State of North Carolina
Office of the State Controller

Michael F. Easley, Governor | Robert L. Powell, State Controller

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
Citizens of North Carolina

It is our pleasure to furnish you with the 2004 Comprehensive Annual Financial Report (CAFR) of the State of North Carolina in compliance with G.S. 143B-426.39. This report has been prepared by the Office of the State Controller. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the State government and this office. To the best of our knowledge and belief, this financial report is complete and reliable in all material respects. We believe all disclosures necessary to enable you to gain an understanding of the State's financial activities have been included.

Although the State budgets and manages its financial affairs on the cash basis of accounting, G.S. 143-20.1 requires the Office of the State Controller to prepare a comprehensive annual financial report (CAFR) in accordance with generally accepted accounting principles in the United States of America (GAAP). Except for exhibits and notes clearly labeled otherwise, this CAFR has been prepared in accordance with GAAP.

For the convenience of users we have divided this comprehensive annual financial report into three major sections, described as follows:

- The **introductory section** includes this transmittal letter and the State's organization chart, including a listing of principal State officials.
- The **financial section** includes management discussion and analysis, the basic financial statements (government-wide financial statements, fund financial statements, and notes), other required supplementary information, the combining and individual fund financial statements, and schedules.
- The **statistical section** includes selected financial, non-financial and demographic information, much of which is presented on a ten-year basis, as well as required supplementary information.

Management of the government is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State 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 generally accepted accounting principles. 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 cost 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.

GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, requires that management provide a narrative introduction, overview and analysis to accompany the Basic Financial Statements in the form of management discussion and analysis (MD&A). This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

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Profile of the Government

State Reporting Entity and Its Services

The State of North Carolina entity as reported in the CAFR includes all fund types of the departments, agencies, boards, commissions and authorities governed and legally controlled by the State's executive, legislative and judicial branches. In addition, the reporting entity includes legally separate component units for which the State is financially accountable. The component units are discretely presented in the government-wide financial statements. The State's discretely presented major component units are the University of North Carolina System; the State's community colleges; Golden LEAF, North Carolina Housing Finance Agency, and North Carolina State Education Assistance Authority. The criteria for inclusion in the reporting entity and its presentation are defined by the Governmental Accounting Standards Board (GASB) in its GASB Codification Section 2100. These criteria are described in Note 1 of the accompanying financial statements.

The State and its component units provide a broad range of services to its citizens, including public education; higher education; health and human services; economic development; environment and natural resources; public safety, corrections, and regulation; transportation; agriculture; and general government services. The costs of these services are reflected in detail and in summary in this report.

Budgetary Control

In addition to internal controls discussed previously, the State maintains budgetary controls. The objective of these budgetary controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the General Assembly. Activities of the General Fund and most departmental special revenue funds are included in the annual appropriated budget. The State Highway Fund and the Highway Trust Fund, the State's major special revenue funds, are primarily budgeted on a multi-year basis. Capital projects are funded and planned in accordance with the time it will take to complete the project. The level of budgetary control (that is, the level at which expenditures cannot legally exceed the appropriated amount) is exercised at both the departmental and university level by way of quarterly allotments, with allotment control exercised by the State Controller, and on the program line-item levels requiring certain approvals by the Director of the Budget. Legislative authorization of departmental expenditures appears in the State Appropriation Bill. This "Certified Budget" is the legal expenditure authority; however, the Office of State Budget and Management (OSBM) may approve executive changes to the legal budget as allowed by law. This results in the "Final Budget" presented in the required supplementary information.

Economic Condition and Outlook

National Economic Outlook

After experiencing robust growth during the first half of the 2004 calendar year, the nation's economy is now working through what is commonly referred to as a "soft patch". This weakness is due to a combination of record energy prices (in actual dollars) and periodic warnings of potential terrorist activity. An additional issue has to do with the fact that the stimulus from three federal tax packages enacted in recent years is starting to run out.

