



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

JOHN D. FERGUSON
COMMISSIONER

January 25, 1999

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, 1998. 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 manufacturing businesses exceeded one billion dollars every year since 1983, and exceeded two billion dollars in the last six years. Announced manufacturing capital investments in 1997 were \$2.9 billion. This growth has created 19,543 new jobs in this year alone, and has had a positive effect on employment and the state's economy. Additionally, investments in headquarters, distribution and selected services grew to \$1.7 billion in 1997. For June 1998, the state unemployment rate of 5.4% was slightly higher than the national average of 4.9%. 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.

These initiatives were developed through the administration's use of its strategic planning process begun in 1997. It is a process of organizational self-assessment, goal-setting, strategy development and performance monitoring that requires making decisions about the future, developing the necessary procedures to achieve that future and determining how success is to be measured. Each state department developed their own departmental strategic plan aligned with the statewide strategic plan. This process included the departments defining their mission, vision, long-term goals, measurable objectives and strategies to reach these objectives. Some of the key effects of this effort include: the use of these plans as the foundation from which departmental budget requests as well as information systems plans are based, and the identification of areas between agencies where duplication of effort can be eliminated, data can be shared, and services can be better delivered through improved coordination.

The first initiative included in the plan was to work on creating a more effective, efficient and focused state government. The State created the Center for Effective Government. The Center worked with state departments in the development of the departmental strategic plans and provides support in process analysis and reengineering activities. The Department of Finance and Administration consolidated the management of various computer networks across the state while reducing positions needed to manage them. A statewide study to reduce the number and complexity of rules and regulations was initiated. Planning continued on a One-Stop Shopping concept to improve the delivery of services to Tennesseans while reducing the cost of providing those services. The state established standards for monitoring sub-recipients of grant funds to align with federal standards and eliminate unnecessary or inconsistent sub-recipient reporting. Financial managers within the state developed several recommendations for improving internal accounting processes, including the identification of several information systems to be developed. Recommendations were developed to improve the service contracting process. A Service Provider Registry system was established to enhance competition and facilitate participation by disadvantaged, minority and small businesses in the state's service procurement process.

Another key initiative for the administration was to offer every child a safe, healthy start. TennCare extended coverage to every uninsured child in Tennessee who does 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. Improvements to that coverage are discussed in the Departmental Focus section of this transmittal. Work continued on the consolidation of services to children. Legislation changed current procedures and a new service delivery system was established. An automated child welfare information system will be available for the department to enhance its employees' ability to improve service.

To create excellence in education is also a priority. The Administration has funded the Basic Education Program (BEP) in full and on time. The BEP provides funds to local school systems based on their student membership, costs of certain educational components, and the community's relative ability to fund education. All Tennessee schools and libraries are connected to the Internet.

To create a climate for good, high paying jobs, the administration has placed emphasis on workforce development through adult basic education, job retraining and better-coordinated job placement efforts.

To protect public health and safety, the Administration has made important strides forward in health care, as mentioned later in the Departmental Focus section of this transmittal. Also, Tennesseans enjoy cleaner air, land and water now more than at any time in the past 25 years. To further protect the health of our citizens, the Tennessee Air Initiative was begun in November 1997. Under the initiative, Tennessee became the first state in the nation to control toxic air pollutants in newly constructed sources. Tennessee also initiated a cooperative agreement with the U.S. Department of the Interior and the U.S. Department of Agriculture to protect the air quality at the Great Smoky Mountains National Park. In conjunction with longer prison sentences and additional legislation, a plan was funded for prison construction and expansion over the next several years.

For the Future: As with any strategic planning process for large organizations, work continues from year to year on established goals. The initiatives identified here reflect the issues facing Tennessee today. Continuing in this endeavor, these major initiatives will remain in the forefront of Tennessee State Government in the future.

Departmental Focus. The Department of Health was created in 1922 as the Department of Public Health to protect and promote the health of the public. It later was the Department of Health and Environment but eventually became the Department of Health when many of the environmental functions were transferred to Environment and Conservation in 1991. The Department now has three main divisions: (1) Health Services containing the traditional public health functions, health facility and manpower licensure, and public health laboratories; (2) TennCare, and (3) Alcohol and Drug Treatment and Prevention Services.

