AUDIT REPORT

Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 2013

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee
Comptroller
of the Treasury

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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January 30, 2014

Members of the General Assembly
Members of the Board of Trustees
The Honorable David H. Lillard, Jr., Treasurer

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Consolidated Retirement System for the year ended June 30, 2013. You will note from the independent auditor's report that an unmodified 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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Audit Report
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2013

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Financial and Compliance Audit

Tennessee Consolidated Retirement System

For the Year Ended June 30, 2013

Opinion on the Financial Statements

The opinion on the financial statements is unmodified.

Audit Findings

The audit report contains no findings.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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NASHVILLE, TENNESSEE 37243-1402

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Independent Auditor's Report

Members of the General Assembly
Members of the Board of Trustees
The Honorable David H. Lillard, Jr., Treasurer

Report on the Financial Statements

We have audited the accompanying financial statements of the Tennessee Consolidated Retirement System, pension trust funds of the State of Tennessee, as of and for the years ended June 30, 2013, and June 30, 2012, and the related notes to the financial statements, which collectively comprise the Tennessee Consolidated Retirement System's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting principles used and reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit 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.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net position of the Tennessee Consolidated Retirement System as of June 30, 2013, and June 30, 2012, and the changes in plan net position thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

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, 2013, and June 30, 2012, 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. Our opinion is not modified with respect to this matter.

As discussed in Note C, the financial statements of the Tennessee Consolidated Retirement System include investments valued at $2,112,637,040 (5.62 percent of net position) whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners. Our opinion is not modified with respect to this matter.

Other Matter - Required Supplementary Information

Accounting principles generally accepted in the United States of America require that management's discussion and analysis on pages 5 through 9 and the schedules of funding progress and employer contributions on page 27 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, which 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 our 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.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 12, 2013, 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, 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 *Government Auditing Standards* in considering the Tennessee Consolidated Retirement System's internal control over financial reporting and compliance.

Deborah V. Loveless

Deborah V. Loveless, CPA
Director
December 12, 2013

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, 2013 and June 30, 2012. 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 position (total assets minus total liabilities) of the TCRS at June 30, 2013 was $37.6 billion, increasing $2.7 billion (7.6 percent) from the plan net position at June 30, 2012. The net position is restricted for 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 2013 totaled $1,278,982,124 an increase of one percent compared to fiscal year 2012.

- Net investment income for fiscal year 2013 was $3,344,589,259. During fiscal year 2013, the TCRS received an investment return on its portfolio of 9.9 percent, compared to 5.6 percent for fiscal year 2012.

- Total benefits and refunds paid for fiscal year 2013 were $1,963,260,297 – representing an increase of 8.5 percent over fiscal year 2012 total benefits and refunds paid of $1,809,901,340.

- Total administrative expenses for fiscal year 2013 were $8,178,696 – representing an increase of 14.1 percent from fiscal year 2012 administrative expenses of $7,166,606.

OVERVIEW OF THE FINANCIAL STATEMENTS

The TCRS financial statements consist of the *Statement of Plan Net Position* (on pages 10 through 11), the *Statement of Changes in Plan Net Position* (on pages 12 through 13), and the *Notes to the Financial Statements* (on pages 14 through 26). In addition, *Required Supplementary Information* is presented, which includes this *Management's Discussion and Analysis,* as well as the schedules on page 27.

The *Statement of Plan Net Position* and the *Statement of Changes in Plan Net Position* report information about the plan net position (total assets in excess of total liabilities) as of the end of the fiscal year and the changes in the plan net position 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 Position*, or net position restricted 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 Position* 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 position 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.

