MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

The following is a discussion and analysis of the State of North Carolina's (the State's) financial performance, providing an overview of the activities for the fiscal year ended June 30, 2003. 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.

Highlights

Government-wide:

— The State's total net assets increased slightly as a result of this year's operations. While net assets of governmental activities increased by $771.6 million, or nearly 3.6 percent, net assets of business-type activities decreased by $449.4 million, or about 31.9 percent. At year-end, net assets of governmental activities and business-type activities totaled $22.31 billion and $958.3 million, respectively.

— Component units reported net assets of $8.87 billion, an increase of $704.6 million or 8.6 percent from the previous year. The State's largest component unit, the University of North Carolina System, had net assets of $6.24 billion at June 30, 2003, an increase of $466 million or 8.1 percent from fiscal year 2002.

Fund Level:

— As of the close of the fiscal year, the State's General Fund reported a total fund balance deficit of $166.96 million, with reserves of $166.2 million, and an unreserved fund balance of negative $333.1 million.

— The Highway Fund and the Highway Trust Fund reported fund balances of $299.9 million and $208.2 million, respectively.

— The State's two major enterprise funds, the Unemployment Compensation Fund and the EPA Revolving Loan Fund, reported net assets of $277.5 million and $581.7 million, respectively.

State Highway System:

— The State highway system includes roadway surfaces, bridges, signage, railings, markings, traffic signals, and other structures related to the State's motor vehicle transportation system. The system includes 78,490 miles of roadway, constituting the second largest highway system in the nation. The system includes 17,250 bridges spanning 380 miles.

— For fiscal year 2003, the State reflected $12.4 billion (net of accumulated depreciation) of highway system infrastructure, an increase of $897.7 million (net) or 7.8 percent from the previous year.

Long-term Debt:

— The State's general obligation debt payable increased during the fiscal year to $4.07 billion, an increase of $599.7 million or 17.3 percent.

— The State maintained its AAA bond rating with Standard and Poor's and Fitch. In August 2002, Moody's downgraded the State's credit rating for general obligation debt from "AAA" to "Aa1", representing the first time since 1960 that North Carolina had less than a "AAA" rating.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information (General Fund budgetary schedule, pension funding progress and contributions) and other supplementary information (combining financial statements) in addition to the basic financial statements. These components are described below.

Government-wide Financial Statements

The Statement of Net Assets and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better off or worse off as a result of this year's activities? 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 Assets (page 46) presents all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 48 and 49) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets 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 – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services.

Business-type Activities – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. The State's Unemployment Compensation Fund and the EPA Revolving Loan Fund are the predominant business-type activities.

Discretely Presented Component Units – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A description of the component units and an address for obtaining their separately issued financial statements can be found beginning on page 64. All component units are combined and displayed in a separate discrete column in the government-wide financial statements to emphasize their legal separateness from the State. In addition, financial statements for major component units are presented in the notes to the financial statements (pages 129 and 130).

Fund Financial Statements

The fund financial statements begin on page 52 and provide detailed information about the major individual funds. 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. In addition to the major funds, page 152 begins the individual fund data for the non-major funds. The State's funds are divided into three categories, governmental, proprietary, and fiduciary, and they use different accounting approaches.

> ***Governmental funds*** -- Most of the State's basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year-end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State's general government operations and the basic services it provides. Governmental fund information helps determine 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. Governmental funds include the general, special revenue, capital project, and permanent funds. 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 governmental activities.

Proprietary funds -- When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting; the same method used by private sector businesses. Enterprise funds report activities that provide claims, grants, and services to the general public. The Unemployment Compensation Fund and the EPA Revolving Loan Fund are our most significant enterprise funds. Internal service funds report activities that provide supplies and services for the State's other programs and activities - such as the State's State Property Fire Insurance Fund, the Motor Fleet Management Fund, Centralized Computing Services Fund, and Telecommunications Services Fund. Internal service funds are reported as governmental activities on the government-wide statements.

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 Assets and Changes in Fiduciary Net Assets. These funds, which include pension and other employee benefits, private-purpose, investment trust, and agency funds, are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and cannot be used to support the State's own programs.

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 fund financial statements. The notes to the financial statements can be found beginning on page 62 of this report.

Additional Required Supplementary Information

Following the basic financial statements and note disclosures is additional Required Supplementary Information that further explains and supports the information in the financial statements. The Required Supplementary Information includes General Fund budgetary comparison schedules reconciling the statutory and generally accepted accounting principles (GAAP) fund balances at fiscal year-end, and pension plan trend information related to funding progress and contributions.

Supplementary Information

Supplementary information includes the introductory section, and the combining financial statements for non-major governmental, proprietary, and fiduciary funds and for non-major discretely presented component units. These funds are added together, by fund type, and presented in single columns in the basic financial statements, but are not reported individually, as with major funds, on the governmental fund financial statements.

