Statutory Financial Statements
June 30, 2014 and 2013

MONTANA STATEFUND

CPAs & BUSINESS ADVISORS

Independent Auditor's Report

To the Board of Directors
Montana State Fund
Helena, Montana

Report on the Financial Statements
We have audited the accompanying statutory financial statements of Montana State Fund (MSF), a component unit of the State of Montana, which comprise the statutory statements of admitted assets, liabilities, and policyholders' equity as of June 30, 2014 and 2013, and the related statutory statements of operations, changes in policyholders' equity, and cash flows for the years then ended, and the related notes to the statutory financial statements.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with the accounting practices prescribed or permitted by the Montana State Auditor, Commissioner of Securities and Insurance. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles
As described in Note 1 to the financial statements, the financial statements are prepared using accounting practices prescribed or permitted by the Montana State Auditor, Commissioner of Securities and Insurance, which is a basis of accounting other than accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between the statutory basis of accounting described in Note 1 and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

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Adverse Opinion on U.S. Generally Accepted Accounting Principles
In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of Montana State Fund as of June 30, 2014 and 2013, or the results of its operations or its cash flows for the years then ended.

Opinion on Regulatory Basis of Accounting
In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' equity of Montana State Fund as of June 30, 2014 and 2013, and the results of its operations, changes in policyholders' equity and its cash flows for the years then ended, on the basis of accounting described in Note 1.

Eide Bailly LLP

Fargo, North Dakota
November 05, 2014

	2014	2013
Admitted Assets		
Investments and Cash		
Bonds	$ 1,083,973,027	$ 1,030,989,483
Equity securities	167,515,006	154,628,154
Real estate		
Properties occupied by the Company	26,908,775	27,441,810
Cash and short-term investments	38,011,790	53,474,261
Other invested assets	74,841,190	36,530,984
Securities lending collateral	166,416,008	141,152,406
Total cash and invested assets	1,557,665,796	1,444,217,098
Other Admitted Assets		
Receivables, net	56,180,284	55,761,527
Equipment, net	914,638	804,502
Accrued investment income	10,092,205	10,412,465
Reinsurance receivables	45,911,683	53,100,879
Other assets	345,640	430,915
Total other admitted assets	113,444,450	120,510,288
Total admitted assets	$ 1,671,110,246	$ 1,564,727,386
Liabilities and Policyholders' Equity		
Liabilities		
Reserve for unpaid losses	$ 805,717,546	$ 785,029,060
Reserve for unpaid loss adjustment expenses	118,880,034	117,818,868
Securities lending liability	166,416,008	141,152,406
Unearned premium	48,080,932	48,073,611
Reinsurance funds withheld	66,702,918	76,971,113
Other expenses payable	21,460,214	23,404,893
Total liabilities	1,227,257,652	1,192,449,951
Policyholders' Equity		
Policyholders' equity	443,852,594	372,277,435
Total liabilities and policyholders' equity	$ 1,671,110,246	$ 1,564,727,386

	2014	2013
Net Premium Earned	$ 165,271,880	$ 156,062,478
Losses incurred	127,812,156	111,458,886
Loss expenses incurred	15,538,264	28,390,180
Underwriting expenses incurred	33,291,300	33,437,101
Contingent commission income	(12,753,215)	(8,577,871)
Net underwriting loss	1,383,375	(8,645,818)
Net investment income earned	42,457,728	42,696,687
Net realized capital gains	14,279,687	11,033,107
Receivable balances charged off, net of recoveries of $1,183,073 and $1,074,508	(380,511)	(315,431)
Other expense	(3,994,562)	(3,345,402)
Net Income Before Dividends	53,745,717	41,423,143
Policyholder Dividends	(12,003,138)	(10,005,214)
Net Income After Dividends	$ 41,742,579	$ 31,417,929
Changes in Policyholders' Equity		
Balance, Beginning of Year	$ 372,277,435	$ 317,667,748
Net income	41,742,579	31,417,929
Net unrealized gain on investments	28,036,023	22,191,618
Change in non-admitted assets	646,364	944,875
Change in provision for reinsurance	-	55,265
Other changes in policyholders' equity	1,150,193	-
Balance, End of Year	$ 443,852,594	$ 372,277,435

	2014	2013
Cash from Operations		
Premiums collected, net of reinsurance	$ 168,246,564	$ 157,885,898
Net investment income	43,680,614	44,856,967
Miscellaneous income	1,299,204	1,396,735
	213,226,382	204,139,600
Benefit and loss related payments	(105,678,089)	(110,622,648)
Loss adjustments and underwriting expenses paid	(48,007,033)	(45,156,454)
Dividends paid to policyholders	(12,003,138)	(10,005,214)
	(165,688,260)	(165,784,316)
Net Cash from Operations	47,538,122	38,355,284
Cash from Investments		
Proceeds from investments sold, matured, or repaid		
Bonds	168,738,186	168,707,839
Equity securities	22,000,000	15,000,000
Total investment proceeds	190,738,186	183,707,839
Cost of investments acquired		
Bonds	(218,722,671)	(159,954,259)
Other invested assets	(34,250,000)	(35,750,000)
Total investments acquired	(252,972,671)	(195,704,259)
Net Cash used for Investments	(62,234,485)	(11,996,420)
Cash from Financing and Other Sources		
Cash provided or (applied)		
Other sources	(766,108)	619,279
Net Cash from (used for) Financing and Other Sources	(766,108)	619,279
Net Increase in Cash and Short-Term Investments	(15,462,471)	26,978,143
Cash and Short-Term Investments - Beginning of Year	53,474,261	26,496,118
Cash and Short-Term Investments - End of Year	$ 38,011,790	$ 53,474,261

Note 1 - Nature of Operations and Significant Accounting Policies

Nature of Operations

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. The Board has full power, authority, and jurisdiction in the administration of MSF as fully and completely as the governing body of a private mutual insurance carrier. MSF is allocated to the State of Montana, Department of Administration for administrative purposes only, and is reported as a component unit in the State's Comprehensive Annual Financial Reports. MSF is exempt from federal or state income and premium taxes. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana. However, MSF is not currently required to file the annual statement and financial reports with the Commissioner of Securities and Insurance.

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. State law 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. 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).

During the 1990 Montana Special Legislative Session, legislation passed establishing separate liabilities, 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. This report reflects only the operations of Montana State Fund. MSF administers and manages the remaining claims of the Old Fund. The State of Montana pays MSF an administrative fee and provides the funding for the Old Fund benefit payments.

Basis of Presentation

The accompanying financial statements of MSF have been prepared in conformity with accounting practices prescribed and permitted by the State Auditor, Commissioner of Securities and Insurance (Statutory Accounting Principles or SAP). Such practices vary from accounting principles generally accepted in the United States of America (GAAP) principally in that certain assets reportable under GAAP are "non-admitted" under SAP and have been excluded from the accompanying statutory statements of admitted assets, liabilities and policyholders' equity and charged directly against equity. In addition, certain investments which would be carried at estimated fair value under GAAP are carried at amortized cost or the lower of amortized cost or fair market value for SAP.

