A Report
to the
Montana
Legislature

Financial Audit

Montana State Fund

For the Fiscal Year Ended June 30, 2007

December 2007

Legislative Audit
Division

07-05

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LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
Tori Hunthausen,
Chief Deputy Legislative Auditor

Deputy Legislative Auditors:
James Gillett
Angie Grove

December 2007

The Legislative Audit Committee
of the Montana State Legislature:

This is our report on the financial audit of the Montana State Fund, a component unit of the state of Montana, for the fiscal year ended June 30, 2007. The objectives of this audit include determining if the financial statements for fiscal year 2006-07, with comparative financial amounts for fiscal year 2005-06, present fairly the Montana State Fund's and the State of Montana - Old Fund's financial position at June 30 for each fiscal year and the results of its operations for the fiscal years then ended. We also tested compliance with laws that have a direct and material effect on the financial statements.

We made no recommendations to Montana State Fund in the prior audit report. This report contains one recommendation related to internal controls. On page A-1, you will find the Independent Auditor's Report followed by the Management's Discussion and Analysis, the financial statements and accompanying notes. The Management's Discussion and Analysis is supplementary information required by the Governmental Accounting Standards Board. As disclosed in the Independent Auditor's Report, we did not audit the information and express no opinion on it. We issued an unqualified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund's response to our audit is on page B-1. We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Scott A. Seacat

Scott A. Seacat
Legislative Auditor

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Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard	President/CEO
	Mark Barry	Vice President, Corporate Support
	Tony Johnson	Vice President, Human Resources
	Layne Kertamus	Vice President, Insurance Operations
	Peter Strauss	Vice President, Insurance Operations Support
	Nancy Butler	General Counsel
	Al Parisian	Chief Information Officer

State Fund Board of Directors		Term Expires
	Joe Dwyer, Chairman	2011
	Jane DeBruycker	2009
	Thomas R. Heisler	2009
	Ken Johnson	2009
	Jim Swanson	2009
	Boyd Taylor	2011
	Wally Yovetich	2011

For additional information concerning the Montana State Fund, contact:

Laurence Hubbard, President/CEO
5 South Last Chance Gulch
Helena MT 59601
(406) 444-6501

Report Summary

Montana State Fund

This financial audit report documents the results of our audit of the Montana Sate Fund New Fund (MSF) and the Old Fund for the fiscal year ended June 30, 2007. We issued unqualified opinions on the statements for MSF and the State of Montana - Old Fund contained in this audit report. This report contains one recommendation to MSF related to improving internal controls for financial reporting.

The prior financial audit report and financial-compliance audit report contained no recommendations to MSF.

The listing below serves as a means of summarizing the recommendations contained in the report, MSF response thereto, and a reference to the supporting comments.

Recommendation #1

We recommend Montana State Fund management implement procedures to ensure access to computer systems is appropriate based on job responsibilities. 3

Fund's Response: Concur B-3

Chapter I — Introduction

Audit Objectives

We performed a financial audit of the Montana State Fund for the fiscal year ending June 30, 2007. The objectives of our audit were:

1. Determine if MSF's and the State of Montana - Old Fund's financial statements present fairly the financial position and results of operations for the fiscal year ended June 30, 2007, with comparitive financial amounts for the fiscal year ended June 30, 2006.
2. Make recommendations for improvements in the management and internal controls of MSF.
3. Determine if MSF complied with state laws and regulations having a direct and material effect on the financial statements.

In accordance with section 5-13-307, MCA, we analyzed and disclosed costs, if significant, of implementing recommendations contained in this report. Issues deemed not to have significant effect on operations have been discussed with management but are not included in this report.

Auditing standards require us to communicate, in writing, control deficiencies we identify as a result of audit objective 2 above and consider to be significant or material. A significant deficiency affects management's ability to accurately process transactions. A material weakness is one or more significant deficiencies that adversely affect management's ability to fairly present its financial statements.

Table 1 below outlines the status of significant deficiencies and material weaknesses we identified during this audit.

Table 1
Summary of Control Deficiencies

Subject	Significant Deficiency	Material Weakness	Page
System Access	X		3

Source: Legislative Audit Division.

Introduction

Montana State Fund is a workers' compensation insurance company established by the state of Montana. It is a nonprofit, independent public corporation that provides Montana employers with an option for workers' compensation and occupational disease insurance. Montana State Fund is governed by a seven-member board of directors appointed by the governor. State law separates funding sources for claims incurred before July 1, 1990, (Old Fund) and those incurred on or after July 1, 1990, (New Fund).

Montana State Fund management must set premium rates for the New Fund at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain a surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs are currently funded by investment earnings and investment principal. If Old Fund assets are insufficient, then, by law, the state General Fund will provide funding for claims. The investments of the Montana State Fund New Fund and the Old Fund are managed by the Montana Board of Investments and invested according to policies established in law.

Chapter II — Findings & Recommendations

System Access

Montana State Fund does not have adequate controls related to access to its computer systems.

Montana State Fund has various computer systems in use to conduct business. These systems include the Policy Holder System (PHS) and the Claims Center (CC) system. Proper internal controls in computer systems require limiting access for users based on job requirements. Limiting access and ensuring only authorized individuals are allowed to perform specific tasks limits the risk of fraud and theft, and protects data validity.

A recent Information Systems audit (#07DP-14) of PHS concluded internal controls were not implemented to ensure access in and to the system was appropriate. The auditors found users had excessive access privileges, generic accounts were used, and MSF management lacked procedures and policies to review for these situations. A separate report was issued related to this issue. MSF management made changes to the accounts that were a problem related to PHS.

During the current audit, we reviewed access in the CC system. MSF personnel stated only customer service personnel can change addresses in the system, except for vendor addresses which are changed by finance personnel. However, we found other personnel have access to make claimant address changes in the system. Some personnel responsible for paying claims may make payments and change addresses.

Without proper controls over system access, there is increased risk of inappropriate payments. Also, without procedures to monitor access, MSF is placing assets at risk. MSF management should implement controls to monitor computer system access and ensure it is appropriate.

Recommendation #1

We recommend Montana State Fund management implement procedures to ensure access to computer systems is appropriate based on job responsibilities.

Independent Auditor's Report and
Montana State Fund and
State of Montana - Old Fund Financial Statements

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
Tori Hunthausen,
Chief Deputy Legislative Auditor

Deputy Legislative Auditors:
James Gillett
Angie Grove

Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statements of Net Assets of the Montana State Fund and the State of Montana - Old Fund, a component unit of the state of Montana, as of June 30, 2007, and 2006, and the related Statements of Revenues, Expenses, and Changes in Net Assets, Montana State Fund and the State of Montana - Old Fund, and Statements of Cash Flows, Montana State Fund and the State of Montana - Old Fund, for the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. 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 respective financial position of the Montana State Fund and the State of Montana - Old Fund as of June 30, 2007, and 2006, and the respective results of operations and cash flows for the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards 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.

Respectfully submitted,

/s/ James Gillett

James Gillett, CPA
Deputy Legislative Auditor

December 5, 2007

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Montana State Fund and the State of Montana - Old Fund Management's Discussion and Analysis, Financial Statements and Notes

Montana State Fund
(A Component Unit of the State of Montana)
Management Discussion and Analysis
June 30, 2007 and 2006

Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. No state General Fund money is used for MSF operations. If MSF is dissolved by an act of law, the money held by MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds held in the Old Fund.

MSF and Old Fund financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. MSF and the Old Fund use the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

Overview of the Financial Statements

This overview is an introduction to MSF and the Old Fund financial statements. The financial statements consist of two components: (1) basic financial statements, and (2) notes to the basic financial statements.

The statement of net assets presents information regarding all of MSF and Old Fund's assets and liabilities, with the difference between the two being reported as net assets.

The statements of revenue, expenses, and changes in fund net assets present the financial results of operations for MSF and the Old Fund for the two most recent fiscal years. This statement presents information showing how the net assets changed during the two most recent fiscal years. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods.

The statement of cash flows details the cash used and provided by the various activities of MSF during the fiscal year. However, this statement does not consider unpaid responsibilities which have been established by contract or other underlying events during the fiscal year.

The following analysis presents two years of comparative condensed financial data.

