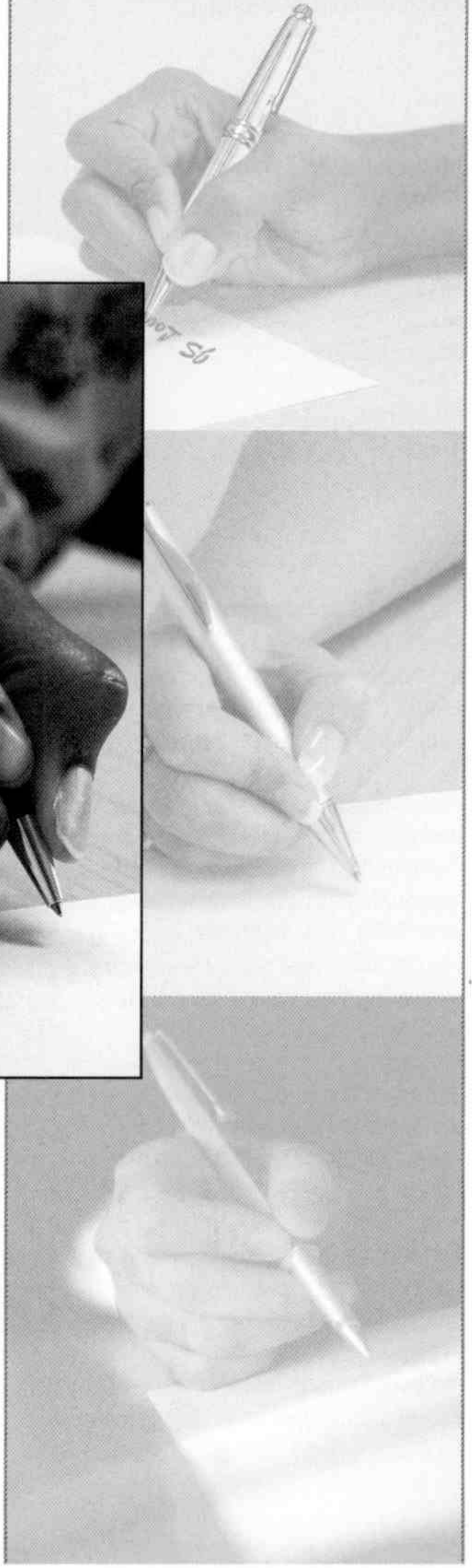
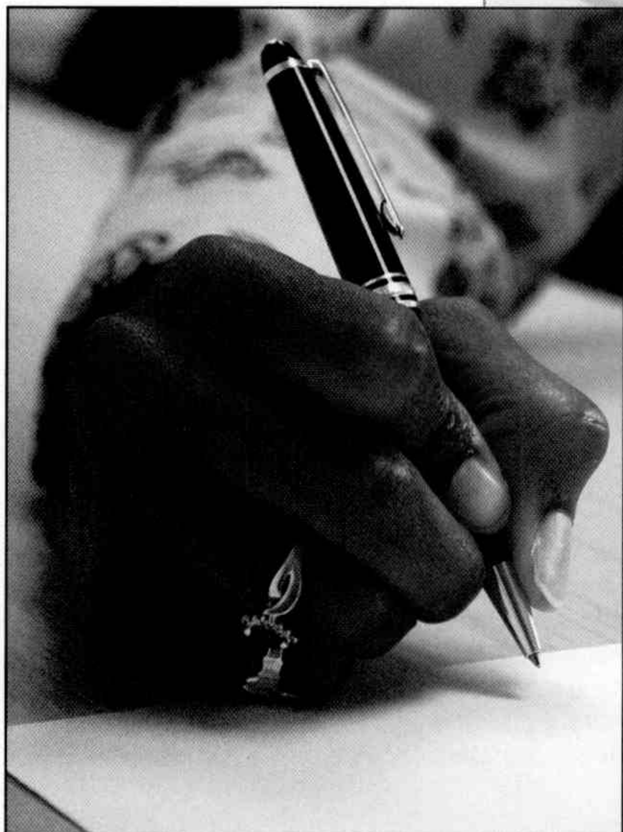
FINANCIAL





As we express our gratitude, we must never forget that the highest appreciation is not to utter words, but to live by them.

John Fitzgerald Kennedy

McGladrey & Pullen
Certified Public Accountants

Independent Auditor's Report

Honorable William G. Holland
Auditor General
State of Illinois

Board of Trustees
Teachers' Retirement System of
The State of Illinois

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statement of plan net assets of the Teachers' Retirement System of the State of Illinois (the System), a component unit of the State of Illinois, as of June 30, 2003 and 2002, and the related statement 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the Teachers' Retirement System of the State of Illinois as of June 30, 2003 and 2002, and the changes in plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management discussion and analysis on pages 18 through 21 and the schedules of funding progress and contributions from employers and other contributing entities on pages 37 and 38 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with Government Auditing Standards, we will also issue, under separate cover, our report dated November 26, 2003 on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations and contracts. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements of the System. The introduction section, other supplementary information on page 39, investments section, actuarial section and statistical section are presented for the purpose of additional analysis and are not a required part of the basic financial statements. The other supplementary information on page 39 has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly presented in all material respects in relation to the basic financial statements taken as a whole. The introduction, investments, actuarial, statistical and acknowledgements sections listed in the table of contents were not subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

McGladrey & Pullen, LLP

Schaumburg, Illinois
November 26, 2003

MANAGEMENT DISCUSSION AND ANALYSIS

Our discussion and analysis of the Teachers' Retirement System of the state of Illinois provides an overview of financial activities for the fiscal year ended June 30, 2003. Please read it in conjunction with the transmittal letter in the Introduction Section on page 5, and the Basic Financial Statements and related notes that follow this discussion.

FINANCIAL HIGHLIGHTS

- TRS net assets at June 30, 2003, were $23.1 billion.
- During FY03, TRS net assets increased $759 million.
- Contributions from members, employers, and the state of Illinois were $1,753 million, an increase of $165 million or 10.4 percent during the fiscal year.
- Total investment income was $1,061 million, an increase of $1,785 million or 246.5 percent compared to FY02.
- Benefits and refunds paid to members and annuitants were $2,042 million, an increase of $243 million or 13.5 percent compared to FY02.
- The pension benefit obligation or total actuarial accrued liability was $46.9 billion at June 30, 2003.
- The unfunded actuarial accrued liability increased from $20.68 billion at June 30, 2002 to $23.81 billion at June 30, 2003. The funded ratio decreased from 52.0 percent at June 30, 2002 to 49.3 percent at June 30, 2003.

