AUDIT REPORT

Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 2014

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee Comptroller of the Treasury

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February 12, 2015

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, 2014. 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 disclosed a deficiency, which is detailed in the Finding and Recommendation section of this report. The agency's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

Deborah V. Loveless

Deborah V. Loveless, CPA
Director

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Audit Report

Tennessee Consolidated Retirement System

For the Year Ended June 30, 2014

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Opinion on the Financial Statements

The opinion on the financial statements is unmodified.

Audit Finding

The Tennessee Consolidated Retirement System does not have sufficient controls to ensure the accuracy of census data received from employers

The Tennessee Consolidated Retirement System does not have procedures to verify underlying payroll records of participating employers in the cost-sharing pension plan.

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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 year ended June 30, 2014, 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 audit. 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. 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 fiduciary net position of the Tennessee Consolidated Retirement System Fund as of June 30, 2014, and the changes in fiduciary net position thereof for the year 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, 2014, and the changes in financial position for the years then ended in accordance 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 $3,379,369,542 (7.88 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.

As discussed in Note A.6, the Tennessee Consolidated Retirement System implemented Governmental Accounting Standards Board Statement 67, *Financial Reporting for Pension Plans*, during the year ended June 30, 2014. 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 the management's discussion and analysis on pages 5 through 9 and the schedule of changes in net pension liability, schedule of net pension liability, schedule of pension plan contributions, schedule of investment returns, and notes to the required supplementary information beginning on page 24 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 19, 2014, 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 19, 2014

MANAGEMENT'S DISCUSSION AND ANALYSIS

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 year ended June 30, 2014. 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, 2014 was $42.9 billion, increasing $5.3 billion (14.2 percent) from the plan net position at June 30, 2013. The net position is restricted for future benefit obligations. This increase in plan net position is mainly attributable to net investment income where the money-weighted rate of return was 16.5 percent. The strong rate of return was driven by domestic equity returns of more than 25 percent and international equity returns of more than 20 percent.

- Net investment income for fiscal year 2014 was $6.16 billion. During fiscal year 2014, the TCRS received a time-weighted rate of return on its portfolio of 16.7 percent, compared to 9.9 percent for fiscal year 2013.

- Based on the latest actuarial valuation as of July 1, 2013, the overall funded ratio for all participating employers within TCRS is 93.6% on an actuarial value of assets basis. The funded ratio would be 89.6% using market value of assets.

- Contribution revenue for fiscal year 2014 totaled $1.31 billion, representing an increase of 2.1 percent compared to fiscal year 2013. Since the actuarially required employer contribution rate did not change, this increase is largely attributable to an increase in the member salary base.

- Total benefits and refunds paid for fiscal year 2014 were $2.11 billion, representing an increase of 7.7 percent over fiscal year 2013 total benefits and refunds paid of $1.96 billion. The growth is due to retiring members' benefits exceeding the benefits of long-term retired members whose benefits ceased due to death.

- Total administrative expenses for fiscal year 2014 were $9.96 million, representing an increase of 21.7 percent from fiscal year 2013 administrative expenses of $8.18 million. Administrative expenses represent less than one-half of one percent of the total deductions from the TCRS. Administrative expenses represent two basis points (two one-hundredth of one percent) of the average of the beginning and ending net position.

OVERVIEW OF THE FINANCIAL STATEMENTS

The TCRS financial statements, which consist of the *Statement of Fiduciary Net Position*, the *Statement of Changes in Fiduciary Net Position*, and the *Notes to the Financial Statements*. In addition, *Required Supplementary Information* and the *Notes to the Required Supplementary Information* are presented, which includes this *Management's Discussion and Analysis*. These financial statements, notes to the financial statements and required supplementary information were prepared in conformity with GASB Statement No. 67, Financial Reporting for Pensions Plans. Collectively, this information presents the combined net position held in trust for pensions for each of the plans administered by TCRS as of June 30, 2014.

The *Statement of Fiduciary Net Position* and the *Statement of Changes in Fiduciary Net Position* report information about the fiduciary net position (total assets in excess of total liabilities) as of the end of the fiscal year and the changes in the fiduciary 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 Fiduciary Net Position*, or net position restricted for pensions, provides a measurement of the financial

(continued)

position of the TCRS as of the end of the fiscal year. The *Statement of Changes in Fiduciary 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 fiduciary net position of the TCRS are one indicator of whether the system's financial health is improving or deteriorating. The change in fiduciary net position is not the sole basis for evaluating the system's financial health. Other factors include, but are not limited to, actuarial data, investment performance, demographic data, and actuarial assumptions.

The *Notes to the Financial Statements* are 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.

ANALYSIS OF ASSETS, LIABILITIES AND PLAN NET POSITION

At June 30, 2014, the TCRS had net position (total assets in excess of total liabilities) of $42.9 billion, an increase of $5.3 billion (14.2 percent) from $37.6 billion at June 30, 2013. 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 increased only slightly from June 30, 2013. Condensed financial information comparing the TCRS' fiduciary net position for the past two fiscal years follows.

