

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the State of North Dakota's (the State's) Comprehensive Annual Financial Report presents a discussion and analysis of the State's financial performance, providing an overview of the activities for the fiscal year ended June 30, 2004. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

FINANCIAL HIGHLIGHTS

Government-wide:

The assets of the State exceeded its liabilities at fiscal year end by \$3.89 billion (reported as net assets), an increase of \$209 million from the previous year. The net assets of governmental activities increased by 4.6% while the net assets of the business-type activities showed an increase of 7.3%.

Fund Level:

As of the close of fiscal year 2004, the State's governmental funds reported combined ending fund balances of \$1.3 billion, an increase of \$113 million. Of this amount, \$541 million represents unreserved fund balance with the remaining amount of \$773 million reserved for specific purposes, such as debt service, capital projects, and permanent trust for education. At the end of the fiscal year, unreserved fund balance for the General Fund was \$196 million.

The proprietary funds reported net assets at year-end of \$1.6 billion, an increase of \$107 million during the year.

Long-term Debt:

The State's total debt (bonds and notes payable) increased during the fiscal year to \$1.52 billion, an increase of \$56 million, 3.7%, which represents the net difference between new issuances, and payments and refundings of outstanding debt. During the year the State issued \$153 million in bonds and \$1.2 billion in notes.

More detailed information regarding these activities and funds is included in Note 3I.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which consists of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements.

Government-wide Statements

The government-wide financial statements provide a broad view of the State's operations in a manner similar to a private-sector business. The statements provide both short-term and long-term information about the State's financial position, which assists in assessing the State's economic condition at the end of the fiscal year. These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid.

The Statement of Net Assets presents all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets are an indicator of whether the State's financial position is improving or deteriorating.

The Statement of Activities presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and

expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave).

Both statements report three activities:

Governmental Activities – The activities in this section are primarily supported by taxes and intergovernmental revenue. Most of the State's basic services, such as education, health and human services and transportation, are reported under this category.

Business-type Activities – These functions are intended to recover all or a significant portion of their costs through user fees and charges to external users of goods and services. The Bank of North Dakota, Workers Compensation, and the University System are examples of the State's business-type activities.

Discretely Presented Component Units – These are operations for which the State has financial accountability but they have certain independent qualities as well. These entities operate similar to private-sector business and the business-type activities described above. The State has 17 discretely presented component units. Financial information for these entities is presented separately from the financial information presented for the primary government.

The government-wide financial statements can be found immediately following this discussion and analysis.

Fund Financial Statements

A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for a particular purpose. The State, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance related legal requirements.

The basic fund financial statements begin immediately after the government-wide statements and provide more detail about the major individual funds. The State's funds are divided into three categories – governmental, proprietary, and fiduciary. It is important to note that these fund categories use different accounting approaches and should be interpreted differently.

Governmental funds -- Most of the State's basic services are reported in the governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental fund financial statements focus on the near-term inflows and outflows of spendable resources. They also focus on the balances left at year-end that are available for future spending. Such information may be useful in evaluating whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. These funds are reported using *modified accrual* accounting, which measures cash and all other financial assets that can readily be converted to cash.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and the governmental activities. These reconciliations are presented on the page immediately following each governmental fund financial statement.

Governmental funds include the General Fund and special revenue, capital project, debt service, and permanent funds. The State has several governmental funds, of which three (3) are considered major individual funds. Those three are the General Fund, the Federal Fund, and the School Permanent Trust Fund. Each of these major funds is presented in a separate column in the governmental fund balance

sheet and in the governmental fund statement of revenues, expenditures and changes in fund balance. The remaining governmental funds are combined in a single aggregated column on the basic fund statements. Individual fund data for each of these nonmajor governmental funds can be found in the other supplementary information section of this report.

Proprietary funds – Services for which the State charges customers a fee are generally reported in proprietary funds. The state maintains two different types of proprietary funds, enterprise funds and internal service funds. Enterprise funds report activities that provide supplies and services to the general public. Internal service funds report activities that provide supplies and services for the State's other programs and activities. Like the government-wide statements, proprietary funds use the accrual basis of accounting. Although the basis of accounting is the same for the government-wide and proprietary fund statements, a reconciliation between these statements is presented because of the allocation of internal service funds' net income.