The State Auditor, Commissioner of Securities and Insurance recognizes only statutory accounting practices prescribed or permitted by the State of Montana for determining and reporting the financial condition and results of operations of an insurance company. The National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures* manual (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the State of Montana.

Differences of NAIC SAP from Generally Accepted Accounting Principles

Statutory accounting practices vary in some respects from U.S. generally accepted accounting principles (GAAP). Such significant differences include the following:

a. Investments in equity securities are carried at current market values as determined by the NAIC;

b. Investments in bonds are generally carried at amortized cost, while under GAAP, they are carried at either amortized cost or estimated fair value based on their classification according to the Company's ability and intent to hold or trade the securities;

c. Assets are reported under NAIC SAP at the "admitted asset" value and "non-admitted" assets are excluded through a charge against unassigned policyholders' equity, while under GAAP, "non-admitted assets" are reinstated to the balance sheet, net of any valuation allowance;

d. Cash, cash equivalents, and short-term investments in the statements of cash flows represent cash balances and investments with initial maturities of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents include cash balances and investments with initial maturities of three months or less.

MSF's financial statements are stated on a NAIC SAP basis. For the years ended June 30, 2014 and 2013, there was no difference of MSF's net income and policyholder's equity between NAIC SAP and practices prescribed and permitted by the State of Montana.

The Montana Code Annotated references conformity with the Accounting Practices and Procedures Manual within section 33-2-701(1) and therefore concludes that no legislation is necessary to adopt its use.

Correction of an Error
During the course of the State of Montana's statewide 2014 audit, an error was identified in the other post-employment benefit plan's (OPEB) valuation that resulted in an overstated liability. Under the Regulatory Basis of Accounting described in Note 1, Statement of Statutory Accounting Principle (SSAP) No. 3, *Accounting Changes and Corrections of Errors*, paragraph 10, states: "Corrections of errors in previously issued financial statements shall be reported as adjustments to unassigned funds (Policyholders' Equity) in the period an error is detected." In accordance with SSAP No. 3, MSF recorded its allocated amount of the correction in 2014. The related liability balance was reduced by $1.5M and Policyholders' Equity was increased by $1.2M to reflect the portion of the change related to prior years.

While this accounting treatment and presentation in the financial statements is required in accordance with the accounting framework used by MSF the OPEB liability included in "Other Expenses Payable" line of the statement of admitted assets, liabilities, and policyholders' equity for the year ended June 30, 2013, is overstated by $1.2M and beginning Policyholders' Equity is understated by $1.2M for the year ended June 30, 2013. Management has determined the amounts of these corrections are not material to the overall fair presentation of the financial statements.

Significant Statutory Accounting Policies

Cash and Cash Equivalents

Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash are savings accounts, certificates of deposits with maturity dates of one year or less, and cash equivalents. Cash equivalents are investments with original maturities of three months or less; are readily convertible to known amounts of cash; and, present insignificant risk of change in value due to changes in interest rates. The Montana State Treasury and the Montana Board of Investments (BOI) hold MSF's cash and cash equivalent balances. At times during the year, MSF's cash balances are in excess of federally insured limits. The Company does not consider this a material risk.

Short-Term Investments

Short-term investments are those investments with remaining maturities of one year or less at the time of acquisition, excluding those investments classified as cash equivalents. Short-term investments include but are not limited to bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans that meet the above criteria. MSF participates in the Short-Term Investment Pool (STIP), maintained by the BOI. STIP balances are highly liquid investments. The market value of investments held in the STIP approximates cost.

Investments

Equity securities, bonds, investments in partnerships and limited liability companies, and certificates of deposit with original maturities greater than one year are long-term investment securities. Long-term securities are held by BOI. State Street Bank is the custodial bank for BOI.

Equity securities are valued at fair market value. The Montana Constitution allows investing in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. The BOI approved a policy statement to keep equities in the 8% to 12% range. Investments in common stock are carried at current fair value as determined by the Securities Valuation Office (SVO), and the related unrealized capital gains (losses) are reported in policyholders' equity.

Bonds are rated and valued in accordance with the NAIC Securities Valuation Office (SVO) rating guidelines. Bonds with a SVO rating of 1 and 2 are valued at amortized cost. Bonds with a SVO rating of 3 or higher are valued at the lower of amortized cost or market.

Investments in partnerships and limited liability companies are valued based on the underlying audited U.S. GAAP equity of the investee in accordance with SSAP 48. The related unrealized capital gains (losses) are reported in policyholders' equity.

MSF has no derivative investments.

Investments in Real Estate – Property occupied by the Company is recorded at depreciable cost net of related debt obligation, which was zero as of June 30, 2014 and 2013. Depreciation is calculated on a straight-line basis over the estimated useful life of the property. Land is valued at cost.

Investment income consists of interest and dividends, net of related investment expenses. Interest is recognized on an accrual basis and dividends are recorded as earned at the ex-dividend date. Realized capital gains and losses are determined using the first-in first-out method at the time of disposition.

Effective July 1, 2013, MSF's fund manager implemented the scientific (constant yield) interest method of amortization in accordance with SSAP 26. Prior to that date, premiums and discounts were amortized or accreted over the estimated lives of the underlying securities using the straight-line method. Management believes the difference between the straight-line method and the scientific method is immaterial to the prior year Statutory Statements of Operations and is not able to determine the cumulative impact to the Statutory Statements of Admitted Assets, Liabilities and Equity. Securities transactions are recorded on the trade date.

Fair Values of Financial Instruments

The Company has adopted Statement of Statutory Accounting Principles (SSAP) No. 100, "Fair Value Measurements." This standard defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and considers assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions and risk of nonperformance.

The Company classified its investments based upon an established fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. SSAP 100 describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value, which are the following:

- Level 1—Quoted prices in active markets for *identical* assets or liabilities.
- Level 2—Inputs other than Level 1 that are observable, either directly or indirectly; such as quoted prices for *similar* assets or liabilities, quoted prices in markets that are not active; or other inputs that can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value or for those assets not stated at fair value in the financial statements but whose estimated fair values are disclosed.

Bonds – Issuer Obligations, including Industrial and Miscellaneous: Valued based on NAIC market values. For those securities not actively traded, quoted market prices of comparable instruments or discounted cash flow analysis are used based upon inputs that are observable in the markets for similar securities. Inputs include benchmark yields, credit spreads, default rates, prepayments and non-bonding broker quotes.

Bonds – Mortgage and Other Asset Backed Bonds: Valued based on Commercial and Residential Mortgage Backed Securities modeling file provided by the NAIC. The prepayment assumptions used for single class and multi-class mortgage backed/asset backed securities were obtained from broker/dealer survey values. These assumptions are consistent with the current interest rate and economic environment.

Common Stock Unaffiliated and Mutual Funds: Valued based on NAIC quoted market values. If NAIC market values are unavailable then value is determined based on the underlying equity.

Other Invested Assets: Value is based on the underlying equity of the related entity.

