

**Department of the Treasury
Tennessee Consolidated Retirement System**

**For the Year Ended
June 30, 2004**

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**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY**

State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

February 10, 2005

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

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Consolidated Retirement System for the year ended June 30, 2004. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed a deficiency, which is detailed in the Results of the Audit section of this report. The Tennessee Consolidated Retirement System's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
05/009

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2004

AUDIT OBJECTIVES

The objectives of the audit were to consider the Tennessee Consolidated Retirement System's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDING

The Tennessee Consolidated Retirement System should strengthen controls over access to the Consolidated Retirement Information System

The Tennessee Consolidated Retirement System should ensure that employee access within the Consolidated Retirement Information System is adequately segregated to minimize the opportunity for certain employees to divert funds to inappropriate accounts.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

Audit Report
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2004

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**Department of the Treasury
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2004**

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee Consolidated Retirement System. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The Tennessee Consolidated Retirement System (TCRS) was established in 1972 by an act of the Tennessee General Assembly. Seven existing retirement systems were consolidated to provide retirement, disability, and death benefits to state employees, public school teachers, higher education employees, and employees of participating local governments. State laws govern the retirement plan, and amendments to the plan can only be made by legislation enacted by the General Assembly of the State of Tennessee.

A 19-member board of trustees has the responsibility to manage and oversee the operation of the consolidated system. The board consists of nine *ex-officio* members from the executive, legislative, and judicial branches of state government; eight representatives of active TCRS memberships; and two representatives of retirees. TCRS is administered by the Department of the Treasury under the legislative branch of state government. By state law, the State Treasurer serves as chairman of the board of trustees and as custodian of the funds of the system.

Membership in the retirement system is a condition of employment for full-time state employees, K-12 teachers, higher education general employees, and employees of participating local governments. Membership is optional for part-time state employees and part-time employees of political subdivisions which have authorized such coverage. Interim teachers and part-time teachers have optional memberships. Faculty and certain other employees of institutions of higher education may elect participation in either TCRS or an optional retirement program.

TCRS membership has grown steadily since 1972, when there were approximately 93,000 members. As of June 30, 2004, there were 200,686 active members and 86,205 retirees.

ORGANIZATION

The Tennessee Consolidated Retirement System is organized into three major service areas: Counseling Services, Member Services, and Financial Services.

Counseling Services is responsible for preretirement counseling of members on their potential benefit payments under different options. The section processes claims for disability retirement and provides field support, including new employer coverage. The section also processes membership forms received from all state agencies, local boards of education, and participating political subdivisions.

Member Services is responsible for prior-service and benefit calculations. Prior service specialists assist in establishing prior-service credit for eligible members or former members who have requested such credit. Benefit calculation specialists compute new retiree benefits based on the option chosen.

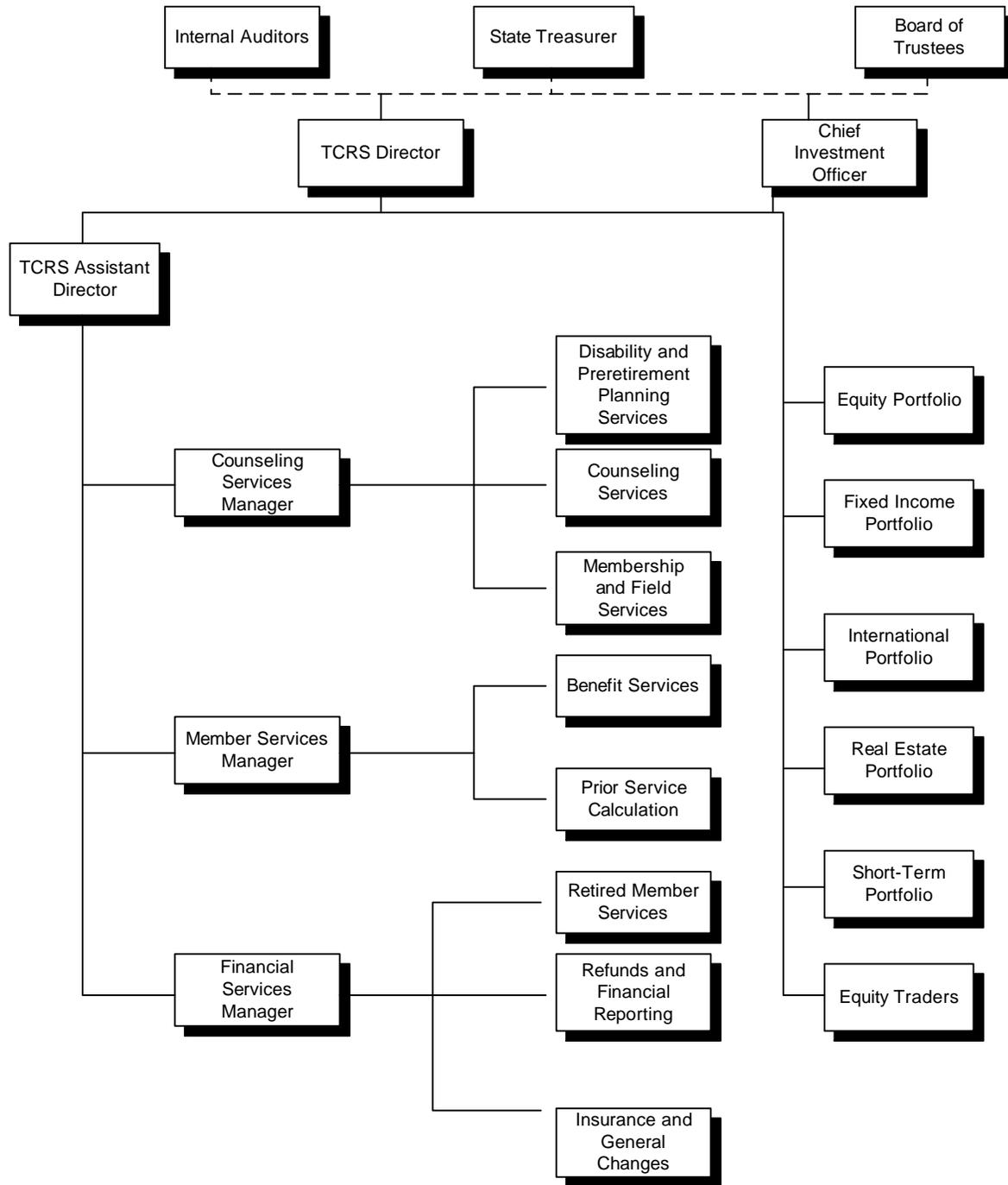
Financial Services processes refunds to terminated members, administers the retired payroll, distributes the pension payments, administers retiree insurance, and coordinates actuarial valuations. The section is also responsible for researching, controlling, and correcting member records on the Treasury Retirement Accounting and Control System.

