

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 2007 Comprehensive Annual Financial Report (CAFR) of the State of North Carolina in compliance with G.S. 143B-426.40H. 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. 143B-426.40H 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 12th 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 9 million, making it the 10th 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 79,042 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 2007-08

Overview

In general, the economy will remain in choppy waters for the next couple of years as the nation's businesses and consumers work through the housing market slump and the economic slowdown. A large part of the economy's projected sluggish growth is being attributed to the loss in household wealth caused by the housing market decline. Fewer home sales coupled with stagnant or even declining prices has led to a decline in retail activity related to the housing market. For example, sales related to home purchases and home construction such as furniture and appliances have started to decline. Despite the slowing economy and housing woes, consumer confidence, though weakened, remains steady even in the face of higher gasoline prices, which reached record highs (in constant dollars) during the second quarter of 2007.

The housing market slump began to show significant signs of affecting the national economy in the second quarter of 2007 as economic growth slowed to 2.7 percent, which is below average economic growth over the last 30 years of 3.1 percent. Some slowdown was expected in the middle of a business cycle, but the impact of the sub-prime lending market meltdown further exacerbated the housing market slump and contributed to weakness in the financial sector.

There are several risks that will need to be monitored as we move into 2008. One of the stronger facets of the nation's economy in the past year has been the increase in export demand. A growing global market coupled with falling exchange rates for the dollar have fueled growth in exports. Thus, exports have bolstered parts of the economy and helped soften the blow caused by housing and financial sector declines. Economic stagnation in global markets, however, could raise recession fears.

Likewise, as we experience the normal mid-cycle slowdown any disruptions to oil supplies raising energy prices significantly could further dampen prospects for economic growth and a quick rebound from the housing slump. Finally, if the sub-prime market failure spreads into other financial markets, including global financial markets, then both consumers and businesses could be hurt resulting in a possible deepening of the slowdown. While these risks exist, their occurrence is not anticipated. So while the economy is projected to slow, it is expected to be relatively mild for both the nation and North Carolina.

National Economic Outlook

United States Economic Indicators

	FY2005-06	FY2006-07	FY2007-08	FY2008-09
	<u>Actual</u>	<u>Actual</u>	<u>Projected</u>	<u>Projected</u>
Economic Growth (GDP)*	3.3%	2.9%	2.3%	2.1%
Personal Income	6.2%	6.4%	5.4%	4.7%
Corporate Pre-Tax Profits	20.2%	9.3%	-10.1%	4.5%
Retail Sales and Food Services	6.8%	4.4%	3.7%	3.1%
CPI	3.8%	2.6%	2.5%	1.8%
30-yr Fixed Mortgage Interest Rate	6.2%	6.3%	6.5%	7.0%

*adjusted for inflation

The forecasted economic growth for the nation is expected to be below the long-term, average growth of 3.1 percent through 2009. With this economic slowdown, personal income growth will slow to 4.7 percent in FY2008-09, which falls below the long-term trend. Businesses coming out of the last recession were able to experience strong growth from increased sales and cost-cutting efficiencies, both of which boosted profits. The impact of slowing demand and upward cost pressures (labor, interest rates, energy) will reduce corporate profits with negative yearly growth projected for 2008, and only a slight increase for 2009.

One key indicator of how the economy is performing is retail sales. This activity is not expected to rebound until late 2009, when the majority of the housing slump and business cycle slowdown will be behind us. Until then, growth will be significantly lower than in the past several years. If the inflation rate is held in check, the Federal Reserve Board will have more flexibility to lower interest rates in response to the housing slump. Nonetheless, forecasted 30-year mortgage rates are expected to increase in both the 2008 and 2009 fiscal years.

The Federal Reserve Board noted most labor markets remain tight; however, the financial services sector layoffs combined with the risk of the housing slump further hurting consumer spending could result in declines in both employment and income. The sub-prime market implosion has only heightened these risks to employment and income growth. To summarize, the nation's economy is headed for a period of sluggish growth with added risks created by housing and financial market troubles, nonetheless, the economy is expected to avoid a recession and return to near normal growth by the end of 2009.

