State Employees' Retirement System of the State of Illinois

Auditors' Report and Financial Audit

For the Year Ended June 30, 2011
Performed as Special Assistant Auditors for
the Auditor General, State of Illinois

BKD LLP
CPAs & Advisors

State Employees' Retirement System of the State of Illinois

Financial Audit

For the Year Ended June 30, 2011

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State Employees' Retirement System
of the State of Illinois
June 30, 2011

System Officials

Executive Secretary	Timothy B. Blair
Accounting Division Manager	Nicholas C. Merrill, Jr., CPA
Internal Auditor	Larry L. Stone

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State Employees' Retirement System of the State of Illinois

Financial Statement Report Summary

For the Year Ended June 30, 2011

Summary

The audit of the accompanying financial statements of the State Employees' Retirement System of the State of Illinois was performed by **BKD, LLP.**

Based on their audit, the auditors expressed an unqualified opinion on the State Employees' Retirement System of the State of Illinois' financial statements.

Summary of Findings

The auditors identified a matter involving the System's internal control over financial reporting that they considered to be a significant deficiency. The significant deficiency is described in the accompanying Schedule of Findings listed in the table of contents as finding 11-1 (Journal Entry Review).

Exit Conference

System management waived a formal exit conference in correspondence dated January 9, 2012.

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Independent Auditors' Report

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

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statement of plan net assets of the State Employees' Retirement System of the State of Illinois (System), as of June 30, 2011 and 2010, and the related statement of changes in plan net assets for the years 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 audits. We did not audit the 2011 and 2010 financial statements of the Illinois State Board of Investment, an internal investment pool of the State of Illinois, which statements represent 99 percent, 99 percent, and 58 percent, respectively in 2011, and 99 percent, 99 percent, and 37 percent, respectively, in 2010 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 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 and the report of other auditors 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 System as of June 30, 2011 and 2010, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 27, 2012 on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis and schedules of funding progress and employer contributions and accompanying notes to required supplementary information as listed in the table of contents are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the System's basic financial statements. The supplementary financial information as noted in the table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplementary financial information has been subjected to the auditing procedures applied by us and other auditors in the audits of the basic financial statements and, in our opinion, based on our audits and the report of other auditors, is fairly stated, in all material respects, in relation to the basic financial statements as of and for the years ended June 30, 2011 and 2010, taken as a whole.

BKD, LLP

January 27, 2012

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, 2011 and 2010. 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 66,000 active state employees and over 59,000 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.

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, 2011 and 2010, 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, 2011 and 2010. 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.

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.

FINANCIAL HIGHLIGHTS

- The Systems' net assets increased by $1,768.9 million and by $723.9 million during fiscal years 2011 and 2010, respectively. The changes were primarily due to an increase of $1,761.9 million (excluding securities lending collateral), and $919.8 million in the System's investments, at fair value, for fiscal years 2011 and 2010, respectively.
- The System was actuarially funded at 35.6% as of June 30, 2011, compared to 37.4% as of June 30, 2010. For fiscal years 2011 and 2010, the actuarial value of assets equals the fair value of assets adjusted for any actuarial gains or losses from investment return incurred in the fiscal year recognized in equal amounts over the five year period following that fiscal year.
- The overall rate of return for the Illinois State Board of Investment (ISBI) Commingled Fund was 21.7% for fiscal year 2011 compared to 9.1% for fiscal year 2010.

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	
	2011	2010	2009	2010 to 2011	2009 to 2010
Cash	$ 54.9	$ 49.9	$ 232.7	$ 5.0	$ (182.8)
Receivables	41.1	39.3	57.4	1.8	(18.1)
Investments, at fair value *	10,908.9	9,143.2	8,200.8	1,765.7	942.4
Property & equipment, net	2.7	2.8	2.6	(.1)	0.2
Total assets	11,007.6	9,235.2	8,493.5	1,772.4	741.7
Liabilities *	36.9	33.4	15.6	3.5	17.8
Total plan net assets	$ 10,970.7	$ 9,201.8	$ 8,477.9	$ 1,768.9	$ 723.9

* Including securities lending collateral

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 $254.2 million and $246.2 million for the years ended June 30, 2011 and 2010, respectively. Participant contribution rates are set by statute as a percentage of gross salary. Employer contributions increased to approximately $1,127.9 million in 2011 from approximately $1,095.5 million in 2010. This increase was the result of the State's funding plan.

DEDUCTIONS FROM PLAN NET ASSETS

Deductions from Plan Net Assets are primarily benefit payments. During 2011 and 2010, the System paid out approximately $1,529.6 million and $1,405.9 million, respectively, in benefits and refunds, an increase of approximately 8.8%. These higher payments were mainly due to a scheduled 3% increase in retirement and other benefit payments, and a 2% increase in beneficiaries. The administrative costs of the System represented approximately 1% of total deductions in both 2011 and 2010.

FUNDED RATIO

The funded ratio of the plan measures the ratio of the actuarial value of 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, 2011 decreased to 35.6% from 37.4% at June 30, 2010. The major reason for the decline was the lingering effect of prior investment performance on the smoothed-market value of assets. The amount by which actuarially determined liabilities exceeded the actuarial value of assets was $20.2 billion at June 30, 2011 compared to $18.3 billion at June 30, 2010.

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.

The net investment gain for the System totaled approximately $1,930.2 million during fiscal year 2011, versus a net investment gain of $799.9 million during fiscal year 2010, resulting in returns of 21.7% and 9.1%, respectively. For the three, five, and ten year period ended June 30, 2011, the ISBI Commingled Fund earned a compounded rate of return of 2.0%, 3.1%, and 4.5%, respectively.

The ISBI is exposed to general market risk. This general market risk is reflected in asset valuations fluctuating with market volatility. Any impact from market volatility on the ISBI's investment portfolio depends in large measure on how deep the market downturn is, how long it lasts, and how it fits within fiscal year reporting periods. The resulting market risk and associated realized and unrealized gains and losses could significantly impact the ISBI's financial condition.