(continued)

ANALYSIS OF ASSETS, LIABILITIES AND PLAN NET POSITION

At June 30, 2013, the TCRS had plan net position (total assets in excess of total liabilities) of $37.6 billion, an increase of $2.7 billion (7.6 percent) from $34.9 billion at June 30, 2012, following the fiscal year 2012 increase of nearly $1.2 billion (3.7 percent) from the $33.7 billion of plan net position as of June 30, 2011. 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 position for the past three fiscal years follows:

PLAN NET POSITION

	June 30, 2013	June 30, 2012	FY13 - FY12 Percentage Change	June 30, 2011	FY12 - FY11 Percentage Change
ASSETS					
Cash and cash equivalents	$732,917,328	$426,627,425	71.8 %	$414,134,562	3.0 %
Member and employer receivables	105,368,164	107,108,579	(1.6) %	99,604,471	7.5 %
Investment receivables	1,851,534,173	1,044,714,969	77.2 %	1,431,331,905	(27.0) %
Short-term securities	74,880,166	19,781,452	278.5 %	0	- - %
Long-term investments	36,550,793,912	34,272,630,084	6.6 %	33,220,879,536	3.2 %
Capital assets	21,887,170	11,426,938	91.5 %	1,896,671	502.5 %
TOTAL ASSETS	39,337,380,913	35,882,289,447	9.6 %	35,167,847,145	2.0 %
LIABILITIES					
Death benefits, refunds and other payables	50,816,303	10,193,417	398.5 %	8,544,407	19.3 %
Investment payables	1,721,659,248	959,323,058	79.5 %	1,495,994,494	(35.9) %
TOTAL LIABILITIES	1,772,475,551	969,516,475	82.8 %	1,504,538,901	(35.6) %
NET POSITION RESTRICTED FOR PENSION BENEFITS	$37,564,905,362	$34,912,772,972	7.6 %	$33,663,308,244	3.7 %

ANALYSIS OF REVENUES AND EXPENSES

Employer contribution rates for the TCRS changed during fiscal year 2013 resulting in a 1.0 percent increase in contributions from fiscal year 2012 to fiscal year 2013. 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. Gross investment income for fiscal year 2013 increased $1.5 billion (84.5 percent) over fiscal year 2012 compared to fiscal year 2012 when gross investment income decreased $3.7 billion (67.0 percent) from investment income for fiscal year 2011.

Investment expenses for fiscal year 2013 increased $5.1 million (15.9 percent) due to the increase in portfolio market value during the year. 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.

Total benefits and refunds paid during the year ended June 30, 2013 were $1,963,260,297, an increase of 8.5 percent over fiscal year 2012 total benefits and refunds paid which can be attributed to an increase in retirees and a 3.0% cost of living adjustment. 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. The increase in benefit expenses for fiscal year 2012 is

(continued)

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. 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.

Administrative expenses for the year ended June 30, 2013 were $8,178,696, an increase of 14.1 percent from fiscal year 2012 administrative expenses. The increase was primarily due to the first phase of the new pension administration system being implemented in the last quarter of fiscal year 2012. The first full year of amortization of software development costs was recognized in fiscal year 2013. 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.