The State has four (4) major enterprise funds: The Bank of North Dakota, Housing Finance, University System, and Workforce Safety and Insurance. These four funds are each presented in separate columns on the basic proprietary fund financial statements. The remaining enterprise funds are combined in a single total column on these statements. Individual fund data for each of the nonmajor enterprise funds can be found in the other supplementary information section of this report.

The State's internal service funds are reported as governmental activities on the government-wide statements, because the services they provide predominantly benefit governmental activities. The State's five (5) internal service funds are reported on the basic proprietary fund financial statements in a single combined column. Individual fund data for the internal service funds is provided in the form of combining statements found elsewhere in this report.

Fiduciary funds -- The State acts as a trustee, or fiduciary, for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets. These funds, which include pension (and other employee benefit) trust, investment trust, private-purpose trust, and agency funds, are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because the State cannot use these assets to finance its operations.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and the fund financial statements. The notes to the financial statements can be found immediately following component units' financial statements.

Required Supplementary Information

The basic financial statements are followed by a section of required supplementary information. This section includes a budgetary comparison schedule, which includes reconciliation between the statutory fund balances for budgetary purposes and the fund balances for the General Fund and Federal Fund as presented in the governmental fund financial statements.

Other Supplementary Information

Other supplementary information includes combining financial statements for non-major governmental, non-major enterprise, internal service, and fiduciary funds. These funds are added together, by fund type, and presented in single columns in the basic financial statements.

FINANCIAL ANALYSIS OF THE GOVERNMENT AS A WHOLE

As noted previously, net assets may serve over time as a useful indicator of a government's financial position. The State's combined net assets (governmental and business-type activities) totaled \$3.89 billion at the end of fiscal year 2004. Net assets increased 5.7% from the prior fiscal year.

State of North Dakota's Net Assets (Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2003	2004	2003	2004	2003	2004
Current and Other Assets	\$ 1,533,469	\$1,676,535	\$ 4,210,468	\$4,393,340	\$ 5,438,584	\$5,745,690
Capital Assets	1,164,688	1,150,372	591,427	640,544	1,756,115	1,790,916
Total Assets	<u>2,698,157</u>	<u>2,826,907</u>	<u>4,801,895</u>	<u>5,033,884</u>	<u>7,194,699</u>	<u>7,536,606</u>
Long-Term Liabilities Outstanding	189,567	188,384	1,956,472	2,040,962	2,146,039	2,229,346
Other Liabilities	312,043	330,753	1,375,249	1,414,986	1,687,292	1,421,554
Total Liabilities	<u>501,610</u>	<u>519,137</u>	<u>3,331,721</u>	<u>3,455,948</u>	<u>3,833,331</u>	<u>3,650,900</u>
Net Assets						
Invested in Capital Assets,						
Net of Related Debt	1,049,298	1,027,252	462,653	499,222	1,511,950	1,526,474
Restricted	856,159	927,324	336,631	366,937	1,192,790	1,294,261
Unrestricted	291,090	353,194	670,890	711,777	961,980	1,064,971
Total Net Assets	<u>\$ 2,196,547</u>	<u>\$2,307,770</u>	<u>\$ 1,470,174</u>	<u>\$1,577,936</u>	<u>\$ 3,666,721</u>	<u>\$3,885,706</u>

The largest component (39.3%) of the State's net assets reflects its investment in capital assets such as land, buildings, equipment, and infrastructure (roads, bridges and other immovable assets) less any related debt outstanding that was needed to acquire or construct the assets. The State uses these capital assets to provide services to citizens; consequentially, these assets are not available for future spending. Although the State's investment in its capital assets is reported net of related debt, it should be noted that the resources need to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

Restricted net assets represent 33.3% of the State's net assets. These represent resources that are subject to external restrictions, constitutional provisions, or enabling legislation on how they can be used. The remaining portion, unrestricted net assets, may be used at the State's discretion, but often have limitations on use based on State statutes.

