INTRODUCTORY SECTION

State of North Carolina
Office of the State Controller

James B. Hunt, Jr., Governor

Edward Renfrow, State Controller
Gwen Canady, Chief Deputy

The Honorable James B. Hunt, Jr.
Governor of the State of North Carolina, and

Members of the North Carolina General Assembly

It is our pleasure to furnish you with the 1999 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, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the State of North Carolina. We believe all disclosures necessary to enable you to gain an understanding of the State's financial activities have been included.

For the convenience of users we have divided this comprehensive annual financial report 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 the general purpose financial statements (combined statements, the notes, and the required supplementary information), the combining and individual fund and account group 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.

State Reporting Entity and Its Services

The State of North Carolina entity as reported in the CAFR includes all fund types and account groups 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. Most component units are presented discretely in the financial statements. Two component units are blended into the financial statements because their activities are so intertwined with the State that they are substantively part of the State. The State's discretely presented component units are the University of North Carolina system, the State's community colleges, and various proprietary organizations providing specific services to the public and private sector. The criteria for inclusion in the reporting entity and its presentation are defined by the Governmental Accounting Standards Board (GASB) in its GASB Codification Section 2100. These criteria are described in Note 1 of the accompanying financial statements.

The State and its component units provide a broad range of services to its citizens, including public education; higher education; health and human services; economic development; environment and natural resources; public safety, corrections, and regulation;

MAILING ADDRESS
1410 Mail Service Center
Raleigh, NC 27699-1410

Telephone: (919) 981-5454
Fax Number: (919) 981-5567
State Courier: 56-50-10
Website: www.osc.state.nc.us/OSC/

LOCATION
3512 Bush Street
Raleigh, NC

transportation; agriculture; and general government services. The costs of these services are reflected in detail and in summary in this report.

Issues and Initiatives

During fiscal year 1998-99, the Governor, the General Assembly, and the departments and agencies of State government worked to address key issues facing the citizens of North Carolina.

Education

The ABCs accountability model is designed to measure achievement and performance with the goal of improving the overall level of student achievement in North Carolina. Testing results for the 1998-99 ABCs of Public Education show that the percentage of K-8 students performing at grade level or better in reading and math continues to increase, moving from 66.3% in 1997-98 to 69.1% in 1998-99. This represents a 9.1% increase since the ABCs began in 1996-97, when 60% were proficient. The number of schools achieving Schools of Excellence recognition doubled from 24 in 1997-98 to 50 in 1998-99. Schools recognized as Schools of Distinction also increased significantly, going from 290 in 1997-98 to 408 in 1998-99. A School of Excellence has at least 90% of its students performing at or above Achievement Level III and met or exceeded its expected growth/gain goal. A School of Distinction has at least 80% of its students performing at or above Achievement Level III. Overall, 81.2% of the schools met either expected or exemplary growth/gain standards. The number of low-performing schools dropped from 30 to 13, six of which were charter schools.

The ABCs model is designed to help low-performing schools improve. Low-performing schools are those schools with less than 50% of their students performing at Achievement Level III and who do not achieve expected growth/gain. This year, 13 schools were identified as low performing. A select group of low-performing schools are chosen each year to receive mandatory assistance based on the percentage of their students at or above Achievement Level III and on their lack of achieving growth/gain. Eleven of the 1997-98 low-performing schools were assigned State Assistance Teams during the 1998-99 school year, which resulted in nine of the eleven schools meeting or exceeding their growth/gain goals under the 1998-99 ABCs model.

Environment

In July 1999, the General Assembly approved legislation enacting a major portion of Governor Hunt's Clean Air Plan for protecting public health, the environment and jobs. The legislation is aimed at reducing car and truck emissions, a major contributor to ozone smog. It will require the use of low-sulfur gasoline statewide by January 2004, and expand the motor vehicle emissions testing program from nine counties now to 48 counties by July 2006.

The State budget includes an additional $19.9 million in critical funding for limiting sediment pollution, for wetland and buffer protection efforts to restore water quality in North Carolina's rivers and other environmental and natural resource programs.

On July 21, 1999, the Clean Water Act of 1999 became law. The Clean Water legislation extends the moratorium on new or expanded large-scale hog farms, raises the maximum water pollution fine from $10,000 per day to $25,000 per day and imposes public disclosure requirements for spills at wastewater treatment plants and from animal operations. The bill also authorizes the Environmental Management Commission to adopt temporary rules to protect water quality in the Cape Fear, Catawba and Tar-Pamlico River basins.

On November 3, 1998, North Carolina voters overwhelmingly approved an $800 million clean water bond referendum. The clean water bonds will provide $330 million in State grants to help local governments repair and improve water supply systems and wastewater collection and treatment, and to undertake water conservation and reuse projects. Another $300 million is to be made available in clean water loans. Outdated systems are allowing millions of gallons of untreated or partially treated wastewater to spill into the state’s rivers and streams. Many communities cannot foster new development or create new jobs because their wastewater systems are already operating at or above capacity. The N.C. Rural Economic Development Center has released a study of more than 650 water and sewer systems in mostly rural areas. The study found that the need for improving and repairing water and sewer systems is more than $11 billion.

Smart Start

In 1993, Governor Hunt proposed significant changes in the way North Carolina provided services to children. The Smart Start program is a comprehensive early childhood initiative designed to provide quality, affordable day care to every child who needs it in North Carolina. Smart Start also boosts other children's services, including basic health care, and provides family-based resources to help at-risk families break the cycle of poverty.

The 1993 General Assembly enacted into law several Smart Start initiatives. A public-private partnership was established to bring together parents, child-care providers, educators, religious and community leaders and non-profit officials to develop a comprehensive blueprint for improving early childhood education, health care and other services. The 1993 program encourages local communties to form similar public-private partnerships to ensure that each child in that community has access to affordable, high quality day care. Smart Start established the guidelines for lowering the State's child-care staff to child ratios for the youngest children. Additional State monitors were hired to ensure that the new program standards were being met.

The State Auditor's most recent report on the Smart Start Program presents information on both the local partnerships and the North Carolina Partnership for Children for the fiscal years ending June 30, 1996 and 1997. Since the inception of the program there has been a significant decrease in the number of audit reports containing audit findings. The percentage of reports with audit findings in the first two years of audits was 92%. The percentage for fiscal years 1996 and 1997 fell to 53% and 38% respectively, while the total number of partnerships grew from 13 to 48. The State Auditor indicated that the results of the partnership audits and the review of management controls still highlight several statewide issues that need to be addressed by the State's leadership.

