

OFFICE OF MANAGEMENT AND BUDGET

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

December 15, 2010

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, 2010. 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, 2010 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, 2010, 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 make headlines as it outperforms the nation. While nationally, one in ten workers is unemployed, North Dakota has the lowest unemployment of any state. In October 2010, North Dakota's non-seasonally adjusted unemployment rate was only 2.8%, one-third the national rate of 9.0%.

Several factors have driven this exceptional economic performance. 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, dry edible beans, canola, flaxseed, lentils, dry edible peas, sunflowers, and several other crops. Agricultural commodity and cattle prices have fallen from recent record highs, but remain high by historic standards.

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 each month and has increased over 200 percent in just the last four years. 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.

Manufacturing is also a prominent player in the state's economy, accounting for 6.5% of employment. Machinery and transportation equipment make up over 40% of the state's exports. Exports totaled nearly \$2.2 billion in 2009.

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 is to target aggressive economic development efforts at five industry sectors where North Dakota has a competitive advantage because of natural or human resources – value-added agriculture, advanced manufacturing, technology-based businesses, energy, and tourism. Economic growth in these industries has grown state revenues and allowed the state to meet three primary budget objectives that have guided the budget process -- to fund priorities, such as education and human services, build significant financial reserves, and provide tax relief.

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 forecast based on state trends, national forecasting models, and input from private industry experts.

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.

North Dakota's fiscally responsible budgeting and revenue forecasting, combined with economic growth, has allowed the accumulation of significant reserve balances. Projected June 30, 2011, balances in the general fund, permanent oil tax trust fund, budget stabilization fund, and foundation aid stabilization fund total \$1.159 billion. In addition, the state's voters approved measure no. 1 on the November 2010 general election ballot, creating the legacy fund. The legacy fund will receive 30.0 percent of the state's oil and gas tax collections, beginning July 1, 2011. This fund will accumulate oil and gas tax revenues and investment interest. No expenditures of the accumulated principal and interest can be made until after June 30, 2017. The June 30, 2013, balance in the fund is estimated to be \$619 million.

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 of \$325 million, or 10 percent of the biennial state general fund budget. In addition, the Governor is able to reduce general fund expenditures to alleviate the effects of a revenue shortfall, if necessary.

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 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. Oil tax collections are split between the state and local political subdivisions. Of the state share, the first \$71 million each biennium is deposited in the general fund; all oil tax collections in excess of \$71 million are deposited into the permanent oil tax trust fund.

Major Initiatives

North Dakota continues to implement programs and policies that improve the lives and well being of its citizens by creating more opportunities and better jobs. Priorities include excellence in education, creating a strong business climate, enhancing energy development, improving agriculture, taking care of people, and providing tax relief for the citizens of North Dakota.

Education

A record \$1.3 billion K-12 education funding package was approved by the 2009 Legislative Assembly. Included in this funding package is an additional \$120 million of state funds and one-time fiscal stimulus funding of \$150 million. State funding significantly increased payments to schools using the state school aid formula and targeted funding to new initiatives, such as mentorships, additional counselors and tutors, and establishment of an Early Childhood Learning Council.

Higher Education received \$795 million of state support. This funding package included \$161 million of additional funding to support students and families, improve campuses, and hold the line on tuition. To make higher education more affordable, more than \$32 million was included for financial aid for students.

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 agriculture 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 \$2 million grant program for the installation of blender pumps at motor fuel retailers to promote expanded use of ethanol and biodiesel.

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, 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 the state. Recently funded state government technology initiatives include:

- Longitudinal data system to follow student progress from kindergarten to career in order to improve educational adequacy and meet the needs of the future workplace.
- Funding for the Medicaid Management Information System.

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:

- A \$20 million appropriation for Centers of Excellence awards. These projects will continue to transform and expand North Dakota's economy.
- Increased funding for the North Dakota Trade office, which helps grow North Dakota's exports.
- More than \$5 million in loan and grant programs for childcare workforce development, quality improvement and technical assistance to establish and expand safe childcare facilities in North Dakota.
- \$2.5 million to support innovation and entrepreneurship.

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 \$380 million increase in the Department of Human Services budget to help seniors, children, and persons with disabilities.
- Increased medical payments to hospitals, physicians, dentists, chiropractors and ambulance service providers to advance quality healthcare in North Dakota.
- Increased funding for home and community based care to help our seniors live more independently.
- Expanded eligibility for SCHIP from 150 to 160 percent net of the federal poverty level.
- Approval for a major expansion of the North Dakota Heritage Center.
- An enhanced Veteran's Bonus Program that removes the current caps for both domestic and overseas service, and compensates for actual time served.

Energy Development

Energy is one of the largest industries in North Dakota. Energy development in North Dakota has expanded greatly from traditional oil, gas and coal energy to renewable energies such as ethanol, biodiesel and wind energy. Recent efforts to further the development of energy in North Dakota include:

- A streamlined oil extraction tax option to promote exploration and development in the Bakken Reserve.
- A carbon credit incentive against coal conversion privilege taxes to help facilities achieve a required level of carbon dioxide capture, and a new tax incentive for cleaner-burning beneficiated coal.
- An extended property tax reduction and sales and use tax exemption for wind power, as well as an extended income tax credit for the installation of any renewable energy device.
- \$3 million for the renewable energy fund.

Tax Relief

In addition to the initiatives above, the 2009 Legislative Assembly supported broad-based tax relief and reform for the people of North Dakota. Elements of the broad-based tax relief include:

- \$295 million property tax relief to help homeowners, farmers, ranchers and commercial businesses by reducing the average school district levy by 75 mills and capping the rate at 110 mills.
- \$90 million in individual income tax rate reductions.
- \$10 million in corporate income tax reductions.
- An increase in the Homestead Tax Credit to help reduce the burden of taxes on seniors and people with disabilities.
- Establishment of a Disabled Veterans Credit program.

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, 2009. This was the 19th 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 2009-2011 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 cursive script that reads "Pam Sharp". The signature is written in black ink and is positioned above the printed name and title.

Pam Sharp, Director
Office of Management and Budget