State of Illinois
State Universities Retirement System

(A Component Unit of the State of Illinois)

Auditors' Report and Financial Audit

For the Year Ended June 30, 2006

Performed as Special Assistant Auditors
for the Auditor General, State of Illinois

BKD LLP

State of Illinois
State Universities Retirement System

Financial Audit

For the Year Ended June 30, 2006

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We will issue under a separate cover the Compliance Examination Report for the Year Ended June 30, 2006.

State of Illinois
State Universities Retirement System

Financial Statement Report Summary

June 30, 2006

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

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

Independent Accountants' Report

The Honorable William G. Holland
Auditor General
State of Illinois

Board of Trustees
State Universities Retirement System

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statement of plan net assets of the State of Illinois, State Universities Retirement System (System), a component unit of the State of Illinois, as of June 30, 2006, and the related statement of changes in plan net assets for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year comparative information has been derived from the System's financial statements as of June 30, 2005 and for the year then ended, on which we expressed an unqualified opinion in our report dated October 27, 2005.

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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the System as of June 30, 2006, and the changes in its financial position for the year 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 October 25, 2006 on our consideration of the State of Illinois, State Universities Retirement System's internal control over financial reporting and on 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 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.

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

Our audit was conducted for the purpose of forming an opinion on the financial statements that comprise the System's basic financial statements. The accompanying supporting schedules are presented for purposes of additional analysis and are not a required part of the basic financial statements. The 2006 supporting schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated, in all material respects, in relation to the basic financial statements as of and for the year ended June 30, 2006, taken as a whole. We also have previously audited, 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, the System's basic financial statements as of and for the year ended June 30, 2005, which are not presented with the accompanying financial statements. In our report dated October 27, 2005, we expressed an unqualified opinion on those basic financial statements. In our opinion, the 2005 supporting schedules are fairly stated, in all material respects, in relation to the basic financial statements as of and for the year ended June 30, 2005, taken as a whole.

BKD, LLP

October 25, 2006

Management's Discussion and Analysis

This section presents management's discussion and analysis of the State Universities Retirement System's (SURS or the System) financial statements and the major factors affecting the operations and investment performance of the System during the year ended June 30, 2006, with comparative reporting entity totals for the year ended June 30, 2005.

Overview of Financial Statements and Accompanying Information

- The financial statements presented in this report are the Statement of Plan Net Assets as of June 30, 2006 and the Statement of Changes in Plan Net Assets for the year ended June 30, 2006. These statements present separate totals for the defined benefit plan and the self-managed plan, with reporting entity totals for the years ended June 30, 2006 and 2005. The Statement of Plan Net Assets presents the assets on hand as of June 30, 2006 and available to be used in the payment of benefits. The Statement of Changes in Plan Net Assets presents the additions to and deductions from the plan net assets during the year ended June 30, 2006.

- The notes to the financial statements are an integral part of the financial statements and provide facts and detailed information to assist the reader in understanding the statements. Disclosures include the description of the plan, summary of significant accounting policies, detailed presentations of major assets and liabilities, and discussions of pending litigation and subsequent events impacting the plan.

- Required supplementary information presents schedules related to employer contributions and the funding of the plan.

- Other supplementary schedules consist of detailed information supporting administrative and investment expenses, fees paid to consultants, and a summary of cash receipts and disbursements.

Financial Analysis of the System

The State Universities Retirement System serves 181,140 members in its defined benefit plan and 14,002 members in its self-managed plan. The funds needed to finance the benefits provided by SURS are accumulated through the collection of member and employer contributions and through income on investments. The total net assets of the System increased from $13.7 billion as of June 30, 2005 to $14.6 billion as of June 30, 2006. This increase was chiefly due to net investment income of $1.6 billion, and contributions of $0.5 billion, offset by benefit and other payments of $1.2 billion.

Plan Net Assets

The summary of plan net assets for the System is presented below:

Condensed Statement of Plan Net Assets
Reporting Entity Total (in millions)

	2006	2005	Change Amount	Change %
Cash and short-term investments	$ 934.7	$ 693.6	$ 241.1	34.8
Receivables and prepaid expenses	47.9	54.0	(6.1)	(11.3)
Pending investment sales	248.4	380.2	(131.8)	(34.7)
Investments and securities lending collateral	15,836.9	15,447.1	389.8	2.5
Capital assets, net	8.1	8.9	(.8)	(9.0)
Total assets	17,076.0	16,583.8	492.2	3.0
Bonds and interest payable	–	9.8	(9.8)	(100.0)
Other liabilities	2,456.8	2,873.5	(416.7)	(14.5)
Total liabilities	2,456.8	2,883.3	(426.5)	(14.8)
Total plan net assets	$14,619.2	$13,700.5	$ 918.7	6.7

Management's Discussion and Analysis

Overall, plan net assets increased by $919 million, or 6.7%, chiefly due to investment income and plan contributions of $2.1 billion, offset by benefit and other payments of $1.2 billion. The allocation of investment assets for the plans making up the reporting entity as of June 30, 2006 and 2005 is as follows:

	2006	2005
Defined Benefit Plan		
Equities	65.5%	66.0%
Opportunity Fund	2.5	2.0
Fixed income	22.0	23.5
TIPS*	4.0	4.0
Real Estate Investment Trusts	4.0	2.5
Direct Real Estate	2.0	2.0
Total	100.0%	100.0%
Self-Managed Plan		
Equities	73.0%	72.0%
Fixed income	27.0	28.0
Total	100.0%	100.0%

*TIPS denotes Treasury Inflation Protected Securities

Proper implementation of the investment policy requires that a periodic adjustment, or rebalancing, of assets be made to ensure conformance with policy target levels. SURS rebalancing policy calls for an immediate rebalancing if an asset class exceeds or falls below its target allocation by 3%. The fund did not require a formal rebalancing during the year as the portfolio was kept within its strategic bounds through the use of System cash flows. The allocation of assets within the self-managed plan is totally determined by the individual participants, and also reflects gains over the past year.

The $426 million decrease in liabilities is due to a $376 million decrease in securities lending collateral value as of June 30, 2006, a $40 million decrease in unsettled trades payable, and a $10 million decrease in bonds and interest payable.

Changes in Plan Net Assets

The summary of changes in plan net assets for the System is presented below:

Condensed Statement of Changes in Plan Net Assets
Reporting Entity (in millions)

	2006	2005	Change	
			Amount	%
Employer contributions	$ 209.6	$ 312.8	$ (103.2)	(33.0)
Participant contributions	292.4	285.6	6.8	2.4
Investment income	1,566.8	1,302.0	264.8	20.3
Total additions	2,068.8	1,900.4	168.4	8.9
Benefits	1,086.5	1,005.3	81.2	8.1
Refunds	51.4	43.2	8.2	19.0
Administrative and bond interest expense	12.2	12.8	(0.6)	(4.7)
Total deductions	1,150.1	1,061.3	88.8	8.4
Net increase in plan net assets	$ 918.7	$ 839.1	$ 79.6	9.5

Management's Discussion and Analysis

Additions

Additions to plan net assets are in the form of employer and participant contributions and investment income or losses. For fiscal year 2006, employer contributions decreased by $103 million due to lower contributions from the State of Illinois. Participant contributions increased by $6.8 million, or 2.4% due to salary increases among active members.

The investment income for fiscal year 2006 was $1.57 billion for the System, of which $1.53 billion is attributable to the defined benefit plan and $35 million to the self-managed plan. For the defined benefit plan, the overall return was 11.7% (net of all investment management fees).

