AUDIT REPORT

Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 2012

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee
Comptroller
of the Treasury

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February 7, 2013

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, 2012. 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,

Deborah V. Loveless

Deborah V. Loveless, CPA
Director

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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, 2012

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, 2012

TABLE OF CONTENTS

TABLE OF CONTENTS (CONT.)

Tennessee Consolidated Retirement System
For the Year Ended June 30, 2012

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, 2012, there were 210,493 active members and 122,499 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.

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.

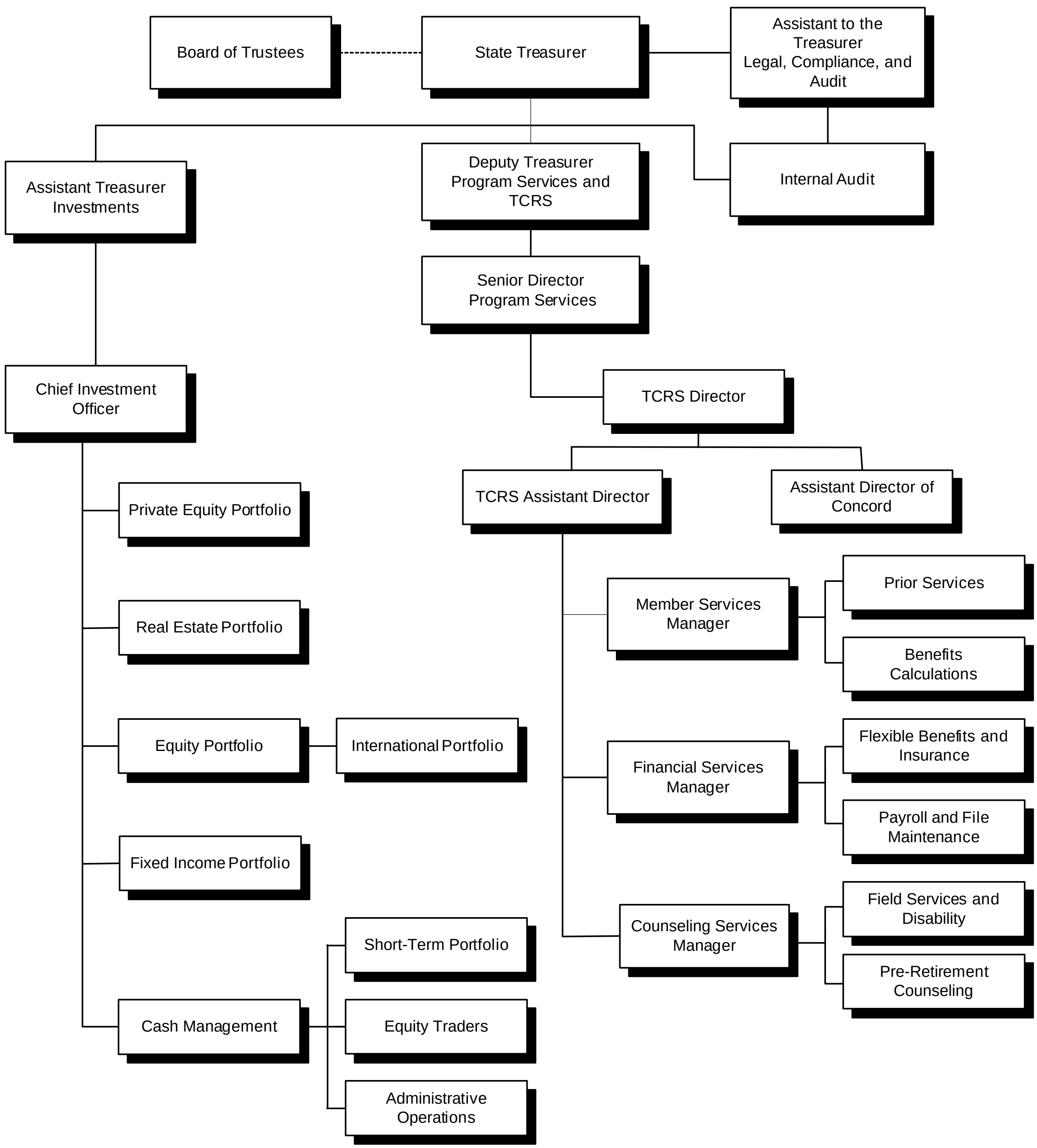
Financial Services processes refunds for terminated members, administers the retired payroll, distributes the pension payments, and coordinates actuarial valuations. The section also processes membership forms received from all state agencies, local boards of education, and participating political subdivisions. In addition, the section is 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, 2011, through June 30, 2012, 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, 2012, and for comparative purposes, the year ended June 30, 2011. 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, 2012, 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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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*

November 30, 2012

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 Capital
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, 2012, and have issued our report thereon dated November 30, 2012. 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

Management of the Tennessee Consolidated Retirement System is responsible for establishing and maintaining effective 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 *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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.

<u>Compliance and Other Matters</u>

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.

Arthur A. Hayes, Jr., CPA
Director

AAH/vn

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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Independent Auditor's Report

November 30, 2012

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:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System, pension trust funds of the State of Tennessee, as of June 30, 2012, and June 30, 2011, 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 the 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. We do not believe that the Comptroller's service in this capacity affected our ability to conduct an independent audit 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, and do not purport to, and do not, present fairly the financial position of the State of Tennessee as of June 30, 2012, and June 30, 2011, 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, 2012, and June 30, 2011, 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 11 through 15 and the schedules of funding progress and employer contributions on page 33 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during the audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

In accordance with generally accepted government auditing standards, we have also issued our report dated November 30, 2012, 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 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 considered in assessing the results of our audit.

Sincerely,

Arthur A. Hayes, Jr.

