Legislative Audit Division

State of Montana

Report to the Legislature

November 2005

Financial Audit

For the Fiscal Year Ended June 30, 2005

Teachers' Retirement System

This report contains the financial statements and our independent auditor's report for the Teachers' Retirement System for the fiscal year ended June 30, 2005. This report contains one recommendation concerning the actuarial soundness of the retirement system.

Direct comments/inquiries to:
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Helena MT 59620-1705

05-09

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FINANCIAL AUDITS

Financial audits are conducted by the Legislative Audit Division to determine if the financial statements included in this report are presented fairly and the agency has complied with laws and regulations having a direct and material effect on the financial statements. 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 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 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
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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

November 2005

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial audit report on the Teachers' Retirement System (system), a component unit of the state of Montana, for the fiscal year ended June 30, 2005. This report contains one recommendation related to the actuarial soundness of the system.

We issued an unqualified opinion on the system's financial statements for the two fiscal years ended June 30, 2005. 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 2004-05 is expected to be available in late December 2005.

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,

/s/ Scott A. Seacat

Scott A. Seacat
Legislative Auditor

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Legislative Audit Division

Financial Audit
For the Fiscal Year Ended June 30, 2005

Teachers' Retirement System

Members of the audit staff involved in this audit were Pearl M. Allen, Chris G. Darragh, Geri Hoffman, and Melissa Soldano.

Table of Contents

Appointed and Administrative Officials

Teachers' Retirement Board

		Term Expires
Tim Ryan, Chair	Great Falls	7/1/09
Scott Dubbs, Vice Chair	Lewistown	7/1/08
Mona Bilden	Miles City	7/1/06
Darrell Laymen	Glendive	7/1/06
Kari Peiffer	Kalispell	7/1/07
James Turcotte	Helena	7/1/10

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
1500 East Sixth Avenue
PO Box 200139
Helena MT 59620-0139
e-mail: dsenn@mt.gov

Teachers’ Retirement System

This report documents the results of our financial audit of the Teachers’ Retirement System for the fiscal year ended June 30, 2005. This report contains one recommendation related to the actuarial soundness of the System. The previous audit report contained one recommendation relating to seeking legislation for funding changes to fund the system on an actuarially-sound basis. Although legislation was sought during the 2005 session, no legislation was passed to correct the funding problem.

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 recommendations contained in the report, the department's response thereto, and a reference to the supporting comments.

Recommendation #1

Agency Response: Conditionally concur. See page B-3.

Introduction

General

We performed a financial audit of the Teachers' Retirement System (system) for the fiscal year ended June 30, 2005. The objectives of our audit were to:

1. Determine if the financial statements prepared by system personnel fairly present the fiduciary net assets of the Teachers' Retirement System as of June 30, 2005, and the changes in fiduciary net assets for the fiscal year then ended, in conformity with generally accepted accounting principles.
2. Determine the system's compliance with direct and material laws and regulations related to the financial statements.

The financial statements are prepared by the Teachers' Retirement System personnel 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.

This report contains one recommendation to the System. Other areas of concern deemed not to have a significant effect on the successful operations of the 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 significant. The cost is discussed in the report section.

Background

The Teacher's Retirement System (system)is a component unit of the state of Montana. A component unit is a legally separate organization for which the state of Montana is financially accountable. The system, established by state law in 1937, had more than 18,247 active members and 1,640 vested inactive members not yet receiving benefits at June 30, 2005. Approximately 10,299 retirees or their beneficiaries were receiving retirement, disability, or survivor benefits as of June 30, 2005.

Introduction

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, but are not limited to, designating an actuary to provide consultation on the technical actuarial aspects of the retirement system. The daily administration of the Teachers' Retirement System is the responsibility of the executive director and system personnel.

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 Montana University System (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 Guaranteed Annual Benefit Adjustment (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.

Prior Audit Recommendations

The financial-compliance audit report for the two fiscal years ended June 30, 2004, contained one recommendation to the board. We recommended the Teachers' Retirement Board seek legislation for funding changes to ensure the system is funded on an actuarially-sound basis. During our financial audit for the fiscal year ended June 30, 2005, we determined the board implemented this recommendation since they sought legislation. However, the 2005 Legislature did not enact any legislation addressing the actuarial soundness of the system. The system's actuarial soundness is discussed in this report beginning on page 3.

