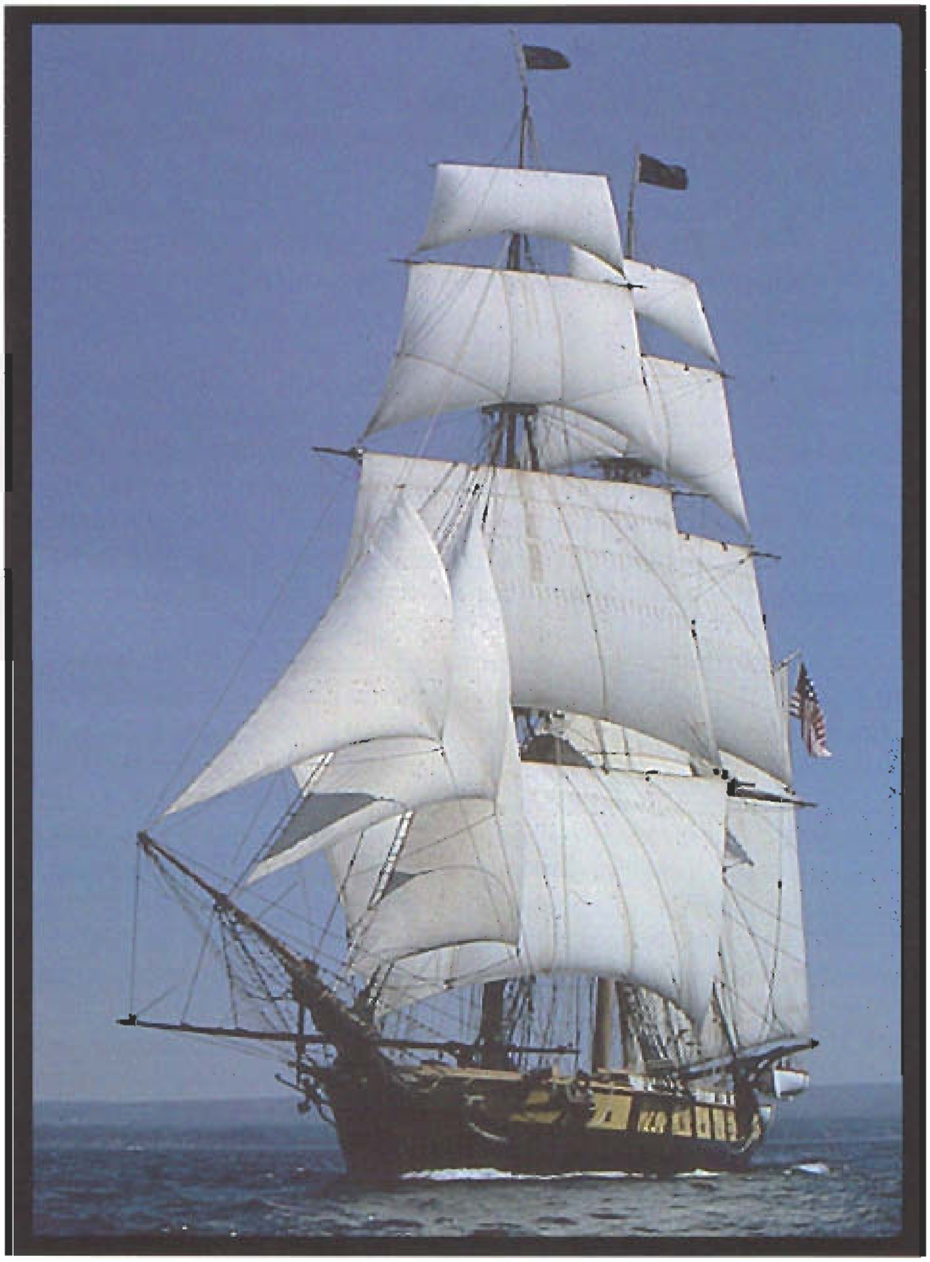
Financial Section



U.S. Brig Niagara, Lake Erie

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Clifton Gunderson LLP
Certified Public Accountants & Consultants

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 year ended June 30, 2003, 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 audit. The financial statements of PSERS as of June 30, 2002 were audited by other auditors whose report dated October 15, 2002, expressed an unqualified opinion on those financial statements.

We conducted our audit 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 audit provides 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, 2003, and the changes in its plan net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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 the Government Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was 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 16, 2003

Offices in 13 states and Washington, DC

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Management's Discussion and Analysis

This section presents management's discussion and analysis of the Pennsylvania Public School Employees' Retirement System's (PSERS) financial performance for the fiscal year ended June 30, 2003. It is presented as required supplemental information to the financial statements.

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 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, 2003, 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, 2002 to June 30, 2003, 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' plan net assets decreased by $1.1 billion from $43.6 billion at June 30, 2002 to $42.5 billion at June 30, 2003. The decrease is primarily attributable to the payment of pension benefits that exceeded contributions and net investment income.
- The funded ratio as of the latest actuarial valuation dated June 30, 2002 decreased from 114.4% to 104.8%. The decrease is due to the net effect of the Cost of Living Adjustments (COLA) provided by Act 38 of 2002, the residual effect of Act 9 of 2001, as well as asset and experience losses.
- The rate of return on investments for the fiscal year ended June 30, 2003 (FY 2003) was 2.74% compared to the fiscal year ended June 30, 2002 (FY 2002) return of (5.25)%.
- Total member and employer contributions increased from $915.0 million in FY 2002 to $1.0 billion in FY 2003.
- Total PSERS' benefit payouts increased by 6.9% from $2.9 billion during FY 2002 to $3.1 billion during FY 2003. The increase is primarily attributable to the impact of the first phase of the Act 38 of 2002 COLA that was effective on July 1, 2002.
- Administrative expenses increased by 19.5% from $35.4 million in FY 2002 to $42.3 million in FY 2003 primarily due to the planned increase for the New Pension Administration System (NPAS) project and increases in the HOP claim processing fees under a newly implemented self-funding plan. All administrative expenses were within PSERS' budgeted amounts for both years.

