

## 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, 2005. 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 \$4.2 billion (reported as net assets), an increase of \$323 million from the previous year. The net assets of governmental activities increased by 11.5% while the net assets of the business-type activities showed an increase of 3.6%

#### Fund Level:

As of the close of fiscal year 2005 the State's governmental funds reported combined ending fund balances of \$1.6 billion, an increase of \$251 million. Of this amount, \$721 million represents unreserved fund balance, with the remaining amount of \$848 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 \$280 million.

The enterprise funds reported net assets at year-end of \$1.6 billion, an increase of \$55 million during the year.

#### Long-term Debt:

The State's total debt (bonds and notes payable) increased during the fiscal year to \$1.54 billion, an increase of \$19 million, or 1.3%, which represents the net difference between new issuances and payments and refundings of outstanding debt. During the year the State issued \$262 million in bonds and \$6.4 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 \$4.2 billion at the end of fiscal year 2005. Net assets increased 7.8% from the prior fiscal year.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2004	2005	2004	2005	2004	2005
Current and Other Assets	\$1,676,140	\$1,970,752	\$4,393,283	\$4,697,809	\$5,745,238	\$6,235,218
Capital Assets	1,150,767	1,223,594	640,601	668,949	1,791,368	1,892,543
Total Assets	<u>2,826,907</u>	<u>3,194,346</u>	<u>5,033,884</u>	<u>5,366,758</u>	<u>7,536,606</u>	<u>8,127,761</u>
Long-Term Liabilities Outstanding	188,384	249,406	2,040,962	2,082,838	2,229,346	2,332,244
Other Liabilities	330,753	367,263	1,414,986	1,647,417	1,421,554	1,581,338
Total Liabilities	<u>519,137</u>	<u>616,669</u>	<u>3,455,948</u>	<u>3,730,255</u>	<u>3,650,900</u>	<u>3,913,582</u>
Net Assets						
Invested in Capital Assets,						
Net of Related Debt	1,027,252	1,094,551	499,222	505,916	1,526,474	1,600,467
Restricted	927,324	1,046,115	366,937	393,237	1,294,261	1,439,352
Unrestricted	353,194	437,011	711,777	737,349	1,064,971	1,174,360
Total Net Assets	<u>\$2,307,770</u>	<u>\$2,577,677</u>	<u>\$1,577,936</u>	<u>\$1,636,502</u>	<u>\$3,885,706</u>	<u>\$4,214,179</u>

NOTE: The Governmental Activities amounts and Business-Type Activities amounts do not cross foot to the total Primary Government column because internal balances are reported separately as internal receivables and internal payables. A total internal balance remains due to certain Business-Type Activities having different fiscal year ends than the Governmental Activities.

The largest component (40%) 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 34% 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:

