

McGladrey & Pullen

Certified Public Accountants

STATE OF ILLINOIS STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

FINANCIAL REPORT
YEARS ENDED JUNE 30, 2007 AND 2006
PERFORMED AS SPECIAL ASSISTANT AUDITORS
FOR THE AUDITOR GENERAL, STATE OF ILLINOIS

TABLE OF CONTENTS

INDEPENDENT AUDITORS' REPORT	1
.....	
MANAGEMENT'S DISCUSSION AND ANALYSIS.....	3
.....	
FINANCIAL STATEMENTS	
Statements of Plan Net Assets.....	5
Statements of Changes in Plan Net Assets	6
Notes to Financial Statements	7
.....	
REQUIRED SUPPLEMENTARY INFORMATION	
Schedule of Funding Progress	18
Schedule of Employer Contributions	18
Notes to Required Supplementary Information	18
.....	
SUPPLEMENTARY FINANCIAL INFORMATION	
Summary of Revenues by Source	19
Summary Schedule of Cash Receipts and Disbursements	19
Schedule of Payments to Consultants and Advisors.....	19
.....	
INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH <u>GOVERNMENT AUDITING STANDARDS</u>	20
CURRENT FINDING	22
.....	
COMPLIANCE EXAMINATION REPORT FOR THE YEAR ENDED JUNE 30, 2007 (issued under separate cover)	

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

FINANCIAL STATEMENTS

JUNE 30, 2007 AND 2006

FINANCIAL STATEMENT REPORT

SUMMARY

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

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

Summary of Finding

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 on page 22 as *Finding 07-1, Lack of Segregation of Duties*. This finding was not considered to be a material weakness.

Exit Conference

The System reviewed the finding and recommendation in this report and waived a formal exit conference. The response to the recommendation was provided by Nicholas C. Merrill, Jr., Chief Fiscal Officer, in an email dated February 11, 2008.

McGladrey & Pullen

Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

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

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

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statements of plan net assets of the State Employees' Retirement System of Illinois (the System), as of June 30, 2007 and 2006 and the related statements of changes in plan net assets for the years then ended, as listed in the table of contents. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of the Illinois State Board of Investment, an internal investment pool of the State of Illinois, which statements represent 98 percent, 98 percent, and 75 percent, respectively, in 2007, and 98 percent, 98 percent, and 72 percent, respectively, in 2006 of total assets, net assets held in trust for pension benefits, and total additions of the System. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Illinois State Board of Investment is based on the report of the other auditors.

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

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the plan net assets of the State Employees' Retirement System of Illinois as of June 30, 2007 and 2006, and the changes in plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated February 8, 2008 on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audits.

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

Our audits were conducted for the purpose of forming an opinion on the basic financial statements of the System for the years ended June 30, 2007 and 2006. The supplementary financial information on page 19 is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplementary financial information on page 19 has been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, based on our audit and the report of other auditors, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

McGladrey & Pullen, LLP

Schaumburg, Illinois
February 8, 2008

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

This section presents management's discussion and analysis of the financial position and performance of the State Employees' Retirement Systems of Illinois (System) for the years ended June 30, 2007 and 2006. 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 nearly 68,000 active state employees and over 55,200 benefit recipients. Throughout this discussion and analysis units of measure (i.e. billions, millions, thousands) are approximate, being rounded up or down to the nearest tenth of the respective unit value.

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

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

OVERVIEW OF THE FINANCIAL STATEMENTS

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

1. Basic Financial Statements. For the fiscal years ended June 30, 2007 and 2006, 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, 2007 and 2006. This financial information also summarizes the changes in net assets held in trust for pension benefits for the years then ended.

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

FINANCIAL HIGHLIGHTS

- The Systems' net assets increased by \$1,179.0 million and \$405.7 million during fiscal years 2007 and 2006, respectively. The increase was primarily due to a \$1,155.2 million and \$383.5 million increase in the System's investments, at fair value, for fiscal years 2007 and 2006, respectively.
- The System was actuarially funded at 54.2% as of June 30, 2007, compared to 52.2% as of June 30, 2006.
- The overall rate of return for the Illinois State Board of Investment (ISBI) Commingled Fund was 17.1% for fiscal year 2007 compared to 11.0% for fiscal year 2006.

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 \$224.7 million and \$214.1 million for the years ended June 30, 2007 and 2006, respectively. Participant contribution rates are set by statute as a percentage of gross salary. Employer contributions increased to approximately \$358.8 million in 2007 from approximately \$210.5 million in 2006. This increase was due to Public Act 94-0004 which was enacted into law on June 1, 2005. This legislation stipulated that state contributions for fiscal year 2006 and 2007 shall be based on specific dollar amounts rather than actuarial calculations.

