Legislative Audit Division

State of Montana

Report to the Legislature

December 2004

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2004

Teachers' Retirement System

Department of Administration
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, 2004. The report contains one recommendation related to the actuarial soundness of the retirement system.

Direct comments/inquiries to:
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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 Government Accountability 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, 2005, will be issued by March 31, 2006. The Single Audit Report for the two fiscal years ended June 30, 2003, was issued on March 23, 2004. Copies of the Single Audit Report can be obtained by contacting:

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

Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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

December 2004

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, 2004. This report contains one recommendation to the Teachers' Retirement Board related to the actuarial soundness of the System.

We issued an unqualified opinion on the System's financial statements for the fiscal years ended June 30, 2004, and 2003. Our opinion on the System's financial statements is also contained in the Teachers' Retirement System Annual Report. 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. Copies of the annual report can be obtained from the Teachers' Retirement System or accessed on its website. The annual report for fiscal year 2003-04 is expected to be available in late December 2004.

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 throughout the audit.

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, 2004

Teachers' Retirement System

Department of Administration
A component unit of the state of Montana

Members of the audit staff involved in this audit were Pearl M. Allen, Chris G. Darragh, John B. Fine, Melissa Heinert, and Laura Norris.

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Appointed and Administrative Officials

Teachers' Retirement Board

		Term Expires
Tim Ryan, Chair	Big Fork	7/1/09
Mona Bilden	Miles City	7/1/06
Scott Dubbs	Lewistown	7/1/08
Barbara Foster	Townsend	7/1/06
Kari Peiffer	Kalispell	7/1/07
James Turcotte	Helena	7/1/05

Administrative Officials

David L. Senn, Executive Director

Tammy Rau, Deputy Executive Director

Dan Gaughan, Accounting/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 the results of our financial-compliance audit of the Teachers' Retirement System for the two fiscal years ended June 30, 2004. This report contains one recommendation related to the actuarial soundness of the System. The previous audit report contained no recommendations.

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

The listing below serves as a means of summarizing the recommendation contained in the report, the System's response thereto, and a reference to the supporting comments.

Recommendation #1

System Response: Concur. See page B-3.

Introduction

General

We performed a financial-compliance audit of the Teachers' Retirement System (System) for the two fiscal years ended June 30, 2004. 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, 2004 and 2003, 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 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.

Our previous financial-compliance audit report of the Teachers' Retirement System, covering the two fiscal years ended June 30, 2002, contained no recommendations. This report contains one recommendation 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. In accordance with section 5-13-307, MCA, we analyzed the cost of implementing the recommendation contained in this report and determined it was not significant.

Background

The Teachers' Retirement System, established by state law in 1937, had more than 18,200 active members and 1,600 vested inactive members not yet receiving benefits at June 30, 2004. Approximately

9,900 retirees or their beneficiaries were receiving retirement, disability, or survivor benefits as of June 30, 2004.

A six-member board, appointed by the Governor for five-year terms, governs the 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 System.

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 Montana University System (MUS), 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 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 MUS also contributes an amount equal to 4.04 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.

Findings and Recommendations

System Not Actuarially Sound

The results of the July 1, 2004 actuarial valuation show the Teachers' Retirement System (System) is not actuarially sound, contrary to the Montana Constitution.

Article VIII, Section 15, of the Montana Constitution requires public retirement systems be funded on an actuarially sound basis. Board policy sets a maximum amortization period of 30 years for the employer and employee contributions to fund current employees' future benefits, and pay off the unfunded actuarial accrued liability, holding all other factors equal.

The Teachers' Retirement Board obtains an actuarial valuation of the System biennially. The most recent actuarial valuation was as of July 1, 2004. The actuary determined that, as of July 1, 2004, the employer contribution rate would have to be increased by 2.87 percent starting July 1, 2005 to maintain an amortization of the unfunded actuarial accrued liability (UAAL) over the 30-year period starting July 1, 2004. A reviewing actuary concurred with these results. The Teachers' Retirement Board also obtained an actuarial valuation of the MUS participation in the System to determine the supplemental contribution rate necessary to amortize the Past Service Liability of the MUS members by July 1, 2033, as required by section 19-21-203, MCA. The actuary projected the current 4.04 percent contribution rate needs to be increased on July 1, 2005 to 7.23 percent if including the 1.5 percent GABA passed in 1999, or to 5.09 percent if excluding the 1.5 percent GABA.

