



# 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 2006 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 (MD&A), 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.

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, the EPA Revolving Loan Fund and the N.C. State Lottery Fund. The MD&A can be found immediately following the Independent Auditor's Report.

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## *Profile of the State of North Carolina*

### **The Old North State, The Tar Heel State**

North Carolina became the 12<sup>th</sup> state of the union in 1789. North Carolina is located on the Atlantic coast and is bordered by Georgia, South Carolina, Tennessee and Virginia. The State has a land area of approximately 50,000 square miles. The State's estimated population is 8.8 million, making it the 11<sup>th</sup> most populated state in the nation. Sixty percent of the population is found in urban areas, while forty percent is found in rural areas. The North Carolina coastline is 301 miles, the greatest distance east to west is 543 miles, and the greatest distance north to south is 188 miles. The State's elevation rises from sea level on the eastern coastline to 6,684 feet at Mount Mitchell in the Appalachian mountain range on our western border. There are 78,844 miles of roads, with Interstate 40 crossing North Carolina east to west, and Interstates 85 and 95 crossing the State north to south. North Carolina's capital and central state government administration is located in Raleigh, in the central piedmont. Charlotte, Raleigh, Greensboro, Durham, and Winston-Salem are North Carolina's largest cities and there are 100 counties.

### **Government**

North Carolina's state government consists of an executive branch, a legislative branch, and a judicial branch. The executive branch is headed by the Governor. The Governor, Lieutenant Governor, and eight other statewide elected officers form the Council of State. The State Constitution provides that, "A Secretary of State, an Auditor, a Treasurer, a Superintendent of Public Instruction, an Attorney General, a Commissioner of Agriculture, a Commissioner of Labor, and a Commissioner of Insurance shall be elected by the qualified voters of the State...."

The legislative power of the State is vested in the General Assembly, which consists of a Senate and a House of Representatives. The Senate is composed of 50 Senators, elected on a biennial basis. The House of Representatives is composed of 120 Representatives, elected on a biennial basis.

The Courts of the Judicial Branch are split into three divisions, the Appellate Division, the Superior Court Division, and the District Court Division. Judges are elected on a non-partisan basis.

### **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 k-12 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, 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. The *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. These changes result in the *final budget* presented in the required supplementary information.

## **Economic Condition**

### **Prospects for Fiscal Year 2006-07**

The consensus revenue estimate for the upcoming fiscal year represented a very cautious stance regarding the portion of the 2005-06 revenue surplus counted as recurring. In addition, the economy-based revenue estimates for the year reflect the view that the combination of a rise in short-term interest rates to 5.25% (9.25% for prime rate) and persistently high energy prices will eventually lead to a "mid-decade slowdown" similar to 1984-86 and 1995. The result is that baseline General Fund tax growth is expected to be only 3.3%. This forecast is in line with the downward adjustments made in many states after a second year of strong April income tax payments.

The projection of slower job growth and retail sales is pretty much the same outlook adopted a year ago during the 2005-06 budget discussions. The difference this year has to do with the loss of the underpinning from the robust real estate market. As the weakness in this sector continues to filter through the economy, we think the Federal Reserve will take note and leave short-term rates at the current 5.25% level. If the economic slowdown accelerates, the Federal Reserve may begin to lower rates during the second half of the fiscal year.

An additional reason the 2006-07 economic outlook is cautious is that even if we get the change in direction of the economy and timing right, it is hard to project the magnitude of the decline. There have been numerous occasions in the past when the Federal Reserve overshot the mark and a planned slowdown turned into an outright recession. This has been especially true when the rate hikes are accompanied by external shocks such as a military engagement or a gas price spike.

Barring any unforeseen international events we think that a full-scale recession can be avoided. One reason has to do with stable long-term interest rates. During a typical monetary tightening phase, long-term rates will follow hikes in short-term rates for the first few moves before stabilizing as investors become comfortable that an economic slowdown and lessening of inflation pressures is underway. During the current cycle long-term rates have remained stable throughout the Federal Reserve actions. Part of the reason for the stability has been the continued supply of funds from overseas. The other reason that a full-scale recession can be avoided has to do with the fact that the sharp increase in energy prices has not translated into a major increase in "core inflation" (prices increase excluding the volatile energy and food components).