North Carolina Economic Outlook

North Carolina Economic Indicators

	FY2005-06	FY2006-07	FY2007-08	FY2008-09
	<u>Actual</u>	<u>Actual</u>	<u>Projected</u>	<u>Projected</u>
Personal Income	6.1%	6.4%	5.6%	4.6%
Wages and Salaries	6.2%	6.6%	5.8%	4.7%
Retail Sales	7.6%	5.8%	3.6%	3.9%
Unemployment Rate	5.0%	4.8%	5.2%	5.2%
Employment: (Nonagricultural)	2.3%	2.5%	1.4%	1.1%
Existing Single-family Home Sales	17.2%	-0.6%	-14.8%	6.8%
Average Hourly Earnings: Manufacturing	0.7%	2.9%	3.8%	3.8%

The impact from the economic slowdown in North Carolina was still unrealized by the end of 2006. The state is typically more volatile with respect to economic cycles than the nation as a whole. However, by early 2007, it was evident the slowdown had begun nationally, yet the state's economy showed less of an effect than the national economy. The mild slowdown experienced by the state in FY2006-07, may be due in part to North Carolina's relatively mild housing problems. For example, real estate conveyance tax receipts in North Carolina have been essentially flat compared to double-digit declines in a many other states. It is projected that the biggest impact to the state's economy from the mid-cycle slowdown, plus the housing and financial sector slump, will occur in 2008. By the end of 2009, the economic and fiscal impacts are expected to dissipate with a return to near normal growth in the state.

North Carolina's impact from the housing slump has been different than many other states. There was negative year-over-year sales growth statewide in existing, single-family homes for the fourth quarter of 2006 and the second quarter of 2007, and only 1.2 percent growth in the first quarter of 2007. The state's housing bubble was limited to a few resort areas, therefore the statewide impact from the housing slowdown has been far less severe than in many states. In addition, the state continued to experience strong population growth as well as employment growth, which may have dampened the impact from the national housing slump.

The state's population is expected to continue growing at a rate above two percent through 2009. Comparatively, the nation's population is only expected to grow at slightly less than one percent. Likewise, non-farm employment grew in the state from August 2006 to August 2007, by 1.7 percent while national employment grew at only 1.2 percent. Another part of the employment story is the state's continued strong growth in the service-providing sectors with annual growth above 2.2 percent. This has more than offset the loss in manufacturing jobs, which continued to decline at a rate of 1.7 percent (an estimated 9,300 jobs) over this same period.

North Carolina's economy has held up well under the strain of the housing slump and the economic slowdown. Therefore, income growth is projected to continue at a moderate pace and grow only slightly below the long-term average of 5.8 percent. As with the nation, the majority of the housing slump's effects will have worked themselves out by 2009, but residual effects will continue to be a drain on the state's economy. These impacts show up in slower than normal growth in retail sales and employment.

The long-term negative growth trends in manufacturing continue as the state transitions from a manufacturing and agricultural based economy to a service and technological economy. The past year also saw a slowing of growth in the housing related industries including financial services, residential construction, and transportation.

In general, North Carolina's economy is expected to expand at a faster pace than the nation. This should bode well for overall employment and help bolster income growth. Employment losses in the manufacturing industries will continue, but growth in the service and tech industries should continue to be a major stimulus to economic growth. There is little doubt that the state will experience an economic slowdown in the next couple of years, but it is in a position to perform better than the nation as a whole.

Issues and Observations

BEACON

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 (*Building Enterprise Access for NC's Core Operational Needs*) 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, the Office of 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.

The seven year plan for implementation of the new SAP business infrastructure involves a gradual roll-out of functionality beginning with HR/Payroll. Since 2004 the General Assembly has appropriated \$76.831 million in non-recurring funding and approximately \$10 million in recurring dollars to support this initiative. The HR/Payroll project is on budget and on schedule to be operational with the Department of Transportation in December 2007, the first agency group in January 2008 and the second agency group in April 2008.

The next phase of implementation will begin in early 2008 with an SAP financials planning project and in summer of 2008 with an E-Recruitment and Learning Solutions Management project. The 2007 Session of the General Assembly authorized \$1.5 million of receipts to the Office of the State Controller for the SAP financials planning project and \$7.39 million of receipts for the two new Human Resource modules. In addition, BEACON will embark on a Data Migration project and a University project in 2008-09.

