State Employees' Retirement System of the State of Illinois

Auditor's Report and Financial Audit

For the Year Ended June 30, 2013
Performed as Special Assistant Auditors for
the Auditor General, State of Illinois

BKD LLP
CPAs & Advisors

State Employees’ Retirement System
of the State of Illinois
Financial Audit
For the Year Ended June 30, 2013

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State Employees' Retirement System
of the State of Illinois
June 30, 2013

System Officials

Executive Secretary	Timothy B. Blair
Accounting Division Manager	Nicholas C. Merrill, Jr., CPA (until 8/31/13)
Accounting Division Manager	Alan Fowler, CPA (effective 9/1/13)
Internal Auditor	Staci A. Crane (effective 9/17/2012 – 11/15/2013)

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State Employees' Retirement System
of the State of Illinois

Financial Statement Report Summary

For the Year Ended June 30, 2013

Summary

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

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

Summary of Findings

The auditors identified a matter involving the System's internal control over financial reporting that they considered to be a significant deficiency. The significant deficiency is described in the accompanying Schedule of Findings listed in the table of contents as finding 2013-001 (Allowance for Uncollectible Accounts Receivable).

Exit Conference

System management waived a formal exit conference in correspondence dated December 4, 2013. The responses to the recommendations were provided by Alan Fowler, Accounting Division Manager, in correspondence dated December 4, 2013.

BKD LLP
CPAs & Advisors

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Independent Auditor's Report

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

Report on the Financial Statements

As Special Assistant Auditors for the Auditor General, we have audited the accompanying financial statements of the State Employees' Retirement System of the State of Illinois (System), as of and for the years ended June 30, 2013 and 2012, and the related notes to the financial statements, which collectively comprise the System's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audits. We did not audit the 2013 and 2012 financial statements of the Illinois State Board of Investment, an internal investment pool of the State of Illinois, which statements represent 97 percent, 98 percent, and 46 percent, respectively in 2013, and 97 percent, 97 percent, and .32 percent, respectively, in 2012 of total assets, net position restricted 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 solely on the report of the other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the System's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

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 position of the System as of June 30, 2013 and 2012, and the respective changes in plan net position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis, the schedule of funding progress, the schedule of employer contributions and notes to required supplementary information listed in the table of contents be presented to supplement the basic financial statements. Such information, although not part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming opinions on the financial statements that collectively comprise the System's basic financial statements. The supplementary financial information as listed in the table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements.

Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The supplementary financial information as listed in the table of contents has been subjected to the auditing procedures applied in the audits of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America by us and other auditors. In our opinion, the supplementary financial information as listed in the table of contents is fairly stated in all material respects, in relation to the basic financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 20, 2013 on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts 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* in considering the System's internal control over financial reporting and compliance.

BKD, LLP

Decatur, Illinois
December 20, 2013

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, 2013 and 2012. 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 approximately 61,500 active state employees and over 65,000 benefit recipients. Throughout this discussion and analysis units of measure (i.e. billions, millions, thousands) are approximate, being rounded up or down to the nearest tenth of the respective unit value.

OVERVIEW OF THE FINANCIAL STATEMENTS

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

1. Basic Financial Statements. For the fiscal years ended June 30, 2013 and 2012, basic financial statements are presented for the System. This information presents the net position-restricted for pension benefits for the System as of June 30, 2013 and 2012. This financial information also summarizes the changes in net position-restricted for pension benefits for the years then ended.

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

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

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

FINANCIAL HIGHLIGHTS

- The Systems' net position increased by $1.4 billion and decreased by $10.0 million during fiscal years 2013 and 2012, respectively. The changes were primarily due to an increase/(decrease) of $1.5 billion (excluding securities lending collateral), and $(206.7) million in the System's investments, at fair value, for fiscal years 2013 and 2012, respectively.
- The System was actuarially funded at 34.2% as of June 30, 2013, compared to 34.7% as of June 30, 2012. For fiscal years 2013 and 2012, the actuarial value of assets equals the fair value of assets adjusted for any actuarial gains or losses from investment return incurred in the fiscal year recognized in equal amounts over the five year period following that fiscal year.
- The overall rate of return for the Illinois State Board of Investment (ISBI) Commingled Fund was 14.1% for fiscal year 2013 compared to 0.1% for fiscal year 2012.

PLAN NET POSITION

The condensed Statements of Plan Net Position 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 Position is presented below.

Condensed Statements of Plan Net Position
(in millions)

	As of June 30			Increase/(Decrease) from	
	2013	2012	2011	2012 to 2013	2011 to 2012
Cash	$ 146.4	$ 134.0	$ 54.9	$ 12.4	$ 79.1
Receivables	145.4	160.8	41.1	(15.4)	119.7
Investments, at fair value *	12,289.6	10,748.6	10,908.9	1,541.0	(160.3)
Property & equipment, net	2.8	2.7	2.7	0.1	–
Total assets	12,584.2	11,046.1	11,007.6	1,538.1	38.5
Liabilities *	183.9	85.4	36.9	98.5	48.5
Total plan net position	$ 12,400.3	$10,960.7	$ 10,970.7	$ 1,439.6	$ (10.0)

* Including securities lending collateral

ADDITIONS TO PLAN NET POSITION

Additions to Plan Net Position include employer and participant contributions and net income from investment activities. Participant contributions were approximately $248.2 million and $259.1 million for the years ended June 30, 2013 and 2012, respectively. Participant contribution rates are set by statute as a percentage of gross salary. Employer contributions increased to approximately $1,531.9 million in 2013 from approximately $1,391.4 million in 2012. This increase was the result of the State's funding plan.

DEDUCTIONS FROM PLAN NET POSITION

Deductions from Plan Net Position are primarily benefit payments. During 2013 and 2012, the System paid out approximately $1,824.3 million and $1,650.9 million, respectively, in benefits and refunds, an increase of approximately 10%. These higher payments were mainly due to a scheduled 3% increase in retirement and other benefit payments, and a 3.6% increase in beneficiaries. The administrative costs of the System represented approximately 1% of total deductions in both 2013 and 2012.

FUNDED RATIO

The funded ratio of the plan measures the ratio of the actuarial value of assets against actuarially determined liabilities and is one indicator of the fiscal strength of a pension fund's ability to meet obligations to its members. An annual actuarial valuation is required by statute. The most recent available valuation showed the funded status of the System on June 30, 2013 decreased to 34.2% from 34.7% at June 30, 2012. The major reason for the decline was the lingering effect of prior investment performance on the smoothed-market value of assets. The amount by which actuarially determined liabilities exceeded the actuarial value of assets was $22.8 billion at June 30, 2013 compared to $21.6 billion at June 30, 2012.

INVESTMENTS

Investments of the System are combined in a commingled investment pool with the Judges' Retirement System, the General Assembly Retirement System and one other State agency. The investments of this other state agency are immaterial to the total commingled investment pool. Each participating entity 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 Position of each retirement system.

The net investment gain for the System totaled approximately $1,501.2 million during fiscal year 2013, versus a net investment gain of $6.0 million during fiscal year 2012, resulting in returns of 14.1% and 0.1%, respectively. For the three, five, and ten year period ended June 30, 2013, the ISBI Commingled Fund earned a compounded rate of return of 11.6%, 3.9%, and 6.6%, respectively.

