AUDIT REPORT

Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 2005

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
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John G. Morgan
Comptroller

March 7, 2006

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, 2005. 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 resulted in no audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

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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, 2005

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.

AUDIT FINDINGS

The audit report contains no findings.

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, 2005

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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 retirement 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 the 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, 2005, there were 204,735 active members and 89,772 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.

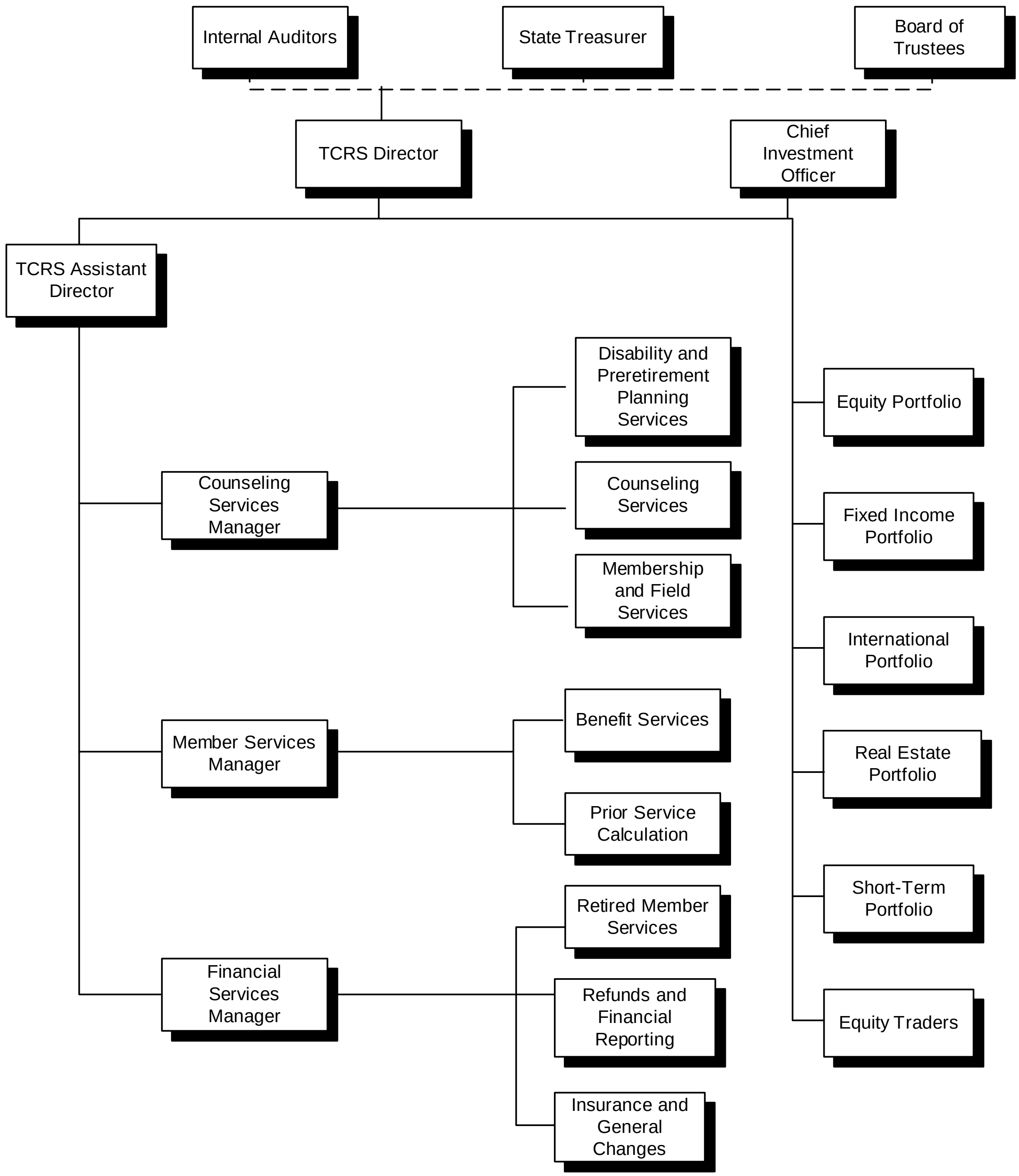
Financial Services processes refunds to terminated members, administers the retired payroll, distributes the pension payments, administers retiree insurance, and coordinates actuarial valuations. The section is also responsible for researching, controlling, and correcting member records on the Treasury 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, 2004, through June 30, 2005, 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, 2005, and for comparative purposes, the year ended June 30, 2004. 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 FINDING

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Tennessee Consolidated Retirement System filed its report with the Department of Audit on June 9, 2005. A follow-up of the prior audit finding was conducted as part of the current audit.

