality rating from a nationally recognized credit ratings agency. The Northern Institutional Government Portfolio has a credit quality rating of AAA at June 30, 2008.

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

**Interest Rate Risk**

Interest rate risk is the risk that future changes in prevailing market rates of interest will have an adverse effect on the fair value of debt investments. The fair values of securities with long terms to maturity may be highly sensitive to interest rate changes. The investment policy for the ESEP states that bonds generally will be purchased and held to maturity, but when necessary, the portfolio will be actively managed in times of volatile interest rate swings to shorten the average maturity and protect principal value. The effective duration for the Lehman Government Aggregate Index fund that ESEP utilizes was 4.68 at June 30, 2008 and 4.72 at June

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**BACCALAUREATE EDUCATION SYSTEM TRUST, EDUCATIONAL SERVICES PLAN**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2008 AND JUNE 30, 2007**

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30, 2007. Duration is a measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows weighted for those cash flows as a percentage of the investment's full price.

**C. DESCRIPTION OF THE EDUCATIONAL SERVICES PLAN**

The Tennessee Baccalaureate Education System Trust, Educational Services Plan, administered by the State Treasurer, was created under *Tennessee Code Annotated*, Title 49, Chapter 7, Part 8 for the purpose of improving higher education in the State of Tennessee by assisting students or their families to pay in advance, a portion of the tuition and other costs of attending colleges and universities. Under the program, a purchaser may enter into a contract with the BEST Board of Trustees to purchase tuition units on behalf of a beneficiary. Each tuition unit purchased entitles the beneficiary to an amount no greater than one percent of the weighted average tuition of Tennessee's four-year public universities during the academic term in which it is used; however, the tuition unit or equivalent funds may be used at any accredited public or private, in-state or out-of-state institution. The purchase price of the tuition unit is determined annually by the BEST Board of Trustees with the assistance of an actuary to maintain the plan's financial soundness. Refunds and tuition payments are guaranteed only to the extent that ESEP program funds are available and neither the State of Tennessee nor the BEST Board of Trustees is liable for any amount in excess of available program funds. The net assets held in trust for plan participants were \$3,572,373 more at June 30, 2008, and \$13,856,044 more at June 30, 2007, than the amounts needed to fund the outstanding tuition units at their weighted average tuition unit prices in effect at the respective dates.

**D. OTHER ACCOUNTING DISCLOSURES**

In accordance with *Public Chapter 603, Acts of 2007*, a transfer of \$25,950,000 from the general fund was made June 30, 2007 to meet the obligations of the ESEP program.

**E. SUBSEQUENT EVENTS**

Continued disruption in the credit markets and overall declines in economic conditions in markets in the United States of America and internationally have resulted in significant declines in the fair market value of the ESEP's investments subsequent to June 30, 2008. As of October 31, 2008, the ESEP estimates that the value of investments has declined approximately \$15 million compared to the value as of June 30, 2008.