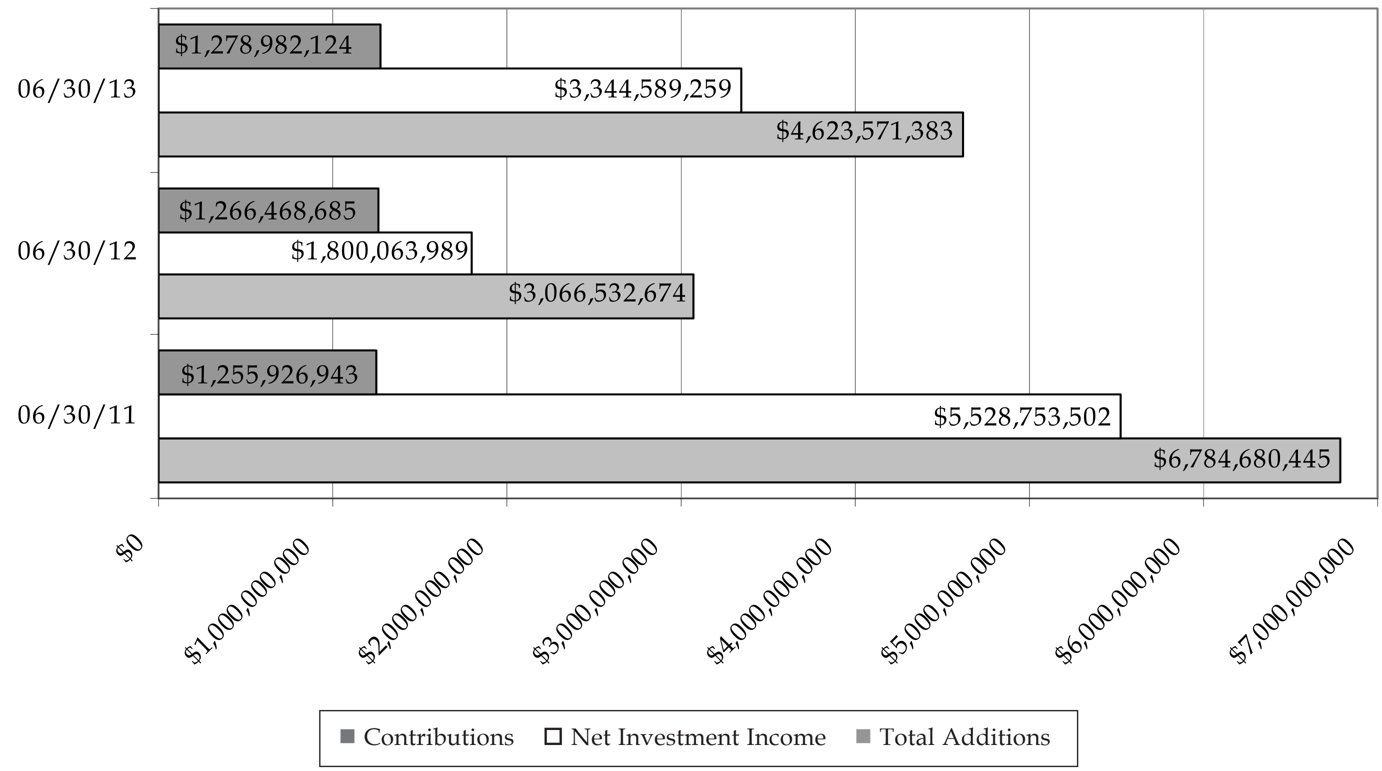
Condensed financial information comparing the TCRS' revenues and expenses for the past three fiscal years follows:

