ILLINOIS STATE BOARD OF INVESTMENT
An Internal Investment Pool of the State of Illinois

Financial Statements

June 30, 2009

(With Independent Auditors' Report Thereon)

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

ILLINOIS STATE BOARD OF INVESTMENT
An Internal Investment Pool of the State of Illinois

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ILLINOIS STATE BOARD OF INVESTMENT
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## Financial Statement Report

### Summary

The audit of the accompanying financial statements of the Illinois State Board of Investment (Board) was performed by McGladrey & Pullen, LLP.

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

### Summary of Findings

The auditors identified matters involving the Board's internal control over financial reporting that they considered to be significant deficiencies. The significant deficiencies are described in the accompanying Schedule of Findings – *Government Auditing Standards* on pages 21 through 24 of this report, as finding 09-1 (Securities Lending Transactions) and finding 09-2 (Alternative Investments). The auditors also consider finding 09-1 to be a material weakness.

### Exit Conference

The findings and recommendations appearing in this report were discussed with the Board personnel at an exit conference on December 16, 2009. Attending were:

<u>Illinois State Board of Investment</u>

| | |
|---|---|
| William Atwood | Executive Director |
| Kathy Spinato | Executive Deputy Director |
| Alise White | Chief Fiscal Officer |

<u>McGladrey & Pullen, LLP</u>

| | |
|---|---|
| Joseph Evans | Partner |
| Rolake Adedara | Director |

<u>Office of the Auditor General</u>

| | |
|---|---|
| Alison Schertz | Audit Manager |

The responses to the recommendations were provided by Alise White in a letter dated December 28, 2009.

McGladrey & Pullen
Certified Public Accountants

# Independent Auditors' Report

Honorable William G. Holland
Auditor General
State of Illinois

Board of Directors
Illinois State Board of Investment:

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statements of net assets of the Illinois State Board of Investment (Board), an internal investment pool of the State of Illinois, as of June 30, 2009 and June 30, 2008, and the related statements of changes in net assets for the years then ended, as listed in the table of contents. These financial statements are the responsibility of the Board's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As discussed in Note 1, the financial statements present only the Board and do not purport to, and do not present fairly the financial position of the State of Illinois as of June 30, 2009 and June 30, 2008, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Illinois State Board of Investment as of June 30, 2009 and June 30, 2008, and the changes in its net assets for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued, under separate cover, our report dated January 20, 2010 on our consideration of the Board's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 4 and 5 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

McGladrey & Pullen, LLP

Chicago, Illinois
January 20, 2010

In October 1969, the Illinois State Board of Investment was created by enactment of Article 22A of the Illinois Pension Code by the 76th General Assembly of Illinois. By statute, the Board was given the responsibility for management of the assets of the General Assembly Retirement System, the Judges' Retirement System of Illinois and the State Employees' Retirement System of Illinois. Board membership consists of five members appointed by the Governor and four ex officio members consisting of the State Treasurer and the Chairman of the Board of Trustees of each of the retirement systems. The Board maintains their office in Chicago, IL.

The following Management Discussion and Analysis (MD&A) provides an introduction and overview of the Illinois State Board of Investment (ISBI or Board) financial activities for the fiscal years ended June 30, 2009 and 2008.

### Financial Highlights

The net assets of the Board totaled approximately $8.7 billion at fiscal year end June 30, 2009. The decrease from the previous year is primarily the result of investment losses.

### General Market Risk

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 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 ISBI's financial condition. The readers of these financial statements are advised that financial markets continue to be volatile and may experience significant changes on almost a daily basis.

### Overview of the Financial Statements

The Board's financial statements are prepared on an accrual basis in accordance with U. S. generally accepted accounting principles promulgated by the Governmental Accounting Standards Board and are comprised of the Statement of Net Assets, the Statement of Changes in Net Assets, and Notes to Financial Statements.

The Statement of Net Assets presents information on the Board's assets and liabilities and the resulting net assets. This statement also reflects the Board's investments along with the cash and short-term investments, receivables, and other assets and liabilities.

The decrease in investments at June 30, 2009 is a result of an investment loss of 20.1% for the fiscal year, net of expenses which are shown in the Statement of Changes in Net Assets. The decrease in liabilities for fiscal 2009 compared with 2008 consisted mainly of decreases in the securities lending collateral obligation and unsettled investment purchases.

### Condensed Summary of Net Assets

| | June 30 | | | 2009/2008 | 2008/2007 |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | Change | Change |
| | $ | $ | $ | $ | $ |
| Cash | 12,662,039 | 43,667,005 | 42,916,419 | (31,004,966) | 750,586 |
| Receivables | 186,099,275 | 187,106,001 | 548,269,714 | (1,006,726) | (361,163,713) |
| Investments | 8,735,057,063 | 11,429,528,114 | 12,805,770,746 | (2,694,471,051) | (1,376,242,632) |
| Securities lending collateral | 1,395,768,802 | 1,703,959,890 | 2,084,820,497 | (308,191,088) | (380,860,607) |
| Prepaid expenses | 16,184 | 16,242 | 14,740 | (58) | 1,502 |
| Capital assets | 57,635 | 52,797 | 49,283 | 4,838 | 3,514 |
| Total assets | 10,329,660,998 | 13,364,330,049 | 15,481,841,399 | (3,034,669,051) | (2,117,511,350) |
| Liabilities | 1,645,606,726 | 2,049,276,888 | 2,929,645,238 | (403,670,162) | (880,368,350) |
| Net assets | 8,684,054,272 | 11,315,053,161 | 12,552,196,161 | (2,630,998,889) | (1,237,143,000) |

The Statement of Changes of Net Assets presents information regarding changes during the fiscal year ended June 30, 2009. This statement reflects additions and deductions, which include the investment income and losses derived from realized and unrealized gains/losses, member system contributions, and income received from securities lending activities. Also reflected in the statement are deductions, which include withdrawals by the member systems and operating expenses of the Board.