Management's Discussion and Analysis (Continued)

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. PSERS has been at least 100% funded since 1997, which is one indicator of the financial soundness of the plan. The most recent actuarial valuation reports that PSERS is 104.8% funded as of June 30, 2002. The results of operations for FY 2003 will be reflected in the actuarial valuation for the year ended June 30, 2003. Due to the normal lag time for completion of the actuarial valuation, the resulting funded status will be available at the end of the calendar year and will be reported in the financial statements for the fiscal year ended June 30, 2004.

Analysis of Plan Net Assets

(Dollar Amounts in Thousands)

Summary of Plan Net Assets:	FY 2003	FY 2002	Change
Assets:			
Receivables	**$ 1,282,433**	$ 1,386,127	$ (103,694)
Investments	**43,720,004**	44,456,217	(736,213)
Securities lending collateral pool	**3,387,690**	2,282,799	1,104,891
Fixed assets	**2,428**	3,150	(722)
Total Assets	**48,392,555**	48,128,293	264,262
Liabilities:			
Payables	**2,516,947**	2,248,844	268,103
Obligations under securities lending	**3,387,690**	2,282,799	1,104,891
Total Liabilities	**5,904,637**	4,531,643	1,372,994
Plan Net Assets	**$42,487,918**	$43,596,650	$(1,108,732)

Summary of Changes in Plan Net Assets:	FY 2003	FY 2002	Change
Additions:			
Contributions	**$ 1,013,763**	$ 915,017	$ 98,746
Net investment income (loss)	**1,022,467**	(2,523,025)	3,545,492
Total Additions	**2,036,230**	(1,608,008)	3,644,238
Deductions:			
Benefit payments	**$ 3,102,684**	$ 2,913,163	$ 189,521
Administrative expenses	**42,278**	35,373	6,905
Total Deductions	**3,144,962**	2,948,536	196,426
Changes in Plan Net Assets	**$(1,108,732)**	$ (4,556,544)	$ 3,447,812

Management's Discussion and Analysis (Continued)

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 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.

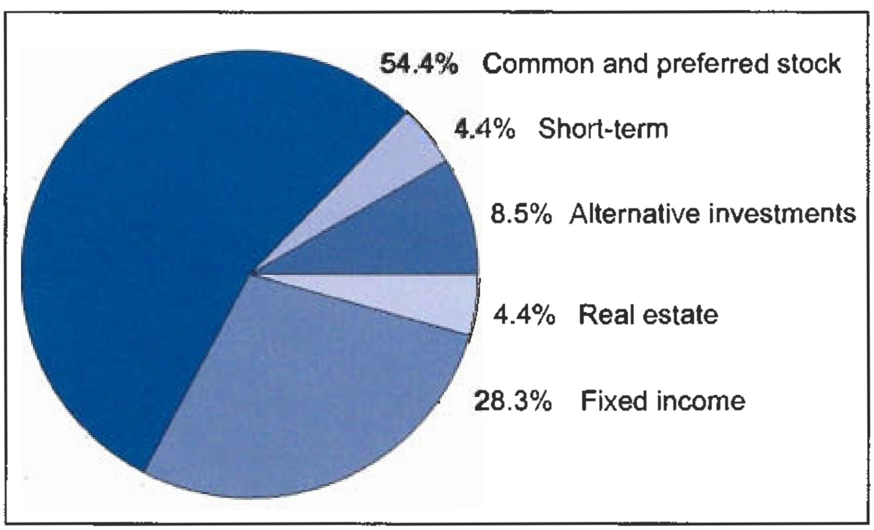
For FY 2003, PSERS' rate of return on investments was 2.74%, which is primarily attributable to a strong fixed income market during FY 2003. The annualized rate of return over the past three and five-year periods ended June 30, 2003 was (3.39)% and 2.57%, respectively. The annualized rate of return for the ten-year period ended June 30, 2003 was 8.30% on a gross of fees basis.

The asset distribution of PSERS' portfolio at June 30, 2003 and June 30, 2002, at fair value, including postemployment healthcare assets, was:

(Dollar Amounts in Thousands)

Asset Class	2003	%	2002	%
Short-term	$ 1,907,821	4.4	$ 1,707,628	3.8
Fixed income	12,372,930	28.3	12,769,652	28.7
Common and preferred stock	23,768,325	54.4	25,280,253	57.0
Real estate	1,934,156	4.4	1,754,636	3.9
Alternative investments	3,736,772	8.5	2,944,048	6.6
Total	$ 43,720,004	100.0	$44,456,217	100.0

Asset Distribution
Fiscal Year Ended June 30, 2003



Management's Discussion and Analysis (Continued)

Common and preferred stock

Common and preferred stock decreased $1.5 billion from June 30, 2002 to June 30, 2003 primarily due to negative returns in the domestic and international equity markets and reductions to the asset class during FY 2003 in accordance with PSERS' asset allocation plan.

Alternative investments

Alternative investments increased $792.7 million from June 30, 2002 to June 30, 2003 due primarily to the addition of new investment partnerships and the drawdowns of commitments to existing partnerships in accordance with PSERS' asset allocation plan.

