

**State of Montana**  
**COMPREHENSIVE ANNUAL FINANCIAL REPORT**  
For the Fiscal Year Ended June 30, 2003

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## MANAGEMENT'S DISCUSSION AND ANALYSIS

### INTRODUCTION

Management of the State of Montana provides this *Management's Discussion and Analysis* of the State of Montana's Comprehensive Annual Financial Report (CAFR) for readers of the State's financial statements. This narrative overview and analysis of the financial activities of the State of Montana is for the fiscal year ended June 30, 2003. We encourage readers to consider this information in conjunction with the additional information that is furnished in the State's financial statements, which follow.

### FINANCIAL HIGHLIGHTS – PRIMARY GOVERNMENT

#### Government-wide Highlights

The assets of the State exceeded its liabilities at the end of fiscal year 2003 by \$4.3 billion (reported as net assets) compared with \$2.9 billion at the end of fiscal year 2002. Of this amount, \$196 million (reported as unrestricted net assets) may be used to meet the government's general obligations to citizens and creditors. Component units reported net assets of \$643.3 million compared with \$653.7 million at fiscal year 2002.

#### Fund Highlights

As of the close of fiscal year 2003, the State's governmental funds reported combined ending fund balances of \$2.2 billion compared with \$2.1 billion at fiscal year 2002. Of this amount, \$572.4 million is available for spending at the government's discretion (reported as unreserved fund balance). The remaining amount of \$1.66 billion is restricted for specific purposes, such as education. At the end of the fiscal year, unreserved fund balance for the General Fund was \$43.1 million compared with \$81.3 million in fiscal year 2002, which is a decrease of \$38.2 million (or 47 percent).

#### Long-term Debt

The State's total long-term debt obligations for governmental activities decreased from \$336.6 million in fiscal year 2002 to \$330.8 million (or 1.7 percent) in fiscal year 2003.

### OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis are intended to serve as an introduction to the State of Montana's basic financial statements. The State's basic financial statements include three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. The report also contains additional required supplementary information (budgetary schedules). These components are described below:

#### Basic Financial Statements

The basic financial statements include two kinds of financial statements that present different views of the State – the *government-wide financial statements* and the *fund financial statements and combining major component unit financial statements*. These financial statements also include the *notes to the financial statements* that explain some of the information in the financial statements and provide more detail.

#### Government-wide Financial Statements

The *government-wide financial statements* provide a broad view of the State's operations in a manner similar to a private-sector business. The statements provide both short-term and long-term information about the State's financial position, which assists in assessing the State's economic condition at the end of the fiscal year. These are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. This basically means they follow methods that are similar to those used by most businesses. They take into account all revenues and expenses connected with the fiscal year, even if cash involved has not been received or paid. The government-wide financial statements include two statements.

The *Statement of Net Assets* presents all of the government's assets and liabilities, with the difference between the two reported as "net assets." Over time, increases or decreases in the State's net assets may serve as a useful indicator of whether the financial position of the State is improving or deteriorating.

The *Statement of Activities* presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods (such as uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenues for each function of the State.

Both of the above financial statements have separate sections for three different types of state programs or activities. These three types of activities are:

*Governmental Activities* – The activities in this section are mostly supported by taxes and intergovernmental revenues (federal grants). Most services normally associated with state government fall into this category, including education (support for both K-12 public schools and higher education), general government, health services, legal and judiciary services, museums, natural resources, public safety and defense, regulatory services, social services, and transportation.

*Business-type Activities* – These functions are normally intended to recover all or a significant portion of their costs through user fees and charges to external users of goods and services. The major business-type activities of the State include the Unemployment Insurance Fund and the Economic Development Bond Program that assists Montana's small businesses and local governments in obtaining long-term fixed-rate financing through private Montana lending institutions.

*Discretely Presented Component Units* – These are operations for which the State has financial accountability but they have certain independent qualities as well. For the most part, these entities operate similar to private sector businesses and the business-type activities described above. The State has three authorities and two universities that are reported as discretely presented component units of the State.

#### **Fund Financial Statements (Reporting the State's Major Funds)**

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The State, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

The fund financial statements focus on individual parts of the state government, reporting the State's operations in more detail than the government-wide statements. All of the funds of the State can be divided into three categories. It is important to note that these fund categories use different accounting approaches and should be interpreted differently. The three categories of funds are:

*Governmental Funds Financial Statements* – Most of the basic services provided by the State are financed through governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental fund financial statements focus on near-term inflows and outflows of spendable resources. They also focus on the balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating the government's near-term financing requirements. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These statements provide a detailed short-term view of the State's finances that assists in determining whether there will be adequate financial resources available to meet the current needs of the State.