The net investment losses for the year ended June 30, 2009 were the result of a downward movement in the securities markets. There was a decrease in withdrawals by the member systems. Fiscal year 2009 withdrawals were $277.0 million compared with $499.5 million in fiscal year 2008. Withdrawals are determined by the member retirement systems based on the State's funding and the systems' benefit payment needs. The decrease in operating expenses for fiscal year 2009 versus 2008 was mainly a result of decreased investment management fees as a result of a reduction of the assets in the portfolio and a decrease in the amount of consulting and professional was due to a reduction in legal fees and movement from implementation costs to ongoing maintenance costs for new systems to upgrade an aging technology structure.

The net investment losses for the year ended June 30, 2008 were the result of a downward movement in the securities markets. The decrease in liabilities for fiscal 2008 compared with 2007 consisted mainly of a decrease in securities lending collateral obligations and a decrease in unsettled investment purchases.

The Notes to the Financial Statements provide additional information, which is necessary to fully understand the data provided in the financial statements.

**Condensed Summary of Changes in Net Assets**

| | Fiscal Years Ended June 30 | | | 2009/2008 | 2008/2007 |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | Change | Change |
| | $ | $ | $ | $ | $ |
| Additions: | | | | | |
| Net investment income (loss) | (2,312,726,206) | (695,792,364) | 1,918,274,641 | (1,616,933,842) | (2,614,067,005) |
| Member systems' contributions | 0 | 0 | 0 | 0 | 0 |
| Total additions | (2,312,726,206) | (695,792,364) | 1,918,274,641 | (1,616,933,842) | (2,614,067,005) |
| Deductions: | | | | | |
| Member systems' withdrawals | 277,000,000 | 499,500,000 | 642,000,000 | (222,500,000) | (142,500,000) |
| Administrative expenses | 41,272,683 | 41,850,636 | 40,563,334 | (577,953) | 1,287,302 |
| Total deductions | 318,272,683 | 541,350,636 | 682,563,334 | (223,077,953) | (141,212,698) |
| Increase/(decrease) in net assets | (2,630,998,889) | (1,237,143,000) | 1,235,711,307 | (1,393,855,889) | (2,472,854,307) |

# Statement Of Net Assets

JUNE 30, 2009

| | 2009 | 2008 |
|---|---|---|
| | $ | $ |
| ASSETS | | |
| Cash | 12,662,039 | 43,667,005 |
| Receivables: | | |
| Foreign taxes | 3,368,678 | 2,336,921 |
| Accounts receivable | 1,557,303 | 2,057,953 |
| Investments sold | 154,225,236 | 146,645,830 |
| Interest & dividends | 26,948,058 | 36,065,297 |
| Total receivables | 186,099,275 | 187,106,001 |
| Prepaid expenses | 16,184 | 16,242 |
| Capital assets | 57,635 | 52,797 |
| Investments at fair value: | | |
| Government and agency obligations | 665,018,889 | 852,045,701 |
| Foreign obligations | 33,237,090 | 113,005,430 |
| Corporate obligations | 668,047,761 | 1,058,164,332 |
| Common stock and equity funds | 2,610,218,733 | 3,823,791,711 |
| Commingled Funds | 335,484,184 | 417,894,222 |
| Preferred stock | 286,429 | 4,491,500 |
| Foreign equity securities | 1,482,594,431 | 1,984,314,463 |
| Foreign preferred stock | 47,856 | 603,032 |
| Hedge funds | 880,939,190 | 598,985,402 |
| Real estate funds | 875,929,700 | 1,332,081,349 |
| Private equity | 450,491,810 | 524,628,589 |
| Money market instruments | 235,126,490 | 307,481,504 |
| Infrastructure funds | 305,969,947 | 209,975,518 |
| Bank loans | 197,259,098 | 202,137,983 |
| Forward foreign currency contracts | (5,594,545) | (72,622) |
| Total investments | 8,735,057,063 | 11,429,528,114 |
| Securities lending collateral | 1,395,768,802 | 1,703,959,890 |
| Total assets | 10,329,660,998 | 13,364,330,049 |
| LIABILITIES | | |
| Payables: | | |
| Investments purchased | 173,277,766 | 338,215,349 |
| Operating expenses | 5,077,999 | 7,101,649 |
| Securities lending cash collateral obligation | 1,467,250,961 | 1,703,959,890 |
| Total liabilities | 1,645,606,726 | 2,049,276,888 |
| Net assets | 8,684,054,272 | 11,315,053,161 |

*See notes to financial statements, pages 8-18.*

# Statement Of Changes In Net Assets

JUNE 30, 2009

| | 2009 | 2008 |
|---|---|---|
| | $ | $ |
| ADDITIONS | | |
| Investment income (loss): | | |
| Net increase (decrease) in fair value of investments | (2,592,469,141) | (1,029,242,365) |
| Interest | 145,432,334 | 154,620,159 |
| Dividends | 116,732,339 | 162,205,372 |
| Securities lending income | 28,308,215 | 91,663,587 |
| Securities lending rebates | (8,690,202) | (72,105,009) |
| Securities lending expenses | (2,039,751) | (2,934,108) |
| Total investment income (loss) | (2,312,726,206) | (695,792,364) |
| Total additions | (2,312,726,206) | (695,792,364) |
| DEDUCTIONS | | |
| Expenses: | | |
| Salaries and benefits: | | |
| Salaries | 1,132,442 | 1,009,739 |
| Benefits | 514,691 | 412,515 |
| Operating expenses: | | |
| Rent and utilities | 167,845 | 160,170 |
| Audit | 144,600 | 140,399 |
| Other | 244,346 | 267,119 |
| External support: | | |
| Custody | 264,532 | 212,604 |
| Consulting and professional | 1,329,476 | 1,471,182 |
| Investment advisors/managers | 37,272,541 | 38,008,970 |
| Investment services and research | 202,210 | 167,938 |
| Total expenses | 41,272,683 | 41,850,636 |
| Member systems' withdrawals | 277,000,000 | 499,500,000 |
| Total deductions | 318,272,683 | 541,350,636 |
| Increase (decrease) in net assets | (2,630,998,889) | (1,237,143,000) |
| Net assets at beginning of year | 11,315,053,161 | 12,552,196,161 |
| Net assets at end of year | 8,684,054,272 | 11,315,053,161 |