The condensed financial information on the following page was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

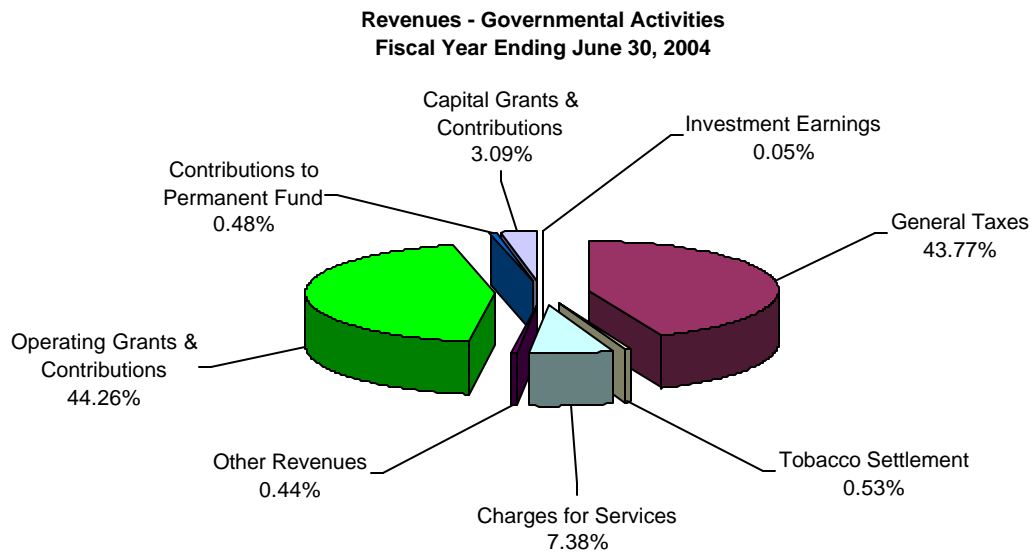
State of North Dakota's Changes in Net Assets
(Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2003	2004	2003	2004	2003	2004
Revenues:						
Program Revenues:						
Charges for Services	\$ 151,891	\$ 175,219	\$ 654,832	\$ 695,621	\$ 806,723	\$ 870,840
Operating Grants & Contributions	917,576	1,050,658	285,158	309,149	1,202,734	1,359,807
Capital Grants & Contributions	102,682	73,413	7,929	9,405	110,611	82,818
General Revenues:						
Income Taxes	248,068	266,253	-	-	248,068	266,253
Sales Taxes	550,221	599,065	-	-	550,221	599,065
Other Taxes	170,440	173,850	-	-	170,440	173,850
Investment Earnings	2,540	1,104	-	-	2,540	1,104
Tobacco Settlement	14,771	12,641	-	-	14,771	12,641
Other	9,647	10,529	-	-	9,647	10,529
Total Revenues	<u>2,167,836</u>	<u>2,362,732</u>	<u>947,919</u>	<u>1,014,175</u>	<u>3,115,755</u>	<u>3,376,907</u>
Expenses						
General Government	82,809	81,510	-	-	82,809	81,510
Education	451,683	466,909	-	-	451,683	466,909
Health and Human Services	776,275	803,601	-	-	776,275	803,601
Regulatory	15,490	15,105	-	-	15,490	15,105
Public Safety and Corrections	99,876	107,036	-	-	99,876	107,036
Agriculture and Commerce	53,051	57,533	-	-	53,051	57,533
Natural Resources	58,941	63,118	-	-	58,941	63,118
Transportation	352,535	360,231	-	-	352,535	360,231
Intergov'tal - Revenue Sharing	148,181	157,201	-	-	148,181	157,201
Interest on Long Term Debt	7,602	7,372	-	-	7,602	7,372
Bank of North Dakota	-	-	67,920	58,866	67,920	58,866
Housing Finance	-	-	55,745	49,646	55,745	49,646
Loan Programs	-	-	12,709	13,846	12,709	13,846
Mill and Elevator	-	-	90,835	92,261	90,835	92,261
State Fair	-	-	4,158	4,324	4,158	4,324
Unemployment Compensation	-	-	56,753	49,328	56,753	49,328
University System	-	-	614,872	656,811	614,872	656,811
Workers Compensation	-	-	171,406	125,728	171,406	125,728
Other	-	-	6,801	11,132	6,801	11,132
Total Expenses	<u>2,046,443</u>	<u>2,119,616</u>	<u>1,081,199</u>	<u>1,061,942</u>	<u>3,127,642</u>	<u>3,181,558</u>
Increase (decrease) in Net Assets Before Contributions and Transfers	121,393	243,116	(133,280)	(47,767)	(11,887)	195,349
Contributions to Permanent Fund Principal	13,127	11,262	-	-	13,127	11,262
Transfers	(159,389)	(152,422)	155,306	155,343	(4,083)	2,921
Increase (Decrease) in Net Assets	<u>(24,869)</u>	<u>101,956</u>	<u>22,026</u>	<u>107,576</u>	<u>(2,843)</u>	<u>209,532</u>
Net Assets - Beginning -As Restated	2,221,416	2,205,814	1,448,148	1,470,360	3,669,564	3,676,174
Net Assets - Ending	<u>\$ 2,196,547</u>	<u>\$ 2,307,770</u>	<u>\$ 1,470,174</u>	<u>\$ 1,577,936</u>	<u>\$ 3,666,721</u>	<u>\$ 3,885,706</u>