Arthur A. Hayes, Jr., CPA
Director

AAH/vn

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, 2012 and June 30, 2011. 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, 2012 were $34.9 billion, increasing over $1.2 billion (3.7 percent) from the plan net assets at June 30, 2011. 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, 2011, the date of the latest actuarial valuation, the TCRS' funded ratio was 92.1 percent for the SETHEEPP group and 89.2 percent for the PSPP group.

- Contribution revenue for fiscal year 2012 totaled $1,266,468,685 an increase of 0.8 percent compared to fiscal year 2011.

- Net investment income for fiscal year 2012 was $1,800,063,989. During fiscal year 2012, the TCRS received an investment return on its portfolio of 5.6 percent, compared to 19.6 percent for fiscal year 2011.

- Total benefits and refunds paid for fiscal year 2012 were $1,809,901,340 – an increase of 7.2 percent over fiscal year 2011 total benefits and refunds paid of $1,688,410,469.

- Total administrative expenses for fiscal year 2012 were $7,166,606 – a slight increase from fiscal year 2011 administrative expenses of $7,156,822.

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 32). In addition, *Required Supplementary Information* is presented, which includes this *Management's Discussion and Analysis,* and the schedules on page 33.

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 essential 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.

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ANALYSIS OF ASSETS, LIABILITIES AND PLAN NET ASSETS

At June 30, 2012, the TCRS had plan net assets (total assets in excess of total liabilities) of $34.9 billion, an increase of over $1.2 billion (3.7 percent) from $33.7 billion at June 30, 2011, following the fiscal year 2011 increase of over $5.1 billion (17.8 percent) from the $28.6 billion of plan net assets as of June 30, 2010. The assets of the TCRS consist primarily of investments. The increase in plan assets is primarily the result of investment return for the year since contributions stayed at the same level. Condensed financial information comparing the TCRS' plan net assets for the past three fiscal years follows:

PLAN NET ASSETS

	June 30, 2012	June 30, 2011	FY12 - FY11 Percentage Change	June 30, 2010	FY11 - FY10 Percentage Change
ASSETS					
Cash and cash equivalents	$ 426,627,425	$ 414,134,562	3.0 %	$ 438,269,286	(5.5) %
Member and employer receivables	107,108,579	99,604,471	7.5 %	89,310,527	11.5 %
Investment receivables	1,044,714,969	1,431,331,905	(27.0) %	2,000,061,173	(28.4) %
Short-term securities	19,781,452	0	- %	0	0 %
Long-term investments	34,272,630,084	33,220,879,536	3.2 %	27,911,282,071	19.0 %
Capital assets	11,426,938	1,896,671	502.5 %	0	- %
TOTAL ASSETS	35,882,289,447	35,167,847,145	2.0 %	30,438,923,057	15.5 %
LIABILITIES					
Death benefits, refunds and other payables	10,193,417	8,544,407	19.3 %	8,205,512	4.1 %
Investment payables	959,323,058	1,495,994,494	(35.9) %	1,856,522,455	(19.4) %
TOTAL LIABILITIES	969,516,475	1,504,538,901	(35.6) %	1,864,727,967	(19.3) %
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$ 34,912,772,972	$ 33,663,308,244	3.7 %	$ 28,574,195,090	17.8 %

ANALYSIS OF REVENUES AND EXPENSES

Employer contribution rates for the TCRS did not change during fiscal year 2012; therefore, the slight change of 0.8 percent in contributions from fiscal year 2011 to fiscal year 2012 was due to changes in salary. Contributions to TCRS had a larger than normal increase of $164.1 million (15 percent) over contributions for fiscal year 2010 due to the change in employer contribution rates effective July 1, 2010. With the decrease of investment income of $3.8 billion (67.4 percent) for fiscal year 2012 compared to investment income for fiscal year 2011, the overall decrease in revenues for 2012 was 54.8 percent compared to revenues for fiscal year 2011.

Investment expenses for fiscal year 2012 increased a slight $166 thousand (0.5 percent). Although market conditions continued to show improvement in fiscal year 2012 which resulted in an overall gain to the TCRS investment portfolio of 5.61 percent and net investment income of $1.8 billion, the return was not as high as the prior fiscal year. The return for fiscal year 2012 decreased (67.4 percent) from fiscal year 2011. Net investment income for fiscal year 2011 was $5.5 billion due to the start of the improved market conditions in fiscal year 2010.

Total benefits and refunds paid during the year ended June 30, 2012 were $1,809,901,340, an increase of 7.2 percent over fiscal year 2011 total benefits and refunds paid. Total benefits and refunds paid during the year ended June 30, 2011 were $1,688,410,470, an increase of 7.4 percent over fiscal year 2010 total benefits and refunds paid. The increase in benefit

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expenses for fiscal year 2012 is attributed to 1.5 percent in cost of living adjustments awarded to retirees on July 1, 2011, as well as more retirees being added to payroll than removed during this fiscal year. The increase in benefit expenses in fiscal year 2011 is attributed to 2.7 percent in cost of living adjustments awarded to retirees on July 1, 2010, as well as more retirees being added to payroll than removed during this fiscal year. Total refunds paid increased $4.5 million (12.81 percent) in fiscal year 2012 from fiscal year 2011 and could be attributed to the weak economy where more terminated members are choosing to withdraw from the system instead of leaving the funds invested. Total refunds paid had decreased $883,258 (2.4 percent) in fiscal year 2011 over fiscal year 2010.

Administrative expenses for the year ended June 30, 2012 were $7,166,606, a slight increase of 0.14 percent over fiscal year 2011 administrative expenses. Administrative expenses for the year ended June 30, 2011 were $7,156,822, a decrease of 5.1 percent from fiscal year 2010 administrative expenses. The decrease was primarily due to the additional expense of the biennial actuarial study performed in fiscal year 2010 and not being performed in fiscal year 2011.