Findings and Recommendations

System Not Actuarially Sound

The results of the July 1, 2005 actuarial valuation show the System is not funded on an actuarially-sound basis as required by the Montana Constitution.

Article VIII, section 15, of the Montana Constitution and Governmental Accounting Standards Board Statement No. 25, paragraph 36, 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 and investment earnings to fund current employees' future benefits, and pay the unfunded actuarial accrued liability.

The Teachers' Retirement Board obtained an actuarial valuation of the system for each of the last two years. The most recent actuarial valuation was as of July 1, 2005. The actuary determined that, as of July 1, 2005, the employer contribution rate would have to be increased by 4.06 percent starting July 1, 2006, to maintain an amortization of the unfunded actuarial accrued liability (UAAL) over the 30-year period starting July 1, 2005.

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	Years
July 1, 2000	$ 304,400,000	15.1 years
July 1, 2002	$ 383,500,000	23.4 years
July 1, 2004	$ 757,800,000	71.3 years
July 1, 2005	$ 903,300,000	Does not amortize*

* At the current contribution rate, the system will never be sound.

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 for 2000-2004 and 7.75 percent in 2005.

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." The system actuary again 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."

As noted above in Table 1, the UAAL increased from $757,800,000 at July 1, 2004, to $903,300,000 at July 1, 2005. In order to comply with a 30-year amortization period the system currently needs a maximum UAAL of $463 million. The system actuary states, "The actuarial return on assets has underperformed the assumption by over 20 percent in the past five years (combined). Over these five years, the asset losses have increased the UAAL by about $500 million." This actuary report also states, "To stay financially sound in the future, the system will need either (1) future gains such as asset returns well over the 7.75 percent assumption, or (2) an increase in contribution rates."

The net recognized loss for the period ended July 1, 2005, is approximately $113.6 million, as shown in Table 2 below. The amortization period as of July 1, 2006, will recognize a loss of approximately $51.5 million from the past four years, and any gain or loss recognized in 2006.

Table 2

Schedule of Investment Gain/(Loss) Recognition (Expressed in Millions)

Year Ending 06/30	Market Value Investment Gain/(Loss) Over Expected	Investment Gain/(Loss) Recognized in Past Years				**Investment Gain/(Loss) Recognized in Current Year**	Investment Gain/(Loss) to be Recognized in Future Years			
		2001	2002	2003	2004	**2005**	**2006**	2007	2008	2009
2001	($310.50)	($62.10)	($62.10)	($62.10)	($62.10)	**($ 62.10)**				
2002	($338.90)		($67.80)	($67.80)	($67.80)	**($ 67.80)**	**($67.80)**			
2003	($ 37.20)			($ 7.40)	($ 7.40)	**($ 7.40)**	**($ 7.40)**	($ 7.40)		
2004	$ 114.40				$22.30	**$ 22.30**	**$22.30**	$22.30	$22.30	
2005	$ 6.80					**$ 1.40**	**$ 1.40**	$ 1.40	$ 1.40	$ 1.40
2006	*						*	*	*	*
Total Net Gross (Loss)						**($113.6)**				

* Gain / (Loss) Not yet known

Source: Montana Teachers' Retirement System

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 did seek legislation for funding changes in the 2005 Legislative Session. However, new legislation was not enacted. The board should work with the legislature to adopt and implement a funding change to ensure the system is funded on an actuarially-sound basis in compliance with the Montana Constitution.

Recommendation #1

We recommend legislation be enacted to provide funding to ensure the Teachers' Retirement System is funded on an actuarially-sound basis as required by 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, 2005 and 2004, 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, 2005 and 2004, 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

At July 1, 2005, the system was not actuarially sound with an Unfunded Actuarially Accrued Liability (UAAL) totaling $903.3 million. In order to comply with a 30-year amortization period the system currently needs a maximum UAAL totaling $463 million. The asset valuation method spreads any market value gains or losses evenly over the five years after they occur. The asset losses over the last five years have increased the UAAL by about $500 million.

Respectfully submitted,

/s/ James Gillett

James Gillett, CPA
Deputy Legislative Auditor

October 7, 2005

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

The following discussion and analysis of the Montana Teachers' Retirement System's (TRS) annual report provides a narrative overview of the TRS's financial activities for the fiscal year ended June 30, 2005 with comparative totals for 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

Because of the long-term nature of a defined benefit pension plan, financial statements alone cannot provide sufficient information to properly reflect the System's ongoing plan perspective.