Analysis of Financial Position - MSF

The following is a comparison of the financial position of MSF at June 30, 2007 to 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Assets:			
Cash and STIP	$13,744	$14,919	($1,175)
Investments	868,027	738,858	129,169
Security Lending Collateral	146,413	132,439	13,974
Receivables (Net)	31,700	30,871	829
Capital Assets (Net)	6,772	6,601	171
Other Assets	25,883	17,313	8,570
Total Assets	1,092,539	941,001	151,538
Liabilities:			
Loss and LAE Reserves	679,209	590,688	88,521
Liability for Securities on Loan	146,413	132,439	13,974
Payables	18,627	19,727	(1,100)
Other Liabilities	46,685	40,562	6,123
Total Liabilities	890,934	783,416	107,518
Net Assets:			
Investment in Capital Assets	6,772	6,601	171
Unrestricted Net Assets	194,833	150,984	43,849
Total Liabilities and Net Assets	$1,092,539	$941,001	$151,538

Net Assets increased approximately $44.0M (million) from the prior year. The increase has primarily resulted from an increase in investment income of $48.1M of which $22.0M was from unrealized gains on investments.

The change in book value of MSF's investment portfolio of fixed and equity securities in fiscal year 2007 was as follows, (In thousands):

Fiscal Year 2006 Book Value	$738,514
Purchases at Cost	254,171
Sales	(146,840)
Net Realized Losses	(656)
Net Accretion of Bonds	486
Fiscal Year 2007 Book Value	$845,675

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2007 and June 30, 2006. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected our best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2007 and 2006. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at $679.2M and $590.7M, as of June 30, 2007, and June 30, 2006, respectively.

The following is a comparison of the financial position of MSF at June 30, 2006, to June 30, 2005, (In thousands):

	6/30/2006	6/30/2005	Change
Assets:			
Cash and STIP	$14,919	$32,157	($17,238)
Investments	738,858	656,029	82,829
Security Lending Collateral	132,439	101,859	30,580
Receivables (Net)	30,871	25,022	5,849
Capital Assets (Net)	6,601	4,690	1,911
Other Assets	17,313	8,429	8,884
Total Assets	941,001	828,186	112,815
Liabilities:			
Loss and LAE Reserves	590,688	511,557	79,131
Liability for Securities on Loan	132,439	101,859	30,580
Payables	19,727	14,973	4,754
Other Liabilities	40,562	31,122	9,440
Total Liabilities	783,416	659,511	123,905
Net Assets:			
Investment in Capital Assets	6,601	4,690	1,911
Unrestricted Net Assets	150,984	163,985	(13,001)
Total Liabilities and Net Assets	$941,001	$828,186	$112,815

Net Assets decreased approximately ($11.1M) from the prior year. The decrease has primarily resulted from an unrealized loss on investment in fixed securities of ($27.3M).

The change in book value of MSF's investment portfolio of fixed and equity securities in fiscal year 2006 was as follows, (In thousands):

Fiscal Year 2005 Book Value	$635,045
Purchases at Cost	190,362
Sales	(86,850)
Net Realized Gains	(256)
Net Amortization of Bonds	213
Fiscal Year 2006 Book Value	$738,514

Tillinghast-Towers Perrin prepares the actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2006, and June 30, 2005. MSF management has selected our best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2006 and 2005. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at $590.7M and $511.6M, as of June 30, 2006, and June 30, 2005, respectively.

Results of Operations – MSF

The following is a comparison of MSF's results of operations for fiscal year 2007 to fiscal year 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Operating Revenues:			
Net Premium Earned	$238,203	$211,892	$26,311
Total Operating Revenue	$238,203	$211,892	$26,311
Operating Expenses:			
Benefits and Claims	208,627	192,699	15,928
Personal Services	19,507	18,974	533
Other Operating Expense	18,427	17,942	485
Total Operating Expense	246,561	229,615	16,946
Net Operating Income (Loss)	(8,358)	(17,723)	9,365
Nonoperating Revenue (Expense):			
Investment Income	37,294	32,141	5,153
Unrealized Gain/(Loss)	22,007	(20,640)	42,647
Other Nonoperating Revenue	79	133	(54)
Dividend Expense	(7,001)	(5,001)	(2,000)
Total Nonoperating Revenue (Expense)	52,379	6,633	45,746
Change in Net Assets	$44,021	($11,090)	$55,111

MSF's book of business grew from $211.9M of net earned premium in fiscal year 2006 to $238.2M of net earned premium in fiscal year 2007. Net earned premium increased by $26.3M

compared to the prior year primarily due to economic growth in the state resulting in an increase in overall payroll levels, the basis for premiums.

MSF paid dividends of $7.0M to policyholders in fiscal year 2007, compared to $5.0M paid in fiscal year 2006. The Board of Directors, at its discretion, determines the amount of dividends to be declared, based on MSF's financial condition.

Investment income, excluding unrealized gain/loss, increased by $5.2M in fiscal year 2007 over investment income earned in fiscal year 2006. This increase was primarily due to an increase in investment in fixed securities of $129.2M. In fiscal year 2007 MSF had a realized loss on the sales and maturities of investments of ($.7M) compared to a realized loss of ($.3M) on sales and maturities of investments in fiscal year 2006.

MSF experienced an unrealized gain on investments of $22.0M in fiscal year 2007, compared to an unrealized loss on investments of ($20.6M) in fiscal year 2006. This increase was due primarily to the increase in fair value of equities of $17.2M in fiscal year 2007.

The following is a comparison of MSF's results of operations for fiscal year 2006 to fiscal year 2005, (In thousands):

	6/30/2006	6/30/2005	Change
Operating Revenues:			
Net Premium Earned	$211,892	$189,379	$22,513
Total Operating Revenue	$211,892	$189,379	$22,513
Operating Expenses:			
Benefits and Claims	192,699	159,612	33,087
Personal Services	18,974	17,168	1,806
Other Operating Expense	17,942	18,757	(815)
Total Operating Expense	229,615	195,537	34,078
Net Operating Income (Loss)	(17,723)	(6,158)	(11,565)
Nonoperating Revenue (Expense)			
Investment Income	32,141	30,128	2,013
Unrealized Gain/(Loss)	(20,640)	6,834	(27,474)
Other Nonoperating Revenue	133	102	31
Dividend Expense	(5,001)	(5,004)	3
Total Nonoperating Revenue (Expense)	6,633	32,060	(25,427)
Change in Net Assets	($11,090)	$25,902	($36,992)

MSF's book of business grew from $189.4M in fiscal year 2005 to $211.9M in fiscal year 2006. The increase of $22.5M was driven by a significant number of new policies, increased pricing on renewing policies and economic growth in the State.

MSF paid dividends of $5.0M to policyholders in fiscal year 2006, the same amount of dividends paid to policyholders in fiscal year 2005.

Investment income increased in fiscal year 2006 by $2.0M. The increase can be attributed to an increased investment in fixed securities of $82.8M. In fiscal year 2006 MSF had a realized loss on the sale and maturity of investments of ($.3M) compared to a realized gain on the sale and maturity of investments of $1.0M in fiscal year 2005.

In fiscal year 2006 MSF had an unrealized loss on invested assets of ($20.6M) compared to an unrealized gain of $6.8M in fiscal year 2005. The difference was due to unrealized losses on fixed security investments of ($27.3M) in fiscal year 2006.

Analysis of Financial Position – Old Fund

The following is a comparison of the financial position of the Old Fund at June 30, 2007, to June 30, 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Assets:			
Cash and STIP	$7,862	$8,676	($814)
Investments	34,713	43,252	(8,539)
Security Lending Collateral	13,688	14,894	(1,206)
Receivables (Net)	574	680	(106)
Total Assets	56,837	67,502	(10,665)
Liabilities:			
Loss and LAE Reserves	75,063	73,737	1,326
Liability for Securities on Loan	13,688	14,894	(1,206)
Payables	720	773	(53)
Total Liabilities	89,471	89,404	67
Net Assets:			
Unrestricted Net Assets	(32,634)	(21,902)	(10,732)
Total Liabilities and Net Assets	$56,837	$67,502	($10,665)

Net Assets decreased ($10.7M) from the prior year. The primary reason for this decrease is the continuing development on remaining loss reserves increasing the estimated amount remaining to be paid on outstanding claims. The decreases in net assets have left a deficit in the net asset account of ($32.6M).

The change in book value of Old Fund's investment portfolio of fixed securities in fiscal year 2007 was as follows, (In thousands):

Fiscal Year 2006 Book Value	$ 43,915
Purchases at Cost	3,017
Sales	(11,842)
Net Realized Gains	10
Net Accretion of Bonds	(173)
Fiscal Year 2007 Book Value	$ 34,927

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for the Old Fund as of June 30, 2007, and June 30, 2006. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. State Fund management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2007 and 2006. The estimated claims payable is presented discounted at $75.1M and $73.7M, as of June 30, 2007 and June 30, 2006, respectively. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. The Old Fund discounted its actuarially determined unpaid balances by a factor of 5.0% for the periods ended June 30, 2007 and June 30, 2006. The estimated claims payable undiscounted for fiscal years 2007 and 2006, respectively, is $98.2M and $97.8M.

