

Puerto Rico System of Annuities  
and Pensions for Teachers

Audited financial statements and  
Independent Auditors' Report

June 30, 2004

1007

**Puerto Rico System of Annuities and Pensions for Teachers**

**Audited Financial Statements**

**June 30, 2004**

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## Rodríguez-Parissi, Vázquez & Co. P.S.C.

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CERTIFIED PUBLIC ACCOUNTANTS TAX & BUSINESS ADVISORS

### Independent Auditors Report

The Board of Trustees  
Puerto Rico System of Annuities and  
Pensions for Teachers

We have audited the accompanying statement of plan net assets of the Puerto Rico System of Annuities and Pensions for Teachers (the System) as of June 30, 2004, and the related statement of changes in plan net assets for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the System as of June 30, 2003 were audited by other auditors whose report dated September 26, 2003, 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, the net assets of the System at June 30, 2004 and the changes in its net assets for the year then ended in conformity with accounting principles generally accepted in the United States America.



Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Management's Discussion and Analysis presented on pages 3 through 7 and the supplemental schedules of employer contributions and funding progress presented on pages 28 and 29 are supplementary information required by the Governmental Accounting Standards Board, and are not a required part of the basic financial statements. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information presented in the Management's Discussion and Analysis and supplemental schedules and, therefore, express no opinion on them.

*Rodriguez-Pérez VJ, S.C. PSC*

San Juan, Puerto Rico  
October 15, 2004

Stamp No 2024723 was affixed to  
the original copy of this report

## Puerto Rico System of Annuities and Pensions for Teachers Management's Discussion and Analysis

The Puerto Rico System of Annuities and Pensions for Teachers ("the System") presents management's overview of the administrative and operational activities that had an impact on the System's assets for the fiscal year ended June 30, 2004. The System administers retirement and other participant benefits, such as personal, cultural and mortgages loans, occupational and non-occupational disability annuities and death benefits.

### **Overview of the Financial Statements**

This discussion and analysis is intended to serve as an introduction to the System's basic financial statements, which are comprised of the following: 1) Statement of Plan Net Assets, 2) Statement of Changes in Plan Net Assets, and 3) Notes to the Financial Statements. Additional information is also presented to supplement the basic financial statements.

### ***Statement of Plan Net Assets and Statement of Changes in Plan Net Assets***

Both these statements provide information about the overall financial status of the System. The Statement of Plan Net Assets includes all of the System's assets and liabilities, with a difference reported as net assets. The Statement of Changes in Plan Net Assets discloses changes in the System's assets during the fiscal year. Comparative information for the years ended June 30, 2004 and 2003 is presented.

### ***Notes to the Basic Financial Statements***

The notes to the financial statements provide additional information that is essential for an understanding of the data provided in the Statements of Plan Net Assets and Changes in Plan Net Assets.

### ***Supplementary Information***

The required supplementary information consists of two schedules and related notes concerning the funded status of the pension plan administered by the System

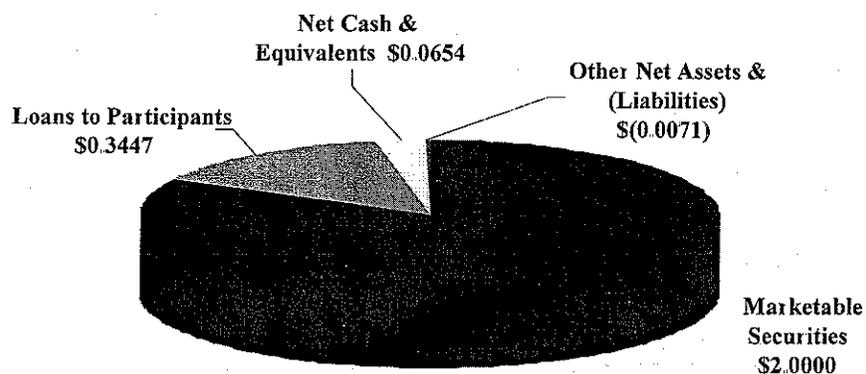
Puerto Rico System of Annuities and Pensions for Teachers  
Management's Discussion and Analysis (continued)

**Financial Highlights**

The System's net assets as of June 30, 2003 increased from approximately \$2.1 billion to \$2.4 billion as of June 30, 2004. The increase was primarily due to the recuperation of the capital markets from the downturn of the prior fiscal period. The amount of \$2,402,995,000 in total net assets consists of the following:

- \$2.0 billion in marketable securities
- \$344.7 million in loans to participants
- \$65.4 million in net cash and equivalents
- (\$7.1) million in other net assets (liabilities)

Total net assets table (in billions):



Following is a comparison of certain items within the financial statements:

- The System's assets exceeded liabilities by \$2.4 billion (net assets) for the fiscal year ended June 30, 2004 when compared to the prior year which assets exceeded liabilities by \$2.1 billion.
- The fair value of the System's investments at June 30, 2004 amounted to \$2 billion, compared to \$1.7 billion at June 30, 2003.
- Administrative expenses increased from approximately \$19.5 million for the year ended June 30, 2003 to approximately \$22.6 million for the year ended June 30, 2004.
- The System's funded ratio of the actuarial accrued liability at June 30, 2003 and 2002 was 47% and 52%, respectively.

