

State of Montana
COMPREHENSIVE ANNUAL FINANCIAL REPORT
For the Fiscal Year Ended June 30, 2005

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State of Montana
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Table of Contents

INTRODUCTORY SECTION

	Page
Title Page.....	1
Table of Contents.....	2
Letter of Transmittal.....	6
Certificate of Achievement for Excellence in Financial Reporting.....	12
State Organization Chart.....	13
Selected State Officials.....	14

FINANCIAL SECTION

Independent Auditor's Report.....	16
Management's Discussion and Analysis.....	18

Basic Financial Statements

Government-wide Financial Statements	
Statement of Net Assets.....	30
Statement of Activities.....	32
Governmental Fund Financial Statements	
Balance Sheet.....	36
Reconciliation of Balance Sheet – Governmental Funds to the Statement of Net Assets.....	37
Statement of Revenues, Expenditures, and Changes in Fund Balances.....	38
Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds to the Statement of Activities.....	40
Proprietary Fund Financial Statements	
Statement of Net Assets.....	44
Statement of Revenues, Expenses, and Changes in Fund Net Assets.....	46
Statement of Cash Flows.....	48
Fiduciary Fund Financial Statements	
Statement of Fiduciary Net Assets.....	52
Statement of Changes in Fiduciary Net Assets.....	53
Component Unit Financial Statements	
Combining Statement of Net Assets.....	56
Combining Statement of Activities.....	58
Notes to the Financial Statements	
Note 1 – Summary of Significant Accounting Policies.....	60
Note 2 – Other Accounting Issues.....	67
Note 3 – Cash/Cash Equivalents and Investments.....	67
Note 4 – Disaggregation of Accounts Receivable and Payable.....	78
Note 5 – Capital Assets.....	80
Note 6 – Retirement Plans.....	83
Note 7 – Other Postemployment Benefits.....	91
Note 8 – Risk Management.....	92

Notes to the Financial Statements (<i>continued</i>)	
Note 9 – Commitments.....	98
Note 10 – Leases/Installment Purchases Payable.....	99
Note 11 – State Debt.....	100
Note 12 – Interfund Balances and Transfers.....	108
Note 13 – Fund Deficits.....	111
Note 14 – Reserved Fund Balances.....	111
Note 15 – Related Party Transactions.....	111
Note 16 – Contingencies.....	112
Note 17 – Subsequent Events.....	115
Note 18 – Material Violations of Finance-Related Legal Provisions.....	116

Required Supplementary Information

Budgetary Comparison Schedule – General and Major Special Revenue Funds.....	118
Notes to the Required Supplementary Information – Budgetary Reporting.....	120
Pension Plan Information – Single Employer Systems – Schedule of Funding Progress.....	121
Notes to the Required Supplementary Information – Pension Plan Information.....	121

Supplementary Information – Combining Statements and Individual Fund Statements and Schedules

Nonmajor Governmental Funds	
Combining Balance Sheet – Governmental Funds by Fund Type.....	124
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds by Fund Type.....	125
Combining Balance Sheet – Debt Service Funds.....	128
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances – Debt Service Funds.....	130
Combining Balance Sheet – Capital Projects Funds.....	134
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances – Capital Projects Funds.....	135
Combining Balance Sheet – Permanent Funds.....	138
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances – Permanent Funds.....	140
Proprietary Funds	
Nonmajor Enterprise Funds	
Combining Statement of Net Assets.....	144
Combining Statement of Revenues, Expenses, and Changes in Fund Net Assets.....	152
Combining Statement of Cash Flows.....	156
Internal Service Funds	
Combining Statement of Net Assets.....	166
Combining Statement of Revenues, Expenses, and Changes in Fund Net Assets.....	170
Combining Statement of Cash Flows.....	174
Fiduciary Funds	
Pension (and Other Employee Benefit) Trust Funds	
Combining Statement of Fiduciary Net Assets.....	184
Combining Statement of Changes in Fiduciary Net Assets.....	186
Private-Purpose Trust Funds	
Combining Statement of Fiduciary Net Assets.....	190
Combining Statement of Changes in Fiduciary Net Assets.....	192
Agency Funds	
Combining Statement of Fiduciary Net Assets.....	196
Combining Statement of Changes in Assets and Liabilities.....	198