The current audit disclosed that the Tennessee Consolidated Retirement System has corrected the previous audit finding concerning internal controls over access to the Consolidated Retirement Information System.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic. The assessment and the controls should be reviewed and approved by the head of the entity.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit,* 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, 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, 2005, 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. 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.

STATE OF TENNESSEE
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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 15, 2005

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, 2005, and have issued our report thereon dated December 15, 2005. 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.

<u>Internal Control Over Financial Reporting</u>

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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted certain 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*.

We did, however, note certain less significant instances of noncompliance or other matters, which we have reported to the Tennessee Consolidated Retirement System's management in a separate letter.

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

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COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
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Independent Auditor's Report

December 15, 2005

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, 2005, and June 30, 2004, 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.

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, 2005, and June 30, 2004, 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, 2005, and June 30, 2004, 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 29 through 31 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 15, 2005, 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,

Arthur A. Hayes, Jr., CPA
Director

AAH/th

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, 2005 and June 30, 2004.

FINANCIAL HIGHLIGHTS

- The plan net assets (total assets minus total liabilities) of the TCRS at June 30, 2005 were $27.2 billion, increasing over $1.6 billion (6.4 percent) from the plan net assets at June 30, 2004. 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 2005 totaled $844,856,748 – an increase of 37.1 percent compared to fiscal year 2004.

- Net investment income for fiscal year 2005 was $1,850,367,215. During fiscal year 2005, the TCRS received an investment return on its portfolio of 7.3 percent, compared to 9.3 percent for fiscal year 2004.

- Total benefits and refunds paid for fiscal year 2005 were $1,059,732,300 – an increase of 7.7 percent over fiscal year 2004 total benefits and refunds paid of $984,377,076.

- Total administrative expenses for fiscal year 2005 were $5,746,030 – an increase of 3.8 percent over fiscal year 2004 administrative expenses of $5,534,441.

OVERVIEW OF THE FINANCIAL STATEMENTS

The TCRS financial statements consist of the Statement of Plan Net Assets (on pages 16 through 17), the Statement of Changes in Plan Net Assets (on pages 18 through 19), and the Notes to the Financial Statements (on pages 20 through 28). In addition, Required Supplementary Information is presented, which includes this Management's Discussion and Analysis, as well as the schedules and notes on pages 29 through 31.

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.

(continued)

ANALYSIS OF ASSETS, LIABILITIES AND PLAN NET ASSETS

At June 30, 2005, the TCRS had plan net assets (total assets in excess of total liabilities) of $27.2 billion, an increase of over $1.6 billion (6.4 percent) from $25.6 billion at June 30, 2004. The assets of the TCRS consist primarily of investments. During fiscal year 2005, all portfolios realized positive returns, thus contributing to $1.85 billion in net investment income. Condensed financial information comparing the TCRS' plan net assets for the past three fiscal years is below.

PLAN NET ASSETS

	June 30, 2005	June 30, 2004	FY05 - FY04 Percentage Change	June 30, 2003	FY04 - FY03 Percentage Change
ASSETS					
Cash and cash equivalents	$ 804,694,718	$ 1,287,694,472	(37.5) %	$ 1,717,734,541	(25.0) %
Contributions receivable	59,611,297	52,655,042	13.2 %	46,850,736	12.4 %
Investment income receivables	168,791,063	136,353,991	23.8 %	134,284,002	1.5 %
Investments sold	28,751,524	84,576,463	(66.0) %	59,060,030	43.2 %
Foreign currency receivable	177,749,703	46,030,024	286.2 %	523,209,732	(91.2) %
Short-term securities	231,988,352	564,645,773	(58.9) %	498,577,125	13.3 %
Long-term investments	25,968,351,692	23,486,279,358	10.6 %	21,736,948,082	8.0 %
TOTAL ASSETS	27,439,938,349	25,658,235,123	6.9 %	24,716,664,248	3.8 %
LIABILITIES					
Death benefits, refunds and other payables	6,721,778	2,350,420	186.0 %	1,244,060	88.9 %
Investments purchased	41,541,888	20,722,128	100.5 %	387,262,530	(94.6) %
Other investment payables	2,295,936	2,127,641	7.9 %	2,154,173	(1.2) %
Foreign currency payable	173,116,862	46,518,682	272.1 %	547,519,127	(91.5) %
TOTAL LIABILITIES	223,676,464	71,718,871	211.9 %	938,179,890	(92.4) %
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$ 27,216,261,885	$ 25,586,516,252	6.4 %	$ 23,778,484,358	7.6 %