## Puerto Rico System of Annuities and Pensions for Teachers Management's Discussion and Analysis (continued)

### Financial Analysis of the System

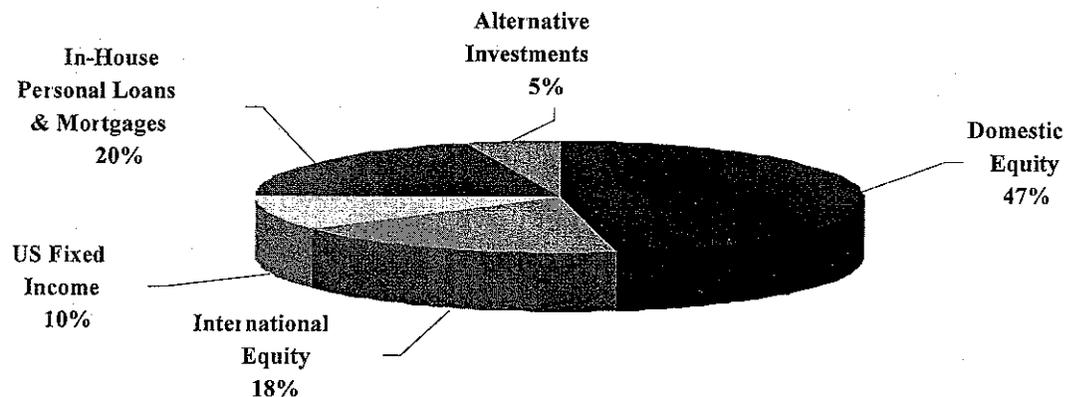
The System provides retirement benefits to teachers within the public education system of the Commonwealth of Puerto Rico. The System's net assets held in trust for benefits at June 30, 2004 amounted to approximately \$2,403 million, an increase of approximately \$260 million from approximately \$2,143 million at June 30, 2003. Additions to the System's net assets held in trust for benefits include employer and member contributions, as well as investment income. For fiscal year 2004, employer and member contributions increased by approximately \$12 million, from approximately \$217 million during fiscal year 2003 to approximately \$229 million during fiscal 2004. The System recognized a net appreciation in the fair value of investments of approximately \$240.7 million for fiscal year 2004.

In fiscal year 2004, the System started a re-engineering and mechanization project that involves different areas; such as Pensions, Loans and Finance. As of June 30, 2004, \$2.3 million was capitalized as a result of the project in progress.

As of June 30, 2004, the long-term debt related with Bonds Payable (see Note 9 in Financial Statements) amounted to \$22 million. In fiscal year 2004, there were payments of principal and interest related to Series A and payments of interest related to Series B.

During the fiscal year ended June 30, 2004, the System went through a re-structuring of its investment portfolio after having selected a new target asset mix and investment managers for the different asset classes. The new investment strategy contemplated a reduction in the number of investment managers and investing 65% of the domestic equity asset class in an S&P 500 Index Fund. Both of these actions contributed to a significant reduction in management fees. As a result of implementing the new target asset mix and given the current market conditions, the fund generated a positive gross return of 13.81% for the year ended June 30, 2004.

The new target asset mix selected is as follows:



## Puerto Rico System of Annuities and Pensions for Teachers Management's Discussion and Analysis (continued)

### *Domestic Equity Overview*

In general, the domestic equity market finally pulled out of the three-year market downturn during the fiscal year. Despite concerns about inflation, the economic recovery, terrorism, and uncertainty regarding the November 2004 presidential election results, the domestic equity markets enjoyed a full year of strong growth. For the year ended June 30, 2004 all major equity markets had a strong performance.

At June 30, 2004, the System held approximately \$1,210 million in U.S. equity securities which represents 50% of the total investment portfolio. During fiscal year ended June 30, 2004, investments in U.S. equity securities earned gross returns of approximately 20.69%.

### *International Equity Overview*

The resurgence of overseas stock markets began before the fiscal year started. Overseas stock markets outperformed the US markets. This resurgence also included emerging markets, nearly every corner of the globe participated. A weak dollar and a strong yen helped pacific basin countries recover from the economic downturn in the Asian markets. Investors were also encouraged by the economic expansion experience in the Latin American countries.

As of June 30, 2004, the System held approximately \$492 million in foreign equity securities which represents 20% of the total investment portfolio. During fiscal year ended June 30, 2004, these securities earned a gross return of 25.20%.

### *Fixed Income Overview*

In general, the bond market returns were largely subdued by two factors during the fiscal year. Demand for fixed income securities waned as a rally in the equity markets made equity investments more desirable. The anticipation of an economic recovery and increases in interest rates also hurt the bond markets.

As of June 30, 2004, the System held approximately \$324 million in domestic fixed income securities which represents 13% of the total investment portfolio. The System's money managers had a gross return of .18% for the fiscal year ended June 30, 2004.

### *Other Investments and Transactions*

At June 30, 2004 and 2003, the System held approximately \$345 million and \$349 million in loans to participants, respectively, which represents 14% of the total investment portfolio. As of June 30, 2004 these loans consist of \$110.3 million in mortgage loans, \$233.3 million in personal loans and \$1.1 million in cultural trip loans.

Puerto Rico System of Annuities and Pensions for Teachers  
Management's Discussion and Analysis (continued)

***Other Investments and Transactions (continued)***

The System earns additional investment income by lending investment securities to brokers via its custodian's securities lending program. The brokers provide collateral to the System and generally use the borrowed securities to cover short sales and failed trades. The cash collateral received from the brokers is invested in order to earn interest. For fiscal year 2004, income from securities lending activity amounted to approximately \$81,000. In addition, the System invests in a commingled fund, which engages in securities lending transactions that resulted in earning \$19,350 as securities lending income.