Though the risks to the economic outlook increased, the cautionary stance taken on the nonrecurring portion of the 2005-06 revenue surplus means that the State is well-positioned for the economic slowdown that is starting to unfold.

## *Issues and Observations*

### **BEACON**

#### **BEACON HR/Payroll**

The State's current core business systems have limited functionality. They rely on dated technology, do not communicate well with each other, are difficult to change for new operational requirements, and are hard to operate and maintain. Moreover, they do not provide information needed for management decision-making in today's business climate, and they are at risk of failure due to old age, withdrawal of vendor support, and being run by a workforce that is rapidly reaching retirement age.

BEACON is a statewide collaborative effort aimed at transforming the way we do business in North Carolina by modernizing and standardizing key business processes in human resources, payroll, budget management, taxation, data storage and accounting. With the implementation of SAP's Enterprise Resource Planning software solution, the goal of BEACON is to build a foundation for management flexibility, increased efficiency, improved access to information, and ultimately to enhance the quality of services provided to the citizens of North Carolina.

The Office of the State Controller, Information Technology Services, the Office of State Budget and Management, the Office of State Personnel, and the Department of Transportation are overseeing the implementation effort with the full support of Governor Easley and the General Assembly. BEACON will impact many of the systems and processes utilized by state agencies and universities. Representatives from nearly every agency in the State are participating in the design of the new infrastructure.

Session Law 2004-129 appropriated \$2.7 million from the IT Fund to the Office of the State Controller in 2004 to begin implementation of the recommendations found in the Statewide Business Infrastructure Study. Of the \$2.7 million, \$1.8 million was allocated to the HR/Payroll Initiative and \$900 thousand to the Enterprise Data Warehouse Initiative. The fiscal year 2005-06 appropriation for the HR/Payroll project was \$20.875 million. Funding for fiscal year 2006-07 is \$44.3 million. The overall estimated cost for the HR/Payroll project is \$125.5 million. The HR/Payroll project is on budget and on schedule to be operational, with the first agency group brought on-line during January 2008, and the second agency group scheduled to be on-line during April 2008.

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

#### **Enterprise Data Warehouse Initiative**

As part of the BEACON program, the BEACON Steering Committee has identified data warehousing and business intelligence as a key technology infrastructure necessary for delivering better citizen services and more effective operations of State government. In an environment where efficiency, accountability and transparency are paramount to the operations of each and every government entity, it is essential that data formerly housed in disparate "silos" be made available for agency and enterprise reporting and analysis.

The State of North Carolina has undertaken a number of initiatives recently to allow the State to better leverage its data assets. These activities have demonstrated the clear need for a more comprehensive approach to data warehousing and business intelligence in the State. From a statewide perspective, the highest value of business intelligence and data warehousing is realized when information is globally consistent and standardized, enabling decision-makers to query across agencies to perform forecasting, trending and data analysis. The Data Warehousing Needs Assessment revealed a number of immediate opportunities for implementation of data warehousing and business intelligence that would allow agencies to better leverage their data assets to provide improved operations or services.

## **State Budget Act**

On July 20, 2006, the General Assembly passed House Bill 914 State Budget Act to replace the Executive Budget Act. This new legislation is effective July 1, 2007 and will affect budget development and management by simplifying, reorganizing, updating the current budget statutes, and making changes to conform the statutes to the state constitutional provisions governing appropriations. The State Budget Act defines key budget aspects and increases the targeted balance of the General Fund savings reserve from 5 percent to 8 percent of prior year operating appropriations expenditures. The new legislation provides that agency budgets be classified in accordance with generally accepted accounting principles as interpreted by the State Controller.

As part of the implementation of the State Budget Act, several budgetary processes and the State's budget code structure will be reviewed and revised as appropriate. Some revisions are expected to require adjustment to the State's budgetary and accounting systems.