FINANCIAL ANALYSIS OF THE STATE AS A WHOLE

The State's combined net assets increased $322.2 million, or 1.4 percent over the course of this fiscal year's operations. The net assets of the governmental activities increased $771.6 million or 3.6 percent and business-type activities had a decrease of $449.4 million or 31.9 percent. The following table was derived from the government-wide Statement of Net Assets:

Net Assets
June 30, 2003 and 2002
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Current and other non-current assets	$ 9,816,418	$ 9,853,413	$ 1,163,089	$ 1,661,161	$ 10,979,507	$ 11,514,574
Capital assets, net	23,727,427	22,324,253	45,428	42,498	23,772,855	22,366,751
Total assets	33,543,845	32,177,666	1,208,517	1,703,659	34,752,362	33,881,325
Long-term liabilities	4,380,170	3,711,385	10,270	10,383	4,390,440	3,721,768
Other liabilities	6,853,153	6,927,395	239,923	285,523	7,093,076	7,212,918
Total liabilities	11,233,323	10,638,780	250,193	295,906	11,483,516	10,934,686
Net assets:						
Invested in capital assets, net of related debt	23,449,373	22,009,712	38,450	38,392	23,487,823	22,048,104
Restricted	1,071,626	1,084,614	863,426	1,317,595	1,935,052	2,402,209
Unrestricted	(2,210,477)	(1,555,440)	56,448	51,766	(2,154,029)	(1,503,674)
Total net assets	$ 22,310,522	$ 21,538,886	$ 958,324	$ 1,407,753	$ 23,268,846	$ 22,946,639

The largest component of the State's net assets ($23.49 billion) reflects its investment in capital assets (land, buildings, machinery and equipment, State highway system, and other capital assets), less related debt still outstanding that was used to acquire or construct those assets. Restricted net assets are the next largest component ($1.94 billion) and represent resources that are subject to external restrictions on how they can be used. The remaining portion, unrestricted net assets, consists of net assets that do not meet the definition of *restricted* or *invested in capital assets, net of related debt.*

The government-wide statement of net assets for governmental activities reflects a negative $2.21 billion unrestricted net asset balance. The State of North Carolina, like many other state and local governments, issues general obligation debt and distributes the proceeds to local governments and component units. The proceeds are used to construct new buildings and renovate and modernize existing buildings on the State's community college and university campuses, assist county governments in meeting their public school building capital needs, and to provide grants and loans to local governments for clean water and natural gas projects. Of the $4.07 billion of outstanding general obligation debt at June 30, 2003, $3.78 billion of the outstanding debt is attributable to debt issued as State aid to component units (universities and community colleges) and local governments. The balance sheets of component unit and local government recipients reflect ownership of the related constructed capital assets without the burden of recording the debt obligation. The policy of selling general obligation bonds and funneling the cash proceeds to non-primary government (non-State) entities has been in place for decades. Through this policy the State was able to promote improved financial management, save bond issuance costs, and receive more attractive financing arrangements. However, by issuing debt and sending the cash proceeds outside of the State, the State must reflect significant liabilities on its statement of net assets (balance sheet) which are reflected in the unrestricted net asset component since there are no offsetting capital assets. Additionally, as of June 30, 2003, the State's governmental activities have significant unfunded liabilities for compensated absences in the amount of $274.5 million and a $20 million cost settlement payable to the federal government (see Note 22 to the financial statements). These unfunded liabilities also contribute to the negative unrestricted net asset balance for governmental activities.