PLAN NET ASSETS

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

Condensed Statements of Plan Net Assets
(in millions)

	As of June 30			Increase/(Decrease) from	
	2007	2006	2005	2006 to 2007	2005 to 2006
Cash	\$ 249.9	\$ 226.7	\$ 204.5	\$ 23.2	\$ 22.2
Receivables	30.9	29.5	36.9	1.4	(7.4)
Investments, at fair value	11,810.1	10,654.9	10,271.4	1,155.2	383.5
Property & equipment, net	2.7	2.9	3.1	(.2)	(0.2)
Total assets	12,093.6	10,914.0	10,515.9	1,179.6	398.1
Liabilities	14.7	14.1	21.7	.6	(7.6)
Total plan net assets	<u>\$ 12,078.9</u>	<u>\$ 10,899.9</u>	<u>\$ 10,494.2</u>	<u>\$ 1,179.0</u>	<u>\$ 405.7</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS

DEDUCTIONS FROM PLAN NET ASSETS

Deductions from Plan Net Assets are primarily benefit payments. During 2007 and 2006, the System paid out approximately \$1,175.6 million and \$1,124.0 million, respectively, in benefits and refunds, an increase of approximately 4.6%. Those higher payments were mainly due to a scheduled 3% increase in retirement and other benefit payments and the Alternative Retirement Cancellation Payment (ARCP) program. The administrative costs of the System represented approximately 1% of total deductions in both 2007 and 2006.

FUNDED RATIO

The funded ratio of the plan measures the ratio of net assets against actuarially determined liabilities and is one indicator of the fiscal strength of a pension fund's ability to meet obligations to its members. An annual actuarial valuation is required by statute. The most recent available valuation showed the funded status of the System on June 30, 2007 increased to 54.2% from 52.2% at June 30, 2006. Major reasons for the increase were increased employer contributions and investment gains. The amount by which actuarially determined liabilities exceeded net assets was \$10.2 billion at June 30, 2007 compared to \$10.0 billion at June 30, 2006.

INVESTMENTS

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

Net investment income less expenses for the System totaled approximately \$1,779.9 million during fiscal year 2007, versus \$1,113.2 million during fiscal year 2006, resulting in returns of 17.1% and 11.0%, respectively. For the three, five, and ten year period ended June 30, 2007, the ISBI Commingled Fund earned a compounded rate of return of 12.6%, 10.8%, and 8.0%, respectively.

LEGISLATION

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

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

CHANGES IN PLAN NET ASSETS

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

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

	For the Year Ended June 30,			Increase/(Decrease) from	
	2007	2006	2005	2006 to 2007	2005 to 2006
Additions					
Participant contributions	\$ 224.7	\$ 214.1	\$ 209.3	\$ 10.6	\$ 4.8
Employer contributions	358.8	210.5	427.4	148.3	(216.9)
Net investment income	1,779.9	1,113.2	953.6	666.7	159.6
Total additions	<u>2,363.4</u>	<u>1,537.8</u>	<u>1,590.3</u>	<u>825.6</u>	<u>(52.5)</u>
Deductions					
Benefits	1,161.3	1,110.6	1,063.9	50.7	46.7
Refunds	14.3	13.4	14.1	.9	(0.7)
Administrative expenses	8.8	8.1	8.3	.7	(0.2)
Total deductions	<u>1,184.4</u>	<u>1,132.1</u>	<u>1,086.3</u>	<u>52.3</u>	<u>45.8</u>
Net increase/(decrease) in plan net assets	<u>\$1,179.0</u>	<u>\$ 405.7</u>	<u>\$ 504.0</u>	<u>\$ 773.3</u>	<u>\$ (98.3)</u>

FINANCIAL STATEMENTS

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Statements of Plan Net Assets
June 30, 2007 and 2006

	2007	2006
Assets		
Cash	\$ 249,858,696	\$ 226,751,078
Receivables:		
Contributions:		
Participants	12,023,467	13,154,690
Employing state agencies	13,421,494	11,284,318
Other accounts	5,452,610	5,066,573
Total Receivables	<u>30,897,571</u>	<u>29,505,581</u>
Investments - held in the Illinois State Board of Investment Commingled Fund at fair value	<u>11,810,137,495</u>	<u>10,654,863,723</u>
Property and equipment, net of accumulated depreciation	2,670,416	2,886,428
Total Assets	<u>12,093,564,178</u>	<u>10,914,006,810</u>
Liabilities		
Benefits payable	3,769,767	3,611,783
Refunds payable	362,801	232,462
Administrative expenses payable	913,946	990,923
Participants' deferred service credit accounts	334,404	275,865
Due to the State of Illinois	9,274,306	9,042,712
Total Liabilities	<u>14,655,224</u>	<u>14,153,745</u>
Net assets held in trust for pension benefits	<u>\$ 12,078,908,954</u>	<u>\$ 10,899,853,065</u>

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

See accompanying notes to financial statements.

FINANCIAL STATEMENTS

**STATE EMPLOYEES' RETIREMENT SYSTEM
OF ILLINOIS**

Statements of Changes in Plan Net Assets
Years Ended June 30, 2007 and 2006

	2007	2006
Additions:		
Contributions:		
Participants	\$ 224,722,599	\$ 214,108,896
Employing State agencies and appropriations	358,786,650	210,499,791
Total Contributions	583,509,249	424,608,687
Investment income:		
Net investment income	266,766,628	264,013,416
Interest earned on cash balances	12,633,405	8,724,784
Net appreciation in fair value of investments	1,500,507,144	840,493,512
Total net investment income	1,779,907,177	1,113,231,712
Total Additions	2,363,416,426	1,537,840,399
Deductions:		
Benefits:		
Retirement annuities	1,030,284,942	985,503,023
Survivors' annuities	65,215,133	61,100,647
Disability benefits	43,053,148	40,271,558
Lump-sum benefits	22,737,815	23,710,733
Total Benefits	1,161,291,038	1,110,585,961
Refunds (including transfers to reciprocating systems)	14,261,872	13,410,048
Administrative	8,807,627	8,139,278
Total Deductions	1,184,360,537	1,132,135,287
Net Increase	1,179,055,889	405,705,112
Net assets held in trust for pension benefits:		
Beginning of year	10,899,853,065	10,494,147,953
End of year	\$ 12,078,908,954	\$ 10,899,853,065

See accompanying notes to financial statements.

