

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, 2008. 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 \$5.7 billion (reported as net assets), an increase of \$521 million from the previous year. The net assets of governmental activities increased by 15.7% while the net assets of the business-type activities showed a decrease of 1%.

Fund Level:

As of the close of fiscal year 2008 the State's governmental funds reported combined ending fund balances of \$2.8 billion, an increase of \$442 million. Of this amount, \$1.65 billion represents unreserved fund balance, with the remaining amount of \$1.15 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 \$785 million.

The enterprise funds reported net assets at year-end of \$1.7 billion, a decrease of \$18 million during the year.

Long-term Debt:

The State's total debt (bonds and notes payable) increased approximately 6% during the fiscal year to \$1.75 billion, an increase of \$102 million, which represents the net difference between new issuances and payments. During the year the State issued \$309 million in bonds and \$6.5 million in notes.

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

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 five (5) major enterprise funds: The Bank of North Dakota, Housing Finance, Mill and Elevator, University System, and Workforce Safety and Insurance. These five 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 \$5.7 billion at the end of fiscal year 2008. Net assets increased 10% from the prior fiscal year.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2008	2007	2008	2007	2008
Current and Other Assets	\$2,772,315	\$3,280,899	\$5,256,162	\$5,685,182	\$7,089,246	\$7,841,302
Capital Assets	1,386,909	1,479,571	748,019	792,216	2,134,928	2,271,787
Total Assets	<u>4,159,224</u>	<u>4,760,470</u>	<u>6,004,181</u>	<u>6,477,398</u>	<u>9,224,174</u>	<u>10,113,089</u>
Long-Term Liabilities						
Outstanding	353,289	349,055	2,238,795	2,365,176	2,592,084	2,714,231
Other Liabilities	375,039	432,439	2,013,791	2,379,563	1,449,600	1,687,223
Total Liabilities	<u>728,328</u>	<u>781,494</u>	<u>4,252,586</u>	<u>4,744,739</u>	<u>4,041,684</u>	<u>4,401,454</u>
Net Assets						
Invested in Capital Assets, Net of Related Debt	1,151,716	1,400,535	527,403	546,699	1,679,120	1,947,234
Restricted	1,384,212	1,458,565	478,219	532,955	1,862,431	1,991,520
Unrestricted	<u>894,967</u>	<u>1,119,876</u>	<u>745,973</u>	<u>653,005</u>	<u>1,640,940</u>	<u>1,772,881</u>
Total Net Assets	<u>\$3,430,896</u>	<u>\$3,978,976</u>	<u>\$1,751,595</u>	<u>\$1,732,659</u>	<u>\$5,182,491</u>	<u>\$5,711,635</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 (35%) 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-four percent (34%) 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)

