

## ***MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)***

The following is a narrative overview and analysis of the State of North Carolina's (the State) financial performance for the fiscal year ended June 30, 2015. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

### ***Financial Highlights***

#### ***Government-wide Financial Statements***

- The State's total net position increased by \$4.95 billion or 12.05% as a result of this year's operations. Net position of governmental activities and business-type activities increased by \$3.26 billion (or 8.23%) and \$1.69 billion (or 114.4%), respectively. At year-end, net position of governmental activities and business-type activities totaled \$42.86 billion and \$3.17 billion, respectively.
- Component units reported net position of \$22.83 billion, an increase of \$941.7 million or 4.3% from the previous year. The majority of the net position is attributable to the University of North Carolina System, a major component unit.

#### ***Fund Financial Statements***

- The fund balance of the General Fund increased from \$1.55 billion at June 30, 2014 (as restated) to \$2.51 billion at June 30, 2015, an increase of 61.44%. A significant decrease in individual income tax refunds, due to tax law changes, is the main contributor to the fund balance increase. Tax refunds were lower due to the elimination of many deductions and tax credits and taxpayers not adjusting their withholding amounts for the 2014 tax year.
- The fund balance of the Highway Fund increased 65.68% to \$367.09 million at June 30, 2015. The increase is attributable, in part, to the issuance of \$264.93 million in grant anticipation vehicle (GARVEE) bonds in May 2015.
- The fund balance of the Highway Trust Fund increased 29.45% to \$1.13 billion at June 30, 2015. The increase is due, in part, to the continued growth in new car sales, which led to an increase in the highway use tax.
- The Unemployment Compensation Fund reported net position of positive \$1.14 billion at June 30, 2015 compared to negative \$370.52 million at June 30, 2014. The improvement in net position is attributable to the drop in the State's unemployment rate and the implementation of Session Law 2013-2. The State paid off the federal unemployment debt (amount that was advanced to finance State unemployment benefit payments) on April 30, 2015.
- Net ticket sales of the N.C. State Lottery Fund (Lottery) increased 7.23% from the previous fiscal year to \$1.97 billion. As required by law, the Lottery transferred \$526.43 million to the General Fund to support educational programs.
- The net position of the N.C. Turnpike Authority (Authority) increased 21.51% to \$335.96 million at June 30, 2015. Total operating revenues increased 24.21% to \$30.71 million primarily due to the increase in toll revenues. The Authority receives gap funding of debt service from the Highway Trust Fund.
- The net position of the EPA Revolving Loan Fund increased 6.94% to \$1.5 billion.

#### ***Capital Assets***

- The State's investment in capital assets (net of accumulated depreciation) was \$47.09 billion, an increase of 3.27% from the previous fiscal year-end.
- Significant year-end construction in progress amounts were for State highway projects (\$1.58 billion), a toll road project (\$263 million), new psychiatric hospitals (\$226 million), and a new system for managing and administering social service benefits (\$301 million).

#### ***Long-term Debt***

- The State had total long-term debt outstanding (bonds, special indebtedness, and notes payable) of \$7.91 billion, a decrease of 1.21% from the previous fiscal year-end. The State issued \$231.36 million in general obligation bonds and \$264.93 million in GARVEE bonds for its governmental activities. Additionally, the State refinanced \$309.2 million of its existing certificates of participation and limited obligation bonds to take advantage of lower interest rates. The refinancing is expected to reduce future debt service payments by approximately \$21 million.
- In connection with the general obligation bonds, all three rating agencies affirmed the triple-A credit rating for the State. The rating agencies recognized the State's historically conservative budgeting, financial management, and debt issuance practices. North Carolina remains one of only 10 states with a triple-A rating from all three rating agencies.

## OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information (Pension and other postemployment benefits trend information and General Fund budgetary schedule) and other supplementary information (combining financial statements) in addition to the basic financial statements. These components are described below.

### Government-wide Financial Statements

The Statement of Net Position and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better off or worse off as a result of this year's activities? These statements include all non-fiduciary assets, deferred outflows of resources, liabilities, and deferred inflows of resources using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The Statement of Net Position (pages 52 and 53) presents all of the State's assets, deferred outflows of resources, liabilities, and deferred inflows of resources, with the sum of these components reported as "net position." Over time, increases and decreases in net position measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 54 and 55) presents information showing how the State's net position changed during the most recent fiscal year. All changes in net position are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned but unused vacation leave).