ANALYSIS OF REVENUES AND EXPENSES

An increase in employer contribution rates adopted pursuant to the actuarial valuation performed as of July 1, 2003 and effective for fiscal year 2005, resulted in contributions for fiscal year 2005 increasing by $228.8 million (37.1 percent) over contributions for fiscal year 2004. Although employer contribution rates did not change between fiscal year 2004 and 2003, the increase of $20 million (3.4 percent) for these years is attributed to increased salaries. As mentioned in the Analysis of Assets, Liabilities and Plan Net Assets section above, the continued market progress contributed to positive net investment income. Net investment income for the year ended June 30, 2005 totaled $1,850,367,215, a decrease of $331 million versus fiscal year 2004. 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. Market conditions have resulted in a return to the TCRS portfolio of 7.3 percent during fiscal year 2005 and 9.3 percent during fiscal year 2004.

Total benefits and refunds paid during the year ended June 30, 2005 were $1,059,732,300, an increase of 7.7 percent over fiscal year 2004 total benefits and refunds paid. Total refunds and benefits paid during the year ended June 30, 2004 of

(continued)

$984,377,076 increased 8.4 percent over fiscal year 2003 total benefits and refunds paid. The increase in benefit expenses can be attributed to 1.9 percent and 2.4 percent cost of living adjustments awarded to retirees on July 1, 2004 and July 1, 2003, 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, 2005 were $5,746,030, an increase of 3.8 percent over fiscal year 2004 administrative expenses. Administrative expenses for fiscal year 2004 of $5,534,441 increased 9.5 percent over administrative expenses for fiscal year 2003.

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

CHANGES IN PLAN NET ASSETS

	For the Year Ended June 30, 2005	For the Year Ended June 30, 2004	FY05 - FY04 Percentage Change	For the Year Ended June 30, 2003	FY04 - FY03 Percentage Change
ADDITIONS					
Contributions	$ 844,856,748	$ 616,089,783	37.1 %	$ 596,045,259	3.4 %
Investment income					
Net appreciation (depreciation) in fair value of investments	938,346,880	1,310,811,851	(28.4) %	268,965,778	387.4 %
Interest, dividends and other investment income	927,714,221	885,509,528	4.8 %	857,325,990	3.3 %
Less: Investment expense	(15,693,886)	(14,467,751)	8.5 %	(13,813,020)	4.7 %
Net investment income	1,850,367,215	2,181,853,628	(15.2) %	1,112,478,748	96.1 %
TOTAL ADDITIONS	2,695,223,963	2,797,943,411	(3.7) %	1,708,524,007	63.8 %
DEDUCTIONS					
Annuity benefits					
Retirement benefits	775,283,016	716,339,066	8.2 %	662,075,122	8.2 %
Survivor benefits	50,388,267	46,416,539	8.6 %	42,638,112	8.9 %
Disability benefits	24,626,014	23,590,867	4.4 %	21,781,588	8.3 %
Cost of living	173,707,939	163,627,253	6.2 %	150,690,914	8.6 %
Death benefits	4,911,365	4,477,589	9.7 %	4,046,275	10.7 %
Refunds	30,815,699	29,925,762	3.0 %	26,631,386	12.4 %
Administrative expenses	5,746,030	5,534,441	3.8 %	5,055,824	9.5 %
TOTAL DEDUCTIONS	1,065,478,330	989,911,517	7.6 %	912,919,221	8.4 %
NET (DECREASE) INCREASE	1,629,745,633	1,808,031,894	(9.9) %	795,604,786	127.3 %
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS					
BEGINNING OF YEAR	25,586,516,252	23,778,484,358	7.6 %	22,982,879,572	3.5 %
END OF YEAR	$ 27,216,261,885	$ 25,586,516,252	6.4 %	$ 23,778,484,358	7.6 %