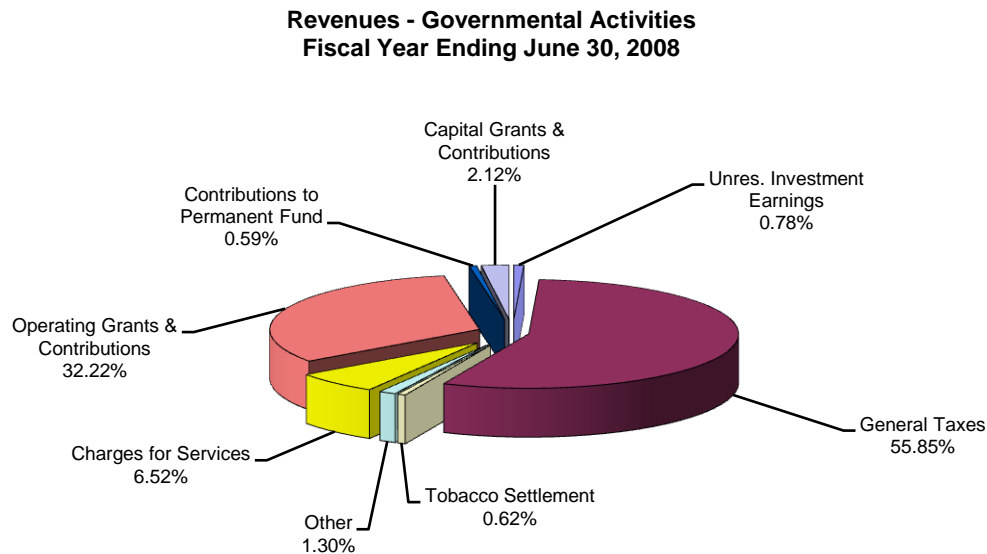
	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2008	2007	2008	2007	2008
Revenues:						
Program Revenues:						
Charges for Services	\$ 194,870	\$ 210,843	\$ 900,946	1,073,777	\$ 1,095,816	\$ 1,284,620
Operating Grants & Contributions	1,148,062	1,041,411	368,698	258,218	1,516,760	1,299,629
Capital Grants & Contributions	71,115	68,472	7,314	9,245	78,429	77,717
General Revenues:						
Income Taxes	449,064	473,235	-	-	449,064	473,235
Sales Taxes	726,913	797,614	-	-	726,913	797,614
Other Taxes	284,898	534,732	-	-	284,898	534,732
Investment Earnings	25,823	25,150	-	-	25,823	25,150
Tobacco Settlement	16,098	20,062	-	-	16,098	20,062
Other	27,836	42,052	-	-	27,836	42,052
Total Revenues	<u>2,944,679</u>	<u>3,213,571</u>	<u>1,276,958</u>	<u>1,341,240</u>	<u>4,221,637</u>	<u>4,554,811</u>
Expenses						
General Government	275,242	313,330	-	-	275,242	313,330
Education	507,385	537,757	-	-	507,385	537,757
Health and Human Services	874,004	960,440	-	-	874,004	960,440
Regulatory	21,181	28,265	-	-	21,181	28,265
Public Safety and Corrections	135,582	135,068	-	-	135,582	135,068
Agriculture and Commerce	58,591	67,942	-	-	58,591	67,942
Natural Resources	57,850	64,090	-	-	57,850	64,090
Transportation	321,279	318,241	-	-	321,279	318,241
Interest on Long Term Debt	14,439	13,293	-	-	14,439	13,293
Bank of North Dakota	-	-	91,262	108,078	91,262	108,078
Housing Finance	-	-	51,178	58,816	51,178	58,816
Loan Programs	-	-	9,453	9,658	9,453	9,658
Mill and Elevator	-	-	126,969	242,924	126,969	242,924
State Lottery	-	-	16,068	16,205	16,068	16,205
Unemployment Compensation	-	-	47,525	46,912	47,525	46,912
University System	-	-	775,600	835,873	775,600	835,873
Workforce Safety and Insurance	-	-	231,787	246,582	231,787	246,582
Other	-	-	16,622	23,269	16,622	23,269
Total Expenses	<u>2,265,553</u>	<u>2,438,426</u>	<u>1,366,464</u>	<u>1,588,317</u>	<u>3,632,017</u>	<u>4,026,743</u>
Increase (decrease) in Net Assets Before Contributions and Transfers	679,126	775,145	(89,506)	(247,077)	589,620	528,068
Contributions to Permanent Fund Principal	15,995	19,181	-	-	15,995	19,181
Transfers	(167,117)	(254,648)	185,841	228,141	18,724	(26,507)
Increase in Net Assets	528,004	539,678	96,335	(18,936)	624,339	520,742
Net Assets - Beginning -As Restated	2,902,892	3,439,298	1,655,259	1,751,595	4,558,151	5,190,893
Net Assets- Ending	<u>\$3,430,896</u>	<u>\$3,978,976</u>	<u>\$ 1,751,595</u>	<u>\$1,732,659</u>	<u>\$ 5,182,491</u>	<u>\$5,711,635</u>

Governmental Activities

Governmental Activities increased the State's net assets by \$540 million, compared to a \$528 million increase in the prior fiscal year. The largest increases in the State's revenues for fiscal year 2008 were from the State's tax revenues. Oil tax revenues doubled from the prior fiscal year, from \$230 million in 2007 to \$469 million in 2008 due to high world oil prices that have led to increases in the state's oil production, especially the expansion of production within the Bakken Formation. Sales and use taxes increased 9.7% because of strong gains in the North Dakota economy including expansion of the retail tax base throughout the state, significant job growth and wage gains in existing jobs. Income taxes increased 5.9%. Corporate tax collections rose due to a very strong business sector, which is due in part to energy companies' profits.

