

AUDIT REPORT

Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 2008



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



Arthur A. Hayes, Jr., CPA, JD, CFE
Director

Edward Burr, CPA
Assistant Director

Teresa L. Hensley, CPA
Audit Manager

Robyn R. Probus, CPA, CFE
In-Charge Auditor

Tana Burks, CFE
David Cook, CPA
Andrew Furlong
Jeff Hughes, CFE
Jonathan Ward, CFE
Staff Auditors

Gerry C. Boaz, CPA
Technical Manager

Amy Brack
Editor

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-1402
(615) 401-7897

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT

SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7897
FAX (615) 532-2765

January 29, 2009

Members of the General Assembly
and
Members of the Board of Trustees
Tennessee Consolidated Retirement System
and
The Honorable David H. Lillard, Jr., 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, 2008. 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,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." in a cursive script.

Arthur A. Hayes, Jr., CPA
Director

AAH/ajm
08/088

State of Tennessee

A u d i t H i g h l i g h t s

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2008

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, 2008

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Tennessee Consolidated Retirement System For the Year Ended June 30, 2008

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 20-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; nine 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, 2008, there were 215,645 active members and 102,306 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.

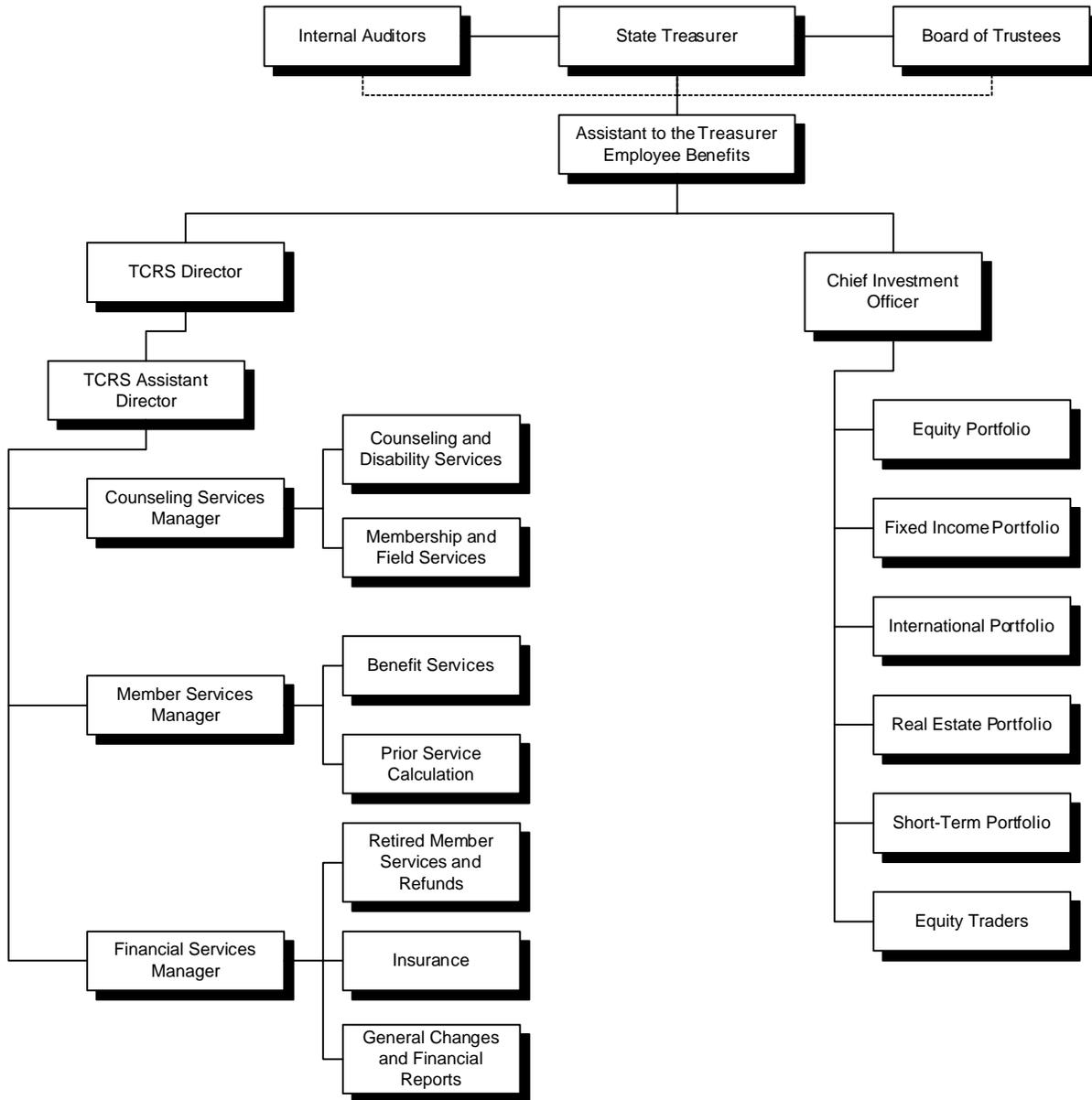
Financial Services processes refunds to terminated members, administers the retired payroll, distributes the pension payments, administers retiree insurance, and coordinates actuarial valuations. The section is also responsible for researching, controlling, and correcting member records on the Treasury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

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

AUDIT SCOPE

The audit was limited to the period July 1, 2007, through June 30, 2008, 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 generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 2008, and for comparative purposes, the year ended June 30, 2007. 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 as a basis for designing 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

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, 2008, we considered internal control over financial reporting as a basis for designing 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 generally accepted government auditing standards. 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 generally accepted 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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DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7897
FAX (615) 532-2765

**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, 2008

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:

We have audited the financial statements of the Tennessee Consolidated Retirement System as of and for the year ended June 30, 2008, and have issued our report thereon dated December 3, 2008. 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 generally accepted government auditing standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Tennessee Consolidated Retirement System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Tennessee Consolidated Retirement System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Tennessee Consolidated Retirement System's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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 generally accepted 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, management, and others within the entity 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/ajm



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT

SUITE 1500
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Independent Auditor's Report

December 3, 2008

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:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System as of June 30, 2008, and June 30, 2007, 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 generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the board of trustees of the Tennessee Consolidated Retirement System.