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, 2012	For the Year Ended June 30, 2011	FY12 - FY11 Percentage Change	For the Year Ended June 30, 2010	FY11 - FY10 Percentage Change
ADDITIONS					
Contributions	$ 1,266,468,685	$ 1,255,926,943	0.8 %	$ 1,091,776,287	15.0 %
Investment income					
Net appreciation in fair value of investments	825,366,874	4,597,653,001	(82.0) %	1,802,314,559	155.1 %
Interest, dividends and other investment income	1,007,076,475	963,313,744	4.5 %	918,842,338	4.8 %
Less: Investment expense	(32,379,360)	(32,213,243)	0.5 %	(28,810,978)	11.8 %
Net investment income	1,800,063,989	5,528,753,502	(67.4) %	2,692,345,919	105.4 %
TOTAL ADDITIONS	3,066,532,674	6,784,680,445	(54.8) %	3,784,122,206	79.3 %
DEDUCTIONS					
Annuity benefits					
Retirement benefits	1,346,462,471	1,248,538,286	7.8 %	1,164,713,725	7.2 %
Survivor benefits	80,772,647	76,298,394	5.9 %	71,380,041	6.9 %
Disability benefits	33,906,448	32,140,006	5.5 %	30,500,247	5.4 %
Cost of living	302,464,015	290,396,251	4.2 %	261,479,337	11.1 %
Death benefits	6,204,207	5,498,139	12.8 %	7,114,008	(22.7) %
Refunds	40,091,552	35,539,393	12.8 %	36,422,651	(2.4) %
Administrative expenses	7,166,606	7,156,822	0.1 %	7,542,822	(5.1) %
TOTAL DEDUCTIONS	1,817,067,946	1,695,567,291	7.2 %	1,579,152,831	7.4 %
NET INCREASE	1,249,464,728	5,089,113,154	(75.4) %	2,204,969,375	130.8 %
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS					
BEGINNING OF YEAR	33,663,308,244	28,574,195,090	17.8 %	26,369,225,715	8.4 %
END OF YEAR	$ 34,912,772,972	$ 33,663,308,244	3.7 %	$ 28,574,195,090	17.8 %

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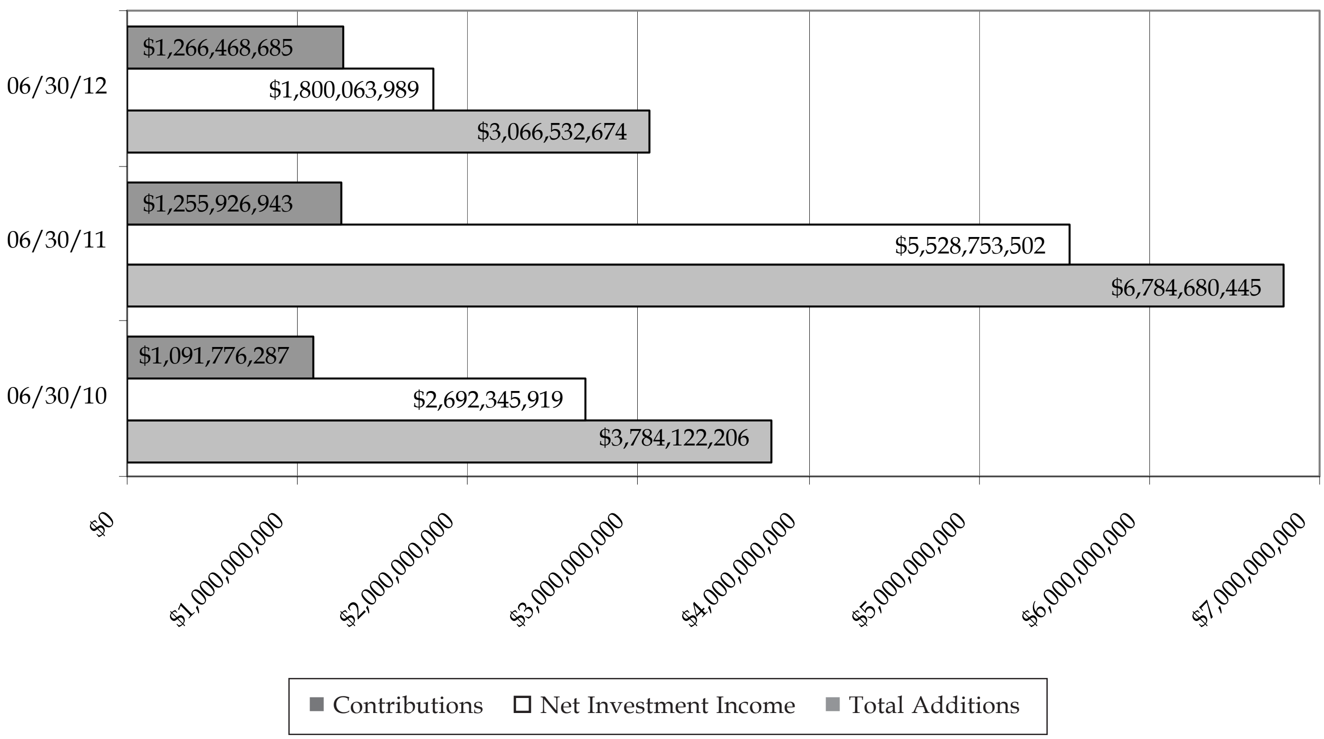
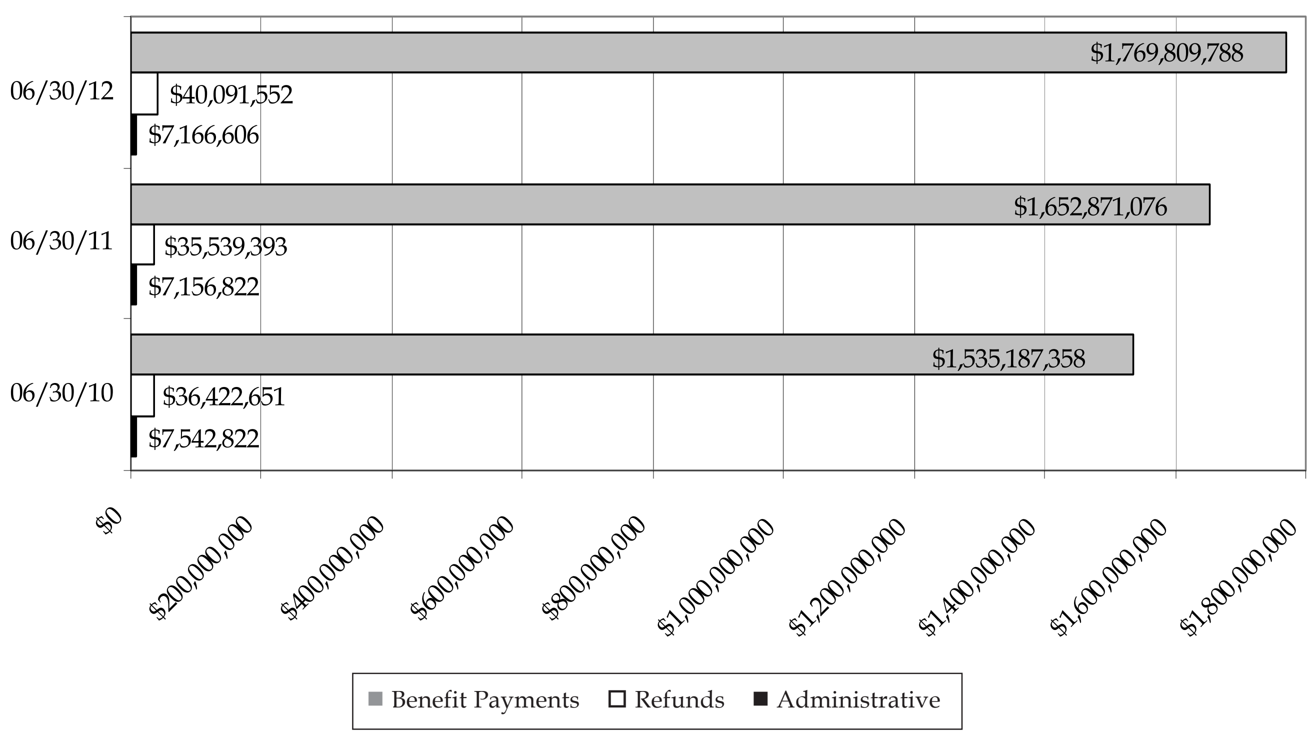
REVENUES BY TYPE



