NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Financial Reporting Entity

The accompanying government-wide financial statements present the State of North Carolina and its component units. The State of North Carolina, as primary government, consists of all organizations that make up its legal entity. All funds, organizations, agencies, boards, commissions, and authorities that are not legally separate are, for financial reporting purposes, part of the primary government. The primary government has a separately elected governing body (the General Assembly) and the primary government must be both legally separate and fiscally independent. Component units are legally separate entities for which the State is financially accountable. Accountability is defined as the State's substantive appointment of a majority of the component unit's governing board. Furthermore, to be financially accountable, the State must be able to impose its will upon the component unit or there must be a possibility that the component unit may provide specific financial benefits to, or impose specific financial burdens on, the State. Financial accountability also exists when an organization is fiscally dependent upon the State. The State's defined benefit pension plans, deferred compensation plans, and other employee benefit plans, being fiduciary in nature, were not evaluated as potential component units but instead are reported as fiduciary funds.

The State's component units are either blended or discretely presented. The blended component unit is so intertwined with the State that it is, in substance, the same as the State and, therefore, is reported as if it was part of the State primary government. The "Component Units" column in the accompanying financial statements includes the financial data of the State's discretely presented component units. They are combined and reported in a separate column in the government-wide financial statements to emphasize their legal separateness from the State.

Blended Component Unit

The North Carolina Infrastructure Finance Corporation

The North Carolina Infrastructure Finance Corporation (Corporation) was created by the General Assembly and organized as a separate not-for-profit corporation. It is managed by a three-member board appointed by the State Treasurer. The Corporation is authorized to issue tax-exempt debt to finance the acquisition, construction, repair and renovation of State facilities and related infrastructure. The debt obligations are secured by lease-purchase agreements or installment financing contracts with the State, which constitute the imposition of a financial burden on the State. The substance of the financing agreements is that the assets and debt are those of the State (lessee). The Corporation is reported with the State's governmental funds since it provides services entirely to the State.

Discretely Presented Component Units - Major

The Golden LEAF (Long-term Economic Advancement Foundation), Inc.

The Golden LEAF, Inc. (Foundation) is a legally separate not-for-profit corporation ordered to be created by the Consent Decree and Final Judgment in the State of North Carolina vs. Philip Morris, et al. The Foundation was established to receive and distribute fifty percent of the tobacco settlement funds allocated to North Carolina, such funds to be used to provide economic impact assistance to economically affected or tobacco-dependent regions of North Carolina. The Foundation is governed by a fifteen-member board, all of whom are appointed by either the Governor, President Pro Tempore of the Senate, or the Speaker of the House. The State assigned fifty percent of its share of the settlement to the Foundation, creating a financial benefit/burden relationship.

University of North Carolina System

The Board of Governors of the consolidated University of North Carolina (UNC) System is a legally separate body, composed of thirty-two members elected by the General Assembly. The Board of Governors establishes system-wide administrative policies while budgetary decisions are exercised at the State level. Within the consolidated System are UNC-General Administration, which is the administrative arm of the Board of Governors; the sixteen constituent universities; and the University of North Carolina Health Care System (UNCHCS). Each of the sixteen universities, in turn, is governed by its own separate board of trustees that is responsible for the operations of that campus only. UNCHCS is governed by a separate board of directors. Funding for the UNC System is accomplished by State appropriations, tuition and fees, sales and services, federal grants, state grants, and private donations and grants.

Also included in the System are the financial data of the universities' significant fund-raising foundations (and similarly affiliated organizations). Although the universities do not control the timing or amount of receipts from their foundations, the majority of resources (or income thereon) that the foundations hold and invest are restricted to the activities of the respective universities by the donors. Because these restricted resources held by the foundations can only be used by, or for the benefit of, the specific universities, the foundations are considered component units of the universities and are included in the universities' financial statements. The foundations are private not-for-profit organizations that report under Financial Accounting Standards Board pronouncements. As such, certain revenue recognition criteria and presentation features are different from that of the Governmental Accounting Standards Board. The foundations' financial statement formats were modified to make them compatible with the universities' financial statement formats.