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, 2011	2010	2009	Increase/(Decrease) from 2010 to 2011	2009 to 2010
Additions					
Participant contributions	$ 254.2	$ 246.2	$ 242.2	$ 8.0	$ 4.0
Employer contributions	1,127.9	1,095.5	774.9	32.4	320.6
Investment income/(loss)	1,930.2	799.9	(2,208.9)	1,130.3	3,008.8
Total additions/(deductions)	3,312.3	2,141.6	(1,191.8)	1,170.7	3,333.4
Deductions					
Benefits	1,492.1	1,390.7	1,300.2	101.4	90.5
Refunds	37.6	15.3	14.8	22.3	0.5
Administrative expenses	13.7	11.7	10.7	2.0	1.0
Total deductions	1,543.4	1,417.7	1,325.7	125.7	92.0
Net increase/(decrease) in plan net assets	$ 1,768.9	$ 723.9	$ (2,517.5)	$ 1,045.0	$ 3,241.4

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Statements of Plan Net Assets
June 30, 2011 and 2010

	2011	2010
Assets		
Cash	$ 54,940,085	$ 49,912,665
Receivables:		
Contributions:		
Participants	15,561,242	15,308,885
Employing state agencies	18,858,218	17,119,073
Other accounts	6,748,407	6,905,516
Total Receivables	41,167,867	39,333,474
Investments - held in the Illinois State Board of Investment Commingled Fund at fair value	10,882,484,004	9,120,601,694
Securities lending collateral with State Treasurer	26,414,000	22,587,000
Property and equipment, net of accumulated depreciation	2,676,348	2,808,489
Total Assets	11,007,682,304	9,235,243,322
Liabilities		
Benefits payable	5,055,752	5,260,823
Refunds payable	684,323	640,022
Administrative expenses payable	1,375,236	1,326,567
Participants' deferred service credit accounts	156,993	215,859
Due to the State of Illinois	3,243,314	3,382,396
Securities lending collateral	26,414,000	22,587,000
Total Liabilities	36,929,618	33,412,667
Net assets held in trust for pension benefits	$ 10,970,752,686	$ 9,201,830,655

See accompanying notes to financial statements.

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Statements of Changes in Plan Net Assets
Years Ended June 30, 2011 and 2010

	2011	2010
Additions:		
Contributions:		
Participants	$ 254,201,379	$ 246,172,971
Employing State agencies and appropriations	1,127,886,796	1,095,545,856
Total Contributions	1,382,088,175	1,341,718,827
Investment income:		
Net investment income	221,489,114	200,200,994
Interest earned on cash balances	448,284	795,373
Net appreciation in fair value of investments	1,708,270,995	598,899,494
Total investment income	1,930,208,393	799,895,861
Total Additions	3,312,296,568	2,141,614,688
Deductions:		
Benefits:		
Retirement annuities	1,329,155,991	1,237,118,008
Survivors' annuities	95,118,041	89,516,980
Disability benefits	53,056,325	48,312,629
Lump sum benefits	14,733,290	15,693,575
Total Benefits	1,492,063,647	1,390,641,192
Refunds *(including transfers to reciprocating systems)*	37,575,929	15,274,174
Administrative	13,734,961	11,720,755
Total Deductions	1,543,374,537	1,417,636,121
Net Increase	1,768,922,031	723,978,567
Net assets held in trust for pension benefits:		
Beginning of year	9,201,830,655	8,477,852,088
End of year	$ 10,970,752,686	$ 9,201,830,655

See accompanying notes to financial statements.

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Notes to Financial Statements June 30, 2011 and 2010

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 thirteen persons, which includes: a. the Comptroller, who shall be the Chairperson; b. six persons appointed by the Governor with the advice and consent of the Senate who may not be members of the system or hold an elective State office and who shall serve for a term of 5 years, except that the terms of the initial appointees under the amendatory Act of the 96th General Assembly shall be as follows: 3 for a term of 3 years and 3 for a term of 5 years; c. four active participants of the System having at least 8 years of creditable service, to be elected from the contributing members of the System by the contribution members; and d. two annuitants of the System who have been annuitants 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.

At June 30, 2011 and 2010, the number of participating state agencies, boards and commissions totaled:

	2011	2010
State agencies	38	39
State boards and commissions	43	43
TOTAL	81	82

At June 30, 2011 and 2010, SERS membership consisted of:

	2011	2010
Retirees and beneficiaries currently receiving benefits:		
Retirement annuities	47,002	45,659
Survivors' annuities	10,428	10,325
Disability benefits	2,356	2,408
TOTAL	59,786	58,392
Inactive employees entitled to benefits, but not yet receiving them	4,489	4,646
TOTAL	64,275	63,038
Current Employees:		
Vested: Coordinated with Social Security	45,839	46,717
Noncoordinated	1,854	2,020
Nonvested: Coordinated with Social Security	17,969	14,723
Noncoordinated	701	683
TOTAL	66,363	64,143

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

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. For fiscal years 2011 and 2010, receipts were approximately $23,800 and $60,500, respectively. For fiscal years 2011 and 2010, disbursements were approximately $53,100 and $41,200, respectively.

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. The plan is comprised of two tiers of contribution requirements and benefit levels. The provisions below apply to both Tier 1 & 2 employees, except where noted. A summary of the plan provisions pertaining to eligibility and membership, contributions, and benefits are displayed in the table below:

a. Eligibility and Membership

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 CETA program, and other exceptions as indicated in state law, become members of the System immediately.

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

b. Employee 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.

Tier 1	Tier 2
No annual compensation limit on contributions.	Beginning on or after January 1, 2011, annual compensation on which contributions are taken cannot exceed $106,800. This amount increases annually by 3% or one-half of the Consumer Price Index, whichever is less.

c. Employer Contributions

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.

d. Retirement Annuity 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. The retirement annuity is based on the member's final average compensation and the number of years of service credit that have been established. 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.

The maximum retirement annuity payable is 75% of final average compensation for regular employees and 80% for alternative formula employees. The minimum retirement annuity payable is $15.00 for each year of covered employment and $25.00 for each year of noncovered employment.

Regular Formula Tier 1	Regular Formula Tier 2
A member must have a minimum of eight years of service credit and may retire at: • Age 60, with 8 years of service credit. • Any age, when the member's age (years & whole months) plus years of service credit (years & whole months) equal 85 years (1,020 months) (Rule of 85) with eight years of credited service. • Between ages 55-60 with 25-30 years of service credit (reduced 1/2 of 1% for each month under age 60). The retirement benefit is based on final average compensation and credited service. Final average compensation is the 48 highest consecutive months of service within the last 120 months of service. Under the Rule of 85, a member is eligible for the first 3% increase on January 1 following the first full year of retirement, even if the member is not age 60. If the member retires at age 60 or older, he/she will receive a 3% pension increase every year on January 1, following the first full year of retirement. If the member retires before age 60 with a reduced retirement benefit, he/she will receive a 3% pension increase every January 1 after the member turns age 60 and has been retired at least one full year. These pension increases are not limited by the 75% maximum.	A member must have a minimum of 10 years of credited service and may retire at: • Age 67, with 10 years of credited service. • Between ages 62-67 with 10 years of credited service (reduced 1/2 of 1% for each month under age 67). The retirement benefit is based on final average compensation and credited service. For regular formula employees, final average compensation is the average of the 96 highest consecutive months of service within the last 120 months of service. The retirement benefit is calculated on a maximum salary of $106,800. This amount increases annually by 3% or one-half of the Consumer Price Index, whichever is less. If the member retires at age 67 or older, he/she will receive a pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, every year on January 1, following the first full year of retirement. If the member retires before age 67 with a reduced retirement benefit, he/she will receive a pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, every January 1 after the member turns age 67 and has been retired at least one full year. These pension increases are not limited by the 75% maximum.
Alternative Formula Tier 1	**Alternative Formula Tier 2**
Members eligible for the alternative formula may retire at age 50 with 25 years of service credit, or at age 55 with 20 years of service credit. Final average compensation is figured one of three ways: • The average of the highest 48 consecutive months over the last 120 months of service (for members in service prior to January 1, 1998). • Average of last 48 months of service. • Final rate of pay; cannot exceed the average of the last 24 months of pay by 115%. Alternative formula retirees receive their first 3% pension increase on January 1 following the first full year of retirement after age 55. These increases are not limited by the 80% maximum.	Members eligible for the alternative formula may retire at age 60 with 20 years of service. Final average compensation is the average monthly salary during the 96 highest consecutive months of service within the last 120 months. The retirement benefit is calculated on a maximum salary of $106,800. This amount increases annually by 3% or one-half of the Consumer Price Index, whichever is less. Alternative formula retirees receive their first pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, following the first full year of retirement after age 60. These increases are not limited by the 80% maximum.

e. Disability & Death Benefits

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.

