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 2005 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 (GAAP) in the United States of America. 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 the CAFR 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.

In compliance with State statute, an annual financial audit of the State financial 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 the Auditor's opinion has been included in this report. In addition, the State coordinates the *Single Audit* effort of all federal funds through the State Auditor.

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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 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, the Highway Trust Fund, the Unemployment Compensation Fund and the EPA Revolving Loan Fund. The MD&A can be found immediately following the Independent Auditor's Report.

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, Inc., 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

Prospects for Fiscal Year 2005-06

The consensus revenue estimate for the upcoming fiscal year took a cautious stance regarding the portion of the 2004-05 revenue surplus that is counted as recurring. This was accomplished by not including in the 2005-06 forecast base certain items which were clearly one-time in nature and being cautious on the April surprise amount. In addition, the economy-based revenue growth estimate for 2005-06 was lowered from the 5.4% rate used in February as part of the Governor's proposed budget to 4.8% in the enacted budget. For reference purposes, the long-term average rate for North Carolina is around 6.0%.

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 the first signs of what economists call a "mid-decade slowdown". Similar events took place during the 1984-86 period after the Federal Reserve raised rates to rein in the overheated economic recovery, and in 1995 after the Fed pushed up short-term rates from 3% to 6% during an 11-month period. The typical time lag between higher interest rates and national economic growth is about one year. The same is generally true of rising energy prices. This means that we are at the point where the full impact of the Fed's actions in raising short term interest rates from 1% to 3.75% and record fuel prices should begin to restrict economic growth.

For now, recent news on the state economic front continues to be very favorable. The primary success has to do with real gains in the job market. In recent months we have begun to see "help wanted" signs for the first time during this recovery. In addition, the difficulty some employers in urban areas are having in filling some positions is exerting upward pressure on wage rates. The acceleration in withholding payments is gratifying for a couple of reasons. First, this revenue source amounts to almost 40% of the total base (personal income tax as a whole amounts to 52%). The other is that it has taken an unusually long time for us to get to this point. During the first two years of the recovery from the 1990-91 recession, withholding tax growth ranged from 8% to 11%. This time around the range was 1% to 4% and it has taken almost three years from the "official" end of the recession to reach the 8% mark. With interest rates rising it is unlikely that we will see any double-digit quarters.

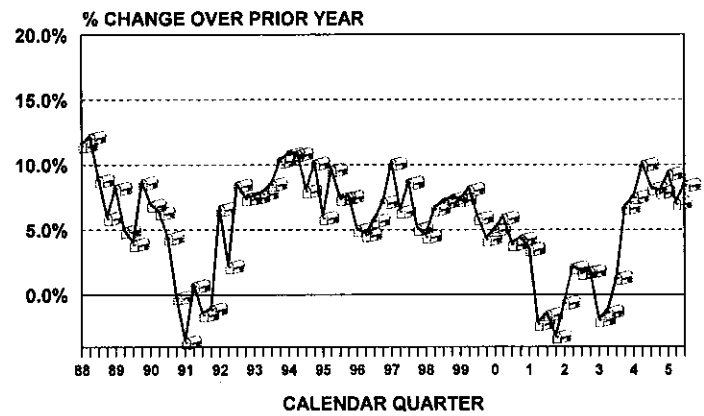
When we look at the published employment data, we have to wonder where the withholding tax base growth is coming from. According to the Employment Security Commission (ESC), net job growth in the state between August 2004 and August 2005 was only .9% (36,400 employees) and wage rate increases are probably no more than 4%. One factor might be the fact that during recoveries the preliminary ESC data understates employment growth because its employer survey does not pick up start-up firms. Another fact is that bonuses are rising due to strong corporate profit growth. Finally, improved profit margins are reflected in more stock options and some of this income shows up in withholding payments.

