STATE OF TENNESSEE
DEPARTMENT OF FINANCE AND ADMINISTRATION
STATE CAPITOL
NASHVILLE, TENNESSEE 37243-0285

JOHN D. FERGUSON
COMMISSIONER

December 18, 1997

The Honorable Don Sundquist
Governor of the State of Tennessee

I am pleased to submit the Comprehensive Annual Financial Report of the State of Tennessee for the fiscal year ended June 30, 1997. Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the state. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the state. All disclosures necessary to enable the reader to gain an understanding of the state's financial activities have been included.

The Comprehensive Annual Financial Report is presented in three sections: introductory, financial and statistical. The introductory section includes this transmittal letter and the state's organizational chart. The financial section includes the general-purpose financial statements and the combining and individual fund and account group financial statements and schedules, as well as the auditor's report on the general-purpose financial statements. The statistical section includes selected financial and demographic information, generally presented on a multi-year basis.

The financial reporting entity of the state includes all the funds and account groups of the primary government as well as all its component units. Component units are legally separate entities for which the primary government is financially accountable. The government provides a full range of services including education, health and social services, transportation, law, correction, safety, resources and regulation, and business and economic development.

ECONOMIC CONDITION AND OUTLOOK

The state's economic diversity has improved substantially over the last several years. Investments announced in new and expanding businesses exceeded one billion dollars each of those years, and exceeded three billion dollars in the last two years. The $3.4 billion in announced capital investments in 1996 was the largest year in Tennessee's history. This growth has created 20,863 new jobs in this year alone, and has had a positive effect on employment and the state's economy. For June 1997, the state unemployment rate of 4.9% was less than the national average of 5.4%. The financial impact of these events is presented later in this letter. Based on current projections, the state's overall growth is expected to exceed the national average into the next century. While having a positive impact, this growth also presents significant challenges for the state. If the present level of services is to be maintained and an ambitious program for major improvements in the educational system is to continue to be implemented, the state, in the future, will need to continue to conservatively manage its financial resources.

Tennessee's economy has remained strong the last four years and is in an expansion period. Tennessee's state government has taken appropriate steps to ensure that the state is able to successfully manage its finances in the future.

MAJOR INITIATIVES

For the Year. The Administration continued to fund the daily operations of state government and its new initiatives within the current tax structure. This has been accomplished through the prudent use of money provided by Tennessee's growing economy, along with a greater focus on providing government services efficiently and effectively. In addition to providing continued funding for all necessary programs and services in Tennessee, the state focused on several high priority items. The major initiatives included extending TennCare coverage to all Tennessee children who do not otherwise have access to health insurance, enhancing all services to children under the newly established Department of Children's Services, fully funding the Basic Education Program (BEP), continuing enhancement of industrial growth and strengthening services for the continued success of the Families First Program of welfare reform.

On April 1, 1997, TennCare enrollment was opened for all uninsured children who do not otherwise have access to health insurance protection, making Tennessee the first state in the nation to make health care coverage universally available to children. TennCare, organizationally managed through the Department of Health, also began the coordination of mental health services through Behavioral Health Organizations.

The reform and consolidation of Children's Services has resulted in better service for more children and at lower cost. Fewer children have required state custody and there has been greater access to important preventative programs and support services while stabilizing the budget for children's programs.

Funding for the Basic Education Program (BEP) continues to be a major initiative of the administration. Major goals of the initiative include funding for enrollment growth and teacher salary equalization.

For the Future. A strategic plan has been developed outlining key goals of the administration. Those key goals are: 1) to create a more effective, efficient and focused state government, 2) to offer every child a safe, healthy start, 3) to create excellence in education, 4) to create a climate for good, high-paying jobs, and 5) to protect public health and safety. The plan is a basis for initiatives managed at the department level. A management team has been identified to facilitate planning and implementation goals.

Departmental Focus. The Department of Children's Services (DCS) was established in July 1996 to continue the efforts begun with the creation of the Children's Plan to improve and coordinate service for children in state custody and at imminent risk of custody. The Children's Plan was initiated after a statewide study of each individual child in custody revealed that forty percent of these children were receiving inappropriate care.

The Department of Children's Services has brought additional focus to the problem of children in state custody which has resulted in major restructuring of Tennessee's children's service delivery system. Two of the most significant changes that have occurred were the pooling of financial resources and the provision of case management services.

The decision to pool financial resources has allowed the department to adopt the fiscal practice of de-categorizing our federal funding sources. De-categorizing funding sources means that the department does not create or maintain programs simply because there is a federal funding source, nor does the department limit children to receiving services because of the eligibility or ineligibility for different types of federal reimbursement. This has allowed the department to better manage its total resources in meeting child and family needs, invest in the more successful services and shift its system from its heavy dependence on custody and residential programs toward more community-based intervention and family support services.