Contributions and Investment Income

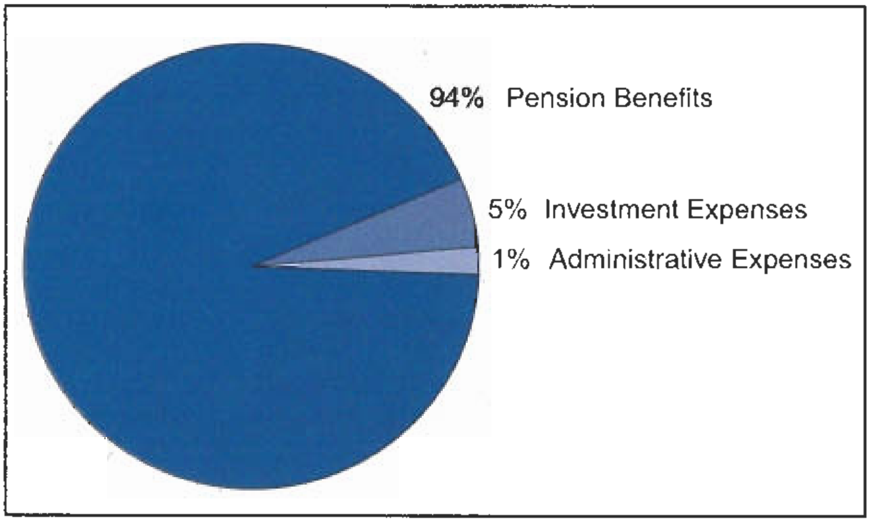
During FY 2003, contributions from employers and members, including the postemployment healthcare program, totaled $1.0 billion compared to $915.0 million during FY 2002. Employer pension contributions increased by $20.3 million from $539.0 thousand in FY 2002 to $20.8 million in FY 2003. The increase was attributable to the increase in the employer pension contribution rate from 0.00% in FY 2002 to 0.18% in FY 2003. Member pension contributions increased by $89.5 million from $662.6 million in FY 2002 to $752.1 million in FY 2003 as a result of the first full-year impact of the increase in the member contribution rate that went into effect January 1, 2002 for members electing T-D class membership service under Act 9 of 2001. The contributions for Premium Assistance decreased by $13.3 million from $108.9 million in FY 2002 to $95.6 million in FY 2003 due to the reduction in the Premium Assistance contribution rate from 1.09% in FY 2002 to 0.97% in FY 2003. Net investment income increased by $3.5 billion from a net investment loss of $(2.5) billion in FY 2002 to net investment income of $1.0 billion in FY 2003. The significant increase in investment performance was primarily attributable to higher returns generated from domestic and international equity and fixed income markets from FY 2002 to FY 2003. Net investment income also includes investment expenses as a deduction. The "Pension Plan Benefits and Expenses" section that follows includes an analysis of investment expenses.

Management's Discussion and Analysis (Continued)

Pension Plan Benefits and Expenses

The primary source of expense during FY 2003 was for payment of benefits totaling $3.1 billion that compares to $2.9 billion during FY 2002. Investment expenses increased $16.2 million from $162.8 million during FY 2002 to $179.0 million during FY 2003 due primarily to the increase in investment management fees that resulted from growth in alternative investments. Administrative expenses totaled $42.3 million during FY 2003 compared to $35.4 million during FY 2002. The increase was largely due to the planned increase for the NPAS project and increases in the HOP claim processing fees under a newly implemented self-funding plan.

Pension Plan Benefits and Expenses
Fiscal Year Ended June 30, 2003



Pension Plan Amendments

Act 38 of 2002 provided a two-phase COLA for retirees. Eligible members who retired prior to July 2, 1990, received a COLA ranging from 8% to 25% depending on their date of retirement. This first phase of the COLA began July 1, 2002. Eligible members who retired on or after July 2, 1990 received a COLA ranging from 2.27% to 9% based on their date of retirement. This second phase of the COLA began July 1, 2003. Act 38 also provided that the actuarial assets of the Fund will be calculated by recognizing the actuarially expected investment return immediately and recognizing the difference between the actual investment return and the actuarially expected investment return over a five-year period.

Statements of Plan Net Assets

Years ended June 30, 2003 and 2002

(Dollar Amounts in Thousands)

	2003			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Assets:				
Receivables:				
Members	$ 190,922	$ 650	$ 36	$ 191,608
Employers	7,421	29,344	-	36,765
Investment income	151,801	574	42	152,417
Investment proceeds	899,329	-	-	899,329
Miscellaneous	2,246	26	42	2,314
Total Receivables	1,251,719	30,594	120	1,282,433
Investments, at fair value:				
Short-term	1,745,381	100,198	62,242	1,907,821
Fixed income	12,372,930	-	-	12,372,930
Common and preferred stock	23,768,325	-	-	23,768,325
Real estate	1,934,156	-	-	1,934,156
Alternative investments	3,736,772	-	-	3,736,772
Total Investments	43,557,564	100,198	62,242	43,720,004
Securities lending collateral pool	3,387,690	-	-	3,387,690
Capital assets (net of accumulated depreciation of $8,921)	2,428	-	-	2,428
Total Assets	48,199,401	130,792	62,362	48,392,555
Liabilities:				
Accounts payable and accrued expenses	29,287	250	8,453	37,990
Benefits payable	175,331	95	-	175,426
Participant premium advances	-	-	12,817	12,817
Investment purchases and other liabilities	2,290,714	-	-	2,290,714
Obligations under securities lending	3,387,690	-	-	3,387,690
Total Liabilities	5,883,022	345	21,270	5,904,637
Net assets held in trust for pension and postemployment healthcare benefits: (A schedule of funding progress is presented on Required Supplemental Schedule 1)	$42,316,379	$ 130,447	$ 41,092	$42,487,918

These financial statements should be read only in connection with the accompanying notes to financial statements.