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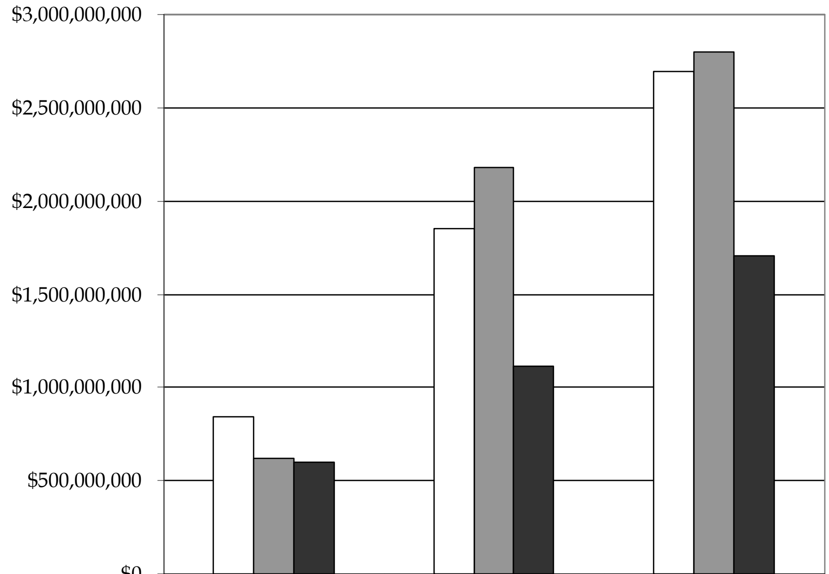
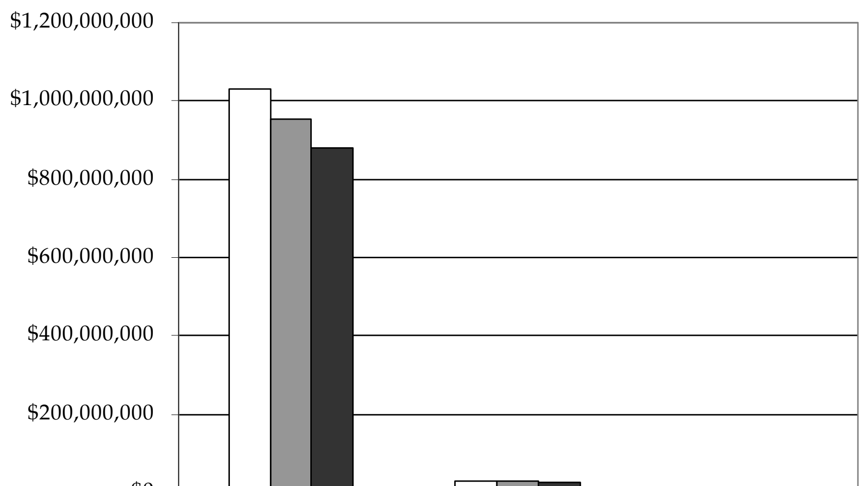
REVENUES BY TYPE



	Contributions	Net Investment Income (Loss)	Total Additions
Year Ended 6/30/05	$844,856,748	$1,850,367,215	$2,695,223,963
Year Ended 6/30/04	$616,089,783	$2,181,853,628	$2,797,943,411
Year Ended 6/30/03	$596,045,259	$1,112,478,748	$1,708,524,007

EXPENSES BY TYPE



	Benefit Payments	Refunds	Administrative
Year Ended 6/30/05	$1,028,916,601	$30,815,699	$5,746,030
Year Ended 6/30/04	$954,451,314	$29,925,762	$5,534,441
Year Ended 6/30/03	$881,232,011	$26,631,386	$5,055,824

(continued)

There was continued strength in both the domestic and international stock markets for the year ended June 30, 2005. The S&P 1500 index, TCRS' domestic equity benchmark, had a return of 7.24% for the fiscal year ended June 30, 2005, preceded by a double-digit return of 19.11% for fiscal year 2004. The international equity market, as represented by the EAFE index, rebounded nicely for the year ended June 30, 2004 with a 32.37% return, followed by a 14.13% return in fiscal year 2005. The domestic bond market, as measured by the Lehman Aggregate index, had an annual return of only .32% at June 30, 2004, which rebounded with a 6.8% return during fiscal year 2005. The international bond market return of 7.62% and real estate at 18.02% represents positive market returns.

In 2004, a strong stock market balanced an under-performing bond market. Broad market strength was realized during 2005, although several indices have not yet fully recovered from the weak markets during the 2000-2003 period.

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, 2005 and June 30, 2004

Expressed In Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ASSETS		
Cash and cash equivalents	$ 685,337	$ 119,358
Receivables		
Member contributions receivable	15,057	3,750
Employer contributions receivable	28,637	12,167
Accrued interest receivable	123,300	21,474
Accrued dividends receivable	19,264	3,355
Real estate income receivable	1,191	207
Foreign currency receivable	151,385	26,365
Investments sold	24,487	4,265
Total receivables	363,321	71,583
Investments, at fair value		
Short-term securities	197,578	34,410
Government securities	9,953,162	1,733,442
Corporate securities	2,147,044	373,929
Corporate stocks	9,603,998	1,672,632
Real estate	412,332	71,812
Total investments	22,314,114	3,886,225
TOTAL ASSETS	23,362,772	4,077,166
LIABILITIES		
Accounts payable		
Death benefits and refunds payable	928	1,880
Other	3,913	0
Investments purchased	35,380	6,162
Foreign currency payable	147,439	25,678
Other investment payables	1,956	340
TOTAL LIABILITIES	189,616	34,060
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS (Schedules of funding progress for the plan are presented on page 29.)	$ 23,173,156	$ 4,043,106