The 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 $132.3 million representing a 5.6% increase for the fiscal year ended June 30, 2005.
- Total contributions to the plan also increased by 2.6% from the previous year from $107.9 million to $110.7 million.
- Net investment income (fair value of investments plus investment income less investment expense) showed a decrease of $93.1 million from the previous year. Representing a decrease of approximately 33%.
- Pension benefits and withdrawals paid to beneficiaries and plan members totaled $165.6 million for the fiscal year, an increase of 6.1% from the previous year.

Financial Analysis (in millions)

	FY2005	FY2004	Percent Inc/(Dec)
Cash/Cash Equivalents	$ 31.9	$ 78.1	(59.2) %
Investments (fair value)	2,540.6	2,362.5	7.5
Liabilities	107.2	109.2	(1.8)
Net Assets	2,487.1	2,354.8	5.6
Contributions	110.7	107.9	2.6
Net Investment Income	188.7	281.8	(33.0)
Benefit Pmts & Withdrawals	165.6	156.1	6.1
Administrative Expenses	1.56	1.51	.03

- The decrease in cash/cash equivalents is due primarily to a decrease in our number of shares held in the Short Term Investment Pool.
- The decrease in net investment income was due primarily to the decrease of $39.6 million in the net appreciation of the fair value of our investments from the previous year and a decrease of $52.7 million in our investment earnings. Also the BOI instituted a policy change in FY2005 for the Montana Private Equity Pool (MPEP) whereby realized gains/losses would remain in the fund and not be distributed to pool participants.
- 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.

Overview of the Actuarial Funding

While the financial statements show a positive net investment income return of $188.7 million for fiscal year 2005, the actuarial return is still less than the actuarial assumed rate of 7.75% 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 (7.75% effective 7/1/04)
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)%
7/1/2004 to 6/30/2005	8.0%	2.7%	(5.05)%

The asset losses over the last five years has increased the unfunded actuarial accrued liability (UAAL) by about $500 million. 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, 2004 the System had $131 million in unrecognized asset losses. At July 1, 2005 the System has $10 million in unrecognized asset losses. This $10 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, 2005, was completed and distributed in October 2005. Based on the results of this valuation the TRS Board will recommend options to the Legislature that are considered necessary to be actuarially sound.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF FIDUCIARY NET ASSETS
JUNE 30, 2005 AND 2004

	2005	2004
ASSETS		
Cash/Cash Equivalents-Short Term		
Investment Pool (Note B)	$ 31,855,506	$ 78,154,124
Receivables:		
Accounts Receivable	15,334,314	14,337,374
Interest Receivable	5,709,232	8,055,656
Due from Primary Government	152,802	80,195
Total Receivables	$ 21,196,348	$ 22,473,225
Investments, at fair value (Note B):		
Mortgages	$ 43,153,151	$ 54,989,718
Investment Pools	2,382,433,759	2,189,335,826
Other Investments	7,949,031	9,708,721
Securities Lending Collateral	107,020,752	108,506,737
Total Investments	$ 2,540,556,693	$ 2,362,541,002
Assets Used in Plan Operations:		
Land and Buildings	$ 193,844	$ 193,844
Less: Accumulated Depreciation	(132,354)	(128,591)
Equipment	147,087	147,087
Less: Accumulated Depreciation	(127,921)	(126,281)
Prepaid Expense	3,126	3,517
Intangible Assets, net of amortization (Note D)	691,795	776,505
Total Other Assets	$ 775,577	$ 866,081
TOTAL ASSETS	$ 2,594,384,124	$ 2,464,034,432
LIABILITIES		
Accounts Payable	$ 77,551	$ 247,108
Due to Primary Government	32,212	327,761
Securities Lending Liability (Note B)	107,020,752	108,506,737
Compensated Absences (Note B)	117,069	108,627
TOTAL LIABILITIES	$ 107,247,584	$ 109,190,233
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$ 2,487,136,540	$ 2,354,844,199

