MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

The following is a narrative overview and analysis of the State of North Carolina's (the State) financial performance for the fiscal year ended June 30, 2005. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

Financial Highlights

Government-wide Financial Statements:

— The State's total net assets increased by $1.302 billion or 5.5% as a result of this year's operations. Net assets of governmental activities increased by $981.8 million, or 4.3% due, in part, to higher than expected growth in tax revenues. Net assets of business-type activities increased by $320.7 million, or 41.6% due to the improved financial results of the Unemployment Compensation Fund. At year-end, net assets of governmental activities and business-type activities totaled $23.909 billion and $1.092 billion, respectively.

— Component units reported net assets of $12.089 billion, an increase of $1.43 billion or 13.4% from the previous year. The majority of the increase ($1.0 billion) is due to the net increase in capital assets for the University of North Carolina System and community colleges. The capital asset additions were financed in part by state debt proceeds.

Fund Financial Statements:

— The fund balance of the General Fund improved from a negative $271.9 million at June 30, 2004 (as restated) to a negative $78.8 million at June 30, 2005. A key factor in reducing the deficit was the General Assembly's decision to forgive repayment of the $125 million advanced from the Highway Trust Fund during the 2002-03 fiscal year.

— The fund balance of the Highway Fund increased from $231.2 million at June 30, 2004 to $369.4 million at June 30, 2005, an increase of 59.8%. The fund balance growth was attributable to increases in federal billings and gasoline taxes.

— The fund balance of the Highway Trust Fund decreased from $266.1 million at June 30, 2004 to a negative $2.9 million at June 30, 2005, a decrease of 101% because of the forgiveness of debt to the General Fund (see above).

— The net assets of the Unemployment Compensation Fund increased from $20.1 million at June 30, 2004 to $258.5 million at June 30, 2005. The significant increase is explained by the State's falling unemployment rate since the 2002 recession.

Capital Assets:

— The State's investment in capital assets (net of accumulated depreciation) was $27.566 billion, which represents an increase of 7.49% from the previous fiscal year.

— The largest component of capital assets, 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 78,844 miles of roadway, constituting the second largest highway system in the nation. The system also includes 17,250 bridges spanning 380 miles. At year-end, the State reflected $14.247 billion (net of accumulated depreciation) of highway system infrastructure.

— This year's major capital asset additions were for highway construction ($1.5 billion), highway land improvements ($556 million) and the acquisition/construction of correctional facilities ($167 million).

Long-term Debt:

— The State had long-term debt outstanding of $6.483 billion, an increase of 17.1% from the previous fiscal year-end. The long-term debt balance includes $740.2 million of special obligation (non-voted) debt issued for governmental activities.

— 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. In September 2004, Moody's upgraded the State's outlook from stable to positive.

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 54) 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 56 and 57) 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 72. 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 145 and 146).

Fund Financial Statements

The fund financial statements provide more detailed information about the State's most significant funds (i.e., major funds) – not the State as a whole. 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 particular purposes. In addition to the major funds, page 168 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 cash and other financial assets that can readily be converted to cash flow in and out (i.e., inflows and outflows of spendable resources) and the balances left at year-end that are available for spending (i.e., balances of spendable resources). Consequently, the governmental fund financial statements provide a detailed short-term view that helps users determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. The State prepares the governmental fund financial statements using the modified accrual basis of accounting and a current financial resources measurement focus. Because this information does not encompass the additional long-term focus of the government-wide statements, a reconciliation schedule, which follows each of the governmental fund financial statements, explains the relationships (or differences) between them. Information is presented separately in the governmental fund financial statements for the General Fund, the Highway Fund, and the Highway Trust Fund, all of which are considered to be major funds. Data for all other governmental funds are combined into a single aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

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 are used to report activities for which fees are charged to external users for goods and services. The Unemployment Compensation Fund and the EPA Revolving Loan Fund are our most significant enterprise funds. Internal service funds are used to report activities that provide goods and services to the State's other programs and activities on a cost-reimbursement basis, such as the State Property Fire Insurance Fund, the Motor Fleet Management Fund, Computing Services Fund, and the State Telecommunications Services Fund. Because the State's internal service funds predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. Information is presented separately in the proprietary fund financial statements for the Unemployment Compensation Fund and the EPA Revolving Loan Fund, both of which are considered to be major funds. Conversely, separately aggregated columns are presented for the nonmajor enterprise funds and the internal service funds. Individual fund data for the nonmajor enterprise funds and internal service funds is provided in the form of combining statements elsewhere in this report.

Fiduciary funds -- The State acts as a trustee or fiduciary for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets. These funds, which include pension and other employee benefit trust funds, private-purpose trust funds, investment trust funds, and agency funds, are reported using accrual accounting. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to the 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 70 of this report.

Required Supplementary Information

Following the basic financial statements and notes to the financial statements is Required Supplementary Information (RSI), which accompanies the basic financial statements. The RSI is mandated by the GASB and includes General Fund budgetary comparison schedules reconciling the statutory to the generally accepted accounting principles (GAAP) fund balances at fiscal year-end, and pension plan trend information related to funding progress and contributions.

Other Supplementary Information

Other supplementary information includes the introductory section, the combining financial statements for non-major governmental funds, non-major enterprise funds, internal service funds, fiduciary funds, and non-major discretely presented component units.