*See notes to financial statements, pages 8-18.*

***Note 1***
***Summary of Significant Accounting Policies***

**Reporting Entity**
The Illinois State Board of Investment (ISBI or Board) is considered to be an internal investment pool of the State of Illinois, operating solely from investment income. The ISBI manages and invests the pension assets of three separate public employee retirement systems: General Assembly Retirement System, the Judges' Retirement System of Illinois, and State Employees' Retirement System of Illinois.

The assets of the member systems are accounted for in a single Commingled Fund. Separate information on each system's participation is presented in Note 3.

**Basis of Accounting**
Accounting records are maintained on an accrual basis. Units are allocated monthly to member systems based upon percentage of ownership. Management expenses are deducted monthly from income before distribution.

**Valuation of Investments**
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 ISBI and its investment managers; (5) Alternative Investments (Private Equity, Hedge Funds and Infrastructure Funds) – fair values as determined by ISBI and its investment managers; (6) Commingled Funds – fair values as determined by ISBI and its investment managers.

**Investment Transactions and Investment Income**
Investment transactions are accounted for on a trade date (date order to buy or sell is initiated) and dividend income is recognized on the ex-dividend date. Interest income is recognized on an accrual basis.

**Custody and Investment Management Fees**
There are no base charges for custody fees. Investment management fees for all accounts, except real estate and alternative investments, are computed quarterly as a percentage of each manager's portfolio market value. Management fees for real estate and alternative investments are not directly charged but are included in the investment income for these investments. The investment management fees for certain holdings within the Alternative Investments asset class (infrastructure funds) are calculated based on capital commitment.

**Risk Management**
The ISBI, as part of the State, provides for risks of loss associated with workers' compensation and general liability through the State's self-insurance program. The ISBI obtains commercial insurance for fidelity and surety and property. There have been no commercial insurance claims in the past five years.

**Risks and Uncertainties**
ISBI invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and those such changes could materially affect the amounts reported in the Statement of Net Assets.

**Use of Estimates**
In preparing financial statements in conformity with U. S. generally accepted accounting principles, the Board 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 additions and deductions during the reporting period. Actual results could differ from those estimates and assumptions and the differences may be material.

**Reclassification**
Certain items in the 2008 financial statements have been reclassified to conform to the 2009 presentation.

**Subsequent Events**
ISBI has evaluated subsequent events for potential recognition and/or disclosure through January 20, 2010, the date the financial statements were available to be issued.

### Deposits

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, 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, 2009 and 2008, ISBI had non-investment related balances of $184,259 and $185,605. Cash held in the investment related bank account is neither insured nor collateralized for amounts in excess of $250,000. During fiscal year 2007, a Credit Risk Policy was implemented by ISBI staff and formally adopted by the 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. State Street Bank and Trust has an AA Long-term Deposit/Debt rating by Standards & Poor and an Aa2 rating by Moody. Certain investments of 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, ISBI reports these types of cash equivalents as Money Market Instruments in the Statement of Net Assets. As of June 30, the amounts held in the investment related bank account with exposure to custodial credit risk are as follows:

| | 2009 | 2008 |
|---|---|---|
| | $ | $ |
| Carrying amounts and Bank Balances at June 30 | | |
| Cash | 12,440,740 | 43,558,219 |
| Amount exposed to custodial credit risk | 0 | 43,458,219 |

### Investment Policy

ISBI's investment authority and responsibilities are specified in the Illinois Compiled Statutes, 40ILCS 5/22A. These statutes provide ISBI with the authority to manage and invest the assets of any Illinois pension or education fund.

As described in Note 1, ISBI currently manages and invests the assets of the General Assembly Retirement System, Judges' Retirement System, and State Employees' Retirement System. All investments undertaken by ISBI are governed by 40ILCS 5 adopted by the General Assembly in 1982, and other standards codified in the above reference to the statutes.

40ILCS 5/1-109 requires all members of the Board and other fiduciaries to "… discharge his or her duties with respect to the retirement system or pension fund solely in the interest of the participants and beneficiaries and: With the care, skill, prudence and diligence…By diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses…"

### Investment Commitments

Real estate and private equity investment portfolios consist of passive interests in limited partnerships. ISBI had outstanding commitments to these limited partnerships of approximately $486 million and $515 million as of June 30, 2009 and 2008, respectively. At the end of fiscal year 2009 and 2008, the Board had outstanding commitments of $159 million and $165 million to separate real estate funds respectively. Also at the end of fiscal year 2009 and 2008, the Board had outstanding amounts of $155 million and $302 million to infrastructure funds.