PLAN NET POSITION

	June 30, 2014	June 30, 2013	Increase (Decrease) Amount	Percentage Change
ASSETS				
Cash and cash equivalents	$ 279,661,206	$ 732,917,328	$ (453,256,122)	(61.8) %
Cash collateral on loaned securities	3,611,068,696	0	3,611,068,696	--
Member and employer receivables	107,700,566	105,368,164	2,332,402	2.2 %
Investment receivables	1,053,100,529	1,851,534,173	(798,433,644)	(43.1) %
Short-term securities	137,164,148	74,880,166	62,283,982	83.2 %
Long-term investments	42,292,975,604	36,550,793,912	5,742,181,692	15.7 %
Capital assets	28,341,604	21,887,170	6,454,434	29.5 %
TOTAL ASSETS	47,510,012,353	39,337,380,913	8,172,631,440	20.8 %
LIABILITIES				
Death benefits, refunds and other payables	14,105,043	50,816,303	(36,711,260)	(72.2) %
Investment payables	979,681,119	1,721,659,248	(741,978,129)	(43.1) %
Securities Lending collateral	3,611,068,696	0	3,611,068,696	--
TOTAL LIABILITIES	4,604,854,858	1,772,475,551	2,832,379,307	159.8 %
NET POSITION RESTRICTED FOR PENSIONS	$ 42,905,157,495	$ 37,564,905,362	$ 5,340,252,133	14.2 %

(continued)

ANALYSIS OF REVENUES AND EXPENSES

Employer contribution rates for the TCRS did not change during fiscal year 2014; therefore, the change of 2.1 percent in contributions from fiscal year 2013 to fiscal year 2014 was due to changes in reported salary of participants and any increase in the number of participants. Gross investment income for fiscal year 2014 increased $2.8 billion (83.4 percent) over fiscal year 2013.

Investment expenses for fiscal year 2014 totaled $43.1 million for a 14.9 percent increase over fiscal year 2013. These expenses were split between portfolio management investment expenses of $42.2 million and $934 thousand in expenses attributed to the securities lending program that was initiated during the 2014 fiscal year. The TCRS investment portfolio earned a time-weighted rate of return of 16.7 percent and net investment income of $6.2 billion.

Total benefits paid during the year ended June 30, 2014 were $2.06 billion, an increase of 7.1 percent over fiscal year 2013 total benefits which can be attributed to an increase in the number of retirees and a 1.7% cost of living adjustment given in July 2013. Total refunds paid increased $14.5 million, an increase of 36.8 percent, in fiscal year 2014 from fiscal year 2013 and were attributed to the change in structure of two large employers where the members of these employers chose to withdraw their funds when they were not rehired by the new employer.

Administrative expenses for the year ended June 30, 2014 were $9.96 million, an increase of 21.7 percent from fiscal year 2013 administrative expenses. The increase was primarily due to the first and second phases of the new pension administration system being implemented in the last quarter of fiscal year 2012 resulting in the amortization expense of the software development costs of $1.2 million for the year. Software development costs are capitalized and amortized over the ten year expected life of this capital asset.

REVENUE BY TYPE
(Expressed in Thousands)

	Year Ended June 30, 2013		Year Ended June 30, 2014	
	Amount	Percentage of Total	Amount	Percentage of Total
Employee Contributions	$ 268,557	5.8%	$ 270,551	3.6%
Employer Contributions	1,010,425	21.9%	1,034,694	13.9%
Net Investment Income	3,344,589	72.3%	6,159,900	82.5%
Total	$ 4,623,571	100.0%	$ 7,465,145	100.0%

EXPENDITURES BY TYPE
(Expressed in Thousands)

	Year Ended June 30, 2013		Year Ended June 30, 2014	
	Amount	Percentage of Total	Amount	Percentage of Total
Benefit Payments	$ 1,923,742	97.6%	$ 2,060,890	97.0%
Refunds	39,518	2.0%	54,046	2.5%
Administrative	8,179	0.4%	9,957	0.5%
Total	$ 1,971,439	100.0%	$ 2,124,893	100.0%

(continued)

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

CHANGES IN FIDUCIARY NET POSITION

	For the Year Ended June 30, 2014	For the Year Ended June 30, 2013	Increase (Decrease) Amount	Percentage Change
ADDITIONS				
Contributions	$ 1,305,245,165	$ 1,278,982,124	$ 26,263,041	2.1 %
Investment income				
Net appreciation in fair value of investments	5,123,250,163	2,334,383,940	2,788,866,223	119.5 %
Interest, dividends and other investment income	1,073,491,403	1,047,724,725	25,766,678	2.5 %
Less: Investment expense	(42,190,619)	(37,519,406)	4,671,213	12.5 %
Net income from securities lending activities	5,348,721	0	5,348,721	--
Net investment income	6,159,899,668	3,344,589,259	2,815,310,409	84.2 %
TOTAL ADDITIONS	7,465,144,833	4,623,571,383	2,841,573,450	61.5 %
DEDUCTIONS				
Annuity benefits	2,056,977,497	1,918,686,339	138,291,158	7.2 %
Death benefits	3,912,205	5,056,081	(1,143,876)	(22.6) %
Refunds	54,045,937	39,517,877	14,528,060	36.8 %
Administrative expenses	9,957,061	8,178,696	1,778,365	21.7 %
TOTAL DEDUCTIONS	2,124,892,700	1,971,438,993	153,453,707	7.8 %
NET INCREASE	5,340,252,133	2,652,132,390	2,688,119,743	101.4 %
NET POSITION RESTRICTED FOR PENSIONS				
BEGINNING OF YEAR	37,564,905,362	34,912,772,972	2,652,132,390	7.6 %
END OF YEAR	$ 42,905,157,495	$ 37,564,905,362	$ 5,340,252,133	14.2 %

(continued)

ECONOMIC FACTORS, FUTURE FUNDING PROVISIONS, OVERALL OUTLOOK

For the year ended June 30, 2014 the portfolio delivered a return of 16.7 percent, which exceeded the actuarial-assumed return of 7.5%, by 9.2 percent. The return of the portfolio for the 2014 fiscal year was satisfying on an absolute basis and also exceeded the returns for the majority of its peers. For the trailing three year period, the fund returned 10.6 percent which exceeded the actuarially required return by over 3 percent and also beat almost 80 percent of comparable portfolios.

The strong results in the 2014 fiscal year were led by a 27.1 percent return for the Canadian Equity portfolio, a 25.2 percent return for the U.S. Equity portfolio and the 20.5 percent return for the International Equity portfolio. Returns were generally good for all asset classes. The Domestic Fixed Income portfolio returned 7.7 percent for the year which is a good result given the low level of interest rates. The Treasury Inflation Protected Securities portfolio gained 4.7 percent which produced the lowest return for the major asset classes.