The Basic Financial Statements contained in this section of the *Comprehensive Annual Financial Report* consist of:

Statement of Plan Net Assets. This section reports the pension trust funds assets, liabilities, and resultant net assets available to pay benefits at the end of the fiscal year. It is the balance sheet of TRS and reflects the financial position of the Teachers' Retirement System as of June 30, 2003.

Statement of Changes in Plan Net Assets. The changes in plan net assets report transactions that occurred during the fiscal year. It is the income statement of TRS and reflects the revenues and expenses recorded throughout the fiscal year. The Statement of Changes in Plan Net Assets supports the change in the value of the net assets reported on the Statement of Plan Net Assets.

Notes to the financial statements. The notes are an integral part of the financial statements and include additional information not readily evident in the statements themselves. The required supplementary information and other schedules following the notes to the financial statements provide historical and additional detailed information considered useful in evaluating the financial condition of the Teachers' Retirement System. The following are condensed comparative financial statements of the TRS pension trust fund.

Condensed Comparative Statement of Plan Net Assets

	As of June 30, 2003	As of June 30, 2002	Increase/(Decrease) Amount	Percentage Change
Cash	$3,651,963	$6,039,088	$(2,387,125)	(39.5)%
Receivables and prepaid expenses	286,769,806	393,200,477	(106,430,671)	(27.1)
Investments	23,935,615,863	22,944,918,073	990,697,790	4.3
Invested securities lending collateral	2,154,422,658	1,897,635,461	256,787,197	13.5
Capital assets	2,630,930	3,113,533	(482,603)	(15.5)
Total assets	**26,383,091,220**	**25,244,906,632**	**1,138,184,588**	**4.5**
Total liabilities	**3,258,268,149**	**2,878,621,920**	**379,646,229**	**13.2**
Net assets	**$23,124,823,071**	**$22,366,284,712**	**$758,538,359**	**3.4**

Condensed Comparative Statement of Changes in Plan Net Assets

	Year Ended June 30, 2003	Year Ended June 30, 2002	Increase/(Decrease) Amount	Percentage Change
Contributions	$1,753,282,676	$1,588,509,682	$164,772,994	10.4%
Total investment income (loss)	1,060,852,111	(723,987,045)	1,784,839,156	246.5
Total additions	2,814,134,787	864,522,637	1,949,612,150	225.5
Benefits and refunds	2,041,737,026	1,798,504,272	243,232,754	13.5
Administrative expenses/transfers	13,859,402	15,379,736	(1,520,334)	(9.9)
Total deductions	2,055,596,428	1,813,884,008	241,712,420	13.3
Net increase (decrease) in net assets	**758,538,359**	**(949,361,371)**	**1,707,899,730**	**179.9**
Net assets beginning of year	**22,366,284,712**	**23,315,646,083**	**(949,361,371)**	**(4.1)**
Net assets end of year	**$23,124,823,071**	**$22,366,284,712**	**$758,538,359**	**3.4%**

FINANCIAL ANALYSIS

TRS was created to provide retirement, survivor, and disability benefits to qualified members. Increases or decreases in plan net assets serve as useful indicators of TRS's financial position. Net assets available to pay benefits were $23.1 and $22.4 billion at June 30, 2003 and 2002, respectively. Net assets increased $759 million during FY03 and decreased $949 million during FY02.

CONTRIBUTIONS

Contributions increased $165 and $123 million during FY03 and FY02, respectively. During FY03, member contributions increased $51 million and employer contributions from school districts decreased $2 million. During FY02, member contributions increased $38 million while employer contributions from school districts decreased $5 million. The decrease in the employer contributions from school districts is attributable to a decrease in the employer contribution rate that was effective mid-year in FY02 and throughout FY03. Contributions from the state of Illinois increased $115 and $91 million in FY03 and FY02, respectively. The state of Illinois provides contributions through state appropriations. The increase in the state contributions were in accordance with actuarial funding requirements determined under Public Act 90-582 which provides for a 50-year funding plan that includes a 15-year phase in period.

INVESTMENTS

The TRS trust fund is invested by authority of the Illinois General Assembly and managed solely in the interest of fund participants and beneficiaries. Principles guiding the investment of funds include preserving the long-term principal of the trust fund and maximizing total return with prudent risk parameters.

Diversification is the cornerstone of the TRS investment philosophy. Investing in a number of broad asset classes helps to minimize the risk associated with a downturn in any single asset class, such as that seen in the equity markets in past years. An additional layer of diversification is provided by employment of multiple investment managers of varying investment styles within each asset class. This broad exposure to markets serves as the portfolio's best defense against the uncertainty of market volatility.

TRS investments resulted in a 4.9 and (3.2) percent rate of return, net of fees, for FY03 and FY02, respectively. Total investments increased $1 billion from $22.9 billion at June 30, 2002 to $23.9 billion at June 30, 2003. The five- and 10-year returns are 3.6 percent and 8.4 percent, respectively. The 10-year return falls just slightly short of the actuarial assumption rate of 8.5 percent.

Fiscal year 2003 ended with a long-awaited return to positive performance in the world financial markets. A conservative investment approach and broad diversification continued to result in a favorable performance when compared to its peers. For the second consecutive year TRS surpassed the returns of over 84 percent of large public funds.

BENEFITS AND REFUNDS

Survivor, disability, and retirement benefit payments increased $239 and $193 million during FY03 and FY02, respectively. During FY03, benefit payments increased from $1,760 million with 67,949 recipients during FY02 to $1,999 million with 73,431 recipients. The overall increase in benefit payments is due mainly to an increase in retirement benefit payments. Retirement benefits increased as a result of an automatic 3 percent annual increase in retirement benefits, an increase in the number of retirees from 59,360 as of June 30, 2002 to 64,702 as of June 30, 2003, and an increase in the final average salaries of teachers that retired during the fiscal year.

Refunds of contributions increased $4 and $3 million during FY03 and FY02, respectively. The increase in refunds is a result of increases in 2.2 upgrade contribution refunds, withdrawal of contributions by members leaving teaching, and an increase in survivor benefit refunds.