	2001-02 Actual	2002-03 Actual	2003-04 Actual	2004-05 Projected
U.S. INDICATORS				
Real Economic Growth*	0.8%	2.3%	4.4%	3.5%
Nonfarm Employment	-1.0%	-0.6%	0.2%	1.7%
Personal Income	2.0%	2.1%	4.7%	4.9%
Industrial Production	-3.5%	0.5%	2.4%	4.4%
Corporate Profits (Pre-Tax)	-8.6%	17.3%	15.2%	12.1%
Short-Term Interest Rates (Actual Rate)	2.3%	1.4%	1.0%	2.0%
Mortgage Rates (Actual Rate)	6.9%	6.0%	5.7%	6.1%
Inflation (CPI)	1.8%	2.2%	2.2%	2.5%

*Adjusted for inflation.

It will be interesting to see how the current weakness affects the speed with which the Federal Reserve ratchets up interest rates. As recently as last winter many observers felt that the tenuous nature of the recovery would eliminate any rate hikes during 2004. Fed officials even confirmed this operating strategy in unusually candid public remarks.

However, strong growth during the first few months of the year led to a re-examination of the position last spring. After raising the benchmark federal funds rate from .75% to 1% on June 30 and to 1.25% in August, the Federal Reserve is now signaling additional rate hikes will take place at a "measured" pace. The message to be gleaned from the Fed's language is that future actions will depend on how the economic data falls out. The recent weakness may cause monetary officials to hold off on the anticipated September increase, especially in light of their pronouncements about the impact of high energy prices.

In any case, the die has been cast and rates will rise over the next couple of years. During the 1994 tightening, short term borrowing rates rose from 3% to 6% in a 13-month period. Economy.com, the forecasting firm used by Fiscal Research, expects the rates to rise to 2.0% by the first quarter of 2005 and to top out at 5.0% during the first quarter of 2007. The forecasting firm used by the Office of State Budget and Management, Global Insight Inc., is also expecting a 2.0% rate by the end of this year, rising to 3.5% by 2006.

A continuing problem for the economy is the subpar recovery in jobs. This is due to a combination of the movement of jobs overseas and the reticence of employers to ramp up staffing levels in an atmosphere of uncertainty. North Carolina is on the front line of this shift, due in part to NAFTA. This impact had begun well before the 2001 recession, as shown by the job growth data below:

N.C. Employment Growth
In Selected Major Sectors

Year	Manufacturing	Finance	Services
1994	0.5%	1.2%	7.6%
1995	0.5%	1.9%	4.5%
1996	-1.7%	8.2%	4.5%
1997	-1.0%	7.4%	5.7%
1998	-0.5%	5.3%	6.0%
1999	-2.5%	-0.4%	6.0%
2000	-2.4%	0.7%	3.3%
2001	-7.1%	4.6%	1.4%
2002	-8.6%	.7%	1.1%
2003	-6.1%	1.5%	.7%

A second issue has to do with the impact of higher energy prices on consumer spending. From late winter 1999 to early summer 1999, gas prices in North Carolina rose from around 80 cents per gallon to $1.00, and to $1.25 by early 2000. Once motorists realized that the increase might be more than a temporary spike, they cut back on purchases of other items (except for vehicles).

One way to measure this impact is to look at gross state and local sales tax collections. After rising 8.6% for the second quarter of 1999, the rate of increase fell to 6.3% for the third quarter, 5.4% for the fourth quarter, and to 4.5% by the first quarter of 2000. This problem was compounded by the fact that heavy promotional activity by auto dealers propped up car sales. The net result of these factors meant that the additional dollars going to vehicle purchases and energy costs "crowded out" spending on other items.

So far the impact of higher energy prices in 2004 on the overall economy and retail sales has been muted. For one thing, the recovery in equity prices has enhanced the "paper wealth" of many investors. In addition, the substitution of natural gas and other energy sources for fuel oil has minimized the impact of higher fuel prices on manufacturing production costs and family budgets. A third factor is the cash received by homeowners who have refinanced their mortgages.

A concern is that financing for retail activity may be coming from additional credit card usage and such levels cannot be sustained indefinitely. A measure of this issue is the fact that unlike the 1992-94 recovery, sales tax collections are growing much faster than withholding tax receipts.

Due to this concern and the phase out of the impact of the 2001-03 federal tax cuts, the underlying national economic assumptions used in the budget reflect the expectation that growth will slow during the 2004-05 fiscal years.

State Prospects

One of the primary characteristics of the 2001 recession was the impact on the manufacturing sector. This is important to North Carolina because 15% of our nonagricultural employment is in manufacturing versus 11% for the U.S. A more important measure is the share of Gross State Product represented by manufacturing: 21% in North Carolina versus 16% for the nation.

