

**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, 2006

Performed as Special Assistant Auditors for
the Auditor General, State of Illinois



Teachers' Retirement System of the State of Illinois

Financial Audit

For the Year Ended June 30, 2006

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**Teachers' Retirement System
of the State of Illinois
Financial Statement Report Summary
June 30, 2006**

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.



Independent Auditors' Report

The Honorable William G. Holland
Auditor General
State of Illinois
and
Board of Trustees
Teachers' Retirement System of the State of Illinois

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statements 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, 2006 and 2005, and the related statements of changes in plan net assets for the years 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 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 System as of June 30, 2006 and 2005, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we will also issue a report dated November 2, 2006 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 audits.

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 accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the financial statements that comprise the System's basic financial statements. The other supplementary information as noted in the table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements. The 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 years ended June 30, 2006 and 2005, taken as a whole.

BKD, LLP

November 2, 2006

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, 2006. 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, 2006, were \$36.6 billion.
- During FY06, TRS net assets increased \$2.5 billion.
- Contributions from members, employers, and the State of Illinois were \$1,457 million, a decrease of \$360 million or 19.8 percent for the fiscal year.
- Total investment income was \$3,993 million, an increase of \$663 million compared to FY05.
- Benefits and refunds paid to members and annuitants were \$2,935 million, an increase of \$342 million or 13.2 percent compared to FY05.
- The pension benefit obligation or total actuarial accrued liability was \$59.00 billion at June 30, 2006.
- The unfunded actuarial accrued liability increased from \$21.99 billion at June 30, 2005 to \$22.41 billion at June 30, 2006. The funded ratio increased from 60.8 percent at June 30, 2005 to 62.0 percent at June 30, 2006.

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, 2006.

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 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

	2006	Percentage Change	2005	Percentage Change	2004
Cash	\$3,867,280	2.4%	\$3,777,107	(11.5%)	\$4,269,329
Receivables and prepaid expenses	352,050,422	(8.0)	382,518,911	8.1	353,725,714
Investments	37,336,880,818	7.0	34,898,361,784	8.9	32,046,373,325
Invested securities lending collateral	4,401,016,409	0.3	4,386,594,663	26.6	3,466,114,601
Capital assets	2,333,759	0.6	2,320,275	2.1	2,273,510
Total assets	42,096,148,688	6.1	39,673,572,740	10.6	35,872,756,479
Total liabilities	5,511,259,261	(1.4)	5,588,354,263	29.1	4,328,027,194
Net assets	<u>\$36,584,889,427</u>	7.3%	<u>\$34,085,218,477</u>	8.1%	<u>\$31,544,729,285</u>

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

	2006	Percentage Change	2005	Percentage Change	2004
Contributions	\$1,456,882,200	(19.8%)	\$1,817,352,355	(71.0%)	\$6,258,086,538
Total investment income	3,993,289,880	19.9	3,330,039,158	(25.8)	4,485,729,345
Total additions	5,450,172,080	5.9	5,147,391,513	(52.1)	10,743,815,883
Benefits and refunds	2,935,197,760	13.2	2,592,498,606	12.2	2,310,349,123
Administrative expenses	15,303,370	6.2	14,403,715	6.2	13,560,546
Total deductions	2,950,501,130	13.2	2,606,902,321	12.2	2,323,909,669
Net increase in net assets	2,499,670,950	(1.6)	2,540,489,192	(69.8)	8,419,906,214
Net assets beginning of year	<u>34,085,218,477</u>	8.1	<u>31,544,729,285</u>	36.4	<u>23,124,823,071</u>
Net assets end of year	<u>\$36,584,889,427</u>	7.3%	<u>\$34,085,218,477</u>	8.1%	<u>\$31,544,729,285</u>

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 \$36.6 and \$34.1 billion at June 30, 2006 and 2005, respectively. Net assets increased \$2.5 billion during both FY06 and FY05.

Contributions

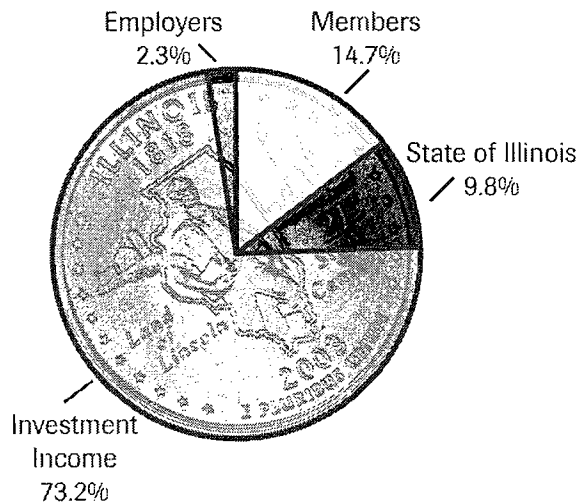
Contributions decreased \$360 and \$4,441 million during FY06 and FY05, respectively. During FY06, member contributions increased \$37 million and employer contributions from school districts decreased \$24 million. During FY05, member contributions decreased \$7 million and employer contributions from school districts increased \$20 million. The majority of the decrease in the employer contributions from school districts in FY06 is attributable to a reduction in the contribution rate on federally-funded salaries from 10.5 percent in FY05 to 7.06 percent in FY06.

and a decrease in employer Early Retirement Option contributions due to a lower number of members electing to retire under the Early Retirement Option.

The State of Illinois makes appropriations to TRS. Receipts from the State of Illinois decreased \$373 and \$4,455 million in FY06 and FY05, respectively. The decrease in FY06 occurred because Public Act 94-0004 specified a lower appropriation that was not based on actuarial funding requirements. The large decrease in FY05 is due to the one-time receipt of pension obligation bond proceeds from the State of Illinois in FY04. On July 2, 2003, TRS deposited \$4.330 billion in bond proceeds received 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.