FINANCIAL ANALYSIS OF THE STATE AS A WHOLE

The State's combined net assets increased $1.302 billion or 5.5% over the course of this fiscal year's operations. The net assets of the governmental activities increased $981.8 million or 4.3% and business-type activities increased $320.7 million or 41.6%. The following table was derived from the government-wide Statement of Net Assets:

Net Assets
June 30, 2005 and 2004
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2005	**2004**	**2005**	**2004**	**2005**	**2004**
Current and other non-current assets	$ 11,958,784	$ 10,572,379	$ 1,439,494	$ 1,232,408	$ 13,398,278	$ 11,804,787
Capital assets, net	27,511,607	25,589,324	54,645	55,173	27,566,252	25,644,497
Total assets	39,470,391	36,161,703	1,494,139	1,287,581	40,964,530	37,449,284
Long-term liabilities	7,031,391	5,961,023	13,131	12,111	7,044,522	5,973,134
Other liabilities	8,529,958	7,273,393	389,398	504,577	8,919,356	7,777,970
Total liabilities	15,561,349	13,234,416	402,529	516,688	15,963,878	13,751,104
Net assets:						
Invested in capital assets, net of related debt	26,434,617	24,702,120	44,007	44,512	26,478,624	24,746,632
Restricted	1,314,397	1,451,548	970,615	665,547	2,285,012	2,117,095
Unrestricted	(3,839,972)	(3,226,381)	76,988	60,834	(3,762,984)	(3,165,547)
Total net assets	$ 23,909,042	$ 22,927,287	$ 1,091,610	$ 770,893	$ 25,000,652	$ 23,698,180

The largest component of the State's net assets ($26.479 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 ($2.285 billion). Net assets are restricted when constraints placed on their use are either externally imposed or are imposed by law through constitutional provisions or enabling legislation. 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 $3.84 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 $6.483 billion of total long-term debt outstanding at June 30, 2005, $5.40 billion 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. However, by issuing such debt, the State is left to reflect significant liabilities on its statement of net assets (reflected in the unrestricted net asset component) without the benefit of recording the capital assets constructed or acquired with the proceeds from the debt issuances. Additionally, as of June 30, 2005, the State's governmental activities have significant unfunded liabilities for compensated absences in the amount of $327 million (see Note 7 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, 2005 and 2004
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2005	2004	2005	2004	2005	2004
Revenues:						
Program revenues:						
Charges for services	$ 1,672,482	$ 1,474,548	$ 1,145,976	$ 955,720	$ 2,818,458	$ 2,430,268
Operating grants and contributions	11,380,864	10,101,118	54,760	305,500	11,435,624	10,406,618
Capital grants and contributions	1,011,451	884,345	452	892	1,011,903	885,237
General revenues:						
Taxes						
Individual income tax	8,244,275	7,407,455	—	—	8,244,275	7,407,455
Corporate income tax	1,143,458	760,180	—	—	1,143,458	760,180
Sales and use tax	4,621,098	4,293,040	—	—	4,621,098	4,293,040
Gasoline tax	1,354,699	1,276,627	—	—	1,354,699	1,276,627
Franchise tax	613,033	560,708	—	—	613,033	560,708
Highway use tax	580,118	578,346	—	—	580,118	578,346
Insurance tax	442,228	432,975	—	—	442,228	432,975
Beverage tax	220,782	213,271	—	—	220,782	213,271
Inheritance tax	135,107	128,352	—	—	135,107	128,352
Other taxes	306,991	285,203	—	—	306,991	285,203
Tobacco settlement	148,800	147,224	—	—	148,800	147,224
Federal grants not restricted to specific programs	—	136,859	—	—	—	136,859
Unrestricted investment earnings	78,546	77,225	—	—	78,546	77,225
Miscellaneous	53,488	62,601	79	3	53,567	62,604
Total revenues	32,007,420	28,820,077	1,201,267	1,262,115	33,208,687	30,082,192
Expenses:						
General government	917,209	803,830	—	—	917,209	803,830
Primary and secondary education	7,699,208	7,223,766	—	—	7,699,208	7,223,766
Higher education	3,576,384	3,140,794	—	—	3,576,384	3,140,794
Health and human services	13,375,794	11,722,834	—	—	13,375,794	11,722,834
Economic development	625,561	511,335	—	—	625,561	511,335
Environment and natural resources	570,241	599,575	—	—	570,241	599,575
Public safety, corrections and regulation	2,125,385	2,093,242	—	—	2,125,385	2,093,242
Transportation	1,795,490	1,870,572	—	—	1,795,490	1,870,572
Agriculture	81,628	82,394	—	—	81,628	82,394
Interest on long-term debt	249,433	191,231	—	—	249,433	191,231
Unemployment compensation	—	—	824,934	1,389,266	824,934	1,389,266
EPA Revolving Loan	—	—	7,170	5,342	7,170	5,342
Other business-type activities	—	—	60,066	68,875	60,066	68,875
Total expenses	31,016,333	28,239,573	892,170	1,463,483	31,908,503	29,703,056
Increase (decrease) in net assets before contributions and transfers	991,087	580,504	309,097	(201,368)	1,300,184	379,136
Contributions to permanent funds	2,288	2,068	—	—	2,288	2,068
Transfers	(11,620)	581	11,620	(581)	—	—
Increase (decrease) in net assets	981,755	583,153	320,717	(201,949)	1,302,472	381,204
Net assets - beginning - restated	22,927,287	22,344,134	770,893	972,842	23,698,180	23,316,976
Net assets - ending	$ 23,909,042	$ 22,927,287	$ 1,091,610	$ 770,893	$ 25,000,652	$ 23,698,180