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

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

CHANGES IN PLAN NET POSITION

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

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

	For the Year Ended June 30,			Increase/(Decrease) from	
	2013	2012	2011	2012 to 2013	2011 to 2012
Additions					
Participant contributions	$ 248.2	$ 259.1	$ 254.2	$ (10.9)	4.9
Employer contributions	1,531.9	1,391.4	1,127.9	140.5	263.5
Investment income/(loss)	1,501.2	6.0	1,930.2	1,495.2	(1,924.2)
Total additions/(deductions)	3,281.3	1,656.5	3,312.3	1,624.8	(1,655.8)
Deductions					
Benefits	1,800.0	1,627.3	1,492.1	172.7	135.2
Refunds	24.3	23.5	37.6	0.8	(14.1)
Administrative expenses	17.4	15.7	13.7	1.7	2.0
Total deductions	1,841.7	1,666.5	1,543.4	175.2	123.1
Net increase/(decrease) in plan net position	$ 1,439.6	$ (10.0)	$1,768.9	$1,449.6	$(1,778.9)

LEGISLATIVE

Public Act 98-0599 ("The Act") was signed by the Governor on December 5, 2013. The Act amends the Illinois Pension Code, and is effective June 1, 2014. The Act applies to all active, inactive and retired Tier 1 members. Tier 2 members are not affected.

The Act's goal is to stabilize retirement system finances and eliminate the retirement system's unfunded liability by 2045. The Act reduces the annual pension adjustments for current and future retirees and requires the skipping of a certain number of the annual pension adjustments for future annuitants retiring on or after July 1, 2014.

The number of annual adjustments to be skipped is based on the future retiree's age at the time the Act becomes effective. In addition, the Act caps the pensionable salary amount and increases the retirement age on a graduated scale and creates a new defined contribution plan. The Act also reduces the employee contribution toward retirement benefits by one percentage point. It provides a funding guarantee requiring the State to make the applicable employer contributions. The System continues to analyze the implementation of this law and its overall effects.

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Statements of Plan Net Position
June 30, 2013 and 2012

	2013	2012
Assets		
Cash	$ 146,354,061	$ 133,959,043
Receivables:		
Contributions:		
Participants	14,151,628	15,059,723
Employing state agencies	124,910,925	139,273,104
Other accounts	6,378,048	6,474,247
Total Receivables	145,440,601	160,807,074
Investments - held in the Illinois State Board of Investment Commingled Fund at fair value	12,176,459,191	10,675,772,261
Securities lending collateral with State Treasurer	113,169,000	72,867,000
Property and equipment, net of accumulated depreciation	2,792,664	2,723,398
Total Assets	12,584,215,517	11,046,128,776
Liabilities		
Benefits payable	5,562,404	6,184,894
Refunds payable	345,475	818,593
Administrative expenses payable	1,598,700	1,539,489
Participants' deferred service credit accounts	197,697	129,753
Due to the State of Illinois	63,041,767	3,901,223
Securities lending collateral	113,169,000	72,867,000
Total Liabilities	183,915,043	85,440,952
Net position-restricted for pension benefits	$ 12,400,300,474	$ 10,960,687,824

See accompanying notes to financial statements.

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Statements of Changes in Plan Net Position
Years Ended June 30, 2013 and 2012

	2013	2012
Additions:		
Contributions:		
Participants	$ 248,169,706	$ 259,122,881
Employing State agencies and appropriations	1,531,932,137	1,391,416,375
Total Contributions	1,780,101,843	1,650,539,256
Investment income:		
Net investment income	315,686,279	253,906,644
Interest earned on cash balances	551,261	687,112
Net appreciation/(depreciation)		
in fair value of investments	1,185,000,651	(248,618,387)
Total investment income	1,501,238,191	5,975,369
Total Additions	3,281,340,034	1,656,514,625
Deductions:		
Benefits:		
Retirement annuities	1,614,596,770	1,454,910,158
Survivors' annuities	107,533,834	101,136,325
Disability benefits	59,882,478	56,098,869
Lump sum benefits	17,952,573	15,228,249
Total Benefits	1,799,965,655	1,627,373,601
Refunds *(including transfers to reciprocating systems)*	24,290,402	23,500,325
Administrative	17,471,327	15,705,561
Total Deductions	1,841,727,384	1,666,579,487
Net Increase/(Decrease)	1,439,612,650	(10,064,862)
Net position-restricted for pension benefits:		
Beginning of year	10,960,687,824	10,970,752,686
End of year	$12,400,300,474	$10,960,687,824

See accompanying notes to financial statements.

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

Notes to Financial Statements June 30, 2013 and 2012

1. Reporting Entity

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

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

Based on the criteria of the Governmental Accounting Standards Board Statement No. 61, there are no other state agencies, boards or commissions, or other organizations required to be combined with the System. However, the System is considered to be part of the State of Illinois financial reporting entity, and is to be combined and included in the State of Illinois' comprehensive annual financial report.

At June 30, 2013 and 2012, the number of participating state agencies, boards and commissions totaled:

	2013	2012
State agencies	40	40
State boards and commissions	43	43
TOTAL	83	83

At June 30, 2013 and 2012, SERS membership consisted of:

	2013	2012
Retirees and beneficiaries currently receiving benefits:		
Retirement annuities	51,994	50,000
Survivors' annuities	10,669	10,502
Disability benefits	2,387	2,286
TOTAL	65,050	62,788
Inactive employees entitled to benefits, but not yet receiving them	4,376	4,391
TOTAL	69,426	67,179
Current Employees:		
Vested: Coordinated with Social Security	41,334	43,165
Noncoordinated	1,615	1,692
Nonvested: Coordinated with Social Security	17,711	17,160
Noncoordinated	885	715
TOTAL	61,545	66,732

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

Pursuant to federal tax laws and regulations governing the administration of public employee pension plans, the System has established a separate fund for the sole purpose of disbursing benefits in accordance with Section 415 of the Internal Revenue Code. For fiscal years 2013 and 2012, receipts were approximately $179,800 and $63,400, respectively. For fiscal years 2013 and 2012, disbursements were approximately $117,500 and $63,600, respectively.

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

2. Plan Description

The System is the administrator of a single-employer, defined benefit public employee retirement system (PERS) established and administered by the State of Illinois to provide pension benefits for its employees. The plan is comprised of two tiers of contribution requirements and benefit levels. The provisions below apply to both Tier 1 & 2 employees, except where noted. A summary of the plan provisions pertaining to eligibility and membership, contributions, and benefits are displayed in the table below:

a. Eligibility and Membership

Generally, anyone entering state service, except those in positions subject to membership in certain other state sponsored retirement systems, persons employed after June 30, 1979 as public service employment program participants under the Federal CETA program, and other exceptions as indicated in state law, become members of the System immediately.

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

b. Employee Contributions

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

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

Tier 1	Tier 2
No annual compensation limit on contributions.	Beginning on or after January 1, 2011, annual compensation on which contributions are taken cannot exceed $106,800. This amount increases annually by 3% or one-half of the Consumer Price Index, whichever is less. The calendar years 2013 and 2012 rates are $109,971.43 and $108,882.60, respectively.

c. Employer Contributions

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

d. Retirement Annuity Benefits

The System is governed by Chapter 40, Article 5/14 of the ILCS. Vesting and benefit provisions of the System are defined in the ILCS. The retirement annuity is based on the member's final average compensation and the number of years of service credit that have been established. The retirement benefit formula available to general state employees is 1.67% for each year of covered service and 2.2% for each year of noncovered service. Alternative formula employees have a formula of 2.5% for covered service and 3.0% for noncovered service.

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

Regular Formula Tier 1

A member must have a minimum of eight years of service credit and may retire at:

- Age 60, with 8 years of service credit.
- Any age, when the member's age (years & whole months) plus years of service credit (years & whole months) equal 85 years (1,020 months) (Rule of 85) with eight years of credited service.
- Between ages 55-60 with 25-30 years of service credit (reduced 1/2 of 1% for each month under age 60).

The retirement benefit is based on final average compensation and credited service. Final average compensation is the 48 highest consecutive months of service within the last 120 months of service.

Under the Rule of 85, a member is eligible for the first 3% increase on January 1 following the first full year of retirement, even if the member is not age 60. If the member retires at age 60 or older, he/she will receive a 3% pension increase every year on January 1, following the first full year of retirement.

If the member retires before age 60 with a reduced retirement benefit, he/she will receive a 3% pension increase every January 1 after the member turns age 60 and has been retired at least one full year. These pension increases are not limited by the 75% maximum.