Tier 1	Tier 2
For disability benefits, final average compensation is the rate of pay on the date of the disability, or the 48 highest consecutive months of service within the last 10 years, whichever is greater.	For disability benefits, final average compensation is the rate of pay on the date of the disability, or the 96 highest consecutive months of service within the last 10 years, whichever is greater. The disability benefit is calculated on a maximum salary of $106,800.

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.

"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

GASB Statement No.59, Financial Instruments Omnibus, was established to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. The ISBI implemented this Statement for the year ending June 30, 2011.

d. Methods Used to Value Investments

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 Government and Corporate Obligations, Convertible Bonds - prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, 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; (5) Alternative Investments (Private Equity, Hedge Funds, and Infrastructure Funds) fair values as determined by the ISBI and its investment managers; and (6) Commingled Funds- 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. 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.

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. An experience review was last performed as of June 30, 2010 resulting in the adoption of new assumptions as of June 30, 2011.

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 four fiscal years.

h. General Litigation
The System is subject to claims and lawsuits that arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the plan net assets or the changes in plan net assets of the System.

i. 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.

j. Reclassifications
Certain fiscal year 2010 amounts have been reclassified to conform to the fiscal year 2011 presentation. These reclassifications have not changed the fiscal year 2010 results.

4. Investments

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

	June 30, 2011	June 30, 2010
U.S. govt. and agency obligations	$ 1,367,098,751	$ 810,739,312
Foreign obligations	37,951,769	44,409,906
Corporate obligations	762,833,382	925,668,388
Domestic common stock & equity funds	3,380,198,858	2,857,144,559
Preferred stock	-	517,676
Foreign equity securities	2,195,201,185	1,733,177,670
Foreign preferred stock	40,032	179,924
Commingled funds	256,817,374	270,510,642
Hedge funds	1,075,584,754	917,854,201
Real estate funds	819,053,366	750,210,957
Private equity	629,256,286	542,441,291
Money market instruments	303,501,465	270,231,935
Infrastructure funds	417,267,415	320,293,041
Bank loans	253,447,070	222,623,999
Forward foreign currency contracts	(353)	(266,410)
Total investments	$11,498,251,354	$ 9,665,737,091

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 a counterparty. As of June 30, 2011 and 2010, there were no investments that were uninsured and unregistered, securities held by the counterparty or by its trust department or agent but not in the ISBI's name.

Deposits
Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, the System's and 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. As of June 30, 2011 and 2010, the ISBI had non-investment related bank balances of $119,804 and $34,557, respectively. During fiscal year 2007, a Credit Risk Policy was implemented by the ISBI staff and formally adopted by the ISBI Board in July of 2007. The policy outlines the control procedures used to monitor custodial credit risk. These assets are under the custody of State Street Bank and Trust Company. State Street Bank and Trust Company has an AA- Long-term Deposit/Debt rating by Standard & Poor's 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, which are not subject to the custodial credit risk. For financial statement presentation and investment purposes, the ISBI reports these types of cash equivalents as Money Market Instruments within their investments. As of June 30, 2011 and 2010, the ISBI had investment related bank balances of $12,234,333 and $3,630,043, respectively. These balances include USD and foreign cash balances. The USD cash balances had no exposure to custodial credit risk as a result of the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") in July, 2010. The FDIC must provide unlimited deposit insurance coverage for balances held in US dollar non-interest bearing transaction accounts (DDAs) for a period of two years, beginning on December 31, 2010 and ending on December 31, 2012. At any given point and time, the foreign cash balances may be exposed to custodial credit risk.

Securities Lending

The ISBI participates in a securities lending program with Credit Suisse AG, New York Branch who acts as securities lending agent. Securities are loaned to brokers and, in return, the ISBI receives cash and non-cash collateral. All of the securities are eligible for the securities lending program. Collateral consists solely of cash and U.S. 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, Credit Suisse AG, New York Branch provides the ISBI with counterparty default indemnification. Investments in the cash collateral account represent securities that were distributed to the ISBI in connection with the in-kind redemption of the ISBI's ownership in the State Street Bank and Trust Company Quality Funds for Short-Term Investment ("Quality D"). Credit Suisse is not responsible for any losses with regards to these legacy investments. This arrangement subjects the ISBI to credit risk as the credit quality of these investments may decline over time. The credit risk on the legacy investments is the risk of a possible loss arising from the inability of a counterparty to meet its obligations. These losses could include the loss of principal, interest and/or decreased expected cash flows in any of the investments held in the ISBI's cash collateral account. In the event a counterparty defaults on its obligations, the ISBI would need to credit the cash collateral account with the amount of the default to make the account whole so that once loaned securities are returned, the cash pledged by borrowers is returned to them. As of June 30, 2011 and 2010, respectively, the collateral received exceeded the fair value of the securities loaned. As of June 30, 2011 and 2010, there were outstanding loaned investment securities having fair values of $221,448,333 and $1,055,476,733, respectively; against which collateral was received with a fair value of $230,083,146 and $1,091,589,381, respectively. Collateral received at June 30, 2011 and 2010 consisted of $216,717,213 and $1,010,115,059, respectively, in cash and $13,987,903 and $81,474,322, respectively, in securities for which the ISBI does not have the ability to pledge or sell.

The cash collateral received is invested in a short term investment pool having a fair value of $211,162,204 and $997,638,887 as of June 30, 2011 and 2010, respectively. This investment pool had an average duration of 31.18 days and 12.45 days as of June 30, 2011 and 2010, respectively. Any decrease in the fair value of invested cash collateral is recorded by the ISBI as unrealized losses and reported as a component of the investment income/loss on the ISBI's Statement of Changes in Net Assets.

Cash and cash equivalents included in the System's Statement of Plan Net Assets consist of deposits held in the State Treasury. The Illinois Office of the Treasurer invests the deposits held and allocates investment income on a monthly basis.

Under the authority of the Treasurer's published investment policy that was developed in accordance with State statute, the State Treasurer lends securities to broker-dealers and other entities for collateral that will be returned for the same securities in the future. The State Treasurer has, through a Securities Lending Agreement, authorized Deutsche Bank Group to lend the State Treasurer's securities to broker-dealers and banks pursuant to a form of loan agreement.

