

State of Montana
COMPREHENSIVE ANNUAL FINANCIAL REPORT
For the Fiscal Year Ended June 30, 2004

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements for the State of Montana have been prepared in accordance with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB).

A. Reporting Entity

For financial reporting purposes, the State of Montana has included all funds which comprise the State of Montana (the primary government) and its component units. The component units are entities for which the State is financially accountable, or whose relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete. The GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body, and (1) the ability of the State to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the State.

Discretely Presented Component Units

These component units are entities which are legally separate from the State because they possess corporate powers, but are financially accountable to the State, or whose relationships with the State are such that exclusion would cause the State's financial statements to be misleading or incomplete. Complete financial statements of the individual component units, which issue separate financial statements, can be obtained from their respective administrative offices. The component unit columns of the combined financial statements include the financial data of these entities:

Housing Authority – This authority, which is a legally separate entity, is governed by a quasi-judicial board appointed by the Governor. It was created in 1975 to facilitate the availability of decent, safe, and sanitary housing to persons and families of lower income. The board issues negotiable notes and bonds to fulfill its purposes. The total amount of notes and bonds outstanding at any time may not exceed \$1.5 million. Neither the faith and credit nor taxing power of the State of Montana may be pledged for the amounts so issued. The authority is audited annually by the State's Legislative Audit Division. The report is issued under separate cover and available at 301 South Park, Room 204, Helena, MT 59620-0545.

Facilities Finance Authority – This authority, which is a legally separate entity, is governed by a quasi-judicial board appointed by the Governor with the advice and consent of the Senate. The authority assists all eligible, non-profit Montana health care and other community-based service providers to obtain and maintain access to the broadest range of low-cost capital financing as possible. The board issues revenue bonds to fulfill its purposes. Neither the faith and credit nor taxing power of the State of Montana may be pledged for the amounts so issued. Individual audit reports are issued every two years by the State's Legislative Audit Division. The report is issued under separate cover and available at 2401 Colonial Drive, 3rd Floor, PO Box 200506, Helena, MT 59620-0506.

State Compensation Insurance Fund (New and Old) – The fund is a nonprofit, independent public corporation governed by a board appointed by the Governor. The fund provides workers compensation insurance. The fund consists of two separate entities: the New Fund and the Old Fund. The New Fund covers claims incurred after June 30, 1990, and is financed by member (employer) premiums. The Old Fund covers claims incurred before July 1, 1990. In 1999, the 56th Legislature determined that the Old Fund was adequately funded and discontinued the Old Fund Liability Tax. Administrative operations and budgets are reviewed by the Governor and the Legislature. The fund is audited annually by the State's Legislative Audit Division. The report is issued under separate cover and available at 5 South Last Chance Gulch, Helena, MT 59601.

Universities and Colleges – The State Board of Regents has responsibility for the following institutions: The University of Montana - Missoula and the units under it including Montana Tech of the University of Montana, The University of Montana - Western and The University of Montana - Helena College of Technology; and Montana State University - Bozeman and the units under it including Montana State University - Billings, Montana State University - Northern, and the Montana State University College of Technology - Great Falls. All units are funded through state appropriations, tuition, federal grants, and private donations and grants. The universities are audited annually by the State's Legislative Audit Division. The reports are issued under separate cover and are available at the President's Office on each of the campuses or by contacting the Commissioner of Higher Education, 2500 Broadway, PO Box 203101, Helena, MT 59620.

Though the following organizations perform functions related to the higher education units, they are not considered part of Montana's reporting entity: (1) Community Colleges which are considered part of local units of government; (2) the Montana Higher Education Student Assistance Corporation, a private non-profit corporation; and (3) the Student Assistance Foundation of Montana, a private non-profit corporation. Entities such as local school districts and local authorities of various kinds are considered part of local units of government and have not been included. The State's support of local public education systems is reported in the General Fund and the State Special Revenue Fund.

Fiduciary Fund Component Units

Teachers Retirement System (Pension Trust Fund) – This retirement system is a legally separate entity with a board appointed by the Governor. Its purpose is to provide retirement, disability, death and lump-sum payments to members of Montana's public teaching profession. The administrative costs of the Teachers Retirement System are paid from investment earnings of the fund. The system is funded from employer and employee contributions and investment earnings. The board is a discretely presented component unit. The system is audited annually by the State's Legislative Audit Division. Its report is issued under separate cover and is available at 1500 Sixth Avenue, PO Box 200139, Helena, MT 59620-0139.

Public Employees Retirement Board (Pension and Other Employee Benefit Trust Funds) – The board, appointed by the Governor, administers ten separate retirement systems for the purpose of providing retirement, disability, death, and lump-sum payments to each system member. These legally separate plans include the Public Employees Defined Benefit Retirement Plan, Public Employees Defined Contribution Retirement Plan, the associated education funds, the Municipal Police Officers, the Game Wardens and Peace Officers, the Sheriffs, the Judges, the Highway Patrol Officers and the Firefighters Unified Retirement Systems, as well as the Volunteer Firefighters Compensation Act. The board also administers the State of Montana Deferred Compensation Program.

The Public Employees Retirement System (PERS) includes the Public Employees Defined Benefit Retirement Plan and the Public Employees Defined Contribution Retirement Plan, and is funded from employer and employee contributions, investment earnings and contributions from state, county, and local governments. The PERS also accounts for the administrative costs, paid from investment earnings, of the system. The Municipal Police Officers Retirement System is funded from member, state, and city contributions. The Game Wardens and Peace Officers Retirement System is funded by employer and

employee contributions. The Sheriffs Retirement System is funded by member, state, and county contributions. The Judges Retirement System is funded by member and state contributions. The Highway Patrol Officers Retirement System is funded by member and state contributions. The Firefighters Unified Retirement System is funded by employer and employee contributions as well as a portion of insurance premium taxes collected by the State. The Volunteer Firefighters Compensation Act is funded by contributions of a percentage of fire insurance premium taxes collected. The State of Montana Deferred Compensation Program is funded from member and investment earnings; there is one employer, Great Falls Transit, that contributes to the program.

The board is a discretely presented component unit responsible for the ten separate public employee retirement systems including the Deferred Compensation Program. These are reported as pension and other employee benefit trust funds. The board is audited annually by the State's Legislative Audit Division. Its report is issued under separate cover and is available at 100 N Park, PO Box 200131, Helena, MT 59620-0131.

B. Government-wide and Fund Financial Statements

The government-wide financial statements (i.e., the Statement of Net Assets and the Statement of Activities) report information on all of the non-fiduciary activities of the State of Montana and its component units. For the most part, the effect of interfund activity has been removed from these statements. Governmental activities, which are normally supported by taxes and intergovernmental revenues, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. Likewise, the State of Montana is reported separately from certain legally separate component units for which the State is financially accountable.

The Statement of Activities demonstrates the degree to which the direct expenses of a function are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Certain indirect costs are included in the program expense reported for the individual functions and activities. Program revenues include: (1) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function; and (2) grants and contributions restricted to meeting the operational or capital requirements of a particular function. Taxes and other revenues not meeting the definition of program revenues are reported as general revenues.

Separate fund financial statements are provided for governmental, proprietary, and fiduciary funds. Fiduciary fund statements are only reported on the fund financial statements. Major individual governmental and major individual enterprise funds are reported as separate columns in the fund financial statements.

C. Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The government-wide, proprietary fund, and fiduciary fund financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are reported when earned; expenses are recorded when a liability is incurred regardless of the timing of the related cash flows. Property taxes are recognized as revenues in the year for which they are levied. Grants and similar items are recognized as revenues as soon as all of the eligibility requirements imposed by the provider are met.

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized when they are both measurable and available. Revenues are considered to be available if they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the State considers revenues to be available if they are collected within 60 days of the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, debt service expenditures as well as expenditures relating to compensated absences and claims and judgments are recorded only when payment is due. Significant intrafund transactions and balances have been eliminated.

The State uses funds to report on its financial position and the results of its operations. A fund is a separate accounting entity with a self-balancing set of accounts. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities.

The financial activities of the State of Montana are classified into fund categories as described below:

Governmental Funds

General Fund – To account for all governmental financial resources except those required to be accounted for in another fund.

Special Revenue Funds – To account for the proceeds of specific revenue sources restricted to expenditure for specified purposes other than major capital projects.

Debt Service Funds – To account for resources accumulated for payment of principal and interest on general long-term obligation debt.

Capital Projects Funds – To account for resources used for the acquisition or construction of major capital facilities, other than those financed by proprietary or trust funds.

Permanent Funds – To account for resources that are permanently restricted to the extent that only earnings, not principal, may be used for the purposes of supporting the government's programs.

Proprietary Funds

Enterprise Funds – To account for operations: (1) financed and operated similar to private business enterprises, where the intent of the Legislature is to finance or recover costs primarily through user charges; (2) where the Legislature has decided periodic determination of revenue earned, expenses incurred, or net income is appropriate; (3) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; (4) when laws or regulations require that the activities' costs of providing services, including capital costs, be recovered with fees and charges rather than with taxes or similar revenues. The primary focus of fee revenues charged by enterprise funds is users outside of the primary government.

Internal Service Funds – To account for the financing of goods and services provided by one department or agency to other departments, agencies, or other governmental entities on a cost-reimbursement basis.

The State of Montana reports two employee group benefits funds. The MUS Group Insurance Fund primarily charges its fees to Montana State University and the University of Montana. The universities are reported as discretely presented component units, which the State considers to be external users, and as such, reports the MUS Group Insurance Fund as an enterprise fund. The Employee Group Benefits Fund charges its fees to funds of the primary government, and as such, is reported as an internal service fund.

Fiduciary Funds

Trust and Agency Funds – To account for assets held by the State in a trustee capacity or as an agent for individuals, private organizations, or other governments. These assets cannot be used to support the government's own programs. These include: (1) pension (and other employee benefit) trust funds, (2) agency funds, (3) investment trust funds, and (4) private-purpose trust funds.

The State reports the following funds as major as defined under GASB 34:

Major Governmental Funds

The General Fund is the State's primary operating fund, as defined above.

The State Special Revenue Fund accounts for all activities funded from state sources, which are restricted either legally or administratively for particular costs of an agency, program, or function.

The Federal Special Revenue Fund accounts for all activities funded from federal sources used in the operation of state government.

The Coal Tax Trust Permanent Fund, created by Article IX, Section 5 of the Montana State Constitution, receives 50% of all coal tax collections. The principal in this fund can be expended only upon affirmative vote of three-fourths of each house of the Legislature.

The Land Grant Permanent Fund accounts for lands granted to the State for support of public schools and state institutions.

Major Proprietary Funds

The Unemployment Insurance Fund accounts for employer contributions deposited with the Secretary of the Treasury of the United States to the credit of the State's unemployment trust fund. Unemployment benefits are paid from this fund to eligible recipients.

The Economic Development Bonds Fund accounts for the Economic Development Bond Act programs and the Municipal Finance Consolidation Act programs. These programs assist Montana's small businesses and local governments in obtaining long-term, fixed-rate financing through private Montana lending institutions.

Private sector standards of accounting and financial reporting issued prior to December 1, 1989, are generally followed by both the government-wide and proprietary fund financial statements to the extent they do not conflict with or contradict guidance of GASB. Governments also have the option of following subsequent private sector guidance for their business-type activities and enterprise funds. The State has elected not to follow subsequent private sector guidance.

As a general rule, material interfund revenues have been eliminated from the government-wide financial statements. These have not been eliminated where their elimination would distort the direct costs and program revenues of the functions involved.

The State does not allocate indirect expenses to functions in the Statement of Activities.

D. Proprietary Activity Accounting and Financial Reporting

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues generally result from providing services and delivering goods in connection with a proprietary fund's principal ongoing operations. Operating expenses for enterprise and internal service funds include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting these definitions are reported as non-operating.

E. Cash/Cash Equivalents

For all funds, cash and cash equivalents consist of amounts deposited in the State Treasurer's pooled cash account, cash deposits in checking accounts, cash invested in the Short-term Investment Pool (STIP), cash held by trustees, undeposited cash held by individual state agencies, and investments categorized as cash equivalents, which are short-term, highly liquid investments with original maturities of three months or less. (See Note 3).

F. Receivables

This classification, net of estimated uncollectibles, consists primarily of receivables for goods sold and services provided; short-term loans and notes; interest and dividends; taxes due within 60 days of fiscal year-end; and income, withholding, and inheritance taxes that are past due. An allowance for uncollectible taxes is provided based upon historical analysis. Further detail relating to receivables is provided in Note 4.

G. Inventories

Inventories of materials and supplies are stated at cost. The State allows agencies to use any generally accepted inventory pricing method, but specifies the first-in, first-out method should be appropriate for most agencies.

Governmental funds use the "purchase method," meaning inventory purchases are recorded as expenditures. At fiscal year-end, significant amounts of inventory are shown as a reservation of fund balance, indicating they do not constitute available expendable resources.

Proprietary and fiduciary funds report using the "consumption method," meaning inventories are expensed as used.

H. Restricted Assets

Certain investments of the Economic Development Bonds Enterprise Fund are classified as restricted assets on the balance sheet because their use is limited by applicable bond indenture agreements.

I. Investments

In accordance with the Montana Constitution and the statutorily mandated "Prudent Expert Rule," the State of Montana invests in various types of securities for each portfolio it manages. Certain securities including asset-backed securities, variable-rate instruments, zero-coupon bonds, preferred stocks, and mortgage-backed securities are purchased for portfolio diversification and a competitive rate of return. Most investments are reported at fair value in the Balance Sheet or Statement of Net Assets. Investments are reported by type in the disclosure of custodial credit risk for each investment portfolio (See Note 3 on Cash/Cash Equivalents and Investments).

J. Equity in Pooled Investments

The Montana Board of Investments manages the State's Unified Investment Program, which includes several internal investment pools. Participation in the pools is restricted to permanent funds, private-purpose trust funds, investment trust funds, pension trust funds, higher education units, and specific trusts established within the State Special Revenue Fund. The participant investments in the pools are reported at fair value in the Balance Sheet within the individual funds (See Note 3 on Cash/Cash Equivalents and Investments).

K. Capital Assets

Capital asset valuation is based on actual historical cost or, in the case of donations, fair market value on the date donated. General government infrastructure capital assets are capitalized and reported in the government-wide financial statements. Infrastructure assets of the primary government are capitalized on the fund financial statements. Interest incurred during the construction of capital assets for proprietary funds and higher education units is capitalized. The State has chosen to use the depreciation approach for infrastructure assets and is reporting accumulated depreciation in the Statement of Net Assets and depreciation expense in the Statement of Activities for these assets.

Capital assets in proprietary, private-purpose trust, and pension trust funds are accounted for within their respective funds and are depreciated. Depreciation is on

a straight-line basis with estimated useful lives of 25 to 60 years for buildings, 7 to 20 years for building improvements, 3 to 10 years for equipment, and 10 to 50 years for infrastructure. State agencies are also required to extend or shorten the useful lives of capital assets to reflect their actual experience or industry standards when appropriate.

The capitalization limit for buildings and building/land improvements is \$25,000. The capitalization threshold for infrastructure is \$500,000. Agencies are allowed to capitalize additions to collections and land acquisitions at any cost. The capitalization limit for other capital assets is set at \$5,000. Purchases under these thresholds are recorded as expenditures/expenses in the current period.

L. Deferred Revenue

Deferred revenue in the government-wide, proprietary fund, and fiduciary fund financial statements relates to unearned revenue. A liability for unearned revenue is recorded when assets are recognized in connection with a transaction prior to the earnings process being completed.

Deferred revenue in the governmental fund financial statements relates to both unearned revenue (as discussed above) and unavailable revenue. A liability for unavailable revenue is recorded when assets are recognized in connection with a transaction, but those assets are not considered available to finance expenditures of the current fiscal period.

M. Long-term Obligations

Long-term obligations expected to be financed from governmental funds are reported in the government-wide financial statements. Long-term debt is recognized as a liability of a governmental fund when due, or when resources have been accumulated in the debt service fund for payment early in the following year. For other long-term obligations, only that portion expected to be financed from current expendable available financial resources is reported as a fund liability of a governmental fund in the fund financial statements. The remaining portion of such obligations is reported in the government-wide financial statements.

Long-term liabilities expected to be financed from proprietary and fiduciary fund operations are accounted for in those funds.

N. Capital Leases

A capital lease is generally defined by Statement of Financial Accounting Standards No. 13, "Accounting for Leases", as one which transfers benefits and risks of ownership to the lessee. At the inception of a capital lease, in the government-wide, proprietary fund, and fiduciary fund financial statements, a capital asset and a capital lease liability is recorded at the present value of the future minimum lease payments. In the governmental fund financial statements, because the modified accrual basis of accounting is used, no asset or liability is recorded related to assets under capital leases. Rather, in the governmental fund financial statements, at the inception of a capital lease, capital outlay expenditure and an other financing source (inception of lease/installment contract) are recorded at the net present value of the minimum lease payments.

O. Bond Discounts/Premiums/Issuance Costs

Bond premiums and discounts, as well as issuance costs, are recognized in the current period for governmental funds in the fund financial statements. Bond proceeds and bond premiums are reported as an other financing source, and bond discounts are reported as an other financing use. Issuance costs are reported as debt service expenditures whether or not they are withheld from the bond proceeds. In proprietary fund types and in governmental funds as presented in the government-wide financial statements, bond premiums and discounts are deferred and amortized over the life of the bonds, which approximates the effective interest method. Bonds payable are recorded net of any applicable premium or discount, while issuance costs are reported as deferred charges.

