Teachers' Retirement System of the State of Illinois

(A Component Unit of the State of Illinois)

Auditors' Report and Financial Audit

For the Year Ended June 30, 2005
Performed as Special Assistant Auditors for
the Auditor General, State of Illinois

BKD LLP

Teachers' Retirement System
of the State of Illinois
Financial Audit
For the Year Ended June 30, 2005

Contents

The compliance examination report for the year ended June 30, 2005 is published in a separate document.

Teachers' Retirement System of the State of Illinois

Financial Statement Report Summary

June 30, 2005

The audit of the accompanying financial statements of the Teachers' Retirement System of the State of Illinois was performed by **BKD, LLP**.

Based on their audit, the auditors expressed an unqualified opinion on the Teachers' Retirement System of the State of Illinois' financial statements.

BKD LLP

Independent Auditors' Report

The 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 (System), a component unit of the State of Illinois, as of June 30, 2005, and the related statement of changes in plan net assets for the year then ended, as listed in the table of contents. 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 audit. The financial statements of the System as of and for the year ended June 30, 2004 were audited by other accountants whose report dated November 5, 2004, expressed an unqualified opinion on those statements.

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

In our opinion, the 2005 financial statements referred to above present fairly, in all material respects, the plan net assets of the System as of June 30, 2005, and the changes in its plan net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we will also issue a report dated November 3, 2005 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 the 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.

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The accompanying management's discussion and analysis and schedules of funding progress and contributions from employers and other contributing entities as listed in the table of contents 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.

Our audit was conducted for the purpose of forming an opinion on the financial statements that comprise the System's 2005 basic financial statements. The other supplementary information as listed in the table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements. The 2005 other supplementary information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements as of and for the year ended June 30, 2005, taken as a whole. The 2004 other supplementary information was audited by other accountants whose report dated November 5, 2004, expressed an unqualified opinion on such information in relation to the basic financial statements as of and for the year ended June 30, 2004, taken as a whole.

/s/ **BKD, LLP**

November 3, 2005

Management's 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, 2005. Please read it in conjunction with the Basic Financial Statements and related notes that follow this discussion.

Financial Highlights

- TRS net assets at June 30, 2005, were $34.1 billion.
- During FY05, TRS net assets increased $2.5 billion.
- Contributions from members, employers, and the State of Illinois were $1,817 million, a decrease of $4,441 million or 71.0 percent during the fiscal year. Please see discussion on treatment of pension obligation bond proceeds for FY04 under "Contributions" on page 5 and under "Funding" on page 15.
- Total investment income was $3,330 million, a decrease of $1,156 million compared to FY04.
- Benefits and refunds paid to members and annuitants were $2,593 million, an increase of $283 million or 12.2 percent compared to FY04.
- The pension benefit obligation or total actuarial accrued liability was $56.08 billion at June 30, 2005.
- The unfunded actuarial accrued liability increased from $19.40 billion at June 30, 2004 to $21.99 billion at June 30, 2005. The funded ratio decreased from 61.9 percent at June 30, 2004 to 60.8 percent at June 30, 2005.

The Basic Financial Statements consist of:

Statements of Plan Net Assets. This statement reports the pension trust fund's 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, 2005.

Statements of Changes in Plan Net Assets. This statement details 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 Statements of Changes in Plan Net Assets supports the change in the value of the net assets reported on the Statements 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 supplementary information 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

	2005	Percentage Change	2004	Percentage Change	2003
Cash	$3,777,107	(11.5%)	$4,269,329	16.9%	$3,651,963
Receivables and prepaid expenses	382,518,911	8.1	353,725,714	23.3	286,769,806
Investments	34,898,361,784	8.9	32,046,373,325	33.9	23,935,615,863
Invested securities lending collateral	4,386,594,663	26.6	3,466,114,601	60.9	2,154,422,658
Capital assets	2,320,275	2.1	2,273,510	(13.6)	2,630,930
Total assets	**39,673,572,740**	**10.6**	**35,872,756,479**	**36.0**	**26,383,091,220**
Total liabilities	**5,588,354,263**	**29.1**	**4,328,027,194**	**32.8**	**3,258,268,149**
Net assets	**$34,085,218,477**	**8.1%**	**$31,544,729,285**	**36.4%**	**$23,124,823,071**

Condensed Comparative Statement of Changes in Plan Net Assets For the Year Ended June 30

	2005	Percentage Change	2004	Percentage Change	2003
Contributions	$1,817,352,355	(71.0%)	$6,258,086,538	256.9%	$1,753,282,676
Total investment income	3,330,039,158	(25.8)	4,485,729,345	322.8	1,060,852,111
Total additions	5,147,391,513	(52.1)	10,743,815,883	281.8	2,814,134,787
Benefits and refunds	2,592,498,606	12.2	2,310,349,123	13.2	2,041,737,026
Administrative expenses	14,403,715	6.2	13,560,546	(2.2)	13,859,402
Total deductions	2,606, 902,321	12.2	2,323,909,669	13.1	2,055,596,428
Net increase in net assets	**2,540,489,192**	**(69.8)**	**8,419,906,214**	**1,010.0**	**758,538,359**
Net assets beginning of year	**31,544,729,285**	**36.4**	**23,124,823,071**	**3.4**	**22,366,284,712**
Net assets end of year	**$34,085,218,477**	**8.1%**	**$31,544,729,285**	**36.4%**	**$23,124,823,071**

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 $34.1 and $31.5 billion at June 30, 2005 and 2004, respectively. Net assets increased $2.5 and $8.4 billion during FY05 and FY04, respectively.