FINANCIAL STATEMENTS

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Notes to Financial Statements June 30, 2007 and 2006

1. Reporting Entity

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

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

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

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

Pursuant to federal tax laws and regulations governing the administration of public employee pension plans, the System has established a separate fund for the sole purpose of disbursing benefits in accordance with Section 415 of the Internal Revenue Code. For fiscal years 2007 and 2006, receipts were approximately \$55,000 and \$60,000, respectively. For fiscal years 2007 and 2006 disbursements were approximately \$46,500 and \$54,000, respectively.

At June 30, 2007 and 2006, the number of participating state agencies, boards and commissions totaled:

	2007	2006
State agencies	37	37
State boards and commissions	41	40
TOTAL	78	77

At June 30, 2007 and 2006, SERS membership consisted of:

Retirees and beneficiaries currently receiving benefits:		
Retirement annuities	42,979	42,676
Survivors' annuities	10,074	10,036
Disability benefits	2,212	2,156
TOTAL	55,265	54,868
Inactive employees entitled to benefits, but not yet receiving them		
TOTAL	4,606	4,605
Current Employees:		
Vested: Coordinated with Social Security	44,151	42,453
Noncoordinated	2,027	1,976
Nonvested: Coordinated with Social Security	20,570	22,726
Noncoordinated	951	920
TOTAL	67,699	68,075

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

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

2. Plan Description

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

a. Eligibility and Membership

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

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

FINANCIAL STATEMENTS

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

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

b. Contributions

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

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

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

c. Benefits

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

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.

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

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

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

3. Summary of Significant Accounting Policies & Plan Asset Matters

a. Basis of Accounting

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

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

b. Cash

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

FINANCIAL STATEMENTS

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

c. New Accounting Pronouncements

In June, 2004, GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions" (OPEB). The statement establishes standards of accounting and financial reporting for OPEB expense/expenditures and related OPEB liabilities or assets, note disclosures, and required supplementary information (RSI) in the financial reports of state and local government employers. The requirements of this statement are effective for periods beginning after December 15, 2006. The first disclosure, if any is required, will be for the year ending June 30, 2008.

In May, 2007, GASB issued Statement No. 50, "Pension Disclosures - an amendment of GASB Statements No. 25 and No. 27". This statement modifies and enhances note disclosure and required supplementary information (RSI) by pension plans and employers that provide pension benefits. The requirements of this statement are effective for periods beginning after June 15, 2007. The first disclosure will be for the year ending June 30, 2008.

d. Investments

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

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

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

Investments owned are reported at fair value as follows: (1) U.S. Government and Agency, Foreign and Corporate Obligations, Convertible Bonds - prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, Convertible Preferred Stock, Preferred Stock, Foreign Equity Securities, Forward Foreign Currency Contracts and Options: (a) Listed - closing prices as reported on the composite summary of national securities exchanges; (b) Over-the-counter - bid prices; (3) Money Market Instruments - average cost which approximates fair values; (4) Real Estate Investments - fair values as determined by the ISBI and its investment managers; and (5) Alternative Investments (Private Equity, Hedge Funds, and Infrastructure 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.

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

	June 30, 2007	June 30, 2006
Government and agency obligations	\$ 1,184,275,884	\$ 1,110,919,988
Foreign obligations	72,189,687	104,455,671
Corporate obligations	1,228,970,012	1,382,574,163
Common stock & equity funds	6,059,409,027	5,369,124,032
Preferred stock	1,865,020	1,057,334
Foreign equity securities	1,365,647,941	1,113,268,102
Hedge Funds	496,404,578	416,462,183
Real estate investments	1,189,614,911	1,134,025,154
Private Equity	563,366,021	482,264,036
Money market instruments	535,699,912	320,641,552
Infrastructure funds	108,436,449	-
Forward foreign exchange contracts	(108,696)	26,145
Total investments	<u>\$ 12,805,770,746</u>	<u>\$11,434,818,360</u>

FINANCIAL STATEMENTS

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. Cash held in the investment related bank account by ISBI is neither insured nor collateralized for amounts in excess of \$100,000. During fiscal year 2007, a Credit Risk Policy was implemented by the ISBI staff and formally adopted by the ISBI Board in July, 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. State Street Bank and Trust has a AA Long-term Deposit/Debt rating by Standard & Poor's and an Aa1 rating by Moody. Certain investments of the ISBI with maturities of 90 days or less would be considered cash equivalents; these consist of short-term investment funds and U.S. Treasury bills with maturities of 90 days or less. For financial statement presentation and investment purposes, the ISBI reports its cash equivalents as Money Market Instruments within their investments. The table at the top of the next column discloses the deposits held by the ISBI at June 30, 2007 and 2006, and the portion of those deposits exposed to custodial credit risk.