Statements of Plan Net Assets

Years ended June 30, 2003 and 2002

(Dollar Amounts in Thousands)

	2002			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Assets:				
Receivables:				
Members	$ 166,238	$ 658	$ 31	$ 166,927
Employers	1,465	35,076	-	36,541
Investment income	180,821	411	51	181,283
Investment proceeds	1,000,379	-	-	1,000,379
Miscellaneous	713	251	33	997
Total Receivables	1,349,616	36,396	115	1,386,127
Investments, at fair value:				
Short-term	1,595,427	67,063	45,138	1,707,628
Fixed income	12,769,652	-	-	12,769,652
Common and preferred stock	25,280,253	-	-	25,280,253
Real estate	1,754,636	-	-	1,754,636
Alternative investments	2,944,048	-	-	2,944,048
Total Investments	44,344,016	67,063	45,138	44,456,217
Securities lending collateral pool	2,282,799	-	-	2,282,799
Capital assets (net of accumulated depreciation of $8,127)	3,150	-	-	3,150
Total Assets	47,979,581	103,459	45,253	48,128,293
Liabilities:				
Accounts payable and accrued expenses	33,703	125	14,657	48,485
Benefits payable	197,558	30	-	197,588
Participant premium advances	-	-	10,499	10,499
Investment purchases and other liabilities	1,992,272	-	-	1,992,272
Obligations under securities lending	2,282,799	-	-	2,282,799
Total Liabilities	4,506,332	155	25,156	4,531,643
Net assets held in trust for pension and postemployment healthcare benefits: (A schedule of funding progress is presented on Required Supplemental Schedule 1)	$43,473,249	$ 103,304	$ 20,097	$43,596,650

These financial statements should be read only in connection with the accompanying notes to financial statements.

Statements of Changes in Plan Net Assets

Years ended June 30, 2003 and 2002

(Dollar Amounts in Thousands)

	2003			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Additions:				
Contributions:				
Members	$ 752,110	$ -	$ 145,197	$ 897,307
Employers	20,831	95,625	-	116,456
Total contributions	772,941	95,625	145,197	1,013,763
Investment income (loss):				
From investing activities:				
Net depreciation in fair value of investments	(170,101)	(2,405)	-	(172,506)
Short-term	26,016	3,566	596	30,178
Fixed income	655,861	-	-	655,861
Common and preferred stock	480,735	-	-	480,735
Real estate	139,267	-	-	139,267
Alternative investments	52,956	-	-	52,956
Total investment activity income (loss)	1,184,734	1,161	596	1,186,491
Investment expenses	(179,033)	(23)	-	(179,056)
Net income (loss) from investing activities	1,005,701	1,138	596	1,007,435
From securities lending activities:				
Securities lending income	43,870	-	-	43,870
Securities lending expense	(28,838)	-	-	(28,838)
Net income from securities lending activities	15,032	-	-	15,032
Total net investment income (loss)	1,020,733	1,138	596	1,022,467
Total Additions	1,793,674	96,763	145,793	2,036,230
Deductions:				
Benefits	2,890,192	67,688	118,745	3,076,625
Refunds of contributions	13,943	-	-	13,943
Net transfer to State Employees' Retirement System	12,116	-	-	12,116
Administrative expenses	34,293	1,932	6,053	42,278
Total Deductions	2,950,544	69,620	124,798	3,144,962
Net (decrease) increase	(1,156,870)	27,143	20,995	(1,108,732)
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	43,473,249	103,304	20,097	43,596,650
Balance, end of year	$42,316,379	$ 130,447	$ 41,092	$42,487,918

These financial statements should be read only in connection with the accompanying notes to financial statements.

Statements of Changes in Plan Net Assets

Years ended June 30, 2003 and 2002

(Dollar Amounts in Thousands)

	2002			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Additions:				
Contributions:				
Members	$ 662,561	$ -	$ 143,006	$ 805,567
Employers	539	108,911	-	109,450
Total contributions	663,100	108,911	143,006	915,017
Investment income (loss):				
From investing activities:				
Net depreciation in fair value of investments	(3,826,141)	(564)	-	(3,826,705)
Short-term	43,668	2,159	1,035	46,862
Fixed income	806,373	-	-	806,373
Common and preferred stock	446,784	-	-	446,784
Real estate	131,890	-	-	131,890
Alternative investments	18,294	-	-	18,294
Total investment activity income (loss)	(2,379,132)	1,595	1,035	(2,376,502)
Investment expenses	(162,755)	(22)	-	(162,777)
Net income (loss) from investing activities	(2,541,887)	1,573	1,035	(2,539,279)
From securities lending activities:				
Securities lending income	57,391	-	-	57,391
Securities lending expense	(41,137)	-	-	(41,137)
Net income from securities lending activities	16,254	-	-	16,254
Total net investment income (loss)	(2,525,633)	1,573	1,035	(2,523,025)
Total Additions	(1,862,533)	110,484	144,041	(1,608,008)
Deductions:				
Benefits	2,707,125	51,738	130,008	2,888,871
Refunds of contributions	14,858	-	-	14,858
Net transfer to State Employees' Retirement System	9,434	-	-	9,434
Administrative expenses	29,756	1,814	3,803	35,373
Total Deductions	2,761,173	53,552	133,811	2,948,536
Net (decrease) increase	(4,623,706)	56,932	10,230	(4,556,544)
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	48,096,955	46,372	9,867	48,153,194
Balance, end of year	$ 43,473,249	$ 103,304	$ 20,097	$ 43,596,650

These financial statements should be read only in connection with the accompanying notes to financial statements.

