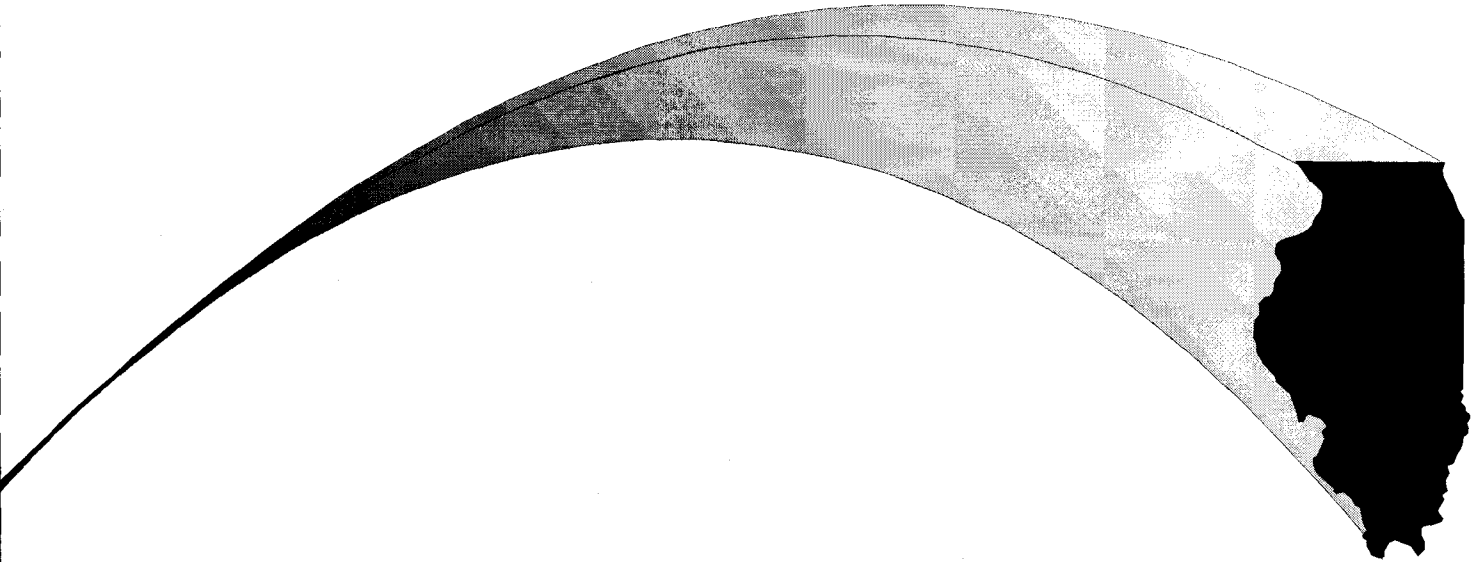


**STATE EMPLOYEES' RETIREMENT SYSTEM
OF ILLINOIS**

**A PENSION TRUST FUND
OF THE STATE OF ILLINOIS**

**COMPREHENSIVE ANNUAL
FINANCIAL REPORT**

**FOR THE FISCAL YEAR ENDED
JUNE 30, 1996**



STATE EMPLOYEES'
RETIREMENT SYSTEM
OF ILLINOIS

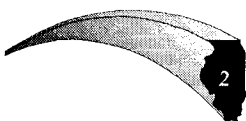
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Prepared by the
Accounting Division

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INTRODUCTORY SECTION

- Letter of Transmittal
- Administration, Board of Trustees and Administrative Staff
- Certificate of Achievement for Excellence in Financial Reporting



- State Employees' Retirement System of Illinois
- General Assembly Retirement System
- Judges' Retirement System of Illinois

2101 South Veterans Parkway, P.O. Box 19255, Springfield, IL 62794-9255, Ph. (217)785-7444

November 29, 1996

The Board of Trustees and Members
State Employees' Retirement System of Illinois
Springfield, IL 62794