In 1996, the Department of Children's Services initiated several significant policy actions to improve services to children. These actions are:

* Emphasis on children and families services rather than just children's services (recognition that reunification must involve the family)
* Residential services should not be the purchase of "beds", but the purchase of services with measurable outcomes through a partnership with child care providers
* Redesign of the service delivery system for child safety, public safety and child permanence through child and family teams.

These policy decisions greatly impact the way the department does business. In order to provide appropriate care, Children's Services acts as its own managed care organization (MCO) for children in state custody. DCS made the decision to adopt the medical/insurance model, but to retain the direct management over the system. Utilization review, quality assurance, provider relations and cost containment are the department's major responsibilities in this structure. Case management has been recognized and designed as the integral part of the department's new service delivery model. In order to effectively manage this new system the department has combined staff resources from the former four state custody departments and the Community Services Agencies into a single consolidated staff called Child and Family Ties.

DCS is committed to implementing this new MCO/case management model. In doing so, the department believes that the needs of the individual children will be more thoroughly identified and promptly and successfully addressed. The department expects the case manager to access the right services more quickly and for the right length of time. This should result in children moving through the system more rapidly with more successful returns home or adoptive placements. In addition to the benefit to the child, consolidating and improving the department's case management should allow the department to better manage its treatment service cost.

FINANCIAL INFORMATION

In developing and modifying the state's accounting system, consideration is given to the adequacy of internal accounting controls. Internal accounting controls are designed to provide reasonable, but not absolute, assurance regarding the safeguarding of assets against loss from unauthorized use or disposition and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a control should not exceed the benefits likely to be derived, and the evaluations occur within the above framework. I believe that the state's internal accounting controls adequately safeguard assets and provide reasonable assurance of proper recording of financial transactions.

Budgeting Controls. In addition to internal controls, the state maintains budgetary controls. The objective of these budgetary controls is to ensure compliance with legal provisions embodied in the annually appropriated budget approved by the legislature. Activities of the general fund and special revenue funds (except the Supreme Court Boards, Fraud and Economic Crime and the Dairy Promotion Board, accounted for as special revenue funds) are included in the annually appropriated budget. Budgetary control is maintained at the departmental level by the encumbrance of estimated purchase amounts prior to the release of purchase orders to vendors. Purchase orders which result in an overrun of available balances are not released until budget revisions are approved or additional appropriations are made. Open encumbrances are reported as reservations of fund balance at June 30, 1997.

General Governmental Functions. General governmental functions are accounted for in four governmental funds - the General, Special Revenue, Debt Service and Capital Projects funds. Revenues for general governmental functions totaled $12.1 billion in 1997. Taxes represented 51.4% of general revenues; it is a slight increase of 1.1% in the percentage of the total funding over the prior year from 50.3% to 51.4%. The amount of revenues from various sources and the changes from last year are shown below (expressed in thousands).

Revenue Source	Amount	Percent of Total	Increase (Decrease) from 1996	Percent of Increase (Decrease)
Taxes	$ 6,214,859	51.4%	$ 343,600	5.9%
Licenses, fines, fees and permits	169,873	1.4	9,515	5.9
Interest on investments	19,296	.2	(4,887)	(20.2)
Federal	4,636,905	38.3	301,834	7.0
Departmental Services	1,034,691	8.5	(223,981)	(17.8)
Other	22,624	.2	1,511	7.2
	$12,098,248	100%	$ 427,592	

The 5.9% increase in tax collections above is primarily due to the normal growth in the sales tax of some $214.7 million.

Interest on investments decreased by $5 million because less cash was available to invest.

Federal revenue for TennCare increased some $209 million.

Departmental services decreased by some $224 million primarily due to the consolidation of services to children into one department, the Department of Children's Services. Because of the consolidation, interdepartmental billings decreased.

The category of other revenues increased because miscellaneous revenue increased some $4 million.

Expenditures for general governmental purposes totaled $11.0 billion in 1997, a 2.2% increase over the previous year. Changes in expenditures by function from 1996 levels are presented in the following tabulation (expressed in thousands).

Function	**Amount**	**Percent of Total**	**Increase (Decrease) from 1996**	**Percent of Increase (Decrease)**
General government	$ 287,635	2.6%	$ 5,486	1.9%
Education	2,535,513	23.0	167,317	7.1
Health and social services	5,829,651	52.9	39,308	.7
Law, Justice and public safety	694,610	6.3	(35,053)	(4.8)
Recreation and resources development	385,673	3.5	20,087	5.5
Regulation of business and professions	41,598	.4	4,679	12.7
Transportation	1,079,683	9.8	56,302	5.5
Debt service	92,286	.8	(2,289)	(2.4)
Capital outlay	79,769	.7	(18,566)	(18.9)
	$11,026,418	100%	$ 237,271	

Education increased $167 million because of increased emphasis on education resulting from the passage of the 21st Century Schools legislation.