Given the long-term orientation of the SURS defined benefit investment program, it is important to track investment returns over several time periods to correctly assess performance. The defined benefit plan returns are as follows:

Time Period	Annualized Return
1-year	11.7%
3-year	13.0%
5-year	6.9%
10-year	8.7%

Deductions

The expenses of the retirement system relate to the provision of retirement annuities and other benefits, refunds to terminated employees, and the cost of administering the System. These expenses for fiscal year 2006 were $1.2 billion, an increase of 8.4% over expenses for 2005. This increase is due to the 8.1% growth in benefits, primarily composed of an increase of 4.9% in the number of retirement annuity recipients and an increase in the average retirement annuity benefit payment of 3.3%. Contribution refunds increased by $8.2 million, or 19% based upon an increase in the average payment of 27.2% and a decrease in the number paid of 6.3%. This higher average payment is a reflection of the increasing number of portable plan vested refunds which include a matching employer portion. Administrative and bond interest expense decreased by 4.7%, primarily related to the decrease in bond interest expense from the bond issue which was paid off in October 2005. Administrative expenses showed no significant change from fiscal year 2005.

Future Outlook

Participant contributions are expected to grow in the future, at least at the pace of wage growth experienced by the employers. The employer contribution, mainly provided by the State of Illinois, will decrease by approximately $180 million or 42% for fiscal year 2007, based upon the provisions of PA 94-0004. This funding bill signed by Governor Blagojevich on June 1, 2005 requires for a departure from the previous funding plan that called for increasing contributions each year, reaching a 90% funding level by 2045. The determination of projected state contributions for fiscal years 2008 and beyond are to return to the plan set out by PA 88-0593 and should be at levels sufficient to fund the employer normal cost while amortizing the unfunded accrued actuarial liability over the period of 2011 to 2045, allowing the System to reach a funding ratio of 90%.

Benefit payments are expected to continue to grow at a rate of approximately 8 –10 % annually as a result of increasing numbers of retirees and the impact of annual salary increases at the participating agencies. Without an increase in the employer contributions as discussed above, the projected deficit of contributions over expenditures is expected to be increasingly negative in future years, forcing the System to liquidate investments to a much greater extent than in the past in order to pay current benefits. SURS will continue to structure its portfolio with the objective of maximizing returns over the long term, taking advantage of investment income to help offset the shortages in employer contributions.

Financial Statements

Statement of Plan Net Assets as of June 30, 2006
With Comparative Reporting Entity Totals as of June 30, 2005

	2006			2005
	Defined Benefit Plan	Self-Managed Plan	Total	Total
Assets				
Cash and short-term investments	$ 934,742,836	$ –	$ 934,742,836	$ 693,592,578
Receivables				
Participants	14,728,054	1,156,021	15,884,075	16,613,644
Federal, trust funds, and other	616,248	937,290	1,553,538	1,463,326
Notes receivable, long-term	616,685	–	616,685	1,857,590
Pending investment sales	248,418,707	–	248,418,707	380,222,473
Interest and dividends	29,784,816	–	29,784,816	34,029,516
Total receivables	294,164,510	2,093,311	296,257,821	434,186,549
Prepaid expenses	18,367	–	18,367	19,530
Investments, at fair value				
Equity investments	9,667,766,558	24,655,972	9,692,422,530	9,160,596,032
Fixed income investments	3,804,222,889	11,856,918	3,816,079,807	3,759,068,138
Real estate investments	131,493,913	76,012	131,569,925	43,258,905
Mutual fund and variable annuities	–	405,332,778	405,332,778	317,175,851
Total investments	13,603,483,360	441,921,680	14,045,405,040	13,280,098,926
Securities lending collateral	1,791,458,483	–	1,791,458,483	2,167,043,809
Capital assets, at cost, net of accumulated depreciation of $16,161,192 and $14,962,725 respectively	8,142,980	–	8,142,980	8,897,568
Total assets	**16,632,010,536**	**444,014,991**	**17,076,025,527**	**16,583,838,960**
Liabilities				
Benefits payable	6,451,829		6,451,829	7,755,235
Refunds payable	5,045,192		5,045,192	3,597,736
Securities lending collateral	1,791,458,483		1,791,458,483	2,167,043,809
Payable to brokers for unsettled trades	643,514,461		643,514,461	683,582,010
Bonds and interest payable	–		–	9,820,360
Administrative expenses payable	10,393,335		10,393,335	11,581,532
Total liabilities	**2,456,863,300**	**–**	**2,456,863,300**	**2,883,380,682**
Net assets held in trust for pension benefits	**$14,175,147,236**	**$444,014,991**	**$ 14,619,162,227**	**$13,700,458,278**

A Schedule of Funding Progress is presented on page 26.
The accompanying notes are an integral part of the financial statements.

Financial Statements

Statement of Changes in Plan Net Assets For the Year Ended June 30, 2006
With Comparative Reporting Entity Totals For the Year Ended June 30, 2005

	2006			2005
	Defined Benefit Plan	Self-Managed Plan	Total	Total
Additions				
Contributions				
Employer	$ 180,018,082	$ 29,633,285	$ 209,651,367	$ 312,834,985
Participant	252,921,802	39,470,386	292,392,188	285,585,320
Total Contributions	432,939,884	69,103,671	502,043,555	598,420,305
Investment Income				
Net appreciation in fair value of investments	1,247,218,217	34,714,729	1,281,932,946	1,073,726,553
Interest	183,792,025	–	183,792,025	137,186,111
Dividends	126,245,756	–	126,245,756	113,089,192
Securities lending	4,525,486	–	4,525,486	4,493,205
	1,561,781,484	34,714,729	1,596,496,213	1,328,495,061
Less investment expense				
Asset management expense	28,813,142	–	28,813,142	25,473,352
Securities lending expense	872,700	–	872,700	1,056,901
Net investment income	1,532,095,642	34,714,729	1,566,810,371	1,301,964,808
Total additions	**1,965,035,526**	**103,818,400**	**2,068,853,926**	**1,900,385,113**
Deductions				
Benefits	1,085,383,795	1,181,623	1,086,565,418	1,005,369,722
Refunds of contributions	42,620,200	8,802,435	51,422,635	43,156,780
Bond interest expense	179,640	–	179,640	692,750
Administrative expense	11,982,284	–	11,982,284	12,087,116
Total deductions	**1,140,165,919**	**9,984,058**	**1,150,149,977**	**1,061,306,368**
Net increase	**824,869,607**	**93,834,342**	**918,703,949**	**839,078,745**
Net assets held in trust for pension benefits				
Beginning of year	13,350,277,629	350,180,649	13,700,458,278	12,861,379,533
End of Year	**$14,175,147,236**	**$444,014,991**	**$14,619,162,227**	**$13,700,458,278**

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

Notes to the Financial Statements

I. Summary of Significant Accounting Policies

A. Reporting Entity

The System is a component unit of the State of Illinois. As defined by accounting principles generally accepted in the United States of America established by the Governmental Accounting Standards Board (GASB), the financial reporting entity consists of a primary government, as well as its component units, which are legally separate organizations for which the elected officials of the primary government are financially accountable, or for which the nature and significance to the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or otherwise incomplete. Financial accountability is defined as:

1. Appointment of a voting majority of the component unit's board and either (a) the ability to impose will by the primary government or (b) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the primary government; or

2. Fiscal dependency on the primary government.

Based upon the required criteria, the System has no component units.

B. Measurement Focus and Basis of Accounting

For both the defined benefit plan and the Self Managed Plan (SMP), the financial transactions are recorded using the economic resources measurement focus and accrual basis of accounting. Member and employer contributions are recognized as revenue when due pursuant to statutory or contractual requirements. Benefits and refunds are recognized as expenses when due and payable in accordance with the terms of the plans.

C. Use of Estimates

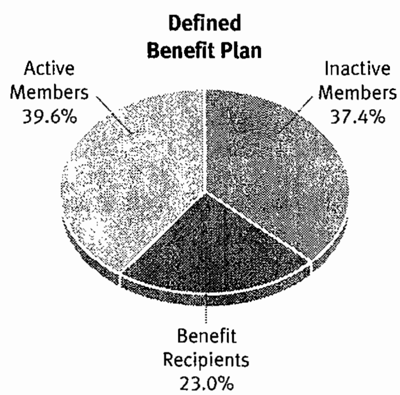
The preparation of the System's financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

D. Description of Plans

Legislation effective January 1, 1998 required State Universities Retirement System (SURS or the System) to introduce a portable benefit package to the existing defined benefit plan and to offer a defined contribution plan. The portable benefit package and the defined contribution plan are available to all participants whose employers elect to make the options available. As of June 30, 2006, the defined benefit plan has two options available. These options are known as the traditional benefit package and the portable benefit package. The defined contribution plan is known as the self-managed plan. The membership, contributions, and benefit provisions related to these plans are presented in the following summary of the provisions of SURS in effect as of June 30, 2006, as defined in the Illinois Compiled Statutes. Interested parties should refer to the SURS Member Guide or the Statutes for more complete information.