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 are 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. Higher state contributions will be needed 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, 2006



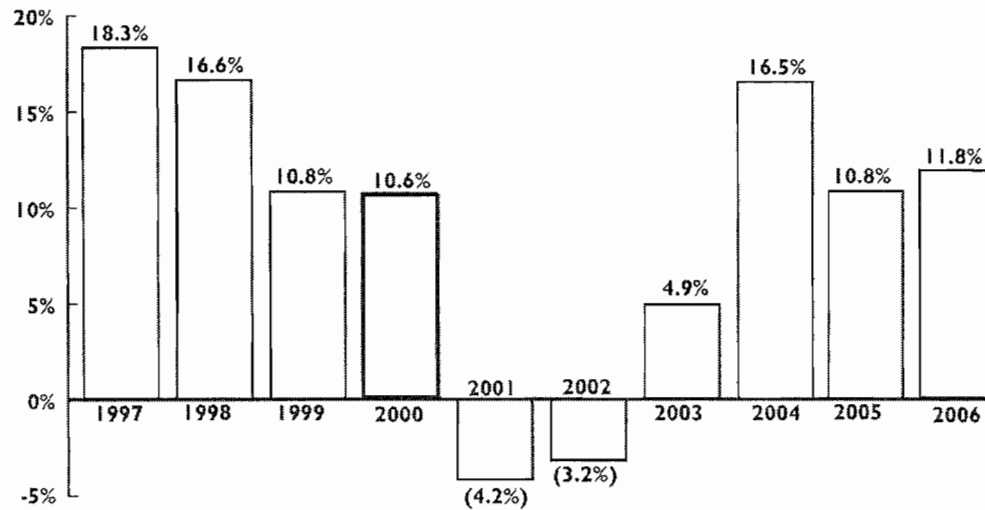
Investments

The TRS trust fund is invested according to law 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 \$2.4 billion from \$34.9 billion at June 30, 2005 to \$37.3 billion at June 30, 2006.

The TRS investment portfolio had another strong year. TRS investments earned an 11.8 and 10.8 percent rate of return, net of fees, for FY06 and FY05, respectively, as all asset classes again produced positive returns. Overall, the U.S. economy remained vibrant and inflation restrained, providing a healthy investment environment. Outside of the U.S., markets were even stronger with stock returns in the high 20 percent range led by continued expansion from emerging market economies. Substantial gains were accumulated in the private markets in FY06 with the TRS private equity portfolio returning 23.8 percent, net of fees, and the TRS real estate portfolio generating an 18.8 percent return, net of fees. The five- and 10-year returns are 7.9 percent and 9.0 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)



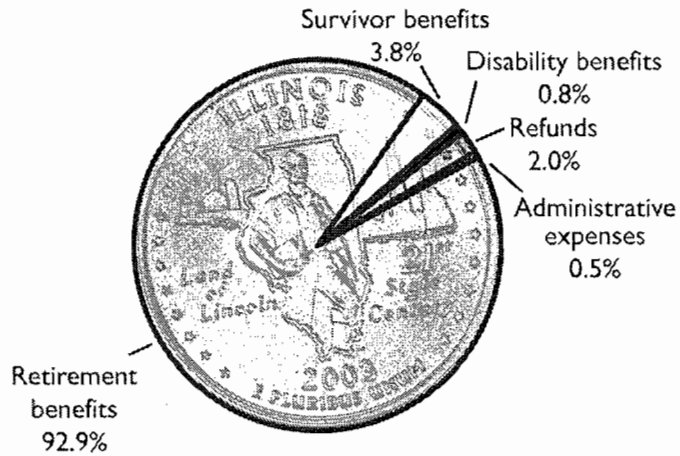
The annual rate of return is an indication of TRS investment performance and is provided by the TRS Master Trustee.

Benefits and Refunds

Survivor, disability, and retirement benefit payments increased \$344 and \$271 million during FY06 and FY05, respectively. During FY06, benefit payments increased from \$2,533 million with 82,575 recipients during FY05 to \$2,877 million with 85,103 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 and an increase in the number of retirees from 73,464 as of June 30, 2005 to 75,747 as of June 30, 2006.

Refunds of contributions decreased \$2 million during FY06 and increased \$12 million during FY05. The decrease in refunds is a result of the decrease in 2.2 upgrade contribution refunds.

Expenses by Type for the Year Ended June 30, 2006

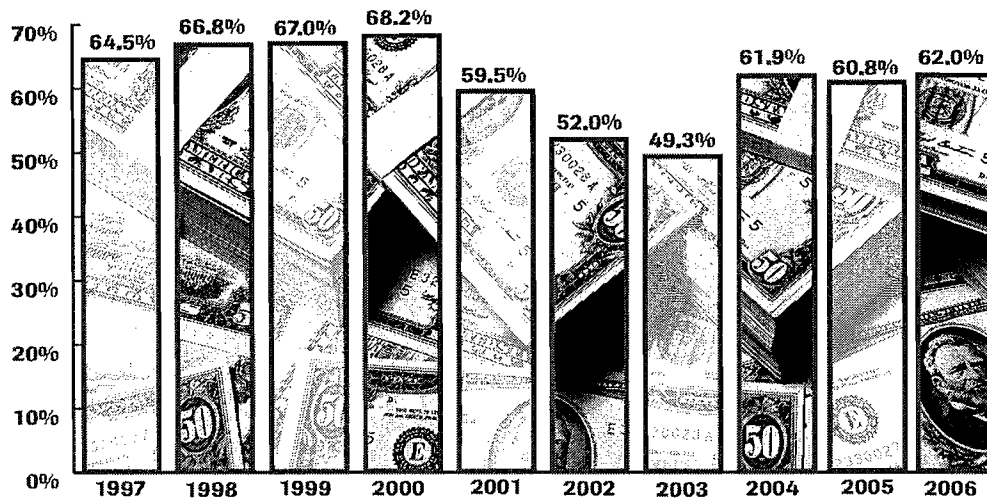


Actuarial

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 \$2.92 and \$5.13 billion during FY06 and FY05, respectively, to \$59.00 billion at June 30, 2006 and \$56.08 billion at June 30, 2005. 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 \$0.42 billion during FY06 to \$22.41 billion at June 30, 2006 and increased \$2.59 billion during FY05 to \$21.99 billion at June 30, 2005. The funded ratio reflects the percentage of the accrued liability covered by net assets at market value. The funded ratio increased to 62.0 percent at June 30, 2006 from 60.8 percent at June 30, 2005.

