

OFFICE OF MANAGEMENT AND BUDGET

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

December 18, 2008

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, 2008. 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 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, 2008, 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, 2008, 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.

Management's Discussion and Analysis (MD&A) immediately follows the Independent Auditor's Report and provides a narrative introduction, overview and analysis of the basic financial statements. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it.

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 outperform the nation and official forecasts. The 2007-09 legislative forecast, finalized at the conclusion of the legislative session in April 2007, predicted 2005-07 revenues of \$2.241 billion and 2007-09 revenues of \$2.257 billion. Actual 2005-07 revenues were \$2.317 billion, \$76.0 million more than anticipated. Through October 2008, actual revenues have exceeded the 2007-09 legislative forecast by \$296.3 million, or 20.2 percent. The November 2008 revised forecast for the 2007-09 biennium projects revenues of \$2.682 billion, \$424.6 million more than originally projected.

Several factors have driven this exceptional economic performance, which occurred during a period of national economic contraction. Although the North Dakota economy is increasingly diversified, the agricultural industry continues to play a key role in the state's economy. The USDA reports that North Dakota is the nation's leading producer of durum wheat, spring wheat, barley, oats, flaxseed, canola, sunflowers, and dry edible peas and beans. Agricultural commodity and cattle prices have fallen from recent record highs, but remain high by historic standards. Moody's Economy.com predicts that the overall value of farm products will continue to increase faster than the rate of inflation – around 6.0 percent per year through 2012, providing a positive outlook for the state's agricultural producers.

The energy industry plays an important role in the state's economy. Oil production continues to set new records each month and has increased personal income through high wage jobs and mineral owner lease bonuses and royalty payments. State and local tax revenues have been bolstered by increased oil and gas tax collections.

Manufacturing is also a prominent player in the state's economy. Machinery and transportation equipment accounted for over 7.0 percent of employment and over 50.0 percent of the state's exports, which totaled over \$2.0 billion in 2007.

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, information technology companies, energy producers, and retail companies.

In upcoming years, Moody's Economy.com, predicts continued growth for the state economy. From 2008 to 2012, the state's gross domestic product is expected to grow by over \$2.9 billion, or 12.6 percent; employment is expected to grow by 11,000 jobs, or 3.0 percent. During that time, the unemployment rate is expected to remain low at between 3.1 and 4.3 percent and personal income is expected to grow at an average annual rate of 5.6 percent per year.

LONG-TERM FINANCIAL PLANNING

The long-term financial plan of the state is to support economic growth in five industry sectors – value-added agriculture, advanced manufacturing, technology-based businesses, energy, and tourism. Economic growth has grown state revenues and allowed the state to fund priorities, such as education and human services, build significant financial reserves, and provide tax relief.

The state exercises responsible 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 forecasting consultant, a 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 fiscally responsible 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 also continue to grow to record levels.

The state's capital budget, developed along with the executive 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's financial policies 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 2.5 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 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, the volatility of oil price and production levels make it difficult to rely on oil tax revenue to fund general government operations. Thus the permanent oil tax trust fund has been established to accumulate oil tax revenue for appropriation by the legislative assembly while limiting general fund reliance on oil tax revenues. All oil tax collections in excess of \$71 million are deposited into the permanent oil tax trust fund; the first \$71 million is deposited in the general fund.

MAJOR INITIATIVES

For fiscal years 2008 and 2009, which comprise the 2007-09 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 recommending improvements to 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 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 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, 2007. This was the 17th 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