The focus for Health Services has been increasing immunization levels for children to reach the goal of having 90% fully immunized by their second birthday and by Year 2000; limiting the cases of infectious disease such as tuberculosis, hepatitis, HIV/AIDS and sexually transmitted diseases; enhancing our surveillance system to detect emerging infectious diseases and respond to acts of bioterrorism; decreasing the gap between health statistics for whites and minorities; improving access to health services in underserved areas; enhancing services for persons with HIV/AIDS; implementing the Governor's Community Prevention Initiative which utilizes prevention funds from several sources on proven strategies which decrease youth violence, teen pregnancy, alcohol and drug use, school drop-out and youth mental health problems; building an interactive health information data system on the Internet with county specific information; enrolling children into TennCare, re-verifying eligibility of TennCare clients and helping in the TennCare appeals process; visiting homes of families no longer on Families First to assure the children are doing well; providing primary care and dental services in counties where there is a health access problem; and recreating county and regional health councils across the state to assess health problems and work toward solutions.

The Department is also the lead agency in the Governor's TN KIDS initiative which involves five state departments undertaking a variety of public/private partnerships to give all children a safe and healthy start and a good education. A Children's Summit was held and teleconferences on "Growing and Learning" will be provided over the next year aimed at several target groups, and designed to gain support and involvement in helping children during the first three years of life when development is so critical.

The Bureau of Alcohol and Drug Services is funded through a federal grant as well as state funds at a level of \$34 million. At least 20% of the funds must go for prevention and the remainder for treatment services for those without another source of care. The focus has been on the implementation of central intake: local health department staff assess clients to determine appropriate placement for services (outpatient, residential care, inpatient, etc.), help clients get the level of care needed, and provide follow-up after treatment. Over the next year the bureau will implement a fee-for-service system to replace the grant system now used for distribution of treatment funds. The bureau has partnered with the Department of Mental Health/Mental Retardation to provide training for providers across the state on care for clients with dual diagnosis.

The TennCare Bureau has a budget of \$3.8 billion and provides coverage to over 1.2 million Tennesseans. TennCare is a leader in the country in making insurance coverage available to children, the uninsured and uninsurable. This past year it has focused on resolving issues related to the TennCare Partners Program, the behavioral health component of TennCare; expanding eligibility for children 18 years of age or younger, at less than 200% of the poverty level, with or without access to health insurance; improving the appeals process; doing focused studies on quality of care issues; increasing compliance rates for Early Periodic Screening Diagnosis and Treatment; and finalizing procedures for termination of clients for the program.

The Department of Health has as its core functions: the prevention of unhealthy conditions by assessing the health problems of Tennesseans, assuring health services for residents and promoting policies which can help all communities be healthier.

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, 1998.

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 \$12.8 billion in 1998. Taxes represented 51.3% of general revenues; it is a slight decrease of .1% in the percentage of the total funding over the prior year from 51.4% to 51.3%. The amount of revenues from various sources and the changes from last year are shown below (expressed in thousands).

<u>Revenue Source</u>	<u>Amount</u>	<u>Percent of Total</u>	<u>Increase (Decrease) from 1997</u>	<u>Percent of Increase (Decrease)</u>
Taxes	\$ 6,556,385	51.3%	\$ 341,526	5.5%
Licenses, fines, fees and permits	174,754	1.4	4,881	2.9
Interest on investments	35,977	.3	16,681	86.4
Federal	4,831,199	37.8	194,294	4.2
Departmental Services	1,129,859	8.8	95,168	9.2
Other	<u>47,537</u>	<u>.4</u>	<u>24,913</u>	110.1
	<u>\$12,775,711</u>	<u>100%</u>	<u>\$ 677,463</u>	

The 5.5% increase in tax collections above is primarily due to the normal growth in the sales tax of some \$186 million and a \$63 million increase in inheritance and estate tax collections.

Interest on investments increased by \$16.7 million because more cash was available to invest.

Federal revenue for TennCare increased some \$109 million.

Departmental services increased by some \$63 million primarily due to increased child support collections.

Expenditures for general governmental purposes totaled \$11.6 billion in 1998, a 5.6% increase over the previous year. Changes in expenditures by function from 1997 levels are presented in the following tabulation (expressed in thousands).