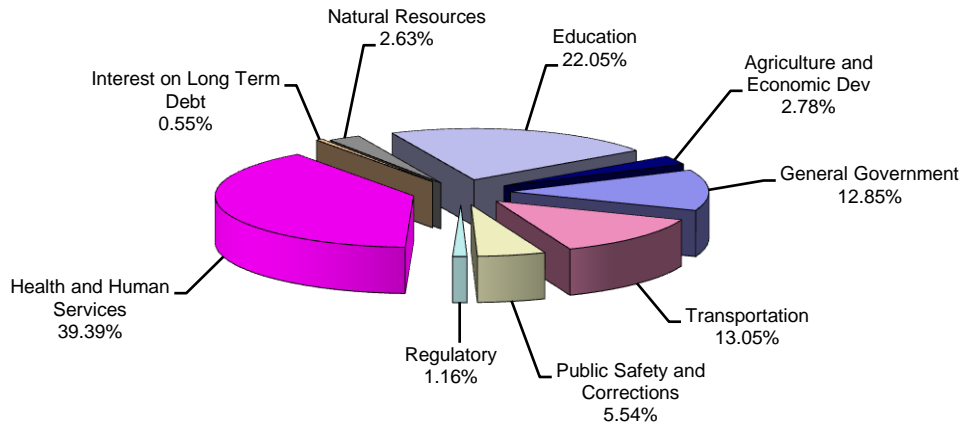
Expenses for total governmental activities increased by 7% from the prior fiscal year. Education expenses increased approximately \$30 million due to an historic increase in funding K-12 education adopted by the 2007 Legislature. The Legislature approved a \$90 million package for the 2007-09 biennium that significantly reformed the state's school funding formula in order to create more equitable state funding on a per student basis. In addition, expenditures for food stamps increased \$8 million due to an increased caseload and Medical Assistance increased about \$27 million due to legislative action including the addition of Medicaid services, eligible groups and increases in fees paid for services.

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, 2008**



Business-type Activities

Net assets of the business-type activities decreased by \$19 million during the fiscal year.

Workforce Safety and Insurance's (WSI) net assets decreased \$81 million mainly due to the decrease in their income on investments of \$120 million.

The Mill and Elevator's net assets decreased slightly, \$.9 million, because of a reduction in gross margins as a percent of gross sales caused by competition and a reduction in demand.

Other business-type activities had increases in net assets, including the Bank of North Dakota, which had an increase of \$29 million; Housing Finance with a \$9 million increase; and the University System with a \$20 million increase.

The Bank of North Dakota net assets increased because of increased loan activity and decreased transfers to other state funds. The increase in Housing Finance is a result of program operations and financing activities. The University System's net assets increased due to 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 \$2.8 billion, an increase of \$442 million from the prior fiscal year. Approximately \$1.65 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 \$785 million and reserved fund balance was \$2.5 million. Total

fund balance rose during the fiscal year by \$149 million, due to increases in tax revenues. Sales and use taxes had the largest increase, \$49 million, followed by oil and gas taxes with a \$42 million increase and then individual income and corporate income taxes with a \$22 million increase. By the end of fiscal year 2008 General Fund revenues increased 11% from the prior year.

The School Permanent Trust Fund balance at June 30, 2008 improved by \$23 million because of increased oil tax revenue and mineral lease revenues

The Federal Fund balance at June 30, 2008 showed a minimal increase of \$3 million due to increased available 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, 2008, was the first year of the 2007-09 budget cycle.

