

# McGladrey & Pullen

Certified Public Accountants

## **STATE OF ILLINOIS STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS**

FINANCIAL REPORT  
YEARS ENDED JUNE 30, 2006 AND 2005  
PERFORMED AS SPECIAL ASSISTANT AUDITORS  
FOR THE AUDITOR GENERAL, STATE OF ILLINOIS

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 (issued under separate cover)

**STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS**

FINANCIAL STATEMENTS

JUNE 30, 2006 AND 2005

**FINANCIAL STATEMENT REPORT**

**SUMMARY**

The audit of the accompanying financial statements of the State Employees' Retirement System of Illinois was performed by McGladrey & Pullen, LLP.

Based on their audit, the auditors expressed an unqualified opinion on the System's financial statements.

# McGladrey & Pullen

Certified Public Accountants

## INDEPENDENT AUDITORS' REPORT

Honorable William G. Holland  
Auditor General, State of Illinois  
Springfield, Illinois

Board of Trustees  
State Employees' Retirement System of Illinois  
Springfield, Illinois

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statements of plan net assets of the State Employees' Retirement System of Illinois (the System), as of June 30, 2006 and 2005 and the related statements of changes in plan net assets for the years then ended, as listed in the table of contents. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of the Illinois State Board of Investment, an internal investment pool of the State of Illinois, which statements represent 98 percent, 98 percent, and 72 percent, respectively, in 2006, and 98 percent, 98 percent, and 60 percent, respectively, in 2005 of total assets, net assets held in trust for pension benefits, and total additions of the System. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Illinois State Board of Investment is based on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the plan net assets of the State Employees' Retirement System of Illinois as of June 30, 2006 and 2005, and the changes in plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated February 21, 2007 on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audits.

The management's discussion and analysis on pages 3 and 4 and the schedules of funding progress and employer contributions on page 18 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements of the System for the years ended June 30, 2006 and 2005. The supplementary financial information on page 19 is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplementary financial information on page 19 has been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, based on our audit and the report of other auditors, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

*McGladrey & Pullen, LLP*

Schaumburg, Illinois  
February 21, 2007

# MANAGEMENT'S DISCUSSION & ANALYSIS

This financial report is designed to provide a general overview of the State Employees' Retirement System's finances for all those with an interest in the System's finances.

This section presents management's discussion and analysis of the financial position and performance of the State Employees' Retirement Systems of Illinois (System) for the years ended June 30, 2006 and 2005. It is presented as a narrative overview and analysis.

The System is a defined benefit, single-employer public employee retirement system. It provides services to over 68,000 active state employees and approximately 54,900 benefit recipients. Throughout this discussion and analysis units of measure (i.e. billions, millions, thousands) are approximate, being rounded up or down to the nearest tenth of the respective unit value.

3. Required Supplementary Information. The required supplementary information consists of two schedules and related notes concerning actuarial information, funded status and required contributions for the System.

4. Other Supplementary Schedules. Other schedules include more detailed information pertaining to the System, including schedules of revenues by source, cash receipts and disbursements, and payments to consultants.

## OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the System's financial reporting which is comprised of the following components:

1. Basic Financial Statements. For the fiscal years ended June 30, 2006 and 2005, basic financial statements are presented for the System. This information presents the net assets held in trust for pension benefits for the System as of June 30, 2006 and 2005. This financial information also summarizes the changes in net assets held in trust for pension benefits for the years then ended.

2. Notes to the Financial Statements. The notes to the Financial Statements provide additional information that is essential to achieve a full understanding of the data provided in the basic financial statements.

## FINANCIAL HIGHLIGHTS

- The Systems' net assets increased by \$405 million and \$504 million during fiscal years 2006 and 2005 respectively. The increase was primarily due to a \$383 million and \$431 million increase in the System's investments, at fair value, for fiscal years 2006 and 2005 respectively.
- The System was actuarially funded at 52.2% as of June 30, 2006, compared to 54.4% as of June 30, 2005.
- The overall rate of return for the Illinois State Board of Investment (ISBI) Commingled Fund was 11.0% for fiscal year 2006 compared to 10.1% for fiscal year 2005.

## ADDITIONS TO PLAN NET ASSETS

Additions to Plan Net Assets include employer and participant contributions and net income from investment activities. Participant contributions were approximately \$214.1 million and \$209.3 million for the years ended June 30, 2006 and 2005, respectively. Participant contribution rates are set by statute as a percentage of gross salary. Employer contributions decreased to approximately \$210.5 million in 2006 from approximately \$427.4 million in 2005. This decrease was due to Public Act 94-0004 which was enacted into law on June 1, 2005. This legislation contained a two-year funding reduction by stipulating that state contributions for fiscal year 2006 and 2007 be based on specific dollar amounts rather than actuarial calculations.

## PLAN NET ASSETS

The condensed Statements of Plan Net Assets reflect the resources available to pay benefits to members, including retirees and beneficiaries, at the end of the years reported. A summary of the System's Plan Net Assets is presented below.

Condensed Statements of Plan Net Assets  
(in millions)

	As of June 30			Increase/(Decrease) from	
	2006	2005	2004	2005 to 2006	2004 to 2005
Cash	\$ 226.7	\$ 204.5	\$ 66.6	\$ 22.2	\$ 137.9
Receivables	29.5	36.9	85.0	(7.4)	(48.1)
Investments, at fair value	10,654.9	10,271.4	9,840.1	383.5	431.3
Property & equipment, net	2.9	3.1	3.2	(0.2)	(0.1)
Total assets	<u>10,914.0</u>	<u>10,515.9</u>	<u>9,994.9</u>	<u>398.1</u>	<u>521.0</u>
Liabilities	<u>14.1</u>	<u>21.7</u>	<u>4.7</u>	<u>(7.6)</u>	<u>17.0</u>
Total plan net assets	<u>\$ 10,899.9</u>	<u>\$ 10,494.2</u>	<u>\$ 9,990.2</u>	<u>\$ 405.7</u>	<u>\$ 504.0</u>

**DEDUCTIONS FROM PLAN NET ASSETS**

Deductions from Plan Net Assets are primarily benefit payments. During 2006 and 2005, the System paid out approximately \$1,124.0 million and \$1,078.0 million, respectively, in benefits and refunds, an increase of approximately 4.4%. Those higher payments were mainly due to a scheduled 3% increase in retirement and other benefit payments and the Alternative Retirement Cancellation Payment (ARCP) program. The administrative costs of the System represented approximately 1% of total deductions in both 2006 and 2005.

**FUNDED RATIO**

The funded ratio of the plan measures the ratio of net assets against actuarially determined liabilities and is one indicator of the fiscal strength of a pension fund's ability to meet obligations to its members. An annual actuarial valuation is required by statute. The most recent available valuation showed the funded status of the System on June 30, 2006 decreased to 52.2% from 54.4% at June 30, 2005. Major reasons for the decrease were reduced employer contributions and changes in plan assumptions, partially offset by investment gains. The amount by which actuarially determined liabilities exceeded net assets was \$10.0 billion at June 30, 2006 compared to \$8.8 billion at June 30, 2005.

