Legislative Audit Division

State of Montana

Report to the Legislature

January 2003

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2002

Teachers' Retirement System

A component unit of the state of Montana

This report contains the financial statements and our independent auditor's report for the Teachers' Retirement System for the two fiscal years ended June 30, 2002.

The report contains no recommendations.

Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
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FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2003, will be issued by March 31, 2004. The Single Audit Report for the two fiscal years ended June 30, 2001, was issued on March 26, 2002. Copies of the Single Audit Report, when available, can be obtained by contacting:

Single Audit Coordinator
Office of Budget and Program Planning
State Capitol
Helena MT 59620
Phone (406) 444-3616

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LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

January 2003

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the Teachers' Retirement System (system), a component unit of the state of Montana, for the two fiscal years ended June 30, 2002. This report contains no recommendations to the Board.

We issued an unqualified opinion on the financial statements of the Teachers' Retirement System. An unqualified opinion means a reader can rely on the information presented in the financial statements. The independent auditor's report appears on page A-3 of this report.

Our opinion on the system's financial statements is also contained in the Teachers' Retirement System Annual Report. Copies of the annual report for fiscal year 2001-02 can be obtained from the Teachers' Retirement System. The annual report contains additional background, statistical, and actuarial information not included in this audit report, which may be of interest to legislators or the public.

The system's written response to the audit is included at the end of the audit report. We thank the Executive Director and his staff for their assistance and cooperation.

Respectfully submitted,

(Signature on File)

Scott A. Seacat
Legislative Auditor

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Legislative Audit Division

Financial-Compliance Audit
For the Two Fiscal Years Ended June 30, 2002

Teachers' Retirement System

A component unit of the state of Montana

Members of the audit staff involved in this audit were Jeane Carstensen-Garrett, Chris G. Darragh, Cindy S. Jorgenson, and Jeff Tamblyn.

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Appointed and Administrative Officials

			Term Expires
Teachers' Retirement Board	Tim Ryan, Chair	Great Falls	7/1/04
	Emily Hall Bogut	Kalispell	7/1/02
	Scott Dubbs	Lewistown	7/1/03
	James Turcotte	Helena	7/1/05
	Barbara Foster	Townsend	7/1/06
	Vacant		

Administrative Officials

David L. Senn, Executive Director

Tammy Rau, Assistant Executive Director

Dan Gaughan, Accountant/Fiscal Manager

For additional information concerning the Montana Teachers' Retirement System, Contact David L. Senn, Executive Director, at:

1500 Sixth Avenue
PO Box 200139
Helena MT 59620-0139

e-mail: dsenn@state.mt.us

Teachers' Retirement System

This report documents our financial-compliance audit of the Teachers' Retirement System for the two fiscal years ended June 30, 2002. The previous audit report contained no recommendations.

We issued an unqualified opinion on the financial statements presented in this report. This means the reader can rely on the presented financial information.

Teachers' Retirement System personnel prepare the financial statements from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustment. Adjustments are made to more accurately present financial activity to the readers of the statements.

This report contains no recommendations.

Introduction

General

We performed a financial-compliance audit of the Teachers' Retirement System (system) for the two fiscal years ended June 30, 2002. The objectives of our audit were to:

1. Determine the system's compliance with applicable laws and regulations.

2. Recommend improvements in the system's management and internal controls.

3. Determine if the financial statements prepared by system personnel fairly present the fiduciary net assets of the Teachers' Retirement System as of June 30, 2002 and 2001, and the changes in fiduciary net assets for the fiscal years then ended, in conformity with generally accepted accounting principles.

The financial statements are prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustment. Adjustments are made for errors in the accounting records and to more accurately present financial activity to the readers of the statements. As such, a reader should not expect these financial statements to agree in all instances to the state's primary accounting records.

This report contains no recommendations to the Teachers' Retirement Board. Other areas of concern deemed not to have a significant effect on the successful operations of the Teachers' Retirement System are not specifically included in the report, but have been discussed with management.

Background

The Teachers' Retirement System, established by state law in 1937, currently has more than 18,000 active members and 5,000 vested inactive members. Approximately 9,651 retirees or their beneficiaries were receiving retirement, disability, or survivor benefits as of July 2002.

A six-member retirement board governs the retirement system. In addition to providing oversight to system personnel, the board's responsibilities include:

- Establishing rules and regulations necessary for the proper administration and operation of the retirement system.
- Determining the eligibility of a person who is applying for membership in the system.
- Granting retirement, disability, and other benefits under the provisions of Title 19, chapter 20, MCA.
- Designating an actuary to provide consultation on the technical actuarial aspects of the retirement system.

System personnel are responsible for the daily administration of the Teachers' Retirement Board.

Except as noted below, all full-time members of the teaching profession are required by law to be members in the Teachers' Retirement System. By law, an eligible employee of the university system, hired after July 1, 1993, must become a member of an optional retirement plan, the Teachers' Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), unless the employee is already a member of the Teachers' Retirement System or the Public Employees' Retirement System. TIAA-CREF is administered by the Board of Regents of Higher Education.