EXPENSES BY TYPE



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ECONOMIC FACTORS, FUTURE FUNDING PROVISIONS, OVERALL OUTLOOK

For the year ended June 30, 2012, the portfolio delivered a return of 5.61 percent; an exceptional result which beat 98 percent of comparable funds. The long duration fixed income portfolio was primarily responsible for the result.

The domestic equity portfolio generated 5.03 percent building on a 33.71 percent increase from the prior year. The S&P 1500 index reported a gain of 4.63 percent for the fiscal year ended June 30, 2012. The international stock portfolio lost 10.79 percent for the year following the gain of 33.01 percent for the year ended June 30, 2011. The international equity market, as represented by the EAFE IMI index, lost 13.97 percent for the fiscal year ended June 30, 2012. Domestic fixed income returned 15.63 percent which followed a return of 6 percent for the prior year. The real estate portfolio gained 10.01 percent for the 2012 fiscal year which followed a gain of 15.5 percent in fiscal year 2011.

The investment environment in the 2012 fiscal year was characterized by continued world-wide economic weakness which was countered somewhat by aggressive monetary stimulus provided by global central banks. Dramatic declines in interest rates led to sizeable returns from long duration fixed income portfolios. These strong returns were countered by weak global equity returns.

An actuarial valuation was performed as of July 1, 2011. The employer contribution rates determined in this valuation will be effective July 1, 2012. The required contributions to the plan increased primarily due to investment returns and mortality improvements.

In December 2010, TCRS contracted with Deloitte Consulting, LLC, to provide a new pension administration system to replace the retirement information system. The new pension administration system, referred to as Concord, will replace five separate operating systems with one integrated web-based system that will greatly improve the level of service we provide to our members and employers. The multi-year Concord project will be implemented in three major phases: document imaging, retired payroll, and active member. The first phase of Concord was implemented during fiscal year 2012. Software development costs have been capitalized and are being amortized over the useful life of the system as each phase is implemented.

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, 502 Deaderick Street, Nashville, TN 37243-0201.

Tennessee Consolidated Retirement System
Statements of Plan Net Assets
June 30, 2012 and June 30, 2011

Expressed in Thousands	**State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)**	**Political Subdivisions Pension Plan (PSPP)**
ASSETS		
Cash and cash equivalents	$ 348,330	$ 78,297
Receivables		
Member receivable	21,313	6,001
Employer receivable	56,430	23,364
Accrued interest receivable	79,795	17,936
Accrued dividends receivable	42,658	9,588
Real estate income receivable	680	153
Derivative instruments receivable	319,335	71,779
Investments sold	410,516	92,275
Total receivables	930,727	221,096
Investments, at fair value		
Short-term securities	16,152	3,630
Government securities	6,736,847	1,514,288
Corporate securities	4,627,801	1,040,222
Corporate stocks	15,374,082	3,455,739
Derivative instruments	531	119
Private equities	142,025	31,924
Real estate	1,101,467	247,585
Total investments	27,998,905	6,293,507
Capital assets (net)	9,330	2,097
TOTAL ASSETS	29,287,292	6,594,997
LIABILITIES		
Accounts payable		
Death benefits and refunds payable	1,475	1,537
Retiree insurance premium payable	5,678	1,276
Other	227	0
Investments purchased	467,947	105,184
Derivative instruments payable	308,316	69,303
Other investment payables	7,000	1,573
TOTAL LIABILITIES	790,643	178,873
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$28,496,649	$6,416,124

See accompanying Notes to the Financial Statements.