Notes to Financial Statements
June 30, 2003 and 2002

(1)
Organization and Description of the Public School Employees' Retirement System (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 members. Membership in the System is mandatory for nearly all qualifying public school employees in the Commonwealth of Pennsylvania (Commonwealth). In certain instances, qualifying employees of charter schools may retain membership in other retirement plans. At June 30, 2003, there were 726 participating employers, generally school districts. Membership as of June 30, 2002, the most recent year for which actual amounts are available, consisted of:

Currently employed members:		
Vested	162,000	
Nonvested	81,000	
Total currently employed members		**243,000**
Retirees and beneficiaries currently receiving benefits	141,000	
Inactive members and vestees entitled to but not receiving benefits	61,000	
Total retirees and other members		**202,000**
Total number of members		**445,000**

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 a governing 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 rates by employers and employees are specified in state law. Changes in benefit and contribution provisions for each 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.

Notes to Financial Statements (Continued)

Based upon the 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.

(b) Pension Benefits

Under the provisions of the 1975 revision of the Pennsylvania Public School Employees' Retirement Code (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. 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 maximum premium assistance benefit had previously been $55 per month. To receive premium assistance, eligible annuitants must obtain their health insurance through either their school employer or the PSERS' Health Options Program (HOP).

Notes to Financial Statements (Continued)

The HOP is a PSERS-sponsored voluntary health care program for the sole benefit of PSERS retirees, survivor annuitants, and the spouse, surviving spouse and dependents of retirees or survivor annuitants. Benefits are provided by insurance carriers, health maintenance organizations or by third-party administrators. All retirees are eligible to participate in the High or Standard Options (indemnity plans) regardless of their residence. The HMO, POS and PPO Options (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 High and Standard Option are self-funded with aggregate stop-loss insurance. 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. Aggregate stop-loss insurance is purchased to pay claims in excess of 125% of expected annual incurred claims up to the limit of the policy. The HOP maintains a reserve for claims that are incurred but not reported (IBNR). At June 30, 2003, PSERS recorded $5.5 million in IBNR. The prescription drug benefits of the High Option and the HMO, POS and PPO Options are fully insured. 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 a period of ten years as required by the Code.

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 1.15% and 1.09% of qualified compensation for the years ended June 30, 2003 and 2002, 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.

Notes to Financial Statements (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 .97% and 1.09% for the years ended June 30, 2003 and 2002, 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.

The System follows Governmental Accounting Standards Board (GASB) guidance as applicable to proprietary funds and applies only those Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins issued on or before November 30, 1989, that do not conflict with or contradict GASB pronouncements.

(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 a published market price or quotation from national security exchanges and 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.

Real estate owned 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, 2003, $132,000,000 in line of credit advances were netted against the related property valuation. The line of credit balance is due on March 19, 2004. The line is payable at an interest rate equivalent to the lender's commercial paper rate and is collateralized by certain fixed income investments of the System.

Notes to Financial Statements (Continued)

Private equity, private debt, venture capital and equity real estate investments are primarily valued based on amounts established by valuation committees. The values for private equity, private debt, venture capital and equity real estate investments are reported on a one-quarter lag (March 31) adjusted for cash flows and significant unrealized losses 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.

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, 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.

(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, 2003 and 2002, $3,023,000 and $2,947,000, respectively, was accrued for unused vacation and sick leave for the System's employees.

(f) Participant Premium Advances

Participant premium advances are for HOP premiums paid in advance in 2003 and 2002 related to health care coverage to be provided in 2004 and 2003, respectively.

Notes to Financial Statements (Continued)

(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 the System, the plan 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 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 similarly expanded the variety of plans that can be used to roll money into PSERS to purchase eligible service credits. EGTRRA increased the annual compensation limits for qualified plans to $200,000, effective July 1, 2002, from the prior amount of $170,000. The annual benefit limits for defined benefit plans also increased to $160,000, effective July 1, 2001, from the previous amount of $140,000.

(h) Risk Management

The System is exposed to various liabilities or risks of loss related to theft or destruction of assets, injuries to employees, and court challenges to fiduciary decisions. To cover such risks, the System carries policies of directors' and officers' liability insurance and fiduciary liability insurance, and it also requires asset managers to carry appropriate policies of insurance. As an administrative agency of the Commonwealth, the System is accorded sovereign immunity, and it participates in a state property insurance program. As Commonwealth employees, the System's employees receive health insurance benefits, disability retirement benefits, and workers' compensation benefits. During the last three fiscal years, insurance settlements did not exceed insurance coverage.

(i) Reclassifications

Certain 2002 balances have been reclassified to conform with 2003 presentation.

(j) New Accounting Pronouncement

In June 1999, the Governmental Accounting Standards Board issued Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB 34). In June 2001, the GASB issued Statement No. 37, *Basic Financial Statements* – and *Management's Discussion and Analysis – for State and Local Governments: Omnibus,* which amended certain provisions of GASB 34. The System implemented GASB 34 in the fiscal year ended June 30, 2002. The adoption of GASB 34 required the presentation of Management's Discussion and Analysis as required supplemental information preceding the financial statements. The System's adoption of GASB 34 did not have an impact on its net assets.

Notes to Financial Statements (Continued)

(k) Members Receivables

Members receivables include an amount for members' obligations to the System for the purchase of service credit in the amount of $121,900,000. 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.

Because members have control over the timing of their remittances to the System, many purchases of service receivables extend beyond one year. An estimated $99,700,000 of the $190,922,000 members pension receivables at June 30, 2003 are expected to be collected by the System subsequent to June 30, 2004.

(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) 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.

Notes to Financial Statements (Continued)

(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 maximum premium assistance benefit had previously been $55 per month. The Health Insurance Account pays all administrative expenses necessary to operate the health insurance premium assistance program.