1. Defined Benefit Plan

SURS is the administrator of a cost-sharing, multiple-employer public employee retirement system established July 21, 1941 to provide retirement annuities and other benefits for staff members and employees of the state universities, certain affiliated organizations, and certain other state educational and scientific agencies and for survivors, dependents, and other beneficiaries of such employees. SURS is included in the State of Illinois' financial reports as a component unit. SURS is governed by Chapter 40, Act 5, Article 15, of the *Illinois Compiled Statutes.* These statutes assign the authority to establish and amend the benefit provisions of the plan to the State Legislature. Operation of the System and the direction of its policies are the responsibility of the Board of Trustees of the System. It is also these statutes that define the scope of SURS' reporting entity. There are no statutory provisions for termination of the System. The Illinois Constitution provides that the pension obligation of the state *shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.*



At June 30, 2006 and 2005, the number of participating employers was:

	2006	2005
Universities	**12**	12
Community Colleges	**39**	39
Allied Agencies	**15**	15
State of Illinois	**2**	2
	68	68

At June 30, 2006 and 2005, defined benefit plan membership consisted of:

	2006	2005
Benefit Recipients	**41,638**	39,800
Active Members	**71,759**	71,662
Inactive Members	**67,743**	64,658
	181,140	176,120

a. Membership

Participation is required as a condition of employment. Employees are ineligible to participate if (a) employed less than full-time and attending classes with an employer; (b) receiving a retirement annuity from SURS; or (c) excluded by subdivision (a)(7)(f) or (a)(19) of Section 210 of the Federal Social Security Act from the definition of employment given in that Section.

b. Benefit Provisions

Public Act 90-448 was enacted effective January 1, 1998 which established an alternative defined benefit program known as the portable benefit package. This option is offered in addition to the existing traditional benefit option. New employees are allowed 6 months from their date of hire to make an irrevocable election. The benefit provisions for these two defined benefit plan packages are as follows:

SURS provides retirement, disability, death and survivor benefits as authorized in Chapter 40, Act 5, Article 15, of the Illinois Compiled Statutes.

Retirement benefits are payable to participants meeting minimum vesting requirements of 5 years of service credit at age 62, 8 years of service credit at age 55, or 30 years of service credit regardless of age. Under both defined benefit options, the annuity is the larger of (a) a percentage of the average of the highest 4 consecutive years earnings, with the percentage based upon total service credit, or (b) an actuarially determined benefit based upon the total employee and employer contributions and the individual's age at time of retirement. Retirement benefits are payable for life and are subject to a 3 percent compounded increase each January 1.

Disability benefits are payable to all participants with at least 2 years of service credit if they are unable to reasonably perform the duties of their assigned position due to a physical or mental impairment as certified by a physician. The benefit becomes payable when sick leave payments are exhausted or after 60 days of the disability, whichever is later. The benefit is payable at a rate of 50% of the monthly rate of compensation on the date the disability began. Disability benefits are reduced by any payments received under the Workers' Compensation or the Occupational Diseases Act. If a participant remains disabled after receiving the maximum benefits due, they may be eligible for a disability retirement annuity equal to 35% of the monthly rate of compensation on the date the disability began.

Upon termination of service, a lump sum refund is available to all members. Under the traditional benefit package, this refund consists of all member contributions and interest at 4-1/2%. Under the portable benefit package, this refund consists of all member contributions and total interest credited, plus for those members with greater than or equal to 5 years of service credit, an equal amount of employer contributions. Under both defined benefit plan options, a member with 5 or more years of service credit who does not apply for a refund may apply for a normal retirement benefit payable at age 62.

Death benefits are payable to named beneficiaries upon the death of any participant of this System. Under the traditional benefit package, monthly survivor benefits may be paid to eligible survivors if the participant established a minimum of 1.5 years of service credit prior to the date of death. If no qualified survivor exists at the date of retirement, the member is paid a refund of all survivor contributions plus interest. Under the portable benefit package, survivor benefits are available through a reduction of the retirement annuity calculated as described above. No refund of survivor contributions is available if there is no qualified survivor at the time of retirement. These provisions are designed to allow the impact of the portable benefit package's enhanced refund opportunity to be cost neutral.

Upon the death of an annuitant, SURS will pay either a death benefit to a non-survivor beneficiary or a monthly survivor benefit to an eligible survivor. The amount of the monthly survivor benefit will differ depending upon whether the annuitant had selected the traditional benefit package or the portable benefit package.

2. Self-Managed Plan

SURS is the plan sponsor and administrator of a defined contribution plan established as of January 1, 1998 by the Illinois General Assembly as an amendment to the Illinois Pension Code through Illinois Public Act 90-448. This plan is referred to as the self-managed plan (SMP) and is offered to employees of all SURS employers who elect to participate. This plan is a qualified money purchase pension plan under Section 401(a) of the Internal Revenue Code. The assets of the SMP are maintained under a trust administered by the SURS Board of Trustees in accordance with the Illinois Pension Code.

At June 30, 2006 and 2005, the number of SMP participating employers was:

	2006	2005
Universities	**12**	12
Community Colleges	**39**	39
Allied Agencies	**13**	13
State of Illinois	**1**	1
	65	65

At June 30, 2006 and 2005, the SMP membership consisted of:

	2006	2005
Annuity Benefit Recipients	**29**	11
Active Members	**9,110**	8,440
Inactive Members	**4,863**	5,191
	14,002	13,642

a. Membership

A member may elect participation in the SMP if (a) all participation criteria for the defined benefit plan are met; (b) the employer has elected through Board action to offer the self-managed plan; (c) the employee is on active status at the plan offering date; and (d) the employee is not eligible to retire as of the employer plan offering date. The member election is irrevocable. New employees are allowed 6 months from the date of hire in which to make their election. If no election is received, members are considered to be part of the defined benefit plan, under the traditional benefit option.

b. Benefit Provisions

The SMP provides retirement, disability, death, and survivor benefits as authorized in Chapter 40, Act 5, Article 15, of the *Illinois Compiled Statutes*, and amended by Public Act 90-448.

Retirement benefits are payable to participants meeting minimum vesting requirements of 5 years of service credit at age 62, 8 years of service credit at age 55, or 30 years of service credit regardless of age. The distribution options available upon reaching retirement eligibility are the following: a lump sum distribution consisting of all employee and employer contributions and related investment earnings; a single life annuity; a 50% or 100% joint and survivor annuity; a single life annuity with a guaranteed period of 10, 15, or 20 years as elected by the participant; and a 50% or 100% joint and survivor annuity with a guaranteed period of 10, 15, or 20 years as elected by the participant.

Disability benefits are payable to all participants with at least 2 years of service credit if they are unable to reasonably perform the duties of their assigned position due to physical impairment as certified by a physician. The benefit becomes payable when sick leave payments are exhausted or after 60 days of the disability, whichever is later. The benefit is payable at a rate of 50% of the monthly rate of compensation on the date the disability began. Disability benefits are reduced by any payments under the Workers' Compensation or the Occupational Diseases Act.

Upon termination of service with less than 5 years of service credit, a lump sum distribution is available which consists of employee contributions and related investment earnings. The employer contributions and related investment earnings are forfeited. Upon termination of service with greater than 5 years of service credit but where the participant is not yet eligible for retirement, a lump sum distribution is available which consists of employee and employer contributions and related investment earnings.

Death benefits are payable to named beneficiaries upon the death of any participant of this plan. If the participant has less than 1.5 years of service credit, the death benefit payable is the employee contributions and related investment earnings. If the participant has 1.5 or more years of service credit, the death benefit payable is the employee and employer contributions and related investment earnings.