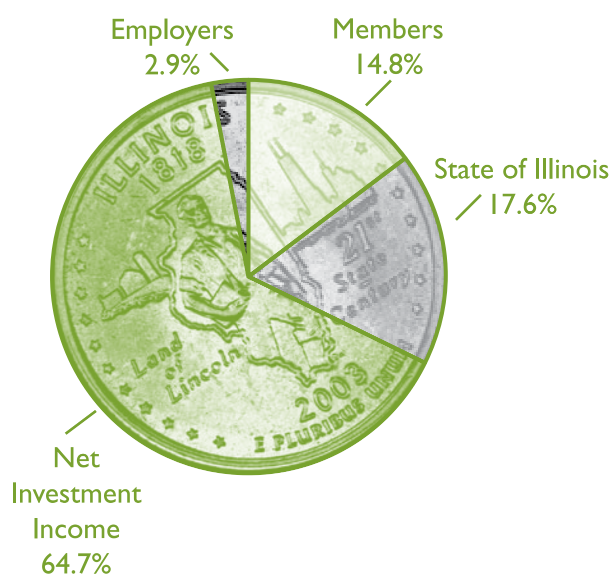
Contributions

Contributions decreased $4,441 million during FY05 and increased $4,505 million during FY04. During FY05, member contributions decreased $7 million and employer contributions from school districts increased $20 million. During FY04, member contributions increased $37 million and employer contributions from school districts increased $37 million. The majority of the increase in the employer contributions from school districts in FY05 is attributable to an increase in employer early retirement option contributions due to a higher number of retirees electing to retire under the early retirement option.

The State of Illinois provides contributions through state appropriations. Receipts from the State of Illinois decreased $4,455 million in FY05 compared to an increase of $4,431 million in FY04. The large decrease in receipts from the state in FY05 and increase in FY04 is due to the one-time receipt of pension obligation bond proceeds from the State of Illinois in FY04. On July 2, 2003, TRS received $4.330 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.

Please note that the $4.330 billion in pension obligation bond proceeds received in FY04 and presented as contributions in this report were not counted as contributions towards TRS's annual actuarial funding requirements for FY04. State funding law provides for a 50-year funding plan that includes a 15-year phase-in period. Minimum state contribution rates were specified in the statute for FY99 through FY04. In FY05, state contributions were reduced in accordance with funding revisions contained in the pension obligation bond law. In FY06 and FY07, state contributions will be based on dollar amounts specified by Public Act 94-0004. The legislation contained a two-year funding reduction of approximately 50 percent or over $1 billion for TRS. State contributions will be higher in future years to make up for the two-year funding reduction, as the overall goal of 90 percent funding in the year 2045 is unchanged.

Revenues by Type for the Year Ended June 30, 2005



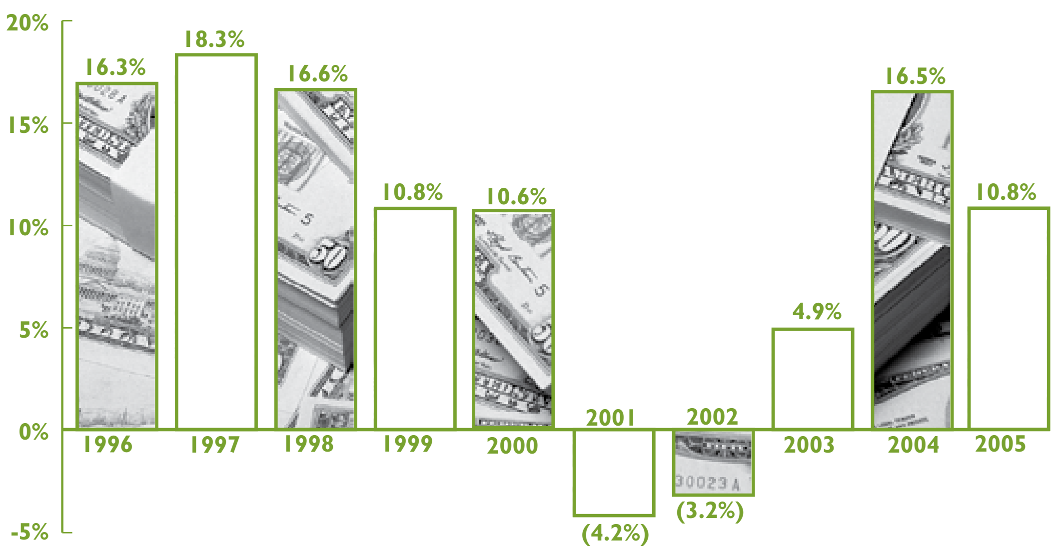
Investments

The TRS trust fund is invested by authority of the Illinois General Assembly under the "prudent person rule" requiring investments to be 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 within prudent risk parameters.

Total investments increased $2.9 billion from $32.0 billion at June 30, 2004 to $34.9 billion at June 30, 2005.

The TRS investment portfolio had another strong year. TRS investments earned a 10.8 and 16.5 percent rate of return, net of fees, for FY05 and FY04, respectively, as all asset classes again produced positive returns. Overall, the United States economy remained vibrant and inflation restrained, providing a healthy investment environment. Substantial gains were accumulated in the private markets in FY05 with the TRS real estate portfolio generating a 19.9 percent return, net of fees, and the TRS private equity portfolio returning 20.0 percent, net of fees. The five- and 10-year returns are 4.7 percent and 9.5 percent, respectively. The long-term return continues to outperform the actuarial assumption rate of 8.5 percent.