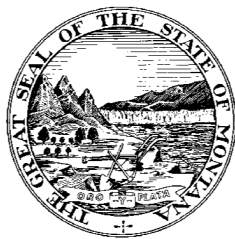
STATISTICAL SECTION

Graphic Presentations:	
Revenues by Source - All Governmental Fund Types.....	202
Expenditures by Function - All Governmental Fund Types	203
Revenues by Source - All Governmental Fund Types.....	204
Expenditures by Function - All Governmental Fund Types	204
Property Tax Levies and Collections.....	205
Taxable and Market (Assessed) Value of Property.....	205
Property Tax Rates - Direct and Overlapping Governments	206
Property Tax Mill Levy for State Purposes	206
Ratio of Direct State Debt to Assessed Value and Direct State Debt per Capita	207
Ratio of Annual Debt Service to Total General Expenditures	207
Revenue Bond Coverage - Higher Education	208
Revenue Bond Coverage – Housing Authority.....	208
Revenue Bond Coverage - Economic Development Bonds.....	209
Construction and Bank Deposits.....	210
Property (Assessed) Values	210
Income Data.....	211
Public Education Enrollment	212
Demographic Statistics	213
Annual Average Nonagricultural Employment by Selected Industries	213
Major Private Employers in Montana.....	214
Miscellaneous Statistics	214

INTRODUCTORY SECTION



**DEPARTMENT OF ADMINISTRATION
DIRECTOR'S OFFICE**



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December 16, 2005

To the Citizens, Governor and Members of the Legislature of the State of Montana:

In accordance with Section 17-2-110, Montana Code Annotated (MCA), I am pleased to submit the Comprehensive Annual Financial Report (CAFR) of the State of Montana for the fiscal year ended June 30, 2005. Responsibility for the accuracy of the data presented and the completeness and fairness of the presentation rests with the Department of Administration. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds of the State of Montana. All disclosures necessary to enable the reader to gain an understanding of the State's financial activities are included.

DESCRIPTION OF THE CAFR

This report and the accompanying financial statements and statistical tables were prepared in accordance with standards set forth by the Governmental Accounting Standards Board (GASB).

This CAFR is divided into three main sections: introductory, financial, and statistical. The introductory section includes an organization chart for the State, a table of contents, and this transmittal letter. The financial section contains management's discussion and analysis, the independent auditor's report, government-wide financial statements, fund financial statements, notes to the financial statements, combining statements by fund type, and other schedules. The statistical section includes financial, economic, and demographic data.

This report includes all funds of those entities that comprise the State of Montana (the primary government) and its component units. The component units are entities that are legally separate from the State, but 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 State is able to impose its will on that organization; or (2) there is the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the State. The following component units are included in the State's financial reporting entity: Housing Authority, Facility Finance Authority, State Compensation Insurance Fund (Old and New), Montana State University, University of Montana, Public Employees Retirement Board, and Teachers Retirement System. These component units are discretely presented in the State's financial statements.

PROFILE OF THE GOVERNMENT

Montana became the 41st state when it was admitted to the Union in 1889, 25 years after the attainment of territorial status. With an area of 145,552 square miles, Montana is the nation's fourth largest state. With an estimated current population of 927,000, it is also one of the nation's most sparsely populated states. It is a vast land: a land including rolling plains, the Northern Rocky Mountains, two national parks, wheat farms and cattle ranches, tribal lands, and extensive natural resources.

In 1972, a constitutional convention convened, rewriting the State's constitution and establishing the current governmental structure. As shown in the organizational chart on page 12, state government is divided into three separate branches: legislative, executive, and judicial. Montana's Legislature consists of 50 senators and 100 representatives elected from single-member districts. The Legislature meets at regular biennial sessions for 90 days in odd-numbered years. Montana is governed by its constitution, and its laws are administered by its executive branch officers and various

boards and commissions. State government services provided to citizens include building and maintaining roads; providing public safety, health, and environmental protection services to protect the general welfare of the State's citizens; helping adults, children, and families through difficult times such as abuse, divorce, illness, death, and unemployment; fostering an attractive business climate to encourage economic growth; and protecting public lands and natural resources for conversation and recreational activities. The State also provides significant financial support to its higher education institutions, local governments, and school districts to help those entities meet the specific needs of their constituents.