Smart Start Issues:
The need for improvement in the oversight capabilities of the North Carolina Partnership for Children, in the form of providing technical assistance and training to the local partnerships.

The continuing need for a uniform fund accounting system and chart of accounts.

The need for a statewide uniform contract management and monitoring process.

The need for more efficient and cost-effective administration.

The challenge of continuing to meet the requirement of having to provide non-State matching funds equal to 10% of the State appropriation each year.

Hurricane Floyd

Hurricane Floyd passed through the eastern portion of North Carolina on September 15 and 16. Hurricane and tropical force winds, torrential rains, and flooding left one-third of North Carolina suffering from an unprecedented natural disaster. The record-high floodwaters of Hurricane Floyd forced thousands of people from their homes. Many citizens lost homes, farms, and businesses. Governor Hunt is seeking $5.3 billion in federal disaster aid to help the recovery efforts in rebuilding homes, restoring transportation systems, and other infrastructure, and in providing resources for critical environmental cleanup efforts. Disputes in the U.S. Congress may delay the requested federal aid. The State is estimating that it will need to set-aside $500 million in state matching funds over the next several years to satisfy federal requirements.

Summary of the damage and devastation:

— 48 people confirmed dead, 5 missing, 4 reported injured.

— The agriculture industry was extremely hard hit. Some 2.8 million chickens and turkeys, 880 cattle and more than 30,000 hogs died in the floods.

— Thousands of homes damaged by floodwaters in 39 of the state's 100 counties; almost 9,000 either severely impacted or destroyed.

— At peak, more than 48,000 people were housed in official shelters.

— More than 650 roads were closed during the peak of the devastation. Three weeks after the storm, almost 300 roads remain closed in eastern North Carolina because of high water or damage. In addition, 11 bridges and culverts were destroyed and 750 locations with drainage pipelines were damaged or lost.

— More than 1.2 million North Carolina customers lost electricity during Floyd; and three weeks later, more than 7,780 still did not have power. These remaining customers were determined to be "unconnectable" because their homes were submerged or due to the requirement that the homes be inspected prior to restoring power.

— There are more than 200 travel trailers occupied, 87 at a group site in Edgecombe County, and 7 at private sites. Construction is underway for temporary housing in Edgecombe, Pitt, Lenoir, Pender and Wayne counties.

New Governmental Reporting Model Infrastructure Reporting

On June 30, 1999, the Governmental Accounting Standards Board published ***GASB Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments***, which provides a new look and focus of reporting public finance in the United States. The new standard will significantly change the way state and local governments report their finances to the public. In addition to the State's general government agencies, the accounting and financial reporting for the State's Community College System campuses (*component unit*), and the campuses of the University of North Carolina (*component unit*) will also be affected by this new GASB standard.

An important aspect of the new standard is the requirement to provide information about infrastructure assets. Infrastructure assets are long-lived capital assets that are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure include roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems.

> *"The fact that no information about this enormous category of assets currently exists in annual financial reports leaves readers with an incomplete picture of government," Mr. Tom Allen, chairman of GASB, said. "For example, if a state decided to issue bonds specifically to finance improvements to its in-state highway system, the current financial statements would show the debt, but not the corresponding assets. Does the debt on the state's books mean that it is less well off? No, because the state used the proceeds from the bond sale to make an investment. But that investment currently does not appear on the state's books. Our new reporting system will make financial reports more complete."*

We expect that our primary focus related to infrastructure will necessarily be at the N.C. Department of Transportation and the State's roads and highway systems. However, a significant amount of effort may be required for our universities and community colleges to complete their individually published financial statements based on the new standard defined by GASB Statement No. 34. As we look at the various aspects of the new GASB standard, the new infrastructure accounting and reporting requirements seem to give us our greatest cause for concern. There undoubtedly will be additional cost to the State to implement this new GASB standard and to maintain the accounting and reporting of this new information on a timely basis.

The effective date of GASB Statement No. 34 is the fiscal year 2001-2002. Minimum requirements will call for an inventory and categorization of the State's major road and highway systems, and an objective assignment of costs and useful lives to the State's major infrastructure assets. The Department of Transportation's accounting system will need to be capable of capturing and maintaining this information. By June 30, 2006, the State will be required to reflect the major infrastructure assets, with related depreciation and accumulated depreciation, acquired or significantly reconstructed, or that received significant improvements since July 1, 1980, on its financial statements. The universities and community colleges will likely be required by GASB Statement No. 34 to have all infrastructure assets placed in service since July 1, 1980, with related depreciation and accumulated depreciation, recorded in their accounting records by June 30, 2002. This undertaking will be no small task.

The new GASB Statement No. 34 is a priority topic for state auditors, state treasurers and state controllers. A task force of the National Association of State Auditors, Comptrollers and Treasurers (NASACT) has begun work on solving the implementation issues presented by GASB Statement No. 34.

North Carolina Highway System: Condition Assessment and Funding

A major new financial reporting requirement for governments, discussed above, is the inclusion of infrastructure assets in governments' financial statements, to include depreciation and accumulated depreciation. One allowable alternative to depreciating infrastructure assets is to demonstrate that the infrastructure assets are being maintained at an acceptable condition level. Our State road system includes an estimated 77,856 miles of roads (or 144,756 lane miles) and 17,145 road-related structures. The Department of Transportation is required by G.S. 136-44.3 to survey and report on the condition of the State highway system. This report provides estimates of :

(1) The annual cost of routine maintenance of the State highway system;
(2) The cost of eliminating any maintenance backlog by categories of maintenance requirements;
(3) The annual cost to resurface the State highway system based upon a 12-year repaving cycle for the primary system and a 15-year cycle for other highways; and
(4) The cost of eliminating any resurfacing backlog, by type of system.

On the basis of this report, the North Carolina Department of Transportation develops a statewide annual maintenance program for the State highway system, which is subject to the approval of the North Carolina Board of Transportation and takes into consideration the general maintenance needs, special maintenance needs, vehicular traffic, and other factors deemed pertinent. Transportation engineers, at the end of the fiscal year, certify the maintenance of highways in each division in accordance with an annual work program, along with explanations of any deviations. The report on the condition of the State highway system and the annual maintenance program are presented to the Joint Legislative Transportation Oversight Committee by November 30 of each even-numbered year. A detailed assessment is conducted of the State's pavements, structures, and roadway features. The methodologies used in the survey and assessment are based on acceptable practices used in other state transportation departments across the country.