The UAAL and amortization period have grown at an increasing rate, as shown in Table 1.

Table 1

Unfunded Actuarial Accrued Liability (UAAL) and Funding Period

Valuation Date		UAAL	Amortization Period
July 1, 2000	$	304,400,000	15.1 years
July 1, 2002	$	383,500,000	23.4 years
July 1, 2004	$	757,800,000	Over 30 years*

* The reviewing actuary contracted by the Teachers' Retirement Board and the Legislative Audit Division calculated an amortization period of 71.3 years.

Source: Compiled by the Legislative Audit Division from actuarial reports.

The actuary attributed the growth in the unfunded liability of the System to investment returns below the actuarial investment return assumption of 8.0 percent.

The System actuary projected, in its July 1, 2002 valuation report, that the System's $443 million in unrecognized asset losses, "if not offset by future gains, will cause the amortization period of the UAAL in future valuations to fall outside the measures accepted as financially sound. Therefore, to stay financially sound in the future, the System will need either (1) future gains such as asset returns well over 8.0 percent, or (2) an increase in contribution rates." The System actuary further cautioned, in its July 1, 2004, valuation report, that the $131 million in actuarially unrecognized asset losses that will be recognized over the next four fiscal years, "if not offset by future gains, will cause the contributions needed to amortize the UAAL in future valuations to increase even further."

The Teachers' Retirement Board's Funding and Benefits Policy states, "whenever the amortization period of the unfunded liabilities for two consecutive valuations are projected to exceed 30 years through the use of long term cash flow projections, and the Board cannot reasonably anticipate that the amortization period would decline without an increase in funding sources, it is the obligation of the Board to recommend to the legislature that funding be increased." Because the July 1, 2002, and 2004, actuarial valuations projected an amortization period of the unfunded liabilities that exceeds 30 years, the Teachers' Retirement Board should seek legislation for funding changes, as required by Board policy.

Recommendation #1

We recommend the Teachers' Retirement Board seek legislation for funding changes to ensure the Teachers' Retirement System is funded on an actuarially sound basis, as required by Board policy and the Montana Constitution.

Independent Auditor's Report, System Financial Statements, Required Supplementary Information, and Supplementary Information

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

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

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, 2004, and 2003, 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 System as of June 30, 2004, and 2003, 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.

Management's Discussion and Analysis, 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 required supplementary information. However, we did not audit the information and express no opinion on it.

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Our audit was conducted for the purpose of forming an opinion on the basic financial statements of the Teachers' Retirement System. The Supporting Schedules of Administrative Expenses and Consultant and Professional Services are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Respectfully submitted,

(Signature on File)

James Gillett, CPA
Deputy Legislative Auditor

October 29, 2004

The Teachers' Retirement System
Management's Discussion and Analysis,
Financial Statements, Required Supplementary Information,
and Supplementary Information

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 the TRS's financial activities for the fiscal year ended June 30, 2004. Please read this in conjunction with the financial statements with accompanying footnotes, required supplementary information with notes, and supporting schedules.

Overview of the Financial Statements

This financial section consists of two financial statements with footnotes, two schedules of historical trend information with footnotes, and two supporting schedules. 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 Contributions from the Employer and Other Contributing Entities displays historical trend data of the annual required employer contributions and the actual contributions made by employers in relation to the requirement.

The schedule of administrative expenses is a presentation of what comprises the administrative expense item as reported on the Statement of Changes in Fiduciary Net Assets. The schedule of consultant and professional services is used to provide information on fees paid to outside professionals.

Financial Highlights

- The TRS plan net assets increased by $231.2 million representing a 10.9% increase for the fiscal year ended June 30, 2004.
- Total contributions to the plan also increased by 3.5% from the previous year from $104.3 million to $107.9 million.
- Net investment income (fair value of investments plus investment income less investment expense) showed a gain of $155.5 million for the fiscal year. Representing an increase of 123.1%.
- Pension benefits and withdrawals paid to beneficiaries and plan members totaled $156.1 million for the fiscal year, an increase of 6.4% from the previous year.
- Administrative expenses totaled $1.51 million down from $1.86 million, a decrease of 18.8%.