(e) Health Insurance Program Account

The Health Insurance Program Account is credited with contributions from members of the HOP. All benefits related to the HOP (premium payments to the insurance companies) 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:

	(Dollar Amounts in Thousands)	
	2003	2002
Pension:		
State accumulation account	**$ 11,318,193**	$ 16,040,082
Members' savings account	**8,282,753**	7,780,370
Reserve for retirement account	**22,715,433**	19,652,797
	$ 42,316,379	$ 43,473,249
Postemployment healthcare:		
Health insurance account	**$ 130,447**	$ 103,304
Health insurance program account	**41,092**	20,097

(4) Investments

(a) Summary of Investments

The Board of Trustees (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 person" 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.

Notes to Financial Statements (Continued)

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

	(Dollar Amounts in Thousands) 2003	2002
Pension investments:		
Short-term:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	$ 1,352,515	$ 1,275,222
Other domestic short-term	324,702	270,667
International short-term	68,164	49,538
	1,745,381	1,595,427
Fixed income:		
Domestic mortgage-backed securities	5,745,057	5,171,543
U.S. government and agency obligations	1,013,771	1,156,844
Domestic corporate and taxable municipal bonds	3,519,398	3,889,054
Miscellaneous domestic fixed income	325,203	377,566
Collective trust funds	380,408	651,925
International fixed income	1,389,093	1,522,720
	12,372,930	12,769,652
Common and preferred stock:		
Domestic common and preferred stock	15,737,452	16,399,629
Collective trust funds	539,600	617,249
International common stock	7,491,273	8,263,375
	23,768,325	25,280,253
Real estate:		
Equity real estate	1,511,803	1,272,826
Real estate owned	422,353	481,810
	1,934,156	1,754,636
Alternative investments:		
Private equity	2,392,040	2,068,683
Private debt	1,153,106	644,171
Venture capital	191,626	231,194
	3,736,772	2,944,048
Pension investments at fair value	$43,557,564	$44,344,016
Postemployment Healthcare short-term investments:		
Premium Assistance:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	$ 27,154	$ 27,101
Other domestic short-term	73,044	39,962
	100,198	67,063
Health Options Program:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	30,431	28,676
Other domestic short-term	31,811	16,462
	62,242	45,138
Postemployment Healthcare investments at fair value	$ 162,440	$ 112,201

Notes to Financial Statements (Continued)

During the fiscal years ended June 30, 2003 and 2002, the System owned no securities issued by and made no loans to school districts, the Commonwealth, or any related parties.

(b) Government Accounting Standards Board Statement No. 3

The System's investments are categorized below to give an indication of the level of credit (counterparty) risk assumed by the System at June 30, 2003 and 2002. In accordance with a contractual relationship between the Commonwealth's Treasury Department and a custodial agent, substantially all investments subject to categorization are held in book-entry form in the Commonwealth's name. Therefore, all such investments are reflected in Category 1, which is defined as insured or registered investments for which the securities are held by the System or its agent in the System's name.

Investments may also be categorized as Category 2, which is defined as uninsured or unregistered investments for which the securities are held by the counterparty's trust department or agent in the System's name, and Category 3, which is defined as uninsured or unregistered investments for which the securities are held by the broker or dealer or by its agent but not in the System's name. The System has no investments that would be classified in Categories 2 or 3. The System does have investments that are not in any of the three defined categories because the securities are not used as evidence of the investment. Such investments are separately identified.

Notes to Financial Statements (Continued)

Government Accounting Standards Board Statement No. 3
Summary of Categorized Investments
As of June 30, 2003 and 2002
(Dollar Amounts in Thousands)

	Fair Value	
	2003	2002
Investments – Category 1		
Domestic mortgage-backed securities	**$ 5,510,242**	$ 5,171,543
U.S. government and agency obligations	**300,975**	411,106
Domestic corporate and taxable municipal bonds	**3,225,505**	3,523,134
Miscellaneous domestic fixed income	**325,203**	377,566
International fixed income	**1,189,225**	1,443,619
Domestic common and preferred stock	**15,080,959**	16,214,804
International common stock	**6,329,856**	7,414,208
International short-term (1)	**68,164**	49,538
Other domestic short-term (2)	**429,557**	327,091
Subtotal	**32,459,686**	34,932,609
Investments – not categorized		
Investments held by broker dealers under securities loans:		
Domestic mortgage-backed securities	**234,815**	-
U.S. government and agency obligations	**712,796**	745,738
Domestic corporate and taxable municipal bonds	**293,893**	365,920
International fixed income	**199,868**	79,101
Domestic common and preferred stock	**656,493**	184,825
International common stock	**1,161,417**	849,167
Collective trust funds – fixed income and equity	**920,008**	1,269,174
Equity real estate	**1,511,803**	1,272,826
Real estate owned	**422,353**	481,810
Private equity	**2,392,040**	2,068,683
Private debt	**1,153,106**	644,171
Venture capital	**191,626**	231,194
Pennsylvania Treasury Domestic Short-Term Investment Fund (3)	**1,410,100**	1,330,999
Total Pension and Postemployment Healthcare investments	**$ 43,720,004**	$ 44,456,217

(1) International short-term investments consist of foreign currency holdings.

(2) Includes $104,855 and $56,424 of Postemployment Healthcare investments at June 30, 2003 and 2002, respectively. The remaining other domestic short-term investments consist primarily of U.S. Treasury Bills and certain government and agency obligations.

(3) Includes $57,585 and $55,777 of Postemployment Healthcare investments at June 30, 2003 and 2002, respectively.

Notes to Financial Statements (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, 2003 and 2002, 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, 2003 and 2002 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, 2003 and 2002.