NOTES TO THE FINANCIAL STATEMENTS

The following constituent institutions comprise the UNC System for financial reporting purposes:

UNC General Administration
Appalachian State University
East Carolina University
Elizabeth City State University
Fayetteville State University
North Carolina Agricultural and Technical State University
North Carolina Central University
North Carolina School of the Arts
North Carolina State University
University of North Carolina at Asheville
University of North Carolina at Chapel Hill
University of North Carolina at Charlotte
University of North Carolina at Greensboro
University of North Carolina at Pembroke
University of North Carolina at Wilmington
Western Carolina University
Winston-Salem State University
University of North Carolina Health Care System

Community Colleges

There are currently 58 community colleges located throughout the State of North Carolina. Each is a separate component unit of the reporting entity and is legally separate. The State does not appoint a voting majority of each community college board of trustees. However, the State is financially accountable for these institutions because the State Board of Community Colleges (the Board) approves the budgeting of state and federal funds, the associated budget revisions, and the selection of the chief administrative officer of each individual community college. The Board is comprised of state officials or their appointees. Each community college is similar in nature and function to all of the others, and the operations of no single community college are considered major in relation to the operations of all community colleges in the system. Therefore, aggregated financial information is presented in this CAFR for all community colleges.

The aggregated financial information for community colleges also includes the financial data of the institutions' significant fund-raising foundations. Although the community colleges do not control the timing or amount of receipts from their foundations, the majority of resources (or income thereon) that the foundations hold and invest are restricted to the activities of the respective community colleges by the donors. Because these restricted resources held by the foundations can only be used by, or for the benefit of, the specific community colleges, the foundations are considered component units of the community colleges and are included in the community colleges' financial statements. The foundations are private not-for-profit organizations that report under Financial Accounting Standards Board pronouncements. As such, certain revenue recognition criteria and presentation features are different from that of the Governmental Accounting Standards Board. The foundations' financial statement formats were modified to make them compatible with the community colleges' financial statement formats.

The following are the State's 58 community colleges:

Alamance Comm. College	Asheville-Buncombe Technical Comm. College
Beaufort County Comm. College	Bladen Community College
Blue Ridge Comm. College	Brunswick Comm. College
Caldwell Comm. College and Tech. Institute	Cape Fear Comm. College
Carteret Comm. College	Catawba Valley Comm. College
Central Carolina Comm. College	Central Piedmont Comm. College
Cleveland Comm. College	Coastal Carolina Comm. College
College of The Albemarle	Craven Comm. College
Davidson County Comm. College	Durham Technical Comm. College
Edgecombe Comm. College	Fayetteville Technical Comm. College
Forsyth Technical Comm. College	Gaston College
Guilford Technical Comm. College	Halifax Comm. College
Haywood Comm. College	Isothermal Comm. College
James Sprunt Comm. College	Johnston Comm. College
Lenoir Comm. College	Martin Comm. College
Mayland Comm. College	McDowell Technical Comm. College
Mitchell Comm. College	Montgomery Comm. College
Nash Comm. College	Pamlico Comm. College
Piedmont Comm. College	Pitt Comm. College
Randolph Comm. College	Richmond Comm. College
Roanoke-Chowan Comm. College	Robeson Comm. College
Rockingham Comm. College	Rowan-Cabarrus Comm. College
Sampson Comm. College	Sandhills Comm. College
South Piedmont Comm. College	Southeastern Comm. College
Southwestern Comm. College	Stanly Comm. College
Surry Comm. College	Tri-County Comm. College
Vance-Granville Comm. College	Wake Technical Comm. College
Wayne Comm. College	Western Piedmont Comm. College
Wilkes Comm. College	Wilson Technical Comm. College

North Carolina Housing Finance Agency

The North Carolina Housing Finance Agency is a legally separate organization established to administer programs to finance construction of low and moderate income housing. The Agency has a thirteen-member board of directors, with twelve appointed by either the Governor or the General Assembly. The thirteenth member is elected by the other twelve. The State has the ability to impose its will since it can significantly influence the programs, projects, activities, and level of services of the Agency.

State Education Assistance Authority

The State Education Assistance Authority is a legally separate authority created to provide a system of financial assistance, consisting of grants, loans, work-study or other employment, and other aids, to qualified students to obtain an education beyond the high school level by attending public or private educational institutions. The Authority is governed by a seven-member board of directors, all of whom are appointed by the Governor. The State provides significant operating subsidies to the Authority; therefore, a financial benefit/burden relationship exists between the State and the Authority.

NOTES TO THE FINANCIAL STATEMENTS

Discretely Presented Component Units - Other

North Carolina Phase II Tobacco Certification Entity, Inc.

