

## 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, 2007. 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 \$5.2 billion (reported as net assets), an increase of \$624 million from the previous year. The net assets of governmental activities increased by 18.2% while the net assets of the business-type activities showed an increase of 5.8%.

#### Fund Level:

As of the close of fiscal year 2007 the State's governmental funds reported combined ending fund balances of \$2.3 billion, an increase of \$415 million. Of this amount, \$1.2 billion represents unreserved fund balance, with the remaining amount of \$1.1 billion 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 \$637 million.

The enterprise funds reported net assets at year-end of \$1.7 billion, an increase of \$95 million during the year.

#### Long-term Debt:

The State's total debt (bonds and notes payable) increased slightly during the fiscal year to \$1.65 billion, an increase of \$6.6 million, less than 1%, which represents the net difference between new issuances and payments and refundings of outstanding debt. During the year the State issued \$218 million in bonds and \$931 million in notes.

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

### 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, Housing Finance Agency 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 18 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, 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 four (4) 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 \$5.2 billion at the end of fiscal year 2007. Net assets increased 12% from the prior fiscal year.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2006	2007	2006	2007	2006	2007
Current and Other Assets	\$2,317,282	\$2,772,315	\$4,962,990	\$5,256,162	\$6,514,553	\$7,089,246
Capital Assets	1,295,151	1,386,909	699,548	748,019	1,994,699	2,134,928
Total Assets	<u>3,612,433</u>	<u>4,159,224</u>	<u>5,662,538</u>	<u>6,004,181</u>	<u>8,509,404</u>	<u>9,224,174</u>
Long-Term Liabilities						
Outstanding	360,935	353,289	2,085,153	2,238,795	2,446,088	2,592,084
Other Liabilities	353,347	375,039	1,849,561	2,013,791	1,437,341	1,449,600
Total Liabilities	<u>714,282</u>	<u>728,328</u>	<u>3,934,714</u>	<u>4,252,586</u>	<u>3,883,429</u>	<u>4,041,684</u>
Net Assets						
Invested in Capital Assets, Net of Related Debt	1,077,843	1,151,716	516,243	527,403	1,594,086	1,679,120
Restricted	1,281,417	1,384,212	391,313	478,219	1,672,730	1,862,431
Unrestricted	538,891	894,967	820,268	745,973	1,359,159	1,640,940
Total Net Assets	<u>\$2,898,151</u>	<u>\$3,430,896</u>	<u>\$1,727,824</u>	<u>\$1,751,595</u>	<u>\$4,625,975</u>	<u>\$5,182,491</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 (36%) of the State's net assets is restricted net assets. These restricted net assets 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.

Thirty-two percent (32%) 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.

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:

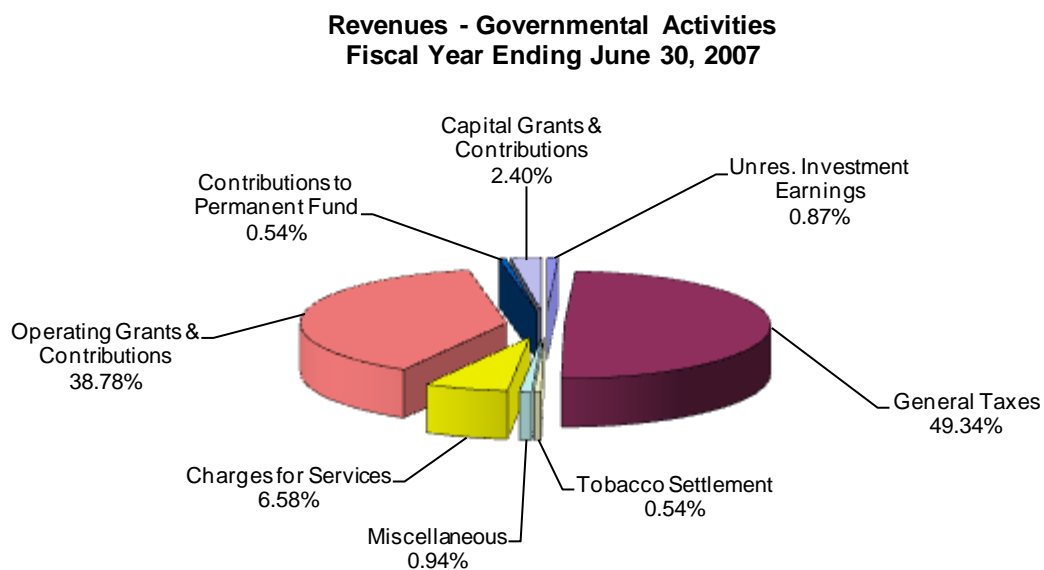
**State of North Dakota's Changes in Net Assets**  
(Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2006	2007	2006	2007	2006	2007
<b>Revenues:</b>						
Program Revenues:						
Charges for Services	\$ 201,847	\$ 194,870	\$ 794,071	\$ 900,946	\$ 995,918	\$ 1,095,816
Operating Grants & Contributions	1,144,749	1,148,062	283,315	368,698	1,428,064	1,516,760
Capital Grants & Contributions	56,557	71,115	577	7,314	57,134	78,429
General Revenues:						
Income Taxes	432,072	449,064	-	-	432,072	449,064
Sales Taxes	678,821	726,913	-	-	678,821	726,913
Other Taxes	276,771	284,898	-	-	276,771	284,898
Investment Earnings	12,409	25,823	-	-	12,409	25,823
Tobacco Settlement	11,712	16,098	-	-	11,712	16,098
Other	23,696	27,836	-	-	23,696	27,836
<b>Total Revenues</b>	<u>2,838,634</u>	<u>2,944,679</u>	<u>1,077,963</u>	<u>1,276,958</u>	<u>3,916,597</u>	<u>4,221,637</u>
<b>Expenses</b>						
General Government	264,911	275,242	-	-	264,911	275,242
Education	496,821	507,385	-	-	496,821	507,385
Health and Human Services	854,450	874,004	-	-	854,450	874,004
Regulatory	19,677	21,181	-	-	19,677	21,181
Public Safety and Corrections	145,480	135,582	-	-	145,480	135,582
Agriculture and Commerce	54,458	58,591	-	-	54,458	58,591
Natural Resources	62,431	57,850	-	-	62,431	57,850
Transportation	372,245	321,279	-	-	372,245	321,279
Interest on Long Term Debt	12,881	14,439	-	-	12,881	14,439
Bank of North Dakota	-	-	71,264	91,262	71,264	91,262
Housing Finance	-	-	46,580	51,178	46,580	51,178
Loan Programs	-	-	17,236	9,453	17,236	9,453
Mill and Elevator	-	-	101,198	126,969	101,198	126,969
State Lottery	-	-	15,622	16,068	15,622	16,068
Unemployment Compensation	-	-	43,314	47,525	43,314	47,525
University System	-	-	743,271	775,600	743,271	775,600
Workforce Safety and Insurance	-	-	116,021	231,787	116,021	231,787
Other	-	-	14,922	16,622	14,922	16,622
<b>Total Expenses</b>	<u>2,283,354</u>	<u>2,265,553</u>	<u>1,169,428</u>	<u>1,366,464</u>	<u>3,452,782</u>	<u>3,632,017</u>
Increase (decrease) in Net Assets Before Contributions and Transfers	555,280	679,126	(91,465)	(89,506)	463,815	589,620
Contributions to Permanent Fund Principal	11,156	15,995	-	-	11,156	15,995
Transfers	(215,089)	(167,117)	188,109	185,841	(26,980)	18,724
<b>Increase in Net Assets</b>	351,347	528,004	96,644	96,335	447,991	624,339
Net Assets - Beginning -As Restated	2,546,804	2,902,892	1,631,180	1,655,259	4,177,984	4,558,151
<b>Net Assets- Ending</b>	<u>\$ 2,898,151</u>	<u>\$3,430,896</u>	<u>\$ 1,727,824</u>	<u>\$ 1,751,595</u>	<u>\$ 4,625,975</u>	<u>\$ 5,182,491</u>