The 1999 Legislature passed legislation directing the Teachers' Retirement Board to implement a Guaranteed Annual Benefit Adjustment (GABA) effective in January 2000. GABA provides retirees meeting certain requirements with a guaranteed 1.5 percent increase in retirement benefits on an annual basis.

The retirement system is funded with contributions from active members, their employers, and earnings on the system's investments. Active members contribute 7.15 percent of their earned compensation, while employers contribute an amount equal to 7.47 percent of the earned compensation of each member employed. The university system also contributes an amount equal to 4.044 percent of the salaries of TIAA-CREF participants. As of July 1, 2002, and as a result of the implementation of GABA, the state of Montana contributes from the General Fund 0.11 percent of the compensation for each member participating in the system. This contribution will continue until the amortization period of the unfunded liability is 10 years or less. The contributions are exempt from income tax to the employees until benefits are drawn against those contributions. The Montana Board of Investments invests the system's assets.

The Teachers' Retirement Board obtains an actuarial valuation of the retirement system biennially, the most recent was as of July 1, 2002. The purpose of the valuation was to determine the financial status of the fund and the unfunded accrued liability based upon present and prospective assets and liabilities of the system. The actuary used the entry age actuarial cost method in the valuation, which is an employee's estimated future benefit cost allocated equally over the employee's years of service.

The results of the July 1, 2002, valuation indicate the system is funded on an actuarially sound basis and the unfunded accrued liability was $495.3 million as of July 1, 2002. The amortization period for the current unfunded liability is 23.4 years at July 1, 2002, as compared to 15.20 years at July 1, 2000. The amortization period measures the time necessary for the employer and employee contributions to fund current employees' future benefits, and pay off the unfunded accrued liability, holding all other factors equal.

Independent Auditor's Report & System Financial Schedules

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying Statement of Fiduciary Net Assets of the Teachers' Retirement System, a component unit of the state of Montana, as of June 30, 2002, and 2001, and the related Statement of Changes in Fiduciary Net Assets for each of the fiscal years then ended. These financial statements are the responsibility of the Teachers' Retirement Board. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Teachers' Retirement Board as of June 30, 2002, and 2001, and the changes in fiduciary net assets for each of the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements of the Teachers' Retirement System. The Management's Discussion & Analysis, and the Schedule of Funding Progress, and the Schedule of Contributions from the Employer and Other Contributing Entities are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standard Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

(Signature on File)

James Gillett, CPA
Deputy Legislative Auditor

November 27, 2002

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TEACHERS' RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS

This discussion and analysis of the Montana Teachers' Retirement System's report provides a narrative overview of TRS's financial activities for the fiscal year ended June 30, 2002. Please read this in conjunction with the financial statements with accompanying footnotes and required supplementary information.

Overview of the Financial Statements

This section consists of two financial statements with footnotes and two schedules of historical trend information. The Statement of Fiduciary Net Assets reflects the resources available to pay benefits to retirees and beneficiaries. The Statement of Changes in Fiduciary Net Assets presents the changes that occurred in those resources for the fiscal year ended.

The Schedule of Funding Progress presents historical trend information about the actuarially funded status for the TRS plan from a long-term, ongoing perspective and the progress made in accumulating sufficient assets to pay benefits when due. The Schedule of Employer Contributions displays historical trend data of the annual required employer contributions and the actual contributions made by employers in relation to the requirement.

Financial Highlights

- The TRS plan net assets decreased by $197.5 million representing an 8.8% decline for the fiscal year ended June 30, 2002.
- Total contributions to the plan increased slightly from the previous year from $99.9 million to $100.2 million.
- Net investment income (fair value of investments plus investment income less investment expense) incurred a loss for the second consecutive year. The $159.6 million loss was an increase of 34% over the previous year's loss of $119.1 million.
- Pension benefits and withdrawals paid to plan members and beneficiaries totaled $136.5 million for the fiscal year. Benefit payments increased 9.4%, $118.8 million to $130 million, and withdrawals increased 20.5%, $5.4 million to $6.5 million.
- Administrative expenses totaled $1.6 million down from $1.7 million, a decrease of 6.4%.

