CITY OF KNOXVILLE PENSION SYSTEM

Knoxville, Tennessee

FINANCIAL STATEMENTS

June 30, 2010 and 2009

CITY OF KNOXVILLE PENSION SYSTEM

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INDEPENDENT AUDITOR'S REPORT

Board of Trustees and Management
City of Knoxville Pension Board
Knoxville, Tennessee

We have audited the accompanying statements of plan net assets of the City of Knoxville Pension System ("System") as of June 30, 2010 and 2009, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, information regarding the City of Knoxville Pension System's plan net assets as of June 30, 2010 and 2009, and the changes therein, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we have also issued our report dated December 30, 2010 on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Management discussion and analysis on pages 2 and 3 and the schedules of funding progress and employer contributions on pages 18 and 19 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Pugh & Company, P.C.

Certified Public Accountants
December 30, 2010

CITY OF KNOXVILLE PENSION SYSTEM

MANAGEMENT DISCUSSION AND ANALYSIS

June 30, 2010

The financial statements of the City of Knoxville Pension System (the System) reflect the investment of fund assets, the benefit payments and the operational costs of the System. The measurement focus is to show the value and annual change in the net assets available for benefits. The accounting statements are prepared on an accrual basis and are in accordance with the GASB pronouncements.

The statement of changes in plan net assets reflects the strength of the financial markets during the fiscal year. The System's investment return for the twelve months ended June 30, 2010 was 14.6% which was above the long term assumed rate of 8.0%. Net assets available for benefits showed an increase of $26.1 million.

The System's overall funding level fell during the July 1, 2009 to June 30, 2010 period. The funding ratio for the entire plan at July 1, 2010 was 88.72% based on the entry age normal funding method. The City will make employer contributions to fund the liabilities of the General Government and Uniformed Bodies sections. The increase in required employer contributions from the City of Knoxville for the 2010-2011 fiscal year will be approximately 18.7% ($1.4 million) greater than received in fiscal 2009-2010. The present value of accrued and projected benefits increased by 3.3% as of July 1, 2010 compared to July 1, 2009.

Pension benefit payouts to currently retired members were adjusted upwards in January 2010 by 3.1%. The total annual payouts increased by 4.6%.

The ultimate focus of any pension system is to assess its ability to pay benefits as due on a very long-term basis. The recovery of the financial market during the fiscal year and the resulting favorable investment performance will offset future required employer contributions. Not withstanding this favorable performance the employer contributions will continue to be above the long term annual cost of the plan which places stress on the City's overall financial environment. The Pension Board is continuing to implement changes in its asset allocation to adjust to the current investment market with a focus on lowering the volatility of the overall fund. Specifically, investments are made to capture a greater percentage of overall return from earnings relative to asset appreciation.

Financial Analysis

At the close of the 2010 fiscal year, the System's assets exceeded its liabilities by $399,097,130. At the close of the 2009 fiscal year, the System's assets exceeded its liabilities by $373,007,858. The table below provides a summary of the System's net assets as of June 30, 2010 and 2009.

	2010	2009
Assets:		
Investments Held by Trustee	$ 399,038,714	$ 372,856,224
Cash on Hand	3,487	2,473
Receivables	6,720,962	1,929,853
Capital Assets	4,316	7,181
	405,767,479	374,795,731
Liabilities	6,670,349	1,787,873
Net Plan Assets	$ 399,097,130	$ 373,007,858

The System's net assets increased by $26,089,272 during the 2010 fiscal year and decreased by $118,510,785 during the 2009 fiscal year. The following table provides a summary of the changes in net assets for the fiscal years ended June 30, 2010 and June 30, 2009.

	2010	2009
Additions to Plan Net Assets		
Net Investment Income (Loss)	$ 53,012,291	$ (92,695,850)
Contributions	11,179,324	10,567,461
	64,191,615	(82,128,389)
Deductions from Net Plan Assets	38,102,343	36,382,396
Net Increase (Decrease) in Plan Assets	26,089,272	(118,510,785)
Net Assets at Beginning of Plan Year	373,007,858	491,518,643
Net Assets at End of Plan Year	$ 399,097,130	$ 373,007,858

Requests for Information

This financial report is designed to provide a general overview of the City of Knoxville Pension System's finances for all of those with an interest in the System's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Executive Director, City of Knoxville Pension System, 917-B East Fifth Avenue, Knoxville, Tennessee 37917.

