

**COMMONWEALTH OF PENNSYLVANIA  
PUBLIC SCHOOL EMPLOYEES'  
RETIREMENT SYSTEM  
(A Component Unit of the Commonwealth  
of Pennsylvania)**

**FINANCIAL STATEMENTS  
June 30, 2007 and 2006**

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## Independent Auditor's Report

The Board of Trustees  
Public School Employees' Retirement System  
Harrisburg, Pennsylvania

We have audited the accompanying basic financial statements of the Public School Employees' Retirement System (PSERS), a component unit of the Commonwealth of Pennsylvania as of and for the years ended June 30, 2007 and 2006, as listed in the table of contents. These financial statements are the responsibility of the PSERS' 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. 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, PSERS' plan net assets as of June 30, 2007 and 2006, 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.

The Management's Discussion and Analysis and Required Supplemental Schedules of Funding Progress and Employer Contributions (Schedules 1 and 2) 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 made for the purpose of forming an opinion on the basic financial statements taken as a whole. The Supplemental Schedules 1 through 3 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Supplemental Schedules 1 through 3 have been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, are presented fairly, in all material respects, in relation to the basic financial statements taken as a whole.

*Clifton Gunderson LLP*

Baltimore, Maryland  
September 27, 2007

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
June 30, 2007**

Management's Discussion and Analysis (MD&A) of the Commonwealth of Pennsylvania Public School Employees' Retirement System's (PSERS) for the fiscal year ended June 30, 2007, provides a narrative summary of PSERS' financial position and performance, including highlights and comparative data. The MD&A is presented as required supplemental information to the financial statements and should be read in conjunction with the letter of transmittal, the financial statements, the notes to financial statements and the supplementary schedules.

**Overview of Financial Statements**

PSERS is primarily responsible for administering a defined benefit pension plan for public school employees in the Commonwealth of Pennsylvania. PSERS also administers two postemployment healthcare programs, the Health Insurance Premium Assistance Program (Premium Assistance) and the Health Options Program (HOP), for its annuitants. The financial statements present the financial activities for the pension plan and the two postemployment healthcare programs.

The *Statements of Plan Net Assets* provide a snapshot of the financial position of PSERS at June 30, 2007, including comparative amounts for the prior year.

The *Statements of Changes in Plan Net Assets* summarize PSERS' financial activities that occurred during the fiscal period from July 1, 2006 to June 30, 2007, including comparative amounts for the prior year.

The *Notes to Financial Statements* provide additional information that is essential to a full understanding of the financial statements. The notes are an integral part of the financial statements and include detailed information not readily evident in the basic financial statements.

The *Required Supplemental Schedules* immediately following the notes to financial statements provide two schedules showing historical information concerning the funded status of PSERS and the employer contributions.

The remaining supplemental schedules provide additional detailed information concerning the operating expenses, investment expenses and payments to non-investment consultants. All of this supplemental information is considered useful in understanding and evaluating the financial activities of PSERS.

**Financial Highlights**

- PSERS' total plan net assets increased by \$10.1 billion from \$57.4 billion at June 30, 2006 to \$67.5 billion at June 30, 2007, the highest fiscal year-end total in PSERS' history. The increase is primarily attributable to net investment income and member and employer contributions combined that exceeded the payment of pension benefits and administrative expenses. The increase in plan net assets from \$52.1 billion to \$57.4 billion in the year ended June 30, 2006, was also attributed to net investment income and member and employer contributions combined that exceeded the payment of pension benefits and administrative expenses.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
June 30, 2007**

- PSERS' funded ratio as of the latest actuarial valuation dated June 30, 2006 decreased from 83.6% at June 30, 2005 to 81.2% at June 30, 2006. The decrease is primarily due to the residual effect of an actuarial asset loss caused by the downturn in the financial markets from 2001 to 2003. The funded ratio at June 30, 2004 was 91.2%.
- The rate of return on investments was 22.93% for the fiscal year ended June 30, 2007 (FY 2007), 15.26% for the fiscal year ended June 30, 2006 (FY 2006) and 12.87% for the fiscal year ended June 30, 2005 (FY 2005).
- Total member contributions increased from \$983 million in FY 2006 to \$1 billion in FY 2007 due to a slight increase in the average member contribution rate and an increase in the active member payroll. Total member contributions also increased between FY 2005 and FY 2006 because of the same factors.
- Total employer contributions increased from \$531 million in FY 2006 to \$746 million in FY 2007. The net increase is primarily attributable to an increase in the total employer contribution rate from 4.69% in FY 2006 to 6.46% in FY 2007. Total employer contributions increased from FY 2005 to FY 2006 due to an increase in the total employer contribution rate from 4.23% to 4.69%.
- Total PSERS' benefit payouts increased by \$200 million from \$4.1 billion in FY 2006 to \$4.3 billion in FY 2007. The increase is primarily attributable to an increase in the number of retirees and beneficiaries currently receiving benefits. Benefit payouts also increased by \$200 million from FY 2005 to FY 2006 due to an increase in the number of retirees added to the payroll.
- Total administrative expenses increased by \$1.9 million from \$48.6 million in FY 2006 to \$50.5 million in FY 2007 primarily due to higher administrative expenses for Premium Assistance and HOP. Administrative expenses increased by \$6 million between FY 2005 and FY 2006 primarily due to the carry-over of expenditures for the New Pension Administration System Project and an increase in expenditures for HOP in FY 2006. Administrative expenses were within PSERS' budgeted amounts for each of the fiscal years.

**Funded Status**

PSERS uses an actuarial reserve type of funding that is financed by member contributions, employer contributions and earnings from invested assets. An independent actuarial valuation of PSERS' actuarial assets and liabilities is performed annually. As part of this valuation, the progress toward funding pension obligations of PSERS is measured by comparing the actuarial value of assets to the actuarial accrued liability. This measurement is referred to as the funded ratio or funded status. The most recent actuarial valuation reports that PSERS is 81.2% funded as of June 30, 2006. The results of operations for FY 2007 will be reflected in the actuarial valuation for the year ended June 30, 2007. Due to the normal lag time for completion of the actuarial valuation, the resulting funded status will be available at the end of the 2007 calendar year and will be reported in the financial statements for the fiscal year ended June 30, 2008 (FY 2008).

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
June 30, 2007**

**Analysis of Plan Net Assets**

<u>Summary of Plan Net Assets:</u>	<u>FY 2007</u>	<u>Increase (Decrease)</u>	<u>FY 2006</u>	<u>Increase (Decrease)</u>	<u>FY 2005</u>
<b>Assets:</b>					
Receivables	\$ 1,766,906	\$ 180,343	\$ 1,586,563	\$ 64,569	\$ 1,521,994
Investments	68,526,533	9,807,264	58,719,269	5,781,217	52,938,052
Securities lending collateral pool	8,806,979	2,469,806	6,337,173	(263,511)	6,600,684
Fixed assets	870	227	643	(230)	873
<b>Total Assets</b>	<b>\$ 79,101,288</b>	<b>12,457,640</b>	<b>66,643,648</b>	<b>5,582,045</b>	<b>61,061,603</b>
<b>Liabilities:</b>					
Payables and other liabilities	2,771,605	(117,569)	2,889,174	539,681	2,349,493
Obligations under securities lending	8,806,979	2,469,806	6,337,173	(263,511)	6,600,684
<b>Total Liabilities</b>	<b>11,578,584</b>	<b>2,352,237</b>	<b>9,226,347</b>	<b>276,170</b>	<b>8,950,177</b>
<b>Plan Net Assets</b>	<b>\$ 67,522,704</b>	<b>\$ 10,105,403</b>	<b>\$ 57,417,301</b>	<b>\$ 5,305,875</b>	<b>\$ 52,111,426</b>
<b><u>Summary of Changes in Plan Net Assets:</u></b>					
<b>Additions:</b>					
Contributions	\$ 1,773,604	\$ 245,874	\$ 1,527,730	\$ 114,413	\$ 1,413,317
Net investment income	12,702,721	4,760,082	7,942,639	1,861,142	6,081,497
<b>Total Additions</b>	<b>14,476,325</b>	<b>5,005,956</b>	<b>9,470,369</b>	<b>1,975,555</b>	<b>7,494,814</b>
<b>Deductions:</b>					
Benefit payments	4,320,440	204,575	4,115,865	238,023	3,877,842
Administrative expenses	50,482	1,853	48,629	5,984	42,645
<b>Total Deductions</b>	<b>4,370,922</b>	<b>206,428</b>	<b>4,164,494</b>	<b>244,007</b>	<b>3,920,487</b>
<b>Changes in Plan Net Assets</b>	<b>\$ 10,105,403</b>	<b>\$ 4,799,528</b>	<b>\$ 5,305,875</b>	<b>\$ 1,731,548</b>	<b>\$ 3,574,327</b>

**Investments**

PSERS is a long-term investor and manages the pension fund with long-term objectives in mind. A primary element of PSERS' investment philosophy is that diversification among various asset classes is the best way to achieve its goals. PSERS makes estimates of future long-term market returns and establishes an asset allocation plan taking into account the risk associated with each asset class as well as the financial objectives of the Fund.