Annual Rate of Return (net of investment expenses)



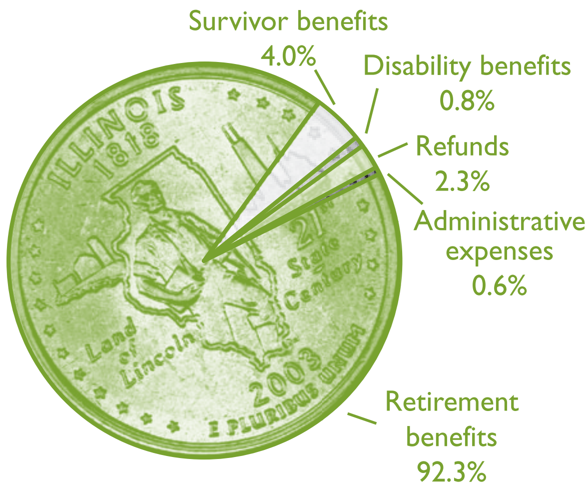
The annual rate of return is an indication of TRS investment performance and is provided by the TRS Master Trustee.

Benefits and Refunds

Survivor, disability, and retirement benefit payments increased $271 and $263 million during FY05 and FY04, respectively. During FY05, benefit payments increased from $2,262 million with 76,905 recipients during FY04 to $2,533 million with 82,575 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 67,950 as of June 30, 2004 to 73,464 as of June 30, 2005, and an increase in the final average salaries of teachers that retired during the fiscal year.

Refunds of contributions increased $12 and $5 million during FY05 and FY04, 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.

Expenses by Type for the Year Ended June 30, 2005



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 $5.13 and $4.02 billion during FY05 and FY04, respectively, to $56.08 billion at June 30, 2005 and $50.95 billion at June 30, 2004. 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 $2.59 billion during FY05 to $21.99 billion at June 30, 2005 and decreased $4.41 billion during FY04 to $19.40 illion at June 30, 2004. The funded ratio reflects the percentage of the accrued liability covered by net assets at market value. The funded ratio decreased to 60.8 percent at June 30, 2005 from 61.9 percent at June 30, 2004. An increase in the unfunded liability and a decrease 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. The last experience analysis was conducted in 2002. TRS actuaries are scheduled to conduct an experience analysis for the five-year period ended June 30, 2006 in 2007.

Funded Ratio at Market Value

The funded ratio is the ratio of assets to liabilities. An increase in this ratio indicates an improvement in TRS's ability to meet future benefit obligations.

New Legislation

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 June 1, 2005, Public Act 94-0004 became law. The legislation addresses the Early Retirement Option (ERO), benefit changes, and funding reductions.

The ERO, which had been scheduled to sunset June 30, 2005, was renewed with modifications that will allow the program to continue at least through 2012. The extension includes a "Pipeline" provision for members who notified their employers on or before June 1, 2005 of their intention to retire under the terms of contracts or collective bargaining agreements. These members have until July 1, 2007 to retire using the Pipeline provision. For these individuals, the contribution rates remain the same as they were for the ERO program that ended June 30, 2005.

Public Act 94-0004 includes a new Modified ERO program. These provisions apply to members who will retire after June 30, 2005, and who do not qualify for Pipeline ERO. The member contribution changed from 7.0 percent to 11.5 percent for each year that the member is under age 60 or that the member's service is under 35 years, whichever is less. The employer (school district) contribution changed from 20.0 percent to 23.5 percent. There is no longer a contribution waiver for employers and members when the member has 34 years of service.

In addition, the actuarial benefit also known as the money purchase benefit is not available for retirees who become members on or after July 1, 2005. The actuarial calculation usually benefits members with exceptionally long careers or large periods of inactive status.

Public Act 94-0004 changes the member contribution rate effective July 1, 2005, from 9.0 percent to 9.4 percent to help cover the cost of ERO. The additional 0.4 percent contribution is refundable if the member does not retire using ERO or the program is terminated.

Public Act 94-0004 also contains new employer contributions. When a member retires, the employer is required to pay TRS a contribution equal to the actuarial value of a pension benefit that results from any salary increase over 6 percent that is used in the final average salary calculation. Also, employers are required to pay a contribution for any sick leave granted to a member in excess of the normal allotment that is used to secure TRS service credit. Contracts and collective bargaining agreements in effect prior to June 1, 2005 are exempt from the provisions contained in the act.

The legislation contained a two-year funding reduction of approximately 50 percent in state contributions that will result in a total reduction of over $1 billion for TRS, $523.9 million in FY06 and approximately $497.6 million in FY07. State contributions will be higher in future years to make up for the funding reduction in FY06 and FY07, as the overall goal of 90 percent funding in the year 2045 is unchanged. The contribution rate for salaries paid from federal funds is equal to the state's TRS funding rate that is 7.06 percent in FY06. As a result of reduced state contributions, effective July 1, 2005, employer contributions on salaries paid from federal funds will decrease from 10.50 percent to 7.06 percent for FY06.

Basic Financial Statements

Teachers' Retirement System of the State of Illinois
Statements of Plan Net Assets
as of June 30, 2005, and 2004

	2005	2004
Assets		
Cash	$3,777,107	$4,269,329
Receivables and prepaid expenses		
Member payroll deduction	57,506,146	69,326,056
Member contributions	41,216,097	37,553,098
Employer contributions	30,947,290	13,115,002
State of Illinois	441,044	251,416
Investment income	249,963,566	230,705,401
Prepaid expenses	2,444,768	2,774,741
Total receivables and prepaid expenses	382,518,911	353,725,714
Investments, at fair value		
Fixed income	10,325,741,083	9,089,445,291
Equities	18,787,194,875	18,604,591,222
Real estate	3,525,456,881	2,680,788,703
Short-term investments	1,163,168,990	806,158,043
Private equity investments	1,068,633,225	840,390,782
Foreign currency	28,166,730	24,999,284
Total investments	34,898,361,784	32,046,373,325
Collateral from securities lending	4,386,594,663	3,466,114,601
Property and equipment, at cost, net of accumulated depreciation of $5,235,129 and $5,308,993 in 2005 and 2004, respectively	2,320,275	2,273,510
Total assets	**39,673,572,740**	**35,872,756,479**
Liabilities		
Benefits and refunds payable	4,124,841	4,940,452
Administrative and investment expenses payable	118,607,225	97,111,469
Payable to brokers for unsettled trades, net	1,079,027,534	759,860,672
Securities lending transactions	4,386,594,663	3,466,114,601
Total liabilities	**5,588,354,263**	**4,328,027,194**
Net assets held in trust for pension benefits	**$34,085,218,477**	**$31,544,729,285**

(A schedule of funding progress is presented on page 28.)
The accompanying notes are an integral part of these statements.