Financial Analysis (in millions)

	FY2002	FY2001	% Inc/(Dec)
Cash/Cash Equivalents	$ 45.1	$ 63.9	(29.4)
Investments (fair value)	2,078.8	2,241.5	(7.3)
Liabilities	111.8	92.8	20.5
Net Assets	2,041.7	2,239.2	(8.8)
Contributions	100.2	99.9	.3
Net Investment Income/(Loss)	(159.6)	(119.1)	(34.0)
Benefit Pmts & Withdrawals	136.5	124.2	9.9
Administrative Expenses	1.6	1.7	(5.9)

- The decrease in current assets is due primarily to a decrease in our number of shares held in the Short Term Investment Pool.
- The decrease in the fair value of investments resulted mostly from the decrease in the equity value of the stocks held as of June 30, 2002.
- The increase in liabilities is due mostly to an $8.4 million increase in the value of Securities on Loan at June 30, 2002. Also an $11.1 million equity purchase was done with a trade date of June 28, 2002 and a settlement date of July 3, 2002, which straddles our fiscal year end date of June 30, 2002.
- The increase in net investment loss was due primarily to the 37.7% decrease in investment earnings.
- The increase in benefit payments and withdrawals was due to an increase in the number of retirees and beneficiaries plus the 1.5% guaranteed annual benefit adjustment.
- The decrease in administrative expenses was due to the net effect of a $.2 million decrease in interest expense offset by an increase of $.09 million in contracted services.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF FIDUCIARY NET ASSETS
JUNE 30, 2002 AND 2001

	2002	2001
ASSETS		
Cash/Cash Equivalents-Short Term		
Investment Pool (Note A)	$ 45,106,331	$ 63,933,176
Receivables:		
Accounts Receivable	14,336,758	14,738,284
Interest Receivable	9,740,964	6,956,040
Due from Primary Government	1,587,305	509,725
Total Receivables	$ 25,665,027	$ 22,204,049
Investments, at fair value (Note A):		
Mortgages	$ 145,439,305	$ 122,669,330
Investment Pools	1,667,824,675	1,836,565,552
Other Investments	165,596,248	190,752,951
Securities Lending Collateral (Note A)	99,887,388	91,502,255
Total Investments	$2,078,747,616	$2,241,490,088
Assets Used in Plan Operations:		
Land and Buildings	$ 193,844	$ 193,844
Less: Accumulated Depreciation	(121,064)	(117,300)
Intangible Assets, net of amortization (Note E)	3,836,503	4,249,099
Equipment	137,249	137,249
Less: Accumulated Depreciation	(112,035)	(102,265)
Total Other Assets	$ 3,934,497	$ 4,360,627
TOTAL ASSETS	$2,153,453,471	$2,331,990,840
LIABILITIES		
Accounts Payable	$ 11,732,963	$ 567,901
Due to Primary Government	58,173	53,068
Securities Lending Liability (Note A)	99,887,388	91,502,255
Compensated Absences (Note A)	83,811	89,085
Installment Purchase Payable (Note D)	0	570,417
TOTAL LIABILITIES	$ 111,762,335	$ 92,782,726
NET ASSETS HELD IN TRUST FOR PENSION BENFITS (Schedule of Funding progress)	$2,041,691,136	$2,239,208,114

The accompanying Notes to the Financial Statements are an integral part of this financial statement.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS
FISCAL YEARS ENDED JUNE 30, 2002 AND 2001

	2002	2001
ADDITIONS		
Contributions:		
Employer	$ 51,518,712	$ 50,989,948
Plan Member	47,872,258	48,277,894
Other	762,422	611,148
Total Contributions	$100,153,392	$ 99,878,990
Rental Income	$ 0	$ 5,581
Workers Comp. Dividend	255	445
Taxes	0	84
Investment Income:		
Net Appreciation/(Depreciation) in Fair Value of Investments	$(253,162,567)	$(271,519,227)
Investment Earnings	96,262,329	154,496,707
Security Lending Income (Note A)	2,796,477	8,215,605
Investment Income/(Loss)	$(154,103,761)	$(108,806,915)
Less: Investment Expense	3,074,434	2,355,589
Less: Security Lending Expense (Note A)	2,407,203	7,887,445
Net Investment Income/(Loss)	$(159,585,398)	$(119,049,949)
Total Additions	$ (59,431,751)	$ (19,164,849)
DEDUCTIONS		
Benefit Payments	$ 130,006,163	$ 118,841,895
Withdrawals	6,472,327	5,370,493
Administrative Expense (Note E)	1,606,737	1,715,782
Total Deductions	$ 138,085,227	$ 125,928,170
NET INCREASE (DECREASE) IN PLAN NET ASSETS	$(197,516,978)	$(145,093,019)
NET ASSETS HELD IN TRUST FOR PENSION BENFITS BEGINNING OF YEAR	2,239,208,114	2,384,301,133
END OF YEAR	$2,041,691,136	$2,239,208,114

The accompanying Notes to the Financial Statements are an integral part of this Financial Statement.

NOTE A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Teachers' Retirement System (TRS), a discretely presented component unit Pension Trust Fund of the State of Montana financial reporting entity, maintains its accounts on the accrual basis of accounting. Employee and employer contributions are recognized as revenues in the period in which employee services are performed and expenses are recorded when the corresponding liabilities are incurred, regardless of when payment is made.