During fiscal year 2004, the System underwent a process of establishing Law 91 of March 29, 2004, which superseded Law 218 of May 6, 1951. The Puerto Rico System of Annuities and Pensions for Teachers was not affected by the new law. The new law was established to gain efficiencies in operational matters.

**Funding Status**

The System performs an actuarial valuation of its assets and obligations at least every other year. The most recent actuarial valuation was performed as of June 30, 2003. According to such valuation, the System's unfunded liability amounted to \$2.4 billion with a capitalization level of 47%.

As a means to protecting the System's financial health, Law 91 of March 29, 2004 established the practice of requiring an actuarial study and identifying the funding prior to granting new benefits.

**Requests for Information**

This financial report is designed to provide a general overview of the System's financial status, comply with related laws and regulations, and demonstrate commitment to public accountability. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Puerto Rico System of Annuities and Pensions for Teachers, Capital Center Building, #235 Arterial Hostos Ave., North Tower, 8th Floor, Hato Rey, PR 00919-1879.

**Puerto Rico System of Annuities and Pensions for Teachers**  
**Statements of Plan Net Assets**

	June 30,	
	2004	2003
	(In Thousands)	
<b>ASSETS</b>		
Cash:		
Cash and cash equivalents	\$ 67,113	\$ 204,886
Cash restricted	2,396	2,236
Cash deposited with Government Development Bank for Puerto Rico	3,717	4,199
Total cash	73,226	211,321
Investments, at fair value:		
Bonds and notes	280,747	737,913
Stocks	1,678,679	971,014
Total investments at fair value	1,959,426	1,708,927
Other investments:		
Mortgage notes acquired from third parties	-	7
Private equity investments	43,660	34,728
Total investments	2,003,086	1,743,662
Loans to plan members:		
Mortgage	110,293	113,116
Personal	233,342	235,118
Cultural trips	1,148	1,210
Total loans to plan members	344,783	349,444
Accounts receivable:		
Receivable for investments sold	5,535	124,400
Accrued interest and dividends receivable	5,380	9,705
Other	2,500	1,845
Total accounts receivable	13,415	135,950
Property and equipment net	24,332	24,964
Other assets	619	597
<b>TOTAL ASSETS</b>	<b>2,459,461</b>	<b>2,465,938</b>
<b>LIABILITIES</b>		
Investments purchased	10,567	238,883
Cash overdraft in cash with fiscal agent	7,812	42,210
Accounts payable	2,570	2,296
Obligation under capital lease	96	-
Accrued expenses	3,071	2,785
Line of credit	240	-
Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan member	9,911	11,311
Bonds payable	22,090	22,943
Other liabilities	109	2,848
Total liabilities	56,466	323,276
<b>NET ASSETS HELD IN TRUST FOR PENSION BENEFITS</b>	<b>\$ 2,402,995</b>	<b>\$ 2,142,662</b>

See accompanying notes.

**Puerto Rico System of Annuities and Pensions for Teachers**  
**Statements of Changes in Plan Net Assets**

	June 30,	
	2004	2003
	(In Thousands)	
<b>Additions:</b>		
Contributions:		
Participating employees	\$ 118,743	\$ 112,774
Employer	110,548	104,403
Special	40,409	27,490
	<u>269,700</u>	<u>244,667</u>
Total contributions		
Investment income:		
Interest income	55,878	82,210
Dividends income	17,264	16,513
Net appreciation (depreciation) in fair value of investments	240,732	(42,227)
	<u>313,874</u>	<u>56,496</u>
Less investment expense	4,958	5,508
	<u>308,916</u>	<u>50,988</u>
Net investment income		
Other income	32,397	1,010
	<u>611,013</u>	<u>296,665</u>
<b>Total additions</b>		
<b>Deductions:</b>		
Benefits paid to participants:		
Annuities and death benefits	292,401	276,096
Special benefits	32,210	22,433
Refunds of contributions	3,432	3,021
Administrative expenses	22,637	19,544
Total deductions	<u>350,680</u>	<u>321,094</u>
<b>Net increase (decrease) in net assets held in trust for pension benefits</b>	<u>260,333</u>	<u>(24,429)</u>
<b>Net assets held in trust for pension benefits</b>		
Beginning of year	<u>2,142,662</u>	<u>2,167,091</u>
<b>End of year</b>	<u>\$ 2,402,995</u>	<u>\$ 2,142,662</u>

See accompanying notes

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements

June 30, 2004

**1. Organization and Summary of Significant Accounting Policies**

The Puerto Rico System of Annuities and Pensions for Teachers (the System) was created by Act No. 91 of March 29, 2004 that superseded Act No. 218 of May 6, 1951. The System is considered an integral part of the Commonwealth of Puerto Rico (the Commonwealth) financial reporting and is included in the Commonwealth's financial statements as a trust fund. The System, as a governmental retirement plan, is excluded from the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

The responsibility for the proper operation and administration of the System is vested in a Board of Trustees (the Board). The Board is comprised of nine members, as follows: the Secretary of the Treasury, the Secretary of Education, the President of the Government Development Bank for Puerto Rico (GDB), two active teachers (one of them a representative of the Teachers Organization according to Act No. 45 of February 25, 1998), two retiree teachers, one representative of the teachers organizations, and one representative of the public interest. The last two trustees are appointed by the Governor of the Commonwealth.