The North Carolina Phase II Tobacco Certification Entity, Inc. (Entity) is a legally separate organization established to serve as the certification entity for the State for the National Tobacco Grower Settlement Trust. Under the settlement, tobacco companies agreed to create a trust fund for tobacco growers and quota holders in 14 grower states, including North Carolina. The Entity is governed by a fourteen-member board. Three members serve by virtue of their positions as state officials and nine members are appointed by either the Governor, President Pro Tempore of the Senate, or the Speaker of the House. The State has the ability to impose its will since appointed members may be removed without cause. The Tobacco Buyout Bill enacted in October 2004 ended the trust agreement that the Entity was formed to oversee. The Entity made a final payment to quota and tobacco owners in late 2005. Management believes that it will take approximately two years from the date of final payment to finalize any outstanding issues related to open payment years and to cease operations.

North Carolina Global TransPark Authority

The North Carolina Global TransPark Authority (formerly North Carolina Air Cargo Airport Authority) is a legally separate authority created to administer the development of the North Carolina Global TransPark. Of the twenty-member governing board, nineteen are voting members. Seven of the voting members are appointed by the Governor and six are appointed by the General Assembly. The State has obligated itself to provide significant funding to the Authority; therefore, a financial benefit/ burden relationship exists between the State and the Authority. Also included in the Authority are the financial data of its blended component unit, the North Carolina Global TransPark Foundation (Foundation). The Authority appoints a majority of the Foundation's governing board and receives financial benefits from the Foundation.

North Carolina State Ports Authority

The North Carolina State Ports Authority is a legally separate authority established to operate the State's port facilities in Wilmington and Morehead City. It is governed by an eleven-member board, all of whom are appointed by either the Governor or the General Assembly. The State has obligated itself to provide significant funding to the Authority; therefore, a financial benefit/burden relationship exists between the State and the Authority.

North Carolina Railroad Company

The North Carolina Railroad Company is a legally separate, for-profit corporation owned by the State for the purpose of promoting trade, industry, and transportation within North Carolina and advancing the economic interests of the State. The Railroad is governed by a fourteen member board, all of whom are elected by shares held by the State. A financial benefit/burden relationship exists between the State and the Railroad. Also, the State is financially accountable since the State's intent in owning the Railroad's stock is to directly enhance its ability to provide governmental services.

North Carolina Agricultural Finance Authority

The North Carolina Agricultural Finance Authority is a legally separate authority created to administer the financing of low-interest loans to farmers. The Authority is governed by a ten-member board, one of whom is a state official and nine of whom are appointed by either the Governor or the General Assembly. A financial benefit/burden relationship exists between the State and the Authority.

North Carolina Partnership for Children, Inc.

The North Carolina Partnership for Children, Inc. is a legally separate organization established to develop a comprehensive long-range strategic plan for early childhood development. A twenty-six-member board governs the Partnership. Certain elected state officials appoint twenty-two of the members, while four members serve ex officio by virtue of their state positions. The State provides significant operating subsidies to the Partnership creating a financial benefit/burden relationship.

Regional Economic Development Commissions:

Northeastern North Carolina Regional Economic Development Commission

The Northeastern North Carolina Regional Economic Development Commission is a legally separate organization created to facilitate economic development and tourism in northeastern North Carolina. The Commission consists of seventeen members, including the Secretary of Commerce and the Secretary of the Department of Environment and Natural Resources (or their designees), five members appointed by the Governor, five by the Speaker of the House, and five by the President Pro Tempore of the Senate. The State provides significant program and operating support to the Commission, creating a benefit/burden relationship.

Southeastern North Carolina Regional Economic Development Commission

The Southeastern North Carolina Regional Economic Development Commission is a legally separate organization created to build economic strength in southeastern North Carolina. The Commission consists of fifteen members, with three appointed by the Governor, two by the Lieutenant Governor, five by the Speaker of the House, and five by the President Pro Tempore of the Senate. The State provides significant program and operating support to the Commission, creating a benefit/burden relationship.

Western North Carolina Regional Economic Development Commission

The Western North Carolina Regional Economic Development Commission is a legally separate organization created to improve economic opportunity in western North Carolina with sensitivity to the resources of that region. The Commission consists of fifteen members, with five appointed by the N.C. House of Representatives, five by the N.C. Senate, three by the Governor, and two by the Lieutenant Governor. The State provides significant program and operating support to the Commission, creating a benefit/burden relationship.

North Carolina Turnpike Authority

The North Carolina Turnpike Authority was created to study, design, plan, construct, finance, and operate a system of toll roads, bridges, and/or tunnels supplementing the traditional non-toll transportation system serving the citizens of the State. The Turnpike Authority is governed by a nine member board consisting of four members appointed by the General Assembly, four members appointed by the Governor, and the Secretary of Transportation. The State has the ability to impose its will since appointed members may be removed without cause.

Availability of Financial Statements

Complete financial statements for the following component units can be obtained from the Office of the State Auditor, 2 South Salisbury Street, 20601 Mail Service Center, Raleigh, N.C. 27699-0601.