Valuation of Investments

Investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Mortgages were decreased by unamortized mortgage discount of $22,808 in fiscal year 2002 and $20,984 in fiscal year 2001. No investment in any one organization represents 5% or more of the net assets available for pension benefits. Investment units are bought/sold on the first business day of each month upon the decision of the Board of Investment's (BOI) Chief Investment Officer.

The six areas of investment during June 30, 2002 and 2001 include: Montana Stock Pool (MTCP); Montana International Equity Pool (MTIP); Montana Short-Term Investment Pool (STIP); Retirement Funds Bond Pool (RFBP); Montana Private Equity Pool (MPEP), and Other Investments.

1. MTCP portfolio consists of common stock in public corporations, convertible equity securities and equity derivatives. Unit values are calculated daily. On August 17, 2000, shareholders on record received one MTCP share for each MTCP share held as the result of a 2:1 split. The unit value on August 31, 2000 prior to the split was $1,014, while the unit value after the split was $507. Value at June 30, 2002 and June 30, 2001 was $317 per unit and $406 per unit respectively.

OWENS-CORNING COMPLAINT

The BOI received a summons and complaint, dated October 11, 2002, regarding the bankruptcy of Owens-Corning. The company seeks a determination that the dividend payments paid from October 1996 through July 2000 represent "fraudulent transfers under Chapter 11 Bankruptcy provisions and applicable state law, and are, therefore, voidable." The complaint states the Montana Board of Investments was the "recipient of dividends in the amount of $357,099 for the relevant period."

2. MTIP portfolio includes equity investments in four funds – BOI Internal International, Pyrford International, Schroder Investment Management NA and SG Pacific Assets Management. The four funds may invest in securities of foreign-based corporations listed on legal and recognized foreign exchanges as well as domestic exchanges. Security types may include ordinary common shares, preferred shares, convertible securities, American Depositary Receipts (ADR's), Global Depositary Receipts (GDR's) and other global securities, as appropriate. Unit values are calculated weekly based upon the fair value of equity holdings, other assets and liabilities. Unit value at June 30, 2002 and June 30, 2001 was $91.12 per unit and $99.22 per unit respectively.

3. STIP as per Montana Code Annotated (MCA) section 17-6-201, 202 and 204, requires investments by state agencies of available funds. Value at June 30, 2002 and June 30, 2001 was $1 per unit. STIP portfolio includes asset-backed and variable-rate securities to provide diversification and a competitive rate of return.

Asset-backed securities are debt securities collateralized by a pool of mortgage and non-mortgage assets pledged by the issuer and have one or more forms of credit enhancement to raise the quality of the security.

Variable rate securities provide many advantages of short-term bonds because they are designed to minimize the investor's interest rate risk. As with variable rate loans issued by banks, the interest rate paid by the issuer of these securities is reset periodically depending on market conditions. The value of these securities will usually remain at or near par because their interest rates are reset to maintain a current market yield.

According to the Governmental Accounting Standards Board (GASB) Statement No. 31, Accounting and Financial Reporting for Certain Investments and External Investment Pools, STIP is considered an external investment pool. An external investment pool is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The Board of Investments has adopted a policy to treat STIP as a 2a7-like pool.

4. RFBP portfolio includes corporate asset-backed, other corporate, U. S. government mortgage-backed, U. S. government and Yankee securities. Unit values are calculated weekly and at month end based on portfolio pricing. Value at June 30, 2002 and June 30, 2001 was $103.56 per unit and $102.04 per unit respectively. Realized portfolio gains/losses are distributed at least annually. The RFBP portfolio includes structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). Some REMICs are principal-only strips (Pos) and interest-only (Ios). TRS has 39% ownership in the RFBP.

As of June 30, 2002, Enron Corp., Burlington Industries, Inc. and WorldCom Inc. presented legal and higher credit risks to the RFBP.

The RFBP holds a $7 million par 6.40% Enron bond maturing July 15, 2006 and a $7 million par 6.95% Enron bond maturing July 15, 2028. The combined book value of these securities was $13,582,030 as of November 30, 2001. On December 12, 2001, the Enron Corp. filed for Chapter 11 bankruptcy protection. Accordingly, we reduced book value for the two issues to $5.6 million as of June 30, 2002. In October 2002, the book value was reduced to $2.8 million for both issues. The Board, currently, anticipates receiving up to $2.8 million from bankruptcy claims.

DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The BOI received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, $5 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of $94.669 plus accrued interest. Deutsche Bank Securities seeks damages of $538,632 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The Board tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of $113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the Board received $5,683,075 in principal and interest plus $150,000 as a consent fee.