The loss of manufacturing jobs did not begin with the 2001 recession. Data compiled by the Employment Security Commission indicate that manufacturing experienced a fairly rapid recovery from the 1990-91 recession, with employment growth of 2.6% in 1993. In fact, the “boom and bust” nature of manufacturing is one reason why the state’s economy grew 33% faster than the national experience following the 1981-82 recession and 45% quicker following the Gulf War downturn. Expressed another way, North Carolina was the fifth fastest growing state during the 1992-93 period in terms of personal income, due in part to the recovery in manufacturing.

After a leveling off period, manufacturing employment began a steady decline in mid-1995 due to the mild national economic slowdown and the kicking in of NAFTA. The rate of decline began to accelerate in February 2001 and peaked at an 8.6% rate in 2002. Particularly hard hit were the textile and apparel sectors, with North Carolina jobs in these sectors dropping over 15% on a year-over-year basis by the spring of 2001. While the rate of decline has slowed due to the start of the economic recovery, the erosion continues. The only saving grace is that the loss of traditional jobs has been so great that these sectors exert a much smaller impact on the overall economy than in the past.

For the 2004-05 fiscal year, we are budgeting on the basis of a continued subpar economic recovery in North Carolina, both in terms of the absolute level and the normal growth premium relative to the U.S. This experience would be very different from the explosive growth in the state’s economy during the last two recoveries.

NORTH CAROLINA INDICATORS	2001-02 Actual	2002-03 Actual	2003-04 Actual	2004-05 Projected
Personal Income	2.2%	2.3%	5.2%	5.5%
Nonfarm Employment	-2.1%	-1.1%	0.1%	2.1%
Unemployment Rate (Actual Rate)	6.5%	6.5%	6.0%	5.4%
Average Hourly Earnings (Manufacturing)	2.6%	2.6%	4.4%	3.2%
Retail Sales	2.5%	1.1%	6.7%	3.9%
Housing Activity	7.3%	6.1%	17.0%	-14.3%
Auto Sales	-5.5%	-1.4%	8.5%	-10.9%

— Economic analysis prepared by David Crotts
Fiscal Research Division
North Carolina General Assembly
October 29, 2004

Issues and Observations

During fiscal year 2004, the Governor, the General Assembly, and the departments and agencies of State government worked to address key issues facing State government and the citizens of North Carolina. More discussion of the financial issues of North Carolina can be found in the Management’s Discussion and Analysis (MD&A) section of this document.

Other Post-Employment Benefits

Rising healthcare costs continue to be a concern throughout the State and the nation. Healthcare costs impact State budget programs through increasing expenses not only in Medicaid, but also in other State and federal healthcare programs. In recent years, adjustments have been made to deductibles, co-payments, and benefits coverage under the State Health Plan in an attempt to slow the growth of State budget healthcare costs.

In light of the current and future concerns related to rising healthcare costs, the Governmental Accounting Standards Board (GASB) has been working on the issuance of accounting and reporting standards for other post-employment benefits since the mid-90’s. In April 2004, GASB issued **Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*** (effective for fiscal year 2006-07), and in June 2004, GASB issued **Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*** (effective for fiscal year 2007-08).

These new standards will require governmental employers to start accounting for the cost of certain post employment benefits while employees are still working. Public sector employers already accrue the cost of pensions as employees are working. These new standards will have a significant impact for most state and local governments. In addition to pensions, many state and local governmental employers provide other postemployment benefits (OPEB) as part of the total compensation offered to attract and retain the services of qualified employees. The cost of these future benefits is a part of the cost of providing public services *today*. OPEB includes postemployment healthcare, as well as other forms of postemployment benefits, such as life insurance and disability. Currently, the State and most other governmental employers finance OPEB plans on a pay-as-you-go basis. The financial statements generally do not report financial effects of OPEB until the promised benefits are paid, often many years after the related employee services are received.

These new GASB standards will improve the relevance and usefulness of financial reporting by (a) requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees’ years of service, and (b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan. In addition, the proposed accounting change would provide information useful in assessing potential demands on the employer’s future cash flows.