The following are significant accounting policies followed by the System in the preparation of its financial statements:

**Basis of Presentation**

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with the provisions of Statement of Governmental Accounting Standards Board No. 25 (GASB No. 25), "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans". Participating employee and employer contributions are recognized as revenues in the period in which the employee services are rendered. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

**Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) in the United States requires management to make estimates and assumptions that affect the reported amounts of net assets held in trust for pension benefits, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions and deductions to net assets held in trust for pension benefits during the reporting period. Actual results could differ from those estimates.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**1. Organization and Summary of Significant Accounting Policies (continued)**

**Cash and Cash equivalents**

Cash and cash equivalents consist of "overnight deposits" with the custodian bank. Restricted cash deposited with GDB consists of payments received from mortgage loan holders to service the loans; and restricted cash deposited with a commercial bank represents an escrow account for purposes of the bonds payable (See Note 9).

**Investments**

Marketable securities are carried at fair value. The fair value of notes, bonds and stocks is based on quotations obtained from national securities exchanges. Securities transactions are accounted for on the trade date. Realized gains and losses on securities are determined by the average cost method and are included in the statement of changes in plan net assets.

The fair value of private equity fund investments is determined by the applicable fund manager.

Mortgage notes acquired from third parties are held to maturity and are not readily marketable. Consequently, these are carried at amortized cost.

No investment in any organization (i.e., company) represents 5% or more of the System's net assets held in trust for pension benefits.

**Loans to Plan Members**

Mortgages, personal and cultural trip loans to plan members are stated at their outstanding principal balance. No allowance for uncollectible amounts has been established since loans to plan members are paid by payroll withholding and secured by mortgage deeds, plan members' contributions and any unrestricted amount remaining in the escrow funds. Maximum amounts that may be loaned to plan members for mortgage and cultural trip loans are \$100,000 (\$150,000 if the spouse is also a plan member) and \$5,000, respectively. The maximum amount of personal loan to be granted to current participating employees is up to 90% of their contributions and \$3,000 in the case of retirees currently receiving benefits.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**1. Organization and Summary of Significant Accounting Policies (continued)**

**Capital Assets**

Capital assets include building, furniture and equipment, capital leases and projects in progress. The System defines capital assets as assets, which have an initial, individual cost of \$500 or more at the date of acquisition and have a useful life of four or more years. Capital assets are recorded at historical cost or at estimated historical cost if actual historical cost is not available. Donated capital assets are recorded at their estimated fair value at time of donation.

Capital assets are depreciated on the straight-line method over the assets estimated useful life. There is no depreciation recorded for projects in progress. The estimated useful lives of capital assets are as follows:

	<u>Years</u>
Buildings and buildings improvements	40
Equipment, furniture, fixtures, and vehicles	4-10

**Long-Lived Assets**

The System reviews the carrying amount of its long-lived assets and identifies assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Any long-lived asset held for disposal is reported at the lower of its carrying amount or fair value less cost to sell.

**Reserve for Life Insurance on Loans to Plan Members**

Premiums collected and benefits claimed are recorded as additions and deductions of the guarantee insurance reserve for life insurance on loans to plan members, respectively.

**2. Plan Description**

The System is a defined benefit plan sponsored by the Commonwealth. Substantially, all active teachers of the Commonwealth's Department of Education are covered by the System under the terms of Act No. 91 of March 29, 2004 that superseded Act No. 218 of 1951. The new law gives the System's active employees as of March 29, 2004 the option to participate in the plan. Employees recruited by the System after the approval of the new law become members of the plan. All active teachers of the Department of Education at the date of employment become plan members of the System. Licensed teachers working in private schools or other educational organizations can be members of the System at their own choice as long as the required employer and employee contributions are satisfied.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**2. Plan Description (continued)**

At June 30, 2004 total membership consisted of the following:

Retirees and beneficiaries currently receiving benefits	27,318
Current participating employees	<u>50,817</u>
Total membership	<u>78,135</u>

The plan members of the System are eligible for the benefits described below:

**Retirement Annuity**

Plan members are eligible for monthly benefit payments determined by the application of stipulated benefit ratios to the plan member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by the System. The annuity for which a plan member is eligible is limited to a minimum of \$300 per month and a maximum of 75% of the average compensation.

The plan members are eligible for retirement annuity upon complying with the following:

<u>Age</u>	<u>Years of Creditable Services</u>	<u>Retirement Annuity Compensation</u>
Fifty (50)	Thirty (30) or more	75% of average compensation
Under fifty (50)	Thirty (30) or more	65% of average compensation
Sixty (60)	At least ten (10) but less than twenty-five (25)	1.8% of average compensation times years of service
Fifty (50)	At least twenty-five (25) but less than thirty (30)	1.8% of average compensation times years of service
Forty-Seven (47) but less than Fifty (50)	At least twenty-five (25) but less than thirty (30)	95% of the annual pension that would have received with 50 years of age

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**2. Plan Description (continued)**

**Deferred Retirement Annuity**

A participating employee who terminates service before age 60, after having accumulated a minimum of ten years of creditable services, qualifies for a deferred retirement annuity payable beginning at age 60. A participating employee who has completed 25 or more years of creditable services and is under the age of 47 at termination, qualifies for a deferred retirement annuity payable beginning at age 47. The vested rights described above are provided if his/her contributions to the System are left within the System until the attainment of the respective retirement age.