CITY OF KNOXVILLE PENSION SYSTEM

STATEMENTS OF PLAN NET ASSETS

As of June 30,	2010	2009
ASSETS		
Investments Held by Trustee		
Cash and Cash Equivalents	$ 5,882,471	$ 5,643,811
United States Government Securities	23,927,298	12,583,324
State and Municipal Government Securities	3,564,525	2,132,369
International Securities	115,914,762	127,694,114
Corporate Bonds and Debentures	73,139,096	58,364,248
Real Estate Investment Trusts	41,200,707	42,800,877
Domestic Equity Securities	135,409,855	123,637,481
Total Investments Held by Trustee	399,038,714	372,856,224
Cash on Hand	3,487	2,473
Receivables		
Pending Sale Proceeds	5,208,303	382,896
Accrued Interest and Dividends	1,500,566	1,536,375
Other Receivables	12,093	10,582
Total Receivables	6,720,962	1,929,853
Capital Assets, Net of Accumulated Depreciation	4,316	7,181
Total Assets Held for Plan Benefits	405,767,479	374,795,731
LIABILITIES		
Accounts Payable - Administrative	500,789	357,415
Liability for Investment Purchases Pending	6,169,560	1,430,458
Total Liabilities	6,670,349	1,787,873
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$ 399,097,130	$ 373,007,858

The accompanying notes are an integral part of these financial statements.

CITY OF KNOXVILLE PENSION SYSTEM

STATEMENTS OF CHANGES IN PLAN NET ASSETS

For the Years Ended June 30,	2010	2009
ADDITIONS TO PLAN NET ASSETS		
Net Investment Earnings (Loss)		
Interest	$ 5,177,139	$ 5,623,812
Dividends	2,788,786	3,805,198
Net Appreciation (Depreciation) in Fair Value of Investments	46,730,025	(100,805,622)
Other Income	447,598	578,582
Total Investment Earnings (Loss)	55,143,548	(90,798,030)
Less Investment Expense	(2,131,257)	(1,897,820)
Net Investment Earnings (Loss)	53,012,291	(92,695,850)
Contributions		
City of Knoxville Employer Contributions	7,623,044	7,159,207
Employee	3,556,280	3,408,254
Total Contributions	11,179,324	10,567,461
Total Additions (Net)	64,191,615	(82,128,389)
DEDUCTIONS FROM PLAN NET ASSETS		
Participant Benefit Payments	37,337,938	35,672,082
Refunds to Terminated Employees	357,110	367,637
Administrative Expenses		
Depreciation	2,865	3,308
Other	404,430	339,369
Total Deductions	38,102,343	36,382,396
NET INCREASE (DECREASE) IN PLAN NET ASSETS	26,089,272	(118,510,785)
NET PLAN ASSETS AT BEGINNING OF YEAR	373,007,858	491,518,643
NET PLAN ASSETS AT END OF YEAR	$ 399,097,130	$ 373,007,858

The accompanying notes are an integral part of these financial statements.

CITY OF KNOXVILLE PENSION SYSTEM

NOTES TO FINANCIAL STATEMENTS

June 30, 2010 and 2009

NOTE 1 - DESCRIPTION OF THE CITY OF KNOXVILLE PENSION SYSTEM

(a) *General*

The City of Knoxville Pension System (the System) is a single-employer contributory, qualified defined benefit plan established under the City of Knoxville Pension Act of 1935, covering substantially all employees of the City of Knoxville (City), including uniformed bodies (Fire and Police) and employees of the former City of Knoxville Education System (Education). The System is designed to provide retirement, disability and death benefits. Participants in the System remain non-vested in the City's contribution and the related earnings thereon until five years of service have been completed, at which time the participant vests fully. The City of Knoxville Pension System is a governmental plan as defined by the Employee Retirement Income Security Act (ERISA) of 1974, and is not subject to many of the provisions of the Act, and is exempt from the reporting requirements of the Internal Revenue Service. The Divisions described in Note 1(g) on pages 7 through 11 are funded by contributions from the employers and employees in the various City departments and agencies.

(b) *Financial Statement Presentation*

The System's actuarial valuations are performed annually. The latest available actuarial valuation is as of July 1, 2010, which corresponds to the financial information as of and for the year ended June 30, 2010.

The assets of the System are included in the City's comprehensive annual financial report as a fiduciary pension trust fund. The System receives significant contributions from the City.

(c) *Membership*

At July 1, 2010, the System had approximately 2,293 retirees and beneficiaries currently receiving benefits, 33 employees currently participating in the Delayed Retirement Option Program ("DROP") and 89 deferred vested participants. Of the approximately 1,539 active employees in the System, 1,099 are fully vested and the remaining 440 are not vested.

