Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 1997

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March 2, 1998

Members of the General Assembly
and
The Honorable Steve Adams, Treasurer
and
Members of the Board
Tennessee Consolidated Retirement System
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Consolidated Retirement System for the year ended June 30, 1997. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Very truly yours,

W. R. Snodgrass
Comptroller of the Treasury

WRS/th
97/107

State of Tennessee

Audit Highlights

Comptroller of the Treasury — Division of State Audit

Financial and Compliance Audit
Tennessee Consolidated Retirement System
For the Year Ended June 30, 1997

AUDIT OBJECTIVES

The objectives of the audit were to consider the system's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts, to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

AUDIT FINDINGS

The audit report contains no findings.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
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Audit Report
Department of the Treasury
Tennessee Consolidated Retirement System
For the Year Ended June 30, 1997

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INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee Consolidated Retirement System. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

LEGISLATIVE HISTORY

The Tennessee Consolidated Retirement System (TCRS) was established in 1972 by an act of the Tennessee General Assembly. Seven existing retirement systems were consolidated to provide retirement, disability, and death benefits to state employees, public school teachers, higher education employees, and employees of participating local governments. State laws govern the retirement plan, and amendments to the plan can only be made by legislation enacted by the General Assembly of the State of Tennessee.

An 18-member Board of Trustees has the responsibility to manage and oversee the operation of the consolidated system. The board consists of nine *ex officio* members from the executive, legislative, and judicial branches of state government, eight representatives of the active TCRS membership, and one representative of retirees. TCRS is administered by the Department of the Treasury under the legislative branch of state government. By state law, the State Treasurer serves as Chairman of the Board of Trustees and as custodian of the funds of the system.

Membership in the retirement system is a condition of employment for full-time state employees, K-12 teachers, higher education general employees, and employees of participating local governments. Membership is optional for part-time state employees and part-time employees of political subdivisions which have authorized such coverage. Interim teachers and part-time teachers have optional membership. Faculty and certain other employees of institutions of higher education may elect participation in either TCRS or an optional retirement program. TCRS membership has grown steadily since 1972 when there were approximately 93,000 members. As of June 30, 1997, there were 179,171 active members and 66,662 retirees.

ORGANIZATION

The Tennessee Consolidated Retirement System is organized into three major service areas: Counseling Services, Financial Services, and Member Services.

Counseling Services is responsible for advising members on their potential benefit payments under different options.

Financial Services calculates retirees' payments based on the option chosen. The payroll section administers the payroll and prepares the checks.

Member Services processes membership forms received from all state agencies, local boards of education, and participating political subdivisions. It also furnishes the information and forms necessary to enable the member agencies to include their employees and employer groups. It also assists political subdivisions in joining TCRS. The prior service section assists in establishing prior service credit for eligible members or former members who have requested such credit. The account services section is responsible for researching, controlling, and correcting member records on the Treasury Retirement Accounting and Control System.

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

AUDIT SCOPE

The audit was limited to the period July 1, 1996, through June 30, 1997, and was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Financial statements are presented for the year ended June 30, 1997. The Tennessee Consolidated Retirement System forms an integral part of state government and as such has been included as a pension trust fund in the Tennessee Comprehensive Annual Financial Report.

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Tennessee Consolidated Retirement System's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;

2. to determine compliance with certain provisions of laws, regulations, and contracts;

3. to determine the fairness of the presentation of the financial statements; and

4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee Consolidated Retirement System's financial statements for the year ended June 30, 1997, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Consideration of internal control disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the financial statements of the Tennessee Consolidated Retirement System.

Report on Compliance and on Internal Control Over Financial Reporting
Based on an Audit of the Financial Statements
Performed in Accordance With *Government Auditing Standards*

December 17, 1997

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the financial statements of the Tennessee Consolidated Retirement System, as of and for the year ended June 30, 1997, and have issued our report thereon dated December 17, 1997. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the 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 that are required to be reported herein under *Government Auditing Standards*.

We did, however, note certain immaterial instances of noncompliance that we have reported to the system's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the system's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted certain matters involving the internal control over financial reporting that we have reported to the system's management in a separate letter.

