1998 TREASURER'S REPORT

Steve Adams, Treasurer - State of Tennessee

1998 Treasurer's Report

Steve Adams, Treasurer
State of Tennessee

Fiscal Year Ended June 30, 1998

Preserving Tennessee's Appalachian History

The Museum of Appalachia

John Rice Irwin's Museum of Appalachia was opened in the late 1960s with one log building, the General Bunch House, on a two-acre plot. Now it has grown to 65 acres and features a pioneer-type farm with a collection of more than 30 authentic log cabins and buildings dating back to the 1700s and more than 400,000 pioneer-frontier relics. The mountain village looks as though the people there have just stepped away from their chores of butchering hogs, building fences, sharpening axes, weaving brooms, making soap, and crushing apples for cider. The farm is home to numerous farm animals including cattle, mules, sheep and goats that graze in the pastures near a huge cantilevered barn. Roosters crow and peacocks scream for attention. Gardens are planted with vegetables and surrounded by split rail fences.

The Museum includes a large Display Barn that houses hundreds of extensive collections of southern mountain artifacts and memorabilia. The Appalachia Hall of Fame is dedicated to the men, women, and children of Appalachia. It includes a "music room" devoted to the people who were part of creating and sustaining the plaintive music of the Appalachian area. The Hall of Fame also includes a basket exhibit dedicated to the old-time mountain basket makers who received scant remuneration and little recognition for their toil in creating one of the most useful and artistic possessions in their lives.

Visitors to the museum come away feeling that they know the people who crafted the items on display. Many of the items have handwritten stories explaining their origins. A gifted writer, Irwin weaves stories that carry visitors into the lives of the people of the region. "Physical objects, no matter whether they're rare or common, are infinitely more interesting and important if they are tied to the people who made, used, cherished and cared for them. These items are a part of our heritage and our culture, but only if the history and the object remain connected."

In the children's room, next to a hand carved toy sled and a black and white picture of the sled in the hands of the old man who had carved it years earlier, is this story. "Little Bower Fisher was seriously ill with diphtheria and her father didn't know if he'd ever see her again. 'I didn't know if she'd live the day, but I had to work to feed the rest of the family. But she was so sick that I decided to come home for dinner. It was four or five miles, but I walked, mostly ran, to get there.' When he came into view of home, he was overjoyed by what he saw. His little girl had tied a string to a block of wood and was pulling it across the yard, pretending it was a sled. 'I was so happy to see how much better she was that I took the rest of the day off from cutting timber and I made her this little sled.' "

The annual Museum of Appalachia's Tennessee Fall Homecoming, held in October, is an event which draws visitors from around the world. The Homecoming features several hundred old-time musicians and mountain craftsmen. Other events held at the Museum include the "July 4th Celebration" and "Christmas in Old Appalachia."

The nationally acclaimed Museum, farm and village is located 16 miles north of Knoxville on I-75, in Norris, Tennessee. For further information about the Museum of Appalachia, write John Rice Irwin at P.O. Box 1189, Norris, Tennessee 37828 or call (423) 494-7680 or 494-0514.

A special thanks to the Museum of Appalachia for furnishing the pictures used in this report.

Pictured above is John Rice Irwin, founder of the Museum of Appalachia with Alex Haley, Pulitzer Prize winner and author of Roots. After visiting the museum in the spring of 1982, Mr. Haley loved it so much that he built his home next door and moved back to Tennessee.

Early morning feeding of the flock means hauling a sled of hay to the waiting flock of sheep. The Museum of Appalachia features a working farm and many farm animals and fowl.

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LETTER OF TRANSMITTAL

State of Tennessee
Treasury Department
State Capitol
Nashville, Tennessee 37243

December 31, 1998

To the Governor, Members of the General Assembly,
and Citizens of the State of Tennessee:

It is again an honor to present the annual Treasurer's Report. This publication is a summary of the activity of our department for the fiscal year ended June 30, 1998. Because of your support and the commitment and expertise of an outstanding staff, we have had a very successful year. As you read this report, I feel that you will be pleased with our performance and our achievements.

While it is impossible to mention all of our successes in this document, please note the continued success and interest of citizens in our prepaid tuition program, BEST. In addition, our comprehensive Internet site has been enhanced to provide even more information about the services we provide to public employees and the citizens of Tennessee. We remain diligent in providing superior service to our constituency.

As we prepare in the months ahead to meet the new millennium, our challenges as public servants will be numerous. The demands for services provided by government will increase and it is essential that we be prepared to meet these tasks. As State Treasurer and as a committed public servant and proud Tennessean, I look forward to working with you to meet these demands. My staff and I are committed to providing professional financial management and programs responsive to the needs of public employees and taxpayers of our state.

Sincerely,

Steve Adams

Steve Adams

EXECUTIVE SUMMARY

INTRODUCTION

The 1998 Treasurer's Report contains reports on various programs administered by the Treasury Department, including Investments, the Tennessee Consolidated Retirement System, the Deferred Compensation Program, the Flexible Benefits Plan, Claims Administration, the Tennessee Claims Commission, Risk Management, the Unclaimed Property Program, the Chairs of Excellence Program, the Baccalaureate Education System Trust, and the Careers Now Program. The following comments represent a brief recap of the purpose and operations of each program administered by the department. The remainder of this report gives detailed data regarding these programs' activities during the 1997-98 fiscal year.

INVESTMENTS

The Investment Division has the responsibility for investing all funds under management of the Treasury Department.

State Cash Management - This section manages the State Pooled Investment Fund which includes the state's cash, the various dedicated reserves and trust funds of the state, and the Local Government Investment Pool. Investments during 1997-98 averaged $2.76 billion, producing $155.73 million in income for an average rate of return of 5.64%. Local governments participating in the Local Government Investment Pool received $88 million in interest at a net rate averaging 5.53%. The State Trust of Tennessee allows the department to use the Federal Reserve Wire Transfer System to transfer funds on a limited basis.

Pension Fund Investments - This section manages the investments of the Tennessee Consolidated Retirement System (TCRS) which at June 30, 1998 totaled $21 billion at fair value. For the year, investments produced $2.7 billion in income for a realized rate of return of 15.1% on a fair value basis. This section also manages investments for the Chairs of Excellence Trust which at June 30, 1998 totaled $210.9 million at fair value.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

The Tennessee Consolidated Retirement System provides retirement coverage to state employees, higher education employees, teachers, and employees of political subdivisions that have elected to participate in the plan. As of June 30, 1998, there were 184,194 active TCRS members: 41,737 state employees; 61,103 K-12 teachers; 62,175 political subdivision employees; and 19,179 higher education employees. As of June 30, 1998, there were 68,944 retirees. TCRS paid out $578.9 million in benefits during fiscal year 1997-98. The state of Tennessee is responsible for the pension liability for state employees and higher education employees and funds a significant portion of the retirement liability for teachers through the BEP. Each participating political subdivision is responsible for the liability of its employees.

DEFERRED COMPENSATION PROGRAM

The State of Tennessee Deferred Compensation Program offers state employees the opportunity to accumulate supplemental retirement income on a tax deferred basis. Participants may direct the investment of their deferred salary into a variety of investment products contracted for the program. During the 1997-98 fiscal year, the state and the University of Tennessee each matched their employees' contribu-

Executive Summary

tions to the 401(k) plan at $20 per month. As of June 30, 1998, 41,500 state and higher education employees had accounts in the program. The market value of accumulated account balances totaled $418.5 million, an increase of $96.6 million during the year.

Flexible Benefits Plan

The State of Tennessee Flexible Benefits Plan is an optional benefit plan which enables state employees to pay for certain expenses with before-tax dollars. At June 30, 1998, there were 37,108 state employees using the plan: 36,672 paid group medical premiums, 13,313 paid group dental premiums, 2,518 used the medical expense reimbursement account, and 358 used the dependent care reimbursement account. The plan generated over $2.3 million in F.I.C.A. savings for the state during the 1997-98 fiscal year.

Claims Administration

The Division of Claims Administration is responsible for investigating and making determinations on claims made against the state for workers' compensation by state employees, employee property damage, tort liability, and criminal injury compensation. Staff support from the Division of Claims Administration also assists the Board of Claims. The Division of Claims Administration received 6,217 claims for tort, employee property damage, and workers' compensation. The Board of Claims took action on 10 matters regarding claims and insurance, and 1,597 victims of criminal injury and drunk driver claims were approved for payment. Payments made during the year for workers' compensation, tort, and employee property damage claims totaled $19.4 million. Payments made to victims of criminal injuries and drunk drivers totaled $6.3 million. Since the first payments were issued in 1982, over $91 million has been paid to crime victims.

Tennessee Claims Commission

The Tennessee Claims Commission is an administrative tribunal created to determine monetary claims against the State of Tennessee. There are three commissioners, one from each grand division of the state. Claims are payable from the Claims Award Fund by the Division of Claims Administration after adjudication by a commissioner. At June 30, 1998, the commission had 1,465 open claims (including claims transferred to administrative law judges). This represented a 31% reduction from cases open at June 30, 1997.

Division of Risk Management

The Division of Risk Management is responsible for administering the state's Property/Casualty Insurance Program, including the procurement of boiler insurance and employee fidelity bond coverage. All state-owned buildings and contents are provided all-risk, replacement cost coverage for the limits of liability listed in the state's Property Insurance Schedule. On July 1, 1997, the total scheduled values were $8.5 billion. The State Reserve for Casualty Losses, in the amount of $5 million, provides an annual aggregate retention for the payment of property claims. Excess property coverage is procured from an independent insurance carrier to provide claim payments in excess of the retention, should losses exceed $5 million in a given fiscal year. In fiscal year 1997-98, the premium cost for total property coverage without the $5 million retention was estimated to be $8.9 million. The actual cost of the program for the same period was $3.4 million, providing a savings to the state of approximately $5.5 million.

EXECUTIVE SUMMARY

UNCLAIMED PROPERTY PROGRAM

The Unclaimed Property Division is responsible for the administration of the state's Uniform Disposition of Unclaimed Property Act. Under this act, the state provides one centralized location for the owners of abandoned property, or their heirs, to turn to when searching for forgotten assets. The types of property covered by this act are primarily cash property such as bank accounts, insurance policies, utility deposits, etc. During the fiscal year, $16.1 million of unclaimed property was turned over to the Treasurer and $4.8 million was returned to owners or their heirs. Since the program began in 1978, over $146.3 million in unclaimed property has been reported to the Treasurer and over $42.1 million (28%) of that property has been returned to the owners or their heirs.

CHAIRS OF EXCELLENCE

The Chairs of Excellence Trust is a nonexpendable trust fund authorized in 1984 to further the cause of education in Tennessee. The funding of the program is provided through contributions made by a private donor and a matching amount by the state, thus, creating a chair. Income from the chair is used to offset the cost of retaining a nationally or regionally recognized scholar at a state college or university who teaches in a specified academic area. During the 1998 fiscal year, one chair was created with matching contributions totaling $625,000. Since 1984, a total of 96 chairs have been created. The Trust totaled $212.9 million fair value at June 30, 1998 and produced income of $33.6 million during the year.

BACCALAUREATE EDUCATION SYSTEM TRUST (BEST)

The Tennessee Baccalaureate Education System Trust, or BEST, is a prepaid college tuition savings program that allows anyone to pay for higher education costs in advance on behalf of a beneficiary. Through the purchase of affordable tuition units, Tennesseans can pay for future tuition at today's price and ease their concerns about whether they will have enough funds to pay for their children's higher education. Flexibility is a key component of the program by allowing participants to determine when and how much to save, and by providing multiple payment options and unlimited school choices. In addition, state college savings programs provide favorable tax benefits to participants. The BEST program began accepting contributions in June 1997.

CAREERS NOW PROGRAM

The Careers NOW Program provides Tennessee college students the opportunity to learn more about the operations of state government and career opportunities therein by working in one of the three constitutional offices for a semester. The program has had 67 students since it began in January 1996.

BOND REFUNDING TRUST

The Treasurer has been appointed Refunding Trustee for the Tennessee Local Development Authority (TLDA), for the Tennessee State School Bond Authority, and for the Funding Board of the State of Tennessee in connection with the sale of bonds issued to refund, in advance of maturity, bonds and notes previously issued by the TLDA, School Bond Authority, and Funding Board. The Treasurer has established a Refunding Trust Fund for the benefit of the holders of the refunded bonds. A portion of the proceeds of the refunding bonds were used to acquire direct general obligations of the United States of America or obligations which are unconditionally guaranteed by the United States of America as to principal and interest. The assets of the Refunding Trust Fund totaled $99.4 million at fair value on June 30, 1998.

TREASURY NUMBERS AT A GLANCE
FISCAL YEAR 1997-98

ADMINISTRATIVE	Number of Filled Positions		175
	Payroll Expenditures	$	7,289,646
	Other Expenditures	$	3,766,237
	Total Administrative Expenditures	$	11,055,883
CASH MANAGEMENT PROGRAM	General Fund Earnings	$	27,141,029
	LGIP Earnings	$	88,929,846
	Restricted Fund Earnings	$	39,842,823
	Total Cash Management Earnings	$	155,913,698
RETIREMENT PROGRAM	Retirement Benefits	$	578,901,713
	Number of Retirees		68,944
	Number of Active Members		184,194
	Retirement Contributions	$	387,314,026
	Retirement Investment Earnings	$	2,758,267,944
CLAIMS ADMINISTRATION PROGRAM	Workers' Compensation Payments	$	12,010,959
	Workers' Compensation Claims Filed		3,918
	Employee Property Damage Payments	$	28,095
	Employee Property Damage Claims Filed		248
	Tort Claims Payments	$	7,403,985
	Tort Claims Filed		2,051
	Criminal Injury Payments	$	6,266,009
	Criminal Injury Claims Filed		1,476
	Claims Award Fund Revenue	$	15,912,326
RISK MANAGEMENT PROGRAM	Property Values Insured	$	8,522,150,600
	Total Cost of Program	$	3,398,975
	Savings to the State over Private Insurance Rates	$	5,549,283
CHAIRS OF EXCELLENCE PROGRAM	Chairs of Excellence Contributions	$	732,000
	Chairs Of Excellence Investment Earnings	$	33,649,111
	Chairs of Excellence Expenses	$	6,785,036
	Total Number of Chairs of Excellence		96
OTHER PROGRAMS	Deferred Compensation Contributions	$	46,959,136
	State Matching Contributions	$	4,569,728
	Deferred Compensation Participants		41,500
	Flexible Benefits Plan Payments	$	3,112,907
	FICA Savings Generated from Flex Plan	$	2,302,902
	Unclaimed Property Revenues	$	16,060,680
	Unclaimed Property Payments	$	4,800,889
	BEST Accounts		2,993
	BEST Contributions (net of fees)	$	5,856,165
FAIR VALUE OF ASSETS UNDER MANAGEMENT AT 6/30/98	Retirement Trust Fund	$	21,116,218,594
	Chairs of Excellence Trust Fund	$	212,884,686
	State Pooled Investment Fund Investments	$	3,318,623,461
	Deferred Compensation (outside managers)	$	418,520,713
	Baccalaureate Education System Trust	$	7,079,890
	Bond Refunding Trust	$	99,389,523
	Total Assets Under Management	$	25,172,716,867

Program Administration

State Cash Management

The state of Tennessee receives revenues from many sources such as taxes, licenses, fees, and the federal government. As these monies are collected, they are deposited into one of the 187 financial institutions in Tennessee that have contracted with the state to serve as depositories. Under the state Constitution, the state may not spend more money on its programs than it has collected in revenues. Consequently, at any point in time the state has a sizable sum of money collected but not yet spent. These monies are invested by the Treasury Department until needed to pay for state expenses, payroll, or benefit program disbursements.

During the 1997-98 fiscal year, the average balance of short term investments in the Treasurer's Cash Management program was $2,763,862,666 per month and interest income of $155,725,074 was earned. This includes deposits in the Local Government Investment Pool administered by the Treasury Department.

The State Funding Board sets the investment policy for the state. The State Funding Board is composed of the Governor, Commissioner of Finance and Administration, Comptroller, Secretary of State, and Treasurer. The foremost investment objective of the State Pooled Investment Fund is safety of principal, followed by liquidity and then yield.

The current investment policy for the State Pooled Investment Fund was established to follow SEC Rule 2a-7-like guidelines for a money market fund. The maximum maturity of any security can not exceed 396 days and the weighted average maturity must be 90 days or less.

Funds may be invested in collateralized certificates of deposit with authorized Tennessee financial institutions; bills, notes and bonds of the U.S. Treasury; other obligations guaranteed as to principal and interest by the United States or any of its agencies; and repurchase agreements against obligations of the United States or its agencies. Securities underlying repurchase agreements must be book-entry and delivered to the State Trust of Tennessee. Funds may also be invested in prime commercial paper and prime banker's acceptances.

At June 30, 1998, investments had an average maturity of 71 days, and an average weighted yield of 5.60%. The total balance in the State Pooled Investment Fund at June 30, 1998 ($3,329,571,000 par value) was allocated as follows: U.S. Treasury government and agency securities, 22.27%; repurchase agreements, .83%; collateralized certificates of deposit, 43.05%; and commercial paper, 33.85%.

STATE CASH MANAGEMENT

STATE CASH MANAGEMENT COMPARATIVE RETURNS

In order to ensure that state investment returns reflect current market conditions, several market indicators are carefully monitored. Among these are rates reported daily in the Wall Street Journal, rates on U.S. Treasury securities and institutional money market funds. The following table illustrates state returns compared with two of these indicators.

Fiscal Year	[1]Total Pool Funds	[2]Merrill Lynch Institutional Fund	[3]New Pool Funds	[4]90 Day Treasury (CD Equivalent Yield)
1997-98	5.64%	5.44%	5.59%	5.17%
1996-97	5.50	5.25	5.40	5.17
1995-96	5.69	5.49	5.60	5.29
1994-95	5.34	5.33	5.47	5.45
1993-94	4.04	3.30	3.41	3.42

[1]Investment return on total portfolio.
[2]This index most closely resembles the structures and objectives of the total cash portfolio.
[3]Investment return on funds invested during the year.
[4]This approximates the reinvestment period for new funds.

ADMINISTRATION OF AUTHORIZED STATE DEPOSITORY ACCOUNTS

The Cash Management Division is responsible for the administration of the state's bank accounts in Tennessee financial institutions designated as authorized state depositories. Taxpayers and state agencies can deposit certain tax funds due to the state directly to any Treasurer's account at any authorized state depository.

The four most significant functions of administering the accounts are: (1) authorizing the state depository to accept state funds; (2) cash concentration; (3) collateralizing deposits; and (4) monitoring collateral and deposits. Financial institutions' requests to become authorized state depositories are received in Cash Management, reviewed, and forwarded to the appropriate state officials for consideration and approval.

The Cash Management Division is responsible for the cash concentration and management of all state depository accounts. Cash Management staff inquire on the balances of bank accounts and concentrate available funds into the State Trust to meet liquidity and investment needs. Account balances are drawn to the floor and concentrated by Fed wire or Automated Clearinghouse (ACH) transactions. The account floor is the minimum amount required by the financial institution for that particular account to earn interest. All of these state accounts are interest bearing.

Changes in branch banking laws and bank ownership due to mergers and acquisitions have brought about a need to quickly identify the parent

State Cash Management

bank, holding company and affiliate trustee custodians for state depositories. The ability to access and update this information on a database enhances the ability to monitor deposits and collateral based on appropriate bank ownership.

This same database is accessed for current account information for balance inquiry and cash concentration. It automates the link from balance inquiry to cash concentration by generating an ACH transaction. This automation provides more time to inquire on more accounts. The account balance floors are automatically compared to the balances entered to calculate ACH transaction amounts.

State Collateral Program

Collateral is required to secure state deposits held in authorized state depository institutions. Statute sets the required collateral level at a market value of 105 percent of the value of the deposit secured, less the amount secured by the Federal Deposit Insurance Corporation. However, if the state depository is operating with a capital-to-asset ratio of less than five percent, additional collateral with a market value of $100,000 is required. The types of investment instruments which are eligible to be pledged as collateral are listed in this report.

The state of the economy and the financial environment has increased the importance of monitoring collateral. Cash Management staff review collateral daily, weekly, and monthly. Any collateral deficiencies at authorized state depository institutions are reported to the Funding Board monthly. Reasons for under-collateralization include market price volatility of the security pledged, unexpected high deposits to an account, interest accruals, capital-to-asset ratios falling below five percent, and principal paydowns on asset backed securities which have been pledged as collateral.

Collateral is held by an authorized trustee custodian in the name of the state of Tennessee. Treasury staff must authorize the receipt, release, and substitution of all collateral.

8-5-110 Collateral

Tennessee Code Annotated, Section 8-5-110 designates the Treasurer as the custodian of all negotiable instruments deposited with the state or any department thereof, and requires the Treasurer to be exclusively responsible for the safekeeping thereof.

Cash Management personnel work directly with the personnel of the state agencies to accept and release collateral held in accordance with their specific instructions. Other state agencies cooperating with the Treasurer in this regard include the Department of Health, the Department of Environment and Conservation, the Department of Commerce and Insurance, the Department of Transportation, and the Department of Financial Institutions. Reports of collateral transactions, holdings, and maturities are regularly shared with these departments.

STATE CASH MANAGEMENT

COLLATERAL POOL

Legislation passed in March 1990 – "The Collateral Pool for Public Deposits Act" – authorized the formation of a collateral pool for banks. The Collateral Pool operates under the jurisdiction of the Collateral Pool Board, which is comprised of four bankers and three government members representing state and local government divisions. The Collateral Pool Board has established rules and procedures that provide a low amount of risk and a high degree of efficiency for participating institutions.

While participation in the Collateral Pool is voluntary, participation is subject to application to and approval by the Collateral Pool Board. The Board has established minimum financial performance levels for applicants which must be met to ensure that only healthy institutions are permitted to participate.

All public funds held by a pool participant are collateralized based on a collateral target calculated each month by the participant. The collateral target is based on the aggregate average balance of all public funds for the month multiplied by the pledge percentage assigned to the participant by the Board.

All collateral transactions for the pool are monitored and processed through the Treasury Department using uniform state-wide procedures. In addition, Treasury Department staff monitors all pool activity through the monthly, quarterly, and annual reports required to be submitted by pool participants.

The Collateral Pool began operations on November 1, 1995 with 13 banks participating. Only banks were initially eligible to participate in the pool, but in the spring of 1996, legislation was passed to allow thrift institutions to participate in the Collateral Pool. The Collateral Pool Board began accepting applications from thrift institutions on August 29, 1996.

Currently, the Collateral Pool has 42 participant institutions collateralizing public funds in excess of $2.5 billion and representing over 9,000 public fund accounts.

STATE CASH MANAGEMENT

SECURITIES ACCEPTABLE AS COLLATERAL FOR STATE DEPOSITS

1. U.S. Treasury Bills

2. U.S. Treasury Notes & Bonds

3. Federal Housing Administration (FHA) debentures

4. Government National Mortgage Associations (GNMA)*

5. Farm Credit System (FCS)
   a. Federal Land Bank Bond (FLBB)
   b. Farm Credit Systemwide Bonds (FCSB)
   c. Farm Credit Systemwide Discount Notes (FCDN)
   d. Farm Credit Systemwide Floating Rate Notes (FCFR)

6. Federal Home Loan Banks
   a. Bonds (FHLB)
   b. Discount Notes (FHDN)
   c. Floating Rate Notes (FHFR)

7. Federal Home Loan Mortgage Corporation (FHLMC)*
   a. Mortgage-Backed Participation Certificates and Adjustable Rate Securities (FMPC, FMAR)
   b. Discount Notes (FMDN)

8. Federal National Mortgage Association (FNMA)*
   a. Bonds, Debentures, Secondary Market Debt Obligations (FNSM)
   b. Discount Notes (FNDN)
   c. Floating Rate Notes (FNFR)
   d. Mortgage-Backed Pass-Through Certificates (FNRF)
   e. Residential Financing Securities (FNRF)
   f. Adjustable Rate Mortgage-Backed Bonds (FNAR)

9. Student Loan Marketing Association (SLMA)
   a. Discount Notes (SLDN)
   b. Fixed Rate Notes (SLMN)
   c. Floating Rate Notes (SLFR)
   d. Bonds (SLBD)

10. Tennessee Valley Authority Bonds and Notes (TVA)

11. Collateralized Mortgage Obligations (CMOs) and Real Estate Mortgage Investment Conduits (REMICs) that are direct obligations of a U.S. agency or FNMA/FHLMC, except that the "residual" class/tranche of such securities will not be acceptable. Sufficient excess securities should be pledged to allow for the periodic reduction of principal.

12. Certain Tennessee Municipal Bonds as specified in T.C.A. Section 9-4-103.

13. Surety Bonds issued by insurance companies meeting certain requirements, including licensure under the laws of Tennessee.