Constituent institutions in the UNC System
Community colleges
North Carolina Turnpike Authority
North Carolina State Ports Authority
North Carolina Partnership for Children, Inc.
North Carolina Agricultural Finance Authority
North Carolina Global Transpark Authority

Complete financial statements for the following component units can be obtained from the respective administrative offices of those units listed below:

The Golden LEAF, Inc.
107 SE Main Street
Rocky Mount, NC 27801

State Education Assistance Authority
P.O. Box 2688
Chapel Hill, N.C. 27515-2688

N.C Phase II Tobacco Certification Entity, Inc.
3125 Popularwood Ct., Suite 112
Raleigh, N.C. 27604

Southeastern N.C. Regional Economic Development Commission
P.O. Box 2556
Elizabethtown, N.C. 28337

N.C. Housing Finance Agency
P.O. Box 28066
Raleigh, N.C. 27611-8066

North Carolina Railroad Company
2809 Highwoods Boulevard, Suite 100
Raleigh, NC 27604-1000

Northeastern N.C. Regional Economic Development Commission
119 West Water Street
Edenton, N.C. 27932

Western N.C. Regional Economic Development Commission
3 General Aviation Dr.
Fletcher, N.C. 28732

The North Carolina Infrastructure Finance Corporation does not issue separate financial statements.

B. Basis of Presentation

The accompanying financial statements of the State of North Carolina financial reporting entity have been prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP") as applicable to governments. The Governmental Accounting Standards Board (GASB) establishes standards of financial accounting and reporting for state and local governmental entities. Private sector standards of accounting and financial reporting issued on or before November 30, 1989 generally are followed in both the government-wide and proprietary fund financial statements to the extent those pronouncements do not conflict with or contradict GASB pronouncements. Governments also have the option of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to this same limitation. The State has elected not to follow subsequent private-sector guidance. The financial statements of the North Carolina Railroad Company (Railroad), a for-profit corporation (discretely presented component unit), have been prepared in accordance with FASB pronouncements.

The financial statements are presented as of and for the fiscal year ended June 30, 2006, except for the USS North Carolina Battleship Commission whose statements are as of and for the fiscal year ended September 30, 2005, and the North Carolina Deferred Compensation Plan, the 401(k) Supplemental Retirement Income Plan, and the North Carolina Railroad Company whose statements are as of and for the fiscal year ended December 31, 2005.

The basic financial statements include both government-wide (based on the State as a whole) and fund financial statements as follows:

Government-wide Financial Statements

The statement of net assets and the statement of activities display information on all the nonfiduciary activities of the primary government (the State) and its component units. Fiduciary activities are excluded from the government-wide statements because they cannot be used to support the State's own programs. As a general rule, the effect of interfund activity has been eliminated from the government-wide financial statements. Exceptions to this general rule are interfund services provided and used between functions. Elimination of these charges would misstate both the expenses of the purchasing function and the program revenues of the selling function. These statements distinguish between the governmental and business-type activities of the State. Governmental activities generally are financed through taxes, intergovernmental revenues, and other nonexchange transactions. Business-type activities are financed in whole or in part by fees charged to external parties. Likewise, the primary government is reported separately from certain legally separate component units for which the primary government is financially accountable.

The statement of activities demonstrates the degree to which the direct expenses of a given function or identifiable activity are offset by program revenues. Direct expenses are those that are clearly associated with a specific function or identifiable activity. Certain charges to other funds or programs for "centralized" expenses also include an overhead markup that is included in direct expenses. Program revenues include (a) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or identifiable activity (including fees, fines and forfeitures and certain grants and contracts that are essentially contracts for services) and (b) grants and contributions that are restricted to meeting the operational or capital requirements of a particular program or identifiable activity (including restricted investment earnings or losses). Revenues that are not classified as program revenues, including all taxes, are presented as general revenues. Unrestricted resources internally dedicated by the State's governing body (General Assembly) are reported as general revenues rather than as program revenues. The State does not allocate general government (indirect) expenses to other functions.

Fund Financial Statements

The fund financial statements provide information about the State's funds, including its fiduciary funds. Separate statements for each fund category—governmental, proprietary, and fiduciary—are presented. The emphasis of fund financial statements is on major governmental and major enterprise funds, each displayed in a separate column. All remaining governmental and enterprise funds are aggregated and reported as nonmajor funds.

The State reports the following major governmental funds:

General Fund

This is the State's primary operating fund. It accounts for all financial resources of the general government, except those required to be accounted for in another fund.