ACTUARIAL

The annual actuarial valuation measures the total liability for all benefits earned to date. The accrued liability is a present value estimate of all the benefits that have been earned to date. The actuarial accrued liability increased $3.89 and $3.88 billion during FY03 and FY02, respectively to $46.93 billion at June 30, 2003 and $43.05 billion at June 30, 2002. The unfunded liability is the present value of future benefits payable that are not covered by assets as of the valuation date. The unfunded liability increased $3.13 and $4.83 billion during FY03 and FY02, respectively, to $23.81 billion at June 30, 2003 and $20.68 billion at June 30, 2002. The funded ratio reflects the percentage of the accrued liability covered by net assets at market value. The funded ratio decreased from 52.0 percent at June 30, 2002 to 49.3 percent at June 30, 2003. Increases in the unfunded liability and decreases in the funded ratio indicate a decline in a system's financial position.

To comply with the Illinois Pension Code, an actuarial experience analysis is performed once every five years to review the actuarial assumptions. In FY02, TRS's actuaries conducted an experience analysis of the previous five-year period ended June 30, 2001. The analysis resulted in a decrease in the salary increase assumption, a decrease in the inflation rate assumption, higher rates of retirement, and minor changes in several other assumptions. The net effect of all the actuarial changes decreased the June 30, 2002, actuarial accrued liability by approximately $346 million compared to the accrued liability that would have been calculated under the old assumptions.

GASB Statement Number 34 requires the Management Discussion and Analysis to include a description of currently known facts expected to have a significant effect on TRS's financial position. On July 2, 2003, TRS received $4.33 billion in bond proceeds from the state of Illinois. These funds represented a portion of the $10 billion of general obligation bonds issued by the state of Illinois for the purpose of reducing the unfunded liabilities for Teachers' Retirement System, State Employees' Retirement System, State Universities Retirement System, General Assembly Retirement System, and Judges' Retirement System. Because the bond proceeds were an appropriation for FY04, the $4.33 billion received is not reflected in this report. If the proceeds had been included, the funded ratio would have increased from 49.3 percent to 58.5 percent.

BASIC FINANCIAL STATEMENTS

Teachers' Retirement System of the State of Illinois
Statement of Plan Net Assets as of
June 30, 2003, and 2002

	2003	2002
Assets		
Cash	$3,651,963	$6,039,088
Receivables and prepaid expenses		
Member payroll deduction	69,189,321	111,106,770
Member contributions	39,383,845	38,806,046
Employer contributions	7,379,497	8,811,602
State of Illinois	2,965,709	651,505
Investment income	165,638,540	233,414,394
Prepaid expenses	2,212,894	410,160
Total receivables and prepaid expenses	286,769,806	393,200,477
Investments, at fair value		
Fixed income	7,314,849,657	8,795,239,241
Equities	12,649,352,623	10,126,648,199
Real estate	2,412,293,598	2,202,925,998
Short-term investments	866,824,921	1,201,995,818
Private equity investments	668,389,537	594,153,359
Foreign currency	23,905,527	23,955,458
Total investments	23,935,615,863	22,944,918,073
Collateral from securities lending	2,154,422,658	1,897,635,461
Property and equipment, at cost, net of accumulated depreciation of $6,456,750 and $6,216,008 in 2003 and 2002, respectively	2,630,930	3,113,533
Total assets	**26,383,091,220**	**25,244,906,632**
Liabilities		
Benefits and refunds payable	8,633,145	7,204,169
Administrative and investment expenses payable	75,872,933	81,017,997
Payable to brokers for unsettled trades, net	1,019,339,413	892,764,293
Securities lending transactions	2,154,422,658	1,897,635,461
Total liabilities	**3,258,268,149**	**2,878,621,920**
Net assets held in trust for pension benefits	**$23,124,823,071**	**$22,366,284,712**

(A schedule of funding progress is presented on page 37.)

The accompanying notes are an integral part of these statements.

Teachers' Retirement System of the State of Illinois
Statement of Changes in Plan Net Assets
Years ended June 30, 2003, and 2002

	2003	2002
Additions		
Contributions		
Members	$732,020,451	$681,151,770
State of Illinois	929,709,762	814,739,766
Employers		
Early retirement	46,773,190	41,347,938
Federal funds	33,354,836	26,282,792
2.2 benefit formula	11,424,437	24,987,416
Total contributions	1,753,282,676	1,588,509,682
Investment income		
From investment activities		
Net appreciation (depreciation) in fair value	467,463,329	(1,461,163,444)
Interest	343,075,998	463,758,715
Real estate operating income, net	184,785,558	174,430,870
Dividends	139,831,006	132,356,304
Private equity income	8,887,682	28,036,960
Other investment income	3,560,189	13,640,070
Investment activity income (loss)	1,147,603,762	(648,940,525)
Less investment expense	(92,431,726)	(86,308,190)
Net investment activity income (loss)	1,055,172,036	(735,248,715)
From securities lending activities		
Securities lending income	28,660,317	59,315,009
Securities lending management fees	(1,420,317)	(2,816,327)
Securities lending borrower rebates	(21,559,925)	(45,237,012)
Net security lending activity income	5,680,075	11,261,670
Total investment income (loss)	1,060,852,111	(723,987,045)
Total additions	**2,814,134,787**	**864,522,637**
Deductions		
Retirement benefits	1,890,511,562	1,660,997,776
Survivor benefits	88,996,829	80,461,343
Disability benefits	19,113,893	18,289,549
Refunds	43,114,742	38,755,604
Administrative expenses	13,859,402	13,487,393
Prior service credits and transfers	0	1,892,343
Total deductions	**2,055,596,428**	**1,813,884,008**
Net increase (decrease)	**758,538,359**	**(949,361,371)**
Net assets held in trust for pension benefits		
Beginning of year	22,366,284,712	23,315,646,083
End of year	**$23,124,823,071**	**$22,366,284,712**

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS

A. PLAN DESCRIPTION

1. Reporting Entity

The Teachers' Retirement System of the State of Illinois (TRS) is the administrator of a cost-sharing multiple-employer defined benefit public employee retirement system (PERS). Membership is mandatory for all full-time, part-time, and substitute public school personnel employed outside of Chicago in positions requiring certification. Persons employed at certain state agencies are also members. Established by the state of Illinois, TRS is governed by the Illinois Pension Code (40 ILCS 5/16). TRS is a component unit of the state of Illinois and is included in the state's financial statements as a pension trust fund.

TRS uses criteria established by the Governmental Accounting Standards Board (GASB) to determine whether other entities should be included within its financial reporting entity. Based on the criteria, TRS includes no other entities in these financial statements.