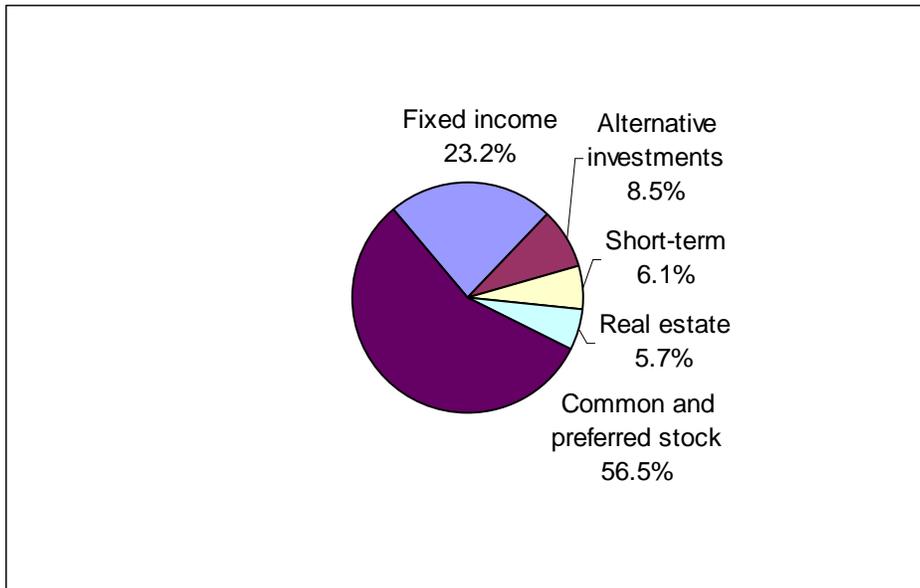
For FY 2007, PSERS' rate of return on investments was 22.93%. The FY 2007 investment return exceeded PSERS' total fund policy index of 18.48% and placed PSERS' performance in the top one percent of the Public Fund Universe prepared by the System's investment consultant, Wilshire Associates Inc. (Wilshire). The annualized rate of return over the past three and five-year periods ended June 30, 2007 was 16.94% and 14.48%, respectively. The annualized rate of return for the ten-year period ended June 30, 2007 was 9.67%. PSERS' long-term actuarial investment rate of return assumption is 8.50%.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
June 30, 2007**

The asset distribution of PSERS' investment portfolio at June 30, 2007 and June 30, 2006, at fair value, including postemployment healthcare assets, was:

<b><u>Asset Class</u></b>	(Dollar Amounts in Thousands)			
	<b><u>2007</u></b>	<b><u>%</u></b>	<b><u>2006</u></b>	<b><u>%</u></b>
Short-term	<b>\$ 4,164,010</b>	<b>6.1</b>	\$ 4,061,926	6.9
Fixed income	<b>15,919,998</b>	<b>23.2</b>	13,962,196	23.8
Common and preferred stock	<b>38,715,473</b>	<b>56.5</b>	32,951,976	56.1
Real estate	<b>3,887,986</b>	<b>5.7</b>	2,542,399	4.3
Alternative investments	<b><u>5,839,066</u></b>	<b><u>8.5</u></b>	<u>5,200,772</u>	<u>8.9</u>
<b>Total</b>	<b><u>\$68,526,533</u></b>	<b><u>100.0</u></b>	<b><u>\$ 58,719,269</u></b>	<b><u>100.0</u></b>

**Asset Distribution  
At June 30, 2007**



**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
June 30, 2007**

Short-term investments (cash and cash equivalents) at the close of FY 2007 increased by \$100 million from \$4.1 billion in FY 2006 to \$4.2 billion in FY 2007. Short-term investments remained high as the Fund continued to maintain a portion of its fixed income allocation in cash and cash equivalents due to favorable short-term yields and a relatively flat yield curve at the end of FY 2007. Fixed income investments increased by \$1.9 billion from \$14.0 billion in FY 2006 to \$15.9 billion in FY 2007 due to favorable investment returns partially reinvested in fixed income, additional allocations to the asset class and as the result of several investment managers shifting a portion of their short-term investments to fixed income. Common and preferred stock investments increased by \$5.7 billion from \$33.0 billion in FY 2006 to \$38.7 billion in FY 2007. The increase was primarily due to strong positive returns in the domestic and international equity markets that were reinvested in the asset class. This increase was partially offset by allocation reductions to the asset class during FY 2007 in accordance with PSERS' asset allocation plan. Real estate investments increased by \$1.4 billion from \$2.5 billion in FY 2006 to \$3.9 billion in FY 2007 due to very strong returns and net allocation increases to new and existing real estate partnerships. Alternative investments increased by \$600 million from \$5.2 billion in FY 2006 to \$5.8 billion in FY 2007 due to the addition of new investment partnerships, drawdowns of commitments to existing partnerships and market value appreciation.

**Contributions and Investment Income**

Employer pension contributions increased by \$202.6 million from \$456.9 million in FY 2006 to \$659.5 million in FY 2007. The increase is attributable to the increase in the employer pension contribution rate from 4.00% in FY 2006 to 5.67% in FY 2007. Member pension contributions increased by \$27.7 million from \$827.6 million in FY 2006 to \$855.3 million in FY 2007 as a result of the increase in the total participant salary base and the average member contribution rate increasing from 7.16% in FY 2006 to 7.21% in FY 2007. The employer contributions for health insurance premium assistance increased by \$12.7 million from \$74.1 million in FY 2006 to \$86.8 million in FY 2007 due to the increase in the employer health insurance premium assistance contribution rate from 0.69% in FY 2006 to 0.74% in FY 2007. Contributions from the Centers for Medicare and Medicaid Services (CMS) increased from \$13.9 million in FY 2006 to \$27.8 million in FY 2007. FY 2007 was the first full year of contributions as PSERS became a Prescription Drug Plan (PDP) on January 1, 2006. Net investment income increased by \$4.8 billion from \$7.9 billion in FY 2006 to \$12.7 billion in FY 2007, which correlates to the increase in the investment rate of return from 15.26% for FY 2006 to 22.93% for FY 2007. The 22.93% investment return for FY 2007 placed PSERS' performance in the top one percent of the Wilshire Public Fund Universe. The annual investment returns for FY 2006 and FY 2005 were also strong at 15.26% and 12.87%, respectively. Net investment income also includes investment expenses as a deduction. The "Total PSERS Benefits and Expenses" section that follows includes an analysis of investment expenses.

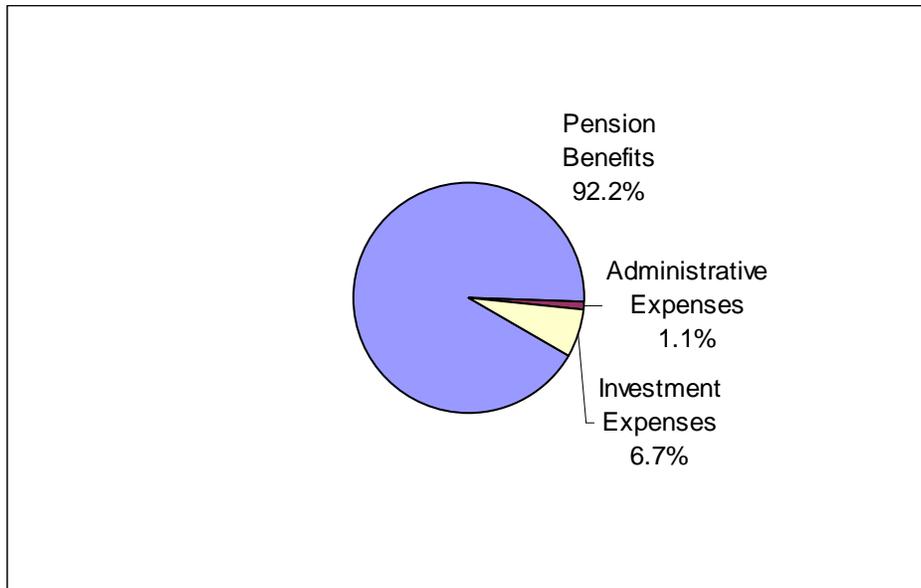
In the 2003 actuarial valuation, the employer contribution rate was projected to sharply increase to 27.73% of payroll for the 2012-2013 fiscal year. In the subsequent time period, PSERS has experienced four consecutive years of exceptionally strong performance in its investment returns. The investment returns for the fiscal years ended June 30, 2004, 2005, 2006 and 2007 were 19.67%, 12.87%, 15.26% and 22.93%, respectively. Factoring in this strong investment performance over the past four years, the 2012-2013 employer contribution rate projection is expected to decrease to below 12.00% of payroll upon completion of the 2007 actuarial valuation. The sub-12.00% of payroll rate represents a substantial improvement over the original projection of 27.73% of payroll.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
June 30, 2007**

**Total PSERS' Benefits and Expenses**

The primary source of expense during FY 2007 was for the payment of benefits totaling \$4.3 billion. This compares to benefit payments of \$4.1 billion during FY 2006 and \$3.9 billion for FY 2005. Investment expenses increased by \$102.5 million from \$211.3 million in FY 2006 to \$313.8 in FY 2007 due primarily to increased manager fees in public and private markets. The higher fees were due to increases in the total Fund value as well as new investments in various portable alpha strategies and private market partnerships, which have higher manager fees. Investment expenses increased by \$18.6 million from \$192.7 million during FY 2005 to \$211.3 million during FY 2006, consistent with the increase in the total Fund value. Investment expenses are reported as a reduction in net investment income on the Statements of Changes in Plan Net Assets. Administrative expenses increased by \$1.9 million from \$48.6 million during FY 2006 compared to \$50.5 million during FY 2007. The increase was due to higher administrative expenses for Premium Assistance and HOP. Administrative expenses for FY 2005 totaled \$42.6 million.

**Total PSERS' Benefits and Expenses  
Fiscal Year Ended June 30, 2007**



**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
STATEMENTS OF PLAN NET ASSETS**

**June 30, 2007 and 2006**

(Dollar Amounts in Thousands)

	2007			Totals
	Pension	Postemployment Healthcare		
		Premium Assistance	Health Options Program	
<b>Assets:</b>				
Receivables:				
Members	\$ 256,932	\$ 545	\$ 77	\$ 257,554
Employers	234,947	28,152	-	263,099
Investment income	229,320	387	401	230,108
Investment proceeds	1,013,317	-	-	1,013,317
Miscellaneous	2,802	26	-	2,828
<b>Total Receivables</b>	<b>1,737,318</b>	<b>29,110</b>	<b>478</b>	<b>1,766,906</b>
Investments, at fair value:				
Short-term	3,983,285	68,869	111,856	4,164,010
Fixed income	15,919,998	-	-	15,919,998
Common and preferred stock	38,715,473	-	-	38,715,473
Real estate	3,887,986	-	-	3,887,986
Alternative investments	5,839,066	-	-	5,839,066
<b>Total Investments</b>	<b>68,345,808</b>	<b>68,869</b>	<b>111,856</b>	<b>68,526,533</b>
Securities lending collateral pool	8,806,979	-	-	8,806,979
Capital assets (net of accumulated depreciation of \$10,656)	870	-	-	870
<b>Total Assets</b>	<b>78,890,975</b>	<b>97,979</b>	<b>112,334</b>	<b>79,101,288</b>
<b>Liabilities:</b>				
Accounts payable and accrued expenses	78,742	292	1,404	80,438
Benefits payable	201,916	395	11,913	214,224
Premium advances	-	-	14,602	14,602
Investment purchases and other liabilities	2,462,341	-	-	2,462,341
Obligations under securities lending	8,806,979	-	-	8,806,979
<b>Total Liabilities</b>	<b>11,549,978</b>	<b>687</b>	<b>27,919</b>	<b>11,578,584</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits</b>				
(Schedules of funding progress are presented on Required Supplemental Schedule 1)	\$67,340,997	\$ 97,292	\$ 84,415	\$67,522,704