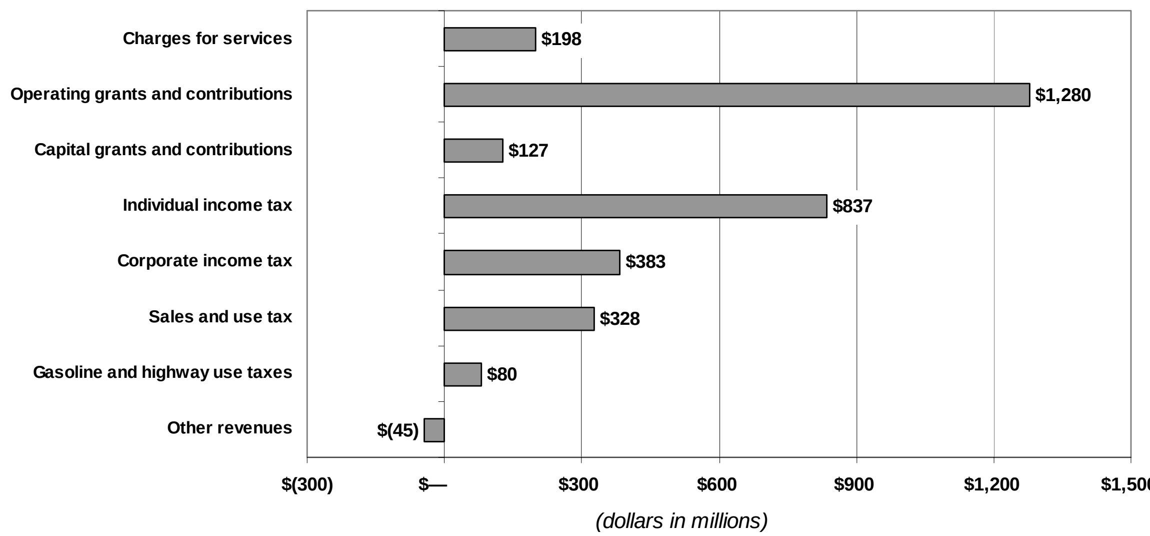
Governmental Activities

As a result of this year's operations, the net assets of governmental activities increased by $981.8 million or 4.3%. The net asset increase is primarily related to the higher than expected growth in tax revenues (e.g., individual income, corporate income, and sales taxes) and spending reversions realized during the current fiscal year. The growth in tax revenues is explained, in part, by the State's continued emphasis on compliance and collection activities and a one-time voluntary compliance program for taxpayers. This program generated an additional $288.6 million in corporate, franchise, and individual income tax for the 2004-05 fiscal year (Note: corporate income taxes generated $214.5 million). Over the last several years, the N.C. Department of Revenue has increased its collection and audit personnel. Additionally, the 2005 General Assembly authorized 60 new collection positions. The growth in corporate income taxes is also due to a combination of increased product demand and efforts by companies to hold down costs.

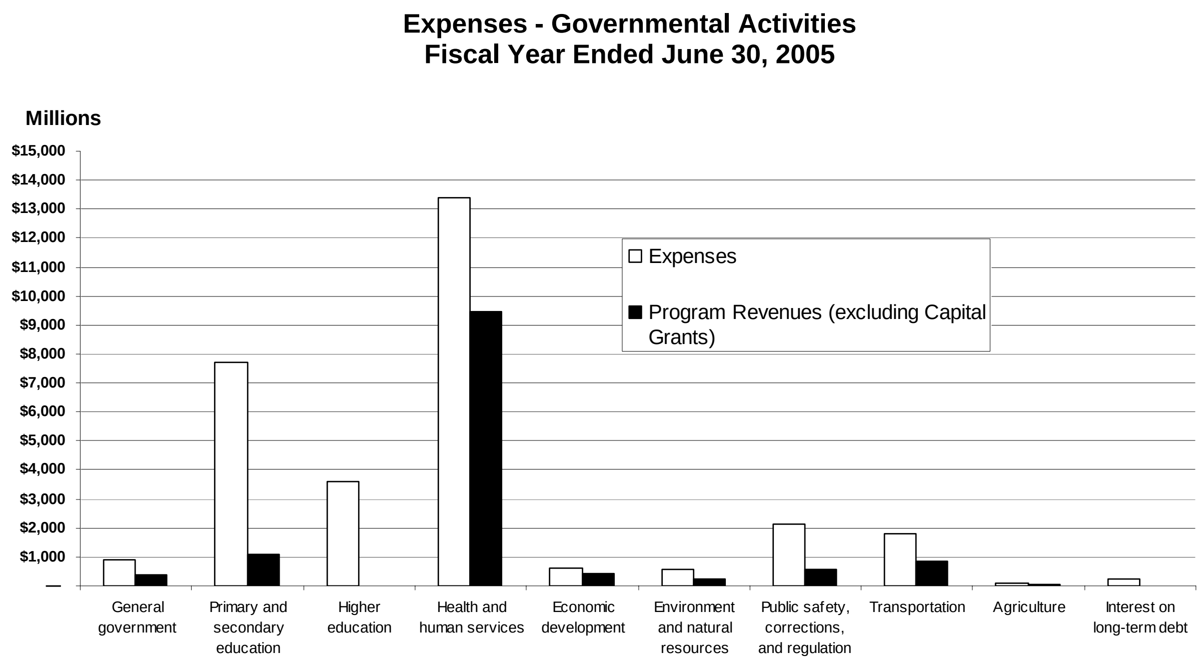
Total expenses of governmental activities grew by 9.8% during the current period (compared to total revenue growth of 11.1%). The majority of the spending growth was the result of funding increases in the State's two largest functional areas, education and health and human services. The increase in education spending is related to enrollment increases at the State's universities and community colleges and funding increases for the State's public schools. The growth in health and human services is the result of increased spending for Medicaid, which is the State's largest public assistance program. Expenses for Medicaid program services increased 9.7% over the prior year. The principal reason for the increase was the addition of bed assessment fees, which resulted in higher payments to nursing home providers. Also, the Medicaid program experienced higher costs in several categories of service, including hospital inpatient and outpatient, long-term care facilities, prescription drugs, and medical equipment. Because the State receives federal matching funds for the Medicaid program, there was also a corresponding increase in program revenues (e.g., operating grants and contributions).

The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2004 and 2005:

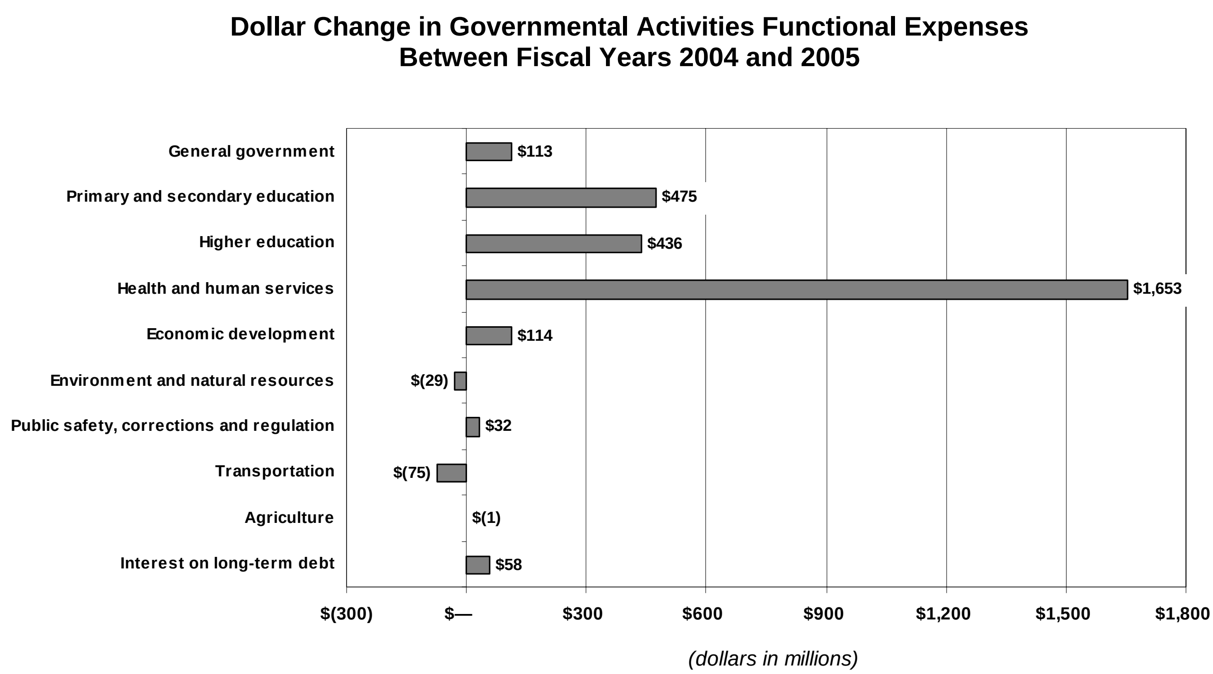
Dollar Change in Governmental Activities Revenues by Source Between Fiscal Years 2004 and 2005



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 2004 and 2005:



Business-type Activities

Business-type activities reflect an increase in net assets of $320.7 million or 41.6%. The growth in net assets is explained primarily by the Unemployment Compensation Fund's improved operating results for the current period. The excess of operating revenues over operating expenses for the Unemployment Compensation Fund was $244.3 million. The Unemployment Compensation Fund and the EPA Revolving Loan Fund are the predominant activities, comprising 88.6% of the total net assets of business-type activities. A more detailed discussion of the State's enterprise funds is provided in the following section.

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 $3.05 billion, a 3.9% increase from the prior fiscal year-end (as restated). The majority of the increase was related to revenue growth in the General Fund and the Highway Fund (major governmental funds) and to unspent debt proceeds reported in other governmental funds for the N.C. Infrastructure Corporation (Corporation), a blended component unit of the State. The Corporation issued debt during the 2004-05 fiscal year to construct and equip a close security correctional facility, to construct a new State psychiatric hospital facility and to finance higher education and other capital projects. The major governmental funds are discussed individually below.

General Fund

The General Fund is the chief operating fund of the State. The fund balance of the General Fund improved from a negative $271.9 million at June 30, 2004 (as restated) to a negative $78.8 million at June 30, 2005. A key factor in reducing the deficit was the General Assembly's decision to forgive repayment of the $125 million advanced from the Highway Trust Fund during the 2002-03 fiscal year. The advance was reclassified to a transfer from the Highway Trust Fund to the General Fund during the 2004-05 fiscal year. Additionally, the General Fund experienced higher than expected growth in tax revenues due to the improving economic picture and one-time collections from a Voluntary Compliance Program undertaken by the N.C. Department of Revenue. The total fund deficit is explained, in part, by the excess of accrued expenditures over accrued revenues for the State's Medicaid program. The State balanced the General Fund budget on a cash basis as required by the State Constitution. A more detailed analysis of the General Fund is provided in the budgetary highlights section (see below).

2004-2005 General Fund Budgetary Highlights

The enacted General Fund budget was founded upon an overall nominal economic (real growth plus inflation) growth rate of 5.5% for 2004-05. 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% and the highest individual income tax rate from 7.75% to 8.25%. The 2003-2005 biennium budget continued the State sales tax rate at 4.5% and the 8.25% income tax bracket. In addition, several streamlining and conformity provisions, as well as trust fund transfers, were authorized to increase General Fund availability. Also, the Department of Revenue was given broader authority and resources to collect unpaid tax liabilities. The following table summarizes the 2005 revenue enhancements (amounts expressed in millions).

Revenue Enhancements – 2005 Fiscal Year

Maintain State sales tax at 4.5%	$ 388.2
Maintain top income tax rate at 8.25%	92.7
Streamline tax revisions	73.0
Department of Revenue - Project Tax Collect	50.0
Tobacco settlement trust fund transfers	65.0
Other trust fund transfers	121.1
Estate tax conformity	70.8
Other enhancements	41.5
Total 2005 enhancements	$ 902.3

The majority of funding increases for 2005 were in the education and human service areas. The budget provided full funding for enrollment increases in the University of North Carolina System ($64.0 million), the community college system ($23.4 million), and public schools ($19.4 million). In addition, the budget included funds to hire additional public school teachers to reduce class size in the third grade ($50.5 million) and to expand the Governor's More-at-Four Program ($9.1 million), which helps prepare at-risk four-year-old children for success in school. It also provided funds for ABC teacher bonuses earned in the 2003-04 school year ($108 million).

The budget provided additional funding for the Health Insurance Program for Children ($6 million), which allows all eligible children to receive health care insurance (see Note 14C to the financial statements). In addition, expansion funds were provided for the Mental Health Trust Fund ($10 million) to facilitate the progress toward mental health reform.

The budget provided over $260 million in 2004-05 to support salary increases for employees of state agencies, the University of North Carolina System, community college institutions, and public schools. Specifically, it authorized an across-the-board salary increase of $1,000 or a 2.5% increase, whichever was greater.

State appropriations for the Medicaid Program totaled $2.4 billion in 2004-05. The General Assembly reduced general fund appropriations for the Medicaid Program by $90 million in 2004-05. This reduction was in addition to the $473 million reduction for 2004-05 that was enacted during the 2003 Session. The most significant reduction resulted from an increase in the federal participation rate ($40.2 million). Other reductions included a one percent reduction in the projected Medicaid growth rate, an additional transfer from the Medicaid Reserve Fund, and the elimination of coverage for weight loss and weight gain drugs.