The State has five governmental funds that are considered major funds for presentation purposes. That is, each major fund is presented in a separate column in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances. The State's five major governmental funds are – the General Fund, the State Special Revenue Fund, the Federal Special Revenue Fund, the Coal Severance Tax Fund, and the Land Grant Fund.

*Proprietary Funds Financial Statements* – When the State charges customers for the service it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting, the same method used by private sector businesses. Enterprise funds report activities that provide supplies and services to the general public. An example is the State Lottery. Internal Service Fund reports activities that provide supplies and services for the State's other programs and activities such as the Motor Pool.

*Fiduciary Funds* – These funds are used to account for resources held for the benefit of parties outside the state government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of these funds are not available to support the State’s own programs. Fiduciary funds use the accrual basis of accounting.

**Notes to the Financial Statements**

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and the fund financial statements. The notes to the financial statements can be found immediately following the component unit financial statements.

**Required Supplementary Information**

The basic financial statements are followed by a section of required supplementary information. This section includes a budgetary comparison schedule, which includes the reconciliation between the statutory fund balance for budgetary purposes and the fund balance for the General Fund, as presented in the governmental fund financial statements.

**GOVERNMENT-WIDE FINANCIAL ANALYSIS**

**Net Assets**

As noted earlier, net assets may serve over time as a useful indicator of a government’s financial position. The State’s combined net assets (government and business-type activities) totaled \$4.3 billion at the end of fiscal year 2003. Net assets of the governmental activities increased \$1.3 billion (or 49.8 percent) and business-type activities had a \$2.8 million (or 1.2 percent) decrease. The Montana Department of Transportation added the retroactive highway infrastructure to the state accounting system during fiscal year 2003.

A portion of the State’s net assets reflects its investment in capital assets such as land, buildings, equipment and infrastructure (roads, bridges, and other immovable assets), less any related debt used to acquire those assets that is still outstanding. The State uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the State’s investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

An additional portion of the State’s net assets represents resources that are subject to external restrictions on how they may be used. The remaining balance of unrestricted net assets may be used to meet the State’s ongoing obligations to citizens and creditors. Internally imposed designations of resources are not presented as restricted net assets.

At the end of the current fiscal year, the State is able to report positive balances in all three categories of net assets, both for the government as a whole, as well as for its separate governmental and business-type activities.

**Net Assets  
As of Fiscal Year Ended June 30  
(expressed in thousands)**

	<b>Governmental Activities</b>		<b>Business-type Activities</b>		<b>Total Primary Government</b>	
	<b>2002</b>	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>	<b>2003</b>
Current and other assets	\$2,627,061	\$2,733,511	\$309,293	\$326,525	\$2,936,354	\$3,060,036
Capital assets	1,038,746	2,225,327	14,658	10,195	1,053,404	2,235,522
<b>Total assets</b>	<b>3,665,807</b>	<b>4,958,838</b>	<b>323,951</b>	<b>336,720</b>	<b>3,989,758</b>	<b>5,295,558</b>
Long-term liabilities	356,517	369,306	14,890	10,010	371,407	379,316
Other liabilities	613,027	545,689	75,632	96,107	688,659	641,796
<b>Total liabilities</b>	<b>969,544</b>	<b>914,995</b>	<b>90,522</b>	<b>106,117</b>	<b>1,060,066</b>	<b>1,021,112</b>
Invested in capital assets, net of related debt	814,026	2,049,489	12,496	9,084	826,522	2,058,573
Restricted	1,742,193	1,817,193	203,710	202,268	1,945,903	2,019,461
Unrestricted	140,044	177,161	17,223	19,251	157,267	196,412
<b>Total net assets</b>	<b>\$2,696,263</b>	<b>\$4,043,843</b>	<b>\$233,429</b>	<b>\$230,603</b>	<b>\$2,929,692</b>	<b>\$4,274,446</b>

The following condensed financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