Regular Formula Tier 2

A member must have a minimum of 10 years of credited service and may retire at:

- Age 67, with 10 years of credited service.
- Between ages 62-67 with 10 years of credited service (reduced 1/2 of 1% for each month under age 67).

The retirement benefit is based on final average compensation and credited service. For regular formula employees, final average compensation is the average of the 96 highest consecutive months of service within the last 120 months of service. The retirement benefit is calculated on a maximum salary of $106,800. This amount increases annually by 3% or one-half of the Consumer Price Index, whichever is less.

If the member retires at age 67 or older, he/she will receive a pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, every year on January 1, following the first full year of retirement. The calendar years 2013 and 2012 rates are $109,971.43 and $108,882.60, respectively.

If the member retires before age 67 with a reduced retirement benefit, he/she will receive a pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, every January 1 after the member turns age 67 and has been retired at least one full year. These pension increases are not limited by the 75% maximum.

Alternative Formula Tier 1

Members eligible for the alternative formula may retire at age 50 with 25 years of service credit, or at age 55 with 20 years of service credit.

Final average compensation is figured one of three ways:

- The average of the highest 48 consecutive months over the last 120 months of service (for members in service prior to January 1, 1998).
- Average of last 48 months of service.
- Final rate of pay: cannot exceed the average of the last 24 months of pay by 115%.

Alternative formula retirees receive their first 3% pension increase on January 1 following the first full year of retirement after age 55. These increases are not limited by the 80% maximum.

Alternative Formula Tier 2

Members eligible for the alternative formula may retire at age 60 with 20 years of service.

Final average compensation is the average monthly salary during the 96 highest consecutive months of service within the last 120 months. The retirement benefit is calculated on a maximum salary of $106,800. This amount increases annually by 3% or one-half of the Consumer Price Index, whichever is less. The calendar years 2013 and 2012 rates are $109,971.43 and $108,882.60, respectively.

Alternative formula retirees receive their first pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, following the first full year of retirement after age 60. These increases are not limited by the 80% maximum.

e. Disability & Death Benefits

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

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

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

Tier 1	Tier 2
For disability benefits, final average compensation is the rate of pay on the date of the disability, or the 48 highest consecutive months of service within the last 10 years, whichever is greater.	For disability benefits, final average compensation is the rate of pay on the date of the disability, or the 96 highest consecutive months of service within the last 10 years, whichever is greater. The disability benefit is calculated on a maximum salary of $106,800. The calendar years 2013 and 2012 rates are $109,971.43 and $108,882.60, respectively.

3. Summary of Significant Accounting Policies & Plan Asset Matters

a. Basis of Accounting

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

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

b. Cash

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

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

c. Implementation of New Accounting Standards

GASB Statement No. 63, "Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position", provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. It also amends the net asset reporting requirements in certain previously issued pronouncements by incorporating deferred outflows of resources and deferred inflows of resources into the definitions of the required components of the residual measure and by renaming that measure as net position, rather than net assets. The System implemented this Statement for the year ending June 30, 2013.

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

d. Methods Used to Value Investments

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

Investments owned are reported at fair value as follows: (1) U.S. Government and Agency, Foreign and Corporate Obligations, Convertible Bonds – prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, Preferred Stock, Foreign Equity Securities, Forward Foreign Currency Contracts and Options: (a) Listed – closing prices as reported on the composite summary of national securities exchanges; (b) Over-the-counter – bid prices; (3) Money Market Instruments – average cost which approximates fair values; (4) Real Estate Investments – fair values as determined by the ISBI and its investment managers; (5) Alternative Investments (Private Equity, Hedge Funds, Bank loans, and Real Assets) fair values as determined by the ISBI and its investment managers; and (6) Commingled Funds- fair values as determined by the ISBI and its investment managers.

Units of the ISBI Commingled Fund are issued to the participating entities 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 participating entities on the last day of the month on the basis of percentage of accumulated units owned by the respective systems. Management expenses are deducted monthly from income before distribution.

The investment authority of the ISBI is provided in Chapter 40, Section 5/22A-112 of the ILCS. Such investment authority requires that all opportunities be undertaken with care, skill, prudence and diligence given prevailing circumstances that a prudent person acting in like capacity and experience would undertake.

e. Actuarial Experience Review

In accordance with Illinois Compiled Statutes, an actuarial experience review is to be performed at least once every five years to determine the adequacy of actuarial assumptions regarding the mortality, retirement, disability, employment, turnover, interest and earnable compensation of the members and beneficiaries of the System. An experience review was last performed as of June 30, 2010 resulting in the adoption of new assumptions as of June 30, 2011.

f. Administrative Expenses

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

g. Risk Management

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

h. General Litigation

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

i. Use of Estimates

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

j. Reclassifications

Certain fiscal year 2012 amounts have been reclassified to conform to the fiscal year 2013 presentation. These reclassifications have not changed the fiscal year 2012 results.

4. Investments

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

	June 30, 2013	June 30, 2012
U.S. govt. and agency obligations	$ 887,400,073	$ 958,131,279
Foreign obligations	415,070,013	385,628,617
Corporate obligations	674,154,128	656,977,663
Common stock & equity funds	3,916,478,305	3,253,103,566
Commingled funds	317,408,396	225,608,712
Foreign equity securities	2,329,387,630	2,012,774,573
Foreign preferred stock	481,493	592,156
Hedge funds	1,166,602,482	1,026,725,785
Real estate funds	1,294,600,976	967,346,450
Private equity	643,775,529	679,423,383
Money market instruments	237,649,781	255,922,180
Real assets	550,739,042	507,019,665
Bank loans	416,649,247	328,593,596
Forward foreign currency contracts	(412,825)	(43,859)
Total investments	$12,849,984,270	$11,257,803,766

Deposits

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, the System's and ISBI's deposits may not be returned. All non-investment related bank balances at year-end are insured or collateralized with securities held by the Illinois State Treasurer or agents in the name of the State Treasurer. As of June 30, 2013 and 2012, the ISBI had non-investment related bank balances of $449,417 and $25,096,663, respectively. Of the June 30, 2012 cash balance, $24,854,573 represents the transfer of the Illinois Power Agency Trust funds. This cash was held by the State Treasurer pending transfer to State Street Bank and Trust Company for investment. The transfer of these funds to State Street Bank and Trust for investment occurred on July 19, 2012. During fiscal year 2007, a Credit Risk Policy was implemented by the ISBI staff and formally adopted by the ISBI Board in July of 2007. The policy outlines the control procedures used to monitor custodial credit risk. These assets are under the custody of State Street Bank and Trust Company. State Street Bank and Trust Company has an AA- Long-term Deposit/Debt rating by Standard & Poor's and an Aa2 rating by Moody. Certain investments of the ISBI with maturities of 90 days or less would be considered cash equivalents; these consist of short-term investment funds and U.S. Treasury bills with maturities of 90 days or less, which are not subject to the custodial credit risk. For financial statement presentation and investment purposes, the ISBI reports these types of cash equivalents as Money Market Instruments within their investments. As of June 30, 2013 and 2012, the ISBI had investment related bank balances of $21,092,710 and $20,601,170, respectively. These balances include USD and foreign cash balances. The USD cash balances had no exposure to custodial credit risk as a result of the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) in July, 2010. The FDIC must provide unlimited deposit insurance coverage for balances held in US dollar non-interest bearing transaction accounts (DDAs) for a period of two years, beginning on December 31, 2010 and ending on December 31, 2012. As of January 1, 2013, cash held in the investment related bank account is neither insured nor collateralized for amounts in excess of $250,000. At any given point and time, the foreign cash balances may be exposed to custodial credit risk.

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 $278 million and $478 million, as of June 30, 2013 and 2012, respectively. Also, at the end of fiscal year 2013 and 2012, the ISBI had outstanding commitments of $7 million and $196 million, respectively, to separate real estate accounts. Also at the end of fiscal year 2013 and 2012, the ISBI had outstanding amounts of $60 million and $63 million, respectively, committed to real assets. The ISBI would fund outstanding commitments by utilizing available cash and then selling liquid securities in the portfolio as necessary.