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, 2008, and June 30, 2007, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the Tennessee Consolidated Retirement System as of June 30, 2008, and June 30, 2007, 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 30 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 generally accepted government auditing standards, we have also issued our report dated December 3, 2008, 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 generally accepted 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/ajm

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2008 & JUNE 30, 2007**

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, 2008 and June 30, 2007. This section should be read in conjunction with the Independent Auditor's Report, the audited financial statements, and the accompanying notes.

FINANCIAL HIGHLIGHTS

- ◆ The plan net assets (total assets minus total liabilities) of the TCRS at June 30, 2008 were \$31.6 billion, decreasing over \$731.8 million (2.3 percent) from the plan net assets at June 30, 2007. 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, 2007, the date of the latest actuarial valuation, the TCRS' funded ratio was 96.2 percent for the SETHEEPP group and 89.4 percent for the PSPP group.
- ◆ Contribution revenue for fiscal year 2008 totaled \$1,084,112,872 an increase of 5.5 percent compared to fiscal year 2007.
- ◆ Net investment income for fiscal year 2008 was \$(430,058,924). During fiscal year 2008, the TCRS received an investment return on its portfolio of (1.21) percent, compared to 13.1 percent for fiscal year 2007.
- ◆ Total benefits and refunds paid for fiscal year 2008 were \$1,378,691,525 – an increase of 8.8 percent over fiscal year 2007 total benefits and refunds paid of \$1,266,775,568.
- ◆ Total administrative expenses for fiscal year 2008 were \$7,201,911 – an increase of 11.3 percent over fiscal year 2007 administrative expenses of \$6,468,558.

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 29). In addition, *Required Supplementary Information* is presented, which includes this *Management's Discussion and Analysis*, as well as the schedules on pages 30 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* and the *Schedules of Employer Contributions* 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)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2008 & JUNE 30, 2007 (CONTINUED)**

ANALYSIS OF ASSETS, LIABILITIES AND PLAN NET ASSETS

At June 30, 2008, the TCRS had plan net assets (total assets in excess of total liabilities) of \$31.6 billion, a decrease of over \$731.8 million (2.3 percent) from \$32.4 billion at June 30, 2007. The assets of the TCRS consist primarily of investments. The decrease in plan net assets is primarily the result of negative investment income caused by unfavorable equity market conditions. Condensed financial information comparing the TCRS' plan net assets for the past three fiscal years follows.

PLAN NET ASSETS

	June 30, 2008	June 30, 2007	FY08 - FY07 Percentage Change	June 30, 2006	FY07 - FY06 Percentage Change
ASSETS					
Cash and cash equivalents	\$ 358,321,692	\$ 569,035,627	(37.0) %	\$ 826,611,111	(31.2) %
Member and employer receivables	86,041,851	86,352,774	(0.4) %	71,671,617	20.5 %
Investment income receivables	159,667,086	169,973,211	(6.1) %	172,541,678	(1.5) %
Investments sold	62,828,189	16,256,391	286.5 %	33,287,736	(51.2) %
Foreign currency receivable	153,933,265	5,796,800	2,555.5 %	19,732,929	(70.6) %
Short-term securities	49,997,750	527,594,750	(90.5) %	503,846,988	4.7 %
Long-term investments	31,015,208,805	31,014,634,498	0.0 %	27,255,904,731	13.8 %
TOTAL ASSETS	<u>31,885,998,638</u>	<u>32,389,644,051</u>	(1.6) %	<u>28,883,596,790</u>	12.1 %
LIABILITIES					
Death benefits, refunds and other payables	1,591,252	2,750,418	(42.1) %	2,319,549	18.6 %
Investments purchased	85,807,691	10,520,944	715.6 %	38,344,946	(72.6) %
Other investment payables	9,367,826	4,606,919	103.3 %	2,563,959	79.7 %
Foreign currency payable	155,102,387	5,796,800	2,575.7 %	19,732,929	(70.6) %
TOTAL LIABILITIES	<u>251,869,156</u>	<u>23,675,081</u>	963.9 %	<u>62,961,383</u>	(62.4) %
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS					
	<u>\$ 31,634,129,482</u>	<u>\$ 32,365,968,970</u>	(2.3) %	<u>\$ 28,820,635,407</u>	12.3 %

ANALYSIS OF REVENUES AND EXPENSES

While contributions to TCRS for fiscal year 2008 increased by \$57 million (5.5 percent) over contributions for fiscal year 2007, a significant decrease in investment income resulted in an overall decline in revenues for 2008 of 86.4 percent compared to revenues for fiscal year 2007. Although employer contribution rates did not change during fiscal year 2008, the increase in contributions can be attributed to new employers joining TCRS and increased salaries. Market conditions resulted in an overall loss to the TCRS investment portfolio of 1.2 percent and negative investment income of \$430.1 million.