During the 2000-01 fiscal year, funds were withheld from the Retirement System and remitted to the General Fund to cover a budget shortfall. Legislation was enacted in 2001 to formalize the General Assembly's intent to repay the debt, subject to the availability of funds, over a five-year period beginning July 1, 2003 (Note: the total obligation to the Retirement System was $129.9 million plus accrued interest). An initial payment of $10 million was made in October 2003 to partially repay the debt to the Retirement System. At June 30, 2004, an additional payment of $20 million was made. The 2005-06 budget authorized a payment of $25 million to the Retirement System.

General Fund Budget Variances

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.

Variances – Original and Final Budget

In general, the variances between original and final budget are attributable to the timing and length of the budget preparation process. The original budget for the 2004-05 fiscal year was prepared approximately 18 months prior to the beginning of the fiscal year and 30 months prior to the final budgeted amounts. Consequently, when the original budget is compared to the final budget, it would be expected that significant variances can occur.

The increase from original to final budget for *federal funds* revenue is attributable to the awarding of new federal funds and the awarding of increased amounts in long-standing federally supported programs. Additionally, federal funds are usually budgeted to equal the maximum allowable amount awarded to the agency.

The budget increase for *intra-governmental transactions* revenue is attributable primarily to the following: $225 million of statewide encumbrance carry forward amounts from fiscal year 2003-2004, $146 million of Medicaid Disproportionate Share, $320.8 million of Department of Health and Human Services (DHHS) intra-governmental transfers within a DHHS General Fund budget code, $371.7 million of DHHS funds transferred from various budget codes within DHHS, and $265 million of non-tax revenue reclassified from the miscellaneous departmental category to intra-governmental revenue.

The budget increase for *fees, licenses, and fines* revenue is attributable to approximately $142.4 million of provider assessment fees implemented within DHHS – Medical Assistance and $8.3 million of underestimated community college tuition and fees. The budget increase for *contributions, gifts and grants* revenue is attributable primarily to DHHS budgeting $125 million of state match, which was not included in the original budget.

For expenditures, the variances between the original budget and final budget are related to the corresponding revenue budget variances. As revenue budget accounts are increased, a corresponding increase occurs in the expenditure budget accounts. In addition to those increases, agency expenditure budgets were also increased by the allocation of statewide reserves such as the legislative salary increase, health insurance, and retirement reserves.

Variances - Final Budget and Actual Results

Actual revenues for *corporate income taxes* exceeded final budget because of improving economic conditions and a one-time settlement of long-standing tax disputes.

Departmental *federal funds* actually received by agencies were $1.1 billion less than the final budget. The three agencies primarily responsible for this variance were the Department of Public Instruction ($455 million), DHHS ($428 million), and the Department of Crime Control and Public Safety ($197 million). Actual federal draw downs are reflective of the actual expenditures of these federal funds. Therefore, if qualifying costs are not incurred by the agency, then the actual drawdown of federal funds could be significantly less than what has been budgeted.

For expenditures, the variances between final budget and actual expenditures for *primary and secondary education, health and human services,* and *public safety, corrections, and regulation* occurred because actual departmental revenues were less than the budgeted revenues; therefore, expenditures that depended on the receipt of these funds could not be made.

Highway Fund

The Highway Fund dates back to 1921, which is when the N.C. General Assembly first imposed the gasoline tax. It accounts for most of the activities of the North Carolina Department of Transportation, including the maintenance and construction of the State's primary and secondary road systems, the State Highway Patrol, the Division of Motor Vehicles, and transit and rail. The primary revenue sources of the Highway Fund are federal funds, three-fourths of gasoline taxes, vehicle registration fees, and driver's license fees.

The fund balance of the Highway Fund increased from $231.2 million at June 30, 2004 to $369.4 million at June 30, 2005, an increase of 59.8%. The fund balance growth was attributable to an overall increase in total revenues and a slight reduction in total expenditures during the current period. Total revenues increased by $257 million or 10.7% primarily because of increases in Federal Highway Administration program activities and gasoline taxes. Federal billings increased by $151.5 million due to increased Federal Highway Administration construction funding and obligational ceiling limits, disaster reimbursement, and greater billing efficiency. Gasoline taxes rose $37.2 million due primarily to a 1% increase in taxable gallons sold combined with an 5.3% rise in the average fuel tax per gallon. Total expenditures decreased by $62.8 million, or 2.4%, due to a $29 million decrease in state funded construction expenditures and a $51.6 million decrease in maintenance expenditures due to cash management initiatives. These were partially offset by an increase in federal construction and public transportation expenditures.

In September 2004, the State Board of Transportation approved a new long-range plan that prioritizes transportation investment for the next 25 years. The Statewide Transportation Plan provides a blueprint for greater investment in maintenance, preservation, and modernization of the State's existing highway system as well as other transportation options such as rail and public transportation. The share of transportation dollars spent on new highway projects will drop from 45% to 26%. The highway needs of the State's growing population will be accommodated in part by maintaining and upgrading existing roads and by increasing anti-congestion measures such as synchronized traffic signals.

The centerpiece of the plan is the *Recommended Investment Scenario*, which outlines priorities from the estimated $55 billion, in today's dollars, expected to be available over the next 25 years for transportation investment. Based on this scenario, the Department of Transportation (NCDOT) will be able to meet an additional 10% of its maintenance and preservation needs and nearly 25% more modernization infrastructure needs. Additionally, the scenario proposes increasing NCDOT's investment in other transportation modes. The plan also identifies $84 billion in total transportation needs and states that NCDOT will only be able to meet two-thirds of the State's 25-year transportation needs at its current funding levels, regardless of how NCDOT's resources are allocated. Full implementation of the Recommended Investment Scenario will be gradual.

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 Highway Trust Fund also provides extra money for the State's municipalities to adequately maintain their streets and it pays the debt service on the State's general obligation bonds issued for highway purposes.