ECONOMIC CONDITION AND OUTLOOK

Montana's economy continues to grow at a rate much higher than that experienced, on average, over the past 35 years. The current estimated growth rate for Montana's economy in calendar year 2005 is estimated at 3.4%, as compared to the 35-year average rate of 2.1%. Montana's economic base remains concentrated in agriculture, mining, wood products, and other manufacturing, nonresident travel, and government. This continued high growth rate is reflected in a strong State financial position at the end of the fiscal year and the related second quarter 2005 income increases in all sectors of Montana's economy. Montana's income tax revenues increased as a result of this internal income growth, trends in the stock market, and the continued low level of U.S. interest rates. Montana corporate income tax revenues are affected by the overall profits of intra and interstate corporations. For a more in-depth analysis of the impact of this growth on the State's financial position, the reader should refer to management's discussion and analysis and the financial statements contained in this document.

Montana's wheat yields grew again in 2005, with winter wheat yields reaching 92.3 million bushels exceeding the high 1993 level for a second year in a row. Spring and durum wheat yields are expected to reach 81.6 and 15.8 million bushels, respectively. This represents a decrease in spring and durum wheat of 10% and 12%, respectively. Montana's overall wheat production is projected to reach 190 million bushels, well above the State's 2004 production level of 173.2 million bushels. Overall barley production fell about 8% to an estimated 39.8 million bushels. The decreases in production in spring and durum wheat and barley are primarily due to the impacts of a very hot summer. At this time, wheat prices appear to be stable in the US, but may be impacted by high production in Argentina and Australia, whose harvests will not occur until November. Current wheat prices appear to be stable, but the positive effect on farm income has also been reduced by the higher cost of fuel.

With 2.35 million head, Montana ranked twelfth in the US cattle and calf industry. Although national cattle exports have decreased, this has been offset by an increase in US consumer demand. As a result, beef prices have risen slightly; with Montana's 2003 receipts from cattle sales exceeding \$950 million.

As of the end of calendar year 2004, Montana's manufacturing sector shows some improvement after a three-year decline. Employment in this industry continued to decline, with about 24,000 workers employed at the end of 2004, as compared to 25,000 workers at the end of 2003. Employee earnings in the manufacturing industry increased to over \$1 billion in 2004. The manufacturing sector produced about \$5 billion in output and accounted for 20% of Montana's economic base. The earnings increase in 2004 was primarily due to higher per-unit prices, not volume increases. The sector continues to face raw material shortages, especially in the timber, steel, and petroleum based products areas. In the second quarter of 2005, Montana's manufacturing sector appears to be reversing this trend, and has posted a 3.2% increase in earnings growth.

Prices for lumber and other wood products increased substantially for the second year in a row. Despite the increase in lumber prices and a very strong demand, production decreased again in Montana for 2004. Due to a major mill closure and the low timber volume provided from national forests, employment decreased 4% to 9,000 workers from the 2003 level of 9,400 workers. Estimated total sales value of the State's primary wood and paper products in 2004 was \$1.2 billion, up about \$230 million from 2003. Montana's estimated lumber production was 1 billion board feet in 2004, down from 1.07 billion board feet in 2003. Montana's timber production will probably decrease slightly again in 2005 because of the dependency on the national forest harvest volume, which continues at a 50 year low.

Nonresident travel to Montana in 2004 remains unchanged with a minimal .03% increase over 2003. The visitor numbers for Glacier and Yellowstone national parks were mixed. While Yellowstone Park posted a 5% decrease in visitors; Glacier Park saw a 22% increase. Motel occupancy posted a slight decrease of 0.4% from the 2003 levels. Current estimates indicate that the travel industry will increase by approximately 2% in 2005. Nonresident travelers contribute to the tax base by paying the lodging tax, excise taxes such as those on gasoline, and indirectly by supporting employment in industries that pay corporate taxes and whose workers pay income, property, and other taxes. Travel expenditures in

Montana totaled \$1.95 billion in 2004, which is a 1% increase from the 2003 level. The direct economic impact of nonresident travel is estimated at \$2.6 billion. Combined with the indirect and induced economic benefits, the economic benefit of nonresident travel on Montana is \$3.7 billion.