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.

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.

The enactment of Public Act 94-0004 in June 2005 continues to have significant impact on TRS because it dramatically reduced the FY06 and FY07 state contributions. The \$523.9 million reduction in FY06 is being followed by a \$497.6 million reduction 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 year 2045 is unchanged.

Basic Financial Statements

Teachers' Retirement System of the State of Illinois

Statements of Plan Net Assets

as of June 30, 2006, and 2005

	2006	2005
Assets		
Cash	<u>\$3,867,280</u>	<u>\$3,777,107</u>
Receivables and prepaid expenses		
Member payroll deduction	51,724,086	57,506,146
Member contributions	45,424,593	41,216,097
Employer contributions	10,285,346	30,947,290
State of Illinois	194,093	441,044
Investment income	243,067,231	249,963,566
Prepaid expenses	<u>1,355,073</u>	<u>2,444,768</u>
Total receivables and prepaid expenses	<u>352,050,422</u>	<u>382,518,911</u>
Investments, at fair value		
Fixed income	10,537,985,786	10,325,741,083
Equities	20,031,392,346	18,787,194,875
Real estate	3,946,280,351	3,525,456,881
Short-term investments	1,273,184,193	1,163,168,990
Private equity investments	1,513,997,646	1,068,633,225
Foreign currency	<u>34,040,496</u>	<u>28,166,730</u>
Total investments	<u>37,336,880,818</u>	<u>34,898,361,784</u>
Collateral from securities lending	<u>4,401,016,409</u>	<u>4,386,594,663</u>
Property and equipment, at cost, net of accumulated depreciation of \$5,149,154 and \$5,235,129 in 2006 and 2005, respectively	<u>2,333,759</u>	<u>2,320,275</u>
Total assets	<u>42,096,148,688</u>	<u>39,673,572,740</u>
Liabilities		
Benefits and refunds payable	4,815,189	4,124,841
Administrative and investment expenses payable	125,120,198	118,607,225
Payable to brokers for unsettled trades, net	980,307,465	1,079,027,534
Securities lending transactions	<u>4,401,016,409</u>	<u>4,386,594,663</u>
Total liabilities	<u>5,511,259,261</u>	<u>5,588,354,263</u>
Net assets held in trust for pension benefits	<u>\$36,584,889,427</u>	<u>\$34,085,218,477</u>

(A schedule of funding progress is presented on page 31.)
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, 2006, and 2005

	2006	2005
Additions		
Contributions		
Members	\$799,034,336	\$761,790,009
State of Illinois	534,305,256	906,749,310
Employers		
Early retirement	53,897,973	65,378,955
Federal funds	24,331,277	39,840,799
2.2 benefit formula	45,162,802	43,593,282
Excess salary/sick leave	150,556	0
Total contributions	<u>1,456,882,200</u>	<u>1,817,352,355</u>
Investment income		
From investment activities		
Net appreciation in fair value	2,971,529,661	2,569,878,360
Interest	489,976,262	352,219,842
Real estate operating income, net	270,388,389	222,603,171
Dividends	353,259,841	268,364,399
Private equity income	26,197,197	20,389,300
Other investment income	1,870,744	1,931,616
Investment activity income	4,113,222,094	3,435,386,688
Less investment expense	(132,196,285)	(114,896,886)
Net investment activity income	<u>3,981,025,809</u>	<u>3,320,489,802</u>
From securities lending activities		
Securities lending income	199,749,533	88,385,077
Securities lending management fees	(2,162,259)	(1,931,333)
Securities lending borrower rebates	(185,323,203)	(76,904,388)
Net securities lending activity income	<u>12,264,071</u>	<u>9,549,356</u>
Total investment income	<u>3,993,289,880</u>	<u>3,330,039,158</u>
Total additions	<u>5,450,172,080</u>	<u>5,147,391,513</u>
Deductions		
Retirement benefits	2,741,163,998	2,407,652,120
Survivor benefits	112,901,636	103,990,670
Disability benefits	23,165,063	21,460,058
Refunds	57,967,063	59,395,758
Administrative expenses	15,303,370	14,403,715
Total deductions	<u>2,950,501,130</u>	<u>2,606,902,321</u>
Net increase	<u>2,499,670,950</u>	<u>2,540,489,192</u>
Net assets held in trust for pension benefits		
Beginning of year	<u>34,085,218,477</u>	<u>31,544,729,285</u>
End of year	<u>\$36,584,889,427</u>	<u>\$34,085,218,477</u>

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. Public Act 94-1057, which became law on July 31, 2006, provides additional exemptions from employer contributions for excess salary increases. Some of these exemptions are permanent while others are available for a limited time period. 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 14.