An organizational chart for the Tennessee Consolidated Retirement System is on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 2003, through June 30, 2004, and was conducted 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. Financial statements are presented for the year ended June 30, 2004, and for comparative purposes, the year ended June 30, 2003. The Tennessee Consolidated Retirement System forms an integral part of state government and as such has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.

Tennessee Consolidated Retirement System Organization Chart



OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Tennessee Consolidated Retirement System's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, and contracts;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, and not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that

management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee Consolidated Retirement System's financial statements for the year ended June 30, 2004, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by 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. A reportable condition, along with the recommendation and management's response, is detailed in the finding and recommendation. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance and Other Matters

The results of our audit tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the Tennessee Consolidated Retirement System's financial statements.



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**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***

December 3, 2004

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Tennessee Consolidated Retirement System as of and for the year ended June 30, 2004, and have issued our report thereon dated December 3, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Tennessee Consolidated Retirement System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Tennessee Consolidated Retirements System's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The following reportable condition was noted:

- The Tennessee Consolidated Retirement System should strengthen controls over access to the Consolidated Retirement Information System

This condition is described in the Finding and Recommendation section of this report.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we do not believe the reportable condition described above is a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the Tennessee Consolidated Retirement System's management in a separate letter.

Compliance and Other Matters

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

This report is intended solely for the information and use of the General Assembly of the State of Tennessee, the board of trustees, and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,



Arthur A. Hayes, Jr., CPA,
Director

AAH/th

FINDING AND RECOMMENDATION

The Tennessee Consolidated Retirement System should strengthen controls over access to the Consolidated Retirement Information System

Finding

The Tennessee Consolidated Retirement System (TCRS) uses the Consolidated Retirement Information System (CRIS) to track all retired members' personal and benefit-related information, such as social security numbers, bank account numbers for direct deposits, and addresses. A lack of segregation of duties exists in some TCRS employees' access to this system, creating an opportunity for fraud.

Twenty-nine employees have the capability within CRIS to change both a member's social security number and the direct deposit bank account information. An employee with this access could change the direct deposit information to divert funds to an unauthorized bank account for a recently deceased member. The same employee could also change the deceased member's social security number to avoid detection through TCRS established procedures, which are to periodically compare social security numbers in CRIS to national and state databases of social security numbers of deceased people.

Of the 29 employees mentioned above, one employee is also responsible for processing the payroll for the members. After the payroll is run, this employee retrieves various payroll checks and mails them. Therefore, this employee has not only the opportunity to divert direct deposit payments but also the opportunity to divert manual payroll checks.

Recommendation

The Tennessee Consolidated Retirement System should properly segregate access in CRIS to reduce the opportunities for fraud. Also, an employee independent of the payroll process and with limited CRIS access should be assigned to physically handle payroll checks.

Management's Comment

Management concurs. Management immediately implemented the refinements to the internal control procedures as was recommended. Our business practice is to continuously evaluate internal controls and to implement improvement in internal controls as new techniques become available or as new technology is developed.

While fraud is a possibility in the scenario, the probability of the fraud to occur and not be detected is remote. The steps necessary to conceal continued payments would be difficult due to other compensating controls.



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Independent Auditor's Report

December 3, 2004

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System, as of June 30, 2004, and June 30, 2003, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of the Tennessee Consolidated Retirement System's 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 *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 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 trustees of the Tennessee Consolidated Retirement System; approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; and participating in the negotiation and procurement of services for the state.

The Honorable John G. Morgan
December 3, 2004
Page Two

As discussed in Note A.1., the financial statements present only the Tennessee Consolidated Retirement System, pension trust funds of the State of Tennessee, and do not purport to, and do not, present fairly the financial position of the State of Tennessee, as of June 30, 2004, and June 30, 2003, 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 plan net assets of the Tennessee Consolidated Retirement System as of June 30, 2004, and June 30, 2003, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis and the schedules of funding progress and employer contributions on pages 11 through 15 and 25 through 27 are not required parts of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 3, 2004, on our consideration of the Tennessee Consolidated Retirement System'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 *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

A handwritten signature in black ink, appearing to read "Arthur A. Hayes, Jr.", written in a cursive style.

Arthur A. Hayes, Jr., CPA,
Director

AAH/th

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2004 & JUNE 30, 2003**

The Management of the Tennessee Consolidated Retirement System (TCRS) provides this discussion and analysis as an overview of the TCRS' financial activities for the fiscal years ended June 30, 2004 and June 30, 2003.

FINANCIAL HIGHLIGHTS

- ◆ The plan net assets (total assets minus total liabilities) of the TCRS at June 30, 2004 were nearly \$25.6 billion, increasing over \$1.8 billion (7.6 percent) from the plan net assets at June 30, 2003. The net assets are held in trust to meet future benefit obligations.
- ◆ The TCRS relies upon contributions from employees and employers, along with investment income, to meet the funding requirements of an actuarially determined accrued liability. As of July 1, 2003, the date of the latest actuarial valuation, the TCRS' funded ratio was 99.8 percent for the SETHEEPP group and 91.9 percent for the PSPP group.
- ◆ Contribution revenue for fiscal year 2004 totaled \$616,089,783 – an increase of 3.4 percent compared to fiscal year 2003.
- ◆ Net investment income for fiscal year 2004 was \$2,181,853,628. During fiscal year 2004, the TCRS received an investment return on its portfolio of 9.3 percent, compared to 4.9 percent for fiscal year 2003.
- ◆ Total benefits and refunds paid for fiscal year 2004 were \$984,377,076 – an increase of 8.4 percent over fiscal year 2003 total benefits and refunds paid of \$907,863,397.
- ◆ Total administrative expenses for fiscal year 2004 were \$5,534,441 – an increase of 9.5 percent over fiscal year 2003 administrative expenses of \$5,055,824.