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

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
STATEMENTS OF PLAN NET ASSETS**

**June 30, 2007 and 2006**

(Dollar Amounts in Thousands)

	<b>2006</b>			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
<b>Assets:</b>				
Receivables:				
Members	\$ 236,005	\$ 400	\$ 276	\$ 236,681
Employers	164,377	27,733	-	192,110
Investment income	193,699	300	353	194,352
Investment proceeds	960,102	224	-	960,326
Miscellaneous	2,357	737	-	3,094
<b>Total Receivables</b>	<b>1,556,540</b>	<b>29,394</b>	<b>629</b>	<b>1,586,563</b>
Investments, at fair value:				
Short-term	3,880,369	64,706	116,851	4,061,926
Fixed income	13,962,196	-	-	13,962,196
Common and preferred stock	32,951,976	-	-	32,951,976
Real estate	2,542,399	-	-	2,542,399
Alternative investments	5,200,772	-	-	5,200,772
<b>Total Investments</b>	<b>58,537,712</b>	<b>64,706</b>	<b>116,851</b>	<b>58,719,269</b>
Securities lending collateral pool	6,337,173	-	-	6,337,173
Capital assets (net of accumulated depreciation of \$10,402)	643	-	-	643
<b>Total Assets</b>	<b>66,432,068</b>	<b>94,100</b>	<b>117,480</b>	<b>66,643,648</b>
<b>Liabilities:</b>				
Accounts payable and accrued expenses	42,059	325	3,062	45,446
Benefits payable	159,390	811	11,709	171,910
Premium advances	-	-	13,852	13,852
Investment purchases and other liabilities	2,657,779	187	-	2,657,966
Obligations under securities lending	6,337,173	-	-	6,337,173
<b>Total Liabilities</b>	<b>9,196,401</b>	<b>1,323</b>	<b>28,623</b>	<b>9,226,347</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits</b>				
(Schedules of funding progress are presented on Required Supplemental Schedule 1)	\$57,235,667	\$ 92,777	\$ 88,857	\$57,417,301

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

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
**Years Ended June 30, 2007 and 2006**  
(Dollar Amounts in Thousands)

	2007			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
<b>Additions:</b>				
Contributions:				
Members	\$ 855,322	\$ -	\$ 144,185	\$ 999,507
Employers	659,545	86,763	-	746,308
Centers for Medicare & Medicaid Services	-	-	27,789	27,789
<b>Total contributions</b>	<b>1,514,867</b>	<b>86,763</b>	<b>171,974</b>	<b>1,773,604</b>
Investment income:				
From investing activities:				
Net appreciation in fair value of investments	10,457,473	88	-	10,457,561
Short-term	181,462	2,517	5,821	189,800
Fixed income	713,257	-	-	713,257
Common and preferred stock	1,019,322	-	-	1,019,322
Real estate	334,264	-	-	334,264
Alternative investments	276,350	-	-	276,350
<b>Total investment activity income</b>	<b>12,982,128</b>	<b>2,605</b>	<b>5,821</b>	<b>12,990,554</b>
Investment expenses	(313,726)	(32)	-	(313,758)
<b>Net income from investing activities</b>	<b>12,668,402</b>	<b>2,573</b>	<b>5,821</b>	<b>12,676,796</b>
From securities lending activities:				
Securities lending income	419,762	-	-	419,762
Securities lending expense	(393,837)	-	-	(393,837)
<b>Net income from securities lending activities</b>	<b>25,925</b>	<b>-</b>	<b>-</b>	<b>25,925</b>
<b>Total net investment income</b>	<b>12,694,327</b>	<b>2,573</b>	<b>5,821</b>	<b>12,702,721</b>
<b>Total Additions</b>	<b>14,209,194</b>	<b>89,336</b>	<b>177,795</b>	<b>14,476,325</b>
<b>Deductions:</b>				
Benefits	4,044,435	82,031	169,784	4,296,250
Refunds of contributions	18,180	-	-	18,180
Net transfer to State Employees' Retirement System	6,010	-	-	6,010
Administrative expenses	35,239	2,790	12,453	50,482
<b>Total Deductions</b>	<b>4,103,864</b>	<b>84,821</b>	<b>182,237</b>	<b>4,370,922</b>
<b>Net increase (decrease)</b>	<b>10,105,330</b>	<b>4,515</b>	<b>(4,442)</b>	<b>10,105,403</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits:</b>				
Balance, beginning of year	57,235,667	92,777	88,857	57,417,301
<b>Balance, end of year</b>	<b>\$ 67,340,997</b>	<b>\$ 97,292</b>	<b>\$ 84,415</b>	<b>\$ 67,522,704</b>

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

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
**Years Ended June 30, 2007 and 2006**  
(Dollar Amounts in Thousands)

	<b>2006</b>			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
<b>Additions:</b>				
Contributions:				
Members	\$ 827,647	\$ -	\$ 155,199	\$ 982,846
Employers	456,878	74,065	-	530,943
Centers for Medicare & Medicaid Services	-	-	13,941	13,941
<b>Total contributions</b>	<b>1,284,525</b>	<b>74,065</b>	<b>169,140</b>	<b>1,527,730</b>
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	5,969,223	(480)	123	5,968,866
Short-term	129,788	3,362	3,641	136,791
Fixed income	694,449	-	439	694,888
Common and preferred stock	771,276	-	-	771,276
Real estate	285,333	-	-	285,333
Alternative investments	273,808	-	-	273,808
<b>Total investment activity income</b>	<b>8,123,877</b>	<b>2,882</b>	<b>4,203</b>	<b>8,130,962</b>
Investment expenses	(211,247)	(32)	-	(211,279)
<b>Net income from investing activities</b>	<b>7,912,630</b>	<b>2,850</b>	<b>4,203</b>	<b>7,919,683</b>
From securities lending activities:				
Securities lending income	270,447	-	-	270,447
Securities lending expense	(247,491)	-	-	(247,491)
<b>Net income from securities lending activities</b>	<b>22,956</b>	<b>-</b>	<b>-</b>	<b>22,956</b>
<b>Total net investment income</b>	<b>7,935,586</b>	<b>2,850</b>	<b>4,203</b>	<b>7,942,639</b>
<b>Total Additions</b>	<b>9,220,111</b>	<b>76,915</b>	<b>173,343</b>	<b>9,470,369</b>
<b>Deductions:</b>				
Benefits	3,860,658	79,298	151,117	4,091,073
Refunds of contributions	16,330	-	-	16,330
Net transfer to State Employees' Retirement System	8,462	-	-	8,462
Administrative expenses	35,391	1,977	11,261	48,629
<b>Total Deductions</b>	<b>3,920,841</b>	<b>81,275</b>	<b>162,378</b>	<b>4,164,494</b>
<b>Net increase (decrease)</b>	<b>5,299,270</b>	<b>(4,360)</b>	<b>10,965</b>	<b>5,305,875</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits:</b>				
<b>Balance, beginning of year</b>	<b>51,936,397</b>	<b>97,137</b>	<b>77,892</b>	<b>52,111,426</b>
<b>Balance, end of year</b>	<b>\$ 57,235,667</b>	<b>\$ 92,777</b>	<b>\$ 88,857</b>	<b>\$ 57,417,301</b>

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

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**1. Organization and Description of the System**

**(a) Organization**

The System was established on July 18, 1917, under the provisions of Pamphlet Law 1043, No. 343 as a governmental cost-sharing multiple-employer plan that provides retirement allowances and other benefits to its members. Membership in the System is mandatory for nearly all qualifying public school employees in the Commonwealth of Pennsylvania (Commonwealth). At June 30, 2007, there were 739 participating employers, generally school districts. Membership as of June 30, 2006, the most recent year for which actual amounts are available, consisted of:

Currently employed members:		
Vested	177,000	
Nonvested	<u>86,000</u>	
<b>Total currently employed members</b>		<b>263,000</b>
Retirees and beneficiaries currently receiving benefits	162,000	
Inactive members and vestees entitled to but not receiving benefits	<u>94,000</u>	
<b>Total retirees and other members</b>		<b><u>256,000</u></b>
<b>Total number of members</b>		<b><u>519,000</u></b>

All members are fully vested in their individual balance in the Members' Savings Account which is described in Note 3.

The System is established by state law as an independent administrative board of the Commonwealth, which is directed by the Public School Employees' Retirement Board (the Board) that exercises control and management of the System, including the investment of its assets. The System's board has fifteen members including the Commonwealth's Secretary of Education, the State Treasurer, the Executive Director of the Pennsylvania School Boards Association, two members appointed by the Governor, six elected members (three from among the System's certified members, one from among the System's non-certified members, one from among the System's annuitants, and one from among school board members in Pennsylvania), two members from the Senate, and two members from the House of Representatives.

The State Treasurer is the custodian of the System's fund. The retirement plan of the System is a contributory defined benefit plan for which the benefit payments to members and contribution provisions by employers and employees are specified in the Pennsylvania Public School Employees' Retirement Code (the Code). Changes in benefit and contribution provisions for the retirement plan must be made by legislation. Pursuant to state law, all legislative bills and amendments proposing to change the System's retirement plan are to be accompanied with an actuarial note prepared by an enrolled pension actuary providing an estimate of the cost and actuarial effect of the proposed change.

Based upon criterion of financial accountability as defined by governmental accounting standards, the System is considered a component unit of the Commonwealth of Pennsylvania financial reporting entity and is included in the Comprehensive Annual Financial Report of the Commonwealth of Pennsylvania.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**1. Organization and Description of the System (Continued)**

**(b) Pension Benefits**

Under the provisions of the 1975 revision of the Code by the Pennsylvania General Assembly, members are eligible for monthly retirement benefits upon reaching (a) age 62 with at least 1 year of credited service; (b) age 60 with 30 or more years of credited service; or (c) 35 or more years of service regardless of age.

Benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member's final average salary (as defined in the Code) multiplied by the number of years of credited service. In most cases after completion of five years of service, a member's right to the defined benefit is vested and early retirement benefits may be elected. Under certain features of the System, active members may purchase credit for various types of prior school and non-school service on a lump-sum, installment purchase basis, or through an actuarially calculated benefit reduction.