### Investment Summary

The following table presents a summary of the Fund's investments at fair value by type at June 30, 2009 and 2008:

| | 2009 | 2008 |
|---|---|---|
| | $ | $ |
| Government and agency obligations | 665,018,889 | 852,045,701 |
| Foreign obligations | 33,237,090 | 113,005,430 |
| Corporate obligations | 668,047,761 | 1,058,164,332 |
| Common stock & equity funds | 2,610,218,733 | 3,823,791,711 |
| Preferred stock | 286,429 | 4,491,500 |
| Foreign equity securities | 1,482,594,431 | 1,984,314,463 |
| Foreign preferred stock | 47,856 | 603,032 |
| Commingled Funds | 335,484,184 | 417,894,222 |
| Hedge funds | 880,939,190 | 598,985,402 |
| Real estate investments | 875,929,700 | 1,332,081,349 |
| Private equity | 450,491,810 | 524,628,589 |
| Money market instruments | 235,126,490 | 307,481,504 |
| Infrastructure funds | 305,969,947 | 209,975,518 |
| Bank loans | 197,259,098 | 202,137,983 |
| Forward foreign currency contracts | (5,594,545) | (72,622) |
| Total investments | 8,735,057,063 | 11,429,528,114 |

ISBI's investments in Private Equity and Real Estate 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.
ISBI's investments in Infrastructure funds represent pooled

***Note 2 (continued)***
***Deposits, Investments, and Investment Risk***

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

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

**Concentration of Credit Risk and Credit Risk for Investments**
The portfolio is managed by professional investment management firms. These investment management firms are required to maintain diversified portfolios. Each investment manager must comply with risk management guidelines individually assigned to them as part of their investment management agreement. The Board did not have any single issuer investment that exceeded 5% of the total net assets of the Board as of June 30, 2009 and 2008. The following table presents the quality ratings of debt securities held by ISBI as of June 30, 2009 and 2008:

| | Moody's Quality Rating | 2009 | 2008 |
|---|---|---|---|
| | | $ | $ |
| Government and agency obligations | | | |
| U.S Government obligations and Federal agency obligations | AAA | 653,019,129 | 661,038,879 |
| | AA | 11,999,760 | 5,057,314 |
| | A | - | 12,617,585 |
| | BAA | - | 4,847,471 |
| | B | - | 976,931 |
| | Not rated | - | 167,507,521 |
| Total Government and agency obligations | | 665,018,889 | 852,045,701 |
| Foreign obligations | AAA | 7,009,777 | 8,105,833 |
| | AA | 3,433,768 | 3,578,088 |
| | A | - | 12,247,911 |
| | BAA | 1,899,728 | 27,477,167 |
| | BA | 10,915,077 | 30,930,973 |
| | B | 7,765,165 | 10,807,260 |
| | CAA | 1,609,335 | - |
| | C | 604,240 | - |
| | Not rated | - | 19,858,198 |
| Total foreign obligations | | 33,237,090 | 113,005,430 |
| Corporate obligations | AAA | 39,162,888 | 129,745,414 |
| | AA | 56,839,344 | 125,292,897 |
| | A | 209,758,077 | 132,759,541 |
| | BAA | 99,409,888 | 148,019,604 |
| | BA | 79,410,130 | 111,315,582 |
| | B | 132,204,912 | 280,234,046 |
| | CAA | 39,940,421 | 64,919,149 |
| | CA | 977,375 | 530,341 |
| | C | - | 556,527 |
| | Not rated | 10,344,726 | 64,791,231 |
| Total corporate obligations | | 668,047,761 | 1,058,164,332 |

### 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, 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, 2009 and 2008, the following investments were uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the Board's name:

| | 2009 | 2008 |
|---|---|---|
| | $ | $ |
| Common stock | 2,529,488 | 2,024,444 |
| Government and agency obligations | 7,847,410 | 9,695,067 |
| Corporate obligations | 0 | 0 |
| Total | 10,376,898 | 11,719,511 |

### Interest Rate Risk

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

Duration is a measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's fair value. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. As of June 30, 2009, ISBI benchmarks its debt security portfolio to Barclay's Capital Intermediate U.S. Government/Credit Bond Index. As of June 30, 2008, ISBI benchmarked its debt security portfolio to Lehman Brothers Aggregate. At June 30, 2009, the effective duration of the Barclay's Capital Intermediate U.S. Government/Credit Bond Index was 3.9 years. At June 30, 2008, the effective duration of the Lehman Brothers Aggregate was 3.8 years. At the same point in time, the effective duration of the ISBI debt security portfolio at June 30, 2009 and 2008 was 3.8 and 4.2 years, respectively.

| | 2009 | | 2008 | |
|---|---|---|---|---|
| | Fair Value | Effective Weighted Duration Years | Fair Value | Effective Weighted Duration Years |
| Investment Type | $ | | $ | |
| Government & agency obligations | | | | |
| U.S. Government | 75,529,694 | 5.3 | 235,753,279 | 5.3 |
| Federal Agency | 589,489,195 | 2.9 | 616,292,422 | 3.4 |
| Foreign Obligations | 33,237,090 | 4.7 | 113,005,430 | 5.1 |
| Corporate Obligations | | | | |
| Bank and Finance | 159,283,917 | 4.0 | 159,397,789 | 3.8 |
| Collateralized Mortgage Obligations | 19,360,918 | 2.8 | 136,048,371 | 1.4 |
| Industrials | 425,239,911 | 4.4 | 593,294,641 | 4.9 |
| Other | 64,163,015 | 4.7 | 169,423,531 | 5.1 |
| | 1,366,303,740 | | 2,023,215,463 | |