Financial Analysis (in millions)

	FY2004	FY2003	Percent Inc/(Dec)
Cash/Cash Equivalents	$ 78.1	$ 67.2	16.2 %
Investments (fair value)	2,362.5	2,098.8	12.6
Liabilities	109.2	70.4	55.1
Net Assets	2,354.8	2,123.6	10.9
Contributions	107.9	104.3	3.5
Net Investment Income	281.8	126.3	123.1
Benefit Pmts & Withdrawals	156.1	146.7	6.4
Administrative Expenses	1.51	1.86	(18.8)

- The increase in cash/cash equivalents is due primarily to an increase in our number of shares held in the Short Term Investment Pool.
- The increase in liabilities is due mostly to a $38.4 million increase in the value of Securities on Loan at June 30, 2004.
- The increase in net investment income was due primarily to the greater appreciation of $121.8 million in the fair value of our investments from the previous year.
- 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 primarily to a decrease in amortization costs of intangible assets.

Overview of the Actuarial Funding

While the financial statements show a positive net investment income return of $281.8 million for fiscal year 2004, the actuarial return is still less than the actuarial assumed rate of 8% as illustrated below. Actuarial gains or losses result when the return on the actuarial value of assets differs from the actuarial investment return assumption.

Fiscal Year	Market Return	Actuarial Return	Actuarial Return over 8.0% Assumption
7/1/2000 to 6/30/2001	(5.1)%	9.2%	1.2%
7/1/2001 to 6/30/2002	(7.3)%	3.8%	(4.2)%
7/1/2002 to 6/30/2003	6.2%	1.6%	(6.4)%
7/1/2003 to 6/30/2004	13.3%	2.1%	(5.9)%

The asset loss in the last two years increased the unfunded actuarial accrued liability (UAAL) by about $302 million. Without the asset losses, the UAAL would be closer to $571 million instead of the $873 million showing in the Schedule of Funding Progress. The root of these losses were the negative market returns of (5.1)% and (7.3)% in the years ending 6/30/2001 and

6/30/2002. The asset valuation method spreads any market value gains or losses evenly over the five years after they occur. As of July 1, 2002 the System had $443 million in unrecognized asset losses. At July 1, 2004 the System has $131 million in unrecognized asset losses. This $131 million in unrecognized asset losses, if not offset by future gains, will cause the contributions needed to amortize the UAAL in future valuations to increase even further. Therefore, to be actuarially sound in future years, the System will need to incur asset returns well over the new 7.75% assumption or an increase in contribution rates.

The actuarial valuation as of July 1, 2004, was completed and distributed in November 2004. Based on the results of this valuation the TRS Board will recommend options to the Legislature that are considered necessary to be actuarially sound.

An actuarial review of the TRS was contracted by the State of Montana's Legislative Audit Division and the Teacher's Retirement Board in 2004. The actuarial review included a full reproduction of the July 1, 2004 actuarial valuation results prepared by the TRS actuary, Milliman, and a review of recent experience studies and actuarial assumptions and methods used in the valuations. Mellon was selected to perform the actuarial review.

Mellon reported that they did not find any significant errors or concerns regarding the valuation prepared by Milliman and the valuation fairly represents the actuarial position and funding requirements of the retirement system. Mellon also concurs with Milliman's conclusion that the employer contribution rate should be increased by at least 2.8% in order to meet a 30-year amortization period. The report contained only two recommendations for improving disclosure and communication of actuarial valuation results. These recommendations do not impact the actuarial valuation results. The full report is available from the TRS, or online at www.trs.doa.state.mt.us/trs_board_info.htm.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF FIDUCIARY NET ASSETS
JUNE 30, 2004 AND 2003

	2004	2003
ASSETS		
Cash/Cash Equivalents-Short Term		
Investment Pool (Note B)	$ 78,154,124	$ 67,248,556
Receivables:		
Accounts Receivable	14,337,374	15,568,694
Interest Receivable	8,055,656	8,927,249
Due from Primary Government	80,195	84,300
Total Receivables	$ 22,473,225	$ 24,580,243
Investments, at fair value (Note B):		
Mortgages	$ 54,989,718	$ 90,823,459
Investment Pools	2,189,335,826	1,926,576,113
Other Investments	9,708,721	11,326,655
Securities Lending Collateral	108,506,737	70,099,111
Total Investments	$ 2,362,541,002	$2,098,825,338
Assets Used in Plan Operations:		
Land and Buildings	$ 193,844	$ 193,844
Less: Accumulated Depreciation	(128,591)	(124,827)
Equipment	147,087	147,087
Less: Accumulated Depreciation	(126,281)	(121,066)
Prepaid Expense	3,517	2,992
Intangible Assets, net of amortization (Note D)	776,505	3,320,631
Total Other Assets	$ 866,081	$ 3,418,661
TOTAL ASSETS	$2,464,034,432	$2,194,072,798
LIABILITIES		
Accounts Payable	$ 247,108	$ 212,760
Due to Primary Government	327,761	22,562
Securities Lending Liability (Note B)	108,506,737	70,099,111
Compensated Absences (Note B)	108,627	104,105
TOTAL LIABILITIES	$ 109,190,233	$ 70,438,538
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$2,354,844,199	$2,123,634,260