OVERVIEW OF THE FINANCIAL STATEMENTS

The TCRS financial statements consist of the *Statement of Plan Net Assets* (on pages 24 through 25), the *Statement of Changes in Plan Net Assets* (on pages 26 through 27), and the *Notes to the Financial Statements* (on pages 28 through 32). In addition, *Required Supplementary Information* is presented, which includes this *Management's Discussion and Analysis*, as well as the schedules and notes on pages 33 through 35.

The *Statement of Plan Net Assets* and the *Statement of Changes in Plan Net Assets* report information about the plan net assets (total assets in excess of total liabilities) as of the end of the fiscal year and the changes in those plan net assets during the fiscal year. These statements include all assets and liabilities using the accrual basis of accounting. Under the accrual basis of accounting, the current year's revenues and expenses are included in the financial activity, regardless of when cash is received or paid. The difference between the total assets and total liabilities on the *Statement of Plan Net Assets*, or net assets held in trust for pension benefits, provides a measurement of the financial position of the TCRS as of the end of the fiscal year. The *Statement of Changes in Plan Net Assets* provides information on the activities that caused the financial position to change during the fiscal year. Over time, increases or decreases in the plan net assets of the TCRS are one indicator of whether the system's financial health is improving or deteriorating.

In addition to the two basic financial statements, the reader should also review the *Schedules of Funding Progress*, the *Schedules of Employer Contributions* and the accompanying *Notes to Required Supplementary Information* to gain an understanding of the funded status of the TCRS over time. This information provides an indication of the TCRS' ability to meet both current and future benefit payment obligations. The *Notes to the Financial Statements* are also important to the reader's understanding of the financial statements and provide additional information regarding the TCRS, such as descriptions of the plans administered by the TCRS, including contribution and benefit provisions, and information about the accounting policies and investment activities.

ANALYSIS OF ASSETS, LIABILITIES AND PLAN NET ASSETS

At June 30, 2004, the TCRS had plan net assets (total assets in excess of total liabilities) of nearly \$25.6 billion, an increase of over \$1.8 billion (7.6 percent) from \$23.8 billion at June 30, 2003. The assets of the TCRS consist primarily of investments. During fiscal year 2004, the domestic and international equity markets provided double-digit positive returns, thus contributing to a nearly \$1.1 billion increase in net investment income over fiscal year 2003. Condensed financial information comparing the TCRS' plan net assets for the past three fiscal years is presented on the following page.

(continued)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2004 & JUNE 30, 2003 (CONTINUED)**

PLAN NET ASSETS

			FY04 - FY03		FY03 - FY02	
	June 30, 2004	June 30, 2003	Percentage		Percentage	
			Change	June 30, 2002	Change	
ASSETS						
Cash and cash equivalents	\$ 1,287,694,472	\$ 1,717,734,541	(25.0) %	\$ 1,621,359,545	5.9 %	
Contributions receivable	52,655,042	46,850,736	12.4 %	46,238,224	1.3 %	
Investment income						
receivables	136,353,991	134,284,002	1.5 %	147,069,784	(8.7) %	
Investments sold	84,576,463	59,060,030	43.2 %	31,817,111	85.6 %	
Foreign currency receivable	46,030,024	523,209,732	(91.2) %	899,292,837	(41.8) %	
Short-term securities	564,645,773	498,577,125	13.3 %	317,388,429	57.1 %	
Long-term investments	23,486,279,358	21,736,948,082	8.0 %	21,015,023,754	3.4 %	
TOTAL ASSETS	25,658,235,123	24,716,664,248	3.8 %	24,078,189,684	2.7 %	
LIABILITIES						
Death benefits, refunds and						
other payables	2,350,420	1,244,060	88.9 %	1,141,905	8.9 %	
Investments purchased	20,722,128	387,262,530	(94.6) %	127,034,613	204.8 %	
Other investment payables	2,127,641	2,154,173	(1.2) %	2,633,994	(18.2) %	
Foreign currency payable	46,518,682	547,519,127	(91.5) %	964,499,600	(43.2) %	
TOTAL LIABILITIES	71,718,871	938,179,890	(92.4) %	1,095,310,112	(14.3) %	
NET ASSETS HELD IN TRUST						
FOR PENSION BENEFITS	\$ 25,586,516,252	\$ 23,778,484,358	7.6 %	\$ 22,982,879,572	3.5 %	

ANALYSIS OF REVENUES AND EXPENSES

Contributions for fiscal year 2004 increased by \$20.0 million (3.4 percent) over contributions for fiscal year 2003 as the employer contribution rates remained constant. An increase in employer contribution rates adopted pursuant to the actuarial valuation performed as of July 1, 2001 and effective for fiscal years 2003 and 2004, resulted in contributions for fiscal year 2003 increasing by \$59.9 million (11.2 percent) over contributions for fiscal year 2002. As mentioned in the *Analysis of Assets, Liabilities and Plan Net Assets* section above, the continued recovery of the equity investment markets contributed to increases in net investment income. Net investment income for the year ended June 30, 2004 totaled \$2,181,853,628, an increase of \$1.1 billion versus fiscal year 2003. Net investment income for the year ended June 30, 2003 totaled \$1,112,478,748, an increase of \$1.6 billion versus fiscal year 2002. Market conditions have resulted in a return to the TCRS portfolio of 9.3 percent during fiscal year 2004 and 4.9 percent during fiscal year 2003.

Total benefits and refunds paid during the year ended June 30, 2004 were \$984,377,076, an increase of 8.4 percent over fiscal year 2003 total benefits and refunds paid. Total refunds and benefits paid during the year ended June 30, 2003 of \$907,863,397 increased 7.8 percent over fiscal year 2002 total benefits and refunds paid. The increase in benefit expenses can be attributed to 2.4 percent and 1.6 percent cost of living adjustments awarded to retirees on July 1, 2003 and July 1, 2002, respectively. In addition, more retirees were added to payroll than removed during these fiscal years.

In addition, administrative expenses for the year ended June 30, 2004 were \$5,534,441, an increase of 9.5 percent over fiscal year 2003 administrative expenses. This increase was due primarily to additional expenses relating to the actuarial valuation and experience studies performed during fiscal year 2004. Administrative expenses for fiscal year 2003 of \$5,055,824 increased 1.0 percent over administrative expenses for fiscal year 2002.