The Federal Reserve slowed its purchases of fixed income securities throughout the year, in a process widely described as the "taper". Interest rates rose in the fall of 2013 due to concerns about the taper and subsequently fell throughout the first half of 2014 as the limited impact of the taper became more understood. Economic growth in the United States was generally robust during the fiscal year and international growth appeared to rebound for most of the year only to end the year at a tepid rate. Investors began to discount weaker global economic growth late in the year, while the outlook for U.S. growth remained solid.

An actuarial valuation was performed as of July 1, 2011 that determined the employer contribution rates for the period July 1, 2012 through June 30, 2014. The July 1, 2013 actuarial valuation determined the employer contribution rates for the period July 1, 2014 through June 30, 2016. An actuarial experience study to establish demographic and economic assumptions was completed effective June 30, 2012, was adopted by the Board of Trustees during fiscal year 2013, and was utilized in the July 1, 2013 actuarial valuation.

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 2015.

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.

STATEMENTS OF FIDUCIARY NET POSITION
FOR THE YEAR ENDED JUNE 30, 2014

Expressed in Thousands

	Public Employee Retirement Plan	Teacher Legacy Pension Plan	Total
ASSETS			
Cash and cash equivalents	$ 141,454	$ 138,207	$ 279,661
Cash collateral on loaned securities	1,826,303	1,784,766	3,611,069
Receivables			
Member receivable	5,627	22,027	27,654
Employer receivable	40,458	39,589	80,047
Accrued interest receivable	46,767	45,703	92,470
Accrued dividends receivable	27,749	27,118	54,867
Real estate income receivable	899	878	1,777
Derivative instruments receivable	286,521	280,004	566,525
Investments sold	170,672	166,790	337,462
Total receivables	578,693	582,109	1,160,802
Investments, at fair value			
Short-term securities	69,371	67,793	137,164
Government securities	4,290,150	4,192,577	8,482,727
Corporate securities	2,888,771	2,823,071	5,711,842
Corporate stocks	12,500,018	12,215,726	24,715,744
Derivative instruments	1,665	1,627	3,292
Strategic Lending	162,654	158,954	321,608
Private equities	394,122	385,158	779,280
Real estate	1,152,345	1,126,137	2,278,482
Total investments	21,459,096	20,971,043	42,430,139
Capital assets (net)	14,333	14,008	28,341
TOTAL ASSETS	24,019,879	23,490,133	47,510,012
LIABILITIES			
Accounts payable			
Death benefits and refunds payable	3,603	2,003	5,606
Retiree insurance premium payable	4,203	4,077	8,280
Other	111	108	219
Investments purchased	202,310	197,708	400,018
Derivative instruments payable	287,082	280,552	567,634
Other investment payables	6,083	5,946	12,029
Securities lending collateral	1,826,303	1,784,766	3,611,069
TOTAL LIABILITIES	2,329,695	2,275,160	4,604,855
NET POSITION RESTRICTED FOR PENSIONS	$ 21,690,184	$ 21,214,973	$ 42,905,157

See accompanying Notes to the Financial Statements.

STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
FOR THE YEAR ENDED JUNE 30, 2014

Expressed in Thousands

	Public Employee Retirement Plan	Teacher Legacy Pension Plan	Total
ADDITIONS			
Contributions			
Member contributions	$ 75,030	$ 195,521	$ 270,551
Employer contributions	686,219	348,475	1,034,694
Total contributions	761,249	543,996	1,305,245
Investment income			
Net appreciation in fair value of investments	2,583,110	2,540,140	5,123,250
Interest	236,137	232,209	468,346
Dividends	250,622	246,452	497,074
Real estate income, net of operating expenses	54,489	53,583	108,072
Total investment income	3,124,358	3,072,384	6,196,742
Less: Investment expense	(21,273)	(20,918)	(42,191)
Net income from investing activities	3,103,085	3,051,466	6,154,551
Securities lending activities			
Securities lending income	3,168	3,115	6,283
Less: securities lending expense	(471)	(463)	(934)
Net income from securities lending activities	2,697	2,652	5,349
Net investment income	3,105,782	3,054,118	6,159,900
TOTAL ADDITIONS	3,867,031	3,598,114	7,465,145
DEDUCTIONS			
Annuity benefits	1,043,927	1,013,051	2,056,978
Death benefits	2,275	1,637	3,912
Refunds	31,720	22,326	54,046
Administrative expense	7,294	2,663	9,957
TOTAL DEDUCTIONS	1,085,216	1,039,677	2,124,893
NET INCREASE	2,781,815	2,558,437	5,340,252
FIDUCIARY NET POSITION RESTRICTED FOR PENSIONS			
BEGINNING OF YEAR (prior to change in accounting principle)	7,080,898	30,484,007	37,564,905
Change in Accounting Principle			
Report State with other Agent Multiple Employer Plans	11,827,471	(11,827,471)	0
BEGINNING OF YEAR, RESTATED	18,908,369	18,656,536	37,564,905
END OF YEAR	$ 21,690,184	$ 21,214,973	$ 42,905,157

See accompanying Notes to the Financial Statements.

The Tennessee Consolidated Retirement System (TCRS) is a public employee retirement system comprised of defined benefit pension plans covering Tennessee State employees, including employees of the state's higher education systems, teachers, and employees of political subdivisions in Tennessee. The TCRS was established in 1972 by a statutory enactment of the Tennessee General Assembly. The provisions of the TCRS are codified in Tennessee Code Annotated Title 8, Chapters 34-37. In accordance with Tennessee Code Annotated Title 8, Chapter 34, Section 202, all funds invested, securities, cash, and other property of the TCRS are held in trust and can be expended only for the purposes of the trust. Although the assets for all pension plans within the TCRS are commingled for investment purposes, the assets of each separate plan may legally be used only for the payment of benefits to the members of that plan and for its administration, 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 a pension trust fund in the Tennessee Comprehensive Annual Financial Report.