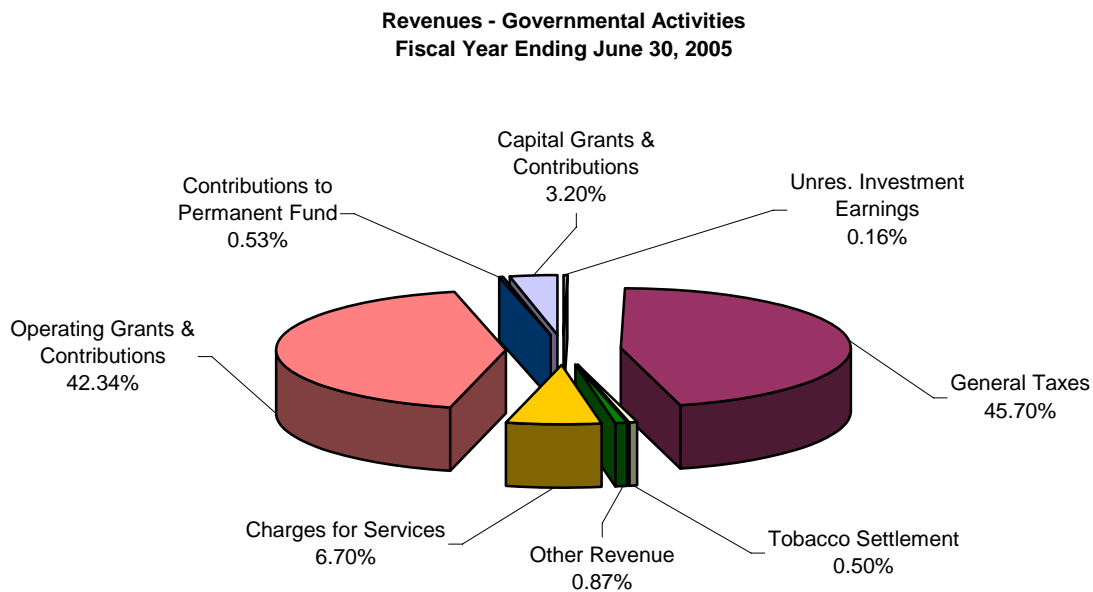
**State of North Dakota's Changes in Net Assets**  
(Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2004	2005	2004	2005	2004	2005
<b>Revenues:</b>						
Program Revenues:						
Charges for Services	\$ 175,219	\$ 171,779	\$ 695,621	\$ 741,172	\$ 870,840	\$ 912,951
Operating Grants & Contributions	1,050,658	1,084,731	309,149	304,001	1,359,807	1,388,732
Capital Grants & Contributions	73,413	81,850	9,405	5,998	82,818	87,848
General Revenues:						
Income Taxes	266,253	320,049	-	-	266,253	320,049
Sales Taxes	599,065	630,179	-	-	599,065	630,179
Other Taxes	173,850	220,751	-	-	173,850	220,751
Investment Earnings	1,104	4,106	-	-	1,104	4,106
Tobacco Settlement	12,641	12,830	-	-	12,641	12,830
Other	10,529	22,337	-	-	10,529	22,337
<b>Total Revenues</b>	<u>2,362,732</u>	<u>2,548,612</u>	<u>1,014,175</u>	<u>1,051,171</u>	<u>3,376,907</u>	<u>3,599,783</u>
<b>Expenses</b>						
General Government	233,634	243,437	-	-	233,634	243,437
Education	469,334	486,221	-	-	469,334	486,221
Health and Human Services	803,601	826,832	-	-	803,601	826,832
Regulatory	17,757	17,966	-	-	17,757	17,966
Public Safety and Corrections	107,036	132,997	-	-	107,036	132,997
Agriculture and Commerce	57,533	55,796	-	-	57,533	55,796
Natural Resources	63,118	53,440	-	-	63,118	53,440
Transportation	360,231	300,322	-	-	360,231	300,322
Interest on Long Term Debt	7,372	8,104	-	-	7,372	8,104
Bank of North Dakota	-	-	58,866	57,502	58,866	57,502
Housing Finance	-	-	49,646	45,922	49,646	45,922
Loan Programs	-	-	13,846	13,889	13,846	13,889
Mill and Elevator	-	-	92,261	95,223	92,261	95,223
State Fair	-	-	4,324	4,496	4,324	4,496
Unemployment Compensation	-	-	49,328	43,394	49,328	43,394
University System	-	-	656,811	696,918	656,811	696,918
Workers Compensation	-	-	125,728	183,466	125,728	183,466
Other	-	-	11,132	20,857	11,132	20,857
<b>Total Expenses</b>	<u>2,119,616</u>	<u>2,125,115</u>	<u>1,061,942</u>	<u>1,161,667</u>	<u>3,181,558</u>	<u>3,286,782</u>
Increase (decrease) in Net Assets Before Contributions and Transfers	243,116	423,497	(47,767)	(110,496)	195,349	313,001
Contributions to Permanent Fund Principal	11,262	13,636	-	-	11,262	13,636
Transfers	(152,422)	(170,925)	155,343	167,350	2,921	(3,575)
<b>Increase (Decrease) in Net Assets</b>	101,956	266,208	107,576	56,854	209,532	323,062
Net Assets - Beginning -As Restated	2,205,814	2,311,469	1,470,360	1,579,648	3,676,174	3,891,117
Net Assets- Ending	<u>\$ 2,307,770</u>	<u>\$ 2,577,677</u>	<u>\$ 1,577,936</u>	<u>\$ 1,636,502</u>	<u>\$ 3,885,706</u>	<u>\$ 4,214,179</u>