Cash and Cash Equivalents: The carrying amounts approximate their fair value.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of the future fair values. Furthermore, although the company believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Other-Than-Temporary Declines in Fair Value

The Company regularly reviews its investment portfolio for factors that may indicate that a decline in fair value of an investment is other-than-temporary. Some factors considered in evaluating whether or not a decline in fair value is other-than-temporary include: the Company's ability and intent to retain the investment for a period of time sufficient to allow for a recovery in value; the duration and extent to which fair value has been less than cost; and the financial condition and prospects of the issuer. When an other-than-temporary impairment is recognized, the security is written down to estimated fair value and the amount of the write-down is recorded as a realized loss.

Cash Collateral and Liability for Securities on Loan

Under the provisions of state statutes, the Montana Board of Investments (BOI) has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank, to lend 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, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral of at least 100% of the market value of the loaned security. BOI retains all rights 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 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 BOI could not determine. On June 30, 2014 and 2013, BOI had no credit risk exposure to borrowers.

Premium Receivable

Premium receivable balances with an amount due over 90 days are non-admitted assets. MSF evaluates the remaining admitted accounts receivable asset for impairment. If it is probable that any amounts are not collectible, the uncollectible receivable is written off and charged to income in the period the determination is made.

Computer Equipment and Software

Computer equipment is capitalized if the actual or estimated historical cost exceeds $5,000. Software is capitalized if the actual or estimated historical cost exceeds $100,000. Computer equipment is depreciated on a straight-line basis over an estimated useful life of three years. Software is amortized on a straight-line basis using a three-year life for operating software and a five year life, or less, for application software. In accordance with statutory accounting principles, computer equipment and operating software are admitted assets. Application software is a non-admitted asset.

Furniture, Equipment and Leasehold Improvements

Furniture and equipment are capitalized if the cost exceeds $5,000, and are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from five to ten years. There are no leasehold improvements. Statutory accounting principles require that furniture, equipment and leasehold improvements be capitalized, depreciated and non-admitted.

Other Assets

Other assets include advances for the Other States Coverage reinsurance contracts.

Risks and Uncertainties

Risks and uncertainties existing as of the date of the financial statements are as follows:

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, fixed 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 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.

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 company 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, 2014 and 2013, all the fixed income and other equity securities were registered in the nominee name of BOI and held in the possession of BOI's custodial bank, State Street Bank.

Concentration of Credit Risk – Concentration of credit risk is the risk of loss attributed to the magnitude of a company's investment in a single issuer. The MSF Investment Policy requires credit risk to be limited to 2% of the total securities portfolio in any one name. The MSF Investment Policy provides for "no limitation on U.S. government/agency securities." Investments issued or explicitly guaranteed by the U.S. Government are excluded from the concentration of credit risk requirement.

Interest Rate Risk – Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. MSF investment policies do not formally address interest rate risk; however, BOI has selected the effective duration method to calculate interest rate risk. This information is provided by the custodial bank.

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.

MSF investments are categorized in Note 2 to disclose credit and interest rate risk as of June 30, 2014 and 2013.

Uncertainty Due to Litigation – In the ordinary course of business, MSF is a defendant in various litigation matters. Although there can be no assurances, as of June 30, 2014 and 2013, in the opinion of MSF's management based on information currently available, the ultimate resolution of these legal proceedings would not be likely to have a material adverse effect on its statutory results of revenue and expenses, admitted assets, liabilities and policyholders' equity or liquidity. For further discussion, refer to Note 14 (Contingencies and Uncertainties).

Vulnerability Due to Certain Concentrations – MSF conducts its business primarily within the State of Montana and is susceptible to risk based on the economy of the geographic territory it serves. As of June 30, 2014, about 71% of total premium was written through appointed agency producers, and about 29% was written directly through MSF. In September 2012, a merger of Payne Financial Group and Western States Insurance was announced which created one of the largest private insurance brokerages in the United States. The producer appointment agreement was reissued as a combined agency under the new entity, PayneWest Insurance, effective January 1, 2013. As of June 30, 2014, this agency represented about 41% of MSF's total premium.

Use of Estimates – The preparation of financial statements in conformity with Statutory Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates. Material estimates susceptible to significant change include loss and loss adjustment expense reserves, the fair value of investments, investment impairments, and cost allocation processes.

<u>Administrative Cost Allocation</u>

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments on 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 received $820K and $870K from the State of Montana for the administration of the Old Fund in fiscal years 2014 and 2013, respectively.

<u>Losses Incurred and Loss Adjustment Expense Estimates</u>

Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are 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. 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. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustments to these estimates of reserves will be reflected in the Statutory Statement of Operations in future years.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. Losses and loss adjustment expenses are presented at face value net of estimated reinsurance recoverable. For further discussion, refer to Note 8.

Reinsurance Recoverable on Paid and Unpaid Losses

Reinsurance recoverables are estimates of paid and unpaid losses collectible from MSF's reinsurers. The amounts ultimately collected may be more or less than these estimates. Any adjustments of these estimates are reflected in revenues and expenses as they are determined.

Unearned Premiums

Unearned premium reflects premium that has been written but not yet earned. The unearned premium was $48M at both June 30, 2014 and 2013, respectively.

Other Liabilities

- Security Deposits - Security deposits are monies held on behalf of certain policyholders based on arranged payment terms or account history.

- Funds Withheld - Funds withheld are premiums due to reinsurers on a contingent basis in accordance with the reinsurance contracts in place.

- Accounts Payable - Accounts payable includes liabilities incurred on behalf of claimants, refunds due to policyholders and amounts due to vendors.

- Compensated Absences - MSF supports two leave programs, the State of Montana Leave Program, (Traditional Plan) and the MSF Personal Leave Program. Employees covered in the Traditional Plan 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. Employees in the Personal Leave Program accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave and banked holiday leave upon termination but extended leave has no cash value at the time of termination.

- Postretirement Benefits - Postretirement benefit obligations are administered by the State of Montana. The liability and expense are recorded, and are amortized on a GAAP basis as provided by the State because a statutory valuation is not available. Management believes the difference between the GAAP valuation and the SAP valuation is not material to these financial statements. For further discussion, refer to Note 9. During the course of the State of Montana's statewide audit, an error was identified in the other post-employment benefit plan's valuation that resulted in an overstated liability. Accordingly, MSF recorded a correction of the error in its 2014 results. Refer to Note 18 for more detailed explanation.

Income and Premium Taxes Payable

MSF is a component unit of the State of Montana and is not subject to Federal or State premium or income tax.

Premium Revenue

Premiums are recognized as revenue on a pro-rata basis over the policy period, beginning on the effective date of the policy. MSF's Board of Directors approves premium rates annually.

Policyholders, with the exception of State of Montana agencies, are contractually obligated to pay certain premiums to MSF in advance of the period in which the premiums are earned. Advance premiums are deferred until the effective date of the policy at which time they are recognized as revenue on a pro-rata basis over the term of the policy. Premium advances are refundable when the policyholder's coverage is canceled and MSF has credited all earned premiums. State agency premium is estimated and payments are received quarterly in arrears based on the actual reported payroll.

