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Governor

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Thomas J. Sadowski
Director

January 20, 2006

The Honorable Matt Blunt
The Honorable Members of the Legislature
Citizens of the State of Missouri

In accordance with generally accepted accounting principles, I submit to you the Comprehensive Annual Financial Report of the State of Missouri for the fiscal year ended June 30, 2005. This report was prepared by the Office of Administration, Division of Accounting, whose management is responsible for its contents.

The report is prepared to show the financial position and operating results of the State. The State's internal accounting controls provide reasonable assurance regarding the safeguarding of assets against loss from unauthorized use or disposal and the reliability of financial records for preparing financial statements. The concept of reasonable assurance recognizes that the cost of a control should not exceed the resulting benefit. We believe the data presented is accurate in all material respects and that all disclosures necessary to enable the reader to gain a reasonable understanding of the State's financial activities have been included.

An annual audit of the basic financial statements is completed each year by the State of Missouri Auditor's Office. The State Auditor conducts the audit in accordance with generally accepted government auditing standards, and her opinion has been included in this report. The State Auditor conducts a "Single Audit" of all federal funds in accordance with the Federal Single Audit Act of 1984, and the U.S. Office of Management and Budget Circular A-133, "Audit of State and Local Governments and Non-Profit Organizations."

A narrative introduction, overview, and analysis of the basic financial statements is presented in the *Management's Discussion and Analysis (MD&A)* section of this report. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

PROFILE OF THE GOVERNMENT

Missouri was organized as a territory in 1812 and was the second state (after Louisiana) of the Louisiana Purchase to be admitted to the Union. Statehood was granted on August 12, 1821, making Missouri the 24th state. The State encompasses 68,945 square miles.

The State operates under three branches of government: executive, legislative, and judicial. The executive branch consists of the Governor, Lieutenant Governor, Secretary of State, State Auditor, State Treasurer, and Attorney General. The legislative branch consists of 34 members of the Senate, and 163 members of the House of Representatives. The judicial branch is a three-tier court system. The Supreme Court, the State's highest court, has statewide jurisdiction; a court of appeals that consists of districts established by the General Assembly; and a system of circuit courts that has original jurisdiction over all cases and matters, civil and criminal.

The State provides a range of services in the areas of agriculture, education, health and social services, transportation systems, public safety, law enforcement, judicial systems, economic development, conservation and natural resources, labor relations, and general administration.

The State operates on a legally adopted budget in order to ensure compliance with legal provisions embodied in the annual appropriated budget passed by the General Assembly and approved by the Governor prior to the beginning of the fiscal year. If appropriations are not sufficient for a fiscal year, supplemental amounts are requested during the next legislative session by the same process that original appropriations are requested. Budgetary control is maintained at the departmental level. Expenditures cannot exceed the appropriation amount at the individual appropriation level. Also, the Governor has the authority to reduce the allotments of appropriations in any fund if it appears that the revenue estimate will not be met. Unexpended appropriations lapse at the end of each appropriation year, unless reappropriated to the following appropriation year.