14. Standby Letters of Credit from approved Federal Home Loan Banks.

** Pass through securities must reflect current paid down values and be kept up to date.*

STATE CASH MANAGEMENT

HISTORICAL ANALYSIS OF STATE CASH INVESTMENTS

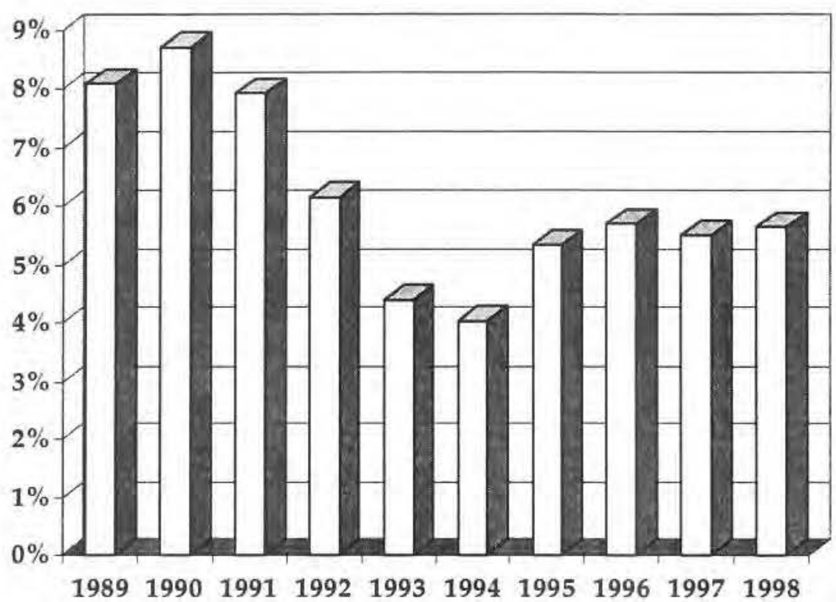
Fiscal Year	*Average Amount Invested*	*Amount Earned*	*Rate of Return*
		Collateralized Time Deposits	
1997-98	$ 1,055,776,333	$ 59,831,252	5.66%
1996-97	848,697,167	46,917,097	5.53%
1995-96	835,888,333	49,605,934	5.89%
1994-95	743,203,083	39,498,384	5.34%
1993-94	524,944,000	18,544,812	3.54%
		Repurchase Agreements	
1997-98	$ 164,851,917	$ 9,136,064	5.56%
1996-97	180,228,167	9,743,171	5.37%
1995-96	176,878,167	9,988,181	5.62%
1994-95	172,311,500	9,375,039	5.46%
1993-94	154,941,333	5,181,537	3.31%
		Commercial Paper	
1997-98	$ 890,313,583	$ 50,659,421	5.69%
1996-97	739,561,917	41,056,244	5.55%
1995-96	591,118,167	33,556,447	5.65%
1994-95	533,771,250	29,866,669	5.60%
1993-94	371,247,833	13,478,983	3.64%
		U.S. Government Securities	
1997-98	$ 652,920,833	$ 36,098,337	5.52%
1996-97	622,375,583	34,547,557	5.45%
1995-96	655,638,667	35,684,775	5.46%
1994-95	692,287,167	34,534,311	5.07%
1993-94	1,082,046,750	47,245,264	4.54%
		Securities Lending Income	
1997-98	N/A	$ 0	N/A
1996-97	N/A	0	N/A
1995-96	N/A	0	N/A
1994-95	N/A	487,467	N/A
1993-94	N/A	1,525,111	N/A

Total Funds

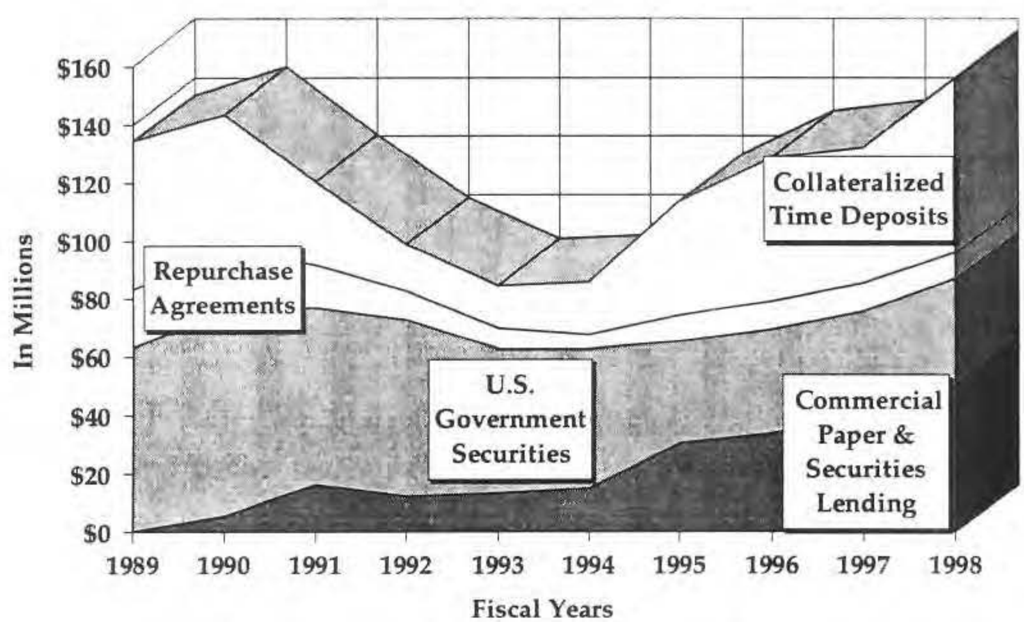
Fiscal Year	*Average Total Funds Invested*	*Cash Management Investment Earnings*	*Composite Weighted Average Rate of Return*
1997-98	$ 2,763,862,666	$ 155,725,074	5.64%
1996-97	2,390,862,834	132,264,069	5.50%
1995-96	2,259,523,334	128,835,337	5.69%
1994-95	2,141,573,000	113,761,870	5.34%
1993-94	2,133,179,916	85,975,707	4.04%

STATE CASH MANAGEMENT

CASH MANAGEMENT INVESTMENTS
COMPOSITE WEIGHTED AVERAGE RATE OF RETURN 1989-1998



ANALYSIS OF STATE CASH EARNINGS 1989-1998



STATE CASH MANAGEMENT

CASH MANAGEMENT PORTFOLIO ANALYSIS
FISCAL YEAR ENDED JUNE 30, 1998

Date	Current Investment Yield	Total Portfolio Yield	Avg. Days to Maturity	*Portfolio Composition* Time Deposits	Repurchase Agreements	U.S. Treasury Notes	U.S. Agencies	Commercial Paper
07/97	5.58%	5.63%	65	35.39%	5.54%	4.45%	20.46%	34.16%
08/97	5.57%	5.62%	67	35.12%	6.43%	5.73%	17.87%	34.85%
09/97	5.61%	5.63%	67	35.79%	6.02%	6.10%	18.66%	33.43%
10/97	5.58%	5.65%	66	38.52%	6.42%	6.24%	14.73%	34.09%
11/97	5.66%	5.69%	70	41.93%	8.12%	6.39%	11.90%	31.66%
12/97	5.69%	5.72%	64	47.89%	6.28%	5.67%	10.41%	29.75%
01/98	5.56%	5.68%	52	40.37%	8.42%	5.14%	16.32%	29.75%
02/98	5.58%	5.61%	56	38.86%	6.62%	3.72%	18.60%	32.20%
03/98	5.61%	5.61%	59	37.52%	5.47%	1.79%	22.55%	32.67%
04/98	5.56%	5.62%	57	33.72%	5.50%	1.59%	27.33%	31.86%
05/98	5.53%	5.59%	81	34.25%	3.86%	1.47%	27.87%	32.55%
06/98	5.53%	5.58%	74	41.55%	4.32%	1.47%	22.85%	29.81%
Dollar Weighted Avg.	5.59%	5.64%	65	38.41%	6.08%	4.15%	19.13%	32.23%

Date	*General Fund* Average	Percent	*LGIP* Average	Percent	*Other Restricted* Average	Percent	*Total Average Invested*
07/97	$ 594,193,545	22.38%	$ 1,397,495,174	52.64%	$ 663,204,281	24.98%	$ 2,654,893,000
08/97	673,712,774	24.93%	1,359,506,015	50.31%	669,112,211	24.76%	2,702,331,000
09/97	575,965,349	21.88%	1,398,595,880	53.12%	658,339,771	25.00%	2,632,901,000
10/97	539,204,555	20.99%	1,351,353,795	52.61%	677,906,650	26.40%	2,568,465,000
11/97	433,988,948	17.29%	1,346,740,700	53.65%	729,301,352	29.06%	2,510,031,000
12/97	259,401,298	11.11%	1,356,188,143	58.11%	718,500,559	30.78%	2,334,090,000
01/98	211,272,427	8.33%	1,589,399,776	62.66%	735,800,797	29.01%	2,536,473,000
02/98	146,245,728	5.72%	1,669,590,020	65.30%	741,150,252	28.98%	2,556,986,000
03/98	138,835,832	4.98%	1,891,647,727	67.90%	755,567,441	27.12%	2,786,051,000
04/98	347,746,469	11.13%	1,993,828,903	63.83%	782,024,628	25.04%	3,123,600,000
05/98	627,052,335	18.55%	1,949,367,725	57.67%	803,724,940	23.78%	3,380,145,000
06/98	776,009,319	22.96%	1,820,479,088	53.85%	783,897,593	23.19%	3,380,386,000
Avg.	$ 443,635,715	15.85%	$ 1,593,682,746	57.64%	$ 726,544,206	26.51%	$ 2,763,862,666

State Cash Management

Local Government Investment Pool

Tennessee municipalities, counties, school districts, utility districts, community service agencies, local government units, and political subdivisions can deposit monies with the Treasurer to be invested in the state cash management investment pool. Of course, these local governments can invest their monies directly in the money market if they so desire. However, by allowing their dollars to be invested by the state they eliminate the complexities of managing day to day investment and collateral relationships with banks and/or securities dealers.

This allows cash managers who have previously been limited either by the relatively small amount of funds available for investment or the complexities of today's investment environment to take advantage of the volume and expertise of the Treasurer's cash management program.

The Local Government Investment Pool began operations in November of 1980. Participation in the LGIP program currently stands at 841 active accounts, representing 283 local government units. In addition, 349 accounts are active in the Department of Transportation program.

Local governments which enter into agreements with the Department of Transportation (DOT) often establish an LGIP account to fund the local matching portion of a highway project grant. These DOT accounts are available to provide the local match to the specific highway project in a timely manner while earning interest for the local government. In a similar fashion, the Tennessee Board of Regents schools provide their matching portion of Capital Projects funds while earning interest for the benefit of the Board of Regents school.

The Treasurer's Office has installed a facsimile copy machine to assist participants of the LGIP in communicating their instructions regarding deposits, transfers or withdrawals of funds. Thus, participants have the choice of communicating these instructions by telephone or telecopier.

In addition, voice mail telephone service has been provided to permit LGIP participants to give telephone transaction instructions while staff is busy on other telephone lines. Voice mail permits an increase in productivity while holding costs constant.

LGIP reports mailed to participants include monthly statements and transaction confirmations. Monthly statements detail all debits and credits to the account during the month, the account's average daily balance, and interest credited. A transaction confirmation is mailed to the participant each time a deposit or withdrawal is made. Many participants rely on this documentation for daily and weekly reconciliations.

Participants earn interest on LGIP deposits based on the average rate of interest earned on the investments acquired for the entire cash management pool each month. This average earnings rate is reduced each month by six one hundredths of one percent (.06%) as an administrative fee for participating in the LGIP program. During the 1997-98 fiscal year, the average rate participants earned on their deposits after the fee reduction was 5.53%.

Other activity is shown on the following schedule by participant group.

State Cash Management

Local Government Investment Pool
Schedule of Activity by Entity Type

Fiscal Year Ended June 30, 1998

	Account Balance 7/1/97	Net Deposits/Withdrawals FY 1997-98	Net Interest Credited FY 1997-98	Account Balance 6/30/98
Cities	$ 253,626,777	$ 37,762,069	$ 15,434,055	$ 306,822,901
Counties	506,388,253	193,294,425	34,162,830	733,845,508
Commitments to D.O.T.	48,224,905	3,596,178	2,732,918	54,554,001
Educational Institutions	369,631,451	(16,527,972)	25,066,069	378,169,548
Community Service Agencies	7,224,646	2,566,106	463,251	10,254,003
Restricted Accounts	936,933	(62,083)	51,247	926,097
Other	193,610,448	(28,107,345)	10,066,545	175,569,648
TOTAL	$ 1,379,643,413	$ 192,521,378	$ 87,976,915	$ 1,660,141,706

STATE CASH MANAGEMENT

STATE TRUST OF TENNESSEE

The State Trust of Tennessee, a not-for-profit corporation, was chartered in the state of Tennessee on April 20, 1979 and began operations in December 1980. The State Trust has enabled the Treasury Department to gain limited membership in the Federal Reserve Bank System. Being a limited member of the Federal Reserve gives the Treasury Department access to the Federal Reserve Wire System, which is used to send, receive, transfer and control funds movement expediently under the Treasurer's management.

Due to restrictions imposed upon state-owned trust companies by the Federal Reserve Board, the State Trust of Tennessee is limited in the number of daily outgoing wire transfers and can no longer settle ACH transactions through its account at the Federal Reserve.

The restrictions required the State Trust of Tennessee to contract with an agent bank to execute these transactions. SunTrust Bank in Nashville began serving as the Trust's agent on July 1, 1994.

The State Trust became an associate member of the Nashville Clearinghouse on April 1, 1994. Approximately 85% of all check items presented for redemption are processed through the clearinghouse.

STATE TRUST OF TENNESSEE FEDERAL RESERVE BANK TRANSACTIONS
FISCAL YEAR 1997-98

Transaction Type	Number	Amount
(1) Wire Disbursements	933	$ 4,236,045,420
(2) Wire Receipts	7,353	13,177,755,529
(3) Security Disbursements	1,007	40,682,202,445
(4) Security Receipts	1,021	40,657,228,472
(5) Check Redemptions	6,296,556	7,554,544,697
TOTAL	6,306,870	$ 106,307,776,563

Explanation of Transaction Types:

(1) Disbursements of cash for the purpose of non-Fed eligible securities, settlement wires to agent bank, and other non-recurring wires.

(2) Receipt of cash for payment of interest and principal for non-Fed eligible securities, concentration of cash deposited in local banks, drawdown of Federal funds, and Local Government Investment Pool (LGIP) deposits.

(3) Disbursement of cash against the receipt of Fed eligible securities (U.S. Government securities held in book-entry form by the Federal Reserve Bank).

(4) Receipt of cash against the disbursement of Fed eligible securities.

(5) Redemption of warrants, drafts, and checks issued by the state.

TCRS Investments

Investment objectives for the TCRS Investment Division are to obtain the highest available return on investments consistent with the preservation of principal, while maintaining sufficient liquidity to react to the changing environment and to pay beneficiaries in a timely manner.

TCRS Investment Division's policies and strategies serve to benefit plan members in several ways. The emphasis on a conservative asset allocation and high quality securities helps to ensure the soundness of the system and the ability to provide the needed funds upon a member's retirement.

Funds in the retirement system are actively managed with a diversified portfolio of high-quality domestic and international bonds, domestic and international stocks, and money market instruments.

The investment authority for TCRS is set out in *Tennessee Code Annotated,* Section 8-37-104(a), which provides that, with certain specific exceptions, investments of TCRS assets are subject to the same terms, conditions, and limitations imposed on domestic life insurance companies. It further provides that investment policy for TCRS funds is subject to the approval of the Board of Trustees.

An Investment Advisory Council was established by the Consolidated Retirement Act of 1972 to provide policy guidance to the Board of Trustees and the investment staff. The current Advisory Council is comprised of senior investment professionals from within the state of Tennessee. All members hold the Chartered Financial Analyst designation.

Effective January 1, 1998, State Street Bank began providing Master Trust Custodial services to TCRS. The master custodian provides safekeeping and accounting services.

Initiatives

Since the Tennessee General Assembly enacted legislation to authorize TCRS to further diversify its portfolio by allowing investments in real estate, the system has been active in establishing the necessary infrastructure to manage this asset class. The system hired an experienced real esate portfolio manager, employed the services of a real estate investment consultant and adopted internal operating procedures to carry out the provisions of the real estate policy as adopted by the TCRS Board of Trustees. It is anticipated that the system will employ the services of real estate investment advisors in early 1999 with real estate purchases occurring in mid 1999.

External Managers for International Equity

TCRS utilizes external managers for the investment management of the international equity asset class. The use of external managers for this asset class began in November 1995 when the number of countries in which stock purchases could be made was increased from seven to 39. Pursuant to T.C.A. Section 8-3-113, the initial selection of eight external managers included one emerging investment manager. The initial allocation of $800 million included $10 million for emerging managers. Subsequent allocations of $620 million in April 1997 and November 1998 included $40 million for emerging managers.

TCRS Investments

Summary of Retirement Fund Investments

	June 30, 1998	*June 30, 1997*
	Fair Value	**Fair Value**
Domestic Securities:		
Government Bonds	$ 7,360,002,937	$ 5,491,015,999
Corporate Bonds	3,089,064,993	3,389,392,600
Corporate Stocks	6,477,250,896	5,539,624,045
Total Domestic Securities	$ 16,926,318,826	$ 14,420,032,644
International Securities:		
Government Bonds	$ 1,347,272,879	$ 1,216,381,373
Corporate Bonds	216,268,307	323,917,513
Corporate Stocks	1,448,384,918	1,560,789,329
Total International Securities	$ 3,011,926,104	$ 3,101,088,215
Short-Term Securities	$ 919,005,431	$ 875,251,761
Total Investments	$ 20,857,250,361	$ 18,396,372,620

TCRS Investments

TCRS Investments Benchmark Analysis

Fiscal Year	[1]Public Fund Index Median Total Return	[2]TCRS Total Return	[3]Yield To Maturity on New Bonds
1997-98	17.9%	15.1%	6.4 %
1996-97	18.9	15.7	6.7
1995-96	15.8	12.8	6.2
1994-95	15.4	12.8	7.3
1993-94	1.6	0.5	5.9
1992-93	13.2	15.1	6.5
1991-92	12.1	13.7	8.2
1990-91	7.9	7.8	8.7
1989-90	10.4	11.6	9.0
1988-89	14.2	15.3	9.4

[1]This index most closely resembles the structure and objectives of TCRS.

[2]This is the time weighted method used to calculate returns and is the most accurate way to measure performance.

[3]This is the yield to maturity on bonds acquired with new funds during each fiscal year.

Summary of TCRS Earnings Fiscal Years 1993-94 Through 1997-98

Fiscal Year	TCRS Portfolio Earnings[1]
1997-98	$ 2,758,267,944
1996-97	2,514,952,816
1995-96	1,806,673,555
1994-95	930,425,055
1993-94	1,229,683,543

[1]Beginning with fiscal year 1995-96, TCRS portfolio earnings include unrealized appreciation on investments.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

The Tennessee Consolidated Retirement System (TCRS) was established July 1, 1972. Prior to this date, there were seven different public employee retirement systems. The TCRS, a defined benefit plan which is qualified under 401(a) of the Internal Revenue Code (IRC), is a retirement system for state employees, higher education employees, teachers, and local government employees.

MEMBERSHIP

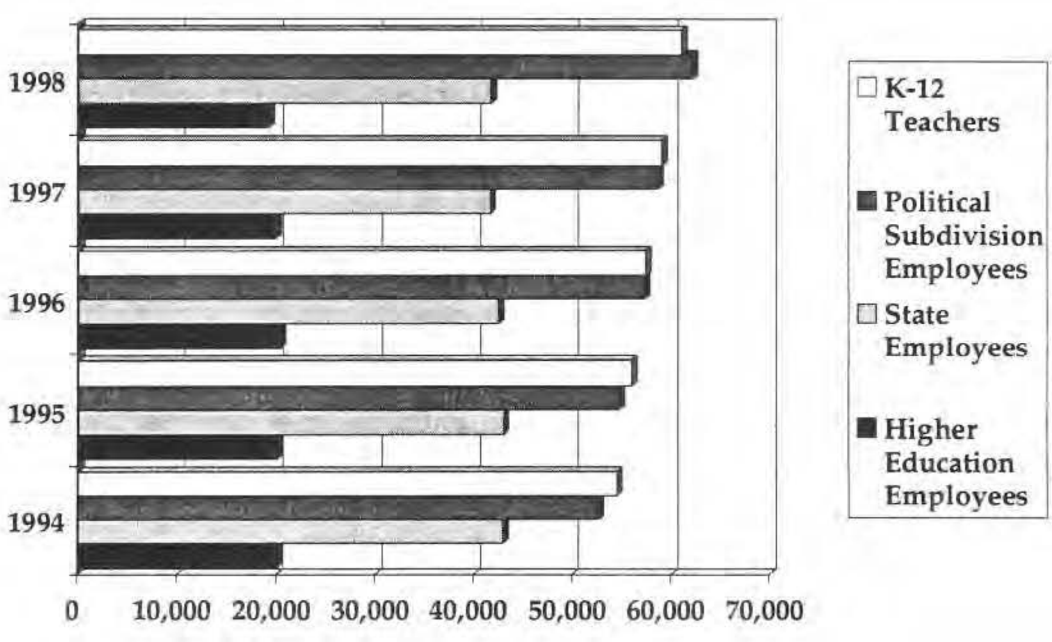
Membership in the retirement system is a condition of employment for full-time state employees, teachers, general employees in higher education, and the employees of local governments that participate in TCRS. Membership is optional for certain part-time employees. Faculty employees in higher education may participate in either TCRS or an Optional Retirement Program (ORP), which is a defined contribution plan designed for faculty employees in institutions of higher education. When an employee joins TCRS, he receives an introductory letter and membership pamphlet outlining various aspects of retirement membership.

State employees and teachers become vested after five years of service. Political subdivision members attain vested status upon completion of 10 years unless five year vesting has been authorized. A vested member is guaranteed a retirement benefit once the age requirements are met.

As of June 30, 1998, there were 184,194 active members of TCRS and 10,366 higher education employees participating in the ORP.

Since July 1, 1976, all new members of the TCRS except state judges have been classified as Group I members. State judges have been permitted to enroll in Group IV since September 1, 1990. From July 1, 1972 to June 30, 1976, all employees were classified as Group I, with the exception of state policemen, wildlife officers, firemen and policemen who were classified as Group II, and judges and elected officials who were classified as Group III. Members of seven superseded systems are permitted to retain their original rights and benefits.

ACTIVE MEMBERS FISCAL YEARS 1994-1998



TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

CONTRIBUTIONS

The funding of retirement benefits is financed by member contributions, employer contributions, and the earnings of the invested assets. Effective July 1, 1981, the employee contributions of certain state employees and higher education employees were assumed by the state. Local governments can also adopt these noncontributory provisions for their employees. Group I K-12 teachers and contributory local government employees contribute to TCRS at the rate of 5% of gross salary. Employee contribution rates vary for superseded classifications.

Effective January 1, 1987, all state employees and teachers who contribute a portion of their income to the retirement system became covered by Section 414(h) of the Internal Revenue Code. Under 414(h), payment of federal income tax on an employee's retirement contributions is deferred until these contributions are withdrawn in the form of a refund or monthly benefit payments. Political subdivisions may pass a resolution adopting Section 414(h) coverage for their employees.

Upon termination of employment, a member may elect to withdraw his contributions and accumulated interest from the retirement system in a lump sum. By obtaining a lump sum refund, a member waives all rights and benefits in the retirement system. A vested member may leave his account balance in TCRS and apply for benefits upon meeting the age requirements. A non-vested member who terminates employment may only leave his account balance in TCRS for up to seven years. During the 1997-98 fiscal year, 4,571 refunds totaling $24.6 million were issued.

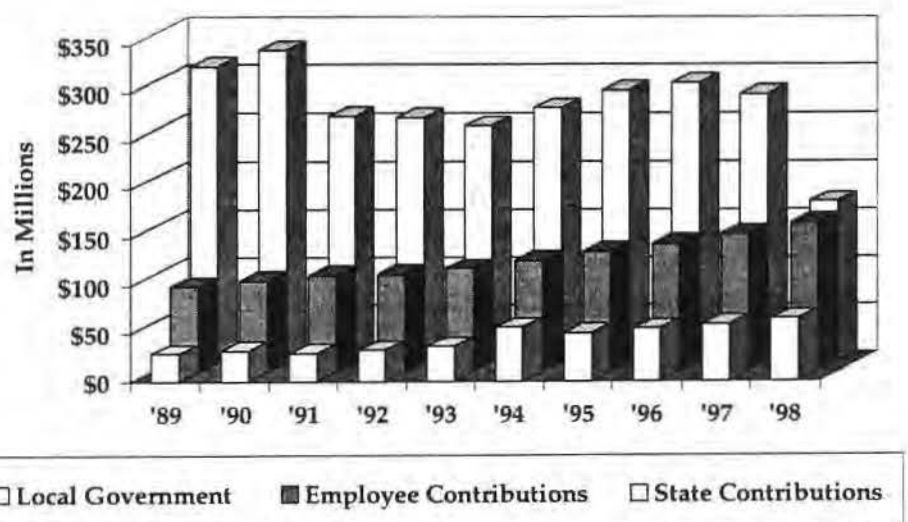
The contribution rate for the employers participating in the retirement system is determined by a biennial actuarial valuation performed by an independent actuarial firm. The contribution rates include funding for the basic benefit, the cost-of-living increase provisions, and amortization of the accrued liability over a 40 year period which began in July of 1975. The employer contribution rates for the year ending June 30, 1998 were as follows:

Noncontributory State and Higher Education Employees	3.65%
K-12 Teachers	3.89%
Political Subdivisions	Individually Determined
Faculty Members Electing to Participate in the ORP	10.00%*

*11% for salary above the social security wage base.

RETIREMENT CONTRIBUTIONS FISCAL YEARS 1989-1998

IN MILLIONS



Tennessee Consolidated Retirement System

Retirement Benefits

The benefits provided by TCRS are designed, when combined with the benefit payable from social security, to allow career employees to maintain their standard of living at retirement.

As of June 30, 1998, 68,944 retirees were receiving monthly benefit payments. This represents a 3.4% increase over the previous year.

Group I state employees and teachers become eligible to retire from the TCRS at age 60 with five years of service or at any age with 30 years of service. State employees and teachers become vested after five years of service. Political subdivision members attain vested status upon completion of 10 years unless five year vesting has been authorized. Retirement benefits are based on the average of the member's five highest consecutive years of salary and the years of creditable service. A reduced retirement benefit is available to vested members at age 55 or upon completion of 25 years of service.

Disability benefits are available to active members with five years of service who become disabled and can not engage in gainful employment. There is no service requirement for disability benefits paid to active members whose disability is a result of an accident or injury occurring while the member was in the performance of duty.

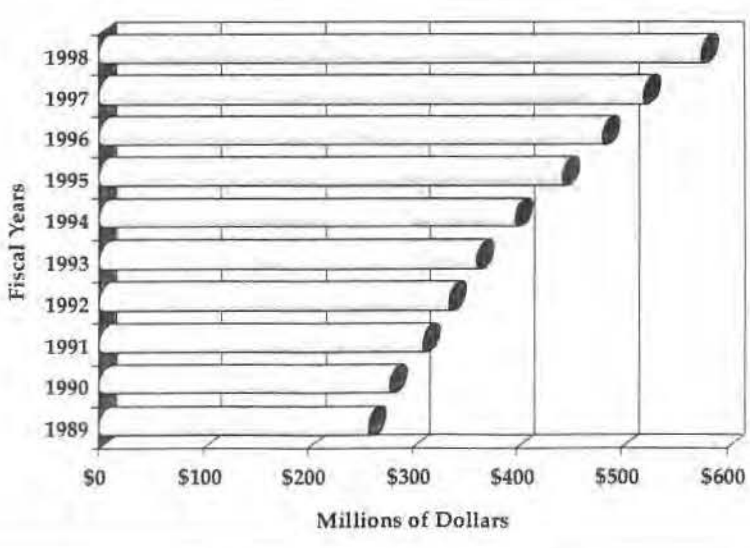
Cost-of-living adjustments after retirement are based on the Consumer Price Index (CPI). If there is an increase in the CPI of as much as .5% in any calendar year, the retired member's benefit will be adjusted by an amount equal to the increase in the CPI, not to exceed 3%.

Certain death benefits are available to the beneficiary(s) of a member who dies prior to retirement. At retirement, a member can select an optional benefit which is actuarially reduced so that his beneficiary may continue to receive a benefit after his death.

Benefits paid in fiscal year 1997-98 totaled \$578.9 million, an increase of \$57.6 million over 1996-97 benefit payments.

Annual Benefit Payments Fiscal Years 1989-1998

In Millions



TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

TENNESSEE'S RETIREMENT PROGRAM

TCRS AND SOCIAL SECURITY BENEFITS

SAMPLE CALCULATIONS FOR CALENDAR YEAR 1998

Five Year Average Final Compensation		20 Years			25 Years			30 Years		
$15,000	TCRS	$	4,725		$	5,906		$	7,088	
	Social Security		8,088			8,088			8,088	
	Total	$	12,813	(85.4%)	$	13,994	(93.3%)	$	15,176	(101.2%)
$20,000	TCRS	$	6,300		$	7,875		$	9,450	
	Social Security		9,720			9,720			9,720	
	Total	$	16,020	(80.1%)	$	17,595	(88.0%)	$	19,170	(95.9%)
$25,000	TCRS	$	7,875		$	9,844		$	11,813	
	Social Security		11,352			11,352			11,352	
	Total	$	19,227	(76.9%)	$	21,196	(84.8%)	$	23,165	(92.7%)
$30,000	TCRS	$	9,482		$	11,852		$	14,222	
	Social Security		12,984			12,984			12,984	
	Total	$	22,466	(74.9%)	$	24,836	(82.8%)	$	27,206	(90.7%)
$35,000	TCRS	$	11,319		$	14,149		$	16,979	
	Social Security		14,040			14,040			14,040	
	Total	$	25,359	(72.5%)	$	28,189	(80.5%)	$	31,019	(88.6%)
$40,000	TCRS	$	13,157		$	16,446		$	19,735	
	Social Security		14,568			14,568			14,568	
	Total	$	27,725	(69.3%)	$	31,014	(77.5%)	$	34,303	(85.8%)
$45,000	TCRS	$	14,994		$	18,743		$	22,491	
	Social Security		15,000			15,000			15,000	
	Total	$	29,994	(66.7%)	$	33,743	(75.0%)	$	37,491	(83.3%)

This chart is based on a date of retirement in 1998. Social Security benefits have been calculated by Bryan, Pendleton, Swats & McAllister, actuarial consultants for the TCRS, utilizing the following assumptions: (1) retirement took place at age 65 in 1998; (2) the retiree worked a full career (TCRS plus other employers, if necessary) of 35 years or more, and; (3) salary increases throughout the retiree's career followed the same pattern as National Average Earnings.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

ACTUARIAL VALUATION

An actuarial valuation of the TCRS is performed by an independent actuarial firm every two years. The purpose of the valuation is to determine the funding requirements for the employers participating in the TCRS. The latest valuation was performed June 30, 1997 to establish employer contribution rates. The system's accrued liability at June 30, 1997 is $111.2 million. The accrued liability is being amortized over a 40 year period which began in 1975.

In addition to the biennial actuarial valuation, an experience study is conducted every four years for the purpose of establishing actuarial and economic assumptions to be used in the actuarial valuation process. Following are the assumptions used in the June 30, 1997 actuarial valuation of the plan:

Economic Assumptions
(1) 7.5% annual return on investments
(2) 5.5% salary increases annually
(3) 4.5% annual increase in social security wage base

Actuarial Assumptions
(1) Pre-Retirement mortality based on age and sex
(2) Post-Retirement mortality based on age and sex
(3) Disability rate based on age
(4) Turnover rate based on age and length of service
(5) Retirement age distribution based on age and service

POLITICAL SUBDIVISIONS

Political subdivisions may participate in the TCRS if the chief governing body passes a resolution authorizing coverage and accepting the liability associated with the coverage. Each political subdivision is responsible for the retirement cost of its employees and, in addition to employer contributions, pays the TCRS a fee for TCRS administration.

Political Subdivision Participation
as of June 30, 1998

Cities	142
Counties	86
Utility Districts	30
Special School Districts	20
Joint Ventures	25
Miscellaneous Organizations	18
Regional Libraries	12
911 Emergency Communication Districts	24
Housing Authorities	10
Development Agencies	12
Total	379

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

MAJOR LEGISLATIVE IMPROVEMENTS 1978-1998

1978 A bonus cost-of-living increase was granted to retirees at a lump-sum cost of $15.3 million.

An optional retirement plan was established for teachers in the Board of Regents system.