The *1998 Report on the Condition of the State Highway System* concludes that the condition of the State highway system is directly related to the level of funding, and that current funding levels for routine maintenance and resurfacing are inadequate. In a high growth State such as North Carolina, the trend of increasing lane miles and increased traffic on existing roads, along with general deterioration from the elements, are at the heart of the problem. Of course, the forces of Hurricane Floyd's torrential rain and flooding dealt a destructive blow to many roads, bridges, and drainage systems in eastern North Carolina.

The most current *Condition* report highlights that while road maintenance funding has increased over the last decade, the increase in funding has not kept pace with inflation. The December 1998 report estimated total maintenance needs, including backlogs, ranges from $705 million in fiscal year 1999-2000, to $1.035 billion in fiscal year 2008-2009 (averaging $849.5 million per year). The approved State budget included $493.1 million road maintenance funding for fiscal year 1999-2000. In addition, $20 million per year from secondary construction funds are used to stabilize unpaved roads scheduled to be paved in the next few years. These stabilization functions are actually maintenance. By adding this $20 million, maintenance funding equals $513.1 million per year, or $191.9 million (27%) less than the estimated funding needs for fiscal year 1999-2000.

Year 2000

The Year 2000 issue is the result of shortcomings in many electronic data processing systems and other equipment that may adversely affect operations in the year 1999 and beyond. For many years, programmers eliminated the first two digits from a year when writing programs. For example, programmers would designate January 1, 1965 as "01/01/65" instead of "01/01/1965." On January 1, 2000 at 12:00:01 a.m., the internal clock in computers and other equipment will roll over from "12/31/99" to "01/01/00." Unfortunately, many programs (if not corrected) will not be able to distinguish between the Year 2000 and the year 1900. This may cause the programs to process data inaccurately or to stop processing data altogether. Another factor that may cause problems in programs is the leap year calculation. Some programs are unable to detect the Year 2000 as a leap year.

All information systems in North Carolina that use dates to generate data will be affected by the new millennium: for example, kindergarten registration and blood supply could be affected. In addition, non-information systems such as forms need to be evaluated because they provide input to software applications. Mail processing equipment may need to be modified to handle the new millennium. Other areas such as elevators, security systems, and vaults will be affected by the Year 2000.

In early 1997, the Year 2000 Project Team (including a statewide Steering Committee and agency co-ordinators) was formed to manage the Year 2000 project from a statewide perspective. The Year 2000 Project Team is responsible for prioritizing systems statewide, developing and maintaining statewide conversion schedules, analyzing third-party product compliance, maintaining a statewide Year 2000 repository, defining the overall conversion approach and milestones, reporting the status of statewide conversion projects, providing statewide communications and coordination, reporting the status of statewide Year 2000 funding and use, reporting the status of statewide quality assurance, developing and maintaining a statewide risk management plan, coordinating the Year 2000 budget process, maintaining an evolving cost estimate, and analyzing the automated tool offerings.

The executive departments, universities, university hospitals, and community colleges are responsible for completing the Year 2000 conversion efforts in their areas. They will work within the framework set forth by the Year 2000 Steering Committee and carried through by the Statewide Year 2000 Project Team.

As of year-end, the State has contracted with several vendors for assistance in addressing the Year 2000 issues relating to its computer systems and other electronic equipment. The amount of those commitments is approximately $131 million.

The following stages have been identified as necessary to address the Year 2000 issue.

Awareness Stage—Encompasses establishing a budget and project plan (for example, a timeline or chart noting major tasks and due dates) for dealing with the Year 2000 issue.

Assessment Stage—When the organization begins the actual process of identifying all of its systems (preparing an inventory) and individual components of the systems. An organization may decide to review all system components or, through a risk analysis, identify only mission-critical systems and equipment (systems and equipment critical to conducting operations).

Remediation Stage—When the organization actually makes changes to systems and equipment. This stage deals primarily with the technical issues of converting existing systems, or switching to compliant systems. During this stage, decisions are made on how to address Year 2000 systems or equipment issues, and the required system changes are made.

Validation/Testing Stage—When the organization validates and tests the changes made during the conversion process. The development of test data and test scripts, the running of test scripts, and the review of test results are crucial for this stage of the conversion process to be successful. If the testing results show anomalies, the tested area needs to be corrected and retested.

As of June 30, 1999, 1,093 application systems existed in the statewide inventory. Of those, 399 were reported by the agencies and universities as Year 2000 ready without remediation. The remaining 694 systems are in the following phases of remediation: 16 are in the assessment stage; 35 are in the remediation stage; 102 are in the validation/testing stage; and 541 have been fully remediated and placed back into production. The systems that have yet to be fully remediated have been grouped by function in the following table.

Functional Category	Assessment	Remediation	Validation/ Testing
General government	1	2	11
Education	10	5	4
Health and human services ..	—	3	19
Economic development	—	—	4
Environment and natural resources	1	1	8
Public safety, corrections, and regulation	1	5	5
Transportation	—	—	7
Agriculture	—	2	3
Universities	3	17	41
Total	16	35	102

The assessment process for computer systems is continuous and ongoing. The Year 2000 Project Team is also working with agencies and universities to address Year 2000 readiness issues in the other following areas: PC/LAN hardware and software, workplace infrastructure (facilities, telephones), embedded chips (medical/lab equipment, transportation vehicles, enforcement systems), supply chain partners, and business continuity planning.

Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot assure that the State and its component units are or will be Year 2000 ready, that the State's and its component units' remediation efforts will be successful in whole or in part, or that parties with whom the State and its component units do business will be Year 2000 ready. In addition, the completion of these stages is not a guarantee that systems and equipment will be Year 2000-compliant.

Other Issues

Tobacco Settlement

On November 23, 1998, 46 states' Attorneys General and the major tobacco companies signed a proposed settlement that reimburses states for smoking-related medical expenses paid through Medicaid and other health care programs. North Carolina could receive approximately $4.6 billion over the next 25 years. The settlement was approved in a Consent Decree in December 1998. On March 16, 1999, the General Assembly enacted a law approving the establishment of a foundation to provide economic impact assistance to economically affected or tobacco dependent regions in North Carolina. The court must review the law for compliance with the intent outlined in the Consent Decree. The foundation would receive 50 percent of the settlement. The remaining half would be split equally between two trust funds established by the General Assembly. One trust fund would be for the benefit of tobacco farmers, quota holders, and persons in tobacco-related businesses, and the second trust fund would be for health programs.