Condensed financial information comparing the TCRS' revenues and expenses for the past three fiscal years follows.
(continued)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2004 & JUNE 30, 2003 (CONTINUED)**

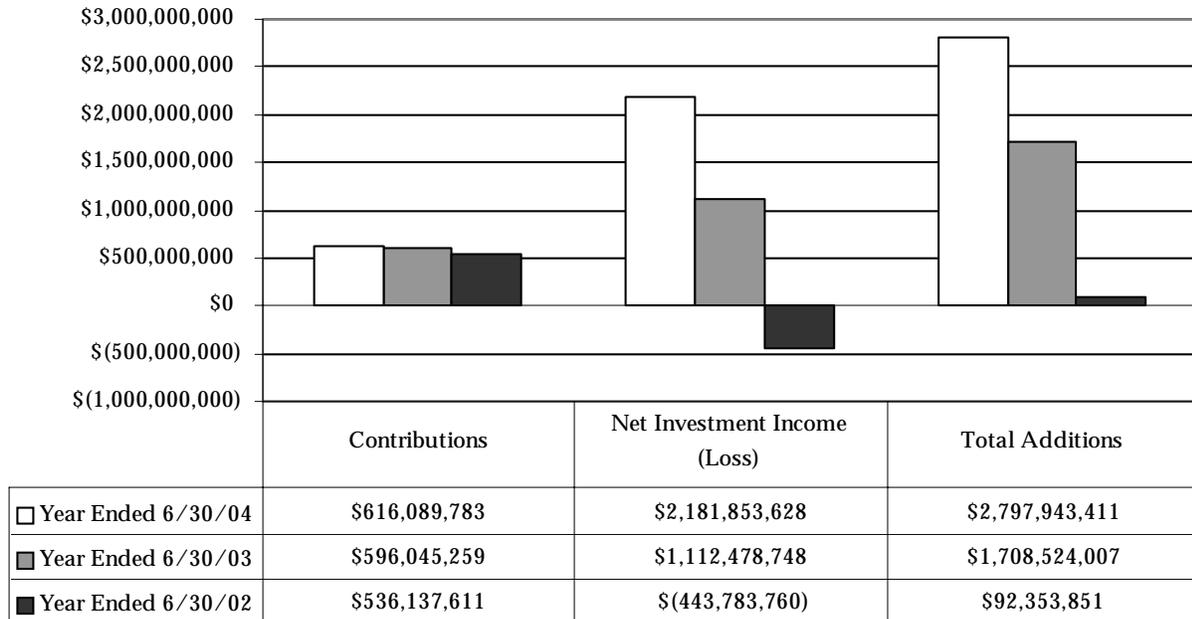
CHANGES IN PLAN NET ASSETS

	For the Year Ended June 30, 2004	For the Year Ended June 30, 2003	FY04 - FY03 Percentage Change	For the Year Ended June 30, 2002	FY03 - FY02 Percentage Change
ADDITIONS					
Contributions	\$ 616,089,783	\$ 596,045,259	3.4 %	\$ 536,137,611	11.2 %
Investment income					
Net appreciation (depreciation) in fair value of investments	1,310,811,851	268,965,778	387.4 %	(1,354,960,400)	119.9 %
Interest, dividends and other investment income	885,509,528	857,325,990	3.3 %	924,647,372	(7.3) %
Less: Investment expense	(14,467,751)	(13,813,020)	4.7 %	(14,093,999)	(2.0) %
Net income from securities lending activities	0	0	0.0 %	623,267	(100.0) %
Net investment income	2,181,853,628	1,112,478,748	96.1 %	(443,783,760)	350.7 %
TOTAL ADDITIONS	2,797,943,411	1,708,524,007	63.8 %	92,353,851	1,750.0 %
DEDUCTIONS					
Annuity benefits					
Retirement benefits	716,339,066	662,075,122	8.2 %	610,554,871	8.4 %
Survivor benefits	46,416,539	42,638,112	8.9 %	38,723,935	10.1 %
Disability benefits	23,590,867	21,781,588	8.3 %	20,109,341	8.3 %
Cost of living	163,627,253	150,690,914	8.6 %	145,335,114	3.7 %
Death benefits	4,477,589	4,046,275	10.7 %	3,367,877	20.1 %
Refunds	29,925,762	26,631,386	12.4 %	24,304,536	9.6 %
Administrative expenses	5,534,441	5,055,824	9.5 %	5,003,984	1.0 %
TOTAL DEDUCTIONS	989,911,517	912,919,221	8.4 %	847,399,658	7.7 %
NET INCREASE (DECREASE)	1,808,031,894	795,604,786	127.3 %	(755,045,807)	205.4 %
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS					
BEGINNING OF YEAR	23,778,484,358	22,982,879,572	3.5 %	23,737,925,379	(3.2) %
END OF YEAR	\$ 25,586,516,252	\$ 23,778,484,358	7.6 %	\$ 22,982,879,572	3.5 %

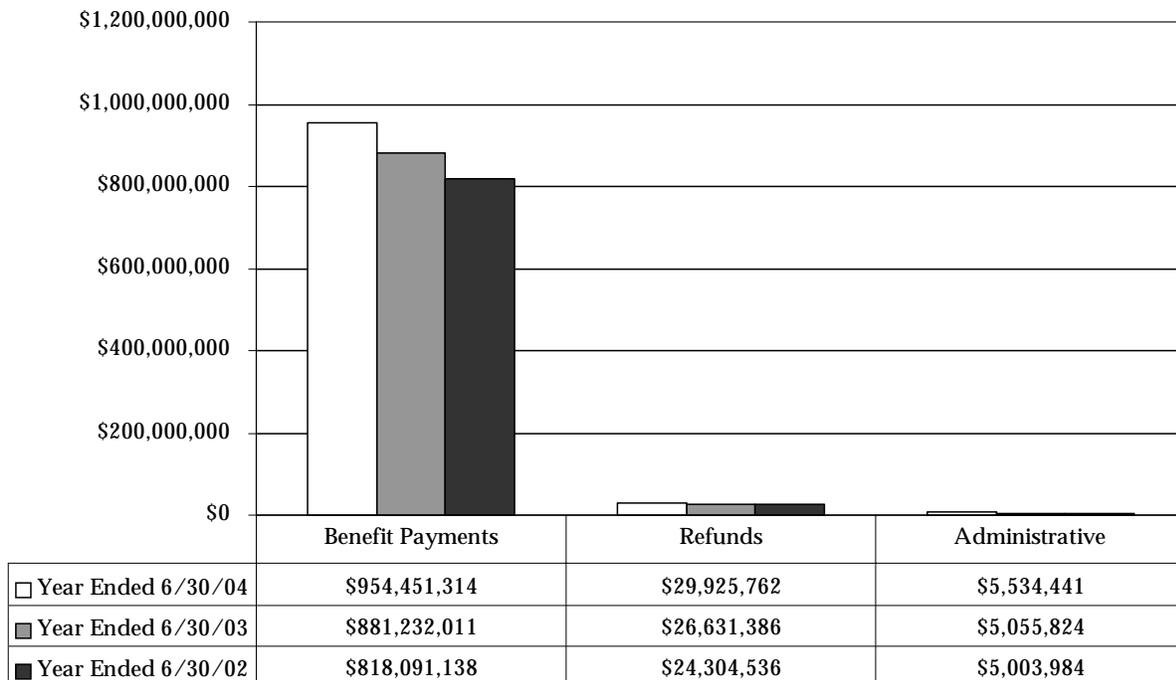
(continued)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2004 & JUNE 30, 2003 (CONTINUED)**