An estimated 315 million barrels of oil reserves exist under Montana's land. Due to increases in the crude oil price significantly above the rough cost of \$27 a barrel it costs to produce oil in Montana, and increases in natural gas prices, the State has seen more production and exploration activity. This not only translates into a positive economic impact for the State as a whole but a much needed economic benefit for eastern areas of the State. The increased oil and natural gas production and exploration activity offset some of the negative impacts that related price increases had on the State's economy. With the oil price increase appearing to be demand rather than supply driven, it appears the additional production and exploration activity may be of a long-term nature.

MAJOR INITIATIVES

The 59th Legislature met in regular session on January 3, 2005, and adjourned on April 21, 2005. Unlike the previous Legislature, this session began with a significantly improved State financial picture, with an estimated ending General Fund balance of \$162.4 million. No major tax policy changes resulted from this legislative session. The only major shift of revenue from the General Fund was to deposit mineral royalties directly into the State Special Revenue Fund. These were previously deposited in the General Fund and later transferred to the State Special Revenue Fund. While this resulted in a decrease in General Fund revenue of \$33 million, a corresponding decrease in transfers out also occurred, leaving a net impact on the General Fund fund balance of \$0. This revenue decrease of \$33 million accounted for 84 percent of the projected decreases in General Fund revenue for the 2007 biennium.

The Legislature passed Senate Bill 152 defining a quality K-12 education and educationally relevant factors to which a funding system must be correlated. Senate Bill 525 was passed creating a Quality Schools Interim Committee to (1) assess the educational needs of Montana Children; (2) determine the cost of providing a quality education; (3) determine the State's share of the costs; and (4) construct a funding formula in accordance with the requirements contained in the legislation. The Interim Committee was given until December 2005 to meet these objectives. Additionally, the Legislature increased K-12 funding by \$88 million over the 2007 biennium. Passage of these bills was related to a December 2004 preliminary decision by the Montana Supreme Court requiring the State to (1) study and determine the components of free quality public elementary and secondary education and the costs of delivering such education; (2) implement a funding system based on educationally relevant factors; (3) fully fund and equitably distribute the State's share of the costs of public elementary and secondary education; (4) include a cost adjustment factoring the funding system; and (5) establish a mechanism for monitoring and adjusting the funding system and an award of attorney's fees. The court required this to be complete by October 2005. This deadline was not met for all of the court's requirements. The court's reaction to the legislative actions remains to be seen. To further address this issue, a special session of the Legislature will convene on December 14, 2005. This case is discussed more fully in Note 17.

The economic and community development initiatives of the 59th Legislature were included in 12 bills passed during the session. These include two bills enacted to provide business retention, expansion or research through tax incentives; two bills aimed at removing or reducing impediments to economic or community development; and eight bills providing appropriations for economic and community development. Appropriations of \$36.1 million were included in the General and State Special Revenue Fund for this activity.

To initiate the process of addressing deferred maintenance of State buildings, the Legislature approved a one-time transfer of \$30 million from the General Fund to the Long-Range Building Capital Projects Fund. This will be used to address a growing backlog of safety, major repair, and deferred maintenance projects.

State employee salaries were increased as a result of the passage of House Bill 447. This bill provided for a salary increase of 3.5% or \$1,005, whichever was greater, beginning on October 1, 2005, and 4% or \$1,118, whichever is greater, beginning on October 1, 2006. The estimated 2007 biennium cost of the salary increase is \$37.6 and \$37.2 million in the general and other funds, respectively.

The Legislature approved Senate Bill 146 creating the Office of State Public Defender to provide equitable public defender services throughout the State. The Legislature set total funding for this office at \$14.6 million for the 2007 biennium.

FINANCIAL INFORMATION

Montana's Statewide Budgeting, Accounting, and Human Resource System (SABHRS) is a centrally maintained, fully computerized, double-entry accounting system. SABHRS records are computer-edited.

Management of the State is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss or misuse, and that adequate accounting data are compiled to allow for the preparation of financial statements in accordance with generally accepted accounting principles. In developing and evaluating the State's accounting system, consideration is given to the adequacy of internal accounting controls. Internal accounting controls are designed to provide reasonable, but not absolute, assurance that the above objectives are met. The concept of reasonable assurance recognizes that the cost of a control should not exceed the benefits likely to be derived, and that the evaluation of costs and benefits requires estimates and judgments by management.