2. Employers

Members of TRS are employed by school districts, special districts, and certain state agencies. Each employer remits member contributions to TRS. Employers are responsible for employer contributions for teachers paid from federal funds and for the employer's portion of the Early Retirement Option contributions. Effective July 1, 1998, Public Act 90-582 required employers to pay an employer contribution equal to 0.3 percent of covered payroll during FY99. The contribution was increased to 0.58 percent of covered payroll from July 1, 2000 through December 31, 2001. For the period January 1, 2002 through June 30, 2003, the employer contribution was reduced to 0.18 percent of covered payroll. In addition, the state of Illinois provides employer contributions. For information about employer contributions made by the state of Illinois, see "Funding" on page 26.

Number of Employers (as of June 30)

	2003	2002
Local school districts	890	890
Special districts	141	140
State agencies	27	27
Total	**1,058**	**1,057**

3. Members

TRS Membership (as of June 30)

	2003	2002
Retirees and beneficiaries receiving benefits	73,431	67,949
Inactive members entitled to but not yet receiving benefits	86,279	66,971
Active members	152,117	155,979
Total	**311,827**	**290,899**

4. Benefit Provisions

Governed by the Illinois Pension Code (40 ILCS 5/16), which is subject to amendment by the Illinois General Assembly and approval by the Governor, TRS provides retirement, death, and disability benefits. A member qualifies for an age retirement annuity after meeting one of the following requirements: age 62 with five years of service credit; age 60 with 10 years; or age 55 with 20 years. If a member retires between the ages of 55 and 60 with fewer than 35 years of service, the annuity will be reduced at the rate of 0.50 percent for each month the member is under age 60. A member who is age 55 and has fewer than 35 years of service credit may use the Early Retirement Option (ERO) to avoid a discount for early retirement if retirement occurs before July 1, 2005, and within six months of the last day of service requiring contributions, and if the member and employer both make a one-time contribution to TRS. However, both member and employer contributions are waived with 34 years of service. A member with fewer than five years of creditable service and service on or after July 1, 1947, is entitled to a single-sum benefit payable once he or she reaches age 65.

A retirement benefit is determined by the average salary of the four highest consecutive salary rates within the last 10 years of creditable service and the percentage of average salary to which the member is entitled. This percentage is determined by the following formula for service earned before July 1, 1998: 1.67 percent for each of the first 10 years, plus 1.9 percent for each of the next 10 years, plus 2.1 percent for each of the next 10 years, plus 2.3 percent for each year over 30 years. The maximum retirement benefit, 75 percent of average salary, is achieved with 38 years of service under the graduated formula.

Public Act 90-582 improved retirement benefits for TRS members by changing the rate at which members accrue benefits beginning July 1, 1998, from a graduated rate to a flat rate equal to 2.2 percent of final average salary. Members may attain the maximum 75 percent benefit with 34 years of service under the 2.2 benefit formula. Members retiring on or after the effective date have the option of upgrading their service earned prior to July 1, 1998, to the flat 2.2 percent formula by making a payment to TRS. Additionally, for members who continue to teach, every three full years worked after July 1, 1998, count toward a full one-year reduction of the years to be upgraded.

A money purchase (actuarial) benefit is payable if it results in a higher annuity than either the graduated or 2.2 formula. The 75 percent cap does not apply to the money purchase benefit.

Essentially all retirees receive an annual 3 percent increase in the current retirement benefit beginning January 1 following the attainment of age 61 or January 1 following the first anniversary in retirement, whichever is later.

If a member leaves covered employment, TRS will refund a member's retirement contributions upon request. The refund consists of actual contributions, excluding the 1 percent death benefit contribution.

On June 25, 2002, Governor Ryan signed the State Employee 5&5 Early Retirement Incentive (Public Act 92-0566) into law.

Under the terms of this legislation, a TRS member employed by a state agency could elect to purchase five years of service credit and enhanced age. The member had to pay TRS an employee contribution based on the member's highest annual salary rate used in the determination of final average salary. The required 5&5 contribution had to be deducted from any lump-sum payment at termination.

If there was no lump sum or if the lump sum was less than the contribution required, the remaining amount due was treated as a reduction from the retirement annuity in 24 equal monthly installments. A member had to retire between August 1, 2002 and December 31, 2002 unless extended by the agency director to a date no later than April 30, 2003.

5. Funding

Member, employer, and state contributions are statutorily defined by the Illinois Pension Code (40 ILCS 5/16), which is subject to amendment by the Illinois General Assembly and approval by the Governor.

Effective July 1, 1998, member contributions increased from 8 percent to 9 percent of salary. These contributions are allocated as follows: 7.5 percent for retirement, 0.50 percent for post-retirement increases, and 1 percent for death benefits.

Employer contributions are made by or on behalf of the employers from several sources. The state of Illinois provides a large source of contributions through state appropriations from the Common School Fund and Education Assistance Fund. Additional sources of state contributions are the State Pensions Fund and the General Revenue Fund. Effective July 1, 1998, the state began making contributions for the 2.2 benefit formula that are included in statutorily specified minimum state contribution rates. Employers also make contributions for the 2.2 benefit formula and for teachers who are paid from federal funds. Additionally, employers contribute their portion of the cost of the Early Retirement Option.

The actuarial funding requirements for FY03 and FY02 were determined under Public Act 90-582. State funding law provides for a 50-year funding plan that includes a 15-year phase-in period. Minimum state contribution rates are specified in the statute for FY99 through FY04. Public Act 93-002, first effective in FY05, establishes a procedure for calculating state contributions after the receipt of pension obligation bond proceeds in early FY04. This procedure will continue through FY33. TRS's funded ratio will be 90 percent at the end of the 50-year period. Beginning July 1, 1995, state contributions have been made through a continuing appropriation instead of through the appropriations process.

Administrative expenses are budgeted and approved by the TRS Board of Trustees. Funding for these expenses is included in the employer contribution, as determined by the annual actuarial valuation.

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Basis of Accounting

TRS's financial statements are prepared using the accrual basis of accounting. Member and employer contributions are recognized as revenues in the period in which member services are performed. Benefits and refunds are recognized as expenditures when they are due and payable in accordance with the terms of the plan.

2. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions to and deductions from net assets during the reporting period. Actual results could differ from those estimates.

3. New Accounting Pronouncements

In March 2003, the Governmental Accounting Standards Board (GASB) issued Statement No. 40, "Deposit and Investment Risk Disclosures" an amendment of GASB Statement No. 3. The statement establishes and modifies disclosure requirements related to investment risks: credit risk (including custodial credit risk and concentrations of credit risk), interest rate risk, and foreign currency risk. This statement also establishes and modifies disclosure requirements for deposit risks: custodial credit risk, and foreign currency risk. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2004.