On or after December 31, 2000, a Division C member or on or after January 6, 2001, a Division G member eligible for Normal Retirement may elect a delayed retirement date, not more than 24 months after the date of election. The monthly benefit payable beginning on the delayed retirement date will be the same as would have been payable had the member retired on the election date except that a single sum amount shall also be paid. The amount of the single sum payment will be equal to the monthly payments times the number of months from the election date to the delayed retirement date plus any cost of living increases which are effective during the DROP period.

(d) *Board of Education*

Included in the financial statements are benefit amounts relating to certain former employees of the City of Knoxville Board of Education which was abolished and transferred to Knox County as of July 1, 1987. The City treats these benefit amounts as belonging to a terminated department and makes actuarially determined contributions sufficient to amortize the participants' accrued pension liabilities through July 1, 1987. The Board of Education merger with Knox County Schools is discussed further in Note 8 to the financial statements.

(e) *Employer Contributions*

The City's employer contribution is based on an actuarially determined percentage of the monthly base earnings of the System's participants. The contribution for the former Board of Education department is an actuarially determined amount based on a level dollar amount to fund any actuarial liability.

NOTE 1 - DESCRIPTION OF THE CITY OF KNOXVILLE PENSION SYSTEM (Continued)

(f) *Plan Termination*

No provision has been made for the System's termination and the resulting order of allocation of benefits if termination should occur. The Pension Benefit Guaranty Corporation does not insure the System.

(g) *Description of Divisions Comprising the System*

<u>DIVISION A</u>

Employees covered

- Substantially all civil service employees hired after 1/15/1963 and before 1/1/1997, who did not elect Division G
- At their option, certain elected officials and appointed employees
- Those Division B members who elected to transfer to Division A
- Any teacher employed by the City between 1/16/1963 (or prior if that teacher elected to transfer from Division B) and 12/31/1976
- Those Division A uniformed body employees who did not elect Division C

Employees excluded

- Teachers hired by the City after 12/31/1976 (they participate in Tennessee Consolidated Retirement System). All City employees hired after December 31, 1996 (now in Division G).

Employee contributions

- 3% of the first $4,800 of annual earnings and 5% of annual earnings in excess of $4,800

Normal Retirement age and required creditable service

- Age 62

Normal Retirement benefit

- The normal retirement benefit for life will be equal to one-twelfth of the product of (a) and (b) below:

(a) Credited service (in years, completed months and days)
(b) X% of average base earnings, plus Y% of average excess earnings as follows:

Age at Retirement	X%	Y%
62 or earlier	0.75	1.50
63	0.78	1.58
64	0.83	1.66
65 or older	0.88	1.76

Base earnings are annual earnings up to $4,800. Excess earnings are annual earnings over $4,800. Average is defined as the highest average earnings over a span of two years (for general government) or three years (for education).

Other

- Members of Division A are covered by Social Security
- Division is closed to new members

NOTE 1 - DESCRIPTION OF THE CITY OF KNOXVILLE PENSION SYSTEM (Continued)

(g) *Description of Divisions Comprising the System* (Continued)

DIVISION B

Employees covered	• All employees, except policemen and firemen, who were employed prior to 1/17/1963, and who participated in the City of Knoxville Pension System as created by the City of Knoxville Pension Act of 1935, who elected to continue in Division B and were not over age 40 when electing to contribute.
Employees excluded	• Members of the Tennessee Consolidated Retirement System
Employee contributions	• 4% of annual earnings • Annual earnings referred to above excludes overtime payments
Normal Retirement age and required creditable service	• Age 50, 25 years of service
Normal retirement benefit	• The immediate monthly pension is 50% of the member's average monthly salary for the highest two years. To this percentage will be added 1% of each year (and fraction based on complete months) of service worked after 1/1/79, and after the member has reached age 50 and completed 25 years of service, subject to a maximum addition of 10%.
Other	• Members of Division B are not covered by Social Security • Division is closed to new members

NOTE 1 - DESCRIPTION OF THE CITY OF KNOXVILLE PENSION SYSTEM (Continued)

(g) *Description of Divisions Comprising the System* (Continued)