Carrying amount of Cash

June 30, 2007 June 30, 2006

Bank balance total

\$ 42,916,419 \$ 80,644,137

Amount exposed to custodial credit risk

\$ 43,068,157 \$ 80,724,748

\$ 42,920,664 \$ 80,566,513

Custodial Credit Risk for Investments

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the ISBI will not be able to recover the value of investments or collateral securities that are in the possession of an outside party. As of June 30, 2007 and 2006, the investments listed in the table below were uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the ISBI's name:

	2007	2006
Common stock	\$ 3,423,509	\$ 7,540,275
Government and agency obligations	28,351,415	43,932,397
Corporate obligations	2,152,096	4,649,641
Total	\$ 33,927,020	\$ 56,122,313

Interest Rate Risk

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

interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. The ISBI benchmarks its debt security portfolio to Lehman Brothers Aggregate. At June 30, 2007 and 2006, the effective duration of the Lehman Brothers Aggregate was 3.7 years and 3.6 years, respectively. The effective duration of the ISBI debt security portfolio at June 30, 2007 and 2006 was 3.3 years and 3.8 years, respectively.

Duration is a measure of a debt investment's exposure to fair value changes arising from changing

Investment Type	2007		2006	
	Fair Value	Effective Weighted Duration Years	Fair Value	Effective Weighted Duration Years
Government & agency obligations				
U.S. Treasury	\$ 317,358,768	4.8	\$ 457,091,471	4.4
Federal agency	866,917,116	1.6	651,140,066	3.3
Municipal	-	N/A	2,688,451	4.8
Foreign obligations	72,189,687	4.5	104,455,671	5.1
Corporate obligations				
Finance	256,092,972	3.7	306,124,824	3.4
Mortgage backed securities	170,384,277	2.4	211,686,803	2.1
Industrials	531,051,552	5.1	580,581,651	4.7
Commingled funds	23,679,106	N/A	40,713,286	N/A
Other	247,762,105	3.6	243,467,599	5.5
	<u>\$ 2,485,435,583</u>		<u>\$ 2,597,949,822</u>	

FINANCIAL STATEMENTS

	Moody's Quality Rating	2007	2006
Government and agency obligations			
U.S. Government obligations	AAA	\$ 317,358,768	\$ 457,091,471
Federal agency obligations	AAA	866,917,116	651,140,066
Municipal	AAA	-	2,688,451
Total Government and agency obligations		<u>\$ 1,184,275,884</u>	<u>\$ 1,110,919,988</u>
Foreign obligations			
	AAA	\$ 16,064,111	\$ 16,124,526
	AA	4,407,275	4,040,041
	A	5,363,202	16,276,367
	BAA	17,202,270	27,419,722
	BA	15,153,571	12,024,660
	B	3,348,055	19,290,811
	CAA	-	1,274,200
	Not rated	10,651,203	8,005,344
Total foreign obligations		<u>\$ 72,189,687</u>	<u>\$ 104,455,671</u>
Corporate obligations			
	AAA	\$ 254,534,185	\$ 324,130,117
	AA	122,242,182	144,481,958
	A	132,484,746	148,904,618
	BAA	111,327,503	115,363,940
	BA	183,959,419	238,778,065
	B	262,208,497	274,358,266
	CAA	50,779,805	14,129,168
	CA	907,309	682,031
	C	683,890	461,236
	Not rated	109,842,476	121,284,764
Total corporate obligations		<u>\$ 1,228,970,012</u>	<u>\$ 1,382,574,163</u>

Concentration of Credit Risk and Credit Risk for Investments

The ISBI's portfolio is managed by professional investment management firms. These investment management firms are required to maintain diversified portfolios. Each investment manager must comply with risk management guidelines individually assigned to them as part of their Investment Management Agreement. The ISBI did not have any single issuer investment that exceeded 5% of the total net assets of the fund as of June 30, 2007 and 2006. The table at left presents the quality ratings of debt securities held by the ISBI as of June 30, 2007 and 2006.

Securities Lending

The ISBI participates in a securities lending program with State Street who acts as securities lending agent. Securities are loaned to brokers and, in return, the ISBI has rights to a portion of a collateral pool. All of the securities are eligible for the securities lending program. Collateral consists solely of cash, letters of credit, commercial paper and government securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-U.S. securities). In the event of borrower default, State Street provides the ISBI with counterparty default indemnification. The ISBI had no credit risk as a result of its securities lending program as the collateral

held exceeded the fair value of the securities lent. As of June 30, 2007 and 2006, there were outstanding loaned investment securities having fair values of \$2,129,513,426 and \$1,568,683,721, respectively; against which collateral was received with a fair value of \$2,189,767,674 and \$1,597,656,445, respectively. Collateral received at June 30, 2007 and 2006 consisted of \$2,084,820,497 and \$1,530,783,382, respectively, in cash and \$104,947,177 and \$66,873,063, respectively, in securities for which the ISBI does not have the ability to pledge or sell.