2. ***Measurement Focus and Basis of Accounting*** - The accompanying financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) 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 the accrual method, revenues are recorded when earned, and expenses are recorded at the time liabilities are incurred, regardless of the timing of related cash flows.

   Plan member and employer contributions are recognized in the period of time for which they are due, in accordance with legal provisions. 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 includes cash, short-term investments with a maturity date within three months of the acquisition date, cash management pools, and cash invested in a short-term, open-end mutual fund under the contractual arrangement for master custody services. Cash received by the TCRS, that cannot be invested immediately in securities or is needed for operations, is invested in the State Pooled Investment Fund sponsored by the State of Tennessee and administered by the State Treasurer.

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. In those years independent appraisals are not conducted, appraisals are completed internally by real estate advisors. The fair value of private equity investments is determined by the fund managers using various methodologies, as applicable under GAAP. 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 in the first two phases of implementation, 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 was valued at $17,978,338 at year end and 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 (document imaging) and second phase (retired payroll) of the computer software have been implemented

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at June 30, 2014 and amortization has been initiated. The final phase (active membership, employer membership, and accounting) of the computer software began implementation after June 30, 2014 and expected to be substantially completed by June 30, 2015. The computer software was valued at $10,363,266 and amortization expense was $1,204,036.

6. ***Adoption of New Accounting Pronouncement*** - During the year ended June 30, 2014, the TCRS financial statements included the adoption of GASB Statement No. 67 which addresses accounting and financial reporting requirements for pension plans. The requirements for GASB Statement No. 67 necessitate changes in presentation of the financial statements, notes to the financial statements, and required supplementary information. Significant changes include an actuarial calculation of total pension liability and net pension liability. It also includes comprehensive footnote disclosure regarding the pension liability, the sensitivity of the net pension liability to the discount rate, and increased investment activity disclosures. The implementation of GASB Statement No. 67 did not significantly impact the accounting for accounts receivable and investment balances. This pronouncement also resulted in renaming the statement of plan net position as the statement of fiduciary net position, and the statement of changes in plan net position as the statement of changes in fiduciary net position. The total pension liability, determined in accordance with GASB Statement No. 67, is presented in Note 4 for the cost-sharing Teacher Legacy Pension Plan.

7. ***Change in Accounting Principle*** - During the 2014 fiscal year, the Tennessee General Assembly passed legislation which clarified that assets accumulated on behalf of teachers of Local Education Agencies (LEAs) shall be for the exclusive benefit of teachers, and assets accumulated on behalf of state employees shall be for the exclusive benefit of state employees. Pursuant to this clarification relative to the legal separation of assets for these two groups of employees, the teachers group, previously reported by the TCRS in the State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP), is now reported under a separate cost-sharing Teacher Legacy Pension Plan. The state employees are reported, along with employees of political subdivisions (previously reported as Political Subdivision Pension Plan (PSPP), within the Public Employee Retirement Plan, an agent multiple-employer pension plan. The net position of the SETHEEPP at June 30, 2013 of $30,484,007,172 was separated into two groups, with the amount attributed to the Teacher Legacy Pension Plan being $18,656,535,899, and the amount attributed to the Public Employee Retirement Plan being $11,827,471,273. The PSPP amount was $7,080,898,191. The beginning balance of each of the plans has been adjusted for this change in accounting principle.

B. PLAN DESCRIPTIONS

Plan Administration - The Tennessee Treasury Department, an agency in the legislative branch of state government, administers the plans of the TCRS.

At June 30, 2014, there were two defined benefit pension plans within the TCRS. The Public Employee Retirement Plan is an agent, multiple-employer defined benefit pension plan for state government employees and political subdivisions electing to participate in the TCRS. The Teacher Legacy Pension Plan is a cost-sharing, multiple-employer defined benefit pension plan for teachers of LEAs. The Teacher Legacy Pension Plan closed to new membership on June 30, 2014, but will continue providing benefits to existing members and retirees. Beginning July 1, 2014, the Teacher Retirement Plan becomes effective for teachers employed by LEAs after June 30, 2014. The Teacher Retirement Plan will be a separate cost-sharing, multiple-employer defined benefit plan.

The general administration and responsibility for proper operation of the TCRS plans are vested in a 20 member Board of Trustees, consisting of 18 voting members and two non-voting members. The Board has nine ex-officio members, two of whom are non-voting. The seven voting ex-officio members are the State Treasurer, Secretary of State, Comptroller of the Treasury, Commissioner of Finance and Administration, Commissioner of Human Resources, Director of the TCRS, and the Administrative Director of the Courts. The two non-voting ex-officio members are the chair and vice-chair of the Legislative Council on Pensions and Insurance.

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Three active teacher members, one from each grand division of the state, and a retired teacher member are selected for three year terms by the Speaker of the House of Representatives and the Speaker of the Senate. Two active state employee members, who are from departments other than those represented by ex-officio members, are elected by state employees for three year terms. A board member is appointed for a two year term by each of the following organizations: Tennessee County Services, Tennessee Municipal League, and the Tennessee County Officials Association. Two members, a public safety employee and a retired state employee, are appointed by the Governor for two year terms. All members must be vested members of the TCRS, except for ex-officio members.

Plan Membership - At June 30, 2014, the membership of the pension plans consisted of the following:

	Public Employee Retirement Plan	Teacher Legacy Pension Plan	Total
Inactive plan members or beneficiaries currently receiving benefits	87,421	45,869	133,290
Inactive vested plan members entitled to but not yet receiving benefits	31,813	7,334	39,147
Inactive non-vested plan members entitled to refund of member account balance	27,353	17,262	44,615
Active plan members	135,554	78,506	214,060
Total membership	282,141	148,971	431,112
Number of participating employers	520	142	662

Membership above includes all plans whether open or closed.