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 enabling legislation also specifies that a designated amount will be transferred each year to the General Fund. From the proceeds of the highway use tax, $242.5 million was transferred to the General Fund for the 2004-05 fiscal year and $252.6 million is scheduled to be transferred to the General Fund during the next two fiscal years. The General Assembly enacted legislation during the 2005-06 Session that repealed the requirement for the

General Fund to repay the $125 million (plus interest) advanced from the Highway Trust Fund during the 2002-03 fiscal year (see Note 9 to the financial statements).

The fund balance of the Highway Trust Fund decreased from $266.1 million at June 30, 2004 to a negative $2.9 million at June 30, 2005, a decrease of 101%. The substantial decrease is attributable, in part, to the General Assembly's decision to forgive repayment of the $125 million advance to the General Fund (see above). During the current period, the advance was reclassified to a transfer from the Highway Trust Fund to the General Fund.

Total revenues increased by $23.5 million or 2.4%, primarily because of increases in the gasoline tax, motor vehicle fees, licenses, and fines. Total expenditures increased by $222.7 million or 26.8%. In 2003 the 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. More than 2,200 miles of highway are being improved through "Moving Ahead". Additionally, it allows $70 million for public transit, rail, ferry, bicycle, and pedestrian projects. As of June 30, 2005, "Moving Ahead" expenditures totaled $290.2 million of the $700 million authorized. Transportation expenditures increased by $185.1 million primarily due to the advancement of the Governor's "Moving Ahead" transportation initiative.

Bond proceeds were realized to reimburse Highway Trust Fund expenditures for prior years in the amount of $300 million dollars in September 2004. These bonds constitute the remaining portion of the $950 million highway bond authorization approved by the voters in November 1996 (Note: $250 million of such bonds were issued in 1997 and $400 million of such bonds were issued in 2003). Debt service on the bonds for 2004-2005 fiscal year was $69 million.

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 increased from $20.1 million at June 30, 2004 to $258.5 million at June 30, 2005, reversing the previous multi-year trend of declining net assets. The growth in net assets is explained, in part, by the 20% surcharge on unemployment contributions that became effective January 1, 2005, as required by State statute. The surcharge was assessed because of the fund's low reserves in prior years. Operating income (excess of operating revenues over operating expenses) was $244.3 million this year versus an operating loss of $509.6 million in 2004. Unemployment benefit expenses decreased 41.1% in fiscal year 2005 to $818.2 million. This decline is explained by the elimination of federal funding for extended unemployment benefits and by a decrease in the unemployment rate. The Temporary Extended Unemployment Compensation Program, which was enacted by the U.S. Congress in March 2002, ended during the 2004 fiscal year because of the decrease in the State's average unemployment rate. North Carolina's seasonally adjusted unemployment rate was 5.3% in June 2005 compared to 5.5% in June 2004 and 6.6% in June 2003. The 2004-05 fiscal year was the first year since the 2002 recession where unemployment contributions exceeded unemployment benefit expenses.

Also, at June 30, 2005, the short-term debt balance was $113.7 million compared to $251.8 million for the previous year-end. To ensure timely payment of unemployment benefits, the State received repayable advances from its Federal Unemployment Account and issued tax anticipation notes (see Note 6 to the financial statements). The State estimated that it will save millions of dollars in interest payments by selling tax anticipation notes instead of borrowing exclusively from the federal government. For the 2005-06 fiscal year, the State plans to issue tax anticipation notes in the amount of $125 million. For comparison purposes, the State issued $269 million in tax anticipation notes for fiscal year 2004-05.

The 2003 Session of the General Assembly enacted legislation to help preserve the integrity of the unemployment insurance tax system. Session Law 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").

EPA Revolving Loan Fund

The net assets of the EPA Revolving Loan Fund increased by $68.1 million during the current fiscal year, which was a 10.6% increase from the prior fiscal year-end. Operating income was $10.3 million (excess of operating revenues over operating expenses). Net nonoperating revenues were $44.4 million, consisting primarily of federal capitalization grants and investment earnings. The $13.6 million transferred in from other governmental funds (i.e., special revenue funds) consisted of clean water bond proceeds and additional funds to meet a required federal match.

Capital Asset and Debt Administration

Capital Assets

As of June 30, 2005, the State's investment in capital assets was $27.566 billion, which represents an increase of 7.49% 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	
	2005	2004	2005	2004	2005	2004
Land	$ 8,912,153	$ 8,300,655	$ 3,146	$ 3,113	$ 8,915,299	$ 8,303,768
Buildings	1,629,882	1,578,749	15,510	16,325	1,645,392	1,595,074
Machinery and equipment	519,359	560,935	1,807	1,955	521,166	562,890
Infrastructure:						
State highway system	14,247,319	13,284,267	—	—	14,247,319	13,284,267
Other infrastructure	77,651	77,091	30,802	9,246	108,453	86,337
Intangible assets	106,038	106,506	1,569	—	107,607	106,506
Art, literature, and other artifacts	47,999	46,193	—	—	47,999	46,193
Construction in progress	1,971,206	1,634,928	1,811	24,534	1,973,017	1,659,462
Total	$ 27,511,607	$ 25,589,324	$ 54,645	$ 55,173	$ 27,566,252	$ 25,644,497
Total percent change between fiscal years 2004 and 2005	**7.51 %**		**(0.96)%**		**7.49 %**	

This year's major capital asset additions were for highway construction ($1.5 billion), highway land improvements ($556 million) and the acquisition/construction of correctional facilities ($167 million).

The largest component of capital assets is the State's highway system and related right-of-ways. The State has an approximately 78,844-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.

The 2002-2003 Session of the General Assembly authorized the issuance of up to $300 million of special indebtedness to finance the repair and renovation of state facilities and related infrastructure that are supported by the State's General Fund. Of the $300 million, approximately $157 million will be allocated to the University of North Carolina System (component unit). Each of the sixteen constituent institutions of the UNC System will receive a portion of the proceeds for repairs and renovations. The remaining $143 million of the proceeds will be used to make repairs and renovations to various state facilities located throughout North Carolina. At year-end, the authorized but unissued repair and renovation debt was $175 million. In addition, the most recent session of the General Assembly (2005-2006 Session) directed the transfer on June 30, 2005, of $125 million from the unrestricted credit balance of the General Fund in fiscal year 2005 to the Repairs and Renovations Reserve Account, to be applied to the repair and renovation of state and university facilities.