Dear Board and Members:

The comprehensive annual financial report of the State Employees' Retirement System of Illinois (System) as of and for the fiscal year ended June 30, 1996 is hereby submitted. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the System. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds of the System. All disclosures necessary to enable the reader to gain an understanding of the System's financial activities have been included. The report consists of six sections:

1. An Introductory Section which contains this letter of transmittal and the identification of the administrative organization;
2. The Financial Section which contains the report of the independent public accountants, the financial statements of the System, and the required supplementary financial information;
3. The Actuarial Section which contains the report of the Actuary as well as the summary of major actuarial assumptions and certain tables;
4. The Investment Section which contains a summary of the System's investment management approach and selected summary tables, including investment performance;
5. The Statistical Section which contains significant statistical data; and
6. A summary of the System's plan provisions and current legislative changes.

The combined financial statements include the State Employees' Retirement System Trust Fund (System Trust Fund) and the Social Security Contribution Fund (Contribution Fund), an Agency Fund. 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 statements to be misleading or incomplete. Based on the criteria of the Governmental Accounting Standards Board Statement No. 14, there are no other state agencies, boards or commissions, or other organizations required to be combined with the System, however, the System is considered to be part of the State of Illinois financial reporting entity, and is to be combined and included in the State of Illinois' comprehensive annual financial report. Although the State Employees' Retirement System, Judges' Retirement System and General Assembly Retirement System share a common administration, they are separate entities for legal and financial reporting purposes. Therefore, the financial statements of the State Employees' Retirement System do not include balance sheet information nor the results of operations of the General Assembly Retirement System or Judges' Retirement System.

PLAN HISTORY AND SERVICES PROVIDED

The System is the administrator of a single-employer public employee retirement system established to provide pension benefits for State of Illinois employees. The System also administers widows and survivors benefits as well as the state's occupational and non-occupational disability programs.

The System Trust Fund was established January 1, 1944 and 17,237 state employees became members on that date. As of June 30, 1944, net assets of the System amounted to \$1,255,778. Plan assets at the end of the fiscal year June 30, 1996 are approximately \$4.4 billion, and there are 79,212 active members.

REVENUES

Collections of employer and employee retirement contributions, as well as income from investments, provide the reserves necessary to finance retirement benefits. These revenue sources totaled \$845.4 million during the fiscal year ending June 30, 1996, which is a significant increase from revenue reported for fiscal year 1995, shown as follows:

	1996 (Millions)	1995 (Millions)	Increase/(Decrease) (Millions) (Percentage)	
Retirement System Trust Fund				
Contributions:				
Employees	\$137.2	\$ 131.6	\$ 5.6	4.3%
Employer	146.4	136.6	9.8	7.2
Investments	561.8	290.8	271.0	93.2
	<u>\$845.4</u>	<u>\$ 559.0</u>	<u>\$286.4</u>	<u>51.2%</u>
Social Security Contribution Fund				
General Revenue, less balances lapsed				
	<u>.1</u>	<u>.1</u>	<u>-</u>	<u>-</u>
	<u>\$845.5</u>	<u>\$ 559.1</u>	<u>\$286.4</u>	<u>51.2%</u>

As indicated in the above schedule, approximately 95% of the total revenue increase was attributable to an increase in investment income which was largely the result of significant net realized gains on the sale of investments.

EXPENSES

The primary expense of a retirement system relates to the purpose for which it is created; namely the payment of benefits. These payments, together with the expense to administer the plan, constitute the total expenses of the System Trust Fund. Expenses of the System Trust Fund and Social Security Contribution Fund for 1996 and 1995 are shown for comparison purposes.