Number of Employers (as of June 30)

	2006	2005
Local school districts	871	878
Special districts	137	139
State agencies	<u>24</u>	<u>25</u>
Total	<u>1,032</u>	<u>1,042</u>

3. Members

TRS Membership (as of June 30)

	2006	2005
Retirees and beneficiaries receiving benefits	85,103	82,575
Inactive members entitled to but not yet receiving benefits	81,218	87,328
Active members	<u>159,272</u>	<u>155,850</u>
Total	<u>325,593</u>	<u>325,753</u>

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 June 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 employers from several sources. The State of Illinois provides the largest source of contributions through state appropriations from the Common School Fund. Additional significant sources of state contributions in prior years have been the Educational Assistance Fund, the General Revenue Fund, and the State Pensions Fund. 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 and any excess salary increase or sick leave costs due.

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 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 are 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 April 2004, GASB issued Statement No. 43, "Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans" (OPEB). The statement requires that OPEB plans accrue for

the liabilities of such benefits over the working careers of plan members. Currently, most government sponsored OPEB plans are funded on a pay-as-you-go basis. The statement pertains to the plans themselves, not participating employers. TRS state agency employers participate in the State Employees Group Insurance Plan; other TRS employers participate in the Teachers' Retirement Insurance Program. For both of these postemployment benefit plans, the requirements of the statement are effective for periods beginning after December 15, 2005. The first disclosure will be for the year ending June 30, 2007.

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 were effective for statistical sections prepared for periods beginning after June 15, 2005. TRS has implemented GASB 44 in the year ending June 30, 2006.

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. The first disclosure will be for the year ending June 30, 2008.

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 reviewing and evaluating the reasonableness of the valuations provided 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, 2006, and 2005 totaled \$1,376,394 and \$1,371,271, 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, real estate and private equity 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 \$51,724,086 and \$57,506,146 as of June 30, 2006, and 2005 respectively.

8. Prior Period Reclassification

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

9. Risk Management

TRS, as a component unit of the State of Illinois, provides for risks of loss associated with workers' compensation and general liability through the State's self-insurance program. TRS obtains commercial insurance for fidelity, surety, and property. No material commercial insurance claims have been filed in the last three fiscal years.

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 adopted a formal policy during FY06 to address custodial credit risk. The policy's purpose is to minimize custodial credit risk through proper due diligence of custody financial institutions and investment advisors; segregate safekeeping of TRS assets; establish investment guidelines and endeavor to have all investments held in custodial accounts through an agent, in the name of custodian's nominee, or in a corporate depository or federal book entry account system. For those investment assets held outside of the custodian, TRS will follow the applicable regulatory rules.

The non-investment bank balance and carrying amount of TRS's deposits were \$3,691,765 and \$3,867,280 at June 30, 2006, and \$3,474,640 and \$3,777,107 at June 30, 2005. Of the bank balance, \$3,567,765 and \$3,121,085 were on deposit with the state treasurer at June 30, 2006, and 2005, 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 \$124,000 and \$353,555 at June 30, 2006 and 2005, 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. Certain investments of TRS with maturities of 90 days or less would be considered cash equivalents; these consist of bank sponsored short-term investment funds, negotiable certificates of deposits, commercial paper, and various futures and option contracts. For financial statement presentation and investment purposes, TRS reports its cash equivalents as short-term investments in the Statements of Plan Net Assets.

For purposes of this disclosure, foreign currency held by investment managers is considered a deposit. However, for financial statement presentation and investment purposes, TRS considers foreign currency an investment asset. Uncollateralized foreign currency subject to custodial credit risk was \$26,484,325 and \$20,862,357 at June 30, 2006 and June 30, 2005, respectively.

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 adopted a formal policy during FY06 to address custodial credit risk. The following table presents investments that were uninsured and unregistered, with the securities held by a counterparty, but not in TRS's name:

	<u>6/30/06</u>	<u>6/30/05</u>
Government Treasury Notes	-	\$902,555
Index Linked Government Bonds	-	31,220,983
Negotiable Bank Certificates of Deposit	-	7,751,882
Short-term Bills and Notes Held with Brokers	\$1,338,197	55,285,738
Cash Deposits Held with Brokers for Variation Margin	116,100	49,238,508
Total	<u>\$1,454,297</u>	<u>\$144,399,666</u>

Note: Beginning in FY06, foreign currency is considered a deposit for purposes of this disclosure. For comparative purposes, FY05 information was reclassified.

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 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, the investment manager's internal ratings, or other mitigating factors.

As of June 30, 2006, 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	U.S. Agency Obligations	Other*	Total
Aaa	\$1,979,700,747	\$235,375,908	\$2,814,237,689	-	\$5,029,314,344
Aa1	126,634,211	15,950,748	1,758,474	-	144,343,433
Aa2	76,775,612	37,053,499	28,000,300	-	141,829,411
Aa3	259,815,386	36,128,610	106,372	-	296,050,368
A1	111,207,193	7,268,977	201,766	-	118,677,936
A2	128,549,253	44,153,283	-	-	172,702,536
A3	137,714,809	42,971,816	-	-	180,686,625
Baa1	89,734,559	63,315,484	-	-	153,050,043
Baa2	212,134,786	43,346,880	-	-	255,481,666
Baa3	118,480,875	6,384,943	4,262,571	-	129,128,389
Ba1	115,729,024	12,453,489	-	-	128,182,513
Ba2	178,831,524	3,163,760	-	-	181,995,284
Ba3	18,517,672	17,143,177	-	-	35,660,849
B1	6,911,118	5,160,893	-	77,089,595	89,161,606
B2	26,089,728	2,173,375	-	-	28,263,103
B3	4,675,600	1,438,992	-	-	6,114,592
Caa1	874,881	295,572	-	-	1,170,453
Not Available	-	-	-	(3,157,583)	(3,157,583)
Not Rated	52,335,632	83,104,367	18,290,504	-	153,730,503
Withdrawn	<u>70</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>70</u>
Total Credit Risk:					
Debt Securities	\$3,644,712,680	\$656,883,773	\$2,866,857,676	\$73,932,012	\$7,242,386,141
US Governments and Agencies**	-	-	1,861,894,930	-	1,861,894,930
U.S. Treasuries**	-	-	1,433,704,715	-	1,433,704,715
Total Bonds, Corporate Notes and Government Obligations	<u>\$3,644,712,680</u>	<u>\$656,883,773</u>	<u>\$6,162,457,321</u>	<u>\$73,932,012</u>	<u>\$10,537,985,786</u>

* Includes commingled funds, interest rate and credit default swaps, and swaptions. Swap positions can be used to mitigate, or add to, the risk associated with various fixed income exposures, tiers, or sectors. The market value of swaps and swaptions is not indicative of actual exposure to counterparty risk.

