

State of North Dakota
OFFICE OF MANAGEMENT AND BUDGET

600 East Boulevard Avenue, Dept. 110 • Bismarck, North Dakota 58505-0400
FAX – 701.328.3230

December 15, 2016

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, 2016. 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, 2016 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, 2016, 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 North Dakota's 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 2015 crop production, North Dakota is the nation's leading producer of durum wheat, spring wheat, canola, flaxseed, dry edible beans, and honey.

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 to the state's economy. North Dakota continued to produce about one million barrels of oil per day in 2016. North Dakota's current crude oil production ranks second in the nation, behind first-ranked Texas. Low oil prices have resulted in lower state and local tax revenues. In October 2016, the actual average price per barrel for North Dakota crude oil was \$43.01, up slightly from the anticipated price.

As North Dakota's 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 the construction industry in North Dakota. Construction accounts for over 7 percent of employment in the state, compared to around 4 percent for the U.S. Manufacturing is also a prominent player in the state's economy, accounting for nearly 6 percent of employment; mining, which includes oil extraction and production, provides jobs for another 6 percent of the state's workforce, compared to less than 1 percent nationally.

Oil and gas make up more than 33 percent of the state's exports. Other major exports are machinery and transportation equipment, agriculture products, chemicals, and coal. In 2015, exports totaled slightly more than \$7 billion.

A listing of the state's 20 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 2015 budget address to the legislature. The Governor's financial plan for the state encompasses three main objectives:

- To fund priorities such as education, human services, and infrastructure development;
- Maintain significant financial reserves; and
- Provide tax relief.

For the 2015-17 biennium, the legislature approved a budget that increased general fund appropriations for elementary and secondary education by 6 percent and human services by 14 percent.

By the end of the 2015-17 biennium, reserves are anticipated to total over \$1 billion. Reserves include the budget stabilization fund, strategic investment and improvements fund, foundation aid stabilization fund, and tax relief fund ending balance. In addition, the legacy fund is projected to have a balance of \$4.24 billion. The legacy fund was established by the voters in November 2010 as a "savings account" to save a portion of 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 majority of both the house and senate.

As recommended by the Governor, the legislature provided reductions in tax rates for individuals and corporations.

Revenue forecasting that is accurate, conservative, and credible 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.

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 statutory limit for the budget stabilization fund for the 2015-17 biennium was \$572 million, which is 9.5 percent of the state general fund budget.

North Dakota did experience a significant revenue shortfall during the 2015-17 biennium due to decreases in oil and agriculture prices, and has committed to transferring the entire amount of the budget stabilization fund to the general fund prior to June 30, 2017.

In addition to accessing the budget stabilization fund, in the event of an economic downturn the Governor is able to reduce general fund expenditure authority uniformly across state agencies through a process known as allotment. In the event of such a general fund expenditure reduction, the foundation aid stabilization fund was established to protect 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 foundation aid stabilization fund is expected to have a June 30, 2017 balance in excess of \$300 million.

Governor Dalrymple did implement a general fund allotment of 4.05 percent during fiscal year 2016. The budget stabilization fund was used to replace \$71.7 million of general funds in K-12 education. As a result K-12 did not experience a reduction in overall funding.

Oil tax collections are split between state government and local political subdivisions. The state has recognized that while tax collections from oil contribute significantly to the state, the volatility of oil price and production levels make it difficult to rely on oil tax revenue to fund general government operations. Consequently, the general fund portion is limited to no more than \$300 million per biennium.

MAJOR INITIATIVES

Major initiatives proposed by Governor Jack Dalrymple and approved by the legislature for the 2015-17 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 2015-17 biennial budget includes funding to rebuild and repair roads throughout the state, and provides increased oil tax distributions and impact grants to counties and cities to fund a variety of local infrastructure projects. General Fund appropriations were subject to a 6.55 percent allotment. Funding for water projects was reduced due to low oil prices and production. Funding for infrastructure improvements, as adjusted for allotments and low oil price and production, includes:

- \$941.1 million to rebuild and repair state highways in the west region of the state;
- \$240 million for county road projects within the 17 oil and gas producing counties in western North Dakota;
- \$241 million dedicated to the repair and rebuilding of county and township roads outside the state's oil and gas region;
- \$140 million in grant funds to help communities in oil country offset direct impacts created by the rapidly developing energy industry; and
- \$565 million for water-related projects, including the Grand Forks water treatment plant, Fargo flood control, Stutsman County water reuse facility, Northwest Area Water Supply, Red River Valley Water Supply, Southwest Pipeline Project, Western Area Water Supply, Weather Modification, and other water programs.

TAX RELIEF

The legislature approved, and the Governor signed into law, a tax relief package that provides:

- individual and corporate income tax rate reductions resulting in taxpayer savings of approximately \$138 million during the 2015-17 biennium;
- state-paid property tax credit of 12 percent, providing property tax relief in the amount of \$250 million; and
- \$20 million for the homestead tax credit program; and
- \$7.7 million for the disabled veteran's property tax credit.

EDUCATION

K-12 education initiatives include:

- \$1.91 billion in state funding for K-12 schools through integrated funding formula;
- \$12.5 million in grants to districts experiencing rapid enrollment growth;
- \$57 million to assist districts in the provision of transportation services; and
- Over \$23 million for grants to support and expand career and technical education course offerings.

Higher Education initiatives include:

- \$166 million for capital projects and extraordinary repairs at the 11 campuses;
- \$14 million to sustain the career and technical education and academic scholarship program; and
- \$23 million for the North Dakota Higher Education Challenge matching grant fund, to encourage philanthropy by providing a state match for private contributions to the state's colleges and universities.
- \$3 million to enhance campus safety and security.

RESERVES

It is anticipated that by June 30, 2017, there will be a total ending balance of approximately \$1 billion in the budget stabilization fund, foundation aid stabilization fund, strategic investment and improvements fund, and tax relief fund. The general fund budget for the 2015-17 biennium has been adjusted downward to \$5.65 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, 2015. This was the 24th 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 2013-2015 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,

A handwritten signature in black ink that reads "Pam Sharp". The signature is written in a cursive, flowing style.

Pam Sharp
Director