In preparation for the implementation of these new standards, the General Assembly through the 2004 Appropriations Act established the Retiree Health Benefit Trust Fund to hold accumulated contributions from employers and any earnings on those contributions shall be used to provide health benefits to retired and disabled employees and their applicable beneficiaries. Employer contributions to the Fund are irrevocable. The assets of the Fund are dedicated to providing health benefits to retired and disabled employees and their applicable beneficiaries and are not subject to the claims of creditors of the employers making contributions.

Three actuarial studies related to retiree healthcare have been completed as the State has worked to get its hands around the issue and how to deal with it. Each of the three studies, beginning in 1996, have reflected a substantial liability related to the State’s commitment to provide healthcare to teacher and state employee retirees. The unfunded actuarial liability has grown based on two formal studies from $5.4 billion in 1996, to $8.1 billion in 1999. More recently, based on an informal estimate, the unfunded accrued liability may be in excess of $10 billion in 2004. This informal study does not reflect any changes that may arise in 2006 due to the “Medicare Prescription Drug, Improvements, and Modernization Act of 2003”.

Beginning in fiscal year 2006-07, the actuarial data will be disclosed in the notes to the State CAFR and will also be presented as Required Supplementary Information (RSI). The unfunded actuarial liability will not be recorded as an accounting liability but will be disclosed in the notes to the financial statements, and as required supplementary information.

Beginning with the 2008 CAFR, the difference between the State’s contractual requirement and the amount the State contributes or pays for retiree medical benefits will be recorded as an accounting liability on the State’s government-wide financial statements.

The State's largest OPEB plan, the Retiree Health Care Plan, is currently being funded on a pay-as-you-go basis, resulting in a significant unfunded actuarial liability. The principal results of the Plan's most recent actuarial valuation are as follows:

Because the GASB's proposed guidance on OPEB will significantly impact the State's CAFR, we have the following recommendations:

- ***The State needs to obtain an actuarial valuation for the retiree health plan at least biennially***. Annual valuations would be preferable for a state of our size, due to the potential impact on teachers and state employees.
- On a prospective basis, the State should consider the long-term impact of the current benefits structure as well as potential changes to that structure**.**

Information Technology

The 2004 General Assembly dedicated considerable time and effort into the evaluation of current information technology management, organization, and operations at the statewide and agency levels for North Carolina State government. The result of that evaluation was legislation enacted in Senate Bill 991 that overhauled information technology authority by transferring it from a central management committee to the Chief Information Officer for the State.

Senate Bill 991 provides for the abolishment of the Information Resources Management Committee, the heretofore approval and oversight group for IT projects, and consolidated all functions under the Chief Information Officer. These functions include:

- **Responsibility for the review, approval and management of all IT projects above an established threshold;**
- **The authority to proceed with an enterprise approach for procurement of IT products and services and the authority to implement such solutions;**
- **The responsibility for review and approval of all agency IT plans and the development of a biennial State Information Technology Plan for submission to the General Assembly;**
- **An assessment of the IT inventory throughout State government and an assessment of the IT deficiencies along with a five year plan for unmet needs;**
- **The creation of an Information Technology Fund that may be used to meet statewide enterprise needs as approved by the General Assembly; and**
- **The authority to establish IT standards statewide.**

In short, the General Assembly adopted the proposal of the Governor to bring the management, oversight and operations of information technology under the direct control of the Governor.

Included in Senate Bill 991 is the continuation of the State Business Infrastructure Program (SBIP) that has been in progress since 2002. This project was authorized by the 2002 General Assembly to evaluate the State's core business functions and report back to the General Assembly with an assessment and plan to address deficiencies. This activity occurred in two phases that included an inventory and assessment, followed by a blueprint for addressing priority deficiencies. The final report was presented to the 2004 General Assembly and funding was authorized under Senate Bill 991 to proceed with the development of business requirements for the most "at risk" component of the study, Human Resources and Payroll (HR/Payroll).

Under the guidance of the Office of the State Controller, and in collaboration with the State Personnel Officer, Chief Information Officer, and Deputy State Budget Officer, the business development phase for HR/Payroll is currently underway. This process is scheduled to be completed by late Spring, at which time an RFP will be developed and the General Assembly will be asked to consider funding for the implementation phase of this component of the SBIP.

If funding is approved, the HR/Payroll implementation will begin by late 2005 with an expected implementation period of between 18 to 24 months.