**INVESTMENTS**

Investments of the System are combined in a commingled investment pool with the Judges' Retirement System and the General Assembly Retirement System. Each system owns an equity position in the pool and receives proportionate investment income from the pool in accordance with respective ownership percentage. Investment gains or losses are reported in the Statement of Changes in Net Assets of each retirement system.

Net investment income less expenses for the System totaled approximately \$1,113.2 million during fiscal year 2006, versus \$953.6 million during fiscal year 2005, resulting in returns of 11.0% and a 10.1%, respectively. For the three, five, and ten year period ended June 30, 2006, the ISBI Commingled Fund earned a compounded rate of return of 12.4%, 5.8%, and 8.3%, respectively.

**LEGISLATION**

On June 1, 2005, Public Act 94-0004 was enacted into law. This legislation contains employer contribution funding reductions of approximately \$486.3 million and \$419.0 million for fiscal years 2006 and 2007, respectively. This resulted in increased transfers from the ISBI Commingled Fund in fiscal year 2006. In addition, it will result in increased transfers in fiscal year 2007 to meet future funding requirements for benefit obligations.

Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the State Employees' Retirement System of Illinois, Accounting Division, 2101 S. Veterans Parkway, P. O. Box 19255, Springfield, Illinois 62794

**CHANGES IN PLAN NET ASSETS**

**The condensed Statements of Changes in Plan Net Assets reflect the changes in the resources available to pay benefits to members, including retirees and beneficiaries.**

Condensed Statements of Changes in Plan Net Assets  
(In millions)

	For the Year Ended June 30,			Increase/(Decrease) from	
	2006	2005	2004	2005 to 2006	2004 to 2005
<b>Additions</b>					
Participant contributions	\$ 214.1	\$ 209.3	\$ 199.8	\$ 4.8	\$ 9.5
Employer contributions	210.5	427.4	1,864.7	(216.9)	(1,437.3)
Net investment income	1,113.2	953.6	1,421.9	159.6	(468.3)
Total additions	1,537.8	1,590.3	3,486.4	(52.5)	(1,896.1)
<b>Deductions</b>					
Benefits	1,110.6	1,063.9	978.2	46.7	85.7
Refunds	13.4	14.1	12.4	(0.7)	1.7
Administrative expenses	8.1	8.3	7.7	(0.2)	0.6
Total deductions	1,132.1	1,086.3	998.3	45.8	88.0
Net increase/(decrease) in plan net assets	\$ 405.7	\$ 504.0	\$2,488.1	\$ (98.3)	\$ (1,984.1)

# FINANCIAL STATEMENTS

## STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Statements of Plan Net Assets  
June 30, 2006 and 2005

	2006	2005
Assets		
Cash	\$ 226,751,078	\$ 204,525,471
Receivables:		
Contributions:		
Participants	13,154,690	13,921,578
Employing state agencies	11,284,318	18,827,922
Other accounts	5,066,573	4,188,506
Total Receivables	<u>29,505,581</u>	<u>36,938,006</u>
Investments - held in the Illinois State Board of Investment Commingled Fund at fair value	<u>10,654,863,723</u>	<u>10,271,356,795</u>
Property and equipment, net of accumulated depreciation	<u>2,886,428</u>	<u>3,071,449</u>
Total Assets	<u>10,914,006,810</u>	<u>10,515,891,721</u>
Liabilities		
Benefits payable	3,611,783	3,511,282
Refunds payable	232,462	358,589
Administrative expenses payable	990,923	958,248
Participants' deferred service credit accounts	275,865	223,927
Due to the State of Illinois	9,042,712	16,691,722
Total Liabilities	<u>14,153,745</u>	<u>21,743,768</u>
Net assets held in trust for pension benefits	<u>\$ 10,899,853,065</u>	<u>\$ 10,494,147,953</u>

(A schedule of funding progress is presented on page 18.)

See accompanying notes to financial statements.



FINANCIAL STATEMENTS

**STATE EMPLOYEES' RETIREMENT SYSTEM  
OF ILLINOIS**

Statements of Changes in Plan Net Assets  
Years Ended June 30, 2006 and 2005

	2006	2005
Additions:		
Contributions:		
Participants	\$ 214,108,896	\$ 209,334,207
Employing State agencies and appropriations	210,499,791	427,434,612
Total Contributions	<u>424,608,687</u>	<u>636,768,819</u>
Investment income:		
Net investment income	264,013,416	227,422,797
Interest earned on cash balances	8,724,784	4,300,338
Net appreciation in fair value of investments	840,493,512	721,856,118
Total net investment income	<u>1,113,231,712</u>	<u>953,579,253</u>
Total Additions	<u>1,537,840,399</u>	<u>1,590,348,072</u>
Deductions:		
Benefits:		
Retirement annuities	985,503,023	935,677,837
Survivors' annuities	61,100,647	57,542,913
Disability benefits	40,271,558	36,828,758
Lump-sum benefits	23,710,733	33,920,915
Total Benefits	<u>1,110,585,961</u>	<u>1,063,970,423</u>
Refunds (including transfers to reciprocating systems)	13,410,048	14,105,301
Administrative	8,139,278	8,311,269
Total Deductions	<u>1,132,135,287</u>	<u>1,086,386,993</u>
Net Increase	<u>405,705,112</u>	<u>503,961,079</u>
Net assets held in trust for pension benefits:		
Beginning of year	<u>10,494,147,953</u>	<u>9,990,186,874</u>
End of year	<u>\$ 10,899,853,065</u>	<u>\$ 10,494,147,953</u>

See accompanying notes to financial statements.

## STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Notes to Financial Statements June 30, 2006 and 2005

### 1. Reporting Entity

Generally accepted accounting principles require that the financial reporting entity include: 1) the primary government; 2) organizations for which the primary government is financially accountable; and 3) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statement to be misleading or incomplete.

The State Employees' Retirement System of Illinois (System) is administered by a Board of Trustees consisting of seven persons, which includes: a. the Director of the Governor's Office of Management and Budget; b. the Comptroller; c. one trustee, not a state employee, who shall be chairman, to be appointed by the Governor for a 5 year term; d. two members of the system, one of whom shall be an annuitant age 60 or over, having at least 8 years of creditable

service, to be appointed by the Governor for terms of 5 years; e. one member of the System having at least 8 years of creditable service, to be elected from the contributing membership of the System by the contributing members; and f. one annuitant of the System who has been an annuitant for at least one full year, to be elected from and by the annuitants of the System.

Based on the criteria of the Governmental Accounting Standards Board Statement No. 14, there are no other state agencies, boards or commissions, or other organizations required to be combined with the System. However, the System is considered to be part of the State of Illinois financial reporting entity, and is to be combined and included in the State of Illinois' comprehensive annual financial report.

Pursuant to federal tax laws and regulations governing the administration of public employee pension plans, the System has established a separate fund for the sole purpose of disbursing benefits in accordance with Section 415 of the Internal Revenue Code. Receipts of the fund for fiscal year 2006 were approximately \$60,000, disbursements were approximately \$54,000. For fiscal year 2005, receipt and disbursement amounts were approximately \$57,000.