Benefits Provided - The TCRS provides retirement, disability, and death benefits. The benefits of the TCRS are established by state law (Tennessee Code Annotated, Title 8, Chapters 34-37). In general, the benefits may be amended prospectively by the General Assembly for employees becoming members of the TCRS after June 30, 2014. Amendments of benefits for employees becoming members before July 1, 2014 may be restricted by precedent established by the Tennessee Supreme Court.

Teacher Legacy Pension Plan

Members of the Teacher Legacy Pension Plan are eligible to retire at age 60 with five years of service credit or after 30 years of service credit regardless of age. Plan members are entitled to receive unreduced service retirement benefits which are determined by a formula using the member's highest five consecutive year average compensation and the member's years of service credit. Service related disability benefits are provided regardless of length of service. Five years of service is required for non-service related disability eligibility. The service related and non-service related disability benefits are determined in the same manner as a service retirement benefit but are reduced 10 percent and include projected service credits. A variety of death benefits are available under various eligibility criteria. Member and beneficiary annuitants are entitled to automatic cost of living adjustments (COLAs) after retirement. A COLA is granted each July for annuitants retired prior to the 2nd of July of the previous year. The COLA

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is based on the change in the consumer price index (CPI) during the prior calendar year, capped at three percent, and applied to the current benefit. No COLA is granted if the change in the CPI is less than one-half percent. A one percent COLA is granted if the CPI change is between one-half percent and one percent.

Public Employee Retirement Plan

State employees are eligible to retire at age 60 with five years of service credit or after 30 years of service credit regardless of age. Plan members are entitled to receive unreduced service retirement benefits which are determined by a formula using the member's highest five consecutive year average compensation and the member's years of service credit. Service related disability benefits are provided regardless of length of service. Five years of service is required for non-service related disability eligibility. The service related and non-service related disability benefits are determined in the same manner as a service retirement benefit but are reduced 10 percent and include projected service credits. A variety of death benefits are available under various eligibility criteria. Member and beneficiary annuitants are entitled to automatic COLAs after retirement. A COLA is granted each July for annuitants retired prior to the 2nd of July of the previous year. The COLA is based on the change in the CPI during the prior calendar year, capped at 3 percent, and applied to the current benefit. No COLA is granted if the change in the CPI is less than one-half percent. A one percent COLA is granted if the CPI change is between one-half percent and one percent. There are additional classes of employees that include state judges, elected members of the general assembly, and public safety officers which have different benefit structures and eligibility requirements. These classifications represent an immaterial percentage of the state employee membership.

For political subdivision employees, there are various tiers of benefits and eligibility requirements. Each political subdivision adopts the benefit structure that the entity provides to its employees. Unreduced service retirement benefits are determined using a multiplier of the member's highest five consecutive year average compensation multiplied by the member's years of service credit. Plan members are eligible for service related disability benefits regardless of length of service. Five years of service is required for non-service related disability eligibility. The service related and non-service related disability benefits are determined in the same manner as a service retirement benefit but are reduced 10 percent and include projected service credits. A variety of death benefits are available under various eligibility criteria. If adopted as a benefit provision by the political subdivision, member and beneficiary annuitants are entitled to automatic COLAs after retirement. A COLA is granted each July for annuitants retired prior to the 2nd of July of the previous year. The COLA is based on the change in the CPI during the prior calendar year, capped at 3 percent, and applied to the current benefit. No COLA is granted if the change in the CPI is less than one-half percent. A one percent COLA is granted if the CPI change is between one-half percent and one percent. There are additional classes of employees, local judges, elected officials, and public safety officers, which may have different benefit structures and eligibility requirements. These classifications represent an immaterial percentage of the political subdivisions' membership.

Contributions - Pursuant to Tennessee Code Annotated Title 8, Chapter 37, the Board of Trustees adopted an actuarially-determined contribution (ADC) for each participating employer, as recommended by an independent actuary following an actuarial valuation.

For the Teacher Legacy Pension Plan, LEAs are required by statute to contribute the ADC. The ADC is the estimated amount necessary to finance the costs of benefits earned by plan members during the year, the unfunded accrued liability, and the cost of administration. Teachers are required by statute to contribute five percent of salary. For the year ended June 30, 2014, the required ADC for LEAs was 8.88 percent of covered-employee payroll.

For the Public Employee Retirement Plan, each governmental entity is required by statute to contribute the ADC. The ADC is the estimated amount necessary to finance the costs of benefits earned by plan members during the plan year, the unfunded accrued liability, and the cost of administration. For the year ended June 30, 2014, the required ADC varied for each participating employer with 20 percent of all employer rates between 8% and 20 percent. By statute, state employees are noncontributory. As adopted by the governmental entity, political subdivision employees may be noncontributory, contribute 2.5 percent of salary, or contribute five percent of salary.

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C. DEPOSITS AND INVESTMENTS

Statutory Authority - State statute authorizes the TCRS to maintain cash, not exceeding ten percent of the total amount of funds in the retirement system, on deposit in one or more banks, savings and loan associations or trust companies that are qualified as state depositories. The TCRS does not utilize its own bank accounts but invests in the State Pooled Investment Fund for the initial deposit of funds and for its operating cash needs. The State Pooled Investment Fund is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee. The current resolution of that board gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements and various U.S. Treasury and Agency obligations. The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities.

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

a. The total sum invested in common and preferred stocks shall not exceed seventy-five percent (75 percent) of the total of the funds of the retirement system.

b. The total sum invested in notes and bonds or other fixed income securities exceeding one year in maturity shall not exceed seventy-five percent (75 percent) of the total funds of the retirement system.

c. Within the restrictions in (a) and (b) above, an amount not to exceed 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.