During fiscal year 2011, Deutsche Bank Group lent U.S. agency securities and received as collateral U.S. dollar denominated cash. Borrowers were required to deliver collateral for each loan equal to at least 100% of the aggregate market value of the loaned securities. Loans are marked to market daily. If the market value of collateral falls below 100%, the borrower must provide additional collateral to raise the market value to 100%.

The State Treasurer did not impose any restrictions during the fiscal year on the amount of the loans of available, eligible securities. In the event of borrower default, Deutsche Bank Group provides the State Treasurer with counterparty default indemnification. In addition, Deutsche Bank Group is obligated to indemnify the State Treasurer if Deutsche Bank Group loses any securities, collateral or investments of the State Treasurer in Deutsche Bank Group's custody. Moreover, there were no losses during the fiscal year resulting from a default of the borrowers or Deutsche Bank Group.

During the fiscal year, the State Treasurer and borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested in repurchase agreements with approved counterparties collateralized with securities approved by Deutsche Bank Group and marked to market daily at no less than 102%. Because the loans are terminable at will, their duration did not generally match the duration of the investment made with cash collateral. The State Treasurer had no credit risk as a result of its securities lending program as the collateral held exceeded the fair value of the securities lent. For the portion related to the System, securities lending collateral was invested in repurchase agreements and the value of securities on loan for the State Treasurer as of June 30, 2011 and 2010 were $26,414,000 and $22,587,000, respectively. Securities on loan are reported at market value with the exception of U.S. Treasury Bills and U.S. Agency Discount notes which are reported at amortized cost.

Concentration of Credit Risk and Credit Risk for Investments

The ISBI's portfolio of investments 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, 2011 and 2010. The table below presents the quality ratings of debt securities held by the ISBI as of June 30, 2011 and 2010.

	Moody's Quality Rating	2011	2010
U.S. Government and Agency obligations	AAA	$ 1,355,098,991	$ 785,753,044
	A	-	11,999,760
	Not Rated	11,999,760	12,986,508
Total U.S. govt. and agency obligations		$ 1,367,098,751	$ 810,739,312
Foreign govt. obligations	AA	$ 2,972,737	$ 1,601,595
	A	9,187,174	13,951,076
	BAA	-	10,708,205
	BA	7,107,320	11,475,920
	B	17,263,610	5,659,170
	Not rated	1,420,928	1,013,940
Total foreign govt. obligations		$ 37,951,769	$ 44,409,906
Corporate obligations	AAA	$ 17,786,171	$ 43,798,021
	AA	87,458,769	78,359,254
	A	193,686,773	272,476,793
	BAA	99,755,613	201,122,004
	BA	84,923,049	85,333,142
	B	243,240,592	188,825,884
	CAA	11,141,685	38,250,212
	Not rated	24,840,730	17,503,078
Total corporate obligations		$ 762,833,382	$ 925,668,388

Derivative Securities

In fiscal year 2010, the ISBI implemented GASB Statement No. 53 Accounting and Financial Reporting for Derivative Instruments with respect to investments held in derivative securities. A derivative security is an investment whose payoff depends upon the value of other assets such as commodity prices, bond and stock prices, or a market index. The ISBI invests in derivative instruments including forward foreign currency contracts, futures, rights and warrants. The ISBI's derivatives are considered investment derivatives.

Foreign currency forward contracts (FX forwards) are used to protect against the currency risk in the ISBI's foreign equity portfolio. A foreign currency forward contract is an agreement to buy or sell a specific amount of a foreign currency at a specified delivery or maturity date for an agreed-upon price. Fluctuations in the market value of foreign currency forward contracts are marked to market on a daily basis. These investments are reported at fair value in the investment section of the ISBI's Statement of Net Assets. The gain or loss arising from the difference between the original contracts and the closing of such contracts is recognized in the net increase/decrease in the fair value of investments in the ISBI's Statement of Changes in Net Assets.

In May 2011, the ISBI removed language from the investment management agreements allowing managers to hedge foreign currencies and/or to hedge equity positions.

The ISBI's investment managers use financial futures to replicate an underlying security they wish to hold (sell) in the portfolio. In certain instances, it may be beneficial to own a futures contract rather than the underlying security (arbitrage). A financial futures contract is an agreement to buy or sell a specific amount at a specified delivery or maturity date for an agreed-upon price. As the fair values of the futures contract vary from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. The gain or loss is recognized in the net increase/decrease in the fair value of investments in the ISBI's Statement of Changes in Net Assets. Financial futures represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts other than the fair values. The cash or securities to meet these obligations are held in the ISBI's investment portfolio.

Rights and warrants allow the ISBI's investment managers to replicate an underlying security they wish to hold (sell) in the portfolio. Rights and warrants provide the holder with the right, but not the obligation, to buy or sell a company's stock at a predetermined price. Rights usually expire after a few weeks and warrants can expire from one to several years. Under certain circumstances, a type of warrant called Participatory Notes (P-Notes) are used in the portfolio by the ISBI's investment managers that are not registered to trade in domestic Indian Capital Markets. P-Notes are issued by Indian-based brokerage firms against an underlying Indian security permitting holders to get a share in the income from the security. These investments are reported at fair value in the investment section of the ISBI's Statement of Net Assets within the common stock and foreign equity classifications. The gain or loss associated with rights and warrants is recognized in the net increase/decrease in the fair value of investments in the ISBI's Statement of Changes in Net Assets.

The fair values of the forward contracts are estimated based on the present value of their estimated future cash flows. Futures contracts are exchange traded instruments where the fair value is determined by the equilibrium between the forces of supply and demand. The fair value of a right or warrant closely tracks the intrinsic value of the underlying stock and can be determined either by formulaic methodology (most commonly Black-Scholes) or intrinsic value methodology.

Derivative 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. Derivatives which are exchange traded are not subject to credit risk. Market risk is the possibility that a change in interest (interest rate risk) or currency rates (foreign currency risk) 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. These limits are approved by the Board of Trustees and management of the ISBI and the risk positions of the investment managers are reviewed on a periodic basis to monitor compliance with the limits. As of June 30, 2011 and June 30, 2010, the ISBI held no derivatives subject to interest rate risk. The ISBI has not adopted a formal policy specific to master netting arrangements.