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, 2004 AND 2003

	2004	2003
ADDITIONS		
Contributions:		
Employer	$ 55,773,716	$ 53,276,950
Plan Member	51,382,941	50,221,491
Other	770,379	753,838
Total Contributions	$ 107,927,036	$ 104,252,279
Misc Income	$ 0	$ 4,011
Workers Comp. Dividend	199	213
Taxes	53	236
Investment Income:		
Net Appreciation in Fair Value of Investments	$ 152,473,601	$ 30,665,509
Investment Earnings	132,052,991	98,020,849
Security Lending Income (Note B)	1,153,276	1,268,968
Investment Income	$ 285,679,868	$ 129,955,326
Less: Investment Expense	2,948,793	2,683,417
Less: Security Lending Expense (Note B)	938,082	1,025,993
Net Investment Income	$ 281,792,993	$ 126,245,916
Total Additions	$ 389,720,281	$ 230,502,655
DEDUCTIONS		
Benefit Payments	$ 150,270,797	$ 140,229,496
Withdrawals	5,843,069	6,468,324
Administrative Expense	1,506,694	1,860,967
Loss on Intangible Assets (Note D)	889,782	0
Total Deductions	$ 158,510,342	$ 148,558,787
NET INCREASE (DECREASE) IN FIDUCIARY NET ASSETS	$ 231,209,939	$ 81,943,868
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS BEGINNING OF YEAR	2,123,634,260	2,041,691,136
Prior Period Adjustment		(744)
END OF YEAR	$2,354,844,199	$2,123,634,260

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
NOTES TO THE FINANCIAL STATEMENTS
FISCAL YEARS ENDED JUNE 30, 2004 AND 2003

NOTE A. 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 persons in Montana employed as teachers or professional staff of any public elementary or secondary school, community college 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, 2004, the number and type of reporting entities participating in the system were as follows:

Local School Districts	372
Community Colleges	3
University System Units	2
State Agencies	8
Total	385

At June 30, 2004, the system membership consisted of the following:

Retirees and Beneficiaries Currently Receiving Benefits	9,970
Terminated Employees Entitled to But Not Yet Receiving Benefits	9,330
Current Active Members:	
Vested	11,683
Nonvested	6,574
Total Membership	37,557

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. A Guaranteed Annual Benefit Adjustment (GABA) of 1.5% is payable each January if the retiree has received at least 36 monthly retirement benefit payments prior to January 1 of the year in which the adjustment is to be made.

NOTE B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The 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.

Compensated Absences

Compensated absences represent 100 percent of accrued vacation and 25 percent of accrued sick leave for TRS personnel at June 30, 2004 and June 30, 2003.

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 $11,040 in fiscal year 2004 and $17,326 in fiscal year 2003. 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, 2004 and 2003 include: Montana Domestic Equity Pool (MDEP); Montana International Equity Pool (MTIP); Short-Term Investment Pool (STIP); Retirement Funds Bond Pool (RFBP); Montana Private Equity Pool (MPEP), and Other Investments.

1. The BOI established the MDEP in April 2003. The MDEP portfolio may include common stock, equity index, preferred stock, convertible equity securities, American Depositary Receipts and equity derivatives. The initial MDEP unit value on May 1, 2003 was $100. Unit value at June 30, 2004 and June 30, 2003 was $122.95 per unit and $106.01 per unit respectively.