P. Compensated Absences

Full-time state employees earn vacation leave ranging from 15 to 24 days per year depending on the individual's years of service. Teachers employed by the State do not receive vacation leave. Vacation leave may be accumulated and carried over from one year to the next. The carryover is limited to two times the maximum number of days earned annually. Sick leave is earned at the rate of 12 days per year with no limit on accumulation. Each contribution year, an employee may contribute a maximum of 40 hours of sick leave to a nonrefundable sick leave pool. Based on a review, the adjusted ending balance of the pool for June 30, 2003, was 204.4 hours. For fiscal year 2004, 4,879.5 hours were contributed to the sick leave pool and 2,911.5 hours were withdrawn leaving a balance of 2,172.4 hours in the pool. No liability is reported in the accompanying financial statements because these hours

are nonrefundable to participants except by grants approved through an application process.

Vested or accumulated leave for proprietary and fiduciary funds is recorded as an expense and liability of those funds in the fund financial statements. For governmental funds, the liability is not expected to be liquidated with expendable financial resources. The expenditure and liability for the governmental funds is reported only in the government-wide financial statements. Upon retirement or termination, an employee is paid for 100% of unused vacation leave and 25% of unused sick leave.

Q. Advances to Other Funds

Noncurrent portions of long-term interfund receivables are reported as advances and are offset equally by a fund balance reserve account in the fund financial statements, which indicates that they do not constitute expendable available financial resources. The transaction is recognized by the receiving fund as advances from other funds.

R. Fund Balance

In the fund financial statements, reservations represent those portions of fund balance or net assets not appropriate for expenditure or legally segregated for a specific future use. Designated fund balances represent tentative plans for the future use of financial resources. The debt service funds designated fund balances represent management's desire to maintain fund balance in relation to bonds payable.

S. Property Taxes

Real property taxes are levied in October and are payable in two installments on November 30 and May 31. These taxes attach as an enforceable lien immediately if not paid when due.

Personal property tax levies are set each August, and notices are normally mailed the following March or April. Half of mobile home taxes are due in 30 days and the remaining half on September 30. Taxes on all other types of personal property are to be paid in full 30 days after receipt of the notice. Personal property taxes attach as an enforceable lien immediately if not paid when due. Property taxes are collected by each of Montana's 56 counties. The counties then remit the State's portion to the State Treasury. The majority of these taxes help fund public school systems and higher education.

T. Other Taxes

On the Statement of Revenues, Expenditures and Changes in Fund Balances for Governmental Funds, the revenue category "Other Taxes" in the General, State Special Revenue, and Nonmajor Governmental funds consists of the following taxes (in thousands):

	General Fund	State Special Revenue Fund	Nonmajor Governmental Funds	Total
Video gaming	\$ 50,733	\$ -	\$ -	\$ 50,733
Insurance premium	52,257	-	-	52,257
Inheritance	10,265	-	-	10,265
University system millage	981	10,963	-	11,944
Cigarette/tobacco	39,619	3,877	1,767	45,263
Accommodations	9,684	13,941	-	23,625
Telephone license	20,789	-	-	20,798
Alcoholic beverage	4,356	1,648	-	6,004
Electrical energy	8,106	-	-	8,106
Public contractor	2,120	-	-	2,120
Livestock	-	3,572	-	3,572
Public Service Commission	-	2,836	-	2,836
Freight line	1,568	-	-	1,568
Fire protection	3,070	2,403	-	5,473
Agriculture sales	-	2,739	-	2,739
Consumer Counsel	-	1,314	-	1,314
Car rental	2,486	-	-	2,486
Light vehicle registration	-	1,429	-	1,429
Miscellaneous	146	232	-	378
Total other taxes	\$206,180	\$44,954	\$1,767	\$252,901

NOTE 2. OTHER ACCOUNTING ISSUES

A. Restatement of Beginning Fund Balances/Net Assets

For the year ended June 30, 2004, the State implemented Statement 39 of the Governmental Accounting Standards Board. As a result of implementing this statement, the State's university component units began reporting their significant fund-raising foundations. The prior year net assets of the fund-raising foundations have been reported as an increase to beginning net assets of the universities as follows: Montana State University, \$96,878,000 and University of Montana, \$126,817,000.

B. Prior Period Adjustments

Prior period adjustments reported in the accompanying financial statements relate to corrections of errors from prior periods. The most significant of these adjustments affected the governmental activities column in the Statement of Net Assets, and related to various capital asset corrections.

C. Fund Reorganization

For reporting purposes, several small funds were combined as follows:

Internal Service Funds – FWP Warehouse Inventory, FWP Office Supply, Statewide Fueling Network, and Procurement Card Purchases were combined into the Other Internal Services fund.

Nonmajor Enterprise Funds – Montana Career Information System, Judiciary Law Library, Department of Agriculture, Advanced Drivers Education, and FWP Visitor Services were combined into the Other Enterprise Funds fund.

Nonmajor Permanent Funds – Jim Bradley Memorial, Thomas Teakle, Merritt-Wheeler Memorial, and Historical Society Acquisitions were combined into the Historical Society Trusts Fund.

NOTE 3. CASH/CASH EQUIVALENTS AND INVESTMENTS

This note details the following asset classifications (in thousands):

Cash/cash equivalents	\$1,895,710
Equity in pooled investments	\$6,876,467
Investments	\$1,745,742

Carrying amounts and fair values (Bank Balance for Cash Deposits) for the State's cash/cash equivalents and investments are presented in Tables 1 through 4.

A. General

(1) Cash and cash equivalents consist of funds deposited by individual funds in the State Treasurer's pooled cash account, cash deposits in checking accounts, cash invested in the Short-term Investment Pool, undeposited cash held by individual state agencies, and investments categorized as cash equivalents.

Cash deposited with the State Treasurer's pooled cash account is invested by the Montana Board of Investments (BOI) in short-term securities and other investments. Because these funds are immediately available to the individual funds, their investment in the pooled cash account is reported as a cash equivalent. In addition to the State Treasurer's pooled cash account, there is the Short-term Investment Pool (STIP) maintained by the BOI. This investment fund provides individual state agencies and local governments an opportunity to invest excess cash in a money market fund. Because these pooled funds are invested in short-term, highly liquid investments, the individual funds investments in the STIP are reported as a cash equivalent.

Although STIP, an external investment pool, is not registered with the Securities and Exchange Commission (SEC) as an investment company, the BOI has as policy that STIP will, and does, operate in a manner consistent with the SEC Rule 2a7 of the Investment Company Act of 1940. In meeting certain conditions, STIP, as a 2a7-like pool, is allowed to use amortized cost rather than fair value to report net assets to compute unit values. Investments held are reported at fair value, annually, and the difference between amortized cost and fair value is reflected as an unrealized gain or loss in the investments managed. The portfolio is carried at amortized cost or book value. State agencies that are allowed to retain their investment earnings within their funds are only allowed to invest in STIP. Local government participation in STIP is also voluntary. Separately issued external

investment pool financial statements may be obtained by contacting the Montana Board of Investments, 2401 Colonial Drive, 3rd Floor, PO Box 200126, Helena, MT 59620-0126.

Deposits with financial institutions are categorized to indicate the level of risk assumed by the State. Category 1 consists of deposits that are insured or collateralized with securities held by the State or by its agent in the State's name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution's trust department or agent in the State's name. Category 3 deposits are uncollateralized. The State's cash deposits are categorized in Table 1.

The State's cash equivalents and investments are categorized to indicate the risk level assumed by the State in Table 2 - Cash Equivalents, Table 3 - Equity in Pooled Investments, and Table 4 - Investments to disclose the level of risk assumed by the State at June 30, 2004.

Category 1 includes investments that are insured or registered securities held by the State or its agent in the State's name. Category 2 includes uninsured and unregistered investments where the securities are held by the counter party's trust department or agent in the State's name. Category 3 includes uninsured and unregistered investments in which the securities are held by the counter party, or by its trust department or agent, but not in the State's name. None of the State's cash equivalents or investments are classified in Category 3 at fiscal year-end. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

(2) The State invests in certain types of securities including asset-backed securities, variable-rate instruments, zero-coupon bonds, preferred stocks (convertible equity securities), and mortgage-backed securities, in addition to other long-term investment securities, to provide a diversified investment portfolio and an overall competitive rate of return. All securities are reported by investment portfolio and type in Table 2 - Cash Equivalents, Table 3 - Equity in Pooled Investments, and Table 4 - Investments.

Asset-backed securities represent debt securities collateralized by a pool of non-mortgage assets such as trade and loan receivables, equipment leases, credit cards, etc. These securities have less credit risk than do securities not backed by pledged assets, while market risk for asset-backed securities is the same as market risk for similar non asset-backed securities.

Variable-rate instruments pay a variable rate of interest until maturity. The variable rate floats with the 91-day treasury bill or the London Interbank Offered Rate (LIBOR). Variable-rate instruments have credit risk

identical to similar fixed-rate securities; however, their market risk (income) is more sensitive to interest rate changes. Their market risk (value/price) may be less volatile than fixed-rate securities because their value will usually remain near par as a result of interest rates being periodically reset to maintain a current market yield.

Zero-coupon bonds and preferred stocks include securities whose structure differs from the basic convertible security structure. These include PENs (Participating Equity Notes), PERCs (Preferred Equity Redemption Coupons), DECS (Dividend Enhanced Common Stock), and ACES (Automatically Convertible Equity Securities). PENs are corporate bonds offering the investor a choice at maturity of receiving the greater of the bond's par value or the value of a preset ratio of an established index. PERCs reflect an investor's acceptance of a cap in a security's price appreciation in exchange for a higher income yield. DECS and ACES are issued and traded at a premium to the underlying common stock in exchange for a higher dividend yield. The State's investment policy requires convertible debt and zero-coupon bonds to be rated at a specific level at time of purchase as a credit risk control measure. These securities carry market risk and the potential for change in market value. Market value changes may occur due to interest rate changes, declines in the value of underlying common stock, or the triggering of a call feature and other factors.

Mortgage-backed securities reflect participation in a pool of residential mortgages. These securities include

structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). Some REMICs are principal-only strips (POS) and interest-only strips (IOS). These securities are based on the cash flows from the principal and interest payments on underlying mortgages, respectively. These securities have credit risk as measured by major credit rating services. The State's investment policy requires these investments to be rated investment grade at the time of purchase. Market risk for these securities is caused by changes in the price or principal value of the securities due to changes in interest rates.

(3) Under the provisions of state statutes, the State has, via a Securities Lending Authorization Agreement, authorized the State's agent to lend the State's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the State receives a fee and the agent must initially receive collateral equal to 102% to 105% of the fair value of the securities on loan and maintain collateral equal to not less than 100% of the fair value of the loaned security. During fiscal year 2004, the State's agent loaned, on behalf of the State, certain securities held by the agent and received US dollar currency cash, US government securities, and irrevocable bank letters of credit. The State's agent does not have the ability to pledge or sell collateral securities unless the borrower defaults. The State retains all rights and risks of ownership for the loaned securities. On June 30, 2004, the State had no credit risk exposure to borrowers.

B. Cash/Cash Equivalents

(1) Cash Deposits – The State requires collateralization based on the average daily bank balance in the depository bank holding the main state bank account. For other depository banks, State statutes require collateralization at 50% of the bank balance. The cash deposits amount includes both primary government and component unit deposits.

Table 1 - Cash Deposits (in thousands)

Risk Category	Carrying Amount	Bank Balance	Fund
1 Insured (FDIC)	\$ 1,510	\$1,510	Various
Collateral held by State/State's agent	5,814	5,814	Various
2	4,115	4,115	Various
3	8,875	8,875	Various
Uncategorized:			
Undeposited cash	1,826		
Cash in U.S. Treasury	185,931		
Less: outstanding warrants	(52,449)		
Cash in MSU component units	6,443		
Cash in UM component units	3,294		
Total cash deposits	\$165,359		

As of June 30, 2004, the carrying amount of deposits for component units was \$81,383,853, and the bank balance was \$75,345,175. Of the carrying amount, \$75,345,175 was fully insured or collateralized with securities held by the component units or their agents in the unit's name, and \$6,488,678 was collateralized with securities held by the pledging institution's trust department or its agent in the respective component unit's name.

(2) Cash Equivalents – consists of cash in the State Treasury invested by individual funds in the Short-term Investment Pool (STIP) and the Treasurer’s Cash Pool in identifiable securities and investments considered to be cash equivalents. Cash equivalents, generally, are short-term, highly liquid investments with original maturities of three months or less. Cash equivalents may be under the control of the Board of Investments or other agencies, as allowed by law.

Table 2 - Cash Equivalents (in thousands)

	Risk Category 1			Carrying Amount	Fair Value	Fund
	Securities Not on Loan	On Loan for Securities Collateral	Not Categorized			
Asset-backed securities	\$940,831	\$-	\$-	\$ 940,831	\$ 940,844	Various
Government securities	182,257	-	-	182,257	181,052	Various
Repurchase agreements	71,848	-	-	71,848	71,848	Various
Variable-rate short term securities	504,982	-	-	504,982	504,931	Various
Direct investments:						
Money markets				30,433	30,433	Various
Total cash equivalents				\$1,730,351	\$1,729,108	
Securities lending collateral						
Investment pool			\$-	\$ -	\$ -	

As of June 30, 2004, local governments invested \$601,911,349 in STIP.

As of June 30, 2004, component units of the State of Montana had investments in cash equivalents with a book value and fair value of \$375,787,462.

C. Equity in Pooled Investments

These securities consist of investments held by pooled investment funds. The Montana Domestic Equity Pool (MDEP), Trust Funds Bond Pool (TFBP), Retirement Funds Bond Pool (RFBP), Montana International Equity Pool (MTIP), and Montana Private Equity Pool (MPEP) were created to allow qualifying funds to participate in diversified investment pools. Purchases are subject to statutory restrictions for quality and size of holdings.

Table 3 - Equity In Pooled Investments (in thousands)

	Risk Category 1			Carrying Amount	Fair Value
	Securities Not on Loan	On Loan for Securities Collateral*	Not Categorized*		
MDEP:					
Common Stock Pool	\$1,616,462	\$ -	\$ 18,799	\$1,635,261	\$1,941,940
Equity Index Fund	544,162	-	-	544,162	596,835
DFA Small Cap Subtrust	260,000	-	-	260,000	323,104
SPIFF	39,638	-	-	39,638	40,405
TFBP:					
Corporate Asset-backed	61,013	-	-	61,013	60,172
Corporate Stocks	504,213	-	13,195	517,408	546,933
US Govt. Mortgage-backed	150,318	-	-	150,318	147,756
US Govt. Direct	225,257	2,532	144,491	372,280	385,438
Yankee Bonds	68,920	-	3,991	72,911	77,757
State and Local Government	9,893	-	-	9,893	9,894
RFBP:					
Corporate Asset-backed	57,411	-	-	57,411	57,044
Corporate Stocks	686,127	-	25,909	712,036	752,472
US Govt. Mortgage-backed	193,434	-	-	193,434	189,125
US Govt. Direct	293,921	-	168,298	462,219	488,067
Yankee Bonds	59,146	-	4,369	63,515	69,524
MTIP:					
BGI MSCI Europe Index	375,434	-	-	375,434	389,188
BOI Internal International	40,005	-	-	40,005	46,168
BGI Cash & Money Market	1	-	-	1	1
SPIFF	31,374	-	-	31,374	31,685
Schroder Capital Management	118,527	-	13,211	131,738	150,237
Pyford International	100,538	-	19,179	119,717	133,028
Nomura	87,496	-	717	88,213	103,631
MPEP:					
Private Equities	212,763	-	-	212,763	234,249
State Street SPIFF	23,948	-	-	23,948	24,230
Total pooled investments	5,760,001	2,532	412,159	6,174,692	6,798,883
Other pool assets (net)	-	-	-	77,584	77,584
Total equity in pooled investments	<u>\$5,760,001</u>	<u>\$2,532</u>	<u>\$412,159</u>	<u>\$6,252,276</u>	<u>\$6,876,467</u>
Securities lending collateral Investment pool			<u>\$453,667</u>	<u>\$ 453,667</u>	<u>\$ 453,667</u>

* At June 30, 2004, these underlying securities, with fair values of \$2,965,830 and \$441,171,420, respectively, were loaned for securities and cash under a security lending agreement with the State's agent.

As of June 30, 2004, component units of the State of Montana had equity in pooled investments with a book value of \$4,167,355,588 and a fair value of \$5,616,651,956.

D. Investments

Long-term investments are primarily administered by three state agencies. Article VIII of Montana's Constitution, with supporting statutes, authorizes the Board of Investments (BOI) to manage the State's unified investment program. State law specifies which agencies may hold investments outside the administration of the BOI. The BOI, as the State's primary administrator of long-term investments, actively manages 71.86% of those investments; the Board of Housing, 9.41%; and the Department of Administration's Public Employees Retirement Board, 16.19% for the State's Deferred Compensation Plan and Defined Contribution Retirement Plan. The Department of Natural Resources and Conservation, the Department of Public Health and Human Services, and the Commissioner of Higher Education, combined, manage 1.39% of total investments for bond-related activities. Additionally, the Montana University System manages 1.03% of total investments.

The BOI must employ the "Prudent Expert Rule" in managing the State's investment portfolio. Investments are presented at fair value. Investment fair values for publicly traded securities are determined primarily by reference to market prices supplied to the BOI's custodial bank or trustee. Amortized cost, or carrying value, represents the original cost, adjusted for premium and discount amortization where applicable.