In addition to regular retirement benefits, the System also provides for disability retirement benefits and death benefits. Participants are eligible for disability retirement benefits after completion of five years of credited service. Such benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member's final average salary (as defined in the Code) multiplied by the number of years of credited service, but not less than one-third of such salary nor greater than the benefit the member would have had at normal retirement age. Members over normal retirement age may apply for disability benefits. Certain exceptions apply to normal disability retirements.

Death benefits are payable upon the death of an active member who has reached age 62 or who has at least five years of credited service. Such benefits are actuarially equivalent to the benefit that would have been effective if the member had retired on the day before death.

Members with credited service in the Commonwealth of Pennsylvania State Employees' Retirement System (SERS) may elect to transfer service to the Public School Employees' Retirement System upon commencement of employment in the public school system. Similarly, a member with credited service in the System may transfer such service to SERS upon becoming a member of that system.

Upon termination of a member's employment in the public school sector, the member's accumulated contributions plus interest are refundable from the Members' Savings Account which is described in Note 3.

**(c) Postemployment Healthcare Benefits**

The System provides a Health Insurance Premium Assistance Program (premium assistance) for all eligible annuitants who elect to participate. Under this program, employer contribution rates for premium assistance are established to provide reserves in the Health Insurance Account that are sufficient for the payment of premium assistance benefits for each succeeding year. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. To receive premium assistance, eligible annuitants must obtain their health insurance through either their school employer or the PSERS' Health Options Program (HOP).

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**1. Organization and Description of the System (Continued)**

**(c) Postemployment Healthcare Benefits (Continued)**

The HOP is a PSERS-sponsored voluntary health insurance program for the sole benefit of annuitants of PSERS, spouses of annuitants, survivor annuitants and their dependents. Benefits are provided by managed care providers or by PSERS self-funded fee for service plans. All retirees are eligible to participate in the Enhanced or Basic Options (indemnity plans) regardless of their residence. The managed care plans are available to retirees residing in the plan's service area. The HOP is funded exclusively by the premiums paid by its participants for the benefit coverage they elect. The hospital, medical/surgical and major medical benefits of the Enhanced and Basic Options are self-funded. PSERS uses a third-party administrator to process these claims. An independent actuarial consulting firm sets the rates for the self-funded benefits so that the combination of contributions and the claims fluctuation reserve equal 125% of expected annual incurred claims. The HOP maintains a reserve for claims that are incurred but not reported (IBNR). At June 30, 2007 and 2006, PSERS recorded \$10,665,000 and \$9,151,000, respectively, in IBNR which is included in benefits payable. Effective January 1, 2006, PSERS made significant changes to HOP, in response to the Medicare Modernization Act. PSERS entered into an Employer/Union Entity contract with the Centers for Medicare and Medicaid Services to operate a voluntary Medicare Prescription Drug Plan (PDP). Monthly contributions are received from CMS covering the 37,000 participants in the PDP. The PSERS pension fund assets are not available to fund or satisfy obligations of the HOP.

**(d) Contributions**

The contribution policy is set by the Code and requires contributions by active members, employers, and the Commonwealth. The System's funding policy provides for periodic employer and Commonwealth contributions at actuarially determined rates, expressed as a percentage of annual covered payroll, such that they, along with employee contributions and an actuarially determined rate of investment return, are adequate to accumulate assets to pay retirement benefits when due. Level percentage of payroll employer contribution rates are determined using the entry age normal actuarial funding method. This method determines the amount of contributions necessary to (1) fully fund all current costs, which represents the estimated amount necessary to pay for the benefits earned by the employees during the current service year; and (2) liquidate the prior service cost for service earned prior to the current service year and subsequent benefit increases, which represents the amount necessary to fund accrued liabilities over the appropriate amortization periods.

Contribution rates for active members are set by law (redefined with the provisions of Act 9 of 2001) and are dependent upon members' class. In most cases, the contribution rates based on qualified member compensation are as follows:

Membership Class T-C	Active members hired before July 22, 1983	5.25%
Membership Class T-C	Active members hired on or after July 22, 1983	6.25%
Membership Class T-D	Active members hired before July 22, 1983	6.50%
Membership Class T-D	Active members hired on or after July 22, 1983	7.50%

Active members newly hired after July 1, 2001, the effective date of Act 9 of 2001, are automatically Class T-D. The contribution rates for all members in Membership Class T-D were effective January 1, 2002.

The total contribution rate for the employers and the Commonwealth was 6.46% and 4.69% of qualified compensation for the years ended June 30, 2007 and 2006, respectively. According to requirements established in Act 29 of 1994, the Commonwealth reimburses school entity employers a portion of the employer contributions paid to the System. The Commonwealth remits employer contributions for employers other than school entities directly to the System. All contributions from employers and the Commonwealth are shown as employer contributions on the Statements of Changes in Plan Net Assets.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**1. Organization and Description of the System (Continued)**

**(d) Contributions (Continued)**

A portion of each employer and Commonwealth contribution to the System is set aside for the funding of the health insurance premium assistance program. The premium assistance contribution rate is set at a level necessary to establish reserves sufficient to provide premium assistance payments for all participating eligible members for the subsequent fiscal year. The portion of the total contribution rate for employers and the Commonwealth used to fund premium assistance was 0.74% and 0.69% for the years ended June 30, 2007 and 2006, respectively.

**2. Summary of Significant Accounting Policies**

**(a) Basis of Accounting**

The financial statements of the System are prepared on the accrual basis of accounting under which expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of their trade date. Member and employer contributions are recognized in the period for which employees' salaries are reported. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

The accounting and reporting policies of the System conform to accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP 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 and deductions in plan net assets during the reporting period. Actual results could differ from those estimates.

**(b) Investments**

The System's investments are reported at fair value. Fair value is the amount that the System can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Short-term securities are carried at cost, which approximates fair value, unless they have published market prices or quotations from national security exchanges or securities pricing services, in which case they are valued at the published market price. Fixed income securities and common and preferred stocks are generally valued based on published market prices and quotations from national security exchanges or securities pricing services. Securities which are not traded on a national security exchange are valued by the respective fund manager or other third parties based on similar sales.

Directly-owned real estate investments are primarily valued based on appraisals performed by independent appraisers or, for properties not appraised, at cost or the present value of the projected future net income stream. Real estate owned investments are reported net of related debt borrowed against the market value of the property. As of June 30, 2007 and 2006, \$132,000,000 in line of credit advances were netted against the related property valuation. The line of credit balance is due on March 14, 2009. The line is payable at an interest rate equivalent to the lender's commercial paper rate plus 30 basis points and is collateralized by certain fixed income investments of the System.

Alternative investments which include private equity, private debt, venture capital and equity real estate investments are valued based on estimated fair value amounts established by valuation committees which includes cash flow activity through June 30. Futures contracts, foreign exchange contracts, and options are marked-to-market daily with changes in market value recognized as part of net appreciation/depreciation in the fair value of investments. Initial margin requirements for such financial instruments are provided by investment securities pledged as collateral or by cash.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**2. Summary of Significant Accounting Policies (Continued)**

**(b) Investments (Continued)**

Collective trust fund investments (CTF) consist primarily of domestic and international institutional funds. The funds do not pay interest or dividends to shareholders and reinvest all income earned on securities held by the fund. The fair value of CTF is based on the reported share value of the respective fund. CTF are managed by state chartered banks for which various state banking departments have regulatory oversight and investment advisors for which the Securities and Exchange Commission has regulatory oversight.

Investment expenses consist of investment manager fees and those administrative expenses directly related to the System's investment operations. Unsettled investment sales are reported as investment proceeds receivable and unsettled investment purchases are included in investment purchases and other liabilities.

**(c) Capital Assets**

Capital assets, consisting primarily of data processing equipment and software, are recorded at historical cost. The System depreciates capital assets using the straight-line method over an estimated useful life of seven years.

**(d) Benefits Payable**

Benefits payable identifies the obligations of the System, on an accrual basis, for the estimated retirement and death benefits payable to PSERS' members or members' beneficiaries at the end of the fiscal year. It also includes the HOP \$10,665,000 IBNR claims reserve and a \$1,246,000 prescription drug benefit payable at June 30, 2007.

**(e) Compensated Absences**

The System uses the accrual basis of accounting for measuring vacation leave, sick leave, and other compensated absences liabilities. Employees of the System are paid for accumulated vacation leave upon termination or retirement. Retiring employees of the System that meet service, age, or disability requirements are paid between 30% and 100% of sick days available at retirement, up to 163 maximum days paid. As of June 30, 2007 and 2006, \$2,762,000 and \$2,946,000, respectively, was accrued for unused vacation and sick leave for the System's employees and included in "Accounts payable and accrued expenses" on the Statements of Plan Net Assets.

**(f) Participant Premium Advances**

Premium advances in 2007 are for HOP and CMS premiums related to health care and prescription drug coverage to be provided in 2007. Premium advances in 2006 are for HOP premiums related to health care coverage provided in 2006.

**(g) Federal Income Taxes**

The Internal Revenue Service (IRS) issued a determination letter dated March 3, 1978 which stated that the plan and its underlying trust qualify under the provisions of Section 501(a) of the *Internal Revenue Code* (IRC) and therefore are exempt from federal income taxes. The plan has been amended since receiving that determination letter. Additionally, the IRS issued a 1982 ruling which concluded that the fund and the board are integral parts of the Commonwealth, and are therefore not subject to federal income tax. In the opinion of management, the System has operated within the terms of the plan and remains qualified under the applicable provisions of the IRC.

Federal tax legislation was enacted in 2001 that modified the rules for making rollovers to or from pension systems and also established maximum amounts of retirement benefits that can be paid from pension systems. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**2. Summary of Significant Accounting Policies (Continued)**

**(g) Federal Income Taxes (Continued)**

the opportunity for members to roll over funds received from PSERS at retirement to a wider variety of plans including, but not limited to, 403(b) tax sheltered annuities and government sponsored 457 deferred compensation plans. The Act permits the rollover of after-tax contributions from PSERS. EGTRRA provided for periodic increases in the annual compensation limits for qualified retirement plans.

The annual compensation limits for 2006 and 2007 were \$220,000 and \$225,000, respectively. EGTRRA also provided for periodic increases in the annual benefit limits for qualified defined benefit plans. The maximum annual defined benefit limits at age 62 for 2006 and 2007 were \$175,000 and \$180,000, respectively.