Investment Liquidity

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

Alternative Investments

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

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

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

Investment strategies of Real Estate investments include, but are not limited to, the purchase, development, ownership, management, rental and/or sale of real estate for profit. In May, 2011, RLJ Lodging Fund II, a limited partnership investment, was exchanged by the ISBI for 1,035,092 shares of restricted common stock as a result of an initial public offering (IPO) transaction conducted by RLJ Lodging Trust. Due to the fact that this holding is currently restricted for sale as a result of a lock-up agreement in place that specifies that during the period that commences 180 days from the date of the initial IPO the holders of the shares will not, without prior written consent of the underwriting group, directly or indirectly offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant for sale of, or otherwise dispose or transfer such shares. As of June 30, 2011, this holding is an illiquid asset as a result of this restriction. During fiscal year 2012, the restriction attached to these shares expired and 1,043,923 in RLJ Lodging Trust shares were sold in March 2012. This included an additional amount of 8,831 shares received by the ISBI during fiscal year 2012.

Certain real estate investments are leveraged whereby partnerships have been established to purchase properties through a combination of contributions from the ISBI and through acquisition of debt. At June 30, 2013, real estate equities of approximately $1,295 million are reported at estimated fair value. Of this amount, $1,145 million is equity and $150 million is long term debt. At June 30, 2012 real estate equities of approximately $967 million were reported at estimated market value. Of this amount, $795 million was equity and $172 million was long term debt.

Required repayment of real estate debt, which is non-recourse debt is as follows as of June 30, 2013 and 2012:

Debt Maturities Year Ending June 30	2013	2012
2013	$ –	$ 38,336,179
2014	–	–
2015	–	39,603,847
2016	28,591,489	28,761,199
2017	56,179,026	64,845,576
2018–2022	43,165,198	–
2023–2026	22,382,920	–
	$ 150,318,633	$171,546,801

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

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

Concentration of Credit Risk and Credit Risk for Investments

The ISBI's portfolio of investments is managed by professional investment management firms. These investment management firms are required to maintain diversified portfolios. Each investment manager must comply with risk management guidelines individually assigned to them as part of their investment management agreement. The ISBI did not have any single issuer investment that exceeded 5% of the total net assets of the fund as of June 30, 2013 and 2012. The table to the right presents the quality ratings of debt securities held by the ISBI as of June 30, 2013 and 2012.

	Moody's Quality Rating	2013	2012
U.S. Government and	AAA	$ 874,539,113	$ 955,072,566
Agency obligations	AA	5,090,968	3,054,072
	Not Rated	7,769,992	4,641
Total U.S. govt. and agency obligations		$ 887,400,073	$ 958,131,279
Foreign Obligations	AAA	$ 76,120,555	$ 186,587,716
	AA	97,449,851	70,836,832
	A	22,791,044	38,941,615
	BAA	39,580,632	17,922,423
	BA	14,681,590	13,976,279
	B	22,678,015	16,044,688
	CAA	849,000	1,411,638
	Not rated	140,919,326	39,907,426
Total Foreign Obligations		$ 415,070,013	$ 385,628,617
Corporate Obligations			
Bank and Finance	AA	$ 2,299,452	$ 6,229,998
	A	61,974,814	65,118,722
	BAA	59,330,835	46,729,424
	BA	22,522,230	13,870,851
	B	20,262,545	17,295,104
	Not Rated	1,119	1,045
Total Bank and Finance		$ 166,390,995	$ 149,245,144
Collateralized Mortgage Obligations	AAA	$ 912,944	$ 1,076,456
Total Collateralized Mortgage Obligations		$ 912,944	$ 1,076,456
Industrial	AA	$ 13,517,204	$ 36,473,262
	A	35,977,341	29,602,573
	BAA	60,411,613	75,478,624
	BA	87,927,262	59,680,342
	B	188,374,139	193,691,505
	CAA	16,149,073	10,775,593
	Not Rated	6,775,458	6,530,791
Total Industrial		$ 409,132,090	$ 412,232,690
Other	AA	$ –	$ 1,127,225
	A	21,306,286	22,075,563
	BAA	9,007,159	7,428,269
	BA	23,383,605	19,369,553
	B	41,440,430	43,572,387
	Not rated	2,580,619	850,376
Total Other		$ 97,718,099	$ 94,423,373
Total Corporate Obligations		$ 674,154,128	$ 656,977,663
Money Market	Not Rated	$ 237,649,781	$ 255,922,180
Total Money Market		$ 237,649,781	$ 255,922,180

Custodial Credit Risk for Investments

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the ISBI will not be able to recover the value of investments or collateral securities that are in the possession of a counterparty. As of June 30, 2013 and 2012, there were no investments that were uninsured and unregistered, securities held by the counterparty or by its trust department or agent but not in the ISBI's name.

Interest Rate Risk

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

Duration is the measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's fair value. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. As of June 30, 2013 and 2012, the ISBI benchmarked its debt security portfolio to Barclay's Capital Intermediate U.S. Government/Credit Bond Index. At June 30, 2013 and 2012, the effective duration of the Barclay's Capital Intermediate U.S. Government/Credit Bond Index was 5.5 years and 3.9 years, repectively. At the same point in time, the effective duration of the ISBI debt security portfolio at June 30, 2013 and 2012 was 4.8 years and 4.6 years, respectively. The table below shows the detail of the duration by investment type as of June 30, 2013 and 2012.

	2013		2012	
Investment Type	Fair Value	Effective Weighted Duration Years	Fair Value	Effective Weighted Duration Years
U.S. Govt. and Agency Obligations				
U.S. Government	$ 381,380,855	5.8	$ 383,122,214	6.7
Agency	506,019,218	2.9	575,009,065	2.7
Foreign Obligations	415,070,013	6.0	385,628,617	6.1
Corporate Obligations				
Bank & Finance	166,390,995	5.4	149,245,144	3.9
Collateralized Mortgage Obligations	912,944	1.8	1,076,456	2.2
Industrial	409,132,090	4.8	412,232,690	4.0
Other	97,718,099	4.8	94,423,373	4.2
Total	$ 1,976,624,214		$2,000,737,559	

Foreign Currency Risk

The ISBI's international portfolio is constructed on the principles of diversification, quality growth, and value. Risk of loss arises from changes in currency exchange rates. International managers may also engage in transactions to hedge currency at their discretion.

Certain investments held in infrastructure funds trade in a reported currency of Euro-based dollars valued at $56,700,762 and $53,539,234 as of June 30, 2013 and 2012, respectively. The table below presents the foreign currency risk by type of investment as of June 30, 2013 and 2012.