DIVISION C

Employees covered	• All firemen and policemen employed after 1/2/1971 • Members who transferred from Division A on 1/2/1971
Employees excluded	• Members who elected to remain in Division A
Employee contributions	• 6% of annual earnings (subject to a maximum of 30 years) • Annual earnings referred to above excludes overtime payments • Member contributions were limited to the 30-year maximum referred to above effective 1/1/1997
Normal Retirement age and required creditable service	• Age 50, 25 years of service
Normal retirement benefit	• The normal monthly retirement benefit payable for life is as follows: 2.0% of member's average salary for each year of service, subject to a maximum of 30 years of service until 1/4/1997 2.1% of member's average salary for each year of service, subject to a maximum of 30 years of service until 1/4/1999 2.4% of member's average salary for each year of service, subject to a maximum of 30 years of service until 1/5/2001, and 2.5% of member's average salary thereafter Average salary is determined over three years until 1/4/1997, two years thereafter. Creditable service was defined in terms of whole years until 1/6/2001, in terms of whole years and whole months until 10/3/2004, and in terms of whole years, whole months and completed days thereafter.
Other	• Members of Division C are covered by Social Security • Delayed Retirement Option Program

NOTE 1 - DESCRIPTION OF THE CITY OF KNOXVILLE PENSION SYSTEM (Continued)

(g) *Description of Divisions Comprising the System* (Continued)

DIVISION F

Employees covered	• Fire and police personnel hired before January 1, 1963
Employees excluded	• Fire and police personnel hired after December 31, 1962
Employee contributions	• 5% of monthly earnings
Normal Retirement age and required creditable service	• Age 50, 25 years of service
Normal retirement benefit	• 50% of the member's highest monthly salary while employed in an eligible position. To this percentage will be added 2% for each year of service worked after 25 years to a maximum of 30 years (maximum of 60% benefit).
Other	• Members of Division F are not covered by Social Security • Division is closed to new members

NOTE 1 - DESCRIPTION OF THE CITY OF KNOXVILLE PENSION SYSTEM (Continued)

(g) *Description of Divisions Comprising the System* (Continued)

DIVISION G

Employees covered
- All general government employees who were employed on or after January 1, 1997 after completion of six months service
- All general government employees who elected to transfer from Division A on July 1, 1997
- Elected members of the legislative and judicial branches of City Government

Employees excluded
- Members of Division A who elected not to transfer
- Members of Divisions B, C and F

Employee contributions
- 6% of annual earnings (Option 1 - 3% defined benefit, 3% supplemental defined contribution; Option 2 - 6% defined benefit)
- Annual earnings referred to above excludes overtime payments

Normal Retirement age and required creditable service
- Age 62 or "Rule of 80" (member's age plus years of service)

Normal retirement benefit

Option 1
- The monthly normal retirement benefit for life will be equal to one-twelfth of the product of (a) and (b) below:

(a) Credited service (in years and completed months and days) times:

	% of Average Annual Earnings	
Age at Retirement	Through 1/5/2001	Thereafter
62 or less	1.07%	1.15%
63	1.12	1.21
64	1.18	1.27
65 or older	1.25	1.35

(b) Average annual earnings - Average is determined by using the two highest 12 month periods. Periods do not have to be consecutive and any month may be used in only one period.

(In addition to the above-defined benefit, 3% of the member contributions are going into a supplemental retirement account. The City is contributing 1-1/2% of gross regular bi-weekly payroll into this account. At retirement, the member is entitled to the value of this account.)

Option 2
- Credited service (in years and completed months and days) times 2% of average annual earnings (until 1/5/2001) as defined above.
- 2.1 % of average annual earnings thereafter

Other
- Members of Division G are covered by Social Security
- Delayed Retirement Option Program

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) *Basis of Accounting*

Employee and employer contributions are recognized as revenues in the period in which the employee services are performed.

(b) *Valuation of Investments*

Investments held by the System are stated at fair value. Many factors are considered in arriving at that fair market value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available, restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices. The fair value of real estate investments, principally rental property subject to long-term leases has been estimated on the basis of future rental receipts and estimated residual values discounted at interest rates commensurate with the risks involved.

Purchases and sales of securities, including gain or loss on sales or exchanges, are recorded on a trade-date basis. Discounts and premiums on fixed income securities are included in net appreciation in the fair value of investments. The effect on the financial statements of not amortizing discounts and premiums is considered immaterial.

(c) *Investment Income*

Dividend income is recorded on the ex-dividend date and interest income is recorded as earned on an accrual basis. Gains and losses on sales, maturities or exchanges of investments are determined on an average cost basis and are reflected in the statements of changes in plan net assets.