FINANCIAL STATEMENTS

Derivative Securities

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

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

Forward foreign currency contracts are used to hedge against the currency risk in the ISBI's foreign stock and fixed income portfolios. Forward foreign currency contracts are agreements to buy or sell specific amounts of a foreign currency at a specified delivery or maturity date for an agreed upon price. As the fair value of the forward contracts varies, the ISBI records an unrealized gain or loss. Forward foreign currency contracts represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts. The fair value of forward foreign currency contracts outstanding at June 30, 2007 and 2006, is shown in the table on the right.

The ISBI also invests in mortgage-backed securities to maximize yields and to

hedge against a rise in interest rates. These securities are based on cash flows from principal and interest payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. As of June 30, 2007 and 2006, the fair value of the ISBI's CMO holdings totaled \$170,384,277 and \$211,686,803, respectively.

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

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

	Cost	Fair Value	Gain/(Loss)
As of June 30, 2007			
Forward currency purchases	\$1,559,632	\$1,550,171	\$ (9,461)
Forward currency sales	7,691,150	7,790,385	(99,235)
Total gain/(loss)			<u>\$ (108,696)</u>
	Cost	Fair Value	Gain/(Loss)
As of June 30, 2006			
Forward currency purchases	\$3,956,106	\$4,008,201	\$ 52,095
Forward currency sales	7,860,622	7,886,572	(25,950)
Total gain/(loss)			<u>\$ 26,145</u>

FINANCIAL STATEMENTS

Futures and options positions held by the ISBI as of June 30, 2007 and 2006

	2007		2006	
	Number of Contracts	Contract Principal*	Number of Contracts	Contract Principal*
Equity futures purchased	2,169	\$ 168,891,330	2,667	\$ 190,210,548
Fixed income futures purchased	609	77,268,953	1,605	269,684,894
Fixed income futures sold	1,333	248,776,093	355	37,149,313
Fixed income written put options	78	33,000,000	71	7,100,000
Fixed income written call options	209	74,900,000	320	122,900,000
Eurocurrency purchased call options	-	-	23,550,000	23,550,000
Fixed income purchased put options	-	-	58	58,000,000
Fixed income purchased call options	241	241,000,000	-	-

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

Investment Commitments

The ISBI'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 \$369 million and \$400 million, as of June 30, 2007 and 2006, respectively. Also, at the end of fiscal years 2007 and 2006, the ISBI had outstanding commitments of \$311 million and \$567 million, respectively, to separate real estate accounts.

Foreign Currency Risk

The ISBI's international portfolio is constructed on the principles of diversification, quality growth and value. Risk of loss arises from changes in currency exchange rates. International managers may also engage in transactions to hedge currency at their discretion. The table below presents the foreign currency risk by type of investment as of June 30, 2007 and 2006.

	2007		2006	
	Foreign Equity Securities	Foreign Obligations	Foreign Equity Securities	Foreign Obligations
Australian Dollar	\$ 72,095,189	\$ -	\$ 45,031,863	\$ -
Canadian Dollar	25,401,638	671,932	27,309,690	-
Danish Krone	14,131,867	-	11,811,080	-
English Pound Sterling	245,374,152	-	208,671,160	-
Euro Currency	434,344,665	-	298,835,278	2,773,684
Hong Kong Dollar	49,855,829	-	48,639,162	-
Malaysian Ringgit	-	5,818,897	-	-
Japanese Yen	276,514,350	4,526,106	272,057,458	-
Iceland Krona	-	2,274,574	-	-
Mexican Peso	-	4,468,150	-	147,648
New Zealand Dollar	-	1,492,263	767,645	2,205,864
Norwegian Krone	13,319,542	-	9,864,745	-
Singapore Dollar	24,082,058	5,774,393	9,200,224	-
South African Rand	-	2,954,509	-	-
South Korean Won	29,407,763	-	22,537,972	-
Swedish Krona	33,723,011	-	29,340,607	-
Swiss Franc	69,190,076	-	54,417,316	-
Foreign investments denominated in U.S. Dollars	78,207,801	44,208,863	74,783,902	99,328,475
Total	\$ 1,365,647,941	\$ 72,189,687	\$ 1,113,268,102	\$ 104,455,671

FINANCIAL STATEMENTS

Other Information

The System owns approximately 94% of the net investment assets of the ISBI Commingled Fund as of June 30, 2007 and 2006. A schedule of investment expenses is included in the ISBI's annual report.

For additional information on ISBI's investments, please refer to their Annual Report as of June 30, 2007. A copy of the report can be obtained from the ISBI at 180 North LaSalle Street, Suite 2015, Chicago, Illinois 60601.

e. Actuarial Experience Review

In accordance with Illinois Compiled Statutes, an actuarial experience review is to be performed at least once every five years to determine the adequacy of actuarial assumptions regarding the mortality, retirement, disability, employment, turnover, interest and earnable compensation of the members and beneficiaries of the System. An experience review was last performed as of June 30, 2005.

f. Administrative Expenses

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

g. Risk Management

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

h. Use of Estimates

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

i. Reclassifications

Certain fiscal year 2006 amounts have been reclassified to conform to the fiscal year 2007 presentation. These reclassifications have not changed the fiscal year 2006 results.

4. Funding - Statutory Contributions Required & Contributions Made

On an annual basis, a valuation of the liabilities and reserves of the System is performed by the System's actuarial consultants in order to determine the amount of contributions statutorily required from the State of Illinois. For fiscal years 2007 and 2006 the actuary used the projected unit credit actuarial method for determining the proper employer contribution rate and amount.