**Occupational Disability Annuity**

A participating employee, who as a direct result of the performance of his/her occupation becomes disabled, is eligible for an annuity of 1.8% of average compensation based on the highest sixty (60) months or the number of months of creditable services, if less than five years, recognized by the System, times years of creditable services; but not less than \$300 per month.

**Non-occupational Disability Annuity**

A participating employee disabled for causes not related to his/her occupation, and with at least five years of credited service, is eligible for annuity of 1.8% of average compensation based on the highest sixty (60) months recognized by the System, time years of service; but not less than \$300 per month.

**Death Benefits**

**Pre-retirement**

- Beneficiary – the contributions and 2% interest accumulated as of the date of death after discounting debts with the System, plus an amount equal to the annual compensation at the time of death.

**Post-retirement**

- Surviving spouse - 50% of retiree's pension.
- Children – 50% of the retiree's pension to the children of age under 22 or disabled.
- Otherwise the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of \$500 are refunded to the beneficiaries.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**2. Plan Description (continued)**

**Cost-of-Living Adjustments**

Act No. 62 of 1992 provided, subject to the approval of the Legislature, for increases of 3% every three years in pensions to those plan members with three or more years of retirement. In years 1995, 1998, 2001 and 2004 the Legislature has replicated the benefit granted per Act No. 62. This benefit is funded by the General Fund of the Commonwealth.

**Refunds**

A participating employee who ceases his/her employment with the Commonwealth without right to a retirement annuity has the right to a refund of the employee contributions paid to the System plus any interest earned thereon.

**Early Retirement**

On January 27, 2000 Act No. 44 was approved, which provided that effective March 9, 2000, plan members are eligible for early retirement upon attaining the age of 50 and 28 years of service in the first year of implementation and age 50 and 25 years of service in subsequent years. Those who select early retirement under these conditions will receive monthly benefits equal to 75% of their average compensation, which is computed based on the highest 36 months of compensation recognized by the System. Effective July 31, 2001 the option for early retirement was closed.

**3. Funding Policy**

The law requires the employer to contribute 8.5% of the applicable payroll. Participating employees are required to contribute 9% of their compensation. Commonwealth contributions should ultimately cover any deficiency between the participating employees' contributions and the System's pension benefit obligations and administrative costs. The employer and participants' contributions will be evaluated at least every five years.

The special contributions of approximately \$40,409,000 and 27,490,000 in 2004 and 2003, respectively, represent the contribution from the General Fund of the Commonwealth for the benefits granted by special laws.

Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 2003 and 2002, using the entry age normal actuarial cost method. Significant assumptions underlying the actuarial computations include: (a) assumed rate of return of investments of 8%, net of investment expense; (b) assumed compound rate of wage increases of 5% per year; and (c) assumed mortality rate based on the Group Annuity Table for 1983.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**3. Funding Policy (continued)**

The actuarial accrued liability as of June 30, 2003 and 2002 was approximately \$4,540,000,000 and \$4,155,000,000, respectively. As of June 30, 2003 and 2002, the unfunded actuarial accrued liability was approximately \$2,397,000,000 and \$1,988,000,000, respectively.

**4. Cash and Investments**

Pursuant to the provisions of Act No. 91 of March 29, 2004 that superseded Act No. 218 of 1951, as amended, the System may invest in different types of securities, including domestic, international and fixed income securities, among others.

Cash deposited with GDB amounting to approximately \$3,717,000 and \$4,199,000 as of June 30, 2004 and 2003, respectively, is not collateralized.

Restricted cash of approximately \$2,396,000 and \$2,236,000 as of June 30, 2004 and 2003, respectively, is held in escrow by Banco Popular de Puerto Rico, as trustee (the Trustee), for purposes of servicing the bonds payable (see Note 9).

As of June 30, 2004, the categories for deposits are the following:

*Category 1:* Insured or collateralized with securities held by the financial institution or by its agent in the System's name.

*Category 2:* Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the System's name.

*Category 3:* Uncollateralized

The carrying amount of the deposits approximates their fair value at June 30, 2004. The following presents the deposits categorized (in thousands):

	Category			Fair Value
	1	2	3	
Deposits in commercial banks	\$ 69,509	\$ -	\$ -	\$ 69,509
Deposits in GDB	-	-	3,717	3,717
	<u>\$ 69,509</u>	<u>\$ -</u>	<u>\$ 3,717</u>	<u>\$ 73,226</u>

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**4. Cash and Investments (continued)**

The System's investments are categorized to provide an indication of the level of custodial credit risk assumed by the System at year-end. Risk categories are described as follows:

**Category 1:** Insured or registered, or securities held by the System or its agents in the System's name.

**Category 2:** Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the System's name.

**Category 3:** Uninsured and unregistered, with securities held by the counterparty or by its trust department or agent, but not in the System's name.