The following financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

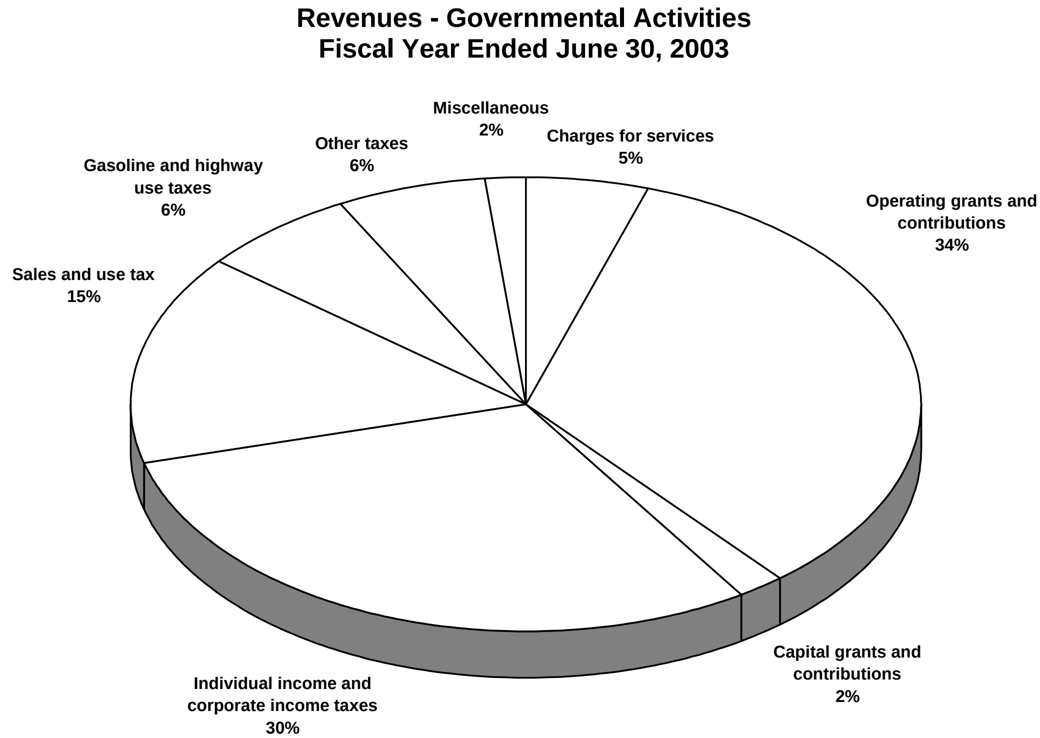
Changes in Net Assets
For the Fiscal Years Ended June 30, 2003 and 2002
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2003	2002	2003	2002	2003	2002
Revenues:						
Program revenues:						
Charges for services	$ 1,350,749	$ 1,301,564	$ 688,517	$ 487,443	$ 2,039,266	$ 1,789,007
Operating grants and contributions	9,043,064	8,725,315	504,550	485,492	9,547,614	9,210,807
Capital grants and contributions	527,498	714,084	1,241	1,121	528,739	715,205
General revenues:						
Taxes						
Individual income tax	7,122,099	7,234,431	—	—	7,122,099	7,234,431
Corporate income tax	921,611	599,382	—	—	921,611	599,382
Sales and use tax	4,029,403	3,778,873	—	—	4,029,403	3,778,873
Gasoline tax	1,154,986	1,212,788	—	—	1,154,986	1,212,788
Franchise tax	584,584	590,992	—	—	584,584	590,992
Highway use tax	552,759	555,320	—	—	552,759	555,320
Insurance tax	417,126	347,893	—	—	417,126	347,893
Beverage tax	198,848	200,593	—	—	198,848	200,593
Inheritance tax	112,150	106,491	—	—	112,150	106,491
Other taxes	289,261	278,740	—	—	289,261	278,740
Tobacco settlement	173,256	175,836	—	—	173,256	175,836
Federal grants not restricted to specific programs	136,859	—	—	—	136,859	—
Unrestricted investment earnings	103,987	139,350	—	—	103,987	139,350
Miscellaneous	41,137	57,484	—	—	41,137	57,484
Total revenues	26,759,377	26,019,136	1,194,308	974,056	27,953,685	26,993,192
Expenses:						
General government	773,835	874,208	—	—	773,835	874,208
Primary and secondary education	6,865,921	6,802,979	—	—	6,865,921	6,802,979
Higher education	2,814,375	2,519,703			2,814,375	2,519,703
Health and human services	10,614,411	10,376,807	—	—	10,614,411	10,376,807
Economic development	489,062	469,102	—	—	489,062	469,102
Environment and natural resources	537,540	623,351	—	—	537,540	623,351
Public safety, corrections and regulation	2,034,225	2,109,488	—	—	2,034,225	2,109,488
Transportation	1,639,866	1,530,869	—	—	1,639,866	1,530,869
Agriculture	73,972	121,729	—	—	73,972	121,729
Interest on long-term debt	151,258	148,595	—	—	151,258	148,595
Unemployment compensation	—	—	1,603,796	1,336,718	1,603,796	1,336,718
EPA Revolving Loan	—	—	4,266	4,018	4,266	4,018
Other business-type activities	—	—	30,757	25,431	30,757	25,431
Total expenses	25,994,465	25,576,831	1,638,819	1,366,167	27,633,284	26,942,998
Increase (decrease) in net assets before contributions and transfers	764,912	442,305	(444,511)	(392,111)	320,401	50,194
Contributions to permanent funds	1,806	2,019	—	—	1,806	2,019
Transfers	4,918	40,887	(4,918)	(40,887)	—	—
Increase (decrease) in net assets	771,636	485,211	(449,429)	(432,998)	322,207	52,213
Net assets - beginning - restated	21,538,886	21,053,675	1,407,753	1,840,751	22,946,639	22,894,426
Net assets - ending	$ 22,310,522	$ 21,538,886	$ 958,324	$ 1,407,753	$ 23,268,846	$ 22,946,639