1980 Death benefits for members dying in-service with 10 years of service was improved by offering a 100% joint and survivor annuity of the member's accrued benefit for the spouse.

1981 Non-contributory retirement for state employees and higher education employees was adopted. The employees' contributions–up to 5%–were assumed by the state. Salaries of employees in active service on the date these provisions were adopted were indexed by 3.6%. Subsequent legislation has continued this indexing each year since.

1983 An actuarially reduced retirement benefit at any age with 25 years of service was authorized.

1984 Credit for out-of-state service for the purpose of determining retirement eligibility was authorized.

Part-time employees were permitted to participate in TCRS and members were allowed to establish credit for previous part-time employment.

The minimum benefit was increased from $7 to $8 per month per year of service.

Retirement credit for armed conflict military service was approved.

1985 An ad hoc increase was granted to retirees at a lump-sum cost of $22 million.

Death benefits for spouse and children were provided when member's death is in the line of duty.

1987 Service credit for half of peacetime military service was made available.

Another ad hoc increase to retirees was provided at a lump-sum cost of $17 million.

A retirement incentive program was offered for state employees retiring during a 90-day window.

Section 414(h) of the IRC was adopted to provide that employee contributions are made on a tax-deferred basis.

1989 Retirement service credit for members receiving worker's compensation due to a temporary disability was made available.

1990 A retirement incentive program was offered for state employees retiring during a 120-day window.

1991 The Board of Trustees was authorized to designate additional vendors for the optional retirement plan for higher education employees.

1992 The minimum number of years required to qualify for retirement was reduced from 10 to five years.

Disability and death benefits were made available to inactive, vested members.

1993 Salary portability for service in different classifications was authorized effective January 1, 1994.

A 5% benefit improvement was authorized effective January 1, 1994.

1996 An installment payment plan for prior service was authorized.

3.6% indexing of salaries for noncontributory employees was extended for an additional year.

1997 Compounding of future cost of living adjustments and catch up adjustments was authorized. 3.6% indexing of salaries for noncontributory employees was extended permanently.

1998 Group 2 and Group 3 service requirements were amended to permit service retirement with 30 years of service, regardless of age.

Group 1 and Prior Class C benefit limitations were increased to 80 percent.

Supplemental bridge benefit established in conjunction with reestablishment of mandatory retirement for all state public safety officers.

Tennessee Consolidated Retirement System

Social Security

The Old Age & Survivors Insurance Agency (OASI) administers Section 218 of the federal Social Security Act for Tennessee public employees. This section relates to coverage agreements and modifications as well as to coverage determinations.

Prior to 1951, social security coverage was not available to public employees. Amendments to the Social Security Act made in 1950 allowed certain groups of state and local government employees who were not covered by an employer-sponsored retirement plan to voluntarily participate in social security. Amendments made in 1954 allowed coverage for public employees who were covered by an employer-sponsored retirement plan if federal referendum requirements are met.

The Tennessee Master Agreement was executed on August 16, 1951. It provided full social security coverage (retirement, survivors, disability, and hospital insurance) to public employees who were not covered by an employer-sponsored retirement plan. A modification to the agreement, effective January 1, 1956, provided social security coverage to employees serving in positions which were then covered by the Tennessee State Retirement System and the Tennessee Teachers' Retirement System. After the Tennessee Consolidated Retirement System was established July 1, 1972, a state-wide social security coverage referendum was held among eligible employees.

The 1985 Budget Reconciliation Act mandated Medicare hospital insurance coverage for public employees hired after March 31, 1986 who do not have full social security coverage. The Omnibus Budget Reconciliation Act of 1990 (OBRA) generally mandated full social security coverage for state and local government employees who are not covered by an employer-sponsored retirement plan.

Effective in 1991, separate wage bases were implemented for social security and Medicare and separate reporting of withholding was required. Since 1991, the social security tax rate has been 6.20% each for employers and employees and the Medicare (hospital insurance) rate has been 1.45% each.

Schedule of Historical Social Security Contribution Rates

Calendar Year	*Employee Rate*	*Employer Rate*	*Social Security Wage Base*	*Medicare Wage Base*
1999	7.65%	7.65%	$ 72,600	No Limit
1998	7.65	7.65	68,400	No Limit
1997	7.65	7.65	65,400	No Limit
1996	7.65	7.65	62,700	No Limit
1995	7.65	7.65	61,200	No Limit
1994	7.65	7.65	60,600	No Limit
1993	7.65	7.65	57,600	$ 135,000
1992	7.65	7.65	55,500	130,200
1991	7.65	7.65	53,400	125,000
1990	7.65	7.65	51,300	51,300

DEFERRED COMPENSATION

The Deferred Compensation Program is a voluntary program designed to provide state employees with the opportunity to accumulate supplemental retirement income on a tax deferred basis. Participants may postpone income taxes on contributions and earnings by agreeing to defer receipt of a portion of their current income until retirement.

This program offers employees two plans. The 457 plan was implemented in the 1981-82 fiscal year and the 401(k) plan was implemented in the 1983-84 fiscal year.

As of June 30, 1998, 37,648 individuals had accounts in the 401(k) plan and 3,852 individuals had accounts in the 457 plan. At June 30, 19,858 state employees, 6,788 University of Tennessee employees, and 5,098 Tennessee Board of Regents employees were actively contributing to the 401(k) plan and 1,339 state employees, 92 University of Tennessee employees, and seven Tennessee Board of Regents employees were actively contributing to the 457 plan.

The program is used by state employees of all ages and salary levels. The majority are under age 50 and earn below $35,000 per year. At June 30, 1998, the average monthly 401(k) deferral among state employee participants was $114 and the average monthly deferral among higher education employee participants was $82.

IRS regulations for 1998 allow a maximum deferral in the 457 plan of 25% of taxable salary up to the maximum annual contribution of $8,000. The maximum deferral in the 401(k) plan is 20% of taxable salary for most members, up to the maximum annual contribution of $10,000. Participants who use more than one tax-deferred savings plan are subject to additional limits.

During the 1997-98 fiscal year, the state and the University of Tennessee each matched their employees' contributions to the 401(k) plan at $20 per month as authorized by the General Assembly. The amount contributed by the state during the year was $4,569,728.

Participants in the program may direct the investment of their deferred salary to Union Planters Time Deposit Account, Aetna's Fixed Account, Calvert's Income Fund, and Fidelity Investments' Magellan Fund, Puritan Fund, OTC Portfolio, Contrafund, International Growth and Income Fund, Asset Manager, and Government Money Market Portfolio. At June 30, state employee participants used an average of 2.4 funds each and higher education participants used an average of 1.9 funds each.

During the 1997-98 fiscal year, the selection process was completed for adding State Street Bank & Trust's S&P 500 Index Fund effective July 1, 1998.

Enrollment and recordkeeping services for the program are provided by Security First Group. The use of an unbundled arrangement enables participants to receive an objective presentation of the investment products, to avoid the sales fees traditionally associated with bundled products, and to receive consolidated account statements and benefit estimates. All of the products available for new enrollment are offered without sales fees, surrender fees, mortality and expense risk fees, or minimum deposit requirements.

Participants in the program receive a quarterly statement showing their contributions and earnings during the quarter. In addition, once a year, participants receive a special statement projecting their account balance to a variety of retirement ages and showing the monthly income those account balances might provide. The program provides a variety of communication and education materials and services, including a comprehensive Internet site, a video, a handbook for participants, several booklets on special topics, investment seminars around the state, and a voice response telephone system which provides participants with telephone access to account balances account activity, and loan initiation 24 hours a day.

The program's Internet site, located at www.treasury.state.tn.us/defcomp.htm, provides full information about the program. Information

DEFERRED COMPENSATION

available through the site includes forms, participation information and illustrations, descriptions of the investment choices and historical performance figures, an interactive benefit calculator, complete information for participants who may be approaching retirement age or considering withdrawing funds from the program, and an e-mail address for participants to request additional personalized information. The National Association of Government Deferred Compensation Administrators awarded the site its outstanding achievement award in communication.

For the year ending June 30, 1998, contributions to the program totaled $46,959,136. Contributions are wired through the State Trust of Tennessee for immediate crediting. At June 30, 1998, participants were directing 85% of their new contributions to variable mutual funds.

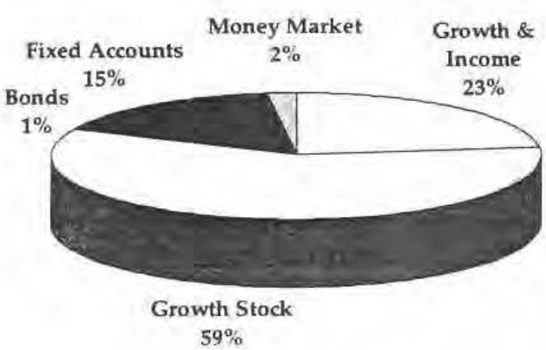
At June 30, 1998, accumulated account balances totaled $418,520,713. At June 30, 1998, the program's assets were invested as follows: 75% in variable mutual funds, 4% in variable annuity products, 17% in insurance companies' fixed accounts, and 4% in a federally insured bank account. Distribution of the program's assets among the program's six investment providers is shown on the following page.

Under the loan program offered in the 401(k) plan, active employees who have accumulated $4,000 or more in their 401(k) account may borrow up to half of their account value. Participants repay principal and interest to their 401(k) account through salary deduction. Taxes continue to be deferred while funds accumulated in the plan are in loan status. As of June 30, 1998, there were 510 loans outstanding from the 401(k) plan. Outstanding loan balances totaled $2.1 million.

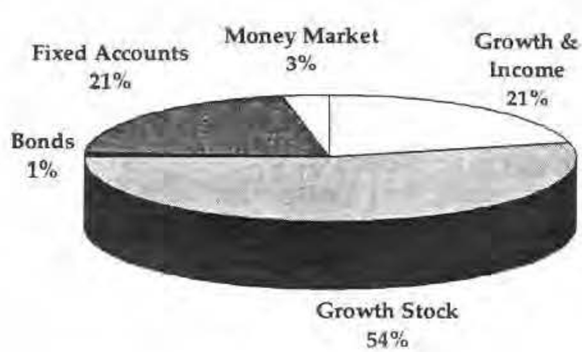
Benefits from the program may be distributed in periodic payments, in an annuity, or in a lump sum. At June 30, 1998, there were 563 individuals receiving periodic payments and 191 individuals receiving annuity payments from the program. In addition, a total of 1,764 lump sum distributions were issued during 1997-98.

DISTRIBUTION OF DEFERRED COMPENSATION ASSETS BY INVESTMENT CATEGORY JUNE 30, 1998

CONTRIBUTIONS



ASSETS



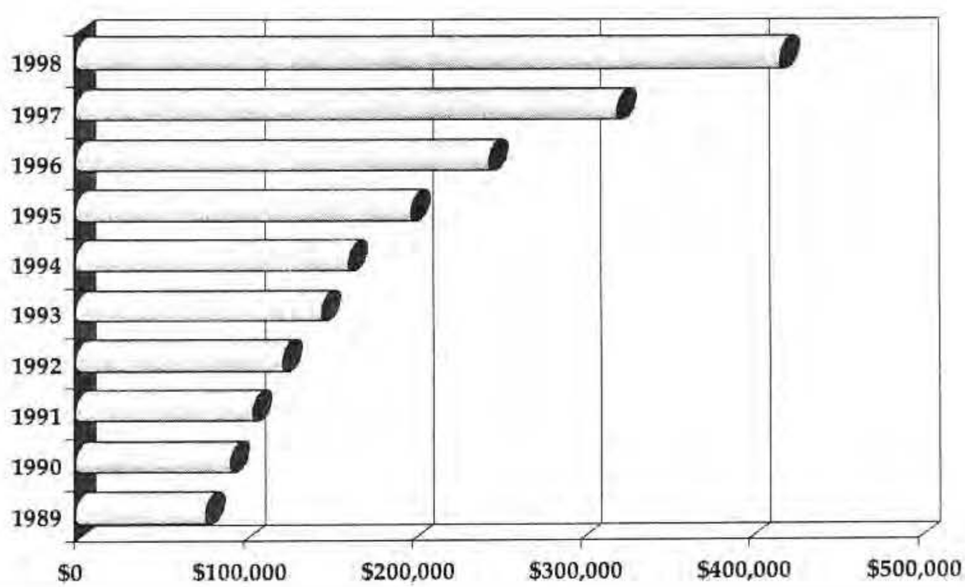
DEFERRED COMPENSATION

DEFERRED COMPENSATION CONTRIBUTIONS AND ASSETS

	Contributions		*Market Value of Account Balances*	
	FY 1997-98	**FY 1996-97**	**June 30, 1998**	**June 30, 1997**
Plan I: 457				
Aetna - Closed Contract	$ 0	$ 0	$ 21,235,441	$ 19,888,499
Aetna - New Contract	448,825	534,817	15,080,164	13,219,644
American General	49,508	53,078	1,030,304	988,523
Calvert Group	39,302	41,796	737,749	494,565
Fidelity Investments	2,205,015	2,334,890	79,553,813	62,967,168
Great West	0	0	2,269,353	3,544,555
Union Planters	397,879	557,807	14,176,840	14,670,926
TOTAL 457	$ 3,140,529	$ 3,522,388	$ 134,083,664	$ 115,773,880
Plan II: 401(k)				
Aetna - Closed Contract	$ 0	$ 0	$ 10,339,249	$ 10,439,932
Aetna - New Contract	3,833,461	4,113,296	24,398,700	19,748,200
Calvert Group	523,770	559,816	2,469,652	1,833,225
Fidelity Investments	37,065,324	32,430,254	230,395,117	157,282,585
Great West	0	0	2,042,208	3,253,414
Union Planters	2,396,052	2,616,891	14,792,123	13,592,395
TOTAL 401(k)	$ 43,818,607	$ 39,720,257	$ 284,437,049	$ 206,149,751
GRAND TOTAL	$ 46,959,136	$ 43,242,645	$ 418,520,713	$ 321,923,631

PROGRAM ASSETS 1989-1998

IN THOUSANDS



Flexible Benefits Plan

The Flexible Benefits Plan is an optional benefit plan which enables state employees to pay for certain expenses with tax-free salary. Authorized under Section 125 of the Internal Revenue Code, this plan allows employees to avoid income tax and social security tax on the portion of the upcoming year's salary they agree to set aside for that year's (1) group medical insurance premiums, (2) group dental insurance premiums, (3) out-of-pocket medical expenses, and (4) dependent care expenses.

In exchange for its favorable tax treatment, the plan must comply with specific rules set forth by the Internal Revenue Code and Regulations. Employees must decide what they will purchase through the plan and how much they will spend before the year begins. State employees enrolled in a group health or dental insurance program are automatically enrolled in the insurance premium portion of the plan unless they elect not to participate. Use of the other benefit options requires a new election each year.

Enrollment in the plan is for a full calendar year. Enrollments may not be changed after the year has begun unless the employee experiences a change in family status and reports that change promptly. Employees must use the amounts set aside in each category for corresponding expenses incurred during the year and any amount not used by the employee must be subject to forfeiture.

Tennessee's Flexible Benefits Plan, or "cafeteria" plan was implemented January 1, 1989. The Treasury Department took over administration of the program effective January 1, 1992.

At June 30, 1998, 37,108 state employees were enrolled in one or more of the plan's four options: 36,672 employees used the plan to pay medical insurance premiums, 13,313 paid dental insurance premiums, 2,518 used the medical expense reimbursement account, and 358 used the dependent care reimbursement account.

Since contributions to the plan are exempt from both employee and employer F.I.C.A. (social security) tax, employees' use of the plan creates F.I.C.A. savings for the state. In fiscal year 1997-98, the state's F.I.C.A. savings totaled $ 2.3 million. Since the program began operation in January 1989, the state's F.I.C.A. savings have totaled $17.2 million. Savings exceeding the costs of administering the plan have been designated for offsetting costs of the state's wellness program, providing assistance for day care programs, and funding matching contributions to the 401(k) plan. As of June 30, 1998, $14.2 million had been transferred to offset costs of other benefit programs.

CLAIMS AGAINST THE STATE

The Division of Claims Administration processes claims filed against the state for the negligent operation of motor vehicles or machinery; negligent care, custody and control of persons or property; professional malpractice; workers' compensation claims by state employees; dangerous conditions on state maintained highways and bridges; and nuisances created or maintained by the state. The Division of Claims Administration operates in conjunction with the Attorney General's Office and the Tennessee Claims Commission in this claims process.

The Division of Claims Administration contracts with a third party administrator for the processing of workers' compensation claims. The division's staff monitors the work done by the third party administrator and acts as a liaison between state employees and the third party administrator.

The division contracts with a managed care organization which has established a workers' compensation preferred provider network for medical treatment for injured state employees. Currently, 98% of state employees have access to this network. The managed care organization also provides case management services such as precertification for inpatient hospital care, bill review, large case management and other services to manage the costs of workers' compensation claims. The use of a preferred provider network has enabled the state to obtain approximately 33% savings off billed charges on workers' compensation medical bills.

The Division of Claims Administration also handles all employee property damage claims and tort claims up to a certain monetary limit.

During fiscal year 1997-98, the Division of Claims Administration received 6,217 claims falling within these categories (including workers' compensation claims filed with the third party administrator).

In order for a claim to be acted upon by the Division of Claims Administration, notice must be filed with the division. The division then has 90 days to make a determination on the claim. If the division is unable to act, the claim is automatically referred to the Tennessee Claims Commission. This process ensures that claims will be processed in a timely fashion.

This division also provides staff support to the Board of Claims. The Board of Claims has the authority to hear claims which do not fall within the jurisdiction of the Tennessee Claims Commission. During the 1997-98 fiscal year, the Board took action on a total of 10 matters regarding claims and insurance. The Board also reviews and approves the purchase of insurance policies by the state and makes recommendations to the Commissioner of Finance and Administration and the General Assembly regarding the required funding for the Claims Award Fund.

The primary function of the Division of Claims Administration, Board of Claims, and Tennessee Claims Commission is to provide an avenue for persons who have been damaged by the state to be heard and, if appropriate, compensated for their loss or damage. All claims are paid through the Claims Award Fund. This fund is supported by premiums paid by each state department, agency and institution. The required funding is based upon an actuarial study which reflects risk assessment and estimated losses.

Claims Against the State

Claims and Payment Activity Fiscal Year 1997-98

	Claims Filed	Payments Made
Workers' Compensation Claims	3,918	
Death Payments		$ 236,394
Medical Payments		5,201,781
Assault Injury Payments		1,734
Temporary Disability (Lost Time)		1,035,185
Permanent Disability		5,535,865
Subtotal		$ 12,010,959
Employee Property Damage	248	$ 28,095
Tort Claims	2,051	
Death Payments		$ 1,211,049
Bodily Injury Payments		5,491,359
Property Damage Payments		701,577
Subtotal		$ 7,403,985
TOTAL	6,217	$ 19,443,039

VICTIMS COMPENSATION PROGRAM

Assisting persons who are innocent victims of crime is the purpose of the Criminal Injury Compensation Program. Payments made under the Criminal Injury Compensation Program are intended to defray the costs of medical services, loss of earnings, burial costs, and other pecuniary losses to either the victim of a crime or to the dependents of deceased victims. This program is funded through privilege taxes assessed in courts against criminal defendants and other offenders upon conviction, fees levied against parolees and probationers, the proceeds of bond forfeitures in felony cases, and a federal grant.

Applications for Criminal Injuries Compensation are filed with the Division of Claims Administration. The division's staff reviews the application and obtains supporting information from the appropriate District Attorney's Office to determine eligibility for payment from the Criminal Injuries Compensation fund. If the division cannot process a claim within 90 days, then the claim is referred to the Tennessee Claims Commission.

During the 1997-98 fiscal year, the Division of Claims Administration made payments on 1,597 criminal injury claims for a total of $6,266,009. Payments are issued promptly to the victim and, if appropriate, his or her attorney. Federal funding assistance for the program has aided in allowing prompt claim payment.

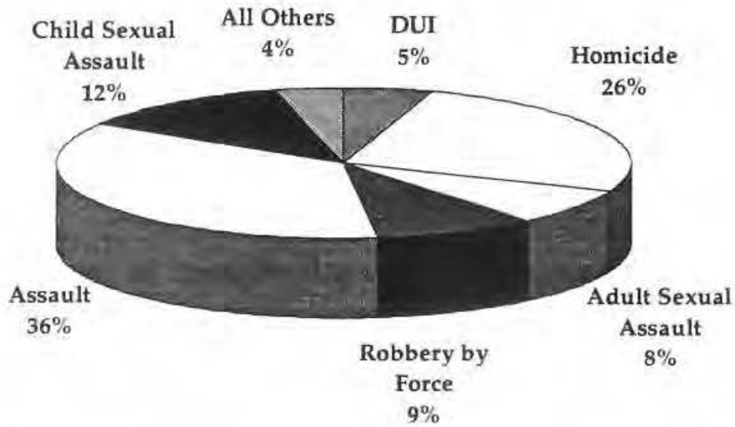
Victims of drunk drivers are also paid from the Criminal Injury Compensation Fund. Identical monetary benefits are available to both drunk driver and criminal injury victims. When the proximate cause of a death or injury is the operator's intoxication as prohibited by T.C.A. 55-10-401, the victim's death or injury is eligible for compensation in the same manner as criminal injury compensation, not to exceed a maximum award of $8,000 per claim plus attorney fees for injuries occurring on or after July 1, 1997. A supplemental award of up to $4,000 was available for crimes occurring during the 1997-98 fiscal year.

Since the first claims were paid in 1982, the program has awarded a total of over $91 million to crime victims. The Division of Claims Administration has made an effort to educate members of the public of the existence and benefits of the Criminal Injury Compensation Program by printing and distributing informative brochures explaining the program. Public awareness efforts and the use of victim assistance coordinators in each judicial district have also aided in providing the public with information about the availability of criminal injury compensation.

VICTIMS COMPENSATION PROGRAM

VICTIMS COMPENSATION AWARDS PAID DURING FISCAL YEAR 1997-98

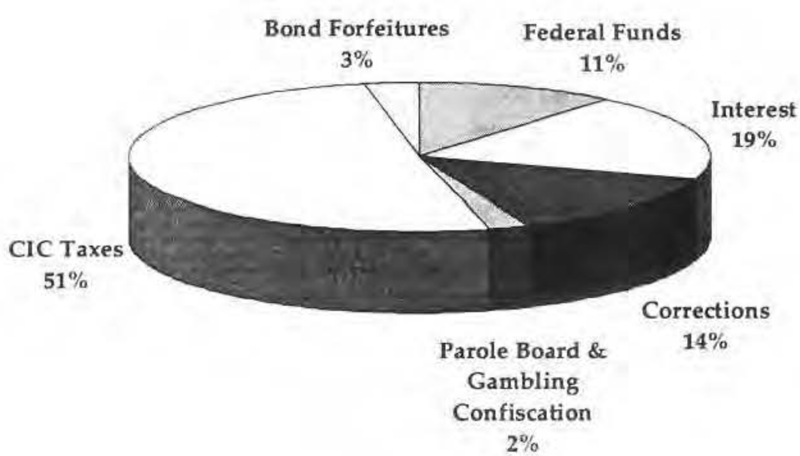
PERCENTAGE OF AWARDS BASED ON CRIME CLASSIFICATION



During fiscal year 1997-98, there were 1,597 awards totaling $6,266,009. Of that amount, $329,886 can be attributed to claims involving DUI with the remaining $5,936,123 related to all other crime types. The average award for all types was $3,924.

SOURCES OF FUNDS

VICTIMS OF CRIMINAL INJURY



Claims Commission

Chapter 972 of the 1984 Public Acts (codified as Tennessee Code Annotated, Section 9-8-301 et seq.) created the Tennessee Claims Commission as the administrative tribunal to determine monetary claims against the state. The commission has three commissioners, one from each grand division of the state. The three commissioners, who are appointed by the Governor and confirmed by the General Assembly, serve staggered six-year terms. Each commissioner has a legal assistant and an executive secretary.

The commission has a central office in Nashville with an administrative clerk, a staff attorney, an administrative services assistant and an administrative secretary. For administrative purposes, the commission is attached to the Department of the Treasury. (Prior to July 1, 1997, the commission was attached to the Department of Commerce and Insurance.)

The commission adjudicates claims involving tax recovery, state workers' compensation, and alleged negligence by state officials or agencies (e.g., negligent care, custody, or control of persons, personal property, or animals; professional malpractice; negligent operation or maintenance of a motor vehicle; and dangerous conditions on state-maintained highways or state controlled real property). These claims are payable from the Claims Award Fund. Damages are limited to $300,000 per claimant and $1,000,000 per occurrence. In addition, the commission awards compensation to victims of crime through the Criminal Injuries Compensation Fund. The Department of the Treasury's Division of Claims Administration is responsible for paying all claims.

Claims Processing

The vast majority of claims are first filed with the Division of Claims Administration. Claims involving taxes are filed directly with the Claims Commission, and claims involving workers' compensation are filed directly with a third-party administrator.

Both the Division of Claims Administration and the third party administrator have 90 days to accept or deny a claim before the claim is automatically transferred to the commission. Claimants can appeal both entities' decisions to the Claims Commission.

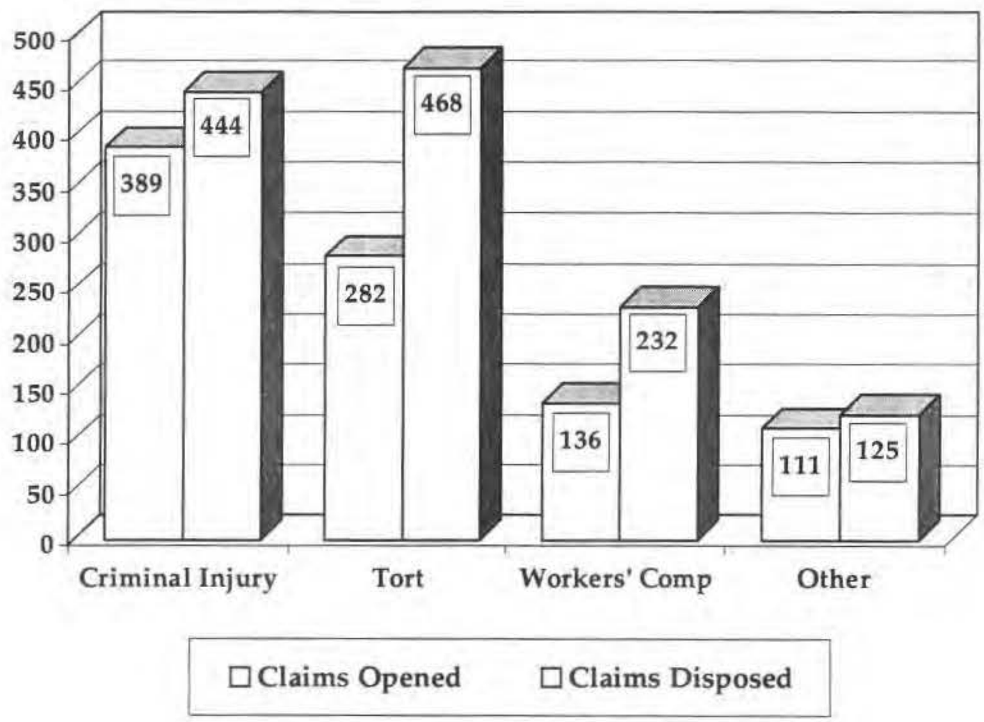
The commission has two separate dockets: a regular docket for claims greater than $15,000 and a small claims docket for claims under that amount. Commission decisions on regular docket claims can be appealed to the Tennessee Court of Appeals or, in the case of tax and workers' compensation claims, to the Tennessee Supreme Court. Small docket claims cannot be appealed, but such claims can be moved to the regular docket (at the discretion of either party) before they go before the commission.

As of July 1, 1997, upon request by the Governor, by an individual claims commissioner, or by the majority of the claims commissioners, the Secretary of State may assign administrative law judges to "assist in the removal of unacceptable congestion or delay on the claims commission docket." In adjudicating claims, the administrative law judges have the same powers as commissioners. The commission has used this authority to transfer 208 cases to administrative law judges.