## Governmental Activities

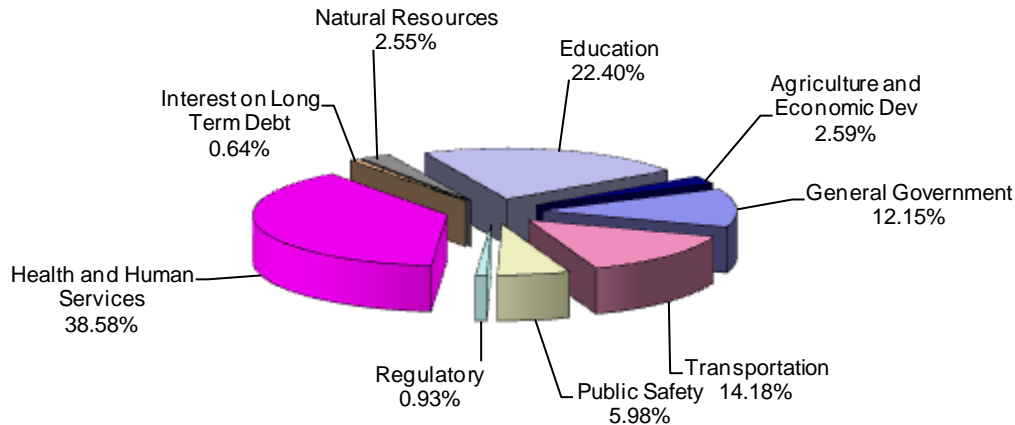
Governmental Activities increased the State's net assets by \$528 million, compared to a \$351 million increase in the prior fiscal year. The largest increases in the State's revenues for fiscal year 2007 were from the State's tax revenues and investment earnings. Sales and use taxes increased 7%, and individual and corporate income taxes increased 4%. The revenue growth was led by a surging economy and strong consumer spending, resulting in increased sales and use tax collections; personal income growth, resulting in increased individual income tax collections; and growing corporate profits, resulting in significantly increased corporate income tax collections. Investment earnings doubled because of a stronger global market. Expenses for total governmental activities were fairly stable from the prior fiscal year, decreasing less than 1%.

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, 2007



### Business-type Activities

Net assets of the business-type activities increased by \$96 million during the fiscal year. Factors contributing to these results included:

The net assets of the Bank of North Dakota increased nearly \$2 million due to increased net interest earnings.

Workforce Safety and Insurance's (WSI) net assets increased \$38 million due to increased investment income.

The net assets of Housing Finance increased about \$8 million as a result of program operations and financing activities.

The North Dakota State University System net assets increased \$27 million during 2007, as a result of increases in tuition, room and board rates.

## FINANCIAL ANALYSIS OF THE STATE'S FUNDS

### Governmental Funds

As the State completed the year, its governmental funds reported combined fund balances of \$2.3 billion, an increase of \$415 million from the prior fiscal year. Approximately \$1.2 billion 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 \$637 million and reserved fund balance was \$1.7 million. Total fund balance rose during the fiscal year by \$217 million, due to increases in tax revenues and investment earnings. Sales and use taxes had the largest increase, \$42 million, followed by individual income and

corporate income taxes with a \$30 million increase. Investment earnings increased \$12 million. By the end of fiscal year 2007 General Fund revenues increased 3.5% from the prior year.

The School Permanent Trust Fund balance at June 30, 2007 improved by \$133 million because of investment earnings that were twice as high as the prior fiscal year.

The Federal Fund balance at June 30, 2007 decreased \$4 million due to increased unavailable revenues.

### **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, 2007, was the second year of the 2005-07 budget cycle. The original budget increased \$19 million.