<u>Function</u>	<u>Amount</u>	<u>Percent of Total</u>	<u>Increase (Decrease) from 1997</u>	<u>Percent of Increase (Decrease)</u>
General government	\$ 289,194	2.5%	\$ 1,559	.5%
Education	2,731,599	23.5	196,086	7.7
Health and social services	6,094,595	52.4	264,944	4.5
Law, Justice and public safety	742,714	6.4	48,104	6.9
Recreation and resources development	372,119	3.2	(13,554)	(3.5)
Regulation of business and professions	41,402	.3	(196)	(.5)
Transportation	1,145,536	9.8	65,853	6.1
Debt service	100,556	.9	8,270	9.0
Capital outlay	<u>121,651</u>	<u>1.0</u>	<u>41,882</u>	52.5
	<u>\$11,639,366</u>	<u>100%</u>	<u>\$ 612,948</u>	

Education increased \$196 million due to the emphasis placed on education as a result of the passage of the Education Improvement Act and increased federal funding.

Health and social services increased \$265 million because TennCare expenditures increased.

Law, justice and public safety increased \$48 million primarily due to the opening of the Hardeman County Correctional Facility and increased disaster relief funding.

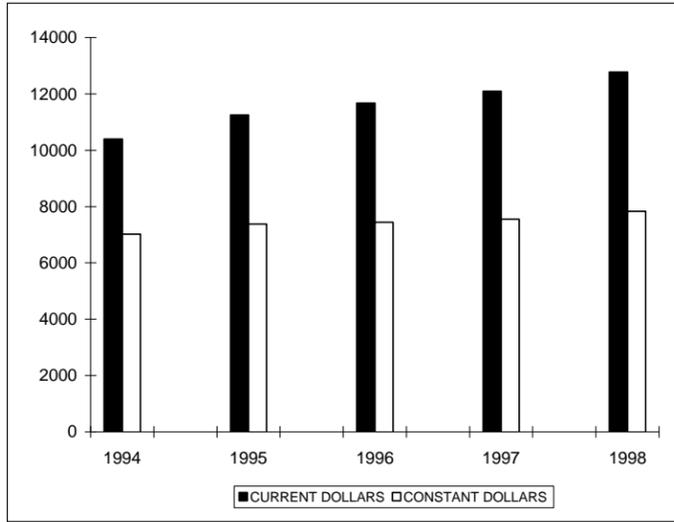
Transportation increased due to an increase in state system construction.

Debt service increased because the amount of long-term debt increased.

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.

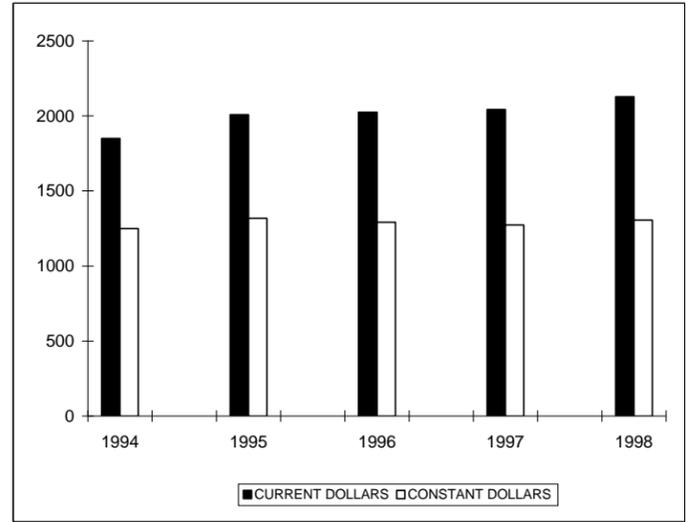
STATE OF TENNESSEE
REVENUES
ALL GOVERNMENTAL FUND TYPES

LAST FIVE YEARS
(Expressed in millions)



STATE OF TENNESSEE
PER CAPITA EXPENDITURES
ALL GOVERNMENTAL FUND TYPES

LAST FIVE YEARS



	1994	1995	1996	1997	1998
CURRENT DOLLARS	\$ 10,397	\$ 11,250	\$ 11,671	\$ 12,098	12,776
CONSTANT DOLLARS	\$ 7,025	\$ 7,377	\$ 7,448	\$ 7,547	7,838

