

OFFICE OF MANAGEMENT AND BUDGET

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

December 12, 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, 2006. 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, 2006, 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, 2006, 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 an expanding and diversifying economy in recent years. Education, health services, and government constitute over 35 percent of the state's employment, providing economic stability and insulating the state from the cyclic extremes of the national economy.

A listing of the state's twenty largest employers demonstrates the diversity of the economy. Top employers include: the U.S. military, the state university system, health care providers, manufacturers, financial and insurance companies, agricultural commodity processors, information technology companies, energy producers, and retail companies.

Increases in the price of crude oil have increased crude oil production in the state. Production has increased from an average of 86,000 barrels per day in September 2004 to 113,000 barrels per day in September 2006. In 2005, the state ranked 9th nationally in crude oil production out of 31 oil-producing states. The 36 million barrels produced in 2005 represented 1.9 percent of the nation's total crude oil production. Production increased 5.9 percent in 2004 and rose 14.5 percent in 2005.

In upcoming years, Moody's Economy.com, the states economic consultant, predicts continued growth for the state economy. Through 2009, gross state product is expected to grow by over 10 percent and the state labor force by 16,000 jobs. During that time, the unemployment rate is expected to remain stable at slightly over 3 percent and personal income is expected to grow by 3.8 to 4.5 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 and developing water resources, and taking care of people.

The North Dakota Trade Office has been extremely effective in increasing the state's international export market. North Dakota exports have nearly doubled since 2000, from \$625 million to \$1.2 billion. The Governor's budget has recommended \$2.6 million to expand these activities.

The Governor is proposing a Workforce and Career Promotion initiative that will strengthen the linkages between public schools and business on careers in North Dakota so students can make career decisions that will allow them to stay in the state. The initiative includes \$1.2 million for 10 workforce talent coordinators to be stationed in each of the North Dakota Joint Powers Agreement areas.

The Internship Program Initiative is a proposal by the Governor to develop the state's workforce by expanding the use of credit and non-credit internships for postsecondary students. The internships will provide a way for students to make connections with North Dakota businesses and serve as an incentive for students to continue employment in the state.

Previously, \$30 million has been invested in the Governor's Centers of Excellence program, which harnesses the University System as an engine of economic growth for North Dakota and creates higher paying jobs and career opportunities for its citizens. The Governor is proposing to invest another \$20 million in this very worthwhile program.

Governor Hoeven created the North Dakota Commission on Education Improvement for the purpose of making recommendations to the legislature for improving funding adequacy and equity among districts. Governor Hoeven's recommendation for elementary and secondary education funding for the 2007-09 not only follows the work of the Commission, but goes above and beyond the Commission's recommendation.

The Commission recommended a landmark change in the state's K-12 funding system, as well as a \$60.0 million general fund increase in funding for state aid to K-12 education. In addition, the Governor has included an additional \$16 million from the general fund and an additional \$4.6 million from the state tuition fund to bring the total state funded increase in state aid to education to an historic \$80.6 million.

To better protect North Dakota citizens by reducing the severity of the flu, the Governor has included \$2.3 million in his budget for the purchase and stockpile of antiviral drugs like Tamflu and Relenza. An antiviral stockpile will assure availability of these drugs at a time when they may not be available through normal distribution supply chains because of high demand in other areas of the country.

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, 2005. This was the 15th 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 2005-2007 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