*Note 2 (continued)*
*Deposits, Investments, and Investment Risk*

### Foreign Currency Risk

The 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 $38,643,067 and $0 as of June 30, 2009 and 2008, respectively. The following table presents the foreign currency risk by type of investment as of June 30, 2009 and 2008:

| | 2009 | | 2008 | |
|---|---|---|---|---|
| | Foreign Equity and Foreign Preferred Securities | Foreign Obligations | Foreign Equity and Foreign Preferred Securities | Foreign Obligations |
| | $ | $ | $ | $ |
| Australian Dollar | 64,845,908 | – | 122,273,518 | – |
| Brazilian Real | 33,224,878 | – | 9,912,719 | 822,627 |
| Canadian Dollar | 47,104,026 | – | 67,312,081 | 640,243 |
| Danish Krone | 22,597,007 | – | 20,127,457 | – |
| Egyptian Pound | 631,787 | – | 315,568 | – |
| English Pound Sterling | 291,255,325 | – | 360,797,972 | 355,913 |
| Euro Currency | 407,541,247 | – | 579,718,291 | 3,464,132 |
| Hong Kong Dollar | 39,652,995 | – | 54,097,173 | – |
| Iceland Krona | – | – | – | 4,149,151 |
| Japanese Yen | 221,156,513 | – | 278,817,201 | – |
| Malaysian Ringgit | – | – | – | 6,031,886 |
| Mexican Peso | 2,121,876 | – | 2,383,899 | 9,829,450 |
| New Zealand Dollar | 1,076,827 | – | 1,093,179 | – |
| Norwegian Krone | 9,277,231 | – | 33,771,404 | – |
| Singapore Dollar | 30,234,461 | – | 33,616,147 | 6,136,820 |
| South African Rand | 3,495,645 | – | 3,038,970 | – |
| South Korean Won | 21,353,474 | – | 22,322,531 | – |
| Swedish Krona | 15,868,385 | – | 38,232,833 | – |
| Swiss Franc | 124,169,874 | – | 129,364,946 | – |
| Foreign Investments denominated in U.S. dollars | 147,034,828 | 33,237,090 | 227,721,606 | 81,575,208 |
| | 1,482,642,287 | 33,237,090 | 1,984,917,495 | 113,005,430 |

### Securities Lending

ISBI participates in a securities lending program with State Street who acts as a securities lending agent. Securities are loaned to brokers and, in return, ISBI has rights to a portion of a collateral pool. All of the securities are eligible for the securities lending program. Collateral consists solely of cash, letters of credit, commercial paper, and government securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-U.S. securities). In the event of borrower default, State Street provides ISBI with counterparty default indemnification. ISBI had no credit risk as a result of its securities lending program as the collateral received exceeded the fair value of the securities loaned. As of June 30, 2009 and 2008, there were outstanding loaned investment securities having fair values of $1,476,903,266 and $1,851,952,625, respectively; against which collateral was received with a fair value of $1,528,744,414 and $1,912,742,552, respectively. Collateral received at June 30, 2009 and 2008 consisted of $1,467,250,961 and $1,703,959,890 respectively, in cash and $61,493,453 and $208,782,662, respectively, in securities for which the Board does not have the ability to pledge or sell.

The cash collateral received is invested in a short term investment pool having a fair value of $1,395,768,803 and $1,703,959,890 as of June 30, 2009 and 2008, respectively. This investment pool had an average duration of 42.64 days and 41.84 days as of June 30, 2009 and 2008, respectively. Any decrease in the fair value of invested cash collateral is recorded as unrealized losses and reported as a component of the investment income (loss) on the Statement of Changes in Net Assets. Regarding the investment pool, at the time of purchase, all securities with maturities of 13 months or less must qualify as first-tier securities and all securities with maturities in excess of 13 months will (a) be rate A or better by at least two nationally recognized statistical rating organization (NRSROs) or (b) if rated by only one NRSRO, be rated A or better by such NRSRO, or (c) if unrated, be determined by State Street to be of comparable quality.

### Derivative Securities

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

During the year, derivative investments included forward foreign currency contracts, collateralized mortgage obligations (CMO's), futures, and options.

Forward foreign currency contracts are used to hedge against the currency risk in ISBI's foreign stock and fixed income portfolios. Forward foreign currency contracts are agreements to buy or sell specific amounts of a foreign currency at a specified delivery or maturity date for an agreed upon price. As the fair value of the forward contracts varies, ISBI records an unrealized gain or loss. Forward foreign currency contracts represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts. The fair value of forward foreign currency contracts outstanding at June 30, 2009 and 2008 was as follows:

| | Cost<br>$ | Fair Value<br>$ | Gain (Loss)<br>$ |
|---|---|---|---|
| June 30, 2009 | | | |
| Forward currency purchases | 173,126,960 | 181,554,864 | 8,427,904 |
| Forward currency sales | 183,451,357 | 197,473,806 | (14,022,449) |
| Total gain (loss) | | | (5,594,545) |
| June 30, 2008 | | | |
| Forward currency purchases | 6,018,928 | 6,025,470 | 6,542 |
| Forward currency sales | 5,890,350 | 5,969,514 | (79,164) |
| Total gain (loss) | | | (72,622) |

***Note 2 (continued)***
***Deposits, Investments, and Investment Risk***

ISBI also invests in mortgage-backed securities to maximize yields and to hedge against a rise in interest rates. These securities are based on cash flows from principal and interest payments on underlying mortgages. The value, liquidity and related income of these securities are sensitive to prepayments by mortgagees, changes in economic conditions, including real estate values, delinquencies or defaults, or both and may be adversely affected by shifts in the market's perception of the issuer's and insurers and changes in interest rates. As of June 30, 2009 and 2008, the fair value of ISBI CMO holdings totaled $23,611,438 and $165,456,226, respectively.