Total benefits and refunds paid during the year ended June 30, 2008 were \$1,378,691,525 an increase of 8.8 percent over fiscal year 2007 total benefits and refunds paid. Total benefits and refunds paid during the year ended June 30, 2007 were \$1,266,775,568 an increase of 9.3 percent over fiscal year 2006 total benefits and refunds paid. The increase in benefit expenses can be attributed to 3.0 percent in cost of living adjustments awarded to retirees on both July 1, 2007 and July 1, 2006 respectively. In addition, more retirees were added to payroll than removed during these fiscal years.

(continued)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2008 & JUNE 30, 2007 (CONTINUED)**

In addition, administrative expenses for the year ended June 30, 2008 were \$7,201,911, an increase of 11.3 percent over fiscal year 2007 administrative expenses. This increase was primarily due to the additional expense of the biennial actuarial study performed in fiscal year 2008. Administrative expenses for the year ended June 30, 2007 were \$6,468,558, an increase of 4.1 percent over fiscal year 2006 administrative expenses.

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

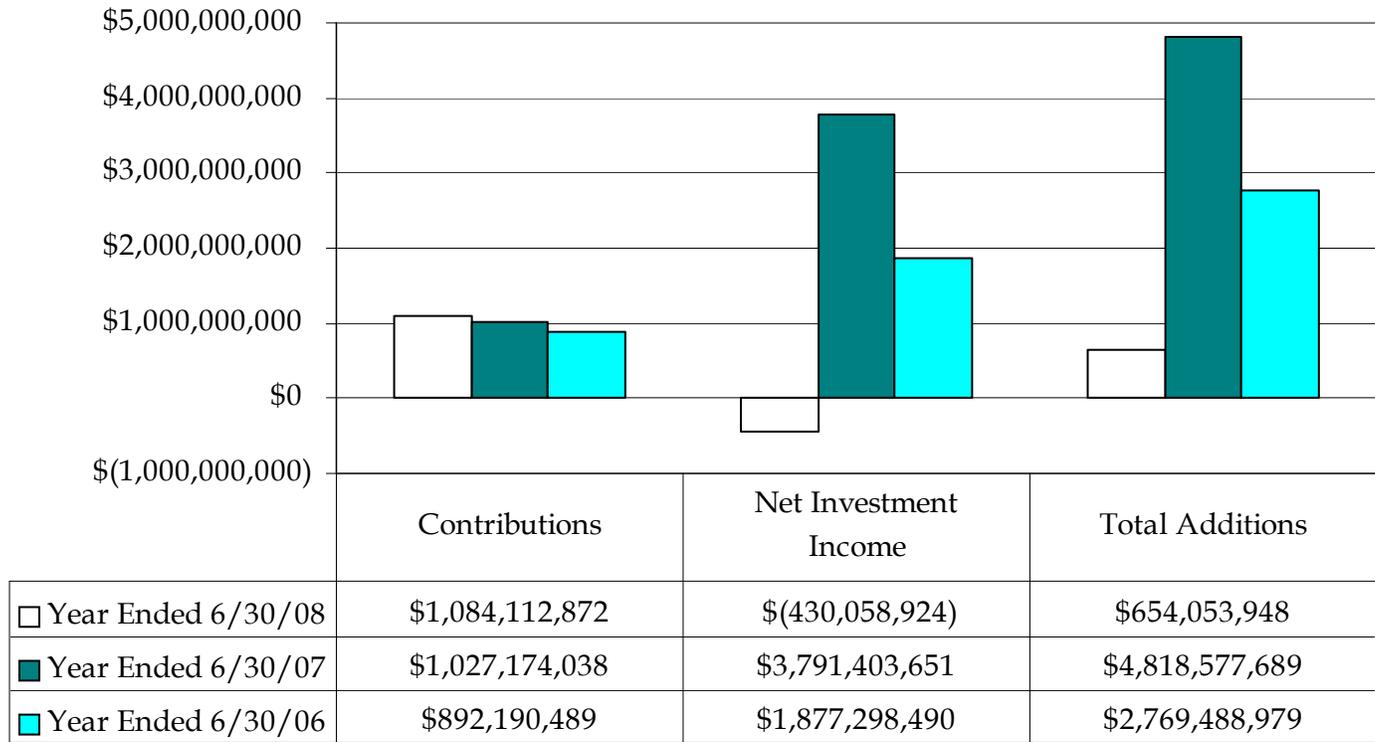
CHANGES IN PLAN NET ASSETS

	For the Year Ended June 30, 2008	For the Year Ended June 30, 2007	FY08 - FY07 Percentage Change	For the Year Ended June 30, 2006	FY07 - FY06 Percentage Change
ADDITIONS					
Contributions	\$ 1,084,112,872	\$ 1,027,174,038	5.5 %	\$ 892,190,489	15.1 %
Investment income					
Net appreciation (depreciation) in fair value of investments	(1,574,090,230)	2,717,644,583	(157.9) %	893,530,576	204.1 %
Interest, dividends and other investment income	1,168,574,283	1,097,511,473	6.5 %	1,002,725,069	9.5 %
Less: Investment expense	(24,542,977)	(23,752,405)	3.3 %	(18,957,155)	25.3 %
Net investment income	(430,058,924)	3,791,403,651	(111.3) %	1,877,298,490	102.0 %
TOTAL ADDITIONS	654,053,948	4,818,577,689	(86.4) %	2,769,488,979	74.0 %
DEDUCTIONS					
Annuity benefits					
Retirement benefits	993,293,429	918,540,446	8.1 %	843,183,130	8.9 %
Survivor benefits	62,811,272	58,202,209	7.9 %	53,991,908	7.8 %
Disability benefits	28,128,249	26,722,134	5.3 %	25,808,859	3.5 %