(d) *Cash and Cash Equivalents*

Cash and cash equivalents consist of highly liquid investments, including cash held on a temporary basis by the Trustee, money market funds and certificates of deposit. Substantially all cash and cash equivalents are uninsured and uncollateralized. Carrying values approximate bank balances.

(e) *Capital Assets*

Property and equipment are stated at cost, less accumulated depreciation. Depreciation has been provided for using the straight line method over the estimated useful life of the related asset.

(f) *Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates. Significant estimates include fair value of investments and all actuarial calculations.

(g) *Reclassifications*

Certain items in the 2009 financial statements have been reclassified to conform with the 2010 financial statements.

NOTE 3 - EMPLOYER CONTRIBUTIONS

Employer contributions represent a percentage of the monthly earnings of Plan members based on an actuarial valuation within three years of the base year. The recommended contributions are determined using the entry age normal funding method. Unfunded actuarial accrued liabilities are being amortized as level dollar annual payments over an amortization period not to exceed thirty years. Projected covered payroll for the years beginning on July 1, 2010 and 2009 (without Board of Education amounts) amounted to approximately $63,977,132 and $60,585,868 respectively.

NOTE 3 - EMPLOYER CONTRIBUTIONS (Continued)

Employer contributions, excluding Board of Education contributions, and percentages of employer-covered payroll for the years ended June 30, 2010 and 2009 were as follows:

	2010		2009	
	Amount	Rate - %	Amount	Rate - %
Uniformed Police and Fire	$ 5,020,898	15.61%	$ 4,829,577	16.33%
General Government Contribution	2,336,728	7.38%	2,075,497	6.76%
Division G Matching Contribution	265,418	0.84%	254,133	0.83%
Total	$ 7,623,044		$ 7,159,207	

NOTE 4 - INVESTMENTS

The System's investments are held by a bank-administered trust fund. Fair value of investments has primarily been determined based on quoted market prices as of June 30, 2010 and 2009.

	2010		2009	
	Fair Value	Weighted Average Maturity (Years)	Fair Value	Weighted Average Maturity (Years)
Investment Type				
United States Government Securities				
US Treasuries	$ 15,682,334	9.7	$ 2,038,725	14.4
US Government Agencies	8,244,964	25.3	10,544,599	26.2
Total United States Government Securities	23,927,298	15.1	12,583,324	24.3
State and Municipal Government Securities	3,564,525	28.7	2,132,369	22.3
Corporate Bonds & Debentures				
Convertible Bonds	15,680,392	9.7	12,542,001	11.9
Corporate Bonds	47,221,951	21.9	34,187,595	22.3
Asset Backed Securities	3,998,969	19.5	785,290	31.5
Collateralized Mortgage Obligations	6,136,377	31.0	7,341,542	31.4
Receivable Backed Securities	101,407	4.8	3,507,820	17.5
Total Corporate Bonds and Debentures	73,139,096	19.9	58,364,248	21.0
International Securities				
Convertible Bonds - Foreign	0	0.0	1,454,338	18.5
Corporate Bonds - Foreign	0	0.0	13,643,338	23.7
Total International Securities	0	0.0	15,097,676	23.2
Total Investments with Maturities	100,630,919	19.1	88,177,617	21.9
Cash and Cash Equivalents	5,882,471		5,643,811	
International Securities				
Common Stock	0		6,568,997	
Mutual Funds	115,914,762		106,027,441	
Real Estate Investment Trust	41,200,707		42,800,877	
Domestic Equity Securities	135,409,855		123,637,481	
Total Investment Assets	$ 399,038,714		$ 372,856,224	

NOTE 4 - INVESTMENTS (Continued)

At June 30, 2010 and 2009 net appreciation (depreciation), including realized gains and losses, associated with the System's investments is as follows:

	2010	2009
Government Securities	$ 4,039,060	$ (3,867,217)
Foreign Securities	16,612,109	(20,357,060)
Corporate Bonds and Debentures	9,701,737	(1,395,364)
Real Estate Investment Trusts	(3,336,755)	(20,930,243)
Domestic Equity Securities	19,713,874	(54,255,738)
	$ 46,730,025	$ (100,805,622)

Interest Rate Risk - The City of Knoxville Pension System has an approved investment policy which targets the combined core bond and long-term bond portfolios between 10% and 20%. The investment policy permits portfolios of fixed income investments to go up to 75% of the total investment value of the fund. As of June 30, 2010, these portfolios were 19.19% (long-term 12.14% and core bonds 7.05%) of the total investment value. Interest rate sensitivity of collateralized mortgage obligations cannot be greater than the underlying mortgage backed security.