The following is a comparison of the financial position of the Old Fund at June 30, 2006 to June 30, 2005, (In thousands):

	6/30/2006	6/30/2005	Change
Assets:			
Cash and STIP	$8,676	$12,207	($3,531)
Investments	43,252	51,354	(8,102)
Security Lending Collateral	14,894	17,769	(2,875)
Receivables (Net)	680	916	(236)
Total Assets	67,502	82,246	(14,744)
Liabilities:			
Loss and LAE Reserves	73,737	79,109	(5,372)
Liability for Securities on Loan	14,894	17,769	(2,875)
Payables	773	949	(176)
Total Liabilities	89,404	97,827	(8,423)
Net Assets:			
Unrestricted Net Assets	(21,902)	(15,581)	(6,321)
Total Liabilities and Net Assets	67,502	82,246	(14,744)

Net Assets decreased ($6.3M) from the prior year. The primary reason for this decrease is the continuing development on remaining loss reserves increasing the estimated amount remaining

to be paid on outstanding claims. The decreases in net assets have left a deficit in the net asset account of ($21.9M).

The change in book value of Old Fund's investment portfolio of fixed and equity securities in fiscal year 2005 was as follows, (In thousands):

Fiscal Year 2005 Book Value	$ 51,005
Purchases at Cost	13,121
Sales	(20,271)
Net Realized Gains	247
Net Accretion of Bonds	(187)
Fiscal Year 2006 Book Value	$ 43,915

Tillinghast-Towers Perrin prepare the actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for the Old Fund as of June 30, 2006, and June 30, 2005. State Fund management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2006 and 2005. The estimated claims payable is presented discounted at $73.7M and $79.1M, as of June 30, 2006 and June 30, 2005, respectively. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. The Old Fund discounted its actuarially determined unpaid balances by a factor of 5.0% for the period ended June 30, 2006, and 5.0% for the period ended June 30, 2005. The estimated claims payable undiscounted for fiscal years 2006 and 2005, respectively, is $97.8M and $104.9M.

Results of Operations – Old Fund

The following is a comparison of Old Fund's results of operations for fiscal year 2007 to fiscal year 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Operating Expenses:			
Benefits and Claims	$12,072	$5,521	$6,551
Personal Services	32	53	(21)
Other Operating Expense	1,336	2,609	(1,273)
Total Operating Expense	13,440	8,183	5,257
Nonoperating Revenue:			
Investment Income	2,253	2,871	(618)
Unrealized Gain/(Loss)	449	(1,011)	1,460
Other Nonoperating Revenue	5	3	2
Total Nonoperating Revenue	2,707	1,863	844
Change in Net Assets	($10,733)	($6,320)	($4,413)

State law (Section 39-71-2352, MCA) requires State Fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from

accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M for both fiscal years 2007 and 2006. MSF allocated $1.25M in administration costs to the Old Fund in fiscal years 2007 and 2006. The Old Fund has a $321K (thousand) obligation to MSF in un-recovered administrative costs incurred in fiscal years 2007 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M.
The change in net assets for fiscal year 2007 is a reduction of ($10.7M) compared to a decrease of ($6.3M) in fiscal year 2006. For an explanation of this decrease in net assets see the Analysis of Financial Position – Old Fund section.

The following is a comparison of Old Fund's results of operations for fiscal year 2006 to fiscal year 2005, (In thousands):

	6/30/2006	6/30/2005	Change
Operating Expenses:			
Benefits and Claims	$5,521	$8,671	($3,150)
Personal Services	53	13	40
Other Operating Expense	2,609	1,425	1,184
Total Operating Expense	8,183	10,109	(1,926)
Nonoperating Revenue:			
Investment Income	2,871	3,176	(305)
Unrealized Gain/(Loss)	(1,011)	(1,214)	203
Other Nonoperating Revenue	3	9	(6)
Total Nonoperating Revenue	1,863	1,971	(108)
Change in Net Assets	($6,320)	($8,138)	$1,818

As allowed under the statute explained above, MSF allocated $1.25M in administration costs to the Old Fund in fiscal years 2006 and 2005. The Old Fund had a $576K obligation to MSF in un-recovered administrative costs incurred in fiscal years 2006 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M.

The change in net assets for fiscal year 2006 is a reduction of ($6.3M) compared to a decrease of ($8.1M) in fiscal year 2005. For an explanation of this decrease in net assets see the section on Analysis of Financial Position – Old Fund.

MONTANA STATE FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2007	2006
ASSETS		
Current Assets		
Cash and cash equivalents	13,744,136	14,919,072
Receivables, net	31,041,246	30,231,787
Due from primary government	13,411	30,599
Due from component units	611,577	574,080
Securities lending collateral	146,413,103	132,438,891
Other assets	25,883,738	17,313,082
Total Current Assets	217,707,211	195,507,511
Noncurrent Assets		
Investments	868,026,676	738,857,572
Notes and loans receivable	33,598	34,798
Equipment	4,559,954	3,881,365
Accumulated depreciation	(2,760,981)	(2,331,912)
Intangible assets	4,972,722	5,051,601
Total Noncurrent Assets	874,831,969	745,493,424
Total Assets	1,092,539,180	941,000,935
LIABILITIES		
Current Liabilities		
Accounts payable	17,212,084	18,556,138
Due to primary government	1,415,043	1,170,730
Due to component units	-	-
Estimated claims payable	137,986,975	124,161,418
Compensated absences	1,310,087	1,096,326
Lease payable	-	-
Securities lending liability	146,413,103	132,438,891
Deferred revenue	10,216,394	16,484,046
Property held in trust	34,273,741	22,119,223
Total Current Liabilities	348,827,427	316,026,772
Noncurrent Liabilities		
Estimated claims payable	541,222,025	466,526,582
Compensated absences	884,566	863,072
Total Noncurrent Liabilities	542,106,591	467,389,654
Total Liabilities	890,934,018	783,416,426
NET ASSETS		
Invested in capital assets, net of related debt	6,771,695	6,601,053
Unrestricted	194,833,467	150,983,456
Total Net Assets	201,605,162	157,584,509
Total Liabilities and Net Assets	1,092,539,180	941,000,935

MONTANA STATE FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2007	2006
Net premiums earned	238,202,708	211,892,198
Operating Expenses		
Benefits and claims	208,627,247	192,699,378
Personal services	19,506,793	18,973,653
Contractual services	13,480,301	7,448,864
Supplies and materials	910,424	1,110,825
Depreciation	453,815	434,183
Amortization	905,704	416,485
Rent and utilities	484,457	469,574
Communications	1,158,400	1,164,512
Travel	231,570	209,519
Repair and maintenance	875,434	1,194,908
Other operating expenses	(72,955)	5,493,638
Total Operating Expenses	246,561,190	229,615,539
Operating Loss	(8,358,482)	(17,723,341)
Nonoperating Revenue (Expenses)		
Investment income	59,893,136	11,756,456
Gain on sale of investments	167,506	442,602
Securities lending income	6,164,519	5,613,768
Loss on sale of investments	(823,312)	(698,494)
Securities lending expense	(6,100,391)	(5,540,476)
Penalties and interest	35,367	23,921
Loss on retirement of assets	(771)	(704)
Dividend expense	(7,000,966)	(5,001,042)
Other income	44,047	37,218
Total Nonoperating Revenue (Expense)	52,379,135	6,633,249
Change in Net Assets	44,020,653	(11,090,092)
Total Net Assets - Beginning	157,584,509	168,674,601
Total Net Assets - Ending	201,605,162	157,584,509

MONTANA STATE FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for premiums	239,497,771	214,435,780
Payments to suppliers for goods and services	(21,313,583)	(15,979,009)
Payments to employees	(19,216,620)	(18,390,435)
Cash payments for claims	(120,013,899)	(113,082,071)
Other operating receipts	79,414	61,139
Net Cash Provided by (Used for) Operating Activities	79,033,083	67,045,404
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Payment of Dividends to Policyholders	(7,000,966)	(5,001,042)
Net Cash Provided by (Used for) Noncapital Financing Activities	(7,000,966)	(5,001,042)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of fixed assets	(1,835,309)	(3,109,880)
Proceeds from sale of fixed assets	27,746	28,152
Net Cash Used for Capital and Related Financing Activities	(1,807,563)	(3,081,728)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(253,443,251)	(194,362,049)
Proceeds from sales or maturities of investments	147,496,410	87,105,705
Proceeds from securities lending transactions	6,164,519	5,613,768
Payments of security lending costs	(6,633,239)	(5,216,110)
Interest and dividends on investments	35,016,071	30,657,767
Net Cash Provided by (Used For) Investing Activities	(71,399,490)	(76,200,919)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,174,936)	(17,238,285)
CASH AND CASH EQUIVALENTS - JULY 1	14,919,072	32,157,357
CASH AND CASH EQUIVALENTS - JUNE 30	13,744,136	14,919,072