Cost of living	243,575,211	221,463,825	10.0 %	195,538,793	13.3 %
Death benefits	4,907,479	5,502,982	(10.8) %	5,668,204	(2.9) %
Refunds	45,975,885	36,343,972	26.5 %	34,710,966	4.7 %
Administrative expenses	7,201,911	6,468,558	11.3 %	6,213,597	4.1 %
TOTAL DEDUCTIONS	1,385,893,436	1,273,244,126	8.8 %	1,165,115,457	9.3 %
NET INCREASE (DECREASE)	(731,839,488)	3,545,333,563	(120.6) %	1,604,373,522	121.0 %
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS					
BEGINNING OF YEAR	32,365,968,970	28,820,635,407	12.3 %	27,216,261,885	5.9 %
END OF YEAR	\$ 31,634,129,482	\$ 32,365,968,970	(2.3) %	\$ 28,820,635,407	12.3 %

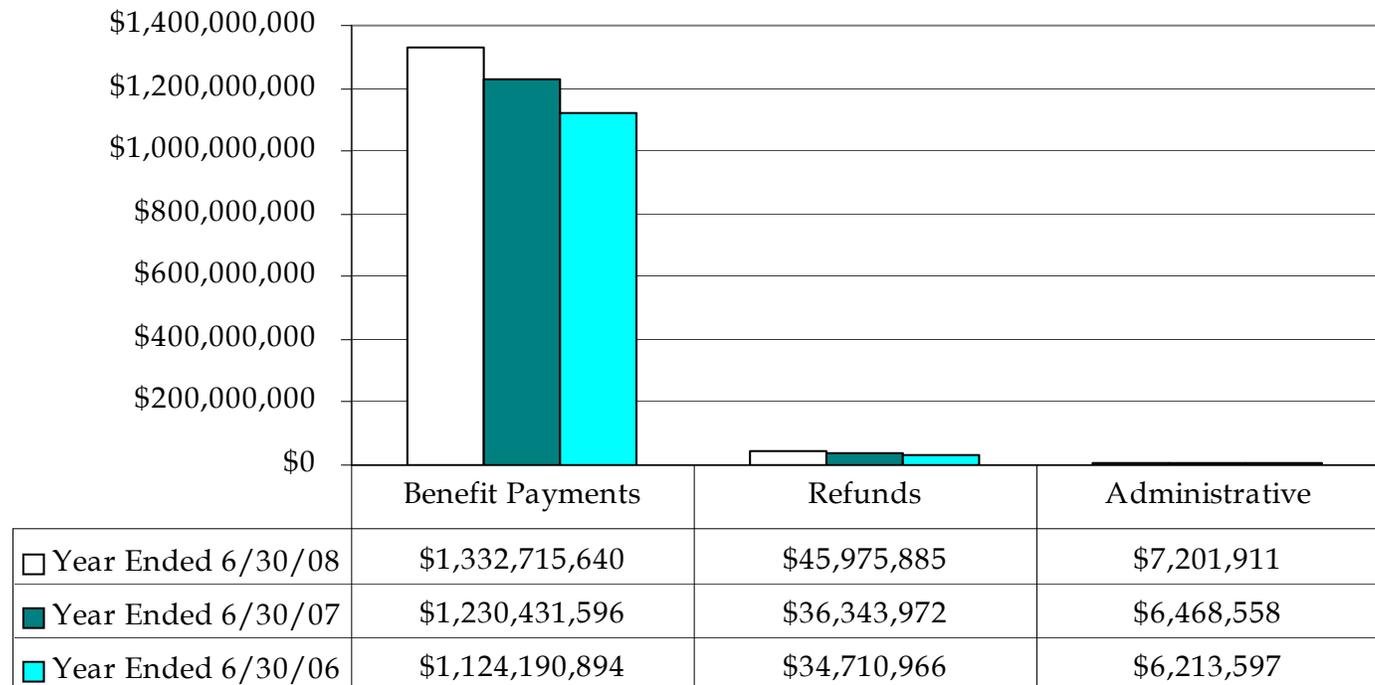
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**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2008 & JUNE 30, 2007 (CONTINUED)**

REVENUES BY TYPE



EXPENSES BY TYPE



(continued)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEARS ENDED JUNE 30, 2008 & JUNE 30, 2007 (CONTINUED)**

ECONOMIC FACTORS, FUTURE FUNDING PROVISIONS, OVERALL OUTLOOK

For the year ended June 30, 2008, the domestic portfolios weakened considerably with a loss of 11.93% following a strong 20.58% return the prior fiscal year. The S&P 1500 index, TCRS' domestic equity benchmark, reported a loss of 12.72% for the fiscal year ended June 30, 2008. Likewise, the international stock portfolios followed a 27.19% return for the year ended June 30, 2007 with a negative return of 6.38% for 2008. The international equity market, as represented by the EAFE index, reported growth of 27% in fiscal year 2007 contrasting with a 10.61% loss in the fiscal year ended June 30, 2008. The domestic bond market, as measured by the Citigroup Broad Investment Grade index, had a positive return of 6.06% for the year ended June 30, 2007, followed by 7.78% return for the 2008 fiscal year. The domestic fixed income portfolio earned 6.17% and 5.98% respectively. Fixed income relative performance began to suffer in the 2008 fiscal year due to the poor performance of asset backed securities. The real estate portfolio earned 12.53% for the year ended June 30, 2008 as compared to the NCREIF index benchmark of 13.58%.