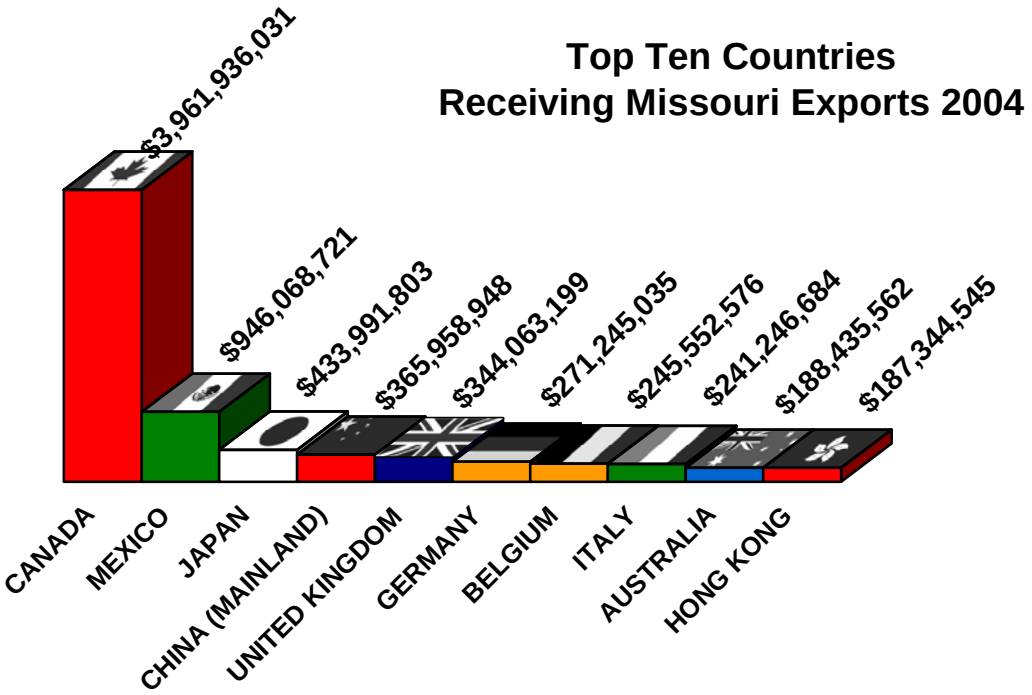
The financial reporting entity of the State includes all of the funds of the primary government as well as component units for which the State is financially accountable. The transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

ECONOMIC CONDITION

State Economy

Missouri's economy is both strong and diverse, the 5th most diversified in the nation. As a major manufacturing, financial, and agricultural state, Missouri's economic health is tied closely to that of the nation.

Missouri's exports totaled nearly $9 billion in 2004, with products and services sold to over 180 countries. This represents an increase of over $1.7 billion compared to 2003. Several factors can be attributed to this increase, including the improvement of the global economy in general as well as the diversity of Missouri's economy. The top five exports in 2004 were transportation equipment, chemicals, machinery, computer and electronic products, and electrical equipment. The majority of exports in 2004 were sold to Canada – nearly $4 billion, while substantial exports were sold to Mexico for approximately $946 million.



Source: MERIC and the World Institute for Strategic Economic Research (WISER)

Both Missouri and the nation experienced employment figures which bottomed out in 2003. Missouri's employment growth began in early 2004, slightly later than the national growth trend. Although Missouri's employment growth during 2004 was somewhat irregular, it has shown strong growth in 2005, with nearly 40,000 jobs being added during the calendar year.

Additional evidence of an improving economy is supported by personal income statistics. Personal income is seen as an indicator of the economic well-being of the residents of a state, of which the largest portion is earnings and wages. Missouri's personal income rose 4.5% in 2004, to nearly $176 billion annually. Along with higher personal income, Missourians saw a decrease in unemployment. Missouri's unemployment rate peaked in January 2005 at 6.0%, but dropped to a rate of 5.4% in June, the lowest since early 2003. Missouri's per capita personal income averaged $30,516 in 2004. Although Missouri's per capita income is below the national average, Missourians live and work where the cost of living ranks 6th lowest in the nation.

Long-Term Financial Planning

Missouri funding priorities include education, health care, corrections, and economic development. In order to maintain adequate funding for those programs, reorganizing state government, reducing expenses, and maximizing use of state resources, have been emphasized. Consolidation of similar functions has resulted in more efficient use of personnel and equipment, increased efficiency, and reduced duplication of efforts.

Relevant Financial Policies

The ability of the State to raise additional money through new taxes enacted by the General Assembly is severely limited due to Article X of the Missouri State Constitution. Article X establishes revenue limitations based on a formula, which if exceeded, requires cash refunds to the citizens. Any significant new tax must be approved through a vote of the people.