Credit risk classification is as follows (in thousands):

	Category			Carrying Amount
	1	2	3	
Bonds and notes	\$ -	\$ -	\$ 280,747	\$ 280,747
Stocks	-	-	1,678,679	1,678,679
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,959,426</u>	<u>1,959,426</u>
Investments not subject to categorization				
Limited partnership/private equity				<u>43,660</u>
				<u>\$ 2,003,086</u>

The following table shows the market value of the investments in marketable securities held by the System as of June 30, 2004 and 2003 (in thousands):

	2004	2003
U S. Government and agencies' securities	\$ 10,321	\$ 406,671
Corporate Bonds	270,426	331,242
Corporate Stocks	1,678,679	971,014
	<u>\$ 1,959,426</u>	<u>\$ 1,708,927</u>
Mortgage notes acquired from third parties	-	7
Private equity investments	43,660	34,728
	<u>\$ 2,003,086</u>	<u>\$ 1,743,662</u>

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**4. Cash and Investments (continued)**

Cash and equivalents and marketable securities include approximately \$55,249,000 and \$55,760,000 as of June 30, 2004 and 2003, respectively, held as collateral by the Trustee in connection with the bonds payable (see Note 9)

The System invests in an S&P 500 commingled fund. As of June 30, 2004, the System owned approximately 3,807,755 shares of the commingled fund with an aggregate market value of approximately \$784,789,915, which represents approximately 32% of the System's investment portfolio as of such date.

**Investments in Limited Partnerships**

The System invested approximately \$6,336,519 in limited partnerships during the fiscal year ended June 30, 2004. The investments were as follows:

- During fiscal year 2004 there were no contributions to Guayacán Fund of Funds, L.P. a Delaware limited partnership created by Grupo Guayacán, Inc. as General Partner in which the System has a total commitment of \$20 million. The Fund has commitments to invest in 15 US based and international venture partnerships and familiarizes the local pension funds with the private equity asset class without the risks inherent in geographically constrained investments.
- \$2,459,677 was invested in Guayacán Fund of Funds II, L.P. a Delaware limited partnership created by Grupo Guayacán, Inc. as General Partner in which the System has a total commitment of \$25 million. The Fund seeks to provide investors with a superior investment return and extensive diversification by investing in 19 Private Equity investment partnerships in the United States and Europe. The Fund also invests a portion of its assets in a Puerto Rico based Private Equity investment entity.
- During fiscal year 2004 there were no contributions to Guayacán Private Equity Fund, a limited partnership organized pursuant to the laws of the state of Delaware and authorized to engage in business in the Commonwealth of Puerto Rico, in which the System has a total commitment of \$5 million. The purpose of the Partnership is to make equity investments in privately held companies as established in its charter.
- \$459,736 was invested in Invesco Venture Partnership Fund III, L.P. a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as General Partner in which the System has a total commitment of \$6 million. The Partnership was organized to invest in other collective investments funds investing in alternative assets, including primarily United States and international funds that focus on both early and later-stage venture capital investments.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**4. Cash and Investments (continued)**

- \$1,416,457 was invested in Invesco Non-U.S. Partnership Fund III, L.P. a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as General Partner in which the System has a total commitment of \$4.5 million. The Partnership was organized to invest in other collective investments funds investing in alternative assets, including primarily investments focusing on non U.S. buyouts, expansion capital, turnaround, mezzanine, and distressed investment partnerships.
- \$556,248 was invested in Invesco U.S. Buyout & Expansion Capital Partnership Fund III, L.P. a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as General Partner in which the System has a total commitment of \$4.5 million. The Partnership was organized to invest in other collective investments funds investing in alternative assets, including primarily investments focusing on small, mid-size and large domestic buyout transactions.
- \$1,444,401 was invested in Chase Capital Partners Private Equity Fund of Funds II, LTD a limited partnership, organized by Chase as General Partner in which the System has a total commitment of \$15 million. The Fund's investment strategy is to capitalize on a globally diversified portfolio of private equity investment opportunities across various sectors including buyouts, growth equity, venture capital and other special situations through partnership investments and direct investments.

The carrying value of these investments at June 30, 2004 amounted to \$43.6 million and is presented within investments in the statements of net assets.

The allocations of net gain and net loss to limited partners are based on certain percentages, as established in the limited partnership agreements.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**4. Cash and Investments (continued)**

As of June 30, 2004, the System had capital commitments and contributions as follows (in thousands):

	Total Commitments	Fiscal year Contributions	Cumulative Contributions	Fair Value
Guayacán Fund of Funds	\$20,000		\$18,623	\$11,848
Guayacán Fund of Funds II	25,000	\$2,460	17,664	12,811
Guayacán Private Equity Fund	5,000		3,930	4,224
Invesco Venture Partnership Fund III, LP	6,000	460	2,173	1,796
Invesco Non-US Partnership Fund III, LP	4,500	1,416	3,264	3,259
Invesco US Buyout & Expansion Capital Partnership Fund III, LP	4,500	556	1,568	1,541
Chase Capital Partners Private Equity Fund of Funds II, LTD	15,000	1,444	11,214	8,181
	<u>\$80,000</u>	<u>\$6,336</u>	<u>\$58,436</u>	<u>\$43,660</u>

**5. Property and Equipment, Net**

Property and equipment additions are recorded at cost. Depreciation is provided using the straight-line method over the useful life of the asset. As of June 30, 2004 and 2003, changes in property and equipment consisted of the following (in thousands):

	Estimated Useful Life (in years)	Balance June 30, 2003	Additions	Retirements	Balance June 30, 2004
Depreciable					
Building	40	\$ 26,008	\$ -	\$ -	\$ 26,008
Furniture and Equipment	4-10	4,512	212	68	4,656
Capital Leases	5	-	106	-	106
		30,520	318	68	30,770
(Less) Accumulated Depreciation and Amortization		(5,556)	(2,762)	-	(8,318)
		24,964	(2,444)	68	22,452
Non-depreciable Project In-Progress		-	1,880	-	1,880
		<u>\$24,964</u>	<u>(\$564)</u>	<u>\$68</u>	<u>\$24,332</u>

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**5. Property and Equipment, Net (continued)**

On August 1, 1996, the System acquired the North Tower of Capital Center (the Building) located in Hato Rey to serve as the System's main office facilities and to lease the additional space to third parties. Approximately one-half of the Building is being used for its operations and the other half for rental. The Building was financed with Industrial Revenue Bonds (see Note 9).