Retrospectively Rated Policies

MSF writes policies for which the premiums vary based on loss experience. Future premium adjustments for these retrospective policies are estimated and accrued at June 30, 2014 and 2013. The premium adjustments are determined through the review of each individual retrospective rated policy, comparing actual losses with projected future losses, to arrive at the best estimates of return or additional retrospective premiums. MSF records retrospective premium accruals and receivables as adjustments to earned premium. Return premiums are recorded as liabilities and additional premiums are recorded as assets.

Policy Acquisition Costs

Expenses incurred in connection with acquiring new insurance business, including such acquisition costs as sales commissions, are charged to operations as incurred.

Advertising Costs

All advertising costs are expensed when incurred. Advertising expense was $473K and $669K for the years ended June 30, 2014 and 2013, respectively.

Policyholder Dividends

Dividends are discretionary and are accrued and expensed when declared and approved by the MSF Board of Directors. The aggregate amount of policyholders' dividends is based on the analysis of policyholder equity balances and the financial results for the year. For further discussion, refer to Note 10.

Note 2 - Investments

The investments of MSF at June 30, 2014 and 2013 are as follows:

June 30, 2014	Total Investment Holdings	Percentage
Bonds:		
U.S. Government obligations	$ 168,923,301	10.85%
All other government obligations	20,969,876	1.35%
U.S. Special revenue	244,520,312	15.70%
Industrial and miscellaneous	589,312,193	37.83%
Mortgage and other loan-backed securities	60,247,345	3.87%
Total bonds	1,083,973,027	69.60%
Equity securities	167,515,006	10.75%
Cash and short-term investments	38,011,790	2.44%
Other invested assets	74,841,190	4.80%
Securities lending collateral	166,416,008	10.68%
Real Estate - Property occupied by the Company	26,908,775	1.73%
Total invested assets	$ 1,557,665,796	100.00%

June 30, 2013	Total Investment Holdings	Percentage
Bonds:		
U.S. Government obligations	$ 169,049,156	11.70%
All other government obligations	15,972,595	1.11%
U.S. Special revenue	225,723,038	15.63%
Industrial and miscellaneous	561,091,559	38.85%
Mortgage and other loan-backed securities	59,153,135	4.10%
Total bonds	1,030,989,483	71.39%
Equity securities	154,628,154	10.71%
Cash and short-term investments	53,474,261	3.70%
Other invested assets	36,530,984	2.53%
Securities lending collateral	141,152,406	9.77%
Real Estate - Property occupied by the Company	27,441,810	1.90%
Total invested assets	$ 1,444,217,098	100.00%

Through July 1, 2013 MSF acquired new investments in two companies – TIAA CREF Asset Management Core Property Fund LP and American Core Realty Fund LLC – that have underlying characteristics of real estate and are classified as other invested assets. The total acquisition cost for each investment was $30M and $40M, respectively.

The cost or amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of invested assets are as follows at June 30:

June 30, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Statutory Fair Value
U.S. Government obligations	$ 168,923,301	$ 9,629,156	$ (701,948)	$ 177,850,509
All other government obligations	20,969,876	57,294	(170,950)	20,856,220
U.S. Special revenue	244,520,312	10,220,779	(367,317)	254,373,774
Industrial and miscellaneous	589,312,193	35,491,502	(288,684)	624,515,011
Mortgage and other loan-backed securities	60,247,345	528,464	(97,462)	60,678,347
Total bonds valued at amortized cost	$ 1,083,973,027	$ 55,927,195	$ (1,626,361)	$ 1,138,273,861

	Actual Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Statutory Fair Value
Equity securities	$ 80,352,084	$ 87,162,922	$ -	$ 167,515,006
Other invested assets	70,000,000	4,841,190	-	74,841,190
Total securities valued at fair value	$ 150,352,084	$ 92,004,112	$ -	$ 242,356,196

June 30, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Statutory Fair Value
U.S. Government obligations	$ 169,049,156	$ 12,669,453	$ (900,051)	$ 180,818,558
All other government obligations	15,972,595	-	(531,408)	15,441,187
U.S. Special revenue	225,723,038	13,008,193	(1,140,679)	237,590,552
Industrial and miscellaneous	561,091,559	34,689,464	(1,989,173)	593,791,850
Mortgage and other loan-backed securities	59,153,135	888,759	(374,128)	59,667,766
Total bonds valued at amortized cost	$ 1,030,989,483	$ 61,255,869	$ (4,935,439)	$ 1,087,309,913

	Actual Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Statutory Fair Value
Equity securities	$ 91,441,049	$ 63,187,105	$ -	$ 154,628,154
Other invested assets	35,750,000	780,984	-	36,530,984
Total securities valued at fair value	$ 127,191,049	$ 63,968,089	$ -	$ 191,159,138

The gross unrealized losses and fair value of the Company's investments, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2014 and 2013, were as follows:

June 30, 2014	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government obligations	$ -	$ -	$ 18,987,199	$ (701,948)	$ 18,987,199	$ (701,948)
All other government obligations	-	-	15,805,653	(170,950)	15,805,653	(170,950)
U.S. Special revenue	-	-	23,332,042	(367,317)	23,332,042	(367,317)
Industrial and miscellaneous	-	-	39,735,952	(288,684)	39,735,952	(288,684)
Mortgage and other loan-backed securities	13,252,045	(14,997)	14,914,458	(82,465)	28,166,503	(97,462)
	$ 13,252,045	$ (14,997)	$ 112,775,304	$ (1,611,364)	$ 126,027,349	$ (1,626,361)

June 30, 2013	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government obligations	$ 18,756,400	$ (900,051)	$ -	$ -	$ 18,756,400	$ (900,051)
All other government obligations	15,441,187	(531,408)	-	-	15,441,187	(531,408)
U.S. Special revenue	52,343,432	(1,140,679)	-	-	52,343,432	(1,140,679)
Industrial and miscellaneous	88,527,008	(1,989,173)	-	-	88,527,008	(1,989,173)
Mortgage and other loan-backed securities	31,124,223	(374,128)	-	-	31,124,223	(374,128)
	$ 206,192,250	$ (4,935,439)	$ -	$ -	$ 206,192,250	$ (4,935,439)

MSF closely monitors its investment portfolio and considers relevant facts and circumstances in evaluating whether the impairment of a security is other than temporary. Relevant facts and circumstances that are considered include: (1) the length of time the fair value has been below cost; (2) the financial position and access to capital of the issuer, including the current and future impact of any specific events; and (3) MSF's ability and intent to hold the security to maturity or until it recovers in value. To the extent the Company determines that a security is deemed other-than-temporarily impaired, the difference between amortized cost and fair value is charged to earnings. Based on the Company's evaluation and ability and intent to hold these securities to maturity or market value recovery, the impairment of the securities identified above is deemed to be temporary.

The amortized cost and estimated statutory fair value of MSF's fixed maturity securities as of June 30, 2014 and 2013 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. Maturities of mortgage-backed securities depend on the repayment characteristics and experience of the underlying mortgage loans.