Missouri will continue to focus on controlling the growth of mandatory programs through various cost-effective alternatives. Missouri has implemented many cost control strategies in the Medicaid program to ensure quality services are provided to the State's neediest residents.

Major Initiatives

Education. Funding for elementary and secondary education is the State's top priority. In response to recently filed lawsuits questioning the adequacy and fairness of the current school funding formula, legislation was passed which guarantees funding for all students consistent with the amount spent by districts that meet all of the State's performance standards. The new school funding formula will be phased in with the 2006-2007 school year. For the 2005-2006 school year, funding to Missouri schools was increased by 4.4% or $158 million.

Transportation. The voters of the State approved a Constitutional amendment during November 2004 which redirects certain revenue such as vehicle sales taxes to the Missouri Department of Transportation. The Department has developed the "Smoother, Safer, Sooner" road initiative, which will result in 2,200 miles of new pavement, shoulders with rumble strips, brighter stripes and signs, and the acceleration of road improvement projects. The amendment will be phased in over four years and will be in full effect in 2009.

Economic Development. In an effort to promote a positive business environment, laws affecting litigation including medical malpractice and workers' compensation were enacted. Some of the most significant litigation changes include strict rules for establishing venue, limits on joint and several liability only when the defendant is 51% at fault, and a cap on non-economic damages to $350,000. For cases involving medical malpractice, the law also requires the plaintiff to file an affidavit from a qualified health care provider which states the defendant failed to use reasonable care. Additional medical malpractice reforms state that physicians providing free health care are not liable for civil damages unless damages were caused by gross negligence or willful or wanton acts. Workers' compensation reforms include modifying the definition of "accident" and "injury", requiring compensation only when the prevailing factor of the condition was work related, and severely limiting the compensation when the injured party did not obey safety rules or was under the influence of drugs or alcohol.

Human Services. Since Medicaid expenses have been increasing at an unsustainable rate, the legislature passed several Medicaid cost containment measures and established the Medicaid Reform Commission. The Commission was required to make recommendations related to reforming, redesigning, and restructuring the current Medicaid system by January 1, 2006. In the meantime, legislation has enacted reforms including yearly income eligibility reviews, the reduction of income levels to be eligible for Medicaid, and the requirement for recipients to share medical costs through co-pays and premiums.

Government. In January 2005, the Governor established the Missouri State Government Review Commission by executive order. The Commission consists of twenty individuals from across the State. The executive order states the Commission's task is "reviewing every Executive Department within our state government to identify opportunities to restructure, retool, reduce, consolidate, or eliminate state government functions in accordance with what will result in the best and most cost-effective service for Missouri citizens." The Commission's report was issued November 23, 2005, identifying 84 suggestions for improving state government. This report can be found at http://review.mo.gov/pdf/MSGRC_FinalReport.pdf.

Prior to the Commission's final report, efficiencies were achieved by consolidating in-home health services provided to the elderly and disabled. These services were merged into one agency rather than three, thereby reducing duplication of efforts. Transitioning the State's revenue license offices into offices run by contract agents will save millions of dollars each year, without decreasing customer service. Further cost savings have been achieved by restricting the purchase of non-emergency vehicles, cell phones, and the purchase and leasing of new office space. The State is also moving toward providing more services online, such as implementing a new online application system for state merit job openings. This new system will speed up the process for job applicants as well as increase efficiency and cut costs to state government.

ACKNOWLEDGEMENTS

While the Office of Administration, Division of Accounting, is responsible for the contents of this report, no one division could do it alone. Many people were involved in the compilation of materials necessary to complete the report.

We want to issue a special thanks to all the personnel at the State agencies who provided us with information quickly and accurately so that we could issue the CAFR in a timely manner. We also owe thanks to the professionalism and dedication demonstrated by technical and management personnel within the State Auditor's Office, the State Treasurer's Office, Office of Administration, Information Technology Services Division, and the State Printing Center. We are greatly appreciative to all.

Sincerely,

Thomas Sadowski

Thomas Sadowski, CGFM, CPA
Director