At the beginning of the 2007-09 budget cycle, there was an increase in the original budget of \$22 million. The majority of this increase is due to the authorized carryover of general fund appropriation authority from the 2007-09 biennium, which is reported as an appropriation adjustment for the 2007-09 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 Department of Public Instruction, \$6 million, Adjutant General, \$2.3 million, Office of Management and Budget, \$2.1 million, Legislative Council and Assembly, \$.6 million, Department of Corrections, \$.5 million, Department of Commerce, \$.9 million, and the University System, \$1.8 million. A few other state agencies received minimal amounts of carryover dollars.

A few agencies also received general fund carryover dollars from the 2007-09 biennium for capital construction projects. These capital construction carryover dollars totaled \$2.1 million, of which \$1.8 million was for the Department of Human Services.

An additional general fund budget appropriation of \$5 million was given to the Department of Public Instruction in April of 2008 as the 2007 Legislature approved this additional amount contingent on the general fund anticipated fund balance exceeding \$30 million at that time.

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 2008, the State had invested \$2.3 billion, net of accumulated depreciation, in a broad range of capital assets. Depreciation charges for this fiscal year totaled \$111 million.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2008	2007	2008	2007	2008
Land and Land Improvements	\$ 51,419	\$ 55,374	\$ 20,171	\$ 19,436	\$ 71,590	\$ 74,810
Building & Building Improvements	222,477	229,159	420,462	474,247	642,939	703,406
Equipment	128,286	135,669	151,917	155,199	280,203	290,868
Infrastructure	601,574	601,393	85,124	85,434	686,698	686,817
Construction in Progress	383,153	457,976	70,345	57,910	453,498	515,886
Total	<u>\$ 1,386,909</u>	<u>\$ 1,479,571</u>	<u>\$ 748,019</u>	<u>\$ 792,216</u>	<u>\$ 2,134,928</u>	<u>\$ 2,271,787</u>

The total increase in the State's investments in capital assets for the current fiscal year was 6.4% in terms of net book value. However, actual expenditures to purchase or construct capital assets were approximately \$255 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 3H 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, 2008.

The State does have a number of revenue bonds outstanding at June 30, 2008. 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 \$244 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 3K to the financial statements.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2007	2008	2007	2008	2007	2008
Revenue Bonds	\$ 277,932	\$ 265,665	\$ 1,073,545	\$ 1,197,845	\$ 1,351,477	\$ 1,463,510
Notes Payable	32,384	35,726	263,820	250,645	296,204	286,371
Total	<u>\$ 310,316</u>	<u>\$ 301,391</u>	<u>\$ 1,337,365</u>	<u>\$ 1,448,490</u>	<u>\$ 1,647,681</u>	<u>\$ 1,749,881</u>

The State's total debt increased approximately 6% during the current fiscal year.

ECONOMIC CONDITION AND OUTLOOK

North Dakota's economy has showed steady growth during the 2007-09 biennium, with broad revenue growth across many tax types.

Although the weakness in the national economy poses a concern for North Dakota, the state has thus far been well insulated from the economic decline facing most other states. The agricultural economy remains healthy – commodity prices have fallen from recent highs, but remain strong by historic standards. Crop prices are anticipated to show continued growth of around 8.0 percent per year and livestock prices of around 4.0 percent per year through the forecast horizon.

High oil prices have led to increased oil exploration activity and increased tax collections for oil extraction and production for both the state and political subdivisions. Oil activity has also had a positive impact on income and sales tax collections. Oil production and drilling activity are at record levels. Eighty-eight rigs were operating in the state in October 2008, compared to 53 rigs one year ago, and only 41 rigs two years ago. Each oil rig represents up to 40 direct jobs and 80 indirect jobs.

The state's unemployment rate continues at an exceptionally low rate. Unemployment declined from 3.2 percent in August 2008 to 2.8 percent in September, up only slightly from the September 2007 rate of 2.5 percent. Nationally, the non-seasonally adjusted unemployment rate rose to 6.0 percent in September 2008, a 33.3 percent increase from the September 2007 rate of 4.5 percent. While the U.S. job market has lost nearly 1.0 percent since this time last year, employment has increased 1.5 percent in North Dakota.

Moody's Economy.com predicts that growth in the North Dakota economy will slow from recent years, but "as the nation begins its recovery, ND will fall into a more sustainable pace of expansion...."

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.