Table 4 – Investments (Risk Categories) (in thousands)

	Risk Category 1		Risk Category 2	Not Categorized*	Carrying Amount	Fair Value
	Securities Not on Loan	On Loan for Securities Collateral*				
Primary government						
Corporate bonds	\$ 1,137	\$ -	\$ -	\$ 31,745	\$ 32,882	\$ 33,937
Corporate asset-backed	12,217	-	-	-	12,217	12,062
Government securities	101,364	\$1,366	-	-	102,730	104,009
Government mortgage-backed	6,642	-	-	-	6,642	6,730
Total	\$121,360	\$1,366	\$ -	\$ 31,745	\$ 154,471	\$ 156,738
Component units/fiduciary funds						
Corporate bonds	\$255,712	\$ -	\$ -	\$ -	\$ 255,712	\$ 262,591
Corporate asset-backed	28,031	-	-	-	28,031	27,642
Government securities	95,179	-	-	185,935	281,114	285,227
Government mortgage-backed	51,047	-	-	-	51,047	51,798
Repurchase agreement	-	-	\$82,655	-	82,655	82,655
Other investments	-	-	-	15,387	15,387	15,312
Total	429,969	-	82,655	201,322	713,946	725,225
Total	\$551,329	\$1,366	\$82,655	\$233,067	\$ 868,417	\$ 881,963
Direct investments:						
Primary government						
Commercial loans					\$ 161,695	\$ 161,695
Other					999	1,007
MUS Workers Compensation					1,842	1,842
Total					\$ 164,536	\$ 164,544
Component units/fiduciary funds						
Real estate					\$ 16,093	\$ 16,242
Mortgages					123,619	123,621
Other					77,348	81,846
Deferred compensation					223,280	224,376
Defined contribution					18,087	20,480
VEBA					122	122
Investments of MSU component units					107,102	107,102
Investments of UM component units					125,446	125,446
Total					691,097	699,235
Total investments					\$1,724,050	\$1,745,742
Securities lending collateral						
Investment pool				\$226,700	\$ 226,700	\$ 226,700

* At June 30, 2004, the underlying securities, with fair values of \$1,328,020 and \$220,907,631, respectively, were loaned for securities and cash collateral under a securities lending agreement with the State's agent.

NOTE 4. DISAGGREGATION OF ACCOUNTS RECEIVABLE AND PAYABLE

A disaggregation of the net receivables and accounts payable (by fund type) as of June 30, 2004, follows (amounts in thousands):

A. Receivables

Receivables	Governmental Funds					
	General Fund	State Special Revenue	Federal Special Revenue	Coal Severance Tax Permanent	Land Grant Permanent	Other Governmental
Licenses and permits	\$ 8,126	\$ 330	\$ -	\$ -	\$ -	\$ -
Taxes	143,533	44,460	-	3,517	-	959
Charges for services/ fines/forfeitures	7,543	9,955	2,356	-	-	-
Investment income	1,696	5,850	-	4,339	5,977	3,932
Other	5,545	6,585	7,080	-	-	368
Total receivables	166,443	67,180	9,436	7,856	5,977	5,259
Less: allowance for doubtful accounts	(15,976)	(2,323)	-	-	-	-
Receivables, net	\$150,467	\$64,857	\$ 9,436	\$7,856	\$5,977	\$5,259

Receivables	Proprietary Funds			
	Unemployment Insurance	Economic Development Bonds	Other Enterprise	Internal Service
Charges for services	\$1,992	\$ -	\$14,395	\$ 165
Investment income	-	736	35	56
Contributions/premiums	4,441	-	2,398	2,823
Other	-	9,176	134	200
Total receivables	6,433	9,912	16,962	3,244
Less: allowance for doubtful accounts	(222)	-	(107)	-
Receivables, net	\$6,211	\$9,912	\$16,855	\$3,244

B. Payables

Payables	Governmental Funds					
	General Fund	State Special Revenue	Federal Special Revenue	Coal Severance Tax Permanent	Land Grant Permanent	Other Governmental
Refunds	\$ 80,388	\$ -	\$ -	\$-	\$ -	\$ -
Tax distributions to other govt	-	23,727	-	-	-	-
Vendors/individuals	31,442	45,586	106,564	-	-	2,757
Payroll	10,587	11,042	4,553	-	-	64
Accrued interest	-	-	-	-	5,842	-
Other	348	1,157	943	-	-	12
Total	\$122,765	\$81,512	\$112,060	\$-	\$5,842	\$2,833

Payables	Proprietary Funds			
	Unemployment Insurance	Economic Development Bonds	Other Enterprise	Internal Service
Vendors/individuals	\$54	\$ 1	\$5,709	\$6,764
Payroll	-	13	429	1,753
Accrued interest	-	613	-	6
Other	-	-	4	15
Total	\$54	\$627	\$6,142	\$8,538

NOTE 5. CAPITAL ASSETS

A. Primary Government

Changes in capital asset balances for the fiscal year ended June 30, 2004, are reflected in the following table; intrafund transfers of capital assets have not been eliminated (in thousands):

Primary Government

	Beginning Balance	Increases	Decreases	Ending Balance
Governmental activities				
Capital assets, not being depreciated				
Land	\$ 300,246	\$ 22,755	\$ (7,280)	\$ 315,721
Construction work in progress	174,368	179,712	(175,011)	179,069
Capitalized collections	64,055	7,812	(1,846)	70,021
Total capital assets, not being depreciated	538,669	210,279	(184,137)	564,811
Capital assets, being depreciated				
Infrastructure	2,821,593	189,668	(63,542)	2,947,719
Land improvements	11,178	1,157	(388)	11,947
Buildings/improvements	323,582	26,267	(21,030)	328,819
Equipment	235,783	29,773	(19,648)	245,908
Other	3,323	1,224	(1,152)	3,395
Total capital assets, being depreciated	3,395,459	248,089	(105,760)	3,537,788
Less: accumulated depreciation for:				
Infrastructure	(1,447,182)	(1,374,944)	1,411,285	(1,410,841)
Land improvements	(1,170)	(824)	532	(1,462)
Buildings/improvements	(145,103)	(10,425)	5,879	(149,649)
Equipment	(140,655)	(22,173)	13,852	(148,976)
Other	(2,527)	(1,752)	1,299	(2,980)
Total accumulated depreciation	(1,736,637)	(1,410,118)	1,432,847	(1,713,908)
Total capital assets, being depreciated, net	1,658,822	(1,162,029)	1,327,087	1,823,880
Intangible assets	27,836	8,312	(15,711)	20,437
Governmental activity capital assets, net	\$2,225,327	\$ (943,438)	\$1,127,239	\$2,409,128

Primary Government (continued)

	Beginning Balance	Increases	Decreases	Ending Balance
Business-type activities				
Capital assets, not being depreciated				
Land	\$ 800	\$ -	\$ -	\$ 800
Construction work in progress	71	246	(63)	254
Total capital assets, not being depreciated	871	246	(63)	1,054
Capital assets, being depreciated				
Infrastructure	884	-	-	884
Land improvements	1,381	6	-	1,387
Buildings/improvements	6,098	-	-	6,098
Equipment	9,881	846	(851)	9,876
Other	-	-	-	-
Total capital assets, being depreciated	18,244	852	(851)	18,245
Less: accumulated depreciation for:				
Infrastructure	(459)	(92)	63	(488)
Land improvements	(1,092)	(9)	-	(1,101)
Buildings/improvements	(3,336)	(275)	87	(3,524)
Equipment	(5,221)	(1,831)	850	(6,202)
Other	-	-	-	-
Total accumulated depreciation	(10,108)	(2,207)	1,000	(11,315)
Total capital assets, being depreciated, net	8,136	(1,355)	149	6,930
Intangible assets	1,188	39	(286)	941
Business-type activity capital assets, net	\$10,195	\$(1,070)	\$ (200)	\$ 8,925

Depreciation expense was charged to governmental functions as follows (in thousands):

	Amount
General government	\$ 1,562
Public safety/corrections	6,085
Transportation (including depreciation of the highway system maintained by the State)	97,490
Health/social services	3,088
Education/cultural	587
Resource/recreation/environment (including depreciation of the State's dams).	4,118
Economic development/assistance	866
Depreciation and amortization on capital assets held by the State's internal service funds is charged to the various functions based on their usage of the assets.	10,438
Total depreciation expense – governmental activities	\$124,234

Depreciation expense was charged to business-type activities as follows (in thousands):

	Amount
Liquor Stores	\$ 102
State Lottery	900
Economic Development Bonds	2
General Government Services	77
Prison Funds	318
Total depreciation expense – business-type activities	\$1,399

B. Discretely Presented Component Units

The following table summarizes net capital assets reported by the discretely presented component units (in thousands). All component units, other than higher education units, are included under the "Other" caption for this schedule:

Discretely Presented Component Units

	Montana State University (MSU)	University of Montana (UM)	Other	Total
Capital assets, not being depreciated				
Land	\$ 4,240	\$ 7,001	\$ -	\$ 11,241
Construction work in progress	5,787	24,094	-	29,881
Capitalized collections	7,780	14,793	-	22,573
Livestock for educational purposes	2,758	-	-	2,758
Total capital assets, not being depreciated	20,565	45,888	-	66,453
Capital assets, being depreciated				
Infrastructure	32,128	-	-	32,128
Land improvements	13,129	9,368	-	22,497
Buildings/improvements	289,418	310,779	-	600,197
Equipment	86,526	47,273	3,226	137,025
Other	55,701	46,547	-	102,248
Total capital assets, being depreciated	476,901	413,968	3,226	894,095
Less: accumulated depreciation	(259,555)	(221,715)	(1,987)	(483,257)
Total capital assets, being depreciated, net	217,346	192,253	1,239	410,838
Intangible assets	1,406	809	1,186	3,401
Capital assets (net) of MSU component units	6,817	-	-	6,817
Capital assets (net) of UM component units	-	5,666	-	5,666
Discretely presented component units				
Total capital assets, net	\$246,135	\$244,615	\$2,425	\$493,175

NOTE 6. RETIREMENT SYSTEMS

Defined Contribution Plans

ORP – Optional Retirement Program – Effective January 1, 1988 through June 30, 1993, eligible employees of the Montana University System (MUS) could elect to participate in the Optional Retirement Program (ORP). The ORP is a defined contribution retirement plan governed by Title 19, chapter 21 of the Montana Code Annotated. The plan is underwritten by the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF); only faculty and staff with contracts under the authority of the Board of Regents may participate. Those faculty and staff members who did not elect the ORP, participate in the Teachers Retirement System or the Public Employees Retirement System, benefit plans discussed in the next section. Beginning July 1, 1993, membership in the ORP was mandatory for eligible employees new to the MUS. The MUS is the only employer contributing to this plan.

The benefits at retirement depend upon the amount of contributions, amount of investment gains and losses, and the employee life expectancy at retirement. Under

the ORP, each employee enters into an individual contract with TIAA-CREF. Individuals are immediately vested with all contributions. Higher education units record employee/employer contribution expenditures in the affected higher education subfund when remitting contributions to the Commissioner of Higher Education. These monies are recorded in the Custodial Accounts Agency Fund. The Commissioner's Office then wire transfers the contributions to TIAA-CREF. The MUS is not liable for asset management or for providing benefits after the required contributions have been made to TIAA-CREF. Required employee contributions were 7.027% of salary; required employer contributions were 4.91% of salary, for a total of 11.9% of salary contributed to the ORP.

	TIAA-CREF (in thousands)
Covered payroll	\$ 133,141
Total payroll	290,673
Employer contributions	\$ 6,535
Percent of covered payroll	4.91%
Employee contributions	\$ 9,355
Percent of covered payroll	7.03%

PERS-DCRP – Public Employees Retirement System - Defined Contribution Retirement Plan – This plan is a multiple-employer plan created by the 1999 Legislature and is governed by Title 19, chapters 2 & 3 of the MCA. The plan began receiving contributions on July 1, 2002.

All new hires initially are members of the Public Employees Retirement System - Defined Benefit Retirement Plan (PERS-DBRP). New hires have a 12-month window during which they may choose to join the PERS-DCRP or remain in the current PERS-DBRP. Members may not be members of both the defined contribution and defined benefit retirement plans. The choice is irrevocable. Members of the defined contribution retirement plan will decide how to invest their contributions and a portion of their employer contributions among the offered investment options. The remaining portion of employer contributions will be used to maintain funding of the defined benefit plan, to provide disability benefits, and to fund an employee education program.

Participant rights are fully vested in their accounts at the time of deposit in regard to participant contributions and interest. Employer contributions and interest are vested after 5 years of service.

The PERS-DCRP has received a long-term loan through the Montana Department of Administration, with the BOI to fund the plan start-up/implementation costs. Authorization for the loan was provided by the Legislature, Chapter 471, Laws of 1999. Five loan draws were taken in the total amount of \$1,498,000. Interest repayments began immediately following the draws. Principal repayments began August 15, 2003, the year following the PERS-DCRP implementation date. The loan was renegotiated as a single sum in fiscal year 2004, to be repaid over a period of 15 years. The interest rate is variable and changes every February, impacting the interest due on the outstanding principal balance.

An inter-entity loan in the amount of \$114,000 was made to the PERS-DCRP from the defined benefit education fund on August 18, 2003, to help cover the costs of the DCRP expenses. The term of this loan is for two years, and the interest rate to be repaid to the defined benefit education fund is the same as STIP. The first repayment of \$28,500 plus interest was made in June 2004, in advance of the actual due date. The remaining principal balance of the inter-entity loan is \$85,500 and is due in August 2005.

For information on the repayment schedules on these loans, please see the separately issued PERS-DCRP financial statements.

Deferred Compensation Plan

457 – Deferred Compensation Plan – The 457 plan was established in 1976 and is governed by Title 19, chapter 50, MCA, in accordance with Internal Revenue Service Code (IRC) 457. All employees of the State, Montana University System, and contracting political subdivisions are eligible to participate. As of June 30, 2004, the net assets of the plan were \$224,748,963.

The 457 plan is a voluntary, tax-deferred retirement plan designed to supplement state service retirement, Social Security, and other retirement plans and savings. Assets of the 457 plan are required to be held in trusts, custodial accounts, or insurance company contracts for the exclusive benefit of participants and their beneficiaries. Participants elect to defer a portion of their salary, within IRC limits. The deferred salary is not available to employees until separation from service, retirement, death, or upon an unforeseeable emergency while still employed and must meet IRS-specified criteria. Participant rights are fully vested in their accounts at the time of deposit.

Defined Benefit Plans

A. General

The Public Employees Retirement Board (PERB), a discretely presented component unit of the State of Montana, administers eight defined benefit plans - Public Employees Retirement System (PERS-DBRP), Highway Patrol Officers Retirement System (HPORS), Judges Retirement System (JRS), Game Wardens and Peace Officers Retirement System (GWPORS), Sheriffs Retirement System (SRS), Municipal Police Officers Retirement System (MPORS), Firefighters Unified Retirement System (FURS), and Volunteer Firefighters Compensation Act (VFCA). The board prepares a publicly issued comprehensive annual financial report that includes financial statements and required supplementary information for PERS, HPORS, JRS, GWPORS, SRS, MPORS, FURS, VFCA, as well as the two defined contribution plans, PERS-DCRP and 457 plan.

The financial statements for PERS-DBRP include activity for the defined benefit and the associated education fund. The PERS-DCRP financial statements include activity for the defined contribution and the associated education fund.

The Teachers Retirement System (TRS) is a discretely presented component unit of the State of Montana. The system prepares a publicly issued financial report that includes financial statements and required supplementary information for TRS.

A summary of government employers participating in PERB, SRS, MPORS, HPORS, FURS, GWPORS, JRS, 457, and TRS by employer type at June 30, 2004, follows:

Retirement System/Plan

	PERS- DBRP	PERS- DCRP	SRS	MPORS	HPORS	FURS	GWPORS	JRS	457	TRS
Employers										
State agencies	35	28	1		1	1	5	1	35	8
Counties	55	44	55							
Cities/towns	94	37		22		14				
Colleges/universities	5	5					3		6	5
School districts	242	88								372
Other	95	27							2	
Total	526	229	56	22	1	15	8	1	43	385

B. Plan Descriptions

The State contributes to and/or administers ten plans in four categories: (1) the State as the single employer; (2) the State as an employer contributor to cost-sharing, multiple-employer plans; (3) the State as a nonemployer contributor to cost-sharing, multiple employer plans; and (4) the State as a nonemployer contributor.

The number of years required to obtain vested rights varies among the systems. All systems provide early retirement options, death benefits, termination, and disability benefits. The post-retirement benefits of each of the systems are included in the plan descriptions below. In addition, the 1999 Legislature passed a guaranteed annual benefit adjustment (GABA) to the PERS-DBRP, MPORS, GWPORS, SRS, JRS, HPORS, and FURS that will provide a maximum benefit increase of 3% each January, inclusive of all other adjustments to the member’s benefit, if the recipient has been receiving a retirement benefit for at least 12 months.

The funding policies for each system provide for periodic employer and employee contributions (except VFCA) at rates specified by state law. An actuary determines the actuarial implications of the funding requirement in a biennial actuarial valuation. The actuarial method used to determine the implications of the statutory funding level is the entry-age normal-cost method, with both normal cost and amortization of the unfunded accrued liability determined as a level percentage of payroll. To maintain a fund on an actuarially sound basis, the rate of contributions should fund the normal cost, in addition to amortizing the unfunded liability over a period not to exceed 30 years.