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

As of June 30, 2005, TRS held the following fixed income investments with respective quality ratings.

Quality Rating	Corporate Debt Securities	Foreign Debt Securities	U.S. Agency Obligations	Commingled/ Closed End Funds	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
Not Available	4,104,203	11,224,776	-	-	15,328,979
Not Rated	16,521,938	-	-	-	16,521,938
Withdrawn	35,368,161	-	-	-	35,368,161
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, 2006 and June 30, 2005 TRS did not have investments in any one organization representing 5 percent or more of TRS assets other than those issued or explicitly guaranteed by the U.S. government.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. TRS's fixed income investments are managed in accordance with operational guidelines that are specific as to the degree of interest rate risk that can be taken. TRS manages the interest rate risk within the portfolio using various methods, including effective duration, option adjusted duration, average maturity, and segmented time distribution, which reflects total fair value of investments maturing during a given time period. In FY05, the System disclosed the option adjusted duration method, but has selected to disclose the segmented time distribution in FY06 for ease in comparability and statewide information compilation.

The segmented time distribution of the various investment types of TRS debt securities at June 30, 2006 and June 30, 2005 are as follows:

Type	2006 Market Value	Maturity in Years				
		Less Than 1 Year	1 to 5 Years	6 to 10 Years	10 to 20 Years	More than 20 Years
U.S. Treasuries	\$1,433,704,715	\$270,592,002	\$610,149,352	\$325,812,394	\$77,136,780	\$150,014,187
U.S. Federal Agencies	1,612,335,642	833,744,349	367,432,569	175,687,738	214,431,570	21,039,416
U.S. Government Index Linked Bonds	263,914,841	3,824,332	84,168,037	84,694,942	39,202,072	52,025,458
U.S. Government Backed Mortgages	2,818,412,775	6,429	15,634,829	65,864,490	1,016,588,172	1,720,318,855
U.S. Municipals (Taxable)	11,619,751	0	0	0	0	11,619,751
U.S. Corporate Obligations						
Asset Backed Securities	721,905,881	2,203,740	265,683,818	46,975,450	25,847,123	381,195,750
Commercial Mortgage Backed Securities	527,255,346	0	0	35,652,693	17,402,809	474,199,844
Collateralized Mortgage Obligations	781,486,169	11,706	25,487,690	89,919	45,943,946	709,952,908
Commingled/Closed End Funds*	77,089,595	0	0	77,089,595	0	0
Corporate Convertible Bonds	2,945,437	0	0	0	0	2,945,437
Credit Obligations						
Financial	955,446,107	78,372,019	539,336,808	227,665,301	3,941,720	106,130,259
Industrial	544,794,865	27,036,179	174,739,721	168,075,086	61,905,703	113,038,176
Utilities	133,348,472	11,790,419	70,424,837	26,060,526	3,405,578	21,667,112
Swaps/Swaptions/ Other Assets	(3,157,583)	(445,532)	(2,171,659)	(86,433)	20,750	(474,709)
Foreign Debt Obligations	656,883,773	72,483,030	174,006,436	148,702,522	61,741,509	199,950,276
Total Bonds, Corporate Notes and Government Obligations	\$10,537,985,786	\$1,299,618,673	\$2,324,892,438	\$1,382,284,223	\$1,567,567,732	\$3,963,622,720

Type	2005 Market Value	Maturity in Years				
		Less Than 1 Year	1 to 5 Years	6 to 10 Years	10 to 20 Years	More than 20 Years
U.S. Treasuries	\$1,957,811,175	\$643,652,805	\$894,956,787	\$142,994,153	\$118,568,913	\$157,638,517
U.S. Federal Agencies	1,331,356,248	630,477,778	321,291,733	177,294,595	181,001,966	21,290,176
U.S. Government Index Linked Bonds	346,564,816	0	126,768,398	149,343,456	7,863,693	62,589,269
U.S. Government Backed Mortgages	2,371,367,541	383	7,528,571	74,772,484	816,749,099	1,472,317,004
U.S. Municipals (Taxable)	12,527,227	0	0	0	5,015,506	7,511,721
U.S. Corporate Obligations						
Asset Backed Securities	614,698,386	3,334,403	249,408,890	52,182,747	21,311,370	288,460,976
Commercial Mortgage Backed Securities	287,002,709	0	0	28,944,821	5,459,160	252,598,728
Collateralized Mortgage Obligations	587,153,543	0	2,942,085	123,630	64,169,826	519,918,002
Commingled/Closed End Funds*	668,564,763	0	0	668,564,763	0	0
Credit Obligations						
Financial	565,452,732	11,100,925	329,936,455	159,621,611	2,803,503	61,990,238
Industrial	821,791,248	56,658,118	297,886,836	246,938,711	60,672,278	159,635,305
Utilities	101,749,141	18,442,008	26,114,884	33,968,126	4,629,055	18,595,068
Foreign Debt Obligations	659,701,554	6,986,478	141,194,711	199,947,435	77,618,832	233,954,098
Total Bonds, Corporate Notes and Government Obligations	\$10,325,741,083	\$1,370,625,898	\$2,398,029,350	\$1,934,696,532	\$1,365,863,201	\$3,256,499,102

* Weighted average maturity figures were used to place the commingled funds within the schedule.