Budgetary restrictions are imposed via appropriations approved by the Legislature or established administratively as provided for by state law. Appropriations are required by state law for the general, state and federal special revenue, and capital projects funds. The level of budgetary control is generally established by fund. SABHRS is designed to provide budgetary control by preventing spending in excess of legislative and administrative authority and/or available cash. SABHRS also provides for encumbrance accounting as a technique for accomplishing budgetary control.

General Fund Balance

The unreserved, undesignated fund balance of the General Fund increased from \$132.9 million at June 30, 2004, to \$289.7 million at June 30, 2005. This represents an increase of \$156.8 million (or 118%).

Pension Trust Fund Operations

The State contributes to eight retirement plans and is the administrator of two additional plans. The two largest plans, in terms of dollars contributed and employees covered, are the Public Employees Retirement System - Defined Benefit Retirement Plan and the Teachers Retirement System.

The 1997 Legislature enacted legislation that establishes a guaranteed annual benefit adjustment (GABA) for enrolled members or surviving beneficiaries under each of the statewide public employee retirement plans. The annual maximum adjustment of 3% begins 36 months after a beneficiary's initiation date. The benefit adjustment, when combined with other benefit adjustments already in law, must equal a maximum of 3% per year. The GABA automatically covers beneficiaries in the retirement plans for public employees, sheriffs, and game wardens. Beneficiaries in the retirement plans for highway patrol officers, municipal police officers, firefighters unified, and judges may choose to be covered by GABA, or by benefits adjustment mechanisms already in place. The legislation establishing the GABA also provides a mechanism to actuarially fund the Judges Retirement System.

The 1999 Legislature enacted legislation that also establishes a guaranteed annual benefit adjustment (GABA) for certain benefit recipients in the Teachers Retirement System. A benefit recipient is eligible for the maximum benefit adjustment of 3% if the retiree's most recent retirement effective date is at least 36 months prior to January 1 of the year in which the adjustment is to be made.

Cash Management

The uniform investment program established by the 1972 Montana Constitution directs that the Board of Investments have sole authority to invest state funds. The board operates under the "prudent person principle", which requires the board to (1) discharge its duties in the same manner as that of a prudent person acting in a like capacity with the same resources and aims; (2) diversify the holdings of each fund to minimize the risk of loss and maximize the rate of return; and (3) discharge duties solely in the interest of, and for the benefit of, the funds managed. Permissible investments include bonds, notes, debentures, equipment obligations, common stock (pension trust and higher education funds only), commercial paper, bankers acceptances, interest bearing deposits in Montana financial institutions, real estate, and any other investment in a Montana business that continues existing jobs or creates new jobs. These investments are subject to statutory restrictions for quality and size of holdings.

Unless otherwise provided by law, treasury cash is pooled for investment regardless of the fund from which it is deposited, and the pool investment earnings are credited to the General Fund. The board reported total investment income from investments under its management of \$349 million, a decrease of 25% from the \$466 million earned last year. The book value of board-managed investments increased by approximately \$787 million, or 8.8%, to \$9.8 billion at fiscal year-end 2005. The board publishes an annual audited report of all its investment activity. That report may be referenced for more in-depth investment information.

Risk Management

Wage loss and medical expense benefits for injured state employees, excluding the Montana University System, are provided by the State Compensation Insurance Fund (State Fund). The State Fund is a nonprofit, independent public corporation that is managed and controlled by a seven-member board of directors. The Governor appoints the board members for four-year terms. Funding is primarily derived from the premiums paid by policyholders.

The Montana University System Workers Compensation Program provides self-insured workers compensation coverage for employees of the Montana University System. 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. The State maintains self-insurance plans for employee comprehensive medical, prescription drug and dental coverage, and state property. Under the State Employee Group Benefits Plan, the State assumes all the risk for claims incurred by plan members including state employees, elected officials, retirees and their dependents with the following exceptions: the Vision Service Plan (VSP) Insurance Company insures vision care services; the Standard (Standard) Life Insurance Company insures life, AD&D, and long-term disability coverage; and UNUM Life Insurance Company insures the long-term care coverage offered to participants. Premiums are collected through payroll deductions, deductions through the Public Employees Retirement System and self-payment.