In November 2004, the N.C Infrastructure Finance Corporation (Corporation), a blended component unit of the State, used the proceeds of lease-purchase revenue bonds to acquire two correctional facilities at a total cost of $51.4 million. Also, during the fiscal year, the Corporation issued $188.39 million in certificates of participation to construct and equip a close security correctional facility and to construct a new state psychiatric hospital facility. The Department of Correction is undertaking construction initiatives to address a cell shortfall and to allow for the implementation of sentencing reform. The State's correctional facility population has more than doubled since 1980 to approximately 37,000 inmates. The rapid growth in inmates is attributable to increases in the State's population, increases in length of stay in correctional facilities, and changes in criminal laws.

As further detailed in Note 20(F) to the financial statements, the State has commitments of $1.98 billion for the construction of highway infrastructure, which are expected to be financed by gasoline tax collections and federal funds. Other commitments for the construction and improvement of state government facilities totaled $575 million, which are expected to be financed primarily by debt proceeds (certificates of participation), state appropriations, and federal funds.

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 $6.483 billion, an increase of 17.10% from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
General obligation bonds..................	$ 5,698,535	$ 4,982,860	$ —	$ —	$ 5,698,535	$ 4,982,860
Revenue bonds.................................	265,045	218,405	9,070	9,325	274,115	227,730
Certificates of participation................	475,170	301,165	—	—	475,170	301,165
Notes payable..................................	34,007	25,008	1,569	—	35,576	25,008
Total..	$ 6,472,757	$ 5,527,438	$ 10,639	$ 9,325	$ 6,483,396	$ 5,536,763
Total percent change between fiscal years 2004 and 2005	**17.10 %**		**14.09 %**		**17.10 %**	

During the 2004-05 fiscal year, the State issued $1.0215 billion in general obligations bonds (excluding refunding issues), $53.64 million in lease-purchase revenue bonds, and $188.39 million in certificates of participation (COPs). The new general obligation debt consisted of $705.5 million in public improvement bonds (consolidation of clean water bonds and higher education bonds), $300 million in highway bonds, and $16 million in natural gas bonds. The proceeds of the lease-purchase revenue bonds were used to acquire correctional facilities in Avery County and Pamlico County and will also be used to pay the cost of design and construction drawings for up to thirteen youth development centers. The proceeds of the COPs will be used to construct and equip a close security correctional facility in Columbus County, to construct a new State psychiatric hospital facility, and to finance higher education and other capital projects.

The State refinanced $986.9 million of its existing debt in fiscal year 2005 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 $47 million over the next thirteen years.

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 (COPs) and lease-purchase revenue bonds issued by the N.C. Infrastructure Finance Corporation, a blended component unit of the State, are secured by lease and installment 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 (as applicable). The COPs issued for repair and renovation projects are not secured by a lien upon or security interest in the projects or any other property of the State.

All payments of the State for the COPs and the lease-purchase revenue bonds are subject to appropriation by the General Assembly. If the state defaulted on its repayments, no deficiency judgment could be rendered against the State, but the state property that serves as security could be disposed of to generate funds to satisfy the debt. Failure to repay the debt would have negative consequences for the State's credit rating. Article 9 of Chapter 142 of the General Statutes prohibits the issuance of special indebtedness (e.g.., COPs and lease-purchase revenue bonds) except for projects specifically authorized by the General Assembly. The use of alternative financing methods provides financing flexibility to the State and permits the State to take advantage of changing financial and economic environments.

Higher Education Authorization

The 1999-2000 Session of the General Assembly authorized the issuance of up to $3.1 billion of higher education improvement bonds, which were subsequently approved by the voters of the State. The $3.1 billion bond authorization represents the largest debt authorization in the State's history. 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 demands 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 $703.5 million.

Recent Legislation

The most recent session of the General Assembly (2005-06 Session) authorized the Department of Transportation to issue "GARVEE" bonds or other eligible debt financing instruments to finance federal-aid highway projects. These bonds are Grant Anticipation Revenue Vehicles, authorized by federal law, that permit states to use anticipated future federal highway funds to finance highway project construction. According to the Federal Highway Administration, candidate projects for GARVEE financing are typically larger projects that have the following characteristics:

- They are large enough to merit borrowing rather than pay-as-you-go grant funding, with the costs of delay outweighing the cost of financing.
- They do not have access to a revenue stream (such as local taxes or tolls) and other forms of repayment (such as state appropriations) are not feasible.
- The sponsors (generally state DOTs) are willing to reserve a portion of future year federal aid highway funds to satisfy debt service requirements.

Total debt would be constrained by the amount of federal aid authorized in the prior federal fiscal year, approximately $950 million for federal fiscal year 2004, the last year for which data is available. More than a dozen other states are already using this type of financing, which Congress authorized in 1995.

Debt Affordability Advisory Committee

During the 2003-04 Session, the General Assembly created a Debt Affordability Advisory Committee (Committee) to annually advise the Governor and the General Assembly on the estimated debt capacity of the State for the upcoming ten fiscal years. The Committee is responsible for preparing an annual debt affordability study and establishing guidelines for evaluating the State's debt burden. The Committee is required to report its findings and recommendations to the Governor, the General Assembly, and the Fiscal Research Division of the General Assembly by February 1 of each year.

In February 2005, the State Treasurer completed the most recent Debt Affordability Study for North Carolina. It provides a methodology for measuring, monitoring, and managing the State's debt capacity. The study evaluated the State's current and projected debt burden using indicators such as tax-supported debt to personal income, debt per capita, debt service to tax revenue, and rapidity of principal repayment ratios. In addition, the report includes several recommendations based on the results of the study. Highway debt and non-tax supported special indebtedness authorized by the 2004 General Assembly were excluded from the study. Also, excluded from this study were the short-term tax anticipation notes issued for unemployment tax benefits (see Note 6 to the financial statements).