E. Cash and Short Term Investments

Included in the $934,742,836 of cash and short-term investments presented in the statement of plan net assets is $561,778,355 of short-term investments with less than 90 days maturity. For purposes of the various data tables presented in Note III, this group of short-term investments is included as part of fixed income investments. Short-term investments are generally reported at cost, which approximates fair value.

F. Investments

Investments are governed by Chapter 40, Act 5, Articles 1 and 15, of the *Illinois Compiled Statutes.* The most important aspect of the statutes is the prudent expert rule, which establishes a standard of care for all fiduciaries. (A fiduciary is any person who has authority or control with respect to the management or administration of plan assets.) The prudent expert rule states that fiduciaries must discharge their duties with the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use under conditions prevailing at the time.

For the defined benefit plan, investments are reported at fair value. Marketable securities (stocks, bonds, warrants, and options) are traded on public exchanges. The Northern Trust Company, SURS' custodial bank, establishes these prices using third-party pricing services. Generally, these prices are reported at the last reported sales price. Certain investments that do not have an established market value are reported at estimated fair value obtained from a custodial bank or investment management firm. These investments include commingled investment pools, where the underlying assets are individually marked to market (i.e., estimated fair value) on a daily basis and individually traded on publicly recognized exchanges. The investment manager, using methods approved by the CFA Institute (formerly known as the Association for Investment Management Research) or other industry standards, values non-marketable securities (real estate and venture capital). These methods generally include detailed property level appraisals and discounted cash flow analysis.

Notes to the Financial Statements

For the SMP, investments are reported at fair value by the Service Providers. These investments include both mutual and variable annuity funds where the underlying assets are marked to market (i.e., estimated fair value) on a daily basis and individually traded on publicly recognized exchanges. Generally, the prices on the underlying investments are reported at the last reported sales price. Purchases and sales of securities are recorded on a trade-date basis. Interest income is reported on the accrual basis. Dividends are recorded on the ex-dividend date.

G. Capital Assets

Capital assets are depreciated over the estimated useful life of each asset. Annual depreciation is computed using the straight-line method.

H. Administrative Expenses

System administrative expenses (which include amounts for both the defined benefit and self-managed plans) are budgeted and approved by the System's Board of Trustees. Funding for these expenses is included in the employer contribution as determined by the annual actuarial valuation and appropriated by the State of Illinois. This funding is included in the allocation of the state employer contribution recognized in the defined benefit plan. Therefore, expenses to administer the self-managed plan are recognized as administrative expenses in the defined benefit plan in these financial statements.

I. Prior Year Comparative Information

The basic financial statements include certain prior-year summarized comparative information in total but not at the level of detail required for a presentation in conformity with accounting principles generally accepted in the United States of America. Accordingly, such information should be read in conjunction with the System's financial statements as of and for the year ended June 30, 2005, from which the summarized comparative information was derived.

J. Reclassification

Certain reclassifications have been made to the 2005 comparative financial information to conform to the 2006 financial statement presentation. These reclassifications had no affect on net assets.

Notes to the Financial Statements

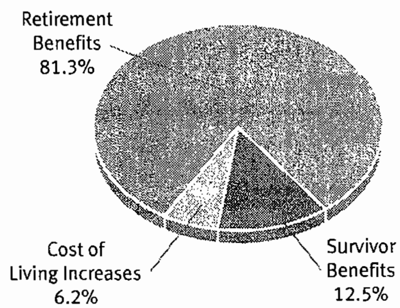
II. Contributions and Net Assets Designations

A. Defined Benefit Plan

1. Membership Contributions

In accordance with Chapter 40, Act 5, Article 15, of the Illinois Compiled Statutes, members of the traditional benefit package contribute 8% of their gross earnings; 6-1/2% of those are designated for retirement annuities, 1/2% for post-retirement increases, and 1% for survivor benefits. Police officers and fire fighters contribute 9-1/2% of earnings; the additional 1-1/2% is a normal retirement contribution. Members of the portable benefit package contribute 8% of their gross earnings; 6-1/2% of those are designated for retirement annuities, 1/2% for post-retirement increases, and 1% for enhanced refund benefits. Police officers and fire fighters contribute 9-1/2% of earnings; the additional 1-1/2% is a normal retirement contribution. These statutes assign the authority to establish and amend the contribution provisions of the plan to the State Legislature. The member contributions are picked up by the employer and treated as employer contributions for income tax purposes. Retirement contributions are based on the gross earnings before the employer pick-up and are included in earnings.

Member Contributions



All contributions on pre-1981 earnings and service credit payments, plus future other public employment, prior service, refund repayments, leave payments, military service payments, and the employee portion of Early Retirement Option payments are considered as previously taxed, unless qualifying funds are rolled over to SURS to make these purchases, or unless the payments are made in installments through employer deductions from payroll. Previously taxed contributions will be recovered tax-free when distributed to the employee in the form of benefits or payments or to his or her beneficiary as a death and/or survivor benefit.

2. Interest Credited on Member Contributions

For the traditional and portable benefit packages, the interest rate credited is fixed by the Board of Trustees and is currently 8.5%. As of July 1, 2006, the rate will remain at 8.5%. For purposes of lump sum refunds to former members, the traditional benefit package offers an interest rate of 4-1/2%, compounded annually, and the portable benefit package offers an interest rate equal to the credited rate, compounded annually. A change brought forth by the enactment of Public Act 94-0004 and effective July 1, 2005 calls for the Comptroller of the State of Illinois to set the interest rate credited to member contribution balances for purposes of the calculation of retirement annuities under the money purchase formula. The Comptroller set that rate at 8.5% for fiscal year 2006, and 8.0% for fiscal year 2007. Members certified after July 1, 2005 will not be eligible for the money purchase formula calculation. Rather, their retirement annuity will be calculated using the general formula.

3. Employer Contributions

On an annual basis, an actuarial valuation is performed in order to determine the amount of statutorily required contributions from the State of Illinois. An actuarial experience study is performed every 5 years to determine the assumptions to be used in the annual valuation. The last actuarial experience study was performed during fiscal year 2002. To determine the funding method, Public Act 88-0593 was passed by the Illinois General Assembly in 1994. This act, which took effect on July 1, 1995, provides a 15-year phase-in to a 35-year plan that requires the state to make continuing appropriations to meet the normal actuarially-determined cost of the System, plus amortize the unfunded accrued liability. Under this plan, the System is expected to be 90% funded by fiscal year 2045.

On June 1, 2005, Governor Blagojevich signed Public Act 94-0004 which impacted state funding and retirement benefit calculations in fiscal year 2006 and beyond. This public act authorizes the following changes. First, it eliminates the money purchase calculation formula for Illinois higher education institution employees hired after June 30, 2005. Second, it transfers responsibility for determining the annual effective rate of interest to be used for the money purchase formula calculation from the SURS Board of Trustees to the State Comptroller. Finally, it required for lower state contributions than the prior funding plan for the fiscal years 2006 and 2007. The decrease in state contributions was $158 million for fiscal year 2006, and will be $140 million for fiscal year 2007.

4. Net Asset Accounts

The System maintains two designated accounts that reflect the assignment of net assets to employee and benefit accounts:

a. The Employee Contribution Account records the pension assets contributed by each employee and the interest income earned by those contributions.

b. The Benefits from Employee and Employer Contributions Account records the net assets available for annuities in force and available for future retirement, death and disability benefits, the undistributed investment income, the unexpended administrative expense allocation, and the variations in actuarial assumptions.

Balances in these designated accounts as of June 30, 2006 are as follows:

Employee contributions	$ 4,957,265,648
Benefits from employee and employer contributions	9,217,881,588
Total Net Assets	**$14,175,147,236**

5. Ownership of Greater than 5 Percent of Net Assets Available for Benefits

In addition to U.S. Government and agency bond issues and treasury notes, there are investments as of June 30, 2006 in Federal National Mortgage Association (FNMA) obligations that represent 5.26% of the System's net assets available for benefits.