	2013		2012	
Currency	Foreign Equity Securities & Foreign Preferred Stock	Foreign Obligations	Foreign Equity Securities & Foreign Preferred Stock	Foreign Obligations
Australian Dollar	$ 84,939,975	$ 17,798,299	$ 82,314,617	$ 16,469,771
Brazilian Real	35,504,150	–	49,364,844	–
Canadian Dollar	128,661,034	22,047,815	126,199,484	27,179,367
Chilean Peso	1,319,421	2,742,742	1,098,684	2,308,184
Czech Koruna	422,126	2,955,792	536,589	2,520,227
Danish Krone	34,412,484	4,925,465	27,321,050	4,165,438
Egyptian Pound	1,067,693	–	1,810,173	–
English Pound Sterling	423,002,548	23,463,993	374,618,002	32,868,184
Euro Currency	531,593,533	124,284,551	394,894,819	103,642,653
Hong Kong Dollar	145,893,712	1,991,143	127,339,809	2,384,108
Hungarian Forint	1,691,945	–	1,457,562	–
Indonesian Rupian	8,906,965	–	9,446,308	–
Israeli Shekel	2,992,079	45,464	2,619,603	28,742
Japanese Yen	273,783,526	65,746,192	191,615,229	65,481,682
Malaysian Ringgit	8,246,099	3,588,730	7,106,044	2,848,977
Mexican Peso	22,585,252	15,855,407	20,566,508	13,648,235
Moroccan Dirham	195,607	–	219,512	–
New Zealand Dollar	3,914,051	2,392,523	5,008,123	1,783,525
Norwegian Krone	27,605,678	7,137,733	24,657,161	6,403,137
Philippine Peso	2,511,702	–	2,219,444	–
Polish Zloty	3,126,169	6,352,962	2,949,201	8,408,688
Singapore Dollar	33,907,567	4,791,667	42,090,664	3,813,610
South African Rand	23,845,529	5,047,409	25,078,599	4,116,002
South Korean Won	84,875,633	18,591,249	71,317,427	13,526,890
Swedish Krona	32,302,268	9,448,272	27,254,280	10,680,201
Swiss Franc	218,884,679	8,538,778	138,838,635	7,455,551
Thailand Baht	4,935,467	5,425,631	3,954,203	4,274,188
Turkish Lira	3,301,243	–	2,811,622	–
Foreign investments denominated in U.S. Dollars	185,440,988	61,898,196	248,658,533	51,621,257
Total	$ 2,329,869,123	$ 415,070,013	$ 2,013,366,729	$ 385,628,617

Securities Lending

The ISBI participates in a securities lending program with Credit Suisse AG, New York Branch who acts as securities lending agent. Securities are loaned to brokers and, in return, the ISBI receives cash and non-cash collateral. All of the securities are eligible for the securities lending program. Collateral consists solely of cash and government securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-U.S. securities). In the event of borrower default, Credit Suisse AG, New York Branch provides the ISBI with counterparty default indemnification. Investments in the cash collateral account represent securities that were distributed to the ISBI in connection with the in-kind redemption of the ISBI's ownership in the State Street Bank and Trust Company Quality Funds for Short-Term Investment (Quality D). Credit Suisse is not responsible for any losses with regards to these legacy investments. This arrangement subjects the ISBI to credit risk as the credit quality of these investments may decline over time. The credit risk on the legacy investments is the risk of a possible loss arising from the inability of a counterparty to meet its obligations. These losses could include the loss of principal, interest and/or decreased expected cash flows in any of the investments held in the ISBI's cash collateral account. In the event a counterparty defaults on its obligations, the ISBI would need to credit the cash collateral account with the amount of the default to make the account whole so that once loaned securities are returned, the cash pledged by borrowers can be returned to them. As of June 30, 2013 and 2012, respectively, the collateral received exceeded the fair value of the securities loaned. As of June 30, 2013 and 2012, there were outstanding loaned investment securities having fair values of $238,382,734 and $115,655,166, respectively; against which collateral was received with a fair value of $245,131,637 and $120,556,697, respectively. Collateral received at June 30, 2013 and 2012 consisted of $61,530,842 and $72,452,520, respectively, in cash and $183,600,796 and $48,104,177, respectively, in government securities for which the ISBI does not have the ability to pledge or sell.

The cash collateral received is invested in a short-term instrument having a fair value of $59,160,611 and $67,893,265 as of June 30, 2013 and 2012, respectively. This investment pool had an average duration of 29.80 days and 32.42 days as of June 30, 2013 and 2012, respectively. Any decrease in the fair value of invested cash collateral is recorded by the ISBI as unrealized losses and reported as a component of the investment income/loss on the ISBI's Statement of Changes in Net Position.

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

The State Treasurer lends securities to broker-dealers and other entities for collateral that will be returned for the same securities in the future. The State Treasurer has, through a Securities Lending Agreement, authorized Deutsche Bank AG to lend the State Treasurer's securities to broker–dealers and banks pursuant to a form of loan agreement.

During fiscal years 2013 and 2012, Deutsche Bank AG lent U.S. Treasury and U.S. Agency securities and received as collateral U.S. dollar denominated cash. Borrowers were required to deliver collateral for each loan equal to at least 100% of the aggregated market value of the loaned securities. Loans are marked to market daily. If the market value of collateral falls below 100%, the borrower must provide additional collateral to raise the market value to 100%.

The State Treasurer did not impose any restrictions during fiscal years 2013 and 2012 on the amount of the loans of available or the eligible securities. In the event of borrower default, Deutsche Bank AG provides the State Treasurer with counterparty default indemnification. Deutsche Bank AG is obligated to indemnify the State Treasurer if the Deutsche Bank AG loses any securities, collateral or investments of the State Treasurer in Deutsche Bank AG's custody. Moreover, there were no losses during the fiscal years 2013 and 2012 resulting from a default of the borrowers or Deutsche Bank AG.

During fiscal years 2013 and 2012, the State Treasurer and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested in repurchase agreements with approved counterparties collateralized with securities approved by Deutsche Bank AG and marked to market daily at no less than 102%. Because the loans are terminable at will, their duration did not generally match the duration of the investments made with the cash collateral. The State Treasurer had no credit risk as a result of its securities lending program as the collateral held exceeded the fair value of the securities lent. The securities lending cash collateral received that was invested in repurchase agreements and the fair value of securities on loan for the State Treasurer as of June 30, 2013 were $6,763,623,576 and $6,742,892,101, respectively. The securities cash value collateral invested in repurchase agreements and the fair value of securities on loan for the State Treasurer as of June 30, 2012 were $4,556,511,251 and $4,551,829,732, respectively. The System's portion of securities lending collateral that was invested in repurchase agreements as of June 30, 2013 and June 30, 2012 were $113,169,000 and $72,867,000, respectively.

Derivative Securities

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

Foreign currency forward contracts (FX forwards) are used to protect against the currency risk in the ISBI's foreign equity portfolio. A foreign currency forward contract is an agreement to buy or sell a specific amount of a foreign currency at a specified delivery or maturity date for an agreed-upon price. Fluctuations in the market value of foreign currency forward contracts are marked to market on a daily basis. These investments are reported at fair value in the investment section of the ISBI's Statement of Net Position. The gain or loss arising from the difference between the original contracts and the closing of such contracts is recognized in the net increase/decrease in the fair value of investments in the ISBI's Statement of Changes in Net Position. In May 2011, the ISBI removed language from the investment management agreements allowing managers to hedge foreign currencies and/or to hedge equity positions.

The ISBI's investment managers use financial futures to replicate an underlying security they wish to hold (sell) in the portfolio. In certain instances, it may be beneficial to own a futures contract rather than the underlying security (arbitrage). Additionally, financial futures are used in the ISBI's fixed income portfolio to adjust portfolio strategy and overall portfolio duration. A financial futures contract is an agreement to buy or sell a specific amount at a specified delivery or maturity date for an agreed-upon price. As the fair values of the futures contract vary from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. The gain or loss is recognized in the net increase/decrease in the fair value of investments in the ISBI's Statement of Changes in Net Position. 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 ISBI's investment portfolio.

The ISBI's 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 ISBI 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 in the ISBI's Statement of Net Position. As a purchaser of financial options, 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. The gain or loss associated with options is recognized in the net increase/decrease in the fair value of investments in the ISBI's Statement of Changes in Net Position.

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

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

The table below presents the investment derivative instruments aggregated by type that were held by the ISBI as of June 30, 2013 and 2012.

	Changes in Fair Value		Fair Value at Year End		Notional Amount Number of Shares	
	2013	2012	2013	2012	2013	2012
FX Forwards	$ (2,963,240)	$ (1,693,910)	$ (412,825)	$ (43,859)	n/a	n/a
Futures	n/a	n/a	n/a	n/a	25,076,117	(16,717,412)
Options	6,068,549	2,744,205	9,078,690	2,811,004	8,040,934	27,000
Rights	(655,303)	(166,937)	22,104	30,249	35,139	153,435
Warrants	3,331,121	(9,022,293)	18	68,676,781	1	7,663,933
	$ 5,781,127	$ (8,138,935)	$ 8,687,987	$ 71,474,175	33,152,191	(8,873,044)

The table below shows the futures positions held by the ISBI as of June 30, 2013 and 2012.