At the beginning of the 2005-07 budget cycle, there was an increase in the original budget of \$8 million. The majority of this increase is due to the authorized carryover of general fund appropriation authority from the 2003-05 biennium, which is reported as an appropriation adjustment for the 2005-07 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, \$.9 million, Legislative Council and Assembly, \$2.2 million, Department of Commerce, \$1 million, and the University System, \$2.6 million. Various other state agencies received smaller amounts of carryover totaling \$.7 million. A few agencies also received general fund carryover dollars from the 2003-05 biennium for capital construction projects. These capital construction carryover dollars totaled \$.7 million.

Additional general fund budget appropriations of \$11 million were authorized by the 2007 Legislative Session in a deficiency appropriation bill. The largest of these appropriations were for the Office of the Adjutant General, \$4.1 million to repay disaster response and recovery loans to the Bank of North Dakota; \$2 million to the University of North Dakota for additional flood costs relating to the 1997 flood disaster; and \$4 million to the Department of Corrections and Rehabilitation for increased prisoner medical and housing costs. Several other state agencies received small appropriation increases for various reasons.

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 2007, the State had invested \$2 billion, net of accumulated depreciation, in a broad range of capital assets. Depreciation charges for this fiscal year totaled \$107 million.



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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2006	2007	2006	2007	2006	2007
Land and Land Improvements	\$ 47,262	\$ 51,419	\$ 18,117	\$ 20,171	\$ 65,379	\$ 71,590
Building & Building Improvements	214,778	222,477	401,537	420,462	616,315	642,939
Equipment	114,355	128,286	145,134	151,917	259,489	280,203
Infrastructure	549,958	601,574	88,195	85,124	638,153	686,698
Construction in Progress	368,798	383,153	46,565	70,345	415,363	453,498
<b>Total</b>	<u>\$ 1,295,151</u>	<u>\$ 1,386,909</u>	<u>\$ 699,548</u>	<u>\$ 748,019</u>	<u>\$ 1,994,699</u>	<u>\$ 2,134,928</u>

The total increase in the State's investments in capital assets for the current fiscal year was 7% in terms of net book value. However, actual expenditures to purchase or construct capital assets were approximately \$256 million for the year. A major portion 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 3G 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, 2007.

The State does have a number of revenue bonds outstanding at June 30, 2007. 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 \$256.6 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 3J to the financial statements.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2006	2007	2006	2007	2006	2007
Revenue Bonds	\$ 287,016	\$ 277,932	\$ 1,038,233	\$ 1,073,545	\$ 1,325,249	\$ 1,351,477
Notes Payable	32,314	32,384	283,509	263,820	315,823	296,204
<b>Total</b>	<u>\$ 319,330</u>	<u>\$ 310,316</u>	<u>\$ 1,321,742</u>	<u>\$ 1,337,365</u>	<u>\$ 1,641,072</u>	<u>\$ 1,647,681</u>

The State's total debt increased by less than 1% during the current fiscal year.

## **ECONOMIC CONDITION AND OUTLOOK**

North Dakota's economy has showed steady growth during the 2005-07 biennium, with tax revenues reaching a record high.

The agricultural economy remains strong, with high commodity prices. Wheat prices have recently reached a ten-year high.

High oil prices have led to increased oil exploration activity and increased tax collections for oil extraction and production. Oil activity is at its highest level in two decades. Fifty oil rigs are currently operating in the state compared to 45 one year ago. The number of producing wells continues to grow and is now over 3,800, up nearly 20.0 percent since January 2003.

The state's unemployment rate averaged only 3.2 percent during 2006 and is expected to remain below 3.5 percent through 2011. Contributing to the low unemployment rate is significant growth in mining and natural resources employment, which has increased by 45 percent since 2004.

The weak dollar is expected to benefit the North Dakota economy in the near future, fueling demand for international exports of agricultural goods and machinery produced in the state. According to a recent report by Moody's Economy.com, the state's exports showed year over year growth of 24.0 percent during the second quarter of 2007.

## **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.