(continued)

(CONTINUED)

June 30, 2012 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2011 Total
$ 426,627	$ 340,115	$ 74,019	$ 414,134
27,314	19,570	5,266	24,836
79,794	53,975	20,793	74,768
97,731	84,099	18,302	102,401
52,246	39,371	8,569	47,940
833	50	11	61
391,114	319,386	69,508	388,894
502,791	732,599	159,437	892,036
1,151,823	1,249,050	281,886	1,530,936
19,782	0	0	0
8,251,135	7,135,403	1,552,887	8,688,290
5,668,023	4,554,482	991,198	5,545,680
18,829,821	14,640,474	3,186,225	17,826,699
650	9	2	11
173,949	61,296	13,340	74,636
1,349,052	891,538	194,026	1,085,564
34,292,412	27,283,202	5,937,678	33,220,880
11,427	1,558	339	1,897
35,882,289	28,873,925	6,293,922	35,167,847
3,012	1,108	899	2,007
6,954	5,290	1,151	6,441
227	97	0	97
573,131	904,384	196,823	1,101,207
377,619	318,780	69,376	388,156
8,573	5,446	1,185	6,631
969,516	1,235,105	269,434	1,504,539
$34,912,773	$27,638,820	$6,024,488	$33,663,308

Tennessee Consolidated Retirement System
Statements of Changes in Plan Net Assets
For the Years Ended June 30, 2012 and June 30, 2011

Expressed in Thousands	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ADDITIONS		
Contributions		
Member contributions	$ 194,180	$ 69,576
Employer contributions	731,352	271,361
Total contributions	925,532	340,937
Investment income		
Net appreciation in fair value of investments	675,639	149,728
Interest	414,344	91,816
Dividends	353,064	78,237
Real estate income, net of operating expenses	56,987	12,628
Total investment income	1,500,034	332,409
Less: Investment expense	(26,384)	(5,995)
Net investment income	1,473,650	326,414
TOTAL ADDITIONS	2,399,182	667,351
DEDUCTIONS		
Annuity benefits		
Retirement benefits	1,145,293	201,169
Survivor benefits	68,705	12,068
Disability benefits	28,840	5,066
Cost of living	266,674	35,790
Death benefits	4,515	1,689
Refunds	22,575	17,517
Administrative expense	4,751	2,416
TOTAL DEDUCTIONS	1,541,353	275,715
NET INCREASE	857,829	391,636
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	27,638,820	6,024,488
END OF YEAR	$28,496,649	$6,416,124

See accompanying Notes to the Financial Statements.

(continued)

(CONTINUED)

For the Year Ended June 30, 2012 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 2011 Total
$ 263,756	$ 192,467	$ 67,920	$ 260,387
1,002,713	721,759	273,781	995,540
1,266,469	914,226	341,701	1,255,927
825,367	3,785,947	811,706	4,597,653
506,160	462,425	99,143	561,568
431,301	277,650	59,528	337,178
69,615	53,168	11,399	64,567
1,832,443	4,579,190	981,776	5,560,966
(32,379)	(26,453)	(5,760)	(32,213)
1,800,064	4,552,737	976,016	5,528,753
3,066,533	5,466,963	1,317,717	6,784,680
1,346,462	1,062,838	185,700	1,248,538
80,773	64,950	11,348	76,298
33,906	27,360	4,780	32,140
302,464	256,137	34,259	290,396
6,204	4,054	1,444	5,498
40,092	18,957	16,583	35,540
7,167	3,525	3,632	7,157
1,817,068	1,437,821	257,746	1,695,567
1,249,465	4,029,142	1,059,971	5,089,113
33,663,308	23,609,678	4,964,517	28,574,195
$34,912,773	$27,638,820	$6,024,488	$33,663,308

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 include cash and short-term investments with a maturity date within three months of the acquisition date. Cash management pools are included 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. The fair value of private equity investments is determined by the fund managers using various methodologies as applicable under Generally Accepted Accounting Principles. In many cases, these valuations are additionally reviewed by advisory boards comprised of a subgroup of the fund's investors. These valuations are audited on an annual basis by independent accounting firms engaged by the private equity fund managers. 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. **Capital Assets –** Capital assets consist of internally generated computer software in development and the first phase of internally generated computer software, which are reported at historical cost, less any applicable amortization. Capital assets are defined by the state as assets with an initial individual cost of $5,000 or more and an estimated useful life in excess of two years. Software in development at June 30, 2011 was valued at $1,896,671 and at June 30, 2012 $9,749,457. Software in development will be amortized using the straight line method over the ten year estimated life of the system once a phase is implemented. The first phase of the computer software was implemented during the fiscal year ended June 30, 2012 and amortization was initiated. The computer software was valued at zero at June 30, 2011 and $1,677,480 at June 30, 2012. Amortization expense was zero in fiscal year 2011 and $43,012 in fiscal year 2012.

(continued)

B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION

At July 1, 2011, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	83,041	33,544
Terminated members entitled to but not receiving benefits	22,867	9,758
Current active members	135,588	79,488
Total	241,496	122,790
Number of participating employers	140	503

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; and (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 who 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, 2012, the plan's Member Reserve and Employer Reserve were fully funded with balances of $3.75 billion and $24.75 billion, respectively. At June 30, 2011, the plan's Member Reserve and Employer Reserve were fully funded with balances of $3.7 billion and $23.93 billion, respectively.

