

OFFICE OF MANAGEMENT AND BUDGET

600 East Boulevard Avenue, Fourth Floor • Bismarck, North Dakota 58505-0400

January 25, 2005

To the Governor, Legislators and Citizens of the State of North Dakota:

In accordance with North Dakota Century Code (NDCC) section 54-44-04(14), we are pleased to submit the Comprehensive Annual Financial Report (CAFR) of the State of North Dakota for the fiscal year ended June 30, 2004. This report has been prepared by the Office of Management and Budget. The financial statements contained in the CAFR have been prepared in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the state's management. To the best of our knowledge and belief, the information contained in the CAFR is accurate in all material respects and reported in a manner that presents fairly the financial position and results of operations of the State's primary government and the component units for which it is financially accountable. All disclosures necessary to enable the reader to gain an understanding of the State of North Dakota's financial affairs have been included.

The CAFR is presented in three sections: Introductory, Financial and Statistical. The introductory section contains this transmittal letter, Certificate of Achievement for Excellence in Financial Reporting, the State organization chart and a list of principal officials. The financial section includes: the independent auditor's report on the basic financial statements; Management's Discussion and Analysis (MD&A), which provides an introduction, overview and analysis of the basic financial statements; the basic financial statements, which present the government-wide financial statements and fund financial statements for governmental funds, proprietary funds, fiduciary funds, and component units, together with notes to the basic financial statements; required supplementary information, other than MD&A, which presents budgetary comparison schedules; and the supplemental financial data which includes the combining financial statements. The statistical section includes a history of selected financial and demographic information.

The State's management is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the government are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the costs of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management.

In compliance with State statute, the Office of the State Auditor (SAO) audited the State's financial statements. The goal of the independent audit was to provide reasonable assurance that the financial statements of the State for the fiscal year ended June 30, 2004, are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and evaluating the overall financial statement presentation. Their examination was conducted in accordance with GAAP and the standards applicable to financial audits contained in *Government Auditing Standards* as published by the Comptroller

General of the United States. The SAO concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the State's financial statements for the fiscal year ended June 30, 2004, are fairly presented in conformity with GAAP. The independent auditor's report is presented as the first component of the financial section of this report

The State of North Dakota is also required to undergo a single audit in conformity with the provision of the Single Audit Act Amendments of 1996 and the U.S. Office of Management and Budget's Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Information related to this single audit, including a schedule of expenditures of federal awards, the independent auditor's reports on internal controls and compliance with applicable laws and regulations, and a schedule of findings and questioned costs, are included in a separately issued biennial single audit report.

GASB Statement No. 34 requires that management provide a narrative introduction, overview and analysis to accompany the basic financial statements in the form of a Management Discussion and Analysis (MD&A). 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

The State of North Dakota provides for a full range of services, including education, health and social services, highway maintenance and construction, law enforcement, judicial, public safety, business regulation, community and economic development, and natural resource development. The State's reporting entity reflected in the CAFR includes all the funds of the state as legally defined, as well as all of its component units in conformity with the requirements of GASB Statement No. 14. Statement No. 14 provides that the financial statements should emphasize the primary government and permit financial statement users to distinguish between the primary government and its component units. Consequently, the transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the discretely presented component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position. The State's reporting entity is described more fully in Note 1A to the basic financial statements.

The State operates through a biennial appropriation, which represents agency appropriations recommended by the governor and presented to the Legislative Assembly at the beginning of each legislative session. The budget is legally required to be adopted through passage of appropriation bills by the Legislative Assembly and signed by the governor. The governor has line item veto powers over all appropriations subject to legislative override. Once passed and signed, the appropriation bill becomes the departments' financial plan for the next two years. Changes to the appropriation are limited to Emergency Commission authorization, initiative, allotment, or referendum action.

The State does not budget by fund nor does it formally budget revenues. The legal level of budgetary control is at the agency, appropriation authority and expenditure line item level. The State's budgetary policies and procedures are further explained in Note 1D on the notes to the basic financial statements.