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, 2005 AND 2004

	2005	2004
ADDITIONS		
Contributions:		
Employer	$ 57,150,364	$ 55,773,716
Plan Member	52,900,262	51,382,941
Other	655,812	770,379
Total Contributions	$ 110,706,438	$ 107,927,036
Misc Income	$ 98	$ 53
Workers Comp. Dividend	0	199
Investment Income:		
Net Appreciation in Fair Value of Investments	$ 112,888,982	$ 152,473,601
Investment Earnings	79,373,616	132,052,991
Security Lending Income (Note B)	2,460,271	1,153,276
Investment Income	$ 194,722,869	$ 285,679,868
Less: Investment Expense	3,701,090	2,948,793
Less: Security Lending Expense (Note B)	2,287,406	938,082
Net Investment Income	$ 188,734,373	$ 281,792,993
Total Additions	$ 299,440,909	$ 389,720,281
DEDUCTIONS		
Benefit Payments	$ 161,247,366	$ 150,270,797
Withdrawals	4,340,382	5,843,069
Administrative Expense	1,560,820	1,506,694
Loss on Intangible Assets (Note D)	0	889,782
Total Deductions	$ 167,148,568	$ 158,510,342
NET INCREASE (DECREASE) IN FIDUCIARY NET ASSETS	$ 132,292,341	$ 231,209,939
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS BEGINNING OF YEAR	2,354,844,199	2,123,634,260
END OF YEAR	$2,487,136,540	$2,354,844,199

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

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, 2005, the number and type of reporting entities participating in the system were as follows:

Local School Districts	368
Community Colleges	3
University System Units	2
State Agencies	8
Total	381

At June 30, 2005, the system membership consisted of the following:

Retirees and Beneficiaries Currently Receiving Benefits	10,299
Terminated Employees Entitled to But Not Yet Receiving Benefits	10,071
Current Active Members:	
Vested	11,756
Nonvested	6,491
Total Membership	38,617

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, 2005 and June 30, 2004.

Cash/Cash Equivalents and Investments

Cash and cash equivalents consist of funds deposited in the State Treasurer's pooled cash account and cash invested in the Short-Term Investment Pool. The Montana Board of Investments (BOI) manages the State's Unified Investment Program, which includes the TRS plan investments as required by Section 19-20-501, Montana Code Annotated. Per the Montana Constitution, Article VIII Section 13(3), investment of TRS assets shall be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use in the conduct of an enterprise of a similar character with similar aims. TRS assets may be invested in private corporate capital stock.

Investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. The six areas of investment include: Short-Term Investment Pool (STIP); Retirement Funds Bond Pool (RFBP); Montana Domestic Equity Pool (MDEP); Montana International Equity Pool (MTIP); Montana Private Equity Pool (MPEP), and All Other Funds (AOF).

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, 105% in MTIP, 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 2005 and 2004, 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 2005 and 2004 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 2005 and 2004. Moreover, there were no losses during fiscal years 2005 and 2004 resulting from a default of the borrowers or State Street Bank.

During fiscal years 2005 and 2004, 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.

Effective June 30, 2005, the TRS implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40 – Deposit and Investment Risk Disclosures. Detailed information demonstrating the risks associated with the TRS plan investments is contained in the State of Montana BOI financial statements, and may be accessed by contacting the Board of Investments at P.O. Box 200126, Helena, MT 59620-0126. The investment risks are described in the following paragraphs.

Credit Risk - Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation.

The STIP securities and the RFBP fixed income instruments with the exception of the U.S. government securities have credit risk as measured by major credit rating services. The risk is that the issuer of a STIP or RFBP security may default in making timely principal and interest payments. The BOI policy requires that STIP securities have the highest investment grade rating in the short term category by at least one Nationally Recognized Statistical Rating Organization (NRSRO). For the RFBP fixed income investments the BOI policy requires the investments at the time of purchase to be rated an investment grade as defined by Moody's or Standard & Poors's rating services.

Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality.

Custodial Credit Risk - Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party.

As of June 30, 2005 and June 30, 2004, all STIP, RFBP, MDEP and MTIP securities were registered in the nominee name for the Montana BOI and held in the possession of the BOI's custodial bank, State Street Bank. According to the STIP Investment Policy, "repurchase agreements require electronic delivery of U.S. Government Treasury collateral, priced at 102 percent market value, to the designated State of Montana Federal Reserve Bank account." All other repurchase agreements were purchased in the State of Montana BOI name. All other investments are registered in the name of the Montana BOI.

Concentration of Credit Risk – Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer.

The STIP Investment Policy Statement does not specifically address concentration of credit risk. The policy does provide for "minimum 3% or $15 million, whichever is higher, to be invested in Repurchase Agreements." As of June 30, 2005, there were no single issuer investments that exceeded 5% of the STIP portfolio.