(1) State as the Single Employer

HPORS – Highway Patrol Officers Retirement System – This system, established in 1971 and governed by Title 19, chapters 2 & 6 of the Montana Code

Annotated (MCA), provides retirement benefits for all members of the Montana Highway Patrol, including supervisory personnel. Rights are vested after five years of service. Member contributions are 9% of total salaries of active highway patrol officers hired prior to July 1, 1997 and not electing GABA coverage; and 9.05% for members hired after June 30, 1997, and members electing GABA coverage. The employer contribution rate is 36.33% of active officer’s salaries. The first 26.15% is payable from the same source used to pay members’ compensation. The remaining amount, equal to 10.18%, is payable from a portion of the fees collected from drivers’ license and duplicate drivers’ license applications. For members, there is no minimum age, but minimum service is 20 years for benefit eligibility. The service retirement benefit is based on a formula of 2.5% times the number of years of service times the highest average compensation. Post-retirement benefits, for non-GABA members, are in the form of minimum benefit supplements which insure the retiree’s benefit is no less than 2% of a probationary highway patrol officer’s salary for each year of the retiree’s service, with the annual increase not to exceed 5% of the benefit paid nor 60% of the current base salary of a probationary officer. Members retired prior to July 1, 1991, who are at least age 55 and have been retired a minimum of five years, may be eligible for an annual lump-sum payment distributed in September. This lump-sum payment is funded by a registration fee of 25 cents per vehicle registration. The average payment in September 2004 was \$2,310. This enhancement is limited to non-GABA members.

JRS – Judges Retirement System – This system, established in 1967 and governed by Title 19, chapters 2 & 5 of the MCA, provides retirement benefits for all Montana judges of district court, justices of the Supreme Court, and the Chief Water Judge. Members contribute 7% of their salaries while the State contributes 25.81% of active judges’ salaries. Rights are vested after five years of membership service. Benefit eligibility is age 60 with at least 5 years of service, or any age with 5 years of service actuarially reduced with

involuntary terminations. The monthly retirement benefit formula is 3 1/3% per year of the member's highest average compensation for the first 15 years of credited service, plus 1.785% per year for each year of credited service after 15 years. For non-GABA members, the percentages are based on the member's current salary, instead of the highest average compensation.

(2) State as an Employer Contributor to Cost-Sharing, Multiple-Employer Systems

PERS-DBRP – Public Employees Retirement System – Defined Benefit Retirement Plan – This mandatory system, established in 1945 and governed by Title 19, chapters 2 & 3 of the MCA, provides retirement benefits to substantially all public employees not covered by another public system. Member contributions are 6.9% of covered compensation. Each state agency and university system employer contributed 6.9% of PERS-covered payroll. Participating local governments and school district employers contributed 6.8% of PERS-covered payroll. The State contributed 0.1% for local governments and school district employers from the State General Fund. Benefit eligibility is age 60 with at least 5 years of service, age 65 regardless of service, or 30 years of service, regardless of age. Actuarially reduced benefits may be taken with 25 years of service, or at age 50 with at least five years of service. Monthly retirement benefits vary based on years of service: the benefit is determined by taking 1.785% (for employees with less than 25 years of service), or 2% (for employees with at least 25 years of service) times the number of years of service times the highest average compensation times any early retirement reduction, if necessary. Members' rights are vested after five years of membership service.

Actuarial Status: The statutory funding rate is tested in the valuation to determine if it is sufficient to cover the normal cost rate plus an amortization payment of the unfunded actuarial liability, if any, over no more than 30 years. Based on the current actuarial value of assets and all future experience emerging as assumed, the unfunded actuarial liability will not be amortized over the next 30 years. In general, the deterioration of the funded status is primarily due to recognizing prior investment losses due to returns less than the long-term assumed rate of 8% per year. Based on the actuarial assumptions, an additional funding rate of 1.19% of payroll would be required to fund the current and projected benefits from the retirement system in accordance with GASB standards and state law.

TRS – Teachers Retirement System – This mandatory system, established in 1937 and governed by Title 19, chapter 20 of the MCA, provides retirement services to all persons employed as teachers or professional staff of any public elementary or secondary school, or unit of

the university system. Member and employer contributions are 7.15% and 7.47%, respectively, of earned compensation. Benefit eligibility is age 60 with at least 5 years of creditable service, or at any age with at least 25 years of creditable service. The formula for annual benefits is 1.6667% times creditable service years times the average final compensation. Rights are vested after five years of creditable service. Vested employees may retire at or after age 50 and receive reduced retirement benefits. Effective January 1, 1988, university system employees eligible to participate in the Teachers Retirement System could elect to participate in an Optional Retirement Plan established by the Board of Regents. A supplemental employer contribution to TRS is required to be amortized by July 1, 2033, for the amount that would not be paid for by contributions of university system members. The fiscal year 2004 contribution percentage of the total compensation of employees participating in the ORP program was 4.04% and the contribution was \$4.7 million.

Actuarial Status: The Montana Constitution, Article VIII, Section 15, requires public retirement systems be funded on actuarially sound basis. The system's actuary has determined that as of July 1, 2004, the current employer contribution rate of 7.47% plus the General Fund contribution of 0.11% of members' salaries are insufficient to meet the actuarial cost of the system and to amortize the unfunded actuarial liability over an open period of 30 years. The unfunded actuarial accrued liability of \$873.5 million is included in the Schedules of Funding Progress. Based on the results of the July 1, 2004 valuation, the TRS Board will recommend options to the Legislature that are considered necessary to remain actuarially sound.

In addition, because actuarial gains and losses are smoothed over five years, only one-fifth of each previous year's actuarial loss has been recognized in the amortization period as of July 1, 2004, leaving almost \$131 million in unrecognized investment losses, which must be recognized over the next three to four years. Therefore, to remain actuarially sound for future years, the retirement system will need to incur future gains that would result from a significant recovery in the investment market, a reduction in liabilities, additional increases in contribution rates, or any combination thereof.

SRS – Sheriffs Retirement System – This system, established in 1974 and governed by Title 19, chapters 2 & 7 of the MCA, covers State Department of Justice criminal investigators hired after July 1, 1993 and all Montana sheriffs. The member contribution is 9.245% of salary; the employer contribution is 9.535% of SRS-covered payroll. Benefit eligibility is age 50 with at least 5 years of service, actuarially reduced, or 20 years of service regardless of age. The service retirement

benefit is calculated at 2.5% of the highest average compensation for each year of membership service. Reduced benefits for early retirement may be taken with a minimum of five years of service and a minimum age of 50. Rights are vested after five years of membership service.

Actuarial Status: The statutory funding rate is tested in the valuation to determine if it is sufficient to cover the normal cost rate plus an amortization payment of the unfunded actuarial liability, if any, over no more than 30 years. Based on the current actuarial value of assets and all future experience emerging as assumed, the unfunded actuarial liability will not be amortized over the next 30 years. In general, the deterioration of the funded status is primarily due to recognizing prior investment losses due to returns less than the long-term assumed rate of 8% per year. Based on the actuarial assumptions, an additional funding rate of 2.15% of payroll would be required to fund the current and projected benefits from the retirement system in accordance with GASB standards and state law.

GWPORS – Game Wardens & Peace Officers Retirement System – This system, established in 1963 and governed by Title 19, chapters 2 & 8 of the MCA, provides retirement benefits for all persons employed as a game warden, warden supervisory personnel, and state peace officers not eligible to join the SRS, HPORS and MPORS systems. The member contributes 10.56% of salary while the State contributes 9.0% of covered active employee salaries. Benefit eligibility is age 50 with at least 20 years of service, or age 55 with at least 5 years of service. The yearly retirement benefit formula is 2.5% times the number of years of service times the highest average compensation. Rights are vested after five years of membership service.

Actuarial Status: The statutory funding rate is tested in the valuation to determine if it is sufficient to cover the normal cost rate plus an amortization payment of the unfunded actuarial liability, if any, over no more than 30 years. Based on the current actuarial value of assets and all future experience emerging as assumed, the unfunded actuarial liability will not be amortized over the next 30 years. In general, the deterioration of the funded status is primarily due to recognizing prior investment losses due to returns less than the long-term assumed rate of 8% per year. Based on the actuarial assumptions, an additional funding rate of 0.23% of payroll would be required to fund the current and projected benefits from the retirement system in accordance with GASB standards and state law.

(3) State as a Nonemployer Contributor to Cost-Sharing, Multiple-Employer Systems

MPORS – Municipal Police Officers Retirement System – The system, established in 1974 and governed

by Title 19, chapters 2 & 9 of the MCA, covers all municipal police officers of cities covered by the plan. It is a cost-sharing defined benefit plan with a special funding situation. The member contribution is 5.8% of salary for members employed prior to July 1, 1975; 7% of salary for members employed after June 30, 1975, and prior to July 1, 1979; 8.5% of salary for members employed after June 30, 1979, and prior to July 1, 1997; and 9% for members hired on or after July 1, 1997, and members electing GABA. Employer contributions are 14.41% of MPORS-covered payroll. The State contributes 29.37% of compensation paid to members. The State's contribution is funded from the General Fund. Rights are vested after five years of membership service. Benefit eligibility is age 50 with at least 20 years of service, or age 55 with at least 5 years of service. The service retirement benefit is 2.5% times the number of years of service times the final average compensation. For non-GABA members, a minimum benefit adjustment is required to insure that the retired members benefit is not less than one-half of the compensation paid to newly confirmed police officers in the city that last employed the member.

Beginning July 2002, eligible members of MPORS have the opportunity to participate in the Deferred Retirement Option Plan (DROP) by filing a one-time irrevocable election with the Board. The DROP is governed by Title 19, Chapter 9, Part 12, MCA. An eligible member must have completed at least 20 years of membership service. They may elect to participate in the DROP for a minimum of one month and a maximum of five years and may participate in the DROP only once. A participant remains a member of the MPORS, but will not receive membership service or service credit in the system for the duration of the member's DROP period. During the participation in the DROP, all mandatory contributions continue to be made to the retirement system. A monthly benefit is calculated based on salary and years of service to the date of the beginning of the DROP period. The monthly benefit is paid into the DROP account until the end of the DROP participation period. At the end of the DROP period, the participant may receive the balance of the DROP account in a lump-sum payment or in a direct rollover to another eligible plan, as allowed by the IRS. If the participant continues employment after the DROP period ends they will again accrue membership service and service credit and the DROP account cannot be distributed until employment is formally terminated.

FURS – Firefighters Unified Retirement System – This system, established in 1981 and governed by Title 19, chapters 2 & 13 of the MCA, provides retirement benefits for firefighters employed by first and second-class cities and other cities that wish to adopt the plan and to firefighters hired by the Montana Air National Guard on or after October 1, 2001. It is a cost-sharing defined benefit plan with a special funding situation.

The member contribution is 9.5% of compensation for members hired prior to July 1, 1997; and 10.7% for members hired after June 30, 1997, and for members electing GABA coverage. City contributions are 14.36% of total annual compensation. The state contribution is 32.61% of total annual compensation for all firefighters and is paid out of the General Fund. Benefit eligibility is 20 years regardless of age, or age 50 with at least 5 years of service. For members not electing GABA and hired prior to July 1, 1981, monthly retirement benefit is 50% of final average compensation, plus 2% per year for each year in excess of 20 years, or 2.5% of final average compensation per year. Members hired before July 1, 1981, with less than 20 years, receive a retirement benefit of 2% per year of service. Members electing GABA and hired after July 1, 1981, receive 2.5% of final average compensation. Post-retirement benefits, for non-GABA members, require that each retiree receive at least 50% of the salary paid a newly confirmed firefighter in the city where last employed. Rights are vested after five years of membership service.

(4) State as a Nonemployer Contributor

VFCA – Volunteer Firefighters Compensation Act – This compensation program, established in 1965 and governed by Title 19, chapter 17 of the MCA, provides pension, disability and death benefits for all volunteer firefighters who are members of eligible volunteer fire companies in unincorporated areas of the state. VFCA also provides limited medical expenses for injuries incurred in the line of duty. VFCA is a plan with a special funding situation. The state contribution is 5% of fire insurance premium taxes collected. Rights are vested after ten years of qualified service. Benefit eligibility is age 55 with at least 20 years of service (full benefit available), or age 60 with at least 10 years of service (partial benefit available).

The 2003 Legislature amended the law so that members of the VFCA can accumulate more than 20 years of service beginning when they are age 55, if they already have 20 years of service (effective 7/1/2003).

C. Summary of Significant Accounting Policies

The pension trust funds' financial statements are prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions to each plan are recognized when due and when the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

D. Method Used to Value Investments

The Montana Board of Investments (BOI) manages the investments for the retirement systems. Investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Mortgages are valued on the basis of future principal and interest payments and are discounted at prevailing interest rates for similar instruments. The fair value of real estate investments is based on a discounted cash flow. Investments that do not have an established market are reported at estimated fair value. These values are based on market prices supplied to the BOI by its custodial bank, State Street Bank, and various brokerage services. The retirement systems have no investments of any commercial or industrial organization whose fair value equals 5% or more of the retirement systems net assets available for benefits.

E. Long-term Contracts for Contributions

The Montana Legislature also provided a new provision of the Employee Protection Act (EPA) (Section 19-2-706, MCA) allowing state and university system employees, eligible for a service retirement, whose positions have been eliminated, to have their employer pay a portion of the total cost of purchasing up to three years of "1 for 5" additional service. As of June 30, 2004, 311 employees have taken advantage of the provision.

The employer has up to ten years to complete payment for the service purchases and is charged 8% interest on the unpaid balance. Total retirement incentive contributions received, including interest, during fiscal year 2003 totaled \$423,969. June 30, 2004, outstanding balances were \$215,459.

F. Actuarial Data

Actuarial valuations are performed every two years. Milliman prepared the July 2004 actuarial reports for PERS and TRS. Mellon was the auditing actuary for all retirement system actuarial reports prepared by Milliman & Robertson. Milliman & Robertson prepared the July 2002 actuarial reports for the retirement systems, including TRS. Milliman & Robertson of Seattle, WA, performed the actuarial valuation for TRS for July 1, 2000. Milliman & Robertson, of Portland, OR, prepared the July 1, 2000 actuarial reports for the retirement systems, excluding TRS. Further disclosure can be found in Note 18.

G. Funding Policy and Annual Pension Cost

The following tables provide information concerning funding policies and annual pension costs (in thousands):

Single Employer Systems

	HPORS	JRS
Annual pension cost	\$3,198	\$1,136
Contributions		
Employer	\$2,859	\$1,136
Employee	743	443
License and registration fees	348	
Actuarial valuation date	7/01/04	7/01/04
Actuarial cost method	Entry age	Entry age
Amortization method	Level percentage of total salaries, open	Level percentage of total salaries, open
Remaining amortization period	19.1 years	30 years
Asset valuation method	4 year smoothed market	4 year smoothed market
Actuarial assumptions:		
Investment rate of return	8.0%	8.0%
Projected salary increases (includes inflation factor)	4.25%	4.25%
Merit	0%-7.3%	None
Postretirement benefit increases	None	None

Single Employer Systems

Year Ended	Annual Pension Costs (APC)	Percentage of APC Contributed	Net Obligation
HPORS			
06/30/02	3,047	101.3%	NONE
06/30/03	3,191	100.9%	NONE
06/30/04	3,198	100.3%	NONE
JRS			
06/30/02	1,032	100.0%	NONE
06/30/03	1,052	100.0%	NONE
06/30/04	1,137	100.0%	NONE

Multiple Employer Systems

Year Ended	Annual Required Contribution (ARC)	Percentage of ARC Contributed
PERS		
06/30/02	55,369	100.5%
06/30/03	58,114	99.1%
06/30/04	57,036	101.0%
MPORS		
06/30/02	9,732	101.1%
06/30/03	10,196	101.0%
06/30/04	10,740	101.4%
FURS		
06/30/02	8,432	98.1%
06/30/03	8,740	100.8%
06/30/04	9,409	100.0%
SRS		
06/30/02	2,338	102.1%
06/30/03	2,435	101.7%
06/30/04	2,610	103.6%
GWPORS		
06/30/02	1,544	103.3%
06/30/03	1,803	101.8%
06/30/04	1,930	104.7%
TRS		
06/30/02	51,519	100.0%
06/30/03	53,277	100.0%
06/30/04	55,774	100.0%

H. Schedules of Funding Progress

Single Employer Systems

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability(AAL) Entry Age (b)	Unfunded (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as Percentage of Covered Payroll ((b-a)/c)
HPORS						
07/01/00	77,810	76,397	(1,413)	101.85%	6,952	(20.33)%
07/01/02	81,734	94,850	13,116	86.17%	7,536	174.04%
07/01/04	79,104	104,069	24,965	76.01%	7,844	318.27%
JRS						
07/01/00	42,043	27,365	(14,678)	153.64%	3,483	(421.42)%
07/01/02	44,963	30,882	(14,081)	145.60%	4,000	(352.03)%
07/01/04	45,134	34,724	(10,410)	129.98%	4,403	(236.43)%

Multiple Employer Systems

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability(AAL) Entry Age (b)	Unfunded (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as Percentage of Covered Payroll ((b-a)/c)
PERS						
07/01/00	2,843,347	2,273,407	(569,940)	125.07%	725,692	(78.54)%
07/01/02	3,076,781	3,077,764	983	99.97%	808,747	0.12%
07/01/04	3,047,287	3,514,085	466,798	86.72%	832,847	56.05%
MPORS						
07/01/00	129,826	181,109	51,283	71.68%	20,252	253.22%
07/01/02	143,516	226,827	83,311	63.27%	22,229	374.79%
07/01/04	149,510	260,094	110,584	57.48%	24,531	450.79%
FURS						
07/01/00	123,492	162,329	38,837	76.08%	16,547	235.00%
07/01/02	136,392	197,946	61,554	68.90%	17,953	342.86%
07/01/04	142,109	227,599	85,490	62.44%	20,248	422.21%
SRS						
07/01/00	126,338	87,836	(38,502)	143.83%	21,559	(178.59)%
07/01/02	138,590	121,625	(16,965)	113.95%	24,521	(69.19)%
07/01/04	141,022	148,608	7,586	94.90%	27,373	27.71%
GWPORS						
07/01/00	32,966	23,922	(9,044)	137.81%	11,875	(76.00)%
07/01/02	38,730	39,109	379	99.03%	17,151	2.21%
07/01/04	45,210	50,310	5,100	89.86%	21,442	23.79%
TRS						
07/01/00	2,247,500	2,648,300	400,800	84.9%	537,500	74.6%
07/01/02	2,484,800	2,980,100	495,300	83.4%	563,200	87.9%
07/01/04	2,485,700	3,359,200	873,500	74.0%	600,700	145.4%

Nonemployer Contributor

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability(AAL) Entry Age (b)	Unfunded (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as Percentage of Covered Payroll ((b-a)/c)
VFCA						
07/01/00	17,769	16,752	(1,017)	106.07%	N/A	N/A
07/01/02	19,254	26,808	7,554	71.82%	N/A	N/A
07/01/04	20,058	28,680	8,622	69.94%	N/A	N/A

NOTE 7. OTHER POSTEMPLOYMENT BENEFITS

In addition to the pension benefits described in Note 6, Retirement Systems, the following postemployment benefits are provided:

The State provides 18 to 36 months optional postemployment health care benefits in accordance with Public Law 99-272, known as the Consolidated Omnibus Budget Reconciliation Act (COBRA), to the following employees and dependents who elect to continue and pay administratively established premiums: (1) employees who are covered by the State Group Benefits Plan at the time they discontinue state employment and (2) spouses or other dependents who lose dependent eligibility. At June 30, 2004, 70 certificate holders were receiving these benefits.