## **Government Performance Audit**

The 2006 General Assembly enacted legislation that established the Government Performance Audit Committee (GPAC). The GPAC will consist of 10 members:

- (i) five members of the House of Representatives appointed by the Speaker of the House of Representatives, and
- (ii) five members of the Senate appointed by the President Pro Tempore of the Senate.

The GPAC committee will contract for a performance audit of the executive branch of state government. The goals of the audit are to evaluate the efficiency and effectiveness of state government, and to identify specific improvements. According to legislation, the audit may examine entire departments, agencies, or institutions, or similar programs in several departments. The results of the audit will be reported on or before February 1, 2008. A Request for Proposal (RFP) will be issued for the government performance audit.

The committee's examination of the efficiency and effectiveness of major management policies, practices, and functions, will include the following areas:

- (1) Planning, budgeting, and program evaluation policies and practices, including an analysis of the compliance of the executive branch with existing planning requirements, such as the Capital Improvement Planning Act, Article 1B of Chapter 143 of the General Statutes;
- (2) Personnel systems operations and management;
- (3) State purchasing operations and management;
- (4) Information technology and telecommunications systems policy, organization, and management; and
- (5) Review of duplications and related or overlapping services or activities for the purpose of coordinating and streamlining programs to achieve consistent and clear objectives.

**Other Post-  
Employment  
Benefits:  
Retiree  
Healthcare**

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).

Beginning in fiscal year 2006-07, the actuarial data will be disclosed in the notes to the State's CAFR, based on the disclosure requirements for a cost-sharing, multiple-employer plan, 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.

Aon Consulting completed an actuarial valuation of retiree health benefits earned as of December 31, 2005. Aon's report was released on December 7, 2006 by the State Health Plan. The State retiree healthcare benefit is currently funded on a pay-as-you-go basis, with minimal additional accumulation of funds to pay the retiree health benefit. Based on the current funding method with limited accumulation of funds, the actuarial assumptions reflect a short-term discount rate of 4.25%.

The actuarial valuation using the unit credit method indicated an accrued liability of \$23.925 billion for the retiree healthcare plan (\$23.786 billion unfunded), with an annual required contribution (ARC) of \$2.39 billion. This accrued liability and annual required contribution are most indicative of the administration and funding of the current retiree health benefit plan and will be incorporated into the required GASB disclosures in the 2007 CAFR.

Participating employers in the retiree health care benefit plan include the primary government state employees, local education agencies (LEAs), the University of North Carolina, community colleges, and several local governments. For the fiscal year ended June 30, 2006, North Carolina's, retiree healthcare employer contributions equaling 3.8% of payroll were \$476.8 million, representing an annual increase of 25.4%. Retiree healthcare premium costs paid to the State Health Plan were \$411.8 million, representing an annual increase of 14.4%. Plan net assets of \$171.1 million represent an increase of \$68.37 million, or 66.5% from the prior year.

## **Debt Affordability**

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.

The Committee produces the Debt Affordability Study on an annual basis. The report was created to serve as a tool for sound debt management practices by the State of North Carolina. The report provides the Governor and the General Assembly with a basis for assessing the impact of future debt issuance on the State's fiscal position and enables informed decision-making regarding both financing proposals and capital spending priorities. The report also provides a methodology for measuring, monitoring and managing the State's debt levels. The concept of Debt Affordability is widely regarded as an essential management tool. The methodology used in the study to analyze the State's debt position incorporates historical and future trends in debt levels, peer group comparisons and provides recommendations within adopted guidelines. The study also provides recommendations regarding other debt management related policies considered desirable and consistent with the sound management of the State's debt. Such recommendations were developed by incorporating management practices consistent with those utilized by the most highly rated states.

## ***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, 2005. This was the 12<sup>th</sup> consecutive year (1994 to 2005) the State has received the 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 11, 2006

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# CERTIFICATE OF ACHIEVEMENT

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# Certificate of Achievement for Excellence in Financial Reporting

Presented to

## State of North Carolina

For its Comprehensive Annual  
Financial Report  
for the Fiscal Year Ended  
June 30, 2005

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



A handwritten signature in black ink, appearing to read "Ronald J. Harter".

President

A handwritten signature in black ink, appearing to read "Jeffrey R. Emer".

Executive Director