The RFBP portfolio includes a $6,000,000 par, 6.95% WorldCom Inc. bond maturing August 15, 2028. The book value of this bond, originally purchased at a discount, was $5,477,400 on June 30, 2002. On July 21, 2002, WorldCom Inc. filed for Chapter 11 bankruptcy protection. As of July 31, 2002, the reduced book value is $2,400,000. At this time, the Board expects bankruptcy recovery up to $2,400,000. On November 7, 2002, the Attorney General for the State of Montana filed a lawsuit against certain Worldcom executives, directors and financial institutions associated with Worldcom such as Arthur Andersen and CitiGroup. The lawsuit, filed in Lewis and Clark County, Montana, alleges that the defendants filed "false and misleading registration statements" relating to the purchase of the bonds by the Montana Board of Investments.

Burlington Industries, Inc. also presented a higher credit risk as of June 30, 2001. The BOI owns a Burlington Industries, Inc., $6 million par, 7.25% bond maturing September 15, 2005. In September 2000, the company announced a reduction of stockholders equity. Due to an increasing senior bank line and declining credit trend, the bond ratings for this issue were downgraded, in May 2001, by the Moody's and Standard & Poor's rating agencies. During fiscal year 2001, the book value of Burlington Industries Inc. was reduced to $2,400,000. Due to the company's filing for Chapter 11 bankruptcy protection on November 11, 2001, the book value was reduced to $1,200,000. The company is expected to emerge from bankruptcy in 2003.

As of June 30, 2001, Asarco Inc., Rite Aid and Service Corp. presented a higher credit risk to the RFBP.

The RFBP held a $7 million par, 7.875% Asarco bond maturing April 15, 2013. Due to bond rating downgrades, high leverage and increased production costs, the book value of this security was reduced to $5,600,000 as of June 30, 2001. In February 2002, the book value of this security was further reduced to $4,200,000. In May 2002, this bond was sold, on the market, for $3,474,250 including interest.

The RFBP owns a Rite Aid $7,000,000 par, 7.13% bond maturing January 15, 2007. In May 2000, the BOI was subordinated to a secured bank line of credit on this issue and the bond ratings were downgraded by the Moody's and Standard & Poor's bond ratings agencies. Based on this subordination and ratings downgrade, the book value was reduced to $5,600,000 as of June 30, 2000. During fiscal year 2001, the book value was further reduced to $5,220,172. Due to an improving credit trend, amortization was resumed in June 2001. The book value of this security at June 30, 2002 is $5,541,139. As of June 30, 2002, Rite Aid does not represent a credit risk.

The RFBP portfolio lists a Service Corp. $5 million par, 6.875% bond maturing October 1, 2007 and a Service Corp. $5 million par, 6% bond maturing December 15, 2005. In January 2001, the bond ratings for these two issues were downgraded by the Moody's bond rating agency. The book value of these two issues is $4,000,000 each as of June 30, 2002 and 2001. Due to an improved credit outlook, Service Corp. is not considered a credit risk as of June 30, 2002.

5. The Montana Private Equity Pool (MPEP) was established by the BOI in April 2002. The BOI contracts with five private equity managers to invest in venture capital, leveraged buyout and other private equity investments. The retained private equity managers are Adams Street Partners, Kohlberg, Kravis, Roberts and Company (KKR), Welsh Carson Anderson and Stowe, Madison Dearborn Partners and Lexington Partners. According to BOI policy, the external managers may not invest more than 20% of private equity invested capital total in non-US company partnerships unless the fund is a designated non-US fund. Venture capital represents private equity investments in early stage financing of rapidly growing companies with an innovative product or service. Leveraged buy-outs permit an investment group to acquire a company by leveraging debt, as a financing technique, to establish a significant ownership position on behalf of the company's current management team.

The TRS transferred all their venture capital and leveraged buyout investments, at cost, into the MPEP at the start-up date and were issued units according to the fair value of each participant's portfolio and cash contributions. The initial unit value as of May 1, 2002 was $100. Unit value at June 30, 2002 was $97.38.

6. Other Investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle" and applicable investment restrictions of the participants. The portfolio includes securities classified as corporate asset-backed, other corporate, U.S. government mortgage-backed, U.S. government, Yankee bonds, equity index, venture capital, leveraged buyouts, real estate, mortgages and loans. Corporate asset-backed securities represent debt securities collateralized by a pool of assets. U.S. government mortgage-backed securities reflect participation in a pool of residential mortgages. U.S. government securities include direct obligations of the U.S. Treasury and indirect obligations of the U.S. government. Yankee bonds are U.S. dollar denominated bonds issued by foreign corporations and governments and U.S. companies issuing debt in foreign markets. Equity index investments are investments in selected mutual funds whose equity portfolios match a broad based index or composite. In May 2000, BOI made its initial equity index investment in the S&P 500 Equity Index Fund. Venture capital represents private equity investments in early stage financing of rapidly growing companies with an innovative product or service. Leveraged buy-outs permit an investment group to acquire a company by leveraging debt, as a financing technique, to establish a significant ownership position on behalf of the company's current management team.

Effective May 1, 2002 all venture capital and leveraged buyout investments were transferred to the new Montana Private Equity Pool (MPEP).