In accordance with section 2-18-704, MCA, the State also provides optional postemployment health care benefits to the following employees and dependents who elect to continue coverage and pay administratively established premiums: (1) employees and dependents who retire under applicable retirement provisions and (2) surviving dependents of deceased employees. Retirement eligibility criteria differ by retirement system (See Note 6). Administratively established retiree medical premiums vary between \$189 and \$560 per month depending on the medical plan selected, family coverage, and Medicare eligibility. Administratively established dental premiums vary between \$28.60 and \$46.60, and vision premiums vary between \$7.85 and \$20.40 depending on the coverage selected. The State acts as secondary payor for retired Medicare-eligible claimants. As of June 30, 2004, 3,259 retirees were covered for health care benefits.

The State reimburses all validated medical claims less member obligations (annual deductibles and co-insurance of the members selected medical plan). Dental claims are reimbursed at 50% to 100% depending on the services provided. Vision services are

provided at prices ranging from a \$10 copay to a \$120 allowance depending on the services obtained and the network status of the provider. The State funds claims on a pay-as-you-go basis. During the fiscal year, expenditures of \$17,467,897 were recognized for postemployment health care benefits. Premium contributions received from former employees amounted to \$13,816,553 leaving \$3,651,344 of claims paid in excess of premium revenue received by the State.

In accordance with section 2-18-702, MCA, the Montana University System (MUS) provides postretirement health insurance benefits to eligible employees who receive a retirement benefit from the Teachers Retirement System, Public Employees Retirement System, or an annuity under the Optional Retirement Plan and have been employed by the MUS at least 5 years. Spouses, unmarried dependent children, and surviving spouses are also eligible. Administratively established premiums vary between \$216 and \$566 per month and are revised annually. The plan provides different coinsurance amounts depending on whether members use preferred, non-preferred, or other hospitals. After an annual \$575 deductible for non-Medicare-eligible retirees, the MUS plan reimburses 65% to 80% of the first \$10,000 in medical claims and 100% thereafter. After a \$400 deductible for Medicare-eligible retirees, the plan reimburses 65% to 80% for the first \$5,000 in medical claims and 100% thereafter. There is an optional \$1500 deductible plan available to retirees with a reduced premium. This plan has a small enrollment (54 enrollees). After the \$1500 annual deductible, the plan pays 65 to 80% of the first \$8,000 and 100% thereafter. The plan automatically reduces claim reimbursement for members eligible for Medicare, even if the member is not enrolled in Medicare. As of June 30, 2004, 1,392 retirees were enrolled in the MUS plan. Funding for the retiree health plan is on a pay-as-you-go basis. Based on amounts recorded through June 2004, estimated expenditures of \$5,651,448 were recognized for postemployment health care benefits. Of this amount, \$5,566,107 was paid by retirees through premiums, and the balance of \$85,341 was paid by the MUS.

NOTE 8. RISK MANAGEMENT

There are four primary government public entity risk pools that are reported within the enterprise fund type and two component unit public entity risk pools. Primary government pools include Hail Insurance, Subsequent Injury, the Montana University System (MUS) Group Benefits Plan, and the Montana University System Workers Compensation funds; component unit pools include State Compensation Insurance (New Fund) and State Compensation Insurance (Old Fund). Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other societal/economic factors. The primary government reports its own risk management activity within two internal service funds: Group Employees Comprehensive Medical and Dental Plan and Property and Casualty Insurance Plans. In all of these funds, there are no significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. These funds use the accrual basis of accounting. By statute, these funds cannot invest in common stock. Investments are recorded at fair value. Premiums and discounts are amortized using the straight-line method over the life of the securities.

A. Public Entity Risk Pools

(1) Hail Insurance – Any Montana producer engaged in growing crops subject to destruction or damage by hail may participate in the Hail Insurance program. The Hail Insurance program issued 2,026 policies during the 2004 growing season. This fund accounts for premium assessments paid by producers for crop acreage insured, investment and interest earnings, administrative costs, and claims paid for hail damage. Depending upon the actuarial soundness of the reserve fund and the damage in a season, producers may receive a premium refund. Anticipated investment income is considered in computing a premium deficiency, of which there is none.

A claim must be submitted to the State Board of Hail Insurance within 14 days of a loss occurrence. The claim must indicate whether the grain is stemming, in the boot, heading out, in the milk, in the stiff dough, ready to bind, or combine. If beans, peas, or other crops are damaged, the growth-stage must also be indicated. Inspection of a crop will occur as promptly as possible after claim receipt. The liability on all insured crops expires after October 1. The insurance only covers loss or damage to growing grain which exceeds 5% destruction by hail.

The fund recorded a liability of \$94,570 based on estimated claims through June 30, 2004. Any crop

insurance liability is paid to producers within one year of occurrence; therefore, liabilities are not discounted. The fund has no excess insurance, reinsurance, or annuity contracts.

(2) Subsequent Injury – This fund provides benefits to workers, certified as disabled at the time of hiring, who are subsequently injured on the job and entitled to benefits under the Workers Compensation or Occupational Disease Act at the time of injury. The liability of the insurer for payment of compensation benefits is limited to 104 weeks of benefits actually paid. This fund will reimburse the insurer for all benefits paid after this 104-week time period. In Montana, there are 3,389 individuals with certified disabilities.

Workers compensation insurance premium experience modification factors are influenced by the two-year limitation, and employers may experience an insurance premium reduction. Therefore, this fund provides employers with a potential incentive for hiring a person with a certified disability.

This fund makes no provision for insured events of the current year. All Montana insurers are annually assessed a percentage of their paid losses sufficient to cover paid losses reimbursed from the fund in the preceding calendar year and the expenses of administration, less other income. An estimated liability is recorded based on a projected cost analysis (case-by-case) of each injured person with a certified disability. As of June 30, 2004, the amount of this liability was estimated to be \$2,363,565.

(3) Montana University System (MUS) Group Benefits Plan – This plan was authorized by the Regents to provide medical, dental, and vision insurance coverage to employees of the Montana University System and the State Bar of Montana, as well as their dependents, retirees, and COBRA members. The MUS Group Benefits Plan is fully self-insured, except for life insurance, long-term disability, and vision insurance. Blue Cross/Blue Shield of Montana is the claims administrator for the self-insured indemnity plan and an HMO plan. New West Health Services and Peak administers claims for the two other self-insured plans. Managed Care Montana (APS) has a contract for utilization management: the utilization management program consists of hospital pre-authorization, case management, and medical necessity review. Premiums are collected from employees through payroll deductions and recorded in the MUS Group Insurance Enterprise Fund. The claims liability is calculated by Mellon Consultants and estimated to be \$4,662,553 as of June 30, 2004, based on prior year experience. A liability is reported in the accompanying financial statements for these estimated claims.

(4) Montana University System (MUS) Workers Compensation Program – This fund was formed to provide self-insured workers compensation coverage for employees of the Montana University System. The Montana University System Board of Regents elected to provide workers compensation coverage under Compensation Plan Number One (MCA 39-71-2101) as of July 1, 2003. Prior to that date, the Montana University System obtained its workers compensation coverage through the State Compensation Insurance Fund. The program is self-insured for workers compensation claims to a maximum of \$500,000 per each occurrence. Losses in excess of \$500,000 are covered by reinsurance with a commercial carrier. Employer's liability claims are covered to a maximum of \$1,000,000 above the self-insured amount of \$500,000. During 2004, the program ceded \$151,286 in premiums to reinsurers.

Premium rates for all participating employees are based on rates established by the MUS Workers Compensation Program Committee. Premium rates are adjusted periodically based on inflation, claims experience, and other factors. Premiums are recorded as revenue in the MUS Workers Compensation Program in the period for which coverage is provided. Members may be subject to supplemental assessments in the event of deficiencies. The program considers anticipated investment income in determining if a premium deficiency exists.

The fund recorded a liability of \$1,622,251 for estimated claims in 2004. Of that amount, \$845,429 was for claims incurred but not reported. The liability is based on the estimated ultimate cost of settling the reported and unreported claims, and claims reserve development including the effects of inflation and other societal and economic factors. Estimated amounts of subrogation and reinsurance recoverable on unpaid claims are deducted from the liability for unpaid claims. Estimated claims liabilities are recomputed periodically based on current review of claims information, experience with similar claims, and other factors. Adjustments to estimated claims liabilities are recorded as an increase or decrease in claims expense in the period the adjustments are made.

(5) State Compensation Insurance (New Fund) – This fund provides liability coverage to employers for injured employees who are insured under the Workers Compensation and Occupational Disease Acts of Montana and workers compensation claims occurring on or after July 1, 1990, are reported in the New Fund. The New Fund is a self-supporting, competitive State fund, and functions as the insurer of last resort. At June 30, 2004, approximately 26,963 employers were insured with the New Fund. Anticipated investment

income is considered for computing a premium deficiency, and employers must pay premiums to the New Fund within specified time frames.

An actuarial study prepared by Tillinghast-Towers Perrin, as of June 30, 2004, estimated the cost of settling claims that have been reported, but not settled; and claims that have been incurred, but not reported. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and societal factors.

A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2004, \$452,115,000 of unpaid claims and claim adjustment expenses were presented at face value. When the New Fund purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of the New Fund is terminated.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. New Fund acquisition costs are capitalized and amortized ratably over the subsequent year. The amount of capitalized acquisition costs for the fiscal year ended June 30, 2004, was \$1,062,259. For the fiscal year ended June 30, 2004, \$1,474,338 of acquisition costs were amortized.

Statute requires the New Fund set premiums at least annually at a level sufficient to insure adequate funding of the insurance program during the period the rates will be in effect. Statute also requires the New Fund to establish a minimum surplus above risk-based capital requirements to secure the New Fund against risks inherent in the business of insurance.

(6) State Compensation Insurance (Old Fund) – The liability and payment of workers compensation claims for incidents occurring before July 1, 1990, are reported in the Old Fund.

An actuarial study prepared by Tillinghast-Towers Perrin, as of June 30, 2004, estimated the cost of settling claims that have been reported, but not settled; and claims that have been incurred, but not reported. At June 30, 2004, \$108,500,000 of unpaid claims and claim adjustment expenses were reported at a net present value of \$80,778,000, discounted at a 5.25% rate.

(7) **Changes in Claims Liabilities For the Past Two Years** – As indicated above, these funds establish liabilities for both reported and unreported insured events including estimates of future payments of losses and related claim adjustment expenses. The following tables present changes (in thousands) in those aggregate liabilities during the past two years. All information in these tables is presented at face value and has not been discounted.

	Primary Government					
	Hail Insurance		Subsequent Injury		MUS Group Benefits	
	2004	2003	2004	2003	2004	2003
Unpaid claims and claim adjustment expenses at beginning of year	\$ 298	\$ 43	\$2,364	\$2,100	\$ 3,444	\$ 2,982
Incurred claims and claim adjustment expenses:						
provision for insured events of the current year	1,164	1,696	-	-	35,451	33,675
Increase (decrease) in provision for Insured events of prior years	(184)	(6)	205	797	1,219	461
Total incurred claims and claim adjustment expenses	980	1,690	205	797	36,670	34,136
Payments:						
Claims and claim adjustment expenses attributable to insured events of the current year	(885)	(1,392)	(29)	(35)	(35,451)	(33,674)
Claims and claim adjustment expenses attributable to insured events of prior years	(298)	(43)	(177)	(498)	-	-
Total payment	(1,183)	(1,435)	(206)	(533)	(35,451)	(33,674)
Total unpaid claims and claim adjust. exp. at end of the year	\$ 95	\$ 298	\$2,363	\$2,364	\$ 4,663	\$ 3,444

	Primary Government		Component Units		
	MUS Workers Compensation Program	State Compensation Insurance (New Fund)	State Compensation Insurance (Old Fund)		
	2004	2004	2003	2004	2003
Unpaid claims and claim adjustments expenses at beginning of year	\$ -	\$413,400	\$346,400	\$113,181	\$128,902
Incurred claims and claim adjustment expenses:					
Provision for insured events of the current year	2,174	136,059	116,598	-	-
Increase (decrease) in provision for insured events of prior years	-	13,568	35,366	8,215	(1,448)
Total incurred claims and claim adjustment expenses	2,174	149,627	151,964	8,215	(1,448)
Payments:					
Claims and claim adjustment expenses attributable to insured events of the current year	(552)	(34,575)	(22,982)	-	-
Claims and claim adjustment expenses attributable to insured events of prior years	-	(76,337)	(61,982)	(12,896)	(14,273)
Total payments	(552)	(110,912)	(84,964)	(12,896)	(14,273)
Total unpaid claims and claim adjust. exp. at end of the year	\$1,622	\$452,115	\$413,400	\$108,500	\$113,181

(8) Risk Management Trend Information – The following tables only present risk management trend information for the State Compensation Insurance (New Fund) and the MUS Workers Compensation Insurance. Both funds have a three to five-year development cycle contemplated by GASB Statement 10. The State Compensation Insurance (Old Fund) does not charge a premium for its services. The Hail Insurance Fund pays claims within a calendar year cycle that parallels the growing season from spring planting to fall harvesting; therefore, it has no three to five-year development cycle. The MUS Group Benefits Fund pays claims within the calendar year, and the plan limits the timing for submission of claims; therefore, it has no three to five-year development cycle. State statute limits the payment of claims and the collection of premiums (and penalties) for the Subsequent Injury Fund from any developmental cycle.

The tables illustrate how the earned revenues (net of reinsurance) of the funds and their investment income compare to related costs of loss (net of loss assumed by reinsurers) and other expenses assumed by the fund as

of the end of the fiscal year (in thousands). Section 3 shows the funds' incurred claims and allocated claim adjustment expense (both paid and accrued) as originally reported at the end of the first year in which the event that triggered coverage under the contract occurred. Section 4 shows the cumulative amounts paid as of the end of successive years for each policy year. Section 6 shows how each policy year's incurred claims increased or decreased as of the end of successive years. This annual re-estimation results from new information received on known claims, reevaluation of existing information on known claims, as well as emergence of new claims not previously known. Section 7 compares the latest re-estimated incurred claims amount to the amount originally established (Section 3) and shows whether this latest estimate of claims cost is greater or less than originally thought. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is commonly used to evaluate the accuracy of incurred claims currently recognized in less mature policy years. This table will be revised as data for successive policy years develops.

