

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, 2014. 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 \$17.3 billion (reported as net position), an increase of \$3.2 billion from the previous year. The net position of governmental activities increased by 24.6% while the net position of the business-type activities showed an increase of 12.2%.

Fund Level:

As of the close of fiscal year 2014 the State's governmental funds reported combined ending fund balances of \$12.1 billion, an increase of \$2.7 billion. Of this amount, \$2.5 billion is non-spendable, primarily for legal requirements. Spendable fund balance consists of \$4.9 billion restricted for specific purposes such as transportation, \$3 billion committed and \$224 million assigned for specific functional expenditures such as public safety and regulatory, with the unassigned fund balance making up the remaining amount of \$1.4 billion. At the end of the fiscal year, unassigned fund balance for the General Fund was \$1.4 billion.

The enterprise funds reported net position at year-end of \$2.7 billion, an increase of \$298 million during the year.

Long-term Debt:

The State's total debt (bonds and notes payable) increased approximately 2% during the fiscal year to \$1.55 billion, an increase of \$31 million, which represents the net difference between new issuances and payments. During the year the State issued \$195 million in bonds and \$150 million in notes.

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

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 Position presents all of the State's assets and liabilities, with the difference between the two reported as "net position". Over time, increases and decreases in net position is 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 position changed during the most recent fiscal year. All changes in net position 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 4 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, special revenue, capital project, debt service, and permanent funds. The State has several governmental funds, of which three (3) are considered major individual funds. These three are the General Fund, the Federal Fund, and the State Special Revenue

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 non-major 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 non-major 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 Position and Changes in Fiduciary Net Position. 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, the State Special Revenue Fund and the 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 position may serve over time as a useful indicator of a government's financial position. The State's combined net position (governmental and business-type activities) totaled \$17.3 billion at the end of fiscal year 2014. Net position increased 22% from the prior fiscal year.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2013	2014	2013	2014	2013	2014
Current and Other Assets	\$10,360,825	\$13,122,425	\$1,076,842	\$9,923,413	\$16,022,202	\$23,045,838
Capital Assets	2,465,894	2,622,367	9,020,465	1,132,736	3,542,735	3,755,103
Total Assets	12,826,719	15,744,792	10,097,307	11,056,149	19,564,937	26,800,941
Deferred Outflows of Resources	-	-	12,866	12,715	12,866	12,715
Long-Term Liabilities						
Outstanding	243,279	225,992	2,509,577	2,602,155	2,752,856	2,828,147
Other Liabilities	869,056	930,133	5,156,513	5,734,314	2,676,480	6,664,447
Total Liabilities	1,112,335	1,156,125	7,666,090	8,336,469	5,429,336	9,492,594
Deferred Inflows of Resources	-	-	-	415	-	415
Net Position						
Invested in Capital Assets,						
Net of Related Debt	2,331,214	2,502,235	792,068	844,395	3,123,282	3,346,630
Restricted	3,786,155	4,966,178	632,432	600,270	4,418,587	5,566,448
Unrestricted	5,597,015	7,120,254	1,019,583	1,287,315	6,616,598	8,407,569
Total Net Position	\$11,714,384	\$14,588,667	\$2,444,083	\$2,731,980	\$14,158,467	\$17,320,647

The largest component (49%) of the State's net position is unrestricted net position. Unrestricted net position may be used at the State's discretion, but often have limitations on use based on State statutes. Restricted net position make up thirty-two percent (32%) of the state's net position. Restricted net position represents resources that are subject to external restrictions, constitutional provisions, or enabling legislation on how they can be used.

Nineteen percent (19%) of the State's net position 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 needed 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 position changed during the fiscal year:

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

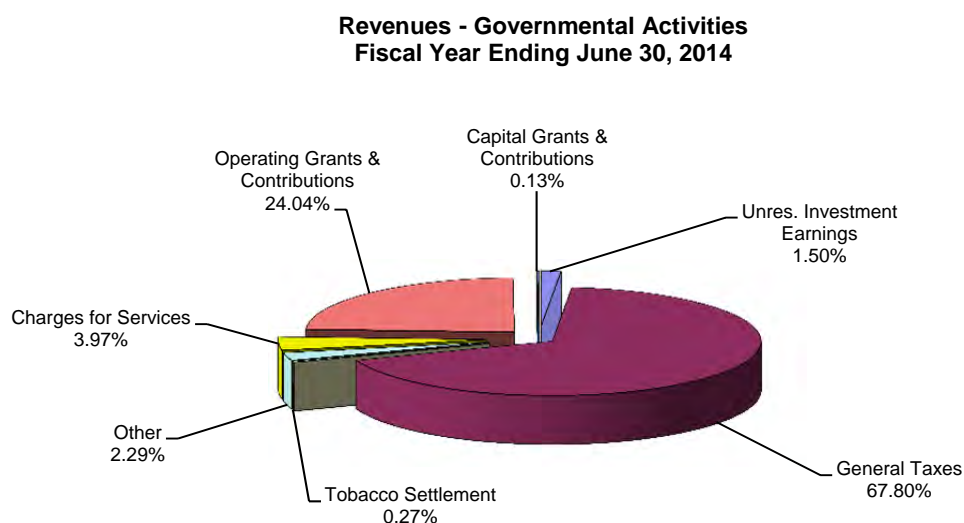
	Governmental Activities		Business-Type Activities		Total Primary Government	
	2013	2014	2013	2014	2013	2014
Revenues:						
Program Revenues:						
Charges for Services	\$319,089	\$344,338	\$1,462,923	\$1,462,622	\$1,782,012	\$1,806,960
Operating Grants & Contributions	1,867,800	2,083,790	370,856	439,951	2,238,656	2,523,741
Capital Grants & Contributions	5,353	11,046	19,866	18,704	25,219	29,750
General Revenues:						
Income Taxes	863,018	700,868	-	-	863,018	700,868
Sales Taxes	1,654,187	1,756,778	-	-	1,654,187	1,756,778
Other Taxes	2,602,391	3,418,372	-	-	2,602,391	3,418,372
Investment Earnings	17,968	130,011	-	-	17,968	130,011
Tobacco Settlement	22,333	23,653	-	-	22,333	23,653
Other	206,709	198,533	39,166	2,214	245,875	200,747
Total Revenues	7,558,848	8,667,389	1,892,811	1,923,491	9,451,659	10,590,880
Expenses						
General Government	889,332	1,283,916	-	-	889,332	1,283,916
Education	875,991	1,075,062	-	-	875,991	1,075,062
Health and Human Services	1,318,900	1,433,599	-	-	1,318,900	1,433,599
Regulatory	44,814	54,728	-	-	44,814	54,728
Public Safety and Corrections	209,733	243,149	-	-	209,733	243,149
Agriculture and Commerce	93,213	96,055	-	-	93,213	96,055
Natural Resources	114,752	119,396	-	-	114,752	119,396
Transportation	595,647	1,066,104	-	-	595,647	1,066,104
Interest on Long Term Debt	8,454	7,602	-	-	8,454	7,602
Bank of North Dakota	-	-	68,888	76,367	68,888	76,367
Housing Finance	-	-	48,368	40,902	48,368	40,902
Loan Programs	-	-	8,756	12,759	8,756	12,759
State Lottery	-	-	19,714	19,264	19,714	19,264
Unemployment Compensation	-	-	118,377	113,989	118,377	113,989
University System	-	-	1,080,817	1,129,869	1,080,817	1,129,869
Workforce Safety and Insurance	-	-	448,535	418,501	448,535	418,501
Other	-	-	279,390	269,600	279,390	269,600
Total Expenses	4,150,836	5,379,611	2,072,845	2,081,251	6,223,681	7,460,862
Increase (decrease) in Net Position	3,408,014	3,287,777	(180,034)	(157,761)	3,227,980	3,130,016
Before Contributions & Transfers						
Special Item – Loss Comp. Proj.	-	-	(14,729)	-	(14,729)	-
Contributions to Permanent Fund Principal	13,723	14,251	-	-	13,723	14,251
Transfers	(409,586)	(424,008)	358,701	455,888	(50,885)	31,880
Increase in Net Position	3,012,151	2,878,020	163,938	298,127	3,176,089	3,176,147
Net Position - Beginning -As Restated	8,702,233	11,710,647	2,280,145	2,433,853	10,982,378	14,144,500
Net Position- Ending	\$11,714,384	\$14,588,667	\$2,444,083	\$2,731,980	\$14,158,467	17,320,647

Governmental Activities

Governmental Activities increased the State's net position by \$2.9 billion. Revenues rose 15%, with the largest dollar increase in the State's revenues for fiscal year 2014 coming from oil, gas and coal tax revenues, an increase of \$818 million. This increase is due to the increased level of oil and gas production in the state and relatively high oil prices. Sales tax revenue increased \$103 million due to a growth in taxable sales and purchases as a result of increased oil production, a strong agricultural sectors and a growing population.