According to the RFBP Investment Policy, "with the exception of U.S. government indirect-backed (agency) securities, additional RFBP portfolio purchases will not be made in a credit if the credit risk exceeds 2 percent of the portfolio at the time of purchase". As of June 30, 2005, the RFBP had a concentration of credit risk exposure to the Federal Home Loan Mortgage Corp of 6.21%. As of June 30, 2004, there were no single issuer investments that exceeded 5% of the RFBP portfolio.

The MDEP investments in pooled investments, such as index funds, are excluded from this requirement. As of June 30, 2005 and 2004 there were no single issuer investments that exceeded 5% of the MDEP portfolio.

Interest Rate Risk – Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. In accordance with GASB Statement No. 40, the BOI selected the effective duration method to disclose interest rate risk.

According to GASB Statement No. 40, interest rate disclosures are not required for STIP since STIP is a 2a-7-like pool. The RFBP and AOF investment policies do not formally address interest rate risk.

Foreign Currency Risk – Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment.

The MTIP has significant investments in 19 foreign countries. Future economic and political developments in these countries could adversely affect the liquidity or value, or both, of the securities held by the funds in which MTIP is invested. At June 30, 2005 approximately 39.5% of the TRS MTIP portfolio is held in foreign currencies.

The TRS investments subject to credit and interest rate risk at June 30, 2005 and June 30, 2004 are categorized below:

Investment		Fair Value 6/30/05	Fair Value 6/30/04	Rating 6/30/05	Rating 6/30/04	Duration 6/30/05	Duration 6/30/04
STIP	$	27,619,404	NA	A1+	NA	NA	NA
RFBP		704,451,127	617,565,665	AA-	AA-	4.95	6.63

*NA (not applicable)

The securities in the RFBP have a maturity ranging from 8/1/2005 to 6/12/2041.

The investment security type MTIP is subject to foreign currency risk at June 30, 2005 as categorized below converted to value in U.S. dollars:

Currency	Carrying Amount 6/30/05	Fair Value 6/30/05	% of Total Investment
Australian Dollar	9,324,767	13,069,609	3.4
France Euro	4,807,346	7,074,643	1.8
Germany Euro	955,424	1,263,926	0.3
Hong Kong Dollar	5,089,469	6,260,393	1.6
Indonesian Rupiah	271,458	389,114	0.1
Ireland Euro	2,726,215	3,132,999	0.8
Japanese Yen	51,298,738	56,043,593	14.5
Malaysian Ringgit	1,471,655	1,532,945	0.4
Netherlands Euro	5,662,069	6,627,187	1.7
New Taiwan Dollar	5,888,132	6,709,912	1.7
New Zealand Dollar	264,615	306,603	0.1
Philippine Peso	725,708	780,675	0.2
Portugal Euro	517,596	511,181	0.1
Pound Sterling	15,085,390	17,289,154	4.5
Singapore Dollar	2,376,100	2,745,693	0.7
South Korean Won	4,385,293	6,224,339	1.6
Spain Euro	5,815,699	8,740,826	2.3
Swiss Franc	12,149,069	13,106,742	3.4
Thailand Baht	927,900	1,120,783	0.3
US Dollar	194,717,022	231,326,060	59.7
Total	324,459,665	384,256,377	99.2

1. 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.

2. The RFBP portfolio includes securities classified as corporate, foreign government bonds, U.S. government direct-backed, U.S. government indirect-backed, and cash equivalents. U.S. government direct-backed securities include direct obligations of the U.S. Treasury and obligations explicitly guaranteed by the U.S. government. U.S. government indirect-backed obligations include U.S. government agency and mortgage-backed securities. U.S. government mortgage-backed securities reflect participation in a pool of residential mortgages. Unit values are calculated weekly and at month end based on portfolio pricing. Unit value at June 30, 2005 and June 30, 2004 was $105.31 per unit and $104.32 per unit respectively.