Cash collateral is invested in the lending agent's short-term investment pool. 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 18 days and 27 days at June 30, 2003 and 2002, 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, 2003, the fair value of loaned securities was $3,439,882,000 which includes $180,600,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statement of Plan Net Assets. The fair value of the associated collateral was $3,569,998,000 of which $3,387,690,000 was cash. As of June 30, 2002, the fair value of loaned securities was $2,364,972,000 which includes $140,221,000 of loaned securities which was collateralized by securities and irrevocable letters of credit that are not included in the Statement of Plan Net Assets. The fair value of the associated collateral was $2,426,955,000 of which $2,282,799,000 was cash. The securities lending collateral pool is not categorized as to credit risk because securities are not used as evidence of the investment.

(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; 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. Short-term investments and cash equal to or greater than performance obligations under these contracts is maintained at all times. The System is exposed to credit risk in the event of non-performance by counterparties to financial instruments. As the System generally enters into 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, 2003 and 2002 (in thousands):

	2003	2002
Futures contracts – long	**$5,067,677**	$4,974,538
Futures contracts – short	**2,727,179**	3,286,061
Foreign exchange forward and spot contracts, gross	**2,792,438**	3,287,684
Options – calls purchased	**85,070**	83,000
Options – puts purchased	**66,213**	-
Options – calls sold	**96,320**	214,148
Options – puts sold	**1,523,489**	129,602

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 or by cash held in segregated accounts by the System's custodial bank or short sale broker. 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, 2003 and 2002 represent a restriction on the amount of assets available as of year-end for use for other purposes.

Notes to Financial Statements (Continued)

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 $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 $2,792,438,000 of foreign currency contracts outstanding at June 30, 2003 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of $1,766,479,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of $1,025,959,000. The $3,287,684,000 of foreign currency contracts outstanding at June 30, 2002 consist of "buy" contracts of $2,223,356,000 and "sell" contracts of $1,064,328,000. The unrealized gain on contracts of $3,234,000 and $54,776,000 at June 30, 2003 and 2002, respectively, is included in the System's net assets and represents the fair value of the contracts.

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, 2003 and 2002 is $2,325,381,000 and $2,229,059,000, 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.

Swap agreements are used to modify investment returns or interest rates on investments in the collective trust funds. Swap transactions involve the exchange of investment returns or interest rate payments without the exchange of the underlying principal amounts. These swaps expose the collective trust funds entering into these types of arrangements to credit risk in the event of nonperformance by counterparties.

(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. The rates applied to annual covered payroll were 0.18% at June 30, 2003, 0% at June 30, 2002 and .61% at June 30, 2001. The System's annual required contributions to SERS for the years ending June 30, 2003, June 30, 2002 and June 30, 2001 were $0, $0 and $87,000 respectively.

(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.

(8)
Act 2002 - 38

On April 23, 2002, Governor Mark Schweiker signed into law an act containing major pension legislation. The numerous provisions included in this legislation (known as Act 2002 – 38) amend the System's Code as follows:

(a) Annuitant Cost of Living Allowance (COLA)

Provided separate COLA's for two groups of retirees:

(i) Those who retired before July 2, 1990 start receiving a COLA beginning July 1, 2002, with funding over ten years at level dollar beginning July 1, 2003. The percentages of increase in monthly benefits are based upon retirement date:

Date of Retirement	Percentage of Increase
Before July 2, 1980	25.00%
July 2, 1980 – July 1, 1983	15.00%
July 2, 1983 – July 1, 1988	10.00%
July 2, 1988 – July 1, 1990	8.00%

(ii) Those who retired on or after July 2, 1990 and on or before July 1, 2002 will receive a COLA beginning July 1, 2003, with funding over ten years at level dollar beginning July 1, 2004. This second COLA includes retirees from July 2, 2001 through July 1, 2002, but excludes anyone who has any PSERS Class T-D, SERS Class D-4 or SERS Class AA service credit. The percentages of increase in monthly benefits are based upon retirement date:

Notes to Financial Statements (Continued)

Date of Retirement	Percentage of Increase
July 2, 1990 – July 1, 1994	9.00%
July 2, 1994 – July 1, 1998	7.50%
July 2, 1998 – July 1, 1999	6.35%
July 2, 1999 – July 1, 2000	4.87%
July 2, 2000 – July 1, 2001	3.08%
July 2, 2001 – July 1, 2002	2.27%

(b) PSERS Actuarial Funding Methodology

(i) Required PSERS to use a five-year smoothing methodology of recognizing investment gains and losses, based upon the SERS method. This method immediately recognizes the difference between the actual investment return and the actuarially expected investment return (total investment return including interest, dividends and realized and unrealized gains and losses) over a five-year period. 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.

(ii) Provided for an employer contribution rate floor of 1%, exclusive of the healthcare premium assistance rate. In effect, this imposes a minimum employer pension rate of 1%, plus the amount necessary to fund healthcare premium assistance. Established that the total employer contribution rate for fiscal year ended June 30, 2003 cannot exceed 1.15%. Required PSERS' Board of Trustees to recertify the previously adopted employer contribution rate of 5.64% for fiscal year ended June 30, 2003 within ten days of enactment of the legislation. In compliance, the PSERS Board of Trustees met on April 26, 2002 and recertified the employer contribution rate for fiscal year ended June 30, 2003 at 1.15%. The 1.15% is composed of a .97% rate for healthcare insurance premium assistance and a .18% rate for pensions.

(c) Miscellaneous Provisions

(i) Increased the minimum death benefit eligible for an annuity from $5,000 to $10,000.

(ii) Allowed multiple service members to take advantage of the System's debt plan for payment of member debts.

(iii) Required school districts to reduce their real estate taxes by the amount saved by the recertification of the employer contribution rate for Fiscal Year 2002-2003 if those tax rates had already been increased. School districts that had not raised their tax rates were required to base that portion of the tax millage attributable to pension costs on the recertified employer contribution rate for Fiscal Year 2002-2003.