B. Self-Managed Plan

1. Membership Contributions

In accordance with Chapter 40, Act 5, Article 15, of the *Illinois Compiled Statutes*, members contribute 8% of their gross earnings. These statutes assign the authority to establish and amend the contribution provisions of the plan to the State Legislature.

The member contributions are picked up by the employer and treated as employer contributions for income tax purposes. Retirement contributions are based on the gross earnings before the employer pick-up and are included in earnings.

Service credit purchase payments are considered as previously taxed, unless qualifying funds are rolled over to SURS to make these purchases. Previously taxed contributions will be recovered tax-free when distributed to the employee in the form of benefits or refunds or to his or her beneficiary as a death and/or survivor benefit.

2. Employer Contributions

In accordance with Chapter 40, Act 5, Article 15, of the *Illinois Compiled Statutes*, employer contributions credited to the SMP participant are at a rate of 7.6% of the participant's gross earnings, less the amount retained by SURS (currently 1%) to provide disability benefits to the participant. The amounts credited are paid into the participant's account. The State of Illinois shall make the employer contribution to SURS on behalf of the SMP participants.

Notes to the Financial Statements

3. Net Asset Accounts
The SMP maintains three designated accounts that reflect the assignment of net assets to employee contributions, disability benefits, and employer forfeiture accounts:

a. The Employee Contribution Account records the pension assets contributed by each employee and the corresponding employer contribution, and the investment income earned by those contributions.

b. The Disability Benefits Account reflects the pension assets contributed by the employer and held to fund member disability benefits.

c. The Employer Forfeiture Account reflects the pension assets contributed by the employer but forfeited from member accounts due to termination prior to reaching 5 years of service. Future employer contributions are reduced by the total forfeitures held by the defined contribution plan.

The assets related to disability benefits and employer forfeitures are commingled with the investment assets of the defined benefit plan. Investment income or loss is credited to these balances based upon the annual investment return or loss of the commingled assets. For fiscal year 2006, the investment income credited to these balances was $3,967,211.

Balances in these designated accounts as of June 30, 2006 are as follows:

Employee contributions	$ 407,428,630
Disability benefits	29,679,890
Employer forfeitures	6,906,471
Total Net Assets	**$ 444,014,991**

4. Ownership of Greater than 5 Percent of Net Assets Available for Benefits
There are no significant investments in any one organization that represent 5% or more of net assets available for benefits.

III. Deposits and Investments

Custodial Credit Risk for Deposits

Custodial credit risk for deposits is the risk that in the event of a financial institution failure, State Universities Retirement System deposits may not be returned. Cash held in the investment related bank account in excess of $100,000 is uninsured and uncollateralized. SURS has no deposit policy for custodial credit risk. Deposits are under the custody of The Northern Trust Company which has a AA- Long Term Deposit/Debt rating by Standard & Poor's, an Aa3 rating by Moody's and an AA- rating by Fitch. At June 30, 2006, the carrying amount of cash was $372,964,480 and the bank balance was $376,546,684, of which $19,913,922 was foreign currency deposits and was exposed to custodial credit risk. The remaining $356,632,762 was made up of short-term invested funds which are considered to be investments for the purpose of assessing custodial credit risk.

Investment Policies

Investments are governed by Chapter 40, Act 5, Articles 1 and 15, of the *Illinois Compiled Statutes*. The most important aspect of the statutes is the prudent expert rule, which establishes a standard of care for all fiduciaries. (A fiduciary is any person who has authority or control with respect to the management or administration of plan assets.) The prudent expert rule states that fiduciaries must discharge their duties with the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use under conditions prevailing at the time. The SURS Board of Trustees has adopted a Statement of Investment Guidelines that contains general guidelines for investments. Within the prudent expert framework, the SURS Board of Trustees establishes specific investment guidelines in the investment management agreement of each individual investment management firm.

Notes to the Financial Statements

Summary of Investment Guidelines

During fiscal year 2006, minor modifications to the SURS asset allocation targets were implemented. These were primarily the result of an asset/liability study completed during the 2004 fiscal year. The System increased its long-term real estate exposure from 2% to 6% with an allocation of 4% Real Estate Investment Trust Securities (REITS) and 2% direct real estate. As of June 30, 2006, the portfolio has attained its target of 6%. This growth in allocation is the result of decreasing its fixed income exposure by a corresponding amount. In addition, the allocation to the Private Equities asset class increased during the year from 3% to 4.5% and the allocation to the Opportunity Fund asset class increased from 2% to 2.5% with funding provided through a corresponding reduction in U.S. equities.

As of June 30, 2006, SURS investment policy targets are 37.5% of the total fund be invested in U.S. equities, 18.5% in non-U.S. equities, 5% in global equities, 4.5% in private equities, 22% in fixed income, 4.0% in treasury inflation protected securities (TIPS), 6% in real estate investment trusts and direct real estate, and 2.5% in the Opportunity Fund.

Investment Objectives

The investment objective of the total portfolio is to produce annualized investment returns, net of all management fees, which exceed the return of a composite market benchmark or policy portfolio. The policy portfolio is comprised of market indices, which are consistent with the overall investment policy. The policy portfolio reflects a passive implementation of the investment policy. The current policy portfolio is comprised of 37.5% of the Wilshire 5000 Stock Index, 18.5% of the Morgan Stanley All Country World Ex-US Index, 5% of the Morgan Stanley World Index, 4.5% of the Wilshire 5000 Stock Index +5%, 22% of the Lehman Brothers Aggregate Bond Index, 4% of the Lehman Brothers U.S. TIPS Index, 4% of the Wilshire Real Estate Securities Index, 2% of the National Council of Real Estate Investment Fiduciaries Open End Index, and 2.5% of the combined benchmarks of the investments in the Opportunity Fund.

Comparisons of total fund performance are also made with a universe of public pension funds implementing generally comparable investment policies. The public pension fund index used for comparative purposes is the Russell/Mellon Public Funds Index.

Investments

The carrying values of investments by type at June 30, 2006 are summarized below:

U.S. equities	$ 8,401,323,090
Non-U.S. equities	1,742,713,472
U.S. private equity	825,206,158
Non-U.S. private equity	3,445,885
Equity futures	(1,280,266,075)
U.S. government obligations	966,305,099
U.S. agency obligations	1,323,685,511
U.S. corporate fixed income	1,878,557,516
U.S. fixed income, other	108,063,589
Non-U.S. fixed income securities	98,471,365
U.S. fixed income derivatives	66,638,082
Non-U.S. fixed income derivatives	258,473,257
U.S. fixed income futures	(66,995,906)
Non-U.S. fixed income futures	(258,473,257)
U.S. short-term investments	(5,190,951)
Non-U.S. short-term investments	56,293
U.S. swaps and options	3,480,406
Non-U.S. swaps and options	4,787,158
Real estate	131,569,925
Self-managed plan mutual funds and variable annuity funds	405,332,778
Total investments	**$ 14,607,183,395**

(a) Fixed income investments presented in this table include $561,778,355 of short-term investments with maturities of less than 90 days which are included in the cash and short-term investments total on the financial statements.
(b) U.S. short-term investments principally consist of money market funds and options.

Notes to the Financial Statements

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty to a transaction, the System will not as of June 30, 2006 be able to recover the value of its investment or collateral securities that are in the possession of an outside party. As of June 30, 2006, SURS has not adopted a formal policy specific to custodial credit risk. At June 30, 2006, no investments were uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the System's name.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss that may be attributed to the magnitude of the System's investment in a single issue. SURS has not adopted a formal policy specific to concentration of credit risk. However, this area is addressed with each of the relevant investment managers in the Investment Management Agreement between the parties. The System's investment portfolios are managed by professional investment management firms. These firms must maintain diversified portfolios and must comply with risk management guidelines specific to each of their investment management agreements. Excluding U.S. government and agency issues, the portfolios are limited to a 5% allocation in any single investment grade U.S. issuer. Allocation limits also apply to international issuers. At June 30, 2006, SURS had investments in Federal National Mortgage Association (FNMA) obligations that represented 5.26% of the System's total investments.