4. Method Used to Value Investments

TRS reports investments at fair value. Fair value for equities is determined by using the closing price listed on national and over-the-counter securities exchanges as of June 30. Fair value for fixed income securities is determined principally by using quoted market prices provided by independent pricing services. Fair value for real estate investments is determined by appraisals. Fair value for private equity assets is determined by the general partner in accordance with the provisions of the individual equity agreements.

5. Property and Equipment

Equipment is stated on the basis of historical cost. Depreciation is computed using the straight-line method based upon the estimated useful lives of the assets. Office furniture and equipment are assigned a useful life of three to 10 years while vehicles are assigned a five-year life. TRS's office building is depreciated over 40 years.

6. Accrued Compensated Absences

When they terminate employment, TRS employees are entitled to receive compensation for all accrued but unused vacation time and one-half of all unused sick leave earned through December 31, 1997. (Lump-sum payments for sick leave earned prior to January 1, 1984, are subject to a maximum of 60 days or 420 hours.) Accrued compensated absences as of June 30, 2003, and 2002 totaled $1,390,654 and $1,360,953 respectively, and are included as administrative and investment expenses payable.

7. Receivables

Receivables consist primarily of 1) member and employer contributions owed and yet to be remitted by the employing districts as of June 30 and 2) interest, dividends and real estate income owed to TRS as of June 30.

TRS assesses penalties for late payment of contributions and may collect any unpaid amounts from the employing districts by filing a claim with the regional superintendent of education or the Office of the Comptroller against future state aid payments to the employer. TRS considers these amounts to be fully collectible.

Members may enter into Payroll Deduction Program agreements with their employers to pay for their optional service balances, to repay refunds previously taken from TRS, to pay for their 2.2 benefit formula upgrade balances, or to pay estimated ERO contributions. Terms and conditions of the agreements are:

- A member must be employed full time.
- The agreement is irrevocable and can be terminated only upon full payment of the member's balance or upon the member's death, disability, retirement, or termination of employment.
- The amount deducted must be a minimum of $50 per month and cannot be changed during the term of the agreement.
- Agreements may begin at the beginning of each calendar year quarter.
- The member may not make direct payments to TRS to reduce the balance under which an agreement has been entered.

If the agreement is to pay for a 2.2 formula upgrade balance, the maximum length of the agreement is 60 months. TRS had outstanding balances in payroll deduction agreements totalling $69,189,321 and $111,106,770 as of June 30, 2003, and 2002, respectively.

8. Prior Period Reclassification

Certain prior year amounts have been reclassified on a basis consistent with the current year presentation.

C. CASH

The bank balance and carrying amount of TRS's deposits were $3,353,886 and $3,651,963 at June 30, 2003, and $2,281,489 and $6,039,088 at June 30, 2002. Of the bank balance, $1,764,260 and $303,041 were on deposit with the state treasurer at June 30, 2003, and 2002, respectively. Bank balances are either insured or collateralized with securities held by the state treasurer or agents in the name of the state treasurer or are collateralized with securities held by TRS or its agents in the name of TRS. Cash equivalents are classified as short-term investments in the Statement of Plan Net Assets.

Investment Summary

	Fair Value	
	2003	**2002**
Category 1		
Government obligations	$2,621,779,743	$4,943,310,948
Corporate obligations	2,581,192,122	2,345,278,328
Preferred stock	122,216,598	100,963,556
Short-term investments		
Commercial paper (including short-term collateral and other)	131,576,415	38,255,078
U.S. Treasury bills	110,756,857	77,397,673
Common stock	6,389,798,694	4,843,826,185
	11,957,320,429	**12,349,031,768**
Not Categorized		
Investments held by broker-dealers under securities loans		
Government obligations	881,558,768	1,201,846,412
Corporate obligations	227,264,276	229,571,417
Common stock	1,296,002,734	894,790,840
Real estate equity	2,272,624,364	2,134,439,485
Mutual funds	5,874,851,004	4,355,554,131
Private equity investments		
Limited partnerships	668,389,537	594,153,359
Foreign currency	23,905,527	23,955,458
Collective investment funds (U.S. dollars)	735,248,505	1,163,740,739
Security lending short-term collateral investment pool	2,152,873,377	1,895,469,925
Investments and collateral from securities lending	26,090,038,521	24,842,553,534
Less collateral from securities lending	(2,154,422,658)	(1,897,635,461)
Total investments*	**$23,935,615,863**	**$22,944,918,073**

** This total does not include accrued income.*

D. INVESTMENTS

1. Investment Policies

Through the Board of Trustees, as authorized in the Illinois Pension Code, TRS serves as fiduciary for the members' trust funds and is responsible for investment of those funds by authority of the "prudent person rule." This rule establishes a standard for all fiduciaries by specifying fiduciary responsibility with regard to the members' trust funds.

2. Investment Summary

The Investment Summary table presents a summary of TRS's investments and related category of custodial credit risk at June 30, 2003, and 2002. TRS's investments are categorized to give an indication of the level of risk at year end.

Category 1 includes investments that are insured or registered, or for which the securities are held by TRS or its agent in the name of TRS. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department in TRS's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty but not in TRS's name. As of June 30, 2003, and 2002, TRS holds no securities classified in either Category 2 or Category 3.

TRS has nonrecourse mortgages totalling $614,593,685 and $292,888,883 on real estate equities at June 30, 2003, and 2002, respectively. The amount reported for real estate equity is net of these mortgages, which mature on various dates through the year 2018.

The real estate equity category includes $5,575,540 and $31,212,240 of mortgages receivable which are fully secured by the properties at June 30, 2003, and 2002, respectively.

At June 30, 2003, and 2002, TRS did not have any investments in one organization that exceeded 5 percent of net assets held in trust for pension benefits.

3. Securities Lending Program

The Board of Trustees' policies permit TRS to use investments to enter into securities lending transactions — loans of securities to broker-dealers and other entities for collateral with a simultaneous agreement to return the collateral for the same securities in the future. TRS's master trustee is the agent in lending the plan's domestic securities for cash collateral of 102 percent of the market value of the securities and international securities for cash collateral of 105 percent of the market value of the securities. Securities on loan at year-end are presented as not categorized in the preceding schedule of custodial credit risk.

At year-end, TRS has no credit risk exposure to borrowers because the amount TRS owes the borrowers exceeds the amount the borrowers owe TRS. The contract with TRS's lending agent requires the agent to indemnify TRS if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay TRS for income distributions by the securities issuers while the securities are on loan. All securities loans can be terminated on demand either by TRS or the borrower, although the average term of the loans is 55 days. In lending domestic securities, cash collateral is invested in the lending agent's short-term investment pool, which at year-end has a weighted average maturity of 70 days. There were no significant violations of legal or contractual provisions, and there were no borrower or lending agent default losses known to the securities lending agent.