	1996 (Millions)	1995 (Millions)	Increase/(Decrease) (Millions) (Percentage)	
Retirement System Trust Fund				
Benefits:				
Retirement annuities	\$ 286.2	\$ 276.6	\$ 9.6	3.5%
Survivors' annuities	33.0	31.1	1.9	6.1
Disability benefits	22.4	21.4	1.0	4.7
Lump-sum death benefits	10.8	9.8	1.0	10.2
	<u>\$ 352.4</u>	<u>\$ 338.9</u>	<u>\$ 13.5</u>	<u>4.0%</u>
Refunds (including Transfers)	13.4	13.4	-	-
Administrative expenses	5.7	5.5	.2	3.6
	<u>\$ 371.5</u>	<u>\$ 357.8</u>	<u>\$ 13.7</u>	<u>3.8%</u>
Social Security Contribution Fund				
Administrative expenses				
	<u>.1</u>	<u>.1</u>	<u>-</u>	<u>-</u>
	<u>\$ 371.6</u>	<u>\$ 357.9</u>	<u>\$ 13.7</u>	<u>3.8%</u>

The increase in benefit payments results primarily from an increase in the average benefit payment amount.

INVESTMENTS

The System's investments are managed by the Illinois State Board of Investment (ISBI) pursuant to Chapter 40, Article 5/22A of the Illinois Compiled Statutes.

Income from investments has, over the years, increasingly become a greater share of the total revenue of the System. Net investment income, combined with a net realized gain on the sale of investments, amounted to \$561.8 million during fiscal year 1996, a significant increase of \$271.0 million from fiscal year 1995. Income from investments represents 66.5% of total fund revenue. The Illinois State Board of Investment had a 16.6% rate of return on market values for the year ended June 30, 1996.

A detailed discussion of investment performance and strategies is provided in the Investment Section of this report.

FUNDING AND RESERVES

Funding is the process of specifically allocating monies for current and future use. Proper funding includes an actuarial review of the fund balances to ensure that funds will be available for current and future benefit payments.

The actuarial determined liability of the System using the projected unit credit actuarial method at June 30, 1996, amounted to \$7.391 billion. The fund balances for participant contributions, interest accumulations and other future benefits amounted to \$4.397 billion as of the same date. The amount by which the liability exceeds the reserves is called the "unfunded present value of credited projected benefits". The unfunded present value of credited projected benefits amounted to \$2.994 billion.

ECONOMIC CONDITION AND OUTLOOK

Financing the retirement benefits that are being earned is one of the most important issues facing the State Employees' Retirement System. In prior years, a number of individuals and organizations stressed the need for sound funding of the state's retirement systems including the State Employees' Retirement System. Although previous attempts have been made at providing an adequate funding level to the System, none have been very successful.

In August, 1994, Governor Edgar signed Senate Bill 533 into law as Public Act 88-0593. This funding legislation, which became effective on July 1, 1995 (i.e. Fiscal Year 1996), 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 new funding plan provides for a 15 year phase-in period to allow the state to adapt to the increased financial commitment. Once the 15 year phase-in period is complete, the state's contribution will then remain at a level percentage of payroll for the next 35 years until the 90% funded level is achieved.

Most importantly, the new funding legislation also provides for the establishment of a continuing appropriation of the required employer contributions to the System. This will, in effect, remove the appropriation of these funds from the annual budgetary process. Although long-term in nature, we believe this legislation is an extremely positive step forward which will ensure the long-term financial integrity of the state's retirement systems including the State Employees' Retirement System.

Besides the new funding plan, there were no other recent legislative changes having a significant impact on the funding of the System.

Assessing the financial status of any retirement system is a difficult task. The valuation of pension liabilities is a complex procedure requiring the application of actuarial techniques. It is not possible to provide a simple measure of the financial status of a retirement system because no universally accepted measure of the financial status presently exists. The passage of a new funding plan by the state's General Assembly should ensure that benefits, both those presently accrued and those that will be earned in the future, will continue to be provided for in a timely and consistent manner.