Teachers' Retirement System of the State of Illinois
Statements of Changes in Plan Net Assets
Years Ended June 30, 2005, and 2004

	2005	2004
Additions		
Contributions		
Members	$761,790,009	$768,661,300
State of Illinois	906,749,310	1,031,477,825
State of Illinois pension obligation bond proceeds	0	4,330,373,948
Employers		
Early retirement	65,378,955	52,495,571
Federal funds	39,840,799	33,651,748
2.2 benefit formula	43,593,282	41,426,146
Total contributions	1,817,352,355	6,258,086,538
Investment income		
From investment activities		
Net appreciation in fair value	2,569,878,360	3,873,564,792
Interest	352,219,842	278,058,533
Real estate operating income, net	222,603,171	194,324,851
Dividends	268,364,399	206,236,790
Private equity income	20,389,300	27,033,133
Other investment income	1,931,616	3,531,886
Investment activity income	3,435,386,688	4,582,749,985
Less investment expense	(114,896,886)	(106,418,281)
Net investment activity income	3,320,489,802	4,476,331,704
From securities lending activities		
Securities lending income	88,385,077	31,637,926
Securities lending management fees	(1,931,333)	(2,348,565)
Securities lending borrower rebates	(76,904,388)	(19,891,720)
Net securities lending activity income	9,549,356	9,397,641
Total investment income	3,330,039,158	4,485,729,345
Total additions	**5,147,391,513**	**10,743,815,883**
Deductions		
Retirement benefits	2,407,652,120	2,145,187,366
Survivor benefits	103,990,670	97,155,092
Disability benefits	21,460,058	19,987,021
Refunds	59,395,758	48,019,644
Administrative expenses	14,403,715	13,560,546
Total deductions	**2,606,902,321**	**2,323,909,669**
Net increase	**2,540,489,192**	**8,419,906,214**
Net assets held in trust for pension benefits		
Beginning of year	31,544,729,285	23,124,823,071
End of year	**$34,085,218,477**	**$31,544,729,285**

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, employer contributions for member benefit increases, and for the employer's portion of the Early Retirement Option contributions. As a result of Public Act 94-0004, which became law on June 1, 2005, employers are also required to pay the cost of pension benefits resulting from end-of-career salary increases over 6 percent. Employers also pay a contribution for sick leave days granted in excess of the member's normal annual allotment and used for service credit at retirement. The contributions do not apply to salary increases awarded or sick leave granted under contracts or collective bargaining agreements entered into, amended, or renewed prior to June 1, 2005. In addition, the State of Illinois provides employer contributions. For information about employer contributions made by the State of Illinois, see "Funding" on page 15.

Number of Employers (as of June 30)

	2005	2004
Local school districts	878	885
Special districts	139	139
State agencies	25	25
Total	**1,042**	**1,049**

3. Members

TRS Membership (as of June 30)

	2005	2004
Retirees and beneficiaries receiving benefits	82,575	76,905
Inactive members entitled to but not yet receiving benefits	87,328	89,641
Active members	155,850	157,990
Total	**325,753**	**324,536**

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 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.

Public Act 94-0004, effective July 1, 2005, made several important changes to the ERO that was scheduled to expire on June 30, 2005. The ERO program will continue at least through 2012. Members are considered to be in the "pipeline" to retire under ERO without modifications if they have met all of the following requirements:

- On or before June 1, 2005, members notified their employer in writing of their intention to retire under the terms of their contract or collective bargaining agreement.
- Members have an effective date of retirement on or before July 1, 2007.

For this Pipeline ERO group only, member and employer contributions are waived for members with 34 years of service.

A Modified ERO is provided for all other members. ERO contribution rates are higher for the modified Early Retirement Option and the contribution waiver for members with 34 years of service is eliminated. Members and employers make a contribution for any member under the age of 60 who retires with less than 35 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 90-0582 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. Public Act 94-0004 eliminates the money purchase benefit for persons who become TRS members after June 30, 2005.

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.

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. The contribution rate changed from 9.0 percent to 9.4 percent effective July 1, 2005 as a result of Public Act 94-0004. The additional 0.4 percent is to help cover the cost of ERO and is refundable if the member does not retire using ERO or if the ERO program terminates.

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.

On April 7, 2003, Public Act 93-0002 authorized the State of Illinois to issue $10 billion in general obligation bonds for the purpose of making contributions to designated retirement systems. TRS was 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 were 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,

- 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 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 bond 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.

The $4.330 billion in pension obligation bond proceeds received in FY04 and presented as contributions in this report were not counted as contributions towards TRS's annual actuarial funding requirements for FY04. State funding law provides for a 50-year funding plan that includes a 15-year phase-in period. Minimum state contribution rates were specified in the statute for FY99 through FY04. In FY05, state contributions were reduced in accordance with funding revisions contained in the pension obligation bond law.