Fair values of investments for publicly traded securities are determined primarily by reference to market prices supplied to BOI by BOI's custodial bank, State Street Bank and Trust. The real estate investments and mortgages are valued based on a discounted cash flow. The commercial in-state coal tax loans and the nonparticipating repurchase agreements are reported at amortized cost.

Real Estate – In January 1996, BOI, on behalf of the Public Employees' and Teachers' Retirement Systems, purchased the 100 North Park Avenue building in Helena, Montana as a real estate investment. As of June 30, 2002 the building carries a cost and fair value of $5,701,360 and $5,344,000, respectively. At June 30, 2001 cost and fair value was $4,864,326 and $5,344,000, respectively.

In August 1997, BOI authorized the construction of an office building at 2401 Colonial Drive, as a real estate investment owned equally by the Public Employees' and Teachers' Retirement Systems. As of June 30, 2002, the building carries a cost and fair value of $6,831,438 and $7,581,000, respectively. At June 30, 2001 cost and fair value was $6,677,986 and $7,581,000, respectively.

Securities Lending – Under the provisions of state statutes, BOI, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the BOI 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, BOI receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. BOI retains all rights and risks of ownership during the loan period.

During fiscal years 2002 and 2001, State Street lent, on behalf of BOI, certain securities held by State Street, as custodian, and received U.S. dollar currency cash, U.S. government securities, and irrevocable bank letters of credit. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

BOI did not impose any restrictions during fiscal years 2002 and 2001 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2002 and 2001. Moreover, there were no losses during fiscal years 2002 and 2001 resulting from a default of the borrowers or State Street.

During fiscal years 2002 and 2001, BOI and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and BOI loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which BOI could not determine. On June 30, 2002 and June 30, 2001, BOI had no credit risk exposure to borrowers.

As of June 30, 2002, the carrying and fair value of the underlying securities on loan within Other Investments was $101,344,163 and $106,533,000, respectively. The collateral provided for the securities on loan totaled $109,960,231 in cash collateral.

As of June 30, 2001, the carrying and fair value of the underlying securities on loan within Other Investments was $106,324,791 and $111,818,481, respectively. The collateral provided for the securities on loan totaled $116,327,019 in cash collateral.

DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The BOI received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, $2 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of $94.669 plus accrued interest. Deutsche Bank Securities seeks damages of $215,453 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The Board tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of $113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the Board received $2,273,230 in principal and interest plus $60,000 as a consent fee.

Compensated Absences

Compensated absences represent 100 percent of accrued vacation and 25 percent of accrued sick leave for TRS personnel at June 30, 2002 and June 30, 2001.

NOTE B. DESCRIPTION OF PLAN

The Teachers' Retirement Board is the governing body of a mandatory multiple-employer cost-sharing defined benefit pension plan, which provides retirement services to all persons in Montana employed as teachers or professional staff of any public elementary or secondary school, colleges of technology or unit of the university system. The system was established by the state of Montana in 1937 to provide, retirement, death and disability benefits and is governed by Title 19, chapter 20, of the MCA.

At June 30, 2002, the number and type of reporting entities participating in the system were as follows:

Local School Districts	378
Community Colleges	3
University System Units	2
State Agencies	8
Total	391

At June 30, 2002, the system membership consisted of the following:

Retirees and Beneficiaries Currently Receiving Benefits	9,342
Terminated Employees Entitled to But Not Yet Receiving Benefits	10,976
Current Active Members:	
Vested	11,656
Nonvested	6,543
Total Membership	38,517
University System Employees Optional Retirement Plan (ORP)	4,350

The pension plan provides retirement benefits and death and disability benefits. Employees with a minimum of 25 years of service or who have reached age 60 with 5 years of service are eligible to receive an annual retirement benefit equal to creditable service years divided by 60 times the average final compensation. Final compensation is the average of the highest three consecutive years of earned compensation. Benefits fully vest after 5 years of creditable service. Vested employees may retire at or after age 50 and receive reduced retirement benefits. Effective July 1, 1999, legislation providing a Guaranteed Annual Benefit Adjustment of 1.5% payable each January was implemented for all retirees who had been receiving benefits for at least 36 months. This legislation also provided for a one-time ad hoc $500 minimum benefit adjustment for any retiree who retired with at least 25 or more years of creditable service and on July 1, 1999, was receiving less than $500 per month. The employee contribution rate was also increased from 7.044% to 7.15%.

The 2001 legislature increased the $500 minimum benefit to $600 for members who retired with 25 or more years of creditable service with no change in contribution rates. The legislature also authorized the TRS Board to increase GABA from 1.5% to a maximum of 3.0%, providing sufficient assets are available. The GABA was not increased in FY 2002.