Due to the immaterial nature of the separate fund, these receipts and disbursements have been included in the financial statements of the System.

### 2. Plan Description

The System is the administrator of a single-employer, defined benefit public employee retirement system (PERS) established and administered by the State of Illinois to provide pension benefits for its employees.

#### a. Eligibility and Membership

Membership is automatic for most state employees who are not eligible for another state-sponsored retirement plan.

Generally, anyone entering state service, except those in positions subject to membership in certain other state sponsored retirement systems, persons employed after June 30, 1979 as public service employment program participants under the Federal

At June 30, 2006 and 2005, the number of participating state agencies, boards and commissions totaled:

	2006	2005
State agencies	37	34
State boards and commissions	40	42
<b>TOTAL</b>	<b>77</b>	<b>76</b>

At June 30, 2006 and 2005, SERS membership consisted of:

Retirees and beneficiaries currently receiving benefits:		
Retirement annuities	42,676	42,649
Survivors' annuities	10,036	10,041
Disability benefits	2,156	2,138
<b>TOTAL</b>	<b>54,868</b>	<b>54,828</b>
Inactive employees entitled to benefits, but not yet receiving them		
<b>TOTAL</b>	<b>4,605</b>	<b>4,672</b>
Current Employees:		
Vested: Coordinated with Social Security	42,453	41,697
Noncoordinated	1,976	2,053
Nonvested: Coordinated with Social Security	22,726	24,612
Noncoordinated	920	801
<b>TOTAL</b>	<b>68,075</b>	<b>69,163</b>

Operation of the System and the direction of its policies are the responsibility of the Board of Trustees of the System.

CETA program, and other exceptions as indicated in state law, become members of the System upon completion of six months of service.

Employees appointed by the Governor and requiring confirmation by the State of Illinois Senate may elect to become members of the System.

**b. Contributions**

Participating members contribute specified percentages of their salaries for retirement annuities and survivors' annuities in accordance with Chapter 40, Section 5/14-133 of the Illinois Compiled Statutes (ILCS).

Contributions are excluded from gross income for Federal and State income tax purposes. The total contribution rate is 4% if the member is covered by Social Security and 8% if the member is not covered. Certain employment categories which are eligible for benefits under alternative formulas contribute at the rate of 8 1/2% or 12 1/2 % depending upon whether or not the employee is covered by Social Security. Participants' contributions are fully refundable, without interest, upon withdrawal from state employment.

The State of Illinois is obligated to make payment for the required departmental employer contributions, all allowances, annuities, any benefits granted under Chapter 40, Article 5/14 of the ILCS and all administrative expenses of the System to the extent specified in the ILCS. State law provides that the employer contribution rate be determined based upon the results of each annual actuarial valuation.

**c. Benefits**

The System is governed by Chapter 40, Article 5/14 of the ILCS. Vesting and benefit provisions of the System are defined in the ILCS. Employees who retire at or after age 60 with 8 years of credited service, at age 55 with at least 25 years of credited service with reduced benefits, or when an employee's age and service equal 85 years, are entitled to an annual retirement benefit, payable monthly for life, in an amount based upon final average compensation and credited service.

Final average compensation for retirement and survivors' annuities, is the employee's average salary, during a 48 consecutive month period within the last 120 months of service in which the total compensation was the highest, to a maximum of 75%. Alternative formula positions use their final rate of pay for the final average compensation, to a maximum of 80%.

The retirement benefit formula available to general state employees is 1.67% for each year of covered service and 2.2% for each year of noncovered service. Alternative formula employees have a formula of 2.5% for covered service and 3.0% for noncovered service.

Occupational and nonoccupational (including temporary) disability benefits are available through the System. To be eligible for nonoccupational (including temporary) disability benefits, an employee must have at least eighteen months of credited service with the System.

The nonoccupational (including temporary) disability benefit is equal to 50% of the monthly rate of compensation of the employee on the date of removal from the payroll. Occupational disability benefits are provided when the member becomes disabled as a direct result of injuries or diseases arising out of and in the course of state employment. The monthly benefit is equal to 75% of the monthly rate of compensation on the date of removal from the payroll. This benefit amount is reduced by Workers' Compensation or payments under the Occupational Diseases Act.

Occupational and nonoccupational death benefits are also available through the System. Certain nonoccupational death benefits vest after eighteen months of credited service. Occupational death benefits are provided from the date of employment.

**3. Summary of Significant Accounting Policies & Plan Asset Matters**

**a. Basis of Accounting**

The financial transactions of the System are maintained and these financial statements have been prepared using the accrual basis of accounting in conformity with generally accepted accounting principles. Employee and employer contributions are recognized as revenues when due pursuant to statutory requirements.

Benefits and refunds are recognized as expenses when due and payable in accordance with the terms of the plan.

**b. Cash**

The System retains all of its available cash in a commingled investment pool managed by the Treasurer of the State of Illinois (Treasurer). All deposits are fully collateralized by the Treasurer.

# FINANCIAL STATEMENTS

"Available cash" is determined to be that amount which is required for the current operating expenditures of the System. The excess of available cash is transferred to the Illinois State Board of Investment (ISBI) for purposes of long-term investment for the System.

c. **Implementation of New Accounting Standard**  
 In May, 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 44 (GASB 44), Economic Condition Reporting: The Statistical Section, an amendment of NCGA Statement No. 1. This statement establishes and modifies requirements related to the supplementary information presented in the statistical section. The requirements of this statement were effective for statistical sections prepared for periods beginning after June 15, 2005. The System implemented GASB 44 for the fiscal year ended June 30, 2006.

d. **Investments**  
 The System transfers money to the ISBI for investment in the ISBI Commingled Fund. This money is then allocated among various investment managers to pursue a specific investment strategy. All investment transactions are initiated by the investment managers. The transaction settlement information is then forwarded to the agent bank's trust department under a master custodial agreement.

Custody of a majority of the actual physical securities is maintained at an agent of the agent bank's trust department using a book-entry system. The ISBI's master custodian is The State Street Bank & Trust Company. The agent of the master custodian is the Depository Trust Company.

Investments are managed by the ISBI pursuant to Chapter 40, Article 5/22A of the Illinois Compiled Statutes (ILCS) and are maintained in the ISBI Commingled Fund.

Investments owned are reported at fair value as follows: (1) U.S. Government and Agency, Foreign and Corporate Obligations, Convertible Bonds - prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, Convertible Preferred Stock, Preferred Stock, Foreign Equity Securities, Forward Foreign Currency Contracts and

Options: (a) Listed - closing prices as reported on the composite summary of national securities exchanges; (b) Over-the-counter - bid prices; (3) Money Market Instruments - average cost which approximates fair values; (4) Real Estate Investments - fair values as determined by the ISBI and its investment managers; and (5) Alternative (Private Equity and Hedge Funds) Investments - fair values as determined by the ISBI and its investment managers.

Units of the ISBI Commingled Fund are issued to the member systems on the last day of the month based on the unit net asset value calculated as of that date. Net investment income of the ISBI Commingled Fund is allocated to each of the member systems on the last day of the month on the basis of percentage of accumulated units owned by the respective systems. Management expenses are deducted monthly from income before distribution.