As of June 30, 2003, and 2002, TRS had outstanding loaned investment securities having a market value of $2,404,825,778 and $2,326,208,668, respectively, against which it had received collateral of $2,487,998,438 and $2,419,253,253, respectively. Collateral from securities lending reflected on the Statement of Plan Net Assets consists primarily of collateral received in the form of cash.

4. Derivatives

TRS invests in derivative securities. A derivative security is an investment where the return depends upon the value of other assets such as commodity prices, bond and stock prices, or a market index. To varying degrees, derivative transactions involve credit risk and market risk. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to the established terms. To eliminate credit risk, derivative securities are generally acquired through a clearinghouse that guarantees delivery and accepts the risk of default by either party.

Market risk is the possibility that a change in interest or currency rates will cause the value of a financial instrument to decrease or become more costly to settle. Imposing limits on the types, amounts, and degree of risk that investment managers may undertake regulates the market risk associated with the constantly fluctuating prices of derivatives. These limits are approved by the Board of Trustees and senior management, and the risk positions of the investment managers are reviewed on a regular basis to monitor compliance with the limits.

During the year, TRS's derivative investments included foreign currency forward contracts, index futures, and options. Derivative contracts are used by experienced investment personnel to implement tactical strategies upon the portfolio in a cost-effective manner.

Foreign Currency Forward Contracts

Objective: Foreign currency forward contracts are agreements to exchange the currency of one country for the currency of another country at an agreed-upon price and settlement date. TRS uses these contracts primarily to hedge the currency exposure of its investments.

Terms: Foreign currency forward contracts are in the form of either forward purchases or forward sales of foreign currency. Forward purchases obligate TRS to purchase specific foreign currency at an agreed upon price. Forward sales obligate TRS to sell specific foreign currency at an agreed upon price. At June 30, 2003, and June 30, 2002, foreign currency forward purchase or sell contracts include primarily the following currencies: Swedish krona, euro, Brazilian real, Japanese yen, Canadian dollar, Swiss franc, British pound sterling, Danish krone, and Australian dollar. These contracts have various settlement dates within 12 months of June 30, 2003.

Fair Value: As of June 30, 2003, and June 30, 2002, TRS's open foreign currency forward contracts had a net negative fair value of ($464,426) and ($6,294,570), respectively.

Market Value	as of June 30, 2003	as of June 30, 2002
Forward currency purchases	$578,413,212	$1,203,574,487
Forward currency sales	(578,877,638)	(1,209,869,057)
Unrealized gain/(loss)	(464,426)	(6,294,570)

Financial Futures

Objective: Financial futures are agreements to purchase or sell a specific amount of an asset at a specified delivery or maturity date for an agreed upon price. These derivative securities are used to improve yield, adjust the duration of the fixed income portfolio, circumvent changes in interest rates, or to replicate an index.

Terms: Futures contracts are standardized and traded on organized exchanges, thereby minimizing TRS's credit risk. As the market value of the futures contract varies from the original contract price, a gain or a loss is recognized and paid to or received from the clearinghouse. At June 30, 2003, and June 30, 2002, TRS had outstanding futures contracts with an underlying notional value of $1,149,927,012 and $1,122,593,616, respectively. Contractual principal values do not represent the actual values in the Statement of Plan Net Assets. The contracts have various expiration dates through March 2005.

Fair Value: Gains and losses on futures contracts are settled daily based on the change of the index price for the underlying notional value. Because of daily settlement, the futures contracts have no fair value.

Type	FY03 Number of Contracts	FY03 Contractual Principal	FY02 Number of Contracts	FY02 Contractual Principal
Fixed Income Index Futures (net)	269	$31,576,813	2,087	$224,125,141
International Fixed Income Index Futures (net)	69	8,980,674	0	0
Stock Index Futures (net)	3,998	972,813,350	3,175	785,891,875
Currency Index Futures (net)	554	136,556,175	461	112,576,600
Total		**$1,149,927,012**		**$1,122,593,616**

Financial Options

Objective: Financial options are agreements that give one party the right, but not the obligation, to buy or sell a specific amount of an asset for a specified price, called the strike price, on or before a specified expiration date. As a writer of financial options, TRS receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the financial instrument underlying the option. Accordingly, it is against TRS policy to invest in any uncovered options. Premiums received are recorded as a liability when the financial option is written.

Terms: At June 30, 2003, TRS had outstanding options contracts with an underlying notional value of $25,184,500. Contractual principal values do not represent the actual values in the Statement of Plan Net Assets. The contracts have various expiration dates through April 2005.

Fair Value: Fluctuations in the fair value of financial options are recognized in TRS's financial statements as incurred rather than at the time the options are exercised or when they expire. As of June 30, 2003, and 2002, the fair value of option contracts written was ($464,047) and ($664,528), respectively. The fair value represents the amount needed to close all positions as of that date. The table below presents the aggregate contractual principal (notional value) of TRS's outstanding contracts at June 30, 2003, and 2002.

Type	FY03 Number of Contracts	FY03 Contractual Principal	FY03 Fair Value	FY02 Number of Contracts	FY02 Contractual Principal	FY02 Fair Value
Fixed Income Written Call Options	367	$9,093,000	($68,797)	343	$14,110,800	($474,375)
Fixed Income Written Put Options	4,178	7,939,000	(327,125)	3,300	0	3
Currency Written Put Options	650	8,152,500	(68,125)	6,161	84,581,500	(190,156)
Total			**($464,047)**			**($664,528)**

Contractual principal amounts are often used to express the volume of these transactions, but do not reflect the extent to which positions may offset one another. These amounts do not represent the much smaller amounts potentially subject to risk.

E. RESERVES

TRS maintains statutory reserve accounts in accordance with the provisions of 40 ILCS 5/16-101 *et seq.* In 1997, the Illinois General Assembly passed legislation that allowed the crediting of income at fair value, as opposed to book value, to the Employer's Contribution Reserve.

1. Members' Contribution

	2003	2002
Balances at June 30	$9,780,678,167	$9,167,409,595

This reserve accumulates, with 6 percent interest, the contributions by members prior to retirement. Contributions have been 7.5 percent of salary since July 1, 1998. Contributions are fully refundable upon withdrawal from TRS, excluding interest credited thereon. The interest accrued is refundable only in the event of death. Interest is credited as of the date of retirement or death of those retiring or dying during the year and as of the end of the fiscal year for all other members. Interest is computed annually based upon the individual member's balance in the reserve at the beginning of the fiscal year. This reserve is fully funded.