NOTE C. CONTRIBUTIONS

The TRS funding policy provides for monthly employee and employer contributions at rates specified by state law. Plan members are currently required to contribute 7.15% of their earned compensation and employers contribute 7.47% of earned compensation. The State General Fund contributes an additional 0.11% of earned compensation. An actuary determines the actuarial implications of the funding requirement in biennial actuarial valuations. The actuarial method used to determine the implications of the statutory funding level is the entry age actuarial cost method, with both normal cost and amortization of the accrued liability determined as a level percentage of payroll. The actuarial valuation prepared as of July 1, 2002, the most recent valuation date, indicates the statutory rate was sufficient to fund the normal cost and to amortize the unfunded accrued liability under the entry age actuarial cost method over 23.4 years.

NOTE D. INSTALLMENT PURCHASE PAYABLE

During fiscal year 1999, TRS contracted for a new data processing system. The new data processing system was financed through Wells Fargo. The first payment was made May 1, 2000. During fiscal year ended, June 30, 2001, the Board approved all debt to be paid prior to maturity. The final payment was made on September 24, 2001 for $659,899.05. Total debt paid was $4,858,050.60, which includes principal and interest of $4,500,000.00 and $358,050.60 respectively.

NOTE E. ADMINISTRATIVE EXPENSES

The administrative costs of the TRS are financed through realized investment income. The expenses, less amortization of intangible assets, may not exceed 1.5% of retirement benefits paid. Administrative expenses for the fiscal years ended June 30, 2002 and 2001, are outlined below:

	2002	2001
Budgeted:		
Personal Services:		
Salaries	$ 470,798	$ 511,459
Other compensation	3,300	3,150
Employee benefits	126,179	124,149
Total Personal Services	$ 600,277	$ 638,758
Operating Expenses:		
Contracted services	$ 298,056	$ 199,503
Supplies and materials	37,198	30,949
Communications	43,207	30,153
Travel	11,067	22,146
Rent	32,490	32,289
Repair and maintenance	22,367	43,462
Other expenses	25,585	17,617
Depreciation	13,533	16,649
Interest	8,858	226,936
Total Operating	$ 492,361	$ 619,704
Nonbudgeted:		
Amortization	$ 514,099	$ 457,320
Total Administrative Expense	$1,606,737	$1,715,782

NOTE F. SUBSEQUENT EVENT

In May of 1999, TRS contracted with Bearing Point Inc. (formerly KPMG Consulting), to customize, integrate and implement the PeopleSoft Pension Administration, Human Resource and Financials modules. The Pension Administration and Human Resource modules were to replace the functions of the Benesys software system that is currently in place at the TRS. The Financials module was needed to minimize the duplication of work effort and to enhance the reconciliation of the Teachers' Retirement and the State of Montana PeopleSoft systems. On September 19, 2001, the Board indefinitely extended the implementation date for the PeopleSoft system in anticipation of potential future development and/or enhancements that may be forthcoming from Bearing Point and/or PeopleSoft.

Teachers' Retirement System
A Component Unit of the State of Montana
Required Supplementary Information

Schedule of Funding Progress
(All dollar amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liabilities (AAL)[1]	Unfunded Actuarial Accrued Liabilities (UAAL)[2]	Funded Ratio	Covered Payroll[3]	UAAL as a Percentage of Covered Payroll
July 1, 1992	$ 954.5	$ 1,533.9	$ 579.3	62.2%	$ 465.1	124.6%
July 1, 1994	1,157.5	1,712.9	555.4	67.6	472.9	117.4
July 1, 1996	1,376.7	1,939.6	562.9 [4]	71.0	501.5	112.2
July 1, 1998(5)	1,809.0	2,123.3	314.3	85.2	529.8	59.3
July 1, 1998(6)	1,809.0	2,342.7	533.7	77.2	529.8	100.7
July 1, 2000(7)	2,247.5	2,648.3	400.8	84.9	537.5	74.6
July 1, 2000(8)	2,247.5	2,652.0	404.5	84.7	537.5	75.3
July 1, 2002	2,484.8	2,980.1	495.3	83.4	563.2	87.9

(1) *Actuarial present value of benefits less actuarial present value of future normal costs based on entry age actuarial cost method.*

(2) *Actuarial accrued liabilities less actuarial value of assets.*

(3) *Covered Payroll includes compensation paid to all active employees on which contributions are calculated. Covered Payroll differs from the Active Member Valuation Payroll shown in Table C-1, which is an annualized compensation of only those members who were active on the actuarial valuation date.*

(4) *Note that although the UAAL increased from 1994 to 1996, the Covered Payroll increased more. Therefore, both the UAAL as a Percentage of Covered Payroll and the amortization period for the UAAL decreased*

(5) *Results of July 1, 1998 Actuarial Valuation.*

(6) *July 1, 1998 results adjusted for 1.5% GABA and $500 minimum benefit for legislation which passed in April 1999 and the new salary scale adopted in November 1998.*

(7) *Results of July 1, 2000 Actuarial Valuation.*

(8) *July 1, 2000 results adjusted for $600 minimum benefit for legislation passed in Spring 2001.*