CHANGES IN PLAN NET POSITION

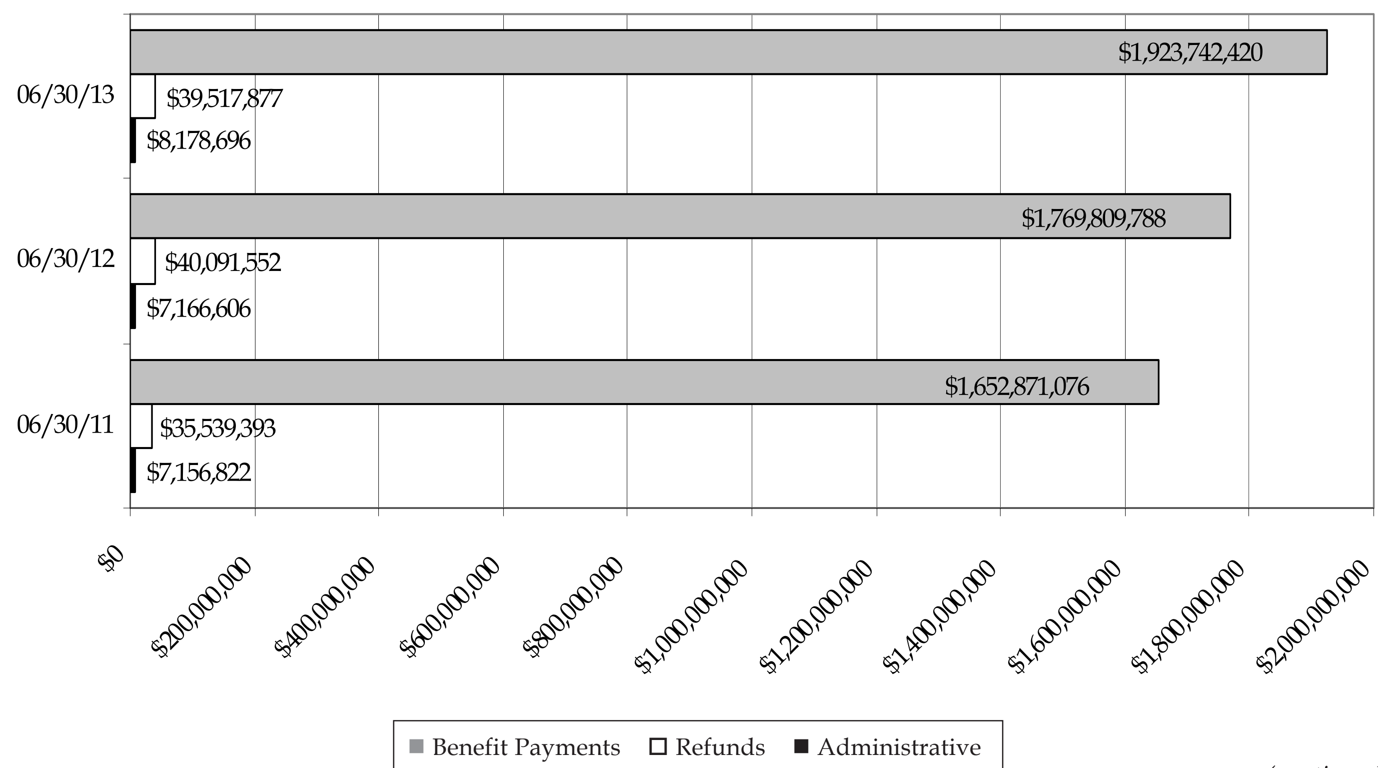
	For the Year Ended June 30, 2013	For the Year Ended June 30, 2012	FY13 - FY12 Percentage Change	For the Year Ended June 30, 2011	FY12 - FY11 Percentage Change
ADDITIONS					
Contributions	$ 1,278,982,124	$ 1,266,468,685	1.0 %	$ 1,255,926,943	0.8 %
Investment income					
Net appreciation in fair value of investments	2,334,383,940	825,366,874	182.8 %	4,597,653,001	(82.0) %
Interest, dividends and other investment income	1,047,724,725	1,007,076,475	4.0 %	963,313,744	4.5 %
Less: Investment expense	(37,519,406)	(32,379,360)	15.9 %	(32,213,243)	0.5 %
Net investment income	3,344,589,259	1,800,063,989	85.8 %	5,528,753,502	(67.4) %
TOTAL ADDITIONS	4,623,571,383	3,066,532,674	50.8 %	6,784,680,445	(54.8) %
DEDUCTIONS					
Annuity benefits	1,918,686,339	1,763,605,581	8.8 %	1,647,372,937	7.1 %
Death benefits	5,056,081	6,204,207	(18.5) %	5,498,139	12.8 %
Refunds	39,517,877	40,091,552	(1.4) %	35,539,393	12.8 %
Administrative expenses	8,178,696	7,166,606	14.1 %	7,156,822	0.1 %
TOTAL DEDUCTIONS	1,971,438,993	1,817,067,946	8.5 %	1,695,567,291	7.2 %
NET INCREASE	2,652,132,390	1,249,464,728	112.3 %	5,089,113,154	(75.4) %
NET POSITION RESTRICTED FOR PENSION BENEFITS					
BEGINNING OF YEAR	34,912,772,972	33,663,308,244	3.7 %	28,574,195,090	17.8 %
END OF YEAR	$ 37,564,905,362	$ 34,912,772,972	7.6 %	$ 33,663,308,244	3.7 %