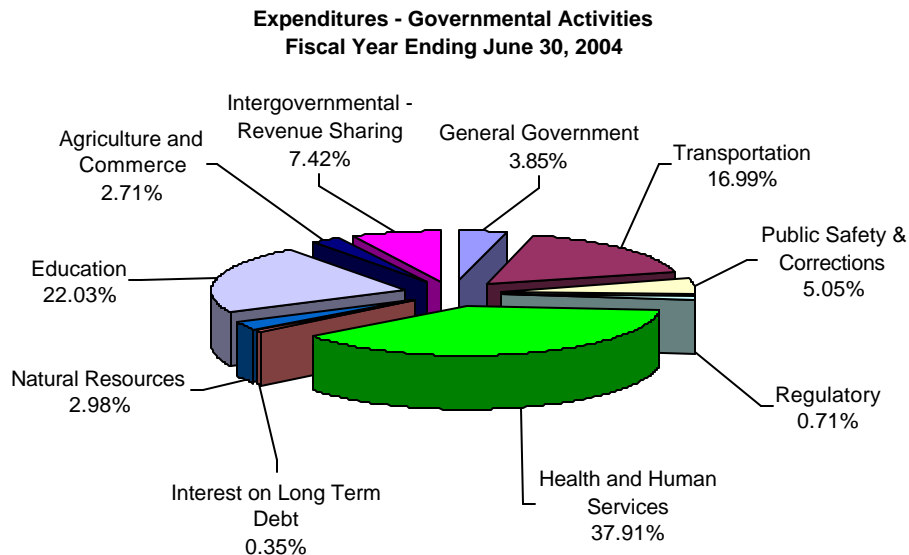
Governmental Activities

Governmental Activities increased the State's net assets by \$101.9 million, compared to a \$24.9 million decrease in the prior fiscal year. The largest increases in the State's revenues for fiscal year 2004 were from sales and use taxes, 8.9%, and individual income tax, 6.8%. Oil and gas taxes also increased nearly 5% this fiscal year. Increases in individual income tax collections reflect an increase in personal income. Additional revenues from sales and use tax and motor vehicle excise taxes indicate growing consumer spending and improving consumer confidence. Oil and gas taxes continue to increase because of record-high energy prices. There was a slight increase in expenses also. Education expenses increased approximately \$15 million due to \$5 million in additional grants to school districts under the Federal No Child Left Behind Act and \$10 million in legislatively authorized state aid to schools. Health and Human Services expenses increased by \$27 million primarily due to a rise in Medicaid and Food Stamps benefit payments.