MONTANA STATE FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2007	2006
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES		
Change in Net Assets	44,020,653	(11,090,092)
Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Depreciation	453,815	434,183
Amortization	905,704	416,485
Interest expense	-	-
Security lending costs	6,100,391	5,540,476
Security lending income	(6,164,519)	(5,613,768)
Interest on investment	(59,237,330)	(11,500,564)
Payments of Dividends to Policyholders	7,000,966	5,001,042
Payment to State of Montana	-	-
Decrease (increase) in		
Accounts receivable	937,944	(4,690,421)
Due from component units of the State of Montana	(88,961)	244,902
Due from Primary Government	17,188	-
Notes receivable	1,200	1,200
Other assets	(8,569,886)	(8,883,654)
Increase (decrease) in		
Accounts payable	(1,210,850)	8,715,506
Due to Primary Government	223,646	(102,405)
Deferred Revenue	(6,267,651)	206,611
Property held in trust	12,154,518	9,064,116
Estimated claims	88,521,000	79,131,000
Lease payable	-	-
Compensated absences	235,255	170,787
Total adjustments	35,012,430	78,135,496
Net Cash Provided by (Used for) Operating Activities	79,033,083	67,045,404

STATE OF MONTANA - OLD FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2007	2006
ASSETS		
Current Assets		
Cash and cash equivalents	7,861,757	8,675,911
Receivables, net	574,258	679,809
Due from component units	-	-
Prepaid Expenses	224	
Securities lending collateral	13,687,883	14,894,170
Total Current Assets	22,124,122	24,249,890
Noncurrent Assets		
Investments	34,713,171	43,252,383
Total Assets	56,837,293	67,502,273
LIABILITIES		
Current Liabilities		
Accounts payable	108,096	197,911
Due to primary government	826	-
Due to component units	611,578	574,936
Estimated claims payable	10,353,698	12,909,275
Securities lending liability	13,687,883	14,894,170
Total Current Liabilities	24,762,081	28,576,292
Noncurrent Liabilities		
Estimated claims payable	64,709,380	60,827,384
Total Noncurrent Liabilities	64,709,380	60,827,384
Total Liabilities	89,471,461	89,403,676
NET ASSETS		
Unrestricted	(32,634,168)	(21,901,403)
Total Net Assets	(32,634,168)	(21,901,403)
Total Liabilities and Net Assets	56,837,293	67,502,273

The notes to the financial statements are an integral part of this statement.

STATE OF MONTANA - OLD FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2007	2006
Operating Expenses		
Benefits and claims	12,071,873	5,521,477
Personal services	32,176	53,530
Contractual services	864,563	814,591
Depreciation	48,467	49,665
Amortization	244,411	294,677
Other operating expenses	179,140	1,449,275
Total Operating Expenses	13,440,630	8,183,215
Operating Loss	(13,440,630)	(8,183,215)
Nonoperating Revenue (Expenses)		
Investment income	2,692,467	1,626,768
Gains on investments	13,402	380,484
Securities lending income	312,700	889,927
Losses on investments	(3,217)	(146,654)
Securities lending expense	(307,487)	(877,365)
Liability tax revenue	-	(10,112)
Total Nonoperating Revenue (Expenses)	2,707,865	1,863,048
Change in Net Assets	(10,732,765)	(6,320,167)
Total Net Assets - Beginning	(21,901,403)	(15,581,236)
Total Net Assets - Ending	(32,634,168)	(21,901,403)

The notes to the financial statements are an integral part of this statement.

STATE OF MONTANA - OLD FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments to suppliers for goods and services	(1,291,419)	(1,301,437)
Payments to employees	(53,530)	13,279
Cash payments for claims	(10,770,720)	(12,211,805)
Collection of payroll taxes	-	(48,468)
Net Cash Used for Operating Activities	(12,115,669)	(13,548,431)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(3,016,775)	(13,121,113)
Proceeds from sales or maturities of investments	11,832,155	20,023,976
Proceeds from securities lending transactions	312,700	889,926
Payments of security lending costs	(321,824)	(860,154)
Interest and dividends on investments	2,495,259	3,084,395
Net Cash Provided by Investing Activities	11,301,515	10,017,030
NET DECREASE IN CASH AND CASH EQUIVALENTS	(814,154)	(3,531,401)
CASH AND CASH EQUIVALENTS - JULY 1	8,675,911	12,207,312
CASH AND CASH EQUIVALENTS - JUNE 30	7,861,757	8,675,911

STATE OF MONTANA - OLD FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2007	2006
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED FOR OPERATING ACTIVITIES		
Change in Net Assets	(10,732,765)	(6,320,167)
Adjustments to Reconcile Change in Net Assets to Net Cash Used for Operating Activities		
Security lending costs	307,487	877,365
Security lending income	(312,700)	(889,927)
Interest on investment	(2,702,652)	(1,860,598)
Decrease (increase) in		
Accounts receivable	36,776	(1,092)
Due from primary government	-	211,852
Other Assets	(224)	
Increase (decrease) in		
Accounts payable	(75,478)	(65,361)
Due to component units	36,642	(128,162)
Due to primary government	826	
Estimated claims	1,326,419	(5,372,341)
Total adjustments	(1,382,904)	(7,228,264)
Net Cash Used for Operating Activities	(12,115,669)	(13,548,431)

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2007 and 2006

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see Note 4). No State general fund money is used for MSF operations.

MSF and Old Fund financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal year 2007 and 2006 financial statements are presented in conformance with Governmental Accounting Standards Board Statement 34, which is a comparable format to the State of Montana Comprehensive Annual Financial Report.

Basis of Accounting

MSF and the Old Fund use the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, revenues are recorded in the accounting period earned, if measurable, and expenses are recorded in the period incurred, if measurable.

Cash and Cash Equivalents

Montana State Fund
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Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. MSF and the Old Fund participate in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less with the exception of securities having rate reset dates. There are no legal risks that the Montana Board of Investments (BOI) is aware of regarding any STIP investments. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balance of $10.3M as of June 30, 2007, represents 0.37% of the total STIP. The Old Fund STIP balance of $7.0M as of June 30, 2007, represents 0.25% of the total STIP. MSF's STIP balance of $12.4M as of June 30, 2006, represents .56% of the total STIP. The Old Fund STIP balance of $8.1M as of June 30, 2006, represents 0.37% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The BOI's policy requires that STIP investments have the highest rating in the short-term category by one of any Nationally Recognized Statistical Rating Organizations (NRSRO). The three NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc.

Asset-backed securities constitute 66.48**%** of the BOI's total STIP portfolio as of June 30, 2007. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constitute 64.88% of the Board of Investment's total STIP portfolio as of June 30, 2006.

Variable rate (floating rate) securities make up 13.80% of the BOI's total STIP portfolio as of June 30, 2007. Variable rate securities make up 10.27% of the BOI's total STIP portfolio as of June 30, 2006. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

Investments

In addition to STIP investments, the BOI invests in long-term securities. Under the provisions of the state constitution, MSF and the Old Fund's invested assets are managed by the BOI. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method

over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

Effective June 30, 2005, the Board implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40 – Deposit and Investment Risk Disclosures. The investment risk disclosures 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. With the exception of the U.S. government securities, Montana State Fund's income instruments have credit risk as measured by major credit rating services. This risk is that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires MSF and Old Fund fixed income investments, at the time of purchase, to be rated an investment grade as defined by Moody's and/or Standard & Poor's (S&P) rating services. The U.S. government securities are guaranteed directly or indirectly by the U.S. government. 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. The credit ratings are provided by S& P's rating services. If an S&P rating is not available, a Moody's rating has been used.

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, 2007 and 2006, all the fixed income and other equity securities were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank, State Street Bank. The Equity Index investment and State Street Bank repurchase agreement were purchased in the State of Montana Board of Investment's name.

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 MSF Investment Policy requires credit risk to be limited to 3 percent in any one name except AAA rated issues will be limited to 6% while the Old Fund investment policy statement does not address concentration of credit risk. The MSF Investment Policy provides for "no limitation on U.S. government/agency securities". MSF also has specified certain client preferences. Investments issued or explicitly guaranteed by the U.S. government are excluded from the concentration of credit

risk requirement.