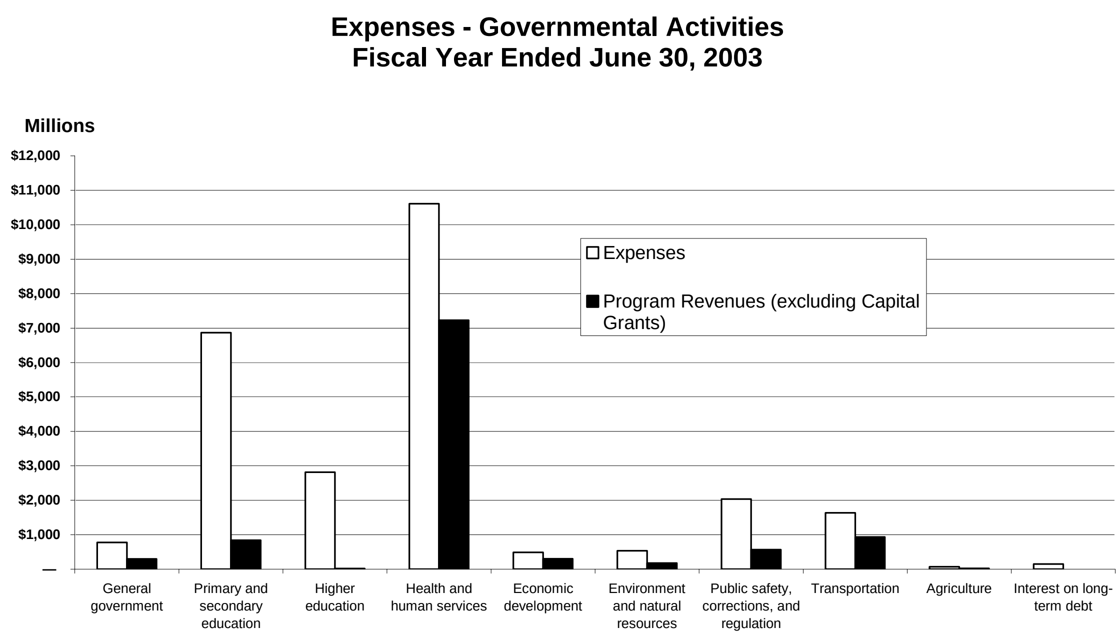
Governmental Activities

As a result of this year's operations, the net assets of governmental activities increased by $771.6 million or 3.6 percent. The net asset increase is primarily related to the receipt of federal fiscal relief in June 2003, an overall increase in tax revenues, and the State's ability to limit the growth in expenses. Total expenses of governmental activities grew by only 1.6 percent during the current period despite funding increases in the State's two largest functional areas, education and health and human services. The growth in education spending is related to enrollment increases at the State's universities and community colleges and the corresponding increases in State capital aid. The growth in health and human services is related to increased spending for the State's Medicaid program, which is the State's largest public assistance program. These funding increases were partially offset by significant spending reductions by other State agencies, which were necessary to manage a budgetary shortfall.

The following chart depicts revenues of the governmental activities for the fiscal year:

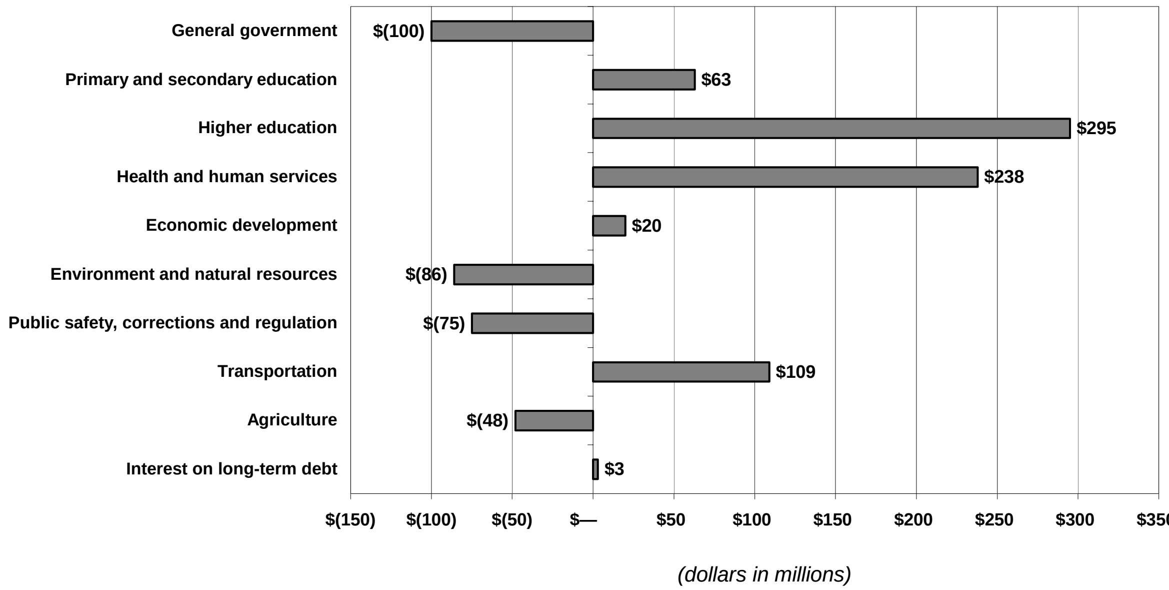


The following chart depicts the total expenses and total program revenues of the State's governmental functions. This format identifies the extent to which each governmental function is self-financing through fees and intergovernmental aid or draws from the general revenues of the State.



The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2002 and 2003:

Dollar Change in Governmental Activities Functional Expenses Between Fiscal Years 2002 and 2003



Business-type Activities

Business-type activities reflect a decrease in net assets of $449.4 million (or 31.9 percent). The key reason for the decline was the State's high unemployment rate, resulting in the unemployment compensation fund finishing the year with a decrease in net assets of $515.6 million (or 65.0 percent). The Unemployment Compensation Fund and the EPA Revolving Loan Fund are the predominant activities, comprising 89.7 percent of the total net assets of business-type activities. Please refer to the discussion of the State's enterprise funds for a more detailed analysis of these two activities.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

The State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements

Governmental Funds

The focus of the State's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. As of the end of the fiscal year, the State's governmental funds reported combined ending fund balances of $2.64 billion, a slight increase (less than one percent) from the prior fiscal year-end (as restated). The major governmental funds are discussed individually below.