(continued)

REVENUES BY TYPE



EXPENSES BY TYPE



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ECONOMIC FACTORS, FUTURE FUNDING PROVISIONS, OVERALL OUTLOOK

For the year ended June 30, 2013 the portfolio delivered a return of 9.92 percent which exceeded the actuarial required return by 2.42 percent. The return of the portfolio for the 2013 fiscal year was satisfying on an absolute basis, but it underperformed most peers in a reversal of its superior relative performance for the 2012 fiscal year. The primary driver of the change in relative performance was the lower risk strategic posture of the fund versus peers which led it to exceptional results in 2012 and then commensurately weaker relative results in 2013.

The strong results for risky assets in the 2013 fiscal year were exemplified by the 20.39 percent return for the U.S. Equity portfolio and the 17.90 percent return for the International Equity portfolio. In a reversal from the 2012 fiscal year, bond returns were poor and the U.S. Fixed Income portfolio lost a modest 0.81 percent versus a gain of 15.63 percent in the prior year. Treasury Inflation Protected Securities (TIPS) lost 5.28 percent which was also a reversal of the 12.22 percent gain they delivered in 2012.

The investment environment in 2013 was defined by a move into higher risk assets from lower risk assets. Investors sought to escape rising interest rates and also aimed to participate in stronger future economic growth than previously anticipated. Actual economic growth rates and corporate earnings were muted, which means that valuation expansion was the key driver of equity returns.

An actuarial valuation was performed as of July 1, 2011. The employer contribution rates determined in this valuation are effective July 1, 2012 through June 30, 2014. The required contributions to the plan increased primarily due to (1) investment returns being less than the actuarial earnings assumption and (2) members and retirees living longer. An actuarial experience study based on data as of June 30, 2012 was completed and adopted by the Board of Trustees during fiscal year 2013.

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 and second phases of Concord have been implemented by the end of fiscal year 2013. Software development costs have been capitalized and are being amortized over the useful life of the system as each phase is implemented. The third and final phase will be implemented during fiscal year 2014.

During the 2013 legislative session, a new pension plan for state employees, higher education and K-12 public school teachers hired on or after June 30, 2014 was enacted into law. Members and retirees currently enrolled in TCRS will remain in the legacy plan. The new hybrid plan contains elements of a defined benefit plan and a defined contribution plan. The goals of the new plan were to provide a sufficient retirement benefit to members, a long term sustainable pension plan, and an affordable plan to employers. The new plan contains provisions to control employer cost and unfunded liability.

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 Position
June 30, 2013 and June 30, 2012

Expressed in Thousands	**State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)**	**Political Subdivisions Pension Plan (PSPP)**
ASSETS		
Cash and cash equivalents	$ 594,870	$ 138,047
Receivables		
Member receivable	21,879	5,490
Employer receivable	57,248	20,752
Accrued interest receivable	73,005	16,942
Accrued dividends receivable	48,110	11,164
Real estate income receivable	1,129	262
Derivative instruments receivable	837,403	194,326
Investments sold	543,151	126,042
Total receivables	1,581,925	374,978
Investments, at fair value		
Short-term securities	60,776	14,104
Government securities	6,801,041	1,578,237
Corporate securities	4,075,011	945,639
Corporate stocks	17,075,653	3,962,545
Derivative instruments	25	6
Private equities	221,369	51,370
Real estate	1,493,353	346,545
Total investments	29,727,228	6,898,446
Capital assets (net)	17,765	4,122
TOTAL ASSETS	31,921,788	7,415,593
LIABILITIES		
Accounts payable		
Death benefits and refunds payable	1,338	1,369
Retiree insurance premium payable	6,285	1,459
Other	54	0
Investments purchased	544,371	126,326
Derivative instruments payable	846,267	196,383
Due to other funds	32,719	7,592
Other investment payables	6,747	1,566
TOTAL LIABILITIES	1,437,781	334,695
NET POSITION RESTRICTED FOR PENSION BENEFITS	$ 30,484,007	$ 7,080,898

See accompanying Notes to the Financial Statements.