## Governmental Activities

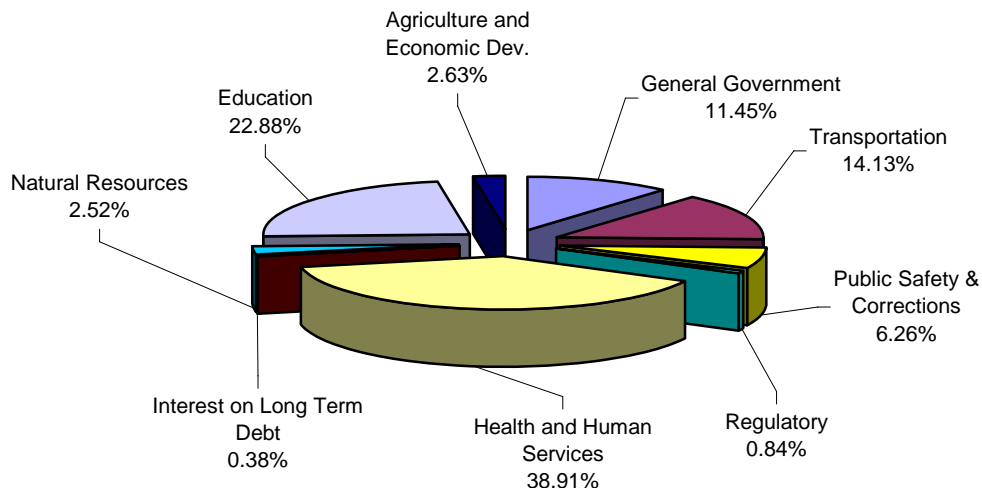
Governmental Activities increased the State's net assets by \$266.2 million, compared to a \$101.9 million increase in the prior fiscal year. The largest increases in the State's revenues for fiscal year 2005 were from the State's tax revenues. Individual and corporate income taxes increased 20%, oil and gas taxes increased 45%, and sales and use taxes increased 5.13%. Increases in income tax and sales tax collections reflect the State's growing economy. Oil and gas tax revenues continue to rise due to increases in global oil prices. There also was a slight increase in intergovernmental revenue, 4.9%, because of increases in federal grants. Expenses for total governmental activities did not change significantly, less than a 1% increase. However, expenses did change for various functions. Education expenses increased 3.6%, caused by additional federal and state grants to school districts. Health and Human Services expenses increased by \$23 million primarily due to a rise in Low Income Home Energy Assistance, Temporary Assistance for Needy Families, and Food Stamps benefit payments. Public Safety and Corrections saw a \$25 million increase for Federal Disaster and Homeland Security programs.

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



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

**Expenditures - Governmental Activities  
Fiscal Year Ending June 30, 2005**



**Business-type Activities**

Net assets of the business-type activities increased by \$56 million during the fiscal year. Factors contributing to these results included:

The net assets of the Bank of North Dakota did not change significantly. A \$1 million decrease in their net assets was due to an increase in transfers to the State's General Fund.

Workforce Safety and Insurance's (WSI) net assets increased \$10 million primarily due to underwriting and investing activities. Underwriting consists of pricing premiums to cover the workers compensation loss exposure, with changes in the loss estimates recognized in the current year of operations. WSI reported investment income of \$79.6 million during 2005. Underwriting activities' income revealed a \$15.4 million loss during fiscal year 2005. Additionally, the discount rate on the unpaid loss liability was decreased in 2005 from 6% to 5% due to the condition of the economy and the markets. This rate decrease resulted in increased liabilities of \$55.1 million.

The net assets of Housing Finance increased \$5 million as a result of the leveling in market value of investments and the deceleration in bond financing costs due to the decrease in bond calls from loan prepayments.

The North Dakota State University System net assets increased \$11 million during 2005, primarily as a result of a tuition increase of 15.4%, and a 2.1% enrollment increase from 2004 to 2005.

The net assets of the Unemployment Compensation Fund increased \$21.5 million due to the continued decrease in federal benefit expenditures. The federal benefit expenditures increased immediately after the Temporary Extended Unemployment Compensation Act passed in 2002, but are now leveling out.