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 or options 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, 2006 is as follows:

Currency	Foreign Currency	Equities	Fixed Income	Total
Argentine Peso	\$37,365	-	-	\$37,365
Australian Dollar	789,971	230,810,274	26,169,835	257,770,080
Brazilian Real	23,937	136,629,481	-	136,653,418
British Pound Sterling	1,765,664	1,349,240,757	85,095,411	1,436,101,832
Canadian Dollar	228,811	68,573,862	15,064,599	83,867,272
Czech Koruna	-	16,929	-	16,929
Danish Krone	10,663	30,964,077	-	30,974,740
Egyptian Pound	185,065	-	-	185,065
Euro	9,947,634	2,131,436,919	111,933,378	2,253,317,931
Hong Kong Dollar	227,425	191,574,469	-	191,801,894
Hungarian Forint	1,368	6,620,329	-	6,621,697
Iceland Krona	(719,953)	-	-	(719,953)
Indian Rupee	-	9,451	-	9,451
Indonesian Rupiah	231,881	4,983,090	-	5,214,971
Japanese Yen	18,050,855	1,116,078,296	44,374,037	1,178,503,188
Malaysian Ringgit	41,911	16,279,287	-	16,321,198
Mexican Peso	524,871	33,640,995	487,104	34,652,970
New Israeli Shekel	88,749	6,314,693	-	6,403,442
New Taiwan Dollar	543,290	190,826,183	-	191,369,473
New Zealand Dollar	758,417	18,346,596	6,758,259	25,863,272
Norwegian Krone	50,242	49,450,370	-	49,500,612
Philippine Peso	-	5,146,128	-	5,146,128
Polish Zloty	-	10,397,421	-	10,397,421
Singapore Dollar	286,826	46,123,066	-	46,409,892
South African Rand	41,103	78,664,878	-	78,705,981
South Korean Won	117,168	291,388,627	-	291,505,795
Swedish Krona	13,939	90,977,321	19,051,307	110,042,567
Swiss Franc	793,287	439,090,536	-	439,883,823
Thai Baht	-	18,270,368	-	18,270,368
Turkish Lira	7	8,058,889	-	8,058,896
Total Subject to Foreign Currency Risk	\$34,040,496	\$6,569,913,292	\$308,933,930	\$6,912,887,718
Investments in International Securities Payable in United States Dollars	-	848,448,548	347,495,188	1,195,943,736
Total International Investment Securities	\$34,040,496	\$7,418,361,840	\$656,429,118	\$8,108,831,454
Domestic Investments	-	12,613,030,506	9,881,556,668	22,494,587,174
Total Fair Value	\$34,040,496	\$20,031,392,346	\$10,537,985,786	\$30,603,418,628

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's foreign currency investments in real estate were \$50,484,037 at June 30, 2006 and \$35,884,547 at June 30, 2005. TRS had foreign currency limited partnerships with fair values totaling \$0 at June 30, 2006 and \$9,964,474 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 121 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 54 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, 2006 and June 30, 2005, TRS had outstanding loaned investment securities having a market value of \$4,788,220,451 and \$4,715,848,757, respectively, against which it had received collateral of \$4,873,673,805 and \$4,839,824,722, 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 as a fundamental part of the overall investment portfolio. 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, sometimes known as default 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 can be 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, currency, or other pertinent market 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, options, swaps, and swaptions.

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, 2006, foreign currency forward purchase or sell contracts included the following currencies: Australian dollar, British pound sterling, Canadian dollar, Chinese yuan renminbi, euro, Japanese yen, Mexican peso, New Taiwan dollar, New Zealand dollar, Singapore dollar, South Korean won, Swedish krona, and U.S. dollar. These contracts have various settlement dates within 12 months of June 30, 2006.

Fair Value: As of June 30, 2006 and June 30, 2005, TRS's open foreign currency forward contracts had a net fair value of \$(663,933) and \$10,840,085, respectively. This represents the unrealized gain/(loss) on the contracts at June 30.

	Market Value as of June 30, 2006	Market Value as of June 30, 2005
Forward Currency Purchases	\$512,644,262	\$456,926,270
Forward Currency Sales	<u>(513,308,195)</u>	<u>(446,086,185)</u>
Unrealized Gain/(Loss)	<u>(\$663,933)</u>	<u>\$10,840,085</u>

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 daily 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, 2006 and June 30, 2005, TRS had outstanding futures contracts with an underlying notional value of \$3,682,521,295 and \$2,704,099,768, respectively. Contractual principal values do not represent the actual values in the Statements of Plan Net Assets. The contracts have various expiration dates through March 2008.

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	FY06 Number of Contracts	FY06 Contractual Principal	FY05 Number of Contracts	FY05 Contractual Principal
Fixed Income Index Futures – Long	5,447	\$752,085,250	1,361	\$168,664,063
Fixed Income Index Futures – Short	(3,508)	(365,874,031)	(2,204)	(246,377,719)
International Fixed Income Index Futures – Long*	24	3,348,324	1,422	18,811,006
International Fixed Income Index Futures – Short	0	0	(1,361)	(51,155,057)
U.S. Stock Index Futures – Long	11,744	1,930,275,240	11,657	1,899,948,375
Cash Equivalent (Eurodollar) Futures – Long	5,831	1,377,105,387	3,808	914,209,100
Cash Equivalent (Eurodollar) Futures – Short	<u>(61)</u>	<u>(14,418,875)</u>	<u>0</u>	<u>0</u>
Total	<u>19,477</u>	<u>\$3,682,521,295</u>	<u>14,683</u>	<u>\$2,704,099,768</u>

* Includes options on futures for FY05.