Session Law 2007-323 directed the Office of the State Controller, in cooperation with the State Chief Information Officer, to develop a Strategic Implementation Plan for the integration of data bases and the sharing of information among state agencies and programs. It further directed that the plan be developed under the governance of the BEACON Project Steering Committee, in conjunction with the leadership in the state agencies and with the support of the Office of State Budget and Management. There was \$5 million appropriated for each fiscal year 2008 and 2009 to deliver the BEACON Data Integration Project. The plan is to be completed and reported to the General Assembly no later than April 30, 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>.

**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 was effective July 1, 2007 and affects 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 have been reviewed and revised as appropriate. Some revisions have required adjustment to the State's budgetary and accounting systems. The State Budget Manual has been updated to reflect changes required by House Bill 914.

**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 is 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.

The General Assembly passed legislation during the 2007 Session that will require annual retiree healthcare valuations. The first valuation under this new law is expected to be conducted for the calendar year ended December 31, 2007, and to be available by August 31, 2008. Currently there are annual valuations for the Disability Income Plan and the pension plans administered by the State Treasurer.

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, 2007, North Carolina's, retiree healthcare employer contributions were \$528.401 million, representing an annual increase of 10.8%. Retiree healthcare premium costs paid to the State Health Plan were \$436.748 million, representing an annual increase of 6%. Plan net assets of \$270.639 million represent an increase of \$99.514 million, or 58.2% from the prior year.

Program Evaluation

The 2007 General Assembly established the Program Evaluation Division and the Joint Legislative Program Evaluation Oversight Committee of the General Assembly. The purpose of the Division is to assist the General Assembly in fulfilling its responsibility to oversee government functions by providing an independent, objective source of information to be used in evaluating whether public services are delivered in an effective and efficient manner and in accordance with law. The Division has the following powers and duties:

- (1) Examine a program or an activity and evaluate the merits of the program or activity and the effectiveness in conducting the program or activity.
- (2) Develop quantitative indicators for measuring the activities performed and services provided and the extent to which the activities and services are achieving desired results.
- (3) Develop unit cost measures to determine the cost of activities performed and services provided.
- (4) Determine if a program or an activity complies with the agency's mission, as established by law.
- (5) Make unannounced visits when needed to evaluate a program or an activity.
- (6) Make recommendations to improve the efficiency and effectiveness.
- (7) Determine the extent to which a State agency has implemented any of the Division's recommendations concerning the agency.
- (8) Require a State agency to submit a written response to a proposed or final recommendation of the Division and to submit a written explanation of the extent to which the agency has implemented the Division's recommendations.
- (9) Make periodic reports of the activities and recommendations of the Division and of any savings achieved by the implementation of its recommendations.

The Joint Legislative Program Evaluation Oversight Committee will receive and review requests for evaluations to be performed by the Program Evaluation Division of the General Assembly. Based on these requests, the Committee will establish an annual work plan for the Program Evaluation Division that describes the evaluations to be performed by the Division. The Committee will consult with the Director of the Program Evaluation Division in performing this duty. Additionally, the Committee will receive reports prepared by the Program Evaluation Division, and will recommend to the General Assembly any changes that are required to implement a recommendation that is included in a report of the Program Evaluation Division and is endorsed by the Committee.

A report of an evaluation of a program or an activity of a State agency by the Program Evaluation Division of the General Assembly must include the findings of the Division concerning the program or activity, specific recommendations for making the program or activity more efficient or effective, legislation needed to implement the Division's findings and recommendations concerning the program or activity, and an estimate of the costs or savings expected from implementing the Division's findings and recommendations concerning the program or activity.

North Carolina Internal Audit Act

The *North Carolina Internal Audit Act* applies to State agencies that have an annual operating budget exceeding \$10 million; more than 100 full-time equivalent employees; or receive and process more than \$10 million in cash in a fiscal year.

Each State agency meeting the above requirements will establish a program of internal auditing that implements an effective system of internal controls, safeguards public funds and assets, and minimizes incidences of fraud, waste, and abuse. Each State agency program should ensure programs and business operations are administered in compliance with federal and state laws, regulations, and other requirements. The State agency program will also review the effectiveness and efficiency of agency and program operations and service delivery. Under this new legislation, major State agency accounting, administrative, and electronic data processing systems and controls, will be periodically audited.

All internal audits will comply with current *Standards for the Professional Practice of Internal Auditing* issued by the Institute for Internal Auditors or, if appropriate, *Government Auditing Standards* issued by the Comptroller General of the United States.