General Fund

The General Fund is the chief operating fund of the State. The fund deficit of the General Fund was reduced from $348.79 million at June 30, 2002 to $166.96 million at June 30, 2003. Key factors in reducing the deficit were higher corporate income and sales tax collections, the accelerated repeal of local government reimbursements, increased transfers from other funds, and significant spending reductions by State agencies. Additionally, the State received $136.9 million in federal fiscal relief in June 2003. A more detailed analysis of the General Fund is provided in the budgetary highlights section (see below).

2002-2003 General Fund Budgetary Highlights

The General Fund revenue forecast for fiscal year 2002-2003 was derived on the basis of a continued slow economic recovery. Accordingly, the General Assembly assumed a zero percent growth in the underlying State economic base. This conservative assumption recognized the many uncertainties facing the North Carolina economy, including the potential for further terrorist attacks and unsteady United States financial markets. Actual General Fund baseline revenue collections under the State tax laws as of January 1, 2002 increased slightly reflecting the annualization of revenue enhancements enacted by the 2001 Session of the General Assembly.

Baseline revenues alone were insufficient to continue essential State services. Consequently, the General Assembly enacted General Fund enhancements for fiscal year 2002-2003 totaling $866 million. The most significant enhancement was the accelerated repeal of the local government reimbursements ($333 million), which were payments by the State to replace revenues lost by local governments as a result of taxes repealed by the State. Local governments were granted the authority to establish a one-half cent local option sales tax to replace the reimbursements. Additionally, the annual transfer from the Highway Trust Fund was increased by $205 million for fiscal year 2002-2003, of which $80 million was a recurring transfer and $125 million was an advance to be repaid in future years. Also, $78 million in tobacco settlement revenues accounted for in special revenue funds were transferred to the General Fund. The State's tax laws were also changed to eliminate several tax preferences. Specifically, the General Assembly took steps to ensure that businesses organized as partnerships pay the franchise tax. The General Assembly also broadened and clarified the definition of business income to minimize the ability of multi-state corporations to avoid taxes on certain income. The following table summarizes the 2003 revenue enhancements (amounts expressed in millions):

Revenue Enhancements – 2003 Fiscal Year

Repeal of local government reimbursements	$	333.4
Transfers from :		
Highway Trust Fund – nonrecurring advance		125.0
Highway Trust Fund – recurring inflation adjustment		80.0
Tobacco settlement funds – nonrecurring		78.0
Other funds - nonrecurring		20.4
Business tax revisions		90.0
Delay of individual income tax breaks		51.7
Departmental fee increases		38.2
Other		49.4
Total 2003 enhancements	$	866.1

The General Assembly reduced departmental appropriated budgets for fiscal year 2002-03 by $763 million, of which $532.5 million were recurring and $230.6 million were nonrecurring. Additional reductions in the retirement system and debt service requirements were $242.3 million, bringing total statewide reductions to over $1 billion. The reduction in debt service requirements was due in part to the savings resulting from the issuance of refunding bonds during the fiscal year. Also, based on actuarial reports, it was determined that a contribution to the State employee retirement funds was not necessary, allowing the retirement fund contribution scheduled in the 2001 Session budget to be redirected to other uses.

The State's tax and non-tax revenue shortfall for the 2002-2003 fiscal year was $221 million. The Governor, as Director of the Budget, is responsible for administering the budget enacted by the General Assembly and making sure that the budget remains balanced. In anticipation of this shortfall, the Governor provided reversion targets or spending reductions to state agencies, which provided sufficient funds to cover the budget shortfall. Additionally, the State received $136.9 million in federal fiscal relief in June 2003 (see below).

Analysis of General Fund Budget Variations

The original General Fund budget, including State appropriations and appropriations supported by departmental receipts, serves as a starting point or plan for the Governor to execute the General Fund budget pursuant to the powers granted by the Executive Budget Act. At the state level in North Carolina, it is not unusual for the budget to change during the fiscal year in relation to budget adjustments made to accommodate departmental receipts. The General Fund budget supported by State appropriation, is a subset of the General Fund financial schedule presented in the CAFR as required supplementary information. The current CAFR schedule reflects all spending required to support the State's General Fund activities and the funding to support those activities, including State tax and non-tax revenues, federal revenues, student tuition, and other fees, licenses, and fines.

Under current State budget management practice, particularly related to departmental federal receipts, primary emphasis is placed on comparisons of the final authorized budget and actual spending.

At the State level, budgetary cuts related to State appropriations are implemented by decreasing allowable actual expenditures, as opposed to decreasing the State appropriation through a formal legislative process. The Governor and State agencies maintain legal authority to spend the dollars originally appropriated to them, however, in recent years the actual spending has been limited by the collection of tax and nontax revenue. In extremely rare cases, the General Assembly has held special sessions to formally amend the State appropriation budget.