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/th

Independent Auditor's Report

December 17, 1997

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the accompanying statement of plan net assets of the Tennessee Consolidated Retirement System, as of June 30, 1997, and the related statement of changes in plan net assets for the year then ended. These financial statements are the responsibility of the system's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Consolidated Retirement System, as of June 30, 1997, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

As discussed in the notes to required supplementary information, the Tennessee Consolidated Retirement System has not presented the schedule of employer contributions that the Governmental Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

As discussed in Note A.3., the Tennessee Consolidated Retirement System implemented Governmental Accounting Standards Board Statement 25, “Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans” and Governmental Accounting Standards Board Statement 28, “Accounting and Financial Reporting for Securities Lending Transactions.”

The schedules of funding progress on page 23 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 17, 1997, on our consideration of the system’s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/th

Exhibit A

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
AS OF JUNE 30, 1997
WITH COMPARATIVE TOTALS FOR JUNE 30, 1996

(Expressed in Thousands)

	State Employees, Teachers, Higher Ed. Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 1997 Total	June 30, 1996 Total
ASSETS				
Cash	$ 24,959	$ 2,415	$ 27,374	$ 4,087
Receivables:				
Member contributions receivable	11,557	2,312	13,869	13,401
Employer contributions receivable	21,508	4,335	25,843	28,918
Accrued interest receivable	137,622	19,555	157,177	142,231
Accrued dividends receivable	8,926	1,268	10,194	11,160
Other investment receivable	3,177	451	3,628	522
Investments sold	33,521	4,763	38,284	104,192
Total receivables	216,311	32,684	248,995	300,424
Investments, at fair value				
Short-term securities	766,362	108,890	875,252	667,733
Domestic securities:				
Government bonds	4,807,877	683,139	5,491,016	4,902,951
Corporate bonds	2,967,717	421,676	3,389,393	3,177,513
Corporate stocks	4,850,437	689,187	5,539,624	4,977,671
International securities:				
Government bonds	1,065,051	151,330	1,216,381	890,090
Corporate bonds	283,619	40,299	323,918	264,546
Corporate stocks	1,366,611	194,178	1,560,789	1,007,260
Total investments	16,107,674	2,288,699	18,396,373	15,887,764
Invested securities lending collateral	306,399	43,536	349,935	1,865,389
Total assets	16,655,343	2,367,334	19,022,677	18,057,664
LIABILITIES				
Retired payroll payable	13,225	1,890	15,115	14,721
Warrants payable	209	226	435	456
Accounts payable:				
Death benefits and refunds payable	1,173	778	1,951	1,470
Other	16	1	17	16
Due to State General Fund	-	-	-	72
Investments purchased	117,031	16,629	133,660	101,361
Other investment payables	1,946	277	2,223	2,002
Securities lending collateral	306,400	43,535	349,935	1,865,389
Total liabilities	440,000	63,336	503,336	1,985,487
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS (Schedules of funding progress for the plans are presented on page 23)	$ 16,215,343	$ 2,303,998	$ 18,519,341	$ 16,072,177

See accompanying Notes to the Financial Statements.

Exhibit B

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 1997
WITH COMPARATIVE TOTALS FOR THE YEAR ENDED JUNE 30, 1996

(Expressed in Thousands)