The Montana University System (MUS) Group Benefits Plan offers medical, dental, life, and vision insurance coverage to employees of the Montana University System, the community colleges, 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 a voluntary vision plan administered by VSP serving employees, retirees and their dependents and life insurance administered by Standard. Blue Cross/Blue Shield is the claims administrator for the self-insured indemnity plan. The plan includes three self-insured HMOs that are administered by Blue Cross, New West Health Services, and Peak. 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.

The State's comprehensive property/casualty insurance plan provides coverage for accidental death/dismemberment of volunteers (Montana University System), automobile liability, automobile physical damage, aviation (i.e., aircraft and airports), boilers and machinery, crime (i.e., faithful performance, fidelity, theft, destruction, and electronic fraud), fine arts, foster care, general liability, inland marine (property in-transit), state-administered foreclosure housing units, and other miscellaneous risks. Commercial excess property insurance is purchased to insure against catastrophic losses, with deductibles ranging from \$10,000 per occurrence to \$1,000,000 per occurrence. Coverage includes auto physical damage, aircraft hull, boilers and machinery, fine arts, crime, and foster care with over \$2.2 billion of state leased/owned or specialty buildings, contents, and other risk insured to \$250,000,000 per occurrence (various sub limits and coverage restrictions apply). The State is entirely self-funded for auto liability and general liability, subject to the terms and conditions of the Montana Tort Claims Act (§2-9-305, MCA). The state's statutory caps are set by the Legislature at \$750,000 per claim/\$1,500,000 per occurrence (§2-9-108, MCA). Premiums for the plan are collected from all state agencies, including component units, and costs are allocated based upon exposure and loss experience.

INDEPENDENT AUDIT

The financial statements contained in Montana's Comprehensive Annual Financial Report were audited in accordance with generally accepted auditing standards by the State's Legislative Audit Division. The Legislative Auditor is appointed by and reports to the Legislative Audit Committee. The Deputy Legislative Auditor issued an unqualified opinion on the State's financial statements for fiscal year 2005.

The Deputy Legislative Auditor added an additional paragraph to the unqualified opinion for 2005 emphasizing four of the retirement systems are not actuarially sound and have an unfunded actuarially accrued liability as of June 30, 2005. The actuarial condition of these plans is fully disclosed and reported as required by Generally Accepted Accounting Principles (GAAP), and explained in greater detail in Notes 6 and 18 of the financial statements. The unfunded actuarial liability is long-term in nature and does not translate into an inability of these plans to meet their current obligations in the near future. The State is very aware of this situation and is taking steps to address it.

In this additional paragraph, the Deputy Legislative Auditor also discusses the underfunding of the Sheriff's Retirement System. This is fully disclosed and reported as required by GAAP, and explained in greater detail in Notes 6 and 18 of the financial statements. This does not translate into an inability of the plan to meet current obligations in the near future.

CERTIFICATE OF ACHIEVEMENT

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Montana for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2004. This was the sixteenth year out of seventeen years that the State received this prestigious award. In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized CAFR, whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current CAFR continues to conform to the Certificate of Achievement Program requirements; we are submitting it to GFOA to determine its eligibility for another certificate.

ACKNOWLEDGEMENTS

The preparation of this report on a timely basis could not be accomplished without the efficient and dedicated service of the entire staff of the Accounting Bureau and the cooperation of accounting personnel at the individual state agencies. I would like to express my appreciation to the Accounting Bureau and other agency personnel who participated in the preparation of this document. I would also like to thank the Legislature and all state agencies for their interest and support in planning and conducting the financial operations of Montana in a professionally responsible and progressive manner.

Respectfully submitted,

A handwritten signature in black ink that reads "Janet Kelly". The signature is written in a cursive style with a large, prominent initial "J".