The investment authority of the ISBI is provided in Chapter 40, Section 5/22A-112 of the ILCS. The ISBI investment authority includes investments in obligations of the U.S. Treasury and other agencies, notes secured by mortgages which are insured by the Federal Housing Commission, real estate, common and preferred stocks, convertible debt securities, deposits or certificates of deposit of federally insured institutions and options.

Such investment authority requires that all opportunities be undertaken with care, skill, prudence and diligence given prevailing circumstances that a prudent person acting in like capacity and experience would undertake.

### Summary of the ISBI Fund's investments at fair value by type

	June 30, 2006	June 30, 2005
Government and agency obligations	\$ 1,110,919,988	\$ 1,130,079,107
Foreign obligations	104,455,671	88,970,486
Corporate obligations	1,382,574,163	1,643,935,794
Convertible bonds	0	1,404,244
Common stock & equity funds	5,369,124,032	5,529,033,328
Preferred stock	1,057,334	1,593,391
Foreign equity securities	1,113,268,102	1,035,874,373
Hedge Funds	416,462,183	0
Real estate investments	1,134,025,154	778,951,123
Private Equity	482,264,036	466,871,030
Money market instruments	320,641,552	283,461,008
Forward foreign exchange contracts	26,145	(497,874)
Total investments	\$ 11,434,818,360	\$10,959,676,010

# FINANCIAL STATEMENTS

## Deposits

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, the System's and the ISBI's deposits may not be returned. All non-investment related bank balances at year end are insured or collateralized with securities held by the Illinois State Treasurer or agents in the name of the State Treasurer. Cash held in the investment related bank account by the ISBI is neither insured nor collateralized for amounts in excess of \$100,000. There is no related deposit policy for custodial risk. These assets are under the custody of State Street Bank and Trust. State Street Bank and Trust has a AA Long-term Deposit/Debt rating by Standards & Poor and an Aa2 rating by Moody. Certain investments of the ISBI with maturities of 90 days or less would be considered cash equivalents; these consist of short-term investment funds and U.S. Treasury bills with maturities of 90 days or less. For financial statement presentation and investment purposes, the ISBI reports its cash equivalents as Money Market Instruments within their investments. The table at the top of the next column discloses the deposits held by the ISBI at June 30, 2006 and 2005, and the portion of those deposits exposed to custodial credit risk.

	June 30, 2006	June 30, 2005
Carrying amount of Cash	\$ 80,644,137	\$ 13,722,061
Bank balance total	<u>\$ 80,724,748</u>	<u>\$ 13,729,252</u>
Amount exposed to custodial credit risk	<u>\$ 80,566,513</u>	<u>\$ 13,501,974</u>

## Custodial Credit Risk for Investments

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the ISBI will not be able to recover the value of investments or collateral securities that are in the possession of an outside party. As of June 30, 2006 and 2005, the following investments were uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the ISBI's name:

	2006	2005
Common stock	\$ 7,540,275	\$ 2,283,261
Government and agency obligations	43,932,397	16,885,000
Corporate obligations	4,649,641	4,725,000
Total	<u>\$ 56,122,313</u>	<u>\$ 23,893,261</u>

## Interest Rate Risk

The ISBI manages its exposure to fair value losses arising from interest rate risk by diversifying the debt securities portfolio and maintaining the debt securities portfolio to an effective weighted average rate between 80 and 120 percent of the benchmark index.

Duration is a measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows,

weighted for those cash flows as a percentage of the investment's full price. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. The ISBI benchmarks its debt security portfolio to Lehman Brothers Aggregate. At June 30, 2006 the effective duration of the Lehman Brothers Aggregate was 3.6 years. At the same point in time, the effective duration of the ISBI debt security portfolio was 3.8 years. The effective duration of the ISBI portfolio at June 30, 2005 was 3.9 years.

	2006		2005	
Investment Type	Fair Value	Effective Weighted Duration Years	Fair Value	Effective Weighted Duration Years
Government & agency obligations				
U.S. Government	\$ 457,091,471	4.4	\$ 556,169,172	4.5
Federal agency	651,140,066	3.3	570,050,982	2.8
Municipal	2,688,451	4.8	3,858,953	3.5
Foreign obligations	104,455,671	5.1	88,970,486	6.1
Corporate obligations				
Bank and finance	306,124,824	3.4	309,725,184	2.5
Collateralized mortgage obligations	211,686,803	2.1	97,392,369	3.0
Industrials	580,581,651	4.7	655,888,086	4.8
Commingled	40,713,286	N/A	341,540,499	N/A
Other	243,467,599	5.5	239,389,656	3.97
Convertible bonds	0	N/A	1,404,244	N/A
	<u>\$ 2,597,949,822</u>		<u>\$ 2,864,389,631</u>	

# FINANCIAL STATEMENTS

	Moody's Quality Rating	2006	2005
Government and agency obligations			
U.S. Government obligations	AAA	\$ 457,091,471	\$ 556,169,172
Federal agency obligations	AAA	651,140,066	570,050,982
Municipal	AAA	2,688,451	3,858,953
Total Government and agency obligations		<u>\$ 1,110,919,988</u>	<u>\$ 1,130,079,107</u>
Foreign obligations			
	AAA	\$ 16,124,526	\$ 15,399,251
	AA	4,040,041	3,307,170
	A	16,276,367	3,845,152
	BAA	27,419,722	18,565,417
	BA	12,024,660	9,027,386
	B	19,290,811	4,172,675
	CAA	1,274,200	0
	Not rated	8,005,344	34,653,435
Total foreign obligations		<u>\$ 104,455,671</u>	<u>\$ 88,970,486</u>
Corporate obligations			
	AAA	\$ 324,130,117	\$ 196,072,210
	AA	144,481,958	137,477,375
	A	148,904,618	165,820,135
	BAA	115,363,940	165,909,475
	BA	238,778,065	161,802,497
	B	274,358,266	269,923,855
	CAA	14,129,168	6,874,324
	CA	682,031	660,671
	C	461,236	0
	Not rated	121,284,764	539,395,252
Total corporate obligations		<u>\$ 1,382,574,163</u>	<u>\$ 1,643,935,794</u>
Convertible bonds			
	AAA	\$ 0	\$ 1,111,744
	BAA	0	292,500
Total convertible bonds		<u>\$ 0</u>	<u>\$ 1,404,244</u>

## Concentration of Credit Risk and Credit Risk for Investments

The ISBI's portfolio is managed by professional investment management firms. These investment management firms are required to maintain diversified portfolios. Each investment manager must comply with risk management guidelines individually assigned to them as part of their Investment Management Agreement. The ISBI did not have any single issuer investment that exceeded 5% of the total net assets of the fund as of June 30, 2006 and 2005. The table at left presents the quality ratings of debt securities held by the ISBI as of June 30, 2006 and 2005.

## Securities Lending

The ISBI participates in a securities lending program with State Street who acts as securities lending agent. Securities are loaned to brokers and, in return, the ISBI has rights to a portion of a collateral pool. All of the securities are eligible for the securities lending program.