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

For fiscal year 2008 the required employer contributions will be computed in accordance with Public Act 88-0593 as modified by Public Act 93-0002. This funding legislation provides for a systematic 50 year funding plan with an ultimate goal to fund the cost of maintaining and administering the System at an actuarial funded ratio of 90%.

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

5. Accrued Compensated Absences

Employees of the System are entitled to receive compensation for all accrued but unused vacation time and one-half of all unused sick leave earned on and after January 1, 1984 and before January 1, 1998 upon termination of employment. These accrued compensated absences as of June 30, 2007 and 2006 totaled \$798,426 and \$831,345, respectively are included in Administrative Expenses Payable.

FINANCIAL STATEMENTS

This is a summary of changes in property and equipment assets for 2007 and 2006:

	2007			
	Beginning Balance	Additions	Deletions	Ending Balance
Assets				
Land	\$ 655,241	\$ -	\$ -	\$ 655,241
Land improvements	250,316	-	-	250,316
Building	3,352,428	-	-	3,352,428
Equipment	2,220,233	63,256	(167,942)	2,115,547
TOTAL	<u>6,478,218</u>	<u>63,256</u>	<u>(167,942)</u>	<u>6,373,532</u>
Accumulated depreciation				
Land Improvements	(363)	(71)	-	(434)
Building	(1,725,366)	(113,382)	-	(1,838,748)
Equipment	(1,866,061)	(165,099)	167,226	(1,863,934)
TOTAL	<u>(3,591,790)</u>	<u>(278,552)</u>	<u>167,226</u>	<u>(3,703,116)</u>
Net property and equipment	<u>\$2,886,428</u>	<u>\$ (215,296)</u>	<u>\$ (716)</u>	<u>\$2,670,416</u>
	2006			
	Beginning Balance	Additions	Deletions	Ending Balance
Assets				
Land	\$ 655,241	\$ -	\$ -	\$ 655,241
Land improvements	250,316	-	-	250,316
Building	3,352,428	-	-	3,352,428
Equipment	2,209,825	84,843	(74,435)	2,220,233
TOTAL	<u>6,467,810</u>	<u>84,843</u>	<u>(74,435)</u>	<u>6,478,218</u>
Accumulated depreciation				
Land Improvements	(292)	(71)	-	(363)
Building	(1,611,984)	(113,382)	-	(1,725,366)
Equipment	(1,784,085)	(156,388)	74,412	(1,866,061)
TOTAL	<u>(3,396,361)</u>	<u>(269,841)</u>	<u>74,412</u>	<u>(3,591,790)</u>
Net property and equipment	<u>\$3,071,449</u>	<u>\$ (184,998)</u>	<u>\$ (23)</u>	<u>\$2,886,428</u>

6. Property & Equipment

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

7. Collection and Remittance of Bond and Interest Payments

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

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

The total debt service payments received for all fiscal year 2007 and 2006 payrolls, amounted to \$72.7 million and \$70.6 million, respectively. The total amount remitted to the State of Illinois as of June 30, 2007 and 2006 was \$63.4 million and \$61.7 million, respectively.

As of June 30, 2007, the following amounts are included in the System's Statement of Plan Net Assets regarding the collection of bond principal and interest payments:

FINANCIAL STATEMENTS

	2007	2006
Cash - payments collected but not yet remitted to the State of Illinois	<u>\$ 7,029,044</u>	<u>\$ 6,183,979</u>
Accounts receivable - for June payrolls received in July and August	<u>\$ 2,245,262</u>	<u>\$ 2,858,733</u>
Due to the State of Illinois	<u>\$ (9,274,306)</u>	<u>\$ (9,042,712)</u>

8. Administrative Expenses & Other Post-Employment Benefits

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

The System pays employer retirement contributions based upon an actuarially determined percentage of its payrolls. For fiscal years 2007, 2006, and 2005 the employer contribution rates were 11.525%, 7.792%, and 16.107%, respectively. The System's contributions to SERS for fiscal years 2007, 2006, and 2005 were \$397,983, \$252,355, and \$500,477 respectively, for the general staff. The System's contributions for the electronic data processing staff for fiscal years 2007, 2006, and 2005 were \$114,204, \$70,438, and \$142,816, respectively. These amounts were equal to the required contributions for each fiscal year.

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

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

Costs incurred for health, dental and life insurance for annuitants and their dependents were not separated from benefits provided to active employees and their dependents for the year ended June 30, 2007. However, post-employment costs for the State as a whole

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

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

A summary of the administrative expenses of the System for fiscal years 2007 and 2006 are as follows:

	2007	2006
Personal Services	\$ 3,450,579	\$ 3,235,537
Employee Retirement Pickup	39,467	108,812
Retirement Contributions	397,983	252,355
Social Security Contributions	255,791	241,079
Group Insurance	850,328	868,983
Contractual Services	1,338,551	1,352,042
Travel	43,884	45,970
Commodities	21,472	21,844
Printing	31,553	55,944
Electronic data processing	2,048,396	1,570,156
Telecommunications	63,704	61,765
Automotive	16,686	20,535
Depreciation	278,553	269,841
Other (net)	(29,320)	34,415
Total	<u>\$ 8,807,627</u>	<u>\$ 8,139,278</u>