The portion of the original budget comprising departmental receipts is not intended to be the sole controlling point to manage the State's General Fund budget. The final budget includes amendments for departmental receipts collected during the fiscal year as allowed by law. General Fund departmental receipts are typically authorized for expenditure within the activity that generated the receipt.

Historically, final estimated receipts have varied significantly from the original estimate at the beginning of the fiscal year. State agencies by law must spend departmental receipts prior to spending tax and nontax supported appropriations. If departmental receipts are higher than expected, appropriated dollars may go unspent and be re-appropriated in a subsequent fiscal year.

For the fiscal year 2003, actual receipts of individual income taxes were $181.7 million (or 2.5%) below final budget amounts. Additionally, sales and use tax collections were $93.98 million (or 2.3%) below final budget amounts. By comparison, the State experienced a shortfall in tax receipts of $1.5 billion (or 10.8%) in fiscal year 2002. The shortfall in individual income and sales and use taxes for the 2003 fiscal year is attributable to the State's high unemployment rate and the slowing national and state economy. However, these shortfalls were partially offset by excess collections in other taxes (e.g., corporate income, franchise, and insurance taxes).

Federal Relief Package

On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003. This legislation provided a total of $20 billion in fiscal relief to the States to be divided equally between a flexible grant and an enhancement to the federal medical assistance percentage (FMAP) for Medicaid. In June 2003, North Carolina received $136.9 million in federal funds, which was the first of two equal flexible grant payments. The second flexible grant payment of $136.9 million was received in October 2003. The flexible grant funds are available to be expended for essential government services or financing unfunded federal mandates. North Carolina's FMAP relief for federal fiscal years 2003 and 2004 is estimated to be $101.9 and $176.0 million, respectively.

Hurricane Impact

Hurricane Isabel came ashore near Ocracoke on the Outer Banks of North Carolina on September 18, 2003. The storm hammered the fragile Outer Banks and raked across the northeastern portion of the State causing widespread destruction to homes, businesses and farms. Forty-seven of the State's 100 counties were declared disaster areas. In the first six weeks following the storm, more than $73 million in federal and State disaster assistance to individuals, households, local governments and private non-profits has been approved. The federal government covers 75 percent of the costs; the State pays the other 25 percent.

2003-04 General Fund Budget

The General Fund budget for fiscal year 2003-04, was signed into law on June 30, 2003. The enacted budget was founded upon an overall nominal (real growth plus inflation) economic growth rate of 3.5 percent for 2003-04. The appropriated budget included provisions that were designed to increase General Fund revenues. The most significant revenue adjustment was the continuation of two temporary tax increases that were scheduled to expire in 2003. In 2001, the General Assembly temporarily raised the State sales tax rate by a half-cent to 4.5 percent and the highest individual income tax rate from 7.75 percent to 8.25 percent. The budget continues the State sales tax rate at 4.5 percent and the 8.25 percent income tax bracket for an additional two years. Additionally, the Department of Revenue was given broader authority and resources to collect unpaid tax liabilities.

Highway Fund

The Highway Fund accounts for most of the activities of the North Carolina Department of Transportation, including the maintenance and construction of the State's primary, secondary, and urban road systems, the State Highway Patrol, the Division of Motor Vehicles, and transit and rail. The primary revenue sources of the Highway Fund are three-fourths of gasoline taxes, vehicle registration fees, driver's license fees, and federal funds.

The fund balance of the State Highway Fund decreased from $410.2 million at June 30, 2002 to $299.9 million at June 30, 2003, a decrease of 26.9 percent. The decline was the result of total expenditures exceeding total revenues for the current period. Total revenues decreased by $54 million or 2.5 percent during fiscal year 2003, primarily because of decreases in gasoline taxes and federal funds. In addition, operating transfers from other funds decreased by $79.9 million.

Highway Trust Fund

Legislation creating the Highway Trust Fund was passed by the General Assembly in 1989. It was established to provide a dedicated funding mechanism to meet highway construction needs in North Carolina. The principal revenue sources of the Highway Trust Fund are highway use taxes, one-fourth of gasoline taxes, and various title and registration fees.

The fund balance of the Highway Trust Fund decreased from $425.99 million at June 30, 2002 to $208.2 million at June 30, 2003, a decrease of 51.1 percent. The decline was caused, in part, by an $80 million increase in the annual transfer to the General Fund (see Note 9B to the financial statements). Additionally, total revenues decreased by $45.1 million or 4.6 percent, primarily because of decreases in investment earnings and gasoline taxes. Investment earnings decreased because of reduced cash balances resulting from advances and transfers to the General Fund.

The 2003 General Assembly passed the Governor's "Moving Ahead" transportation initiative to allow, over two years, the use of $630 million of Highway Trust Fund cash balances for highway preservation, modernization, and maintenance. Additionally, it allows $70 million for public transit, rail, ferry, bicycle, and pedestrian projects.

Enterprise Funds

The State's enterprise funds or business-type activities provide the same type of information found in the government-wide financial statements, but in more detail. The major enterprise funds are discussed individually below.