REVENUES BY TYPE



EXPENSES BY TYPE



(continued)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2004 & JUNE 30, 2003 (CONTINUED)**

ECONOMIC FACTORS, FUTURE FUNDING PROVISIONS, OVERALL OUTLOOK

There were dramatic improvements in both the domestic and international stock markets for the year ended June 30, 2004 after two years of sub par returns. The S&P 500, TCRS' domestic equity benchmark, had a double digit negative return of 17.99 % for the fiscal year ended June 30, 2002, followed by a small positive return of .25% for fiscal year 2003, and then a double digit positive return of 19.11% for fiscal year 2004. The international equity market, as represented by the EAFE index, had negative returns of 6.46% and 9.49% for fiscal years 2003 and 2002, respectively. Fortunately, the international markets rebounded nicely for the year ended June 30, 2004 with a 32.37 % return. On the other hand, the domestic bond market, as measured by the Lehman Aggregate index, had an annual return of only .32% at June 30, 2004 compared with 10.40% and 8.63% in the previous two years. The international bond market return of 7.74% and real estate at 9.71% represent positive market returns.

The past three years reflect the benefits of a diversified portfolio where the weak stock market was countered by a positive bond market during fiscal years 2002 and 2003. In 2004 the opposite occurred where a strong stock market balanced an under-performing bond market.

The employer contribution rate increased July 1, 2004 for most of the employers participating in TCRS. The increase was the result of the July 1, 2003 actuarial valuation that took into consideration that investment results were less than the earnings assumptions for the two years since the last actuarial valuation. With the asset smoothing method utilized for valuation purposes that recognized only a portion of the underperformance of investment income, upward pressure on the employer rate is expected for the next actuarial valuation to be performed effective July 1, 2005. However, some upward pressure will be mitigated by the positive return of 9.32% realized for the year ended June 30, 2004. It was refreshing to realize such a return after three straight years where returns were less than the actuarial assumption of 7.5%. With TCRS being such a strongly funded plan, volatility in investment income will cause employer contribution rates to fluctuate.

CONTACTING THE TCRS

This report is designed to provide a financial overview of the TCRS to state legislators, members of the Board of Trustees of the TCRS, state officials, participating employers and any other interested parties. Questions or requests for additional information regarding the financial information presented in this report may be addressed in writing to the Tennessee Treasury Department, Consolidated Retirement System, 10th Floor Andrew Jackson Building, Nashville, TN 37243-0230.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF PLAN NET ASSETS
AS OF JUNE 30, 2004 AND JUNE 30, 2003

Expressed in Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ASSETS		
Cash and cash equivalents	\$ 1,102,224	\$ 185,470
Receivables		
Member contributions receivable	17,687	3,954
Employer contributions receivable	19,905	11,109
Accrued interest receivable	100,996	16,995
Accrued dividends receivable	15,719	2,644
Other investment receivable	0	0
Foreign currency receivable	39,400	6,630
Investments sold	72,395	12,182
Total receivables	<u>266,102</u>	<u>53,514</u>
Investments, at fair value		
Short-term securities	483,319	81,327
Government bonds	9,302,636	1,565,340
Corporate bonds	1,607,676	270,521
Corporate stocks	8,796,542	1,480,181
Real estate	396,641	66,742
Total investments	<u>20,586,814</u>	<u>3,464,111</u>
TOTAL ASSETS	<u>21,955,140</u>	<u>3,703,095</u>
LIABILITIES		
Accounts payable		
Death benefits and refunds payable	1,038	1,267
Other	45	0
Investments purchased	17,737	2,985
Foreign currency payable	39,819	6,700
Other investment payables	1,821	307
TOTAL LIABILITIES	<u>60,460</u>	<u>11,259</u>
NET ASSETS HELD IN TRUST FOR PENSION		
BENEFITS (Schedules of funding progress for the plans are presented on page 33)	<u>\$ 21,894,680</u>	<u>\$ 3,691,836</u>

See accompanying Notes to the Financial Statements

(continued)

(CONTINUED)

June 30, 2004	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2003
Total			Total
<u>\$ 1,287,694</u>	<u>\$ 1,477,468</u>	<u>\$ 240,266</u>	<u>\$ 1,717,734</u>
21,641	14,863	3,586	18,449
31,014	18,194	10,208	28,402
117,991	104,068	16,938	121,006
18,363	11,418	1,859	13,277
0	1	0	1
46,030	449,823	73,387	523,210
84,577	50,790	8,270	59,060
<u>319,616</u>	<u>649,157</u>	<u>114,248</u>	<u>763,405</u>
564,646	428,785	69,792	498,577
10,867,976	8,955,774	1,457,697	10,413,471
1,878,197	1,988,160	323,605	2,311,765
10,276,723	7,430,045	1,209,359	8,639,404
463,383	320,192	52,116	372,308
<u>24,050,925</u>	<u>19,122,956</u>	<u>3,112,569</u>	<u>22,235,525</u>
<u>25,658,235</u>	<u>21,249,581</u>	<u>3,467,083</u>	<u>24,716,664</u>
2,305	686	542	1,228
45	16	0	16
20,722	333,050	54,213	387,263
46,519	470,723	76,796	547,519
2,128	1,852	302	2,154
<u>71,719</u>	<u>806,327</u>	<u>131,853</u>	<u>938,180</u>
<u>\$ 25,586,516</u>	<u>\$ 20,443,254</u>	<u>\$ 3,335,230</u>	<u>\$ 23,778,484</u>