June 30, 2014	Amortized Cost	Estimated Statutory Fair Value
Due one year or less (excludes STIP)	$ 82,073,191	$ 83,730,911
Due after one year through five years	594,164,941	629,268,286
Due after five years through ten years	400,735,635	417,192,855
Due after ten years through twenty years	2,999,259	3,036,644
Due after twenty years	4,000,001	5,045,165
	$ 1,083,973,027	$ 1,138,273,861

June 30, 2013	Amortized Cost	Estimated Statutory Fair Value
Due one year or less (excludes STIP)	$ 96,121,835	$ 98,167,793
Due after one year through five years	556,292,747	594,569,403
Due after five years through ten years	373,807,216	388,818,418
Due after ten years through twenty years	-	-
Due after twenty years	4,767,685	5,754,299
	$ 1,030,989,483	$ 1,087,309,913

Proceeds from sales of investments in debt securities and gross realized gains and gross realized losses on the sales of all investments were as follows for the years ended June 30:

	2014	2013
Proceeds from sales	$ 168,738,186	$ 183,707,839
Gross realized gains	14,425,774	11,058,788
Gross realized losses	(146,087)	(25,681)

Investment income and related expenses were as follows for the years ended June 30:

	2014	2013
Investment income		
Interest		
Bonds	$ 38,422,743	$ 41,286,698
Cash and short-term investments	51,652	104,115
Real estate	1,643,010	1,643,010
Other invested assets	3,237,558	73,622
Securities lending income	757,879	992,207
Total investment income	44,112,842	44,099,652
Investment expenses		
Investment expenses	1,122,079	869,930
Depreciation on real estate	533,035	533,035
Total investment expenses	1,655,114	1,402,965
Net investment income	$ 42,457,728	$ 42,696,687

MSF's investment in property occupied by the Company is as follows at June 30:

	2014	2013
Land	$ 1,139,460	$ 1,139,460
Properties occupied by the Company, net	25,769,315	26,302,350
Total real estate	$ 26,908,775	$ 27,441,810

Note 3 - Cash Collateral and Liability for Securities on Loan

The following table presents the carrying and market values of the securities on loan and the total collateral held as of June 30:

	2014	2013
Securities on loan - carrying value	$ 195,125,895	$ 239,575,067
Securities on loan - market value	206,786,455	253,069,509
Total cash collateral held	166,416,008	141,152,406
Total non-cash collateral held	44,281,936	117,242,383

Note 4 - Fair Value of Financial Instruments

Certain financial instruments are reported at fair value and others are stated at cost or amortized cost, as shown below. For those assets carried at fair value in the financial statements and for those assets not stated at fair value in the financial statements but whose estimated fair values are disclosed, the following table indicated the inputs used to estimate fair value measurements.

The statement values, fair values and related inputs for financial instruments at June 30 are:

	2014				
	Statement Value	Fair Value	(Level 1)	(Level 2)	(Level 3)
Assets reported at amortized cost:					
Bonds	$1,083,973,027	$1,138,273,861	$ -	$1,138,273,861	$ -
Assets reported at fair value:					
Equity securities	$ 167,515,006	$ 167,515,006	$ 147,383,391	$ 20,131,615	$ -
Other invested assets	74,841,190	74,841,190	-	-	**(A)**
Total assets reported at fair value	$ 242,356,196	$ 242,356,196	$ 147,383,391	$ 20,131,615	$ -

	2013				
	Statement Value	Fair Value	(Level 1)	(Level 2)	(Level 3)
Assets reported at amortized cost:					
Bonds	$1,030,989,483	$1,087,309,913	$ -	$1,087,309,913	$ -
Assets reported at fair value:					
Equity securities	$ 154,628,154	$ 154,628,154	$ 138,103,604	$ 16,524,550	$ -
Other invested assets	36,530,984	36,530,984	-	-	**(A)**
Total assets reported at fair value	$ 191,159,138	$ 191,159,138	$ 138,103,604	$ 16,524,550	$ -

(A) – These investments are accounted for using the equity method. For purposes of this disclosure, the equity method is presumed to approximate fair value. If management were to determine fair value for its equity method investments, it would use level 3 inputs.

There were no liabilities reported at fair value as of June 30, 2014 and 2013.

Note 5 - Cash, Cash Equivalents and Short-Term Investments

MSF participates in the Short-Term Investment Pool (STIP) maintained by BOI. STIP balances are highly liquid investments. The market value of STIP approximates cost. The STIP investments' credit risk is measured by investment grade ratings given individual securities. BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The three NRSRO's include Standard and Poor's, Moody's Investors Service, and Fitch, Inc.

Cash, cash equivalents and short-term investments at June 30, 2014 and 2013 consist of:

	2014	2013
Cash in bank	$ 7,019,465	$ 4,430,575
STIP investment	30,992,325	49,043,686
	$ 38,011,790	$ 53,474,261

Note 6 - Receivables, Net

Net receivables consist of the following at June 30:

	2014	2013
Uncollected premiums	$ 10,484,325	$ 9,940,281
Unbilled premiums and installments including earned but unbilled premiums of $4,924,023 and $4,756,142, respectively	46,442,230	46,367,254
Accrued retrospective premiums	138,744	149,762
Other receivables	2,060,610	2,761,379
	59,125,909	59,218,676
Less: nonadmitted receivables	(2,945,625)	(3,457,149)
Total receivables, net	$ 56,180,284	$ 55,761,527

Note 7 - Equipment, Net

Equipment and software are recorded at cost net of accumulated depreciation and admitted or non-admitted in accordance with statutory accounting principles as follows:

June 30, 2014	Computer Equipment and Operating Software	Vehicles, Furniture and Office Equipment	Application Software	Total
Assets	$ 5,305,455	$ 2,199,290	$ 16,760,501	$ 24,265,246
Accumulated depreciation	(4,390,817)	(931,956)	(16,086,977)	(21,409,750)
Subtotal	914,638	1,267,334	673,524	2,855,496
Less: Net assets non-admitted	-	(1,267,334)	(673,524)	(1,940,858)
Net assets admitted	$ 914,638	$ -	$ -	$ 914,638
Depreciation expense	$ 139,888	$ 183,265	$ 354,285	$ 677,438

June 30, 2013	Computer Equipment and Operating Software	Vehicles, Furniture and Office Equipment	Application Software	Total
Assets	$ 5,168,580	$ 2,138,722	$ 20,506,731	$ 27,814,033
Accumulated depreciation	(4,364,078)	(743,400)	(19,757,570)	(24,865,048)
Subtotal	804,502	1,395,322	749,161	2,948,985
Less: Net assets non-admitted	-	(1,395,322)	(749,161)	(2,144,483)
Net assets admitted	$ 804,502	$ -	$ -	$ 804,502
Depreciation expense	$ 640,188	$ 190,831	$ 998,369	$ 1,829,388

Note 8 - Loss and Loss Adjustment Expense Reserves

Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are 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. The reserves are reported on an undiscounted basis.

Towers Watson, an external independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and IBNR as of June 30, 2014 and 2013. The study provides a range of potential costs associated with the reported claims, the future development of those claims and IBNR. MSF management has selected a central estimate within that range as the estimated loss reserves. 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.

