

# OFFICE OF MANAGEMENT AND BUDGET

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

December 12, 2007

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, 2007. 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, 2007, 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, 2007, 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**

The North Dakota economy continues to exhibit strong growth, fueling record state tax collections in sales and income taxes. 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 recent Bureau of Economic Analysis (BEA) report ranking metropolitan areas in terms of gross domestic product (GDP) provides a positive look at the three metropolitan areas in the state. The BEA analysis groups metropolitan areas into five categories, or quintiles, based on percentage growth in GDP from 2004 to 2005. North Dakota has three metropolitan areas: Bismarck, Fargo, and Grand Forks. Based on the

BEA analysis, the three North Dakota metro areas, when viewed nationally, ranked in the first, second, and third quintile, respectively for GDP growth. In fact, North Dakota's capital city is the only metropolitan area ranked in the first quintile among metropolitan areas in the surrounding states of Minnesota, Wisconsin, South Dakota, Nebraska, Kansas, Wyoming, and Montana.

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.

The increasing price of oil has fueled a rapid growth in crude oil production in the state. Production has increased from an average of 86,000 barrels per day in September 2004 to 127,000 barrels per day in September 2007, an increase of 48 percent. As reported by Moody's Economy.com, the state's economic consultant, employment in mining and natural resource industries in North Dakota has increased "by 45 percent since 2004, which is one of the largest increases of any state." Many of the mining sector jobs created are high-paying jobs, contributing to the state's record individual income tax collections.

In upcoming years, Moody's Economy.com, predicts continued growth for the state economy. From 2006 to 2011, the state's gross domestic product is expected to grow by over \$3.6 billion, or 16.4 percent; the state labor force is expected to grow by 20,000 jobs, or 5.7 percent. During that time, the unemployment rate is expected to remain stable at slightly over 3 percent and personal income is expected to grow by 3.4 to 5.9 percent per year.

### **LONG-TERM FINANCIAL PLANNING**

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

The state exercises conservative revenue forecasting practices. With the assistance of the Revenue Forecasting Advisory Committee, comprised of representatives of all major industries in the state as well as the legislative and executive branches of government, along with the expertise of a national economic forecast consultant, a conservative revenue forecast is developed. The forecast is based on state trends, national forecasting models, and input from state private industry experts.

With a biennial budget cycle, each revenue forecast and budget proposal provides a three-year plan for the revenues and expenditures of state government.

North Dakota's conservative budgeting and revenue forecasting, combined with economic growth, has allowed the accumulation of significant balances available as reserves to offset general fund revenues in the event of an economic downturn. The budget stabilization fund has grown to its current statutory maximum of \$200 million. Balances in the oil tax trust fund and foundation aid stabilization fund continue to grow to record levels.

The state's capital budget is a six-year plan for the facility needs of the state. 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, which are taken into account by the executive and legislative branches as new projects are considered.

### **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 \$200 million. In addition, the Governor is able to reduce general fund expenditures across the board to alleviate the effects of a revenue shortfall.

In the event of such a general fund expenditure reduction, the foundation aid stabilization fund was established to insulate the state education aid program. 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 tax 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**

For fiscal years 2006 and 2007, which comprise the 2005-07 biennium, Governor Hoeven recommended, and the legislature supported, major initiatives centered around the Governor's six pillars of growth:

### **Education**

In 2006, Governor Hoeven created the North Dakota Commission on Education Improvement for the purpose of improving funding adequacy and equity among school districts. The Commission provided a unique approach to addressing equity concerns by combining legislative, executive and local school district experts to work together to solve equity concerns in lieu of a lawsuit between the state and local districts. The 2007 legislature adopted the work of the Commission by endorsing a landmark change in the state's K-12 funding system, as well providing an \$84 million general fund increase in funding for K-12 education.

For higher education, the 2007 legislature approved a bill to increase funding for the system by over 20 percent. Recent changes in the way the university system is funded has resulted in giving the institutions flexibility with accountability to help contribute to the economic growth of North Dakota. Flexible spending means North Dakota universities can use tuition dollars and other revenue to produce excellence in education and help with job creation.