For fiscal year 2007, MSF had concentration of credit risk exposure of 12.04% to the Federal National Mortgage Association and Federal Home Loan Bank of 10.03%. For fiscal year 2006, MSF had concentration of credit risk exposure to the Federal National Mortgage Association of 12.72%.

For fiscal year 2007, Old Fund had concentration of credit risk exposure to the Federal National Mortgage Association of 35.88%, Commercial Mortgage Trust of 8.49%, and Federal Home Loan Mortgage Corp of 7.06%. For fiscal year 2006, Old Fund had concentration of credit risk exposure to the Federal National Mortgage Association of 29.10%, Commercial Mortgage Trust of 7.76%, JPMorgan Chase of 5.84% and Federal Home Loan Mortgage Corp of 5.63%.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. MSF and Old Fund investment policies do not formally address interest rate risk. In accordance with GASB Statement No. 40, the Board has selected the effective duration method to disclose interest rate risk. This method, as provided by the BOI, is "An option-adjusted measure of a bond's (or portfolio's) sensitivity to changes in interest rates. Duration is calculated as the average percentage change in a bond's value (price plus accrued interest) under shifts of the Treasury curve plus/minus 100 basis points. The effective duration method incorporates the effect of the embedded options for bonds and changes in prepayments for mortgage-backed securities (including pass-throughs, CMOs and ARMs)."

As of June 30, 2007 and 2006, MSF and the Old Fund portfolios did not hold any structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). REMICs are pass-through vehicles for multiclass mortgage-backed securities. The REMIC securities are based on separate or combined cash flows from principal and interest payments on underlying mortgages.

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, and other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets.

As of June 30, 2007, the MSF portfolio held three variable rate corporate bonds with an amortized cost of $19 million. As of June 30, 2006, the MSF portfolio held two variable rate corporate bonds with an amortized cost of $14 million. The MSF variable-rate securities float with LIBOR (London Interbank Offered Rate), or a residual component.

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MSF and Old Fund investments are categorized below to disclose credit and interest rate risk as of June 30, 2007 and June 30, 2006. Credit risk reflects the bond quality rating, by investment type, as of the June 30 report date. If a bond investment type is unrated, the quality type is indicated by NR (not rated). Interest rate risk is disclosed using effective duration. Both the credit quality ratings and duration have been calculated excluding cash equivalents.

Legal Risk

The Board is not aware of any legal risks regarding any MSF or Old Fund investments.

MSF Credit Quality Rating and Effective Duration as of June 30, 2007

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	**$**	**399,771,819**	**A+**	**3.98**
U.S. Govt Direct-Backed		**32,100,766**	**AAA**	**5.66**
U.S. Govt Indirect-Backed		**334,469,292**	**AAA**	**4.18**
STIP (Unrated)		**10,305,619**	**NR**	**NA**
Total Fixed Income Investments		**776,647,496**		
Direct Investments				
Real Estate	**$**	**1,139,460**		
Equity Index Fund		**100,545,339**		
Total Direct Investments		**101,684,799**		
Total Investments	**$**	**878,332,295**	**AA**	**4.14**
Securities Lending Collateral Investment Pool	**$**	**146,413,103**	**NR**	**NA**

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2007 and 2006

MSF Credit Quality Rating and Effective Duration as of June 30, 2006

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	$	343,140,818	A	3.91
U.S. Govt Direct-Backed		33,644,312	AAA	5.54
U.S. Govt Indirect-Backed		278,695,080	AAA	3.33
STIP (Unrated)		12,396,116	NR	NA
Total Fixed Income Investments		667,876,326		
Direct Investments				
Equity Index Fund	$	83,377,362		
Total Investments	$	751,253,688	AA-	3.74
Securities Lending Collateral Investment Pool	$	132,438,891	NR	NA

Old Fund Credit Quality Rating and Effective Duration as of June 30, 2007

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	$	7,301,835	AA+	2.17
U.S. Govt Direct-Backed		8,312,706	AAA	2.64
U.S. Govt Indirect-Backed		19,098,630	AAA	0.89
STIP (Unrated)		6,995,425	NR	NA
Total Investments	$	41,708,596	AAA	1.58
Securities Lending Collateral Investment Pool	$	13,687,883	NR	NA

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2007 and 2006

Old Fund Credit Quality Rating and Effective Duration as of June 30, 2006

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	$	13,714,502	AA	1.63
U.S. Govt Direct-Backed		10,016,309	AAA	2.65
U.S. Govt Indirect-Backed		19,521,572	AAA	1.63
STIP (Unrated)		8,101,168	NR	NA
Total Investments	$	51,353,551	AA+	1.86
Securities Lending Collateral Investment Pool	$	14,894,170	NR	NA

MSF and Old Fund investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered, or securities held by the BOI or its agent in the BOI's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank (SSB), to lend the BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the BOI receives a fee and the custodial bank must initially receive collateral equal to 102% of the fair value of the securities on loan and must maintain collateral equal to but not less than 100% of the fair value of the loaned security. The BOI retains all rights and risks of ownership during the loan period.

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. On June 30, 2007 and June 30, 2006, the BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total cash collateral held for fiscal years ended June 30, 2007 and June 30, 2006 for both MSF and the Old Fund:

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	MSF		Old Fund	
	Fiscal Year 2007	Fiscal Year 2006	Fiscal Year 2007	Fiscal Year 2006
Securities on Loan-Book Value	**$ 226,634,560**	**$ 130,560,457**	**$13,366,599**	**$14,605,995**
Securities on Loan-Market Value	**$ 201,895,993**	**$ 130,023,855**	**$13,442,243**	**$14,483,751**
Total Collateral Held	**$ 205,512,665**	**$ 132,438,891**	**$13,687,883**	**$14,894,170**

As of June 30, 2007, MSF and the Old Fund investments include $226.7M and $13.4M respectively, in long-term securities on loan that earned interest income during the fiscal year of $6.2M and $313K (thousand) respectively. Expenses related to long-term securities on loan for MSF and Old Fund for June 30, 2007 were $6.1M and $307K respectively.

As of June 30, 2006, MSF and the Old Fund investments include $130.6M and $14.6M respectively, in long-term securities on loan that earned interest income during the fiscal year of $5.6M and $890K respectively. Expenses related to long-term securities on loan for MSF and Old Fund for June 30, 2006 were $5.5M and $877K respectively.

In November 2000, the Montana Constitution was amended to allow MSF to invest in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. However, in May 2003, the BOI approved a policy statement to keep equities in the 8% to 12% range. As of June 30, 2007, equity securities in MSF include $68.4M at book value, enhanced by $32.1M in market value appreciation. As of June 30, 2006, equity securities in MSF include $68.4M at book value, enhanced by $15.0M in market value appreciation.

Additional investment information can be found in Note 2.

Receivables

At June 30, 2007, MSF's premium receivable and claim benefit recoveries balance is $22.6M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $2.8M leaving a net receivable balance of $19.8M. Other receivables include $11.2M in investment income due and $101K in notes and loans receivable, of which $34K is long term.

At June 30, 2006, MSF's premium receivable and claim benefit recoveries balance is $23.3M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $2.7M leaving a net receivable of $20.6M. Other receivables include $9.5M in investment income due and $158K in notes and loans receivable, of which $35K is long term.

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Accounts receivable includes $11.4M at June 30, 2007 and $14.4M at June 30, 2006 for premium that has been Earned But Unbilled, (EBUB). This represents a change in method of recording EBUB premium from previous periods. In fiscal year 2006 the EBUB was netted against Deferred Revenue. Deferred Revenue for June 30, 2006 has increased by $14.4M to show the gross amount of EBUB and Deferred Revenue. This change in methodology has no effect on Net Assets for fiscal year 2007 or 2006.

Accounts receivable in the Old Fund include medical and indemnity overpayments. Old Fund accounts receivable for year ended June 30, 2007 and June 30, 2006 were $1.29M and $1.34M, respectively. Estimated uncollectible receivables are reported as an allowance for doubtful accounts and are recorded at $1.28M and $1.29M for the years ended June 30, 2007 and June 30, 2006 respectively. Interest receivable of $558K at June 30, 2007 and $627K at June 30, 2006 represent investment income due.

Equipment, Accumulated Depreciation and Intangible Assets

Equipment is capitalized if the actual or estimated historical cost exceeds $5K. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF financials. Because MSF administers the Old Fund, the Old Fund does not carry fixed assets.

Other Assets

Other assets include advances, prepaid expenses and deferred acquisition costs. Deferred acquisition costs are amounts incurred during the policy writing process that are recognized ratably over the related policy term.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study that provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. State Fund management has selected our best estimates within that range as the estimated claims payable for both MSF and Old Fund. For additional disclosure related to the estimated claims payable, refer to Note 4.