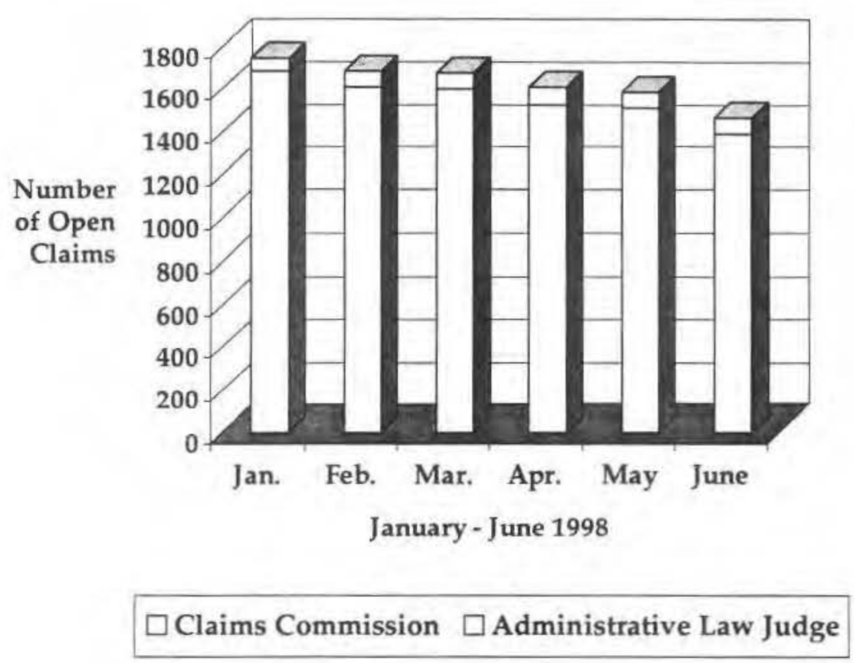
Information is included on claims open with the commission. Prior to January 1, 1998, this information was not consistently maintained. For that reason, information presented is from January 1, 1998, through June 30, 1998.

CLAIMS COMMISSION

NUMBER OF CLAIMS OPENED AND NUMBER OF DISPOSITIONS BY CLAIM TYPE



CLAIMS COMMISSION AND ADMINISTRATIVE LAW JUDGE OPEN CLAIMS



Division of Risk Management

The Division of Risk Management administers a variety of insurance programs for the state. The Property/Casualty Insurance Program provides all-risk, replacement cost coverage, including flood and earthquake, for all state-owned buildings and contents. This is accomplished through a $5 million annual aggregate retention – a property/casualty reserve fund appropriated for the payment of property claims within a given fiscal year – and an excess property insurance policy purchased from a private carrier.

All property exposures are thoroughly inspected and evaluated to determine appropriate rates for premium development and allocation of premium costs to the various departments. As of July 1, 1997, the state's property values exceeded $8.5 billion. The premium cost for excess property coverage and fidelity bond amounted to $495,130. This translates to an annual rate of .0058 cents per $100 of coverage.

The Builders' Risk Insurance Program provides property insurance coverage for building construction or renovation projects which have been approved by the State Building Commission. The Division of Risk Management reviews all construction contracts and insurance specifications and issues builders' risk policies providing all-risk coverage for the state agency, contractor and subcontractors for the duration of the project.

Boiler insurance must be provided to ensure protection for all state-owned boiler objects. A boiler insurance policy is purchased from a private insurance carrier which is not only responsibile for the insurance coverage, but must also provide a boiler inspection service. Certified inspectors evaluate all boiler objects on a regularly scheduled basis to ensure the safe operation of these systems. This loss prevention program has proven very effective with results showing no major incidents within the past five years.

In order to protect the state from financial loss due to employee dishonesty, the Division of Risk Management procures an Honesty Blanket Position and Faithful Performance Blanket Position Bond. This bond is provided by the excess property insurance carrier and is negotiated as part of the property insurance package. Fidelity coverage is provided in the amount of $1 million per incident for 29 scheduled employees and $100,000 per incident for all remaining state employees.

The Division of Risk Management also has the responsibility to investigate and process all property, boiler, and fidelity bond claims. A detailed property inventory schedule is maintained which provides the insurable values for both buildings and contents in the event a loss occurs. There is a $5,000 deductible per occurrence which must be assumed by the individual departments. Documented losses above the deductible amount are indemnified by the property/casualty reserve fund, through an allotment revision process. Should this reserve fund become completely exhausted within a given fiscal year, the excess property policy would provide the primary fund resource for claim payments.

During fiscal year 1997-98, a total of 146 claims were reported. Of this number, 117 did not exceed the $5,000 deductible and were closed with no action. The remaining 29 incurred losses amounted to $2,996,784, with a net loss to the fund of $2,851,784. Two million dollars of this total was the result of one catastrophic loss (tornado of April 1998). With a manual premium for first dollar coverage of $8.9 million, the state's pure property loss ratio would be 31.8%. Since the generally expected standard in the insurance industry for loss ratio break-even is approximately 48%, the state's property loss experience remains at an excellent level.

Division of Risk Management

The prevention and control of losses continues to be an item of growing importance in the area of state risk management. Effective July 1, 1995, the Division of Risk Management initiated a statewide fire/life safety inspection program. This in-depth inspection process targets high risk state-owned facilities in an effort to prevent extensive loss to property and human life. The individual departments are issued detailed safety reports which outline all safety hazards and provide recommendations for corrective action. Also, with the continuing rise in workers compensation and tort liability loss costs, the Division of Risk Management will expand its loss control program in an effort to mitigate the growth in these areas.

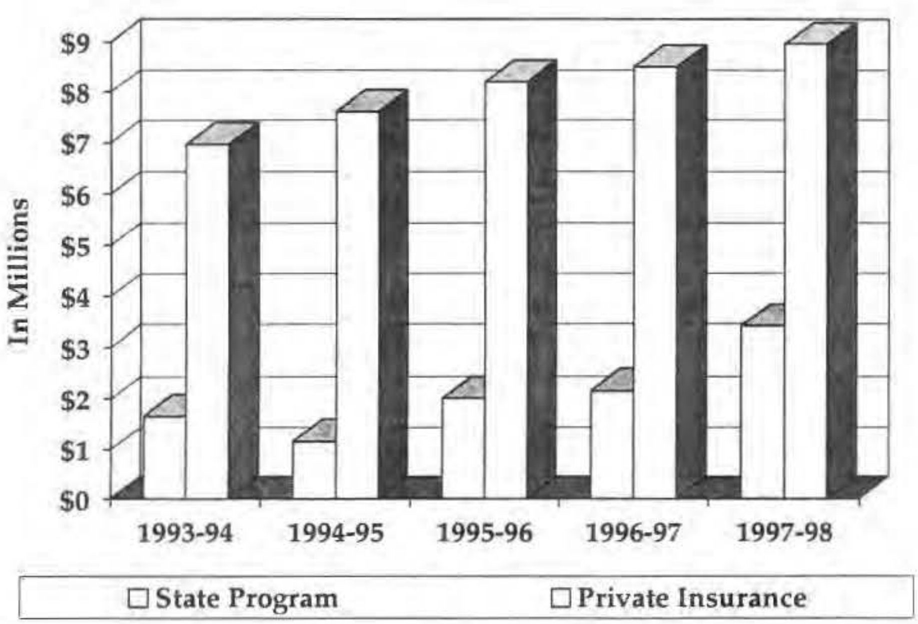
Cost of Property/Casualty Program versus Private Insurance

Fiscal Year 1997-98

[1]Premium - Excess Property & Bond Coverage	$ 495,130
Premium - Boiler Insurance Coverage	52,061
Total Premium	547,191
[2]Net Incurred Losses	2,851,784
Total Cost of State Program	3,398,975
[3]Private Insurance Premium Cost at Manual Rates with No State Retention	8,948,258
Net Savings to State	$ 5,549,283

[1] Based on July 1, 1997 values totaling $8,522,150,600
[2] Includes $2 million catastrophic loss (tornado of April 1998)
[3] Estimated based on July 1, 1997 values at .105 cents per $100 of coverage. Rates provided by Royal Insurance Company.

Fiscal Years 1993-94 through 1997-98



UNCLAIMED PROPERTY

The Treasury Department has administered the Uniform Disposition of Unclaimed Property Act since it was enacted in 1978. Administration of this act is carried out by the Unclaimed Property Division which operates the program in a manner designed to return unclaimed property to the rightful owner.

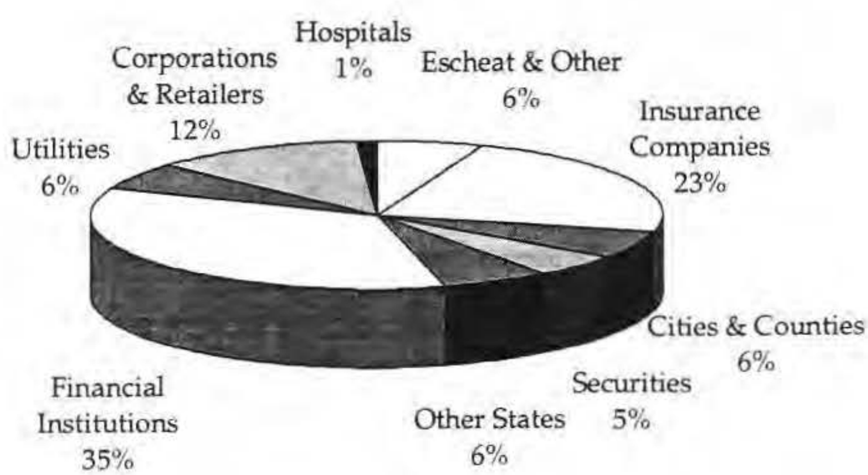
The Unclaimed Property Act provides that cash property which an organization or individual is holding for another person will be delivered to the Treasurer for custody if the holder of the property has had no contact with the owner for a period of five years and if the holder cannot locate the owner. Once property is delivered, the Treasurer advertises the owner's name and last known address in order to locate the owners. Since the program began operations in 1979, $146 million in unclaimed property has been reported to the Treasurer and $42.1 million (28%) has been returned to owners or heirs.

During the period July 1, 1997 through June 30, 1998, $16,060,680 of cash property was turned over to the Treasurer. This includes $3,682,379 in cash and stock remitted by third party audit organizations from out-of-state non-reporting holders for Tennessee residents. The chart below illustrates the sources of cash collections for fiscal year 1997-98.

In addition to advertising the property, the Treasurer makes several other efforts to locate the rightful owner. Another location method used is to send notification to the last known address of each owner. If no response is received, additional search efforts are made through employment security records, telephone directories, drivers' license records, and other sources. In addition, the records of unclaimed property owners are available for viewing by the public in the Unclaimed Property office. All property turned over to the Treasurer is held in trust for the rightful owner or his heirs in perpetuity, thereby allowing the owners or their heirs to make claims on it at anytime.

During the period July 1, 1997 through June 30, 1998, $4,800,889 of cash property was returned by the Unclaimed Property Division to the owners or their heirs. An analysis of the methods used to return this property is shown on the next page.

SOURCES OF UNCLAIMED PROPERTY



Unclaimed Property

Methods Used To Return Property
July 1, 1997 - June 30, 1998

Location Method	Number of Accounts	Value of Claims	Percentage of Claim Value
Postcards	2,198	$ 1,065,651	26%
Advertisement	2,071	1,051,401	26
Independent Locator	261	651,400	16
Holder Referral	424	447,838	11
Other	504	325,700	8
Legislator Listings	85	244,275	6
Telephone Directory	231	162,850	4
Employment Security & Dept. of Safety Match	298	122,138	3
Total Claim Payments	6,072	$ 4,071,253	100%
Refunds to Local Governments	11	$ 677,363	
Interstate Exchanges	1	52,273	
Total Payments	6,084	$ 4,800,889	

Any local government in Tennessee which turns over unclaimed property to the state may request that the property be returned to the local government for safekeeping after it has been held by the state for 18 months. This fiscal year, $677,363 was refunded to 11 local governments.

Tennessee has reciprocal agreements with other states' unclaimed property programs to exchange property held by one state for owners with a last known address in the other state. During this fiscal year, Tennessee received $869,401 for residents or former residents and paid $52,273 to other states' unclaimed property offices.

CHAIRS OF EXCELLENCE

The Chairs of Excellence (COE) Trust provides funds with which state colleges and universities are able to contract with persons of regional or national prominence to teach in specified academic areas. The program is open to all state four-year colleges and universities, and the UT Space Institute.

The funding of the program is provided through contributions made by a private donor and a matching amount by the state, thus, creating a chair. Income from the fixed income portion of the trust is used to fund required expenditures for the chair. All other funds, including equity income and profit/loss, become part of the corpus of the fund for use in supporting the trust in future years.

Since the start of the program in 1984, there have been 96 chairs created, with state appropriations totaling $44,000,000 and matching contributions totaling $53,926,206. For the year ending June 30, 1998, investment income totaled $33,649,111 with expenses of $6,785,036.

THE UNIVERSITY OF TENNESSEE

Chattanooga

- Miller COE in Management & Technology
- Sun Trust Bank COE in the Humanities
- Provident Life & Accident Ins. Co. COE in Applied Math
- West COE in Communications & Public Affairs
- COE in Judaic Studies
- Cline COE in Rehabilitation Technology
- Frierson COE in Business Leadership
- Harris COE in Business
- Lyndhurst COE in Arts Education

Knoxville

- Racheff Chair of Ornamental Horticulture
- Racheff Chair of Material Science & Engineering
- COE in English
- Condra COE in Computer Integrated Engineering & Manufacturing
- Condra COE in Power Electronics Applications
- Pilot COE in Management
- Holly COE in Political Economy
- Schmitt COE in History
- COE in Science, Technology & Medical Writing
- Shumway COE in Romance Languages
- Goodrich COE in Civil Engineering
- Clayton Homes COE in Finance
- COE in Policy Studies
- Blasingame COE in Agricultural Policy Studies
- Lincoln COE in Physics
- Hunger COE in Environmental Studies

Martin

- Hendrix COE in Free Enterprise & Economics
- Dunagan COE in Banking
- Parker COE in Food & Fiber Industries

Memphis

- Van Vleet COE in Microbiology & Immunology
- Van Vleet COE in Pharmacology
- Van Vleet COE in Biochemistry
- Van Vleet COE in Virology
- Muirhead COE in Pathology
- COE in Obstetrics & Gynecology
- LeBonheur COE in Pediatrics
- Crippled Children's Hospital COE in Biomedical Engineering
- Plough COE in Pediatrics
- Gerwin COE in Physiology
- Hyde COE in Rehabilitation
- Dunavant COE in Pediatrics
- First Tennessee Bank COE in Pediatrics
- Federal Express COE in Pediatrics
- Semmes-Murphey COE in Neurology
- Bronstein COE in Cardiovascular Physiology
- Goodman COE in Medicine
- LeBonheur COE in Pediatrics (II)
- Soloway COE in Urology

Space Institute

- Boling COE in Space Propulsion
- H. H. Arnold COE in Computational Mechanics

Chairs of Excellence

Tennessee Board of Regents

Austin Peay State University
Acuff COE in Creative Arts
Harper/James and Bourne COE in Business
The Foundation Chair of Free Enterprise
Reuther COE in Nursing

East Tennessee State University
Quillen COE of Medicine in Geriatrics & Gerontology
AFG Industries COE in Business & Technology
Harris COE in Business
Long Chair of Surgical Research
Dishner COE in Medicine
Quillen COE in Teaching and Learning
Basler COE for Integration of Arts, Rhetoric, and Sciences
Leeanne Brown and Universities Physicians Group COE in General Pediatrics

Middle Tennessee State University
Seigenthaler Chair of First Amendment Studies
Jones Chair of Free Enterprise
Adams COE in Health Care Services
National Healthcorp COE in Nursing
Russell COE in Manufacturing Excellence
Murfree Chair of Dyslexic Studies
Miller COE in Equine Health
Miller COE in Equine Reproductive Physiology
* Jones COE in Urban & Regional Planning

Tennessee State University
Frist COE in Business Administration

Memphis State University
COE in Molecular Biology
Herff COE in Law
Fogelman COE in Real Estate
Sales & Marketing Executives of Memphis COE in Sales
COE in Accounting
Arthur Andersen Company Alumni COE in Accounting
Moss COE in Philosophy
Wunderlich COE in Finance
Herff COE in Biomedical Engineering
Bornblum COE in Judaic Studies
Shelby County Government COE in International Economics
Wang COE in International Business
COE in Free Enterprise Management
COE in English Poetry
Herff COE in Computer Engineering
Lowenberg COE in Nursing
COE in Art History
Federal Express COE in Mgmt. Info. Systems
Moss COE in Psychology
Moss COE in Education
Hardin COE in Combinatorics
Hardin COE in Economics/Managerial Journalism
Sparks COE in International Relations

Tennessee Technological University
Owen Chair of Business Administration
Mayberry Chair of Business Administration

* Chair established during fiscal year 1997-98.

BACCALAUREATE EDUCATION SYSTEM TRUST

The Baccalaureate Education System Trust, or BEST, is a prepaid college tuition savings program that allows anyone to pay for higher education tuition in advance on behalf of a beneficiary. The BEST program was created under T.C.A. Section 49-7-8 to make higher education more affordable for the citizens of Tennessee.

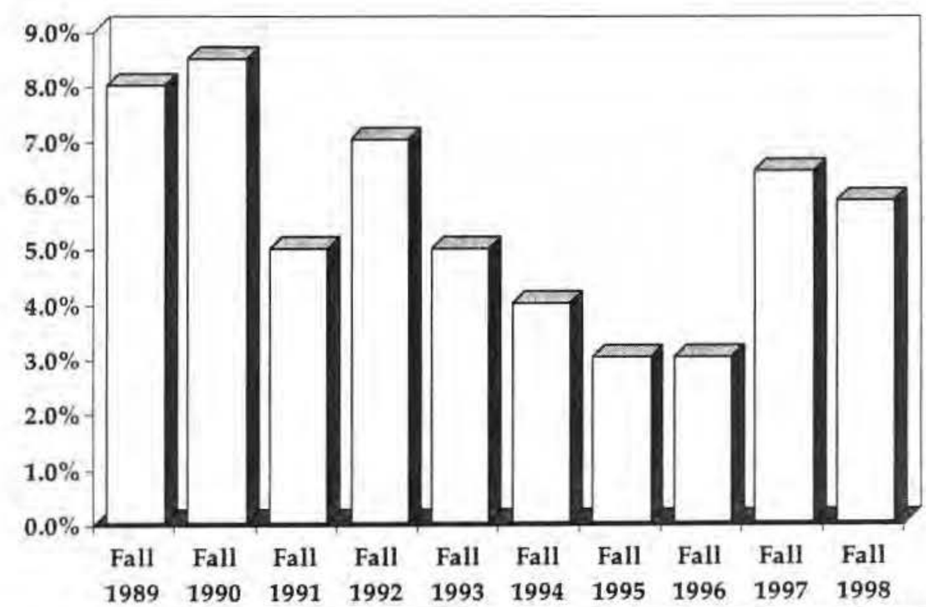
Tuition and mandatory fees may be purchased in increments known as tuition units. One tuition unit represents a value of one percent of the weighted average undergraduate tuition at Tennessee's four-year public universities plus an amount to cover administration and actuarial soundness of the program. The cost for one academic year of tuition at the average-priced, four-year undergraduate Tennessee public university will be covered by roughly 100 tuition units. Higher education institutions that cost more than the average Tennessee four-year public university will require more units; those that cost less will require fewer units.

Over the last 10 years, the weighted average tuition for Tennessee four-year public institutions has increased an average of 5.5% per year.

New to BEST this year is an expansion of the program to include room and board costs. This is a significant benefit since room and board often account for more than 50% of higher education expenses. Additional units may be used to pay dorm fees and meal plans if the child lives on campus and is enrolled at least half-time. Currently, the total number of units which can be purchased for a beneficiary is limited to 1,500 units. Another improvement is the availability of payroll deduction. This option offers employers an inexpensive employee benefit while allowing employees an easy way to save for the higher education costs of their children.

Anyone who wants to set up a tuition prepayment plan for a child can participate. The person who opens the account or the child must be a resident of Tennessee when the tuition account is

AVERAGE TUITION INCREASES FOR TENNESSEE PUBLIC INSTITUTIONS



BACCALAUREATE EDUCATION SYSTEM TRUST

opened. There is no age limit for enrollment; however, tuition units must be on account with BEST for at least two years prior to use. Flexibility is a key component of the program by allowing participants to determine when and how much to save and by providing multiple payment options.

The BEST units may be used for tuition, fees, room and board at any accredited higher education institution— in-state or out-of-state, public or private. The units may also be used at vocational and technical schools or professional and graduate schools. Participants do not have to choose a specific school when they enroll in the program.

The BEST program also offers favorable tax benefits to its participants. Federal income tax on the appreciation of tuition units is deferred until the units are used. In addition, the tax is assessed at the child's rate, rather than the parent's rate. BEST contracts are exempt from all state and local taxes.

The Treasury Department uses technology to keep interested parties and participants informed about the BEST program. The Internet site, located at www.treasury.state.tn.us/best.htm provides full information about BEST. The site also features the contract application which can be downloaded, completed, and mailed to the BEST office. Questions or comments to BEST staff can be e-mailed through this site. In addition, participants are provided with telephone access to account balances and activity 24 hours a day.

The Baccalaureate Education System Trust began accepting contracts and contributions in June 1997. Unit prices are calculated annually on August 1. At June 30, 1998, unit prices were $23.75 for ACH and payroll deduction while cash and check unit purchases were $24.50. The weighted average tuition value of one unit was $21.66.

During the 1997-98 fiscal year, 2,840 new contracts were opened, bringing the total under administration to 2,993. Contributions received during the year totaled $5.9 million, net of fees. At year-end, the market value of the funds under management was $6.6 million.

CAREERS NOW PROGRAM

College students in Tennessee have the opportunity to learn more about the operation of state government and the various career opportunities in state government through the Careers NOW Program. Students in the program work in one of the three constitutional offices for a semester. The Treasurer, the Comptroller of the Treasury, and the Secretary of State work together to match opportunities with students' interests.

The Careers NOW Program's first class of 12 students began in January 1996. Since the program's inception, nine classes with a total of 67 students have been selected to participate from a total of 167 applicants.

Applicants have come from Austin Peay State University, East Tennessee State University, Fisk University, David Lipscomb University, Middle Tennessee State University, Rhodes College, Tennessee State University, Tennessee Technological University, University of Memphis, University of Tennessee at Martin, University of Tennessee at Knoxville, University of the South, and Vanderbilt University. The majority of the participants have been Business or Accounting majors and have come from Middle Tennessee State University, Tennessee State University and Tennessee Technological University. Thirty eight percent of the student participants have been minorities.

The goal of the program is to develop a pool of students who, upon graduation, will be candidates for career positions in one of the three constitutional offices. Thus far, ten students have received job offers from the state following their participation in the program.

The students receive hands on work experience and the participating institutions and constitutional offices jointly facilitate the development of a detailed curriculum to meet the academic commitment made to higher education institutions.

Careers NOW is designed to offer students a combination of practical work experience and formal training, while giving them the opportunity to see the challenges of public service. In addition to their daily work responsibilities, students attend seminars, visit other state agencies, complete written work assignments or special projects, and engage in other opportunities to increase their overall understanding and knowledge of Tennessee state government.

STATUTORY DUTIES OF THE STATE TREASURER

BOARDS AND COMMISSIONS

	Tennessee Code Annotated Section
Advisory Council on Workers Compensation	50-6-121
Baccalaureate Education System Trust Board	49-7-801, et seq.
Bank Collateral Pool Board	9-4-501, et seq.
Board of Claims	9-8-101, et seq.
Board of Equalization	4-3-5101
Board of Trustees of the Tennessee Consolidated Retirement System	8-34-301 - 8-34-319
Chairs of Excellence Trust	49-7-501 - 49-7-502
Commission to Purchase Federal Property	12-1-103
Council on Pensions and Insurance	3-9-101
Funding Board	9-9-101
National Resources Trust Fund	11-14-304
Public Records Commission	10-7-302
Sick Leave Bank Board	8-50-903
State Building Commission	4-15-101
State Capitol Commission	4-8-301, et seq.
State Insurance Committee	8-27-101
State Library and Archives Management Board	10-1-101, et seq.
State School Bond Authority	49-3-1204
State Teacher Insurance Comm.	8-27-301
State Trust of Tennessee	9-4-801, et seq.
Tennessee Child Care Loan Guarantee Board	4-37-101, et seq.
Tennessee Competitive Export Corp.	13-27-104
Tennessee Higher Education Commission	49-7-201, et seq.
Tennessee Housing Development Agency	13-23-106
Tennessee Local Development Authority	4-31-103
Tennessee Sports Hall of Fame	4-3-5402
Tennessee Student Assistance Corp.	49-4-202
Tennessee Tomorrow	4-17-405
Tuition Guaranty Fund Board	49-7-2018
Volunteer Public Education Trust	49-3-401, et seq.
Workers Compensation Fund Board	50-6-604

ADMINISTRATION

	Tennessee Code Annotated Section
Baccalaureate Education System Trust	49-7-801, et seq.
Board of Claims	9-8-101, et seq.
Chairs of Excellence Trust	49-7-501 - 49-7-502
Collateral Pool	9-4-501 - 9-4-523
Collateral Program	9-4-101 - 9-4-105
Council on Pensions and Insurance	3-9-101
Criminal Injury Compensation Fund	29-13-101, et seq.
Deferred Compensation	8-25-101, et seq.
Escheat	31-6-101, et seq.
Flexible Benefits Plan	8-25-305
Investment Advisory Council	8-37-108
Investment of State Idle Cash Funds	9-4-602
Local Government Investment Pool	9-4-704
Old Age and Survivors Insurance Agency	8-38-101, et seq.
Pooled Investment Fund	9-4-704
Receipt and Disbursement of Public Funds	8-5-106 - 8-5-111; 9-4-301, et seq.
State Cash Management	9-4-106 - 9-4-108; 9-4-401 - 9-4-409
State Treasurer's Office	8-5-101, et seq.
State Trust of Tennessee	9-4-801, et seq.
Tennessee Claims Commission	9-8-301, et seq.
Tennessee Consolidated Retirement System and Miscellaneous Systems	Title 8, Chptrs. 34, 35, 36, 37 & 39
Unclaimed Property	66-29-101, et seq.
Victims of Drunk Drivers Compensation Fund	40-24-107

EXECUTIVE STAFF DIRECTORY

Treasurer's Office		
Treasurer	Steve Adams, CPA	(615) 741-2956
Executive Assistant	Dale Sims	(615) 741-2956
Executive Assistant	Janice Cunningham	(615) 741-2956
Director of Personnel	Ann Taylor-Tharpe	(615) 741-2956
Staff Assistant to the Treasurer	Rhonda Hicks, CPA	(615) 532-8552
Investments		
Chief Investment Officer	Tom Milne, CFA	(615) 532-1157
Director of Equity	Michael Keeler, CFA	(615) 532-1165
Senior Equity Portfolio Manager	Jeremy Conlin	(615) 532-1152
Senior Equity Portfolio Manager	Jim Robinson, CFA	(615) 532-1177
Senior Equity International Portfolio Manager	Roy Wellington, CFA	(615) 532-1151
Director of Fixed Income	Jeff Bronnenburg, CFA, CPA	(615) 532-1182
Senior Fixed Income International Portfolio Manager	Leighton Shantz	(615) 532-1183
Senior Short-Term Portfolio Manager	Randy Graves, CPA	(615) 532-1154
Director of Real Estate	Peter Katseff	(615) 532-1160
Retirement Administration		
Director of TCRS	Steve Curry, CEBS, CPA	(615) 741-7063
Assistant Director of TCRS	Ed Hennessee, CFP	(615) 741-7063
Director of Deferred Compensation, Research and Publications	Deana Reed Hannah	(615) 741-7063
Publications Editor	Janice Reilly	(615) 741-7063
General Counsel	Mary Roberts-Krause, JD	(615) 741-7063
Director of Old Age and Survivors Insurance	Mary E. Smith	(615) 741-7902
Manager of Counseling Services	Donna Finley	(615) 741-1971
Manager of Member Services	Velva Booker	(615) 741-1971
Manager of Financial Services	Connie Gibson, CPA	(615) 741-4913
Other Divisions		
Director of Accounting	Rick DuBray, CPA	(615) 532-3840
Director of Baccalaureate Education System Trust	Jill Bachus, CPA	(615) 532-8045
Director of Careers Now Program	Diana Collins	(615) 532-2992
Director of Claims Administration and Unclaimed Property	Susan Clayton	(615) 741-2734
Director of Computer Operations	Sam Baker, CCP, CDP	(615) 532-8026
Director of Information Systems	Newton Molloy, III, CDP	(615) 532-8035
Director of Internal Audit	Beth Chapman, CPA	(615) 532-1164
Director of Management Services	Grady Martin	(615) 741-4985
Director of Risk Management	Steve Gregory	(615) 741-9076
East Tennessee Claims Commissioner	Michael Lacy, JD	(423) 854-5330
Middle Tennessee Claims Commissioner	William Baker, JD	(615) 792-7471
Executive Administrative Assistant, Claims Commission	Margie Douglas	(615) 741-0741
Budget Officer	Wendy Padgett	(615) 741-4985

The Treasurer is housed on the 1st floor of the State Capitol Building.
Divisions are housed on the 9th, 10th, 11th, and 13th floors of the Andrew Jackson Building.