	State Employees, Teachers, Higher Ed. Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 1997 Total	For the Year Ended June 30, 1996 Total
ADDITIONS				
Contributions:				
Member contributions	$ 110,697	$ 32,959	$ 143,656	$ 133,603
Employer contributions	278,417	59,167	337,584	345,100
Total contributions	389,114	92,126	481,240	478,703
Investment income:				
Net appreciation in fair value of investments	1,499,296	212,126	1,711,422	1,081,839
Interest	596,369	84,368	680,737	595,590
Dividends	110,218	15,593	125,811	129,290
Total investment income	2,205,883	312,087	2,517,970	1,806,719
Less: Investment expense	7,632	1,088	8,720	4,715
Net income from investing activities	2,198,251	310,999	2,509,250	1,802,004
Securities lending activities:				
Securities lending income	76,749	10,858	87,607	107,580
Less: Securities lending expense	71,753	10,151	81,904	102,910
Net income from securities lending activities	4,996	707	5,703	4,670
Net investment income	2,203,247	311,706	2,514,953	1,806,674
Total additions	2,592,361	403,832	2,996,193	2,285,377
DEDUCTIONS				
Annuity benefits:				
Retirement benefits	346,192	49,478	395,670	365,465
Survivor benefits	21,829	3,120	24,949	23,204
Disability benefits	11,578	1,655	13,233	11,812
Cost of living	73,751	10,540	84,291	78,322
Death benefits	2,395	801	3,196	3,225
Refunds	11,444	12,389	23,833	20,722
Administrative expense	2,221	1,636	3,857	3,911
Total deductions	469,410	79,619	549,029	506,661
NET INCREASE	2,122,951	324,213	2,447,164	1,778,716
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS				
BEGINNING OF YEAR	14,092,392	1,979,785	16,072,177	14,293,461
END OF YEAR	$ 16,215,343	$ 2,303,998	$ 18,519,341	$ 16,072,177

See accompanying Notes to the Financial Statements.

Tennessee Consolidated Retirement System
Notes to the Financial Statements
June 30, 1997

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 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 conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The TCRS follows all applicable GASB pronouncements, as well as applicable private sector pronouncements issued on or before November 30, 1989. The financial statements have been prepared using the 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 in which the contributions are due. 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. Changes in Accounting Principles

Effective July 1, 1996, the TCRS adopted Statement Number 25 of the Governmental Accounting Standards Board (GASB), *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. The provisions of this statement require retroactive restatement of financial information to July 1, 1995, as comparative information when fiscal year 1996 is presented. The effect of the change in accounting principle on the TCRS' previously reported net assets held in trust for pension benefits (fund balance) is as follows (expressed in thousands):

	Net assets held in trust for pension benefits (fund balance) as previously reported	Adjustments from Implementation of GASB No. 25	Net assets held in trust for pension benefits as restated
June 30, 1995	$13,171,549	$1,121,912	$14,293,461
June 30, 1996	$14,738,658	$1,333,519	$16,072,177

The restatement of the TCRS' 1996 financial statements resulted in an increase in the fiscal year 1996 investment income of $211,607,000 due to the requirement to report investments at fair value. Requirements for disclosures regarding pension benefit obligation were eliminated by GASB Statement Number 25.

Effective July 1, 1996, the TCRS also adopted Statement Number 28 of the Governmental Accounting Standards Board, *Accounting and Financial Reporting for Securities Lending Transactions*. GASB Statement Number 28 requires that securities loaned and cash collateral, as well as investments made with cash collateral, be reported as assets on the statement of plan net assets with a corresponding liability for the collateral received. In addition, the statement requires that the costs of securities lending transactions be reported separately from the income from securities lending transactions on the statement of changes in plan net assets. Totals on the Statement of Plan Net Assets as of June 30, 1996, and the Statement of Changes in Plan Net Assets for the period of July 1, 1995, through June 30, 1996, have been restated for comparative purposes. There is no effect on net assets or on net investment income resulting from the restatement.

4. Cash

Cash and cash equivalents, by definition, includes cash and short-term investments with a maturity date within three months of the acquisition date. The state's accounting policy regarding the definition of cash and cash equivalents includes cash management pools as cash. In addition, under the policy, short-term securities otherwise defined as cash equivalents, that are in portfolios where the primary purpose is to facilitate the placement of funds in long-term investments, are classified as investments.

Cash received by the TCRS that cannot be invested immediately in securities is invested in the Pooled Investment Fund administered by the State Treasurer. The 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, various U.S. Treasury and Agency obligations, and in obligations of the State of Tennessee pursuant to *Tennessee Code Annotated*, Section 9-4-602(b). The Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned to brokers for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. The pool's custodial credit risk is presented in the *Tennessee Comprehensive Annual Financial Report* for the years ended June 30, 1997, and June 30, 1996. The classification of Cash also includes cash held in a custody account by Mellon Trust Company under a contractual arrangement for master custody services. Cash balances with the custodial agent are not classified into the credit risk categories established by Statement Number 3 of the Governmental Accounting Standards Board because the custody account relationship does not meet the definition for either a deposit with a financial institution or a security.