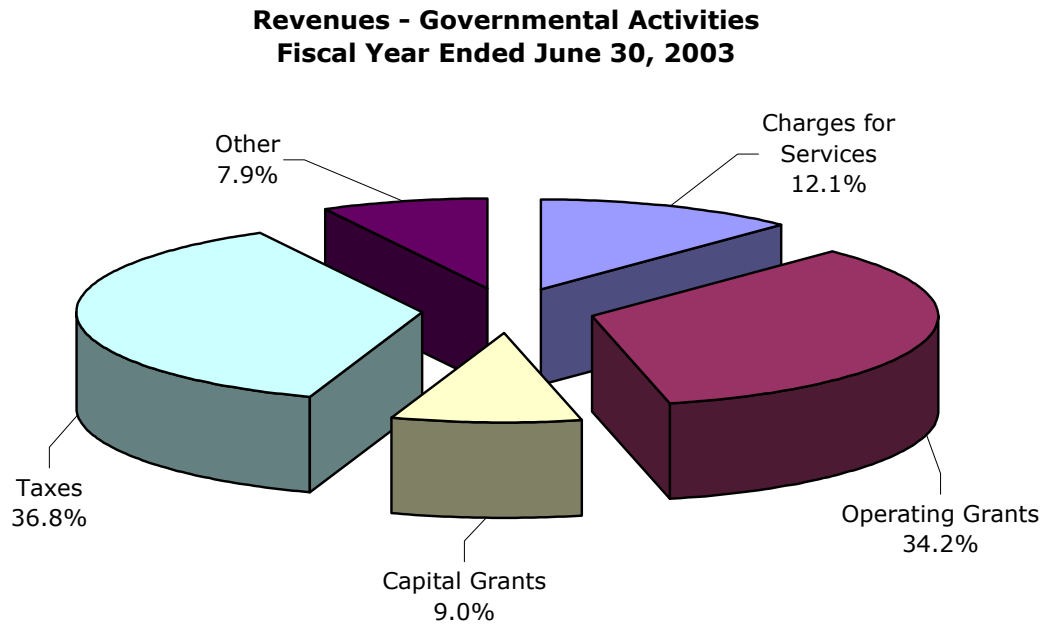
**Changes in Net Assets**  
**For Fiscal Year Ended June 30**  
*(expressed in thousands)*

	<u>Governmental</u> <u>Activities</u>		<u>Business-type</u> <u>Activities</u>		<u>Total Primary</u> <u>Government</u>	
	2002	2003	2002	2003	2002	2003
<b>Revenues:</b>						
Program revenues						
Charges for services	\$ 364,614	\$ 415,033	\$189,771	\$206,233	\$ 554,385	\$ 621,266
Operating grants	1,080,374	1,170,703	29,335	10,442	1,109,709	1,181,145
Capital grants	280,489	308,021	602	510	281,091	308,531
General revenues						
Taxes	1,238,151	1,260,398	12,907	13,650	1,251,058	1,274,048
Other	207,193	267,080	17,419	21,778	224,612	288,858
Total revenues	<u>3,170,821</u>	<u>3,421,235</u>	<u>250,034</u>	<u>252,613</u>	<u>3,420,855</u>	<u>3,673,848</u>
<b>Expenses:</b>						
General government	248,089	280,740	-	-	248,089	280,740
Public safety/corrections	205,983	194,885	-	-	205,983	194,885
Transportation	169,282	286,181	-	-	169,282	286,181
Health/social services	1,086,012	1,023,893	-	-	1,086,012	1,023,893
Educational/cultural	845,324	899,575	-	-	845,324	899,575
Resource/rec/enviro	108,642	234,848	-	-	108,642	234,848
Econ dev/assistance	164,761	169,270	-	-	164,761	169,270
Interest on long-term debt	22,763	19,910	-	-	22,763	19,910
Unemployment Insurance	-	-	83,944	92,639	83,944	92,639
Liquor Stores	-	-	38,074	40,097	38,074	40,097
State Lottery	-	-	26,585	27,320	26,585	27,320
Economic Dev Bonds	-	-	3,251	2,426	3,251	2,426
Hail Insurance	-	-	2,045	2,029	2,045	2,029
Gen Govt Services	-	-	11,134	14,177	11,134	14,177
Prison Funds	-	-	5,444	4,515	5,444	4,515
MUS Group Insurance	-	-	34,594	35,906	34,594	35,906
Total expenses	<u>2,850,856</u>	<u>3,109,302</u>	<u>205,071</u>	<u>219,109</u>	<u>3,055,927</u>	<u>3,328,411</u>
Increase (decrease) in net assets before transfers	319,965	311,933	44,963	33,504	364,928	345,437
Transfers	26,756	32,366	(26,756)	(32,366)	-	-
Change in net assets	346,721	344,299	18,207	1,138	364,928	345,437
Net assets, beg of year (restated)	<u>2,349,542</u>	<u>3,699,544</u>	<u>215,222</u>	<u>229,465</u>	<u>2,564,764</u>	<u>3,929,009</u>
Net assets, end of year	<u>\$2,696,263</u>	<u>\$4,043,843</u>	<u>\$233,429</u>	<u>\$230,603</u>	<u>\$2,929,692</u>	<u>\$4,274,446</u>