MAJOR EVENTS/INITIATIVES

During the past fiscal year, the System was involved with several major projects. One such project was limited in scope, however, represented a significant step forward in the area of automated data retrieval. The Administrative Services Division implemented a process to electronically image the supporting documentation of administrative expenses paid by the System. Another completed project involved the "linking" of several separate computer data bases to each other in order to assist users in obtaining member account information using a single entry lookup.

A new member trustee, Ms. Caryl Wadley-Foy, was elected to the System's Board of Trustees while Ms. Doris Clark, annuitant, was elected to represent the System's retirees for a third consecutive term. Congratulations to both Caryl and Doris, we look forward to working with you during the upcoming years.

Other projects completed by the System primarily affect internal processing and/or communication. These projects are intended to expedite the response time in providing service and information to our members and other interested parties.

Projects for Fiscal Year 1997 include: Development of a New Employee Orientation Program by the Field Services Division and the automation of certain data which is presently in a microfilm or microfiche format.

ACCOUNTING SYSTEM AND INTERNAL CONTROL

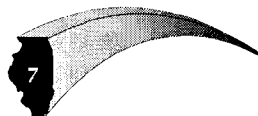
This report has been prepared to conform with the principles of governmental accounting and reporting pronounced by the Governmental Accounting Standards Board and the American Institute of Certified Public Accountants. The accrual basis of accounting is used to record the assets, liabilities, revenues and expenses of the System Trust Fund. Revenues are recognized in the accounting period in which they are earned, without regard to the date of collection, and expenses are recognized when the corresponding liabilities are incurred, regardless of when payment is made. The administrative expenses of the Social Security Contribution Fund are appropriated annually by the Illinois State Legislature and included in the financial statements of the System Trust Fund. The Contribution Fund uses the modified accrual basis of accounting. The System also uses the State of Illinois, Comptroller's Uniform Statewide Accounting System (CUSAS) as a basis for the preparation of the financial statements. In developing the System's accounting system, consideration is given to the adequacy of internal accounting controls. These controls are designed to provide reasonable assurance regarding the safekeeping of assets and the reliability of financial records. Constant effort is directed by the System at improving this level to assure the participants of a financially sound retirement system.

PROFESSIONAL SERVICES

Independent consultants are retained by the Board of Trustees to perform professional services that are essential to the effective and efficient operation of the System. Actuarial services are provided by Watson Wyatt Worldwide, Chicago, Illinois. Tax consulting services are provided by the accounting firm of KPMG Peat Marwick, Chicago, Illinois. The annual financial audit of the System was conducted by the accounting firm of McGladrey & Pullen, LLP, under the direction of the Auditor General of the State of Illinois. In addition to the annual financial audit, a one year compliance audit was also performed by the auditors. The purpose of the compliance audit was to determine whether the System obligated, expended, received and used public funds of the state in accordance with the purpose for which such funds have been authorized by law. The System's investment function is managed by the Illinois State Board of Investment.

CERTIFICATE OF ACHIEVEMENT

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State Employees' Retirement System of Illinois for its comprehensive annual financial report for the fiscal year ended June 30, 1995. The Certificate of Achievement is the highest form of recognition for excellence in state and local government financial reporting.



Letter of Transmittal


In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such financial report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The State Employees' Retirement System of Illinois has received a Certificate of Achievement for the past ten consecutive years (fiscal years ended June 30, 1986 through June 30, 1995). We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

ACKNOWLEDGMENTS AND COMMENTS

The preparation of this report reflects the combined efforts of the System's staff under the direction of the Board of Trustees. It is intended to provide complete and reliable information as a basis for making management decisions, as a means of determining compliance with legal provisions, and as a means for determining responsible stewardship for the assets contributed by the members in the State of Illinois. On behalf of the Board of Trustees, we would like to express our appreciation to the staff and professional consultants who worked so effectively to ensure the successful operation of the System.

Respectfully submitted,


Michael L. Mory
Executive Secretary


Nicholas C. Merrill, Jr., CPA
Chief Fiscal Officer