The initial stages of broad equity and fixed income market weakness began during the 2008 fiscal year. The outlook for domestic and international markets is unsettled at best.

The employer contribution rates changed on July 1, 2008 for most of the employers participating in TCRS. The contribution levels did not change significantly because of the overall positive experience of the plan.

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
JUNE 30, 2008 AND JUNE 30, 2007

Expressed in Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ASSETS		
Cash and cash equivalents	\$ 300,422	\$ 57,899
Receivables		
Member receivable	20,835	4,794
Employer receivable	41,864	18,549
Accrued interest receivable	104,184	20,079
Accrued dividends receivable	28,482	5,489
Real estate income receivable	1,202	232
Foreign currency receivable	129,060	24,873
Investments sold	52,676	10,152
Total receivables	<u>378,303</u>	<u>84,168</u>
Investments, at fair value		
Short-term securities	41,919	8,079
Government securities	6,225,179	1,199,756
Corporate securities	5,512,517	1,062,408
Corporate stocks	13,150,692	2,534,486
Real estate	1,115,236	214,935
Total investments	<u>26,045,543</u>	<u>5,019,664</u>
TOTAL ASSETS	<u>26,724,268</u>	<u>5,161,731</u>
LIABILITIES		
Accounts payable		
Death benefits and refunds payable	1,195	212
Other	52	133
Investments purchased	71,943	13,865
Foreign currency payable	130,040	25,062
Other investment payables	7,854	1,514
TOTAL LIABILITIES	<u>211,084</u>	<u>40,786</u>
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	<u>\$ 26,513,184</u>	<u>\$ 5,120,945</u>

See accompanying Notes to the Financial Statements

(continued)

(CONTINUED)

June 30, 2008 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2007 Total
<u>\$ 358,321</u>	<u>\$ 479,656</u>	<u>\$ 89,379</u>	<u>\$ 569,035</u>
25,629	20,405	5,023	25,428
60,413	40,814	20,111	60,925
124,263	122,665	22,857	145,522
33,971	19,480	3,630	23,110
1,434	1,131	211	1,342
153,933	4,886	910	5,796
62,828	13,703	2,553	16,256
<u>462,471</u>	<u>223,084</u>	<u>55,295</u>	<u>278,379</u>
49,998	444,725	82,870	527,595
7,424,935	7,643,081	1,424,212	9,067,293
6,574,925	4,476,732	834,194	5,310,926
15,685,178	13,110,008	2,442,920	15,552,928
1,330,171	913,303	170,185	1,083,488
<u>31,065,207</u>	<u>26,587,849</u>	<u>4,954,381</u>	<u>31,542,230</u>
<u>31,885,999</u>	<u>27,290,589</u>	<u>5,099,055</u>	<u>32,389,644</u>
1,407	1,396	1,063	2,459
185	291	0	291
85,808	8,869	1,653	10,522
155,102	4,886	910	5,796
9,368	3,883	724	4,607
<u>251,870</u>	<u>19,325</u>	<u>4,350</u>	<u>23,675</u>
<u>\$ 31,634,129</u>	<u>\$ 27,271,264</u>	<u>\$ 5,094,705</u>	<u>\$ 32,365,969</u>

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF CHANGES IN PLAN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2008 AND JUNE 30, 2007

Expressed in Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ADDITIONS		
Contributions		
Member contributions	\$ 181,236	\$ 64,617
Employer contributions	593,412	244,847
Total contributions	<u>774,648</u>	<u>309,464</u>
Investment income		
Net appreciation (depreciation) in fair value of investments	(1,322,815)	(251,275)
Interest	631,028	119,867
Dividends	297,009	56,418
Real estate income, net of operating expenses	53,995	10,257
Total investment income	<u>(340,783)</u>	<u>(64,733)</u>
Less: Investment expense	<u>(20,625)</u>	<u>(3,918)</u>
Net investment income	<u>(361,408)</u>	<u>(68,651)</u>
TOTAL ADDITIONS	<u>413,240</u>	<u>240,813</u>
DEDUCTIONS		
Annuity benefits		
Retirement benefits	851,426	141,867
Survivor benefits	53,840	8,971
Disability benefits	24,111	4,017
Cost of living	215,810	27,765
Death benefits	3,309	1,599
Refunds	19,113	26,863
Administrative expense	3,711	3,491
TOTAL DEDUCTIONS	<u>1,171,320</u>	<u>214,573</u>
NET INCREASE	(758,080)	26,240
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	<u>27,271,264</u>	<u>5,094,705</u>
END OF YEAR	<u>\$ 26,513,184</u>	<u>\$ 5,120,945</u>

See accompanying Notes to the Financial Statements

(continued)

(CONTINUED)