Intangibles Tax Ruling

On May 25, 1999, the North Carolina Superior Court entered judgement in *Smith* against the State in the amount paid by non-protesting taxpayers for tax years 1991-1994. In a closely related class action tax refund case, *Shaver v. State of North Carolina*, filed July 16, 1998, non-protesting taxpayers sought refunds, totaling approximately $100 million, for tax year 1990. On July 8, 1999, class counsel in *Smith* and *Shaver* entered into a settlement agreement with the State, subject to the General Assembly's approval, providing for the payment of the *Smith* and *Shaver* claims for a total of $440 million to be paid in two installments. The settlement agreement provides for an initial payment of $200 million to be paid on October 1, 1999, and a final payment of $240 million on July 10, 2000. On July 9, 1999, the Superior Court entered judgement against the State in *Shaver*, formalizing the memorandum ruling to that effect on July 1, 1999.

North Carolina Low-Level Radioactive Waste Management Authority/Southeast Interstate Low-level Radioactive Waste Management Compact (Southeast Compact)

At June 30, 1999, the North Carolina Low Level Radioactive Waste Management Authority (component unit proprietary fund) had a $33.384 million retained earnings deficit. The financial statements of the Authority have been prepared following the accounting principles that apply to developmental stage enterprises. The retained earnings deficit reflects losses sustained in the developmental stage. The North Carolina Low Level Radioactive Waste Management Authority was created in 1987 to locate, build, operate and close a repository in North Carolina. In July 1999, the General Assembly ratified Senate Bill 247 which withdraws North Carolina from the Southeast Compact after the State's unsuccessful attempts to locate a suitable geographic site for toxic waste storage. Each state within the Southeast Compact was to assume responsibility, on a twenty year rotating basis, as the Southeast's low-level radioactive waste repository. Additionally, Senate Bill 247 established that the sole function of the Authority is to finalize all business relating to closure and restoration of its proposed waste site on or before June 30, 2000. As of July 1, 2000, the Authority will officially cease to exist. Since the Authority currently has no revenue sources, the advance to the Authority is considered to be uncollectible. At June 30, 1999, total assets were $450 thousand and total liabilities were $235 thousand.

General Obligation Debt

In November 1996, the voters of North Carolina approved bonds in the amount of $1.8 billion for school construction and $950 million for highway construction. In November 1998, North Carolina voters approved $800 million of new debt to finance grants and loans to local government units for water supply systems, wastewater collection systems, wastewater treatment works, and water conservation and water reuse projects; and an additional $200 million of new debt to finance grants, loans, or other financing to public or private entities for construction of natural gas facilities. The amount of authorized, but unissued bonds was $2.15 billion as of June 30, 1999.

The third bond issue related to the $1.8 billion of school construction bonds which were approved in November 1996 was issued April 1, 1999 in the amount of $450 million. These bonds were issued at rates ranging from 4.5% to 5.0% with a final maturity of April 1, 2018.

The State sold $450 million of general obligation school construction bonds on March 17, 1999. Additionally, the State sold $25.905 million of Clean Water Refunding Bonds on March 17, 1999. The refunding bonds provided funds for refunding $24 million of Clean Water Bonds, Series 1994A.

Economic Condition and Outlook

Condition

1999 was the eighth straight year of economic growth. Most of the economic indicators moved in a favorable direction during the year. Nationally, the economy grew at a robust 3.7% real (inflation-adjusted) rate, and the unemployment rate fell to a generation low 4.2%. However, inflation, which can accelerate when growth is sustained for a long period, remained tame. The Consumer Price Index rose a modest 2.2%, and a broader measure of inflation increased only 1.3%.

One indicator of concern in 1999 was interest rates. Interest rates trended higher, especially during the second half of the year. Short-term interest rates rose one-half percentage point, while long-term interest rates rose over a full percentage point. Higher interest rates caused some jitters in the financial markets, particularly the stock market.

Technological improvements and the resulting gains in labor productivity continued to drive the economy. Worker productivity rose 2.5% in 1999. This allowed businesses to increase worker compensation per hour by 4% without comparable increases in product prices.

Consumer spending accounts for the majority of economic activity, and consumers were on a spending spree in 1999. Consumer spending, after inflation, jumped 5%, faster than consumer take-home pay. As a result, consumers continued to take on more debt during the year, prompted by the good economy and a bullish stock market. But, despite the fact that consumer debt loads were at an all-time high, debt payment delinquencies did not rise significantly.

With international trade becoming a greater part of the economy, foreign economic conditions are increasingly important. Fortunately, after a shaky second half of 1998, foreign markets stabilized in 1999. With the U.S. economy growing faster than most foreign economies in 1999, the U.S. trade deficit grew.

Most of North Carolina also enjoyed a good economy in 1999. The state's Gross State Product is estimated to have grown 5%, and the statewide unemployment rate averaged near 3%. The state continued to be ranked very high as an attractive location for new businesses in surveys of executives. Indeed, much of the recent growth in large urban centers is a result of in-migration of households from other states.

Yet, as part of this economic growth, North Carolina’s economy continues to undergo a transformation. Service jobs are increasing relative to manufacturing jobs. Also, within manufacturing, traditional industries like tobacco, textiles, and apparel continue to downsize in employment, while “growth” industries like electronic equipment, transportation equipment, and metals add jobs.

Importantly, this transformation is not occurring equally in all regions of North Carolina. In general, the urban centers, especially in the Piedmont, are attracting the growth manufacturing industries and business services, like computer software development, while many rural counties are suffering from the loss of tobacco and textile jobs. Indeed, nine urban counties account for 62% of the new jobs added in North Carolina since 1991. At the other end of the spectrum, twenty-five counties – all but one considered rural – have actually lost jobs since 1991. This urban/rural economic gap shows no signs of narrowing.

Finally, a natural disaster in the form of Hurricane Floyd hit North Carolina in late 1999, and its aftermath will have profound economic impacts. Hurricane Floyd wrecked havoc on counties accounting for 20% of the state’s economy. Millions of dollars of wealth were destroyed and thousands of lives were disrupted. Dealing with the aftermath of Hurricane Floyd will be a major challenge for North Carolina’s economy in 2000.