**6. Other Assets**

At June 30, 2004 and 2003, other assets consisted of repossessed and in-substance foreclosed properties amounting to \$ 619,000 and \$597,000, respectively.

Repossessed and in-substance foreclosed properties consist mainly of properties acquired or to be acquired upon foreclosure proceedings as collateral from delinquent mortgage loans. Foreclosed properties are valued at the outstanding principal balance of the related mortgage upon foreclosure. These will be sold under a bidding process intended to recover the outstanding principal balance. Losses are recognized based on impairment of the asset, and are measured by Statement of Financial Accounting Standard No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Management believes that the carrying value of these properties approximates their fair value.

**7. Obligation under Capital Leases**

During the fiscal year ended June 30, 2004, the System acquired office equipment under capital leases in the total amount of \$105,709 that expire in January 2009 and the annual interest rate is 3.75%. The assets and liabilities under capital leases are recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. The assets are amortized over the lesser of their related lease terms or their estimated productive lives. Amortization of assets under capital leases is included in the depreciation expense for fiscal year ended June 30, 2004.

Following is a summary of equipment under capital lease and accumulated depreciation as of June 30, 2004 (in thousands):

Equipment under capital lease	\$	106
Accumulated depreciation		<u>21</u>
Book value	\$	<u><u>85</u></u>

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**7. Obligation under Capital Leases (continued)**

The future minimum lease payments under capital leases and the net present value of the future minimum lease payments as of June 30, 2004 for each of the next five years are (in thousands):

Year ending <u>June 30,</u>	<u>Amount</u>
2005	\$ 23
2006	23
2007	23
2008	23
2009	<u>12</u>
Total minimum lease payments	104
Less amount representing interest	<u>8</u>
Present value of minimum lease payments	<u><u>\$ 96</u></u>

**8. Line of Credit**

The System has a line of credit with the Governmental Development Bank (GDB) of \$15,000,000, which is due on October 31, 2010 and is guaranteed by a pool of investments of the System. As of June 30, 2004, the outstanding balance of the line of credit was \$240,000 at an annual interest rate of 5%.

**9. Bonds Payable**

On August 1, 1996, the System entered into a loan agreement with the Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority (the Authority), which secured the Authority's issuance of \$26,945,000 of Industrial Revenue Bonds (the Bonds). The Bonds were issued under a trust agreement (the Trust Agreement) dated August 1, 1996, between the Authority and the Trustee. The Bonds are secured by a pledge of certain marketable securities of the System.

The proceeds from the sale of the bonds were loaned by the Authority to the System to (i) finance the acquisition of the Building; a sixteen story mixed use office and commercial building and a portion of the adjoining seven story parking facility and (ii) pay certain expenses incurred in connection with the issuance and sale of the Bonds.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**9. Bonds Payable (continued)**

The following is a summary of changes in the bonds payable principal balance:

	Balance June 30, 2003	Additions	Deductions	Balance June 30, 2004
Series A:				
6.50% Term Bonds due July 1, 2006	\$ 2,513,333	\$ -	\$ 853,333	\$ 1,660,000
6.50% Term Bonds due July 1, 2011	5,220,000	-	-	5,220,000
	\$ 7,733,333	\$ -	\$ 853,333	\$ 6,880,000
Series B:				
5.50% Term Bonds due July 1, 2016	\$ 6,575,000	\$ -	\$ -	\$ 6,575,000
5.50% Term Bonds due July 1, 2021	8,635,000	-	-	8,635,000
	\$ 15,210,000	\$ -	\$ -	\$ 15,210,000
Total Bonds Payable	\$ 22,943,333	\$ -	\$ 853,333	\$ 22,090,000

Interest on the Series A Bonds is payable on a monthly basis and for the Series B Bonds semiannually on each July and January. Future minimum mandatory principal and interest requirements follow:

Fiscal Year	Series A			Series B		
	Principal	Interest	Total	Principal	Interest	Total
2005	\$ 805,000	\$ 455,030	\$ 1,260,030		\$ 836,550	\$ 836,550
2006	855,000	402,705	1,257,705		836,550	836,550
2007	915,000	347,130	1,262,130		836,550	836,550
2008	975,000	286,283	1,261,283		836,550	836,550
2009	1,040,000	221,445	1,261,445		836,550	836,550
2010-2014	2,290,000	230,755	2,520,755	3,725,000	3,985,300	7,710,300
2015-2019	-	-	-	7,745,000	2,352,350	10,097,350
2020-2022	-	-	-	3,740,000	311,300	4,051,300
	\$ 6,880,000	\$ 1,943,348	\$ 8,823,348	\$ 15,210,000	\$ 10,831,700	\$ 26,041,700

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**9. Bonds Payable (continued)**

The Series A and B Bonds at the time outstanding, maturing on or after July 1, 2006 and July 1, 2016, respectively, are subject to redemption, at the option of the System, in whole or in part on July 2006, or any date thereafter at the determined redemption prices, accrued interest to the redemption date is as follows:

July 1, 2006 through June 30, 2007	102%
July 1, 2007 through June 30, 2008	101%
July 1, 2008 and thereafter	100%

**10. Insurance Reserve for Life Insurance on Loans to Plan Members**

The System provides life insurance that guarantees the payment of the outstanding principal balance of mortgage, personal and cultural trip loans in case of death of a plan member. This coverage is paid in its entirety by the plan members who obtain these loans from the System. The life insurance rates are determined by the actuary.