	2013		2012	
	Number of Contracts	Contract Principal*	Number of Contracts	Contract Principal*
Equity Futures Purchased	1,398	$113,135,073	1,410	$92,997,500
Fixed Income Futures Purchased	723	94,816,672	382	48,411,940
Fixed Income Futures Sold	371	66,975,628	421	63,940,695

** Contract principal amounts shown represent the market value of the underlying assets the contracts control. These are shown to present the volume of the transactions but do not reflect the extent to which positions may offset one another. These amounts do not represent the much smaller amounts potentially subject to risk. Contract principal values also do not represent actual recorded values reported in the ISBI's Statement of Net Position.*

Derivative transactions involve, to varying degrees, credit risk and market risk. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to terms. Derivatives which are exchange traded are not subject to credit risk. No derivatives held are subject to custodial credit risk. Market risk is the possibility that a change in interest (interest rate risk) or currency rates (foreign currency risk) will cause the value of a financial instrument to decrease or become more costly to settle. The market risk associated with derivatives, the prices of which are constantly fluctuating, is regulated by imposing strict limits as to the types, amounts and degree of risk that investment managers may undertake. These limits are approved by the Board of Trustees and management of the ISBI and the risk positions of the investment managers are reviewed on a periodic basis to monitor compliance with the limits. As of June 30, 2013 and 2012, respectively, the ISBI held futures contracts whose underlying instruments were exposed to interest risk but there were no GASB 53 reportable elements. The ISBI has not adopted a formal policy specific to master netting arrangements.

The ISBI's derivative investments in foreign currency forward contracts are held with counterparties. The credit ratings and net exposure as of June 30, 2013 and 2012 for the counterparties are as follows:

	2013			2012		
Moody's Rating	Fair Value	Net Exposure	Percentage of Net Exposure	Fair Value	Net Exposure	Pecentage of Net Exposure
Aa3	$ 196,480	$ 196,480	26.97%	$ 45,189	$ 45,189	11.57%
Aa2	68,353	68,353	9.39%	46,885	46,885	12.00%
A3	198,724	198,724	27.28%	84,367	84,367	21.59%
A2	106,379	106,379	14.61%	64,971	64,971	16.62%
A1	92,066	92,066	12.64%	3,119	3,119	0.80%
Baa1	66,323	66,323	9.11%	146,228	146,228	37.42%
	$ 728,325	$ 728,325	100.00%	$ 390,759	$ 390,759	100.00%

The following table presents the fair value of derivative investments exposed to foreign currency risk as of June 30, 2013 and 2012:

	2013				2012			
Currency	FX Forwards	Rights	Warrants	Options	FX Forwards	Rights	Warrants	Options
Australian Dollar	$ 7,424	$ 1,571	$ –	$ –	$(85,578)	$ –	$ –	$ –
Brazilian Real	7,385	–	–	–	1,589	–	–	–
Canadian Dollar	(43,143)	–	–	397,444	(13,256)	10,733	–	–
Chilean Peso	6,394	–	–	–	1,450	1,296	–	–
Columbian Peso	–	–	–	–	(15,312)	–	–	–
Czech Koruna	7,402	–	–	–	9,411	–	–	–
Danish Krone	9,832	–	–	–	(30)	–	–	–
Egyptian Pound	(137)	–	–	–	(148)	–	–	–
English Pound Sterling	(99,137)	–	–	2,107,735	49,917	–	–	–
Euro Currency	95,900	18,101	–	2,062,912	118,889	18,220	6,103	–
Hong Kong Dollar	321	3	–	–	234	–	–	–
Indonesian Rupiah	–	–	–	–	(619)	–	–	–
Israeli Shekel	1,440	–	–	–	–	–	–	–
Japanese Yen	(533,639)	–	–	–	(19,071)	–	–	–
Malaysian Ringgit	2,157	–	–	–	(1,234)	–	–	–
Mexican Peso	14,205	–	–	–	27,008	–	–	–
New Zealand Dollar	25,808	–	–	–	46,885	–	–	–
Norwegian Krone	48,222	–	–	–	4,157	–	–	–
Polish Zloty	(6,005)	–	–	–	(32,461)	–	–	–
Singapore Dollar	(25,115)	–	–	–	(13,207)	–	–	–
South African Rand	11,768	–	–	–	14,798	–	–	–
South Korean Won	(31,319)	–	–	–	23,502	–	–	–
Swedish Krona	16,622	–	–	–	(154,835)	–	–	–
Swiss Franc	72,344	–	–	–	(5,251)	–	–	–
Thailand Baht	(1,555)	–	–	–	(697)	–	–	–
Investments denominated in U.S. dollars	–	2,429	18	4,510,599	–	–	68,670,678	2,806,363
	$ (412,825)	$ 22,104	$ 18	$9,078,690	$(43,859)	$ 30,249	$68,676,781	$2,806,363

Other Information

The System owns approximately 94% of the net position of the ISBI Commingled Fund as of June 30, 2013 and 2012. 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, 2013. A copy of the report can be obtained from the ISBI at 180 North LaSalle Street, Suite 2015, Chicago, Illinois 60601.

5. Funding - Statutory Contributions Required & Contributions Made

On an annual basis, a valuation of the liabilities and reserves of the System is performed by the System's actuarial consultants in order to determine the amount of contributions statutorily required from the State of Illinois. For fiscal years 2013 and 2012 the actuary used the projected unit credit actuarial method for determining the proper employer contribution rate and amount.

For fiscal year 2013 and 2012 the required employer contributions was computed in accordance with the State's funding plan. This funding legislation provides for a systematic 50 year funding plan with an ultimate goal to fund the cost of maintaining and administering the System at an actuarial funded ratio of 90%.

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

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

The funded status of the System as of June 30, 2013, the most recent actuarial valuation date, is in the table below:

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 of Covered Payroll ([b-a]/c)
$11,877,418,896	$34,720,764,557	$22,843,345,661	34.2%	$4,236,191,257	539.2%

Valuation date: June 30, 2013

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: 32 years, closed

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

Actuarial assumptions:

Investment rate of return:	7.75 percent
Projected salary increases:	1.0 to 5.87 percent, based upon member's age
Assumed inflation rate:	3.0 percent
Group size growth rate:	0.0 percent
Post-retirement increase:	Tier 1 - 3.0 percent per year, compounded annually
	Tier 2 - 3.0 percent per year or one-half of the annual increase in the Consumer Price Index, whichever is less, on the original benefit

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

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

6. Accrued Compensated Absences

Employees of the System are entitled to receive compensation for all accrued but unused vacation time and one-half of all unused sick leave earned on and after January 1, 1984 and before January 1, 1998 upon termination of employment. These accrued compensated absences as of June 30, 2013 and 2012 totaled $1,267,237 and $1,085,222, respectively are included in Administrative Expenses Payable.

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 2013 and 2012 payrolls, amounted to $28.4 and $29.0 million, respectively. The total amount remitted to the State of Illinois as of June 30, 2013 and 2012 was $23.9 million and $25.1 million, respectively.

As of June 30, 2013 and 2012 the following amounts are included in the System's Statement of Plan Net Position regarding the collection of bond principal and interest payments:

	2013	2012
Cash - payments collected but not yet remitted to the State of Illinois	$ 2,577,276	$ 2,831,875
Accounts receivable - for June payrolls received in July and August	$ 1,856,911	$ 1,069,348
Due to the State of Illinois	$ (4,434,187)	$ (3,901,223)

8. Property & Equipment

Capital assets over $100 are capitalized at their cost at the time of acquisition. Depreciation is computed using the straight-line method over the estimated useful life of the asset. The estimated useful lives are as follows: (1) office furniture - 10 years, (2) equipment - 6 years, (3) automobiles and certain electronic data processing equipment - 3 years, and (4) building - 30 years. Land is carried at its original cost, including applicable legal fees, surveying costs, etc.