Effective July 1, 2003, Public Act 93-0469 will combine the Member's and Employer's Contribution Reserves into a new Benefit Trust Reserve.

2. Minimum Retirement Annuity

	2003	2002
Balances at June 30	$3,719,746	$3,479,416

The minimum annuity is set by law at $25 per month for each year of creditable service to a maximum of $750 per month after 30 or more years of creditable service. To qualify, annuitants are required to make a one-time contribution that is credited to the reserve. Interest at 6 percent is credited to the reserve annually based upon the average reserve balance. The state of Illinois also appropriated funds necessary to pay the minimum benefits provided in the legislation. All benefits paid under this program are charged to the reserve. This reserve is fully funded.

3. Employer's Contribution

	2003	2002
Balances at June 30	$13,340,425,158	$13,195,395,701

This reserve serves as a clearing account for TRS income and expenses. The reserve is credited with contributions from the state of Illinois that are not specifically allocated to other reserves, member and employer contributions, income from TRS invested assets, the interest portion of the accumulated contributions of members who are granted refunds, and contributions from annuitants who qualify for automatic annual increases in annuity. The reserve is charged with amounts necessary to be transferred to the Members' Contribution Reserve, all amounts necessary to be refunded to withdrawing members, all retirement annuity payments except as provided by other reserve accounts, all benefits that are paid to temporarily or accidentally disabled members, all death benefits that are paid, and all survivor benefit contributions that are refunded to annuitants.

This reserve does not equal the present value of expected benefit payments. The additional amount needed (the unfunded actuarial accrued liability) as calculated by the actuary was $23,808,609,000 in 2003 and $20,681,389,000 in 2002.

Effective July 1, 2003, Public Act 93-0469 will combine the Member's and Employer's Contribution Reserves into a new Benefit Trust Reserve.

F. TRS EMPLOYEE PENSION BENEFITS

1. Plan Description

All full-time TRS employees who are not eligible to participate in TRS participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the state of Illinois reporting entity. SERS is a single-employer defined benefit public employee retirement system (PERS) in which state employees participate, except those who are covered by the State Universities Retirement System, Teachers' Retirement System, General Assembly Retirement System, and Judges' Retirement System. SERS's financial position and results of operations for FY03 and FY02 are included in the state of Illinois' Comprehensive Annual Financial Report (CAFR) for the years ended June 30, 2003, and 2002, respectively. SERS also issues a separate CAFR that may be obtained by writing to SERS, 2101 South Veterans Parkway, Springfield, Illinois 62794-9255 or by calling (217) 785-7444. The state of Illinois CAFR may be obtained by writing to Office of the Comptroller, Financial Reporting Department, 325 West Adams Street, Springfield, Illinois 62704-1858 or by calling (217) 782-2053.

A summary of SERS's benefit provisions; changes in benefit provisions; employee eligibility requirements, including eligibility for vesting; and the authority under which benefit provisions are established are included as an integral part of the SERS CAFR. Also included is a discussion of employer and employee obligations to contribute and the authority under which those obligations are established.

2. Funding Policy

TRS pays employer retirement contributions to SERS based on an actuarially determined percentage of the TRS employee payroll representing TRS employees who are members of SERS. For FY03, FY02, and FY01, the SERS employer contribution rates were 10.321 percent, 10.040 percent, and 9.944 percent, respectively. TRS made the required contributions to SERS for the current year and each of the two preceding years. TRS contributions for the years ending FY03, FY02, and FY01 were $541,552, $529,400, and $523,129, respectively. Effective for pay periods beginning after July 1, 1993, the TRS Board of Trustees opted to pay the employee contribution for all employees. The contribution pickup (4 percent for SERS members, 9 percent for TRS members beginning in FY02 and 8 percent for TRS members in prior years) was included in the FY03 and FY02 administrative budgets approved by the board.

TRS pays an employer contribution for its employees who are members of TRS. Additional employer contributions for these employees are paid by the state of Illinois and are included in the annual state contribution to TRS.

3. Post-Employment Benefits – TRS Employees

In addition to providing pension benefits, the State Employees Group Insurance Act of 1971 requires certain health, dental, and life insurance benefits be provided by the state. Substantially, all TRS employees may become eligible for post-employment benefits if they eventually become annuitants. Health and dental benefits include basic benefits for TRS retirees under the state's self-insurance plan and insurance contracts currently in force. Life insurance benefits are limited to $5,000 per annuitant who is age 60 or older.

Costs incurred for health, dental, and life insurance for annuitants and their dependents were not separated from benefits that were provided to active employees and their dependents for the years ended June 30, 2003, and 2002. However, post-employment costs for the state as a whole for all state agencies or departments for dependent health, dental, and life insurance for annuitants and their dependents are disclosed in the state's Comprehensive Annual Financial Report. Cost information for retirees by individual state agency is not available. Payments are made on a "pay-as-you-go" basis.

G. SUBSEQUENT EVENTS

House Bill 2660 became law on April 7, 2003. Public Act 93-002 authorized the state of Illinois to issue $10 billion in general obligation bonds for the purpose of making contributions to designated retirement systems. TRS is one of the designated retirement systems for the purpose of this new law. In addition, the Pension Contribution Fund was created as a special fund in the state treasury.

On June 12, 2003, the state of Illinois issued $10 billion in general obligation bonds, pension funding series of June 2003, and deposited the net bond proceeds of $7,317,292,916 into the Pension Contribution Fund. Bond proceeds of $2,682,707,084 will be utilized

- to reimburse the General Revenue Fund $2,160,000,000 for the last quarter of the state's FY03 required contributions and the total FY04 required contributions to the designated retirement systems, and
- to fund $481,038,334 in interest payments due December 1, 2003 and June 1, 2004 on the general obligation bonds, pension funding series of June 2003, and
- to fund bond issuance and other costs totaling $41,668,750.

The net bond proceeds of $7,317,292,916 were allocated among the five state-funded retirement systems to reduce their actuarial reserve deficiencies as provided in Public Act 93-0002. Pursuant to the amendments to the General Obligation Bond Act (30 ILCS 330/7.2), the Governor's Office of Management and Budget has determined the percentage distribution of the proceeds. The allocation of the proceeds was based on the percentage distribution of the state's total actuarial reserve deficiency as of June 30, 2002.