Teachers' Retirement System
A Component Unit of the State of Montana
Required Supplementary Information

Schedule of Contributions from the Employer and Other Contributing Entities
(All dollar amounts in thousands)

Fiscal Year Ending	Covered Employee Payroll (1)	Actual Employer Contributions (2)	Actual Employer Contribution % (2)	Annual Required Contribution (ARC) % (3)	Percentage of ARC Contributed
6/30/1995	$486,809	$39,073	7.47%	7.47%	100%
6/30/1996	501,516	40,627	7.47	7.47	100
6/30/1997	511,934	41,640	7.47	7.47	100
6/30/1998	529,795	44,476	7.47	7.47	100
6/30/1999	543,071	44,987	7.47	7.47	100
6/30/2000	537,507	48,376	7.58	7.58	100
6/30/2001	567,861	51,524	7.58	7.58	100
6/30/2002	563,163	51,519	7.58	7.58	100

(1) *Computed as the dollar amount of the actual employer contribution made as a percentage of payroll divided by the contribution rate expressed as a percentage of payroll.*

(2) *The actual and required employer contributions are expressed as a percentage of payroll. Contributions for termination pay are included in the actual employer contribution, but are not made as a set percentage of payroll. In Fiscal Year ended June 30, 2002, there were $5.5 million of contributions for termination pay. Contributions made as a percentage of salaries of the members in the ORP are included. In the Fiscal Year ended June 30, 2002, $4.0 million were contributed based on ORP member salaries. The ORP contribution rate varies from year to year.*

(3) *The State makes employer contributions as a percentage of actual payroll. Thus, as long as the percentage equals the percentage required by the most recent actuarial valuation, the dollar amount of the Annual Required Contributions (ARC) is equal to the actual dollar amount of the required employer contributions.*

Actuarial Cost Method

The actuarial valuation was prepared using the entry age actuarial cost method. Under this method, the actuarial present value of the projected benefits of each individual included in the valuation is allocated as a level percentage of the individual's projected compensation between entry age and assumed exit. The portion of this actuarial present value allocated to a valuation year is called the normal cost. The normal cost was first calculated for each individual member. The normal cost rate was defined to equal the total of the individual normal costs, divided by the total pay rate as of July 1, 2002.

The portion of this actuarial present value not provided for at a valuation date by the sum of (a) the actuarial value of the assets and (b) the actuarial present value of future normal costs is called the unfunded actuarial liability. The unfunded actuarial liability is amortized as a level percentage of the projected salaries of present and future members of the System.

Valuation of Assets - Actuarial Basis

Adopted July 1, 2000, the actuarial asset valuation method spreads asset gains and losses over five years. The expected return is determined each year based on the beginning of year market value and actual cash flows during the year. Any difference between the expected market value return and the actual market value return is recognized evenly over a period of five years. The gains and losses are measured starting with the fiscal year ended June 30, 1997.

Investment Earnings

The annual rate of investment earnings of the assets of the System is assumed to be 8%, compounded annually.

Guaranteed Annual Benefit Adjustment Increases

On January 1 of each year, the retirement allowance payable must be increased by 1.5% 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.

Future Salaries

The rates of annual salary increases assumed for the purpose of the valuation include a 5.0% annual rate of increase in the general wage level of the membership plus a variable merit and longevity rate from 0% to 4.51%. The merit and longevity increases for the Montana University System (MUS) members did not show a pattern of increasing or decreasing with service at the time of our most recent study. Therefore, the MUS members have a flat 1% merit and longevity assumption. The general wage increase assumption was adopted July 1, 1998 and the merit and longevity scales were adopted July 1, 2002.

MUS members are assumed to have a 0.63% higher average final compensation to account for the larger than average annual compensation increases observed in the years immediately preceding retirement.

Amortization Period

The current employer contribution rate of 7.47% and the State General Fund contribution of 0.11% of members' salaries are sufficient to meet the actuarial cost of the System accruing at the valuation date and to amortize the unfunded actuarial liability over an open period of 23.4 years as of July 1, 2002.

Agency Response

TEACHERS' RETIREMENT SYSTEM

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(406) 444-3134
JUDY MARTZ, GOVERNOR

STATE OF MONTANA

January 27, 2003

Mr. Scott A. Seacat, Legislative Auditor
Legislative Audit Division
PO Box 201705
State Capitol
Helena, Montana 59620

Dear Mr. Seacat:

Thank you for the opportunity to respond to the financial compliance audit report on the Teachers' Retirement System for the two fiscal years ending June 30, 2002. We are pleased that the report contains an unqualified opinion and no audit recommendations. The Teachers' Retirement Board and Staff are proud of the services we provide to Montana educators and will continue to strive to meet the demands of our members as the baby boomers move closer to retirement.

We appreciate the cooperation and thoroughness of your staff while they were on site.

Sincerely,

David L. Senn

David L. Senn
Executive Director

DLS/klh