(continued)

Political Subdivisions Pension Plan

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

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

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 2012, the plan's Member Reserve and Employer Reserve were fully funded with balances of $1.15 billion and $5.27 billion, respectively. At June 30, 2011, the plan's Member Reserve and Employer Reserve were fully funded with balances of $1.1 billion and $4.92 billion, 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.

(continued)

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 twenty-five percent (25 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 ten percent (10 percent) of the market value of total assets.

g. The total sum invested in private equities 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 ten percent (10 percent) of the market value of total assets. Gross exposure to approved fixed income financial instruments will be limited to 10% of the market value of the System’s total assets for risk mitigating positions and 10% for risk positions. Position sizes will be measured by notional amounts. Options will be measured in their notional equivalents.

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

As of June 30, 2012 and June 30, 2011, the TCRS had the following investments:

(continued)

Investments

(Expressed in Thousands)

2012

Investment Type	Fair Value as of June 30, 2012	U.S. Treasury/ Agency (1)	Credit Quality Ratings										
			AAA	AA	A	BBB	BB	B	CCC	CC	D	A1(3)	Not Rated
Debt Investments													
U.S. Govt. Agencies	$ 188,455		$ 19,332	$169,123									
U.S. Govt. Inflation Indexed	2,654,938	$2,654,938											
U.S. Govt. Treasuries, Notes and Bonds	1,558,334	1,558,334											
U.S. Govt. Asset Backed	76,372	76,372											
Municipal Bonds	155,316		2,336	99,328	$ 53,652								
Govt. Mortgage Backed	3,291,737	271,967		13,277									$3,006,493 (2)
Comm. Mortgage Backed	268,585		176,255	92,330									
Corporate CMO's	232,639		33,643					$43,223	$121,425	$24,197	$10,151		
Corporate Bonds	4,349,054		109,541	95,364	1,182,495	$2,675,562	$211,398	26,616		738			47,340
Corporate Asset Backed	782,669		573,571	98,607	35,353	24,745	1,291		8,020				41,082
Non-U.S. Govt./Sovereign	325,983		113,408	212,575									
Short-Term Comm. Paper	113,853											$113,853	
Short-Term Bills and Notes	304,269												304,269
Total Debt Investments	$14,302,204	$4,561,611	$1,028,086	$780,604	$1,271,500	$2,700,307	$212,689	$69,839	$129,445	$24,935	$10,151	$113,853	$3,399,184
Other Investments													
U.S. Equity	$12,887,225												
Non-U.S. Equity	5,974,207												
Derivatives	650												
Real Estate	1,349,052												
Private Equities	173,949												
Money Market Funds (not rated)	4,375												
Escrow Claim	3,468												
Total Other Investments	$20,392,926												
Total Investments	$34,695,130												
Less: Short-Term Investments Classified as Cash Equivalents on the Statements of Plan Net Assets	(402,718)												
Total Investments as Shown on Statements of Plan Net Assets	$34,292,412												

(1) Includes obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government.

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

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

(continued)

Investments

(Expressed in Thousands)

2011

Investment Type	Fair Value as of June 30, 2011	U.S. Treasury/ Agency (1)	Credit Quality Ratings									
			AAA	AA	A	BBB	BB	B	CCC	CC	D	A1(3)	Not Rated
Debt Investments													
U.S. Govt. Agencies	$ 311,472	$ 102,034	$164,431	$ 16,960									$ 28,047 (2)
U.S. Govt. Inflation Indexed	2,475,914	2,475,914											
U.S. Govt. Treasuries, Notes and Bonds	1,355,666	1,345,642	10,024										
U.S. Govt. Asset Backed	117,625	117,625											
Municipal Bonds	149,480		32,649	55,086	$ 61,745								
Govt. Mortgage Backed	3,667,503	437,001	26,576										3,203,926 (2)
Comm. Mortgage Backed	381,608		306,660	64,905	10,043								
Corporate CMO's	313,391		56,374				$ 2,021	$68,922	$156,593	$15,529	$10,077		3,875
Corporate Bonds	3,764,808		138,541	290,304	1,117,282	$1,967,171	168,915	28,325		1,201			53,069
Corporate Asset Backed	1,015,712		769,168	123,431	70,559	41,765			9,152				1,637
Non-U.S. Govt./Sovereign	610,630		290,256	320,374									
Short-Term Comm. Paper	388,064											$388,064	
Total Debt Investments	$14,551,873	$4,478,216	$1,794,679	$871,060	$1,259,629	$2,008,936	$170,936	$97,247	$165,745	$16,730	$10,077	$388,064	$3,290,554
Other Investments													
U.S. Equity	$11,399,485												
Non-U.S. Equity	6,497,376												
Derivatives	11												
Real Estate	1,085,564												
Private Equities	74,636												
Money Market Funds (not rated)	113,893												
Total Other Investments	$19,170,965												
Total Investments	$33,722,838												
Less: Short-Term Investments Classified as Cash Equivalents on the Statements of Plan Net Assets	(501,958)												
Total Investments as Shown on Statements of Plan Net Assets	$33,220,880												

(1) Includes obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government.

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

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

(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, 2012 and June 30, 2011 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 *State of Tennessee Treasurer's Report*. That report is available on the state's website at http://www.tn.gov/treasury/.

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, 2012		June 30, 2011	
Issuer Organization	**Fair Value**	**Percentage**	**Fair Value**	**Percentage**
Federal National Mortgage Association	$1,932,517,086	5.54%	$2,029,898,227	6.03%

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 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, 2012 and June 30, 2011.