Collateral consists solely of cash, letters of credit, commercial paper and government securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-U.S. securities). In the event of borrower default, State Street provides the ISBI with counterparty default indemnification.

The ISBI had no credit risk as a result of its securities lending program as the collateral held exceeded the fair value of the securities lent. As of June 30, 2006 and 2005, there were outstanding loaned investment securities having fair values of \$1,568,683,721 and \$1,442,715,435, respectively; against which collateral was received with a fair value of \$1,597,656,445 and \$1,476,263,962, respectively. Collateral received at June 30, 2006 and 2005 consisted of \$1,530,783,382 and \$1,444,871,284, respectively, in cash and \$66,873,063 and \$31,392,678, respectively, in securities for which the ISBI does not have the ability to pledge or sell.

# FINANCIAL STATEMENTS

## Derivative Securities

Some of the ISBI managers invest in derivative securities. A derivative security is an investment whose payoff depends upon the value of other assets such as bond and stock prices, a market index, or commodity prices. The ISBI's investments in derivatives are not leveraged. Obligations to purchase (long a financial future or a call option) are held in cash or cash equivalents. In the case of obligations to sell (short a financial future or a put option), the reference security is held in the portfolio. Derivatives transactions involve, to varying degrees, credit risk and market risk. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to terms. Market risk is the possibility that a change in interest or currency rates will cause the value of a financial instrument to decrease or become more costly to settle. The market risk associated with derivatives, the prices of which are constantly fluctuating, is regulated by imposing strict limits as to the types, amounts and degree of risk that investment managers may undertake. The ISBI Board of Directors and senior management approve these limits, and the risk positions of the investment managers are reviewed on a regular basis to monitor compliance with the limits.

During the year, derivative investments included forward foreign currency contracts, collateralized mortgage obligations (CMO's), futures and options. The remaining derivative securities are used to improve the yields or to hedge changes in interest rates.

Forward foreign currency contracts are used to hedge against the currency risk in the ISBI's foreign stock and fixed income portfolios. Forward foreign currency contracts are agreements to buy or sell specific amounts of a foreign currency at a specified delivery or maturity date for an agreed upon price. As the fair value of the forward contracts varies, the ISBI records an unrealized gain or loss. Forward foreign currency contracts represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts. The fair value of forward foreign currency contracts outstanding at June 30, 2006 and 2005, was as follows:

	Cost	Fair Value	Gain/(Loss)
As of June 30, 2006			
Forward currency purchases	\$3,956,106	\$4,008,201	\$ 52,095
Forward currency sales	7,860,622	7,886,572	(25,950)
Total gain/(loss)			<u>\$ 26,145</u>
As of June 30, 2005			
Forward currency purchases	\$41,391,551	\$40,355,914	\$ (1,035,637)
Forward currency sales	47,581,929	47,044,166	537,763
Total gain/(loss)			<u>\$ (497,874)</u>

The ISBI also invests in mortgage-backed securities to maximize yields and to hedge against a rise in interest rates. These securities are based on cash flows from principal and interest payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. As of June 30, 2006 and 2005, the fair value of the ISBI's CMO holdings totaled \$211,686,803 and \$97,392,369, respectively.

The ISBI investment managers utilize financial futures to replicate an underlying security they desire to hold (sell) in the portfolio. In certain instances, it may be beneficial to own a futures contract rather than the underlying security (arbitrage). Financial future contracts are also used to improve the yield or adjust the duration of the portfolio. Financial futures contracts are agreements to buy or sell a specified amount at a specified delivery or maturity date for an agreed upon price. The fair values of the futures contracts vary from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. Financial futures represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts. The cash or securities to meet these obligations are held in the investment portfolio.

The ISBI's investment managers utilize options in an effort to add value to the portfolio (collect premiums) or protect (hedge) a position in the portfolio. Options are agreements that give one party the right, but not the obligation, to buy or sell a specific amount of an asset for a specific price (called the strike price) on or before a specified expiration date. As the writer of financial options, the ISBI receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the instrument underlying the option. As the purchaser, the ISBI pays a premium at the outset of the agreement and the counterparty bears the risk of an unfavorable change in the price of the financial instrument underlying the option.

# FINANCIAL STATEMENTS

Futures and options positions held by the ISBI as of June 30, 2006 and 2005

	2006		2005	
	Number of Contracts	Contract Principal*	Number of Contracts	Contract Principal*
Equity futures purchased	2,667	\$ 190,210,548	847	\$ 141,009,225
Fixed income futures purchased	1,605	269,684,894	689	131,827,288
Fixed income futures sold	355	37,149,313	630	74,051,321
Fixed income written put options	71	7,100,000	158	15,800,000
Fixed income written call options	320	122,900,000	18,150,179	36,050,000
Eurocurrency purchased call options	23,550,000	23,550,000	0	0
Fixed income purchased call options	58	58,000,000	278	138,500,000
Fixed income purchased put options	0	0	131	77,000,000

\* Contract principal amounts shown represent the fair value of the underlying assets the contracts control. These are shown to present the volume of the transactions but do not reflect the extent to which positions may offset one another. These amounts do not represent the much smaller amounts potentially subject to risk. Contract principal values also do not represent recorded values.

### Investment Commitments

The ISBI real estate and private equity investment portfolios consist of passive interests in limited partnerships. The ISBI had outstanding commitments to these limited partnerships of approximately \$400 million and \$524 million, as of June 30, 2006 and 2005, respectively. Also, at the end of fiscal year 2006, the ISBI had an outstanding commitment of \$567 million to separate real estate accounts.

### Foreign Currency Risk

The ISBI's international portfolio is constructed on the principles of diversification, quality growth and value. Risk of loss arises from changes in currency exchange rates. International managers may also engage in transactions to hedge currency at their discretion. The table below presents the foreign currency risk by type of investment as of June 30, 2006 and 2005.

	2006		2005	
	Foreign Equity Securities	Foreign Obligations	Foreign Equity Securities	Foreign Obligations
Australian Dollar	\$ 45,031,863	\$ 0	\$ 47,593,913	\$ 0
Canadian Dollar	27,309,690	0	32,554,284	0
Danish Krone	11,811,080	0	11,599,786	0
English Pound Sterling	208,671,160	0	202,953,950	0
Euro Currency	298,835,278	2,773,684	281,227,718	4,417,066
Hong Kong Dollar	48,639,162	0	44,843,103	0
Japanese Yen	272,057,458	0	228,925,686	4,569,663
Mexican Peso	0	147,648	0	2,573,969
New Zealand Dollar	767,645	2,205,864	519,315	2,741,363
Norwegian Krone	9,864,745	0	5,641,688	0
Singapore Dollar	9,200,224	0	9,859,570	0
South Korean Won	22,537,972	0	21,372,559	0
Swedish Krona	29,340,607	0	29,822,230	0
Swiss Franc	54,417,316	0	52,437,404	0
Foreign investments denominated in U.S. Dollars	74,783,902	99,328,475	66,523,167	74,668,425
Total	<u>\$ 1,113,268,102</u>	<u>\$ 104,455,671</u>	<u>\$ 1,035,874,373</u>	<u>\$ 88,970,486</u>



**Other Information**

The System owns approximately 94% of the net investment assets of the ISBI Commingled Fund as of June 30, 2006. A schedule of investment expenses is included in the ISBI's annual report.