Credit Risk - The System's investment policy mandates a diversified investment portfolio among several asset classes. The policy further requires general adherence to the prudent person rule for the investments within that classification to have an overall credit rating of investment grade or better.

Concentration of Credit Risk - Investment with any one issuer shall not exceed 5%, except for obligations of the U.S. Government. As of June 30, 2010 only non U.S. Government investments in fully diversified commingled funds/pooled funds/mutual funds were greater than the 5% of the total investment value of the fund.

Investments that represent 5% or more of the System's net assets are as follows:

<u>June 30, 2010:</u>	
Silchester International - International Equity Group Trust	$ 57,639,937
RREEF America II - Real Estate Investment Trust	$ 25,357,877
Gryphon International LLC	$ 33,366,887
Acadian Asset Management Trust	$ 24,872,597
<u>June 30, 2009</u>	
Silchester International - International Equity Group Trust	$ 77,611,234
RREEF America II - Real Estate Investment Trust	$ 26,628,465
Gryphon International LLC	$ 28,416,208
Cadogan Management LLC	$ 18,947,160

Foreign Currency Risk - All investments of the System are denominated in U.S. dollars. International equity investment is done via fully diversified open-ended commingled funds.

Custodial Credit Risk - Deposits - In the case of bank deposits, this is the risk that in the event of a bank failure, the System's deposits may not be returned to it. As required by state statutes, the System's policy is to require that financial institutions holding its deposits to be members of the Tennessee Collateral Pool or pledge collateral for deposits exceeding federal depository insurance. Collateral is required to be held by the System or its agent in the System's name. At June 30, 2010, the System's bank balance of $3,287 was not exposed to custodial credit risk.

NOTE 4 - INVESTMENTS (Continued)

Custodial Credit Risk - Investments - For an investment this is the risk that, in the event of a failure of the counterparty, the System will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The System's policies permit the System to lend its securities to a list of approved broker-dealers with a simultaneous agreement to return the collateral for the same securities in the future. The total amount of securities on loan is restricted to no more than 30% of the assets of the fund. The lending is managed by the System's custodial bank. The System's custodian lends securities of the type on loan at year-end for collateral in the form of cash or other securities of 102 percent.

Pursuant to the Securities Lending Authorization Agreement, State Street had an obligation to indemnify the System in the event of default by a borrower. There were no failures by any borrowers to return loaned securities or pay distributions thereon during the fiscal year that resulted in a declaration or notice of default of the borrower.

All securities loans can be terminated on demand by either the System or the borrowers. Cash collateral is invested in the lending agent's short-term investment pool, which at year-end has a weighted-average maturity of twenty-nine (29) days and an expected average maturity of two hundred and forty-four (244) days. The relationship between the maturities of the investment pool and the System's loans is affected by the maturities of the securities loans made by other entities that use the agent's pool, which the System cannot determine. The System cannot pledge or sell collateral securities received unless the borrower defaults.

At June 30, 2010 and 2009, investments associated with the System's securities lending activities were as follows:

	2010	2009
Investments held by broker-dealers under securities loans with cash and securities collateral:		
United States Government and Agency Securities	$ 10,854,419	$ 1,601,515
Domestic Equity Securities	30,376,825	21,057,599
Domestic Fixed Income Securities	5,429,014	7,733,296
	$ 46,660,258	$ 30,392,410

	2010	2009
Investments held by third parties under securities loans with non-cash collateral:		
United States Government and Agency Securities	$ 46,506	$ 0
Domestic Equity Securities	143,239	235,814

The System also has a credit risk exposure for cash held in its securities lending short-term collateral investments pools (not included in the System's financial statements) as follows:

	2010	2009
Cash and Securities held by Broker-Dealers as Collateral for Securities Loans	$ 48,433,866	$ 31,257,276
Cash and Securities held by Third Parties as Collateral for Securities Loans	203,976	248,615

NOTE 5 - CAPITAL ASSETS

Capital asset activity for years ended June 30, 2010 and 2009 was as follows:

	Beginning Balance	Additions	Deletions	Ending Balance
June 30, 2010:				
Depreciable				
Furniture and Equipment	$ 41,772	$ 0	$ 0	$ 41,772
Accumulated Depreciation				
Furniture and Equipment	34,591	2,865	0	37,456
	$ 7,181	$ (2,865)	$ 0	$ 4,316
June 30, 2009:				
Depreciable				
Furniture and Equipment	$ 35,883	$ 5,889	$ 0	$ 41,772
Accumulated Depreciation				
Furniture and Equipment	31,283	3,308	0	34,591
	$ 4,600	$ 2,581	$ 0	$ 7,181