	MUS Workers Compensation Program 2004
1. Premiums and investment revenue	
Earned	\$2,456
Ceded	151
Net earned	<u>\$2,305</u>
2. Unallocated expenses including overhead	\$8,637
3. Estimated losses and expenses end of accident year	
Incurred	\$2,174
Ceded	-
Net incurred	<u>\$2,174</u>
4. Net paid (cumulative) as of:	
End of policy year	\$ 552
5. Re-estimated ceded losses and expenses	\$ -
6. Re-estimated net incurred losses and expense:	
End of policy year	\$2,174
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	\$ -

(State Compensation Insurance (New Fund) Table presented on next page)

	<u>State Compensation Insurance (New Fund)</u>									
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1. Premiums and investment revenue										
Earned	\$193,096	\$136,939	\$104,260	\$89,522	\$81,215	\$89,885	\$114,225	\$127,292	\$161,713	\$121,494
Ceded	269	519	348	303	260	855	2,952	(465)	5,654	6,563
Net earned	\$192,827	\$136,420	\$103,912	\$89,219	\$80,955	\$89,030	\$111,273	\$127,757	\$156,059	\$114,931
2. Unallocated expenses including overhead	\$ 14,463	\$ 17,554	\$ 12,736	\$14,525	\$19,136	\$22,306	\$ 27,035	\$ 29,844	\$ 33,842	\$ 42,088
3. Estimated losses and expenses end of accident year										
Incurred	\$164,628	\$ 95,067	\$ 76,067	\$64,983	\$64,645	\$65,957	\$ 68,267	\$ 81,560	\$110,153	\$120,705
Ceded	-	-	-	-	-	-	-	-	-	-
Net incurred	\$164,628	\$ 95,067	\$ 76,067	\$64,983	\$64,645	\$65,957	\$ 68,267	\$ 81,560	\$110,153	\$120,705
4. Net paid (cumulative) as of:										
End of policy year	\$ 18,137	\$ 15,818	\$ 12,589	\$12,943	\$13,723	\$13,177	\$ 14,140	\$ 16,693	\$ 22,982	\$ 26,123
One year later	40,473	32,890	28,451	28,222	29,976	29,218	32,888	38,185	48,861	
Two years later	52,073	42,361	35,706	35,753	39,298	37,555	45,218	52,359		
Three years later	58,722	47,283	39,860	41,004	45,748	43,649	55,248			
Four years later	62,419	50,267	43,105	44,478	49,984	48,322				
Five years later	65,919	52,791	46,478	47,584	54,212					
Six years later	68,541	54,962	48,505	50,188						
Seven years later	70,816	57,654	50,402							
Eight years later	72,803	59,193								
Nine years later	74,989									
5. Re-estimated ceded losses and expenses	\$ -	\$ -	\$ 6,477	\$ 582	\$ 2,311	\$ -	\$ -	\$ -	\$ -	\$ -
6. Re-estimated net incurred losses and expense:										
End of policy year	\$164,628	\$ 95,067	\$ 76,067	\$64,983	\$64,645	\$65,957	\$ 68,267	\$ 81,560	\$110,153	\$120,705
One year later	124,123	88,923	67,235	64,308	64,348	66,421	71,094	86,799	110,532	
Two years later	107,074	77,286	59,054	60,467	66,660	66,662	81,053	91,241		
Three years later	95,456	73,864	60,811	61,989	69,345	70,302	88,157			
Four years later	94,517	74,022	64,439	64,944	69,345	72,492				
Five years later	92,231	73,197	59,079	67,312	72,435					
Six years later	91,771	74,329	60,528	67,772						
Seven years later	92,637	76,955	60,630							
Eight years later	93,637	76,849								
Nine years later	94,036									
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	\$ (70,592)	\$ (18,218)	\$ (15,437)	\$ 2,789	\$ 9,065	\$ 6,535	\$ 19,890	\$ 9,681	\$ 379	\$ -

B. Entities Other Than Pools

(1) Group Employee Comprehensive Medical and Dental Plan – The medical and dental health plans provided by the State are fully self-insured with the State assuming the risk for claims incurred by employees of the State, elected officials, retirees, former employees covered by COBRA benefits, and their dependents. The State contracts with Blue Cross/Blue Shield, PEAK, and New West for administration of its self-insured plans. Premiums are collected through payroll deductions, deductions through the Public Employees Retirement Administration, the Legislative Branch, and self-payments, and are recorded as revenue in the Employee Group Benefits Internal Service Fund. At June 30, 2004, estimates for claims liabilities, which include both incurred but not reported claims and grandfathered claims resulting from a 1998 change in period for which the benefit coverage is available, were \$11,195,548 based on a formula provided by Mellon Consultants, a consulting actuarial firm, of which \$5,864,318 is estimated to be paid in fiscal year 2005.

(2) Property & Casualty Insurance Plans – This self-insurance plan provides coverage for general liability, automobile liability, automobile physical damage, foster care liability, and state-administered foreclosure housing units. The State self-insures the \$250,000 deductible per occurrence for most property insurance, as well as various deductible amounts for other state property. The State also self-insures against losses of property below \$250,000 of value, with state agencies paying the first \$1,000. Commercial property insurance protects approximately \$2.6 billion of state-owned buildings and contents. The State’s property insurance includes separate earthquake and flood protection coverage, with deductibles of \$1 million for earthquake and \$500,000 for flood per occurrence. Premiums are collected from all state agencies, including component units, and recorded as revenue in the Administration Insurance Internal Service Fund.

An annual actuarial study, prepared by Tillinghast-Towers Perrin Company, and issued for the accident period July 1, 1994 through June 30, 2004, is the basis for estimating the liability for unpaid claims and is supported by historical loss data. The June 30, 2004, estimated claims liability of \$25,557,823 is reported in the accompanying financial statements.

(3) Changes in Claims Liabilities For the Past Two Years – These funds establish liabilities for both reported and incurred, but not reported, claims. The following table presents changes in the balances of claims liabilities during the past two fiscal years (in thousands):

	<u>Group Employees Medical & Dental</u>		<u>Prop. & Casualty Insurance</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Amount of claims liabilities at the beginning of each fiscal year	\$ 11,487	\$ 9,164	\$30,927	\$29,848
Incurred claims:				
Provision for insured events of the current year	70,164	72,085	7,723	7,544
Increases (decreases) in provision for insured events of prior years	(290)	2,323	(8,651)	(602)
Total incurred claims	69,874	74,408	(928)	6,942
Payments:				
Claims attributable to insured events of the current year	(64,699)	(66,300)	(816)	(742)
Claims attributable to insured events of prior years	(5,467)	(5,785)	(3,625)	(5,121)
Total payments	(70,166)	(72,085)	(4,441)	(5,863)
Total claims liability at end of each fiscal year	\$ 11,195	\$ 11,487	\$25,558	\$30,927

NOTE 9. COMMITMENTS

A. Highway Construction

At June 30, 2004, the Department of Transportation had contractual commitments of approximately \$141.8 million for construction of various highway projects. Funding for these highway projects is to be provided from federal grants and matching state special revenue funds.

B. Capital Construction

At June 30, 2004, the Department of Administration, Architecture & Engineering Division, had commitments of approximately \$10.3 million for capital projects construction. The primary government will fund \$6.9 million of these projects, with the remaining \$3.4 million coming from the state university system.

C. Coal Tax Loan and Mortgage Commitments

The Board of Investments (BOI) makes firm commitments to fund loans from the Coal Severance Tax Permanent Fund. These commitments have expiration dates and may be extended according to the BOI's policies. As of June 30, 2004, the BOI had committed but not yet purchased \$69,281,764 in loans from Montana lenders. In addition to the above commitments, lenders had reserved \$12,021,150 for loans as of June 30, 2004.

The BOI makes firm commitments to fund mortgages from the Public Employees and Teachers retirement funds. As of June 30, 2004, the BOI had committed but not yet purchased from Montana lenders, mortgages totaling \$124,550. Lenders had reserved no funding for mortgages as of June 30, 2004.

D. Proprietary Fund Commitments

Budgets are administratively established in the enterprise and internal service funds, excluding depreciation, compensated absences, and bad debt expense. Appropriations may be committed for goods/services that are not received as of fiscal year-end. These executory commitments are included in unrestricted net assets in the accompanying financial statements as follows (in thousands):

Primary Government	<u>Amount</u>
<u>Enterprise funds</u>	
HUD Section 8 Housing	\$ 25
Liquor Warehouse	12
Historical Society Publications	4
Subtotal-enterprise funds	<u>\$ 41</u>
<u>Internal service funds</u>	
DEQ Indirect Cost Pool	\$335
Admin Supply	205
Building and Grounds	194
Info Tech Services Division	87
FWP Equipment	59
Payroll Processing	2
Subtotal-internal service funds	<u>\$882</u>
Total-primary government	<u>\$923</u>

NOTE 10. LEASES/INSTALLMENT PURCHASES PAYABLE

The State has entered into various capital and operating leases for land, buildings, equipment, and computer software. Lease contracts are required by law to contain a clause indicating continuation of the lease is subject to funding by the Legislature. It is expected, in the normal course of operations, that most of these leases will be replaced by similar leases.

A. Capital Leases/Installment Purchases

Obligations under capital leases/installment purchases at June 30, 2004, were as follows (in thousands):

Fiscal Year Ending June 30	Primary Government	Discretely Presented Component Units		
	Governmental Activities	Montana State University	University of Montana	Total
2005	\$ 861	\$33	\$ 437	\$ 470
2006	768	25	241	266
2007	522	11	205	216
2008	180	-	38	38
2009	33	-	20	20
2010-2014	256	-	-	-
Total minimum pmts	2,620	69	941	1,010
Less: interest	(288)	(8)	(113)	(121)
Present value of minimum payments	<u>\$2,332</u>	<u>\$61</u>	<u>\$ 828</u>	<u>\$ 889</u>

B. Operating Leases

Primary government rental payments for operating leases in fiscal year 2004 totaled \$12,358,000. Future rental payments under operating leases are as follows (in thousands):

Fiscal Year Ending June 30	Primary Government	Discretely Presented Component Units
2005	\$12,241	\$1,459
2006	10,296	1,000
2007	9,189	723
2008	8,045	642
2009	7,523	510
2010-2014	24,748	2,180
2015-2019	9,520	1,726
2020-2024	1,119	-
Total future rental payments	<u>\$82,681</u>	<u>\$8,240</u>

NOTE 11. STATE DEBT

A. General Information

The State has no constitutional limit on its power to issue obligations or incur debt, other than a provision that no debt may be created to cover deficits incurred because appropriations exceeded anticipated revenues. The Board of Examiners (consisting of the Governor, Secretary of State, and Attorney General) is authorized, pursuant to various enabling acts, to issue bonds and notes of the State.

B. Short-term Debt

The Board of Examiners, upon recommendation of the Department of Administration, may issue notes in anticipation of the receipt of taxes and revenues. No notes may be issued to refund outstanding notes. The notes must be redeemed by the end of the fiscal year in which issued.

The State issued a tax and revenue anticipation note (TRAN) during fiscal year 2004. The proceeds of the tax anticipation note were used to meet anticipated cash flow deficits during the fiscal year. The TRAN was fully repaid by the end of the fiscal year. The following schedule summarizes the above activity for the year ended June 30, 2004 (in thousands):

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>
TRAN	\$-	\$73,400	\$73,400	\$-

The Board of Investments (BOI) of the State of Montana is authorized to issue Intermediate Term Capital (INTERCAP) bonds under the Municipal Finance Consolidation Act. These bonds may not aggregate more than \$120 million as amended by the 2003 Legislature. Previously, INTERCAP bonds could not aggregate more than \$80 million through June 30, 2011 and then \$75 million thereafter. The purpose of the bonds is to provide funds for the BOI to make loans to eligible government units. The bonds are limited obligations of the BOI, payable solely from repayments of principal and interest on loans made by the BOI to participating eligible governmental units, investment income under the indenture, and an irrevocable pledge by the BOI. The BOI has no taxing power. Bondholders may elect to have their bonds purchased by the trustee on March 1 of each year until maturity. These issues are considered to be demand bonds and are included in short-term debt. The amounts issued and outstanding at June 30, 2004, were as follows (in thousands):

<u>Series</u>	<u>Amount Issued</u>	<u>Balance June 30, 2004</u>
1992	\$6,500	\$ 6,055
1994	7,500	6,895
1995	7,500	7,080
1997	10,000	9,740
1998	12,500	12,285
2000	15,000	15,000
2003	15,000	15,000
2004	18,500	18,500
Total		<u>\$90,555</u>

The following schedule summarizes the activity relating to the demand bonds during the year ended June 30, 2004 (in thousands):

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>
Demand bonds	\$72,190	\$18,500	\$135	\$90,555

C. Long-term Debt

The full faith, credit, and taxing powers of the State are pledged for the payment of all general obligation debt. Revenue and mortgage bonds are secured by a pledge from the facilities to which they relate and by certain other revenues, fees, and assets of the State and the various colleges and universities. Primary government bonds and notes outstanding at June 30, 2004, were as follows (in thousands):

Governmental Activities	Series	Amount Issued	Interest Range (%) (11)	Principal Payments		Balance June 30, 2004
				FY 2005	In Year of Maturity (7)	
General obligation bonds						
Wastewater Treatment Works						
Revolving Fund	1994B	2,200	4.2-6.1	95	180 (2016)	1,590
Long-Range Bldg Program	1994C	21,955	5.125-7.0	1,000	1,000 (2005)	1,000
Energy Conservation Program (2)	1994D	1,600	4.9-7.0	200	200 (2005)	200
Energy Conservation Program (2)	1996A	1,650	3.5-4.4	185	195 (2006)	380
Wastewater Treatment Works						
Revolving Fund	1996C	2,765	3.75-5.75	135	120 (2017)	2,040
Renewable Resource Program (1)	1997A	2,000	6.8-8.0	120	210 (2013)	1,435
Long-Range Bldg Program	1997B	12,640	4.5-5.0	830	595 (2018)	8,345
Wastewater Treatment Works						
Revolving Fund	1998A	3,510	3.75-5.15	140	260 (2019)	2,885
Long-Range Bldg Program (16)	1998B	34,545	4.2-5.1	1,430	2,555 (2018)	26,980
Information Technology	1998C	41,390	4.5-5.0	3,600	4,075 (2008)	15,330
Long-Range Bldg Program Refunding	1998D	14,855	4.4-5.0	105	1,720 (2015)	14,165
Energy Conservation Program (2)	1998E	1,250	3.6-4.6	130	150 (2008)	555
Renewable Resource Program (1)	1999	1,035	6.0-6.5	55	105 (2015)	845
Long-Range Bldg Program	1999C	16,990	4.0-5.0	665	1,250 (2019)	13,785
Drinking Water Revolving Fund (9)	1998F	3,065	3.6-4.85	130	230 (2019)	2,595
Drinking Water Revolving Fund (9)	2000A	2,990	4.25-5.6	100	240 (2021)	2,705
Water Pollution Control Revolving Fund (10)						
Long-Range Bldg Program	2000B	3,325	4.25-5.6	115	270 (2021)	3,020
Long-Range Bldg Program	2000C	17,195	5.0-5.55	580	1,320 (2020)	14,385
Information Technology	2000D	18,000	5.0-5.25	1,735	1,830 (2006)	3,565
Long-Range Bldg Program	2001B	11,430	4.1-5.75	400	830 (2021)	9,875
Information Technology	2001C	1,600	3.85-4.2	145	185 (2011)	1,145
Energy Conservation Program (2)	2001D	1,250	3.85-4.2	115	145 (2011)	890
Renewable Resource Program (1)	2001E	1,040	5.2-6.8	50	105 (2017)	950
Drinking Water Revolving Fund (9)	2001G	3,190	4.0-5.0	115	235 (2022)	2,985
Water Pollution Control Revolving Fund (10)						
Long-Range Bldg Program	2001H	2,690	4.0-5.0	100	200 (2022)	2,515
Long-Range Bldg Program	2002B	10,475	3.35-4.7	405	730 (2023)	10,110
Hard Rock Mining Reclamation	2002C	2,500	3.5-4.7	80	200 (2023)	2,435
Long-Range Bldg Program Refunding	2002D	15,805	2.5-3.7	1,250	1,685 (2014)	14,455
Long-Range Bldg Program	2003A	9,730	2.375-4	320	655 (2024)	9,730
Energy Conservation Program (2)	2003B	1,250	2.0-3.0	105	145 (2014)	1,250
Renewable Resource Program Refunding (1)						
Water Pollution Control Revolving Fund (10)	2003C	1,970	1.45-5.25	440	90 (2019)	1,970
Water Pollution Control Revolving Fund (10)						
Drinking Water Revolving Fund (9)	2003D	2,730	2.0-3.75	145	225 (2019)	2,730
Drinking Water Revolving Fund (9)	2003E	1,675	2.0-3.75	90	140 (2019)	1,675
Long-Range Bldg Program Refunding	2003G	26,610	2.0-5.0	1,970	2,310 (2017)	26,610
Information Technology Refunding	2003H	8,725	2.0-40	165	2,225 (2010)	8,725
Water Pollution Control Revolving Fund (10)						
Long-Range Bldg Program	2004A	2,665	2.0-3.8	-	230 (2020)	2,665
Long-Range Bldg Program	2004B	3,125	3.0-4.75	-	170 (2025)	3,125
Total general obligation bonds		\$311,420		\$17,245		\$219,645
Special revenue bonds						
Water Conservation (3)		\$ 50	5.0	\$ 2	\$ 1 (2012)	\$ 18
Renewable Resource Program Refunding (4)						
State Hospital Project (6)	1996A	14,985	3.7-5.2	1,145	110 (2017)	7,060
Renewable Resource Program (4)	1997	25,915	4.0-5.05	805	1,820 (2022)	22,360
Renewable Resource Program (4)	1997A	1,205	6.0-7.3	45	110 (2018)	995

Governmental Activities	Series	Amount Issued	Interest Range (%) (11)	Principal Payments		Balance June 30, 2004
				FY 2005	In Year of Maturity (7)	
Renewable Resource Program (4)	1997B	2,660	3.75-5.375	105	210 (2018)	2,125
Renewable Resource Program (4)	2001A	420	3.65-5.59	15	30 (2021)	375
Renewable Resource Program (4)	2001B	1,750	5.2-7.1	55	150 (2021)	1,605
Renewable Resource Program Refunding (4)	2001C	12,155	2.55-4.3	1,750	790 (2013)	6,700
Broadwater Power Proj Refunding (4)	2001D	21,450	2.25-4.7	1,100	1,795 (2018)	19,480
Renewable Resource Program (4)	2001E	885	2.1-4.85	35	65 (2022)	825
Renewable Resource Program (4)	2001F	900	3.3-6.2	30	75 (2022)	850
Renewable Resource Program (4)	2003A	3,000	1.05-4.05	110	215 (2024)	3,000
Developmental Center Project Refunding (6)	2003	11,510	3.0-5.0	550	970 (2019)	10,975
Total special revenue bonds		<u>\$ 96,885</u>		<u>\$ 5,747</u>		<u>\$ 76,368</u>
Notes payable (17)						
Middle Creek Dam Project (5)		\$ 3,272	8.125	\$ 46	207 (2034)	\$ 2,885
Tongue River Dam Project (8)		11,300	-	290	290 (2038)	9,851
Dept of Corrections Resident Accounting System Loan (10)		320	5.73	71	71 (2005)	71
Total notes payable		<u>\$ 14,892</u>		<u>\$ 407</u>		<u>\$ 12,807</u>
Subtotal governmental activities, before deferred balances						308,820
Deferred amount on refunding						(5,438)
Unamortized discount						(161)
Unamortized premium						1,880
Total governmental activities		<u>\$423,197</u>		<u>\$23,399</u>		<u>\$305,101</u>