The table below presents the investment derivative instruments aggregated by type that were held by the ISBI as of June 30, 2011 and 2010:

	Changes in Fair Value		Fair Value at Year End		Notional Amount *(number of shares)*	
	2011	2010	2011	2010	2011	2010
FX Forwards	$(15,460,385)	$ 4,751,552	$ (353)	$ (266,410)	n/a	n/a
Futures	n/a	n/a	n/a	n/a	65,250	51,300
Rights	840,746	1,184,339	162,133	227,807	901,548	905,044
Warrants	16,898,459	12,100,555	66,421,545	65,373,110	5,272,322	3,391,468
	$ 2,278,820	$ 18,036,446	$ 66,583,325	$ 65,334,507	6,239,120	4,347,812

The ISBI's derivative investments in foreign currency forward contracts are held with counterparties. The credit ratings and net exposure as of June 30, 2011 and 2010 for the counterparties are as follows:

	2011			2010		
Moody's Rating	Fair Value	Net Exposure	Percentage of Net Exposure	Fair Value	Net Exposure	Pecentage of Net Exposure
Aa3	$ 188	$ 188	0.01%	$ -	$ -	-
A3	2,736,018	2,736,018	99.99%	-	-	-
A	-	-	-	2,478,451	2,478,451	97.28%
AA	-	-	-	69,204	69,204	2.72%
	$2,736,206	$ 2,736,206	100.00%	$ 2,547,655	$2,547,655	100.00%

The following are the amounts of foreign investments by the currency in which they are denominated as of June 30, 2011 and 2010:

	2011			2010		
Currency	FX Forwards	Rights	Warrants	FX Forwards	Rights	Warrants
Australian Dollar	$ -	$ -	$ -	$ 367,196	$ -	$ -
Brazilian Real	-	-	-	(510,309)	-	-
Canadian Dollar	-	-	-	(81,756)	-	-
English Pound Sterling	-	-	-	(603,992)	-	-
Euro	(391)	153,078	-	293,614	191,452	722
Hong Kong Dollar	-	9,055	-	-	31,000	18,357
Indian Ruppe	-	-	-	625,478	-	-
Japanese Yen	38	-	-	(2,226)	-	-
Norwegian Krone	-	-	-	-	5,355	-
Singapore Dollar	-	-	-	(991)	-	-
South Korean Won	-	-	-	841	-	-
Swedish Krona	-	-	-	(768)	-	-
Swiss Franc	-	-	-	(353,497)	-	-
Investments denominated in U.S. dollars	-	-	66,421,545	-	-	65,354,031
	$ (353)	$ 162,133	$ 66,421,545	$ (266,410)	$ 227,807	$ 65,373,110

Futures positions held by the ISBI as of June 30, 2011 and 2010

2011	Number of Contracts	Contract Principal*
Equity futures purchased	1,305	$85,836,375

2010	Number of Contracts	Contract Principal*
Equity futures purchased	1,026	$52,664,580

* Contract principal amounts shown represent the market 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 actual recorded values reported in the ISBI's Statement of Net Assets.

Investment Liquidity

The ISBI holds investments in hedge funds, real estate funds, private equity funds and infrastructure funds that are considered illiquid by the very nature of the investment. Market risk exists with respect to these investments as the ISBI may not be able to exit from the investments during periods of significant market value declines.

Investment Commitments

The ISBI's 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 $344 million and $463 million, as of June 30, 2011 and 2010, respectively. Also, at the end of fiscal year 2011 and 2010, the ISBI had outstanding commitments of $321 million and $154 million, respectively, to separate real estate accounts. Also at the end of fiscal year 2011 and 2010, the ISBI had outstanding amounts of $102 million and $147 million, respectively, committed to infrastructure funds. The ISBI would fund outstanding commitments by utilizing available cash and then selling liquid securities in the portfolio as necessary.

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. Certain investments held in infrastructure funds trade in a reported currency of Euro-based dollars valued at $50,878,191 and $34,896,279 as of June 30, 2011 and 2010, respectively. The following table presents the foreign currency risk by type of investment as of June 30, 2011 and 2010:

The ISBI's investments in Private Equity and Real Estate funds represent investment vehicles used for making investments in various equity and debt securities according to the investment strategies as determined by the fund managers at the commencement of the fund.

Investment strategies of Private Equity funds include, but are not limited to, leveraged buyouts, venture capital, growth capital and mezzanine capital.

Investment strategies of Real Estate investments include, but are not limited to, the purchase, development, ownership, management, rental and/or sale of real estate for profit. In May, 2011, RLJ Lodging Fund II, a limited partnership investment, was exchanged

	2011		2010	
Currency	Foreign Equity and Foreign Preferred Securities	Foreign Govt. Obligations	Foreign Equity and Foreign Preferred Securities	Foreign Govt. Obligations
Australian Dollar	$ 109,809,451	$ -	$ 80,124,165	$ -
Brazilian Real	62,981,703	-	52,217,836	-
Canadian Dollar	144,335,493	-	97,585,461	-
Danish Krone	25,279,264	-	29,767,544	-
Egyptian Pound	1,549,693	-	2,121,276	-
English Pound Sterling	388,163,730	-	333,465,799	-
Euro	550,189,912	-	401,821,017	-
Hong Kong Dollar	83,691,016	-	60,278,477	-
Hungarian Forint	1,711,349	-	266,743	-
Indonesian Rupian	1,735,957	-	992,274	-
Israeli Shekel	4,293,903	-	-	-
Japanese Yen	249,633,309	-	222,916,572	-
Mexican Peso	10,577,337	-	5,584,047	-
New Zealand Dollar	4,812,384	-	3,181,046	-
Norwegian Krone	25,479,679	-	15,111,055	-
Singapore Dollar	51,977,284	-	35,452,297	-
South African Rand	11,571,713	-	8,691,759	-
South Korean Won	62,696,222	-	39,303,338	-
Swedish Krona	35,264,901	-	21,927,042	-
Swiss Franc	154,181,296	-	121,970,148	-
Thailand Baht	-	-	1,081,519	-
Foreign investments denominated in U.S. Dollars	215,305,621	37,951,769	199,498,179	44,409,906
Total	$ 2,195,241,217	$ 37,951,769	$ 1,733,357,594	$ 44,409,906

Alternative Investments
The ISBI's investments in hedge funds are structured to achieve a diversified hedged equity fund-of-funds portfolio. Capital is allocated to a select group of hedge fund managers that invest predominately in equity securities, both long and short. The investments shall be managed with the intent of preserving capital in a declining market and in a rising market they will generate a smaller return than the overall equity market.

by the ISBI for 1,035,092 shares of restricted common stock as a result of an initial public offering (IPO) transaction conducted by RLJ Lodging Trust. Due to the fact that this holding is currently restricted for sale as a result of a lock-up agreement in place that specifies that during the period that commences 180 days from the date of the initial IPO the holders of the shares will not, without prior written consent of the underwriting group, directly or indirectly offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant for sale of, or otherwise dispose or transfer such shares. As of June 30, 2011, this holding is an illiquid asset as a result of this restriction. The fair value of these shares at June 30, 2011 is $17,959,548. As a result of the current illiquidity of this investment, the ISBI has determined that it is appropriate to continue to classify the asset as a real estate investment. When the restrictions imposed by the lock-up agreement lapse the ISBI will reclassify the investment as common stock.

The ISBI's investments in infrastructure funds represent pooled investment vehicles used to seek capital appreciation and current income by acquiring, holding, financing, refinancing and disposing of infrastructure investments and related assets. Infrastructure assets include various public works (e.g. bridges, tunnels, toll roads, airports, public transportation and other public works) that are made typically as a part of a privatization initiative on the part of a government entity.