NOTE 6 - FUNDED STATUS

The System adopted the use of the entry age normal method effective with the July 2007 valuation. As of June 30, 2010, the most recent actuarial valuation date, the plan was 88.7% funded. The actuarial accrued liability for benefits was $578.2 million, and the actuarial value of assets was $512.9 million, resulting in an unfunded actuarial accrued liability (UAAL) of $65.3 million. The covered payroll (annual payroll of active employees covered by the plan) was $64.0 million, and the ratio of the UAAL to the covered payroll was 102.0%.

The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

For the year ended June 30, 2010, the actual annual pension cost for the System equaled the required contributions for the uniformed police and fire and for the general government contribution. Significant actuarial assumptions used in the valuation as of July 1, 2010 include: (a) rate of return on investment of present and future assets of 8%; (b) the assumed salary scale is based on a review of the experience study of the plan, the assumed salary increases are greater at younger ages and lower at older ages; and (c) projected post retirement increases of 3.5% annually. The actuarial value of assets was determined using techniques that smooth the effect of short-term volatility in the market value of equities over a ten-year period.

The two significant actuarial assumptions used by the System are the investment return assumption of 8% and the increase in salary scale assumption which is based on an experience study shown below:

	Divisions A, B and G	Divisions C and F
Age 20	12.00%	12.00%
Age 35	5.20%	6.20%
Age 50	4.10%	4.30%
Age 60	3.50%	3.50%

NOTE 7 - OTHER INCOME

Other income consists of the following:

	2010	2009
Securities loan income	$ 118,357	$ 374,429
Securities litigation income	324,923	201,208
Commission recapture income	4,318	2,945
	$ 447,598	$ 578,582

NOTE 8 - ABOLISHMENT OF THE CITY SCHOOL SYSTEM

Effective July 1, 1987, the City School System, whose employees were members of the Board of Education department, was abolished and the former City school operations were absorbed into those of Knox County. Although there has not been an actual plan termination, the City's abolishment of its school system and a Court of Appeals ruling has resulted in an in-substance termination of the Board of Education department of the Pension Board.

Pension benefits for non-certified employees of the former City Schools are projected based on the salaries received and to be received from the Knox County Board of Education, as well as the estimated retirement dates for such personnel. Under the terms of the City of Knoxville Charter as construed by the Pension Board, the City is responsible for the difference in the total benefits due non-certified personnel had they remained in the System and amounts payable to such personnel under the Knox County retirement plan. The pension benefit obligation for certified personnel is calculated on a termination basis as of July 1, 1987. Under the terms of an agreement with Knox County executed November 7, 1994, the City is responsible for funding the benefits earned by certified personnel through July 1, 1987. Knox County is responsible for funding the difference, if any, between the pension benefits due based on the employee's salary and service at July 1, 1987, and the actual pension obligation when the employee retires.

The System's actuary has determined the actuarial value of pension benefits which former City school system employees would be entitled to if their earned benefits were frozen at July 1, 1987. The excess of this amount over the fair value of System's assets allocated to the Board of Education is being amortized by City contributions to the System.

The City was not actuarially required and did not make a contribution for this department for the years ended June 30, 2010 and 2009.

CITY OF KNOXVILLE PENSION SYSTEM

Required Supplementary Information
June 30, 2010

Schedule of Funding Progress

Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (b)	Unfunded Actuarial Accrued Liability (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
July 1, 2010	$ 512,943,851	$ 578,180,826	$ 65,236,975	88.7%	$ 63,977,132	102.0%
July 1, 2009	523,121,786	561,660,015	38,538,229	93.1%	60,585,868	63.6%
July 1, 2008	524,596,859	544,826,299	20,229,440	96.3%	58,226,253	34.7%
July 1, 2007	509,837,414	528,228,802	18,391,388	96.5%	56,599,723	32.5%

Note: Beginning July 1, 2007, the Actuarial Accrued Liability and Unfunded Accrued Liability values are calculated and reported using the Entry Age Normal funding method. Prior to July 1, 2007, the aggregate actuarial cost method was used.

Does not include Board of Education payroll amounts for teachers with frozen benefits as described in Note 8.