The following chart depicts revenues of the governmental activities for the fiscal year:



The following chart depicts expenses of the governmental activities for the fiscal year:



Business-type Activities

Net assets of the business-type activities increased by \$107 million during the fiscal year. Factors contributing to these results included:

The Bank of North Dakota's net assets increased \$4 million because of a decrease in the transfers to the State's General Fund. The Bank's results of operations decreased 11.5%, from \$33.1 million to \$29.3. Results of operations are primarily dependent upon the level of net interest income, which is affected by the mix of earning assets and the interest rates earned thereon; and the amount of interest-bearing liabilities on which interest is paid and the rates of interest paid thereon. Net interest income declined because of shrinkage of the net interest margin.

Workforce Safety and Insurance's (WSI) net assets increased \$68 million primarily due to underwriting and investing activities. Underwriting consists of pricing premiums to cover the workers compensation loss exposure. Annual premium rates are set to achieve break-even results for the current fiscal year; however, an independent actuarial analysis in fiscal years 2003 and 2004 indicated unfavorable development on prior years' loss reserves. The 2004 analysis revealed unfavorable development on prior years' loss reserves of \$31.6 million. Changes in the loss estimates are recognized in the current year of operations. Underwriting activities' income revealed a \$23.7 million loss during fiscal year 2004 as opposed to a \$77.7 million loss during fiscal year 2003. WSI's investment income increased in 2004 to \$91.4 million as compared to \$80.4 million in 2003.

The net assets of Housing Finance did not change significantly, a 3% increase. The \$2 million increase is due to income from program operations and investing activities.

The North Dakota State University System net assets increased \$27 million during 2004 as a result of the year's activity. Investments increased \$23.5 million due to market gains and re-investment of cash and equivalents into longer-term instruments as a result of increasing interest rates and improvement in the market. Grants and contracts increased \$3.2 million, which is related to an increase in grant awards.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

Governmental Funds

As the State completed the year, its governmental funds reported combined fund balances of \$1.3 billion, an increase of \$113 million from the prior fiscal year. Approximately \$541 million of this total amount constitutes unreserved fund balance, which is available for appropriation for the general purposes of the funds. The remainder of fund balance is reserved and is not available for new spending because it has already been dedicated to various commitments such as long-term receivables, debt service, and capital projects.

The General Fund is the chief operating fund of the State. At the end of current fiscal year, unreserved fund balance of the General Fund was \$196 million and reserved fund balance was \$1 million. Total fund balance rose during the fiscal year by \$69.8 million, due to a \$70 million increase in tax revenues. Sales and use taxes had the largest increase, followed by individual income taxes and then, oil and gas taxes. By the end of fiscal year 2004, General Fund revenues increased 8 percent from the prior year.

The School Permanent Trust Fund balance at June 30, 2004, improved by \$72 million from the prior year due to the improvement in the conditions of the securities market. During 2004, the fund reported investment income of \$76.6 million as compared to \$24.7 million in 2003.

The Federal Fund balance at June 30, 2004, decreased \$5 million due to increased expenses in various federal programs.

Proprietary Funds

The State's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail. The increases in the net assets of the proprietary funds are discussed under "Business-type Activities" above.

General Fund Budgetary Highlights:

The State has a biennial appropriated budget. The fiscal year ended June 30, 2004, was the first year of the 2003-05 budget cycle. The original budget increased \$6.8 million.

At the beginning of the 2003-05 budget cycle, there was an increase in the original budget of \$6.8 million due to the authorized carryover of general fund appropriation authority from the 2001-03 biennium, which is reported as an appropriation adjustment for the 2003-05 budget. Some of those carryover amounts are noted below.

Several state agencies were authorized by appropriation laws to carryover a portion or all of their general fund appropriation for various purposes, including the Office of Management and Budget, \$1.5 million, Legislative Council and Assembly, \$.7 million, Department of Commerce, \$1.2 million, and the University System, \$2.2 million. Various other state agencies received smaller amounts of carryover totaling .7 million.

A few agencies received general fund carryover dollars from the 2001-03 biennium for capital construction projects. These carryover dollars totaled \$.5 million.

There were no expenditures in excess of general fund spending authority.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets: At the end of the fiscal year 2004, the State had invested \$1.8 billion, net of accumulated depreciation, in a broad range of capital assets. Depreciation charges for this fiscal year totaled \$185 million.