According to the report, all of the State's debt ratios are below median levels for all fifty states, as compiled by Moody's Investors Service, and for a peer group of seven states rated triple AAA by all three credit rating agencies. Thus, the study concludes that the State's debt is considered low and is manageable at the current level. However, due to the projected issuance of $2.1 billion of tax-supported debt over the next three years (67 percent for higher education purposes), all of the State's debt ratios are expected to increase over this period. The State Treasurer noted in the report that credit rating agencies consider a debt affordability study as a positive factor when evaluating issuers and assigning credit ratings.

Credit Ratings

Credit ratings are the rating agencies' assessment of a governmental entity's ability and willingness to repay debt on a timely basis. Credit ratings are an important factor in the public credit markets and can influence interest rates a borrower must pay.

The State's general obligation bonds are rated "AAA" by Fitch Ratings, "Aa1" with a positive outlook by Moody's Investors Service (Moody's) and "AAA" with a stable outlook by Standard & Poor's Ratings Services. All three agencies base their prime ratings on the State's strong, diverse economic base, its sound financial management, and low debt levels.

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. In September 2004, Moody's revised the State's outlook from stable to positive and noted the following:

> "*This rating reflects the State's slowly stabilizing economy, its improving tax revenues, its conservative debt policy, and its effective financial management. While general fund balances remain negative, flexible cash reserves outside the general fund are ample, and pension funding is exceptionally strong. Moody's expects that the state will continue to take actions to restore structural balance and rebuild reserves*."

The COPs and lease-purchase revenue bonds 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 upon the increase of certain state debt. It restricts the General Assembly from contracting debts 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.

Next Year's Budget and Rates

The economy-based revenue growth estimate for 2005-06 was lowered from the 5.4% rate used as part of the Governor's proposed budget to 4.8% in the enacted budget. The primary reason for reducing baseline revenue growth is that prolonged exposure to higher energy prices and interest rate hikes by the Federal Reserve has already led to what economists call a "mid-decade slowdown".

The budget continues the current 4.5% state sales tax rate and 8.25% income tax bracket for two additional years (see 2004-05 General Fund Budgetary Highlights section). It includes changes to simplify and modernize the sales tax in order to comply with the Streamlined Sales Tax Agreement and to equalize rates on consumption. The budget also includes a 25 cent per pack increase in the cigarette tax effective September 1, 2005 and an additional 5 cent increase effective July 1, 2006. These adopted changes total $628 million for the 2005-06 fiscal year. The fiscal year 2005-06 budget is also supported by overcollections and reversions from fiscal year 2004-05 that factor into the beginning General Fund unreserved fund balance of $478.509 million. The 2005-06 budget calls for using $365.1 million of beginning availability, with an estimated ending unreserved fund balance of $113.387 million at June 30, 2006.

Conditions Expected to Impact Future Operations

Demographic Factors: The Baby Boomers

The process of retirement for the demographic cohort known as the "Baby Boomers" will have tremendous economic, social, and political impact on North Carolina. A critical area in which the "Boomer" retirement will be significantly consequential is the cost to the State of providing retirement benefits.

- The first year of the eighteen (18) year boomer cohort has just reached the average age of retirement in the state system for 2003, which is aged 58 ½. **Impact: the first of the Boomer cohort is on the cusp of retirement, marking the beginning of boomer retirement from the North Carolina public sector.**
- The total number of retirees in the North Carolina Teachers' and State Employees' Retirement System will increase 135% through 2022 (the total increase for both the State and the Local government systems is 141%). **Impact: the cost to the State of providing retirement benefits will increase**. (Note: Increasing costs are not driven by the cost of providing an actual pension since employees and employers fund the pension over the employee's service career. The significant increase in cost will come from providing Cost of Living Adjustments (COLAs) for a significantly larger retiree pool.)

Retiree Health Care

The Governmental Accounting Standards Board (GASB) reporting guidelines that will require disclosure of the State's liabilities for retiree health care costs (i.e., GASB Statements No. 43 and 45) are one of the State's largest looming fiscal items. The Retirement System facilitates the benefit by making the deduction for the State Health Plan from retirees' pension checks. The Retirement System is also the front line organization for retirees who want to voice their concerns about changes, or potential changes, to benefits. Ultimately, the provision of health care for the State's public sector retirees is the responsibility of the State Health Plan. The unfunded actuarial liability for retiree health care is substantial because of the State's policy of funding these benefits on a pay-as-you-go basis.

In preparation for the new GASB standards on other postemployment benfits, the North Carolina General Assembly enacted legislation in 2004 establishing a Retiree Health Benefit Fund. The State's contributions to this fund are irrevocable, and the assets of the fund are not subject to the claims of the State's creditors. More detailed information about the State's obligations for Retiree Health Care is presented in the Letter of Transmittal.

Escheat Fund

Legislation passed in 2005 authorized the State Treasurer to diversify the investments of the Escheat Fund (a special revenue fund). Previously, the Fund was limited to participating in the Long Term Investment Portfolio. The State Constitution mandates that proceeds of the Escheat Fund shall be used to aid needy and worthy North Carolina students enrolled in public institutions of higher education. The continuing demand on resources at the universities and community colleges has necessitated regular tuition increases. The establishment of a modern investment allocation strategy aimed at increasing returns was identified as a way to enhance the Fund's constitutionally provided purpose. Under the new provisions, the State Treasurer is authorized to invest up to 20% of the assets of the Escheat Fund in private equity investments.

North Carolina State Lottery

On August 30, 2005 the General Assembly passed House Bill 1023, North Carolina State Lottery Act. North Carolina becomes the last state on the east coast to approve a lottery. In accordance with House Bill 1023 and Senate Bill 22, 2005 Appropriations Act (*with elements of House Bill 1023 rewritten*), the net proceeds of the Lottery will be used to further the goal of providing enhanced educational opportunities, to support public school construction, and to fund college and university scholarships.

The Lottery legislation directs that 50% of the net proceeds be dedicated to pre-kindergarten and class-size reduction programs that have been implemented over the last five years. To this point, these programs have been funded by the General Fund. The remaining net proceeds will be distributed to the Public School Building Capital Fund (40%) and the State Education Assistance Authority (10%). More detailed information about the new education lottery is presented in the Letter of Transmittal.

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.ncosc.net/financial/financial.html.