Credit Risk of Debt Securities

Credit risk is the risk that the issuer or other counterparty to an investment will not fulfill obligations. SURS has not adopted a formal policy specific to credit risk of debt securities. However, this area is addressed with each of the relevant investment managers in the Investment Management Agreement between the parties. The quality ratings of investments in fixed income securities of the System as described by Standard & Poor's rating agency at June 30, 2006 are as follows:

Quality Rating: Standard & Poor's	Domestic	International	Total
AAA	$ 2,386,035,605	$ 22,207,494	$ 2,408,243,099
AA+	42,743,913	730,948	43,474,861
AA	176,401,263	2,925,581	179,326,844
AA-	60,849,265	6,667,451	67,516,716
A+	193,875,460	8,388,619	202,264,079
A	47,912,687	2,898,837	50,811,524
A-	28,276,354	8,037,211	36,313,565
BBB+	38,703,844	10,780,612	49,484,456
BBB	66,655,467	15,462,128	82,117,595
BBB-	20,030,310	1,479,768	21,510,078
BB+	15,675,204	1,156,022	16,831,226
BB	21,950,247	4,978,500	26,928,747
BB-	24,591,451	–	24,591,451
B+	3,185,551	239,875	3,425,426
B	37,196,490	114,400	37,310,890
B-	3,047,099	95,625	3,142,724
CCC+	1,356,739	–	1,356,739
CCC	525,834	–	525,834
CCC-	789,508	–	789,508
D	170,413	–	170,413
Not Rated	169,871,902	12,308,294	182,180,196
Total credit risk: debt securities	**$ 3,339,844,606**	**$ 98,471,365**	**$ 3,438,315,971**
U.S. Government Agencies *	972,732,213	–	972,732,213
Total fixed income investments	**$ 4,312,576,819**	**$ 98,471,365**	**$ 4,411,048,184**

* Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The State Universities Retirement System manages its exposure to fair value loss arising from increasing interest rates by diversifying the debt securities portfolio. The System has not adopted a formal policy specific to interest rate risk. However, this area is addressed with each of the relevant investment managers in the Investment Management Agreement between the parties.

At June 30, 2006 the segmented time distribution of the various investment types of debt securities of the System are as follows:

		Maturities in Years				
Type	2006 Fair Value	Less than 1 year	1 to 5 years	6 to 10 years	10 to 20 years	More than 20 years
U.S. Gov't & Agency Fixed Income	$ 2,296,417,724	$205,872,444	$381,180,120	$264,977,018	$ 288,293,865	$1,156,094,277
U.S. Corporate Fixed Income	1,908,095,506	438,903,557	369,604,172	137,802,524	107,366,448	854,418,805
U.S. Fixed Income, Other	108,063,589	2,410,131	3,873,130	101,780,328	–	–
Non-U.S. Fixed Income	98,471,365	23,563,762	29,570,592	14,537,375	9,071,117	21,728,519
Total	**$ 4,411,048,184**	**$670,749,894**	**$784,228,014**	**$519,097,245**	**$404,731,430**	**$2,032,241,601**

Notes to the Financial Statements

Foreign Currency Risk

Foreign currency risk is the risk that changes in currency exchange rates will adversely affect the fair value of an investment or a deposit. SURS has not adopted a formal policy specific to foreign currency risk. The investment policy does state that fund assets are to be diversified to reduce risk. International investment management firms maintain portfolios with diversified foreign currency risk for SURS. The System's exposure to foreign currency risk derives from its positions in foreign currency and foreign currency-denominated equity and fixed income investments. At June 30, 2006 the System's exposure to foreign currency risk is as follows:

Currency	Equity	Fixed Income	Total
Australian dollar	$ 43,121,607	$ 108,277	$ 43,229,884
British pound sterling	234,089,185	(4,763,691)	229,325,494
Canadian dollar	37,742,031	4,336,422	42,078,453
Chinese yuan renminbi	–	7,584,339	7,584,339
Danish krone	1,485,076	6,846	1,491,922
Egyptian pound	–	1,370,552	1,370,552
Euro	428,022,630	10,816,814	438,839,444
Hong Kong dollar	17,706,728	72,468	17,779,196
Japanese yen	235,085,326	45,856,196	280,941,522
Mexican peso	–	3,403	3,403
New Taiwan dollar	2,555,740	418,332	2,974,072
New Zealand dollar	2,320,680	(1,162,809)	1,157,871
Norwegian krone	8,611,026	1,169	8,612,195
Polish zloty	–	20,774	20,774
Russian ruble (new)	–	3,409,944	3,409,944
Singapore dollar	9,174,730	4,681,074	13,855,804
Slovak koruna	–	19,568	19,568
South African rand	5,258,903	–	5,258,903
South Korean won	4,123,816	6,183,475	10,307,291
Swedish krona	29,782,148	435,474	30,217,622
Swiss franc	73,365,831	(2,425,839)	70,939,992
Total securities subject to foreign currency risk	**$1,132,445,457**	**$ 76,972,788**	**$ 1,209,418,245**
Foreign investments denominated in U.S. Dollars	**613,713,900**	**26,342,028**	**640,055,928**
Total foreign investment securities	**$1,746,159,357**	**$ 103,314,816**	**$ 1,849,474,173**

Derivative Securities

The System invests 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 System's investments in derivatives are not leveraged. In the case of an obligation to purchase (long a financial future or a call option), the full value of the obligation is held in cash or cash equivalents. For obligations to sell (short a financial future or a put option), the reference security is held in the portfolio. 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. 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. These limits are approved by the Board of Trustees and senior management, and the risk positions of the investment managers are reviewed on a periodic basis to monitor compliance with the limits. During the year, SURS' derivative investments included foreign currency forward contracts, collateralized mortgage obligations (CMOs), treasury inflation protected securities (TIPS), options, futures, and swaps.

Foreign currency forward contracts are used to hedge against the currency risk in SURS' foreign stock and fixed income security portfolios. 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.

SURS fixed income managers invest in CMOs to improve the yield or adjust the duration of the fixed income portfolio. As of June 30, 2006, the carrying value of the System's CMO holdings totaled $399,342,226.

Treasury inflation protected securities (TIPS) are used by SURS fixed income managers to provide a real return against inflation (as measured by the Consumer Price Index). In addition, SURS employs TIPS at the total fund level in order to utilize their diversification benefits. As of June 30, 2006, the carrying value of the System's TIPS holdings totaled $591,102,473.

SURS 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). Additionally, SURS investment managers use futures contracts to improve the yield or adjust the duration of the fixed income portfolio. 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. Financial future positions are recorded with a corresponding offset, which results in a carrying value equal to zero. As the market value of the futures contract varies from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. The cash or securities to fulfill these obligations are held in the investment portfolio.

SURS investment managers use options in an attempt to add value to the portfolio (collect premiums) or protect (hedge) a position in the portfolio. Financial options are an agreement that gives one party the right, but not the obligation, to buy or sell a specific amount of an asset for a specified price, called the strike price, on or before a specified expiration date. As a writer of financial options, the System receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the financial instrument underlying the option. All written financial options are recognized as a liability on the System's financial statements. As a purchaser of financial options, the System 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.