Law, justice and public safety decreased because the Department of Youth Development was consolidated into the Department of Children's Services on July 1, 1996.

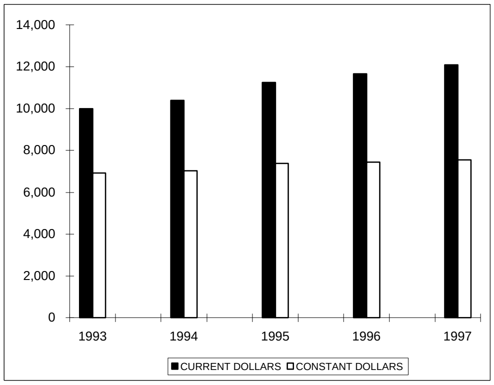
Regulation of business and professions increased by $4.7 million primarily because expenditures for the Department of Commerce and Insurance increased by $5 million.

Capital outlay decreased by $18.6 million mostly because of the construction of the Bicentennial Mall for $21.0 million in fiscal year 1995-96.

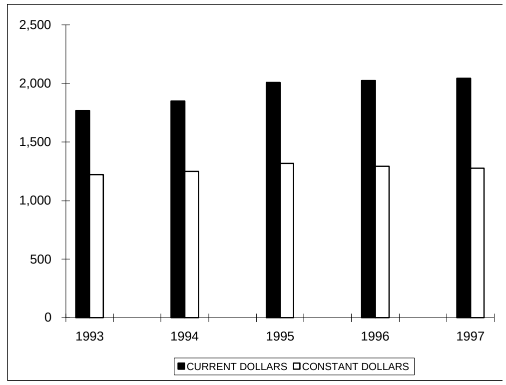
Presented below are tables depicting revenues and expenditures for the last five years on a current dollar and constant dollar basis. In addition, a chart showing per capita expenditures on a current and constant dollar basis is presented.

STATE OF TENNESSEE
REVENUES
ALL GOVERNMENTAL FUND TYPES
LAST FIVE YEARS

(Expressed in millions)



STATE OF TENNESSEE
PER CAPITA EXPENDITURES
ALL GOVERNMENTAL FUND TYPES
LAST FIVE YEARS



	1993	1994	1995	1996	
CURRENT DOLLARS	$ 9,987	$ 10,397	$ 11,250	$ 11,671	$
CONSTANT DOLLARS	$ 6,916	$ 7,025	$ 7,377	$ 7,448	$
PERCENT INCREASE OVER PRIOR YEAR IN CURRENT DOLLARS	11.0%	4.1%	8.2%	3.7%	
PERCENT INCREASE OVER PRIOR YEAR IN CONSTANT DOLLARS	7.8%	1.6%	5.0%	1.0%	

	1993	1994	1995	1996	
CURRENT DOLLARS	$ 1,767	$ 1,850	$ 2,009	$ 2,025	$
CONSTANT DOLLARS	$ 1,224	$ 1,250	$ 1,317	$ 1,292	$
PERCENT INCREASE OVER PRIOR YEAR IN CURRENT DOLLARS	7.6%	4.7%	8.6%	0.8%	
PERCENT INCREASE OVER PRIOR YEAR IN CONSTANT DOLLARS	4.5%	2.2%	5.4%	-1.9%	

General Fund Balance. The fund balance of the general fund increased by $145.6 million in 1997. Departmental reversions to the general fund were higher than anticipated. Also, revenue collections within TennCare were higher due to an agreement with the federal Health Care Financing Administration regarding certain program expenditures.

Proprietary Funds. Combined operating results for the State's enterprise funds remained strong in 1997 and were paced by the insurance activities for local government and local government teacher employees. Operating revenues were $142 million, an increase of $12.7 million over 1996. Operating expenses increased to $142 million from $127 million the previous year.

Combined operating results for the State's internal service funds also remained strong in 1997. Operating revenues and expenses for these cost-reimbursement agencies aggregated $561 million and $537 million, respectively, as compared to 1996 amounts of $528 million and $498 million. The principal internal service operations provide data processing services, third party liability claims processing, agency housing, and employee group insurance.

Pension Plan. Total assets of the State's pension trust fund reached $19 billion at June 30, 1997. The net assets held in trust for pension benefits total $18.5 billion.