**(h) Risk Management**

The System is exposed to various liabilities and risks of loss, including, without limitation, the ordinary risks of investment losses, risks related to theft or destruction of assets, liabilities resulting from injuries to employees, and liabilities resulting from court challenges to fiduciary decisions. As an administrative agency of the Commonwealth of Pennsylvania, the System is accorded sovereign immunity. For claims not shielded by sovereign immunity, the System participates in certain Commonwealth pooled insurance programs and requires asset managers to carry certain insurance coverage for the protection of the System. The System has implemented a self-insurance program for fiduciary and director and officer liability coverage. During the past three fiscal years, insurance settlements did not exceed insurance coverage.

**(i) Reclassifications**

Certain 2006 balances have been reclassified in conformity with the 2007 presentation.

**(j) Members Receivables**

Member's receivables include an amount for members' obligations to the System for the purchase of service credit in the amount of \$149,363,923. Members have a variety of options to remit purchase of service payments:

- Remit a lump sum payment.
- Request an installment plan from one to seven years where the member's employer establishes a payroll deduction process. The member's employer then forwards quarterly payments of the withheld amounts to PSERS.
- Accept an actuarial reduction debt through which the amount of the purchase plus accumulated interest will reduce the member's retirement or death benefit.
- Rollover funds from an eligible distribution.

Because members have control over the timing of their remittances to the System, many purchases of service receivables extend beyond one year. An estimated \$133,608,420 of the \$256,932,000 member's pension receivables at June 30, 2007 are expected to be collected by the System subsequent to June 30, 2008.

**(k) Adoption of New Accounting Standards**

During the year ended June 30, 2006, the System adopted Governmental Accounting Standards Board Statement No. 44, *Economic Condition Reporting: The Statistical Section (an amendment of NCGA Statement 1)* ("GASB 40"). The adoption of GASB 44 requires the System to meet reporting standards in the Statistical Section of its CAFR. These standards are designed to enhance the provision of information for the assessment of the financial position and the financial condition of the System.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**2. Summary of Significant Accounting Policies (Continued)**

**(k) Adoption of New Accounting Standards (Continued)**

During the year ended June 30, 2007 the System adopted Governmental Accounting Standards Board Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* ("GASB 43"). GASB 43 established reporting standards for the annual financial reports of postemployment benefit plans other than pension plans. These reporting requirements apply to the Health Insurance Premium Assistance Program. The adoption of GASB 43 required the System to include disclosures for premium assistance in the Required Supplemental Information's Schedule of Funding Progress and Schedule of Employer Contributions.

**3. Description of Accounts**

The Code requires the System to maintain the following accounts which represent reserves held for future and current benefit payments as follows:

**(a) State Accumulation Account**

The State Accumulation Account is credited with the contributions of the Commonwealth and the employers. Additionally, interest earnings of the System (after crediting the Members' Savings Account with 4% interest and the reserve for retirement with 5.50% statutory interest) are credited to this account. Each year, the necessary amounts, as determined by the actuary for the payment of retirement, disabilities, and death benefits, are transferred from the State Accumulation Account to the Reserve for Retirement Account increasing the reserve credit to the 8.5% valuation assumption rate determined by the actuary. All administrative expenses necessary for the operation of the System, except for premium assistance and HOP expenses are paid from the State Accumulation Account.

**(b) (b) Members' Savings Account**

The Members' Savings Account is credited with all contributions made by active members of the System. Interest is added to the member's individual account at an annual rate of 4%.

Upon death or retirement of a member, the accumulated contributions, plus interest are transferred to the Reserve for Retirement Account for subsequent payment of benefits.

**(c) Reserve for Retirement Account**

The Reserve for Retirement Account represents the amounts transferred from the Members' Savings and State Accumulation Accounts, plus additional contributions made by the Commonwealth and employers for the payment of supplemental annuities and cost-of-living increases. All death, disability, and retirement benefits are paid from this account. Annual interest of 5.50% is credited to the Reserve for Retirement Account.

**(d) Health Insurance Account**

The Health Insurance Account is credited with contributions of the Commonwealth and the employers for the health insurance premium assistance program. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. The Health Insurance Account pays all administrative expenses necessary to operate the health insurance premium assistance program.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**3. Description of Accounts (Continued)**

**(e) Health Insurance Program Account**

The Health Insurance Program Account is credited with contributions from members of the HOP and from CMS. All benefits related to the HOP (premium payments to the insurance companies and self-funded benefits) are paid from this account. The Health Insurance Program Account pays all administrative expenses necessary to operate the HOP.

**(f) Pension and Postemployment Healthcare Net Assets**

Net assets held in trust for pension and postemployment healthcare benefits at June 30 follows:

	<b>(Dollar Amounts in Thousands)</b>	
	<u>2007</u>	<u>2006</u>
Pension:		
State accumulation account	\$ 25,839,716	\$ 17,370,947
Members' savings account	10,183,433	9,571,668
Reserve for retirement account	<u>31,317,848</u>	<u>30,293,052</u>
<b>Total pension</b>	<b><u>\$ 67,340,997</u></b>	<b><u>\$ 57,235,667</u></b>
Postemployment healthcare:		
Health insurance account	\$ 97,292	\$ 92,777
Health insurance program account	<u>84,415</u>	<u>88,857</u>
<b>Total postemployment healthcare</b>	<b><u>\$ 181,707</u></b>	<b><u>\$ 181,634</u></b>

**4. Investments**

**(a) Summary of Investments**

The Board has the responsibility to invest and reinvest available funds of the System in accordance with the guidelines and limitations set forth in the Code and other applicable state law. The Board accomplishes the daily management of the System's investments through investment advisors who act as agents for the System and through internal investment managers.

The Board invests the funds of the System using the "prudent investor" standard which allows the Board to consider the probable safety of investments, avoid speculative investments, and invest as people of prudence, discretion, and intelligence would manage their own affairs. The Board has adopted its investment policy to formally document investment objectives and responsibilities. This policy, as well as applicable state law, establishes guidelines for permissible investments of the System.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**4. Investments (Continued)**

A summary of the fair value of investments at June 30 follows:

(Dollar Amounts in Thousands)

	2007	2006
<b>Pension investments:</b>		
<b>Short-term:</b>		
Pennsylvania Treasury Domestic Short-Term Investment Fund	\$ 3,148,246	\$ 2,848,280
Other domestic short-term	724,343	683,350
International short-term	110,696	348,739
	<b>3,983,285</b>	<b>3,880,369</b>
<b>Fixed income:</b>		
Domestic mortgage-backed securities	6,190,646	5,670,890
U.S. government and agency obligations	2,608,384	3,152,963
Domestic corporate and taxable municipal bonds	3,633,248	2,880,975
Miscellaneous domestic fixed income	150,039	170,880
Collective trust funds	1,202,848	304,949
International fixed income	2,134,833	1,781,539
	<b>15,919,998</b>	<b>13,962,196</b>
<b>Common and preferred stock:</b>		
Domestic common and preferred stock	15,185,715	13,647,660
Collective trust funds	4,564,836	6,272,121
International common and preferred stock	18,964,922	13,032,195
	<b>38,715,473</b>	<b>32,951,976</b>
<b>Real estate:</b>		
Equity real estate	3,566,959	2,255,291
Directly-owned real estate	321,027	287,108
	<b>3,887,986</b>	<b>2,542,399</b>
<b>Alternative investments:</b>		
Private equity	4,140,276	3,634,938
Private debt	1,093,256	992,673
Venture capital	605,534	573,161
	<b>5,839,066</b>	<b>5,200,772</b>
<b>Pension investments at fair value</b>	<b>\$ 68,345,808</b>	<b>\$ 58,537,712</b>
<b>Postemployment Healthcare investments:</b>		
Premium Assistance:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	\$ 21,363	\$ 14,563
Other domestic short-term	47,506	50,143
	<b>68,869</b>	<b>64,706</b>
Health Options Program:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	66,538	72,553
Other domestic short-term	45,318	44,298
	<b>111,856</b>	<b>116,851</b>
<b>Postemployment Healthcare investments at fair value</b>	<b>\$ 180,725</b>	<b>\$ 181,557</b>

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**4. Investments (Continued)**

**(b) Deposit and Investment Risk Disclosures**

**i. Deposits**

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, the System would not be able to recover the value of the deposits. The State Treasury Department is the custodian of the System's fund. State Treasury Department deposits must be held in insured depositories approved by the Commonwealth's Board of Finance and Revenue and must be fully collateralized.

The System, through its third party administrator, maintains certain bank deposits for the operation of its voluntary health insurance program. These deposits are not required to be collateralized by statute or policy. These deposits totaled \$45,318,000 and \$44,928,000 at June 30, 2007 and 2006, respectively, and are under the custody of M&T Bank which has an A Deposit/Debt rating by Standard and Poor's (S&P) and an A2 rating by Moody's Investor Services (Moody's).

**ii. Investment Risks**

The System's investments may be subject to various risks. Among these risks are concentration of credit risk, custodial credit risk, credit risk, interest rate risk, and foreign currency risk. The policies addressing each one of these risks, discussed in more detail below, are contained within the Investment Policy Statement, Objectives, and Guidelines reviewed and approved annually by the Board.

**Concentration of Credit Risk**

Concentration of credit risk is the risk of loss attributed to the magnitude of the System's investment in a single issuer. As of June 30, 2007 and 2006 the System has no single issuer that exceeds 5% of total investments. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments are excluded.

**Custodial Credit Risk**

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System would not be able to recover the value of investment or collateral securities that are in the possession of an outside party. In accordance with a contractual relationship between the Commonwealth's Treasury Department and its custodial agent, substantially all investments, where securities are used as evidence of the investment, are held by the custodian in book-entry form in the System's name. Those investments are defined as insured or registered investments for which the securities are held by the System or its agent and, therefore, have very minimal level of custodial credit risk. The remaining investments, which do not have securities that are used as evidence of the investment, are primarily in collective trust funds and limited partnerships, which include real estate and alternative investments.