Debt Investments

(Expressed in Thousands)

Investment Type	Fair Value as of June 30, 2012	Effective Duration (years)
Debt Investments		
Government Agencies	$ 215,919	8.63
Government Bonds	1,856,853	12.08
Government Inflation Indexed	2,654,938	8.82
Government Mortgage Backed	3,291,737	1.38
Government Asset Backed	76,372	5.06
Municipal Bonds	155,316	10.97
Collateralized Mortgage Obligations (CMO)	232,639	3.40
Commercial Mortgage Backed	268,585	2.22
Corporate Asset Backed Securities	782,669	1.52
Corporate Bonds	4,349,054	6.91
Short-Term Commercial Paper	113,853	0.19
Short-Term Bills & Notes	304,269	0.13
Total Debt Investments	$ 14,302,204	6.09

Investment Type	Fair Value as of June 30, 2011	Effective Duration (years)
Debt Investments		
Government Agencies	$ 397,214	5.50
Government Bonds	1,870,530	9.25
Government Inflation Indexed	2,475,914	3.80
Government Mortgage Backed	3,667,503	2.89
Government Asset Backed	117,625	6.31
Municipal Bonds	149,480	10.56
Collateralized Mortgage Obligations (CMO)	313,391	3.82
Commercial Mortgage Backed	381,608	2.21
Corporate Asset Backed Securities	1,015,712	0.71
Corporate Bonds	3,764,808	6.83
Guaranteed Fixed Income	10,024	0.25
Short-Term Commercial Paper	388,064	0.01
Total Debt Investments	$ 14,551,873	4.83

(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, 2012 was $501,224,120 of which $341,027,671 were CMOs that are generally more sensitive to interest rate changes. The fair value of CMOs at June 30, 2011 was $694,999,254 of which $427,338,919 were CMOs that are generally more sensitive to interest rate changes.

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, 2012 and June 30, 2011 was as follows:

Foreign Currency-Denominated Investments

(Expressed in Thousands)

Currency	Total Fair Value June 30, 2012	Fixed Income	Equity	Cash
Australian Dollar	$ 285,935	$ 0	$ 285,556	$ 379
British Pound Sterling	945,058	36,073	908,427	558
Canadian Dollar	1,543,638	8,430	1,535,028	180
Danish Krone	76,389	0	76,373	16
Euro Currency	1,066,157	63,906	968,412	33,839
Hong Kong Dollar	106,932	0	106,775	157
Japanese Yen	1,145,912	212,575	927,031	6,306
New Israeli Shekel	14,916	0	14,819	97
New Zealand Dollar	6,410	0	6,337	73
Norwegian Krone	46,034	13,429	32,603	2
Singapore Dollar	67,835	0	67,753	82
Swedish Krona	93,496	0	93,286	210
Swiss Franc	318,426	0	317,464	962
Total	$ 5,717,138	$ 334,413	$ 5,339,864	$ 42,861

Currency	Total Fair Value June 30, 2011	Fixed Income	Equity	Cash
Australian Dollar	$ 284,181	$ 0	$ 284,011	$ 170
British Pound Sterling	1,042,358	67,057	975,026	275
Canadian Dollar	1,831,495	112,936	1,717,840	719
Danish Krone	69,323	0	69,163	160
Euro Currency	1,397,786	99,868	1,287,817	10,101
Hong Kong Dollar	134,900	0	134,886	14
Japanese Yen	1,308,285	320,374	984,129	3,782
New Israeli Shekel	11,348	0	11,348	0
New Zealand Dollar	4,964	0	4,945	19
Norwegian Krone	89,807	23,985	65,639	183
Singapore Dollar	76,919	0	76,899	20
Swedish Krona	111,190	0	110,983	207
Swiss Franc	321,680	0	321,112	568
Total	$ 6,684,236	$ 624,220	$ 6,043,798	$ 16,218

(continued)

Custodial Credit Risk – Custodial Credit Risk for deposits is the risk that in the event of a bank failure, the TCRS' deposits may not be returned to TCRS. The TCRS does not have an explicit policy with regards to Custodial Credit Risk for deposits. As of June 30, 2012 and June 30, 2011, the TCRS had uninsured and uncollateralized cash deposits of $42,861,324 and $16,218,307, respectively in foreign currency held by our master custodian, Northern Trust, in Northern Trust's name. These deposits were used for investments pending settlement.

Derivatives – The TCRS may buy or sell fixed income and equity index futures contracts for the purposes of making asset allocation changes in an efficient and cost effective manner and to improve liquidity. Gains (losses) on futures hedge losses (gains) produced by any deviation from the TCRS' target 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. At year end, the TCRS was under contract for fixed income and equity index futures and the resulting payable is reflected in the financial statements at fair value.

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. Foreign currency forward contracts expose the TCRS to foreign currency risk as they are denominated in foreign currency. Any unrealized gain on foreign currency forward contracts has been reflected in the financial statements as an investment. The notional amount of the foreign currency forward contracts has been reflected in the financial statements as a receivable and a payable. Any unrealized loss on foreign currency forward contracts has been included in the payable established for the contracts.

The TCRS is authorized to invest in To Be Announced (TBA) mortgage backed securities similar to the foreign currency forward contracts. The TCRS enters into agreements to purchase pools of mortgage backed securities prior to the actual security being identified. The TCRS will roll this agreement prior to settlement date to avoid taking delivery of the security. Any unrealized gain on TBA mortgage backed securities has been reflected in the financial statements as an investment. Any unrealized loss on TBA mortgage backed securities has been included in the payable established for the mortgages. The notional amounts of these agreements have been included in the financial statements as a receivable and a payable. The TCRS invests in these derivatives to adjust its exposure to mortgage coupon risk and to replicate the return on mortgage backed securities portfolios without actually purchasing the security.

The TCRS is authorized to enter into option contracts and any income earned on option contracts has been included in investment income in the financial statements. At year end, the TCRS was under contract for options and the resulting payable is reflected in the financial statements at fair value.