Notes to the Financial Statements

The following table presents the derivative positions held by SURS as of June 30, 2006:

Derivative Contracts Outstanding

	Number of Contracts	Contractual Principal(a)	Carrying Value(b)
Domestic Index Products			
Equity futures purchased	1,604	$ 514,147,125	$ 514,147,125
Derivative offset	–	–	(514,147,125)
Equity written put options	14	1,400,000	(66,500)
Equity written call options	883	88,300,000	(410,574)
Domestic Interest Rate Products			
Fixed income futures purchased	2,173	217,300,000	337,717,634
Derivative offset	–	–	(337,717,634)
Fixed income futures sold	900	90,000,000	(164,643,875)
Derivative offset	–	–	164,643,875
Fixed income written put options	1,453	145,300,000	(310,679)
Fixed income written call options	1,232	123,200,000	(88,020)
Fixed income purchased put options	218	21,800,000	40,875
International Interest Rate Products			
International fixed income futures purchased	7,862	7,821,009,654	1,851,986,310
Derivative offset	–	–	(1,851,986,310)
International fixed income futures sold	93	82,534,380	(20,899,272)
Derivative offset	–	–	20,899,272
International fixed income written put options	13,702,040	2,053,700,000	(4,177,991)
International fixed income written call options	2,459	2,459,000,000	(83,299)
International fixed income purchased put options	6,600,044	50,600,000	220,815
International fixed income purchased call options	7,202,717	2,728,800,375	292,143
Foreign Currency Products			
Foreign forward currency purchases	–	–	135,980,232
Foreign forward currency sales	–	–	(137,346,429)

a) The contractual principal amounts listed above represent the market value of the underlying assets the derivative contracts control. Contractual principal amounts are often used to express 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. Contractual principal values do not represent actual recorded values.

b) Carrying value for futures in the table above, while shown as zero, is recorded in the financial statements as an asset in an amount equal to the contractual principal and is offset by a corresponding liability.

Securities Lending

The SURS Board of Trustees policies permit the System to lend its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The Northern Trust Company, the System's custodian, lends securities of the type on loan at year end for collateral in the form of cash, irrevocable letters of credit or other securities of 102%, and international securities for collateral of 105%. Cash collateral is shown in the System's financial statements. Securities lent are included in the Statement of Plan Net Assets. At year end, the System has no credit risk exposure to borrowers because the amount the System owes to the borrowers exceeds the amounts the borrowers owe to the System. The contract with the System's custodian requires it to indemnify the System if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay the System for income distributions by the securities' issuers while the securities are out on loan.

All securities loans can be terminated on demand by either the System or the borrower, although the average term of the loans is 128 days. Cash collateral is invested in the lending agent's short-term investment pool, which at year end has a weighted average maturity of 39 days. The relationship between the maturities of the investment pool and the System's loans is affected by the maturities of the securities loans made by other entities that use the agent's pool, which the System cannot determine. The System cannot pledge or sell collateral securities received unless the borrower defaults.

Loans outstanding as of June 30, 2006 *($ millions)*

Market value of securities loaned	$ 1,758.2
Market value of collateral received from borrowers	$ 1,791.8

Self-Managed Plan

The SMP participants have the ability to invest their account balances in 35 mutual and variable annuity funds. These funds are offered by two providers: Fidelity Investments and Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF). As of June 30, 2006, the SMP had investments of $441,921,680. A detailed schedule (unaudited) of the funds and balances at June 30, 2006 is located in the Investment Section of The Comprehensive Annual Financial Report.

IV. Capital Assets

Capital assets activity for the year ended June 30, 2006 was as follows:

	Beginning Balance	Additions	Disposals	Ending Balance
Land	$ 531,834	$ –	$ –	$ 531,834
Office building	6,323,910	–	–	6,323,910
Information system equipment & software	15,060,502	631,931	287,129	15,405,304
Furniture and fixtures	1,944,047	101,632	2,555	2,043,124
	23,860,293	733,563	289,684	24,304,172
Less accumulated depreciation:				
Office building	1,512,231	126,019	–	1,638,250
Information system equipment, software, furniture and fixtures	13,450,494	1,362,132	289,684	14,522,942
	14,962,725	1,488,151	289,684	16,161,192
	$ 8,897,568	$ (754,588)	$ –	$ 8,142,980

Notes to the Financial Statements

The average estimated useful lives for depreciable capital assets are as follows:

Office building	40 years	Information systems equipment	3 years
Information systems software	10 years	Furniture and fixtures	3 years

V. Bonds and Interest Payable

Special Revenue Bonds, Series 1990, Capital Appreciation Bonds (the Bonds), in the principal amount of $10 million, which matured October 1, 2005, with an interest rate of 7.45%, were issued November 15, 1990.

The Bonds were special revenue obligations of the Board of Trustees of the State Universities Retirement System of Illinois issued pursuant to Section 15-167.2 of Chapter 40, Act 5, Article 15, of the Illinois Compiled Statutes, as amended, and a Resolution of the Board. The Bonds were payable solely from and secured by a pledge of and first lien on the net revenues derived from investments of the System. The Bonds were not payable from any employee or employer contributions to the System derived from appropriations from the State of Illinois nor did they constitute obligations or indebtedness of the State of Illinois or of any municipal corporation or other body politic and corporate of the State (other than the Board), and the owners thereof never had the right to demand payment of the Bonds or interest thereon out of any funds other than the revenues and income of the System pledged for payment thereof. The Bonds were not subject to redemption prior to maturity. Regularly scheduled payments on the Bonds were insured under a financial guaranty insurance policy issued by Municipal Bond Investors Assurance Corporation.

Bonds payable and related accrued interest activity for the year ended June 30, 2006 was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
Bonds Payable	$ 9,820,360	$ 179,640	$ 10,000,000	–	–

VI. Compensated Absences and Postemployment Benefits

The System is obligated to pay employees at termination for unused vacation and sick time. The maximum time for which any individual may be paid is 448 hours of vacation and one-half of unused sick time earned between January 1, 1984 and December 31, 1997. No sick time earned after December 31, 1997 will be compensable at termination. At June 30, 2006, the System had a liability of $927,104 for compensated absences, based upon the vesting method used for calculation of sick leave payable. The annual increase or decrease in liability is reflected in the financial statements as an increase or decrease in salary expense.

Compensated absences payable for the year ended June 30, 2006 was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Estimate Amount Due Within One Year
Compensated Absences Payable	$ 841,788	$ 106,180	$ 20,864	$ 927,104	$ 50,000

Notes to the Financial Statements

SURS employees are members of the State Universities Retirement System. In addition to providing pension benefits, the State of Illinois provides certain health, dental, and life insurance benefits to annuitants who are former State employees. This includes annuitants of the State Universities Retirement System. Most State employees, including the System's employees, may become eligible for postemployment benefits if they eventually become annuitants. Health and dental benefits include basic benefits for annuitants under the State's self-insurance plan currently in force. Life insurance benefits for annuitants under age 60 are equal to their annual salary at the time of retirement; for annuitants age 60 or older, life insurance benefits are limited to $5,000 per annuitant.

Currently, the State does not segregate payments made to annuitants from those made to current employees for health, dental, and life insurance benefits. The cost of health, dental, and life insurance benefits is recognized on a pay-as-you-go basis.

VII. Insurance Coverage

The System is exposed to various risk of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The System has minimized the risk of loss through private insurance carriers for commercial, business owners, and automobile policies. The deductible for this insurance coverage ranges from $250 to $500 per occurrence. The System has not experienced a material fluctuation between insurance claims filed and paid in the past three fiscal years.

Required Supplementary Information

Defined Benefit Plan

Schedule of Funding Progress ($ millions)

Fiscal Year	Assets	Accrued Actuarial Liabilities	Unfunded Accrued Actuarial Liabilities	Funding Ratio	Payroll	UAAL as % of Payroll
1998	$ 9,792.0	$ 11,416.1	$ 1,624.1	85.8%	$ 2,377.6	68.3%
1999	10,761.7	12,617.5	1,855.8	85.3%	2,411.1	77.0%
2000	12,063.9	13,679.0	1,615.1	88.2%	2,424.2	66.6%
2001	10,753.3	14,915.3	4,162.0	72.1%	2,474.6	168.2%
2002	9,814.7	16,654.0	6,839.3	58.9%	2,607.2	262.3%
2003	9,714.5	18,025.0	8,310.5	53.9%	2,763.4	300.7%
2004	12,586.3	19,078.6	6,492.3	66.0%	2,814.1	230.7%
2005	13,350.3	20,349.9	6,999.6	65.6%	2,939.1	238.1%
2006	14,175.1	21,688.9	7,513.8	65.4%	3,054.1	246.0%

Schedule of Employer Contributions ($ millions)

Fiscal Year	Total ARC*	Member Contributions	Net ER/State ARC	Actual ER/State Contribution	State Contributions as % of Net ARC	Total Contributions as % of Total ARC
1998	$ 512.1	$ 221.7	$ 290.4	$ 227.7	78.4%	87.8%
1999	509.2	213.0	296.2	237.9	80.3%	88.6%
2000	547.8	222.5	325.3	241.1	74.1%	84.6%
2001	548.1	221.6	326.5	247.1	75.7%	85.5%
2002	686.9	250.0	436.9	256.1	58.6%	73.7%
2003	843.8	246.3	597.5	285.3	47.7%	63.0%
2004	934.8	243.8	691.0	1,757.5	254.4%	214.1%
2005	859.7	251.9	607.8	285.4	47.0%	62.5%
2006	914.9	252.9	662.0	180.0	27.2%	47.3%

* Annual Required Contribution as defined in GASB Statement No. 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans."