ECONOMIC CONDITIONS AND OUTLOOK

North Dakota's economy is in solid shape. Private service-producing industries have paced the State's recent gains, and natural resource-based industries are expanding as well as a result of higher energy prices and investment by utilities. Agriculture continues to provide a boost to North Dakota's economy.

Taxable sales and purchases in the third quarter of 2004 were 5.9 percent ahead of the same period one year earlier. Taxable sales and purchases are expected to grow by 4 percent in 2005.

Throughout 2004 North Dakota's unemployment rate was consistently among the lowest in the nation. North Dakota's unemployment rate for November 2004 was tied for the lowest at 3.0 percent. In addition, wages and personal income continue to increase. Personal income in North Dakota increased by 7.7 percent in

2003, compared to a national average of 3.2 percent. The low unemployment rate combined with the growth in wages and personal income reflect a stable job market with a steady growth factor.

North Dakota currently has 21 oil rigs drilling, compared to 17 one year ago. The current price of oil is in the range of \$42 per barrel. Actual collections are considerably ahead of projections due to the high price of oil. In addition, oil production continues to increase.

MAJOR INITIATIVES AND FUTURE PROJECTS

In December 2004 Governor Hoeven documented accomplishments to date in maintaining fiscal responsibility and sustaining economy growth, while providing for the basic needs of the citizens and proposed expansion in some areas.

The State maintained positive revenues throughout the recent economic downturn. North Dakota had the largest increase in per capita income growth and the second largest increase in wages last year. The ability of the State to manage its finances was rationally recognized when Moody's bond rating service increased the bond ranking from Aa3 to Aa2. To continue the fiscal responsibility into the future, policy changes have been proposed that will establish a minimum of \$60 million in rainy day funds.

The future viability of the State is being enhanced through numerous economic initiatives. These include providing additional funding for the Trade Office, pursuing fair rates for rail traffic, and measuring economic development activity through performance measurement for entities that receive assistance from the State.

The establishment of a North Dakota Transmission Authority is providing the necessary mechanism to promote the power plants and enhance the capacity to export energy beyond the state borders. Other efforts in this area include expansion of the biofuel program with a western North Dakota malting and ethanol barley initiative, expanded incentives for wind energy farms, and preparation for building additional power plants.

North Dakota University System campuses are being used to generate economic growth while providing opportunities for employment through Centers of Excellence. These centers continue to promote research and commercialization of local products and ideas. The expansion of the NDSU Beef Center of Excellence will identify additional products available in the local industry and create a model integrated meat processing facility. New greenhouse facilities at NDSU will allow additional research work on North Dakota crops. North Dakota University student opportunities for careers have been enhanced through an internship program that is actively marketed and coordinated with Job Service North Dakota.

The needs of the citizens are being addressed in multiple areas. The most exposed citizens have been the individuals serving the military in the recent conflict. To provide for these individuals, bonus payments for military service has been combined with increased tuition credit. In addition, health insurance and retirement benefits will be continued for state employees mobilized in the National Guard or Reserves.

The needs of senior citizens and persons with disabilities have been met with increased Homestead Property Tax Credit for homeowners and renters. The unemployment benefit penalty for persons over 65 on social security is being repealed. Senior citizens are also benefiting from a single point of entry for long-term care and supportive services. This allows them to receive the home, community, and nursing home care at appropriate levels with the least restrictions on their lives.

Safety through law enforcement and crime prevention activities has been noteworthy throughout the year. Life sentences without parole for sex crime offenders involved in a death are being imposed. Civil commitments are enhanced to provide additional monitoring and supervision of dangerous sex offenders. Included in the supervision is the use of global positioning systems for felon sex offenders under probation. An additional drug treatment and incarceration facility, together with expanded drug courts as an alternative to incarceration, will provide additional safety features while recognizing the need in this area.