## **FINANCIAL ANALYSIS OF THE STATE'S FUNDS**

### **Governmental Funds**

As the State completed the year, its governmental funds reported combined fund balances of \$1.6 billion, an increase of \$251 million from the prior fiscal year. Approximately \$721 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 \$280 million and reserved fund balance was \$1.5 million. Total fund balance rose during the fiscal year by \$85 million, due to increases in tax revenues. Sales taxes had the largest increase, over \$45 million, followed by individual income and corporate income taxes, which each increased over \$20 million. By the end of fiscal year 2005, General Fund revenues increased eight percent from the prior year.

The School Permanent Trust Fund balance at June 30, 2005, improved by \$75 million from the prior year, largely because of an increase in royalties income. During 2005, the fund reported royalties of \$34 million as compared to \$16 million in fiscal year 2004.

The Federal Fund balance at June 30, 2005, decreased \$20 million due to increased expenses in various federal programs and a repayment of a long-term advance to the Department of Transportation's special fund.

### **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, 2005, was the second year of the 2003-05 budget cycle. The original budget increased \$19.7 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 also received general fund carryover dollars from the 2001-03 biennium for capital construction projects. These carryover dollars totaled \$.5 million.

During the 2005 Legislative Session, several state agencies received deficiency appropriations for the remainder of the 2003-05 biennium. This additional appropriation increased the general fund budget by about \$13 million. The largest increase, \$7.6 million, was for the Department of Emergency Management to repay a loan that had been used for the State's share of disaster costs. Information Technology Department received \$1 million for general operating costs that could not legally be recovered from fees. North Dakota State University received \$1.5 million for the State's share of flood costs. The Department of Corrections received \$1.7 million to cover the costs associated with a higher than anticipated inmate population. A few other agencies received smaller increases, making up the remaining increase.



One state agency, Protection and Advocacy, overspent their general fund appropriation authority by a minimal amount, \$803.

## CAPITAL ASSETS AND DEBT ADMINISTRATION

*Capital Assets:* At the end of the fiscal year 2005, the State had invested \$1.9 billion, net of accumulated depreciation, in a broad range of capital assets. Depreciation charges for this fiscal year totaled \$133 million.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2004	2005	2004	2005	2004	2005
Land and Land Improvements	\$ 43,280	\$ 44,208	\$ 18,565	\$ 18,397	\$ 61,845	\$ 62,605
Building & Building Improvements	206,373	216,344	380,442	391,982	586,372	608,326
Equipment	91,764	105,675	123,131	144,703	215,135	250,378
Infrastructure	602,282	569,336	87,407	88,158	689,496	657,494
Construction in Progress	207,068	288,031	31,056	25,709	238,124	313,740
<b>Total</b>	<b>\$ 1,150,767</b>	<b>\$ 1,223,594</b>	<b>\$ 640,601</b>	<b>\$ 668,949</b>	<b>\$ 1,791,368</b>	<b>\$ 1,892,543</b>

The total increase in the State's investments in capital assets for the current fiscal year was 6% in terms of net book value. However, actual expenditures to purchase or construct capital assets were approximately \$304 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, 2005.

The State does have a number of revenue bonds outstanding at June 30, 2005. 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 \$436 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 3I to the financial statements.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2004	2005	2004	2005	2004	2005
Revenue Bonds	\$ 146,384	\$ 204,240	\$ 835,535	\$ 887,350	\$ 981,919	\$ 1,091,590
Notes Payable	5,455	5,613	535,253	445,080	540,708	450,693
<b>Total</b>	<u>\$ 151,839</u>	<u>\$ 209,853</u>	<u>\$ 1,370,788</u>	<u>\$ 1,332,430</u>	<u>\$ 1,522,627</u>	<u>\$ 1,542,283</u>

The State's total debt increased by 1.3% during the current fiscal year.

**ECONOMIC CONDITION AND OUTLOOK**

At the end of December 2005, revenue collections exceeded the legislative forecast by \$78.1 million. Of this amount, \$21.7 million is attributed to overages in oil tax collections. Once \$71 million of oil tax collections are deposited into the general fund, the remaining amount will be deposited into the permanent oil tax trust fund.

The general fund revenue growth North Dakota has experienced in the first six months of the biennium can be attributed to a strong and growing economy, as evidenced by exceptionally strong sales tax collections, individual income tax collections and corporate income tax collections. In addition, the high price of oil has generated very high oil tax collections for the general fund.

The outlook for the 2005-07 biennium is very good. North Dakota's economy continues to grow, and that growing economy will continue to fuel the general fund.

**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.