For additional information on ISBI's investments, please refer to their Annual Report as of June 30, 2006. A copy of the report can be obtained from the ISBI at 180 North LaSalle Street, Suite 2015, Chicago, Illinois 60601.

**e. Actuarial Experience Review**

In accordance with Illinois Compiled Statutes, an actuarial experience review is to be performed at least once every five years to determine the adequacy of actuarial assumptions regarding the mortality, retirement, disability, employment, turnover, interest and earnable compensation of the members and beneficiaries of the System.

The System's actuarial consultant performed an experience review for the four-year period ending June 30, 2005. Based upon the results of the review, several changes were made to the actuarial assumptions which were used in the actuarial valuation for the fiscal year ended June 30, 2006. These changes had the effect of increasing the actuarial liability and the related unfunded accrued liability by \$710,975,535.

**f. Administrative Expenses**

Expenses related to the administration of the System are financed through investment earnings and employer retirement contributions. These expenses are budgeted and approved by the System's Board of Trustees.

**g. Risk Management**

The System, as part of the primary government of the State, provides for risks of loss associated with workers' compensation and general liability through the State's self-insurance program. The System obtains commercial insurance for fidelity, surety, and property. There have been no commercial insurance claims in the past three fiscal years.

**h. Use of Estimates**

In preparing financial statements in conformity with U.S. generally accepted accounting principles, the System makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

**i. Reclassifications**

Certain fiscal year 2005 amounts have been reclassified to conform to the fiscal year 2006 presentation. These reclassifications have not changed the fiscal year 2005 results.

## 4. Funding - Statutory Contributions Required & Contributions Made

On an annual basis, a valuation of the liabilities and reserves of the System is performed by the System's actuarial consultants in order to determine the amount of contributions statutorily required from the State of Illinois. For fiscal years 2006 and 2005 the actuary used the projected unit credit actuarial method for determining the proper employer contribution rate and amount.

For fiscal year 2005 the required employer contributions was computed in accordance with Public Act 88-0593 as modified by Public Act 93-0002. This funding legislation provides for a systematic 50 year funding plan with an ultimate goal to fund the cost of maintaining and administering the System at an actuarial funded ratio of 90%.

For fiscal years 2006 and 2007, state contributions were and will be based on dollar amounts specified by Public Act 94-0004, rather than actuarial calculations. The legislation contains a two-year funding reduction of approximately 62% or \$905.3 million for the System. State contributions will be higher in future years to make up for the two-year funding reduction, as the overall goal of 90% funding in fiscal year 2045 is unchanged.

In addition, the funding plan provides for a 15 year phase-in period to allow the state to adapt to the increased financial commitment. Once the 15 year phase-in period is complete, the state's contribution will then remain at a level percentage of payroll for the next 35 years until the 90% funded level is achieved.

## 5. Accrued Compensated Absences

Employees of the System are entitled to receive compensation for all accrued but unused vacation time and one-half of all unused sick leave earned on and after January 1, 1984 and before January 1, 1998 upon termination of employment. These accrued compensated absences as of June 30, 2006 and 2005 totaled \$831,345 and \$799,836, respectively are included in Administrative Expenses Payable.

# FINANCIAL STATEMENTS

This is a summary of changes in property and equipment assets for 2006 and 2005:

		2006			
Assets	Beginning Balance	Additions	Deletions	Ending Balance	
Land	\$ 655,241	\$ -	\$ -	\$ 655,241	
Land improvements	250,316	-	-	250,316	
Building	3,352,428	-	-	3,352,428	
Equipment	2,209,825	84,843	(74,435)	2,220,233	
TOTAL	<u>6,467,810</u>	<u>84,843</u>	<u>(74,435)</u>	<u>6,478,218</u>	
Accumulated depreciation					
Land Improvements	(292)	(71)	-	(363)	
Building	(1,611,984)	(113,382)	-	(1,725,366)	
Fixed Assets	(1,784,085)	(156,388)	74,412	(1,866,061)	
TOTAL	<u>(3,396,361)</u>	<u>(269,841)</u>	<u>74,412</u>	<u>(3,591,790)</u>	
Net property and equipment	<u>\$3,071,449</u>	<u>\$ (184,998)</u>	<u>\$ (23)</u>	<u>\$2,886,428</u>	
		2005			
Assets	Beginning Balance	Additions	Deletions	Ending Balance	
Land	\$ 655,241	\$ -	\$ -	\$ 655,241	
Land improvements	245,351	4,965	-	250,316	
Building	3,352,428	-	-	3,352,428	
Equipment	2,214,084	157,565	(161,824)	2,209,825	
TOTAL	<u>6,467,104</u>	<u>162,530</u>	<u>(161,824)</u>	<u>6,467,810</u>	
Accumulated depreciation					
Land Improvements	(220)	(71)	-	(292)	
Building	(1,496,576)	(115,409)	-	(1,611,984)	
Fixed Assets	(1,818,227)	(127,091)	161,233	(1,784,085)	
TOTAL	<u>(3,315,023)</u>	<u>(242,571)</u>	<u>161,233</u>	<u>(3,396,361)</u>	
Net property and equipment	<u>\$ 3,152,081</u>	<u>\$ (80,041)</u>	<u>\$ (591)</u>	<u>\$3,071,449</u>	

## 6. Property & Equipment

Capital assets are capitalized at their cost at the time of acquisition. Depreciation is computed using the straight-line method over the estimated useful life of the asset. The estimated useful lives are as follows: (1) office furniture - 10 years, (2) equipment - 6 years, (3) automobiles and certain electronic data processing equipment - 3 years, and (4) building - 30 years. Land is carried at its original cost, including applicable legal fees, surveying costs, etc.

## 7. Collection and Remittance of Bond and Interest Payments

On April 7, 2003 House Bill 2660 was signed into law as Public Act 93-0002. This legislation authorized the State to issue \$10 billion in general obligation bonds for the purpose of making required contributions to the five state-funded retirement systems, including the State Employees' Retirement System. On July 1, 2003, the net bond proceeds were allocated and distributed to each of the five state-funded retirement systems based on each system's relative percentage of the total unfunded liability at June 30, 2002. The State Employees' Retirement System received an allocation of bond proceeds totaling \$1,385,895,278 and deposited all of the proceeds into the Illinois State Board of Investment Commingled Fund on July 2, 2003.

Public Act 93-0839, effective July 30, 2004, requires that employer contributions to the System shall include an additional amount to be paid over to the General Obligation Bond Retirement and Interest Fund to pay principal of and interest on those general obligation bonds due that fiscal year. This debt service payment is to be made on the first day of each month, or as soon thereafter as practical.

The total debt service payments received for all fiscal year 2006 and 2005 payrolls, amounted to \$70.6 million and \$134.1 million, respectively. The total amount remitted to the State of Illinois as of June 30, 2006 and 2005 was \$61.7 million and \$117.5 million, respectively.