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF CHANGES IN PLAN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2004 AND JUNE 30, 2003

Expressed in Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ADDITIONS		
Contributions		
Member contributions	\$ 154,334	\$ 50,650
Employer contributions	271,298	139,808
Total contributions	<u>425,632</u>	<u>190,458</u>
Investment income		
Net appreciation in fair value of investments	1,124,041	186,771
Interest	579,747	96,331
Dividends	157,233	26,126
Real estate income, net of operating expenses	22,357	3,715
Total investment income	<u>1,883,378</u>	<u>312,943</u>
Less: Investment expense	<u>(12,406)</u>	<u>(2,062)</u>
Net investment income	<u>1,870,972</u>	<u>310,881</u>
TOTAL ADDITIONS	<u>2,296,604</u>	<u>501,339</u>
DEDUCTIONS		
Annuity benefits		
Retirement benefits	617,659	98,680
Survivor benefits	40,022	6,394
Disability benefits	20,341	3,250
Cost of living	145,767	17,860
Death benefits	3,149	1,329
Refunds	15,305	14,621
Administrative expense	2,935	2,599
TOTAL DEDUCTIONS	<u>845,178</u>	<u>144,733</u>
NET INCREASE	1,451,426	356,606
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	<u>20,443,254</u>	<u>3,335,230</u>
END OF YEAR	<u><u>\$ 21,894,680</u></u>	<u><u>\$ 3,691,836</u></u>

See accompanying Notes to the Financial Statements

(continued)

(CONTINUED)

For the Year Ended June 30, 2004 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 2003 Total
\$ 204,984	\$ 148,493	\$ 49,218	\$ 197,711
<u>411,106</u>	<u>264,320</u>	<u>134,014</u>	<u>398,334</u>
<u>616,090</u>	<u>412,813</u>	<u>183,232</u>	<u>596,045</u>
1,310,812	232,015	36,950	268,965
676,078	577,854	92,529	670,383
183,359	137,167	21,963	159,130
<u>26,072</u>	<u>23,974</u>	<u>3,839</u>	<u>27,813</u>
2,196,321	971,010	155,281	1,126,291
<u>(14,468)</u>	<u>(11,900)</u>	<u>(1,913)</u>	<u>(13,813)</u>
<u>2,181,853</u>	<u>959,110</u>	<u>153,368</u>	<u>1,112,478</u>
<u>2,797,943</u>	<u>1,371,923</u>	<u>336,600</u>	<u>1,708,523</u>
716,339	571,703	90,372	662,075
46,416	36,818	5,820	42,638
23,591	18,809	2,973	21,782
163,627	134,455	16,236	150,691
4,478	3,052	994	4,046
29,926	14,250	12,381	26,631
<u>5,534</u>	<u>2,631</u>	<u>2,425</u>	<u>5,056</u>
<u>989,911</u>	<u>781,718</u>	<u>131,201</u>	<u>912,919</u>
1,808,032	590,205	205,399	795,604
23,778,484	19,853,049	3,129,831	22,982,880
<u>\$ 25,586,516</u>	<u>\$ 20,443,254</u>	<u>\$ 3,335,230</u>	<u>\$ 23,778,484</u>

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2004 AND JUNE 30, 2003

The Tennessee Consolidated Retirement System (TCRS) administers two defined benefit pension plans - State Employees, Teachers and Higher Education Employees Pension Plan (SETHEEPP) and Political Subdivisions Pension Plan (PSPP). Although the assets of the plans are commingled for investment purposes, each plan's assets may be used only for the payment of benefits to members of that plan, in accordance with the terms of the plan.

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The TCRS is included in the State of Tennessee Financial Reporting Entity. Because of the state's fiduciary responsibility, the TCRS has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.
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 method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Plan member contributions are recognized in the period in which the contributions are due. Plan employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

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 TCRS that cannot be invested immediately in securities is invested in the State Pooled Investment Fund administered by the State Treasurer. 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, various U.S. Treasury and Agency obligations, and in obligations of the state of Tennessee pursuant to *Tennessee Code Annotated*, Section 9-4-602(b). 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. The pool's custodial credit risk is 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 Eighth Avenue North, Nashville, Tennessee 37243-0298. The classification of cash and cash equivalents also includes cash invested in a short-term, open-end mutual fund under the contractual arrangement for master custody services.
4. **Method Used to Value Investments** - Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. The fair value of real estate investments is determined at least every three years by qualified independent appraisers who are members of the Appraisal Institute and internally by real estate advisors for those years when independent appraisals are not performed. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.
5. **Receivables** - Receivables primarily consist of interest which is recorded when earned. The receivables for contributions as of June 30, 2004 consist of member contributions of \$17.7 million and \$3.9 million due to SETHEEPP and PSPP respectively, and employer contributions of \$19.9 million and \$11.1 million due to SETHEEPP and PSPP respectively. The receivables for contributions as of June 30, 2003 consist of member contributions of \$14.9 million and \$3.6 million due to SETHEEPP and PSPP respectively, and employer contributions of \$18.2 million and \$10.2 million due to SETHEEPP and PSPP respectively.

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2004 AND JUNE 30, 2003 (CONTINUED)

6. **Accounting Change** - During the year ended June 30, 2003, the TCRS changed its method of reporting foreign currency forward contracts to include their associated unrealized gains and losses on the financial statements. The receivables and payables relating to these contracts, previously treated as off-balance sheet items, have been included on the Comparative Statements of Changes in Plan Net Assets.

B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION

At July 1, 2003, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	59,959	23,162
Terminated members entitled to but not receiving benefits	16,721	3,972
Current active members	<u>127,597</u>	<u>71,320</u>
Total	204,277	98,454
Number of participating employers	140	418

State Employees, Teachers and Higher Education Employees Pension Plan

Plan Description - SETHEEPP is a cost-sharing, multiple employer defined benefit pension plan that covers the employees of the state, teachers with Local Education Agencies (LEA's) and higher education employees. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan on or after July 1, 1979 are vested after five years of service. Members joining prior to July 1, 1979 are vested after four years of service. Compounded cost of living adjustments (COLA) are provided each July based on the percentage change in the Consumer Price Index (CPI) during the previous calendar year except that (a) no COLA is granted if the CPI is less than one-half percent; (b) a COLA of 1 percent will be granted if the CPI increases between one-half percent and one percent; (c) the maximum annual COLA is capped at three percent. Benefit provisions are established by state statute found in Title Eight, Chapters 34 through 37 of the *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly. Ad hoc increases may only be authorized by the General Assembly. Public safety officers receive an additional supplemental benefit that is paid from age 60 to age 62.