As of June 30, 2005, Delta Airlines Corp. presented a higher credit risk to the BOI. The RFBP holds $3 million par 10.0% Delta Airlines Corp. bond maturing June 5, 2013, a $1.971 million par 10.0% Delta Airlines Corp. bond maturing June 5, 2011 and a $6 million par 10.14% Delta Airlines Corp. bond maturing August 14, 2012. Due to a weak credit outlook and potential bankruptcy, the BOI stopped the interest income accruals after the December 2004 and February 2005 pay dates. Although the interest accruals were stopped, the BOI received the interest due in June 2005 and August 2005. The combined book value of these securities was $10,949,050 as of June 30, 2005. Due to the company's filing for Chapter 11 bankruptcy protection on September 14, 2005, the book values were reduced to $1.5 million, $985,500 and $3 million, respectively.

As of June 30, 2005, Northwest Airlines Inc. presented a higher credit risk to the BOI. The RFBP held a $9,930,036 par 6.81% Northwest Airlines Inc. bond maturing February 1, 2020, a $7,802,614 par 7.935% Northwest Airlines Inc. MBIA Insurance Corp. insured bond maturing April 1, 2019 and a $5,745,000 par 4.64% Northwest Airlines Inc. real estate backed bond maturing July 7, 2010. The combined book value of these securities was $22,989,339 as of June 30, 2005. On September 14, 2005, the company filed for Chapter 11 bankruptcy protection. Due to this action, the BOI stopped the interest income accruals for the 6.81% bond maturing February 1, 2020 after the August 2005 pay date. This issue was sold on September 20, 2005 generating a loss of $642,183. The sale included accrued interest from August 1, 2005 to September 20, 2005. Since the 7.935% bond maturing April 1, 2019 is insured by MBIA Insurance Corp. to support the payment of any interest due and outstanding principal balance, the BOI did not stop the interest income accrual or reduce book value. The 4.64% bond maturing July 7, 2010 is secured by Northwest Airlines Inc.'s corporate headquarters building and land.

As of June 30, 2005 and June 30, 2004, Burlington Industries, Inc. presented a legal and higher credit risk to the BOI. 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. In February 2005 and May 2005, the BOI received an additional $208,771 and $194,247, respectively, for its unsecured claim. The BOI is expected to receive additional proceeds over the next two to three years.

As of June 30, 2004, Winn Dixie presented a higher credit risk to the BOI. The RFBP held a Winn Dixie Trust, $70 million par, zero coupon bond maturing September 1, 2024. Due to a weak credit outlook and collateral uncertainty, the BOI stopped accruing income and reduced the book value to $5.2 million in February 2004. On February 21, 2005, Winn Dixie declared bankruptcy. On February 28, 2005, the BOI sold the bonds and recorded a $4.6 million gain.

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 23, 2005, this matter is still pending.

3. The MDEP portfolio may include common stock, equity index, preferred stock, convertible equity securities, American Depositary Receipts and equity derivatives. Unit value at June 30, 2005 and June 30, 2004 was $128.67 per unit and $122.95 per unit respectively.

OWENS-CORNING COMPLAINT

On October 11, 2002, the BOI received a summons and complaint 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". The BOI has prepared a response to the complaint.

4. 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, the BGI All Country Pacific Index Strategy Fund and DFA International Small Company Portfolio. 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, ADRs, 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, 2005 and June 30, 2004 was $121.64 per unit and $107.70 per unit respectively.

5. 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. Private equity investments are long-term, by design, and very illiquid. Due to the complexity and specialization of private equity investment, the BOI contracts with external private equity managers to invest in venture capital, leveraged buyout and other private equity investments.

Unit value at June 30, 2005 and June 30, 2004 was $116.06 and $99.26 per unit respectively. The unit value is calculated at month end.

6. The AOF investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle" and applicable investment restrictions of the participants. The AOF portfolio includes residential mortgages, multifamily commercial loans and real estate investments. In November and December 2004, the multifamily commercial loans held by TRS were sold to the Coal Severance Tax Trust Fund. 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 $6,024,526 as of June 30, 2005. During fiscal year 2005, building improvements for tenant remodeling, video conferencing, heating/cooling, parking lot resurfacing and leasing fees totaling $151,567 were added to the cost of the building. Building improvements and leasing fees totaling $453,209 were added to the cost of the building in fiscal year 2004. 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. In fiscal year 2005, parking lot resurfacing and heating/cooling improvements of $48,838 were added to the building cost. For fiscal year 2004, $55,287 was expended on building improvements and leasing fees. The three-story building was constructed for a cost of $6,481,741 and provides office space for three tenants. As of June 30, 2005, the building carries a cost and fair value of $7,090,594 and $7,581,000, respectively.