Unemployment Compensation Fund

The net assets of the Unemployment Compensation Fund decreased by $515.6 million during the current fiscal year, which is a 65 percent decrease from the prior fiscal year-end. The decline was primarily related to the significant number of plant closings and layoffs, mainly in the textile, apparel, furniture, and technology industries. Unemployment benefit expenses increased 20.2 percent in fiscal year 2003 to $1.6 billion. The operating loss (excess of operating expenses over operating income) was $956.1 million this year versus $523.8 million in 2002. The cash and investment balances decreased 91.3 percent to $58.2 million. Because of the significant reduction in cash and investment balances, it became necessary for the State to receive advances from its Federal Unemployment Account to ensure timely payment of unemployment benefits. From April to June 2003, the State received repayable advances totaling $62.8 million, which were repaid by year-end with subsequent employer contributions (see Note 6 to the financial statements). From July to September 2003, the State received additional advances totaling $61.5 million. These advances were repaid with subsequent employer contributions and the proceeds from tax anticipation notes. In September 2003, the State issued $150 million in tax anticipation notes with a maturity date of June 30, 2004. The State will use subsequent employer contributions to repay these notes (see Note 22 to the financial statements). The State has estimated that it will save millions of dollars in interest payments by selling tax anticipation notes instead of continuing to borrow from the federal government.

In fiscal years 2003 and 2002, the State also received funding for extended unemployment benefits. In March 2002, the U.S. Congress signed into law the Temporary Extended Unemployment Compensation Act of 2002. This program, which is financed entirely by federal funds, provides extended benefits to claimants who had exhausted their regular State unemployment benefits.

The 2003 Session of the General Assembly enacted legislation to help preserve the integrity of the unemployment insurance tax system. S.L. 2003-67 (Senate Bill 326) clarifies that an employer cannot avoid an undesirable unemployment insurance rate by shifting employees to a newly created company with a more desirable tax rate. This practice is known as State unemployment tax avoidance or "SUTA dumping" (i.e., since the bulk of the old company's employees are moved to a new company and the higher tax rate of the older company is "dumped").

In September 2003, North Carolina's seasonally adjusted unemployment rate was 6.4 percent, which was slightly higher than the national unemployment rate of 6.1 percent. For comparison, the State and national unemployment rates in September 2002 were 6.6 percent and 5.7 percent, respectively.

EPA Revolving Loan Fund

The net assets of the EPA Revolving Loan Fund increased by $61.4 million during the current fiscal year, which was an 11.8 percent increase from the prior fiscal year-end. Operating income was $8.5 million (excess of operating revenues over operating expenses). Nonoperating revenues were $45.7 million, consisting primarily of federal capitalization grants. In addition, $7.3 million of clean water bond proceeds were transferred in from special revenue funds. In previous years, the activities of this fund were accounted for in a special revenue fund (see Note 21 to the financial statements).

Capital Asset and Debt Administration

Capital Assets

As of June 30, 2003, the State's investment in capital assets was $23.77 billion, which represents an increase of 6.3 percent from the previous fiscal year-end (see table below).

Capital Assets as of June 30
(net of depreciation, dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Land	$ 7,714,059	$ 7,209,632	$ 2,563	$ 2,563	$ 7,716,622	$ 7,212,195
Buildings	1,332,508	1,329,529	13,816	14,603	1,346,324	1,344,132
Machinery and equipment	551,041	561,897	1,046	857	552,087	562,754
Infrastructure:						
State highway system	12,444,210	11,546,521	—	—	12,444,210	11,546,521
Other infrastructure	84,093	87,709	7,984	8,800	92,077	96,509
Intangible assets	105,650	106,629	—	—	105,650	106,629
Art, literature, and other artifacts	29,977	28,594	—	—	29,977	28,594
Construction in progress	1,465,889	1,453,742	20,019	15,675	1,485,908	1,469,417
Total	$ 23,727,427	$ 22,324,253	$ 45,428	$ 42,498	$ 23,772,855	$ 22,366,751
Total percent change between fiscal years 2002 and 2003	**6.3 %**		**6.9 %**		**6.3 %**	

The increase in capital assets is explained primarily by additions to construction in progress ($1.2 billion) and right-of-ways ($487 million) related to the State highway system.

The largest component of capital assets is the State highway system. The State has approximately a 78,490-mile highway system, making it the second largest State-maintained highway system in the nation. The system continues to increase as roads are widened and new roads and bridges are constructed.

In an effort to manage a budgetary shortfall for the 2002-2003 fiscal year, the Office of State Budget and Management (OSBM) reduced capital spending. OSBM halted, as necessary, capital improvement projects for which State funds had been appropriated but not placed under State contract and transferred unused capital improvement funds to the General Fund.

In July 2003, the N.C. Infrastructure Finance Corporation (i.e., a blended component unit of the State) acquired three close security correctional facilities by issuing $218.4 million in lease-purchase revenue bonds. The Department of Correction is undertaking construction initiatives to address a cell shortfall and to allow for the implementation of sentencing reform.