Investment Policy - The TCRS investment authority is established pursuant to Tennessee Code Annotated Title 8, Chapter 37. The statute provides the Board of Trustees with the responsibility to establish the investment policy of the TCRS. The investment policy may be amended by the Board. The TCRS plan assets are managed on a total

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return basis with a long-term objective of achieving and maintaining a fully funded status for the benefits provided by the TCRS. The following was the TCRS Board's adopted asset allocation policy as of June 30, 2014:

Authorized Asset Class	Target Allocation
U.S. Equity	33%
Canadian Equity	4%
Developed Market International Equity	13%
Emerging Market International Equity	5%
Private Equity	3%
U.S. Fixed Income	25%
Inflation Indexed Fixed Income	4%
International Fixed Income	0%
Strategic Lending	5%
Real Estate	7%
Short-Term Securities	1%
Total	100%

Securities Lending - The TCRS is authorized to invest in securities lending investments by TCA 8-37-104(a)(6) with the terms established in the investment policy whereby TCRS loans securities to brokers and dealers (borrower) and in turn, TCRS receives cash as collateral. TCRS pays the borrower interest on the collateral received and invests the collateral with the goal of earning a higher yield than the interest rate paid to the borrower. Loans are limited to no more than thirty percent (30%) of the market value of the total assets in the TCRS portfolio and provided further that such loans are secured by collateral. Securities received as collateral hereunder shall have a market value equal to at least one hundred two percent (102%) of the market value of the loaned domestic security or one hundred five percent (105%) of any foreign security. Cash received as collateral shall equal at least one hundred percent (100%) of the market value of the loaned securities and may be invested by or on behalf of the TCRS in any instrument the TCRS may be directly invested.

The TCRS securities lending program is managed by a third party lending agent, Deutsche Bank AG. The TCRS may loan any debt or equity securities which is owned by TCRS. At June 30, 2014, the TCRS had the following securities on loan and received the cash collateral as shown below:

Securities on Loan	Fair Value of Securities on Loan	Cash/Non-Cash Collateral Received
Fixed	$1,580,955,871	$1,623,590,738
Equity	1,935,287,556	1,987,477,958
Total	$3,516,243,427	$3,611,068,696

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The TCRS has the ability to sell the collateral securities only in the case of a borrower default.

As of June 30, 2014 the TCRS had the following investments:

Credit Quality Distribution for Securities with Credit Exposure as a Percentage of Total Investments

Rating	Fair Value (in thousands)	Percentage of Total Investments
AAA	$ 906,618	2.137%
AA	548,236	1.292%
A	1,079,470	2.544%
BBB	2,917,707	6.901%
BB	295,057	0.671%
B	49,484	0.117%
CCC	110,158	0.260%
CC	1,576	0.004%
D	45,704	0.108%
NR	3,155,001	7.436%
	9,109,011	
Government Agencies and Obligations*	5,323,742	
Total Fixed Income Securities	$14,432,753	

**Includes obligations of the U.S. government or obligations explicitly guaranteed by U.S. government.*

Credit Risk - Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit quality distribution for the TCRS' investments in fixed income securities at year end is 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/.

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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 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 year end.

Investment Type	Fair Value as of June 30, 2014	Effective Duration (years)
Government Agencies	$ 245,508	7.24
Government Bonds	2,049,684	12.97
Government Inflation Indexed	2,480,124	8.23
Government Mortgage Backed	3,495,299	4.15
Government Asset Backed	51,791	2.48
Municipal Bonds	156,846	9.94
Non-Government Backed CMOs	127,912	2.04
Commercial Mortgage Backed	429,665	1.82
Corporate Asset Backed Securities	670,436	1.39
Corporate Bonds	4,388,339	8.64
Short-Term Commercial Paper	149,989	0.08
Short-Term Bills & Notes	187,160	0.23
Total Debt Investments	$14,432,753	7.27

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, 2014 was $557,576,973 of which $341,517,633 were CMOs that are generally more sensitive to interest rate changes.

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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 was as follows:

Currency	Total Fair Value June 30, 2014	Fixed Income	Equity	Cash
Australian Dollar	$ 283,539	$0	$ 283,448	$ 91
British Pound Sterling	1,095,088	0	1,085,973	9,115
Canadian Dollar	1,919,373	0	1,919,233	140
Danish Krone	127,596	0	127,571	25
Euro Currency	1,519,998	0	1,500,315	19,683
Hong Kong Dollar	179,740	0	177,918	1,822
Japanese Yen	1,287,069	0	1,274,238	12,831
New Israeli shekel	6,513	0	6,513	0
New Zealand Dollar	6,131	0	6,131	0
Norwegian Krone	78,057	0	78,007	50
Singapore Dollar	74,181	0	74,009	172
Swedish Krona	136,993	0	136,993	0
Swiss Franc	457,132	0	455,376	1,756
Total	$ 7,171,410	$0	$ 7,125,725	$ 45,685

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. At year end, the TCRS had uninsured and uncollateralized cash deposits of $45,684,593 in foreign currency held by our master custodian, Northern Trust, in Northern Trust's name. These deposits were used for investments pending settlement.

Rate of Return - For the year, the money-weighted rate of return on pension plan investments, net of pension plan investment expense, was 16.5 percent. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested.

Derivatives:

Futures - 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. Any resulting payable is reflected in the financial statements at fair value.

Foreign Currency Forward Contracts - The international securities expose the TCRS to potential losses due to a possible rise in the value of the US dollar. The TCRS investment managers can reduce foreign currency exposure by selling foreign currency forward contracts, at agreed terms and for future settlement, usually within a year. The manager will reverse the contract by buying the foreign currency before the settlement date. A gain (loss) on this transaction pair will hedge a loss (gain) on the currency movement of the international security. The TCRS can sell

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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.

Mortgages - 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.

Options - 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.