This is a summary of changes in property and equipment assets for 2013 and 2012:

2013	Beginning Balance	Additions	Deletions	Ending Balance
Assets				
Land	$ 655,241	$ –	$ –	$ 655,241
Land improvements	315,779	–	–	315,779
Building	3,482,678	–	–	3,482,678
Equipment	2,511,829	464,608	(480,455)	2,495,982
TOTAL	6,965,527	464,608	(480,455)	6,949,680
Accumulated depreciation				
Land Improvements	(4,081)	(2,336)	–	(6,417)
Building	(2,415,908)	(117,021)	–	(2,532,929)
Equipment	(1,822,140)	(275,517)	479,987	(1,617,670)
TOTAL	(4,242,129)	(394,874)	479,987	(4,157,016)
Net property and equipment	2,723,398	69,734	(468)	2,792,664

2012	Beginning Balance	Additions	Deletions	Ending Balance
Assets				
Land	$ 655,241	$ –	$ –	$ 655,241
Land improvements	298,979	16,800	–	315,779
Building	3,484,264	15,214	(16,800)	3,482,678
Equipment	2,278,291	374,495	(140,957)	2,511,829
TOTAL	6,716,775	406,509	(157,757)	6,965,527
Accumulated depreciation				
Land Improvements	(1,931)	(2,150)	–	(4,081)
Building	(2,295,277)	(120,631)	–	(2,415,908)
Equipment	((1,743,219)	(218,217)	139,296	(1,822,140)
TOTAL	(4,040,427)	(340,998)	139,296	(4,242,129)
Net property and equipment	$2,676,348	$ 65,511	$ (18,461)	$2,723,398

9. Administrative Expenses & Other Post-Employment Benefits

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

The System pays employer retirement contributions based upon an actuarially determined percentage of its payrolls. For fiscal years 2013, 2012, and 2011 the employer contribution rates were 37.987%, 34.190%, and 27.988%, respectively. The System's contributions to SERS for fiscal years 2013, 2012 and 2011 were $1,971,920, $1,645,229, and $1,254,741 respectively, for the general staff. The System's contributions for the electronic data processing staff for fiscal years 2013, 2012 and 2011 were $718,451, $558,319, and $338,798, respectively. These amounts were equal to the required contributions for each fiscal year.

The State provides health, dental, vision, and life insurance benefits for retirees and their dependents in a program administered by the Department of Central Management Services. Substantially all State employees become eligible for post-employment benefits if they eventually become annuitants of one of the State sponsored pension plans.

Health, dental, and vision benefits include basic benefits for annuitants and dependents under the State's self-insurance plan and insurance contracts currently in force. Annuitants may be required to contribute towards health, dental, and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed health care plan. Annuitants who retired prior to January 1, 1998, and who are vested in the State Employees' Retirement System do not contribute towards health, dental, and vision benefits. For annuitants who retired on or after January 1, 1998, the annuitant's contribution amount is reduced five percent for each year of credited service with the State allowing those annuitants with twenty or more years of credited service to not contribute towards health, dental, and vision benefits. However, Public Act 97-0695, effective June 30, 2012, alters the contributions to be paid to the State, annuitants, survivors, and retired employees under the

State Employee Group Insurance Act. This Act requires the Director of Central Management Services to, on an annual basis, determine the amount that the State should contribute. The remainder of the cost of coverage shall be the responsibility of the annuitant, survivor, or retired employee. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefit becomes $5,000.

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

A summary of post-employment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the Department of Central Management Services. A copy of the financial statements of the Department of Central Management Services may be obtained by writing to the Department of Central Management Services, Stratton Office Building, 401 South Spring Street, Springfield, Illinois, 62706.

A summary of the administrative expenses of the System for fiscal years 2013 and 2012 are as follows:

	2013	2012
Personal Services	$ 5,197,492	$ 4,802,680
Employee Retirement Pickup	36,532	30,209
Retirement Contributions	1,971,920	1,645,229
Social Security Contributions	390,523	356,953
Group Insurance	1,629,448	1,229,725
Contractual Services	2,691,900	2,381,755
Travel	19,977	20,095
Commodities	26,742	31,180
Printing	61,649	35,672
Electronic data processing	4,758,679	4,619,087
Telecommunications	92,329	79,703
Automotive	10,164	15,764
Depreciation	394,875	340,997
Other (net)	189,097	116,512
Total	$17,471,327	$ 15,705,561

10. Social Security Division - Administrative Expenses

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

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

In addition, the Social Security Division was responsible for collecting wage information and contribution payments from covered retirement systems and units of local government on wages paid prior to January 1, 1987. Administrative expenses for the Social Security Division are appropriated annually by the State Legislature.

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

	2013	2012
Personal services	$ 30,606	$ 50,119
Retirement contributions	–	–
Social Security contributions	2,328	3,776
Contractual services	19,900	12,590
Travel	–	846
Commodities	–	115
Electronic Data Processing	–	-
Telecommunications	384	414
Total	$ 53,218	$ 67,860

11. Analysis of Changes in Reserve Balances

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

a. Participants' contributions: Accounts for assets contributed by each participant

b. Interest accumulations: Accounts for interest credited to each participant's account

c. Other future benefits: Accounts for all assets not otherwise specifically provided for in items (a) and (b) above.

State Employees' Retirement System
Statements of Changes in Reserve Balances Years Ended June 30, 2013 and 2012

	Participants' Contributions	Interest Accumulations	Other Future Benefits	Total Reserve Balances
Balance at June 30, 2011	$ 2,586,284,410	$ 1,733,461,375	$ 6,651,006,901	$10,970,752,686
Add (deduct):				
Excess revenue over expenses	223,428,809	–	(233,493,671)	(10,064,862)
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	(114,840,114)	–	114,840,114	–
Interest credited to members' accounts	–	(3,932,243)	3,932,243	–
Balance at June 30, 2012	$ 2,694,873,105	$ 1,729,529,132	$ 6,536,285,587	$10,960,687,824
Add (deduct):				
Excess revenue over expenses	212,949,532	–	1,226,663,118	1,439,612,650
Reserve transfers:				
Accumulated contributions of members who retired during the year, less contributions of annuitants returning to active status	69,775,830	–	(69,775,830)	–
Interest credited to members' accounts	–	11,444,815	(11,444,815)	–
Balance at June 30, 2013	$ 2,977,598,467	$ 1,740,973,947	$ 7,681,728,060	$ 12,400,300,474

12. New Accounting Pronouncements

GASB Statement No. 65, “Items Previously Reported as Assets and Liabilities”, establishes accounting and financial reporting standards that reclassify and recognize, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities. The Statement also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources, such as changes in the determination of the major fund calculations and limiting the use of the term “deferred” in financial statement presentations. The System is required to implement this Statement for the year ending June 30, 2014.

GASB Statement No. 67, “Financial Reporting for Pension Plans”, was established to provide improved financial reporting by state and local governmental pension plans. The scope of the Statement addresses accounting and financial reporting for the activities of pension plans that are administered through trusts that have the specific characteristics. For defined benefit pension plans, the Statement establishes standards of financial reporting for separately issued financial reports and specifies the required approach to measuring the pension liability for benefits provided through the pension plan. The System is required to implement this Statement for the year ending June 30, 2014.

13. Subsequent Event

On December 5, 2013, Governor Patrick Quinn signed Public Act 98-0599 into law. This new law includes a reduction of the Automatic Annual Increase, capping pensionable earnings of Tier 1 employees, creating a new defined contribution plan, delaying the retirement age of members under age 46, reducing of employee contributions for Tier 1 employees and funding guarantees. It takes effect no earlier than June 1, 2014.