As of June 30, 2006, the following amounts are included in the System's Statement of Plan Net Assets regarding the collection of bond principal and interest payments:

# FINANCIAL STATEMENTS

	2006	2005
Cash - payments collected but not yet remitted to the State of Illinois	<u>\$ 6,183,979</u>	<u>\$ 12,180,829</u>
Accounts receivable - for June payrolls received in July and August	<u>\$ 2,858,733</u>	<u>\$ 4,510,893</u>
Due to the State of Illinois	<u>\$ (9,042,712)</u>	<u>\$ (16,691,722)</u>

## 8. Administrative Expenses & Other Post-Employment Benefits

Expenses related to the administration of the System are financed through investment earnings and employer retirement contributions. These expenses are budgeted and approved by the System's Board of Trustees.

The System pays employer retirement contributions based upon an actuarially determined percentage of its payrolls. For fiscal years 2006, 2005, and 2004 the employer contribution rates were 7.792%, 16.107%, and 13.439%, respectively. The System's contributions to SERS for fiscal years 2006, 2005, and 2004 were \$252,355, \$500,477, and \$401,155 respectively, for the general staff. The System's contributions for the electronic data processing staff for fiscal years 2006, 2005, and 2004 were \$70,438, \$142,816, and \$107,998, respectively. These amounts were equal to the required contributions for each fiscal year.

In addition to providing pension benefits, the State Employees Group Insurance Act of 1971, as amended, requires that certain health, dental and life insurance benefits shall be provided by the state to annuitants who are former state employees. This includes annuitants of the System. Substantially all state employees including the System's employees may become eligible for post-employment benefits if they eventually become annuitants.

Health and dental benefits include basic benefits for annuitants under the state's self-insurance plan and insurance contracts currently in force. Life insurance benefits are limited to five thousand dollars per annuitant age 60 and older.

Costs incurred for health, dental and life insurance for annuitants and their dependents were not separated from benefits provided to active employees and their dependents for the year ended June 30, 2006. However, post-employment costs for the State as a whole

for all State agencies/departments for health, dental and life insurance for annuitants and their dependents are disclosed in the State of Illinois Comprehensive Annual Financial Report.

Cost information for retirees by individual State agency is not available. Payments are made on a "pay-as-you-go" basis. The System is not the administrator of any of the other post-employment benefits described previously.

A summary of the administrative expenses of the System for fiscal years 2006 and 2005 are as follows:

	2006	2005
Personal Services	\$ 3,235,537	\$ 3,119,207
Employee Retirement Pickup	108,812	119,180
Retirement Contributions	252,355	500,477
Social Security Contributions	241,079	232,929
Group Insurance	868,983	803,980
Contractual Services	1,352,042	1,352,284
Travel	45,970	49,509
Commodities	21,844	25,081
Printing	55,944	65,592
Electronic data processing	1,570,156	1,724,842
Telecommunications	61,765	63,012
Automotive	20,535	20,615
Depreciation	269,841	242,571
Other (net)	34,415	(8,010)
Total	<u>\$ 8,139,278</u>	<u>\$ 8,311,269</u>

## 9. Social Security Division - Administrative Expenses

The Social Security Division of the State Employees' Retirement System was created by 40 ILCS 5/21, to administer the state's responsibilities under Title II Section 218 of the Federal Social Security Act and the master federal-state agreement.

The state's responsibilities include extending Social Security coverage by agreement to any of the

# FINANCIAL STATEMENTS

retirement systems or units of local government requesting social security or medicare only coverage for their members or employees.

Administrative expenses for the Social Security Division are appropriated annually by the State Legislature

	2006	2005																								
<p>In addition, the Social Security Division was responsible for collecting wage information and contribution payments from covered retirement systems and units of local government on wages paid prior to January 1, 1987. Administrative expenses for the Social Security Division are appropriated annually by the State Legislature.</p>	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Personal services</td> <td style="width: 20%; text-align: right;">\$43,809</td> <td style="width: 20%; text-align: right;">\$ 42,228</td> </tr> <tr> <td>Retirement contributions</td> <td style="text-align: right;">3,413</td> <td style="text-align: right;">6,802</td> </tr> <tr> <td>Social Security contributions</td> <td style="text-align: right;">3,238</td> <td style="text-align: right;">3,120</td> </tr> <tr> <td>Contractual services</td> <td style="text-align: right;">17,750</td> <td style="text-align: right;">19,350</td> </tr> <tr> <td>Travel</td> <td style="text-align: right;">1,167</td> <td style="text-align: right;">494</td> </tr> <tr> <td>Commodities</td> <td style="text-align: right;">188</td> <td style="text-align: right;">182</td> </tr> <tr> <td>Telecommunications</td> <td style="text-align: right;">354</td> <td style="text-align: right;">341</td> </tr> <tr> <td><b>Total</b></td> <td style="text-align: right; border-top: 1px solid black; border-bottom: 3px double black;"><b>\$ 69,919</b></td> <td style="text-align: right; border-top: 1px solid black; border-bottom: 3px double black;"><b>\$ 72,517</b></td> </tr> </table>	Personal services	\$43,809	\$ 42,228	Retirement contributions	3,413	6,802	Social Security contributions	3,238	3,120	Contractual services	17,750	19,350	Travel	1,167	494	Commodities	188	182	Telecommunications	354	341	<b>Total</b>	<b>\$ 69,919</b>	<b>\$ 72,517</b>	
Personal services	\$43,809	\$ 42,228																								
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Travel	1,167	494																								
Commodities	188	182																								
Telecommunications	354	341																								
<b>Total</b>	<b>\$ 69,919</b>	<b>\$ 72,517</b>																								

## 10. Analysis of Changes in Reserve Balances

The System maintains three reserve accounts. The reserves are defined as follows:

- a. Participants' contributions: Accounts for assets contributed by each participant,
- b. Interest accumulations: Accounts for interest credited to each participant's account,
- c. Other future benefits: Accounts for all assets not otherwise specifically provided for in items (a) and (b) above.

### State Employees' Retirement System Statements of Changes in Reserve Balances Years Ended June 30, 2006 and 2005

	Participants' Contributions	Interest Accumulations	Other Future Benefits	Total Reserve Balances
Balance at June 30, 2004	1,570,508,130	\$ 1,005,580,314	\$ 7,414,098,430	\$ 9,990,186,874
Add (deduct):				
Excess revenue over expenses	177,273,796	-	326,687,283	503,961,079
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	(64,399,611)	-	64,399,611	-
Interest credited to members' accounts	-	92,569,784	(92,569,784)	-
Balance at June 30, 2005	\$ 1,683,382,315	\$ 1,098,150,098	\$ 7,712,615,540	\$10,494,147,953
Add (deduct):				
Excess revenue over expenses	186,684,209	-	219,020,903	405,705,112
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	(50,167,965)	-	50,167,965	-
Interest credited to members' accounts	-	115,074,193	(115,074,193)	-
Balance at June 30, 2006	\$ 1,819,898,559	\$ 1,213,224,291	\$ 7,866,730,215	\$10,899,853,065