**Credit Risk**

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by nationally recognized statistical rating organizations (NRSRO) such as Fitch Investor Services (Fitch), Moody's, and S&P. Annually, the Board establishes an asset allocation plan. This plan manages the overall credit risk of the fixed income asset class through a clearly defined long-term asset allocation policy. This policy establishes a long-term target allocation of the fixed income asset class at 22% of the investment portfolio. The fixed income target allocation consists of:

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**4. Investments (Continued)**

**Credit Risk (Continued)**

- An allocation of 13.7% of the portfolio has been made to the domestic core plus and high yield segments of the fixed income asset class benchmarked to the Lehman Brothers U.S. Universal Index. The domestic core plus allocation is composed of primarily investment grade, relatively liquid, public domestic bonds with an overall weighted-average NRSRO credit rating of A or better while the high yield allocation focuses on less liquid public non-investment grade fixed income securities with an overall weighted-average NRSRO credit rating of BB+ or less;
- An allocation of 5% of the portfolio has been made to the Treasury Inflation-Protected Securities (TIPS) segment of the fixed income asset class benchmarked to the Lehman U.S. TIPS Index and composed of primarily government issued TIPS with an overall weighted-average NRSRO credit rating of AA or better;
- An allocation of 3.3% of the portfolio has been made to the global core plus fixed income asset class benchmarked to the Lehman Brothers Multiverse Index composed of primarily investment grade, relatively liquid U.S. and non-U.S. public bonds with an overall weighted-average NRSRO credit rating of A or better.

The following table discloses aggregate market value by credit quality rating category. Many securities have ratings from more than one NRSRO and sometimes those ratings differ from one NRSRO to another. The data listed below uses the rating (expressed as S&P equivalent); available from Fitch, Moody's and/or S&P that indicates the greatest degree of risk at June 30, 2007 and 2006.

<u>Quality Rating</u>	(Dollar Amounts in Thousands)	
	<b>2007</b>	<b>2006</b>
	<b>Fair Value</b>	<b>Fair Value</b>
AAA	\$ 7,608,036	\$ 6,445,960
AA	907,907	1,072,388
A	1,254,699	1,260,292
BBB	1,291,445	1,152,165
BB and below	957,173	854,747
NR*	<b>5,206,707</b>	<b>3,801,658</b>
<b>Total Exposed to Credit Risk</b>	<b>17,225,967</b>	14,587,210
<b>U.S. Government Guaranteed**</b>	<b>2,858,041</b>	<b>3,436,912</b>
<b>Total Fixed Income and Short-Term Investments</b>	<b>\$ 20,084,008</b>	<b>\$ 18,024,122</b>

\* Not Rated securities include \$1,202,848 and \$304,949 in collective trust funds at June 30, 2007 and 2006, respectively. Also included are \$3,236,147 and \$2,935,396 at June 30, 2007 and 2006, respectively, in the Pennsylvania (PA) Treasury Domestic Short-Term Investment Fund (STIF), a pooled investment fund for which ratings were unavailable. The STIF pool is comprised of short-term, high credit quality securities which are mainly U.S. Treasuries, agencies or repurchase agreements.

\*\* Composed of U.S. government and agency obligations explicitly guaranteed by the U.S. government and not considered to have credit risk.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**4. Investments (Continued)**

**Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of a fixed income investment. The System manages its interest rate risk by diversifying the fixed income portfolio and maintaining the fixed income portfolio at an effective duration range between 65 and 135 percent of the benchmark index.

Duration is a measure of the approximate sensitivity of a bond's value to interest rate changes. The higher the duration, the greater the changes in fair value when interest rates change. For example, a duration of 4.0 would mean that, given a 100-basis point change up/down in rates, a bond's price would move down/up approximately 4.0 percent. PSERS measures interest rate risk using option-adjusted duration, which recognizes the fact that yield changes may change the expected cash flows due to embedded options.

At June 30, 2007 and 2006, the System's fixed income portfolio had the following option-adjusted durations by fixed income sector:

Investment Type	(Dollar Amounts in Thousands)			
	2007		2006	
	Option-Adjusted Duration	Fair Value	Option-Adjusted Duration	Fair Value
Domestic mortgage-backed securities	3.3	\$ 6,190,646	3.1	\$ 5,670,890
U.S. government and agency obligations	6.6	2,608,384	5.1	3,152,963
Domestic corporate and taxable municipal bonds	3.0	3,633,248	3.4	2,880,975
Miscellaneous domestic fixed income	1.0	150,039	1.0	170,880
Fixed income collective trust funds	4.2	1,202,848	3.8	304,949
International fixed income	5.2	2,134,833	6.2	1,781,539
PA Treasury Domestic Short-Term Investment Fund	0.1	<u>3,236,147</u>	0.1	<u>2,935,396</u>
<b>Total fixed income &amp; PA Treasury Domestic Short-Term Investment Fund</b>	<b>3.4*</b>	<b>19,156,145</b>	<b>3.3*</b>	<b>16,897,592</b>
Total adjustment for futures contracts	<u>0.1**</u>	<u>-</u>	<u>0.2**</u>	<u>-</u>
<b>Total fixed income &amp; PA Treasury Domestic Short-Term Investment Fund</b>	<b><u>3.5**</u></b>	<b><u>\$ 19,156,145</u></b>	<b><u>3.5**</u></b>	<b><u>\$16,897,592</u></b>

\* The option-adjusted duration of 3.4 and 3.3 at June 30, 2007 and 2006, respectively, for the total fixed income & PA Treasury Domestic Short-Term Investment Fund portfolio is calculated by weighting the option-adjusted duration of each investment type by market value.

\*\* Fixed income investment managers enter into futures contracts to adjust the durations of their portfolios as a whole rather than any particular investment type within the portfolio. In total, the futures contracts have adjusted PSERS' total fixed income & PA Treasury Domestic Short-Term Investment Fund portfolio duration upward by 0.1 and 0.2 at June 30, 2007 and 2006, respectively.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**4. Investments (Continued)**

**Foreign Currency Risk**

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. As part of the System's program to manage risk and enhance returns, the System invests in non-U.S. markets. Investment managers in non-U.S. equity and global fixed income may hedge their non-U.S. foreign currency exposure back to U.S. dollars. The System also reduces the exposure to currency risk by hedging up to 30% of MSCI EAFE Index country currencies to the U.S. dollar. At June 30, 2007 and 2006 PSERS had the following non-U.S. currency exposure:

<b>2007</b>						
(Dollar Amounts in Thousands)						
<b>Currency</b>	<b>Equity</b>	<b>Fixed Income</b>	<b>Alternative Investments</b>	<b>Short-Term*</b>	<b>Currency Hedge</b>	<b>Total Fair Value</b>
Euro	\$ 4,543,147	\$ 924,033	\$ 720,273	\$ (232,932)	\$ (1,864,314)	\$ 4,090,207
British pound sterling	3,330,681	242,722	67,078	596,752	(864,825)	3,372,408
Japanese yen	3,096,446	218,152	-	(177,619)	(1,056,235)	2,080,744
Australian dollar	779,589	7,225	-	244,290	-	1,031,104
Canadian dollar	845,365	127,283	15,675	(120,701)	-	867,622
Hong Kong dollar	856,048	-	-	6,503	(86,725)	775,826
South Korean won	529,302	12,076	-	38,661	-	580,039
Swedish krona	475,061	75,172	-	(64,834)	-	485,399
New Zealand dollar	13,059	14,251	-	316,422	-	343,732
Taiwan dollar	298,257	-	-	40,574	-	338,831
South African rand	305,065	-	-	10,776	-	315,841
Norwegian krone	169,799	3,156	-	129,486	-	302,441
Other non-U.S. currencies	<u>2,544,082</u>	<u>99,498</u>	<u>-</u>	<u>(697,691)</u>	<u>(363,529)</u>	<u>1,582,360</u>
<b>Total</b>	<u>\$ 17,785,901</u>	<u>\$ 1,723,568</u>	<u>\$ 803,026</u>	<u>\$ 89,687</u>	<u>\$ (4,235,628)</u>	<u>\$ 16,166,554</u>

<b>2006</b>						
(Dollar Amounts in Thousands)						
<b>Currency</b>	<b>Equity</b>	<b>Fixed Income</b>	<b>Alternative Investments</b>	<b>Short-Term*</b>	<b>Currency Hedge</b>	<b>Total Fair Value</b>
Euro	\$ 3,213,586	\$ 796,778	\$ 678,328	\$ (775)	\$ (1,346,075)	\$ 3,341,842
British pound sterling	2,271,685	177,855	66,613	85,278	(792,495)	1,808,936
Japanese yen	2,497,865	132,200	-	20,222	(895,990)	1,754,297
Canadian dollar	680,242	98,029	11,692	39,068	-	829,031
South Korean won	402,962	12,068	-	51,739	-	466,769
Swedish krona	292,826	38,141	-	22,711	-	353,678
Hong Kong dollar	407,870	-	-	2,093	(87,275)	322,688
Swiss franc	706,145	-	-	(74,409)	(314,409)	317,327
Australian dollar	360,776	5,309	-	131,491	(200,827)	296,749
Other non-U.S. currencies	<u>1,349,383</u>	<u>127,742</u>	<u>-</u>	<u>151,258</u>	<u>-</u>	<u>1,628,383</u>
<b>Total</b>	<u>\$ 12,183,340</u>	<u>\$ 1,388,122</u>	<u>\$ 756,633</u>	<u>\$ 428,676</u>	<u>\$ (3,637,071)</u>	<u>\$ 11,119,700</u>

\* Includes investment receivables and payables.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
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**June 30, 2007 and 2006**

**4. Investments (Continued)**

**(c) Securities Lending**

In accordance with a contract between the Commonwealth and its custodial agent, the System participates in a securities lending program. Under this program, the custodian, acting as the lending agent, loans securities (equities, fixed income issues and money market instruments) to independent brokers and dealers in exchange for collateral in an amount not less than 102% of the fair value of any securities loaned except for non-U.S. corporations for which 105% of the fair value is required. For Euro fixed income debt issues, for which the Commonwealth receives Euros as collateral and international fixed income debt issues denominated in U.S. dollars, the collateral required to be exchanged is in an amount not less than 102% of the fair value of any securities loaned. Collateral is marked-to-market daily. If the fair value of the collateral held falls below the minimum guidelines for securities loaned, additional collateral is obtained. In lieu of certain approved securities or cash, the borrower may deliver to the lending agent irrevocable bank letters of credit as collateral. If the collateral obtained consists in whole or in part of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the Commonwealth.