Notes to Trend Data

Valuation date	June 30, 2006
Actuarial cost method	Projected unit credit
Amortization method	Level percent of payroll
Remaining amortization period	40 years, open
Asset valuation method	Market value
Actuarial assumptions:	
Investment rate of return	8.5%
Projected salary increases*	5.5% - 9.5%
Postretirement benefits	3.0%

* Includes inflation assumption of 4.0%. A range is presented to address higher increases seen in the earlier years of service.

Supporting Schedules

Defined Benefit Plan
Summary Schedule of Administrative Expenses
For the Years Ended June 30, 2006 and 2005

	2006	2005
Personnel services		
Salary and wages	$ 5,704,875	$ 5,587,523
Retirement contributions	605,751	590,008
Insurance and payroll taxes	1,467,340	1,379,793
	7,777,966	7,557,324
Professional services		
Computer services	431,948	553,737
Medical consultation	55,073	38,206
Technical and actuarial	491,754	569,332
Legal services	208,309	156,996
	1,187,084	1,318,271
Communications		
Postage	272,041	277,650
Printing and copying	134,924	123,864
Telephone	90,890	80,438
	497,855	481,952
Other services		
Equipment repairs, rental and maintenance	106,216	121,816
Building operations and maintenance	232,748	220,608
Surety bonds and insurance	34,081	33,168
Memberships and subscriptions	31,304	36,564
Transportation, travel and conferences	153,325	133,809
Education	19,928	6,461
Supplies	92,716	87,091
	670,318	639,517
Self-managed plan administration		
Salary and wages	195,705	172,634
Retirement contributions	20,201	19,067
Insurance and payroll taxes	45,476	37,631
Technical and actuarial	52,020	41,660
Legal services	8,992	11,591
Postage	25,780	26,180
Printing	13,759	10,470
	361,933	319,233
Depreciation and amortization	1,487,128	1,770,819
Total administrative expenses	**$ 11,982,284**	**$ 12,087,116**

Supporting Schedules

Defined Benefit Plan
Summary Schedule of Consultant Payments
For the Years Ended June 30, 2006 and 2005

	2006	2005
Defined benefit plan		
Technical and actuarial services		
Debbie Allen	$ –	$ 26,328
JP Morgan Chse (formerly BankOne)	34,326	32,977
Berwyn Group	1,743	1,120
DHR International	81,782	61,438
DMA LLC	–	25,831
James Dulebohn	14,200	–
Economic Research	2,973	2,998
Gabriel, Roeder, Smith & Co.	164,051	241,545
International Claims Specialist	–	2,246
International Foundation for Retirement Education	1,425	3,025
Mayer, Brown, Rowe & Maw	45,826	67,534
Northern Illinois University	500	–
Parkland Community College	–	1,000
Smith Investigations	2,982	1,825
Sorling, Northrup, Hanna, Cullen & Cochran, Ltd.	36,010	30,704
The Northern Trust	60,820	55,043
David Whitford	–	1,425
Woolard Marketing Consultants, Inc.	14,879	14,293
Video Production	5,000	–
Miscellaneous	1,122	–
Various- position search costs	24,115	–
	491,754	569,332
Legal services		
Investors Responsibility Support Services	25,000	25,000
Mayer, Brown, Rowe & Maw	114,475	52,582
Thomas, Mamer & Haughey	51,790	59,054
Winters, Featherstun, et al	17,044	20,360
	208,309	156,996
Self-managed plan		
Technical and actuarial services		
Fidelity	43,875	39,920
Ennis & Knupp, Investment Consulting	6,990	–
Inquisite	1,155	–
Morningstar	–	1,740
	52,020	41,660
Legal services		
Mayer, Brown, Rowe & Maw	8,992	11,591
Total consultant payments	**$ 761,075**	**$ 779,579**

Supporting Schedules

Defined Benefit Plan
Summary Schedule of Investment Fees, Commissions, and Administrative Expenses
For the Years Ended June 30, 2006 and 2005

	2006	2005
Master trustee & custodian		
The Northern Trust Company	$ 125,000	$ 125,000
Investment manager firm		
Adams Street Partners	2,095,057	1,952,480
Ariel Capital Management	120,973	110,217
Barclays Global Investors	2,616,944	3,036,604
BlackRock Financial Management	1,392,363	1,495,389
Capital Guardian Trust Company	1,442,715	1,219,147
Fidelity Management Trust Company	310,227	456,646
Genesis Asset Management	4,484	362,951
GlobeFlex Capital	504,030	262,313
ING Clarion Real Estate Securities	889,818	765,494
Manager Development Program	557,454	56,349
Martin Currie, Inc.	1,657,326	1,636,509
Metropolitan West Asset Management	380,522	434,526
Mondrian Investment Partners	443,919	298,583
Muller & Monroe	250,000	–
New Amsterdam Partners	350,512	309,665
Northern Trust Global Advisors	1,027,441	928,897
Northern Trust Investments	251,518	254,292
Pacific Investment Management Company	3.136,751	2,730,111
Pantheon Ventures	2,570,339	1,409,515
Paradigm Asset Management	57,139	–
Payden & Rygel	167,467	138,432
Progress Investment Management Company	1,263,650	1,089,520
Rasara Strategies	358,886	344,591
Rhumbline Advisors	134,349	43,564
Rosenberg Real Estate Equity Funds	3,276,914	1,804,599
Van Wagoner	239,824	1,307,995
Wellington Management Company	1,496,181	1,316,546
Western Asset Management	814,394	732,617
	27,811,197	24,497,552
Investment consultant, measurement & counsel		
Ennis, Knupp & Associates, Inc.	252,954	267,159
Mayer, Brown, Rowe & Maw	62,185	54,123
	315,139	321,282
Investment administrative expenses		
Personnel	446,544	424,432
Resources, board and travel	58,567	54,209
Performance measurement and database	56,695	50,877
	561,806	529,518
Total investment expenses	**$ 28,813,142**	**$ 25,473,352**

Supporting Schedules

Defined Benefit Plan
Summary Schedule of Cash Receipts and Disbursements
For the Year Ended June 30, 2006 ($ millions)

Beginning Cash and Short-Term Investments Balance	$ 693.6
Receipts	
Member contributions	$ 257.0
Employer contributions	180.0
Investment income	1,564.2
Investments redeemed	36,020.4
Total Receipts	$ 38,021.6
Disbursements	
Benefit payments	$ 1,084.0
Administrative expenses	13.7
Bond principal payment	10.0
Investment expenses	26.8
Refunds	42.6
SMP balance transfers	1.7
Investments purchased	36,601.7
Total Disbursements	$ 37,780.5
Ending Cash and Short-Term Investments Balance	**$ 934.7**

Independent Accountants' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on the 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 Universities Retirement System (SURS)

As Special Assistant Auditors for the Auditor General, we have audited the financial statements of the State of Illinois, State Universities Retirement System (System), a component unit of the State of Illinois, as of and for the year ended June 30, 2006 and have issued our report thereon dated October 25, 2006. 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.

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.

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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*.

We noted certain matters that we reported to the Auditor General and System Management in a separate letter dated October 25, 2006.

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.

BKD, LLP

October 25, 2006