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)
6/30/08	10,995,366,485	23,841,280,102	12,845,913,617	46.1	3,967,704,000	323.8
6/30/09	10,999,953,527	25,298,346,092	14,298,392,565	43.5	4,027,263,000	355.0
6/30/10	10,961,540,164	29,309,464,296	18,347,924,132	37.4	4,119,360,842	445.4
6/30/11	11,159,836,617	31,395,007,782	20,235,171,165	35.6	4,211,186,269	480.5
6/30/12	11,477,264,329	33,091,186,194	21,613,921,865	34.7	4,329,083,716	499.3
6/30/13	11,877,418,896	34,720,764,557	22,843,345,661	34.2	4,236,191,257	539.2

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

SCHEDULE OF EMPLOYER CONTRIBUTIONS

Year Ended June 30	Annual Required Contribution per GASB Statement No. 25 (1)	Percentage Contributed	Annual Required Payroll Contribution per State Statute(2)	Percentage Contributed
2008	986,410,891	59.6	576,626,422	102
2009	1,003,432,849	77.2	769,851,595	101
2010	1,177,313,343	93.1	1,093,072,413	100
2011	1,289,002,005	87.5	1,102,783,348	102
2012	1,614,834,808	86.2	1,396,216,080	100
2013	1,741,286,416	88.0	1,529,942,834	100

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

Notes to Required Supplementary Information

Valuation date: June 30, 2013
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 – 32 years, closed
Asset valuation method – Fair value, adjusted for any actuarial gains or losses from investment return incurred in the fiscal year recognized in equal amounts over the five year period following that fiscal year.
Actuarial assumptions:
Investment rate of return – 7.75 percent
Projected salary increases – 1.0 to 5.87 percent, based upon member's age
Assumed inflation rate – 3.0 percent
Group size growth rate – 0.0 percent
Post-retirement increase – Tier 1 - 3.0 percent per year, compounded annually
Tier 2 - 3.0 percent per year or one-half of the annual increase in the Consumer Price Index, whichever is less, on the original benefit.

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

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

SUMMARY OF REVENUES BY SOURCE

	2013	2012
Contributions:		
Participants	$ 242,970,097	$ 251,069,057
Repayments of contributions refunded	805,791	1,206,505
Interest received from participants	4,393,818	6,847,319
Total participants contributions	248,169,706	259,122,881
Employing state agencies and appropriations	549,167,917	484,513,819
General Revenue Fund	982,764,220	906,902,556
Total employer contributions	1,531,932,137	1,391,416,375
Investments:		
Net investments income	315,686,279	253,906,644
Interest earned on cash balances	551,261	687,112
Net appreciation/(depreciation) in fair value of investments	1,185,000,651	(248,618,387)
Total investment income	1,501,238,191	5,975,369
TOTAL REVENUE	$ 3,281,340,034	$ 1,656,514,625

SUMMARY SCHEDULE OF CASH RECEIPTS & DISBURSEMENTS

	2013	2012
Cash balance, beginning of year	$ 133,959,043	$ 54,940,085
Receipts:		
Participant contributions	237,765,007	248,044,784
Employer contributions		
(net of bond principal and interest transfers)	530,813,772	479,354,208
General Revenue Fund/Pension Contribution Fund	1,074,426,646	794,090,903
Transfers from Illinois State Board of Investment	–	212,000,000
Interest income on cash balance	547,744	666,229
Claims receivable payments	5,564,459	5,857,181
Installment payments	3,609,042	4,225,472
Other	152,214	132,514
Total cash receipts	1,852,878,884	1,744,371,291
Disbursements:		
Annuity payments:		
Retirement annuities	1,615,849,287	1,454,166,796
Widow's and Survivor's annuities	107,678,716	101,235,641
Disability benefits	55,664,045	51,642,228
Lump Sum benefits	18,178,664	16,042,336
Refunds (including transfers to reciprocal systems)	25,610,884	24,411,129
Administrative expenses	17,502,270	17,854,203
Total cash disbursements	1,840,483,866	1,665,352,333
Cash balance, end of year	$ 146,354,061	$ 133,959,043

SCHEDULE OF PAYMENTS TO CONSULTANTS & ADVISORS

	2013	2012
Legal Services	$ 73,267	$ 64,983
Actuarial Costs	26,733	201,000
Audit Expense	94,454	94,176
Physicians and Disability Inspections	236,034	297,625
Financial Planning	48,354	60,626
Management Consultants	675,148	1,346,534
TOTAL	$ 1,153,990	$ 2,064,944

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

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

As Special Assistant Auditors for the Auditor General, we have audited, in accordance with the 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 financial statements of the State Employees' Retirement System of the State of Illinois (System), as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the System's basic financial statements, and have issued our report thereon dated December 20, 2013. Our report includes a reference to other auditors who audited the financial statements of the Illinois State Board of Investment, an internal investment pool of the State of Illinois, as described in our report on the System's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

Management of the System is responsible for establishing and maintaining effective internal control over financial reporting (internal control). In planning and performing our audit of the financial statements, we considered the System's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of the System's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatement on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the System's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify a certain deficiency in internal control, described in the accompanying schedule of findings as item 2013-001 that we consider to be a significant deficiency.

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*.

State Employees' Retirement System's Response to Finding

The System's response to the finding identified in our audit is described in the accompanying schedule of findings. The System's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the System's internal control or on compliance. This report is an integral part of the audit performed in accordance with *Government Auditing Standards* in considering the System's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

BKD, LLP

Decatur, Illinois
December 20, 2013

2013-001. Finding – Allowance for Uncollectible Accounts Receivable

The State Employees' Retirement System (System) did not maintain an adequate allowance for uncollectible accounts receivable.

During testing, we noted the System had delinquent accounts receivable of $3,100,000 at June 30, 2013. Of the delinquent balance $540,000 was over ten years old. Based on a review of receivable aging and other risk factors identified, we determined that the System should have evaluated the delinquent receivables to estimate the allowance for the portion of the receivables that it believes might be uncollectible and to determine its potential impact on the fair presentation of the financial statements.

The System did not have a formal methodology to review and evaluate the allowance for uncollectible accounts receivable that takes into account historical factors, such as collections, along with other qualitative factors. The System passed on recording any adjustment for an estimated allowance to accounts receivable because the delinquent balance was not material to the financial statements.

According to generally accepted accounting principles (GAAP), the allowance for doubtful accounts should represent management's best estimate of the amount of receivables that will not be collected. The allowance for bad debts is a significant estimate that requires proper analysis and evaluation of past and current events as well as the assumptions used. Typically organizations will perform a retrospective review to determine if the methodology used in developing the estimate compares to the actual results achieved in a subsequent period.

The Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the System establish and maintain fiscal and administrative controls to provide assurance that resources applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over the State's resources.

System officials stated they do not write-off accounts receivable amounts until notified by the Attorney General they are not collectible.

Failure to perform a periodic analysis of amounts due to the System and failure to develop a consistent methodology to support the amounts recorded as uncollectible accounts receivable could result in a misstatement of the financial statements. (Finding Code No. 2013-001)

<u>Recommendation</u>

We recommend the System develop and adopt a methodology to review and evaluate an estimate for the allowance for uncollectible accounts receivable.

System Response

The System concurs with the Finding and has already developed and adopted a methodology to review and evaluate an estimate for the allowance for uncollectible accounts receivable.

Prior Finding Not Repeated – *Government Auditing Standards*

A. Finding – Noncompliance with Fiscal Control and Internal Auditing Act

The State Employees' Retirement System (System) was not in compliance with the Fiscal Control and Internal Auditing Act (the Act). (Finding Code No. 12-1)

During the current year audit, we noted the System hired a full-time internal auditor. As a result, the System was able to complete audits in accordance with its current two-year plan for fiscal years 2013-2014. The System also prepared and transmitted to the Auditor General a certification that the systems of internal fiscal and administrative controls of the System complied with the requirements of the Act (30 ILCS 10/1003) within the required timeframe.