A Commingled fund is a kind of mutual fund or common trust fund which consists of multiple kinds of assets from several accounts combined together. 'Commingling' these separate assets mitigates risk for the trader through investment diversification and reduces the cost of managing each account separately. Commingled funds are also called "pooled funds" and "master trusts".

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 duration between 80% and 120% of the benchmark index.

Duration is the 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 fair value. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. As of June 30, 2011 and 2010, the ISBI benchmarked its debt security portfolio to Barclay's Capital Intermediate U.S. Government/Credit Bond Index. At June 30, 2011 and 2010, the effective duration of the Barclay's Capital Intermediate U.S. Government/Credit Bond Index was 3.9 years. At the same point in time, the effective duration of the ISBI debt security portfolio at June 30, 2011 and 2010 was 4.6 and 3.8 years, respectively. Below is the detail of the duration by investment type as of June 30, 2011 and 2010.

	2011		2010	
Investment Type	Fair Value	Effective Weighted Duration Years	Fair Value	Effective Weighted Duration Years
U.S. Govt. and Agency Obligations				
U.S. Government	$ 479,422,631	6.9	$ 155,303,411	4.8
Agency	887,676,120	3.6	655,435,901	2.3
Foreign Govt. Obligations	37,951,769	4.3	44,409,906	4.9
Corporate Obligations				
Bank & Finance	204,608,577	4.2	246,087,134	4.8
Collateralized Mortgage Obligations	13,492,526	2.1	39,240,826	3.0
Industrials	425,847,041	4.4	496,856,383	4.8
Other	118,885,238	4.2	143,484,045	5.0
Total	$ 2,167,883,902		$1,780,817,606	

Other Information

The System owns approximately 94% of the net investment assets of the ISBI Commingled Fund as of June 30, 2011 and 2010. 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, 2011. A copy of the report can be obtained from the ISBI at 180 North LaSalle Street, Suite 2015, Chicago, Illinois 60601.

5. 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 2011 and 2010 the actuary used the projected unit credit actuarial method for determining the proper employer contribution rate and amount.

For fiscal year 2011 and 2010 the required employer contributions was computed in accordance with the State's funding plan. 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%.

In addition, the funding plan provided for a 15 year phase-in period to allow the state to adapt to the increased financial commitment. Since the 15 year phase-in period ended June 30, 2010, the state's contribution will remain at a level percentage of payroll for the next 35 years until the 90% funded level is achieved.

The funded status of the System as of June 30, 2011, the most recent actuarial valuation date, is in the table below:

The schedule of funding progress, presented as required supplementary information (RSI) following the notes to the financial statements, present multi-year trend information about whether the actuarial values of plan assets are increasing or decreasing over time relative to the AALs for benefits.

Additional information as of the latest actuarial valuation follows:

Valuation date: June 30, 2011

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: 30 years, open
- b. Per state statute: 34 years, closed

Asset valuation method: Fair value, adjusted for any actuarial gains or losses from investment return incurred in the fiscal year recognized in equal amounts over the five year period following that fiscal year.

Actuarial assumptions:

Investment rate of return:	7.75 percent
Projected salary increases: upon member's age	1.0 to 5.35 percent, based
Assumed inflation rate:	3.0 percent
Group size growth rate:	0.0 percent
Post-retirement increase:	Tier 1 - 3.0 percent per year, compounded annually Tier 2 - 3.0 percent per year or one-half of the annual increase in the Consumer Price Index, whichever is less, on the original benefit
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.

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)
$ 11,159,836,617	$ 31,395,007,782	$ 20,235,171,165	35.6%	$4,211,186,269	480.5%

6. 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, 2011 and 2010 totaled $976,988 and $880,127, respectively are included in Administrative Expenses Payable.

7. Property & Equipment

Capital assets over $100 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.

This is a summary of changes in property and equipment assets for 2011 and 2010:

	2011			
Assets	Beginning Balance	Additions	Deletions	Ending Balance
Land	$ 655,241	$ -	$ -	$ 655,241
Land improvements	298,979	-	-	298,979
Building	3,380,093	104,171	-	3,484,264
Equipment	2,311,750	155,124	(188,583)	2,278,291
TOTAL	6,646,063	259,295	(188,583)	6,716,775
Accumulated depreciation				
Land Improvements	(649)	(1,282)	-	(1,931)
Building	(2,178,893)	(116,384)	-	(2,295,277)
Equipment	(1,658,032)	(252,561)	167,374	(1,743,219)
TOTAL	(3,837,574)	(370,227)	167,374	(4,040,427)
Net property and equipment	$2,808,489	$ (110,932)	$ (21,209)	$2,676,348

	2010			
Assets	Beginning Balance	Additions	Deletions	Ending Balance
Land	$ 655,241	$ -	$ -	$ 655,241
Land improvements	250,316	48,663	-	298,979
Building	3,352,428	27,665	-	3,380,093
Equipment	1,945,131	429,910	(63,291)	2,311,750
TOTAL	6,203,116	506,238	(63,291)	6,646,063
Accumulated depreciation				
Land Improvements	(577)	(72)	-	(649)
Building	(2,065,512)	(113,381)	-	(2,178,893)
Equipment	(1,562,268)	(158,876)	63,112	(1,658,032)
TOTAL	(3,628,357)	(272,329)	63,112	(3,837,574)
Net property and equipment	$ 2,574,759	$ 233,909	$ (179)	$2,808,489

8. 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.

As of June 30, 2011 and 2010 the following amounts are included in the System's Statement of Plan Net Assets regarding the collection of bond principal and interest payments:

	2011	2010
Cash - payments collected but not yet remitted to the State of Illinois	$ 2,527,808	$ 2,426,434
Accounts receivable - for June payrolls received in July and August	$ 715,506	$ 955,962
Due to the State of Illinois	$ (3,243,314)	$ (3,382,396)

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 2011 and 2010 payrolls, amounted to $25.7 million for each year. The total amount remitted to the State of Illinois as of June 30, 2011 and 2010 was $22.5 million and $22.3 million, respectively.

9. 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 2011, 2010, and 2009 the employer contribution rates were 27.988%, 28.377%, and 21.049%, respectively. The System's contributions to SERS for fiscal years 2011, 2010, and 2009 were $1,254,741, $1,206,740, and $852,808 respectively, for the general staff. The System's contributions for the electronic data processing staff for fiscal years 2011, 2010, and 2009 were $338,798, $270,504, and $179,993, respectively. These amounts were equal to the required contributions for each fiscal year.

The State provides health, dental, vision, and life insurance benefits for retirees and their dependents in a program administered by the Department of Healthcare and Family Services along with the Department of Central Management Services. Substantially all State employees become eligible for post-employment benefits if they eventually become annuitants of one of the State sponsored pension plans. Health, dental, and vision benefits include basic benefits for annuitants and dependents under the State's self-insurance plan and insurance contracts currently in force. Annuitants may be required to contribute towards health, dental, and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed health care plan. Annuitants who retired prior to January 1, 1998, and who are vested in the State Employee's Retirement System do not contribute towards health, dental, and vision benefits. For annuitants who retired on or after January 1, 1998, the annuitant's contribution amount is reduced five percent for each year of credited service with the State allowing those annuitants with twenty or more years of credited service to not contribute towards health, dental, and vision benefits. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefit becomes $5,000.