See accompanying Notes to the Financial Statements

(continued)

(CONTINUED)

June 30, 2005 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2004 Total
$ 804,695	$ 1,102,224	$ 185,470	$ 1,287,694
18,807	17,687	3,954	21,641
40,804	19,905	11,109	31,014
144,774	100,996	16,995	117,991
22,619	15,719	2,644	18,363
1,398	0	0	0
177,750	39,400	6,630	46,030
28,752	72,395	12,182	84,577
434,904	266,102	53,514	319,616
231,988	483,319	81,327	564,646
11,686,604	9,311,372	1,566,810	10,878,182
2,520,973	1,597,428	268,796	1,866,224
11,276,630	8,798,054	1,480,436	10,278,490
484,144	396,641	66,742	463,383
26,200,339	20,586,814	3,464,111	24,050,925
27,439,938	21,955,140	3,703,095	25,658,235
2,808	1,038	1,267	2,305
3,913	45	0	45
41,542	17,737	2,985	20,722
173,117	39,819	6,700	46,519
2,296	1,821	307	2,128
223,676	60,460	11,259	71,719
$ 27,216,262	$ 21,894,680	$ 3,691,836	$ 25,586,516

Tennessee Consolidated Retirement System
Comparative Statements of Changes in Plan Net Assets
For the Years Ended June 30, 2005 and June 30, 2004

Expressed In Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ADDITIONS		
Contributions		
Member contributions	$ 160,686	$ 54,921
Employer contributions	448,154	181,096
Total contributions	608,840	236,017
Investment income		
Net appreciation in fair value of investments	800,850	137,497
Interest	547,898	94,067
Dividends	217,309	37,309
Real estate income, net of operating expenses	26,569	4,562
Total investment income	1,592,626	273,435
Less: Investment expense	(13,394)	(2,300)
Net investment income	1,579,232	271,135
TOTAL ADDITIONS	2,188,072	507,152
DEDUCTIONS		
Annuity benefits		
Retirement benefits	668,340	106,943
Survivor benefits	43,437	6,951
Disability benefits	21,229	3,397
Cost of living	154,522	19,186
Death benefits	3,731	1,180
Refunds	15,329	15,487
Administrative expense	3,008	2,738
TOTAL DEDUCTIONS	909,596	155,882
NET INCREASE	1,278,476	351,270
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	21,894,680	3,691,836
END OF YEAR	$ 23,173,156	$ 4,043,106

See accompanying Notes to the Financial Statements

(continued)

For the Year Ended June 30, 2005 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 2004 Total
$ 215,607	$ 154,334	$ 50,650	$ 204,984
629,250	271,298	139,808	411,106
844,857	425,632	190,458	616,090
938,347	1,124,041	186,771	1,310,812
641,965	579,747	96,331	676,078
254,618	157,233	26,126	183,359
31,131	22,357	3,715	26,072
1,866,061	1,883,378	312,943	2,196,321
(15,694)	(12,406)	(2,062)	(14,468)
1,850,367	1,870,972	310,881	2,181,853
2,695,224	2,296,604	501,339	2,797,943
775,283	617,659	98,680	716,339
50,388	40,022	6,394	46,416
24,626	20,341	3,250	23,591
173,708	145,767	17,860	163,627
4,911	3,149	1,329	4,478
30,816	15,305	14,621	29,926
5,746	2,935	2,599	5,534
1,065,478	845,178	144,733	989,911
1,629,746	1,451,426	356,606	1,808,032
25,586,516	20,443,254	3,335,230	23,778,484
$ 27,216,262	$ 21,894,680	$ 3,691,836	$ 25,586,516

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 of time for which the contributions are assessed. 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, or that is needed for operations, is invested in the State Pooled Investment Fund sponsored by the State of Tennessee and administered by the State Treasurer. 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, 2005 consist of member contributions of $15 million and $3.7 million due to SETHEEPP and PSPP respectively, and employer contributions of $28.6 million and $12.2 million due to SETHEEPP and PSPP respectively. 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.