9. Social Security Division - Administrative Expenses

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

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

FINANCIAL STATEMENTS

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

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

	2007	2006
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.		
Personal services	\$ 46,800	\$ 43,809
Retirement contributions	5,394	3,413
Social Security contributions	3,459	3,238
Contractual services	17,300	17,750
Travel	1,143	1,167
Commodities	176	188
Telecommunications	535	354
Total	<u>\$ 74,807</u>	<u>\$ 69,919</u>

10. Analysis of Changes in Reserve Balances

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

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

State Employees' Retirement System Statements of Changes in Reserve Balances Years Ended June 30, 2007 and 2006

	Participants' Contributions	Interest Accumulations	Other Future Benefits	Total Reserve Balances
Balance at June 30, 2005	\$ 1,683,382,315	\$ 1,098,150,098	\$ 7,712,615,540	\$10,494,147,953
Add (deduct):				
Excess revenue over expenses	186,684,209	-	219,020,903	405,705,112
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	(50,167,965)	-	50,167,965	-
Interest credited to members' accounts	-	115,074,193	(115,074,193)	-
Balance at June 30, 2006	<u>\$ 1,819,898,559</u>	<u>\$ 1,213,224,291</u>	<u>\$ 7,866,730,215</u>	<u>\$10,899,853,065</u>
Add (deduct):				
Excess revenue over expenses	196,457,605	-	982,598,284	1,179,055,889
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	(64,379,988)	-	64,379,988	-
Interest credited to members' accounts	-	114,210,259	(114,210,259)	-
Balance at June 30, 2007	<u>\$ 1,951,976,176</u>	<u>\$ 1,327,434,550</u>	<u>\$ 8,799,498,228</u>	<u>\$12,078,908,954</u>

REQUIRED SUPPLEMENTARY INFORMATION

SCHEDULE OF FUNDING PROGRESS

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) - Projected Unit Credit (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage Covered Payroll ((b-a)/c)
6/30/02	\$ 7,673,892,691	\$ 14,291,044,457	\$ 6,617,151,766	53.7	3,713,020,000	178.2%
6/30/03	7,502,111,416	17,593,980,039	10,091,868,623	42.6	3,639,334,000	277.3
6/30/04	9,990,186,874	18,442,664,834	8,452,477,960	54.2	3,439,251,000	245.8
6/30/05	10,494,147,953	19,304,646,648	8,810,498,695	54.4	3,475,528,000	253.5
6/30/06	10,899,853,065	20,874,541,910	9,974,688,845	52.2	3,572,541,000	279.2
6/30/07	12,078,908,954	22,280,916,665	10,202,007,711	54.2	3,762,777,000	271.1

SCHEDULE OF EMPLOYER CONTRIBUTIONS

Year Ended June 30	Annual Required Contribution per GASB Statement No. 25 ⁽¹⁾	Percentage Contributed	(A) Annual Required Payroll Contribution per State Statute ⁽³⁾	(B) State Pension Fund Contribution	(A) + (B) Total Required State Contribution	Percentage Contributed
2002	\$ 306,509,801	126.0%	\$ 372,787,208	\$ 10,290,000	\$ 383,077,208	100%
2003	449,348,569	88.1	375,615,662	17,195,000	392,810,662	100
2004	576,219,951	83.1 ⁽²⁾	462,200,942	15,150,000 ⁽⁴⁾	477,350,942	100 ⁽²⁾
2005	727,428,010	58.8	425,682,669	-	425,682,669	100
2006	672,555,569	31.3	207,814,710	-	207,814,710	100
2007	823,802,760	43.6	361,113,709	-	361,113,709	99

Notes to Required Supplementary Information

Valuation date: June 30, 2007

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 - 38 years, closed

Asset valuation method - Fair Value

Actuarial assumptions:

- Investment rate of return - 8.5 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 - 3.0 percent, compounded
- Mortality table - 1994 Group Annuity Mortality Table for males and females. Five percent of deaths amongst active employees are assumed to be in the performance of their duty.

(1) This amount includes both payroll and non-payroll employer required contributions.

(2) This percentage excludes the additional employer contributions received from the State of General Obligation bonds by the State of Illinois. These proceeds were not part of the current fiscal year required contributions.

(3) Employer required contribution determined in accordance with P.A. 88-0593, and P.A. 94-0004 (for Fiscal Years 2006 and 2007 only). These amounts reflect only payroll required contributions.

(4) The actual distribution from the State Pension Fund was \$5,970,645, the additional amount of \$9,179,355 was received in accordance with HB585 (P.A.93-0665), as a distribution from the Pension Contribution Fund.