### **Agriculture**

Agriculture is one of the foundations of the North Dakota economy, and remains the state's largest industry. The state has created a value-added board in the Commerce Department to promote opportunities in value-added processing; created investment tax credits to spark value-added ventures; eliminated the used farm equipment sales tax to reduce the burden on farmers; and increased general fund dollars for agricultural research.

However, production agriculture is no longer just about food -- new technology and soaring oil prices have helped to foster new relationships between agriculture and energy. New agriculture-related energy initiatives include a comprehensive \$42 million ag-based renewable energy plan, to support, biodiesel, ethanol, as well as geothermal, solar, and wind energy.

### **Technology**

The state is working to build information technology infrastructure to help businesses and government become more profitable and efficient. Various initiatives have been implemented to support technology in education, including K-12 schools and the university system. Technology is a targeted industry for growth in the North Dakota economy and several companies, including Microsoft, PacketDigital, Alien Technologies and Eagle Creek Software have developed successful and growing business operations in the state.

The State of North Dakota is working to build an enterprise infrastructure that supports the business processes of state agencies and delivers cost effective technology services that will benefit the citizens of North Dakota. Recently funded state government technology initiatives include:

- Enhancing the Criminal Justice Information System's hub, which helps law enforcement agencies better protect the public by providing criminal information to our law enforcement officials via a secure information hub.
- Funding for the Medicaid Management Information System (MMIS).
- Funding for the GIS hub, which benefits education, economic development, agriculture, energy, and technology.
- Creation of a central database to manage animal tracking and disease containment.

### **Economic Development**

North Dakota's aggressive economic development efforts have resulted in new jobs and expanding exports. Key new initiatives to continue the momentum in economic growth include:

- \$20 million for *Centers of Excellence* to transform and expand North Dakota's economy.
- A doubling of the budget for the North Dakota Trade Office to further expand overseas trade.
- One of the most aggressive research and development investment tax credit programs in the nation, offering up to 25 percent of expenditures.
- Increase of the seed capital investment tax credit limit to \$3.5 million per year and expansion of the agricultural business investment tax credit.
- An increase in funding of \$4 million in the North Dakota Development Fund to provide gap financing for business start-ups and expansions.

### **Energy Development**

Since 2001 the state has seen a nearly \$2 billion investment in renewable energy production.

- Ethanol: With announced new projects, the state's ethanol production will grow from about 30 million gallons a year to more than 440 million gallons.
- Biodiesel: Biodiesel production will grow from 0 to an estimated 85 million gallons per year.
- Coal: Currently, the state produces more than 4,000 megawatts of electricity a year from coal. There are three to four potential new power plants in development, including a coal to liquids facility and a new coal gasification plant.
- Wind: Only a few years ago, the state had no commercial wind facilities. With new projects under construction or planned, 600 megawatts of wind power will be online in the near future.
- Oil and gas: With directional drilling technology and high oil prices making more oil exploration in North Dakota feasible, crude oil production continues to grow.

### **Quality of Life**

North Dakotans enjoy a quality of life that is unsurpassed in the nation. From clean air and safe communities to exceptional schools and four-season recreational opportunities, recent initiatives that help to maintain this quality of life by caring for the neediest citizens, providing public safety, and supporting the military include:

- A \$100 million general fund increase in the Department of Human Services budget to help those in need.
- A Medicaid buy-in program to help families cover the cost of care for children with severe disabilities.
- A state Prescription Drug Repository under the State Pharmacy Board to collect and distribute unused medications so that pharmacies and physicians can distribute them to those in need.
- Expanded eligibility for Healthy Steps Children's Health Insurance Program and medical assistance benefits to provide medical insurance coverage for 1,450 more children.
- Mandated minimum sentences for violent sexual criminals, even first time offenders, background checks for personnel in sensitive positions; and enhanced funding for GPS monitoring of offenders.
- Expansion of the beds for civilly committed sex offenders at the State Hospital and increased funding for community-based sex offender treatment.
- Authorization and funding for the state's share of a \$21 million new Veterans Retirement Home in Lisbon and an expanded Veterans Bonus Program.
- Additional funding for tuition assistance for National Guard members.

## **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, 2006. This was the 16th 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 2007-2009 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