The following analysis provides a reconciliation of the activity in the reserve for losses and loss adjustment expenses for the years ended June 30:

	2014 (in 000's)	2013 (in 000's)
At beginning of year:		
Net reserves for losses and loss expenses	$ 902,848	$ 889,941
Losses and loss expenses incurred during the year related to:		
Current year	153,408	142,029
Prior years	(9,951)	(2,180)
Total losses incurred	143,457	139,849
Losses and loss expenses paid during year related to:		
Current year	(29,310)	(28,326)
Prior years	(92,397)	(98,616)
Total losses paid	(121,707)	(126,942)
Total losses and loss adjustment expenses at end of year	$ 924,598	$ 902,848

The increase in the reserve for loss and loss adjustment expenses of $21.8M incurred during the period ended June 30, 2014 is a result of ongoing analysis of loss development trends, changes to the loss expense factors, re-estimation of unpaid claims, reinsurance recovery adjustments, and reserve strengthening. An additional $10M was recorded for reserve strengthening. This increase is due to the uncertainty from anticipated savings resulting from House Bill 334 and the consequences of the 20% premium reduction that was executed in fiscal year 2011.

Included in the amounts above are reserves for asbestos exposure. MSF's exposure to asbestos claims arose from the direct sale of workers compensation policies to companies with incidental exposure to asbestos. Case reserves related to these claims are as follows as of June 30:

	2014	2013
Beginning case reserves (including LAE)	$ 747,023	$ 214,704
Losses and LAE incurred	2,967,997	680,093
Payments for losses and LAE	(972,346)	(147,774)
Ending case reserves (including LAE)	$ 2,742,674	$ 747,023

Note 9 - Retirement Plans, Deferred Compensation and Postretirement 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 Government Accounting Standards Board (GASB) recently issued standards No. 67 and No. 68, Accounting and Financial Reporting for Pensions. These standards will require MSF to record pension accounting entries as well as financial statement disclosures. The requirements of these Standards are effective for financial statements for fiscal years beginning after June 15, 2014. The State of Montana is in the process of determining the effect of the change in accounting and obtaining an estimate of MSF's proportionate share of the unfunded liability. Management believes the amount attributable to MSF will be significant, once the State of Montana completes its valuation. MSF will be required to record a proportionate share of the unfunded pension liability and related pension disclosures in the statutory basis financial statements for the year ended June 30, 2015.

As described in Note 1 to the financial statements, during the course of the State of Montana's statewide 2014 audit, an error was identified in the other post-employment benefit plan's OPEB valuation that resulted in an overstated liability. Under the Regulatory Basis of Accounting described in Note 1, Statement of Statutory Accounting Principle (SSAP) No. 3, *Accounting Changes and Corrections of Errors*, paragraph 10, states: "Corrections of errors in previously issued financial statements shall be reported as adjustments to unassigned funds (Policyholders' Equity) in the period an error is detected." In accordance with SSAP No. 3, MSF recorded its allocated amount of the correction in 2014. The related liability balance was reduced by $1.5M and Policyholders' Equity was increased by $1.2M as of June 30, 2014, to reflect the portion of the change related to prior years.

While this accounting treatment and presentation in the financial statement is required in accordance with the accounting framework used by MSF, the OPEB liability is overstated and beginning Policyholders' Equity is understated by $1.2M for the year ended June 30, 2013. Management has determined the amounts of these corrections are not material to the overall fair presentation of the statutory financial statements.

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 and 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. During fiscal year 2014, MSF employees were required to contribute 7.9% of annual compensation regardless of hire date. During fiscal year 2013, MSF employees hired prior to July 1, 2011 were required to contribute 6.9% of annual compensation and those hired on or after July 1, 2011 were required to contribute 7.9%. The employer (MSF) is required to contribute 8.17% of annual compensation in fiscal year 2014 and 7.17% in fiscal year 2013 regardless of the hire date of the employee. MSF's contributions amounted to $1.4M for both fiscal years 2014 and 2013. MSF and its employees paid 100% of required contributions to PERS and there is no unpaid liability as of June 30, 2014.

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.

MSF employees and dependents are eligible to receive health care through the State Employee Group Benefits Plan administered by the State of Montana Department of Administration. The State of Montana provides optional post-employment medical, vision and dental health care benefits to qualified employees and dependents that elect to continue coverage and pay administratively established premiums.

MSF's allocated annual OPEB cost (expense) for the years ended June 30, 2014 and 2013 was $633K and $620K, respectively. The liability is reported at the same amount determined on a GAAP basis for financial reporting required as a component unit of the State of Montana. While this liability is disclosed for financial statement purposes it does not represent a legal liability of MSF, and MSF does not complete a separate actuarial analysis for Statutory reporting purposes.

Note 10 - Policyholder Dividends

During the fiscal year ended June 30, 2014, the MSF Board of Directors authorized and MSF paid dividends of $12M to eligible policyholders for the policy year 2011. During the fiscal year ended June 30, 2013, MSF paid dividends of $10M to eligible policyholders for the policy year 2010.

Note 11 - Reinsurance Assumed and Ceded

For the fiscal years ended June 30, 2014 and 2013, 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 occurrences over stipulated amounts and aggregate stop loss contracts. The excess of loss contracts provide for the following coverage:

Contract Period	Reinsurance Coverage
2013	Workers' compensation accidents of up to $5M in excess of $5M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $20M in excess of $10M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $70M in excess of $30M, maximum of $5M per any one claimant.
2012	Workers' compensation accidents of up to $5M in excess of $5M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $20M in excess of $10M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $70M in excess of $30M, maximum of $5M per any one claimant.

The current aggregate stop loss contract provides coverage based on MSF’s premium levels not to exceed 15% of subject net earned premium. 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 $9.5M and $8.5M in fiscal years 2014 and 2013, 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, 2014 is $66.7M for contracts in place from July 1, 2002 to June 30, 2014. The funds withheld account at June 30, 2013 was $77.0M for contracts in place from July 1, 2002 to June 30, 2013. Interest must be accrued on the funds withheld account which resulted in accrued interest of $4.1M for fiscal year 2014 and $3.7M for fiscal year 2013.

During fiscal years 2014 and 2013, estimated claim reserves were reduced $12.0M and $12.1M, respectively, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excess of loss reinsurance contract. In fiscal years 2014 and 2013, estimated claim reserves were reduced by an additional $20.6M and $23.7M, respectively, 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 Zurich American Insurance Company, Argonaut Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2014 and 2013 is $2.3M and $2.0M, respectively. The assumed liability for OSC claims is $2.6M and $4.2M for fiscal years 2014 and 2013, respectively.

MSF commuted two of its outstanding reinsurance contracts during fiscal year 2014. Commutation of the ceded aggregate stop loss contract for the period July 1, 2005 to July 1, 2008 resulted in a reduction in the funds withheld balance of $19.9M and a reduction in the reinsurance receivables balance of $19.9M. No funds were exchanged between MSF and the reinsurers, XL Re Ltd. and Imagine International Reinsurance Co., as part of this commutation and it had no impact on incurred losses or reserves for unpaid losses or LAE. Commutation of the assumed reinsurance contracts with Legion Insurance Company for the period January 1, 1999 to July 1, 2001 resulted in a reduction of reserves for unpaid losses and LAE of $1.4M.