The State pays the System's portion of employer costs for the benefits provided. The total cost of the State's portion of health, dental, vision, and life insurance benefits of all members, including post-employment health, dental, vision, and life insurance benefits, is recognized as an expenditure by the State in the Illinois Comprehensive Annual Financial Report. The State finances the costs on a pay-as-you-go basis. The total costs incurred for health, dental, vision, and life insurance benefits are not separated by department or component unit for annuitants and their dependents nor active employees and their dependents.

A summary of post-employment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the Department of Healthcare and Family Services. A copy of the financial statements of the Department of Healthcare and Family Services may be obtained by writing to the Department of Healthcare and Family Services, 201 South Grand Ave., Springfield, Illinois, 62763-3838.

A summary of the administrative expenses of the System for fiscal years 2011 and 2010 are as follows:

	2011	2010
Personal Services	$ 4,464,468	$ 4,248,014
Employee Retirement Pickup	31,159	42,062
Retirement Contributions	1,254,741	1,206,740
Social Security Contributions	331,002	314,861
Group Insurance	1,071,977	947,163
Contractual Services	2,370,364	1,777,453
Travel	24,080	39,497
Commodities	28,453	27,108
Printing	50,517	42,225
Electronic data processing	3,523,259	2,665,507
Telecommunications	76,199	67,333
Automotive	14,301	13,801
Depreciation	370,227	272,329
Other (net)	124,214	56,662
Total	$13,734,961	$ 11,720,755

The state's responsibilities include extending Social Security coverage by agreement to any of the state's retirement systems or units of local government requesting social security or medicare only coverage for their members or employees.

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.

10. 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.

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

	2011	2010
Personal services	$ 45,049	$ 41,465
Retirement contributions	-	3,329
Social Security contributions	3,309	3,122
Contractual services	25,500	25,000
Travel	-	1,161
Commodities	105	243
Electronic Data Processing	-	-
Telecommunications	415	403
Total	$ 74,378	$ 74,723

11. 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, 2011 and 2010

	Participants' Contributions	Interest Accumulations	Other Future Benefits	Total Reserve Balances
Balance at June 30, 2009	$ 2,188,602,984	$ 1,537,128,750	$ 4,752,120,354	$8,477,852,088
Add (deduct):				
Excess revenue over expenses	218,288,124	-	505,690,443	723,978,567
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	(19,811,506)	-	19,811,506	-
Interest credited to members' accounts	-	109,187,475	(109,187,475)	-
Balance at June 30, 2010	$ 2,387,079,602	$ 1,646,316,225	$ 5,168,434,828	$9,201,830,655
Add (deduct):				
Excess revenue over expenses	223,751,499	-	1,545,170,532	1,768,922,031
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	(24,546,691)	-	24,546,691	-
Interest credited to members' accounts	-	87,145,150	(87,145,150)	-
Balance at June 30, 2011	$ 2,586,284,410	$ 1,733,461,375	$ 6,651,006,901	$ 10,970,752,686

12. New Accounting Pronouncements

GASB Statement No. 62, "Codification of Accounting and Financial Reporting Guidance contained in pre-November 1989 FASB and AICPA Pronouncements", was established to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in certain FASB and AICPA pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements. The System is required to implement this Statement for the year ending June 30, 2013.

GASB Statement No. 63, "Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position", was established to provide a framework that specifies where deferred outflows of resources and deferred inflows of resources, assets, liabilities and net position should be displayed on the financial statements. The System is required to implement this Statement for the year ending June 30, 2013.

GASB Statement No. 64, "Derivative Instruments: Application of Hedge Accounting Termination Provisions - An Amendment to GASB Statement No. 53", was established to enhance comparability and improve financial reporting by clarifying the circumstances in which hedge accounting should continue when a swap counterparty, or a swap counterparty's credit support provider, is replaced. The ISBI is required to implement this Statement for the year ending June 30, 2012.

The System's and ISBI's management has not yet completed their assessment of these Statements; however, they are not expected to have a material effect on the overall financial statement presentation.

13. Subsequent Events (Unaudited)

Subsequent to the June 30 fiscal year end, the overall financial markets experienced a decline in value. The decline in the ISBI's investments as of October 31, 2011 is depicted in the strategic asset allocation chart below. The chart represents assets assigned to investment managers within each asset allocation class, not by security type. Therefore, amounts noted below will differ from those as presented in the ISBI's Statement of Plan Net Assets. The chart represents the most current information available for both public and private market investments as compared to June 30, 2011.

	June 30, 2011	October 31, 2011 *	Increase/ (Decrease)	Percentage Increase/ (Decrease)
U. S. Equities	$ 3,380,198,858	$3,241,223,055	$(138,975,803)	(4.11)%
Commingled Funds**	256,817,374	208,080,726	(48,736,648)	(18.98)
Foreign Equity Securities	2,195,201,185	2,002,588,947	(192,612,238)	(8.77)
Foreign Preferred Stock	40,032	206,197	166,165	415.08
Fixed Income	2,167,883,902	1,887,365,453	(280,518,449)	(12.94)
Real Estate**	819,053,366	809,618,861	(9,434,505)	(1.15)
Private Equity**	629,256,286	633,685,952	4,429,666	0.70
Hedge Funds**	1,075,584,754	997,862,476	(77,722,278)	(7.23)
Infrastructure Funds**	417,267,415	479,237,585	61,970,170	14.85
Money Market Instruments	303,501,465	216,097,627	(87,403,838)	(28.80)
Bank Loans**	253,447,070	307,092,370	53,645,300	21.17
Foreign Currency Forward Contracts	(353)	(36,366)	(36,013)	(10,201.98)
Total Investments	$11,498,251,354	$10,783,022,883	$(715,228,471)	(6.22)%

* October 31, 2011 information is based upon best available data on December 1, 2011 as recorded by the ISBI's custodian and is preliminary and unaudited.

** Mark to market adjustments as of September 30, 2011 have been incorporated into the ISBI's custodian data and represents the most recent investment manager mark to market information to date.