(continued)

(CONTINUED)

June 30, 2013 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2012 Total
$ 732,917	$ 348,330	$ 78,297	$ 426,627
27,369	21,313	6,001	27,314
78,000	56,430	23,364	79,794
89,947	79,795	17,936	97,731
59,274	42,658	9,588	52,246
1,391	680	153	833
1,031,729	319,335	71,779	391,114
669,193	410,516	92,275	502,791
1,956,903	930,727	221,096	1,151,823
74,880	16,152	3,630	19,782
8,379,278	6,736,847	1,514,288	8,251,135
5,020,650	4,627,801	1,040,222	5,668,023
21,038,198	15,374,082	3,455,739	18,829,821
31	531	119	650
272,739	142,025	31,924	173,949
1,839,898	1,101,467	247,585	1,349,052
36,625,674	27,998,905	6,293,507	34,292,412
21,887	9,330	2,097	11,427
39,337,381	29,287,292	6,594,997	35,882,289
2,707	1,475	1,537	3,012
7,744	5,678	1,276	6,954
54	227	0	227
670,697	467,947	105,184	573,131
1,042,650	308,316	69,303	377,619
40,311	0	0	0
8,313	7,000	1,573	8,573
1,772,476	790,643	178,873	969,516
$ 37,564,905	$ 28,496,649	$ 6,416,124	$ 34,912,773

STATEMENTS OF CHANGES IN PLAN NET POSITION
FOR THE YEARS ENDED JUNE 30, 2013 AND JUNE 30, 2012

Expressed in Thousands	**State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)**	**Political Subdivisions Pension Plan (PSPP)**
ADDITIONS		
Contributions		
Member contributions	$ 196,792	$ 71,765
Employer contributions	735,886	274,539
Total contributions	932,678	346,304
Investment income		
Net appreciation in fair value of investments	1,899,653	434,731
Interest	380,175	87,002
Dividends	402,619	92,138
Real estate income, net of operating expenses	69,813	15,977
Total investment income	2,752,260	629,848
Less: Investment expense	(30,532)	(6,987)
Net investment income	2,721,728	622,861
TOTAL ADDITIONS	3,654,406	969,165
DEDUCTIONS		
Annuity benefits	1,639,031	279,655
Death benefits	3,051	2,006
Refunds	19,520	19,998
Administrative expense	5,446	2,732
TOTAL DEDUCTIONS	1,667,048	304,391
NET INCREASE	1,987,358	664,774
NET POSITION RESTRICTED FOR PENSION BENEFITS		
BEGINNING OF YEAR	28,496,649	6,416,124
END OF YEAR	$ 30,484,007	$ 7,080,898

See accompanying Notes to the Financial Statements.

(continued)

For the Year Ended June 30, 2013 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 2012 Total
$ 268,557	$ 194,180	$ 69,576	$ 263,756
1,010,425	731,352	271,361	1,002,713
1,278,982	925,532	340,937	1,266,469
2,334,384	675,639	149,728	825,367
467,177	414,344	91,816	506,160
494,757	353,064	78,237	431,301
85,790	56,987	12,628	69,615
3,382,108	1,500,034	332,409	1,832,443
(37,519)	(26,384)	(5,995)	(32,379)
3,344,589	1,473,650	326,414	1,800,064
4,623,571	2,399,182	667,351	3,066,533
1,918,686	1,509,512	254,093	1,763,605
5,057	4,515	1,689	6,204
39,518	22,575	17,517	40,092
8,178	4,751	2,416	7,167
1,971,439	1,541,353	275,715	1,817,068
2,652,132	857,829	391,636	1,249,465
34,912,773	27,638,820	6,024,488	33,663,308
$ 37,564,905	$ 28,496,649	$ 6,416,124	$ 34,912,773

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 two phases 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, 2012 and June 30, 2013 was valued at $9,749,457 and $10,319,868, respectively. 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 and second phases of the computer software had been implemented at June 30, 2013 and amortization has been initiated. The computer software was valued at $1,677,480 and $11,567,302 at June 30, 2012 and June 30, 2013, respectively. Amortization expense was $43,012 in fiscal year 2012 and $430,046 in fiscal year 2013.