Highway Fund

This fund accounts for most of the activities of the Department of Transportation, including the construction and maintenance of the State's primary and secondary road systems. In addition, it supports areas such as the N.C. Ferry System, the Division of Motor Vehicles, public transportation, and railroad operations. The fund provides revenue to other State agencies to support initiatives such as the State Highway Patrol and driver's education. The principal revenues of the Highway Fund are motor fuels taxes, motor vehicle registration fees, driver's license fees, and federal aid. A portion of the motor fuels taxes is distributed to municipalities for local street projects.

Highway Trust Fund

This fund was established by legislation (Chapter 692 of the 1989 Session Laws) to provide a dedicated funding mechanism to meet highway construction needs for North Carolina. Taxes were increased for the specific purpose of improving identified primary transportation corridors within the State and for the completion of urban loops around seven major metropolitan areas. Additionally, this fund provides supplemental allocations for secondary road construction and supplemental assistance to municipalities for local street projects. The fund also makes transfers to the General Fund and the Highway Fund. The principal revenues of the Highway Trust Fund are highway use taxes, motor fuels taxes, and various title and registration fees.

The State reports the following major enterprise funds:

Unemployment Compensation Fund

This fund accounts for the State's unemployment insurance program, which is part of a national system established to provide temporary benefit payments to eligible unemployed workers. The unemployment benefits are financed primarily by State unemployment insurance taxes, distributions of federal unemployment insurance taxes, and federal funding for the unemployment benefits of civilian and military employees. The unemployment taxes collected from employers are transferred to the United States Treasury and deposited into North Carolina's Unemployment Insurance Trust Fund.

N.C. State Lottery Fund

This fund accounts for the activities of the N.C. Education Lottery Commission, which began ticket sales on March 30, 2006. The net profits of the fund are transferred periodically to the Education Lottery Fund, a nonmajor special revenue fund.

EPA Revolving Loan Fund

This fund accounts for the activities of the State's clean water and drinking water revolving loan programs, which provide low cost loans to units of local government for the construction of wastewater facilities and drinking water infrastructure. These programs are financed primarily by federal capitalization grants from the United States Environmental Protection Agency (EPA), interest earnings on loans, loan repayments, and State funds (i.e., bond proceeds and State appropriations).

Additionally, the State reports the following fund types:

Internal Service Funds

These funds account for workers compensation and state property fire insurance coverages, motor fleet management services, mail services, temporary staffing services, computing and telecommunication services, and surplus property services provided to other departments or agencies of the State and its component units, or to other governments, on a cost-reimbursement basis.

Pension and Other Employee Benefits Trust Funds

These funds account for resources held in trust for the members and beneficiaries of the State's defined benefit pension plans, Internal Revenue Code (IRC) Section 401(k) plan, IRC Section 457 plan, other defined contribution plans, death benefit plan, disability income plan, State health plan, and retiree health benefit fund.

Investment Trust Fund

This fund accounts for the external portion of the Investment Pool sponsored by the Department of State Treasurer.

Private-purpose Trust Funds

These funds account for resources held in trust for insurance carriers, designated beneficiaries by the Administrative Office of the Courts, and other departmental trust funds in which the principal and income benefit individuals, private organizations, or other governments.

Agency Funds

These funds account for sales tax collections held on behalf of local governments, resources held by the Administrative Office of the Courts for distribution to designated beneficiaries, the Investment Pool's securities lending assets and liabilities allocated to participating component units, insurance company receivership assets, and other resources held by the State in a purely custodial capacity for individuals, private organizations, or other governments. Insurance company receivership assets are held by the Commissioner of Insurance exclusively in his capacity as Receiver. These assets belong to insurance companies and other entities in receivership and are not the property of the State.

C. Measurement Focus and Basis of Accounting

Government-wide, Proprietary, and Fiduciary Fund Financial Statements

The government-wide, proprietary, and fiduciary fund financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, except for agency funds which do not have a measurement focus. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of the timing of related cash flows.

Lottery games are sold to the public by contracted retailers. For Powerball, revenue is recognized at the time of sale. For instant games, revenue is recognized at the time a pack of tickets is settled. For Powerball, prize expense is recorded at fifty percent of sales. For instant games, prize expense is accrued based on the final production prize structure percentage provided by the gaming vendor for each game and recorded on the value of packs settled. For instant games with prize tickets, the final prize structure percentage used is adjusted to eliminate the value of the prize tickets.