The key to North Carolina's business cycle experience continues to be our dependence on the declining manufacturing sector (15% of all nonagricultural employment in N.C. vs. 11% for the nation). This is the reason our downturn began earlier than the national experience and why our recovery has been slow in coming. The result is that the state has lost the "recovery premium" normally experienced during a business cycle recovery. For example, the state's economy grew 33% faster than the national experience following the 1981-82 recession and 45% stronger 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. The favorable North Carolina experience was due to the fact that manufacturing employment in the state actually rose during this recovery. This time around we are continuing to shed manufacturing jobs and our turnaround has been 10% **slower** than the U.S. Problems in the manufacturing side of the economy began well before the 2001 recession.

Data indicates that manufacturing employment grew by 2.2% in 2003. After a leveling off period, manufacturing jobs began a steady decline in 1996 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 8.8% 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 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.

While the job market typically lags overall economic trends, retail sales tell us how the economy is performing at a particular point in time. The prospects for consumer spending are important for the state budget because the sales tax makes up 30% of the revenue base. The most surprising thing about the experience of the last two years has been the resiliency of retail sales in the face of sharply higher energy prices, terrorist warnings, and the rise in interest rates. This pattern can be illustrated by looking at sales tax receipts in North Carolina:

STATE AND LOCAL SALES TAX GROWTH



This pattern is in stark contrast to the 1999 situation where the sales tax growth dropped from 8% to 4-5% within a few months of the uptick in prices at the pump. There are a number of different reasons for the stubbornness of retail sales:

(1) the recovery in stock prices since 2003
(2) gains on investment real estate, especially in resort areas
(3) conservation efforts of consumers
(4) additional cash generated from mortgage refinancing and home equity loans
(5) the continued rise in consumer debt.

The final factor, record debt levels, will be a problem once the economy begins to slow and job prospects worsen. In addition, while consumers and businesses have adjusted their driving habits to higher prices at the pump, we are very concerned about the potential impact of sharply higher heating bills during the next few months.

Another positive has been the prolonged strength of the housing market. The 2001-02 recession was somewhat unique in business cycle history as residential construction activity and home sales remained stable in the face of worsening economic fundamentals. The key to sustainability in this market was the lowest mortgage rates in four decades. Even the recent rise in short-term interest rates has had little impact on the long end of the yield curve. Part of the reason for stability in long-term interest rates is the supply of funds from overseas economies. However, unless energy prices and the housing markets slow their rate of increase, inflation will rise beyond the modest rate of the last few years. The acceleration in prices will eventually be factored into long-term interest rates. Higher mortgage rates, combined with the sharp drop in housing affordability (rising home prices), will eventually choke-off demand for new homes.

During the next few months, we think the favorable news on the employment, retail sales, and housing front in North Carolina will begin to fade. For one thing, we have to deal with the potential impact of Hurricane Katrina. The long-term effect of the largest natural disaster in the U.S. on the economy is still very much up in the air. In the short-run, economists are concerned that the resulting rise in energy prices will shave .5-.7% of annual growth from the nation's economy for the next two quarters. At the same time numerous studies of other large-scale natural disasters have indicated a strong positive impact from the rebuilding effort. Most of the stimulus would occur during the first half of 2006 and may offset the front-end negative impact of Katrina.

The other factor we must continue to monitor is the actions of the Federal Reserve. We expect the Federal Reserve to push interest rates up to 4.5% by early 2006. Normally, the rise in fuel prices would cause the Federal Reserve to eliminate, or at least delay, future rate hikes due to the impact of the "energy tax". However, as the markets contemplate the transition to the Greenspan replacement, the regional bank presidents are sending strong signals to say that now is the time to re-exert the Federal Reserve's independence by pushing the traditional inflation fighting posture. Our quarrel with this policy stance is that if we exclude energy prices from the Consumer Price Index, the resulting "core inflation" continues to be restrained. This opens the possibility that the Federal Reserve may push interest rates to an unnecessarily high level, leading to a more serious slowdown. Thus, we should be more concerned about monetary policy coming out of Washington than the effects of Hurricane Katrina.

Though the risks to the economic outlook have become heightened, our current assessment is that the final 2005-06 revenue forecast has positioned the State well for the economic slowdown that is starting to unfold.