Outlook

The national economy is expected to continue expanding in 2000. Growth may be significantly down in the early part of the year due to adjustments related to Y2K. These adjustments are expected to be short-lived and won’t prevent a ninth straight year of economic growth.

The U.S. economy is projected to grow somewhat slower in 2000 than in 1999, with real Gross Domestic Product increasing 2.7% compared to 1999’s rate of 3.7%. The reason is the upward trend in interest rates. Interest rates are expected to rise one-fourth to one-half percentage point in 2000. Higher interest rates reduce borrowing by businesses and consumers and thereby slow spending in the economy.

Several leading inflationary indicators suggest the rate of price increases will be slightly faster in 2000. A key determinant of inflation is labor costs. To date in the current expansion, technological improvements, advances in labor productivity, and increased domestic and foreign competition have kept labor costs in check. If these conditions remain, inflation will not be a problem in 2000.

A watchful eye should be kept on the stock market in 2000. The strong gains in the stock market in recent years have certainly contributed to national wealth and economic prosperity. Any sustained downward trend in the stock market could cause consumers to retrench, lower their spending plans, and potentially slow the economy to near recessionary levels.

The North Carolina economy is also expected to grow in 2000, although also at a slower rate than in 1999. Growth in real Gross State Product will be closer to 4% in 2000, down from 1999’s 5% rate.

Ironically, the spending associated with the rebuilding and recovery from Hurricane Floyd will boost the state's economic numbers in 2000. The real economic damper from the disaster will come in 2001 and thereafter, as businesses and households in the eastern part of the state will find their resources depleted by the recovery spending. Floyd will also likely speed the on-going economic transformation in the State's eastern counties. Recovering the wealth destroyed by Floyd will take several years.

— Economic analysis prepared by Dr. Michael L. Walden, Professor
North Carolina State University
October 31, 1999

Financial Information

Internal Control

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.

As a recipient of federal financial assistance, the State also is responsible for ensuring that an adequate internal control structure is in place to ensure compliance with applicable laws and regulations related to those programs. This internal control structure is subject to periodic evaluation by management, internal audit staff, and independent auditors of the government.

Budgetary Control

In addition, the State maintains budgetary controls. The objective of these budgetary controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the General Assembly. Activities of the General Fund and most departmental special revenue funds are included in the annual appropriated budget. The State Highway Fund and the Highway Trust Fund, the State's major special revenue funds, are primarily budgeted on a multi-year basis. Capital projects are funded and planned in accordance with the time it will take to complete the project. The level of budgetary control (that is, the level at which expenditures cannot legally exceed the appropriated amount) is exercised at both the departmental and university level by way of quarterly allotments, with allotment control exercised by the State Controller, and on the program line-item levels requiring certain approvals by the Director of the Budget. Legislative authorization of departmental expenditures appears in the State Appropriation Bill. This "Certified Budget" is the legal expenditure authority; however, executive changes to the legal budget may be approved by the Office of State Budget and Management (OSBM). This results in the "Final Budget" presented in the financial statements.

GAAP Accounting

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). Furthermore, the Governmental Accounting Standards Board and the nation's financial community have encouraged states to present, in their annual reports, financial statements of the governmental funds that are prepared on the modified accrual basis of accounting, following generally accepted accounting principles. Under this basis, which more adequately serves the financial community's analytical and other needs, revenues are recognized when they become both measurable and available to finance operations of the fiscal year, or to liquidate liabilities existing at fiscal year-end. Generally, expenditures are recognized when a liability is incurred.

Except for exhibits and notes clearly labeled otherwise, this CAFR has been prepared in accordance with GAAP.

Results of Operations

General Governmental Funds

Revenues and Other Financing Sources

Revenues and other financing sources for general governmental functions (General Fund, special revenue funds, and capital projects funds) amounted to $24.15 billion for the fiscal year ended June 30, 1999, using the modified accrual basis of accounting. The major categories of revenues and other financing sources are shown in the following table. Amounts are expressed in millions.

	Amount	Percent of Total
Revenues:		
Taxes	$ 13,818	57.2%
Federal funds	6,297	26.1%
Local funds	470	1.9%
Investment earnings	529	2.2%
Fees, licenses and fines	896	3.7%
Other	369	1.5%
Total revenues	22,379	92.6%
Other Financing Sources:		
Operating transfers in and other sources	1,294	5.4%
Proceeds from bond sale	450	1.9%
Proceeds from capital leases	1	—
Proceeds of refunding debt	26	0.1%
Total other financing sources	1,771	7.4%
Total Revenues and Other Financing Sources	$ 24,150	100.0%

Tax Revenues. Tax revenues increased by $530 million in 1999, reflecting a slower rate of growth in income tax collections. Individual income tax collections increased by $461 million in 1999 to $6.586 billion, a 7.53% increase over 1998. Sales tax collections grew by $69.4 million in 1999, a 2.12% increase over 1998. Highway taxes were $1.505 billion in 1999, $27.7 million more than in 1998.

Federal Funds. Federal funds revenues grew by $314 million in 1999, up by 5.2% over 1998. Increases in Federal revenues are due to increased Federal program expenditures for which the State is reimbursed.

Investment Earnings. Investment earnings of $529 million reflect a decrease of $47 million in 1999. Investment earnings include realized/unrealized gains, distributed and accrued interest on cash and investments, and securities lending activity. Cash and cash equivalents decreased by $164.2 million, while investments decreased by $616.4 million, with $472 million of the decrease coming from the General Fund.

Expenditures and Other Financing Uses

Expenditures and other financing uses for general governmental purposes totaled $24.663 billion in 1999, using the modified accrual basis of accounting. The major categories of expenditures and other financing uses, by function, are shown in the following table. Amounts are expressed in millions.