Nonexchange transactions, in which the State receives (or gives) value without directly giving (or receiving) equal value in exchange, include taxes; fines and forfeitures; grants, entitlements, and similar items; and donations. Recognition standards are based on the characteristics and classes of nonexchange transactions. Income taxes, sales taxes, and other similar taxes on earnings or consumption are recognized as revenues, net of estimated refunds and uncollectible amounts, in the accounting period when the underlying exchange transaction has occurred. Franchise taxes, other taxes, and fines and forfeitures are recognized as revenues, net of estimated refunds and uncollectible amounts, in the accounting period when an enforceable legal claim to the assets arises and the use of resources is required or is first permitted. Grants, entitlements, and donations are recognized as revenues, net of estimated uncollectible amounts, as soon as all eligibility requirements imposed by the provider have been met, if probable of collection. Amounts received before all eligibility requirements have been met are reported as deferred revenues. Grants and similar aid to other organizations are recognized as expenses as soon as recipients have met all eligibility requirements. Amounts paid before all eligibility requirements have been met are reported as prepaid items.

Governmental Fund Financial Statements

Governmental funds are reported using the current financial resources measurement focus and the modified accrual basis of accounting. With this measurement focus, only current assets and liabilities are generally included on the balance sheet. The operating statement presents increases (revenues and other financing sources) and decreases (expenditures and other financing uses) in spendable resources. General capital asset acquisitions are reported as expenditures and proceeds of general long-term debt are reported as other financing sources.

Under the modified accrual basis of accounting, revenues are recognized when both measurable and available. Generally, the State considers revenues reported in the governmental funds to be available if they are collected with thirty-one days after year-end. Exceptions are individual income tax revenues and federal and county funds accrued for the matching share of medicaid claims payable, which the State considers to be available if they are collected within twelve months after year-end. Furthermore, in the circumstance where underpayments exceed overpayments, individual income tax revenues are recognized to the extent of estimated overpayments (i.e., refunds payable and applied refunds). Principal revenue sources considered susceptible to accrual include taxes, federal funds, local funds, and investment earnings. Other revenues are considered to be measurable and available only when cash is received by the State.

Expenditures are recorded when the related fund liability is incurred, except for principal and interest on general long-term debt, claims and judgments, compensated absences, obligations for workers' compensation, and arbitrage rebate liabilities, which are recognized as expenditures when payment is due. Pension contributions to cost-sharing pension plans are recognized as expenditures in the period to which the payment relates, even if payment is not due until the subsequent period.

D. Cash and Cash Equivalents

This classification includes undeposited receipts; petty cash; deposits held by the State Treasurer in the Short-term Investment portfolio (see Note 3); and demand and time deposits with private financial institutions, excluding certificates of deposit. The Short-term Investment portfolio maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit additional cash at any time and also may withdraw cash at any time without prior notice or penalty.

E. Investments

This classification includes deposits held by the State Treasurer in certain long-term investment portfolios (see Note 3) as well as investments held separately by the State and its component units. Investments are generally reported at fair value. Additional investment valuation information is provided in Note 3. The net increase (decrease) in the fair value of investments is recognized as a component of investment income.

F. Securities Lending

Cash and securities received as collateral on securities lending transactions are reported as assets in the accompanying financial statements. Liabilities resulting from the securities lending transactions are also reported. Certain component units of the State deposit funds with the State Treasurer's Investment Pool, which participates in securities lending activities. The component units' position in the pool and related securities lending assets and liabilities are reported in an agency fund. Additional disclosures about the State Treasurer's securities lending transactions are provided in Note 3.

G. Receivables and Payables

Receivables in all funds represent amounts that have arisen in the ordinary course of business and are shown net of allowances for uncollectible amounts.

Activity between funds that are representative of lending/borrowing arrangements outstanding at the end of the fiscal year are referred to as either "due to/due from other funds" (i.e., current portion of interfund loans) or "advances to/from other funds" (i.e., the non-current portion of interfund loans). All other outstanding balances between funds related to services provided and used, reimbursements, and transfers are classified as "due to/due from other funds." Any residual balances outstanding between the governmental activities and business-type activities are reported in the government-wide financial statements as "internal balances."

In the fund financial statements, advances between funds (and to component units) and notes receivable are offset by a reserve account in applicable governmental funds to indicate that they are not available for appropriation and are not expendable available financial resources.

H. Inventories and Prepaid Items

The inventories of the State and component units are valued at cost using either the first-in, first-out, last invoice cost, or average cost method. These inventories consist of general supplies and materials. Institutions of the UNC system and community colleges also use these valuations along with the retail inventory method for some bookstore operations. The State Highway Fund (special revenue fund) accounts for its maintenance and construction inventories using the average cost method.