ECONOMIC INDICATORS (STATE FISCAL YEAR BASIS)
ANNUAL RATES OF CHANGE

	2003-04 Actual	2004-05 Actual	2005-06 Projected	2006-07 Projected
U.S. INDICATORS				
Real Economic Growth*	4.1%	3.7%	3.8%	3.1%
Nonfarm Employment	.3%	1.6%	1.8%	1.4%
Personal Income	4.6%	6.6%	5.8%	4.9%
Industrial Production	2.0%	4.0%	2.7%	2.3%
Corporate Profits (Pre-Tax)	22.0%	13.0%	25.1%	.3%
Short-Term Interest Rates (Actual Rate)	1.0%	2.2%	4.1%	4.7%
Mortgage Rates (Actual Rate)	5.9%	5.8%	6.5%	7.4%
Inflation (CPI)	2.2%	3.0%	2.8%	2.7%
NORTH CAROLINA INDICATORS				
Personal Income	4.8%	6.9%	4.8%	4.8%
Nonfarm Employment	-.5%	1.7%	1.5%	1.4%
Unemployment Rate (Actual Rate)	6.1%	5.3%	5.2%	5.2%
Average Hourly Earnings (Manufacturing)	4.6%	2.7%	1.5%	3.4%
Retail Sales	7.3%	8.0%	4.7%	4.3%
Housing Activity	13.1%	4.1%	-4.4%	-16.0%
Auto Sales	-6.8%	-.8%	2.0%	-4.2%

*Adjusted for inflation.

— Economic analysis prepared by David Crotts, Economist
North Carolina General Assembly Fiscal Research Division
October 18, 2005

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 9.85% for the one-year period, a return of 9.79% for the three-year period and a return of 4.31% for the five-year period, ended June 30, 2005. 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 Teachers' and State Employees' Retirement System (TSERS), the largest of the pension trust funds, continued to be fully funded, based on the December 31, 2004 actuarial valuation. Specifically, the TSERS was funded at 108.1%, with the actuarial value of assets of $47.4 billion exceeding the actuarial accrued liability of $43.8 billion by $3.6 billion at December 31, 2004. Employer contributions to the TSERS increased by $194.4 million above the prior fiscal year ended June 30. Investment balances increased by $2.99 billion, or 6.4% above the prior fiscal year, with a net investment income of $4.5 billion. The TSERS experienced a $173.9 million increase in benefit payments to retirees, an increase of 7.99% from fiscal year 2004.

Debt Administration

You will find a more in-depth discussion of the State's long-term debt in the MD&A. 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.

The 2004 General Assembly passed legislation creating the Debt Affordability Advisory Committee. The committee is charged, on an annual basis, with advising the Governor and the General Assembly of the estimated debt capacity of the State for the upcoming 10 fiscal years.

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 2005, 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 2.875%.

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.

Issues and Observations

The Future of Financial Management in North Carolina

The State of North Carolina, like most state governments in the United States, plans, budgets, and manages operations funded by its General Fund on a cash basis. In the most basic sense, we run the General Fund like many of you may monitor your checkbook at home. At home, we think about what we bring home in net pay over the next several months and we write checks based on what we have available in the check book. Only when we go to the local financial institution to borrow money for a car or a home, are we forced to look at all of our income and all of our expenses, our assets and our debts to prove that we are capable of supporting the additional payments required to repay the loan we are seeking. Even then, there is little or no account of deferred maintenance on our personal assets, or other future spending for unmet personal or family needs. At home, we generally operate based on cash flow.

On a daily basis, State officials hear the suggestion that the State needs to be more responsive to its citizenry and operate more like a business, that is to say operate more like private industry. State Government is big business. For the fiscal year ended June 30, 2005, the State's CAFR reported on $149.3 billion of assets within its financial reporting entity umbrella (including fiduciary funds). For fiscal year 2005, on a cash basis the General Fund spent over $29.1 billion, including $15.8 billion of state appropriation expenditures.