2. The MTIP portfolio includes equity investments in six funds - BOI Internal International through January 2004, Pyrford International, Schroder Investment Management NA, Nomura Asset Management U.S.A, Inc. from December 2003, SG Yamaichi Asset Management Co. through October 2003, the BGI MSCI Europe Index Fund and the BGI All Country Pacific Index Strategy Fund. The six 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 and once a month at the close of the last business day of the month, based upon the fair value of the MTIP equity holdings, other assets and

liabilities. Unit value at June 30, 2004 and June 30, 2003 was $107.70 per unit and $83.39 per unit respectively.

3. STIP as per Montana Code Annotated (MCA) sections 17-6-201, 202 and 204, requires investments by state agencies of available funds. The STIP unit value is fixed at $1 for both participant buys and sells. The STIP portfolio may include asset-backed securities, commercial paper, corporate and government securities, repurchase agreements, and variable-rate (floating-rate) instruments to provide diversification and a competitive rate of return.

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 BOI 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, government, Yankee securities and cash investments. Unit values are calculated weekly and at month end based on portfolio pricing. Unit value at June 30, 2004 and June 30, 2003 was $104.32 per unit and $110.84 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).

As of June 30, 2004 and June 30, 2003, Enron Corp. and Burlington Industries, 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, the November 2001 book value for the two issues was reduced to $5.6 million as of June 30, 2002. In October 2002, the book value was reduced to $2.8 million for both issues. In July 2003, both issues were sold, on the market, for a total of $2.36 million.

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 from the August 31, 2000 book value of $5,609,640 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. In October 2003, Burlington Industries, Inc. received court approval to sell its assets. Under the company's recovery plan, the BOI received $1,454,961 in August 2004 for its unsecured claim. This transaction reduced the book value to $0 and generated a gain of $254,961. The BOI is expected to receive additional proceeds for its claim.

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 BOI 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 BOI received $5,683,075 in principal and interest plus $150,000 as a consent fee. As of September 10, 2004, this matter is still pending.

5. The MPEP was established by the BOI in April 2002. Given the complexity and specialization of private equity investment, the BOI contracts with seven 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, Lexington Partners, Oaktree Capital Management and ArcLight Energy Partners. According to BOI policy, the external managers may not invest more than 30% of total private equity invested capital in non-US company partnerships unless the fund is a designated non-US fund. Total non-US exposure in MPEP is limited to 25% of total invested capital.

The MPEP portfolio includes venture capital, leveraged buyout, mezzanine, distressed debt, special situation and secondary investments. 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. Mezzanine investments are the subordinated debt and/or equity of privately owned companies. Distressed debt represents the private and public debt of companies that appear unlikely to meet their financial obligations. Special situation investments include the investment in the exploration for oil and/or gas reserves or in the development of proven reserves, investment in land to harvest timber, and investments that have a special component usually related to geographical, economic, or social issues. Secondary investments are investments in previously owned limited partnerships. These investments may be direct or via a general partner specializing in secondary investments.

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. Unit value at June 30, 2004 and June 30, 2003 was $99.26 and $102.28 per unit respectively. The unit value is calculated at month end.

6. Other Investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle" and applicable investment restrictions of the participants. The TRS portfolio includes residential mortgages, commercial loans and real estate investments. The real estate investments and mortgages are valued based on a discounted cash flow.

Real Estate - In January 1996, the BOI, on behalf of the Public Employees' and Teachers' Retirement funds, purchased the 100 North Park Avenue Building in Helena, Montana as a real estate investment. Acquired for a cost of $4,864,326, the building carries a fair value of $5,795,000 as of June 30, 2004. During fiscal year 2004, building improvements for lighting, fire alarms, sprinkler systems, hallway remodeling and leasing fees totaling $453,209 were added to the cost of the building. Building improvements and leasing fees totaling $129,465 were added to the cost of the building in fiscal year 2003. The three-story building provides office space for approximately eight to ten tenants.

In August 1997, the BOI authorized the construction of an office building at 2401 Colonial Drive in Helena, as a real estate investment owned equally by the Public Employees' and Teachers' Retirement funds. Construction costs, including interest capitalization, totaled $6,481,741 as of June 30, 2000. In fiscal year 2004, office remodeling payments and leasing fees of $54,517 were added to the building cost. For fiscal year 2003, $155,800 was expended on building landscaping, leasing fees, lighting and construction. The three-story building, providing office space for three tenants, was occupied in November 1999. As of June 30, 2004, the building carries a cost and fair value of $7,041,755 and $7,581,000, respectively.