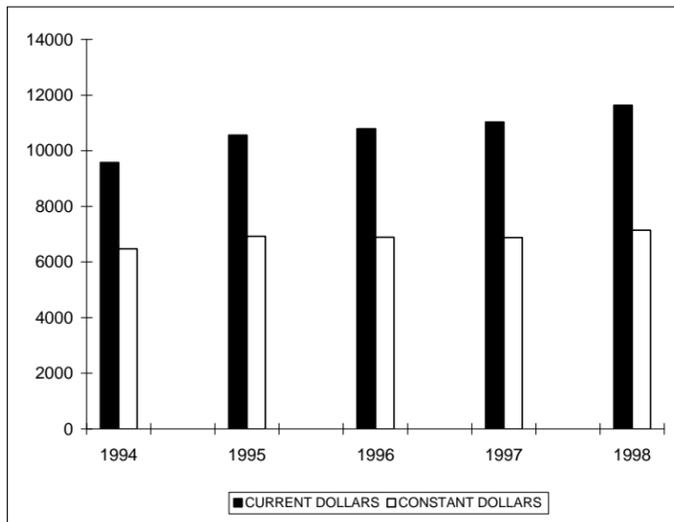
	1994	1995	1996	1997	1998
CURRENT DOLLARS	\$ 1,850	\$ 2,009	\$ 2,025	\$ 2,043	2,129
CONSTANT DOLLARS	\$ 1,250	\$ 1,317	\$ 1,293	\$ 1,274	1,306

	1994	1995	1996	1997	1998
PERCENT INCREASE OVER PRIOR YEAR IN CURRENT DOLLARS	4.1%	8.2%	3.7%	3.7%	5.6%
PERCENT INCREASE OVER PRIOR YEAR IN CONSTANT DOLLARS	1.6%	5.0%	1.0%	1.3%	3.9%

	1994	1995	1996	1997	1998
PERCENT INCREASE OVER PRIOR YEAR IN CURRENT DOLLARS	4.7%	8.6%	0.8%	0.9%	4.2%
PERCENT INCREASE OVER PRIOR YEAR IN CONSTANT DOLLARS	2.2%	5.4%	-1.9%	-1.4%	2.5%

STATE OF TENNESSEE
EXPENDITURES
ALL GOVERNMENTAL FUND TYPES
LAST FIVE YEARS

(Expressed in millions)



	1994	1995	1996	1997	1998
CURRENT DOLLARS	\$ 9,576	\$ 10,558	\$ 10,789	\$ 11,026	11,639
CONSTANT DOLLARS	\$ 6,470	\$ 6,923	\$ 6,885	\$ 6,878	7,140

	1994	1995	1996	1997	1998
PERCENT INCREASE OVER PRIOR YEAR IN CURRENT DOLLARS	6.4%	10.3%	2.2%	2.2%	5.6%
PERCENT INCREASE OVER PRIOR YEAR IN CONSTANT DOLLARS	3.8%	7.0%	-0.6%	-0.1%	3.8%

General Fund Balance. The fund balance of the general fund increased by \$229.8 million in 1998. 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 1998 and were paced by the insurance activities for local government and local government teacher employees. Operating revenues were \$158.1 million, an increase of \$16.1 million over 1997. Operating expenses decreased slightly to \$140.3 million from \$142.5 million the previous year.

Combined operating results for the State's internal service funds also remained strong in 1998. Operating revenues and expenses for these cost-reimbursement agencies aggregated \$559.4 million and \$551 million, respectively, as compared to 1997 amounts of \$560.9 million and \$536.5 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 \$21.1 billion at June 30, 1998. The net assets held in trust for pension benefits total \$21.06 billion.

Debt Administration. At June 30, 1998, the State had a number of debt issues outstanding. These issues included \$826.8 million of general obligation bonds, \$26.6 million of enterprise fund debt with state commitment, and \$139.4 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 (AAA), 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, 1998, the state's annual legal debt service limit of \$414.1 million was well above the debt service required of \$117.9 million, with a legal debt service margin of \$296.2 million. Debt per capita equaled \$167, and the ratio of net general long-term bonded debt to assessed property valuation was 1.52 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 1998, uncommitted State funds were invested in short-term collateralized deposits as follows (averaged): certificates of deposit (38%); repurchase agreements (6%); commercial paper (32%); U.S. Treasuries (23%); and money market accounts (1%). The composite average yield on these investments was 5.64, up from 5.5% 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 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, 1997. This is the nineteenth 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 ten 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/jm



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY**
STATE CAPITOL
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-2501

**JOHN G. MORGAN
COMPTROLLER**

January 25, 1999

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, 1998.

Respectfully,

\s\ John G. Morgan

John G. Morgan
Comptroller of the Treasury

JGM/jm