The fair value balances and notional amounts of derivative instruments outstanding at year end, 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:

	Changes in Fair Value		Fair Value at June 30, 2014			
	Financial Statement Classification	Amount	Financial Statement Classification	Amount	Notional Amount	Currency
Foreign Currency Forward Contracts						
		($200)		($200)	23,203	EUR
		(909)		(909)	14,101,216	JPY
	Investment Income	($1,109)	Derivative Instruments Payable	($1,109)		
Futures Contracts						
	Investment Income	$6,481	Derivative Instruments Receivable	$3,381	$930,356	
TBA Mortgage Backed Securities						
	Investment Income	$3,292	Derivative Instruments	$3,292	$399,932	

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.

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Alternative Investments - The TCRS has investments in private equity funds and real estate with an estimated fair value of $3,379,369,542 at June 30, 2014. 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. Title to real property invested in by TCRS is held by real estate investment holding companies.

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.

Alternative Investments – The TCRS had unfunded commitments of $2,708,699,810 in private equity, strategic lending, and real estate commitments at year end.

D. NET PENSION LIABILITY (ASSET) OF THE TEACHER LEGACY PENSION PLAN FOR LOCAL EDUCATION AGENCIES

The components of net pension liability of the Teacher Legacy Pension Plan at June 30, 2014, were as follows:

Total Pension Liability	$21,151,810,794
Plan Fiduciary Net Position	21,214,973,134
Net Pension Liability (Asset)	$ (63,162,340)
Fiduciary Net Position as a Percentage of the Total Pension Liability	100.30%

Actuarial assumptions - The total pension liability was determined by an actuarial valuation as of July 1, 2013, updated to roll forward to June 30, 2014, using the following actuarial assumptions applied to all prior periods included in the measurement:

Inflation	3.0 percent
Salary Increases	Graded salary ranges from 8.97 to 3.71 percent based on age, including inflation, averaging 4.25 percent
Investment Rate of Return	7.5 percent, net of pension plan investment income, including inflation
Cost-of-Living Adjustment	2.5 percent

Mortality rates were based on actual experience from the June 30, 2012 actuarial experience study plus some adjustment for expected future improvement in life expectancy.

The actuarial assumptions used in the July 1, 2013 actuarial valuation were based on the results of an actuarial experience study performed for the period July 1, 2008 through June 30, 2012. The demographic assumptions were adjusted to more closely reflect actual and expected future experience.

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The long-term expected rate of return on pension plan investments was established by the TCRS Board of Trustees in conjunction with the June 30, 2012 actuarial experience study by considering the following three techniques: (1) the 25-year historical return of the TCRS at June 30, 2012, (2) the historical market returns of asset classes from 1926 to 2012 using the TCRS investment policy asset allocation, and (3) capital market projections that were utilized as a building-block method in which best-estimate ranges of expected future real rate of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. Four sources of capital market projections were blended and utilized in the third technique. The blended capital market projection established the long-term expected rate of return by weighting the expected future real rate of return by the target asset allocation percentage and by adding inflation of 3 percent. The target allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

Asset Class	Long-Term Expected Real Rate of Return	Target Allocations
U.S. Equity	6.46%	33%
Developed Market International Equity	6.26%	17%
Emerging Market International Equity	6.40%	5%
Private Equity and Strategic Lending	4.61%	8%
U.S. Fixed Income	0.98%	29%
Real Estate	4.73%	7%
Short-Term Securities	0.00%	1%
		100%

The long-term expected rate of return on pension plan investments was established by the TCRS Board of Trustees as 7.5 percent based on a blending of the three techniques described above.

Discount Rate - The discount rate used to measure the total pension liability was 7.5 percent. The projection of cash flows used to determine the discount rate assumed that employee contributions from plan members will be made at the statutorily required contribution rates and that employer contributions from LEAs will be made at the actuarially determined rate as required by statute. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of Net Pension Liability (Asset) to Changes in the Discount Rate - The following presents the Teacher Legacy Pension Plan's net pension liability for LEAs using the discount rate of 7.5 percent, as well as what its net pension liability would be if it were calculated using a discount rate that is one percentage point lower (6.5%) or one percentage point higher (8.5%) than the current rate:

	One Percent Decrease (6.5%)	Current Discount Rate (7.5%)	One Percent Increase (8.5%)
Net Pension Liability (Asset)	$2,677,321,642	$(63,162,340)	$(2,332,660,416)

(continued)

SCHEDULES OF REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULE OF CHANGES IN THE TEACHER LEGACY PENSION PLAN

Teacher Legacy Pension Plan's Net Pension Liability
Fiscal Year Ended June 30

	2014
Total pension liability	
Service cost	$ 404,576,942
Interest	1,483,656,307
Change of benefit terms	
Difference between expected and actual experience	
Change of assumptions	
Benefit payments, including refunds of member contributions	(1,037,013,093)
Net change in total pension liability	851,220,156
Total pension liability - beginning	20,300,590,638
Total pension liability - ending (a)	21,151,810,794
Plan fiduciary net position	
Contributions – employer	348,474,888
Contributions - members	195,520,938
Net investment income	3,054,117,821
Benefit payments, including refunds of member contributions	(1,037,013,093)
Administrative expense	(2,663,319)
Net change in plan fiduciary net position	2,558,437,235
Plan fiduciary net position - beginning	18,656,535,899
Plan fiduciary net position - ending (b)	21,214,973,134
Net pension liability (asset) - ending (a) - (b)	$ (63,162,340)

Teacher Legacy Pension Plan's Net Pension Liability
Fiscal Year Ended June 30

	2014
Total pension liability	$ 21,151,810,794
Plan fiduciary net position	21,214,973,134
Net pension liability (asset)	$ (63,162,340)
Plan fiduciary net position as a percentage of the total pension liability	100.30%
Covered-employee payroll	$ 3,925,131,835
Net pension liability (asset) as a percentage of covered-employee payroll	-1.61%