In FY06 and FY07, state contributions will be based on dollar amounts specified by Public Act 94-0004. The legislation contains a two-year funding reduction of approximately 50 percent or over $1 billion for TRS. State contributions will be higher in future years to make up for the two-year funding reduction, as the overall goal of 90 percent funding in the year 2045 is unchanged.

Beginning July 1, 1995, state contributions have been made through a continuing appropriation. However, in FY06 and FY07 the total state appropriations are specified by the statute rather than actuarial calculations.

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 when due, pursuant to formal commitments, as well as statutory or contractual requirements. 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 accepted accounting principles generally accepted in the United States of America 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. TRS's adoption of GASB 40 in FY05 had no effect on net assets or the changes in net assets in the prior or current year.

In May 2004, GASB issued Statement No. 44, "Economic Condition Reporting: The Statistical Section," an amendment of NCGA Statement 1. The statement establishes and modifies requirements related to the supplementary information presented in the statistical section. The requirements of this statement are effective for statistical sections prepared for periods beginning after June 15, 2005.

In June 2004, GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions" (OPEB). The statement establishes standards of accounting and financial reporting for OPEB expense/expenditures and related OPEB liabilities or assets, note disclosures, and required supplementary information (RSI) in the financial reports of state and local government employers. The requirements of this statement are effective for TRS's financial statements for periods beginning after December 15, 2006.

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 in the individual 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, 2005, and 2004 totaled $1,371,271 and $1,311,493, 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 $57,506,146 and $69,326,056 as of June 30, 2005, and 2004 respectively.

8. Prior Period Reclassification

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

C. Cash

Custodial credit risk for deposits is the risk that in the event of a bank failure, TRS's deposits may not be returned. TRS does not have a formal policy for custodial credit risk. The bank balance and carrying amount of TRS's deposits were $3,474,640 and $3,777,107 at June 30, 2005, and $4,076,472 and $4,269,329 at June 30, 2004. Of the bank balance, $3,121,085 and $3,654,191 were on deposit with the state treasurer at June 30, 2005, and 2004, respectively. State treasurer deposits are in an internal investment pool collateralized at a third party custodial bank and are not subject to custodial credit risk. The remaining bank balance of $353,555 and $422,281 at June 30, 2005 and 2004, respectively, are amounts TRS deposited and received credit for at The Northern Trust Company, but Northern had not yet received the money from the payor's financial institution. The amounts, called uncollected funds, are not subject to custodial credit risk. Cash equivalents are classified as short-term investments in the Statements of Plan Net Assets.

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 Risk

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of a financial institution failure, TRS would not be able to recover the value of the investments in the possession of an outside party. TRS does not have a formal policy for custodial credit risk. At June 30, 2005, the following investments were uninsured and unregistered, with the securities held by a counterparty, but not in TRS's name:

Foreign Currency Held by Investment Managers	$20,862,357
Government Treasury Notes	902,555
Index Linked Government Bond	31,220,983
Negotiable Bank Certificate of Deposit	7,751,882
Short term Bills and Notes	55,285,738
Cash Deposits Held with Brokers for Variation Margin	49,238,508
Total	**$165,262,023**

At June 30, 2004, under the effective reporting standard at that time, TRS did not identify any investments subject to custodial credit risk. However, TRS had investments of $15,691,796,501 that were not categorized.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to TRS. Credit risk exposure is dictated by each investment manager's agreement. Each portfolio is managed in accordance with investment guidelines that are specific as to permissible credit quality ranges, exposure levels within individual security quality rating tiers, and/or the average credit quality of the overall portfolio. With the exception of certain commingled funds, bonds below B- are not permissible in any of the fixed income investment manager guidelines. However, in circumstances where position downgrades occur, investment managers have been given permission to hold securities due to circumstances such as a higher peer group rating from another nationally recognized statistical rating organization, firm internal ratings, or other mitigating factors.

As of June 30, 2005, TRS held the following fixed income investments with respective quality ratings, excluding those obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government, which are not considered to have credit risk.

Quality Rating	Corporate Debt Securities	Foreign Debt Securities	US Agency Obligations	Pooled Debt Investments	Total
Aaa	$1,063,700,016	$327,676,193	$2,377,363,562	-	$3,768,739,771
Aa1	84,205,161	8,856,817	955,170	-	94,017,148
Aa2	66,155,649	10,211,496	-	620,158,258	696,525,403
Aa3	540,277,352	21,399,522	-	-	561,676,874
AA	5,769,581	-	-	-	5,769,581
A1	117,260,305	8,712,788	560,530	-	126,533,623
A2	111,571,412	41,244,582	5,015,506	-	157,831,500
A3	129,264,431	28,028,454	-	-	157,292,885
Baa1	94,550,534	58,632,955	-	-	153,183,489
Baa2	381,901,008	31,160,219	-	-	413,061,227
Baa3	112,181,190	42,328,600	-	-	154,509,790
Ba1	63,826,208	18,671,420	-	-	82,497,628
Ba2	47,672,026	8,044,378	-	-	55,716,404
Ba3	27,299,705	9,317,791	-	48,406,505	85,024,001
B1	22,156,273	32,315,563	-	-	54,471,836
B2	15,877,496	1,217,650	-	-	17,095,146
B3	8,500,013	658,350	-	-	9,158,363
Caa1	6,609,388	-	-	-	6,609,388
Caa	3,611,418	-	-	-	3,611,418
NR	16,521,938	-	-	-	16,521,938
WR	35,368,161	-	-	-	35,368,161
NA	4,104,203	11,224,776	-	-	15,328,979
Total Credit Risk: Debt Securities	$2,958,383,468	$659,701,554	$2,383,894,768	$668,564,763	$6,670,544,553
US Governments and Agencies*	-	-	1,697,385,355	-	1,697,385,355
U.S. Treasuries*	-	-	1,957,811,175	-	1,957,811,175
Total Fixed Income	**$2,958,383,468**	**$659,701,554**	**$6,039,091,298**	**$668,564,763**	**$10,325,741,083**

** Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk.*

Concentration of Credit Risk

Concentration of credit risk is the risk of loss that may be attributed to the magnitude of TRS's investment in a single issue. TRS's Investment Policy states securities representing debt and equity of any one company shall not exceed 5 percent of the fair value of any manager's portfolio without prior approval. At June 30, 2005, TRS did not have investments in any one organization representing 5 percent or more of the System's assets other than those issued or explicitly guaranteed by the U.S. government and investments in investment pools.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. TRS manages interest rate risk within the portfolio using the effective duration or option-adjusted duration methodology. Yield curve and interest rate duration management is widely used in the management of fixed income portfolios in that it quantifies the risk of interest rate changes to the portfolio or an individual security. The methodology takes into account optionality on securities and scales the risk of price changes on bonds depending upon the degree of change in interest rates and the slope of the yield curve. All of the TRS's fixed income portfolios are managed in accordance with operational guidelines and are specific as to the degree of interest rate risk taken. Active portfolios are managed with a duration band of +/- 30 percent of the index effective duration, but are not security specific. TRS does employ the use of interest-only and principal-only securities, as well as floating grade securities, as dictated by the portfolio manager's discretion or views on interest rates.

At June 30, 2005, the following table shows TRS's investments by investment type, fair value, and the option adjusted duration rate.

Option Adjusted Duration

	Fair Value Total	Fair Value % Total	OAD Total	Fair Value US	Fair Value % U S	OAD US	Fair Value Foreign	Fair Value % Foreign	OAD Foreign
U. S. Treasuries	**$2,604,882,093**	**27.12%**	**4.87**	**$2,323,966,110**	**24.19%**	**4.00**	**$280,915,983**	**2.93%**	**12.22**
Agency	391,836,779	4.08	3.88	375,448,053	3.91	3.95	16,388,726	0.17	2.38
Local Authority	831,912	0.01	3.21	831,912	0.01	3.21	0	0	-
Sovereign	91,201,199	0.95	6.23	91,201,199	0.95	6.23	0	0	-
U.S. Agency Obligations Government-Related	**483,869,890**	**5.04**	**4.32**	**467,481,164**	**4.87**	**4.39**	**16,388,726**	**0.17**	**2.38**
Industrial	893,130,118	9.30	5.46	891,587,363	9.28	5.47	1,542,755	0.02	3.61
Utility	108,525,017	1.13	5.20	108,525,017	1.13	5.20	0	0	
Financial Institutions	604,095,734	6.29	4.08	596,154,864	6.21	4.09	7,940,870	0.08	3.48
Other Corporate	4,244,824	0.04	10.63	4,244,824	0.04	10.63	0	0	-
Corporate Debt Securities	**1,609,995,693**	**16.76**	**4.94**	**1,600,512,068**	**16.66**	**4.95**	**9,483,625**	**0.10**	**3.50**
Industrial	2,242,938	0.02	2.58	2,242,938	0.02	2.58	-	-	-
Financial Institutions	1,280,835	0.01	0.06	1,280,835	0.01	0.06	-	-	-
Mortgage Backed Security Passthrough	2,041,548,277	21.25	1.89	2,041,548,277	21.25	1.89	-	-	-
Asset Backed Securities	614,223,250	6.39	1.24	614,223,250	6.39	1.24	-	-	-
Commercial Mortgage Backed Securities	333,634,857	3.47	3.54	333,634,857	3.47	3.54	-	-	-
Covered Bonds	14,160,463	0.15	2.02	14,160,463	0.15	2.02	-	-	-
Collateralized Mortgage Obligations	944,789,414	9.84	5.35	944,789,414	9.84	5.35	-	-	-
Other Securitized	141,126,449	1.48	0.97	141,126,449	1.48	0.97	-	-	-
U.S. Agency Obligations-Securitized	**4,093,006,483**	**42.61**	**2.22**	**4,093,006,483**	**42.61**	**2.22**	**-**	**-**	**-**
Cash	**585,443,165**	**6.09**	**0**	**585,442,894**	**6.09**	**0**	**271**	**0**	**0**
Others	**228,323,183**	**2.38**	**13.27**	**204,772,051**	**2.13**	**12.07**	**23,551,132**	**0.25**	**15.23**
Total	**$9,605,520,507**	**100%**	**3.62**	**$9,275,180,770**	**96.55%**	**3.30**	**$330,339,737**	**3.45%**	**11.67**
Securities Not Modeled*	721,726,566								
Pricing Adjustment**	(1,505,990)								
Total Fixed Income	**$10,325,741,083**								

Source: Lehman Brothers, Inc. POINT©

* *The amount includes pooled investments with a market value of $668,564,763 and a weighted average option adjusted duration of 3.66. The remaining $53,161,803 represent bonds that cannot be modeled on the Lehman Brothers, Inc. POINT© system due to the limited market for these securities.*

** *The Lehman Brothers, Inc. POINT© system uses pricing sources that may vary from the pricing sources used by the custodian to value the portfolio.*

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. TRS's currency risk exposure, or exchange rate risk, is primarily derived from its holdings in foreign currency-denominated equity, fixed income investments and foreign currency. TRS's international equity and global fixed income managers, at their discretion, may or may not hedge the portfolio's foreign currency exposures with currency forward contracts depending upon their views on a specific country or foreign currency relative to the U.S. dollar.