Expenditures:	Amount	Percent of Total
Current:		
General government	$ 1,040	4.2%
Education	6,254	25.4%
Health and human services	7,665	31.1%
Economic development	370	1.5%
Environment and natural resources	354	1.4%
Public safety, corrections, and regulation	1,671	6.8%
Transportation	2,509	10.2%
Agriculture	73	0.3%
Tax judgments	399	1.6%
Capital outlay	183	0.7%
Debt service	228	0.9%
Total expenditures	20,746	84.1%
Other Financing Uses:		
Operating transfers out	1,308	5.3%
Operating transfers to component units	2,583	10.5%
Payment to refunded debt escrow agent	26	0.1%
Total other financing uses	3,917	15.9%
Total Expenditures and Other Financing Uses	$ 24,663	100.0%

Significant changes in expenditures. The trend of increases in expenditures, an increase of $1.8 billion for 1999, was directly related to the continued emphasis on education, health and human services, and transportation. A large portion of the increase in governmental expenditures, *tax judgments*, is the result of the North Carolina Supreme Court ruling in the Bailey case (**Note 18**). On June 9, 1998, representatives of the State and the various retirees involved in the Bailey and Patton cases announced a settlement, which was later approved by the court, in the amount of $799 million. Of this amount, $400 million was disbursed in refunds in fiscal year 1998-99, and $399 million was paid in refunds early in fiscal year 1999-2000. Educational expenditures increased by $838 million largely because of growth in dollars spent on State administered programs and the increasing costs associated with providing public education. Health and human services increased by $365 million in 1999. Transportation expenditures increased in fiscal year 1999 by $125 million. Debt service will continue to climb, a $58 million increase from 1998 to 1999, as the State continues to issue general obligation debt to fund capital projects for education, highways and utilities.

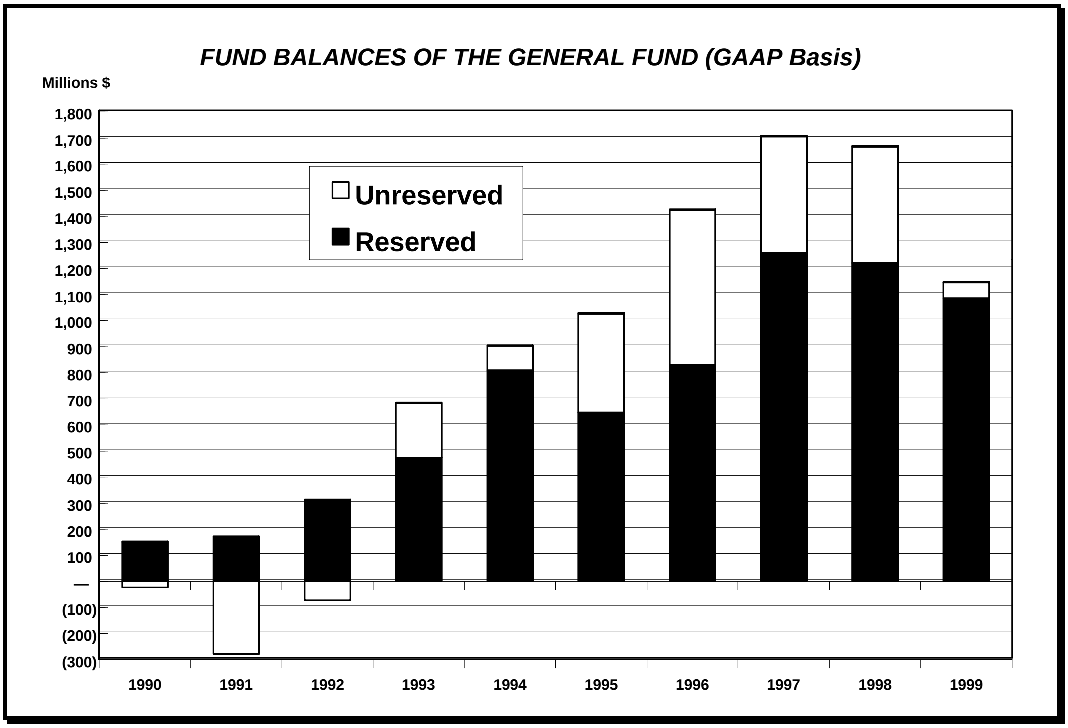
Additional information, in greater detail and for the past ten years, may be examined in the statistical section.

General Fund

GAAP Fund Balance

The fund balance of the General Fund declined by $521 million in 1999. Expenditures and transfers out exceeded revenues and transfers in by $478 million. At June 30, 1999, total fund balance of the General Fund on the modified accrual basis was $1.144 billion, in comparison to a $1.665 billion balance at the end of 1998. See **Note 15** of the Notes to the Financial Statements for a discussion of reserved and unreserved fund balance.

The following chart illustrates the fund balances on the modified accrual (GAAP) basis of the General Fund for the last ten fiscal years.



Budgetary Savings Reserve Account

During the 1991 session, the General Assembly established a Savings Reserve Account as a restricted reserved portion of fund balance in the General Fund, becoming effective for the year ended June 30, 1992. Under this legislation, one-fourth of any unreserved credit balance (*defined by the General Statutes as "...the credit balance, as determined on a cash basis, not already reserved to the Savings Reserve Account."*) remaining in the General Fund at the end of each fiscal year will be transferred to the Savings Reserve until the account contains funds equal to 5% of the amount appropriated to the General Fund operating budget for the preceding year. For the fiscal year ended June 30, 1999, the General Assembly delayed the $40.4 million deposit into the Savings Reserve Account, leaving the total reserve at $522.5 million. For fiscal year 1999-2000, the General Assembly voted to use $200 million from the Savings Reserve Account to be appropriated to fund the first installment payment resulting from the intangibles tax cases in which the State received adverse rulings (See *Intangibles Tax Ruling* above). Early in fiscal year 1999-2000, the Savings Reserve Account reflects a balance of $322.5 million, which is $296.2 million below the 5% threshold for the fiscal year ending 1999-2000.

Summary of Savings Reserve Account (in millions) :

Date		Description	Increase/ (Decrease)	Balance
		Reserve - Budget Stabilization (Rainy Day Fund)	$ 0.4	$ 0.4
June	1992	Statutory Reservation - G. S. 143-15.3	41.2	41.6
June	1993	Statutory Reservation - G. S. 143-15.3	134.3	175.9
July	1993	Withdrawal from Reserve	(121.0)	54.9
June	1994	Statutory Reservation - G. S. 143-15.3	155.7	210.6
January	1995	Budget Stabilization Appropriation	66.7	277.3
June	1995	Statutory Reservation - G. S. 143-15.3	146.3	423.6
June	1996	Statutory Reservation - G. S. 143-15.3	77.3	500.9
June	1997	Statutory Reservation - G. S. 143-15.3	—	500.9
June	1998	Statutory Reservation - G. S. 143-15.3	21.6	522.5
June	1999	Statutory Reservation - G. S. 143-15.3	$ —	$ 522.5

Other Funds

Proprietary Funds

Operating revenues and operating expenses for the State's enterprise funds were $22.424 million and $50.123 million, respectively, in 1999. Operating loss was $27.699 million, with the majority of the loss reflected in the Child Health Insurance Program at $25.232 million.