SUPPLEMENTARY FINANCIAL INFORMATION

SUMMARY OF REVENUES BY SOURCE

	2007	2006
Contributions:		
Participants	\$ 217,812,833	\$ 207,667,143
Repayments of contributions refunded	1,208,417	1,345,085
Interest received from participants	5,701,349	5,096,668
Total participants contributions	<u>224,722,599</u>	<u>214,108,896</u>
Employing state agencies	<u>358,786,650</u>	<u>210,499,791</u>
Investments:		
Net investments income	266,766,628	264,013,416
Interest earned on cash balances	12,633,405	8,724,784
Net appreciation in fair value of investments	<u>1,500,507,144</u>	<u>840,493,512</u>
Total investment revenue	<u>1,779,907,177</u>	<u>1,113,231,712</u>
TOTAL REVENUE	<u>\$ 2,363,416,426</u>	<u>\$ 1,537,840,399</u>

SUMMARY SCHEDULE OF CASH RECEIPTS AND DISBURSEMENTS

	2007	2006
Cash balance, beginning of year	\$ 226,751,078	\$ 204,525,471
Receipts:		
Participant contributions	215,998,315	205,265,817
Employer contributions (net of bond principal and interest transfers)	356,527,986	209,677,099
Transfers from Illinois State Board of Investment	612,000,000	721,000,000
Interest income on cash balance	12,495,855	8,324,160
Claims receivable payments	4,909,785	4,687,995
Installment payments	4,577,997	5,068,650
Other	<u>249,747</u>	<u>114,964</u>
Total cash receipts	<u>1,206,759,685</u>	<u>1,154,138,685</u>
Disbursements:		
Annuity payments:		
Retirement annuities	1,030,623,103	985,960,464
Widow's and Survivor's annuities	65,154,085	61,366,786
Disability benefits	40,784,251	38,155,674
Lump Sum benefits	12,407,692	12,022,378
Refunds	25,946,116	26,466,430
Administrative expenses	8,720,615	7,941,346
Transfers to reciprocal systems	<u>16,205</u>	<u>-</u>
Total cash disbursements	<u>1,183,652,067</u>	<u>1,131,913,078</u>
Cash balance, end of year	<u>\$ 249,858,696</u>	<u>\$ 226,751,078</u>

SCHEDULE OF PAYMENTS TO CONSULTANTS AND ADVISORS

	2007	2006
Legal Services	\$ 83,506	\$ 32,689
Actuarial Costs	93,859	107,894
Audit Expense	71,808	56,248
Physicians and Disability Inspections	187,576	162,535
Financial Planning	44,590	47,506
Management Consultants	<u>329,320</u>	<u>-</u>
TOTAL	<u>\$ 810,659</u>	<u>\$ 406,872</u>

McGladrey & Pullen

Certified Public Accountants

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

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

Board of Trustees
State Employees' Retirement System
Springfield, Illinois

As Special Assistant Auditors for the Auditor General, we have audited the statement of plan net assets and statement of changes in plan net assets of the State Employees' Retirement System of Illinois (System), as of and for the year ended June 30, 2007, and have issued our report thereon dated February 8, 2008. Our Independent Auditors' Report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the Illinois State Board of Investment, as described in our Independent Auditors' 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

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.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency 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 or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that

adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiency described in Finding 07-1 in the accompanying current finding section to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be detected by the entity's internal control.

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 that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe the significant deficiency described in the current finding is not a material weakness.

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 are currently conducting a State compliance examination of the System as required by the Illinois State Auditing Act. The results of that examination will be reported to management under separate cover.

The System's response to the finding identified in our audit is presented in the current finding section. 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, System management, and Board of Trustees, and is not intended to be and should not be used by anyone other than these specified parties.

McGladrey & Pullen, LLP

Schaumburg, Illinois
February 8, 2008

**State of Illinois
State Employees' Retirement Systems
Year Ended June 30, 2007**

Current Findings – Government Auditing Standards

Finding No. 07-1 Lack of Segregation of Duties

The State Employees' Retirement System (System) did not have an adequate segregation of duties for the approval and payment of contracts.

During our testing of contractual expenditures, we identified 6 out of 8 contracts (75%), totaling \$95,383, where the Administrative Services Manager signed off for both his position and also for the Executive Secretary indicating approval of the contract. The Administrative Services Manager and Executive Secretary's signatures were the only signatures required on the contracts noted as exceptions. The Contract - Obligation Documents required to be filed with the Office of the Comptroller to obligate funds for payment of the contracts were also signed off as being approved by the Administrative Services Manager. In addition, we found the Administrative Services Manager approved the invoice vouchers for payment on all 6 of the contracts.

The Fiscal Control and Internal Auditing Act (Act) (30 ILCS 10/3001) notes State agencies shall establish and maintain a system of internal fiscal and administrative controls, which shall provide assurance that funds, property, and other assets and resources are safeguarded against waste, loss, unauthorized use, and misappropriation. A lack of segregation of duties does not provide assurance against waste, loss, unauthorized use, and misappropriation.

The previous Executive Secretary and current Acting Executive Secretary granted the Administrative Services Manager authority to sign for them on contracts and invoice vouchers. System management indicated they were not aware of the lack of segregation of duties when the Administrative Services Manager approves / signs for himself and the Executive Secretary on contracts and payments.

Because of the significance of the lack of segregation of duties noted, we are considering this to be a significant deficiency in the design of the System's internal control. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the System's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the System's financial statements that is more than inconsequential will not be prevented or detected by the System's internal control.

A lack of segregation of duties leaves the System open to risks of error and fraud if left uncorrected. (Finding Code No. 07-1)

Recommendation:

We recommend someone other than the Administrative Services Manager review and sign for the Executive Secretary in those instances when the Executive Secretary is unavailable to approve contracts and payments when both the Administrative Services Manager and Executive Secretary signatures are required.

System Response:

The System concurs with the Recommendation of the auditors.