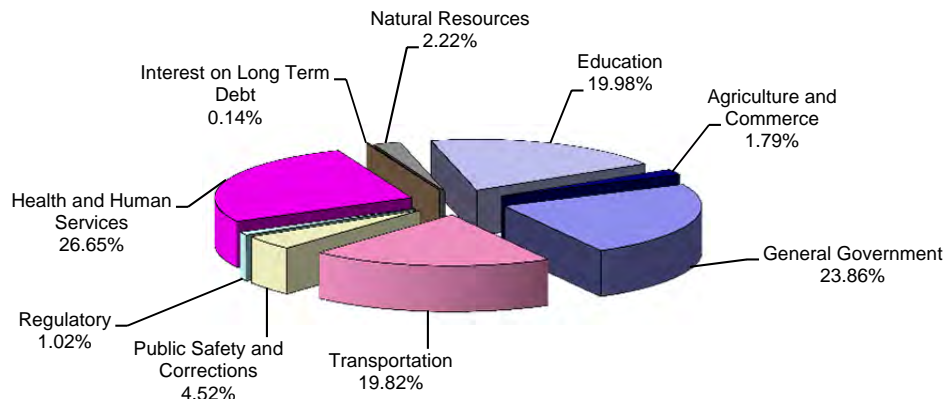
Expenses for governmental activities increased by 30%. Transportation expenses had the largest percentage increase, 79%, due to increase in spending for the construction and repair of state roads and also for county and city roads through grants and direct expenses. Transportation also had an increase in spending for oil impact projects.

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, 2014



Business-type Activities

Net position of the business-type activities increased by \$298 million during the fiscal year.

Workforce Safety and Insurance's (WSI) net position increased \$84.4 million. Policyholder count continues to increase but at a slower pace than 2013. In fiscal year 2014, an additional 596 policyholders came on board for a total of 25,389. In fiscal years 2013 and 2012, there were 981 and 2,437 new policyholders. Written premium for fiscal year 2014 totaled 350.2 million, closely paralleling fiscal year 2013's total of \$350.9. WSI's investment portfolio yielded a year to date return of 11.7% (net of fees), a gain of \$184 million. Incurred losses for fiscal year 2014 increased also since active employer accounts have risen due to the oil industry activity and the state's overall strong economic standing.

The Bank of North Dakota net position increased \$89.8 million. Net position increased because of a decrease in transfers and continued growth in state deposits and liquidity of banks investing at the Bank. Operating income decreased due to a decrease in net interest income and a net decrease in the fair value of securities.

The University System's net position increased \$77.9 million. Net position increased due to an increase in tuition and fee revenues. In addition, state appropriations increased so the University system's net income was slightly higher than the prior year.

Housing Finance net position increase of \$7.8 million was similar to the prior year's net position change as revenues and expenses remained fairly consistent.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

Governmental Funds

As the State completed the year, its governmental funds reported combined fund balances of \$12.1 billion, an increase of \$2.7 billion from the prior fiscal year. Of the \$12.1 billion in net position, \$2.5 billion is non-spendable, \$4.9 billion is restricted, \$3 billion is committed, \$224 million is assigned and \$1.4 billion is unassigned. These fund balance categories are a result of GASB Statement 54. Note 1S

provides definitions for these categories. The following analysis of funds provides the explanation for the overall change in net position for governmental funds.

The General Fund is the chief operating fund of the State. At the end of current fiscal year, unassigned fund balance of the General Fund was \$1.4 billion, non-spendable was \$2.4 billion and \$1.4 billion was committed for expenditure by various governmental functions.

Total General fund balance increased during the fiscal year by \$897 million. Revenues increased approximately 20%, due primarily to increases in oil, gas, and coal taxes of approximately \$584 million and sales use tax revenue of more than \$69 million. Explanations for these increases were explained with the increase in net position for governmental activities.

General fund expenditures increased by 48.3%. Transportation expenditures increased because of an increase in spending for oil impacted projects as previously discussed.

The State Special Revenue ending fund balance grew by \$1.8 billion resulting in \$6.8 billion fund balance. Revenues increased 18% and expenditures increased 16%. Revenues increased in the state special revenue fund primarily due to an increase in oil, gas and coal tax revenues. General Government expenditures saw the highest increase in expenses due to an increase in tax distributions to the counties.

The June 30 Federal Fund balance of \$5.6 million consists of non-spendable items such as prepaids and inventory and unavailable revenue for those revenues to be received later than the time period used for revenue recognition.

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 position 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 ending June 30, 2014, was the first year of the 2013-15 budget cycle. The original budget increased \$74.4 million.

At the beginning of the 2013-15 budget cycle, there was an increase in the original budget of \$63.7 million due to the authorized carryover of general fund appropriation authority from the 2011-13 biennium, and a \$19.7 million increase for capital construction carryover.