Combined operating results for the State's internal service funds exhibited continued strength in 1999. Operating revenues and expenses for these cost-reimbursement funds totaled $1 billion and $1.1 billion, respectively, in 1999. Principal internal service fund operations include the State Health Plan, the Disability Income Plan, the Death Benefit Plan, Prison Enterprises, the State Property Fire Insurance, Motor Fleet Management, Centralized Computing Services, and State Telecommunications.

Pension Trust Funds

The operations of the Teachers' and State Employees' Retirement System continued its steady growth in 1999. The system's contributions increased by 5.47%. The system experienced a 1% increase in benefit payments to participants. For the fiscal year ended June 30, 1999, the State continued to fund the actuarial required contribution. The State also participates in the Consolidated Judicial Retirement System, the Legislative Retirement System, the Firemen's and Rescue Squad Workers' Pension Fund, the Supplemental Retirement Income Plan of North Carolina, 401(k), and the North Carolina National Guard Pension Fund. The Local Governmental Employees' Retirement System is administered by the State but the State is not a participant.

Debt Administration

At June 30, 1999, the State had a number of debt issues outstanding. These issues included $2.452 billion in general obligation bonds, $1.535 billion in revenue bonds in the component unit proprietary funds and $898 million in revenue bonds in the university funds. North Carolina continues to have AAA bond ratings issued by Standard and Poor's Corporation and Moody's Investors Service, the highest ratings attainable. These favorable ratings have enabled the State to sell its bonds at interest rates considerably below the Bond Buyer's Index, thereby providing substantial savings to North Carolina taxpayers. North Carolina is one of only a very small number of states currently having the AAA ratings. In addition, approximately 25 percent of all AAA ratings for state and local governments nationwide are located in North Carolina.

Cash Management

It is the policy of the State that all agencies, institutions, departments, bureaus, boards, commissions and officers of the State shall devise techniques and procedures for the receipt, deposit and disbursement of monies coming into their control and custody which are designed to maximize interest-bearing investment of cash, and to minimize idle and nonproductive cash balances. The State Controller, with the advice and assistance of the State Treasurer, the State Budget Officer, and the State Auditor, develops, implements, and amends the *Statewide Cash Management Policy*. All cash deposited with the State Treasurer by State entities is managed in pooled investment accounts to maximize interest earnings. During fiscal year 1999, uncommitted State funds were invested in short-term and medium-term U.S. Government notes and bonds, as well as other deposits, which had a composite average yield of 6.159%.

Risk Management

The State has a limited risk management program for fire and other property losses. As part of this comprehensive plan, resources are being accumulated in an internal service fund to meet potential losses. See **Note 12** of the Notes to the Financial Statements for a full description of the State's risk management program.

Other Information

Independent Audit

In compliance with State statute, an annual financial audit of the State entity is completed each year by the North Carolina Office of the State Auditor. The Auditor's examination was conducted in accordance with generally accepted government auditing standards and his opinion has been included in this report. In addition, the State coordinates the "Single Audit" effort of all federal funds through the State Auditor.

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, 1998. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to 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 State government 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,