Investment Portfolios

STATE CASH PORTFOLIO

	Rating	Maturity	Yield to Maturity	Par Value	Fair Value
U S TREASURY AND AGENCY OBLIGATIONS					
FED HOME LOAN MORTGAGE CORP DISC NOTES	AAA	07/31/98	5.47%	$ 50,000,000	$ 49,465,000
FED HOME LOAN MORTGAGE CORP DISC NOTES	AAA	08/04/98	5.47%	50,000,000	49,435,000
FED HOME LOAN MORTGAGE CORP DISC NOTES	AAA	08/07/98	5.53%	50,000,000	49,710,000
FED HOME LOAN MORTGAGE CORP DISC NOTES	AAA	09/11/98	5.49%	50,000,000	49,150,000
FED HOME LOAN MORTGAGE CORP DISC NOTES	AAA	07/07/98	5.46%	28,000,000	27,801,200
FED HOME LOAN MORTGAGE CORP DISC NOTES	AAA	07/30/98	5.48%	71,560,000	70,808,620
FED HOME LOAN BANK BONDS	AAA	04/15/99	5.84%	50,000,000	49,935,000
FED HOME LOAN BANK BONDS	AAA	04/15/99	5.84%	50,000,000	49,935,000
FED NATL MORTGAGE ASSOC DISCOUNT NOTES	AAA	07/10/98	5.46%	95,785,000	95,066,612
FED NATL MORTGAGE ASSOC DISCOUNT NOTES	AAA	07/17/98	5.47%	50,000,000	49,570,000
FED NATL MORTGAGE ASSOC DISCOUNT NOTES	AAA	07/27/98	5.47%	50,000,000	49,495,000
FED NATL MORTGAGE ASSOC DISCOUNT NOTES	AAA	07/30/98	5.49%	25,572,000	25,303,494
FED NATL MORTGAGE ASSOC NOTES	AAA	09/30/98	5.65%	20,000,000	19,962,000
WORLD BANK DISC NOTES	AAA	08/03/98	5.49%	35,500,000	35,105,950
WORLD BANK DISC NOTES	AAA	07/02/98	5.48%	18,750,000	18,631,875
UNITED STATES TREAS NOTES	AAA	02/15/99	5.52%	50,000,000	49,840,000
TOTAL U. S. TREASURY AND OBLIGATIONS				$ 745,167,000	$ 739,214,751

	Maturity	Yield to Maturity	Par Value	Fair Value
CERTIFICATES OF DEPOSIT				
BANK OF CROCKETT, BELLS	07/31/98	5.80%	$ 300,000	$ 300,000
BANK OF CROCKETT, BELLS	01/08/99	5.80%	200,000	200,000
PEOPLES BANK, BENTON	01/29/99	5.50%	100,000	100,000
PEOPLES BANK, BENTON	02/12/99	5.50%	200,000	200,000
BANK OF BRADFORD	09/30/98	5.80%	100,000	100,000
PEOPLES BK & TR, BYRDSTOWN	12/15/98	5.80%	200,000	200,000
PEOPLES BK & TR, BYRDSTOWN	03/23/99	5.50%	100,000	100,000
PEOPLES BK & TR, BYRDSTOWN	01/08/99	5.80%	100,000	100,000
PEOPLES BK & TR, BYRDSTOWN	02/19/99	5.50%	100,000	100,000
PEOPLES BK & TR, BYRDSTOWN	07/17/98	5.70%	100,000	100,000
CUMBERLAND BANK, CARTHAGE	08/28/98	5.80%	90,000	90,000
CUMBERLAND BANK, CARTHAGE	12/11/98	5.80%	500,000	500,000
CUMBERLAND BANK, CARTHAGE	07/14/98	5.80%	1,000,000	1,000,000
FIRST STATE BANK, CHAPEL HILL	08/14/98	5.80%	200,000	200,000
SUNTRUST BK, CHATTANOOGA	08/25/98	5.80%	10,000,000	10,000,000
SUNTRUST BK, CHATTANOOGA	04/30/99	5.50%	20,000,000	20,000,000
SUNTRUST BK, CHATTANOOGA	08/17/98	5.40%	10,000,000	10,000,000
SUNTRUST BK, CHATTANOOGA	09/10/98	5.80%	10,000,000	10,000,000
SUNTRUST BK, CHATTANOOGA	09/03/98	5.80%	10,000,000	10,000,000
SUNTRUST BK, CHATTANOOGA	07/15/98	5.80%	10,000,000	10,000,000
FARMERS & MERCHANTS BK, CLARKSVILLE	06/25/99	5.50%	100,000	100,000
FIRST FED SVGS BK ,CLARKSVILLE	08/14/98	5.40%	3,000,000	3,000,000
FIRST FED SVGS BK ,CLARKSVILLE	04/28/99	5.50%	2,000,000	2,000,000
FIRST FED SVGS BK ,CLARKSVILLE	08/21/98	5.80%	100,000	100,000
HERITAGE BANK, CLARKSVILLE	03/26/99	5.50%	1,900,000	1,900,000
HERITAGE BANK, CLARKSVILLE	09/21/98	5.40%	1,000,000	1,000,000
FIRST BANK POLK CO, COPPERHILL	07/13/98	5.40%	4,300,000	4,300,000

(Continued)

STATE CASH PORTFOLIO

	Maturity	Yield to Maturity	Par Value	Fair Value
RHEA CO NAT'L BANK - DAYTON	09/18/98	5.80%	1,200,000	1,200,000
PEOPLES BANK, DICKSON	10/16/98	5.80%	500,000	500,000
PEOPLES BANK, DICKSON	10/16/98	5.80%	500,000	500,000
WEAKLEY CO BANK, DRESDEN	07/31/98	5.80%	1,000,000	1,000,000
FARMERS & MERCHANTS, DYER	09/16/98	5.40%	500,000	500,000
FARMERS & MERCHANTS, DYER	07/22/98	5.40%	500,000	500,000
FIRST CITIZENS BANK, DYERSBURG	09/22/98	5.50%	2,000,000	2,000,000
FIRST CITIZENS BANK, DYERSBURG	08/27/98	5.50%	2,000,000	2,000,000
FIRST CITIZENS BANK, DYERSBURG	11/03/98	5.50%	3,000,000	3,000,000
FIRST CITIZENS BANK, DYERSBURG	11/23/98	5.50%	3,000,000	3,000,000
FIRST CITIZENS BANK, DYERSBURG	07/24/98	5.70%	2,000,000	2,000,000
FIRST CITIZENS BANK, DYERSBURG	02/10/99	5.50%	2,000,000	2,000,000
FIRST CITIZENS BANK, DYERSBURG	07/24/98	5.40%	2,000,000	2,000,000
FIRST CITIZENS BANK, DYERSBURG	07/24/98	5.40%	1,000,000	1,000,000
SECURITY BANK, DYERSBURG	07/17/98	5.40%	300,000	300,000
SECURITY BANK, DYERSBURG	07/21/98	5.50%	300,000	300,000
SECURITY BANK, DYERSBURG	07/27/98	5.80%	400,000	400,000
SECURITY BANK, DYERSBURG	08/18/98	5.40%	1,000,000	1,000,000
MCMINN BK & TR, ETOWAH	08/14/98	5.70%	1,000,000	1,000,000
BANK OF FRIENDSHIP	08/05/98	5.40%	90,000	90,000
JACKSON BANK & TRUST, GAINESBORO	02/26/99	5.50%	2,500,000	2,500,000
JACKSON BANK & TRUST, GAINESBORO	08/07/98	5.40%	500,000	500,000
JACKSON BANK & TRUST, GAINESBORO	09/01/98	5.40%	250,000	250,000
JACKSON BANK & TRUST, GAINESBORO	08/04/98	5.40%	500,000	500,000
JACKSON BANK & TRUST, GAINESBORO	09/25/98	5.50%	500,000	500,000
JACKSON BANK & TRUST, GAINESBORO	11/10/98	5.80%	1,000,000	1,000,000
CITIZENS BANK, GAINESBORO	10/02/98	5.80%	300,000	300,000
GATES BANKING AND TRUST	10/27/98	5.80%	450,000	450,000
FIRST NATL BANK, GATLINBURG	07/20/98	5.40%	2,000,000	2,000,000
FIRST NATL BANK, GATLINBURG	07/03/98	5.40%	4,000,000	4,000,000
FIRST NATL BANK, GATLINBURG	08/17/98	5.40%	2,000,000	2,000,000
TENNESSEE ST BANK, GATLINBURG	03/09/99	5.50%	5,000,000	5,000,000
TRUST ONE BANK, GERMANTOWN	08/12/98	5.40%	1,500,000	1,500,000
TRUST ONE BANK, GERMANTOWN	08/14/98	5.50%	1,000,000	1,000,000
TRUST ONE BANK, GERMANTOWN	09/11/98	5.50%	1,000,000	1,000,000
TRUST ONE BANK, GERMANTOWN	10/13/98	5.50%	1,000,000	1,000,000
TRUST ONE BANK, GERMANTOWN	07/14/98	5.50%	1,000,000	1,000,000
TRUST ONE BANK, GERMANTOWN	11/10/98	5.50%	1,000,000	1,000,000
TRUST ONE BANK, GERMANTOWN	11/10/98	5.50%	2,000,000	2,000,000
TRUST ONE BANK, GERMANTOWN	07/14/98	5.50%	2,000,000	2,000,000
TRUST ONE BANK, GERMANTOWN	08/12/98	5.40%	1,500,000	1,500,000
TRUST ONE BANK, GERMANTOWN	08/14/98	5.50%	2,000,000	2,000,000
TRUST ONE BANK, GERMANTOWN	09/11/98	5.50%	2,000,000	2,000,000
TRUST ONE BANK, GERMANTOWN	10/13/98	5.50%	2,000,000	2,000,000
BANK OF GLEASON	02/19/99	5.50%	350,000	350,000
BANK OF GLEASON	07/17/98	5.80%	300,000	300,000
BANK OF GLEASON	12/18/98	5.80%	200,000	200,000

(Continued)

STATE CASH PORTFOLIO

	Maturity	Yield to Maturity	Par Value	Fair Value
BANK OF HALLS	08/14/98	5.80%	300,000	300,000
BANK OF HALLS	02/05/99	5.50%	200,000	200,000
BANK OF HALLS	07/24/98	5.70%	200,000	200,000
BANK OF HALLS	04/06/99	5.50%	700,000	700,000
BANK OF HALLS	08/19/98	5.40%	400,000	400,000
CHESTER CO BANK, HENDERSON	01/15/99	5.50%	100,000	100,000
VOLUNTEER BANK, JACKSON	02/26/99	5.50%	2,500,000	2,500,000
FENTRESS CO BANK, JAMESTOWN	07/07/98	5.80%	500,000	500,000
FENTRESS CO BANK, JAMESTOWN	12/23/98	5.80%	200,000	200,000
FENTRESS CO BANK, JAMESTOWN	09/11/98	5.80%	500,000	500,000
FENTRESS CO BANK, JAMESTOWN	07/17/98	5.80%	450,000	450,000
FENTRESS CO BANK, JAMESTOWN	10/27/98	5.80%	300,000	300,000
FENTRESS CO BANK, JAMESTOWN	08/19/98	5.40%	500,000	500,000
PROGRESSIVE SAVINGS, JAMESTOWN	03/05/99	5.50%	300,000	300,000
CITIZENS STATE BANK, JASPER	04/07/99	5.50%	100,000	100,000
CITIZENS STATE BANK, JASPER	04/09/99	5.50%	200,000	200,000
CITIZENS STATE BANK, JASPER	01/22/99	5.50%	200,000	200,000
SUNTRUST BK, JOHNSON CITY	08/28/98	5.40%	7,000,000	7,000,000
SUNTRUST BK, JOHNSON CITY	07/23/98	5.40%	10,000,000	10,000,000
FIRST STATE BANK, KENTON	07/27/98	5.40%	5,000,000	5,000,000
FIRST STATE BANK, KENTON	07/27/98	5.40%	3,000,000	3,000,000
FIRST STATE BANK, UNION CITY	07/27/98	5.40%	3,000,000	3,000,000
FIRST STATE BANK, UNION CITY	07/27/98	5.40%	2,000,000	2,000,000
FIRST UNION BANK, KINGSPORT	07/17/98	5.50%	1,050,000	1,050,000
SUNTRUST BK, KNOXVILLE	07/23/98	5.40%	10,000,000	10,000,000
SUNTRUST BK, KNOXVILLE	08/12/98	5.40%	15,000,000	15,000,000
SUNTRUST BK, KNOXVILLE	08/28/98	5.40%	5,000,000	5,000,000
SUNTRUST BK, KNOXVILLE	08/28/98	5.40%	5,000,000	5,000,000
SUNTRUST BK, KNOXVILLE	07/23/98	5.40%	10,000,000	10,000,000
SUNTRUST BK, KNOXVILLE	09/25/98	5.40%	25,000,000	25,000,000
SUNTRUST BK, KNOXVILLE	09/04/98	5.40%	50,000,000	50,000,000
SUNTRUST BK, KNOXVILLE	08/12/98	5.40%	25,000,000	25,000,000
SUNTRUST BK, KNOXVILLE	08/12/98	5.40%	10,000,000	10,000,000
FIRST BANK EAST TN, LA FOLLETTE	04/09/99	5.50%	100,000	100,000
CITIZENS BANK, LAFAYETTE	02/03/99	5.50%	500,000	500,000
CITIZENS BANK, LAFAYETTE	09/09/98	5.40%	100,000	100,000
CITIZENS BANK, LAFAYETTE	09/28/98	5.70%	250,000	250,000
CITIZENS BANK, LAFAYETTE	11/04/98	5.80%	100,000	100,000
FIRST CENTRAL BK, LENOIR CITY	03/24/99	5.50%	500,000	500,000
FIRST CENTRAL BK, LENOIR CITY	10/08/98	5.50%	500,000	500,000
FIRST NATL BANK, LENOIR CITY	03/26/99	5.50%	200,000	200,000
FIRST NATL BANK, LENOIR CITY	01/28/99	5.50%	300,000	300,000
FIRST NATL BANK, LENOIR CITY	09/14/98	5.70%	100,000	100,000
COFFEE CO BANK, MANCHESTER	06/16/99	5.50%	280,000	280,000
COFFEE CO BANK, MANCHESTER	08/07/98	5.80%	350,000	350,000
CITY STATE BANK, MARTIN	10/30/98	5.80%	1,500,000	1,500,000
CITY STATE BANK, MARTIN	07/29/98	5.50%	500,000	500,000

(Continued)

STATE CASH PORTFOLIO

	Maturity	Yield to Maturity	Par Value	Fair Value
PLANTERS BANK, MAURY CITY	07/17/98	5.80%	200,000	200,000
UNION PLANTERS NATL BK, MEMPHIS	07/24/98	5.40%	5,000,000	5,000,000
BOATMAN'S BANK, MEMPHIS	08/10/98	5.40%	10,000,000	10,000,000
BOATMAN'S BANK, MEMPHIS	11/27/98	5.80%	10,000,000	10,000,000
BOATMAN'S BANK, MEMPHIS	12/11/98	5.80%	5,000,000	5,000,000
ENTERPRISE NATIONAL BK, MEMPHIS	03/26/99	5.50%	500,000	500,000
ENTERPRISE NATIONAL BK, MEMPHIS	01/08/99	5.80%	500,000	500,000
ENTERPRISE NATIONAL BK, MEMPHIS	09/02/98	5.80%	500,000	500,000
ENTERPRISE NATIONAL BK, MEMPHIS	01/15/99	5.50%	1,000,000	1,000,000
ENTERPRISE NATIONAL BK, MEMPHIS	12/11/98	5.50%	1,000,000	1,000,000
ENTERPRISE NATIONAL BK, MEMPHIS	02/26/99	5.50%	500,000	500,000
ENTERPRISE NATIONAL BK, MEMPHIS	10/23/98	5.80%	500,000	500,000
FIRST COMMERCIAL BK, MEMPHIS	07/10/98	5.40%	1,000,000	1,000,000
NATL BANK OF COMMERCE, KNOXVILLE	09/16/98	5.40%	2,000,000	2,000,000
NATL BANK OF COMMERCE, KNOXVILLE	07/17/98	5.40%	10,000,000	10,000,000
NATL BANK OF COMMERCE, MEMPHIS	06/01/99	5.50%	20,000,000	20,000,000
NATL BANK OF COMMERCE, MEMPHIS	07/29/98	5.40%	25,000,000	25,000,000
NATL BANK OF COMMERCE, MEMPHIS	09/29/98	5.80%	25,000,000	25,000,000
NATL BANK OF COMMERCE, MEMPHIS	04/29/99	5.50%	50,000,000	50,000,000
NATL BANK OF COMMERCE, MEMPHIS	09/17/98	5.70%	30,000,000	30,000,000
NATL BANK OF COMMERCE, MEMPHIS	07/17/98	5.40%	25,000,000	25,000,000
NATL BANK OF COMMERCE, MEMPHIS	12/17/98	5.80%	10,000,000	10,000,000
NATL BANK OF COMMERCE, MEMPHIS	07/17/98	5.80%	50,000,000	50,000,000
NATL BANK OF COMMERCE, MEMPHIS	04/30/99	5.50%	50,000,000	50,000,000
NATL BANK OF COMMERCE, MEMPHIS	05/06/99	5.50%	50,000,000	50,000,000
NATL BANK OF COMMERCE, MEMPHIS	07/03/98	5.40%	100,000,000	100,000,000
NATL BANK OF COMMERCE, MEMPHIS	07/15/98	5.40%	50,000,000	50,000,000
NATL BANK OF COMMERCE, MEMPHIS	04/29/99	5.50%	50,000,000	50,000,000
SOUTHTRUST BANK, MEMPHIS	06/18/99	5.50%	25,000,000	25,000,000
SOUTHTRUST BANK, MEMPHIS	06/11/99	5.50%	1,000,000	1,000,000
SOUTHTRUST BANK, MEMPHIS	12/24/98	5.80%	1,000,000	1,000,000
SOUTHTRUST BANK, MEMPHIS	07/30/98	5.70%	2,000,000	2,000,000
SOUTHTRUST BANK, MEMPHIS	07/27/98	5.40%	4,000,000	4,000,000
SOUTHTRUST BANK, MEMPHIS	07/13/98	5.40%	10,000,000	10,000,000
SOUTHTRUST BANK, MEMPHIS	09/25/98	5.40%	3,000,000	3,000,000
SOUTHTRUST BANK, MEMPHIS	09/25/98	5.40%	2,800,000	2,800,000
SOUTHTRUST BANK, MEMPHIS	08/10/98	5.40%	4,000,000	4,000,000
SOUTHTRUST BANK, MEMPHIS	09/11/98	5.40%	6,000,000	6,000,000
SOUTHTRUST BANK, MEMPHIS	09/14/98	5.40%	3,500,000	3,500,000
SOUTHTRUST BANK, MEMPHIS	08/24/98	5.40%	2,000,000	2,000,000
BANK OF GREEN HILLS	10/07/98	5.80%	95,000	95,000
FIRST AMERICAN NATL BK, NASHVILLE	08/12/98	5.40%	50,000,000	50,000,000
FIRST AMERICAN NATL BK, NASHVILLE	07/28/98	5.40%	50,000,000	50,000,000
FIRST AMERICAN NATL BK, NASHVILLE	07/31/98	5.40%	50,000,000	50,000,000
FIRST AMERICAN NATL BK, NASHVILLE	08/03/98	5.40%	50,000,000	50,000,000
FIRST AMERICAN NATL BK, NASHVILLE	08/19/98	5.40%	100,000,000	100,000,000
FIRST AMERICAN NATL BK, NASHVILLE	09/02/98	5.40%	50,000,000	50,000,000

(Continued)

STATE CASH PORTFOLIO

	Maturity	Yield to Maturity	Par Value	Fair Value
FIRST AMERICAN NATL BK, NASHVILLE	09/09/98	5.40%	20,000,000	20,000,000
FIRST AMERICAN NATL BK, NASHVILLE	09/09/98	5.40%	30,000,000	30,000,000
NEWPORT FEDERAL S&L, NEWPORT	06/22/99	5.50%	95,000	95,000
NEWPORT FEDERAL S&L, NEWPORT	09/29/98	5.80%	500,000	500,000
NEWPORT FEDERAL S&L, NEWPORT	06/22/99	5.50%	300,000	300,000
UNION PLANTERS BANK, OBION	09/25/98	5.80%	200,000	200,000
FIRST NATL BANK, ONEIDA	07/03/98	5.80%	500,000	500,000
FIRST NATL BANK, ONEIDA	08/28/98	5.80%	500,000	500,000
FIRST NATIONAL BANK, PIKEVILLE	09/04/98	5.40%	300,000	300,000
COMMUNITY BANK, PULASKI	01/08/99	5.80%	790,000	790,000
COMMUNITY BANK, PULASKI	07/06/98	5.70%	790,000	790,000
COMMUNITY BANK, PULASKI	01/15/99	5.50%	795,000	795,000
COMMUNITY BANK, PULASKI	10/16/98	5.80%	750,000	750,000
FIRST NATIONAL BANK, PULASKI	01/21/99	5.50%	1,000,000	1,000,000
FIRST NATIONAL BANK, PULASKI	08/14/98	5.80%	300,000	300,000
FIRST NATIONAL BANK, PULASKI	02/05/99	5.50%	300,000	300,000
FIRST NATIONAL BANK, PULASKI	02/12/99	5.50%	300,000	300,000
FIRST NATIONAL BANK, PULASKI	02/05/99	5.50%	700,000	700,000
FIRST NATIONAL BANK, PULASKI	01/21/99	5.50%	1,000,000	1,000,000
FIRST NATIONAL BANK, PULASKI	08/14/98	5.80%	1,000,000	1,000,000
FIRST NATIONAL BANK, PULASKI	02/12/99	5.50%	500,000	500,000
BANK OF RIPLEY	02/12/99	5.50%	100,000	100,000
BANK OF RIPLEY	07/07/98	5.60%	100,000	100,000
BANK OF RIPLEY	08/12/98	5.40%	150,000	150,000
BANK OF RIPLEY	03/26/99	5.50%	200,000	200,000
BANK OF RIPLEY	01/20/99	5.50%	100,000	100,000
FIRST UNION BANK, ROGERSVILLE	08/07/98	5.40%	1,600,000	1,600,000
FIRST UNION BANK, ROGERSVILLE	08/07/98	5.40%	1,650,000	1,650,000
BANK OF SHARON	10/23/98	5.80%	1,000,000	1,000,000
BANK OF SHARON	01/20/99	5.50%	1,500,000	1,500,000
BANK OF SHARON	06/11/99	5.50%	1,000,000	1,000,000
BANK OF SHARON	08/28/98	5.40%	1,000,000	1,000,000
BANK OF SHARON	08/18/98	5.80%	1,000,000	1,000,000
SOMERVILLE BANK AND TRUST	08/21/98	5.80%	200,000	200,000
MERCHANTS & PLANTERS BK, TOONE	08/14/98	5.80%	200,000	200,000
MERCHANTS & PLANTERS BK, TOONE	02/12/99	5.50%	200,000	200,000
MERCHANTS & PLANTERS BK, TOONE	08/28/98	5.80%	100,000	100,000
MERCHANTS & PLANTERS BK, TOONE	09/25/98	5.80%	100,000	100,000
CITIZENS CITY & CO BK, TRENTON	03/16/99	5.50%	450,000	450,000
FIRST STATE BANK, UNION CITY	07/27/98	5.40%	5,000,000	5,000,000
WAYNE COUNTY BANK, WAYNESBORO	08/28/98	5.40%	900,000	900,000
WHITEVILLE BANK	08/21/98	5.80%	500,000	500,000
WHITEVILLE BANK	09/25/98	5.80%	400,000	400,000
WHITEVILLE BANK	07/03/98	6.00%	700,000	700,000
WHITEVILLE BANK	07/24/98	5.80%	300,000	300,000
WHITEVILLE BANK	08/14/98	5.80%	300,000	300,000
BANK OF COMMERCE, WOODBURY	12/24/98	5.80%	2,000,000	2,000,000
TOTAL CERTIFICATES OF DEPOSIT			**$ 1,425,275,000**	**$ 1,425,275,000**

(Continued)

STATE CASH PORTFOLIO

	Maturity	Yield to Maturity	Par Value	Fair Value
REPURCHASE AGREEMENTS				
CIBC	07/01/98	5.30%	$ 12,500,000	$ 12,500,000
SUNTRUST	07/01/98	5.56%	15,000,000	15,000,000
TOTAL REPURCHASE AGREEMENTS			**$ 27,500,000**	**$ 27,500,000**

	Rating	Maturity	Yield to Maturity	Par Value	Fair Value
COMMERCIAL PAPER					
APRECO	A1	08/28/98	5.62%	$ 50,000,000	$ 49,552,111
APRECO INC.	A1	07/07/98	5.60%	30,000,000	29,972,300
APRECO INC.	A1	07/08/98	5.58%	30,000,000	29,967,683
APRECO INC.	A1	08/18/98	5.60%	25,000,000	24,815,000
CORP ASSET SECUR AUSTRALIA	A1	07/31/98	5.58%	50,000,000	49,769,167
CORP RECEIVABLES CORP	A1	08/25/98	5.61%	45,000,000	44,617,750
GENERAL ELECTRIC CAPITAL CORP	A1	07/06/98	5.56%	50,000,000	49,961,667
GENERAL ELECTRIC CAPITAL SERVICE	A1	08/27/98	5.60%	50,000,000	49,561,417
GENERAL MOTORS ACCEPTANCE CORP	A1	08/10/98	5.58%	50,000,000	49,692,778
GENERAL MOTORS ACCEPTANCE CORP	A1	08/14/98	5.58%	50,000,000	49,662,056
MERRILL LYNCH & CO., INC.	A1	07/06/98	5.56%	40,000,000	39,969,444
MERRILL LYNCH & CO., INC.	A1	08/04/98	5.59%	50,000,000	49,737,917
MERRILL LYNCH & CO., INC.	A1	08/17/98	5.59%	50,000,000	49,638,361
MITSUBISHI INTERNATIONAL CORP	A1	07/27/98	5.64%	33,000,000	32,867,487
MITSUBISHI INTERNATIONAL CORP	A1	07/29/98	5.60%	40,000,000	39,827,956
MITSUI & CO. (USA) INC	A1	07/15/98	5.64%	27,000,000	26,942,250
MITSUI & CO., USA INC.	A1	07/01/98	5.59%	11,490,000	11,488,229
MITSUI & CO., USA INC.	A1	07/07/98	5.61%	16,000,000	15,985,253
NOMURA HOLDING AMERICA	A1	07/06/98	5.72%	29,000,000	28,977,200
NOMURA HOLDING AMERICA	A1	07/07/98	5.78%	25,000,000	24,976,500
NOMURA SECURITIES	A1	08/28/98	5.71%	20,000,000	19,817,944
PHH CORPORATION	A1	08/03/98	5.67%	50,000,000	49,742,417
PHH CORPORATION	A1	07/06/98	5.64%	47,000,000	46,963,640
PHH CORPORATION	A1	07/09/98	5.74%	50,000,000	49,936,333
RECEIVABLES CAPITAL CORP	A1	07/28/98	5.60%	25,389,000	25,282,937
SHEFFIELD RECEIVABLES CORP	A1	07/07/98	5.56%	27,750,000	27,724,516
SHEFFIELD RECEIVABLES CORP	A1	08/03/98	5.58%	50,000,000	49,746,542
SUMITOMO CORP OF AMERICA	A1	07/14/98	5.69%	20,000,000	19,959,411
SUMITOMO CORP OF AMERICA	A1	08/13/98	5.70%	20,000,000	19,866,222
TOSHIBA AMERICA	A1	08/06/98	5.63%	50,000,000	49,720,500
TOSHIBA INTERNATIONAL FIN (UK)	A1	08/05/98	5.69%	20,000,000	19,890,722
TOTAL COMMERCIAL PAPER				**$ 1,131,629,000**	**$ 1,126,633,710**
TOTAL PORTFOLIO				**$ 3,329,571,000**	**$ 3,318,623,461**

TCRS Portfolio
Largest Stock Holdings
By Fair Value

Shares	Security Name	Fair Value
2,390,000	General Elec. Co.	$ 217,191,250
1,783,000	MicroSoft Corp.	193,232,625
1,712,000	Coca Cola Co.	146,376,000
1,681,000	Exxon Corp.	119,981,375
874,000	Merck & Co. Inc.	116,897,500
1,808,000	Walmart Stores Inc.	109,836,000
1,164,000	Procter & Gamble Co.	105,996,750
872,000	Pfizer Inc.	94,775,500
792,000	Bristol Myers Squibb Co.	91,030,500
1,088,810	Lucent Technologies Inc.	90,575,382

TCRS Portfolio
Largest Bond Holdings
By Fair Value

Shares	Security Name	Yield	Maturity	Moody's Quality Rating	Fair Value
355,000,000	United States Treasury Notes	5.52%	8/31/99	AAA	$ 356,388,050
143,810,000	United States Treasury Bonds	5.73%	11/15/18	AAA	199,872,890
162,500,000	United States Treasury Bonds	5.72%	11/15/16	AAA	195,076,375
139,624,000	United States Treasury Bonds	5.74%	11/15/21	AAA	179,983,713
174,609,308	GNMA Pool 780410	6.72%	8/15/26	AAA	179,519,321
175,195,000	United States Treasury Notes	5.52%	7/31/99	AAA	175,823,950
132,265,000	United States Treasury Bonds	5.56%	11/15/03	AAA	170,456,519
168,390,000	United States Treasury Notes	5.05%	3/31/00	AAA	168,337,799
250,000,000	Canada Gov't Treasury Bills CDs	4.77%	10/1/98	NR	166,443,733
150,000,000	GNMA Pool 780811	6.80%	6/15/28	AAA	155,437,500

A complete portfolio listing is available upon request.