TRS's exposure to foreign currency risk in U.S. dollars as of June 30, 2005 is as follows:

Currency	Foreign Currency	Equities	Fixed Income	Total
Australian Dollar	$1,172,965	$186,055,772	$12,202,400	$199,431,137
Brazilian Real	40,406	97,423,708	-	97,464,114
British Pound Sterling	1,087,289	1,039,816,250	80,583,088	1,121,486,627
Canadian Dollar	410,967	41,389,874	17,124,339	58,925,180
Czech Koruna	4,108	24,093	-	28,201
Danish Krone	39,051	29,897,532	-	29,936,583
Egyptian Pound	319,899	5,432,914	-	5,752,813
Euro	3,852,761	1,760,075,362	172,011,459	1,935,939,582
Hong Kong Dollar	353,275	113,211,528	-	113,564,803
Hungarian Forint	348	31,515	-	31,863
Indonesian Rupiah	2,482,612	19,248,998	-	21,731,610
Japanese Yen	9,524,287	939,294,878	16,234,999	965,054,164
Malaysian Ringgit	299,367	22,337,230	-	22,636,597
Mexican Peso	892,188	27,908,148	8,550,901	37,351,237
New Israeli Shekel	543	498,067	-	498,610
New Taiwan Dollar	86,956	129,028,454	-	129,115,410
New Zealand Dollar	3,934,384	31,106,509	8,526,210	43,567,103
Norwegian Krone	195,589	24,559,777	-	24,755,366
Philippine Peso	-	6,001,588	-	6,001,588
Polish Zloty	148,640	11,227,832	-	11,376,472
Singapore Dollar	82,221	58,606,996	-	58,689,217
South African Rand	123,051	62,191,736	12,270	62,327,057
South Korean Won	2,724,788	212,608,084	-	215,332,872
Swedish Krona	184,820	79,148,408	16,091,882	95,425,110
Swiss Franc	187,156	374,041,213	-	374,228,369
Thai Baht	19,059	5,810,338	-	5,829,397
Turkish Lira	-	18,795,994	-	18,795,994
Total subject to foreign currency risk	**$28,166,730**	**$5,295,772,798**	**$331,337,548**	**$5,655,277,076**
Investments in international securities payable in United States dollars	**-**	**931,685,057**	**328,364,006**	**1,260,049,063**
Total international investment securities	**$28,166,730**	**$6,227,457,855**	**$659,701,554**	**$6,915,326,139**
Domestic Investments	**-**	**12,559,737,020**	**9,666,039,529**	**22,225,776,549**
Total Fair Value	**$28,166,730**	**$18,787,194,875**	**$10,325,741,083**	**$29,141,102,688**

In addition to the above, TRS has foreign currency investments in real estate and limited partnerships with fair values totaling $35,884,547 and $9,964,474, respectively at June 30, 2005.

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 primary lending agent for the plan's domestic securities for collateral of 102 percent of the market value of the securities and international securities for collateral of 105 percent of the market value of the securities.

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 78 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 39 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, 2005, and 2004, TRS had outstanding loaned investment securities having a market value of $4,715,848,757 and $3,921,190,369, respectively, against which it had received collateral of $4,839,824,722 and $4,024,263,673, respectively. Collateral from securities lending reflected on the Statements 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 whose 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 derivative 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, cash equivalent futures, and options.

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, 2005, foreign currency forward purchase or sell contracts included the following currencies: euro, Mexican peso, New Zealand dollar, Japanese yen, Australian dollar, Singapore dollar, Canadian dollar, Swedish krona, British pound sterling, Hong Kong dollar, Swiss franc, and U.S. dollar. These contracts have various settlement dates within 12 months of June 30, 2005.

Fair Value: As of June 30, 2005, and June 30, 2004, TRS's open foreign currency forward contracts had a net fair value of $10,840,085 and ($3,011,319), respectively.

	Market Value as of June 30, 2005	Market Value as of June 30, 2004
Forward currency purchases	$456,926,270	$361,979,928
Forward currency sales	(446,086,185)	(364,991,247)
Unrealized gain/(loss)	**$10,840,085**	**($3,011,319)**

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, 2005 and June 30, 2004, TRS had outstanding futures contracts with an underlying notional value of $2,704,099,768 and $2,343,330,544, respectively. Contractual principal values do not represent the actual values in the Statements of Plan Net Assets. The contracts have various expiration dates through December 2006.

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

Type	FY05 Number of Contracts*	FY05 Contractual Principal*	FY04 Number of Contracts	FY04 Contractual Principal
Fixed Income Index Futures – Long	1,361	$168,664,063	4,600	$502,427,875
Fixed Income Index Futures – Short	(2,204)	(246,377,719)	(1,065)	(115,703,625)
International Fixed Income Index Futures – Long	1,422	18,811,006	486	143,164,325
International Fixed Income Index Futures – Short	(1,361)	(51,155,057)	(80)	(10,735,719)
Stock Index Futures – Long	11,657	1,899,948,375	10,267	1,416,098,300
Cash Equivalent (Eurodollar) Futures – Long	3,808	914,209,100	1,692	408,079,388
Total	**14,683**	**$2,704,099,768**	**15,900**	**$2,343,330,544**

** Includes options on futures.*

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, 2005, TRS had outstanding options contracts with an underlying notional value of $72,711,812. Contractual principal values do not represent the actual values in the Statements of Plan Net Assets. The contracts have various expiration dates through September 2006.

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, 2005, and June 30, 2004, the fair value of option contracts written was $380,116 and ($288,983), respectively. The fair value represents the amount needed to close all positions as of that date. The following table presents the aggregate contractual principal (notional value) of TRS's outstanding contracts at June 30, 2005, and June 30, 2004. 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.