5. 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. Investments that do not have an established market are reported at estimated fair values. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.

6. Receivables

Receivables primarily consist of interest which is recorded when earned. The receivables for contributions as of June 30, 1997, consist of $6.6 million due from other funds within the state and $33.0 million due from other governments.

B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION

At June 30, 1997, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	48,834	17,828
Terminated members entitled to but not receiving benefits	10,681	2,393
Current active members	120,515	58,656
Total	180,030	78,877
Number of participating employers	142	365

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 (LEAs), 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. 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. No COLA is granted if the CPI increases less than one percent. 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 *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly.

Superseded Systems and Certain Employment Classifications
Members of superseded systems that became members of the TCRS at consolidation in 1972 have their rights preserved to the benefits of the superseded system, if the benefit from the superseded plan exceeds that provided by the Group 1 (teachers and general employees)

TCRS formula. Likewise, public safety employees and officials of TCRS Groups 2, 3, and 4 are entitled to the benefits of those formulas, if better than the Group 1 benefits.

Contributions and Reserves
Effective July 1, 1981, the plan became noncontributory for most state and higher education employees. The contribution rate for teachers is five percent of gross salary. The employers contribute a set percentage of their payrolls, determined by an actuarial valuation. *Tennessee Code Annotated*, Title Eight, Chapter 37, provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the State of Tennessee's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income, and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 1997, the plan's Member Reserve and Employer Reserve were fully funded, with balances of $2,141.0 million and $14,074.3 million, respectively.

Political Subdivisions Pension Plan

Plan Description
PSPP is an agent multiple-employer defined benefit pension plan that covers the employees of participating political subdivisions of the State of Tennessee. Employee class differentiations are not made under PSPP. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan prior to July 1, 1979, are vested after four years of service. Members joining on or after July 1, 1979, are vested upon completion of ten years of service, unless five years vesting is authorized by resolution of the chief governing body. Cost of living adjustments, if adopted by a political subdivision, are provided each July

based on the percentage change in the Consumer Price Index (CPI) during the previous calendar year. No COLA is granted if the CPI increases less than one percent. The maximum annual COLA is capped at three percent. Benefit provisions are established and amended by state statute. Pursuant to Article Two, Section 24, of the *Constitution of the State of Tennessee*, the state cannot mandate costs on local governments. Any benefit improvement may be adopted by the governing body of a governmental entity participating in the TCRS.

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

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income, and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 1997, the plan's Member Reserve and Employer Reserve were fully funded, with balances of $425.7 million and $1,878.3 million, respectively.

C. INVESTMENTS

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

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

c. Within the restrictions in (a) and (b) above, an amount not to exceed fifteen percent (15%) 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.

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

e. Private Placements are limited to 15% of the total fixed-income portfolio.

The TCRS may also invest in multifamily residential real estate through direct equity investment vehicles including, but not limited to, sole proprietorships and joint ventures.

The TCRS maintains a portfolio of short-term investments in order to actively manage all funds waiting to be placed in a more permanent investment. These short-term investments may include U.S. Treasury obligations, commercial paper, medium-term corporate notes, promissory notes, and repurchase agreements.

The TCRS investment securities are categorized below according to the level of custodial credit risk associated with the custodial arrangements at year-end. Category 1 includes investments that are insured or registered, or for which the securities are held by the TCRS or its agent in the name of the TCRS. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the name of the TCRS. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the counterparty's trust department or agent, but not in the name of the TCRS.

