OFFICE OF MANAGEMENT AND BUDGET

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

December 20, 2011

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, 2011. 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, 2011 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, 2011, 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

Although the North Dakota economy is increasingly diversified, the agricultural industry continues to play a key role in the state's economy. The USDA's National Agricultural Statistics Service reports that for 2010 crop production, North Dakota is the nation's leading producer of durum wheat, spring wheat, barley, sunflowers, canola, flaxseed, dry edible beans, dry edible peas, and lentils. Agricultural commodity and cattle prices remain high by historic standards and contribute to growth in farm income. Moody's Analytics, which prepares a five-year forecast of the state's major economic indicators, reports that "Maintained price appreciation in the state's core commodities will help promote above-average farm income growth throughout the forecast."

The energy industry plays an important role in the state's economy. The development of wind and coal resources, the production of ethanol and bio-diesel, and oil and natural gas extraction all contribute the state's economy. Oil production continues to set new records and has increased over 250 percent from 2001 to 2010. North Dakota's current crude oil production ranks fourth in the nation, with only Texas, Alaska, and California producing more oil. State and local tax revenues have been bolstered by increased oil and gas tax collections. Local economies throughout the western part of the state have seen unprecedented growth with an influx of energy-related jobs and people.

As the flourishing North Dakota economy attracts workers to the state, the state's population continues to grow and, based on the 2010 census, has reached a level not seen since the 1930's. The influx of people, along with a large state investment in infrastructure, has helped to fuel a construction boom. Construction accounts for nearly 6 percent of employment in the state, compared to only around 4 percent for the U.S. average. Manufacturing is also a prominent player in the state's economy, accounting for 6 percent of employment.

Machinery and transportation equipment make up nearly 40 percent of the state's exports. Other major exports are agriculture products, food, and oil and gas. In 2010, exports totaled over $2.5 billion.

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.

LONG-TERM FINANCIAL PLANNING

The long-term financial plan of the state was summarized by Governor Dalrymple in his budget address to the 2011 legislature. The Governor's financial plan for the state encompassed three main objectives: to fund priorities such as education and human services, build significant financial reserves, and provide tax relief.

For the 2011-13 biennium, the legislature approved a budget that increases general fund appropriations for elementary and secondary education by 12 percent, higher education by 11 percent, and human services by 43 percent. In order to address needs for infrastructure improvements that facilitate continued economic growth in the state, the legislature approved an unprecedented $371 million general fund investment in roads.

By the end of the 2011-13 biennium, reserves are anticipated to total over $1.5 billion. Reserves include the budget stabilization fund, legacy fund, foundation aid stabilization fund, and general fund ending balance. The legacy fund was established by the voters in November 2010 as a "savings account" to save a portion of current oil tax revenues. The legacy fund will accumulate 30 percent of the state's share of oil tax revenue. Through a constitutional limitation, moneys in the fund cannot be spent until July 1, 2017. After that time, oil tax collections will continue to add to the principal of the fund and interest will accrue to the state general fund. Beginning July 1, 2017, up to 15 percent of the principal of the fund can be spent each biennium, but only with the approval of two-thirds of the members of both houses of the legislature.

As recommended by the Governor, the legislature continued the property tax relief program with an appropriation of $342 million. In addition, the legislature approved the reduction of tax rates for individuals, corporations, and financial institutions, providing $147 million in tax relief over two years.

Revenue forecasting is a critical component of the state's financial planning process. The state utilizes a Revenue Forecasting Advisory Committee, comprised of representatives of the major industries in the state and the legislative and executive branches of government, along with the expertise of a national economic forecasting consultant. With the assistance of these experts, the state's Tax Department and Office of Management and Budget develop a revenue forecast for use in the budgeting process.

The budgeting process begins with the development of a biennial budget proposal reflecting the Governor's priorities for the next two years. The budget is submitted to the legislature for their consideration and eventual enactment. With a biennial budget cycle, each revenue forecast and budget proposal provides a three-year plan for the revenues and expenditures of state government.

MAJOR INITIATIVES

Major initiatives proposed by Governor Jack Dalrymple and approved by the legislature for the 2011-13 biennium include investing in infrastructure and in other priorities, continuing to build the state's reserves, and providing North Dakota's citizens with substantial tax relief.

INFRASTRUCTURE INVESTMENTS

The 2011-13 biennium budget includes funding to rebuild and repair roads throughout the state; to provide impact grants to counties and cities and to fund water supply and flood control projects. Funding for infrastructure improvements includes:

- $600 million to rebuild and repair state highways in every region of the state.
- $228.6 million for state highway projects within the 17 oil and gas producing counties in western North Dakota.
- $142 million for reconstruction and repair projects on county and township roads within the state's oil and gas counties.
- $83 million dedicated to the repair and rebuilding of city, county and township roads in counties outside the state's oil and gas region.
- $22 million in matching funds to help local governments cover costs associated with flooding, including the repair of flood-damaged roads.
- $2.9 million in funding to raise the road to Grahams Island State Park.
- $135 million in grant funds to help communities in oil country offset direct impacts created by the rapidly developing energy industry.
- $285 million for state water projects.
- $110 million state financing commitments to the newly created Western Area Water Supply Authority. The funding will support the development of a water supply system that will transfer water from the Missouri River to communities and industrial users in western North Dakota.

TAX RELIEF

The legislature approved and the Governor signed into law a tax relief package of nearly $500 million. The package provides:

- $342 million in property tax relief for homeowners, farmers, ranchers and commercial businesses during the 2011-13 biennium.
- $147 million in tax relief for individuals, corporations, and financial institutions through a reduction in tax rates.

EDUCATION

K-12 education initiatives include:

- $997 million in state funding for K-12 schools.
- $20 million for grants to support and expand career and technical education course offerings.

Higher Education initiatives include:

- $15.2 million for distribution to campuses to minimize tuition increases and to address funding inequities.
- $10 million for scholarships for North Dakota students who perform well in high school and attend North Dakota colleges.
- $20.5 million for a the state University System information technology center on the UND campus.
- $9.5 million for construction of the third and final phase of the $34.9 million Research Greenhouse Complex at NDSU. Total state investment in the project is $27.4 million.
- $13.7 million for the geothermal energy project at Minot State University.

- $11 million for major repairs at existing facilities.
- $10.5 million to build an addition and refurbish the Rhoades Science Center at Valley City State University.
- $10.5 million for the Bisek Hall diesel technology building at North Dakota State College of Science.
- $4.3 million to complete the Bismarck State College National Energy Center of Excellence building.

RESERVES

The 2011-13 biennium budget keeps ongoing expenditures in balance with ongoing revenues continues to grow reserve funds. By June 30, 2013, total reserves in the budget stabilization fund, foundation aid stabilization fund, legacy fund, and general fund ending balance are anticipated to exceed $1.5 billion. The general fund budget for the 2011-13 biennium totals $4.1 billion.

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, 2010. This was the 20th 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 2011-2013 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

Pam Sharp, Director
Office of Management and Budget