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. Premiums received are recorded as a liability when the financial option is written.

Terms: At June 30, 2006 and June 30, 2005, TRS had outstanding options contracts, including options on futures, with underlying notional value of \$1,913,991,322 and \$72,711,812, respectively. Contractual principal/notional values do not represent the actual values in the Statements of Plan Net Assets. The contracts have various expiration dates through December 2007.

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, 2006 and June 30, 2005, the fair value of option contracts written, gross of premiums received, was (\$9,977,064) and \$380,116, 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, 2006 and June 30, 2005. 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. For FY06, all positions are options on futures representing the corresponding futures exposure.

Type	FY06 Number of Contracts	FY06 Contractual Principal	FY05 Number of Contracts	FY05 Contractual Principal
Fixed Income Written Call Options	0	\$0	568	\$15,697,907
Fixed Income Written Put Options	0	0	554	(4,405,895)
Fixed Income Call Options on Futures	(154)	2,789,600	0	0
Fixed Income Put Options on Futures	(242)	3,630,000	0	0
Cash Equivalent Written Call Options (Eurodollar)	0	0	1,468	61,419,800
Cash Equivalent Call Options on Futures	3,055	145,533,250	0	0
Cash Equivalent Put Options on Futures	5,203	1,122,213,000	0	0
Cash Equivalent Call Options on Futures (Non-dollar)	1,310	590,997,356	0	0
Cash Equivalent Put Options on Futures (Non-dollar)	55	48,828,116	0	0
Total	<u>9,227</u>	<u>\$1,913,991,322</u>	<u>2,590</u>	<u>\$72,711,812</u>

Swaptions

Objective: Swaptions are options on swaps that give the purchaser the right, but not the obligation, to enter into a swap at a specific date in the future. An interest-rate swaption gives the buyer the right to pay or receive a specified fixed rate in a swap in exchange for a floating rate for a stated time period. Conversely, the writer of a swaption sells the right to another party, and thus is obligated to pay or receive a fixed rate in exchange for a floating rate, if the buyer exercises the option. A purchased (long) call swaption gives the buyer the right to receive a fixed rate in exchange for a floating rate for a stated period of time. In a written call swaption, the seller (writer) has the obligation to pay a fixed rate in exchange for a floating rate for a stated period of time, if the swaption is exercised. A purchased (long) put swaption gives the buyer the right to pay a fixed rate in exchange for a floating rate for a stated period of time. In a written put swaption, the seller has the obligation to receive a fixed rate in exchange for a floating rate for a stated period of time, if the swaption is exercised. TRS has both written and purchased swaptions in its portfolio. As the writer of a swaption, TRS receives a premium at the outset of the agreement. Premiums are recorded as a liability when the swaption is written.

Terms: At June 30, 2006, TRS had outstanding purchased call swaption exposure of \$138,072,686, written call swaption exposure of (\$22,798,766), and written put swaption exposure of

(\$13,549,576). The contracts have various expiration dates through June 2007. The exposure amounts do not represent the actual values in the Statement of Plan Assets.

Fair Value: Fluctuations in the fair value of swaptions are recognized in TRS's financial statements as incurred rather than at the time the swaptions are exercised or when they expire. As of June 30, 2006, and June 30, 2005, the fair value of swaption contracts was (\$485,657) and \$0, respectively.

Interest Rate Swaps

Objective: Interest rate swaps are agreements between two or more parties to exchange sets of cash flows over a period of time. In the most common type of interest rate swap arrangement, one party agrees to pay fixed interest payments on designated dates to a counterparty who, in turn, agrees to make return interest payments that float with some reference rate. Long swap positions (receive fixed) increase exposure to long-term interest rates; short positions (pay fixed) decrease exposure.

Terms: At June 30, 2006, TRS was a party to interest rate swaps in euro, pound sterling, and U.S. dollars. The swap agreements have various maturity dates ranging from 2007 to 2035. Swap agreements typically are settled on a net basis, which means that the two payment streams are netted out, with a party receiving or paying only the net amount of the two payments. Payments may be made at the conclusion of a swap agreement or periodically during its term.

Fair Value: The table below presents the fair value of TRS's interest rate swap exposure at June 30, 2006. The retirement system held no interest rate swaps at June 30, 2005.

	Par/Notional Value	Receivable/(Payable)
Receive Floating/Pay Fixed	\$81,900,000	\$1,018,351
Receive Fixed/Pay Floating	151,900,000	(3,256,206)

Credit Default Swaps

Objective: Credit default swaps are derivative instruments that are constructed to replicate the effect of investing in debt obligations of corporate bond issuers as a means to manage corporate bond exposure. The risk of the credit default swaps is comparable to the credit risk of the underlying debt obligations of corporate issuers that comprise the credit default swaps. The owner of protection (long the swap) pays an annual premium to the seller of protection (short the swap) for the right to sell a bond at a previously agreed upon value in the event of a default by the bond issuer. The premium is paid periodically over the term of the swap or until a credit event of the bond issuer occurs. In the event of a default, the swap expires, and the seller of protection makes a payment to the buyer, which is usually based on a fixed percentage of total par. Purchased credit default swaps decrease credit exposure (buying protection), providing the right to sell bonds to the counterparty in the event of a default. Written credit default swaps increase exposure (selling protection), obligating the portfolio to buy bonds from counterparties in the event of a default.

Terms: At June 30, 2006, TRS had both purchased and written credit default swaps in its portfolio. The swap agreements have various maturity dates ranging from 2006 to 2020. TRS held no credit default swaps during FY05. The total notional value of purchased credit default swaps (buying protection) was \$28,220,000 at June 30, 2006. The total notional value of written credit default swaps (selling protection) was \$8,900,000 at June 30, 2006.