(Expressed in Thousands)	Fair Value June 30, 1997	Fair Value June 30, 1996
Investments - Category 1		
Short-term Securities	$ 749,460	$ 544,910
Commercial Paper	-	96,321
Medium-term Corporate Notes	125,792	26,502
U. S. Government Securities	-	-
Repurchase Agreements		
Long-term Investments		
Domestic Securities		
Government Bonds - not on loan	5,443,664	3,272,842

Government Bonds - on loan for securities collateral	-	103,880
Corporate Bonds	3,296,759	3,087,494
Corporate Stocks	5,458,081	4,923,099
International Securities		
Government Bonds	1,195,959	747,381
Corporate Bonds	323,918	264,546
Corporate Stocks	1,319,756	889,184
Total Investments - Category 1	17,913,389	13,956,159
Investments - Category 2	-	-
Investments - Category 3		
Short-term securities lending collateral investments held by custodian bank	349,935	1,865,389
Margin Deposit on Futures Contracts		
Domestic Government Bonds	19,036	-
Total Investments - Category 3	368,971	1,865,389
Investments - Not Categorized		
Investments held by broker-dealers under securities on loan contracts for cash collateral		
Domestic Securities		
Government Bonds	-	1,513,180
Corporate Bonds	78,986	90,019
Corporate Stocks	63,265	29,944
International Securities		
Government Bonds	-	87,658
Corporate Stocks	192,304	110,798
Unsettled Investment Acquisitions		
Domestic Securities		
Government Bonds	28,316	13,049
Corporate Bonds	13,648	-
Corporate Stocks	18,278	24,628
International Securities		
Government Bonds	20,422	55,051
Corporate Stocks	48,729	7,278

Total Investments - Not Categorized	463,948	1,931,605
Total investments and invested securities lending collateral	$18,746,308	$17,753,153

Securities Lending
The TCRS is authorized by its investment policy, as adopted by the Board of Trustees, to enter into collateralized securities lending agreements whereby the TCRS loans its debt and equity securities for a fee to a select few of the highest quality securities firms and banks. Loans must be limited so the total amount on loan does not exceed 30 percent of the TCRS' assets. The TCRS' custodian bank manages the lending program and maintains the collateral on behalf of the TCRS. The borrower may deliver collateral to the lending agent in the form of cash or bonds, notes, and treasury bills of the United States or other obligations guaranteed as to principal and interest by the United States or any of its agencies or by the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Student Loan Marketing Association, and other United States government sponsored corporations or enterprises. Cash received as collateral may be reinvested by the lending agent in accordance with the investment policy, as further restricted under the TCRS securities lending agreement. Collateral securities cannot be pledged or sold unless the borrower defaults.

The loaned securities are initially collateralized at 102 percent of their fair value for domestic securities and 105 percent for international. Collateral is marked-to-market daily, and additional collateral is pledged by the borrower if the fair value of the collateral subsequently falls below 100 percent for domestic securities and 105 percent for international. At year-end, the TCRS had no credit risk exposure to borrowers because the amounts the TCRS owed the borrowers exceeded the amounts the borrowers owed the TCRS.

Although there is no specific policy for matching the maturities of the collateral investments and the securities loans, all securities on loan can be terminated on demand by either the TCRS or the borrower, and at June 30, 1997, substantially all cash collateral was invested in overnight or on-demand investments with a weighted-average term to maturity of four days.

As of June 30, 1997, the fair value of securities on loan to brokers was $334,555,819, and the fair value of collateral pledged for the securities on loan was $349,934,991. The TCRS securities lending income, net of expenses, was $5,703,225 for the year ended June 30, 1997.

Financial Instruments with Off-Balance Sheet Risk

The TCRS is a party to financial instruments with off-balance sheet risk used in the normal course of business to generate earnings and reduce its own exposure to fluctuations in market conditions. The TCRS is authorized by statute to engage in forward contracts to exchange different currencies at a specified future date and rate and in domestic stock index futures contracts. These contracts involve elements of custodial credit, market, and legal risk in excess of amounts recognized in the Statement of Plan Net Assets as of June 30, 1997. The TCRS may purchase or sell domestic stock index futures contracts for the purposes of making asset allocation changes and improving liquidity. Futures contracts are limited to the S&P 500 Index, the S&P Midcap 400 Index and the Russell 2000 Index. The contractual or notional amounts express the extent of the TCRS' involvement in these instruments and do not represent exposure to credit loss. The credit risk on forward and futures contracts is controlled through limits and monitoring procedures. Market risk, the risk that changing market conditions may make a financial instrument less valuable, is controlled through limitations on the use of such instruments. Legal risk is controlled through the use of only authorized instruments and brokers.