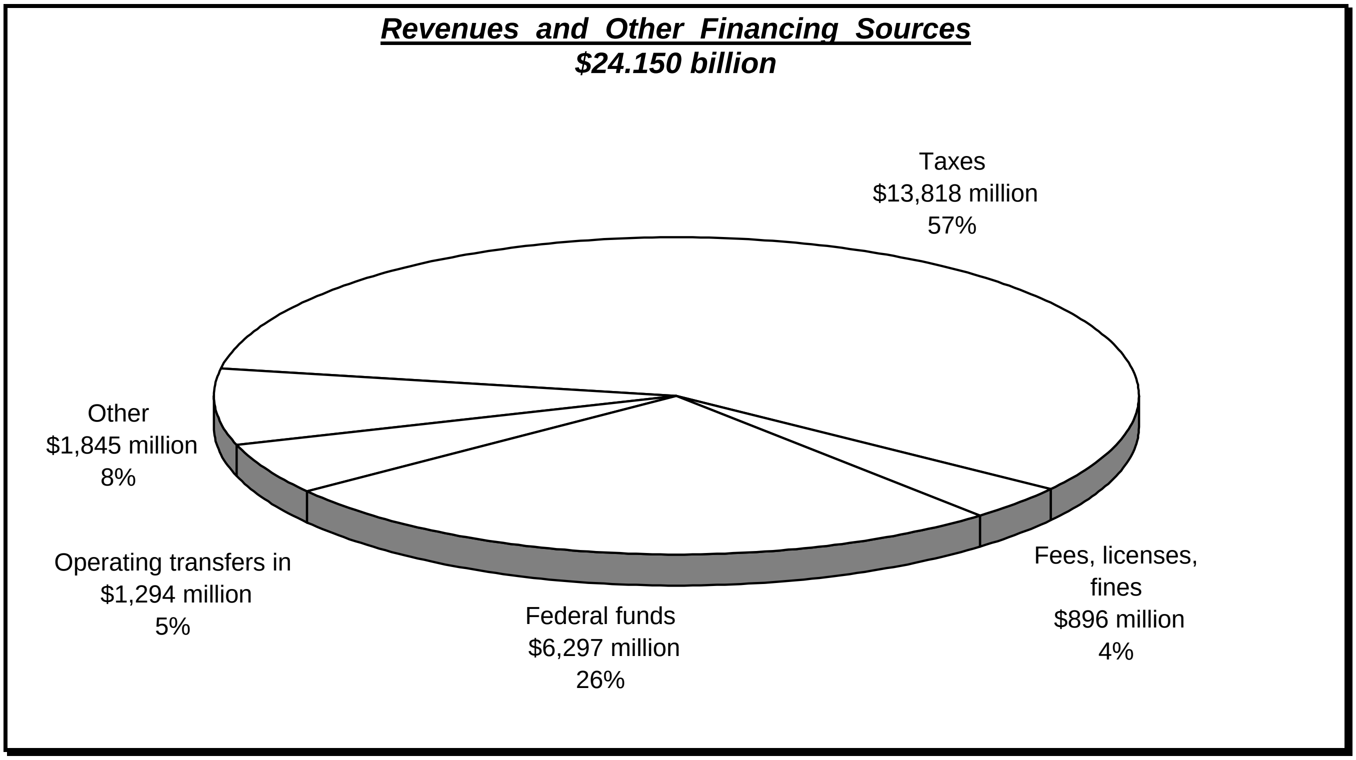
Edward Renfrow

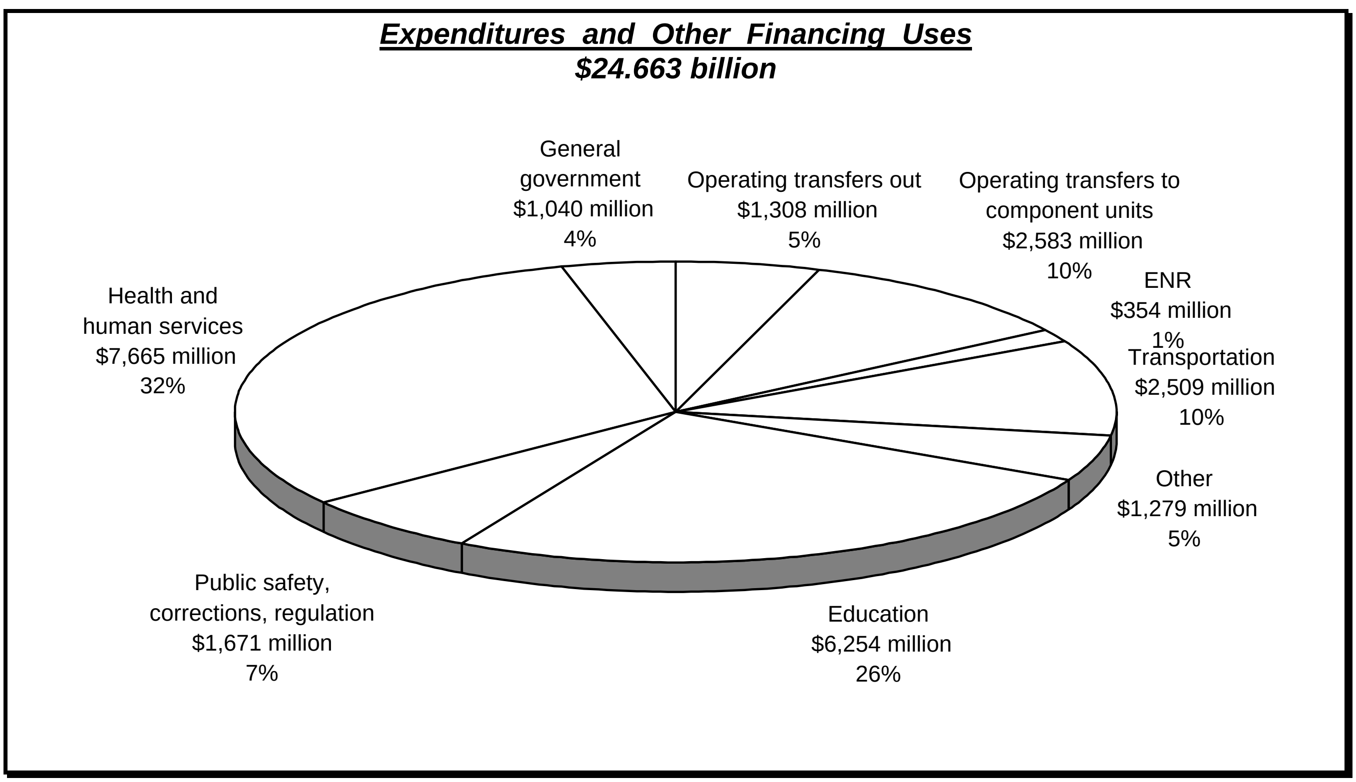
Edward Renfrow
State Controller

December 3, 1999

General Governmental

General, Special Revenue, and Capital Projects Funds
For the Fiscal Year Ended June 30, 1999





THIS PAGE INTENTIONALLY LEFT BLANK.

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, 1998

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

ORGANIZATION OF NORTH CAROLINA STATE GOVERNMENT INCLUDING PRINCIPAL STATE OFFICIALS

EXECUTIVE BRANCH

Council of State

Governor
James B. Hunt, Jr.

Lieutenant Governor
Dennis A. Wicker

Secretary of State
Elaine F. Marshall

State Auditor
Ralph Campbell, Jr.

State Treasurer
Harlan E. Boyles

Superintendent of Public Instruction
Dr. Michael E. Ward

Attorney General
Michael F. Easley

Commissioner of Agriculture
James A. Graham

Commissioner of Labor
Harry E. Payne

Commissioner of Insurance
James E. Long

Cabinet Secretaries — Appointed by the Governor

Administration
Katie G. Dorsett

Correction
Theodis Beck

Crime Control and Public Safety
David E. Kelly

Cultural Resources
Betty Ray McCain

Commerce
Rick Carlisle

Environment & Natural Resources
Bill Holman

Health and Human Services
Dr. H. David Bruton

Revenue
Muriel K. Offerman

Transportation
David McCoy

Appointed by Governor, confirmed by Legislature

Office of the State Controller
Edward Renfrow
State Controller

State Board of Education
Phillip J. Kirk, Jr.
Chairman

Appointed by State Board of Community Colleges

H. Martin Lancaster
President

Appointed by University Board of Governors

Molly C. Broad
President

LEGISLATIVE BRANCH

General Assembly

Senate

President
Lieutenant Governor

President Pro Tempore
Marc Basnight

Deputy Pres. Pro Tempore
Frank W. Ballance, Jr.

Majority Leader
Roy A. Cooper, III

Minority Leader
Patrick J. Ballentine

House of Representatives

Speaker
James B. Black

Speaker Pro Tempore
Joe Hackney

Majority Leader
Philip A. Baddour

Minority Leader
N. Leo Daughtry

JUDICIAL BRANCH

North Carolina Supreme Court

Chief Justice
Henry E. Frye

Associate Justices
Franklin E. Freeman, Jr.
I. Beverly Lake, Jr.
Robert F. Orr
Mark D. Martin
Sarah Parker
George L. Wainwright, Jr.

Administrative
Office of the Courts
Judge Thomas W. Ross
Director

Component Units

- ***University of North Carolina System***
- ***Community Colleges***
- ***Proprietary Funds***