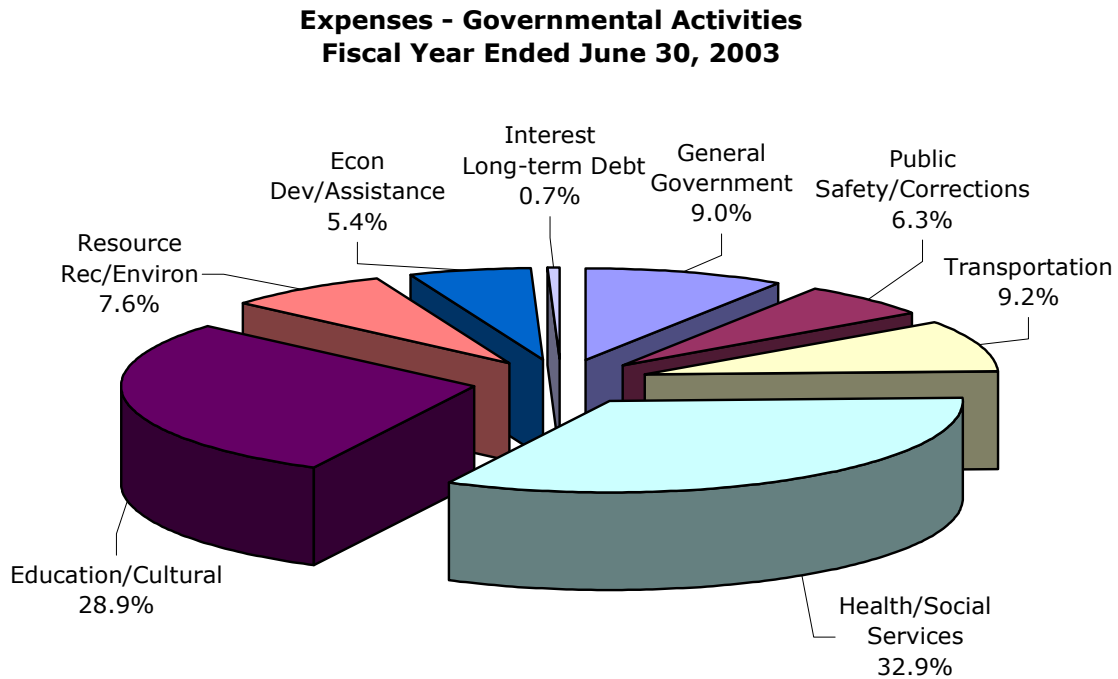


**Governmental Activities**

The following chart depicts revenues of the governmental activities for the fiscal year:



The following chart depicts expenses of the governmental activities for the fiscal year:



**FINANCIAL ANALYSIS OF THE STATE’S INDIVIDUAL FUNDS**

As the State completed the year, its governmental funds reported fund balances of \$2.2 billion. Of this total amount, \$572.4 million, or 26%, constitutes unreserved fund balance, which is available for spending at the government’s discretion. The remainder of fund balance is reserved because it is legally segregated for a specific future use, or is not available for new spending as it has already been dedicated for various commitments.

**General Fund**

The General Fund is the chief operating fund of the State. At the end of the current fiscal year, unreserved fund balance of the General Fund was \$43.065 million. Total fund balance diminished during the fiscal year by \$39.6 million, primarily because of lower corporation and property tax collections and interest rates.