In August 1999, the BOI authorized the purchase of a new office building at 2273 Boot Hill Court in Bozeman, Montana. Construction was completed in March 2004. The Public Employees' and Teachers' Retirement funds purchased the building, as a real estate investment with equal ownership, for $2,051,032. The building, located on state school trust land, is occupied by four state agencies. As of June 30, 2004, the building carries a fair value of $2,082,014.

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 2004 and 2003, State Street Bank lent, on behalf of the BOI, certain securities held by State Street, as custodian, and received US dollar currency cash, US 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.

The BOI did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street Bank made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street Bank.

During fiscal years 2004 and 2003, the 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 the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine.

As of June 30, 2004, the carrying and fair value of the underlying securities on loan for the All Other Funds was $219,045,397 and $222,235,651, respectively. The collateral provided for the securities on loan totaled $228,078,235 representing $226,699,848 in cash and $1,378,387 in securities collateral.

As of June 30, 2003, the carrying and fair value of the underlying securities on loan for the All Other Funds was $49,363,730 and $55,128,809, respectively. The collateral provided for the securities on loan totaled $56,643,400 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 BOI 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 BOI received $2,273,230 in principal and interest plus $60,000 as a consent fee. As of November 5, 2004, this matter is still pending.

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. Each employer in the Montana university system shall contribute to the TRS a supplemental employer contribution currently at a rate of 4.04% of the total compensation of employees participating in the Optional Retirement Program (ORP). 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, 2004, the most recent valuation date, indicates the statutory rate is insufficient to fund the normal cost and to amortize the unfunded accrued liability under the entry age actuarial cost method over 30 years. The unfunded actuarial accrued liability is included in the Schedule of Funding Progress.

NOTE D. CAPITAL ASSET LOSS

In May of 1999, TRS contracted with BearingPoint, Inc. (formerly KPMG Consulting), to customize, integrate and implement the PeopleSoft Pension Administration, Human Resource and Financials modules. On December 23, 2002, the Board indefinitely suspended the implementation date for the PeopleSoft system in anticipation of discontinuing the contract with BearingPoint. On July 22, 2003 working through a mediator an agreement was reached in which BearingPoint would pay TRS $1.5 million and the contract would end. TRS received the $1.5 million payment on September 12, 2003. At that time it was determined the actual value of the usable software development to TRS was $847,096. This resulted in a net loss on intangible assets of $889,782 to TRS in fiscal year 2004.

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, 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	71.0	501.5	112.2
July 1, 1998[4]	1,809.0	2,123.3	314.3	85.2	529.8	59.3
July 1, 1998[5]	1,809.0	2,342.7	533.7	77.2	529.8	100.7
July 1, 2000[6]	2,247.5	2,648.3	400.8	84.9	537.5	74.6
July 1, 2000[7]	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
July 1, 2004	2,485.7	3,359.2	873.5	74.0	600.7	145.4

(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.*

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

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

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

(7) *July 1, 2000 results adjusted for $600 minimum benefit for legislation which 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
6/30/2003	597,131	53,277	7.58	7.58	100
6/30/2004	600,728	55,774	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 the Fiscal Year ended June 30, 2004 there were $6.2 million of contributions for termination pay. Contributions made as a percentage of the salaries of the members in the Optional Retirement Plan (ORP) are included. In the Fiscal Year ended June 30, 2004, $4.7 million was 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.*

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
NOTES TO THE REQUIRED SUPPLEMENTARY INFORMATION

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, 2004.

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 accrued liability. The unfunded actuarial accrued liability is amortized as a level percentage of the projected salaries of present and future members of the System.

The ultimate cost of any pension program over time equals the benefits paid and expenses incurred while administering the program. The source of revenue used to pay for this cost is equal to the contribution from employers and employees to fund the program, plus investment return earned on contributions made through pre-funding the benefit payments.