Note 12 - Leases and Commitments

MSF leases office facilities and equipment under various operating leases that expire through December 2015. Rental expense for fiscal years 2014 and 2013 was $343K and $331K, respectively.

MSF leases 350 parking spaces in a parking garage that was built by the City of Helena adjacent to the MSF facility that expire June 30, 2040. The cost of the parking spaces will be the same monthly rate as equivalent parking passes sold by the City. The annual subsequent parking cost is estimated to be $272K with potential to change based on parking rates assigned by Helena Parking Commission.

Future minimum rental payments are as follows for the years ending June 30:

Fiscal Year	Amount
2015	$ 317,935
2016	316,475
2017	300,419
2018	297,869
2019	289,271
Thereafter	5,713,596
	$ 7,235,565

Note 13 - Subsequent Events

Subsequent events were evaluated through November 05, 2014, which is the same date the audited financial statements were available to issue.

During September 2014, MSF entered into a commitment with TIAA-CREF Asset Management Core Property Fund LP to purchase additional shares of $5M. Purchases of $1M and $2.1M were made on October 1, 2014 and November 1, 2014, respectively.

Note 14 - Contingencies and Uncertainties

Victory Insurance Company, Inc. v. Montana State Fund et al. Victory filed its Amended Complaint in this action on March 29, 2011, in which it asserts various tort claims against Montana State Fund. No specific amount of damages was stated in the complaint. In October 2012, the district court granted Montana State Fund's motion for summary judgment, and dismissed State Fund from the case. However, the plaintiff refiled the suit against Montana State Fund. Montana State Fund filed a second motion for summary judgment, and the district court granted judgment to Montana State Fund on December 26, 2013. The judgment was wholly in State Fund's favor, and the case was dismissed. An appeal has been filed with no decision yet on the appeal. Based on the district court's decision, State Fund anticipates the chances are remote that State Fund has potential liability with this matter.

Susan Hensley v. Montana State Fund Montana State Fund received a Petition for Hearing that was filed before the Workers' Compensation Court in October 2013. The matter is Susan Hensley vs. Montana State Fund, WCC No. 2013-3235. Under HB 334, as passed by the legislature in 2011 and codified in 39-71-703 (2), MCA, when a claimant receives a Class I impairment, it is not payable unless the claimant has an actual wage loss as a result of the compensable injury or occupational disease. The law was effective July 1, 2011 and applicable to claims that occurred on or after that date. The petitioner in this matter is challenging the constitutionality of 39-71-703 (2), MCA. State Fund anticipates the chances are remote, but as with any litigated matter there is the possibility of an adverse decision. Should the statute be held unconstitutional, determined to be applicable to other claims and also determined to be retroactively applicable, potential liability is estimated to be at least $2.2 million per year, as based on NCCI initial pricing, and current estimated business volumes.

Montana State Fund also is involved in other litigation in the areas of workers' compensation and disputes with policyholders. These are of a generally routine nature and there are no known matters at this time that will have a large and widespread financial impact.

Note 15 - Related Party Transactions

In the ordinary course of business, Montana State Fund conducts many of its transactions through State of Montana agencies. The following significant transactions occurred with state agencies during the year ended June 30:

	2014	2013
INCOME:		
State of Montana agencies		
Premium	$ 15,523,004	$ 16,901,895
Volume discount/employee return to work	(1,819,786)	(2,027,312)
Retrospective premium	(466,658)	(256,470)
Dividends	(652,347)	(487,359)
Net premium income from State of Montana agencies	$ 12,584,213	$ 14,130,754
EXPENSES:		
Montana Department of Administration		
Support services costs	$ 1,465,174	$ 1,430,208
Benefits Bureau: group insurance	2,551,812	2,413,678
PERS retirement contributions	1,357,403	1,371,714
Montana Department of Labor & Industry - unemployment insurance	63,809	50,556
Montana Board of Investments - transaction fees	383,940	426,572
Montana Department of Justice - Fraud investigation services	351,151	257,536
Montana - various other	52,045	13,343
Expenses paid to State of Montana agencies	$ 6,225,334	$ 5,963,607

MSF writes policies for which the premiums vary based on loss experience. Future premium adjustments for these retrospective policies are estimated and accrued at year-end, and are determined through a review comparing actual losses with projected future losses, to arrive at the estimate of return premium. The State of Montana agencies are considered a retrospective rated group and the estimated accrual at June 30, 2014 was $2.6M for the policy periods July 1, 2012 to June 30, 2013 and July 1, 2013 to June 30, 2014 combined. At June 30, 2014, future premium adjustments for retrospective policies for the policy period July 1, 2012 to June 30, 2014 were estimated to be $2.2M.

Volume discounts payable to state agencies were approximately $501K and $560K at June 30, 2014 and 2013, respectively.

Other amounts due to and from other State of Montana agencies are settled regularly and are not material as of June 30, 2014 and 2013.

Note 16 - Policyholders' Equity – Change in Non-Admitted Assets

The following is an accounting of the changes in non-admitted assets included in the Statement of Changes in Policyholders' Equity for the years ended June 30:

	2014	2013
Balance of non-admitted assets, beginning of year	$ 6,416,890	$ 7,361,765
Increase (decrease) in non-admitted assets:		
Change in premiums receivable	(593,523)	292,845
Change in short-term notes and loans receivable	81,999	(165,551)
Change in net tangible assets	(127,988)	11,224
Change in intangible assets	(75,637)	(1,057,940)
Change in property held in trust	3,885	(20,156)
Change in other assets	64,900	(5,297)
Net increase (decrease) in non-admitted assets	(646,364)	(944,875)
Balance of non-admitted assets, end of year	$ 5,770,526	$ 6,416,890

Note 17 - Policyholders' Equity –Reconciliation of Statutory Equity to GASB Net Position

The following schedule reconciles statutory policyholders' equity calculated in accordance with NAIC SAP to GASB Net Position as determined by governmental accounting principles generally accepted in the United States of America at June 30:

	2014	2013
Statutory policyholders' equity (NAIC)	$ 443,852,594	$ 372,277,435
Add:		
Non-admitted assets as shown above	5,770,526	6,416,890
Change in investment value of bonds to fair market value	54,300,834	56,320,430
Change in investment value of other invested assets to equity method	(1,306,687)	(508,996)
Change in allowance for doubtful accounts	(2,509,688)	(2,962,481)
Change in net income between NAIC SAP and GAAP for:		
Deferred acquisition costs	-	5,178,674
GASB net position	$ 500,107,579	$ 436,721,952

Note 18 - Policyholders' Equity –Other Changes in Policyholders' Equity

During the course of the State of Montana's statewide 2014 audit, an error was identified in the other post-employment benefit plan's valuation that resulted in an overstated liability. Under the Regulatory Basis of Accounting described in Note 1, Statement of Statutory Accounting Principle (SSAP) No. 3, *Accounting Changes and Corrections of Errors*, paragraph 10, states: "Corrections of errors in previously issued financial statements shall be reported as adjustments to unassigned funds (Policyholders' Equity) in the period an error is detected." In accordance with SSAP No. 3, MSF recorded its allocated amount of the correction in 2014. The Policyholders' Equity was increased by $1.2M to reflect the portion of the change related to prior years.