6. **Adoption of New Accounting Pronouncement** – During the year ended June 30, 2005, the TCRS adopted the provisions of Statement No. 40 of the Governmental Accounting Standards Board *Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3.* The adoption of this statement requires the TCRS to provide certain additional disclosures, as well as modify other disclosures relating to investment and deposit risks, including credit risk, custodial credit risk, concentrations of credit risk, interest rate risk and foreign currency risk. Disclosure information relative to the year ended June 30, 2004 has been restated to conform to the new pronouncement.

(continued)

7. **Reclassifications –** Certain investment amounts previously presented on the June 30, 2004 Statement of Plan Net Assets have been reclassified for comparative purposes. Corporate bonds in the amount of $20,009,658 have been reclassified as government bonds. Government bonds in the amount of $9,803,600 have been reclassified as corporate bonds, and corporate bonds in the amount of $1,767,564 have been reclassified as corporate stocks.

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	127,597	71,320
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.

(continued)

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, 2005, the plan's Member Reserve and Employer Reserve were fully funded with balances of $3,167.8 million and $20,005.3 million, respectively. 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.

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, 2005, the plan's Member Reserve and Employer Reserve were fully funded with balances of $795.4 million and $3,247.7 million, respectively. 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.

C. DEPOSITS AND INVESTMENTS

State statute authorizes the TCRS to maintain cash, not exceeding ten percent of the total amount of funds in the retirement system, on deposit in one or more banks, savings and loan associations or trust companies that are qualified as state depositories. The TCRS does not utilize its own bank accounts but invests in the State Pooled Investment Fund for the initial deposit of funds and 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'

(continued)

acceptances, certain repurchase agreements and various U.S. Treasury and Agency obligations. Prior to the adoption of the current investment policy on December 14, 2004, allowable investments also included 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.

State statute also 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 further subject to the following statutory restrictions and provisions:

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.

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, provided that such percentage may be increased by the board with the subsequent approval of the council on pensions and insurance.

d. Within the restrictions in (a) and (b) above, funds may be invested in Canadian securities which are substantially of the same kinds, classes and investment grades as those otherwise eligible for investment.

e. The total amount of securities loaned under a securities lending program cannot exceed thirty percent (30 percent) of total assets.

f. The total sum invested in real estate shall not exceed five percent (5 percent) of the market value of total assets.

State statute also authorizes the TCRS to invest in forward contracts to hedge its foreign currency exposure and to purchase or sell domestic stock index futures contracts for the purpose of asset allocation relating to the domestic equity portfolio. The total amount of the financial futures contract obligation shall not exceed five percent (5 percent) of the market value of total assets.

As of June 30, 2005 and June 30, 2004, the TCRS had the following investments:

(continued)

Investments

(Expressed in Thousands)

Investment Type	Fair Value as of 6/30/05	U.S. Treasury/ Agency (1)	Credit Quality Ratings					
			AAA	AA	A	BBB	A1 (2)	Not Rated (3)
Debt Investments								
U.S. Govt. Treasuries, Notes, Bonds	$4,299,553	$4,299,553						
U.S. Govt. TIPS	1,539,429	1,539,429						
U.S. Govt. Agencies	1,712,743		$1,712,743					
Mortgage-Backed Govt. Pass-through	3,589,366	409,117						$3,180,249
Corporate Bonds	1,933,308		80,495	$267,782	$1,066,627	$518,404		
Corporate Asset-Backed	16,685					16,685		
Corporate Private Placements	150,081		9,996	69,988	27,705	42,392		
Yankee Bonds	39,780				9,641	30,139		
Supranationals	107,804		95,713	12,091				
Non-U.S. Govt./Sovereign	533,423		354,114	74,956	104,353			
Non-U.S. Corporate	285,405		172,592	9,941	51,310	51,562		
Short-Term Commercial Paper	493,731						$493,731	
Short-Term Agencies	543,891							543,891
Total Debt Investments	$15,245,199	$6,248,099	$2,425,653	$434,758	$1,259,636	$659,182	$493,731	$3,724,140
Other Investments								
U.S. Equity	$7,588,283							
Non-U.S. Equity	3,688,347							
Real Estate	484,144							
Money Market Funds	27							
Total Other Investments	$11,760,801							
Total Investments	$27,006,000							
Less: Short-term Investments Classified as Cash Equivalents on the Statements of Plan Net Assets	(805,661)							
Total Investments as Shown on Statements of Plan Net Assets	$26,200,339							

(1) Includes obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government and are not considered to have credit risk.

(2) A1 is the highest rating category for commercial paper.

(3) Includes securities that are implicitly guaranteed by the U.S. government, but are not rated by Standard & Poor's or Moody's.