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

ISBI investment managers utilize options in an effort to add value to the portfolio (collect premiums) or protect (hedge) a position in the portfolio. Options are agreements that give one party the right, but not the obligation, to buy or sell a specific amount of an asset for a specific price (called the strike price) on or before a specified expiration date. As the writer of financial options, ISBI receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the instrument underlying the option. As the purchaser, 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 following table shows the foreign and domestic futures and options positions held by ISBI as of June 30, 2009 and 2008.

| | 2009 | | 2008 | |
|---|---|---|---|---|
| | Number of Contracts | Contract Principal* $ | Number of Contracts | Contract Principal* $ |
| Equity futures purchased | 1,626 | 74,430,150 | 1,892 | 122,985,600 |
| Fixed income futures purchased | – | – | 3 | 599,694 |
| Fixed income futures sold | – | – | 790 | 167,444,230 |
| Fixed income written put options | – | – | 347 | 34,700,000 |
| Fixed income written call options | – | – | 283 | 28,300,000 |

* Contract principal amounts shown represent the market value of the underlying assets the contracts control. Contract principal is shown to present the volume of the transactions but does 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 balance sheet values.

### Investment Liquidity

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

| ***Note 3*** ***Member Systems' Participation*** | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| **Member Systems' Income and Expenses Fiscal Year Ended June 30, 2009** | $ | $ | $ | $ |
| Interest and dividends | 1,549,538 | 13,449,740 | 247,165,395 | 262,164,673 |
| Net securities lending income | 104,640 | 904,710 | 16,568,912 | 17,578,262 |
| Net decrease in fair value of investments | (16,141,323) | (135,286,901) | (2,441,040,917) | (2,592,469,141) |
| Total Investment income/(loss) | (14,487,145) | (120,932,451) | (2,177,306,610) | (2,312,726,206) |
| Management expenses | (243,045) | (2,118,645) | (38,910,993) | (41,272,683) |
| Net investment income/(loss) | (14,730,190) | (123,051,096) | (2,216,217,603) | (2,353,998,889) |
| **Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2009** | | | | |
| Net assets at beginning of year | 71,923,943 | 589,155,697 | 10,653,973,521 | 11,315,053,161 |
| Member systems' net (withdrawals) | (9,500,000) | (30,500,000) | (237,000,000) | (277,000,000) |
| Net investment income/(loss) | (14,730,190) | (123,051,096) | (2,216,217,603) | (2,353,998,889) |
| Net assets at end of year | 47,693,753 | 435,604,601 | 8,200,755,918 | 8,684,054,272 |

The source of net assets of the member systems since inception at June 30, 2009, is as follows:

| | | | | |
|---|---|---|---|---|
| Member systems' net (withdrawals) | (54,759,496) | (100,832,730) | (1,545,086,756) | (1,700,678,982) |
| Accumulated net investment income | 102,453,249 | 536,437,331 | 9,745,842,674 | 10,384,733,254 |
| Net assets at fair value | 47,693,753 | 435,604,601 | 8,200,755,918 | 8,684,054,272 |

** Combined column for the member systems is presented for information purposes only and does not indicate that the assets of one system may be used for another system.*

| ***Note 3 (continued)*** ***Member Systems' Participation*** | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| **Member Systems' Income and Expenses Fiscal Year Ended June 30, 2008** | $ | $ | $ | $ |
| Interest and dividends | 2,056,927 | 16,497,137 | 298,271,467 | 316,825,531 |
| Net securities lending income | 107,307 | 864,473 | 15,652,690 | 16,624,470 |
| Net decrease in fair value of investments | (6,734,639) | (53,819,542) | (968,688,184) | (1,029,242,365) |
| Total Investment income/(loss) | (4,570,405) | (36,457,932) | (654,764,027) | (695,792,364) |
| Management expenses | (270,594) | (2,180,095) | (39,399,947) | (41,850,636) |
| Net investment income/(loss) | (4,840,999) | (38,638,027) | (694,163,974) | (737,643,000) |
| **Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2008** | | | | |
| Net assets at beginning of year | 83,864,942 | 658,193,724 | 11,810,137,495 | 12,552,196,161 |
| Member systems' net (withdrawals) | (7,100,000) | (30,400,000) | (462,000,000) | (499,500,000) |
| Net investment income/(loss) | (4,840,999) | (38,638,027) | (694,163,974) | (737,643,000) |
| Net assets at end of year | 71,923,943 | 589,155,697 | 10,653,973,521 | 11,315,053,161 |

The source of net assets of the member systems since inception at June 30, 2008, is as follows:

| | | | | |
|---|---|---|---|---|
| Member systems' net (withdrawals) | (45,259,495) | (70,332,730) | (1,308,086,756) | (1,423,678,981) |
| Accumulated net investment income | 117,183,438 | 659,488,427 | 11,962,060,277 | 12,738,732,142 |
| Net assets at fair value | 71,923,943 | 589,155,697 | 10,653,973,521 | 11,315,053,161 |

** Combined column for the member systems is presented for information purposes only and does not indicate that the assets of one system may be used for another system.*

### Plan Description

All of the ISBI employees participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois reporting entity. The SERS is a single-employer, defined benefit, public employee retirement system (PERS) in which State employees participate, except those covered by the State Universities, Teachers', General Assembly, and Judges' Retirement Systems. The financial position and results of operations of the SERS for fiscal years 2009 and 2008 are included in the State of Illinois' Comprehensive Annual Financial Report (CAFR). The SERS also issues a separate CAFR that may be obtained by writing to the SERS, 2101 Veterans Parkway, Springfield, IL 62794-9255 or by calling 217/785-7202. The State of Illinois CAFR may be obtained by writing to the State Comptroller's Office, Financial Reporting Department, 325 West Adams Street, Springfield, IL 62704-1858 or by calling 217/782-2053.

A summary of SERS' 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 SERS' CAFR. Also included is a discussion of employer and employee obligations to contribute, and the authority under which those obligations are established.

### Funding Policy

ISBI pays employer retirement contributions based upon an actuarially determined percentage of payroll. For fiscal year 2009 and 2008 the employer contribution rates were 21.049% and 16.561%, respectively. ISBI contributions to SERS for fiscal years 2009 and 2008 were $241,690 and $172,154, respectively, and were equal to the required contributions for each fiscal year.