The increases to the beginning appropriated budget are from authorized carryover of general fund appropriation authority and the larger ones 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 Trust Lands, \$26.2 million, the University System, \$10.7 million, the Historical Society, \$5.7 million, Legislative Council, \$4.3 million, the Adjutant General, \$3.3 million and the Office of Management & Budget, \$3.1 million.

Of the \$19.7 million in capital construction carryover dollars, \$8.5 million was for the Department of Human Services; \$3.7 million was for the Information Technology Department; \$3.3 million was for the Department of Transportation; \$2.8 million was for the Office of Management and Budget and various smaller amounts for several other state agencies.

There were no expenditures in excess of general fund authority.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets: At the end of the fiscal year 2014, the State had invested \$3.3 billion, net of accumulated depreciation, in a broad range of capital assets. Depreciation charges for this fiscal year totaled \$165 million.

(Net of Depreciation, Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2013 Restated	2014	2013 Restated	2014	2013 Restated	2014
Land and Land Improvements	\$76,924	\$132,263	\$18,742	\$19,169	\$95,666	\$151,432
Building & Building Improvements	321,272	365,203	640,870	732,665	962,142	1,097,868
Equipment	141,231	146,430	163,238	174,753	304,469	321,183
Intangibles						
Software	31,788	33,155	14,638	12,401	46,426	45,556
Other	7,208	8,417	708	684	7,916	9,101
Infrastructure	1,026,212	1,138,286	108,003	103,744	1,134,215	1,242,030
Construction in Progress	857,521	798,612	133,770	89,321	991,291	887,933
Total	\$2,462,156	\$2,622,366	\$1,079,969	\$1,132,737	\$3,542,125	\$3,755,103

The total increase in the State's investments in capital assets for the current fiscal year was 6% in terms of net book value. However, actual expenditures to purchase or construct capital assets were approximately \$799 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 3J 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, 2014.

The State does have a number of revenue bonds outstanding at June 30, 2014. 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 \$465 million. The advances have a fixed rate of interest, ranging from 1.12 percent to 7.35 percent.

More detailed information regarding the State's long-term obligations is presented in Note 3N to the financial statements.

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2013	2014	2013	2014	2013	2014
Revenue Bonds	\$180,757	\$163,030	\$919,506	\$901,528	\$1,100,263	\$1,064,558
Notes Payable	6,211	4,980	415,856	484,764	422,067	489,744
Total	<u>\$186,968</u>	<u>\$168,010</u>	<u>\$1,335,362</u>	<u>\$1,386,292</u>	<u>\$1,522,330</u>	<u>\$1,554,302</u>

The State's total debt increased approximately 2% during the current fiscal year.

ECONOMIC CONDITION AND OUTLOOK

Moody's Analytics recently completed an analysis of the North Dakota economy for its *Précis U.S. State* October 2014 publication. The report depicts a strong, growing economy, leading the nation in several areas. North Dakota's state gross domestic product (GDP), the value of goods and services produced in the state, has grown by over 55 percent from 2009 through 2013. In sharp contrast, GDP nationally has grown by only around 9 percent during that time. Moody's predicts that North Dakota's GDP will continue to outpace the nation over the next several years. The rate of growth in North Dakota's GDP is expected to approach 5 percent during calendar year 2014 compared to around 2 percent for the U.S.

The state's unemployment rate, only 2.1 percent in October 2014, is less than half the U.S. rate of 5.5 percent and remains the lowest in the nation. The state's unemployment rate is expected to remain well below the national rate, remaining under 3 percent through 2018; the national rate is expected to remain at or above 5 percent through 2018.

The high level of economic activity, combined with the extremely low unemployment rate, has led to growth in the state's population. As the number of jobs has increased, so has the labor force as potential workers migrate from states with much weaker labor markets. From 2009 through 2013, employment in North Dakota grew by over 21 percent; nationally, it increased by less than 4 percent during that time.

Median household income and per capita income for North Dakota have both surpassed the national average. For 2012, median household income in North Dakota was \$52,888 compared to \$51,939 for the U.S. Per capita income for 2013 was \$53,182 for North Dakota, but only \$44,765 for the U.S.

Another indication of the state's strong economy -- the State of North Dakota recently earned a AAA credit rating, the highest rating available, from Standard & Poor's Rating Services. The new rating is an upgrade from the state's previous credit rating of AA+, the second-highest rating available. In determining the state's upgraded credit rating, Standard and Poor's considered the state's capacity to meet financial commitments, its strong government management and budgetary performance, growing reserves, low unemployment rate, and growth in per-capita gross state product. Standard and Poor's also upgraded the state's appropriation bonds from AA to AA+.

Moody's concludes that "North Dakota's economy will outperform that of the U.S. for the next several years thanks to a booming energy industry and the positive spillover that it generates."

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.