Investment Type	Fair Value as of 6/30/04	U.S. Treasury/ Agency (1)	Credit Quality Ratings					
			AAA	AA	A	BBB	A1 (2)	Not Rated (3)
Debt Investments								
U.S. Govt. Treasuries, Notes, Bonds	$6,086,447	$6,086,447						
U.S. Govt. TIPS	58,640	58,640						
U.S. Govt. Agencies	636,627		$636,627					
Mortgage-Backed Govt. Pass-through	3,735,523	645,225						$3,090,298
Corporate Bonds	1,440,631		101,313	$200,374	$995,688	$143,256		
Corporate Private Placements	162,213		34,491	55,977	64,681	7,064		
Yankee Bonds	33,981				9,139	24,842		
Supranationals	96,502		96,502					
Non-U.S. Govt./Sovereign	661,789		604,334	31,271	26,184			
Non-U.S. Corporate	132,897		123,093	9,804				
Short-Term Commercial Paper	550,108						$550,108	
Short-Term Agencies	998,565							998,565
Total Debt Investments	$14,593,923	$6,790,312	$1,596,360	$297,426	$1,095,692	$175,162	$550,108	$4,088,863
Other Investments								
U.S. Equity	$7,567,710							
Non-U.S. Equity	2,710,780							
Real Estate	463,383							
Money Market Funds	106							
Total Other Investments	$10,741,979							
Total Investments	$25,335,902							
Less: Short-term Investments Classified as Cash Equivalents on the	(1,284,977)							
Total Investments as Shown on Statements of Plan Net Assets	$24,050,925							

(1) Includes obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government and are not considered to have credit risk.

(2) A1 is the highest rating category for commercial paper.

(3) Includes securities that are implicitly guaranteed by the U.S. government, but are not rated by Standard & Poor's or Moody's.

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Credit Risk - Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Credit quality ratings for the TCRS' investments in fixed income securities as of June 30, 2005 and June 30, 2004 are included in the above schedule. Securities are rated using Standard and Poor's and/or Moody's and are presented above using the Standard and Poor's rating scale. The State Pooled Investment Fund has not obtained a credit quality rating from a nationally recognized credit ratings agency.

The TCRS' investment policy specifies that bond issues subject for purchase are investment grade bonds rated in the four highest ratings by one of the recognized rating agencies. In addition, the policy states that private placements that do not have an active secondary market shall be thoroughly researched from a credit standpoint and shall be viewed by TCRS' investment staff as having the credit quality rating equivalent of an AA rating on a publicly traded issue. For short-term investments, the TCRS' investment policy provides for the purchase of only the highest quality debt issues. Commercial paper should be rated in the highest tier by all rating agencies which rate the paper, with a minimum of two ratings required. Commercial paper cannot be purchased if a rating agency has the commercial paper on a negative credit watch. The investment policy also requires preparation of a credit analysis report on the corporation prior to purchasing commercial paper.

As noted above, the TCRS does not utilize its own bank accounts but invests in the State Pooled Investment Fund for its operating cash purposes. 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 Eighth Avenue North, Nashville, Tennessee 37243-0298.

Concentration of Credit Risk - A concentration of investments in any one single issuer of debt securities presents a greater risk for loss in the event that the issuer fails on its obligations. The TCRS had the following investment amounts and percentages of plan net assets, in organizations representing five percent or more of plan net assets, excluding those organizations whose issues are explicitly guaranteed by the United States government, and investments in mutual funds, external investment pools, and other pooled investments:

	June 30, 2005		June 30, 2004	
Issuer Organization	**Fair Value**	**Percentage**	**Fair Value**	**Percentage**
Federal Home Loan Mortgage Corp.	$1,988,470,907	7.31%	$2,128,995,481	8.32%
Federal National Mortgage Assoc.	2,629,912,338	9.66%	2,242,683,999	8.77%

The TCRS' investment policy limits the maximum amount of a specific corporation's commercial paper that can be purchased to $100 million. There are no specific investment policies that limit investment in any one issuer.

(continued)

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 TCRS' investment policy does not specifically address limits on investment maturities. The fixed income portfolio, however, is benchmarked against the Citigroup Broad Investment Grade Index and tends to have a duration within a tight range around that index. The TCRS had the following investments and effective duration at June 30, 2005 and June 30, 2004.