Debt Administration. At June 30, 1997, the State had a number of debt issues outstanding. These issues included $767.1 million of general obligation bonds, $29.5 million of enterprise fund debt with state commitment, and $143.3 million of internal service fund debt with state commitment. Tennessee continues to receive excellent bond ratings from Moody's Investors Service (Aaa), Standard and Poor's Corporation (AA+), and Fitch Investors Service, Inc. (AAA) on general obligation bond issues, reflecting our long-standing record of sound financial management. Under current state statutes, the state's general obligation bonded debt issuances are subject to an annual legal debt service limitation based on a pledged portion of certain current year revenues. As of June 30, 1997, the state's annual legal debt service limit of $463 million was well above the debt service required of $110 million, with a legal debt service margin of $353 million. Debt per capita equaled $163, and the ratio of net general long-term bonded debt to assessed property valuation was 1.55 percent.

Cash Management. The State Treasurer has pursued an aggressive cash management and investment program. One aspect of this, which we believe is unique to Tennessee, is our direct access into the Federal Reserve wire system. Through the State Trust of Tennessee, wire services in the federal system are available via a terminal located in the State's investment offices. This provides the State flexibility in investing and concentrating cash balances and pension fund assets, and in redeeming warrants and checks issued against the Treasury. During fiscal year 1997, uncommitted State funds were invested in short-term collateralized deposits as follows (averaged): certificates of deposit (35%); repurchase agreements (7%); commercial paper (31%); U.S. Treasuries (26%); and money market accounts (1%). The composite average yield on these investments was 5.5%, down from 5.69% last year.

Risk Management. In 1989, the state initiated a loss prevention program. A loss prevention specialist has been employed to assist the state in analyzing the underlying cause of losses and in recommending measures to minimize the reoccurrence of similar losses. All state property is insured under an all risk policy for full value, with no upper limit on aggregate claims for losses. The insurance policy has an annual $5 million aggregate deductible which is covered by a $5 million state designation for casualty losses.

OTHER INFORMATION

Securities and Exchange Commission Disclosures. The State Funding Board, the Tennessee State School Bond Authority, and the Tennessee Local Development Authority have each entered into Continuing Disclosure Undertakings with respect to certain debt issues. These Undertakings were made for the benefit of the holders of the debt pursuant to U.S. Securities and Exchange Commission Rule 15c2-12. The issuers have covenanted to provide certain Annual Financial Information, including audited financial statements as well as certain additional financial and operating data. With the exceptions of information related to Tennessee Consolidated Retirement System and of certain local government financial information related to the Tennessee Local Development Authority provided to the Nationally Recognized Municipal Securities Information Repositories (NRMSIRs) under separate cover, financial and operating data required pursuant to the Undertakings is located in this Comprehensive Annual Financial Report. The reader should use the index located at the end of this report to identify the specific page where the information is presented.

Independent Audit. State statutes require an annual audit of all fund types and account groups of the State. The accompanying financial statements have been examined by the Office of the Comptroller of the Treasury, Division of State Audit. Their examination was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in the Governmental Auditing Standards issued by the Comptroller General of the United States, and their unqualified opinion appears elsewhere herein.

In conjunction with this examination, the Division of State Audit conducted an organization-wide audit as described in the Single Audit Act of 1984 as amended and Office of Management and Budget Circular A-133, Audits of State, Local Governments, and Non-Profit Organizations. The audit included tests of compliance with applicable federal laws and regulations as well as a study and evaluation of internal controls, including internal accounting and administrative controls used in administering federal financial assistance programs. The results of this single audit are published under separate cover by the Division of State Audit.

Awards. The Government Finance Officers Association of the United States and Canada (GFOA), awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Tennessee for its Comprehensive Annual Financial Report for the year ended June 30, 1996. This is the eighteenth consecutive year that the state has received this prestigious award. In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements. A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to conform to the Certificate of Achievement Program requirements, and we are submitting it to GFOA to determine its eligibility for another certificate.

In addition, the Tennessee Consolidated Retirement System has received this award for nine consecutive years for its Comprehensive Annual Financial Report.

Acknowledgments. The preparation of the comprehensive annual financial report was made possible by the dedication of the entire staff of the Division of Accounts in the Department of Finance and Administration. This report could not have been prepared without the cooperation of all state agencies and branches.

Respectfully submitted,

\s\ John D. Ferguson

John D. Ferguson, Commissioner
Department of Finance and Administration

JDF/CMP/jm

STATE OF TENNESSEE
William R. Snodgrass **COMPTROLLER OF THE TREASURY**

Comptroller

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NASHVILLE, TENNESSEE 37243-0264
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December 17, 1997

To the Members of the General Assembly
of the State of Tennessee
and
The Honorable Don Sundquist, Governor
of the State of Tennessee

Ladies and Gentlemen:

In accordance with Section 4-3-304, Tennessee Code Annotated, transmitted herewith is the auditor's report on the Comprehensive Annual Financial Report of the State of Tennessee for the fiscal year ended June 30, 1997.

Respectfully,

\s\ W.R. Snodgrass

W. R. Snodgrass
Comptroller of the Treasury

WRS/jm