Superseded Systems and Certain Employment Classifications - Members of superseded systems that became members of the TCRS at consolidation in 1972, have their rights preserved to the benefits of the superseded system, if the benefit from the superseded plan exceeds that provided by the Group 1 (teachers and general employees) TCRS formula. Likewise, public safety employees and officials of TCRS Groups 2, 3 and 4 are entitled to the benefits of those formulas, if better than the Group 1 benefits.

Contributions and Reserves - Effective July 1, 1981, the plan became noncontributory for most state and higher education employees. The contribution rate for teachers is five percent of gross salary. The employers contribute a set percentage of their payrolls, determined by an actuarial valuation. *Tennessee Code Annotated* Title Eight, Chapter 37 provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state of Tennessee's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 2004, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$3,059.2 million and \$18,835.5 million, respectively. At June 30, 2003, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$2,909.3 million and \$17,533.9 million, respectively.

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2004 AND JUNE 30, 2003 (CONTINUED)

Political Subdivisions Pension Plan

Plan Description - PSPP is an agent multiple-employer defined benefit pension plan that covers the employees of participating political subdivisions of the state of Tennessee. Employee class differentiations are not made under PSPP. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan prior to July 1, 1979 are vested after four years of service. Members joining on or after July 1, 1979 are vested upon completion of 10 years of service, unless five years vesting is authorized by resolution of the chief governing body. Cost of living adjustments (COLA) are the same as provided by SETHEEPP except that the local government may elect (a) to provide no COLA benefits or (b) to provide COLA benefits under a non-compounding basis rather than the compounded basis applicable under SETHEEPP. Benefit provisions are established and amended by state statute. Pursuant to Article Two, Section 24 of the *Constitution of the State of Tennessee*, the state cannot mandate costs on local governments. Any benefit improvement may be adopted by the governing body of a governmental entity participating in the TCRS.

Contributions and Reserves - Political subdivisions may elect contributory or noncontributory retirement for their employees. The contribution rate for contributory employees of political subdivisions is five percent of gross salary. The employers contribute a set percentage of their payrolls, equal to at least, the percentage determined by an actuarial valuation. State statute provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 2004, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$746.9 million and \$2,944.9 million, respectively. At June 30, 2003, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$691.1 million and \$2,644.1 million, respectively.

C. INVESTMENTS

State statute authorizes the TCRS to invest in bonds, debentures, preferred stock and common stock, real estate and in other good and solvent securities subject to the approval of the Board of Trustees, but subject to the following statutory restrictions:

- a. The total sum invested in common and preferred stocks shall not exceed seventy-five percent (75 percent) of the total of the funds of the retirement system.
- b. The total sum invested in notes and bonds or other fixed income securities exceeding one year in maturity shall not exceed seventy-five percent (75 percent) of the total funds of the retirement system. Private Placements are limited to 15 percent of the total fixed income portfolio.
- c. Within the restrictions in (a) and (b) above, an amount not to exceed fifteen percent (15 percent) of the total of the funds of the retirement system may be invested in securities of the same kinds, classes, and investment grades as those otherwise eligible for investment in various approved foreign countries.
- d. The total amount of securities loaned under a securities lending program cannot exceed thirty percent (30 percent) of total assets.
- e. The total sum invested in real estate shall not exceed five percent (5 percent) of the total of the funds of the retirement system.

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2004 AND JUNE 30, 2003 (CONTINUED)

The TCRS investment securities are categorized on the chart that follows according to the level of custodial credit risk associated with the custodial arrangements. Category 1 includes investments that are insured or registered, or for which the securities are held by the TCRS or its agent in the name of the TCRS. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the name of the TCRS. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the counterparty's trust department or agent, but not in the name of the TCRS. TCRS investments as of June 30, 2004 and June 30, 2003 included SEC-registered open-end mutual funds of \$106,167 and \$108,761, respectively.

<i>Expressed in Thousands</i>	Fair Value	Fair Value
	June 30, 2004	June 30, 2003
Investments - Category 1		
Cash equivalents and short-term securities		
Commercial paper	\$ 550,108	\$ 717,397
Government bonds	1,299,409	1,501,324
Long-term investments		
Government bonds	10,867,976	10,081,502
Corporate bonds	1,876,185	2,293,728
Corporate stocks	10,258,064	8,613,755
Total Investments - Category 1	<u>24,851,742</u>	<u>23,207,706</u>
Investments - Category 2	<u>0</u>	<u>0</u>
Investments - Category 3	<u>0</u>	<u>0</u>
Investments - Not Categorized		
Investment in open-end mutual fund	106	109
Real estate	463,383	372,308
Unsettled investment acquisitions		
Government bonds	0	331,969
Corporate bonds	2,012	18,037
Corporate stocks	18,659	25,649
Total Investments - Not Categorized	<u>484,160</u>	<u>748,072</u>
Total investments	25,335,902	23,955,778
Less: Short-term investments classified as cash equivalents on the Statements of Plan Net Assets	<u>(1,284,977)</u>	<u>(1,720,253)</u>
Total investments as shown on the Statements of Plan Net Assets	<u>\$ 24,050,925</u>	<u>\$ 22,235,525</u>

As of June 30, 2004 and June 30, 2003, the TCRS had no concentrations of investments, other than those issued or guaranteed by the U.S. government, in any one organization that represents five percent or more of plan net assets.

Securities Lending - The TCRS is authorized by its investment policy, as adopted by the Board of Trustees, to enter into collateralized securities lending agreements whereby the TCRS loans its debt and equity securities for a fee to a select few of the highest quality securities firms and banks. Loans must be limited so the total amount on loan does not exceed 30 percent of the TCRS' assets. The TCRS' custodian bank manages the lending program and maintains the

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2004 AND JUNE 30, 2003 (CONTINUED)

collateral on behalf of the TCRS. The borrower must deliver cash collateral to the lending agent. The cash collateral may be reinvested by the lending agent in accordance with the investment policy, as further restricted under the TCRS securities lending agreement. Collateral securities cannot be pledged or sold unless the borrower defaults.