As of June 30, 2007 and 2006, the System had no credit risk exposure to borrowers because the amounts the System owed the borrowers exceeded the amounts the borrowers owed the System. Under the securities lending program, the lending agent provides indemnification to the Commonwealth if the same borrowers fail to return the underlying securities (and the collateral is inadequate to replace the loaned securities) or fail to pay income distributions on them. There were no losses during the fiscal years ended June 30, 2007 and 2006, resulting from a default of the borrowers or the lending agent.

All securities loans can be terminated on demand by either the System or the borrower, although the average term of the loan is one day. There were no term loans as of June 30, 2007 and 2006.

Cash collateral is invested in the lending agent's short-term investment pool and is not subject to custodial credit risk. The System's income from securities lending represents its pro-rata share from participating in the program. The weighted-average maturity of the investments in the pool was 36 days and 31 days at June 30, 2007 and 2006, respectively. The relationship between the maturities of the investment pool and the System's loans is affected by the maturities of the securities loans made by other entities that use the lending agent's pool, which the System cannot determine. The System cannot pledge or sell collateral securities received unless the borrower defaults. In the event of a default, the lending agent may use the collateral to replace the loaned securities.

As of June 30, 2007, the fair value of loaned securities was \$9,843,769,000, which includes \$1,345,657,000 of loaned securities, which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$10,209,493,000 of which \$8,806,979,000 was cash. As of June 30, 2006, the fair value of loaned securities was \$7,028,659,000, which includes \$818,469,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$7,166,598,000 of which \$6,337,173,000 was cash.

**5. Derivative and Other Similar Investments**

The System enters into a variety of financial contracts, which include options and futures. The System also enters into foreign exchange positions, such as forward and spot contracts to obtain or hedge foreign currency exposure; swap agreements to gain exposure to certain sectors of the equity and fixed income markets; collateralized mortgage obligations (CMOs); other forward contracts, and U.S. Treasury strips. The System is not a dealer, but an end-user of these instruments. The contracts are used primarily to enhance performance and reduce the volatility of the portfolio. The System is exposed to credit risk in the event of non-performance by counterparties to financial instruments. As the System generally enters into

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**5. Derivative and Other Similar Investments (Continued)**

transactions only with high quality institutions, no losses associated with counterparty nonperformance on derivative financial instruments have been incurred. Legal risk is mitigated through selection of executing brokers and review of all documentation. The System is exposed to market risk, the risk that future changes in market conditions may make an instrument less valuable. Exposure to market risk is managed in accordance with risk limits set by senior management, through buying or selling instruments or entering into offsetting positions.

The notional or contractual amounts of derivatives indicate the extent of the System's involvement in the various types and uses of derivative financial instruments and do not measure the System's exposure to credit or market risks and do not necessarily represent amounts exchanged by the parties. The amounts exchanged are determined by reference to the notional amounts and the other terms of the derivatives.

The following table summarizes the aggregate notional or contractual amounts for the System's derivative financial instruments at June 30, 2007 and 2006 (in thousands):

	<b>2007</b>	<b>2006</b>
Futures contracts – long	<b>\$ 11,887,271</b>	\$ 11,547,597
Futures contracts – short	<b>4,528,407</b>	3,828,194
Foreign exchange forward and spot contracts, gross	<b>21,675,965</b>	10,161,833
Options – calls purchased	<b>1,622,129</b>	25,109
Options – puts purchased	<b>278,896</b>	-
Options – calls sold	<b>1,675,223</b>	23,230
Options – puts sold	<b>363,893</b>	53,167
Swaps – total return	<b>949,347</b>	-
Swaps – interest rate	<b>183,000</b>	-

Futures contracts are contracts in which the buyer agrees to purchase and the seller agrees to make delivery of a specific financial instrument at a predetermined date and price. Gains and losses on futures contracts are settled daily based on a notional (underlying) principal value and do not involve an actual transfer of the specific instrument. Futures contracts are standardized and are traded on exchanges. The exchange assumes the risk that a counterparty will not pay and generally requires margin payments to minimize such risk. In addition, the System enters into short sales, sales of securities it does not presently own, to neutralize the market risk of certain equity positions. Initial margin requirements on futures contracts and collateral for short sales are provided by investment securities pledged as collateral and by cash held by various brokers. Although the System has the right to access individual pledged securities, it must maintain the amount pledged by substituting other securities for those accessed. The value of securities pledged and the amount of cash held at June 30, 2007 and 2006 represent a restriction on the amount of assets available as of year-end for other purposes.

Option contracts provide the option purchaser with the right, but not the obligation, to buy or sell the underlying security at a set price during a period or at a specified date. The option writer is obligated to buy or sell the underlying security if the option purchaser chooses to exercise the option. The System generally uses exchange listed currency, index, stock, and futures options. The System has authorized an investment manager to write covered call stock index option spreads up to a notional amount of \$1,500,000,000.

Foreign exchange contracts involve an agreement to exchange the currency of one country for the currency of another country at an agreed-upon price and settlement date. The contracts reported above primarily include forwards. The \$21,675,965,000 of foreign currency contracts outstanding at June 30, 2007 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**5. Derivative and Other Similar Investments (Continued)**

currencies of \$9,327,473,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of \$12,348,492,000. The \$10,161,833,000 of foreign currency contracts outstanding at June 30, 2006 consist of "buy" contracts of \$3,869,444,000 and "sell" contracts of \$6,292,389,000. The unrealized gain (loss) on contracts of \$26,459,000 and \$(52,689,000) at June 30, 2007 and 2006, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The System has authorized an investment manager to manage a currency hedge portfolio consisting of foreign exchange spot and forward contracts, currency futures, and currency options to hedge up to a notional amount of \$5,100,000,000 of the MSCI EAFE Index currencies to U.S. dollars.

Swap agreements provide for periodic payments at predetermined future dates between parties based on the change in value of underlying indexes or interest rates. During the year ended June 30, 2007, the System entered into total return swaps and interest rate swaps. Under the total return swap arrangements, the System receives the net return of certain equity indexes in exchange for a short-term rate minus a spread. The payable on the total return swap contracts of \$(7,110,000) and \$0 at June 30, 2007 and 2006, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The contracts have varying maturity dates ranging from January 30, 2008 to April 11, 2008. Interest rate swap agreements involve the exchange by the System with another party of their respective commitments to pay or receive interest, e.g. an exchange of floating rate payments for fixed rate payments with respect to a notional amount of principal. The System uses interest rate swaps as the most cost-effective way to gain exposure to certain sectors of the fixed income market. The receivable on the interest rate swap contracts of \$2,424,000 and \$0 at June 30, 2007 and 2006, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The contracts have varying maturity dates ranging from April 15, 2010 to April 15, 2028.

The System also invests in mortgage-backed securities (MBS) such as CMOs and MBS forwards to maximize yields. These securities are sensitive to prepayments of mortgages, which may result from a drop in interest rates. The MBS forwards are subject to credit risk in the event of nonperformance by counterparties. The fair value of CMOs at June 30, 2007 and 2006 is \$2,566,980,000 and \$2,295,764,000, respectively.

The System invests in U.S. Treasury strips which essentially act as zero coupon bonds and are subject to market volatility from a rise or drop in interest rates.

Through certain collective trust funds, the System also indirectly holds various derivative financial instruments. The collective trust funds invest in futures and options thereon; forward foreign currency contracts; options; interest rate, currency, equity, index, and total return swaps; interest-only strips; and CMOs, to enhance the performance and reduce the volatility of their portfolios.

**6. Pension Plan for Employees of the System**

The System contributes to the Commonwealth's State Employees' Retirement System (SERS), a cost-sharing multiple-employer defined benefit pension plan. SERS provides retirement, death, and disability benefits to plan members and beneficiaries according to Commonwealth statute. SERS issues a publicly available financial report that can be obtained by writing to SERS, 30 N. Third Street, P. O. Box 1147, Harrisburg, Pennsylvania 17108-1147.

The contribution requirements of plan members and the System are mandated by Commonwealth statute. Most SERS plan members are required to contribute 5% or 6.25% of their annual covered payroll depending upon service class. The System is required to contribute at an actuarially determined rate.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO FINANCIAL STATEMENTS**  
**June 30, 2007 and 2006**

**6. Pension Plan for Employees of the System (Continued)**

The rates applied to annual covered payroll were 3.23% at June 30, 2007 and 2.37% at June 30, 2006. The System's contributions to SERS for the year ended June 30, 2007 and 2006 were \$533,000 and \$418,000, respectively, which were equal to the required contributions each year.

**7. Litigation and Contingencies**

The System is subject to various threatened and pending lawsuits. These lawsuits include issues related to benefit calculations and eligibility including challenges to amendments to the Public School Employees' Retirement Code which increased retirement benefits for certain active public school employees but did not provide for increased benefits for employees who retired before the effective date of the amendments. It is the opinion of management that the ultimate liability arising from such threatened and pending litigation will not have a material effect on the financial position of the System. The System is exposed to various other liabilities and risks related to fiduciary responsibilities of directors and officers.

**REQUIRED SUPPLEMENTAL SCHEDULES**

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
REQUIRED SUPPLEMENTAL SCHEDULE 1  
SCHEDULES OF FUNDING PROGRESS\***  
(Unaudited – See Accompanying Auditor's Report)  
(Dollar amounts in millions)

<b>Pension</b>						
Valuation as of June 30	(1)  Actuarial accrued liabilities (AAL)	(2)  Actuarial value of assets	(3) (Funded) Unfunded actuarial accrued liabilities (FAAL) or UAAL (1) – (2)	(4)  Ratio of assets to AAL (2) / (1)	(5)  Covered payroll	(6) (FAAL) or UAAL as a percentage of covered payroll (3) / (5)
2006	\$ 64,627.3	\$ 52,464.7	\$ 12,162.6	81.2%	\$ 11,419.0	106.5%
2005	61,129.4	51,122.1	10,007.3	83.6%	10,527.7	95.1%
2004	56,978.1	51,949.6	5,028.5	91.2%	10,030.7	50.1%
2003	54,313.3	52,770.0	1,543.3	97.2%	9,652.9	16.0%
2002	51,693.2	54,193.1	(2,499.9)	104.8%	9,378.9	(26.7)%
2001	47,870.9	54,783.9	(6,913.0)	114.4%	9,414.9	(73.4)%

<b>Premium Assistance</b>						
Valuation as of June 30	(1)  Actuarial accrued liabilities (AAL)	(2)  Actuarial value of assets	(3) (Funded) Unfunded actuarial accrued liabilities (FAAL) or UAAL (1) – (2)	(4)  Ratio of assets to AAL (2) / (1)	(5)  Covered payroll	(6) (FAAL) or UAAL as a percentage of covered payroll (3) / (5)
2006	\$ 1,056.2	\$ 92.8	\$ 963.4	8.8%	\$ 11,419.0	8.4%

\* The amounts reported in the Schedule of Funding Progress do not include assets or liabilities for the HOP.