Educational excellence continues to be an ongoing activity. Teacher salary increases have occurred in the past four years through a system recognizing local responsibility combined with additional state funding.

Supplemental payments to property-poor districts allow the students to receive an equitable education. School districts have been cooperating through joint power agreements to reduce operational costs and redirect funding to the educational needs of the students.

FINANCIAL INFORMATION

The MD&A provides an overview of the State's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, MD&A focuses on the State's major funds: the General Fund, Federal Fund, School Permanent Trust Fund, Bank of North Dakota, Housing Finance, Workforce Safety & Insurance, and the University System.

Cash Management: North Dakota Century Code section 21-04-02 provides that public funds belonging to or in the custody of the State shall be deposited in the Bank of North Dakota. Cash balances, as required by law, are pooled by the State Treasurer and deposited in the Bank of North Dakota. All interest revenue is allocated to the General Fund unless state law (as outlined in the North Dakota Century Code) requires allocations of interest to other funds. For the fiscal year ended June 30, 2004, pooled deposits in the Bank of North Dakota yielded an average of .50 percent on a cash pool that ranged from \$232 to \$285 million. Cash is primarily invested in demand deposits and certificates of deposit in the Bank of North Dakota. Cash deposits not held in the State Treasury and controlled by various other state officials are generally held in interest bearing accounts.

Risk Management: The 1995 Legislature established the Risk Management Fund to pay damages for claims for which the state is liable. The statutory liability of the state is limited to a total of \$250,000 per person and \$1,000,000 per occurrence. The State purchases commercial insurance for claims in excess of coverage provided by the Fund and continues to transfer liabilities for medical malpractice and aviation to private insurance carriers. The 2001 Legislature established a single Workers Compensation account for state entities to be administered by the department that also administers the Risk Management Fund.

The State has several other funds that accumulate assets to cover risks that the state may incur. The State Fire and Tornado Fund insures against loss to public buildings, fixtures and permanent contents. The State Bonding Fund covers bonding of public employees and public officials. Workforce Safety & Insurance is a state insurance fund and a "no-fault" insurance system that covers the state's employers and employees. See Note 13 to the financial statements for additional disclosures on the State's risk management activities.

Pension Trust Plans: The State administers four major retirement systems: North Dakota Public Employees' Retirement System (PERS), North Dakota Highway Patrolmen's Retirement System (NDHPRS), the Teachers' Fund for Retirement (TFFR), and the Retirement Plan for Employees of Job Service North Dakota (JSND). Certain employees may elect to participate in a deferred contribution pension plan.

PERS is the largest of the defined benefit plan for which the State is responsible for providing funding. This plan covers substantially all employees of the State of North Dakota, its agencies and various participating political subdivisions. Total net assets of PERS at June 30, 2004, were \$1.27 billion. The State also provides postemployment health-care benefits to members receiving retirement benefits from the PERS, NDHPRS, Retirement Plan for Employees of JSND, and certain retired judges. Additional disclosures relating to the State's pension funds are provided in the notes to the financial statements.

OTHER INFORMATION

Certificate of Achievement: The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of North Dakota for its comprehensive annual financial report for the fiscal year ended June 30, 2003. This was the 13th consecutive year that the government has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

In addition, the State of North Dakota received the GFOA's Award for Distinguished Budget Presentation for its 2003-2005 budget. In order to qualify for the Distinguished Budget Presentation Award, the State's budget document was judged to be proficient in several categories, including policy documentation, financial planning, and organization.

Acknowledgments: This report was prepared by staff members of the Fiscal Management Division of the Office of Management and Budget. Their dedication and efforts are greatly appreciated. We also extend our gratitude to the numerous individuals from virtually all the state agencies and institutions, especially the Office of the State Auditor, for their commitment to assist us in preparing this report.

Sincerely,

Pam Sharp, Director
Office of Management and Budget