Chairs of Excellence Portfolio
Largest Stock Holdings By Fair Value

Shares	Security Name	Fair Value
46,600	GENERAL ELEC CO	$ 4,234,775
34,000	MICROSOFT CORP	3,684,750
43,000	COCA COLA CO	3,676,500
33,000	SCHERING PLOUGH CORP	3,023,625
39,000	EXXON CORP	2,783,625
43,000	GAP INC	2,641,813
46,000	BANKBOSTON CORP	2,558,750
62,000	SAFEWAY INC	2,522,625
18,000	MERCK & CO INC	2,407,500
32,000	AMERICAN GEN CORP	2,278,000

Chairs of Excellence Portfolio
Largest Bond Holdings By Fair Value

Shares	Security Name	Yield	Maturity	Moody's Quality Rating	Fair Value
20,000,000	UNITED STATES TREAS NOTES	5.45%	8/15/05	AAA	$21,106,200
10,000,000	TENNESSEE VALLEY AUTH	6.13%	7/15/24	AAA	10,161,600
10,000,000	UNITED STATES TREAS NOTES	5.53%	10/31/02	AAA	10,081,200
5,000,000	FORD CAPITAL BV	6.03%	11/15/00	A1	5,443,500
5,000,000	MERRILL LYNCH & CO INC	6.20%	5/15/06	AA3	5,346,400
4,805,349	SMALL BUSINESS ADMIN PART	8.33%	9/10/01	AAA	5,065,415
5,000,000	INTL LEASE FIN CORP MTN	6.02%	8/1/01	A1	5,036,900
5,000,000	SEARS ROEBUCK ACCEP CORP MTN	5.94%	12/26/00	A2	5,002,600
3,760,197	FED HM LN PC	6.60%	12/1/25	AAA	3,757,828
3,500,000	UNITED STATES TREAS NTS	5.56%	8/15/07	AAA	3,641,645

A complete portfolio listing is available upon request.

Key to Ratings

All ratings presented are from Moody's Investors Service with the exception of some of the government agency securities. Moody's does not rate these securities. Standard & Poor's does provide ratings for the securities (AAA is Standard & Poor's highest rating). Government Securities are not rated per se' but are considered the best quality securities. By policy, TCRS considers convertible bonds as an equity investment, thus the ratings of the convertible bonds are not as large a factor when an investment decision is made. As a result, some of the convertible bond ratings are lower than other TCRS bond investments. In accordance with generally accepted accounting principles, the convertible bonds are classified as corporate bonds for financial reporting purposes.

Moody's rates securities as follows:

Aaa .... Best Quality
Aa .... High Quality
A .... Upper Medium Quality
Baa .... Medium Quality

Moody's applies numerical modifiers in each rating classification as follows:

1 .... Higher End
2 .... Mid-range
3 .... Lower End

NR indicates the security is not rated by Moody's.

Financial Statements

State Pooled Investment Fund

Tennessee Consolidated Retirement System

Deferred Compensation

Flexible Benefits Plan

Claims Award Fund

Criminal Injuries Fund

Baccalaureate Education System Trust

Chairs of Excellence

Bond Refunding

State Pooled Investment Fund
Independent Auditor's Report

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying statement of net assets of the State Pooled Investment Fund as of June 30, 1998, and the related statement of changes in net assets for the year then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The State Pooled Investment Fund has included such disclosures in Note C.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the State Pooled Investment Fund's disclosures with respect to the year 2000 issue made in Note C.2. Further, we do not provide assurance that the State Pooled Investment Fund is or will be year 2000 ready, that the State Pooled Investment Fund year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the State Pooled Investment Fund does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the State Pooled Investment Fund as of June 30, 1998, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, 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.

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

STATE POOLED INVESTMENT FUND
STATEMENT OF NET ASSETS
JUNE 30, 1998

ASSETS

Cash and Cash Equivalents	$	2,348,874,134
Short-term Investments, at Amortized Cost		1,001,246,478
Accrued Income Receivable		20,257,957
Total Assets	$	3,370,378,569

LIABILITIES AND NET ASSETS

Net Assets Held in Trust for Pool Participants	$	3,370,378,569

See accompanying Notes to the Financial Statements.

STATE POOLED INVESTMENT FUND
STATEMENT OF CHANGES IN NET ASSETS
FOR THE FISCAL YEAR ENDED JUNE 30, 1998

Operations:		
Investment Income	$	155,913,698
Expenses:		
Administrative Fee		1,636,816
Custodian and Banking Services Fees		58,656
Total Expenses		1,695,472
Net Investment Income		154,218,226
Capital Share Transactions (dollar amounts and number of shares are the same)		
Shares Sold		20,641,304,102
Less Shares Redeemed		20,170,760,242
Increase from Capital Share Transactions		470,543,860
Total Increase in Net Assets		624,762,086
Net Assets Held in Trust for Pool Participants		
July 1, 1997		2,745,616,483
June 30, 1998	$	3,370,378,569

See accompanying Notes to the Financial Statements.

STATE POOLED INVESTMENT FUND
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity -** The State Pooled Investment Fund (SPIF) is an external investment pool sponsored by the State of Tennessee. The external portion of the State Pooled Investment Fund, consisting of funds belonging to entities outside of the State of Tennessee Financial Reporting Entity, has been included as a separate investment trust fund in the *Tennessee Comprehensive Annual Financial Report.* The internal portion, consisting of funds belonging to the State and its component units, has been included in the various participating funds and component units 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 SPIF 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 basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

3. **Cash and Cash Equivalents -** This classification includes deposits in demand accounts as well as short-term investments with a maturity date within three months of the date acquired by the State.

4. **Method Used to Report Investments and Participant Shares -** The SPIF is not registered with the Securities and Exchange Commission (SEC) as an investment company but, through its investment policy adopted by the Funding Board of the State of Tennessee (Funding Board), operates in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. Rule 2a7 allows SEC registered mutual funds to use amortized cost to report net assets in computing share prices. Likewise, the SPIF uses amortized cost accounting measures to report investments and share prices. During the fiscal year ended June 30, 1998, the State had not obtained or provided any legally binding guarantees to support the value of participant shares.

B. DEPOSITS AND INVESTMENTS

1. **Investment Policy -** The State Pooled Investment Fund is authorized by statute to invest funds in accordance with policy guidelines approved by the Funding Board. The current resolution of the Funding Board gives the Treasurer approval to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, 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, repurchase agreements for obligations of the United States or its agencies, and in certain obligations of the State of Tennessee pursuant to *Tennessee Code Annotated*, Section 9-4-602(b). Investment in derivative type securities and investments of high risk is prohibited.

   This resolution further states that the dollar weighted average maturity of the State Pooled Investment Fund shall not exceed 90 days and that no investment may be purchased with a remaining maturity of greater than 397 calendar days. In addition, it is the intent of the Funding Board that the market value of the SPIF not deviate more than 0.5 percent from amortized cost. If it does, actions may include but not be limited to selling securities whose market value substantially deviates from amortized cost and investing in securities with 90 days or less to maturity.

   The State Pooled Investment Fund is also authorized by policy to contractually loan securities to investment brokers. The contract for a security loan provides that the fund loan specific securities from its holdings to the broker in return for collateral securities. Statute requires that the loaned securities be collateralized at 102% of their market value. There were no securities on loan from the State Pooled Investment Fund during the year ended June 30, 1998.

   Statutes require that state deposits be secured by collateral securities with a market value of 105% of the face of the deposit secured thereby after considering the applicable FDIC coverage, or the depository must be a member of the State Collateral Pool and the pool must have securities pledged which in total equal the required percentage established by the Collateral Pool Board.

   Certificates of deposit are not placed or renewed with a financial institution until adequate collateral is pledged. Open accounts maintained for deposit of state revenues are collateralized on an estimate of the average daily balance in the account based on previous balances and monitored for variation to actual balances. The Treasurer is required, by statute, to evaluate the market value of required collateral monthly, and more frequently if market conditions require. Statutes provide for the Commissioner of Financial Institutions to advise, on a timely basis, the Treasurer and the Com-

(Continued)

missioner of Finance and Administration of the condition of each state bank and state chartered savings and loan association, including his recommendations regarding its condition and safety as a state depository. Similar provisions apply to federally chartered banks and savings and loan associations designated as state depositories. This process ensures that institutions whose financial status is uncertain are monitored for collateral sufficiency. All repurchases are done with primary dealers in government securities which have executed a master repurchase agreement with the State which provides for securities underlying repurchase agreements to have a market value of not less than 100 percent (100%) nor more than 102 percent (102%) of the cost of the repurchase agreement plus accrued interest. Prime commercial paper may be acquired from authorized broker dealers or directly from the issuer. There is no collateral requirement for prime commercial paper.

2. **Deposits** - Deposits with financial institutions are required to be categorized to indicate the level of custodial credit risk assumed by the State. Category 1 consists of deposits that are insured or collateralized with securities held by the State or by its agent in the State's name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution's trust department or agent in the State's name. Category 3 deposits are uncollateralized. This includes any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the State's name.

   As of June 30, 1998, the carrying amount of the State Pooled Investment Fund deposits was $1,453,344,189 and the bank balance, including accrued interest, was $1,471,715,287. Of the bank balance, $ 1,471,663,653 was considered category 1, covered by insurance or collateral (at fair value) held in the state's name by independent custodial banks or in the state's account at the Federal Reserve Bank, and $51,634 (at fair value) was considered category 3, uninsured and uncollateralized. There were no material amounts uncollateralized during the year ended June 30, 1998.

   At June 30, 1998, the principal amount of certificates of deposit in state depositories was $1,131,629,000. Interest rates on certificates of deposit held at June 30, 1998 ranged from 5.40% to 6.00% and days to maturity ranged from 3 to 360 days.

3. **Investments** - Investments are also required to be categorized to indicate the level of custodial credit risk assumed by the State. Category 1 includes investments that are insured or registered, or for which securities are held by the State or its agent in the name of the State. 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 State. 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 State.

   The State Pooled Investment Fund's investments, shown below as of June 30, 1998, are all considered category 1. All securities, whether owned outright or pledged as collateral against repurchases, are held in the State's account in the Federal Reserve Bank or at a third party trustee custodian in the State's name.

	Carrying Amount	Fair Value	Par Value	Interest Rate Range	Days to Maturity
Cash Equivalents and Short-term Investments:					
Repurchase Agreements	$ 27,500,000	$ 27,500,000	$ 27,500,000	5.30% to 5.56%	1 day
U.S. Government and Agency Obligations	742,642,713	739,214,751	745,167,000	4.95% to 5.70%	2 to 289 days
Commercial Paper	1,126,633,710	1,126,633,710	1,131,629,000	5.50% to 5.73%	1 to 59 days
Total Cash Equivalents and Short-term Investments	$ 1,896,776,423	$ 1,893,348,461	$ 1,904,296,000		
Less: short-term investments classified as cash equivalents on Statement of Net Assets	(1,424,964,945)				
Add: certificates of deposit classified as short-term investments on Statement of Net Assets	529,435,000				
Short-term investments as shown on Statement of Net Assets	$ 1,001,246,478				

(Continued)

STATE POOLED INVESTMENT FUND
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998

C. OTHER ACCOUNTING DISCLOSURES

1. **Description of the State Pooled Investment Fund** - The State Pooled Investment Fund is established by *Tennessee Code Annotated*, Section 9-4-603 "for the purpose of receiving and investing any money in the custody of any officer or officers of the state unless prohibited by statute to be invested." Participants in the SPIF include the general fund of the State and any department or agency of the State which is required by court order, contract, state or federal law or federal regulation to receive interest on invested funds and which are authorized by the State Treasurer to participate in the SPIF. In addition, funds in the State of Tennessee Local Government Investment Pool (LGIP), which includes certain funds belonging to the State or its component units as well as funds belonging to separate legal entities, are consolidated with the SPIF for investment purposes only. The SPIF, as noted in A.4 above, is not registered as an investment company with the SEC. The primary oversight responsibility for the investment and operations of the SPIF rests with the Funding Board.

   Investment in the SPIF is optional and participants may invest any amount for any length of time in the SPIF. However, some deposits made to the LGIP are contractually required and committed to the State Department of Transportation (DOT). The only withdrawals allowed from these accounts are to pay the DOT in accordance with progress billings for construction projects contracted between the entity and the DOT.

   An average rate of return is calculated on the investments made each month in the SPIF and is used to credit earnings to LGIP participants and the State departments and agencies required to earn interest. The State's general fund is credited with the residual earnings. An administrative fee of .06 percent for LGIP and .08 percent for the State's departments and agencies was charged against each participant's average daily balance to provide for recovery of administrative cost.

2. **Year 2000 Compliance** - The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the SPIF as well as the other systems upon which the SPIF depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the SPIF did not result in the commitment of significant resources as of June 30, 1998.

   The State Treasurer has assessed the impact of Y2K on the SPIF computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the SPIF from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

   The SPIF relies principally upon two major computer systems, the Treasury Earnings and Account Management System (TEAMS) for participant level accounting and the Cash Movement Control System (CMCS) for the actual transfer of funds between the Fund and participants. Other systems critical to the SPIF operations include the Statewide Accounting and Reporting System (STARS), utilized to record SPIF transactions and in the preparation of financial statements, the State Treasurer's general ledger accounting system, utilized to reconcile the subsidiary ledgers and to produce financial statements, and the investment system which maintains a perpetual inventory of all the securities owned by the SPIF and maintains a record of all acquisitions, dispositions and maturity of securities in the SPIF portfolio.

   The State Treasurer has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

(Continued)

State Pooled Investment Fund
Notes to the Financial Statements
June 30, 1998

Awareness stage - Establishing a budget and project plan for dealing with the Year 2000 issue.
Assessment stage - Identifying the systems and components for which the Year 2000 compliant work is needed.
Remediation stage - Making changes to systems and equipment.
Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

The State Pooled Investment Fund's Year 2000 remediation work for its mission-critical systems and electronic equipment are in the following stages of work. "C" means complete, "P" means in progress, "A" means still needs to be addressed.

	Awareness	Assessment	Remediation	Validation/Testing
TEAMS	C	C	C	P
CMCS	C	C	P	P
Investment System	C	C	C	P
General Ledger System	C	C	P	P
Electronic Equipment	C	C	P	P

The State Treasurer has begun soliciting information from other organizations whose Y2K compliance could affect the SPIF regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the SPIF operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the SPIF operations or financial status.

Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the State Pooled Investment Fund is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the SPIF does business will be Year 2000 ready.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
INDEPENDENT AUDITOR'S REPORT

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System, as of June 30, 1998, and June 30, 1997, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Tennessee Consolidated Retirement System has included such disclosures in Note D.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Tennessee Consolidated Retirement System's disclosures with respect to the year 2000 issue made in Note D.2. Further, we do not provide assurance that the Tennessee Consolidated Retirement System is or will be year 2000 ready, that the Tennessee Consolidated Retirement System year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the Tennessee Consolidated Retirement System does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, 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, 1998, and June 30, 1997, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary schedule of actuarial balances is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, 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.

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

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF PLAN NET ASSETS
AS OF JUNE 30, 1998 AND JUNE 30, 1997

Expressed in Thousands	State Employees, Teachers, Higher Ed. Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ASSETS:		
Cash	$ 23,097	$ 234
Receivables:		
Member Contributions Receivable	12,681	2,596
Employer Contributions Receivable	13,491	4,899
Accrued Interest Receivable	140,343	20,395
Accrued Dividends Receivable	8,442	1,227
Other Investment Receivable	927	135
Investments Sold	26,631	3,870
Total Receivables	202,515	33,122
Investments, at fair value		
Short-term Securities	802,397	116,608
Domestic Securities:		
Government Bonds	6,426,129	933,874
Corporate Bonds	2,697,109	391,956
Corporate Stocks	5,655,385	821,866
International Securities:		
Government Bonds	1,176,324	170,949
Corporate Bonds	188,826	27,442
Corporate Stocks	1,264,607	183,778
Total Investments	18,210,777	2,646,473
Invested Securities Lending Collateral	0	0
TOTAL ASSETS	18,436,389	2,679,829
LIABILITIES:		
Retired Payroll Payable	12,463	1,778
Warrants Payable	408	298
Accounts Payable:		
Death Benefits and Refunds Payable	789	428
Other	54	58
Investments Purchased	35,760	5,197
Other Investment Payables	1,308	190
Securities Lending Collateral	0	0
TOTAL LIABILITIES	50,782	7,949
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS (Schedule of Funding Progress for the PSPP Plan is presented on page 78)	$ 18,385,607	$ 2,671,880

See accompanying Notes to the Financial Statements.

(Continued)

CONTINUED

June 30, 1998 Total	State Employees, Teachers, Higher Ed. Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 1997 Total
$ 23,331	$ 59,917	$ 7,382	$ 67,299
15,277	11,557	2,312	13,869
18,390	21,508	4,335	25,843
160,738	137,622	19,555	157,177
9,669	8,926	1,268	10,194
1,062	3,177	451	3,628
30,501	33,521	4,763	38,284
235,637	216,311	32,684	248,995
919,005	766,362	108,890	875,252
7,360,003	4,807,877	683,139	5,491,016
3,089,065	2,967,717	421,676	3,389,393
6,477,251	4,850,437	689,187	5,539,624
1,347,273	1,065,051	151,330	1,216,381
216,268	283,619	40,299	323,918
1,448,385	1,331,653	189,211	1,520,864
20,857,250	16,072,716	2,283,732	18,356,448
0	306,399	43,536	349,935
21,116,218	16,655,343	2,367,334	19,022,677
14,241	13,225	1,890	15,115
706	209	226	435
1,217	1,173	778	1,951
112	16	1	17
40,957	117,031	16,629	133,660
1,498	1,946	277	2,223
0	306,400	43,535	349,935
58,731	440,000	63,336	503,336
$ 21,057,487	$ 16,215,343	$ 2,303,998	$ 18,519,341

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF CHANGES IN PLAN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 1998 AND JUNE 30, 1997

Expressed in Thousands	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ADDITIONS		
Contributions:		
Member contributions	$ 116,196	$ 39,086
Employer contributions	166,756	65,276
Total contributions	282,952	104,362
Investment income:		
Net appreciation in fair value of investments	1,655,047	239,084
Interest	655,178	94,644
Dividends	108,996	15,745
Total investment income	2,419,221	349,473
Less: Investment expense	9,332	1,350
Net income from investing activities	2,409,889	348,123
Securities lending activities:		
Securities lending income	2,080	301
Less: Securities lending expense	1,857	268
Net income from securities lending activities	223	33
Net investment income	2,410,112	348,156
TOTAL ADDITIONS	2,693,064	452,518
DEDUCTIONS		
Annuity benefits:		
Retirement benefits	378,485	53,991
Survivor benefits	24,127	3,441
Disability benefits	12,694	1,811
Cost of living	88,435	12,615
Death benefits	2,557	746
Refunds	14,311	10,338
Administrative expense	2,191	1,694
TOTAL DEDUCTIONS	522,800	84,636
NET INCREASE	2,170,264	367,882
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	16,215,343	2,303,998
END OF YEAR	$ 18,385,607	$ 2,671,880

See accompanying Notes to the Financial Statements.

(Continued)

CONTINUED

For the Year Ended June 30, 1998 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 1997 Total
$ 155,282	$ 110,697	$ 32,959	$ 143,656
232,032	278,417	59,167	337,584
387,314	389,114	92,126	481,240
1,894,131	1,499,296	212,126	1,711,422
749,822	596,369	84,368	680,737
124,741	110,218	15,593	125,811
2,768,694	2,205,883	312,087	2,517,970
10,682	7,632	1,088	8,720
2,758,012	2,198,251	310,999	2,509,250
2,381	76,749	10,858	87,607
2,125	71,753	10,151	81,904
256	4,996	707	5,703
2,758,268	2,203,247	311,706	2,514,953
3,145,582	2,592,361	403,832	2,996,193
432,476	346,192	49,478	395,670
27,568	21,829	3,120	24,949
14,505	11,578	1,655	13,233
101,050	73,751	10,540	84,291
3,303	2,395	801	3,196
24,649	11,444	12,389	23,833
3,885	2,221	1,636	3,857
607,436	469,410	79,619	549,029
2,538,146	2,122,951	324,213	2,447,164
18,519,341	14,092,392	1,979,785	16,072,177
$ 21,057,487	$ 16,215,343	$ 2,303,998	$ 18,519,341

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND 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. **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, 1998 and June 30, 1997. The classification of Cash also includes cash held in a custody account 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 as the custody account relationship does not meet the definition for either a deposit with a financial institution or a security.

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. 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.

5. **Receivables** - Receivables primarily consist of interest which is recorded when earned. The receivables for contributions as of June 30, 1998 consist of $26.2 million due from other funds within the state and $7.5 million due from other governments. The receivables for contributions as of June 30, 1997 consist of $33.0 million due from other funds within the state and $6.6 million due from other governments.

6. **Reclassification** - Foreign currency in the amount of $39,924,683, classified as International Corporate Stocks on the June 30, 1997 Statement of Plan Net Assets has been reclassified as cash.

(Continued)

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 (LEA's) and higher education employees. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan on or after July 1, 1979 are vested after five years of service. Members joining prior to July 1, 1979 are vested after four years of service. 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 the *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, 1998, the plan's Member Reserve and Employer Reserve were fully funded with balances of $2,268.7 million and $16,116.9 million, respectively. 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

(Continued)

Tennessee Consolidated Retirement System
Notes to the Financial Statements
June 30, 1998 and June 30, 1997 (continued)

benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan prior to July 1, 1979 are vested after four years of service. Members joining on or after July 1, 1979 are vested upon completion of 10 years of service, unless five years vesting is authorized by resolution of the chief governing body. Cost of living adjustments, 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, 1998, the plan's Member Reserve and Employer Reserve were fully funded with balances of $467.6 million and $2,204.3 million, respectively. 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, real estate 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. Private Placements are limited to 15% of the total fixed income portfolio.

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. The total sum invested in real estate shall not exceed five percent (5%) of the total of the funds of the retirement system.

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 on the chart that follows according to the level of custodial credit risk associated with the custodial arrangements. 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.

(Continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997 (CONTINUED)

Expressed in Thousands

Investments - Category 1	Fair Value June 30, 1998	Fair Value June 30, 1997
Short-term Securities:		
Commercial Paper	$730,938	$749,460
Medium-term Corporate Notes	31,584	0
U. S. Government Securities	156,483	125,792
Long-term Investments:		
Domestic Securities:		
Government Bonds	7,354,911	5,443,664
Corporate Bonds	3,089,065	3,296,759
Corporate Stocks	6,465,187	5,458,081
International Securities:		
Government Bonds	1,347,273	1,195,959
Corporate Bonds	216,268	323,918
Corporate Stocks	1,412,509	1,279,831
Total Investments - Category 1	20,804,218	17,873,464
Investments - Category 2	0	0
Investments - Category 3		
Short-term securities lending collateral investments held by custodian bank	0	349,935
Margin Deposit on Futures Contracts:		
Domestic Government Bonds	5,092	19,036
Total Investments - Category 3	5,092	368,971
Investments - Not Categorized		
Investments held by broker-dealers under securities on loan contracts for cash collateral:		
Domestic Securities:		
Corporate Bonds	0	78,986
Corporate Stocks	0	63,265
International Securities:		
Corporate Stocks	0	192,304
Unsettled Investment Acquisitions:		
Domestic Securities:		
Government Bonds	0	28,316
Corporate Bonds	0	13,648
Corporate Stocks	12,064	18,278
International Securities:		
Government Bonds	0	20,422
Corporate Stocks	35,876	48,729
Total Investments - Not Categorized	47,940	463,948
Total Investments and invested securities lending collateral	$ 20,857,250	$ 18,706,383

(Continued)

Tennessee Consolidated Retirement System
Notes to the Financial Statements
June 30, 1998 and June 30, 1997 (continued)

As of June 30, 1998 and June 30, 1997, the TCRS had no concentrations of investments, other than those issued or guaranteed by the U.S. government, in any one organization that represents five percent or more of plan net assets.

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. Although there is no specific policy for matching the maturities of collateral investments and the securities loans, the securities on loan can be terminated on demand by either the TCRS or the borrower. As of June 30, 1998 the TCRS had no securities on loan. The TCRS securities lending income, net of expenses, was $255,740.83 for the year ended June 30, 1998 and $5,703,225 for the year ended June 30, 1997. 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. At June 30, 1997, 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.

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, 1998 and 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, 1998, there were forward exchange contracts outstanding at a total net notional amount of $528,898,678 and a fair value of $524,041,284. At June 30, 1997, there were forward exchange contracts outstanding at a total net notional amount of $310,259,951 and a fair value of $315,161,569.

At June 30, 1998, the notional amount of futures contracts was $138,731,250 at a fair value of $142,875,000. 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, 1998 and June 30, 1997.

D. COMMITMENTS

1. **Standby Note Purchase Agreement** - 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.

(Continued)

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997 (CONTINUED)

2. **Year 2000 Compliance** - The TCRS is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the TCRS as well as the other systems upon which the TCRS depends to fulfill its mission. The TCRS' Y2K initiatives relating to the retirement system did not result in the commitment of significant financial resources as of June 30, 1998.

The TCRS has assessed the impact of Y2K on its computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the TCRS from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the TCRS would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

The TCRS relies upon three major computer systems to manage the responsibilities of the retirement program. The retired payroll system generates monthly annuity payments to more than 68,000 retirees each month. The active membership system maintains the data of more than 200,000 member records. This system is utilized to record employee and employer contributions; to record service and salary credit for each member; to process lump sum refunds to terminating members; to maintain records of each employer participating in the retirement plan; to maintain member data including beneficiary, date of birth, etc.; to provide annual statements to members; to invoice members for the purchase of service credit; and to provide benefit estimates. The third major system is the investment system which maintains a perpetual inventory of all the securities owned by TCRS. The investment system maintains a record of all the acquisitions, dispositions, and maturity of securities in the TCRS portfolio.

Other important but less significant systems include the document inventory system and the general ledger accounting system. The document inventory system is utilized to maintain a record of the incoming and outgoing documents and correspondence. The general ledger accounting system is utilized to reconcile the subsidiary ledgers and to produce financial statements.

TCRS has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

Awareness stage - Establishing a budget and project plan for dealing with the Year 2000 issue.
Assessment stage - Identifying the systems and components for which the Year 2000 compliant work is needed.
Remediation stage - Making changes to systems and equipment.
Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

TCRS' Year 2000 remediation work for its mission-critical systems and electronic equipment are in the following stages of work. "C" means complete, "P" means in progress, "A" means still need to be addressed.

	Awareness	Assessment	Remediation	Validation/Testing
Retired Payroll System	C	C	P	P
Active Membership System	C	C	P	P
Investment System	C	C	C	P
Document Inventory System	C	C	P	A
Accounting System	C	C	P	P
Electronic Equipment	C	C	P	P

The TCRS has contacted external organizations with a mission critical relationship whose Year 2000 compliance could affect the operations of the retirement system. Such organizations have responded that they are Year 2000 compliant or expect to achieve compliance prior to January 1, 2000. Other organizations with less critical relationships have been contacted to remind them of the potential problems surrounding Year 2000 and the need to evaluate their systems.

Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that TCRS is or will be Year 2000 ready, that the TCRS' remediation efforts will be successful in whole or in part, or that parties with whom TCRS does business will be Year 2000 ready.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULE OF FUNDING PROGRESS

SETHEEPP

For budgetary purposes, the cost of funding the pension obligations of the state employees, teachers and higher education employees pension plan (SETHEEPP) is determined separately as follows:

(1) General state employees and higher education employees
(2) Teachers (grades K-12)
(3) State Judges employed after June 30, 1972
(4) Attorneys General employed after June 30, 1972
(5) State Judges and Attorneys General employed prior to July 1, 1972
(6) County Officials employed prior to July 1, 1972

All the groups above, except the County Officials group and the State Judges and Attorneys General group employed prior to July 1, 1972, are funded under the aggregate actuarial cost method. The frozen entry age actuarial method is utilized for these two groups not under the aggregate actuarial cost method. The aggregate actuarial cost method does not identify or separately amortize unfunded actuarial liabilities. The SETHEEPP groups funded under the aggregate method would not have an unfunded actuarial liability under the frozen entry age actuarial method.

In accordance with GASB 25, a schedule of funding progress is not presented since more than 98% of the liabilities are determined under the aggregate actuarial funding method.

PSPP

The political subdivision pension plan (PSPP) represents 365 participating entities at June 30, 1997, some of which are funded under the aggregate actuarial cost method and others under the frozen entry age actuarial method. The following data represents only those political subdivisions where the frozen entry age actuarial method is utilized.

Expressed in Thousands

Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Accrued Liability (AAL) Frozen Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
6/30/97	1,020,240	1,078,231	57,991	94.62%	583,294	9.94%

There are 168 of the 365 political subdivisions in TCRS as of the June 30, 1997 actuarial valuation, with an unfunded actuarial accrued liability. 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 transition year.

See accompanying Notes to Required Supplementary Information.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULES OF EMPLOYER CONTRIBUTIONS

Expressed in Thousands

	SETHEEPP		PSPP	
Year Ended June 30	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
1998	$ 166,756	100%	$ 64,617	101%

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.

See accompanying Notes to Required Supplementary Information.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
NOTES TO REQUIRED SUPPLEMENTARY INFORMATION
AS OF JUNE 30, 1998 AND JUNE 30, 1997

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

	SETHEEPP	PSPP
Valuation Date	6/30/97	6/30/97
Actuarial cost method	Aggregate (1)	(2)
Amortization method	Level Dollar (3)	Level Dollar (3)
Remaining amortization period	18 years (3) closed period (3)	(4) 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	(5)	(5)
Cost-of-living adjustments	3%	3%
Increase in Social Security wage base	4.5%	4.5%

(1) The frozen entry age actuarial method is utilized for two small closed groups: county officials employed prior to July 1, 1972, and a group of state judges and attorneys general employed prior to July 1, 1972.

(2) Some political subdivisions are funded under the aggregate actuarial funding method and some under the frozen entry age actuarial method.

(3) Applies to groups funded under the frozen entry age actuarial method.

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

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

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
ACTUARIAL BALANCE SHEET
AS OF JUNE 30, 1997

	Political Subdivision Pension Plan (PSPP)	State Employees, Teachers, Higher Ed. Employees Pension Plan (SETHEEPP)	Total
ASSETS			
Present Assets Creditable To:			
Employer Accumulation Fund	$ 1,800,448,644	$ 13,529,975,707	$ 15,330,424,351
Members' Accumulation Fund	426,442,166	2,141,702,347	2,568,144,513
Total Present Assets	2,226,890,810	15,671,678,054	17,898,568,864
Present Value Of Prospective Contributions Payable To:			
Employer Accumulation Fund:			
Normal	358,895,672	1,928,526,419	2,287,422,091
Accrued Liability	57,991,294	111,172,072	169,163,366
Total Employer Accumulation	416,886,966	2,039,698,491	2,456,585,457
Members' Accumulation Fund:	238,234,111	1,105,935,845	1,344,169,956
Total Prospective Contributions	655,121,077	3,145,634,336	3,800,755,413
TOTAL ASSETS	2,882,011,887	18,817,312,390	21,699,324,277
LIABILITIES			
Present Value Of Prospective Benefits Payable On Account Of:			
Present retired members and Beneficiaries	743,565,148	5,456,072,528	6,199,637,676
Present active members	2,096,342,374	13,156,059,038	15,252,401,412
Former members	42,104,365	205,180,824	247,285,189
TOTAL LIABILITIES	$ 2,882,011,887	$ 18,817,312,390	$ 21,699,324,277

UNAUDITED

IRC SECTION 457 DEFERRED COMPENSATION
INDEPENDENT AUDITOR'S REPORT

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the IRC Section 457 Deferred Compensation Plan as of June 30, 1998, and June 30, 1997, and the related statement of changes in assets and liabilities for the year ended June 30, 1998. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The IRC Section 457 Deferred Compensation Plan has included such disclosures in Note B.5. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the IRC Section 457 Deferred Compensation Plan's disclosures with respect to the year 2000 issue made in Note B.5. Further, we do not provide assurance that the IRC Section 457 Deferred Compensation Plan is or will be year 2000 ready, that the IRC Section 457 Deferred Compensation Plan year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the IRC Section 457 Deferred Compensation Plan does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the IRC Section 457 Deferred Compensation Plan as of June 30, 1998, and June 30, 1997, and the changes in assets and liabilities for the year ended June 30, 1998, in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, on our consideration of the IRC Section 457 Deferred Compensation Plan'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.

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

IRC Section 457 Deferred Compensation Comparative Balance Sheets June 30, 1998 and June 30, 1997

	June 30, 1998	June 30, 1997
ASSETS		
Investments Held by Vendors:		
Aetna	$ 36,315,605	$ 33,108,143
American General	1,030,304	988,523
Calvert Group	737,749	494,565
Fidelity Investments	79,553,813	62,967,168
Great West	2,269,353	3,544,555
Union Planters	14,176,840	14,670,926
Total Investments	134,083,664	115,773,880
Due from Other Funds for:		
Aetna	13,827	20,083
American General	1,996	2,083
Calvert Group	744	1,594
Fidelity Investments	62,459	103,473
Union Planters	11,725	17,062
Total Receivables	90,751	144,295
TOTAL ASSETS	$ 134,174,415	$ 115,918,175
LIABILITIES		
Amounts Held in Custody for Others	$ 134,174,415	$ 115,918,175

See accompanying Notes to the Financial Statements.

IRC Section 457 Deferred Compensation Statement of Changes in Assets and Liabilities For the Year Ended June 30, 1998

	Balance July 1, 1997	Additions	Deductions	Balance June 30, 1998
ASSETS				
Investments, at Fair Value	$115,773,880	$34,438,095	$16,128,311	$134,083,664
Due from other Funds	144,295	90,751	144,295	90,751
TOTAL ASSETS	$115,918,175	$34,528,846	$16,272,606	$134,174,415
LIABILITIES				
Amounts Held in Custody for Others	$115,918,175	$34,528,846	$16,272,606	$134,174,415

See accompanying Notes to the Financial Statements.

IRC Section 457 Deferred Compensation
Notes to the Financial Statements
June 30, 1998 and June 30, 1997

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The Deferred Compensation Plan is part of the primary government and has been included in the *Tennessee Comprehensive Annual Financial Report* as an agency fund.

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) using the modified accrual basis of accounting. The agency fund is custodial in nature and does not measure results of operations or have a measurement focus.

B. OTHER ACCOUNTING DISCLOSURES

1. The state offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all state employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All costs of administering and funding the plan are the responsibility of plan participants.

2. All amounts of compensation deferred under the plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the state, (without being restricted to the provisions of benefits under the plan), subject only to the claims of the state's general creditors. Participants' rights under the plan are equal to those of general creditors of the state in an amount equal to the fair value of the deferred account for each participant.

3. It is the opinion of the state's legal counsel that the state has no liability for losses under the plan, but does have the duty of due care that would be required of an ordinary prudent investor. The state believes that it is unlikely that it will use the assets to satisfy the claims of general creditors in the future.

4. The deferred compensation investments are not required to be classified into the custodial risk categories specified by the Governmental Accounting Standards Board because the investments are in pools or mutual funds where the specific securities related to the plan cannot be identified.

5. **Year 2000 Compliance** - The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the Deferred Compensation Plan as well as the other systems upon which the Deferred Compensation Plan depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the Deferred Compensation Plan did not result in the commitment of significant resources as of June 30, 1998.

   The State Treasurer has assessed the impact of Y2K on the Deferred Compensation Plan computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the Deferred Compensation Plan from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

   The State Treasurer relies upon a third party vendor for administration of and recordkeeping for the Deferred Compensation Plan. The State Treasurer has begun soliciting information from the third party vendor and other organizations whose Y2K compliance could affect the Deferred Compensation Plan regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the Deferred Compensation Plan operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the Deferred Compensation Plan operations or financial status.

   Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the Deferred Compensation Plan is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the Deferred Compensation Plan does business will be Year 2000 ready.

FLEXIBLE BENEFITS PLAN
INDEPENDENT AUDITOR'S REPORT

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the Flexible Benefits Plan as of June 30, 1998, and June 30, 1997, and the related statements of revenues, expenditures, and changes in fund balances for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Flexible Benefits Plan has included such disclosures in Note B.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Flexible Benefits Plan's disclosures with respect to the year 2000 issue made in Note B.2. Further, we do not provide assurance that the Flexible Benefits Plan is or will be year 2000 ready, that the Flexible Benefits Plan year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the Flexible Benefits Plan does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Flexible Benefits Plan as of June 30, 1998, and June 30, 1997, and the changes in fund balances for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, on our consideration of the Flexible Benefits Plan'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

Flexible Benefits Plan
Comparative Balance Sheets
June 30, 1998 and June 30, 1997

	June 30, 1998	June 30, 1997
ASSETS		
Cash	$ 458,712	$ 2,826,104
Due from Other Funds	1,842	1,599
TOTAL ASSETS	460,554	2,827,703
LIABILITIES AND FUND BALANCES		
LIABILITIES:		
Warrants Payable	3,151	3,917
Accounts Payable	103,253	76,316
Dependent Care Deposits	140,051	130,610
Medical Reimbursement Deposits	146,849	78,819
Due to Other Funds	67,250	63,440
TOTAL LIABILITIES	460,554	353,102
FUND BALANCES, RESERVED FOR EMPLOYEE BENEFITS	0	2,474,601
TOTAL LIABILITIES AND FUND BALANCES	$ 460,554	$ 2,827,703

See accompanying Notes to the Financial Statements.

Flexible Benefits Plan
Comparative Statements of Revenues, Expenditures and Changes in Fund Balances
For the Years Ended June 30, 1998 and June 30, 1997

	For the Year Ended June 30, 1998	For the Year Ended June 30, 1997
REVENUES:		
FICA Savings	$ 2,302,902	$ 2,269,211
Flexible Benefit Forfeiture	2,937	7,785
TOTAL REVENUES	2,305,839	2,276,996
EXPENDITURES:		
Deferred Compensation Match	4,569,728	4,359,140
Administrative Fees	185,557	205,345
Employee Benefit Program	67,813	53,525
TOTAL EXPENDITURES	4,823,098	4,618,010
DEFICIENCY OF REVENUES UNDER EXPENDITURES	(2,517,259)	(2,341,014)
OTHER FINANCING SOURCES (USES):		
Operating Transfer From General Fund	427,598	0
Operating Transfer to General Fund	(151,946)	(172,857)
Operating Transfer to Internal Service Fund	(232,994)	(474,044)
DEFICIENCY OF REVENUES UNDER EXPENDITURES AND OTHER FINANCING USES & SOURCES	(2,474,601)	(2,987,915)
FUND BALANCES, JULY 1	2,474,601	5,462,516
FUND BALANCES, JUNE 30	$ 0	$ 2,474,601

See accompanying Notes to the Financial Statements.

FLEXIBLE BENEFITS PLAN
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The Flexible Benefits Plan is part of the primary government and has been included in the *Tennessee Comprehensive Annual Financial Report* as an expendable trust fund. The state offers its employees a cafeteria plan created in accordance with Internal Revenue Code Section 125. The plan is available on an optional basis to all state employees. Through the plan, employees may elect to direct a portion of their salary to pay for certain benefits. Benefits which may be purchased through the plan include state group medical insurance, state group dental insurance, out-of-pocket medical expenses and/or dependent care expenses. Because elections must be filed before the salary or the benefits are received and because salary directed to the plan may not be withdrawn by participants for any other purpose, salary directed to the plan is exempt from federal income tax and social security tax. Elections made by employees may not be changed during the calendar plan year except in the event of a corresponding change in the participant's family status. Contributions to the plan not withdrawn by the end of the plan year are forfeited to the state and are used for funding other employee benefit programs as specified in the state appropriations' bill.

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) using the flow of current financial resources measurement focus and the modified accrual basis of accounting. Under this method, revenues are recorded when they become both measurable and available, and expenditures are recognized at the time the fund liabilities are incurred.

3. **Cash** - Cash deposited in the Flexible Benefits Plan is pooled with the Pooled Investment Fund, administered by the State Treasurer, which 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 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, 1998, and June 30, 1997.

B. OTHER ACCOUNTING DISCLOSURES

1. The Appropriations Act of 1997 (Public Chapter 552, Section 12, item 21) provided for the State match of employee deferrals into the State's 401(k) to be funded by the Flexible Benefits Fund. The Appropriations Act further provided that should the match exceed the fund balance, an operating transfer from the general fund would be made to bring the fund balance to zero. At June 30, 1998 an operating transfer of $427,598.11 was received from the general fund in accordance with the appropriations act.

2. **Year 2000 Compliance** - The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the Flexible Benefits Plan as well as the other systems upon which the Flexible Benefits Plan depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the Flexible Benefits Plan did not result in the commitment of significant resources as of June 30, 1998.

   The State Treasurer has assessed the impact of Y2K on the Flexible Benefits Plan computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the Flexible Benefits Plan from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

(Continued)

Flexible Benefits Plan
Notes to the Financial Statements
June 30, 1998 and June 30, 1997 (continued)

The Flexible Benefits Plan relies principally upon one major computer system, the Flexible Benefit System for managing flexible benefits reimbursement requests. Other systems critical to the Flexible Benefits Plan operations include the State Treasurer's general ledger accounting system and the Statewide Accounting and Reporting System (STARS) which are both utilized to make payments on approved reimbursement claims, to reconcile the subsidiary ledger and to produce financial statements. Another system that is important, but less significant, is the document inventory system (MODOC) utilized to maintain a record of the incoming and outgoing documents and correspondence.

The State Treasurer has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

Awareness stage - Establishing a budget and project plan for dealing with the year 2000 issue.
Assessment stage - Identifying the systems and components for which the year 2000 compliant work is needed.
Remediation stage - Making changes to systems and equipment.
Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

As of June 30, 1998, the awareness stage had been completed for the Flexible Benefits System. The Flexible Benefit System is in the process of the assessment stage. The general ledger, document inventory systems and other electronic equipment had completed the awareness and assessment stages and are in the remediation stage.

The State Treasurer has begun soliciting information from other organizations whose Y2K compliance could affect the Flexible Benefits Plan regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the Flexible Benefits Plan operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the Flexible Benefits Plan operations or financial status.

Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the Flexible Benefits Plan is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the Flexible Benefits Plan does business will be Year 2000 ready.

Claims Award Fund
Independent Auditor's Report

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the Claims Award Fund as of June 30, 1998, and June 30, 1997, and the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Claims Award Fund has included such disclosures in Note B.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Claims Award Fund's disclosures with respect to the year 2000 issue made in Note B.2. Further, we do not provide assurance that the Claims Award Fund is or will be year 2000 ready, that the Claims Award Fund year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the Claims Award Fund does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Claims Award Fund as of June 30, 1998, and June 30, 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, on our consideration of the Claims Award Fund'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

Claims Award Fund
Comparative Balance Sheets
June 30, 1998 and June 30, 1997

	June 30, 1998	June 30, 1997
ASSETS		
Cash	$ 83,703,656	$ 93,935,853
TOTAL ASSETS	83,703,656	93,935,853
LIABILITIES AND EQUITY		
LIABILITIES:		
Warrants Payable	161,114	102,567
Checks Payable	339,347	201,538
Accounts Payable	239,761	473,634
Claims Liability	55,663,634	53,461,703
TOTAL LIABILITIES	56,403,856	54,239,442
EQUITY		
Retained Earnings, Reserved for Claims	27,299,800	39,696,411
TOTAL LIABILITIES AND EQUITY	$ 83,703,656	$ 93,935,853

See accompanying Notes to the Financial Statements.

CLAIMS AWARD FUND
COMPARATIVE STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS
FOR THE YEARS ENDED JUNE 30, 1998 AND JUNE 30, 1997

	For the Year Ended June 30, 1998	For the Year Ended June 30, 1997
OPERATING REVENUES:		
Insurance Premiums	$ 10,651,600	$ 32,217,086
OPERATING EXPENSES:		
Torts		
Death	1,211,049	940,248
Bodily Injury	5,491,359	3,397,800
Property Damage	701,577	947,679
Total Torts	7,403,985	5,285,727
Workers' Compensation:		
Death	236,394	242,775
Medical	5,201,781	5,614,756
Assault Injury	1,734	0
Temporary Disability	1,035,185	1,349,207
Permanent Disability	5,535,865	4,398,532
Total Workers' Compensation	12,010,959	11,605,270
Employee Property Damage	28,095	31,206
Professional/Administrative	6,663,967	6,213,776
Addition to (Reduction in) Actuarial Liability	2,201,931	1,851,651
Total Operating Expenses	28,308,937	24,987,630
OPERATING INCOME	(17,657,337)	7,229,456
Nonoperating Revenues:		
Interest Income	5,256,941	5,565,728
Taxes	3,785	3,100
Total Nonoperating Revenues	5,260,726	5,568,828
NET INCOME	(12,396,611)	12,798,284
RETAINED EARNINGS, JULY 1	39,696,411	26,898,127
RETAINED EARNINGS, JUNE 30	$ 27,299,800	$ 39,696,411

See accompanying Notes to the Financial Statements.

Claims Award Fund
Comparative Statements of Cash Flows
For the Years Ended June 30, 1998 and June 30, 1997

	For the Year Ended June 30, 1998	For the Year Ended June 30, 1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
Operating Income	$(17,657,337)	$ 7,229,456
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Change in Assets and Liabilities:		
Increase (Decrease) in Warrants Payable	58,547	(23,480)
Increase (Decrease) in Checks Payable	137,809	(110,998)
(Decrease) in Accounts Payable	(233,873)	(94,143)
Increase in Claims Liability	2,201,931	1,851,651
Total Adjustments	2,164,414	1,623,030
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	(15,492,923)	8,852,486
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Taxes	3,785	3,100
NET CASH PROVIDED BY NONCAPITAL FINANCING ACTIVITIES	3,785	3,100
CASH FLOWS FROM INVESTING ACTIVITIES:		
Interest on Pooled Investment Fund	5,256,941	5,565,728
NET CASH PROVIDED BY INVESTING ACTIVITIES	5,256,941	5,565,728
NET INCREASE (DECREASE) IN CASH	(10,232,197)	14,421,314
CASH AT JULY 1	93,935,853	79,514,539
CASH AT JUNE 30	$ 83,703,656	$ 93,935,853

See accompanying Notes to the Financial Statements.

CLAIMS AWARD FUND
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997 (CONTINUED)

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The Claims Award Fund is part of the primary government and has been included in the *Tennessee Comprehensive Annual Financial Report* as an internal service fund.

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 Claims Award Fund follows all applicable GASB pronouncements as well as applicable private sector pronouncements issued on or before November 30, 1989. The Claims Award Fund uses the accrual basis of accounting and the flow of economic resources measurement focus. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

3. **Cash** - Cash deposited in the Claims Award Fund is pooled with the Pooled Investment Fund, administered by the State Treasurer, which is authorized by 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 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, 1998, and June 30, 1997.

B. OTHER ACCOUNTING DISCLOSURES

1. **Risk Management** - It is the policy of the state not to purchase commercial insurance for the risks of losses for general liability, automobile liability, professional malpractice, and workers' compensation. The state's management believes it is more economical to manage these risks internally and set aside assets for claim settlement in its internal service fund, the Claims Award Fund (CAF).

   CAF services claims for risk of loss to which the state is exposed including general liability, automobile liability, professional malpractice, and workers' compensation. All agencies and authorities of the state participate in CAF, except for the Board of Professional Responsibility, The Dairy Promotion Board, Women's Suffrage, and Certified Cotton Growers' Organization. CAF allocates the cost of providing claims servicing and claims payment by charging a premium to each agency based on a percentage of each organization's expected loss costs which include both experience and exposures. This charge considers recent trends in actual claims experience of the state as a whole. An actuarial valuation is performed as of each fiscal year end to determine the fund liability and premium allocation.

   CAF liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. Because actual claims liabilities depend on such complex factors as inflation, changes in legal doctrines, and damage awards, the process used in computing claims liability does not necessarily result in an exact amount. Claims liabilities are reevaluated annually to take into consideration recently settled claims, the frequency of claims, and other economic and social factors. At June 30, 1998, the present value of these liabilities discounted at 5.81% was $55,663,634. Changes in the balances of claims liabilities during fiscal years 1998 and 1997 were as follows:

	Beginning of Fiscal Year Liability	Current Year Claims and Changes in Estimates	Claim Payments	Balance at Fiscal Year End
1997-1998	$53,461,703	$21,644,970	$(19,443,039)	$55,663,634
1996-1997	$51,610,052	$18,773,854	$(16,922,203)	$53,461,703

   At June 30, 1998, CAF held $83.7 million in cash designated for payment of these claims.

(Continued)

Claims Award Fund
Notes to the Financial Statements
June 30, 1998 and June 30, 1997

2. **Year 2000 Compliance -** The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the CAF as well as the other systems upon which the CAF depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the CAF did not result in the commitment of significant resources as of June 30, 1998.

The State Treasurer has assessed the impact of Y2K on the CAF computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the CAF from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

The CAF relies principally upon one major computer system, the Division of Claims System (DOCS) for managing claims filed against the state. Other systems critical to the CAF operations include the Statewide Accounting and Reporting System (STARS) utilized to make payments on approved claims filed with the state, to reconcile the subsidiary ledger and to produce financial statements. Another system that is important, but less significant, is the document inventory system (MODOC) utilized to maintain a record of the incoming and outgoing documents and correspondence.

The State Treasurer has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

Awareness stage - Establishing a budget and project plan for dealing with the year 2000 issue.
Assessment stage - Identifying the systems and components for which the year 2000 compliant work is needed.
Remediation stage - Making changes to systems and equipment.
Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

As of June 30, 1998, the awareness, assessment, and remediation stages had been completed for all mission-critical systems and electronic equipment. The document inventory system has completed the awareness and assessment stages and is in the remediaton stage. The validation stage is in process for all mission-critical systems and electronic equipment.

The State Treasurer has begun soliciting information from other organizations whose Y2K compliance could affect the CAF regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the CAF operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the CAF operations or financial status.

Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the CAF is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the CAF does business will be Year 2000 ready.

Criminal Injury Compensation Fund
Independent Auditor's Report

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the Criminal Injuries Compensation Fund as of June 30, 1998, and June 30, 1997, and the related statements of revenues, expenditures, and changes in fund balances for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Criminal Injuries Compensation Fund has included such disclosures in Note B.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Criminal Injuries Compensation Fund's disclosures with respect to the year 2000 issue made in Note B.2. Further, we do not provide assurance that the Criminal Injuries Compensation Fund is or will be year 2000 ready, that the Criminal Injuries Compensation Fund year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the Criminal Injuries Compensation Fund does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Criminal Injuries Compensation Fund as of June 30, 1998, and June 30, 1997, and the changes in fund balances for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, on our consideration of the Criminal Injuries Compensation Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

Sincerely,

Arthur A. Hayes, Jr.

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

Criminal Injury Compensation Fund
Comparative Balance Sheets
June 30, 1998 and June 30, 1997

	June 30, 1998	June 30, 1997
ASSETS		
Cash	$ 60,010,113	$ 51,594,585
Accounts Receivable	646,447	647,723
TOTAL ASSETS	60,656,560	52,242,308
LIABILITIES AND FUND BALANCES		
LIABILITIES:		
Warrants Payable	597,808	570,230
Accounts Payable	379,773	152,839
Claims Liability	5,449,522	6,075,383
TOTAL LIABILITIES	6,427,103	6,798,452
FUND BALANCES:		
Reserved for Future Benefits	53,239,801	44,476,185
Reserved for Victims of Drunk Drivers	989,656	967,671
TOTAL FUND BALANCES	54,229,457	45,443,856
TOTAL LIABILITIES AND FUND BALANCES	$ 60,656,560	$ 52,242,308

See accompanying Notes to the Financial Statements.

Criminal Injury Compensation Fund
Comparative Statements of Revenues, Expenditures and Changes in Fund Balances
For the Years Ended June 30, 1998 and June 30, 1997

	For the Year Ended June 30, 1998	For the Year Ended June 30, 1997
REVENUES:		
State		
Taxes	$ 7,712,237	$ 7,567,806
Fines	2,302,448	2,026,830
Federal	1,605,000	1,578,000
Interest Income	3,007,089	2,499,253
TOTAL REVENUES	14,626,774	13,671,889
EXPENDITURES:		
Claim Payments	5,640,148	4,817,664
Victims' Coalition Grant	100,000	0
Administrative Cost - Public Awareness Program	101,025	97,937
TOTAL EXPENDITURES	5,841,173	4,915,601
EXCESS OF REVENUES OVER EXPENDITURES	8,785,601	8,756,288
FUND BALANCES, JULY 1	45,443,856	36,687,568
FUND BALANCES, JUNE 30	$ 54,229,457	$ 45,443,856

See accompanying Notes to the Financial Statements

Criminal Injury Compensation Fund
Notes to the Financial Statements
June 30, 1998 and June 30, 1997

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. ***Reporting Entity*** - The Criminal Injuries Compensation Fund is part of the primary government and has been included in the *Tennessee Comprehensive Annual Financial Report* as a special revenue fund. The Criminal Injuries Compensation Program (CIC) is funded through privilege taxes assessed in courts against certain criminal defendants upon conviction, fees levied against parolees, probationers and employed releasees, the proceeds from sales of illegal contraband and bond forfeitures in felony cases, and a federal grant. Payments made under the CIC program are intended to defray the costs of medical services, loss of earnings, burial costs, and other pecuniary losses to either the victim of a crime or to the dependents of deceased victims. According to state statute, the CIC program can only compensate victims to the extent funds are available within the program. State funds cannot be utilized for claim payments.

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) using the flow of current financial resources measurement focus and the modified accrual basis of accounting. Under this method, revenues are recorded when they become both measurable and available, and expenditures are recognized at the time the fund liabilities are incurred.

3. ***Cash*** - Cash deposited in the Criminal Injuries Compensation Fund is pooled with the Pooled Investment Fund, administered by the State Treasurer, which is authorized by 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,

(Continued)

CRIMINAL INJURY COMPENSATION FUND
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997 (CONTINUED)

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 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, 1998, and June 30, 1997.

B. OTHER ACCOUNTING DISCLOSURES

1. **Reserves** - The Victims of Drunk Drivers Compensation Fund (VDDC) is a part of the Criminal Injuries Compensation Fund. A requirement of the CIC and VDDC combination is that a reserve be established annually for an amount equal to three times the awards paid for VDDC during the fiscal year. Chapter 761 of the Public Acts of 1992 discusses the fund combination as well as the VDDC reserve requirement.

2. **Year 2000 Compliance** - The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the CIC program as well as the other systems upon which the CIC program depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the CIC program did not result in the commitment of significant resources as of June 30, 1998.

   The State Treasurer has assessed the impact of Y2K on the CIC program computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the CIC program from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

   The CIC program relies principally upon one major computer system, the Criminal Injury System (CIS) for managing claims filed by victims of a crime or dependents of deceased victims. Other systems critical to the CIC program operations include the Statewide Accounting and Reporting System (STARS) utilized to make payments on approved claims, to reconcile the subsidiary ledger and to produce financial statements. Another system that is important, but less significant, is the document inventory system (MODOC) utilized to maintain a record of the incoming and outgoing documents and correspondence.

   The State Treasurer has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

   Awareness stage - Establishing a budget and project plan for dealing with the year 2000 issue.
   Assessment stage - Identifying the systems and components for which the year 2000 compliant work is needed.
   Remediation stage - Making changes to systems and equipment.
   Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

   As of June 30, 1998, the awareness, assessment, and remediation stages had been completed for all mission-critical systems and electronic equipment. The document inventory system has completed the awareness and assessment stages and is in the remediaton stage. The validation stage is in process for all mission-critical systems and electronic equipment.

   The State Treasurer has begun soliciting information from other organizations whose Y2K compliance could affect the CIC program regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the CIC program operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the CIC program operations or financial status.

   Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the CIC program is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the CIC program does business will be Year 2000 ready.