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Accounts Payable

Accounts payable is a short term liability account reflecting amounts owed for goods and services received by MSF.

Deferred Revenue

Deferred revenue reflects amounts received or billed in advance, but not yet earned for policies effective July 1, 2007 or July 1, 2006.

Property Held in Trust

Property Held in Trust consists of security deposits owed to certain policyholders and the reinsurance funds withheld account, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. For additional information on distributions impacting total net assets see Note 6.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the GASB. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF and Old Fund, not the State of Montana.

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An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which 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. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

2. Investments

The amortized cost and market value of MSF's fixed maturity and equity securities as of June 30, 2007, and June 30, 2006, are as follows:

		Gross Unrealized		
June 30, 2007	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 333,096,617	$ 1,009,249	$ 6,707,433	$ 327,398,433
Government Mortgage-Backed	16,058,517	20,149	172,469	15,906,197
Corporate Securities Asset-Backed	92,143,171	2,050,666	643,274	93,550,563
Other Corporate Securities	319,888,189	507,304	5,912,342	314,483,151
Other Securities	14,942,986	303,856	243,309	15,003,533
Real Estate Securities	1,139,460	-	-	1,139,460
Equity Securities	68,406,676	32,138,662	-	100,545,339
STIP	10,305,619	-	-	10,305,619
Total	$ 855,981,236	$ 36,029,886	$ 13,678,827	$ 878,332,295

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June 30, 2006	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 298,646,776	$ 1,068,039	$ 7,285,782	$ 292,429,033
Government Mortgage-Backed	20,208,115	21,769	319,525	19,910,359
Corporate Securities Asset-Backed	36,640,073	-	794,411	35,845,663
Other Corporate Securities	300,626,964	2,211,091	9,384,126	293,453,929
Other Securities	13,985,513	221,971	366,258	13,841,226
Equity Securities	68,406,676	14,970,686	-	83,377,362
STIP	12,396,116	-	-	12,396,116
Total	$ 750,910,234	$ 18,493,556	$ 18,150,102	$ 751,253,688

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2007 and June 30, 2006, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2007

	Amortized Cost	Market Value
Due one year or less	$ 40,188,690	$ 40,028,813
Due after one year through five years	314,848,836	312,243,506
Due after five years through ten years	367,205,417	360,136,543
Due after ten years	64,192,156	64,238,635
Real Estate Securities	1,139,460	1,139,460
Equity Securities	68,406,676	100,545,339
Total	$ 855,981,236	$ 878,332,295

June 30, 2006

	Amortized Cost	Market Value
Due one year or less	$ 72,383,275	$ 72,088,693
Due after one year through five years	346,456,863	338,447,216
Due after five years through ten years	216,052,865	209,755,675
Due after ten years	47,610,555	47,584,741
Equity Securities	68,406,676	83,377,362
Total	$ 750,910,234	$ 751,253,688

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During the fiscal year ending June 30, 2007, MSF realized gross gains from sales of securities of $168K and gross realized losses of $823K. During the fiscal year ending June 30, 2006, MSF realized gross gains from sales of securities of $443K and gross realized losses of $698K.

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2007, investment income for MSF reflects an increase of $22.0M due to the unrealized gain on long-term investments. Investment income for fiscal year 2006 reflects a decrease of ($20.6M) due to the unrealized loss on long-term investments.

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2007 and June 30, 2006 are as follows:

		Gross Unrealized		
June 30, 2007	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 20,072,572	$ 909	$ 176,335	$ 19,897,146
Government Mortgage-Backed	1,185,000	4,362	1,473	$ 1,187,889
Corporate Securities Asset-Backed	11,644,729	59300.25	61,553	$ 11,642,476
Other Corporate Securities	2,024,442	0	38,783	$ 1,985,659
Other Securities	0	0	0	-
STIP	6,995,425	0	0	$ 6,995,425
Total	$ 41,922,168	$ 64,571	$ 278,144	$ 41,708,596

		Gross Unrealized		
June 30, 2006	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 28,320,200	$ 27,761	$ 498,423	$ 27,849,538
Government Mortgage-Backed	1,694,255	5,244	11,158	$ 1,688,342
Corporate Securities Asset-Backed	6,304,106	0	140,517	$ 6,163,589
Other Corporate Securities	7,596,719	3,807	49,611	$ 7,550,914
Other Securities	0	0	0	-
STIP	8,101,168	0	0	$ 8,101,168
Total	$ 52,016,448	$ 36,812	$ 699,709	$ 51,353,551

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The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2007 and June 30, 2006 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2007

	Amortized Cost	Market Value
Due one year or less	$ 19,072,720	$ 18,985,938
Due after one year through five years	14,695,154	14,614,175
Due after five years through ten years	2,776,566	2,792,307
Due after ten years	5,377,729	5,316,176
Total	41,922,168	41,708,596

June 30, 2006

	Amortized Cost	Market Value
Due one year or less	$ 8,221,472	$ 8,203,492
Due after one year through five years	34,068,761	33,628,676
Due after five years through ten years	3,422,109	3,357,794
Due after ten years	6,304,106	6,163,589
Total	52,016,448	51,353,551

During the fiscal year ended June 30, 2007, the Old Fund realized $13K in gross gains from sales of securities and $3K in gross losses from sales of securities. During the fiscal year ended June 30, 2006, the Old Fund realized $380K in gross gains from sales of securities and $147K in gross losses from sales of securities.

During fiscal year 2007, the effect of GASB 31 on Old Fund investment income was an increase of $0.4M due to unrealized gains on its long-term portfolio. The effect of GASB 31 on Old Fund investment income for fiscal year 2006 was a decrease of ($1.0M) due to unrealized losses on its long-term portfolio.

3. Reinsurance

For the fiscal years ended June 30, 2007 and June 30, 2006, MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against individual occurrences over stipulated amounts and an aggregate stop loss contract which protects MSF against the potential that

aggregate losses will exceed expected levels expressed as a percentage of premium. The excess of loss contracts provide coverage of $95.0M for both fiscal years 2007 and 2006. During fiscal years 2007 and 2006, MSF retained the first $5.0M for the first layer of reinsurance coverage. Individual, per person coverage was provided up to $5.0M per any one individual loss for both fiscal years 2007 and 2006.

The term of the current aggregate stop loss contract is July 1, 2005 through June 30, 2008. The contract provides coverage based on MSF's premium levels at a maximum of$33.8M per year and a minimum of $28.5M but in aggregate not to exceed 80.0% of the sum of the annual limits for all contract years. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $14.9M and $13.6M in fiscal years 2007 and 2006, respectively. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The total funds withheld account at June 30, 2007 is $29.7M. The funds withheld account at June 30, 2006 was $17.0M. Interest must be accrued quarterly at an annual rate of 5.0% for the fiscal years 2007 and 2006 funds withheld account, resulting in accrued interest of $1.6M for fiscal year 2007 and $1.0M for fiscal year 2006.

During fiscal years 2007 and 2006, estimated claim reserves were reduced $10.0M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excessive loss reinsurance contract. In fiscal year 2007 estimated claim reserves were reduced by an additional $8.6M and in fiscal year 2006 an additional $2.9M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the aggregate stop loss contract.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk related to Montana domiciled businesses with operations in other states, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2007 and 2006 is $2.4M and $2.2M, respectively. The assumed liability for OSC claims is $3.9M for fiscal year 2007 and $2.9M for fiscal year 2006.

4. Risk Management

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MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF. At June 30, 2007, approximately 28,499 active policies were insured by MSF. At June 30, 2006, approximately 28,410 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the insurer of last resort for employers since workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

MSF serves as claim administrator on claims for injuries that occurred before July 1, 1990, known as the Old Fund. Should the reserves in the Old Fund become inadequate the State of Montana and general fund will be obligated to cover benefit payments. Neither MSF nor the Old Fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. When MSF purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of MSF is terminated.

Towers, Perrin, Tillinghast, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2007 and June 30, 2006. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected our best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2007 and 2006. The MSF estimated unpaid claims and claims adjustment expenses payable is presented at face value, net of estimated reinsurance recoverable, at $679.2M and $590.7M, as of June 30, 2007 and June 30, 2006, respectively. The estimated claims payable increased $88.5M from 2006 to 2007, which included reserve strengthening of approximately $21.9M on prior year claims. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate.

State law (Section 39-71-2311, MCA) requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2007 and June 30, 2006 are $3.9M and $775K respectively. For the years ended June 30, 2007 and June 30, 2006, acquisition costs that were amortized are $775K and $1.3M, respectively.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments was provided by Old Fund Liability Taxes (OFLT), which are no longer in effect. The only OFLT activity that remains is miscellaneous collections and adjustments. Old Fund investment earnings must fund future claims payments.