General Fund Budgetary Highlights

Differences between the original budget and the final budget, which were the result of reductions imposed by two Legislative special sessions held in June and August 2002, amounted to \$78.9 million. The most significant budget reductions are listed below:

1. Office of Public Instruction was assessed a \$6.8 million budget reduction in its K-12 Education programs.
2. Montana University System was assessed a reduction of \$13 million in its fiscal year 2003 budget.
3. Department of Public Health and Human Services received a \$12.1 million budget reduction in its fiscal year 2003 budget.
4. Economic development appropriations were reduced by \$2.6 million in fiscal year 2003.
5. All General Funded agencies received an across the board reduction and a hiring freeze in the August 2002 special session that totaled \$6.1 million in budget reductions.
6. Department of Corrections was assessed a \$2.3 million budget reduction in its fiscal year 2003 budget.
7. Funding switches to replace General Fund with other funds totaled \$18.5 million.

**General Governmental Functions**

Revenue sources for general governmental functions, which include the general, special revenue, debt service, capital projects, and permanent funds, increased 7.6 percent from fiscal year 2002 to fiscal year 2003. Revenues from various sources for fiscal year 2003, and the amount and percentage of increases and decreases in relation to prior year revenues, are shown in the following table (amounts in thousands):

Revenue Source	Amount	2003 Percent of Total	Increase (Decrease) from 2002	Percent Increase (Decrease)
Licenses/permits	\$ 210,611	6.2%	\$ 8,121	4.0%
Taxes	1,250,181	36.7	20,568	1.7
Chg srv/finer/forfeits/settle	157,939	4.6	(14,387)	(8.3)
Investment earnings	204,406	6.0	58,422	40.0
Securities lending income	1,950	.1	(2,508)	(56.3)
Sales doc/merch/property	13,104	.4	(2,467)	(15.8)
Rentals/leases/royalties	28,324	.8	3,886	15.9
Contributions/premiums	6,933	.2	839	13.8
Grants/contracts/donations	24,560	.7	3,696	17.7
Federal	1,454,165	42.6	114,314	8.5
Federal indir cost rcvy	33,883	1.0	31,122	1,127.2
Other revenues	24,044	.7	19,585	439.2
<b>Total revenues</b>	<b>\$3,410,100</b>	<b>100.0</b>	<b>\$241,191</b>	

An explanation of significant changes by revenue source follows:

Taxes – The increase in revenues was primarily due to 1) a \$13 million increase in individual income tax receipts; 2) a \$24.3 million decrease in corporation tax receipts; 3) a \$3.3 million increase in property tax receipts; 4) a \$15.4 million increase in natural resource tax; 5) a \$2.1 million increase in video gaming tax; 6) a \$3.2 million increase in insurance premium tax; and 7) a \$5.4 million increase in cigarette/tobacco tax.

Securities Lending Income – The decrease in revenue was due to the lower interest rates in fiscal year 2003.

Federal – The increase in revenue was primarily due to 1) a \$28.5 million increase in highway construction funds; 2) a \$13.1 million increase in Fish, Wildlife and Park federal funds; 3) A \$33 million increase in unemployment funds; and 4) \$25 million from the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Federal Indirect Cost Recoveries – The increase in revenue is due to a change in the Federal Highway Act, which now permits the State Department of Transportation to recover indirect costs from the federal government. This change was partially implemented in fiscal year 2002, and completed in fiscal year 2003.

Other Revenues – The increase in revenue is primarily due to the transfer of \$20.2 million from the State Fund (Old) to the General Fund as a result of the 2003 Legislature eliminating the 10 percent excess reserve requirement.

Total expenditures for all general governmental functions increased 4.3 percent from fiscal year 2002 to fiscal year 2003. Expenditures by function for fiscal year 2003, and the amount and percentage of increases or decreases in relation to the prior year amounts, are shown in the following table:

<b>Expenditure Function</b>	<b>Amount (in thousands)</b>	<b>2003 Percent of Total</b>	<b>Increase (Decrease) from 2002</b>	<b>Percent Increase (Decrease)</b>
General government	\$ 239,707	7.2%	\$ 10,935	4.8%
Public safety/corrections	189,302	5.7	(205)	(.1)
Transportation	510,866	15.4	70,694	16.1
Health/social services	1,018,333	30.6	(60,970)	(5.6)
Education/cultural	894,591	26.9	33,557	3.9
Resource/recreation/environment	184,359	5.5	72,971	65.5
Economic development/assistance	168,007	5.0	4,112	2.5
Securities lending	1,734	.1	(2,202)	(55.9)
Debt service	57,168	1.7	630	1.1
Capital outlay	63,073	1.9	(1,983)	(3.0)
<b>Total expenditures</b>	<b>\$3,327,140</b>	<b>100.0</b>	<b>\$127,539</b>	

An explanation of significant changes by expenditure function follows:

Transportation – Expenditure increases were primarily due to increased spending for highway construction in Montana Department of Transportation.