The allowable currencies for hedging purposes are limited by policy of the Board of Trustees to the currencies of those countries otherwise authorized for investment. At June 30, 1997, there were 22 forward exchange contracts outstanding at a total notional amount of $371,633,497 and a fair value of $374,833,463.

At June 30, 1997, the notional amount of futures contracts was $426,325,000 at a fair value of $445,125,000. The changes in fair value of outstanding futures contracts are settled daily.

The TCRS is also authorized by investment policy to engage in the issuance of options. Activity is limited to selling covered call options. The TCRS had no options outstanding at June 30, 1997.

D. COMMITMENTS

The TCRS has agreed to serve as standby note purchaser for notes issued by the Funding Board of the State of Tennessee. By serving as a standby note purchaser, the TCRS receives an annual fee of 7.5 basis points on the $250 million maximum issuance under this agreement. In the unlikely event that the TCRS would be called upon to purchase the notes, the TCRS would receive interest at a rate equal to prime plus 75 basis points. Moody's Investors Services, Inc., and Standard and Poor's have given these notes of the Funding Board ratings of M1G1/VM1G1 and SP-1+/A-1+, respectively.

E. OTHER NOTE DISCLOSURES

The financial statements include summarized comparative information in total for the prior fiscal year ended June 30, 1996. Such information for the prior year does not include sufficient, comparative detail by plan to constitute a presentation in conformity with generally accepted accounting principles but has been presented for informational purposes.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULES OF FUNDING PROGRESS

(Expressed in Thousands)

Actuarial Valuation Date	**Actuarial Value of Assets (a)**	**Actuarial Accrued Liability (AAL) Frozen Entry Age (b)**	**Unfunded AAL (UAAL) (b-a)**	**Funded Ratio (a/b)**	**Covered Payroll (c)**	**UAAL as a Percentage of Covered Payroll ((b-a)/c)**
SETHEEPP						
06/30/97	$ 15,671,678	$ 15,782,850	$ 111,172	99.30%	$ 3,810,231	2.92%
PSPP						
06/30/97	$ 2,226,891	$ 2,247,787	$ 20,896	99.07%	$ 1,130,585	1.85%

Information according to the parameters for measuring pension expenditures, expense, and related actuarially determined disclosure information, as required by GASB, is available beginning with the current transition year.

See accompanying Notes to Required Supplementary Information.

Tennessee Consolidated Retirement System
Notes to Required Supplementary Information
June 30, 1997

An actuarial valuation of the TCRS is performed every two years. The June 30, 1995, valuation determined the employer contribution rate for the year ended June 30, 1997. Therefore, the Schedule of Employer Contributions, in accordance with the parameters of GASB Statement Number 25, is not available for the year ended June 30, 1997, but will be available for future years.

The information presented in the required supplementary Schedules of Funding Progress was determined as part of the actuarial valuations as of June 30, 1997. Additional information as of the latest actuarial valuation follows.

	SETHEEPP	PSPP
Valuation Date	06/30/97	06/30/97
Actuarial cost method	Frozen Entry Age	Frozen Entry Age
Amortization method	Level Dollar	Level Dollar
Remaining amortization period	18 years closed period	(1) closed period
Asset valuation method	5-year Moving Market Average	5-year Moving Market Average
Actuarial assumptions:		
Investment rate of return	7.5%	7.5%
Projected salary increases	5.5%	5.5%
Includes inflation at	(2)	(2)
Cost-of-living adjustments	3%	3%
Increase in Social Security wage base	4.5%	4.5%

(1) The length of the amortization period varies by individual political subdivision but does not exceed 20 years.

(2) No explicit assumption is made regarding the portion attributable to the effect of inflation on salaries.