Big businesses in private industry operate on an accrual basis. They record revenues in the period they are earned and expenses in the periods they are incurred. In contrast, most state governments manage their operating budgets in a variety of ways...most of the time on a cash basis. The State of Michigan is a notable exception; having recently implemented an accrual based accounting system with accrual elements in its General Fund budget management process. Governmental entities all over the United States are beginning to grapple with the notion of injecting accrual accounting concepts into age old processes for budget management. As opposed to accrual accounting, there are no national standards for budget management. You cannot readily compare the budgets or budget processes of different state governments.

The Governmental Accounting Standards Board (GASB) was formed in 1984. In 1986, the General Assembly established the Office of the State Controller. One of the primary charges to the State Controller was to prepare a Comprehensive Annual Financial Report (CAFR) based on generally accepted accounting principles (GAAP) and to develop and maintain the systems and personnel to support that effort. Furthermore, the Office of the State Auditor was charged with performing an independent audit and expressing an opinion on the financial statements and note disclosures in the CAFR. The State Auditor's examination is 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.

The CAFR has received unqualified opinions, otherwise known as "clean opinions" from fiscal year 1994 through fiscal year 2004. Over and above the quality of financial information warranting a clean opinion, the State has received the Government Finance Officers Association *Certificate of Achievement for Excellence in Financial Reporting*. These clean opinions and awards are something the State is very proud of. However, we should be ever-vigilant and remember that clean opinions and awards are not automatic. The successes of the State Controller are directly attributed not only to the professionalism and integrity of the State Controller's technical and accounting personnel, but also to the professionalism and integrity of financial and accounting managers throughout the State of North Carolina financial reporting entity. We move to the future recognizing the need to continue to develop and protect our accounting integrity by supporting our financial and accounting professionals whenever possible. As part of the effort of assuring accounting integrity, the State Controller provides training and continuing professional education on a regular basis to state fiscal personnel.

The CAFR document is one of the most important documents available to bond raters and investors. Users of the CAFR are looking for a financial statement document that gives them the elements of standardization, consistency, and objectivity...that gives full disclosure, that follows industry practice, that is conservative in its interpretations, that in short, is based on generally accepted accounting principles. So far so good. As the GASB has matured, the issuance of new governmental accounting standards has escalated. These standards are being issued for specific reasons, that is, the user community has seen a need and the GASB has responded.

We could not be pointing to our success in financial management without the acknowledgement of the foresight the General Assembly and the State's fiscal managers have had to invest in the State's business infrastructure to meet the needs of our ever expanding business. The job of investing in our State's business future is never-ending.

What opportunities do we have to improve financial management? The process of improvement has begun. The General Assembly and the State's fiscal leaders have put the process in motion with the investment of time, effort and money to support the implementation of an up-to-date human resource/payroll system and the development of a statewide data warehouse. Soon to follow will be the much larger scale effort to replace the State's accounting system with an ERP (*enterprise resource planning*) system that will more completely integrate our human resource and financial information systems. This new ERP system will have the off-the-shelf capability of doing accrual accounting and budgeting, and will incorporate best business practices. As we look to implement new systems, the major question arises as to whether we are investing in new systems to do our business *the old way*, or whether we want to take full advantage of our investment and the best business practice capabilities of a state-of-the-art ERP system. Should we pay to initially amend and then maintain the ERP system to do cash basis accounting and budgeting as we have always done, and possibly limit the ERP's capabilities...or should we make a move to the future by incorporating accrual concepts into our budget management process? The State's current accounting system was implemented in 1995. Therefore, we are making decisions in 2005 that can affect us for the next 10, 15, or 20 years into the future.

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 622, 2005 Appropriations Act, 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 nine-member Lottery Commission is located in the Department of Commerce for budgetary purposes. The North Carolina State Lottery (Lottery) is defined in legislation as an enterprise fund of the State of North Carolina. Lottery financial information and disclosures will be included in the CAFR for the fiscal year ending June 30, 2006, with the expectation that the Lottery is to begin operations during the 2005-06 fiscal year. It is estimated that once fully operational, the Lottery will contribute over $200 million annually to the General Fund.