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)
6/30/06	$10,899,853,065	$ 20,874,541,910	$ 9,974,688,845	52.2%	$ 3,572,541,000	279.2%
6/30/07	12,078,908,954	22,280,916,665	10,202,007,711	54.2	3,762,777,000	271.1
6/30/08	10,995,366,485	23,841,280,102	12,845,913,617	46.1	3,967,704,000	323.8
6/30/09	10,999,953,527	25,298,346,092	14,298,392,565	43.5	4,027,263,000	355.0
6/30/10	10,961,540,164	29,309,464,296	18,347,924,132	37.4	4,119,360,842	445.4
6/30/11	11,159,836,617	31,395,007,782	20,235,171,165	35.6	4,211,186,269	480.5

** For fiscal years prior to 2009, the actuarial value of assets was equal to the fair value of assets. Beginning in fiscal year 2009, the actuarial value of assets was equal to the fair value of assets adjusted for any actuarial gains or losses from investment return incurred in the fiscal year recognized in equal amounts over the five year period following that fiscal year.*

SCHEDULE OF EMPLOYER CONTRIBUTIONS

Year Ended June 30	Annual Required Contribution per GASB Statement No. 25 (1)	Percentage Contributed	Annual Required Payroll Contribution per State Statute(2)	Percentage Contributed
2006	$ 672,555,569	31.3	$ 207,814,710	100
2007	823,802,760	43.6	361,113,709	99
2008	986,410,891	59.6	576,626,422	102
2009	1,003,432,849	77.2	769,851,595	101
2010	1,177,313,343	93.1	1,093,072,413	100
2011	1,289,002,005	87.5	1,102,783,348	102

(1) This amount includes both payroll and non-payroll employer required contributions.
(2) Employer required contribution determined in accordance with P.A. 88-0593, and P.A. 94-0004 (for Fiscal Years 2006 and 2007 only). These amounts reflect only payroll required contributions.

Notes to Required Supplementary Information

Valuation date: June 30, 2011
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 - 30 years, open
b. Per state statute - 34 years, closed
Asset valuation method - Fair value, adjusted for any actuarial gains or losses from investment return incurred in the fiscal year recognized in equal amounts over the five year period following that fiscal year.
Actuarial assumptions:
Investment rate of return - 7.75 percent
Projected salary increases - 1.0 to 5.35 percent, based upon member's age
Assumed inflation rate - 3.0 percent
Group size growth rate - 0.0 percent
Post-retirement increase - Tier 1 - 3.0 percent per year, compounded annually
Tier 2 - 3.0 percent per year or one-half of the annual increase in the Consumer Price Index, whichever is less, on the original benefit

Mortality: FY2011: Post-Retirement Mortality - RP2000 Combined Health mortality table, sex distinct, with rates projected to 2015 with scale aa. No adjustment is made for post-disabled mortality. The table used is a static table with the provision for future mortality improvement in the projection to 2015, which is in sync with the next scheduled experience study.

Pre-Retirement Mortality - based on 85% for males and 70% for females of post-retirement mortality. Five percent of deaths amongst active employees is assumed to be in the performance of their duty.

FY2010: 1994 Group Annuity Mortality Table for males and females. Five percent of death amongst active employees is assumed to be in the performance of duty.

SUMMARY OF REVENUES BY SOURCE

	2011	2010
Contributions:		
Participants	$ 246,221,470	$ 238,860,138
Repayments of contributions refunded	991,532	911,169
Interest received from participants	6,988,377	6,401,664
Total participants contributions	254,201,379	246,172,971
Employing state agencies and appropriations	438,764,595	372,408,603
Pension Contribution Fund	689,122,201	723,137,253
Total employer contributions	1,127,886,796	1,095,545,856
Investments:		
Net investments income	221,489,114	200,200,994
Interest earned on cash balances	448,284	795,373
Net appreciation in fair value of investments	1,708,270,995	598,899,494
Total investment loss	1,930,208,393	799,895,861
TOTAL REVENUE	$ 3,312,296,568	$ 2,141,614,688

SUMMARY SCHEDULE OF CASH RECEIPTS & DISBURSEMENTS

	2011	2010
Cash balance, beginning of year	$ 49,912,665	$ 232,679,069
Receipts:		
Participant contributions	243,861,823	235,574,760
Employer contributions (net of bond principal and interest transfers)	414,626,625	386,572,210
Pension Contribution Fund	689,122,201	720,745,289
Transfers from Illinois State Board of Investment	857,000,000	600,000,000
Interest income on cash balance	466,694	911,074
Claims receivable payments	6,490,495	6,874,476
Installment payments	4,526,432	4,020,445
Other	304,693	107,455
Total cash receipts	2,216,398,963	1,954,805,709
Disbursements:		
Annuity payments:		
Retirement annuities	1,329,698,219	1,237,349,115
Widow's and Survivor's annuities	95,322,411	89,582,037
Disability benefits	50,000,581	47,201,278
Lump Sum benefits	15,002,758	15,355,322
Refunds (including transfers to reciprocal systems)	18,514,104	15,257,661
Administrative expenses	13,711,269	12,032,748
Transfer to Illinois State Board of Investment	689,122,201	720,793,952
Total cash disbursements	2,211,371,543	2,137,572,113
Cash balance, end of year	$ 54,940,085	$ 49,912,665

SCHEDULE OF PAYMENTS TO CONSULTANTS & ADVISORS

	2011	2010
Legal Services	$ 43,641	$ 39,499
Actuarial Costs	177,677	125,190
Audit Expense	89,132	96,722
Physicians and Disability Inspections	277,791	336,682
Financial Planning	56,787	63,131
Management Consultants	1,160,200	658,058
TOTAL	$ 1,805,228	$ 1,319,282

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

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

As Special Assistant Auditors for the Auditor General, we have audited the financial statements of the State Employees' Retirement System of the State of Illinois (System), as of and for the year ended June 30, 2011 and have issued our report thereon dated January 27, 2012, which contained a reference to the report of 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 Independent Auditor's Report on the 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

Management of the System is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

A deficiency in control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, detect and correct misstatement on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the System's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting of the System that we consider to be material weaknesses, as defined above. However, we identified a certain deficiency in internal control over financial reporting, described in the accompanying schedule of findings and responses as item 11-1, that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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*.

The System's response to the finding identified in our audit is described in the accompanying schedule of findings. We did not audit the System's response and, accordingly, we express no opinion on it.

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

BKD, LLP

January 27, 2012

11-1. Finding – Journal Entry Review

The State Employees' Retirement System (System) does not have a policy or procedure for the review of financial journal entries by a person independent of the person that initiates them.

During our audit testing, we noted the same individual prepares and records the financial journal entries without an independent review by another individual.

The Fiscal Control and Internal Auditing Act (Act) (30 ILCS 10/3001) notes agencies shall establish and maintain a system of internal and fiscal and administrative controls, which shall provide assurance that revenue, expenditures, and transfers of assets, resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports to maintain accountability over the State's resources.

System officials indicated the management staff preparing the journal entries are not involved in the preparation and/or processing of the underlying transactions. Due to the relatively small size of the Accounting Division, however, there has been a lack of appropriate personnel to perform a meaningful review of financial journal entries. However, there is a subsequent, independent review of the System's financial statements on a quarterly basis for potential irregularities.

The lack of an independent review of financial journal entries leaves the System open to risks of error and material misstatement of financial information. (Finding Code No. 11-1)

Recommendation:

We recommend the System develop a policy and procedure for someone independent of the individual preparing and recording financial journal entries to document their review of the financial journal entries and related supporting documentation.

System Response:

The System will reallocate the review function of financial journal entries to other management staff which are independent of the person that initiates them. The System recently hired another management staff member who will provide assistance in the financial journal entry review process. The new process will be incorporated into the System's policy and procedures in fiscal year 2012.