Business-type Activities

Bonds/notes payable

<u>Economic Development Bonds (12)</u>						
Municipal Finance Consolidation Act Bonds (Irrigation Program) (13)	1998	\$ 4,976	6.60-7.75	\$ 325	130 (2014)	\$ 1,204
Municipal Finance Consolidation Act Bonds (School District Pooled Refunding Program) (14)	1991	6,234	4.75-6.5	294	294 (2005)	294
Conservation Reserve Enhancement Program (CRP Bonds) (15)		4,789	6-8	1,053	377 (2009)	4,789
Subtotal economic dev bonds		<u>15,999</u>		<u>1,672</u>		<u>6,287</u>
MUS Workers Compensation Bond Payable		2,050	2.8	395	430 (2008)	1,655
Total business-type activities		<u>\$ 18,049</u>		<u>\$ 2,067</u>		<u>\$ 7,942</u>

- (1) All Water Development Program Bonds and the Renewable Resource Program Bonds are secured additionally by a pledge of, and payable from, certain coal severance taxes. The bonds are also secured by a pledge of loan repayments from loans made from the bond proceeds.
- (2) Bonds issued for financing the design, construction, and installation of energy conservation projects at various state buildings.
- (3) Bonds sold to Farmers Home Administration.
- (4) Issued by the Department of Natural Resources and Conservation (DNRC) and backed by a pledge of coal severance taxes and project revenues.
- (5) U.S. Bureau of Reclamation loan to Montana Department of Natural Resources & Conservation. The outstanding balance includes \$230,812 of interest owed.
- (6) Facility Finance Authority loan to the Department of Public Health and Human Services for the Montana Developmental Center Project and the Montana State Hospital Project.
- (7) Year of maturity refers to fiscal year.
- (8) Northern Cheyenne Tribe loan to the Montana Dept. of Natural Resources & Conservation (DNRC). The loan will not accrue interest and will be repaid over 39 years. Loan repayment is secured by the issuance of a coal severance tax bond to the tribe.
- (9) Provide matching funds to enable the State to obtain capitalization grants from the U.S Environmental Protection Agency for water system development loans to state political subdivisions.
- (10) Norwest loan to provide funds for the development of a Y2K-compliant resident accounting system.
- (11) The interest range is over the life of the obligation.

- (12) Economic Development Bonds (EDB) & Municipal Finance Consolidation Act Bonds (MFCAB) – This program is directed by the Board of Investments, which is attached to the Department of Commerce for administrative purposes. The program assists Montana’s small businesses and local governments in obtaining low-cost financing.
- (13) These bonds were issued to obtain funds for the Board of Investments, State of Montana, to purchase the refunding bonds of participating Irrigation Districts for the purpose of prepaying the U.S. Department of Interior, Bureau of Reclamation Projects Loans. The Irrigation Bonds, and the interest thereon, are payable solely from the collection of a special tax or assessment, which is a lien against real property in the Irrigation District. The Irrigation Bonds are not obligations of the State of Montana. However, the Irrigation Bonds are limited obligations of the Board of Investments, due to an irrevocable pledge to lend money for deposit by the trustee of the Irrigation District Pooled Loan Program Reserve Account E in an amount equal to any deficiencies therein, on any payment date. The indenture does not permit the issuance of additional bonds.
- (14) These bonds were issued for the purpose of providing funds for the Board of Investments, State of Montana, to purchase the general obligation refunding bonds of participating Montana school districts. The School District Refunding Bonds, and the interest thereon, are payable from real property taxes levied within the school district. These bonds are limited obligations of the Board of Investments and are not a debt or liability of the State of Montana, and neither the faith and credit nor the taxing power of the State is pledged to the payment of principal of or interest on the bonds.
- (15) The Conservation Reserve Enhancement Program is funded by the Montana Trust Funds Bond Pool.
- (16) The interest range on general obligation bond 1998B has been corrected. It was previously misstated at 3.5-4.85.
- (17) At the beginning of fiscal 2004, the INTERCAP loan balances were reclassified to advances from other funds.

D. Debt Service Requirements

Primary government debt service requirements at June 30, 2004, were as follows (in thousands):

Governmental Activities

Year Ended June 30	General Obligation Bonds		Special Revenue Bonds		Notes Payable	
	Principal	Interest	Principal	Interest	Principal	Interest
2005	\$ 17,245	\$ 8,991	\$ 5,747	\$ 3,337	\$ 407	\$ 50
2006	18,025	8,324	5,502	3,128	337	45
2007	18,250	7,595	4,347	2,937	339	44
2008	18,695	6,862	4,152	2,765	341	44
2009	14,410	6,195	4,933	2,568	342	43
2010-2014	68,675	22,363	22,931	9,746	1,743	202
2015-2019	51,560	8,406	21,820	4,545	1,859	175
2020-2024	12,615	1,045	6,936	688	1,951	138
2025-2029	170	4	-	-	2,070	93
2030-2034	-	-	-	-	2,259	36
2035-2039	-	-	-	-	1,159	-
Total	\$219,645	\$69,785	\$76,368	\$29,714	\$12,807	\$870

Business-type Activities

Year Ended June 30	Economic Development Bonds		MUS Workers Compensation Bonds	
	Principal	Interest	Principal	Interest
2005	\$1,672	\$ 436	\$ 395	\$46
2006	1,204	337	410	35
2007	1,161	249	420	24
2008	1,228	164	430	12
2009	463	74	-	-
2010-2014	559	114	-	-
Total	\$6,287	\$1,374	\$1,655	\$117

Debt service requirements of discretely presented component units at June 30, 2004, were as follows (in thousands):

Year Ended June 30	Housing Authority		Montana State University		University of Montana	
	Principal	Interest	Principal	Interest	Principal	Interest
2005	\$ 7,782	\$ 32,604	\$ 4,937	\$ 3,158	\$ 3,650	\$ 7,002
2006	10,066	32,261	4,988	2,928	4,681	6,753
2007	10,704	31,848	4,022	2,712	4,872	6,588
2008	11,255	31,390	2,943	3,788	5,057	6,416
2009	12,230	30,877	2,736	3,982	5,078	6,237
2010-2014	70,900	144,835	17,024	16,395	25,828	28,146
2015-2019	92,198	126,999	24,760	8,798	32,291	21,530
2020-2024	117,775	97,388	20,215	2,516	42,155	11,659
2025-2029	146,340	61,542	2,085	119	13,730	2,346
2030-2034	116,760	23,043	-	-	4,565	508
2035-2039	23,305	4,948	-	-	-	-
2040-2044	9,730	917	-	-	-	-
Total	\$629,045	\$618,652	\$83,710	\$44,396	\$141,907	\$97,185

E. Summary of Changes in Long-term Liabilities Payable

Primary government long-term liability activity for the year ended June 30, 2004, was as follows (in thousands):

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year	Amounts Due In More Than One Year
Governmental activities						
Bonds/notes payable						
General obligation bonds	\$227,625	\$ 14,515	\$ 22,495	\$219,645	\$17,245	\$202,400
Special revenue bonds	85,070	11,510	20,212	76,368	5,747	70,621
Notes payable (2)	13,210	-	403	12,807	407	12,400
	325,905	26,025	43,110	308,820	23,399	285,421
Deferred amount on refunding	(4,594)	(1,491)	(647)	(5,438)	-	(5,438)
Unamortized discount	(182)	-	(21)	(161)	-	(161)
Unamortized premium	1,590	477	187	1,880	-	1,880
Total bonds/notes payable	322,719	25,011	42,629	305,101	23,399	281,702
Other liabilities						
Lease/installment purchase payable (3)	3,277	2,382	3,327	2,332	740	1,592
Compensated absences payable (1)	71,133	48,407	44,535	75,005	44,528	30,477
Early retirement benefits payable (1)	316	54	155	215	38	177
Arbitrage rebate tax payable (1)	147	22	92	77	46	31
Estimated insurance claims (1)	42,413	77,887	83,547	36,753	14,063	22,690
Total other liabilities	117,286	128,752	131,656	114,382	59,415	54,967
Total governmental activities Long-term liabilities	\$440,005	\$153,763	\$174,285	\$419,483	\$82,814	\$336,669
Business-type activities						
Bonds/notes payable						
Economic Development Bonds	\$ 9,266	\$ 100	\$ 3,079	\$ 6,287	\$ 1,672	\$ 4,615
State Lottery	1,110	-	1,110	-	-	-
MUS Workers Compensation	-	2,050	395	1,655	395	1,260
Total bonds/notes payable	10,376	2,150	4,584	7,942	2,067	5,875
Other liabilities						
Compensated absences payable	1,097	797	666	1,228	665	563
Arbitrage rebate tax payable	170	56	86	140	84	56
Estimated insurance claims	6,105	40,214	37,576	8,743	5,341	3,402
Total other liabilities	7,372	41,067	38,328	10,111	6,090	4,021
Total business-type activities Long-term liabilities	\$ 17,748	\$ 43,217	\$ 42,912	\$ 18,053	\$ 8,157	\$ 9,896

- (1) The compensated absences liability attributable to the governmental activities will be liquidated by several of the governmental and internal service funds. The early retirement benefits payable will be liquidated by the general, state special revenue, and federal special revenue funds. The arbitrage rebate tax payable will be liquidated by debt service funds. The Employee Group Benefits and Administration Insurance internal service funds will liquidate the estimated insurance claims liability.
- (2) Governmental activities notes payable beginning balance has been reduced by \$8,089,000 to reflect that INTERCAP loans payable have been reclassified to advances from other funds.
- (3) Governmental activities lease/installment purchase payable beginning balance has been reduced by \$9,000 to reflect a reclassification to advances from other funds.

Long-term liability activity of discretely presented component units for the year ended June 30, 2004, was as follows (in thousands):

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year	Amounts Due In More Than One Year
Discretely presented component units						
Bonds/notes payable						
Housing Authority	\$ 624,089	\$164,879	\$158,013	\$ 630,955	\$ 7,782	\$ 623,173
Montana State University (MSU) (1)	90,304	19,326	22,376	87,254	4,937	82,317
University of Montana (UM) (1)	132,050	40,946	33,000	139,996	3,650	136,346
Total bonds/notes payable	846,443	225,151	213,389	858,205	16,369	841,836
Other liabilities						
Lease/installment purch pay	1,873	113	1,097	889	404	485
Compensated absences pay	41,856	19,812	18,894	42,774	18,996	23,778
Arbitrage rebate tax payable	1,137	322	435	1,024	47	977
Estimated insurance claims	494,300	162,401	123,808	532,893	114,140	418,753
Due to federal government	29,157	1,092	7	30,242	-	30,242
Total other liabilities	568,323	183,740	144,241	607,822	133,587	474,235
	<u>\$1,414,766</u>	<u>\$408,891</u>	<u>\$357,630</u>	<u>\$1,466,027</u>	<u>\$149,956</u>	<u>\$1,316,071</u>
Long-term liabilities of MSU component units					299	1,713
Long-term liabilities of UM component units					483	521
Total discretely presented component units					<u>\$150,738</u>	<u>\$1,318,305</u>
Long-term liabilities						

(1) MSU and UM notes payable beginning balances have been reduced by \$3,012,000 and \$1,427,000, respectively, to reflect that INTERCAP loans payable have been reclassified to advances from primary government.

F. Refunded and Early Retired Debt

Primary Government

Pre-payments

During fiscal year 2004, the Department of Natural Resources and Conservation used current available resources to make the following pre-payments on special revenue bonds: \$445,000 of Series 2001C Renewable Resource Program Refunding.

Advance Refundings

On September 1, 2003, the Department of Public Health and Human Services (DPHHS) issued \$11,510,000 of Series 2003 Developmental Center Project Refunding bonds to advance refund \$10,665,000 of Series 1994 Developmental Center Project bonds. The net proceeds of \$11,442,750 (including an original issue premium of \$110,416 and after payment of \$361,178 in underwriting fees and other issuance costs) plus an additional \$183,512 of certain other available funds were used to purchase U.S. government securities. Those securities were deposited in an irrevocable trust, with an escrow agent, to provide for future debt service payments. As a result, the Series 1994 bonds are considered to be defeased, and the liability for those bonds has been removed from the financial statements. The defeasance resulted in a reduction of debt service to maturity of \$1,129,765 and an economic gain of \$692,129.

On November 1, 2003, the Montana Department of Administration (DofA) issued \$8,725,000 of Series 2003H General Obligation Information Technology Refunding bonds to advance refund \$8,335,000 of Series 2000D Information Technology bonds with stated maturities in the years 2006, 2007, 2008, and 2009. The net proceeds of \$8,943,141 (including a reoffering premium of \$344,229 and after payment of \$126,088 in underwriting fees and other issuance costs) were used to purchase U.S. government securities. Those securities were deposited in an irrevocable trust, with an escrow agent, to provide for future debt service payments. As a result, the Series 2000D Information Technology bonds with stated maturities in the years 2006, 2007, 2008, and 2009, are considered to be defeased, and the liability for those bonds has been removed from the financial statements. The defeasance resulted in a reduction of debt service to maturity of \$299,451 and an economic gain of \$280,140.

Deferred loss on primary government refundings at June 30, 2004, was \$5,438,000.

Defeased Debt Outstanding

The State of Montana has defeased certain general obligation and special revenue bonds by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and the

liability for the defeased bonds are not included in the financial statements. At June 30, 2004, \$38,405,000 of bonds outstanding are considered defeased.

Discretely Presented Component Units

Current Refundings

Housing Authority – On August 14, 2003, Series 2003B bonds were issued in the amount of \$70,700,000. \$20,000,000 of the proceeds were used for a replacement refunding of a portion of the 1995B-1 bonds on September 1, 2003. The refunding resulted in a reduction of debt service to maturity of \$11,216,801 and an economic gain of \$6,589,802.

Deferred loss on Housing Authority refundings at June 30, 2004, was \$1,500,335.

Defeased Debt Outstanding

Montana State University and the University of Montana have defeased certain bond issues by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the financial statements. At June 30, 2004, \$4,965,000 and \$49,351,963 of bonds outstanding are considered defeased for Montana State University and the University of Montana, respectively.

G. No-Commitment Debt

Information is presented below for financing authorities participating in debt issues. The State has no obligation for this debt. Accordingly, these bonds and notes are not reflected in the accompanying financial statements.

(1) Montana Board of Investments (BOI) – Under the Economic Development Act, the BOI is authorized to issue industrial revenue bonds to finance projects for qualifying borrowers. Assets and revenues of the borrower are pledged to repay the bonds. At June 30, 2004, industrial revenue bonds outstanding aggregated \$207.8 million.

The BOI is also authorized to issue Qualified Zone Academy Bonds (QZAB), under the Municipal Finance Consolidation Act. The revenues, and in some cases, the taxing power of the borrower are pledged to repay the bonds. At June 30, 2004, QZAB debt outstanding aggregated \$4.3 million.

Neither the industrial revenue bonds, nor the QZAB debt issued by the BOI constitutes a debt, liability, obligation, or pledge of faith and credit of the State of Montana.

(2) Beginning Farm Loan Program – The Montana Department of Agriculture is authorized to request issuance of bonds by the Montana Board of Investments to finance projects for beginning farmers within the State, if it appears, after a properly noticed public hearing, that the project is in the public interest of the State. These non-recourse, industrial development revenue bonds do not constitute a debt, liability, or obligation of the State of Montana. The amount issued and outstanding at June 30, 2004, was as follows: Hershberger Project – issued \$129,412, outstanding \$118,125; Young Project – issued \$223,300, outstanding \$222,338.

(3) Facility Finance Authority (FFA) - Component Unit – The FFA is authorized to issue bonds and notes to finance projects for qualifying health care and other community-based service providers. The revenue bonds are payable solely from loan repayments to be made by eligible facilities pursuant to loan agreements, and further, from the funds created by the indentures and investment earnings thereon. The notes are payable solely from loan repayments to be made by health institutions pursuant to loan agreements. The revenue bonds and notes payable issued by the FFA do not constitute a debt, liability, obligation, or pledge of faith and credit of the State of Montana. At June 30, 2004, revenue bonds outstanding aggregated \$631 million, and notes payable outstanding aggregated \$14 million.

The Board of Investments and the FFA have entered into a capital reserve account agreement for certain bond issues. See Note 16.C. (miscellaneous contingencies) for more information.

NOTE 12. INTERFUND BALANCES AND TRANSFERS

A. Balances Due From/To Other Funds

Balances due from/to other funds arise when there is a time lag between the dates that reimbursable expenditures and interfund services provided/used are recorded in the accounting system, and the dates on which payments are made. Balances also arise when there is a time lag between the dates that transfers between funds are recorded, and the dates on which payments are made. Balances due from/to other funds also includes the current portion of balances related to amounts loaned by the Economic Development Bonds Fund to other funds, under the Board of Investments INTERCAP loan program. Balances due from/to other funds are expected to be repaid within one year from the date of the financial statements.