The Lottery will be responsible for the same monthly and annual accounting and reporting as other state agencies. Additionally, the Commission will send quarterly and annual reports on the operations of the Commission to the Governor, State Treasurer, and to the General Assembly. The reports will include complete statements of lottery revenues, prize disbursements, expenses, net revenues, and all other financial transactions involving lottery funds, including the occurrence of any audit.

In accordance with House Bill 1023, the books and records must be accurate and complete and permit the preparation of financial statements in conformity with *generally accepted accounting principles* (GAAP). The Lottery's financial statements will be prepared based on GAAP as promulgated by the Governmental Accounting Standards Board (GASB).

The funds remaining in the North Carolina State Lottery Fund after receipt of all revenues to the Lottery Fund and after accrual of all obligations of the Commission for prizes and expenses will be considered to be the net revenues (*at least 35% of total revenues*) of the North Carolina State Lottery Fund.

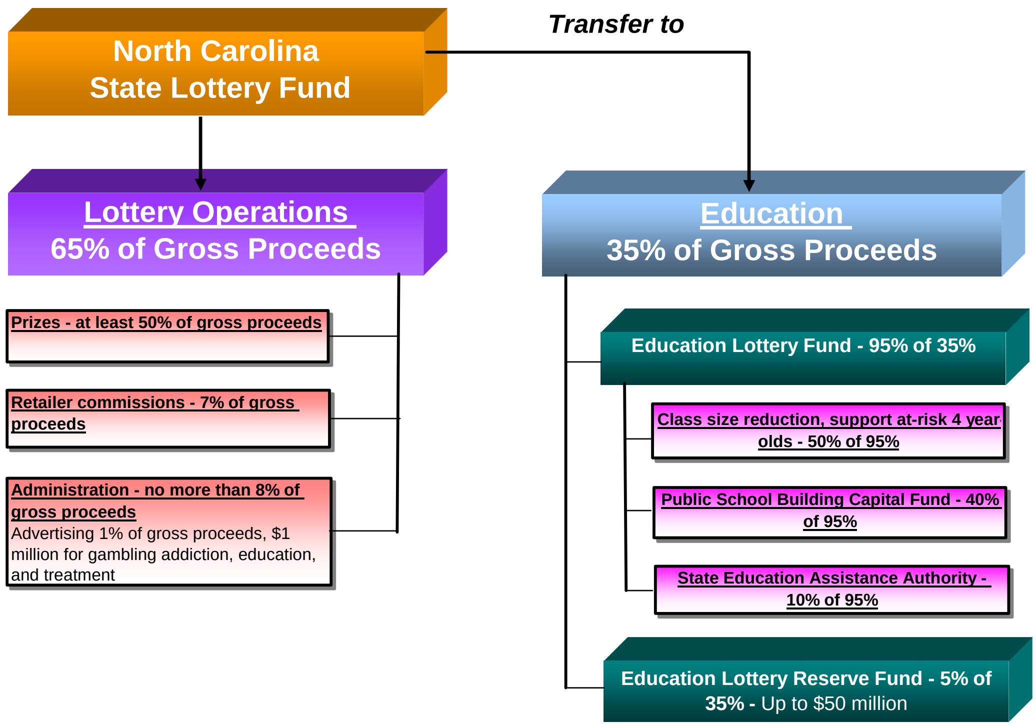
The net revenues of the North Carolina State Lottery Fund will be transferred periodically to the Education Lottery Fund. From the Education Lottery Fund, the Commission will transfer 5% of the net revenue of the prior year to the Education Lottery Reserve Fund. The Education Lottery Reserve

Fund will be capped at $50 million. The Commission will distribute the remaining net revenue of the Education Lottery Fund, in the following manner:

(1) 50% to support reduction of class size in early grades to class size allotments not exceeding 1:18 in order to eliminate achievement gaps and to support academic pre-kindergarten programs for at-risk four-year-olds who would otherwise not be served in a high-quality education program in order to help those four-year-olds be prepared developmentally to succeed in school.

(2) 40% to the Public School Building Capital Fund.

(3) 10% to the State Education Assistance Authority to fund college and university scholarships.