**REQUIRED SUPPLEMENTARY INFORMATION**

**SCHEDULE OF FUNDING PROGRESS**

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) -Projected Unit Credit (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage Covered Payroll ([b-a]/c)
6/30/01	\$ 8,276,661,352	\$ 12,572,240,145	\$ 4,295,578,793	65.8	\$ 3,564,441,000	120.5%
6/30/02	7,673,892,691	14,291,044,457	6,617,151,766	53.7	3,713,020,000	178.2
6/30/03	7,502,111,416	17,593,980,039	10,091,868,623	42.6	3,639,334,000	277.3
6/30/04	9,990,186,874	18,442,664,834	8,452,477,960	54.2	3,439,251,000	245.8
6/30/05	10,494,147,953	19,304,646,648	8,810,498,695	54.4	3,475,528,000	253.5
6/30/06	10,899,853,065	20,874,541,910	9,974,688,845	52.2	3,572,541,000	279.2

**SCHEDULE OF EMPLOYER CONTRIBUTIONS**

Year Ended June 30	Annual Required Contribution per GASB Statement No. 25 <sup>(1)</sup>	Percentage Contributed	(A) Annual Required Payroll Contribution per State Statute <sup>(3)</sup>	(B) State Pension Fund Contribution	(A) + (B) Total Required State Contribution	Percentage Contributed
2001	\$ 294,351,538	124.3%	\$ 354,448,013	10,490,000	\$ 364,938,013	100%
2002	306,509,801	126.0	372,787,208	10,290,000	383,077,208	100
2003	449,348,569	88.1	375,615,662	17,195,000	392,810,662	100
2004	576,219,951	83.1 <sup>(2)</sup>	462,200,942	15,150,000 <sup>(4)</sup>	477,350,942	100 <sup>(2)</sup>
2005	727,428,010	58.8	425,682,669	-	425,682,669	100
2006	672,555,569	31.3	207,814,710	-	207,814,710	100

**Notes to Required Supplementary Information**

Valuation date: June 30, 2006

Actuarial cost method: Projected Unit Credit

Amortization method:

- a. For GASB Statement No. 25 reporting purposes - Level percent of payroll
- b. Per state statute - 15-year phase-in to a level percent of payroll until a 90% funding level is achieved

Remaining amortization period:

- a. For GASB Statement No. 25 reporting purposes - 40 years, open
- b. Per state statute - 39 years, closed

Asset valuation method - Fair Value

Actuarial assumptions:

- Investment rate of return - 8.5 percent
- Projected salary increases - 1.0 to 6.1 percent, based upon member's age
- Assumed inflation rate - 3.0 percent
- Group size growth rate - 0.0 percent
- Post-retirement increase - 3.0 percent, compounded
- Mortality table - 1994 Group Annuity Mortality Table for males and females. Five percent of deaths amongst active employees are assumed to be in the performance of their duty.

- (1) This amount includes both payroll and non-payroll employer required contributions.
- (2) This percentage excludes the additional employer contributions received from the State of General Obligation bonds by the State of Illinois. These proceeds were not part of the current fiscal year required contributions.
- (3) Employer required contribution determined in accordance with SB533 (P.A. 88-0593). These amounts reflect only payroll required contributions.
- (4) The actual distribution from the State Pension Fund was \$5,970,645, the additional amount of \$9,179,355 was received in accordance with HB585 (P.A.93-0665), as a distribution from the Pension Contribution Fund.

## SUPPLEMENTARY FINANCIAL INFORMATION

### SUMMARY OF REVENUES BY SOURCE

	2006	2005
Contributions:		
Participants	\$ 207,667,143	\$ 201,764,897
ERI payments	-	538
Repayments of contributions refunded	1,345,085	1,413,352
Interest received from participants	5,096,668	6,155,420
Total participants contributions	<u>214,108,896</u>	<u>209,334,207</u>
Employing state agencies	<u>210,499,791</u>	<u>427,434,612</u>
Investments:		
Net investments income	264,013,416	227,422,797
Interest earned on cash balances	8,724,784	4,300,338
Net appreciation in fair value of investments	<u>840,493,512</u>	<u>721,856,118</u>
Total investment revenue	<u>1,113,231,712</u>	<u>953,579,253</u>
<b>TOTAL REVENUE</b>	<u><u>\$ 1,537,840,399</u></u>	<u><u>\$ 1,590,348,072</u></u>

### SUMMARY SCHEDULE OF CASH RECEIPTS & DISBURSEMENTS

	2006	2005
Cash balance, beginning of year	\$ 204,525,471	\$ 66,642,027
Receipts:		
Participant contributions	205,265,817	200,680,710
Employer contributions		
(net of bond principal and interest transfers)	209,677,099	490,689,715
Transfers from Illinois State Board of Investment	721,000,000	518,000,000
Interest income on cash balance	8,324,160	3,851,374
Claims receivable payments	4,687,995	5,331,207
Installment payments	5,068,650	5,860,986
Other	<u>114,964</u>	<u>317,324</u>
Total cash receipts	<u>1,154,138,685</u>	<u>1,224,731,316</u>
Disbursements:		
Annuity payments:		
Retirement annuities	985,960,464	936,358,756
Widow's and Survivor's annuities	61,366,786	57,606,256
Disability benefits	38,155,674	34,554,392
Lump Sum benefits	12,022,378	10,295,772
Refunds	26,466,430	39,443,480
Administrative expenses	7,941,346	8,559,571
Transfers to reciprocal systems	-	29,645
Total cash disbursements	<u>1,131,913,078</u>	<u>1,086,847,872</u>
Cash balance, end of year	<u><u>\$ 226,751,078</u></u>	<u><u>\$ 204,525,471</u></u>

### SCHEDULE OF PAYMENTS TO CONSULTANTS & ADVISORS

	2006	2005
Legal Services	\$ 32,689	\$ 36,209
Actuarial Costs	107,894	184,164
Audit Expense	56,248	56,557
Physicians and Disability Inspections	162,535	160,490
Financial Planning	47,506	47,056
<b>TOTAL</b>	<u><u>\$ 406,872</u></u>	<u><u>\$ 484,476</u></u>

# McGladrey & Pullen

Certified Public Accountants

## **Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards**

Honorable William G. Holland  
Auditor General, State of Illinois  
Springfield, Illinois

Board of Trustees  
State Employees' Retirement System  
Springfield, Illinois

As Special Assistant Auditors for the Auditor General, we have audited the statement of plan net assets and statement of changes in plan net assets of the State Employees' Retirement System of Illinois (System), as of and for the year ended June 30, 2006, and have issued our report thereon dated February 21, 2007. Our report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the Illinois State Board of Investment, as described in our report on System's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

### **Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted certain immaterial instances of internal control deficiencies, which we have reported to the Auditor General and management of the System in a separate letter dated February 21, 2007.

### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards. However, we noted one instance of noncompliance which is reported in a separately issued compliance examination report as a State compliance finding in the schedule of findings. We also noted certain other immaterial matters which we have reported to the Auditor General and management of the System in a separate letter dated February 21, 2007.

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

*McGladrey & Pullen, LLP*

Schaumburg, Illinois  
February 21, 2007