Type	FY05 Number of Contracts	FY05 Contractual Principal	FY05 Fair Value	FY04 Number of Contracts	FY04 Contractual Principal	FY04 Fair Value
Fixed Income Written Call Options	568	$15,697,907	($294,034)	532	$10,536,700	($201,938)
Fixed Income Written Put Options	554	(4,405,895)	(299,501)	308	4,826,850	(86,026)
International Fixed Income Written Put Options	0	0	0	67	430,000	(1,019)
Cash Equivalent Written Call Options (Eurodollar)	1,468	61,419,800	973,651	0	0	0
Total	**2,590**	**$72,711,812**	**$380,116**	**907**	**$15,793,550**	**($288,983)**

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. Benefit Trust

	2005	2004
Balances at June 30	$34,081,019,184	$31,540,767,937

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 the Minimum Retirement Annuity Reserve, member and employer contributions, income from TRS invested assets, and contributions from annuitants who qualify for automatic annual increases in annuity.

The 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 charged for transfers to the Minimum Retirement Annuity Reserve and all

- refunds to withdrawing members,
- retirement annuity payments (except as provided by the Minimum Retirement Annuity Reserve),
- benefits that are paid to temporarily or accidentally disabled members,
- death benefits paid, and
- refunds to annuitants for survivor benefit contributions.

The expected benefit payments do not equal the present value of the reserve. The additional amount needed (the unfunded actuarial accrued liability) as calculated by the actuary was $21,989,811,000 in 2005 and $19,402,722,000 in 2004.

2. Minimum Retirement Annuity

	2005	2004
Balances at June 30	$4,199,293	$3,961,348

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.

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 FY05 and FY04 are included in the State of Illinois' Comprehensive Annual Financial Report (CAFR) for the years ended June 30, 2005, and 2004, respectively. SERS also issues a separate CAFR that may be obtained at www.state.il.us/srs, 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 at www.ioc.state.il.us, 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 FY05, FY04, and FY03, the SERS employer contribution rates were 16.107 percent, 13.439 percent, and 10.321 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 FY05, FY04, and FY03 were $824,671, $662,711, and $541,552, 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 FY05 and FY04 administrative budgets approved by the board. Effective for pay periods beginning after July 1, 2005, the TRS Board of Trustees opted to begin phasing out paying the employee contribution for all employees. The contribution pickup for SERS members will be reduced to 2 percent in FY06 and expires July 1, 2006. The contribution pickup for TRS members will be reduced to 6 percent in FY06, 3 percent in FY07, and expires July 1, 2007.

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, 2005, and 2004. 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.

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
6/30/04	31,544,729,000	50,947,451,000	61.9	19,402,722,000	7,280,795,000	266.5
6/30/05	**34,085,218,000**	**56,075,029,000**	**60.8**	**21,989,811,000**	**7,550,510,000**	**291.2**

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
2004	1,028,259,000	75,078,000	1,103,337,000	1,716,977,000	64.3	1,100,264,000	100.3
2005	**903,928,000**	**83,434,000**	**987,362,000**	**1,683,212,000**	**58.7**	**986,269,000**	**100.1**

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.*

Pension obligation bonds are not treated as a state contribution in FY04 because they do not count towards the annual funding requirement calculated by the actuary. In FY03, the annual contributions required per state statute is the state funding requirement certified after Public Act 92-0505 was enacted. The diversion to THIS Fund was effective for the entire fiscal year. In FY02, the annual contribution required per state statute is the state funding requirement certified before Public Act 92-0505 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.

2 *Excludes employer ERO and ERI payments, 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, 2005	June 30, 2004
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	15-year phase-in to a level percent of payroll until a 90% funding level is achieved
	FY05 is the first year that state contributions were calculated under the funding mechanism contained in Public Act 93-0002 Mimimum state contribution rates were eliminated.	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	40 years, closed	41 years, closed
Asset valuation method:	Fair value	Fair value
Actuarial assumptions:		
Investment rate of return	8.5%	8.5%
Projected salary increases	5.9% (at age 69) to 10.2% (at age 19); composite 6.5%	5.9% (at age 69) to 10.2% (at age 19); 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; rated forward one year for female benefit recipients; and 95.6% times the table rates for male retirees.)	1995 Buck Mortality Tables (rated forward three years for male benefit recipients only; rated forward one year for female benefit recipients; and 95.6% times the table rates for male retirees.)

See accompanying Independent Auditors' Report.

Other Supplementary Information

Schedule of Administrative Expenses
For Years Ended June 30

	2005	2004
Personal services	$10,787,362	$9,855,223
Professional services	981,768	981,402
Postage	452,629	436,283
Machine repair and rental	462,559	503,353
Other contractual services	765,214	792,565
Commodities	506,844	435,978
Occupancy expense	172,652	182,991
Depreciation	277,617	372,751
Loss on disposal of equipment	(2,930)	0
Total administrative expenses	**$14,403,715**	**$13,560,546**

Schedule of Investment Expense
For Years Ended June 30

	2005	2004
Investment manager fees	$104,343,041	$93,944,558
Private equity investment expense	7,480,091	10,645,742
Miscellaneous	3,073,754	1,827,981
Total investment expense	**$114,896,886**	**$106,418,281**

Schedule of Payments to Consultants
For Years Ended June 30

	2005	2004
Actuarial services	$390,392	$204,154
External auditors	119,254	112,142
Legal services	140,011	129,844
Management consultants		
Information systems	227,000	481,315
TRS STAR audit	41,990	0
Benchmarking	30,000	0
Board and staff training	26,922	27,548
Operations	3,360	23,289
Other	2,839	3,110
Total payments to consultants	**$981,768**	**$981,402**

See accompanying Independent Auditors' Report.