Except for maintenance and construction inventories of the State Highway Fund, inventories in the State's governmental funds are recorded as expenditures when purchased. In the fund financial statements, inventories are offset by a fund balance reserve account in applicable governmental funds to indicate that they are not available for appropriation and are not expendable available financial resources. All other inventories of the State and its component units are recognized as expenses or expenditures when consumed.

Certain payments to vendors and grantees reflect costs applicable to future accounting periods and are recorded as prepaid items in both government-wide and fund financial statements.

I. Restricted/Designated Assets

In the enterprise funds, unexpended proceeds of revenue bonds and unexpended capital contributions are classified as restricted assets because their use is limited by applicable bond covenants or donor/grantor agreements. These assets are also classified as noncurrent since they cannot be used for current operations (i.e., are restricted for the acquisition/construction of capital assets). Unrestricted assets that are internally designated for capital purposes are also classified as noncurrent. Certain other assets are classified as restricted because their use is limited by statute.

J. Capital Assets

Capital assets, which include property, plant, equipment; easements; and infrastructure assets (e.g., State highway network, utility systems, and similar items), are reported in the government-wide financial statements and the fund financial statements for proprietary funds. Purchased or constructed capital assets are reported at cost or estimated historical cost. The State highway network constructed prior to July 1, 2001 is recorded at estimated historical cost. Since July 1, 2001 the State highway network is recorded at cost. The initial estimated historical cost of the network is based on construction expenditures reported by the Department of Transportation less amounts estimated for the cost of right-of-ways and land

improvements. The cost of normal maintenance and repairs that do not add to the value of the asset or materially extend its useful life are not capitalized. Donated capital assets are recorded at their estimated fair value at the date of donation.

Generally, capital assets are defined by the State and component units as assets with an initial value or cost greater than or equal to $5,000 and an estimated useful life of two or more years. Exceptions are certain component units (The Golden LEAF, Inc., N.C. Housing Finance Agency, N.C. Phase II Tobacco Certification Entity, Inc., N.C. Railroad Company, and N.C. Regional Economic Development Commissions), which maintain minimum thresholds of $1,000 or below.

The value of assets constructed by the State and its component units for their own use includes all material direct and indirect construction costs that are increased as a result of the construction. In proprietary funds and component units, interest costs incurred (if material) are capitalized during the period of construction.

The depreciation methods and estimated useful lives used by the state and component units are as follows:

Asset Class	Method	Estimated Useful Life
Buildings	Straight-line	10-50 years
Machinery and Equipment	Straight-line	2-25 years
	Units of output for motor vehicles	90,000 miles
Intangible assets	Straight-line	2-40 years
Art, literature, and other artifacts	Straight-line	2-25 years
General infrastructure	Straight-line	10-75 years
State highway network	Composite	50 years

For the State highway network, depreciation is based on a weighted average of the estimated useful lives of dissimilar assets in the network (e.g., subsurface foundations, roadway surfaces, bridges, traffic control devices, guardrails, markings, signage, etc.).

K. Tax Refund Liabilities

Tax refund liabilities consist primarily of accrued income and sales and use tax refunds due to taxpayers. During the calendar year, the State collects employee withholdings and taxpayers' payments for income taxes. At June 30, the State estimates the amount it owes taxpayers for income tax overpayments during the preceding six months. Sales and use tax refund liabilities are also estimated at June 30. These liabilities are recorded as "Tax refunds payable."

L. Compensated Absences

Employees of the State and component units are permitted to accumulate earned but unused vacation pay benefits. All vacation pay is accrued when incurred in the government-wide and proprietary fund financial statements. Also, when determining the vacation pay liability due within one year, leave is considered taken on a last in, first out (LIFO) basis. In governmental funds, a liability for these amounts is reported only as payments come due each period upon the occurrence of relevant events such as employee resignations and retirements. The State's policy provides for a maximum accumulation of unused vacation leave of 30 days which can be carried forward each January 1 or for which an employee can be paid upon termination of employment. Also, any accumulated vacation leave in excess of 30 days at year end is converted to sick leave.

In addition to the vacation leave described above, compensated absences include the accumulated unused portion of the special annual leave bonuses awarded by the North Carolina General Assembly. The bonus leave balance on December 31 is retained by employees and transferred into the next calendar year. It is not part of the 30 day maximum applicable to regular vacation leave and is not subject to conversion to sick leave.

There is no liability for unpaid accumulated sick leave because the State has no obligation to pay sick leave upon employee termination or retirement. However, additional service credit for retirement pension benefits is given for accumulated sick leave upon retirement.