State of North Dakota's Capital Assets (Net of Depreciation, Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2003	2004	2003	2004	2003	2004
Land and Land Improvements	\$ 39,972	\$ 43,280	\$ 16,989	\$ 18,565	\$ 56,961	\$ 61,845
Building & Building Improvements	197,223	205,930	333,548	378,292	530,771	584,222
Equipment	91,438	92,004	114,413	122,687	205,851	214,691
Infrastructure	658,205	602,089	90,854	89,943	749,059	692,032
Construction in Progress	177,850	207,068	35,623	31,056	213,473	238,124
Total	\$ 1,164,688	\$ 1,150,371	\$ 591,428	\$ 640,543	\$ 1,756,115	\$ 1,790,914

The total increase in the State's investments in capital assets for the current fiscal year was 2% in terms of net book value. However, actual expenditures to purchase or construct capital assets were approximately \$323 million for the year. More than half of this amount was used to construct or reconstruct assets at the University Systems and for highway construction. More detailed information on the State's capital assets can be found in Note 3F to the financial statements.

Long-term Debt: Article X, Section 13 of the Constitution of North Dakota provides that the state may issue or guarantee the payment of bonds provided that all bonds in excess of \$2 million are: secured by

first mortgage upon property and no further indebtedness may be incurred by the state unless evidenced by a bond issue; authorized by law, for a certain purpose; provisioned to pay the interest semiannually, and pay the principal within 30 years. The law authorized the bond issue must specifically appropriate the provisions to the payment of the principal and interest of the bond. The state has no general obligation bonds outstanding at June 30, 2004.

The State does have a number of revenue bonds outstanding at June 30, 2004. Current state statutes empower certain state agencies and the Building Authority, a component unit of the State, to issue bonds as part of their activities. This debt is not backed by the full faith and credit of the State of North Dakota. The principal and interest on revenue bonds issued by state agencies is payable from designated revenue sources. The Building Authority's bonds generate revenue to finance the construction and improvements of State buildings. Revenues derived from leases on the buildings fund the debt service requirements.

The Bank of North Dakota has advances from the Federal Home Loan Bank in the amounts of \$525 million. The advances have a fixed rate of interest, ranging from 2.98 percent to 7.35 percent.

More detailed information regarding the State's long-term obligations is presented in Note 3 to the financial statements.

State of North Dakota's Outstanding Debt
(Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2003	2004	2003	2004	2003	2004
Revenue Bonds	\$ 146,795	\$ 146,384	\$ 886,185	\$ 835,535	\$ 1,032,980	\$ 981,919
Notes Payable	5,671	5,455	427,683	535,253	433,354	540,708
Total	\$ 152,466	\$151,839	\$ 1,313,868	\$1,370,788	\$ 1,466,334	\$1,522,627

The State's total debt increased by 3.9% during the current fiscal year.

ECONOMIC CONDITION AND OUTLOOK

At the end of December 2004, revenue collections exceeded the legislative forecast by \$60.9 million, excluding the impact of the \$56.5 million North Dakota received from the Jobs and Growth Tax Relief Reconciliation Act of 2003. In addition, oil tax collections have reached the statutory cap of \$71 million that can be deposited into the general fund. As a result, \$3.8 million has been reserved for transfer into the permanent oil tax trust fund at the end of the 2003-05 biennium. An additional \$36 million is expected to flow into that trust fund by the end of the biennium.

The general fund revenue growth North Dakota has experienced in the first 18 months of the biennium can be attributed primarily to strong sales tax collections. Individual income tax collections and withholdings are also exceeding forecast. Both are good indicators that North Dakota's economy is growing. In addition, the high price of oil has also been of benefit to the general fund.

The outlook for the 2005-07 biennium is very good. A strong ending general fund balance coupled with a growing economy will provide the funding necessary to serve the citizens of North Dakota.

CONTACTING THE STATE'S OFFICE OF FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. Questions about this report or additional financial information should be addressed to the State of North Dakota, Office of Management and Budget, 600 E. Boulevard, Dept. 110, Bismarck, ND 58505.