Required Supplemental Schedule 1
Schedule of Funding Progress*

(Unaudited - see accompanying auditors' report)
(Dollar Amounts in Millions)

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 of percentage of covered payroll (3) / (5)
2002	# $ 51,796.5	$ 54,296.4	$ (2,499.9)	104.8%	$ 9,378.9	(26.7)%
2001	# 47,917.3	54,830.3	(6,913.0)	114.4%	9,414.9	(73.4)%
2000	39,822.8	49,293.0	(9,470.2)	123.8%	8,939.6	(105.9)%
1999	37,499.1	44,606.5	(7,107.4)	119.0%	8,247.6	(86.2)%
1998	36,136.2	39,969.0	(3,832.8)	110.6%	8,091.5	(47.4)%
1997	33,209.5	34,872.6	(1,663.2)	105.0%	7,745.0	(21.5)%

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

\# Includes the effects of Act 9 of 2001 and Act 38 of 2002.

See accompanying notes to required supplemental schedules.

Required Supplemental Schedule 2
Schedule of Employer Contributions*

(Unaudited - see accompanying auditors' report)
(Dollar Amounts in Thousands)

Year ended June 30	Annual required contributions	Percentage contributed
2003	$ 20,831	100%
2002	539	100%
2001	158,193	100%
2000	390,504	100%
1999	513,940	100%
1998	718,431	100%

The Board adopted all contribution rates as recommended by the Actuary.

* The amounts reported in the Schedule of Employer Contributions do not include premium assistance contributions.

See accompanying notes to required supplemental schedules.

Notes to Required Supplemental Schedules

June 30, 2003 and 2002

(Unaudited - see accompanying auditors' report)

(1)
Description of Schedule 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 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 to be amortized over a 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.

Notes to Required Supplemental Schedules (Continued)

(c) Actuarial Assumptions

Significant actuarial assumptions employed by the actuary for funding purposes as of June 30, 2002, the date of the most recent actuarial valuation include:

- Investment return – 8.5%, includes inflation at 3.5%
- Salary increases – 6.25%, which reflects an allowance for inflation of 3.5%, national productivity of 1%, and merit or seniority increases of 1.75%
- Amortization method – level dollar funding
- Remaining amortizations period – 10 years
- 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.

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.

Supplemental Schedule 1
Schedule of Operating Expenses
Fiscal Year Ended June 30, 2003

(Dollar Amounts in Thousands)

	Administrative expenses (1)	Investment expenses (2)	Total
Personnel costs:			
Salaries and wages	$ 13,269	$ 2,017	$ 15,286
Social security contributions	1,010	155	1,165
Retirement contributions	9	1	10
Employees' insurance contributions	2,331	267	2,598
Other employee benefits	303	315	618
Total personnel costs	16,922	2,755	19,677
Operating costs:			
Investment managers' fees	-	171,709	171,709
Custodian fees	-	370	370
Specialized services	14,464	7	14,471
Rental of real estate, electricity	1,522	111	1,633
Consultant and legal fees	1,047	2,153	3,200
Treasury and other Commonwealth services	1,102	83	1,185
Postage	1,407	-	1,407
Contracted maintenance and repair services	475	12	487
Office supplies	361	6	367
Rental of equipment and software	1,311	3	1,314
Printing	703	-	703
Travel and training	348	35	383
Telecommunications	709	5	714
Equipment (not capitalized)	676	114	790
Miscellaneous expenses	350	1,693	2,043
Total operating expenses	24,475	176,301	200,776
Fixed charges:			
Furniture and fixtures	9	-	9
Depreciation	872	-	872
Total fixed charges	881	-	881
Total operating expenses	$ 42,278	$ 179,056	$ 221,334

(1) Includes administrative expenses of $1,932 related to Postempoyment Healthcare Premium Assistance and $6,053 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2003.

(2) Does not include $23,368 in capitalized broker commissions for the fiscal year ended June 30, 2003.

Supplemental Schedule 2
Summary of Investment Expenses
Fiscal Year Ended June 30, 2003

(Dollar Amounts in Thousands)

	Assets under management*	Fees
External management		
Domestic equity	$ 6,126,000	$ 17,140
International equity	7,379,000	20,131
Fixed income	7,301,000	13,115
Real estate	2,508,000	35,143
Private equity and debt	3,545,000	75,265
Venture capital	192,000	10,915
Total external management	**27,051,000**	**171,709**
Total internal management	**15,430,000**	**3,937**
Total investment management	**$ 42,481,000**	**175,646**
Custodian fees		370
Consultant and legal fees		2,153
Miscellaneous expenses		887
Total investment expenses		**$ 179,056**

* Net asset value at June 30, 2003.

Supplemental Schedule 3
Schedule of Payments to Non-Investment Consultants
Fiscal Year Ended June 30, 2003

(Payment amounts greater than $50,000)

Consultant	Fees	Services Provided
CoreSource, Inc.	$ 3,841,183	Postemployment healthcare benefits administration and claims adjudication
Tier Technologies, Inc.	3,468,295	NPAS project development
AON	1,199,746	HOP Communication, open enrollment and consulting services
Buck Consultants, Inc.	670,540	Pension benefit actuarial services
Info-Matrix Corporation	605,950	Computer programming/analysis
Intellimark, Inc.	406,659	Information technology consulting
L.R. Wechsler Ltd.	394,860	Information technology consulting
KPMG LLP	103,192	Financial audit of pension system and postemployment healthcare programs
The Segal Company	90,106	HOP consulting
Eckert Seamans Cherin & Mellot LLC	83,266	Legal services