The loaned securities are initially collateralized at 102 percent of their fair value for domestic securities and 105 percent for international. Collateral is marked-to-market daily and additional collateral is pledged by the borrower if the fair value of the collateral subsequently falls below 100 percent for domestic securities and 105 percent for international. Although there is no specific policy for matching the maturities of collateral investments and the securities loans, the securities on loan can be terminated on demand by either the TCRS or the borrower. As of June 30, 2004 and June 30, 2003, there were no securities on loan.

Derivatives – The TCRS may buy or sell equity index futures contracts for the purposes of making asset allocation changes in an efficient and cost effective manner and to improve liquidity. The futures contracts are limited to the S&P 500 Index, the S&P Midcap 400 Index and the Russell 2000 Index. The TCRS can increase (decrease) equity market exposure by buying (selling) the equity index future to obtain its target domestic equity allocation. Gains (losses) on equity index futures hedge losses (gains) produced by any deviation from the TCRS' target equity allocation. The gains and losses resulting from daily fluctuations in the fair value of the outstanding futures contracts are settled daily, on the following day, and a receivable or payable is established for any unsettled gain or loss as of the financial statement date. As of June 30, 2004 and June 30, 2003, the TCRS was not under any futures contracts.

The international securities expose the TCRS to potential losses due to a possible rise in the value of the US dollar. The TCRS investment managers can reduce foreign currency exposure by selling foreign currency forward contracts, at agreed terms and for future settlement, usually within a year. The manager will reverse the contract by buying the foreign currency before the settlement date. A gain (loss) on this transaction pair will hedge a loss (gain) on the currency movement of the international security. The TCRS can sell up to 80% of its foreign currency exposure into US dollars. The fair value of foreign currency forward contracts outstanding as of June 30, 2004 and June 30, 2003 has been reflected in the financial statements.

The TCRS is also authorized by investment policy to engage in the issuance of options. Activity is limited to selling covered call options. The TCRS had no options outstanding at June 30, 2004 and June 30, 2003.

Asset-Backed Securities – The TCRS invests in collateralized mortgage obligations (CMOs) which are mortgage-backed securities. These securities are based on cash flows from interest and principal payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgages, which may result from a decline in interest rates. There were no CMOs held at June 30, 2004. The fair value of CMOs at June 30, 2003 was \$9,715,380. The TCRS also invests in various asset-backed securities, representing ownership interests in trust consisting of credit card and auto loan receivables. These securities are issued by organizations with AAA or AA credit ratings. TCRS invests in these securities primarily to enhance returns by taking advantage of opportunities available in this sector of the securities markets.

D. COMMITMENTS

Standby Commercial Paper Purchase Agreement - The TCRS has agreed to serve as standby commercial paper purchaser for commercial paper issued by the Funding Board of the State of Tennessee. By serving as a standby commercial paper purchaser, the TCRS receives an annual fee of 7.5 basis points on the \$250 million maximum issuance under this agreement during times when both Moody's and Standard and Poor's investment ratings assigned to the State of Tennessee's general obligation bonds are Aaa and AAA respectively, and 12 basis points during times when either Moody's or Standard and Poor's has assigned ratings other than Aaa and AAA respectively. In the unlikely event that the TCRS would be called upon to purchase the commercial paper, the TCRS would receive interest at a rate equal to prime plus 75 basis points during the first 30 consecutive days, plus an additional 50 basis points for each consecutive 30 days thereafter, up to a maximum rate allowed by state law.

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULES OF FUNDING PROGRESS**

SCHEDULES OF FUNDING PROGRESS

Expressed in Thousands

	Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Liability (AAL) Frozen Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
SETHEEPP	7/1/2003	\$ 22,099,252	\$ 22,151,745	\$ 52,493	99.76%	\$ 4,773,297	1.10%
	7/1/2001	20,760,989	20,842,216	81,227	99.61%	4,451,452	1.82%
	7/1/1999	18,327,133	18,420,156	93,023	99.49%	4,132,409	2.25%
PSPP	7/1/2003	3,605,529	3,923,475	317,946	91.90%	1,731,135	18.37%
	7/1/2001	3,187,990	3,528,137	340,147	90.36%	1,545,593	22.01%
	7/1/1999	2,690,781	2,890,942	200,161	93.08%	1,341,363	14.92%

The SETHEEPP is comprised of a number of employee groups. However, the unfunded liability of \$52.5 million at July 1, 2003 is attributable to two employee groups: 1) County Officials employed prior to July 1, 1972 and 2) State Judges and Attorneys General employed prior to July 1, 1972. The PSPP represents 418 participating entities at July 1, 2003. The unfunded liability of \$317.9 million is attributable to 353 of the 418 entities.

See accompanying Notes to Required Supplementary Information

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULES OF EMPLOYER CONTRIBUTIONS**

SCHEDULES OF EMPLOYER CONTRIBUTIONS

Expressed in Thousands

Year Ended June 30	SETHEEPP		PSPP	
	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
2004	\$ 271,298	100%	\$ 139,808	100%
2003	264,320	100%	134,014	100%
2002	243,498	100%	103,374	100%
2001	232,149	100%	103,681	100%
2000	252,162	100%	82,749	100%
1999	244,453	100%	69,230	100%

An actuarial valuation of the TCRS is performed every two years with the next valuation scheduled to be effective July 1, 2005.

See accompanying Notes to Required Supplementary Information

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO REQUIRED SUPPLEMENTARY INFORMATION
AS OF JUNE 30, 2004 AND JUNE 30, 2003

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the July 1, 2003 actuarial valuation follows.

	<u>SETHEEPP</u>	<u>PSPP</u>
Valuation Date	July 1, 2003	July 1, 2003
Actuarial cost method	Frozen Entry Age	Frozen Entry Age
Amortization method	Level Dollar	Level Dollar
Remaining amortization period	12 years closed period	(1) closed period
Asset valuation method	5-year Moving Market Average	5-year Moving Market Average
Actuarial assumptions:		
Investment rate of return	7.50%	7.50%
Projected salary increases	4.75% (3)	4.75% (3)
Includes inflation at	(2)	(2)
Cost-of-living adjustments	3.00%	3.00%
Increase in Social Security wage base	3.50%	3.50%

- (1) The length of the amortization period varies by political subdivision, not to exceed 30 years.
- (2) No explicit assumption is made regarding the portion attributable to the effect of inflation on salaries.
- (3) Uniform rate that approximates the effect of a graded salary scale.