

OFFICE OF MANAGEMENT AND BUDGET

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

January 26, 2006

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, 2005. 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, 2005, 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, 2005, 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.

LOCAL ECONOMY

North Dakota has enjoyed a stable and growing economy in recent years. Education, health services, and government constitute over 36 percent of the state's employment, providing economic stability even during times when other states are experiencing economic downturns. However, the state's economy is becoming increasingly diversified. Construction and hospitality industries have led the recent economic expansion; the manufacturing and professional services sectors of the economy continue to grow as well.

An indication of the growing diversity of the state's economy is the variety of economic sectors represented in the state's top 20 employers, which include education, health services, professional and technical services, finance and insurance, entertainment and recreation, mining, and federal military.

Energy related sectors of the economy have experienced recent growth. Not only has the recent rise in oil prices led to a growth in oil and gas exploration and production, it has also contributed to a surge in renewable energy development. Ethanol and biodiesel production facilities are under development, as well as numerous wind-powered electrical generating facilities.

The state's unemployment rate continues to be below the national average. During the past five years, the national unemployment rate was climbing, but North Dakota's rate remained low, hovering between 2.7 and 3.5 percent.

Economy.com, the state's economic forecasting consultant, predicts continued economic, employment, and wage growth for North Dakota. During the next five years, total employment is anticipated to grow by nearly 4 percent, the unemployment rate is anticipated to continue at around 3.5 percent, and personal income is anticipated to grow by 3.9 to 7.2 percent per year.

LONG-TERM FINANCIAL PLANNING

The long-term financial plan of the state is to support programs that result in steady, stable growth of its economy. In turn, the growing and stable economy supports important government functions such as education and human services.

North Dakota's conservative budgeting and revenue forecasting, combined with economic growth, has allowed the budget stabilization fund to grow to its statutory maximum of five percent of the general fund biennial budget. Balances in the oil trust fund and foundation aid stabilization fund continue to grow as well.

Conservative revenue forecasting is a practice in North Dakota. With the assistance of the Revenue Forecasting Advisory Committee, comprised of representatives of all major industries in the state, the legislative and executive branches of government form a consensus on all revenue forecasts. These forecasts have very accurately reflected the state's economy and resulting tax collections.

Statutorily, bond payments for capital construction bonding projects are limited to one-tenth of the revenue generated from a one-cent sales tax. All capital budget requests for new or expanded facilities require information on increased operating and maintenance costs. The capital budget is a six-year plan for the facility needs of the state.

RELEVANT FINANCIAL POLICIES

North Dakota has several financial policies that will ensure that in the event of an economic downturn, North Dakota state government will be able to continue to provide its citizens with necessary services. Should North Dakota experience a revenue shortfall of 2 percent or more, the State is able to access funds from the budget stabilization fund. The budget stabilization fund currently has a balance \$99.5 million. In addition, the state is also able to reduce general fund expenditures across the board to alleviate the effects of a revenue shortfall.

In the event of such general fund expenditure cuts, the foundation aid stabilization fund was established to hold K-12 education harmless. Dollars from this fund would replace the amount of general fund dollars cut, thus K-12 education would not experience a reduction in funding. Funding for the foundation aid stabilization fund comes from a portion of oil extraction tax collections.

The State also recognizes that, while tax collections from oil contribute significantly to the general fund, we cannot count on those resources indefinitely. Thus the permanent oil trust fund has been established. All oil tax collections in excess of \$71 million are deposited into the permanent oil tax trust fund.

MAJOR INITIATIVES

North Dakota continues to implement programs and policies that improve the lives and well being of its citizens by creating more opportunities and better jobs. Priorities include creating a strong business climate, excellence in education, enhancing energy, improving agriculture, developing water resources, and taking care of people.

The business climate of the state has been strengthened through multiple efforts. Higher education has continued to establish Centers of Excellence to pursue academic excellence, enhance research, and develop and promote technology. Recent legislation provides up to \$50 million for Centers of Excellence. The dollars will be leveraged with private and federal matching funds to generate a total investment in new jobs and businesses of more than \$150 million.

Recently approved projects include: Bismarck State College's Career and Technology Center, a world-class facility combining energy workforce training with environmental research; North Dakota State University's Center of Excellence in Advanced Electronic Design and Manufacturing, researching small sensor chips used in high-tech applications; Lake Region State College for the Dakota Center for Technology – Optimized Agriculture; and the University of North Dakota's National Center for Hydrogen Technology. Together, the new ventures have the potential to create hundreds of good paying jobs in North Dakota. These projects received approximately \$9 million to be matched with an additional \$31.5 million.

Economic development accountability has provided a mechanism for measuring reports on new jobs, average compensation, target goals for activities, and has defined consequences for companies that are unable to meet their goals. These types of activities have received national recognition of the state's economic competitiveness, recently recognized by the Beacon Hill Institute.

The Department of Commerce created the state Ambassador's program as a way to generate new businesses to diversify the state's economy. The program grooms current and former North Dakotans to be a volunteer sales force for the state. The Ambassador program has been named the Best Program of the Year by Business Facilities Magazine in December and is directly linked to the creation of six new North Dakota businesses.

North Dakota continues its commitment to K-12 education. Declining enrollments, fewer school districts, teacher compensation, and educational funding equity are key factors that are continually reviewed. The 2005 legislative session provided increased funding for the student funding formula, isolated schools, information technology, and joint powers agreements. Other changes included adjustments to per student funding formulas to improve the equity of the funding formula.

In October 2003, nine school districts filed a lawsuit requesting a judgment that the school finance plan violates the constitution. The school districts and the Office of the Governor have recently come to an agreement to stay the lawsuit pending the outcome of the next legislative session. In the interim, the governor will create the North Dakota Commission on Education Improvement, which will make recommendations to the legislature for improving both funding adequacy and equity among districts. In his next executive budget to the legislature, the governor will recommend an increase of at least \$60 million for K-12 education. If the legislature then agrees to adopt the North Dakota Commission on Education Improvement as a vehicle for improving education funding, and appropriates at least \$60 million in new funding for K-12 education, the districts will dismiss their lawsuit.

The newly created North Dakota Renewable Energy Office promotes wind, ethanol, biodiesel, hydrogen, and other renewable energy resources. Recently, groundbreaking occurred for a new 49.5 megawatt, 33-tower wind energy center southeast of Wilton. This facility will generate enough electrical energy to power 15,000 homes. This facility, along with the other four projects now under development in the state, will add more than 230 towers and 330 megawatts of new wind energy to our total capacity.

North Dakota's own brand of ethanol, GoE, provides the state with a method to promote its own product. Local farmers grow the corn, in-state facilities process it into ethanol, and it is blended with gasoline at two

plants in the state. It translates into higher prices for farmers, more good jobs, a more robust economy, and a cleaner, safer environment.

To help provide a more cost effective method to transport farm products and goods, the state has recently begun to study rail rates in North Dakota to ensure that local users are receiving competitive rates.

Federal legislation transitioned prescription drug coverage for Medicaid recipients to the Medicare program. The state has worked to ensure individuals have been properly transitioned while providing resources for those who have additional needs during the initial implementation phases.

Rising costs for home heating fuel prompted the state to continue providing fuel assistance at original eligibility levels rather than reducing eligibility as proposed by the federal government.

AWARDS AND ACKNOWLEDGEMENTS

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, 2004. This was the 14th 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.

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 assistance.

Sincerely,

Pam Sharp, Director
Office of Management and Budget