(continued)

6. **Adoption of New Accounting Pronouncement -** The TCRS implemented the Governmental Accounting Standards Board's Statement 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, during the year ended June 30, 2013. The effect on the TCRS was the renaming of the residual of all other elements in the statement of financial position as net position, rather than net assets.

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 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 position of the plan is 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

(continued)

Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 2013, the plan's Member Reserve and Employer Reserve were fully funded with balances of $3.76 billion and $26.73 billion, respectively. 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.

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 position of the plan is 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, 2013, the plan's Member Reserve and Employer Reserve were fully funded with balances of $1.2 billion and $5.88 billion, respectively. 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.

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 ten percent (10 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, 2013 and June 30, 2012, the TCRS had the following investments:

(continued)

Investments

(Expressed in Thousands)

2013

Investment Type	Fair Value as of June 30, 2013	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	$ 201,383		$ 18,065	$178,317									$ 5,001
U.S. Govt. Inflation Indexed	2,796,073	$2,796,073											
U.S. Govt. Treasuries, Notes and Bonds	1,672,391	1,672,391											
U.S. Govt. Asset Backed	56,918	56,918											
Municipal Bonds	149,678		2,197	95,804	$ 51,677								
Govt. Mortgage Backed	3,485,764	412,972		12,739									3,060,053 (2)
Comm. Mortgage Backed	398,696		328,998	67,111		$ 2,587							
Corporate CMO's	160,649				544			$ 1,335	$104,360	$24,389	$30,021		
Corporate Bonds	3,807,694		64,851	78,132	1,013,124	2,267,916	$336,402	17,648					29,621
Corporate Asset Backed	590,035		378,969	97,032	43,287	40,635	15,276				7,837		6,999
Non-U.S. Govt./Sovereign	17,068					17,068							
Short-Term Comm. Paper	644,339											$644,339	
Short-Term Bills and Notes	116,334												116,334
Total Debt Investments	$14,097,022	$4,938,354	$793,080	$529,135	$1,108,632	$2,328,206	$351,678	$18,983	$104,360	$24,389	$37,858	$644,339	$3,218,008
Other Investments													
U.S. Equity	$13,386,439												
Non-U.S. Equity	7,711,681												
Derivatives	31												
Real Estate	1,839,898												
Private Equities	272,739												
Money Market Funds (not rated)	3,007												
Escrow Claim	3,656												
Total Other Investments	$23,217,451												
Total Investments	$37,314,473												
Less: Short-Term Investments Classified as Cash Equivalents on the Statements of Plan Net Position	(688,800)												
Total Investments as Shown on Statements of Plan Net Position	$36,625,673												

(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)

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 Position	(402,718)												
Total Investments as Shown on Statements of Plan Net Position	$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)

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, 2013 and June 30, 2012 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 position, in organizations representing five percent or more of plan net position, 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, 2013		June 30, 2012	
Issuer Organization	**Fair Value**	**Percentage**	**Fair Value**	**Percentage**
Federal National Mortgage Association	$2,131,504,198	5.67%	$1,932,517,086	5.54%

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, 2013 and June 30, 2012.

Debt Investments

(Expressed in Thousands)

Investment Type	Fair Value as of June 30, 2013	Effective Duration (years)
Debt Investments		
Government Agencies	$201,383	8.64
Government Bonds	1,689,459	13.10
Government Inflation Indexed	2,796,073	8.64
Government Mortgage Backed	3,485,765	4.62
Government Asset Backed	56,918	5.48
Municipal Bonds	149,678	10.02
Collateralized Mortgage Obligations (CMO)	160,649	1.73
Commercial Mortgage Backed	398,696	2.00
Corporate Asset Backed Securities	590,035	1.60
Corporate Bonds	3,807,694	8.16
Short Term Commercial Paper	644,339	0.03
Short Term Bills & Notes	116,334	0.63
Total Debt Investments	$14,097,023	7.03

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

(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, 2013 was $559,344,004 of which $326,396,099 were CMOs that are generally more sensitive to interest rate changes. 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.