The fair value balances and notional amounts of derivative instruments outstanding at June 30, 2012 and June 30, 2011, classified by type, and the changes in fair value of derivative instrument types for the year ended as reported in the financial statements are as follows:

(continued)

Derivative Summary

(Expressed in Thousands)

	Changes in Fair Value		Fair Value at June 30, 2012			
	Financial Statement Classification	Amount	Financial Statement Classification	Amount	Notional Amount	Currency
Foreign Currency Forward Contracts		$ (360)		$ (360)	11,210	AUD
		(248)		(248)	18,710	EUR
		120		120	1,489,342	JPY
	Investment Income	$ (488)	Derivative Instruments Payable	$ (488)		
Futures Contracts	Investment Income	$ (5,479)	Derivative Instruments Payable	$ (2,393)	$1,520,747	
Options Contracts	Investment Income	$ (9)	Derivative Instruments	$ 2	$ 2	
TBA Mortgage Backed Securities	Investment Income	$ 648	Derivative Instruments	$ 648	$ 324,377	

	Changes in Fair Value		Fair Value at June 30, 2011			
	Financial Statement Classification	Amount	Financial Statement Classification	Amount	Notional Amount	Currency
Foreign Currency Forward Contracts		$ (121)		$ (121)	4,450	AUD
		(1,304)		(1,304)	65,000	CAD
		(953)		(953)	37,260	EUR
	Investment Income	$ (2,378)	Derivative Instruments Payable	$ (2,378)		
Futures Contracts	Investment Income	$ 123,632	Derivative Instruments Receivable	$ 3,883	$1,585,441	
Options Contracts	Investment Income	$ (17)	Derivative Instruments	$ 11	$ 11	
TBA Mortgage Backed Securities	Investment Income	$ (767)	Derivative Instruments Payable	$ (767)	$ 260,632	

The fair values of foreign currency forward contracts are estimated based on the present value of their estimated future cash flows. Futures, Options and TBA mortgage backed securities are exchange traded and their price is based on quoted market prices at year end. It is the TCRS policy to conduct derivative transactions through the custodian bank and high quality money center banks or brokerage firms. The credit risk of foreign currency forward contracts is managed by limiting the term of the forward contracts and restricting the trading to high quality banks. The credit risk of futures contracts is managed by maintaining a daily variation margin.

(continued)

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 37 basis points on the $350 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, 75 basis points during times when either Moody's or Standard and Poor's has assigned ratings of Aa and AA respectively, or 100 basis points during times when either Moody's or Standard and Poor's has assigned ratings lower than Aa and AA 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, 2012 the TCRS had unfunded commitments of $113,088,500 for pending real estate purchases. Subsequent to that time, the TCRS decided to not close on $74,588,500 of the June 30, 2012 commitment amount. At June 30, 2011 the TCRS did not have any commitments for pending real estate purchases.

Alternative Investments – The TCRS had unfunded commitments of $581.3 million and $324.1 million in limited partnerships as of June 30, 2012 and June 30, 2011, respectively.

E. FUNDED STATUS AND FUNDING PROGRESS

The funded status of each plan as of July 1, 2011, the most recent actuarial valuation date, is as follows (dollar amounts in thousands):

SCHEDULES OF FUNDING PROGRESS
(Expressed in Thousands)

	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	$ 30,118,178	$ 32,707,625	$ 2,589,447	92.08%	$ 6,058,348	42.74%
PSPP	$ 6,562,604	$ 7,361,707	$ 799,103	89.15%	$ 2,354,939	33.93%

The TCRS uses the Frozen Entry Age actuarial cost method to calculate the annual required contribution (ARC). Effective July 1, 2011, the TCRS reestablished unfunded accrued liabilities for all groups.

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.

(continued)

Additional information as of the latest actuarial valuation follows:

	SETHEEPP	PSPP
Valuation Date	July 1, 2011	July 1, 2011
Actuarial cost method	Frozen Entry Age	Frozen Entry Age
Amortization method	Level Dollar	Level Dollar
Remaining amortization period	Teachers - 6 years; State - 9 years; closed period	9 years weighted average; (1) closed period
Asset valuation method	5-year moving market average for FYE on or before June 30, 2007	5-year moving market average for FYE on or before June 30, 2007
	10-year moving market average for FYE after June 30, 2007	10-year moving market average for FYE after June 30, 2007
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	2.50%	2.50%
Increase in Social Security wage base	3.50%	3.50%

(1) An actuarial valuation is performed on each political subdivision participating in the Political Subdivision Pension Plan. Each political subdivision selects the period over which their unfunded accrued liability is amortized, not to exceed 30 years. The weighted average amortization period for all plans is presented above.

(2) Uniform rate that approximates the effect of a graded salary scale.

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	7/1/2011	$ 30,118,178	$ 32,707,625	$ 2,589,447	92.08%	$ 6,058,348	42.74%
	7/1/2009	$ 26,335,199	$ 29,054,966	$ 2,719,767	90.64%	$ 6,054,528	44.92%
	7/1/2007	$ 26,214,995	$ 27,240,151	$1,025,156	96.24%	$ 5,742,866	17.85%
PSPP	7/1/2011	$ 6,562,604	$ 7,361,707	$ 799,103	89.15%	$ 2,354,939	33.93%
	7/1/2009	$ 5,304,455	$ 6,143,775	$ 839,320	86.34%	$ 2,282,082	36.78%
	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 multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

SCHEDULES OF EMPLOYER CONTRIBUTIONS

Expressed in Thousands

	SETHEEPP		PSPP	
Year Ended June 30	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
2012	$ 731,352	100.00%	$ 271,361	100.00%
2011	721,759	100.00%	273,781	100.00%
2010	578,403	100.00%	258,324	100.00%
2009	583,985	100.00%	252,926	100.00%
2008	593,412	100.00%	244,847	100.00%
2007	562,729	100.00%	231,699	100.00%

An actuarial valuation of the TCRS is performed every two years with the next valuation scheduled to be effective July 1, 2013.