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 were smoothed 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 7.75%, compounded annually. (Adopted effective July 1, 2004)

Guaranteed Annual Benefit Adjustment Increases

On January 1 of each year, the retirement allowance payable must be increased by 1.5% if the retiree has received at least 36 monthly retirement benefit payments 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 4.5% 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, 2004 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 insufficient 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 30 years as of July 1, 2004.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
SUPPORTING SCHEDULES
FISCAL YEARS ENDED JUNE 30, 2004 AND 2003

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, 2004 and 2003, are outlined below:

Budgeted Expenses:	2004	2003
Personal Services:		
Salaries	$ 587,001	$ 589,127
Other compensation	2,250	2,000
Employee benefits	164,040	151,779
Total Personal Services	$ 753,291	$ 742,906
Operating Expenses:		
Contracted services	$ 377,440	$ 401,576
Supplies and materials	26,050	36,052
Communications	40,380	38,334
Travel	13,172	10,624
Rent	41,184	31,928
Repair and maintenance	40,948	34,016
Other expenses	46,384	16,571
Total Operating	$ 585,558	$ 569,101
Non-Budgeted Expenses:		
Compensated Absences	4,522	20,294
Depreciation	8,979	12,795
Amortization of Intangible Assets	$ 154,344	$ 515,872
Total Non-Budgeted	$ 167,845	$ 548,961
Total Administrative Expense	**$ 1,506,694**	**$ 1,860,968**

CONSULTANT AND PROFESSIONAL SERVICES

	2004	2003
Personnel Management	$ 4,125	$ 9,688
Actuarial Services	45,764	63,092
Legal Services	31,669	21,344
Medical Evaluations	1,025	1,675
Audit Services	26,099	17,487
Information Technology Services	105,045	142,386
Total Expense	$ 213,727	$ 255,672

System Response

TEACHERS' RETIREMENT SYSTEM

1500 E. SIXTH AVENUE
PO BOX 200139
HELENA, MONTANA 59620-0139 (406) 444-3134 JUDY MARTZ, GOVERNOR

STATE OF MONTANA

December 9, 2004

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DEC 1 0 2004

LEGISLATIVE AUDIT DIV.

Scott A. Seacat
Legislative Auditor
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

Dear Mr. Seacat:

Thank you for the opportunity to reply to the audit report for the Teachers' Retirement System. Once again, we are pleased with the unqualified opinion on the financial statements for the two fiscal years ending June 30, 2004.

The report includes one recommendation that the Teachers' Retirement Board seek legislation for funding changes to ensure the Teachers' Retirement System is funded on an actuarially sound basis, as required by Board policy and the Montana Constitution. The Board concurs with the recommendation.

The Board's Funding and Benefits Policy is an anticipatory approach, based on historical and expected asset returns, designed to forecast the future funding condition of the System. This policy, under normal market conditions, would allow the Board sufficient time to recommend funding increases to the legislature in advance of the System becoming actuarially unsound. As of July 1, 2000, the TRS had an amortization period of 15.1 years, on July 1, 2002 after taking into account benefit enhancements enacted in 2001, two fifths of the asset losses from fiscal year 2001 and one fifth of the loss in fiscal year 2002, the system still had an amortization period of 23.4 years. Even with an amortization period under 30 years, the Board sounded the alarm that the amortization period could exceed 30 years if there were not significant future gains and/or contribution increases. The asset losses experienced in FY 2001 and FY 2002, were unprecedented, and could not have been foreseen under any reasonable policy.

In December 2002, prior to the start of the 2003 Legislative Session, the Teachers' Retirement System wrote the Leadership of the Montana House and Senate advising them of the Board's concerns with a number of legislative proposals that could have significantly increased the System's unfunded liabilities. We informed them of the results of the 2002 Valuation and the Actuary's projection which show that if the unrecognized asset losses of $443 million were not offset by future gains, the amortization period of the System would likely exceed 30 years in the near future.

In anticipation that contribution rate increases would be recommended in 2005, the Board began working with the Governor's Budget Office in late 2003 providing projections regarding our best estimate the long term funded status of the TRS. Early projections and the July 1, 2004 Valuation confirmed that an employer contribution rate increase and/or benefit reductions are required to ensure that the TRS will remain actuarially sound.

In addition, the State of Montana's Legislative Audit Division, and the Teachers' Retirement Board authorized an independent actuarial review of the Teachers Retirement System. The actuarial review included a full reproduction of the July 1, 2004 actuarial valuation results prepared by the TRS actuary, Milliman, and a review of recent experience studies, actuarial assumptions and methods used in the valuations. Mellon was selected to perform the actuarial review and concurred with the results of the July 1, 2004 actuarial valuation.

Legislation has been drafted at the request of the Teachers' Retirement Board for funding changes to ensure the Teachers' Retirement System is funded on an actuarially sound basis, as required by Board policy and the Montana Constitution.

Sincerely,

David L. Senn
Executive Director

DLS/nc