TRS received an allocation of bonds proceeds equal to $4,330,373,948 on July 1, 2003. The monies were deposited into TRS's Master Trust account with The Northern Trust Company on July 2, 2003.

REQUIRED SUPPLEMENTARY INFORMATION

Schedule of Funding Progress[1]

Actuarial Valuation Date	Actuarial Value of Assets (a)	Accrued Liability (AAL-Projected Unit Credit) (b)	Funded Ratio (a)/(b)	Unfunded Actuarial Accrued Liability (UAAL) (b) - (a)	Covered Payroll (c)	Unfunded Actuarial Accrued Liability as a Percentage of Covered Payroll (b-a)/(c)
6/30/96	$15,103,927,000	$26,141,794,000	57.8%	$11,037,867,000	$4,734,250,000	233.1%
6/30/97	17,393,108,000	26,951,585,000	64.5	9,558,477,000	5,013,583,000	190.7
6/30/98	19,965,887,000	29,908,241,000	66.8	9,942,354,000	5,323,403,000	186.8
6/30/99	22,237,709,000	33,205,513,000	67.0	10,967,804,000	5,698,117,000	192.5
6/30/00	24,481,413,000	35,886,404,000	68.2	11,404,991,000	6,062,884,000	188.1
6/30/01	23,315,646,000	39,166,697,000	59.5	15,851,051,000	6,430,612,000	246.5
6/30/02	22,366,285,000	43,047,674,000	52.0	20,681,389,000	6,785,236,000	304.8
6/30/03	**23,124,823,000**	**46,933,432,000**	**49.3**	**23,808,609,000**	**7,059,032,000**	**337.3**

Schedule of Contributions from Employers and Other Contributing Entities[1]

Year Ended June 30	State Contributions[2]	Federal and Employer Contributions[2]	Total	Annual Required Contribution per GASB Statement #25	Percentage Contributed	Annual Required Contribution per State Statute	Percentage Contributed
1996	$324,276,000	$16,997,000	$341,273,000	$1,350,997,000	25.3%	$341,276,000	100.0%
1997	377,969,000	17,379,000	395,348,000	927,842,000	42.6	395,269,000	100.0
1998	460,439,000	17,246,000	477,685,000	983,312,000	48.6	478,439,000	99.8
1999	567,068,000	36,535,000	603,603,000	932,909,000	64.7	592,547,000	101.9
2000	634,039,000	54,547,000	688,586,000	1,003,612,000	68.6	686,384,000	100.3
2001	719,357,000	58,985,000	778,342,000	1,102,441,000	70.6	775,732,000	100.3
2002	810,619,000	51,270,000	861,889,000	1,163,262,000	74.1	872,283,000	98.8
2003	**926,066,000**	**44,779,000**	**970,845,000**	**1,427,519,000**	**68.0**	**963,858,000**	**100.7**

1 *For consistency with figures reported by TRS's actuaries, the amounts have been rounded to the nearest thousand. Actual contributions varied slightly from contributions that are required by statute mainly because of differences between estimated and actual federal contributions.*

In FY02, the annual contribution required per state statute is the state funding requirement certified before Public Act 92-505 was enacted. This act allowed districts to reduce their contributions to TRS by the amount they contributed to the Teachers' Health Insurance Security Fund. The diversion was effective January 1, 2002 through June 30, 2003.

In FY03, the annual contributions required per state statute is the state funding requirement certified after Public Act 92-505 was enacted. The diversion to THIS Fund was effective for the entire fiscal year.

2 *Excludes ERO, ERI, minimum retirement, and supplemental annuity contributions. Beginning in FY01, the supplemental annuity appropriation was not requested. These amounts are not counted for actuarial purposes.*

See accompanying Independent Auditors' Report.

NOTES TO REQUIRED SUPPLEMENTARY INFORMATION

Valuation Dates	June 30, 2003	June 30, 2002
Actuarial cost method:	Projected unit credit	Projected unit credit
Amortization method:		
a) For GASB Statement #25 reporting purposes	Level percent of payroll	Level percent of payroll
b) Per state statute	15-year phase-in to a level percent of payroll until a 90% funding level is achieved Minimum state contribution rates in statute include cost 2.2 benefit formula change as a level percent of payroll	15-year phase-in to a level percent of payroll until a 90% funding level is achieved Minimum state contribution rates in statute include cost 2.2 benefit formula change as a level percent of payroll
Remaining amortization period:		
a) For GASB Statement #25 reporting purposes	40 years, open	40 years, open
b) Per state statute	42 years, closed	43 years, closed
Asset valuation method:	Fair value	Fair value
Actuarial assumptions:		
Investment rate of return	8.5%	8.5%
Projected salary increases	5.9-10.1% composite 6.5%	5.9-10.1% composite 6.5%
Group size growth rate	0%	0%
Assumed inflation rate	3.5%	3.5%
Post-retirement increase	3% compounded	3% compounded
Mortality table	1995 Buck Mortality Tables (rated forward three years for male benefit recipients only)	1995 Buck Mortality Tables (rated forward three years for male benefit recipients only)

See accompanying Independent Auditors' Report.

OTHER SUPPLEMENTARY INFORMATION

Schedule of Administrative Expenses
(for years ended June 30)

	2003	2002
Personal services	$9,499,683	$9,328,695
Professional services	1,385,493	1,434,574
Postage	488,524	390,748
Machine repair and rental	553,562	473,750
Other contractual services	716,257	657,504
Commodities	488,669	396,268
Occupancy expense	194,205	174,040
Depreciation	532,511	631,520
Loss on disposal of equipment	498	294
Total administrative expenses	**$13,859,402**	**$13,487,393**

Schedule of Investment Expense
(for years ended June 30)

	2003	2002
Investment manager fees	$71,646,159	$62,293,193
Private equity investment expense	18,614,717	22,606,797
Miscellaneous	2,170,850	1,408,200
Total investment expense	**$92,431,726**	**$86,308,190**

Schedule of Payments to Consultants
(for years ended June 30)

	2003	2002
Actuarial services	$149,870	$187,558
External auditors	110,226	108,127
Legal services	273,951	244,016
Management consultants		
Information systems	692,086	774,452
TRS STAR audit	6,234	61,989
Benchmarking	25,000	0
Salary review	250	15,190
Executive search	76,226	37,708
403(b) survey	25,000	0
Member satisfaction survey	20,000	0
Other	6,650	5,534
Total payments to consultants	**$1,385,493**	**$1,434,574**

See accompanying Independent Auditors' Report.