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, 2013 and June 30, 2012 was as follows:

Foreign Currency-Denominated Investments

(Expressed in Thousands)

Currency	Total Fair Value June 30, 2013	Fixed Income	Equity	Cash
Australian Dollar	$ 281,116	$ 0	$ 280,971	$ 145
British Pound Sterling	917,788	0	916,850	938
Canadian Dollar	1,553,299	1,467	1,548,611	3,221
Danish Krone	78,322	0	78,304	18
Euro Currency	1,179,772	0	1,154,129	25,643
Hong Kong Dollar	127,953	0	127,700	253
Japanese Yen	1,152,368	0	1,144,096	8,272
New Israeli Shekel	14,616	0	14,571	45
New Zealand Dollar	7,434	0	7,373	61
Norwegian Krone	45,473	0	45,351	122
Singapore Dollar	85,610	0	85,360	250
Swedish Krona	111,727	0	111,672	55
Swiss Franc	412,766	0	412,751	15
Total	$ 5,968,244	$ 1,467	$ 5,927,739	$ 39,038

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

(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, 2013 and June 30, 2012, the TCRS had uninsured and uncollateralized cash deposits of $39,038,045 and $42,861,324, 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, 2013 and June 30, 2012, 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, 2013			
	Financial Statement Classification	Amount	Financial Statement Classification	Amount	Notional Amount	Currency
Foreign Currency Forward Contracts		$ (29)		$ (29)	35,685	CHF
		23		23	21,212	DKK
		183		183	25,750	EUR
		286		286	8,212	GBP
		(12)		(12)	0	HKD
		(906)		(906)	14,899,846	JPY
		10		10	0	SGD
	Investment Income	$ (445)	Derivative Instruments Payable	$ (445)		
Futures Contracts	Investment Income	$ (51,331)	Derivative Instruments Receivable	$ 6,153	$ 1,248,457	
Options Contracts	Investment Income	$ (221)	Derivative Instruments	$ 31	$ 31	
TBA Mortgage Backed Securities		$ (10,476)	Derivative Instruments Payable	$ (10,476)	$ 473,078	

	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		$ 648	Derivative Instruments	$ 648	$ 324,377	

(continued)

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.

Alternative Investments - The TCRS has investments in private equity funds and real estate with an estimated fair value of $2,112,637,040 and $1,523,000,878 at June 30, 2013 and June 30, 2012, respectively. Because these investments are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investments existed, and such differences could be material.

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 25 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, 40 basis points during times when either Moody's or Standard and Poor's has assigned ratings of Aa and AA respectively, or 75 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, 2013 the TCRS had unfunded commitments of $70,077,563 for pending real estate purchases. At June 30, 2012 the TCRS had unfunded commitments of $113,088,500 for pending real estate purchases.

Alternative Investments – The TCRS had unfunded commitments of $773.9 million and $581.3 million in limited partnerships as of June 30, 2013 and June 30, 2012, 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%

(continued)

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.

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
2013	$ 735,886	100.00%	$ 274,539	100.00%
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%

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

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Independent Auditor's 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*

Members of the General Assembly
Members of the Board of Trustees
The Honorable David H. Lillard, Jr., Treasurer

We have audited the financial statements of the Tennessee Consolidated Retirement System as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the Tennessee Consolidated Retirement System's basic financial statements, and have issued our report thereon dated December 12, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Tennessee Consolidated Retirement System's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of the Tennessee Consolidated Retirement System's internal control.

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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

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

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Deborah V. Loveless

Deborah V. Loveless, CPA
Director
December 12, 2013