As further detailed in Note 19(F) to the financial statements, the State has commitments of $1.6 billion for the construction of highway infrastructure. Other commitments for the construction and improvement of State government facilities totaled $362.6 million.

More detailed information about the State's capital assets is presented in Note 5 to the financial statements.

Long-term Debt

At year-end, the State had total long-term debt outstanding of $4.10 billion, an increase of 17.6 percent from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
General obligation bonds	$ 4,066,990	$ 3,467,325	$ —	$ —	$ 4,066,990	$ 3,467,325
Revenue bonds	—	—	9,570	9,805	9,570	9,805
Certificates of participation	17,500	—	—	—	17,500	—
Notes payable	9,629	11,753	—	—	9,629	11,753
Total	$ 4,094,119	$ 3,479,078	$ 9,570	$ 9,805	$ 4,103,689	$ 3,488,883
Total percent change between fiscal years 2002 and 2003	**17.7 %**		**(2.4)%**		**17.6 %**	

The State's general obligation bonds are secured by a pledge of the faith, credit, and taxing power of the State. The revenue bonds issued by the State are secured solely by specified revenue sources. The certificates of participation issued by the N.C. Infrastructure Finance Corporation, a blended component unit of the State, are secured solely by lease payments made by the State, and in the event of default, by a security interest in the leased facilities pursuant to a leasehold deed of trust.

During the 2003 fiscal year, the State issued $711.6 million in general obligations bonds (excluding refunding issues) and $17.5 million in certificates of participation (COPs). The new general obligation debt consisted of $25.3 million in clean water bonds, $83.0 million in natural gas bonds, and $603.3 million in public improvement bonds (consolidation of clean water bonds and higher education bonds). The proceeds of the COPs will be used to acquire, construct, and equip wildlife education centers and administrative facilities for the North Carolina Wildlife Resources Commission. In addition, the State refinanced $502.4 million of its existing debt in 2003 to improve cash flow and to take advantage of lower interest rates. By refinancing the debt, the State will reduce its future debt service payments by approximately $39.0 million over the next 16 years.

The 1999-2000 Session of The General Assembly of North Carolina authorized the issuance of up to $3.1 billion of higher education improvement bonds, which were subsequently approved by the voters of the State on November 7, 2000. The proceeds of these general obligation bonds will be used solely to construct new buildings and to renovate and modernize existing buildings on the State's 58 community college and 16 University of North Carolina campuses. These improvements are needed to meet enrollment demand and to ensure that the State's college and university buildings meet modern code requirements and are equipped to prepare graduates for twenty-first century jobs. The bond legislation passed by the General Assembly specifies the amount of bond funding that will flow to each community college and university campus. At year-end, the authorized but unissued higher education bonds were $1.99 billion.

The State obtained authorization from the General Assembly in 2003 to enter into financing agreements or special indebtedness to:

- Provide $300 million for the repair and renovation of State facilities and related infrastructure;
- Provide $110 million for the construction of a new State mental health facility, which will replace two hospitals being closed;
- Lease purchase three prison facilities;
- Acquire two private prisons that are currently being leased by the State; and
- Provide $6.8 million for the planning and design of three youth development centers and some utility infrastructure and site work.

The timing of these issues has not been determined; however, funds were provided in the biennium budget ending June 30, 2005 for debt service for the $300 million of repair and renovation special indebtedness. The use of alternative financing methods, which do not require voter approval, will provide financing flexibility to the State and will permit the State to take advantage of changing financial and economic environments.

Credit Ratings

The State's general obligation bonds are rated "AAA" by Standard & Poor's and Fitch and "Aa1" by Moody's. In August 2002, Moody's downgraded the State's credit rating for general obligation debt from "AAA" to "Aa1", representing the first time since 1960 that North Carolina had less than a "AAA" rating. While Moody's praised the strength of executive powers available to insure a balanced budget, it advised that the primary reasons for the downgrade were the State's continued budget pressure, reliance on non-recurring revenues, and weakened balance sheet. Also, Moody's commented that the task of restoring structural budget balance and rebuilding reserves faces political and economic obstacles.

The certificates of participation issued by the North Carolina Infrastructure Finance Corporation are rated "AA+" by Standard & Poor's, "AA" by Fitch, and "Aa2" by Moody's.

Limitations on Debt

The Constitution of North Carolina (Article 5, Section 3) imposes limitations on the increase of State debt. It restricts the General Assembly from contracting a debt secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State, except for the following purposes:

1. To fund or refund a valid existing debt;
2. To supply an unforeseen deficiency in the revenue;
3. To borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 percent of such taxes;
4. To suppress riots or insurrections; or to repel invasions;
5. To meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor; and
6. For any other lawful purpose, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the next preceding biennium.

More detailed information about the State's long-term liabilities is presented in Note 7 to the financial statements.

Requests for Information

This financial report is designed to provide our citizens, taxpayers, customers, and investors and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the North Carolina Office of the State Controller, Accounting and Financial Reporting Section, 1410 Mail Service Center, Raleigh, N.C. 27699-1410. In addition, this financial report is available on the Office of the State Controller's Internet home page at http://www.osc.state.nc.us/financial/financial.html.