See accompanying notes to required supplemental schedules.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
 REQUIRED SUPPLEMENTAL SCHEDULE 2  
 SCHEDULES OF EMPLOYER CONTRIBUTIONS  
 (Unaudited – See Accompanying Auditor's Report)  
 (Dollar amounts in thousands)**

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**Pension**

<b>Year ended June 30</b>	<b>Annual Required Contributions</b>	<b>Actual Employer Contributions</b>	<b>Percentage Contributed</b>
2007	\$ 1,708,821	\$ 659,545	39%
2006	1,328,373	456,878	34%
2005	945,107	431,556	46%
2004	321,091	321,091	100%
2003	20,831	20,831	100%
2002	539	539	100%

**Premium Assistance**

<b>Year ended June 30</b>	<b>Annual Required Contributions</b>	<b>Actual Employer Contributions</b>	<b>Percentage Contributed</b>
2007	\$ 94,970	\$ 86,763	91%

The Board adopted all contribution rates as recommended by the Actuary pursuant to the prevailing provisions of the Retirement Code for each year.

See accompanying notes to required supplemental schedules.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO REQUIRED SUPPLEMENTAL SCHEDULES**  
**June 30, 2007 and 2006**

**1. Description of Schedules of Funding Progress**

Each time a new benefit is added which applies to service already rendered, an "unfunded accrued liability" is created. The laws governing PSERS require that these additional liabilities be financed systematically over a period of future years. Also, if actual financial experiences are less favorable than assumed financial experiences, the difference is added to unfunded accrued liabilities.

In an inflationary economy, the value of the dollar is decreasing. In this environment, employees pay in greater dollar amounts, resulting in a dollar increase in unfunded accrued liabilities. This occurs at a time when the actual substance of these items may be decreasing. Looking at just the dollar amounts of unfunded accrued liabilities can be misleading. Unfunded accrued liabilities divided by active employee payroll provides an index which clarifies understanding. The smaller the ratio of unfunded liabilities to covered payroll, the stronger the system. Observation of this relative index over a period of years will give an indication of whether the system is becoming financially stronger or weaker.

**2. Actuarial Assumptions and Methodologies**

**(a) Funding Method**

An entry-age normal actuarial cost method of valuation is used in determining benefit liabilities and normal cost. The outstanding balance of the June 30, 2001 unfunded accrued liability is being amortized over a closed 10-year period commencing July 1, 2002, with level dollar funding. Changes in the unfunded accrued liability, including actuarial gains and losses, subsequent to June 30, 2001 are being amortized over a closed period of 10 years from the first day of July next following the change, with level dollar funding.

**(b) Asset Valuation Method**

For actuarial purposes, assets are valued using a five-year moving market average value that will recognize the 8.5% actuarial expected investment return immediately and spread the difference between actual and expected investment return (beginning with fiscal year ending June 30, 2001) over a period of five years (adopted as of June 30, 2001). Previously, PSERS immediately recognized interest and dividends when earned, and recognized realized and unrealized gains and losses on the market value of assets over a three-year period.

**(c) Actuarial Assumptions**

Significant actuarial assumptions employed by the actuary for funding purposes as of June 30, 2006, the date of the most recent actuarial valuation include:

- Investment return – 8.5%, includes inflation at 3.25%
- Salary increases – 6.00%, which reflects an allowance for inflation of 3.25%, national productivity of 1%, and merit or seniority increases of 1.75%
- Amortization method – level dollar funding
- Remaining amortizations period (closed) – 10 years and 30 years in accordance with Act 40 of 2003
- Benefit payments – no postretirement benefit increases assumed in the future
- Multiple Decrement Tables – mortality, vesting, retirement age, and withdrawal estimates are based upon tables provided by the actuary

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**NOTES TO REQUIRED SUPPLEMENTAL SCHEDULES**  
**June 30, 2007 and 2006**

**2. Actuarial Assumptions and Methodologies (Continued)**

**(c) Actuarial Assumptions (continued)**

The System's actuarial values are calculated separately for retirees and beneficiaries and for active and inactive members.

The actuarial present value of benefits to be paid to retirees and beneficiaries currently receiving benefits and deferred survivor beneficiaries, whose benefits have been determined, is calculated using the assumptions noted above. The Reserve for Retirement Account with interest credited thereon at an annual rate of 5.50% is compared to the actuarial accrued liability for the remaining lifetimes of the retirees and beneficiaries and any deficiency is then funded by a transfer from the State Accumulation Account. Consequently, all such determined benefits are fully funded.

The actuarial accrued liability for active and inactive members is calculated on the projected benefit basis using the entry-age normal actuarial cost method under which the present value of each member's expected benefit payable at retirement or death is determined. The assets of the Members' Savings Account, State Accumulation Account and the fair value adjustment are subtracted from this present value to arrive at the funded or unfunded actuarial accrued liability.

**3. Actuarial Assumptions and Methodologies – Health Insurance Premium Assistance Plan**

The health insurance liability and funding provisions of the PSERS Code differ from the GASB disclosure requirements. As a result, there are different determinations of actuarial liability and contribution requirements for GASB accounting purposes and for Commonwealth funding purposes. For purposes of funding, the actuarial liability equals the assets in the health insurance account, and the contribution required is the amount necessary to establish reserves sufficient to provide premium assistance payments to all participating eligible annuitants during the fiscal year that immediately follows the year the employer contribution is made. For GASB accounting purposes, the actuarial liability has been determined under the entry age actuarial cost method, and the annual required contribution of employers (ARC) is equal to the entry age normal cost for health insurance plus an amount that will amortize the entry age unfunded actuarial liability for health insurance over a period of 30 years. (The entry age actuarial cost method was selected for this calculation because it meets the GASB parameters for determining actuarial liability and normal cost, and is the cost method specified by the PSERS Code for the PSERS pension plan.)

The Schedules of Funding Progress shows that as of June 30, 2006, the health insurance premium assistance assets were \$92,777,000, measured on a market value basis.

**SUPPLEMENTAL SCHEDULES**

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**SUPPLEMENTAL SCHEDULE 1**  
**SCHEDULE OF OPERATING EXPENSES**  
**Year Ended June 30, 2007**  
(Dollar Amounts in Thousands)

	Administrative expenses (1)	Investment expenses (2)	Total
<b>Personnel costs:</b>			
Salaries and wages	\$ 13,867	\$ 2,375	\$ 16,242
Social security contributions	1,100	181	1,281
Retirement contributions	435	99	534
Employees' insurance contributions	4,129	438	4,567
Other employee benefits	629	736	1,365
<b>Total personnel costs</b>	<b>20,160</b>	<b>3,829</b>	<b>23,989</b>
<b>Operating costs:</b>			
Investment managers' fees	-	304,728	304,728
Custodian fees	-	352	352
Specialized services	21,243	-	21,243
Rental of real estate, electricity	1,768	139	1,907
Consultant and legal fees	978	2,461	3,439
Treasury and other Commonwealth services	1,025	117	1,142
Postage	1,024	-	1,024
Contracted maintenance and repair services	305	152	457
Office supplies	452	11	463
Rental of equipment and software	954	137	1,091
Printing	567	1	568
Travel and training	265	47	312
Telecommunications	516	10	526
Equipment (not capitalized)	287	33	320
Miscellaneous expenses	203	1,741	1,944
<b>Total operating expenses</b>	<b>29,587</b>	<b>309,929</b>	<b>339,516</b>
<b>Fixed charges:</b>			
Furniture and fixtures	481	-	481
Depreciation	254	-	254
<b>Total fixed charges</b>	<b>735</b>	<b>-</b>	<b>735</b>
<b>Total operating expenses</b>	<b>\$ 50,482</b>	<b>\$ 313,758</b>	<b>\$ 364,240</b>

(1) Includes administrative expenses of \$2,790 related to Postemployment Healthcare Premium assistance and \$12,453 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2007.

(2) Does not include \$32,673 in capitalized broker commissions for the fiscal year ended June 30, 2007.

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**  
**SUPPLEMENTAL SCHEDULE 2**  
**SUMMARY OF INVESTMENT EXPENSES**  
**Year Ended June 30, 2007**  
(Dollar Amounts in Thousands)

	<b>Assets under management*</b>	<b>Fees</b>
<b>External management</b>		
Domestic equity	\$ 7,311,000	\$ 89,014
International equity	14,513,000	56,421
Fixed income	9,926,000	14,124
Real estate	5,020,000	45,607
Private equity and debt	5,233,000	79,763
Venture capital	606,000	16,252
Commodities	1,669,000	3,547
<b>Total external management</b>	44,278,000	304,728
<b>Total internal management</b>	23,030,000	6,217
<b>Total investment management</b>	\$ 67,308,000	\$ 310,945
Custodian fees		352
Consultant and legal fees		2,461
<b>Total investment expenses</b>		\$ 313,758

\* Net asset value of investments at June 30, 2007

**PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
SUPPLEMENTAL SCHEDULE 3  
SCHEDULE OF PAYMENTS TO NON-INVESTMENT CONSULTANTS  
Year Ended June 30, 2007  
(Payment amounts greater than \$50,000)**

<u>Consultant</u>	<u>Fees</u>	<u>Services Provided</u>
CoreSource, Inc.	\$ 8,787,242	Postemployment healthcare benefits administration and claims adjudication
Benecard Services, Inc.	3,658,757	Administration of postemployment healthcare benefits and prescription drug plan
Tier Technologies, Inc.	3,343,374	NPAS project development
The Segal Company	1,198,345	Actuarial services and consulting for HOP and prescription drug plan
Vitech Systems Group, Inc.	1,000,000	NPAS project development
Rx Solutions, Inc.	810,594	Administration of postemployment healthcare benefits and prescription drug plan
Buck Consultants LLC	501,494	Pension benefit actuarial services
Independent Pharmaceutical Consultants, Inc.	209,810	Administration of postemployment healthcare benefits and prescription drug plan
Independent Fiduciary Services, Inc.	111,875	Auditing services
Clifton Gunderson LLP	111,000	Financial audit of pension system and postemployment healthcare programs