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2007 and June 30, 2006, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2007 and 2006. As of June 30, 2007, the undiscounted estimated claims payable is $98.2M and is presented at net present value of $75.1M discounted at a 5.0% rate. As of June 30, 2006, the undiscounted estimated claims payable is $97.8M and is presented at net present value of $73.7M discounted at a 5.0% rate.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF and the Old Fund for the past two years, net of estimated reinsurance recoverable. The information presented has not been discounted.

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	MSF	
	2007	**2006**
Unpaid claims and claim adjustment expenses at beginning of year	$590,688,000	$511,557,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	189,203,678	170,398,933
Increase(Decrease) in provision for events in prior years	34,045,667	35,438,825
Total incurred claims and claim adjustment expenses	223,249,345	205,837,758
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	(38,677,130)	(36,131,780)
Claims and claim adjustment expenses attributable to insured events of PY	(96,051,215)	(90,574,978)
Total payment	(134,728,345)	(126,706,758)
Total unpaid claims and claim adjustment expenses at end of the year	679,209,000	590,688,000

	(OLD FUND - undiscounted)	
	2007	**2006**
Unpaid claims and claim adjustment expenses at beginning of year	97,768,808	104,851,596
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	-	-
Increase(Decrease) in provision for events in prior years	11,209,186	3,811,030
Total incurred claims and claim adjustment expenses	11,209,186	3,811,030
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	-	-
Claims and claim adjustment expenses attributable to insured events of PY	(10,745,454)	(10,893,818)
Total payment	(10,745,454)	(10,893,818)
Total unpaid claims and claim adjustment expenses at end of the year	98,232,540	97,768,808

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Risk Management Trend Information

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 1998 through 2007. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

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(In Millions's)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1. Premiums and Investment Revenue										
Earned	110,007	91,202	93,441	110,576	117,765	154,769	162,059	218,988	237,782	272,722
Ceded	303	260	855	2,952	(465)	5,654	6,563	6,788	13,618	14,856
Net Earned	109,704	90,942	92,586	107,624	118,230	149,115	155,496	212,200	224,164	257,867
2. Unallocated expenses including overhead	14,364	18,992	22,048	26,698	29,350	32,506	38,872	40,816	43,400	47,680
3. Estimated losses and expenses, end of accident year										
Incurred	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290	155,057	170,652
Ceded	-	-	-	-	-	-	-	-	-	-
Net Incurred	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290	155,057	170,652
4. Net paid (cumulative) as of:										
End of policy year	12,943	13,723	13,177	14,140	16,693	22,982	26,123	25,721	30,977	32,708
One year later	28,222	29,976	29,218	32,888	38,185	48,861	50,888	57,239	66,063	
Two years later	35,753	39,298	37,555	45,218	52,359	63,773	66,140	72,229		
Three years later	41,004	45,748	43,649	55,248	60,029	72,957	74,697			
Four years later	44,478	49,984	48,322	61,846	64,922	79,060	-			
Five years later	47,584	54,212	52,027	66,031	68,343	-	-			
Six years later	50,188	56,974	54,473	69,553	-	-	-			
Seven years later	52,240	59,935	57,077	-	-	-	-			
Eight years later	54,004	62,158	-	-	-	-	-			
Nine years later	55,639	-	-	-	-	-	-			
5. Re-estimated ceded losses and expenses	609	1,940	-	-	-	8,600	-	-	-	-
6. Re-Estimated net incurred losses and expense:										
End of policy year	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290	155,057	170,652
One year later	64,308	64,348	66,421	71,094	86,799	110,532	112,609	136,235	157,711	
Two years later	60,467	66,660	66,662	81,053	91,241	112,443	124,413	138,447		
Three years later	61,989	69,345	70,302	88,157	94,615	117,245	127,827			
Four years later	64,944	72,435	72,492	92,329	99,755	115,414	-			
Five years later	67,312	73,710	73,423	95,727	100,925	-	-			
Six years later	67,772	75,537	76,048	98,124	-	-	-			
Seven years later	68,601	78,046	77,929	-	-	-	-			
Eight years later	69,764	80,116	-	-	-	-	-			
Nine years later	71,099	-	-	-	-	-	-			
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	6,116	15,471	11,972	29,857	19,365	5,261	7,122	4,157	2,654	0

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5. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M. MSF allocated $1.25M in administration costs to the Old Fund in each of fiscal years 2007 and 2006. The Old Fund has a $321K obligation to MSF in unrecovered administrative costs incurred in fiscal years 2006 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M.

6. MSF Distributions

Dividends Paid to Policyholders

During the fiscal years ended June 30, 2007 and June 30, 2006, the MSF Board of Directors authorized and paid dividends to policyholders for $7.0M for policy year 2005 and $5.0M for policy year 2004, respectively.

Payments from Old Fund to MSF and State of Montana

House Bill Number 363 (HB 363), enacted by the 2003 Montana Legislature, changed existing law regulating the Old Fund transfer of surplus. HB 363 removed the 10% contingency reserve requirement for the Old Fund and transfers the reserve as well as any remaining available funds from Old Fund to the State of Montana General Fund.

There was no transfer amount to the General Fund for fiscal years 2007 and 2006. Refer to Note 7 for additional information regarding HB 363.

7. Old Fund Net Asset Position

As of December 31, 1998, the Old Fund Liability Tax was terminated and a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis using a discount factor of 5.0% to determine compliance with state law requirements for maintaining fund adequacy.

Section 39-71-2352 (5), MCA, provided for the payment of excess funds from the Old Fund to the State of Montana General Fund based on adequate funding levels in the Old Fund. This law defined the term "adequately funded" to mean the present value of:

a) the total cost of future benefits remaining to be paid; and,

b) the cost of administering the claims; and,
c) adjusted for any unrealized gains and losses.

As stated in Note 6, HB 363, enacted by the 2003 Montana Legislature, changed the law regulating the Old Fund transfer of surplus. HB 363 requires the transfer of any amounts above the amount of "adequately funded" to the State of Montana General Fund. In addition, future excess funds will continue to be transferred to the General Fund.

There were no excess funds to transfer to the General Fund as of June 30, 2007 and June 30, 2006 as a result of HB363. In order to value liabilities consistently with investments, the estimated claims liability discount rate is 5.0% in fiscal years 2007 and 2006. The Old Fund net asset level, using a present value discount factor of 5.0%, is $(32.6M) as of June 30, 2007. Using a present value discount factor of 5.0% as of June 30, 2006, the net asset level is $(21.9M). The negative balance for June 30, 2007 is the direct result of the transfers made from the Old Fund to the General Fund mandated by HB 363. This does not indicate that the Old Fund does not have adequate financial resources to satisfy current claims obligations. Applying the current actuarially estimated payout pattern of the Old Fund there are sufficient invested assets to meet its obligations until the year 2011. Current law requires the General Fund to satisfy all outstanding claims when the Old Fund has liquidated all financial resources and cannot meet its obligations.

8. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program, (Traditional Plan) and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers union represented employees who have elected to remain in the plan. These employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to employees in the Traditional Plan. MSF Personal Leave Program covers all non-union employees, union employees hired before July 26, 2006 who have elected to adopt the plan, and all employees hired after July 25, 2007. Employees in the Personal Leave Program accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

MSF absorbs expenditures for termination pay in its annual operational costs. MSF may allocate some of these costs to Old Fund as a portion of the Old Fund administrative cost allocation. The total leave liability for MSF and Old Fund is $2.2M and $0, respectively, for fiscal year 2007. The total leave liability for MSF and Old Fund is $2.0M and $0, respectively, for fiscal year 2006.

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9. Retirement Plans

MSF and its employees contribute to the Public Employees' Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2007 and 2006. MSF's contributions amounted to $1.0M for fiscal year 2007 and $1.0M for fiscal year 2006. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2007.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from PERB at 100 North Park Avenue, Suite 220, P. O. Box 200131, Helena, MT 59620-0131, 406 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

10. Claim Benefit Overpayments

As the result of implementing a new claim management system in fiscal year 2006 the process to identify and interface receivable balances for claim benefit overpayments to the state general ledger was initiated. Claim benefit overpayments in the previous claim system were at the claim level and were not recorded as a receivable on the financial statements. As funds were collected from the injured employee or provider the payments were applied directly as a credit to claims expense.