In August 1999, the BOI authorized the purchase of a new office building 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. In fiscal year 2005, telecommunication system payments of $10,238 were added to the building cost. The building, located on state school trust land, is occupied by four state agencies. As of June 30, 2005, the building carries a fair value of $2,082,014.

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 September 23, 2005, 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, 2005, 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]	Present Value of Future University Supplemental Contributions	Unfunded Actuarial Accrued Liabilities (UAAL)[2]	Funded Ratio[3]	Covered Payroll[4]	UAAL as a Percentage of Covered Payroll
July 1, 1996	$ 1,376.7	$ 1,939.6	$ *[9]	$ 562.9	71.0%	$ 501.5	112.2%
July 1, 1998[5]	1,809.0	2,123.3	90.6	223.7	89.0	529.8	42.2
July 1, 1998[6]	1,809.0	2,342.7	90.6	443.1	80.3	529.8	83.6
July 1, 2000[7]	2,247.5	2,648.3	96.4	304.4	88.1	537.5	56.6
July 1, 2000[8]	2,247.5	2,652.0	96.4	308.1	87.9	537.5	57.3
July 1, 2002	2,484.8	2,980.1	111.8	383.5	86.6	563.2	68.1
July 1, 2004	2,485.7	3,359.2	115.7	757.8	76.6	600.7	126.2
July 1, 2005	2,497.5	3,527.0	126.2	903.3	73.4	612.6	147.5

(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 and present value of future university supplemental contributions.
(3) Funded Ratio is the ratio of the actuarial value of assets over the actuarial accrued liabilities less the present value of future university supplemental contributions.
(4) Covered Payroll includes compensation paid to all active employees on which contributions are calculated.
(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 Spring 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 which passed in Spring 2001.
(9) Not available.

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
6/30/1996	$ 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
6/30/2005	612,622	57,150	7.58	7.58	100

(1) Computed as the dollar amount of the actual employer contribution made as a percentage of payroll (less ORP and term pay contributions) 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, 2005 there were $6.0 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, 2005, $5.4 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 is defined to equal the total of the individual normal costs, divided by the total pay rate.

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 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 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'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 an assumed 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, 2005.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
SUPPORTING SCHEDULES
FISCAL YEARS ENDED JUNE 30, 2005 AND 2004

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, 2005 and 2004, are outlined below:

Budgeted Expenses:	2005	2004
Personal Services:		
Salaries	$ 584,815	$ 587,001
Other compensation	1,900	2,250
Employee benefits	174,390	164,040
Total Personal Services	$ 761,105	$ 753,291
Operating Expenses:		
Contracted services	$ 481,222	$ 377,440
Supplies and materials	24,840	26,050
Communications	38,003	40,380
Travel	12,770	13,172
Rent	42,437	41,184
Repair and maintenance	53,078	40,948
Other expenses	48,810	46,384
Total Operating	$ 701,160	$ 585,558
Non-Budgeted Expenses:		
Compensated Absences	8,442	4,522
Depreciation	5,403	8,979
Amortization of Intangible Assets	$ 84,710	$ 154,344
Total Non-Budgeted	$ 98,555	$ 167,845
Total Administrative Expense	**$ 1,560,820**	**$ 1,506,694**

CONSULTANT AND PROFESSIONAL SERVICES

	2005	2004
Personnel Management	$ 3,263	$ 4,125
Actuarial Services	150,859	45,764
Legal Services	4,306	31,669
Medical Evaluations	1,180	1,025
Audit Services	5,447	26,099
Information Technology Services	177,735	105,045
Total Expense	**$ 342,790**	**$ 213,727**

TEACHERS' RETIREMENT SYSTEM

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

STATE OF MONTANA

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NOV 21 2005
LEGISLATIVE AUDIT DIV.

November 21, 2005

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, 2005.

The report includes one recommendation that legislation be enacted to provide funding to ensure the Teachers' Retirement System is funded on an actuarially-sound basis, as required by the Montana Constitution. The Board conditionally concurs with the recommendation.

While the Teachers' Retirement Board cannot enact legislation, in anticipation of a December 2005 special session, legislation has been drafted by the State Administration and Veterans' Affairs interim committee that will ensure the Teachers' Retirement System is funded on an actuarially sound basis. If a special session is not called, the proposed legislation will be introduced during the next regular session.

Sincerely,

David L. Senn

David L. Senn
Executive Director