Effective for pay periods beginning after December 31, 1991, the Board opted to pay the employee portion of retirement for ISBI employees covered by the State Employees' Retirement Systems. Generally, this pickup of employee retirement was part of the budget process and was, in part, a substitute for salary increases. ISBI contributions to SERS for the employee portion for fiscal years 2009 and 2008 were $44,104 and $37,225, respectively.

### Post-retirement Benefits

The State provides health, dental, and life insurance benefits for retirees and their dependents in a program administered by the Department of Healthcare and Family Services along with the Department of Central Management Services. Substantially all State employees become eligible for post-employment benefits if they eventually become annuitants of one of the State sponsored pension plans. Health, dental and vision benefits include basic benefits for annuitants 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 toward 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 have to contribute towards health, dental and vision benefits. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefits become $5,000.

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 cost on a pay-as-you-go basis. The total costs incurred for health, dental, vision and life insurance benefits are not separated by department of component unit for annuitants and their dependents nor active employees and their dependents.

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

***Note 5***
***New Governmental Accounting Standards***

Statement No. 51, Accounting and Financial Reporting for Intangible Assets, establishes accounting and financial reporting requirements for intangible assets (including certain internally developed software). All intangible assets not specifically excluded by the scope of this Statement should be classified as capital assets. All existing authoritative guidance for capital assets should be applied to those intangible assets, as applicable. ISBI is required to implement this Statement for the year ending June 30, 2010.

Statement No. 53, Accounting and Financial Reporting for Derivative Instruments, issued June 2008, is effective for ISBI beginning with its year ending June 30, 2010. This Statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by the State and local governments. Derivative instruments are often complex financial arrangements used by governments to manage specific risks or to make investments.

ISBI has not currently determined what impact, if any, these Standards may have on its financial statements.

McGladrey & Pullen
Certified Public Accountants

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

Honorable William G. Holland
Auditor General
State of Illinois

Board of Directors
Illinois State Board of Investment

As Special Assistant Auditors for the Auditor General, we have audited the financial statements of the Illinois State Board of Investment (the Board), an internal investment pool of the State of Illinois, as of and for the years ended June 30, 2009 and June 30, 2008, and have issued our report thereon dated January 20, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

### Internal Control Over Financial Reporting

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

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings we identified certain deficiencies in the internal control over financial reporting that we consider to be material weaknesses.

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 misstatements 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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described in finding 09-1 in the accompanying schedule of findings to be a material weakness.

A significant deficiency is a deficiency or 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. We consider the deficiencies described in findings 09-1 and 09-2 in the accompanying schedule of findings to be significant deficiencies.

## Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Board'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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings as items 09-1 and 09-2.

The Board's responses to the findings identified in our audit are described in the accompanying schedule of findings. We did not audit the Board's responses and, accordingly, we express no opinion on it.

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

McGladrey & Pullen, LLP

Chicago, Illinois
January 20, 2010

## Finding No. 09-1 Securities Lending

The Illinois State Board of Investment (ISBI) did not have adequate internal controls over financial reporting for its securities lending transactions.

ISBI did not record the fair value of the investment of cash collateral received for securities lending transactions. The fair value of the investment as of June 30, 2009 was $1,395 million with related obligations of $1,467 million. The cash collateral was invested in a money market fund that had declined in value during the fiscal year. Management accounted for the investment at its historical par value and did not take into consideration market fluctuations. The resulting unrealized loss of $71.4 million was proposed by the auditors and recorded in the June 30, 2009 financial statements.

Accounting principles generally accepted in the United Statements of America (GAAP) require that the Board record the collateral assets, liabilities and gains or losses associated with securities lending transactions and disclose certain information relating to the securities lending transactions in its financial statements. The Fiscal Control and Internal Auditing Act, 30 ILCS 10/3001 requires all State agencies to establish and maintain a system, or systems, of internal fiscal and administrative controls, which provide assurance that revenues, expenses, and transfers of assets, resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the State's resources.

Management indicated different personnel in the Agency were responsible for monitoring different facets of the securities lending process and not all pertinent information was disseminated to the Accounting Unit which is responsible for recording the financial effects of these types of transactions in the Agency financial records.

Failure to accurately record material assets, liabilities and investment losses resulted in materially misstated financial statements not prepared in accordance with GAAP. (Finding Code No. 09-1)

### Recommendation:

We recommend that ISBI improve its controls so it timely obtains and reviews all relevant investment information necessary to properly record and disclose all material investment transactions in ISBI's annual financial statements. ISBI should record the related assets and obligations on the general ledger and not only as a report entry. In addition, ISBI's investment portfolio should be continuously reviewed to ensure non-viable investments are re-directed to more viable options.

### Board Response:

The Board will update internal control procedures to incorporate a monthly closing process for securities lending that records all securities lending assets and obligations at fair value in the general ledger.

## Finding No. 09-2 Alternative Investments

The Illinois State Board of Investment (ISBI) should enhance its accounting and reporting process for determining and reviewing the fair value measurements and disclosures used for reporting its alternative investments on a timely basis.

During a review of ISBI's alternative investments, it was discovered that the financial activity reported for certain alternative investments was not current as of the Statement of Plan Net Assets for interim reporting periods. Many of the alternative investment fund balances in the December 31, 2008 internal financial statements were represented by the values provided by ISBI's private investment funds and separate account investment advisers as of September 30, 2008 with cash activity through December 31, 2008, but did not include any unrealized gains or losses for the underlying investments and underlying private investment funds for the period from October 1 through December 31. Additionally, certain private investment funds and separate account investment advisers did not report the quarterly valuation of investments as of June 30, 2009 within a reasonable time period, causing a delay in the audit process as well as issuance of the audited financial statements. As a result, ISBI's Alternative Investment balances were overstated by approximately $21.6 million at June 30, 2009, until ISBI received reports from its private investment funds and separate account investment advisers and made adjustments accordingly.