For the Year Ended June 30, 2008 TOTAL	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 2007 TOTAL
\$ 245,853	\$ 175,743	57,003	\$ 232,746
838,259	562,729	231,699	794,428
<u>1,084,112</u>	<u>738,472</u>	<u>288,702</u>	<u>1,027,174</u>
(1,574,090)	2,295,671	421,974	2,717,645
750,895	618,197	113,632	731,829
353,427	258,925	47,594	306,519
64,252	49,977	9,186	59,163
<u>(405,516)</u>	<u>3,222,770</u>	<u>592,386</u>	<u>3,815,156</u>
(24,543)	(20,064)	(3,688)	(23,752)
<u>(430,059)</u>	<u>3,202,706</u>	<u>588,698</u>	<u>3,791,404</u>
<u>654,053</u>	<u>3,941,178</u>	<u>877,400</u>	<u>4,818,578</u>
993,293	789,603	128,937	918,540
62,811	50,032	8,170	58,202
28,128	22,971	3,751	26,722
243,575	196,439	25,025	221,464
4,908	3,719	1,784	5,503
45,976	19,231	17,113	36,344
7,202	3,385	3,084	6,469
<u>1,385,893</u>	<u>1,085,380</u>	<u>187,864</u>	<u>1,273,244</u>
(731,840)	2,855,798	689,536	3,545,334
<u>32,365,969</u>	<u>24,415,466</u>	<u>4,405,169</u>	<u>28,820,635</u>
<u>\$ 31,634,129</u>	<u>\$ 27,271,264</u>	<u>\$ 5,094,705</u>	<u>\$ 32,365,969</u>

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007

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 includes 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. Real estate transactions are recorded in the financial statements at the time of closing.
5. **Reclassification** - The fair value of collateralized mortgage obligations at June 30, 2007 which was originally reported in Note C as \$141,501,440 has been reclassified to \$1,665,827,439 due to securities previously classified as mortgage-backed securities being more accurately classified as CMOs.

B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION

At July 1, 2007, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	70,598	27,632
Terminated members entitled to but not receiving benefits	21,032	9,732
Current active members	<u>136,329</u>	<u>76,396</u>
Total	227,959	113,760
Number of participating employers	140	488

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

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, 2008, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$3,495.6 million and \$23,017.6 million, respectively. At June 30, 2007, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$3,386.5 million and \$23,884.7 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

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

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, 2008, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$951.5 million and \$4,169.5 million, respectively. At June 30, 2007, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$896.1 million and \$4,198.6 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' acceptances, certain repurchase agreements and various U.S. Treasury and Agency obligations. The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities.

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.

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

- 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 equity 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.

Changes were made to the statute relative to the investment guidelines for the TCRS during the 2008 legislative session. These changes include increasing the allowable real estate allocation from five percent (5 percent) to ten percent (10 percent) and allowing investment in private equities not to exceed five percent (5 percent) of the market value of total assets. The Board of Trustees approved these revisions to the investment policy after June 30, 2008 and therefore, the changes were not in effect at year end.

Title to real property invested in by the TCRS is held by real estate investment holding companies.

As of June 30, 2008 and June 30, 2007, the TCRS had the following investments:

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

Investments
(Expressed in Thousands)

Investment Type	Fair Value as of June 30, 2008	U.S. Treasury/ Agency (1)	Credit Quality Ratings							(2)	(3)
			AAA	AA	A	BBB	BB	B	A1		
Debt Investments											
U.S. Govt. Treasuries, Notes, Bonds	\$ 859,779	\$ 859,779									
U.S. Govt. Inflation Indexed	1,617,494	1,617,494									
U.S. Govt. Agencies	489,958		\$ 489,958								
Mortg.-Backed Govt.	3,481,814	463,141									\$ 3,018,673
Corporate CMO's	2,186,147		2,133,824	\$ 33,463							18,860
Corporate Bonds	3,045,230		12,142	220,368	\$ 981,941	\$ 1,767,224	\$ 45,258	\$ 18,297			
Corporate Asset-Backed	1,230,858		1,112,036	62,183	19,641	36,998					
Non-U.S. Govt./Sovereign	975,890	767,765	208,125								
Non-U.S. Corporate	19,614		19,614								
Short-Term Commercial Paper	287,352										287,352
Short-Term Agencies	121,969	121,969									
Total Debt Investments	\$ 14,316,105	\$ 3,830,148	\$ 3,975,699	\$ 316,014	\$ 1,001,582	\$ 1,804,222	\$ 45,258	\$ 18,297	\$ -		\$ 3,324,885
Other Investments											
U.S. Equity	\$ 10,937,097		(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.								
Non-U.S. Equity	4,841,156										
Real Estate	1,330,171										
Total Other Investments	\$ 17,108,424		(2) A1 is the highest rating category for commercial paper								
Total Investments	\$ 31,424,529										
Less: Short-Term Investments Classified as Cash Equivalents on the Statements of Plan Net Assets	(359,322)										(3) Includes securities that are implicitly guaranteed by the U.S. government, but are not rated by Standard and Poor's or Moody's.
Total Investments as Shown on Statements of Plan Net Assets	\$ 31,065,207										