Health/Social Services – Expenditure decreases are related to moving Department of Environmental Quality to the Resource/Recreation/Environment function. The remaining net increase between the two functions is comprised of 1) decreased General Fund expenditures of approximately \$25 million imposed by the August 2002 Special Session; 2) an increase in federal Medicaid costs; and 3) an increase of approximately \$12 million for the Thompson/Fisher land exchange.

Resource/Recreation/Environment – The expenditure increase is primarily related to moving Department of Environmental Quality expenditures from the Health/social services category to this category.

Securities Lending – The expenditure decrease was due to the lower interest rates in fiscal year 2003.

**CAPITAL ASSETS AND DEBT ADMINISTRATION**

**Capital Assets**

The State’s investment in capital assets for its governmental and business-type activities as of June 30, 2003, amounts to \$4 billion, net of accumulated depreciation of \$1.8 billion, leaving a net book value of \$2.2 billion. This investment in capital assets includes land, buildings, improvements, equipment, infrastructure, and construction in progress. Infrastructure assets are items that are normally immovable and of value only to the State, such as roads, bridges, streets and sidewalks, drainage systems, lighting systems, and similar items.

The total increase in the State’s investment in capital assets for the current fiscal year was approximately 112% in terms of net book value. The significant increase in capital assets is the inclusion of infrastructure assets in place prior to fiscal

year 2002. Most of the year’s capital expenditures were for construction or reconstruction of roads and bridges. Depreciation charges for the year totaled \$37 million compared to \$30 million in fiscal year 2002. Additional information on the State’s capital assets can be found in Note 5 of the notes to the financial statements .

**Debt Administration**

Montana receives excellent bond ratings from both Moody’s Investor Service (Aa3) and Standard and Poor’s Corporation (AA-). State debt may be authorized either by a two-thirds vote of the members of each house of the Legislature or by a favorable vote of a majority of the State’s electors voting thereon. There is no constitutional limit on the amount of debt that may be incurred by the State. The Montana Constitution does, however, prohibit the incurring of debt to cover deficits caused by appropriations exceeding anticipated revenue.

The State of Montana’s general obligation debt increased from \$214.135 million at June 30, 2002, to \$227.625 million at June 30, 2003.

The ratio of general obligation debt to assessed property valuation and the amount of general obligation debt per capita are:

	<b>Amount</b> <i>(in thousands)</i>	<b>Ratio</b> <b>Debt to</b> <b>Assessed Value (1)</b>	<b>State Debt</b> <b>Per Capita (2)</b>
General obligation debt	\$227,625	.48%	\$250.41

- (1) Assessed value is based on tax year.
- (2) Based on a 2002 estimated Montana population.

More detailed information regarding the State’s long-term obligations is presented in Note 11 to the financial statements.

**ECONOMIC CONDITION AND OUTLOOK**

The unemployment rate for the State of Montana was 4.0 percent in the second quarter of 2003, which is an increase from a rate of 3.4 percent during the second quarter of 2002. This compares favorably with the nation’s average unemployment rate of 6.1 percent during the same time period.

When the 58<sup>th</sup> Legislative Session convened on January 6, 2003, the Legislature was faced with a substantial General Fund budget deficit of \$230.4 million for the 2005 biennium. The primary reasons for this projection were the estimated decline in individual and corporation income taxes, reduced investment earnings and higher human service and correction costs. The Legislature erased the projected deficit through general operating reductions and the enactment of numerous pieces of other legislation that enhanced state revenues. The Legislature adjourned on April 26, 2003, with a projected General Fund balance for the 2005 biennium of \$46.2 million.

**REQUESTS FOR INFORMATION**

This financial report is designed to provide a general overview of the State of Montana’s finances for all of Montana’s citizens, taxpayers, customers, investors and creditors. The financial report seeks to demonstrate the State’s accountability for the money it receives. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the State of Montana, Administrative Financial Services Division, Room 255 Mitchell Building, Capitol Complex, Helena, Montana 59620.