Accounting principles generally accepted in the United Statements of America (GAAP) require ISBI to report its investments at fair value in its financial statements. Timeliness is a necessary component of relevant reporting so that decision makers can make use of the information to influence future decisions. The Fiscal Control and Internal Auditing Act, 30 ILCS 10/3001, requires all State agencies to establish and maintain a system, or systems, of internal fiscal and administrative controls, which provide assurance that revenues, expenses, and transfers of assets, resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the State's resources.

Alternative investments are defined as investments for which a readily determinable fair value does not exist. These are investments not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System (NASDAQ). Alternative investments comprise approximately 25% of ISBI's total investments and include real estate, private equity, infrastructure, and hedge funds as of June 30, 2009. Based on the organizational structure and limited staff of the ISBI, they oversee the valuation procedures performed by the alternative portfolio's private investment funds and separate account investment advisers. ISBI management may look to the private investment funds and separate account investment advisers for guidance, but management must have sufficient information to evaluate and independently challenge the information provided by these private investment funds and separate account investment advisers.

In connection with the issuance of the Institute of Certified Public Accountants (AICPA) Practice Aid, *Alternative Investments – Audit Considerations*, management performed additional procedures and an evaluation of their alternative investment valuations. These procedures are a part of ISBI's Alternative Investment Protocol, an ongoing comprehensive internal control process related to the valuation of alternative investments. However, ISBI relies on its private investment funds and separate account investment advisers to report unrealized gains and losses with respect to underlying investments or underlying private investment funds; due to investor transparency restrictions unique to alternative investments, management has limited available information on the underlying investments or underlying private investment funds to provide for a timely valuation as of their financial statement date without the private investment funds' and separate account investment advisers' reported valuations.

Finding No. 09-2 Alternative Investments (Continued)

According to ISBI management, the 2008 meltdown in the financial markets precipitated the alternative portfolio's private investments funds and separate account investment advisers, as well as their auditors, to be extremely careful in the release of data to investors during the December 2008 reporting cycle. Auditors of private investment funds and separate account investment advisers counseled their clients not to release any interim capital statement data to investors until the auditors' annual audit work was complete. Contrary to repeated requests from ISBI, the private investment funds and separate account investment advisers would not release the data until their auditors signed off on their December 2008 information. Regarding the other incident at June 30, 2009, the delay for the largest valuation adjustment in the amount of $16 million was the result of waiting on data from a terminated separate account investment adviser's auditor. The second highest valuation adjustment for $3.2 million was late due to the fact that a particular private investment fund's auditor requested late entries to be posted at the June 30, 2009 reporting period for disclosure of the fund's non-economic losses. The remaining two private investment funds' ' data was distributed late despite requests from ISBI to provide estimates. ISBI management further stated that ISBI's direct investments in private investment funds are governed by limited partnership agreements that are negotiated at the front-end of the direct investment. If provisions regarding failure to release timely financial data and associated penalties for breach were not negotiated into the limited partnership agreement s and side letters at the time of ISBI's initial subscriptions to these direct investments, ISBI has no remedy to force release of this information or assess penalties after the fact, unless failure to release the information would violate the law that governs the agreements. ISBI could attempt to renegotiate the limited partnership agreements or side letters, but ISBI's likelihood of success is de minimus, given ISBI's lack of negotiating leverage and the understandable lack of incentive by the funds to impose more stringent requirements. With respect to separate account hedge fund of fund investment advisers, the advisers are similarly bound by the underlying private investment funds' limited partnership agreement terms regarding the release of financial data and associated penalties for breach. When ISBI receives final valuations from private investment funds and separate account investment advisers that were not reported in the current period, the valuations are adjusted accordingly in the subsequent period.

Failure to obtain timely reports from ISBI's private investment funds and separate account investment advisers for alternative investments resulted in ISBI improperly reporting the fair value of their alternative investments at 12/31/2008, which could result in a material misstatement of ISBI's annual financial statements. (Finding Code No. 09-2)

Recommendation:

We recommend that ISBI improve its controls so it timely obtains and reviews all relevant investment information necessary to properly record and disclose material investment transactions in ISBI's annual financial statements. ISBI should emphasize the importance of timely reporting to each private investment fund and separate account investment adviser. This notice may increase the likelihood that ISBI will receive timely financial statements from its alternative investments, which would provide assurance to ISBI that its financial statements are accurately represented as of a given date as well as improve ISBI's exercise of the Alternative Investment Protocol.

Finding No. 09-2 Alternative Investments (Continued)

Board Response

The Board will update internal control procedures to include a distribution of an annual letter to all private investment fund and separate account advisors stressing the importance of timeliness of reporting quarterly and annual valuation information to ISBI.

ISBI will disclose in the quarterly financial statements the nature and amount of any valuations that are stated on a cashflow basis for the current period as well as the historical impact of using those amounts. ISBI will also determine through a retroactive look back process if the necessary adjustments to bring those cashflow amounts reported in line with the funds' final reported valuation exceed 2% of the value of the particular asset class impacted for the prior period. If the amount of the retroactive adjustment amount exceeds 2% of the value of the asset class, the prior period financial statements will be restated.

ISBI will notify the auditors in writing when they come for annual financial fieldwork if there are valuations yet to be received and that the books are still open. ISBI will also inform the retirement systems in writing of any valuations to be received and that the books are still open during financial statement fieldwork.

## PRIOR FINDINGS NOT REPEATED

Year Ended June 30, 2009

***None.***