Balances due from/to other funds at June 30, 2004, consisted of the following (in thousands):

	Due To Other Funds					
	Coal Severance Tax Permanent	Economic Development Bonds	Federal Special Revenue	General Fund	Internal Service Funds	Land Grant Permanent
	Due From Other Funds					
Coal Severance Tax Permanent	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Economic Development Bonds	-	-	-	-	1,699	-
Federal Special Revenue	-	-	-	185	6	-
General Fund	6,868	1	774	-	98	-
Internal Service Funds	43	5	1,178	1,674	388	-
Land Grant Permanent	-	-	-	-	-	-
Nonmajor Enterprise Funds	-	-	32	108	45	-
Nonmajor Governmental Funds	-	-	519	-	112	537
State Special Revenue	196	-	1,358	6,872	304	13,056
Unemployment Insurance	-	-	-	-	1	-
Total	\$7,107	\$6	\$3,861	\$8,839	\$2,653	\$13,593

	Nonmajor Enterprise Funds	Nonmajor Governmental Funds	Pension (And Other Employee Benefit) Trust Funds	State Special Revenue	Unemployment Insurance	Total
Coal Severance Tax Permanent	\$ -	\$ -	\$ -	\$1,854	\$ -	\$ 1,854
Economic Development Bonds	-	501	24	918	-	3,142
Federal Special Revenue	-	-	-	590	657	1,438
General Fund	9,490	88	-	1,326	-	18,645
Internal Service Funds	130	157	-	2,606	-	6,181
Land Grant Permanent	-	99	-	177	-	276
Nonmajor Enterprise Funds	-	-	-	47	-	232
Nonmajor Governmental Funds	3	4	-	66	-	1,241
State Special Revenue	67	2,304	-	-	-	24,157
Unemployment Insurance	-	-	-	-	-	1
Total	\$9,690	\$3,153	\$24	\$7,584	\$657	\$57,167

B. Interfund Loans Receivable/Payable

Montana statutes include a provision for interfund loans when the expenditure of an appropriation is necessary and the cash balance in the account from which the appropriation was made is insufficient to pay the expenditure. Interfund loans receivable/payable are expected to be repaid within one year from the date of the financial statements.

Interfund loans receivable/payable at June 30, 2004, consisted of the following (in thousands):

	Interfund Loans Payable							Total
	Coal Severance Tax Permanent	Federal Special Revenue	Internal Service Funds	Nonmajor Enterprise Funds	Nonmajor Governmental Funds	State Special Revenue	Unemployment Insurance	
Interfund Loans Receivable								
Federal Special Revenue	\$ -	\$ -	\$ 50	\$ -	\$ -	\$ 194	\$ -	\$ 244
General Fund	42	24,357	10	120	200	19,607	-	44,336
Internal Service Funds	-	399	-	175	-	-	-	574
Nonmajor Enterprise Funds	-	93	-	-	-	-	-	93
State Special Revenue	-	39,031	2,159	-	430	-	1	41,621
Total	\$42	\$63,880	\$2,219	\$295	\$630	\$19,801	\$1	\$86,868

C. Advances To/From Other Funds

Advances to/from other funds represents the portion of interfund loans that are not expected to be repaid within one year from the date of the financial statements. Advances to/from other funds also includes the noncurrent portion of balances related to amounts loaned by the Economic Development Bonds Fund to other funds, under the Board of Investments INTERCAP loan program.

Advances to/from other funds at June 30, 2004, consisted of the following (in thousands):

	Advances From Other Funds					Total
	Federal Special Revenue	Internal Service Funds	Nonmajor Governmental Funds	Pension (And Other Employee Benefit) Trust Funds	State Special Revenue	
Advances To Other Funds						
Coal Severance Tax Permanent	\$ -	\$ -	\$ -	\$ -	\$52,469	\$52,469
Economic Development Bonds	-	3,181	-	204	5,797	9,182
Federal Special Revenue	-	100	-	-	-	100
General Fund	40	-	-	-	60	100
Nonmajor Enterprise Funds	75	180	-	-	-	255
Nonmajor Governmental Funds	-	-	-	-	3,002	3,002
State Special Revenue	778	-	10,805	-	-	11,583
Total	\$893	\$3,461	\$10,805	\$204	\$61,328	\$76,691

Advance payable balances at June 30, 2004, owed to the Economic Development Bonds Fund under the INTERCAP loan program, consisted of the following (in thousands):

<u>Department</u>	<u>Balance</u>
Administration	\$ 204
Environmental Quality	1,137
Historical Society	72
Justice	4,417
Natural Resources and Conservation	171
Transportation	<u>3,181</u>
Total	<u>\$9,182</u>

Advance payable balances at June 30, 2004, owed to the Coal Severance Tax Permanent Fund, consisted of the following (in thousands):

<u>Department</u>	<u>Balance</u>
Justice	\$ 2,225
Natural Resources and Conservation	44,546
Revenue	<u>5,698</u>
Total	<u>\$52,469</u>

D. Interfund Transfers

Routine transfers between funds are recorded to: (1) transfer revenues from the fund legally required to receive the revenue to the fund authorized to expend the revenue, (2) transfer resources from the General Fund and special revenue funds to debt service funds to support principal and interest payments, (3) transfer resources from enterprise funds to the General Fund to finance general government expenditures, and (4) provide operating subsidies.

Interfund transfers for the year ended June 30, 2004, consisted of the following (in thousands):

	Transfers In					
	Coal Severance Tax Permanent	Federal Special Revenue	General Fund	Internal Service Funds	Nonmajor Enterprise Funds	Nonmajor Governmental Funds
Transfers Out						
Coal Severance Tax Permanent	\$ -	\$ -	\$35,134	\$ -	\$ -	\$ 1,474
Federal Special Revenue	-	-	1	-	3,520	1,979
General Fund	-	-	-	398	47	17,082
Internal Service Funds	-	-	-	550	-	369
Land Grant Permanent	-	-	-	-	-	2,042
Nonmajor Enterprise Funds	-	-	26,298	-	-	-
Nonmajor Governmental Funds	-	-	932	500	-	1,488
State Special Revenue	3,405	20	4,036	719	18	15,318
Unemployment Insurance	-	4,297	-	-	-	-
Total	\$3,405	\$4,317	\$66,401	\$2,167	\$3,585	\$39,752

(1)

	State Special Revenue	Total
Transfers Out (continued)		
Coal Severance Tax Permanent	\$ 7,361	\$ 43,969
Federal Special Revenue	22,165	27,665
General Fund	12,097	29,624
Internal Service Funds	-	919
Land Grant Permanent	63,776	65,818
Nonmajor Enterprise Funds	3,710	30,008
Nonmajor Governmental Funds	16,654	19,574
State Special Revenue	-	23,516
Unemployment Insurance	-	4,297
Total	\$125,763	\$245,390

(2)

(1) Total transfers-in for non-major enterprise funds on the financial statements is reported as \$3,452,000. The difference of \$133,000 between the amount reported above of \$3,585,000 and the amount reported on the financial statements relates to the movement of general long-term liabilities as a result of reclassifying a federal special revenue fund to the HUD Section 8 Enterprise Fund. The general long-term liabilities related to the federal special revenue fund were assigned to the HUD Section 8 Enterprise Fund. No amounts relating to this transfer were reported in the federal special revenue fund on the fund financial statements, as governmental funds do not record general long-term liabilities. However, because enterprise funds report long-term liabilities in the fund financial statements, the HUD Section 8 fund reported transfer activity related to these liabilities.

(2) Total transfers-out for all internal service funds on the financial statements is reported as \$1,339,000. The difference of \$420,000 between the amount reported above of \$919,000 and the amount reported on the financial statements relates to the movement of capital assets as a result of combining the Mail & Messenger Internal Service Fund with the Publications & Graphics Internal Service Fund. The new combined fund is reported as the Print & Mail Services Internal Service Fund. When the capital assets were transferred between these funds, the receiving fund recorded the net book value of the capital assets as a capital contribution and the transferring fund recorded the net book value of the capital assets as a transfer-out.

NOTE 13. FUND DEFICITS

The following funds have a deficit fund balance/net assets position at June 30, 2004, (in thousands):

Fund Type/Fund	Deficit
<u>Capital projects funds</u>	
Federal/Private Construction Grants	\$ (426)
<u>Enterprise funds</u>	
MUS Workers Compensation	\$ (127)
Subsequent Injury	\$ (527)
<u>Internal service funds</u>	
Administration Insurance	\$(21,213)
Administration Central Services	\$ (48)
OPI Central Services	\$ (44)
Justice Legal Services	\$ (86)
<u>Pension (and other employee benefit) trust funds</u>	
Voluntary Employee Benefit Association	\$ (95)

The net assets deficit in the Administration Insurance and Subsequent Injury funds are due to recording the expense for estimated claims including claims incurred, but not reported. Refer to Note 8 for further discussion of these funds.

NOTE 14. RESERVED FUND BALANCES

Special Revenue Funds – The State and Federal Special Revenue Fund Reserved fund balances are for the following purposes:

Fund Type/Purpose	Amount
<u>State Special Revenue funds</u>	
General Government	\$ 15,913
Public Safety/Corrections	174,772
Transportation	40,038
Health/Social Services	6,383
Education/Cultural	3,166
Resource/Recreation/Environment	264,734
Economic Development/Assistance	33,494
Total state special revenue funds	<u>\$538,500</u>
<u>Federal Special Revenue funds</u>	
General Government	\$ 9,768
Public Safety/Corrections	507
Health/Social Services	1,309
Education/Cultural	11,221
Resource/Recreation/Environment	3,863
Economic Development/Assistance	389
Total federal special revenue funds	<u>\$27,057</u>

Coal Severance Tax Permanent Fund – The reserve for trust principal is comprised of the following: Permanent Coal Tax Trust \$658,947 and the Treasure State Endowment Fund \$128,981 (in thousands).

NOTE 15. RELATED PARTY TRANSACTIONS

The Montana Board of Regents, an agency within the State, is the guarantor of the loans owned by the Montana Higher Education Student Assistance Corporation (MHESAC), a private non-profit corporation. The Board of Regents and MHESAC have four common board members. Approximately 57.27% of the Regents' outstanding loan volume, or \$646,792,084, is held by MHESAC. During fiscal year 2000, MHESAC undertook a reorganization under which its operating staff and assets were transferred to the Student Assistance Foundation of Montana (SAF), and MHESAC entered into agreements with SAF to provide management and loan servicing to MHESAC. The Board of Regents and SAF have four common board members. The Office of Commissioner of Higher Education (OCHE) paid SAF during fiscal year 2004 for its share of various costs, such as personnel costs for employees of SAF who performed services that were of direct benefit to the State, equipment leases, computer maintenance costs, utilities, and other shared operating expenses. The total amount of these expenses for fiscal year 2004 amounted to \$495,739. SAF also pays OCHE reimbursement for services such as telephones, postage, and computer services. During fiscal year 2004, SAF paid OCHE a total of \$146,141.

A staff member in the Department of Administration, Personnel Division, serves as Director of the Montana Association of Health Care Purchasers for no remuneration. The Department pays this Association \$1 per member per year to maintain its membership as

well as a monthly fee of \$3 on behalf of each employee who participates in a managed care plan. These fees are payment for data analysis, actuarial analysis and consulting services performed by Association staff on behalf of member employers.

contention that subsistence pay which was to cover meals, travel, uniform maintenance, and a home telephone for each officer should have been included in the officers' base pay. Depending upon the size of the class as defined by the court, the State's potential exposure is \$9 million to \$20 million. This case is scheduled for mediation on December 10, 2004.

NOTE 16. CONTINGENCIES

A. Litigation

The State is party to legal proceedings, which normally occur in government operations. The legal proceedings are not, in the opinion of the State's legal counsel and the Department of Administration, likely to have a material adverse impact on the State's financial position, except where listed below.

In Swingley, et al. v. Montana Highway Patrol, filed in Lewis and Clark County, Highway Patrol officers brought an administrative wage claim seeking payment for overtime hours. In this case, the court held that there was a waiver of sovereign immunity and, therefore, the Fair Labor Standards Act (FLSA) applies. If the class is defined based on the FLSA statute of limitations, that class includes in excess of 200 officers and seeks overtime compensation for all lunch hours for a period of 3 ½ years, and seeks to have overtime and retirement contributions and benefits recalculated based on the

B. Federal Contingencies

USDA Commodities – In fiscal year 2004, the State distributed \$4,780,825 in commodities. The value of the commodities stored in the State's warehouses was \$1,509,580 at June 30, 2004, for which the State is liable in the event of loss.

C. Miscellaneous Contingencies

Loan Guarantees – As of June 30, 2004, the Board of Investments (BOI) had provided loan guarantees from the Coal Severance Tax Permanent Fund to the Economic Development Bonds Fund and the Facility Finance Authority, (a component unit of the State of Montana), totaling \$126,787,072. The BOI's exposure to bond issues of the Economic Development Bonds Fund was \$92,052,796, while exposure to bond issues and surety bonds of the Facility Finance Authority was \$34,734,276.

Gain Contingencies – Certain natural resource and corporation tax assessments are not reported on the State's financial statements because they are being protested administratively. As of June 30, 2004, the following assessments (by fund type) were outstanding (in thousands):

Taxes	General	State Special Revenue	Permanent Trust	Debt Service	Capital Projects
Coal severance	\$ 542	\$153	\$1,027	\$19	\$238
Oil & gas	1,999	217	-	-	-
Corporation tax	5,050	-	-	-	-
Total	\$7,591	\$370	\$1,027	\$19	\$238

Collectibility of these contingencies is dependent upon the decisions of the court, other authorities, or agreed upon settlements. Interest related to Corporation Tax Assessments is distributed to the General Fund.

Loss Contingencies – Certain corporations have requested refunds that are not reported on the State's financial statements as of June 30, 2004. The corporations have appealed the decision. As of June 30, 2004, these include \$4,917,321 of General Fund corporation tax refunds.

Certain companies have protested property taxes that have been included as revenue on the State's financial statements as of June 30, 2004. As of June 30, 2004, these include \$8,950,000 of protested General Fund property taxes.

NOTE 17. SUBSEQUENT EVENTS**A. Bond Issues**

On July 8, 2004, the Montana Board of Housing issued \$68 million in Single Family Mortgage Revenue bonds, Series 2004B.

On August 25, 2004, the Department of Natural Resources and Conservation issued \$1.6 million of taxable general obligation Renewable Resource Loan Program bonds, Series 2004B.

On October 26, 2004, Montana State University issued \$23.665 million in Facilities Improvement Revenue bonds, Series 2004H. The bond proceeds will be used to construct and equip a new chemistry/biochemistry building on the Bozeman campus.

On November 10, 2004, the Montana Board of Housing issued \$54.6 million in Single Family Mortgage Revenue bonds, Series 2004C.

B. Federal Financial Assistance

The State receives federal financial assistance for specified purposes, which is subject to review and audit in accordance with the Single Audit Act Amendments of 1996. Any disallowances resulting from these audits become the liability of the State. For fiscal year 2004, the federal government disallowed various National Highway Traffic Safety sub-grant costs. In fiscal year 2005, a payment was made to the federal government in the amount of \$351,154 to reimburse for these disallowed costs.

NOTE 18. MATERIAL VIOLATIONS OF FINANCE-RELATED LEGAL PROVISIONS**A. Constitutionality of IRIS Funding**

The State's bond counsel and the State's Legislative Audit Division have raised several legal concerns related to legislation passed by the State's Legislature. A discussion of these concerns and the actions planned to address them follows.

Chapter 597, Laws of 2003, authorized funding not to exceed \$17 million for the Department of Revenue to replace the Process Oriented Integrated System computer system. The replacement system is called the Integrated Revenue Information System (IRIS). In accordance with this legislation, the Department of Revenue entered into an interfund advance agreement

with the Montana Board of Investments to borrow money from the Coal Severance Tax Permanent Fund. As of June 30, 2004, the Department of Revenue had drawn \$5,886,467 on the interfund advance and repaid \$188,025, leaving a balance of \$5,698,442.

The legislation discussed above, related to funding for the IRIS project, authorized state debt without the constitutionally mandated two-thirds vote of the members of each house of the Legislature or a majority of the electors voting on the issue. Although the Department of Revenue liability is reported as an interfund advance payable in the State Special Revenue Fund on the State's financial statements, state law defines state debt as the incurring of an obligation for which repayment extends beyond the existing budgeting and reporting period and for which the source of repayment is revenue derived from the State's taxing power. In addition, the legislation indirectly places the Coal Severance Tax Permanent Fund corpus at risk, and inappropriately delegates authority to allocate state tax resources to the Executive branch.

The 2007 Biennium Executive Budget recommendations submitted to the Fifty-Ninth Legislative Assembly by the State's Governor, includes a recommendation to appropriate funds from the General Fund, which would repay the interfund advance to the Coal Severance Tax Permanent Fund.

B. Constitutionality of Retirement System Funding

The Montana Constitution, Article VIII, Section 15 states that public retirement systems shall be funded on an actuarially sound basis. As of June 30, 2004, there were four retirement systems not in compliance: the Teachers Retirement System (TRS), the Public Employee Retirement System (PERS) Defined Benefit Retirement Plan, the Sheriffs Retirement System, and the Game Wardens and Peace Officers Retirement System. Detailed information for each plan can be found in Note 6.

Based on the results of an actuarial valuation completed in 2004, the TRS Board will recommend options to the Legislature that are considered necessary for the Teachers Retirement System to remain actuarially sound. For the remaining three retirement systems not in compliance, the PERS Board has drafted legislation for the 2005 Legislative Session to address the requirement that the plans remain actuarially sound.