Each affected agency head will appoint a *Director of Internal Auditing* who will report directly to the agency head. Any internal auditor employed by a State agency will at a minimum have a bachelor's degree from an accredited college or university and; certification or licensure as a certified public accountant, certified internal auditor, certified fraud examiner, certified information systems auditor, professional engineer, or attorney; a minimum of five years' experience in internal or external auditing, management consulting, program evaluation, management analysis, economic analysis, industrial engineering, or operations research.

As part of this new legislation the *Council of Internal Auditing* was created, consisting of the State Controller, who will serve as Chair, the State Budget Officer, the Secretary of Administration, the Attorney General, the Secretary of Revenue, and the State Auditor who will serve as a nonvoting member. The State Auditor may appoint a designee.

The *Council of Internal Auditing* will play a significant role in the implementation of the *North Carolina Internal Audit Act*. The *Council* will be responsible for promulgating guidelines for the uniformity and quality of State agency internal audit activities; recommending the number of internal audit employees required by each State agency; developing internal audit guides, technical manuals, and suggested best internal audit practices; administering an independent peer review system for each State agency internal audit activity; specify the frequency of such reviews consistent with applicable national standards; and assisting agencies with selection of independent peer reviewers from other State agencies; providing central training sessions, professional development opportunities, and recognition programs for internal auditors; administering a program for sharing internal auditors among State agencies needing temporary assistance and assembly of interagency teams of internal auditors to conduct internal audits beyond the capacity of a single agency; maintaining a central database of all annual internal audit plans; topics for review proposed by internal audit plans; internal audit reports issued and individual findings and recommendations from those reports; and requiring reports in writing from any State agency relative to any internal audit matter.

If determined necessary by a majority vote of the *Council*, the *Council* will conduct hearings relative to any attempts to interfere with, compromise, or intimidate an internal auditor, inquire as to the effectiveness of any internal audit unit, authorize the State Controller, as Chair, to issue subpoenas for the appearance of any person or internal audit working papers, report drafts, and any other pertinent document or record regardless of physical form needed for the hearing.

The *Council* will also issue an annual report including, but not limited to, service efforts and accomplishments of State agency internal auditors and to propose legislation for consideration by the Governor and General Assembly.

**State Governmental
Accountability and
Internal Control
Act**

The purpose of the *State Governmental Accountability and Internal Control Act* is to establish internal control standards for State government and to increase fiscal accountability. Recognizing the public interest and the importance of oversight over public institutions, the Governor and General Assembly enacted new legislation that provides for the implementation of an effective and efficient system of internal control providing reasonable assurance that the public's objectives are met. Moving forward, the *State Governmental Accountability and Internal Control Act* will ensure that our State system of internal control incorporates applicable statewide standards and clearly defines and assigns specific internal control related responsibilities.

Internal control is defined to be an integral process, affected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives related to the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

Standards setting responsibilities

The State Controller, in consultation with the State Auditor, will establish comprehensive standards, policies, and procedures to ensure a strong and effective system of internal control within State government. These standards, policies, and procedures will be made readily available to all State agencies, and the State Controller will make appropriate education efforts to inform relevant State agency staffs of the standards, policies, procedures, and internal control best practices. These efforts will include the development of training courses, manuals, and other information sources to promulgate internal control standards, policies, procedures, and best practices throughout all State agencies.

Agency management responsibilities

The management of each State agency bears full responsibility for establishing and maintaining a proper system of internal control within that agency. Each principal executive officer and each principal fiscal officer will annually certify, in a manner prescribed by the State Controller, that the agency has in place a proper system of internal control. The State Controller will develop policies and procedures to direct agencies in their evaluation.

The management of each State agency also bears the responsibility periodically to submit accurate and complete financial information to the State Controller for compilation into North Carolina State government's various financial reports and other related financial information disseminated to the public. With the submission of such periodic reports to the State Controller, each agency's principal executive officer and each agency's principal fiscal officer will certify, in a manner prescribed by the State Controller, to the accuracy and completeness of the financial information submitted.

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, 2006. This was the 13th consecutive year (1994 to 2006) the State has received the prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

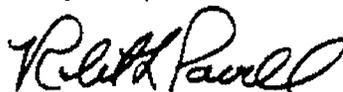
In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report, whose contents conform to program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal 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 7, 2007

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CERTIFICATE OF ACHIEVEMENT

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of North Carolina

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2006

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



President

Executive Director