Fair Value: The fair value of credit default swaps held by TRS at June 30, 2006 was \$36,098. This amount represents the net amount of payments due to TRS under these agreements.

Basket Default Swaps

Objective: Basket default swap are products through which an investor gains either long or short exposure to a relatively small basket of credits or a specific market sector. The investor is either selling or buying protection against default on one of the credits in the basket to default, similar to a credit default swap. A seller of credit protection against a basket of securities receives an upfront or periodic payment to compensate against potential default events. If a default event occurs, the seller must pay the buyer the full notional value of the reference obligation in exchange for the reference obligation. If no default occurs, the buyer loses the premium paid. A buyer of credit protection against a basket of securities pays an upfront or periodic payment until either maturity or default. In the event of a default, the buyer receives a lump-sum payment.

Terms: At June 30, 2006, TRS had basket default swaps buying protection with a total notional value of \$79,725,000. TRS held no basket default swaps at June 30, 2005. The swap agreements have expiration dates ranging from 2010 to 2020.

Fair Value: The fair value of the basket default swaps held by TRS at June 30, 2006, was (\$470,171). This amount represents the payments due from TRS to counterparties under the terms of the agreements, with all positions still open.

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 Benefit Trust Reserve.

1. Benefit Trust

	2006	2005
Balances at June 30	\$36,580,437,823	\$34,081,019,184

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 \$22,412,024,000 in 2006 and \$21,989,811,000 in 2005.

2. Minimum Retirement Annuity

	2006	2005
Balances at June 30	\$4,451,604	\$4,199,293

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 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 FY06 and FY05 are included in the State of Illinois' *Comprehensive Annual Financial Report* (CAFR) for the years ended June 30, 2006, and 2005, 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 FY06, FY05, and FY04, the SERS employer contribution rates were 7.792 percent, 16.107 percent, and 13.439 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 FY06, FY05, and FY04 were \$416,093, \$824,671, and \$662,711, 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, 9.4 percent for TRS members beginning in FY06, formerly 9 percent during FY02 through FY05, and 8 percent in prior years) was included in the FY06 and FY05 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 was reduced to 2 percent in FY06 and expired July 1, 2006. The contribution pickup for TRS members was reduced to 6 percent in FY06, will be reduced to 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, 2006, and 2005. 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 Progress¹

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)
6/30/97	\$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
6/30/06	36,584,889,000	58,996,913,000	62.0	22,412,024,000	7,765,752,000	288.6

Schedule of Contributions from Employers and Other Contributing Entities¹

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
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
2006	531,828,000	69,645,000	601,473,000	1,679,524,000	35.8	601,555,000	100.0

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. Beginning in FY06, employer contributions for excess salary increases are included.

See accompanying Independent Auditors' Report.

Notes to Required Supplementary Information

Valuation Dates	June 30, 2006	June 30, 2005
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 However, FY06 and FY07 state contributions are specified by Public Act 94-0004, not based on the 15-year phase-in. FY08 state contribution will increase from actual FY07 contribution, returning to the phase-in schedule.	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. Minimum state contribution rates were eliminated.
Remaining amortization period:		
a) For GASB Statement #25 reporting purposes	40 years, open	40 years, open
b) Per state statute	40 years, closed	40 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

	2006	2005
Personal services	\$10,945,763	\$10,787,362
Professional services	1,015,544	981,768
Postage	505,394	452,629
Machine repair and rental	876,807	462,559
Other contractual services	1,028,647	765,214
Commodities	457,939	506,844
Occupancy expense	169,096	172,652
Depreciation	303,203	277,617
Gain/(Loss) on disposal of equipment	977	(2,930)
Total administrative expenses	<u>\$15,303,370</u>	<u>\$14,403,715</u>

Schedule of Investment Expense For Years Ended June 30

	2006	2005
Investment manager fees	\$120,493,923	\$104,343,041
Private equity investment expense	8,604,312	7,480,091
Miscellaneous	<u>3,098,050</u>	<u>3,073,754</u>
Total investment expense	<u>\$132,196,285</u>	<u>\$114,896,886</u>

Schedule of Payments to Consultants For Years Ended June 30

	2006	2005
Actuarial services	\$253,162	\$390,392
External auditors	102,529	119,254
Legal services	454,861	140,011
Management consultants		
Information systems	155,496	227,000
TRS STAR audit	20,000	41,990
Benchmarking	0	30,000
Board and staff training	10,500	26,922
Operations	15,000	3,360
Other	<u>3,996</u>	<u>2,839</u>
Total payments to consultants	<u>\$1,015,544</u>	<u>\$981,768</u>

See accompanying Independent Auditors' Report.



**Independent Accountants' Report on Internal Control over
Financial Reporting and on Compliance and Other Matters
Based on the Audit of the Financial Statements Performed
in Accordance With *Government Auditing Standards***

The Honorable William G. Holland
Auditor General
State of Illinois
and
The Board of Trustees
Teachers' Retirement System of the State of Illinois

As Special Assistant Auditors for the Auditor General, we have audited the financial statements of the Teachers' Retirement System of the State of Illinois, a component unit of the State of Illinois, as of and for the year ended June 30, 2006 and have issued our report thereon dated November 2, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted certain immaterial instances of internal control deficiencies, which have been reported to the Auditor General and System management in a separate letter dated November 2, 2006.

Compliance and Other Matters

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

However, we noted certain matters that we have reported to the Auditor General and System management in a separate letter dated November 2, 2006.

This report is intended solely for the information and use of the Auditor General, the General Assembly, the Legislative Audit Commission, the Governor and System management and is not intended to be and should not be used by anyone other than these specified parties.

BKD, LLP

November 2, 2006