Supplementary Information
June 30, 2014 and 2013

MONTANA STATE FUND

EideBailly
CPAs & BUSINESS ADVISORS

Independent Auditor's Report on Supplementary Information

To the Board of Directors
Montana State Fund
Helena, Montana

We have audited the statutory financial statements of Montana State Fund as of and for the year ended June 30, 2014, and our report thereon dated November 05, 2014, which expressed an unmodified opinion on those financial statements, appears on page 1. Our audit was conducted for the purpose of forming an opinion on the basic statutory-basis financial statements taken as a whole. The accompanying supplementary information included in the *Supplemental Schedule of Investment Risk Interrogatories, Summary Investment Schedule, and Supplemental Reinsurance Interrogatories* on pages 31 through 35 are required to be presented to comply with the National Association of Insurance Commissioners' Annual Statement Instructions and the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual and are not a required part of the basic statutory-basis financial statements. Such information included in the schedules referred to above is the responsibility of management, is presented for purposes of additional analysis and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other procedures in accordance with the auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic statutory-basis financial statements taken as a whole.

Eide Bailly LLP

Fargo, North Dakota
November 05, 2014

Basis of Presentation

The following supplemental disclosures present selected statutory-basis financial data as of June 30, 2014, and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and agree to or are included in the amounts reported in the Company's 2014 Statutory Annual Statement.

Supplemental Investment Risk Interrogatories

1. The Company's total admitted assets as of June 30, 2014 are $1.7B.

2. The Company's ten largest exposures to a single issuer/borrower/investment are as follows:

	Amount	Percentage of Total Admitted Assets
American Core Realty Fund LLC	$ 42,563,685	2.547%
TIAA-CREF	32,277,505	1.932%
General Electric Co.	24,488,070	1.465%
JPMorgan Chase & Co.	23,946,151	1.433%
Citigroup Inc.	17,018,811	1.018%
Bunge Limited	14,992,145	0.897%
Morgan Stanley	14,760,158	0.883%
American Express Co.	12,979,002	0.777%
Walmart Stores Inc.	12,176,493	0.729%
Burlington Northern Santa Fe	12,130,544	0.726%

3. The amounts and percentages of the Company's total admitted assets held in bonds by NAIC rating are as follows:

	Amount	Percentage of Total Admitted Assets
NAIC-1	$ 842,191,784	50.397%
NAIC-2	238,784,414	14.289%
NAIC-3	2,996,829	0.179%
NAIC-6	-	0.000%
Total Bonds	$ 1,083,973,027	64.865%

4. The amount of assets held in foreign investments is $37M, which is 2.21% of the Company's total admitted assets. None of that amount is denominated in a foreign currency.

(continued on next page)

5. The amount of assets held in Canadian investments is less than 2.5% of the Company's total admitted assets.

6. The Company does not hold any assets with contractual sales restrictions.

7. The amounts and percentages of the Company's total admitted assets held in equity interests are as follows:

June 30, 2014	Amount	Percentage of Total Admitted Assets
Blackrock Equity Index Fund	$ 147,383,391	8.819%
Blackrock ACWI Ex-US Superfund	20,131,615	1.205%

8. The Company does not hold any privately placed equities.

9. The Company does not hold any general partnership interests.

10. The Company does not hold any mortgage loans.

11. The amount of assets held in real estate is less than 2.5% of the Company's total admitted assets.

12. The Company does not hold any mezzanine real estate loans.

13. The amounts and percentages of the Company's total admitted assets subject to securities lending agreements are as follows:

	Amount	Percentage of Total Admitted Assets
Securities lending agreements	$ 195,125,895	11.676%

14. The Company does not hold any warrants.

15. The Company does not have any exposure for collars, swaps, or forwards.

16. The Company does not have any exposure for futures contracts.

	Gross investment holdings		Admitted Assets as Reported in the Annual Statement	
	Amount	%	Amount	%
Bonds:				
U.S. Treasury securities	$ 168,423,064	10.81%	$ 168,423,064	10.81%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	500,237	0.03%	500,237	0.03%
Issued by U.S. government sponsored agencies	237,742,875	15.26%	237,742,875	15.26%
Non-U.S. government (including Canada, excluding mortgage-backed securities)	20,969,876	1.35%	20,969,876	1.35%
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	-	0.00%	-	0.00%
Issued or guaranteed by FNMA and FHLMC	6,777,437	0.44%	6,777,437	0.44%
All other	-	0.00%	-	0.00%
CMOs and REMICs:				
All other	-	0.00%	-	0.00%
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	589,312,193	37.83%	589,312,193	37.83%
Unaffiliated non-U.S. securities (including Canada)	60,247,345	3.87%	60,247,345	3.87%
Affiliated securities	-	0.00%	-	0.00%
Equity interests:				
Investments in mutual funds	167,515,006	10.75%	167,515,006	10.75%
Real estate investments:				
Properties occupied by the company	26,908,775	1.73%	26,908,775	1.73%
Securities lending	166,416,008	10.68%	166,416,008	10.68%
Cash, cash equivalents and short-term investments	38,011,790	2.44%	38,011,790	2.44%
Other invested assets	74,841,190	4.80%	74,841,190	4.80%
Total invested assets	$ 1,557,665,796	100.0%	$ 1,557,665,796	100.0%

The following interrogatories are included in accordance with SSAP 62:

Has the reporting entity reinsured any risks under a quota share reinsurance contract with any other entity that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g. deductible, a loss ratio corridor, loss cap)? If yes, indicate the number of reinsurance contracts containing such provision and if the amount of reinsurance credit taken reflects the reduction in quota share coverage caused by any applicable limiting provision(s).

Yes ☐ No ☒

Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative UW result greater than 5% of prior year-end surplus as regards to policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded great than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

a. A contract term longer than two years and the contract is non-cancellable by the reporting entity during the contract term;
b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
c. Aggregate stop loss reinsurance coverage;
d. An unconditional or unilateral right by either party to commute the reinsurance contract, except for such provisions which are only triggered by a decline in the credit status of the other party;
e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
f. Payment schedule, accumulating retention from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

Yes ☒ No ☐

Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under commune control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders or the reporting entity is a member, where:

a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents 50% or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or
b. 25% or more of the written premium ceded to the reinsurer has been retro-ceded back to the reporting entity or its affiliates.

Yes ☐ No ☒

Except for transactions meeting the requirements of paragraph 30 of SSAP No. 62, has the reporting entity ceded any risk under any reinsurance contract during the period covered by the financial statements, and either:

a. Accounted for that contract as reinsurance (either prospective or retroactive) under SAP and as a deposit under GAAP; or
b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

Yes ☐ No ☒

The accompanying schedules and interrogatories present selected statutory-basis financial data as June 30, 2014 and for the year then ended for the purpose of complying with paragraph 9 of the Annual Audited Financial Reports in the Annual Audited Report section of the National Association of Insurance Commissioners' Annual Statement Instructions and the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual and agree to or are included in the amounts reported in the Company's fiscal year 2014 Statutory Annual Statement.