Investment Type	Fair Value as of June 30, 2007	U.S. Treasury/ Agency (1)	Credit Quality Ratings							(2)	(3)
			AAA	AA	A	BBB	BB	B	A1		
Debt Investments											
U.S. Govt. Treasuries, Notes, Bonds	\$ 825,413	\$ 825,413									
U.S. Govt. STRIPS	264,838	264,838									
U.S. Govt. TIPS	1,959,797	1,959,797									
U.S. Govt. Agencies	1,252,600		\$ 1,252,600								
Mortg.-Backed Govt. Pass-Through	3,923,008	217,693									\$ 3,705,315
Govt. CMO's	117,568		117,568								
Corporate CMO's	1,548,259		1,528,268	\$ 19,991							
Corporate Bonds	2,294,723		49,523	300,677	\$ 818,312	\$ 1,097,950	\$ 9,782	\$ 18,479			
Corporate Asset-Backed	772,069		652,730	20,035	9,019	90,285					
Private Placements	399,024		77,963	108,899	69,798	142,364					
Yankee Bonds	18,369				9,122	9,247					
Supranationals	41,217		41,217								
Non-U.S. Govt./Sovereign	724,069		359,185	100,506	264,378						
Non-U.S. Corporate	237,265		237,265								
Short-Term Commercial Paper	566,543								\$ 566,543		
Short-Term Certificate of Deposit	9,982			9,982							
Short-Term Agencies	517,613										517,613
Total Debt Investments	\$ 15,472,357	\$ 3,267,741	\$ 4,316,319	\$ 560,090	\$ 1,170,629	\$ 1,339,846	\$ 9,782	\$ 18,479	\$ 566,543		\$ 4,222,928
Other Investments											
U.S. Equity	\$ 10,765,940		(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.								
Non-U.S. Equity	4,786,988										
Real Estate	1,083,488										
Commingled Money Market Funds	9		(2) A1 is the highest rating category for commercial paper								
Total Other Investments	\$ 16,636,425										
Total Investments	\$ 32,108,782										(3) Includes securities that are implicitly guaranteed by the U.S. government, but are not rated by Standard and Poor's or Moody's.
Less: Short-Term Investments Classified as Cash Equivalents on the Statements of Plan Net Assets	(566,552)										
Total Investments as Shown on Statements of Plan Net Assets	\$ 31,542,230										

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

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, 2008 and June 30, 2007 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 Rosa Parks Avenue, 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:

Issuer Organization	June 30, 2008		June 30, 2007	
	Fair Value	Percentage	Fair Value	Percentage
Federal Home Loan Mortgage Corp.	\$1,373,411,585	4.34%	\$2,043,123,831	6.31%
Federal National Mortgage Assoc.	2,214,699,793	7.00%	2,865,385,846	8.85%

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)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (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 range around that index. Duration is a measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows weighted for those cash flows as a percentage of the investment's full price. The TCRS had the following investments and effective duration at June 30, 2008 and June 30, 2007.

Debt Investments
(Expressed in Thousands)

Investment Type	Fair Value as of June 30, 2008	Effective Duration (years)
<u>Debt Investments</u>		
Government Agencies	\$ 698,083	4.54
Government Bonds	1,627,544	7.30
Government Inflation Indexed	1,617,494	7.29
Government Mortgage-Backed	3,481,814	4.39
Corporate Collateralized Mortgage Obligations (CMO)	2,186,148	3.94
Corporate Asset Backed Securities	1,230,857	2.94
Corporate Bonds	3,064,844	6.42
Short-Term Commercial Paper	287,352	0.00
Short-Term Agencies	121,969	0.13
Total Debt Investments	\$14,316,105	5.17

Investment Type	Fair Value as of June 30, 2007	Effective Duration (years)
<u>Debt Investments</u>		
Government Agencies	\$ 1,256,788	2.87
Government Bonds	1,500,391	8.04
Government STRIPS	264,838	12.77
Government Notes	40,648	0.27
Government Inflation Indexed	1,959,797	3.57
Government State and Local Obligations	4,255	0.19
Government National Mortgage Association (GNMA)	217,693	3.47
Federal Home Loan Mortgage Corporation (FHLMC)	1,390,664	4.69
Federal National Mortgage Association (FNMA)	2,314,651	4.60
Government Collateralized Mortgage Obligations (CMO)	117,568	7.49
Corporate Collateralized Mortgage Obligations (CMO)	1,548,259	5.90
Asset Backed Securities	772,069	3.85
Corporate Bonds	2,586,646	6.13
Private Placements	399,024	7.38
Miscellaneous Other Fixed Income	4,928	6.93
Short-Term Commercial Paper	566,543	0.03
Short-Term Certificate of Deposit	9,982	0.00
Short-Term Agencies	517,613	0.43
Total Debt Investments	\$15,472,357	4.99

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

Asset-Backed Securities – The TCRS invests in various collateralized mortgage obligations (CMOs) which are mortgage-backed securities. These securities are based on cash flows from interest and principal payments on underlying mortgages and could therefore be more sensitive to prepayments by mortgagees as a result of a decline in interest rates. The fair value of CMOs at June 30, 2008 was \$2,186,147,672 of which \$1,223,407,319 were CMOs that are generally more sensitive to interest rate changes. The fair value of CMOs at June 30, 2007 was \$1,665,827,439 of which \$899,811,328 were CMOs that are generally more sensitive to changes in interest rates.

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, 2008 and June 30, 2007 was as follows:

Foreign Currency-Denominated Investments

(Expressed in Thousands)

Currency	Total Fair Value June 30, 2008	Fixed Income	Equity	Cash
Australian Dollar	\$ 262,220		\$ 262,220	
British Pound Sterling	1,256,316	\$ 128,214	1,128,102	
Canadian Dollar	47,193		47,193	
Danish Krone	93,241		93,220	\$ 21
Euro Currency	1,779,678	332,656	1,445,990	1,032
Hong Kong Dollar	141,112		141,020	92
Japanese Yen	1,554,682	534,634	1,016,364	3,684
New Zealand Dollar	4,900		4,819	81
Norwegian Krone	63,305		63,305	
Singapore Dollar	79,452		79,106	346
Swedish Krona	117,084		116,720	364
Swiss Franc	326,064		325,978	86
Total	\$ 5,725,247	\$ 995,504	\$ 4,724,037	\$ 5,706