Janet Kelly, Director
Department of Administration

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of Montana

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2004

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



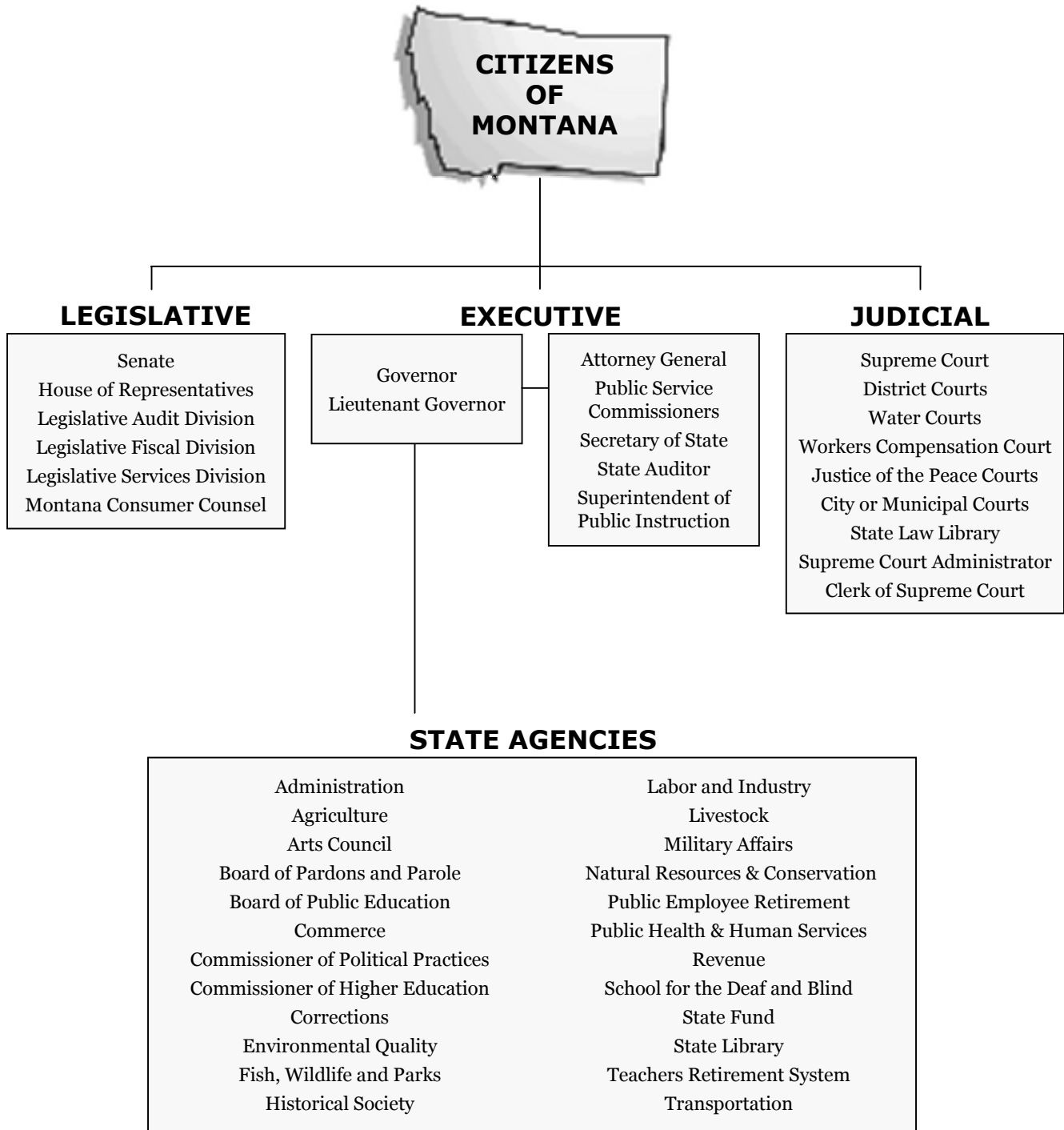
Nancy L. Ziehl

President

Jeffrey R. Emmer

Executive Director

STATE OF MONTANA ORGANIZATION CHART



State of Montana
SELECTED STATE OFFICIALS

EXECUTIVE

Brian Schweitzer

Governor

John Bohlinger

Lieutenant Governor

JUDICIAL

Karla Gray

Chief Justice

LEGISLATIVE

Jon Tester

President of the Senate

Gary Matthews

Speaker of the House