Since conversion to the new claim system, all overpayments have been identified and recorded as a receivable in the financial statements. The result of this transaction in fiscal year 2006 was an increase to receivables and a reduction to claims expense of $2.1M in the New Fund. For those overpayments that were older than 90 days, a bad debt expense was recorded and an allowance for doubtful accounts set up. The bad debt expense and the allowance for doubtful accounts for the overpayments were $1.8M for the New Fund in fiscal year 2006. The result to Net Assets in fiscal year 2006 was an increase of $300K.

In fiscal year 2007 MSF had a receivable balance of $2.2M and an allowance for doubtful account balance of $2.1M.

The result of the transaction in the Old Fund was an increase in receivables and a decrease to claims expense of $1.3M. There was also an increase to bad debt expense and a corresponding increase to the allowance for doubtful accounts of $1.3M for fiscal year 2006. There was no impact to Net Assets in the Old Fund in fiscal year 2006.

In fiscal year 2007 the Old Fund had a receivable balance and an allowance for doubtful accounts of $1.2M.

11. Building

MSF leases an office building from the State of Montana. Under an agreement with the State of Montana, which expires on July 31, 2009, MSF pays all costs associated with the building, including utilities, property assessments, janitorial services, and maintenance plus an administrative rental fee to the State of Montana, Department of Administration. .

On May 16, 2007, the State of Montana, Board of Investments purchased property as an investment of MSF assets. The real estate property was purchased for $1.14M. Under an agreement with the Board of Investments, BOI will coordinate construction of an office building to be occupied by MSF. The BOI will manage the property as an investment of MSF assets and assess a rental charge to MSF to occupy the building. The rental rate will be established in an arms length transaction taking into consideration market rental rate and a market rate of return on the investment in the real estate. Montana State Fund will continue to pay all other costs of the property including utilities, property assessments, janitorial services, and maintenance. The rent charged to MSF and received by the BOI will be recorded as investment income to MSF. The building is not expected to be complete until fiscal year 2009 or 2010.

12. Contingencies

Stavenjord v. State Compensation Insurance Fund. The first *Stavenjord* decision was issued by the

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Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (workers' compensation act) violates the claimant's right to equal protection of the law. Relying on the *Henry* case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court held that MCA §39-72-405 is unconstitutional as applied to Debra Stavenjord. "Where PPD benefits calculated pursuant to the WCA are greater than the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to $27,027 under the WCA, versus $10,000 under the ODA." The Montana Supreme Court affirmed the case on April 1, 2003. On August 27, 2004 the Workers Compensation Court held that *Stavenjord* is retroactive to June 3, 1999 (the date of the *Henry* decision). The Court held that a common fund was created for claimants reaching Maximum Medical Improvement on or after June 3, 1999. The decision was appealed to the Montana Supreme Court.

The Montana Supreme Court issued their decision on the appeal on October 6, 2006, and modified the lower court decision holding that a common fund was not created. The court also held that the decision applies retroactively to claims from July 1, 1987. The cost to retroactively pay claims to July 1, 1987 is estimated at $9.5 million dollars for the Montana State Fund (New Fund- for claims on or after July 1, 1990). The impact on the Old Fund liability for claims that occurred from July 1, 1987 to June 30, 1990 is estimated at $2.0 million. The case is currently pending before the Workers' Compensation Court on matters related to identification and notification of claimants. Once file reviews and payments are completed the actual financial impact as compared to the estimated financial impact could possibly increase or decrease. The estimated liability is recorded in loss reserves.

Satterlee v. Lumberman's Mutual Casualty Company et al., WCC No. 2003-0840, was filed before the Workers' Compensation Court on July 18, 2003. The *Satterlee vs. Lumberman's Mutual Casualty Company* case challenges the constitutionality of state statute, (39-71-710, MCA) passed by the Montana Legislature in 1981. That statute authorizes termination of permanent total disability benefits and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. Should the statute be found to be unconstitutional as applied to permanent total benefits, *Satterlee, et al.* request payment of lifetime permanent total disability benefits. In addition, the petition requests certification of this case as a class action or the establishment of a common fund for similarly situated claimants. Petitioners filed a motion and brief for summary judgment on the constitutional issue. The Worker's Compensation Court provided an opportunity for any workers' compensation insurer to intervene until June 6, 2005. The Workers' Compensation Court rendered its decision on December 12, 2005, holding that § 39-71-710, MCA is constitutional as applied to PTD benefits. The case is currently pending on appeal to the Supreme Court. Should 39-71-710, MCA ultimately be held to be unconstitutional as applied to permanent total disability benefits by the Montana Supreme Court, and

also found to apply retroactively, the cost impact has been estimated for non-settled claims arising on or after July 1, 1990 through December 22, 2004 at $135 million to $186 million. The estimated cost of retroactively applying the decision to the Old Fund, for non-settled permanent total disability claims that occurred before July 1, 1990 is $93 to $116 million. The potential for liability for MSF and the state of Montana is reasonably possible. Actual cost impact is unknown.

***Reesor v. Montana State Fund*, 2004 MT 370.** *Reesor* was receiving social security retirement benefits at the time he suffered an industrial accident. He received an impairment award but was denied other permanent partial disability (PPD) benefits pursuant to section 39-71-710, MCA, which provides that persons who are receiving social security benefits or are eligible for full social security retirement benefits are ineligible for PPD benefits other than an impairment award. *Reesor* challenged the constitutionality of section 39-71-710, MCA, on equal protection grounds and sought full PPD benefits. On July 26, 2003, the Workers' Compensation Court found 39-71-710, MCA, to be constitutional. *Reesor* appealed to the Montana Supreme Court, where on December 22, 2004, the Court held that limiting *Reesor's* permanent partial benefit pursuant to 39-71-710, MCA, violated the Equal Protection Clause of the Montana Constitution. Pending before the Workers' Compensation Court are the retroactive application of the decision and common fund status. MSF has estimated the cost of benefits associated with a retroactive application of *Reesor*. MSF's estimate did not include claims with entitlement dates occurring on or after July 1, 1991 through June 30, 1995 because the *Russette* decision appears to make *Reesor* inapplicable during that timeframe. Excluding the *Russette* timeframe, for claims arising on or after July 1, 1990 through December 22, 2004, the increase in benefit costs for MSF is estimated at $2.0 million. For claims arising on or after July 1, 1987 through June 30, 1990, the retroactive application of *Reesor* will result in an estimated benefit cost increase of $1.0 million for the Old Fund. The potential for the litigation to create a liability for MSF and the state of Montana is reasonably possible. Actual cost impact should the decision be applied retroactively is unknown.

Working Rx, Inc.*, *v. Montana State Fund, Ed Henrich, (Chairman of the Board of Directors of the Montana State Fund), Laurence Hubbard (President of the Montana State Fund), National Medical Health Card Systems, Inc, and John Does 1-20. This complaint was served in September, 2006, but has since been dismissed to provide for the presentation of the claim to the Department of Administration as required in 2-9-301, MCA. Whether Montana State Fund has any responsibility to Working Rx for payment of pharmacy claims is the basis of the claim. Montana State Fund does not have sufficient information to determine potential liability or cost impact.

MONTANA STATE FUND

FUND'S RESPONSE

MONTANA STATEFUND

5 South Last Chance Gulch • P.O. Box 4759 • Helena, MT 59604-4759
Customer Service: 1-800-332-6102 or 406-444-6500
Fraud Hotline: 1-800-682-7463 (800-MT-CRIME)

December 20, 2007

RECEIVED
DEC 20 2007
LEGISLATIVE AUDIT DIV.

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

Dear Mr. Seacat:

Montana State Fund (MSF) appreciates the efficient and professional approach of the audit staff involved in this review of our governmental financial statements. Once again, we are pleased with your issuance of an unqualified opinion. We take pride in our overall internal control at MSF, and embrace the opportunity to further strengthen our control environment. The report contained one recommendation: *We recommend Montana State Fund management implement procedures to ensure access to computer systems is appropriate based on job responsibilities.*

MSF concurs with the recommendation and has already corrected the security issue identified. MSF management and our Internal Auditor have begun an extensive review and analysis of our employees' security roles, authorities, and accesses to various computer systems. This review will enable us to further evaluate appropriateness of employee access to critical systems in comparison to employee job responsibilities and maintain segregation of duties. This review will take place over the next several months and should be completed by fiscal year end. We are currently strengthening our authorization process and providing for additional review of requested new or changed computer access. Further, we plan to enhance our monitoring process of accesses granted with more frequent periodic reviews by management and the Internal Auditor.

The management and staff of MSF are very proud of our accomplishments in serving Montana businesses. We continually strive to improve our operations to ensure Montana businesses and the community will continue to benefit from a strong Montana State Fund many years into the future.

Sincerely,

Laurence A. Hubbard
President/CEO

LAH/sh