The General Assembly will appropriate these funds annually based on estimates of lottery net revenue recognized in the Education Lottery Fund. If the actual net revenues are less than the appropriation for a particular year, the Governor may transfer from the Education Lottery Reserve Fund an amount sufficient to equal the appropriation by the General Assembly. If the monies available in the Education Lottery Reserve Fund are insufficient to reach a full appropriation, the Governor will transfer monies in order of priority, to the following:

(1) support academic pre-kindergarten programs for at-risk four-year-olds who would otherwise not be served in a high-quality education program in order to help those four-year-olds be prepared developmentally to succeed in school;

(2) reduce class size;

(3) provide financial aid for needy students to attend college; and

(4) support the Public School Building Capital Fund.

If the actual net revenues exceed the amounts appropriated in that fiscal year, the excess net revenues will remain in the Education Lottery Fund, and then be transferred as follows:

(1) 50% to the Public School Building Capital Fund.

(2) 50% to the State Education Assistance Authority.

The State Treasurer is authorized to loan up to $10 million to the North Carolina State Lottery Commission to cover initial operating expenses.

Human Resource Management in State Government

Office of State Personnel Study. In February 2005, the Office of State Personnel (OSP) published its annual Compensation and Benefits Report. North Carolina's official pay philosophy states that, *"It is the policy of the State to compensate its employees at a level sufficient to encourage excellence of performance and to maintain the labor market competitiveness necessary to recruit and retain a competent workforce."* However, the most recent OSP report continues to support the notion, as the report has in recent years, that we are falling further behind relative to private industry, to local governments in North Carolina, and to neighboring state governments in pay and total compensation for our state employees. The report describes the compounding problem over the next 10 years, that state agencies in the Raleigh and Research Triangle Park area will encounter as they will be competing for employees and attempting to retain employees in one of the fasted growing job markets in the country. Further concern is generated by the recent warnings of the nation's human resource staffing experts that competition for qualified, competent employees will be fierce over the next 10 to 25 years, with the trend of increasing retirements and fewer young people entering the workforce.

All state and local governments are working to come to terms with the issues addressed in the OSP study. Various strategies cited across the nation may include improvements in technology (ERP) to accommodate a smaller workforce, implementation of deferred retirement option programs (DROP) to slow the increasing trend of retirements, improvements in compensation for targeted hard-to-hire positions, and improved retirement savings options.

State Business Infrastructure Program (SBIP)

HR/Payroll Project. The 2005 General Assembly appropriated $20.875 million for the 2005-06 fiscal year to begin the replacement of the HR/Payroll system. The State completed negotiations with SAP in September. SAP will be the software provider for the business infrastructure moving forward. An RFP has been issued for a systems integrator to implement the new system. Our goal is to have the integrator on board by the end of January and the new system in place by January 2008. We are currently identifying the state project team that will be responsible for working with the integrator to put the new system in place. The HR/payroll project team will consist of a core project team, agency liaisons, and subject matter experts. The team will be staffed by existing state employees, along with several new hires, and each agency will designate a liaison to the HR/payroll team.

The HR/payroll project is a huge effort that will transform the way our State does business. Project benefits will include increased standardization in human resource administration and payroll processing. The new HR/payroll system will provide state-of-the-art business intelligence that will replace many manual processes, and will allow employees direct access and update capability related to personal data, benefits and leave balances.

Data Warehousing. A data warehousing workforce analysis pilot project is now underway that will combine resources of the Office of the State Controller with the Office of State Personnel, Department of State Treasurer Retirement Systems Division, Information Technology Services, and SAS. We are currently conducting a needs assessment to identify financial data that can be captured and reported through an enterprise data warehouse, in a timely manner, and in an easily retrievable format. The goal is to have information available to make the best management and policy decisions possible through an improved ability to conduct analysis, identify trends, and forecast areas for targeted workforce management.

Over the next few months, change management and communication activities will be ramped up in our effort to begin working with each State agency to prepare for project implementation.