Currency	Total Fair Value June 30, 2007	Fixed Income	Equity	Cash
Australian Dollar	\$ 259,144	\$ 8,443	\$ 250,425	\$ 276
British Pound Sterling	1,263,570	77,543	1,183,999	2,028
Canadian Dollar	49,779	67	49,571	141
Danish Krone	62,477		62,475	2
Euro Currency	1,806,669	312,885	1,493,692	92
Hong Kong Dollar	134,801		134,750	51
Japanese Yen	1,569,152	569,953	995,983	3,216
New Zealand Dollar	10,640		10,606	34
Norwegian Krone	82,993	33,727	49,171	95
Singapore Dollar	84,307		84,119	188
Swedish Krona	164,588		164,150	438
Swiss Franc	302,380		302,334	46
Total	\$ 5,790,500	\$ 1,002,618	\$ 4,781,275	\$ 6,607

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

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 contract 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, 2008, the TCRS was under contract for equity index futures and the resulting payable is reflected in the financial statements at fair value. The TCRS was not under any futures contracts at June 30, 2007.

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, 2008 and June 30, 2007 has been reflected in the financial statements.

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.

Pending Real Estate Items - At June 30, 2008 the TCRS had unfunded commitments of \$18,476,000 for pending real estate purchases. At June 30, 2007 the TCRS had unfunded commitments of \$32,777,459 for pending real estate purchases.

E. SUBSEQUENT EVENT

Market Decline - Continued disruption in the credit markets and overall declines in economic conditions in markets in the United States of America and internationally have resulted in significant declines in the fair market value of the TCRS' investments subsequent to June 30, 2008. As of October 31, 2008, the TCRS estimates that the value of investments excluding the real estate portfolio has declined approximately \$5.5 billion compared to the value as of June 30, 2008.

(continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2008 AND JUNE 30, 2007 (CONTINUED)

F. FUNDED STATUS AND FUNDING PROGRESS

The funded status of each plan as of July 1, 2007, the most recent actuarial valuation date, is as follows:

SCHEDULES OF FUNDING PROGRESS							
<i>(Expressed in Thousands)</i>							
	Actuarial	Actuarial	Actuarial Accrued	Unfunded		Annual	UAAL as a
	Valuation	Value of	Liability (AAL)	AAL	Funded	Covered	Percentage of
	Date	Plan Assets	Frozen Entry Age	(UAAL)	Ratio	Payroll	Covered Payroll
		(a)	(b)	(b-a)	(a/b)	(c)	((b-a)/c)
SETHEEPP	7/1/2007	\$ 26,214,995	\$ 27,240,151	\$ 1,025,156	96.24%	\$ 5,742,866	17.85%
PSPP	7/1/2007	\$ 4,897,974	\$ 5,475,620	\$ 577,646	89.45%	\$ 2,081,964	27.75%

The TCRS uses the Frozen Entry Age actuarial cost method to calculate the annual required contribution (ARC). Effective July 1, 2007, the TCRS reestablished unfunded accrued liabilities for all groups. For the year ended June 30, 2008, information regarding the funded status and funding progress is required to be presented using the entry age actuarial cost method. In the actuarial valuation in which unfunded accrued liabilities are reestablished, the Frozen Entry Age actuarial cost method and the entry age normal actuarial cost method produce the same results.

The required schedule of funding progress immediately following the notes to the financial statements is intended to present multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits. Since the requirement to present the Schedule of Funding Progress using the entry age actuarial cost method is effective beginning for the year ended June 30, 2008, only the funded status information relating to the most recent actuarial valuation date is provided in the required supplementary information. Additional required historical information will be provided in subsequent years once available.

Additional information as of the latest actuarial valuation follows:

	SETHEEPP	PSPP
Valuation Date	July 1, 2007	July 1, 2007
Actuarial cost method	Frozen Entry Age	Frozen Entry Age
Amortization method	Level Dollar	Level Dollar
Remaining amortization period	20 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% (2)	4.75% (2)
Included inflation at	3.00%	3.00%
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) Uniform rate that approximates the effect of a graded salary scale.		

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

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	7/1/2007	\$ 26,214,995	\$ 27,240,151	\$ 1,025,156	96.24%	\$ 5,742,866	17.85%
PSPP	7/1/2007	\$ 4,897,974	\$ 5,475,620	\$ 577,646	89.45%	\$ 2,081,964	27.75%

The schedule of funding progress is intended to present multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits. Since the TCRS has previously calculated the annual required contribution (ARC) using the aggregate actuarial cost method and the requirement to present the Schedule of Funding Progress using the entry age actuarial cost method is effective beginning for the year ended June 30, 2008, only the funded status information relating to the most recent actuarial valuation date is provided. Additional required historical information will be provided in subsequent years once available.

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

SCHEDULES OF EMPLOYER CONTRIBUTIONS

Expressed in Thousands

Year Ended June 30	SETHEPP		PSPP	
	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
2008	\$ 593,412	100.00%	\$ 244,847	100.00%
2007	562,729	100.00%	231,699	100.00%
2006	474,879	100.00%	191,000	100.00%
2005	448,154	100.00%	181,096	100.00%
2004	271,298	100.00%	139,808	100.00%
2003	264,320	100.00%	134,014	100.00%

An actuarial valuation of the TCRS is performed every two years with the next valuation scheduled to be effective July 1, 2009.