**11. Rent income**

The System is the lessor of an office building for which it has lease contracts that expire between the years 2005 through 2009. The future revenue under the existing operating leases is as follows (in thousands):

<u>Fiscal Year Ending</u>	<u>Amount</u>
2005	\$ 939
2006	400
2007	411
2008	420
2009	42
	<u>\$ 2,212</u>

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**12. Commitments**

The System leases offices for the operation of its regional offices (Ponce, Mayagüez, Arecibo, Humacao) and maintains four contracts for this purpose that expire between the years 2005 through 2008.

The minimum future payments under the existing operating leases are as follows (in thousands):

<u>Fiscal Year Ending</u>	<u>Amount</u>
2005	\$ 121
2006	61
2007	61
2008	9
	<u>\$ 252</u>

**13. Contingencies**

Loss Contingencies

The System is a defendant or co-defendant in various lawsuits resulting from the ordinary conduct of its operations. Management and legal counsel believe that, there are no contingent matters that would have a material adverse effect on the System's financial status.

Gain Contingency

The System, besides receiving contributions received from participants and the plan sponsor, also receives legislative appropriations from special laws to cover the increase in benefits to retired teachers. Law No. 62 of September 4, 1992, as amended, established an increase of 3% in pension annuities every three years for those members who meet the requirements. In addition, there have been other laws that granted benefits; such as, summer and christmas bonuses, medical plan contributions, among others. Most of the funds used to cover these benefits are budgeted by the Commonwealth through the Legislature. Nevertheless, the costs of pension benefits that increased from 1992 to June 30, 2004 were not received in full by the System from legislative appropriations. The System had to cover \$119,575,193 from its resources that should have been received through special laws. As of June 30, 2004 the System has a claim with the Office of Management and Budget to collect this amount as per a resolution approved by the Board of Trustees on May 31, 2004. Since the parties involved in this claim are discussing how this situation will be resolved, the amount claimed has not been accrued in the System's financial statements.

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Financial Statements (continued)

June 30, 2004

**14. Reclassifications**

Certain reclassifications have been made to the financial statements for the fiscal year ended June 30, 2003 to be comparative with financial data of the fiscal year ended June 30, 2004.

Puerto Rico System of Annuities and Pensions for Teachers

June 30, 2004

Supplemental and Required  
Supplementary Information

PDF

Puerto Rico System of Annuities and Pensions for Teachers

Schedule of Employer Contributions  
(In Thousands)

As of June 30, 2004

<b>Year ended June 30</b>	<b>Annual Required Contributions</b>	<b>Contributions</b>	<b>Percentage Contributed</b>
2003	\$172,300	\$140,300	81.39%
2002	150,900	124,200	82.28%
2001	103,200	116,100	112.50%
2000	122,800	86,200	76.43%
1999	120,600	91,200	75.60%
1998	126,200	95,100	75.37%

Puerto Rico System of Annuities and Pensions for Teachers

Schedule of Funding Progress  
(In Thousands)

As of June 30, 2004

<b>Actuarial Valuation Date</b>	<b>Actuarial Value of Plan Assets</b>	<b>Actuarial Accrued Liability (AAL)</b>	<b>Unfunded AAL (UAAL)</b>	<b>Funded Ratio</b>	<b>Annual Covered Payroll</b>	<b>UAAL Percentage of Annual Covered Payroll</b>
6/30/2003	\$2,143,000	\$4,540,000	\$2,397,000	47%	\$1,195,000	201%
6/30/2002	2,167,000	4,155,000	1,988,000	52%	991,000	201%
6/30/2001	2,284,000	3,683,000	1,400,000	62%	871,000	161%
6/30/2000	2,509,000	3,205,000	695,000	78%	1,006,000	69%
6/30/1999	2,314,000	2,904,000	590,000	80%	996,000	59%
6/30/1998	2,135,000	2,920,000	785,000	73%	1,004,000	78%

Puerto Rico System of Annuities and Pensions for Teachers

Notes to Schedules of Trend Information

June 30, 2004

**1. Schedule of Funding Progress**

The Schedule of Funding Progress provides information about the funded status of the System and the progress being made in accumulating assets to pay benefits when due.

**2. Schedule of Employer Contributions**

The Schedule of Employer Contributions provides information about the annual required contributions (ARC) and the extent to which contributions made cover the ARC. The ARC is the annual required contribution for the year calculated with certain parameters, which include actuarial methods and assumptions.

**3. Actuarial Data**

The information presented in the schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows:

Valuation Date	June 30, 2003
Actuarial Cost Method	Entry age normal
Amortization	Level percentage closed
Remaining Amortization Period	17 years
Asset Valuation Method	Market value of assets
Actuarial Assumptions:	
Investment rate of return*	8.00%
Projected salary increases*	5.00%
Inflation	3.50%
Cost of living adjustment	None

\* Includes inflation at 3.5%