Concurrent with this is the next phase of the SBIP, the development of a statewide data warehouse for consolidation of information for use by state managers. The SBIP Program Steering Committee will be considering a plan for moving forward with this component of the SBIP within the next thirty to sixty days. Depending on the development plan, the data warehouse project is expected to begin in early 2005.

Financial Information

The MD&A provides an overview of the State's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, MD&A focuses on the State's major funds: the General Fund, the Highway Fund and the Highway Trust Fund.

Pension Benefits

The State contributes to the Teachers' and State Employees' Retirement System, the Consolidated Judicial Retirement System, the Legislative Retirement System, the Firemen's and Rescue Squad Workers' Pension Fund, the Supplemental Retirement Income Plan of North Carolina, and the North Carolina National Guard Pension Fund. The Local Governmental Employees' Retirement System is administered by the State but the State is not a participant.

The retirement systems experienced a total return from investments of 12.01% for the one-year period, a return of 4.85% for the three-year period and a return of 4.18% for the five-year period, ended June 30, 2004. These returns represent strong investment results, and reflect the conservative asset allocation and attention to investment quality that have guided the plan's investment policy. The combined North Carolina Retirement Systems lead the nation in fiscal health because of wise management, consistent state contributions and a conservative investment strategy.

The Teachers' and State Employees' Retirement System (TSERS), the largest of the pension trust funds, continued to be fully funded, based on the December 31, 2003 actuarial valuation. Specifically, the TSERS was funded at 108.1%, with the actuarial value of assets of $45.118 billion exceeding the actuarial accrued liability of $41.734 billion by $3.384 billion at December 31, 2003. Employer contributions to the TSERS increased by $55.8 million above the prior fiscal year. Investment balances increased by $3.546 billion, or 8.21% above the prior fiscal year, with a net investment income of $5.132 billion. The TSERS experienced a $149.3 million increase in benefit payments to retirees, an increase of 7.4% from fiscal year 2003.

Debt Administration

The State's general obligation bonds are rated Aa1 by Moody's, AAA by Standard & Poors, and AAA by Fitch. These favorable ratings have enabled the State to sell its bonds at interest rates considerably below the Bond Buyer's Index, thereby providing substantial savings to North Carolina taxpayers.

Cash Management

It is the policy of the State that all agencies, institutions, departments, bureaus, boards, commissions and officers of the State shall devise techniques and procedures for the receipt, deposit and disbursement of monies coming into their control and custody which are designed to maximize interest-bearing investment of cash, and to minimize idle and nonproductive cash balances. The State Controller, with the advice and assistance of the State Treasurer, the State Budget Officer, and the State Auditor, develops, implements, and amends the *Statewide Cash Management Policy*. All cash deposited with the State Treasurer by State entities is managed in pooled investment accounts to maximize interest earnings. During fiscal year 2004, uncommitted State funds were invested in short-term and medium-term U.S. Government notes and bonds, as well as other deposits, which had a composite average yield of 3.22%.

Risk Management

The State maintains self-insurance programs for employee health; general liability; medical malpractice; workers' compensation; and automobile, fire and other property losses. The State limits its risk for general liability; medical malpractice; and automobile fire and other property losses by purchasing private insurance for losses in excess of deductibles. See Note 14 of the Notes to the Financial Statements for a full description of the State's risk management program.

Other Information

Independent Audit

In compliance with State statute, an annual financial audit of the State reporting entity is completed each year by the North Carolina Office of the State Auditor. The Auditor's examination was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and his opinion has been included in this report. In addition, the State coordinates the *Single Audit* effort of all federal funds through the State Auditor.

Certificate of Achievement

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 Carolina for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2003. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. The CAFR 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 our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to GFOA.

Acknowledgments

In conclusion, we believe this report provides useful data to all parties using it in evaluating the financial activity of the State of North Carolina. We in the Office of the State Controller express our appreciation to the financial officers throughout State government and to the Office of the State Auditor for their dedicated efforts in assisting us in the preparation of this report. Any questions concerning the information contained in this Comprehensive Annual Financial Report should be directed to the Office of the State Controller at (919) 981-5454.

Respectfully submitted,

Robert L. Powell
State Controller

December 8, 2004

Certificate of Achievement

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of North Carolina

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2003

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.

President

Executive Director