CITY OF KNOXVILLE PENSION SYSTEM

Required Supplementary Information
June 30, 2010

Schedule of Employer Contributions

	General Government		Fire and Police		Total	
Year Ended June 30	Annual Required Contribution	Percent Contributed	Annual Required Contribution	Percent Contributed	Annual Required Contribution	Percent Contributed
2010	$ 2,336,728	100%	$ 5,020,898	100%	$ 7,385,690 *	100%
2009	2,075,497	100%	4,829,577	100%	6,935,152 *	100%
2008	1,991,152	100%	4,702,520	164%	6,693,672	145%
2007	1,618,040	100%	3,764,587	100%	5,382,627	100%
2006	1,133,337	100%	3,077,456	100%	4,210,793	100%
2005	610,584	100%	2,302,822	100%	2,913,406	100%

Annual required contributions do not include Plan G matching contributions.

Employer contributions to the defined contribution plan for the current fiscal year ending June 30, 2010 totaled $265,418.

*Increase in net pension obligation was $28,064 in 2010 and $30,078 in 2009. These amounts are included in Total Annual Required Contribution.

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Trustees and Management
City of Knoxville Pension Board
Knoxville, Tennessee

We have audited the financial statements of the City of Knoxville Pension System as of and for the year ended June 30, 2010, and have issued our report thereon, dated December 30, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over financial reporting, described in the accompanying schedule of findings and responses and referred to as 2009-1 and 2009-2, that we consider to be significant deficiencies in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

<u>Compliance and Other Matters</u>

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The System's responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the System's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Board of Trustees, senior management and the Comptroller of the Treasury of the State of Tennessee, and is not intended to be and should not be used by anyone other than these specified parties.

Pugh & Company, P.C.

Certified Public Accountants
December 30, 2010

CITY OF KNOXVILLE PENSION SYSTEM

Schedule of Findings and Responses
For the Year Ended June 30, 2010

Findings related to the audit of the financial statements of the City of Knoxville Pension System.

Unresolved Prior Year Audit Findings:

Finding 2009-1: Formal Risk Assessment Process

Criteria: Risk Assessment procedures should be performed to identify any conflicts of interest between money managers, investment advisors, and the custodian. These procedures should be performed to ensure the Pension System is treated with equity in all investment transactions.

Condition: In documenting an understanding of the potential risks related to investments, it came to our attention that there is no formal risk assessment process to identify any conflicts of interest between money managers, investment advisors, and the custodian.

Context: The Pension System's investments total approximately $399 million for the year ended June 30, 2010.

Cause: The Pension System staff and investment advisors have not performed procedures to ensure all parties related to investment transactions are working in the best interest of the System.

Effect: The Pension System may be paying higher fees and commissions on investment transactions which would reduce the amount of net assets available for pension benefits.

Recommendation: We recommend that the Pension System develop a risk assessment process for identifying any conflicts of interest to ensure that all parties are working in the best interest of the Pension System.

Management's Response: The Executive Director will recommend to the Pension Board appropriate professional entities be engaged during the current fiscal year to specifically analyze our professional relationships with investment managers, custodial services and investment consultation services for the express purpose of reporting any actual or potential conflicts of interest. The resulting report should also address any possible cost inefficiencies in our current structure. Lastly, we will request recommendations for ongoing monitoring by the pension staff.

Finding 2009-2: Segregation of Duties

Criteria: In general, no one employee should have access to physical assets as well as authorization and recording responsibilities for a single transaction. Currently, the Executive Director is responsible for the majority of accounting functions including investments transactions, accruals, journal entries, and financial statement preparation.

Condition: During the course of our audit, which includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, it became apparent that the Executive Director is responsible for most accounting functions.

Context: The Pension System's investments total approximately $399 million for the year ended June 30, 2010.

Finding 2009-2: Segregation of Duties (Continued)

Cause: The Pension System does not have enough financial employees to aid the Executive Director in performing accounting functions.

Effect: Incompatible functions place a person in the position to both perpetrate and conceal errors or fraud in the normal course of his/her duties.

Recommendation: We recommend a reallocation of accounting duties or an additional controller/financial executive to assist with the financial statements and investment transactions. This would enhance segregation of duties and allow the Executive Director the ability to review the information and focus on the investment relationships.

Management's Response: The Pension Board authorized a new accounting/finance position be created and funded. This has been completed with the City's Civil Service Department. The Executive Director advertised for the position and is evaluating the applicants. It is anticipated the position will be filled in the first quarter of 2011.