Baccalaureate Education System Trust
Independent Auditor's Report

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the Baccalaureate Education System Trust as of June 30, 1998, and June 30, 1997, and the related statements of revenues, expenditures, and changes in fund balances for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues,* requires disclosure of certain matters regarding the year 2000 issue. The Baccalaureate Education System Trust has included such disclosures in Note D.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Baccalaureate Education System Trust's disclosures with respect to the year 2000 issue made in Note D.2. Further, we do not provide assurance that the Baccalaureate Education System Trust is or will be year 2000 ready, that the Baccalaureate Education System Trust year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the Baccalaureate Education System Trust does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Baccalaureate Education System Trust as of June 30, 1998, and June 30, 1997, and the changes in fund balance for the years then ended in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying supplementary schedule of cash receipts and disbursements following the notes to the financial statements is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

In accordance with *Government Auditing Standards,* we have also issued our report dated December 29, 1998, on our consideration of the Baccalaureate Education System Trust'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.

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

Baccalaureate Education System Trust
Comparative Balance Sheets
June 30, 1998 and June 30, 1997

	June 30, 1998		June 30, 1997	
ASSETS:				
Cash	$	408,961	$	163,215
Contributions Receivable		3,121		0
Investment Income Receivable		66,644		0
Investments:				
Short-term Investments (Amortized Cost)				
Commercial Paper		705,720		126,078
Long-term Investments (Fair Value)				
Government Bonds		4,287,537		0
Corporate Bonds		487,533		0
Investment in Equity Mutual Fund		1,120,374		0
TOTAL ASSETS	$	7,079,890	$	289,293
LIABILITIES AND FUND BALANCE				
LIABILITIES:				
Accounts Payable	$	0	$	78,837
Advance from State Contingent Revenue Fund		940,000		527,918
TOTAL LIABILITIES		940,000		606,755
FUND BALANCE:				
Fund Balance Reserved for Plan Participants		5,987,551		183,453
Fund Balance, Unreserved		152,339		(500,915)
TOTAL FUND BALANCE		6,139,890		(317,462)
TOTAL LIABILITIES AND FUND BALANCE	$	7,079,890	$	289,293

See accompanying Notes to the Financial Statements.

Baccalaureate Education System Trust
Comparative Statements of Revenues, Expenditures and Changes in Fund Balances
For the Years Ended June 30, 1998 and June 30, 1997

	For the Year Ended June 30, 1998	For the Year Ended June 30, 1997
REVENUES:		
Contributions	$ 5,856,165	$ 183,553
Investment Income:		
Net Increase in Fair Value of Investments	155,580	0
Interest and Dividend Income	228,651	165
Administrative Fees	705,058	26,738
TOTAL REVENUES	6,945,454	210,456
EXPENDITURES:		
Refunds	4,325	0
Administrative Cost	483,777	527,918
TOTAL EXPENDITURES	488,102	527,918
EXCESS OF REVENUES OVER EXPENDITURES	6,457,352	(317,462)
FUND BALANCE, JULY 1, 1997	(317,462)	0
FUND BALANCE, JUNE 30, 1998	$ 6,139,890	$ (317,462)

See accompanying Notes to the Financial Statements.

Baccalaureate Education System Trust
Notes to the Financial Statements
June 30, 1998 and June 30, 1997

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The Tennessee Baccalaureate Education System Trust Fund (BEST), which began operating in June, 1997, is an integral part of the primary government and has been included in the *Tennessee Comprehensive Annual Financial Report* as an expendable trust fund.

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 BEST is accounted for on the modified accrual basis of accounting and the flow of current financial resources measurement focus. Under this basis, revenues are recorded when they become both measurable and available and expenditures are recognized at the time liabilities are incurred.

3. **Cash** - The classification of Cash and Cash Equivalents, by definition, includes cash and short-term investments with a maturity date within three months of the acquisition date. The primary government's policy regarding the definition of Cash and Cash Equivalents includes cash management pools as cash. In addition, short-term securities 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 BEST 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, 1998 and June 30, 1997.

(Continued)

BACCALAUREATE EDUCATION SYSTEM TRUST
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997 (CONTINUED)

4. **Method used to Value Investments -** Investments are reported at fair value as of June 30, 1998. For fair value reporting, securities traded on a national exchange are valued at the last reported sales price. The fair value of investments in open-end mutual funds is based on the share price. Short-term investments consisting of commercial paper is valued at amortized cost. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments. Investments are reported at amortized cost as of June 30, 1997. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.

5. **Fund Balance, Reserved for Plan Participants -** The amount of Fund Balance Reserved for Plan Participants is based on the number of outstanding tuition units and the weighted average tuition in effect at year end.

6. **Restatement of Unreserved Fund Balance -** The "Fund Balance, Unreserved" as reported on the Balance Sheet as of June 30, 1997 was ($317,462). The amount of $183,453 has been reclassified as Fund Balance Reserved for Plan Participants as of June 30, 1997. The Fund Balance, Unreserved has been restated to ($500,915).

B. INVESTMENTS

The authority for investing the assets of the BEST is vested in its Board of Trustees and the responsibility for implementing the investment policy established by the Board is delegated to the State Treasurer. In accordance with the investment policy, the BEST assets may be invested in any instrument, obligation, security or property that constitutes a legal investment for assets of the Tennessee Consolidated Retirement System.

The classification of Short-term Investments includes funds invested in a portfolio of short-term securities maintained by the Tennessee Consolidated Retirement System. These short-term securities may include U.S. Treasury obligations, commercial paper, medium-term corporate notes, promissory notes and repurchase agreements.

At June 30, 1998, BEST investments included $1,120,374 in SEC-registered open-end mutual funds. The BEST investment securities are categorized below according to the level of custodial credit risk associated with the custodial arrangements at year-end. Category 1 consists of investments that are insured or registered, or for which securities are held by the BEST or its agent in the name of the BEST. Category 2 consists of uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the name of the BEST. Category 3 consists of uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent, but not in the name of the BEST. The open-end mutual fund is not categorized as the investment is not evidenced by securities that exist in physical or book entry form.

	June 30, 1998	June 30, 1997	
	Fair Value	Amortized Cost	Fair Value
Investments - Category 1:			
Short-term Investments			
Commercial Paper	705,720	$ 126,078	$ 126,078
Long-term Investments			
Government Bonds	4,287,537	0	0
Corporate Bonds	487,533	0	0
Investments - Category 2	0	0	0
Investments - Category 3	0	0	0
Investments - Not categorized			
Investment in Open-end Mutual Fund	1,120,374	0	0
	$ 6,601,164	$ 126,078	$ 126,078

C. DESCRIPTION OF THE BEST

The Tennessee Baccalaureate Education System Trust, administered by the State Treasurer, is created under *Tennessee Code Annotated*, Title 49, Chapter 7, Part 8 for the purpose of improving higher education in the State of Tennessee by assisting students or their families to pay in advance, a portion of the tuition costs of attending colleges and universities. Under the program, a purchaser may enter into a contract with BEST to purchase tuition units on behalf of a beneficiary.

(Continued)

Baccalaureate Education System Trust
Notes to the Financial Statements
June 30, 1998 and June 30, 1997 (continued)

Each tuition unit purchased entitles the beneficiary to an amount equal to one percent of the weighted average tuition of Tennessee's four-year public universities during the academic term in which it is used, however, the tuition unit or equivalent funds may be used at any accredited public or private, in-state or out-of-state institution. The price of the tuition unit is determined annually by the BEST Board of Trustees.

D. OTHER ACCOUNTING DISCLOSURES

1. **Advance from State Contingent Revenue Fund** - The advance from the State Contingent Revenue Fund to the BEST was authorized by Chapter 1083 of the *Public Acts of the 99th General Assembly* for the purpose of covering implementation and other costs for the BEST program from the Local Government Investment Pool.

2. **Year 2000 Compliance** - The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the BEST as well as the other systems upon which the BEST depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the BEST did not result in the commitment of significant resources as of June 30, 1998.

The State Treasurer has assessed the impact of Y2K on the BEST computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the BEST from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

The BEST relies principally upon one major computer system (the BEST system) for maintenance of data and participant accounting. Other systems critical to the BEST operations include the State Treasurer's general ledger accounting system, utilized to reconcile the subsidiary ledgers and to produce financial statements, the document inventory system, utilized to maintain a record of incoming and outgoing documents and correspondence and the investment system, which maintains a perpetual inventory of all the securities owned by BEST and maintains a record of all acquisitions, dispositions and maturity of securities in the BEST portfolio.

The State Treasurer has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

Awareness stage - Establishing a budget and project plan for dealing with the year 2000 issue.
Assessment stage - Identifying the systems and components for which the year 2000 compliant work is needed.
Remediation stage - Making changes to systems and equipment.
Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

As of June 30, 1998, the awareness and assessment stages had been completed for all mission-critical systems and electronic equipment. The remediation stage is complete for the BEST and investment systems and in process for the general ledger system, the document inventory system and electronic equipment. The validation stage is complete for the BEST system and is in process for the general ledger, investment and document inventory systems.

The State Treasurer has begun soliciting information from other organizations whose Y2K compliance could affect the BEST regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the BEST operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the BEST operations or financial status.

Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the BEST is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the BEST does business will be Year 2000 ready.

CHAIRS OF EXCELLENCE
INDEPENDENT AUDITOR'S REPORT

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the Chairs of Excellence as of June 30, 1998, and June 30, 1997, and the related statements of revenues, expenses, and changes in fund balances and cash flows for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Chairs of Excellence has included such disclosures in Note C.3. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Chairs of Excellence's disclosures with respect to the year 2000 issue made in Note C.3. Further, we do not provide assurance that the Chairs of Excellence is or will be year 2000 ready, that the Chairs of Excellence year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the Chairs of Excellence does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Chairs of Excellence as of June 30, 1998, and June 30, 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note A.4., the Chairs of Excellence implemented GASB Statement 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools."

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, on our consideration of the Chairs of Excellence'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.

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

Chairs of Excellence
Comparative Balance Sheets
June 30, 1998 and June 30, 1997

	June 30, 1998	June 30, 1997
ASSETS		
Cash	$ 35,227	$ 0
Investments (1998 stated at fair value, 1997 stated at cost/amortized cost)		
Short-term Investments	15,549,349	10,339,976
Long-term Investments:		
Domestic Securities:		
Government Bonds	68,176,079	57,151,246
Corporate Bonds	15,385,900	22,460,526
Corporate Stocks	103,821,869	60,878,509
International Securities:		
Corporate Bonds	5,617,335	5,675,599
Corporate Stocks	2,315,187	897,694
Total Investments	210,865,719	157,403,550
Receivables:		
Due From College and University Fund	410,000	366,000
Investment Income Receivable	1,573,740	1,387,783
Total Receivables	1,983,740	1,753,783
TOTAL ASSETS	212,884,686	159,157,333
LIABILITIES AND FUND BALANCES		
LIABILITIES:		
Due to College and University Fund	1,783,159	1,798,956
Due to the Academic Scholars Fund	3,673,891	3,720,861
Due to State General Fund	0	35,519
TOTAL LIABILITIES	5,457,050	5,555,336
FUND BALANCES:		
Endowment Reserve	200,558,716	148,447,774
Special Reserve	6,868,920	5,154,223
TOTAL FUND BALANCES	207,427,636	153,601,997
TOTAL LIABILITIES & FUND BALANCES	$212,884,686	$159,157,333

See Accompanying Notes to the Financial Statements

CHAIRS OF EXCELLENCE
COMPARATIVE STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND BALANCES
FOR THE YEARS ENDED JUNE 30, 1998 AND JUNE 30, 1997

	For the Year Ended June 30, 1998	For the Year Ended June 30, 1997
OPERATING REVENUES:		
Investment Income	$ 33,649,111	$ 13,567,562
Securities Lending Income	0	151,171
Contributions from Private Sources	732,000	1,423,000
TOTAL OPERATING REVENUES	34,381,111	15,141,733
OPERATING EXPENSES:		
Payments to the University of Tennessee	3,418,265	3,129,879
Payments to the Tennessee Board of Regents	2,911,168	3,335,704
Interest Payments to the Academic Scholars Fund	298,230	264,826
Securities Lending Expense	0	137,809
Administrative Cost	157,373	134,290
TOTAL OPERATING EXPENSES	6,785,036	7,002,508
NET INCOME	27,596,075	8,139,225
FUND BALANCES, JULY 1	153,601,997	145,462,772
Add: Cumulative Effect of Change in Accounting Principle (Note A.4)	26,229,564	0
Restated Fund Balances, July 1	179,831,561	145,462,772
FUND BALANCES, JUNE 30	$ 207,427,636	$ 153,601,997

See Accompanying Notes to the Financial Statements.

Chairs of Excellence
Comparative Statements of Cash Flows
For the Years Ended June 30, 1998 and June 30, 1997

	For the Year Ended June 30, 1998	For the Year Ended June 30, 1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME	$ 27,596,075	$ 8,139,225
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH USED BY OPERATING ACTIVITIES:		
Investment Income	(33,649,111)	(13,720,192)
Securities Lending Income	0	(151,171)
Securities Lending Expense	0	137,809
Net Amortization	0	152,630
Interest Paid to the Academic Scholars Fund	298,230	264,826
Changes in Assets and Liabilities:		
Increase in Due From College & University Fund	(44,000)	(8,000)
Increase(Decrease) in Due to College & University Fund	(15,797)	121,464
Decrease in Due to Academic Scholars Fund	(46,970)	(62,624)
Increase(Decrease) in Due to State General Fund	(35,519)	5,578
NET CASH USED BY OPERATING ACTIVITIES	(5,897,092)	(5,120,455)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment Income Received	8,313,828	8,911,391
Securities Lending Income Received	0	183,234
Securities Lending Expenses Paid	0	(168,703)
Proceeds from Sales and Maturities of Investments	246,084,070	129,058,733
Purchase of Investments	(248,167,349)	(132,599,374)
Interest Paid to the Academic Scholars Fund	(298,230)	(264,826)
NET CASH PROVIDED BY INVESTING ACTIVITIES	5,932,319	5,120,455
NET INCREASE/DECREASE IN CASH	35,227	0
CASH AT JULY 1	0	0
CASH AT JUNE 30	$ 35,227	$ 0

NONCASH INVESTING, CAPITAL AND FINANCING ACTIVITIES:

The Chairs of Excellence Trust had no unsettled investment purchases and no unsettled investment sales at June 30, 1998 and at June 30, 1997.

See Accompanying Notes to the Financial Statements

Chairs of Excellence
Notes to the Financial Statements
June 30, 1998 and June 30, 1997

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The Chairs of Excellence (COE) Trust forms an integral part of the primary government and has been included as a nonexpendable 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 COE Trust 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 flow of economic resources measurement focus and the accrual basis of accounting. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

3. **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 COE Trust that cannot be immediately invested 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, 1998, and June 30, 1997. The classification of Cash also includes cash held in a custody account 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 as the custody account relationship does not meet the definition for either a deposit with a financial institution or a security.

4. **Changes in Accounting Principles** - Effective July 1, 1997, the COE Trust adopted Statement Number 31 of the Governmental Accounting Standards Board (GASB), *Accounting and Financial Reporting for Certain Investments and for External Investment Pools.* The provisions of this statement require that the investments of the COE Trust be reported at fair value on the balance sheet. The cumulative effect of the change in accounting principle as of July 1, 1997 resulted in increases to both Investments and Fund Balance of $26,229,564.

5. **Method Used to Value Investments** - Investments are reported at fair value as of June 30, 1998. For fair value reporting, securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. As of June 30, 1997, equity securities are reported at cost subject to adjustment for market declines judged to be other than temporary and fixed income securities are reported at amortized cost with discounts or premiums amortized using the effective interest rate method, subject to adjustment for market declines judged to be other than temporary. For the year ended June 30, 1998, investment income includes realized and unrealized appreciation (depreciation) in the fair value of investments. For the year ended June 30, 1997, investment income includes realized gains and losses on the sale of investments. Interest income is recognized as earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.

6. **Fund Balance** - The Endowment Reserve includes funds provided by contributions from the state, colleges and universities and private sources, as well as gains and losses from fixed income and equity investments. The income from both fixed and equity investments that is not used to meet current needs is distributed to the Special Reserve. At the discretion of the Board of Trustees of the COE Trust, the Special Reserve may be used for future nonrecurring expenses or to supplement corpus or income.

(Continued)

CHAIRS OF EXCELLENCE
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997 (CONTINUED)

B. INVESTMENTS

The investment policy of the COE Trust requires that public funds, capital gains on public funds, and all current income exceeding withdrawals be invested in fixed income securities. Private contributions may be invested in equity securities, including domestic and foreign common stocks, preferred stocks and convertible bonds. Subsequent to the initial funding of a chair, funds may be transferred from the equity corpus to the fixed income corpus but not from the fixed income corpus to the equity corpus.

The classification of Short-term Investments includes funds invested in a portfolio of short-term investments maintained by the Tennessee Consolidated Retirement System. These short-term investments may include U.S. Treasury obligations, commercial paper, medium-term corporate notes, promissory notes and repurchase agreements.

The COE Trust 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 securities are held by the COE Trust or its agent in the name of the COE Trust. 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 COE Trust. 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 COE Trust.

	June 30, 1998	June 30, 1997	
	Fair Value	Book Value	Fair Value
Investments - Category 1:			
Short-term Investments:			
Commercial Paper	$ 15,549,349	$ 10,339,976	$ 10,339,976
Long-term Investments:			
Domestic Securities:			
Government Bonds	68,176,079	57,151,246	58,102,265
Corporate Bonds	15,385,900	22,460,526	22,176,880
Corporate Stocks	103,821,869	60,878,509	86,075,783
International Securities:			
Corporate Bonds	5,617,335	5,675,599	5,660,710
Corporate Stocks	2,315,187	897,694	1,277,500
	210,865,719	157,403,550	183,633,114
Investments - Category 2	0	0	0
Investments - Category 3	0	0	0
Total Investments	$ 210,865,719	$ 157,403,550	$ 183,633,114

(Continued)

Chairs of Excellence
Notes to the Financial Statements
June 30, 1998 and June 30, 1997 (continued)

The COE Trust is authorized by its investment policy, as adopted by the Board of Trustees of the COE Trust, to enter into collateralized securities lending agreements whereby the Trust 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 Trust's assets. The Trust's custodian bank manages the lending program and maintains collateral on behalf of the COE Trust. 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 COE 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. Although there is no specific policy for matching the maturities of collateral investments and the securities loans, the securities on loan can be terminated on demand by either the COE Trust or the borrower.

As of June 30, 1998 and June 30, 1997, the COE Trust had no securities on loan. The securities lending income, net of expenses, was $13,362 for the year ended June 30, 1997.

C. OTHER ACCOUNTING DISCLOSURES

1. **Chairs of Excellence Endowment Trust**
The COE Trust is a nonexpendable trust fund authorized by the 94th General Assembly to further the cause of education in Tennessee. The COE Trust is administered by the State Treasurer. The Trust is set up into two general accounts which equally divide any state appropriations: one for the University of Tennessee and one for the Tennessee Board of Regents. As each Chair is designated, a portion of the appropriation is transferred to a sub-account for that Chair. The awarding college or university must provide matching contributions, of which at least 50 percent of the funds are from private contributions.

As of June 30, 1998, 96 Chairs have been established with matching contributions received totaling $53,926,206. This is an increase of 1 Chair and $732,000 since June 30, 1997. Total contributions to the COE Trust totaled $97,926,206 as of June 30, 1998. This includes $44,000,000 from the State, $10,321,300 from Colleges and Universities, and $43,604,906 from private contributions.

2. **Academic Scholars Fund** - Funds from the Academic Scholars Fund are combined with the COE Trust for investment purposes only. The Academic Scholars Fund general account receives only the income earned on its principal and does not receive any COE Trust state contributions or appropriations. These funds are invested in fixed income securities.

3. **Year 2000 Compliance** - The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the COE Trust as well as the other systems upon which the COE Trust depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the COE Trust did not result in the commitment of significant resources as of June 30, 1998.

The State Treasurer has assessed the impact of Y2K on COE Trust computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance

(Continued)

Chairs of Excellence
Notes to the Financial Statements
June 30, 1998 and June 30, 1997 (continued)

would prevent the COE Trust from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

The COE Trust relies principally upon one major computer system , the Treasury Earnings and Account Management System (TEAMS) for participant level accounting. Other systems critical to the COE Trust operations include the State Treasurer's general ledger accounting system, utilized to reconcile the subsidiary ledgers and to produce financial statements, and the investment system which maintains a perpetual inventory of all the securities owned by the COE Trust and maintains a record of all acquisitions, dispositions and maturity of securities in the COE Trust portfolio.

The State Treasurer has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

Awareness stage - Establishing a budget and project plan for dealing with the Year 2000 issue.
Assessment stage - Identifying the systems and components for which the Year 2000 compliant work is needed.
Remediation stage - Making changes to systems and equipment.
Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

As of June 30, 1998, the awareness and assessment stages had been completed for all mission-critical systems and electronic equipment. The remediation stage is complete for the investment system and in process for the TEAMS system, general ledger system and electronic equipment. The validation stage is in process for all mission-critical systems and electronic equipment.

The State Treasurer has begun soliciting information from other organizations whose Y2K compliance could affect the COE Trust regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the COE Trust operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the COE Trust operations or financial status.

Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the COE Trust is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the COE Trust does business will be Year 2000 ready.

Bond Refunding
Independent Auditor's Report

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697

December 29, 1998

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

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the Bond Refunding Trust as of June 30, 1998, and June 30, 1997, and the related statement of changes in assets and liabilities for the year ended June 30, 1998. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Bond Refunding Trust has included such disclosures in Note D.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Bond Refunding Trust's disclosures with respect to the year 2000 issue made in Note D.2. Further, we do not provide assurance that the Bond Refunding Trust is or will be year 2000 ready, that the Bond Refunding Trust year 2000 remediation efforts will be successful in whole or in part, or that the parties with which the Bond Refunding Trust does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Bond Refunding Trust as of June 30, 1998, and June 30, 1997, and the changes in assets and liabilities for the year ended June 30, 1998, in conformity with generally accepted accounting principles.

As discussed in Note A.3., the Bond Refunding Trust implemented GASB Statement 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools."

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, on our consideration of the Bond Refunding Trust'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.

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

BOND REFUNDING
COMPARATIVE BALANCE SHEETS
JUNE 30, 1998 AND JUNE 30, 1997

	June 30, 1998	June 30, 1997
ASSETS		
Cash	$ 1,068	$ 621
Investments, (1998 at Fair Value, 1997 at amortized cost)	99,022,489	80,863,961
Accrued Interest Receivable	365,966	49,292
TOTAL ASSETS	$ 99,389,523	$ 80,913,874
LIABILITIES		
Amounts Held in Custody for Others	$ 99,389,523	$ 80,913,874

See Accompanying Notes to the Financial Statements.

BOND REFUNDING
STATEMENT OF CHANGES IN ASSETS AND LIABILITIES
FOR THE YEAR ENDED JUNE 30, 1998

	Balance July 1, 1997	Additions	Deductions	Balance June 30, 1998
ASSETS				
Cash	$ 621	$ 61,263,000	$ 61,262,553	$ 1,068
Investments	80,863,961	25,530,984	7,372,456	99,022,489
Accrued Interest Receivable	49,292	365,966	49,292	365,966
TOTAL ASSETS	$ 80,913,874	$ 87,159,950	$ 68,684,301	$ 99,389,523
LIABILITIES				
Amounts Held in Custody for Others	$ 80,913,874	$ 38,600,842	$ 20,125,193	$ 99,389,523

See Accompanying Notes to the Financial Statements.

BOND REFUNDING
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The Bond Refunding Trust forms an integral part of the primary government and has been included as an agency 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 agency fund is custodial in nature and does not measure results of operations or have a measurement focus.

3. **Change in Accounting Principle** - Effective July 1, 1997, the Bond Refunding Trust adopted Statement Number 31 of the Governmental Accounting Standards Board (GASB), *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. The provisions of this statement require that the investments of the Bond Refunding Trust be reported at fair value on the balance sheet. The cumulative effect of the change in accounting principle as of July 1, 1997 resulted in deductions to both Investments and Amounts Held in Custody for Others of $1,973,374 on the Statement of Changes in Assets and Liabilities.

4. **Method Used to Value Investments** - Investments are reported at fair value as of June 30, 1998 and cost or amortized cost as of June 30, 1997. For fair value reporting, U.S. Government Securities are valued at the last reported price and State and Local Government Series Securities are valued at cost.

B. CASH

Cash held by the trustee is pooled with the Pooled Investment Fund administered by the State Treasurer which is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee (Funding Board). The current resolution of the Funding 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 for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. The Pooled Investment Fund's custodial credit risk is presented in the *Tennessee Comprehensive Annual Financial Report* for the years ended June 30, 1998 and June 30, 1997.

C. INVESTMENTS

The investments held by the trustee at June 30, 1998 included U.S. Government Securities at a fair value of $78,953,699 and State and Local Government Series Securities valued at cost of $20,068,790. The investments held by the trustee at June 30, 1997 were U.S. Government Securities which were carried at $80,863,961 (amortized cost) with a fair value of $78,890,588. The trust is restricted by the Tennessee Local Development Authority's and the Funding Board's Bond Resolutions to investing in direct general obligations of, or obligations the payment of the principal and interest of which are unconditionally guaranteed by, the United States of America, which are non-callable at the option of the issuer. All securities are held in accounts with the Federal Reserve Bank or the Bureau of Public Debt in the state's name.

D. OTHER ACCOUNTING DISCLOSURES

1. **Description of Bond Refunding Trust** - The State Treasurer has been designated as a trustee for the Tennessee Local Development Authority and for the Funding Board pursuant to various refunding trust agreements. Refunding bonds are issued to take advantage of lower interest rates and the proceeds resulting from the advance refundings are held by the trustee in an irrevocable trust to provide for the debt service payments and call premiums at the redemption dates. In February, 1996, the Funding Board issued refunding bonds of $190,965,000 to refund: (1) $26,385,000 of the General Purpose bonds dated August 1, 1980 maturing on and after March 1, 1997, (2) $98,000,000 of the General Purpose bonds dated May 1, 1986 maturing on and after April 1, 1997, (3) $23,000,000 of the General Purpose bonds dated June 15, 1989 maturing on and after June 1, 2000 and (4) $50,000,000 of the General Purpose bonds dated June 15, 1991 maturing on and after June 1, 2002.

   In March 1996, the 1980 refunded bonds were redeemed and in April 1996, the 1986 refunded bonds were redeemed. The 1989 refunded bonds will be redeemed in June 1999 and the 1991 refunded bonds will be redeemed in June 2001.

   In November 1997 the Tennessee Local Development Authority issued refunding bonds of $37,385,000 to refund $19,515,000 of the 1991 Series A State Loan Program Revenue bonds, dated June 25, 1991 maturing on and after March 1, 1998 and $16,495,000 of the 1997 Series A State Loan Program Revenue Bond Anticipation Notes. The Note refunding matured and paid out in May 1998.

(Continued)

BOND REFUNDING
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998 AND JUNE 30, 1997 (CONTINUED)

2. **Year 2000 Compliance** - The State Treasurer is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to "year" on the assumption that the first two digits are "19". These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the Bond Refunding Trust as well as the other systems upon which the Bond Refunding Trust depends to fulfill its mission. The State Treasurer's Y2K initiatives relating to the Bond Refunding Trust did not result in the commitment of significant resources as of June 30, 1998.

   The State Treasurer has assessed the impact of Y2K on the Bond Refunding Trust computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the Bond Refunding Trust from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the State Treasurer would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

   Systems critical to the Bond Refunding Trust operations include the State Treasurer's general ledger accounting system, utilized to reconcile the subsidiary ledgers and to produce financial statements, and the investment system, which maintains a perpetual inventory of all the securities owned by the Bond Refunding Trust and maintains a record of all acquisitions, dispositions and maturity of securities in the Bond Refunding Trust portfolio.

   The State Treasurer has identified the above mentioned computer systems that are mission-critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

   Awareness stage - Establishing a budget and project plan for dealing with the year 2000 issue.
   Assessment stage - Identifying the systems and components for which the year 2000 compliant work is needed.
   Remediation stage - Making changes to systems and equipment.
   Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

   As of June 30, 1998, the awareness and assessment stages had been completed for both mission-critical systems and electronic equipment. The remediation stage is complete for the investment system and in process for the general ledger system, and electronic equipment. The validation stage is in process for the general ledger and investment systems.

   The State Treasurer has begun soliciting information from other organizations whose Y2K compliance could affect the Bond Refunding Trust regarding the status of their assessment, remediation, and testing of their computer systems. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the Bond Refunding Trust operations. The State Treasurer does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the Bond Refunding Trust operations or financial status.

   Because of the unprecedented nature of the Year 2000 issue, its effects and success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the Bond Refunding Trust is or will be Year 2000 ready, that the remediation efforts will be successful in whole or in part, or that parties with whom the Bond Refunding Trust does business will be Year 2000 ready.

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