M. Long-Term Liabilities

In the government-wide financial statements, long-term debt and other long-term obligations are reported as liabilities in the columns for governmental activities, business-type activities, and component units. These amounts are also reported as liabilities in the fund financial statements for proprietary funds. Debt premiums of the State are deferred and amortized over the life of the debt using the effective interest method, if material. Losses on the State's refundings are deferred and amortized over the remaining life of the old debt or the life of the new debt, whichever is shorter, using the effective interest method. Losses on refundings of the NC Housing Finance Agency are deferred and amortized using the straight-line method. Debt premiums, discounts, and losses on refundings of the University of North Carolina System (component unit) are generally deferred and amortized using the straight-line method, if material. Long-term debt is reported net of the applicable debt premium, discount, and/or deferred loss on refunding. Debt issuance costs of the State's governmental activities and the University of North Carolina System (component unit) are generally expensed. Debt issuance costs of the State's business-type activities and the NC Housing Finance Agency and the NC State Education Assistance Authority (component units) are deferred and amortized over the life of the debt using the straight-line method.

Capital appreciation bonds are those bonds that are issued at stated interest rates (which may be zero) significantly below their effective interest rate, resulting in a substantial discount (deep discount). The implicit interest (i.e., discount) is not paid until the bonds mature. Therefore, the net value of the bonds accrete (i.e., the discount is reduced) over the life of the bonds. This deep-discount debt is reported in the government-wide financial statements at its net or accreted value rather than at face value.

In the fund financial statements, governmental fund types recognize debt premiums, as well as debt issuance costs, during the current period. The face amount of the debt issued and premiums received are reported as other financing sources. Issuance costs, whether or not withheld from the actual proceeds received, are reported as debt service expenditures.

N. Sureties

Sureties include various assets, including securities from insurance companies and bail bondsmen doing business within North Carolina, that have been placed in safekeeping with a financial institution or the State Treasurer, as required by applicable general statutes.

O. Net Assets/Fund Balance

Net assets are reported as restricted when constraints placed on them are either externally imposed by creditors, grantors, contributors, or laws or regulations of other governments or are imposed by law through constitutional provisions. Constraints placed on net asset use by enabling legislation are not reported as net asset restrictions since such constraints are not legally enforceable. An Attorney General Advisory Opinion referenced that the Governor, pursuant to his constitutional authority under Article III, Section 5(3), may use resources restricted by enabling legislation in his discretion to meet a budget shortfall. Legal enforceability means that the State can be compelled by an external party, such as citizens, public interest groups, or the judiciary to use resources created by enabling legislation only for the purposes specified by the legislation. Situations where the State's internal governing body (General Assembly) places restrictions on existing resources or earmarks existing revenue sources are considered to be constraints that are internally imposed. Such internally dedicated net assets are presented as unrestricted.

Under some programs, the State has the option of using either restricted or unrestricted resources to make certain payments. When both restricted and unrestricted resources are available for use, generally it is the State's policy to use receipts first (which include restricted and unrestricted resources), then State appropriations as necessary. Receipts are defined as all funds collected by an agency or institution other than State appropriations. The decision to use restricted or unrestricted receipts to fund a payment is transactional-based within the departmental management system in place at the agency or institution. For projects funded by tax-exempt debt proceeds and other sources, the debt proceeds are always used first.

In the fund financial statements, governmental funds report reservations of fund balance for amounts that are (a) externally restricted for a specific use, (b) not available for appropriation or expenditure because the underlying asset is not an available financial resource, or (c) for encumbrances, which represent commitments related to unperformed contracts for services and undelivered goods. Designations of fund balance represent tentative management plans that are subject to change (See Note 10, Fund Balance Reserves).

P. Revenues and Expenses

Proprietary funds distinguish operating revenues and expenses from nonoperating items and capital contributions. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Proprietary fund operating revenues result from exchange transactions associated with the principal activity of the fund. Exchange transactions are those in which each party receives and gives up essentially equal values. Nonoperating revenues, such as noncapital grants and investment earnings, result from nonexchange transactions or ancillary activities. Capital contributions are reported separately, after nonoperating revenues and expenses.

Q. Food Stamps

In accordance with GASB Statement No. 24, Accounting and Financial Reporting for Certain Grants and Other Financial Assistance, the State recognizes distributions of food stamp benefits as revenue and expenditures in the general fund, whether the benefits are distributed directly or through agents and whether the benefits are in paper or electronic form. Expenditures are recognized when the benefits are distributed to the individual recipients by the State or its agents; revenue is recognized at the same time. Revenue, expenditures, and balances of food stamps are measured based on face value.