Teacher Legacy Pension Plan's Contributions
Fiscal Year Ended June 30

	Actuarially-Determined Contribution	Contributions in Relation to the Actuarially-Determined Contributions	Contribution Deficiency	Covered-Employee Payroll	Contributions as a Percentage of Covered-Employee Payroll
2014	$348,474,888	$348,474,888	$0	$3,931,983,889	8.88%
2013	344,534,643	344,534,643	0	3,879,878,989	8.88%
2012	343,594,496	343,594,496	0	3,796,077,699	9.05%
2011	339,833,421	339,833,421	0	3,754,600,827	9.05%
2010	236,545,072	236,545,072	0	3,683,968,661	6.42%
2009	233,214,598	233,214,598	0	3,632,637,952	6.42%
2008	218,862,049	218,862,049	0	3,507,360,900	6.24%
2007	204,370,625	204,370,625	0	3,333,693,142	6.13%
2006	175,719,201	175,719,201	0	3,194,957,343	5.50%
2005	170,392,879	170,392,879	0	3,098,164,695	5.50%

SCHEDULES OF REQUIRED SUPPLEMENTARY INFORMATION PUBLIC EMPLOYEE RETIREMENT PLAN AND THE TEACHER LEGACY PENSION PLAN

Investment Returns
Fiscal Year Ended June 30

	2014
Annual Money-Weighted Rate of Return, Net of Investment Expense	16.49%

Method and Assumptions Used in Calculations of Actuarially-Determined Contributions - The actuarially determined contribution rates for the fiscal year ended June 30, 2014 for Local Education Agencies were calculated as the result of an actuarial valuation performed as of July 1, 2011. The following actuarial methods and assumptions were used to determine contribution rates reported in the schedule:

Actuarial Cost Method	Frozen Initial Liability Method
Amortization Method	Level Dollar Amortization
Remaining Amortization Period	Six Years
Inflation	3.0 Percent
Salary Increases	Graded Salary Ranges from 9.49 Percent to 4.22 Percent, Including Inflation, Averaging 4.75 Percent
Investment Rates of Return	7.50 Percent, Net of Pension Plan Investment Expense, Including Inflation

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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, 2014, 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 19, 2014. 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 department'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, and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify a deficiency in internal control, as described below, that we consider to be a significant deficiency.

- The Tennessee Consolidated Retirement System does not have sufficient controls to ensure the accuracy of census data received from employers.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Tennessee Consolidated Retirement System's financial statements are free from material misstatement, we performed tests of its 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*.

Department's Response to Finding

The Tennessee Consolidated Retirement System's response to the finding identified in our audit is included in the Finding and Recommendation section of this report. The department's response was not subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion on it.

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 19, 2014

Finding and Recommendation

<u>The Tennessee Consolidated Retirement System does not have sufficient controls to ensure the accuracy of census data received from employers</u>

Condition

Based on our interviews with management, we determined that the Tennessee Consolidated Retirement System does not currently have procedures to verify underlying payroll records of participating employers in the cost-sharing pension plan.

Criteria

The recently effective accounting standard, *Financial Reporting for Pension Plans* (GASB 67), requires pension plans to report total pension liability in the footnotes to the financial statements of cost-sharing pension plans. The calculation of the total pension liability for cost-sharing plans is dependent on the completeness and accuracy of the underlying census data of the members of that plan.

Plan management is responsible for designing, implementing and maintaining a system of internal control related to amounts reported in the financial statements. A complete system of internal control related to the total pension liability calculation includes procedures to verify the underlying payroll records to ensure completeness and accuracy of the data, and the lack of such procedures constitutes a control deficiency. This fact is emphasized in the American Institute of Certified Public Accountants (AICPA) whitepaper *Single-Employer and Cost-sharing Multiple-Employer Plans: Issues Associated with Testing Census Data in an Audit of Financial Statements*: “the absence of effective management processes and controls by the plan to . . . verify the underlying payroll records of participating employer census data in a single-employer or cost-sharing plan is a deficiency in internal control over financial reporting.”

Cause

Prior to the issuance of GASB 67 and the related AICPA whitepaper, management had not considered the verification of census data received from employers to be essential.

Effect

This control deficiency increases the risk of misstatement in the footnotes to the financial statements.

Recommendation

Management should ensure procedures are implemented to verify the census data received from employers agrees with the underlying payroll records of the participating employers.

Management's Comment

Management concurs. The Tennessee Consolidated Retirement System (TCRS) was created in 1972 and it has been the long-term practice that local governments participating in TCRS were responsible for the accurate reporting of census data of their participants to the retirement system, particularly since the local government is ultimately responsible for the pension cost of their employees. While this has been the historical practice, the American Institute of Certified Public Accountants (AICPA) highlighted a need to change this practice in February 2014 with the issuance of a whitepaper titled *Single-Employer and Cost-Sharing Multiple-Employer Plans: Issues Associated with Testing Census Data in an Audit of Financial Statements*. The whitepaper was published by the AICPA as a result of the Governmental Accounting Standards Board (GASB) issuing statements 67 and 68 that changed the financial reporting standards for defined benefit pension plans and employers.

The late publishing of the AICPA white paper just four months before the close of the fiscal year and confusion over the specific requirements has caused difficulty within the industry to meet the full requirements of the paper. As a result, it was difficult, if not impossible for TCRS to comply with the parameters of the white paper for the full fiscal year. In addition, TCRS did not have the personnel within the department's budget to enhance the internal controls of the census data of the employers within TCRS by a direct audit of the data.

This finding specifically addresses the census data of teachers in Local Education Agencies (LEAs) participating in the cost-sharing plan. However, we believe all entities within the TCRS should be held to the same standard for accuracy of the census data. While it was not possible to comply with the requirements in fiscal year 2014, the Treasury Department is committed to enhancing our internal controls of the census data reported to TCRS by employers through the practice of audits. During fiscal year 2015, the Treasury Department will reallocate resources from other programs on a temporary basis and begin the auditing of the census data. For fiscal year 2016, the Treasury Department will request additional positions and resources in the department's budget to fully implement a new audit plan to confirm the reasonableness of the census data submitted by employers.