Debt Investments

(Expressed in Thousands)

Investment Type	Fair Value as of June 30, 2005	Effective Duration (years)
Debt Investments		
U.S. Govt. Treasuries, Notes, Bonds	$4,299,553	3.87
U.S. Govt. TIPS	1,539,429	4.00
U.S. Govt. Agencies	1,712,743	2.63
Mortgage-Backed Govt. Pass-thrus	3,589,366	2.84
Corporate Bonds	1,933,308	5.63
Corporate Asset-Backed	16,685	2.16
Corporate Private Placements	150,081	3.45
Yankee Bonds	39,780	8.03
Supranationals	107,804	3.43
Non-U.S. Govt./Sovereign	533,423	6.95
Non-U.S. Corporate	285,405	6.29
Short-Term Commercial Paper	493,731	0.03
Short-Term Agencies	543,891	0.17
Total Debt Investments	$15,245,199	3.63

Investment Type	Fair Value as of June 30, 2004	Effective Duration (years)
Debt Investments		
U.S. Govt. Treasuries, Notes, Bonds	$6,086,447	4.98
U.S. Govt. TIPS	58,640	6.59
U.S. Govt. Agencies	636,627	3.43
Mortgage-Backed Govt. Pass-thrus	3,735,523	4.03
Corporate Bonds	1,440,631	4.98
Corporate Private Placements	162,213	4.12
Yankee Bonds	33,981	8.36
Supranationals	96,502	3.40
Non-U.S. Govt./Sovereign	661,789	4.43
Non-U.S. Corporate	132,897	5.15
Short-Term Commercial Paper	550,108	0.06
Short-Term Agencies	998,565	0.09
Total Debt Investments	$14,593,923	4.12

(continued)

Foreign Currency Risk - Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or deposit. The TCRS' investment policy limits the asset allocation for international investments to twenty-five percent of total assets. The TCRS' exposure to foreign currency risk at June 30, 2005 and June 30, 2004 was as follows:

Foreign Currency-Denominated Investments

(Expressed in Thousands)

Currency	Total Fair Value June 30, 2005	Fixed Income	Equity	Cash
Australian Dollar	$209,165	$12,039	$197,008	$118
British Pound Sterling	990,301	78,452	911,846	3
Canadian Dollar	5,690		5,690	
Danish Krone	73,101		73,101	
Euro Currency	1,436,934	263,623	1,173,275	36
Hong Kong Dollar	88,767		87,638	1,129
Japanese Yen	1,240,158	447,300	792,359	499
New Zealand Dollar	5,552		5,552	
Norwegian Krone	29,000		29,000	
Singapore Dollar	34,482		34,378	104
Swedish Krona	121,748		121,748	
Swiss Franc	209,949		209,949	
Total	$4,444,847	$801,414	$3,641,544	$1,889

Currency	Total Fair Value June 30, 2004	Fixed Income	Equity	Cash
Australian Dollar	$115,554	$10,885	$104,670	($1)
Brazilian Real	5,811		5,411	400
British Pound Sterling	710,090	71,975	638,113	2
Canadian Dollar	2,791		2,791	
Chilean Peso	147		147	
Danish Krone	33,590		33,590	
Euro Currency	993,858	223,990	769,768	100
Hong Kong Dollar	69,726		69,706	20
Indian Rupee	19,314		12,939	6,375
Indonesian Rupiah	3,990		3,305	685
Japanese Yen	912,655	309,904	602,405	346
Malaysian Ringgit	14,461		12,786	1,675
Mexican Nuevo Peso	5,145		5,145	
New Taiwan Dollar	19,745		13,611	6,134
New Zealand Dollar	0			
Norwegian Krone	17,584		17,587	(3)
Philippine Peso	402		402	
Renminbi Yuan	1,045		1,045	
Singapore Dollar	18,998		18,971	27
South African Rand	9,662		9,662	
South Korean Won	45,701		33,739	11,962
Swedish Krona	72,878		72,880	(2)
Swiss Franc	145,800		147,231	(1,431)
Thai Baht	7,327		7,327	
Turkish Lira	2,216		2,216	
Total	$3,228,490	$616,754	$2,585,447	$26,289

(continued)

Derivatives - 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, 2005 and June 30, 2004 has been reflected in the financial statements.

Asset-Backed Securities – Mortgage-backed securities are based on cash flows from interest and principal payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. The 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.

SCHEDULES OF FUNDING PROGRESS
Expressed in Thousands

	Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Accrued 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

SCHEDULES OF EMPLOYER CONTRIBUTIONS
Expressed in Thousands

Year Ended June 30	SETHEEPP Annual Required Contribution	SETHEEPP Percentage Contributed	PSPP Annual Required Contribution	PSPP Percentage Contributed
2005	$ 448,154	100%	$ 181,096	100%
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%

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

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.

	SETHEEPP	PSPP
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.