For additional information on SBIP, you can access the SBIP website through the Office of the State Controller website at http://www.ncosc.net.

Increasing Cost of Healthcare

Health and Human Services. The Medicaid program continues to grow at a record pace, not only in North Carolina, but nationwide. The increased cost can be attributed to expansion of services provided, increased numbers of qualifying recipients, the increasing age of program beneficiaries, and increasing health care costs. State health and human service spending made up 42% of the General Fund cash basis budget in fiscal year 1995-96. Health and human services spending accounted for 48.8% of the General Fund budget for fiscal year 2004-05. During the same ten-year period, health and human services General Fund cash basis spending, including federal and state funding, more than doubled by increasing from $7.07 billion in fiscal year 1995-96 to $14.2 billion in fiscal year 2004-05. For fiscal year 2004-05, federal Medicaid funding was $5.8 billion, or 42.4% of all federal funds reported on the Schedule of Expenditures of Federal Awards.

As the economy slows, Medicaid programs and other health and human services programs are most needed, and General Fund dollars are more difficult to find to support the increased need. The two largest users of General Fund dollars are health and human services (48.8%) and public education (39.4%). Together they comprised $25.7 billion of state and federal spending, or just over 88% of the General Fund expenditures for fiscal year 2004-05.

Employee and Retiree Health Insurance. The State Health Plan provides comprehensive major medical care for employees and retirees of the State and its participating component units, and it allows for optional coverage of employee and retirees' dependents. This care is also extended to employees and retirees of the Local Education Agencies (LEAs), which are not part of the State's reporting entity. Coverage is self-funded by contributions to the State Health Plan. Contributions for employee and retiree coverage are made by the State, its participating component units, and LEAs. Contributions for dependent coverage are made by employees and retirees. Coverage is also extended to certain individuals as an other postemployment benefit. The Plan pays most expenses that are medically necessary and eligible for coverage based on usual, customary and reasonable allowances. Claims are subject to specified annual deductible and copayment requirements. The Plan disallows claims in excess of a lifetime maximum of $5 million.

For fiscal year 2004-05, employer contributions to the Plan increased by $121.5 million, or 9.7%, while member (employees and retirees) contributions declined by $26.15 million, or 8%. Claims and benefits paid increased by $292.7 million, or 20.4%. The Plan experienced a decline in net assets of $100.8 million in fiscal year 2004-05, ending the year with negative $60.5 million in net assets on an accrual basis. For fiscal year 2003-04, net assets had increased by $109.7 million.

Historically, the State's health benefits package has been a key component of an overall compensation package enabling the State to hire and retain quality personnel.

Other Post-Employment Benefits

In response to concerns related to rising healthcare costs, the Governmental Accounting Standards Board (GASB) has recently issued accounting and reporting standards for other post-employment benefits. 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).

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, 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.

Three actuarial studies related to retiree healthcare have been completed as the State has worked to get its hands around this issue and how to deal with it. Each of the three studies, beginning in 1996, has reflected a substantial liability related to the State's commitment to provide healthcare to retirees and long-term disability beneficiaries. 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". If the decision is made to continue pay-as-you-go financing, the expense on an actuarial basis is likely to be 5 to 8 times the current pay-as-you-go cost.

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. The actuarial study will need to be conducted at a minimum of every two years.

Quoting a May 20, 2005 article from the San Diego Tribune:

> ***A credit-rating firm, Standard & Poor's, said in a report in December that a net annual increase in retiree health obligation "would be a negative rating factor, just as an increasing net pension obligation would be." Dave Hitchcock of Standard & Poor's said that few states have reported their unfunded liability for retiree health care. But when they do, he said, "It's probably going to change behavior." One reaction might be a move to trim costs by reducing benefits. Corporations were required to begin reporting their long-term retiree health debt in the early 1990s. In the following decade, the Mercer consultants said, the number of large corporations that provide health coverage for their Medicare-eligible retirees dropped to 21 percent from 40 percent.***

Awards and Acknowledgements

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, 2004. 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 the 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 the State 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, 2005

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CERTIFICATE OF ACHIEVEMENT