In the government-wide financial statements, the State's activities are divided into three categories:

- *Governmental Activities* – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services.
- *Business-type Activities* – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. The State's Unemployment Compensation Fund, the EPA Revolving Loan Fund, the N.C. State Lottery Fund, and the N.C. Turnpike Authority are the predominant business-type activities.
- *Discretely Presented Component Units* – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A description of the component units and an address for obtaining their separately issued financial statements can be found beginning on page 76. Discretely presented component units are combined and displayed in a separate discrete column in the government-wide financial statements to emphasize their legal separateness from the State. In addition, financial statements for major component units are presented in the notes to the financial statements (pages 172 and 173).

### Fund Financial Statements

The fund financial statements provide more detailed information about the State's most significant funds (i.e., major funds) – not the State as a whole. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for particular purposes. In addition to the major funds, page 216 begins the individual fund data for the nonmajor funds. The State's funds are divided into three categories (governmental, proprietary, and fiduciary) and they use different accounting approaches.

**Governmental funds** – Most of the State's basic services are reported in the governmental funds, which focus on how cash and other financial assets that can readily be converted to cash flow in and out (i.e., inflows and outflows of spendable resources) and the balances left at year-end that are available for spending (i.e., balances of spendable resources). Consequently, the governmental fund financial statements provide a detailed short-term view that helps users determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. The State prepares the governmental fund financial statements using the modified accrual basis of accounting and a current financial resources measurement focus. Because this information does not encompass the additional long-term focus of the government-wide statements, a reconciliation schedule, which follows each of the governmental fund financial statements, explains the relationships (or differences) between them. Information is presented separately in the governmental fund financial statements for the General Fund, the Highway Fund, and the Highway Trust Fund, all of which are considered to be major funds. Data for all other governmental funds are combined into a single aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

**Proprietary funds** – When the State charges customers for the services it provides, whether to outside customers or to agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting, which is the same method used by private sector businesses. Enterprise funds are used to report activities for which fees are charged to external users for goods and services. The Unemployment Compensation Fund, the EPA Revolving Loan Fund, the N.C. State Lottery Fund, and the N.C. Turnpike Authority are our most significant enterprise funds. Internal service funds are used to report activities that

provide goods and services to the State's other programs and activities on a cost-reimbursement basis, such as the State Property Fire Insurance Fund, the Motor Fleet Management Fund, Computing Services Fund, and the State Telecommunications Services Fund. Because the State's internal service funds predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. Information is presented separately in the proprietary fund financial statements for the Unemployment Compensation Fund, the EPA Revolving Loan Fund, the N.C. State Lottery Fund, and the N.C. Turnpike Authority, all of which are considered to be major funds. Conversely, separately aggregated columns are presented for the nonmajor enterprise funds and the internal service funds. Individual fund data for the nonmajor enterprise funds and internal service funds is provided in the form of combining statements elsewhere in this report.

**Fiduciary funds** – Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the State's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Position and Changes in Fiduciary Net Position. These funds include pension and other employee benefit trust funds, private-purpose trust funds, investment trust funds, and agency funds.

### **Notes to the Financial Statements**

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found beginning on page 76 of this report.

### **Required Supplementary Information**

Required Supplementary Information (RSI) follows the basic financial statements and notes to the financial statements. The RSI is mandated by the GASB and includes 1) pension plan and employer trend information related to the net pension liability, employer contributions, and investment returns, 2) other postemployment benefits trend information related to funding progress and employer contributions, and 3) General Fund budgetary comparison schedules reconciling the statutory to the generally accepted accounting principles fund balances at fiscal year-end.

### **Other Supplementary Information**

Other supplementary information includes the introductory section; combining financial statements for nonmajor governmental funds, nonmajor enterprise funds, internal service funds, fiduciary funds, and nonmajor discretely presented component units; a statement of cash flows for the State Health Plan, a major component unit, which does not issue separate financial statements; and the statistical section.

### **FINANCIAL ANALYSIS OF THE STATE AS A WHOLE**

The State's overall assets and deferred outflows of resources exceeded liabilities and deferred inflows of resources by \$46.03 billion (total primary government) at the close of the most recent fiscal year. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the State is improving or deteriorating. The following table was derived from the government-wide Statement of Net Position:

#### **Net Position as of June 30, 2015 and 2014** (dollars in thousands)

	<b>Governmental Activities</b>		<b>Business-type Activities</b>		<b>Total Primary Government</b>		<b>Total Percentage Change 2014-2015</b>
	<b>2015</b>	<b>2014 (as restated)</b>	<b>2015</b>	<b>2014 (as restated)</b>	<b>2015</b>	<b>2014 (as restated)</b>	
Current and other non-current assets.....	\$ 10,865,267	\$ 9,607,068	\$3,962,905	\$ 3,394,803	\$ 14,828,172	\$ 13,001,871	14.05%
Capital assets, net.....	45,804,367	44,388,041	1,287,441	1,213,315	47,091,808	45,601,356	3.27%
<b>Total assets.....</b>	<b>56,669,634</b>	<b>53,995,109</b>	<b>5,250,346</b>	<b>4,608,118</b>	<b>61,919,980</b>	<b>58,603,227</b>	<b>5.66%</b>
<b>Total deferred outflows of resources.....</b>	<b>607,444</b>	<b>532,787</b>	<b>4,599</b>	<b>6,180</b>	<b>612,043</b>	<b>538,967</b>	<b>13.56%</b>
Long-term liabilities.....	8,666,978	9,887,589	1,654,144	2,679,671	10,321,122	12,567,260	(17.87%)
Other liabilities.....	4,717,689	5,037,685	413,186	458,006	5,130,875	5,495,691	(6.64%)
<b>Total liabilities.....</b>	<b>13,384,667</b>	<b>14,925,274</b>	<b>2,067,330</b>	<b>3,137,677</b>	<b>15,451,997</b>	<b>18,062,951</b>	<b>(14.45%)</b>
<b>Total deferred inflows of resources.....</b>	<b>1,030,957</b>	<b>0</b>	<b>21,666</b>	<b>0</b>	<b>1,052,623</b>	<b>—</b>	<b>NA</b>
Net position:							
Net investment in capital assets.....	43,612,584	42,139,297	534,380	442,100	44,146,964	42,581,397	3.68%
Restricted.....	1,061,817	861,988	1,256	1,940	1,063,073	863,928	23.05%
Unrestricted.....	(1,812,947)	(3,398,663)	2,630,313	1,032,581	817,366	(2,366,082)	134.55%
<b>Total net position.....</b>	<b>\$ 42,861,454</b>	<b>\$ 39,602,622</b>	<b>\$ 3,165,949</b>	<b>\$ 1,476,621</b>	<b>\$ 46,027,403</b>	<b>\$ 41,079,243</b>	<b>12.05%</b>

The largest component of the State's net position (\$44.15 billion) reflects its investment in capital assets (land, buildings, machinery and equipment, state highway system, toll road system, and other capital assets), less related debt still outstanding that was used to acquire or construct those assets. Restricted net position is the next largest component (\$1.06 billion). Net position is restricted when constraints placed on their use are 1) externally imposed by creditors, grantors, contributors, or laws or regulations of other governments or 2) legally imposed through constitutional provisions. The remaining portion, unrestricted net position, consists of net position that does not meet the definition of "restricted" or "net investment in capital assets."

The government-wide statement of net position for governmental activities reflects a negative \$1.81 billion unrestricted net position balance. The State of North Carolina, like many other state and local governments, issues general obligation debt and special indebtedness and distributes the proceeds to local governments and component units. The proceeds are used to construct new buildings and renovate and modernize existing buildings on the State's community college and university campuses, assist county governments in meeting their public school building capital needs, and to provide grants and loans to local governments for clean water and natural gas projects. Of the \$6.87 billion of bonds and special indebtedness outstanding for governmental activities at June 30, 2015, \$4.39 billion is attributable to debt issued as state aid to component units (universities and community colleges) and local governments. The balance sheets of component unit and local government recipients reflect ownership of the related constructed capital assets without the burden of recording the debt obligation. The policy of issuing bonded debt and distributing the cash proceeds to non-primary government (non-state) entities has been in place for decades. However, by issuing such debt, the State is left to reflect significant liabilities on its statement of net position (reflected in the unrestricted net position component) without the benefit of recording the capital assets constructed or acquired with the proceeds from the debt issuances. Additionally, as of June 30, 2015, the State's governmental activities have significant unfunded liabilities for compensated absences of \$456.7 million, net pension liabilities of \$344.96 million, worker's compensation of \$202.16 million, and a court judgment payable of \$737.3 million (see Note 8 to the financial statements). The State of North Carolina implemented GASB Statements 68 and 71 this year (see Note 22 to the financial statements). In 2008, a Superior Court judge ruled that certain civil fines and penalties should have been remitted to North Carolina public schools and not diverted to other uses. These unfunded liabilities also contribute to the negative unrestricted net position balance for governmental activities.

The State's overall net position increased \$4.95 billion or 12.05% (total primary government) from the prior fiscal year. The net position of the governmental activities increased \$3.26 billion or 8.23% and business-type activities increased \$1.69 billion or 114.4%. The following financial information was derived from the government-wide Statement of Activities:

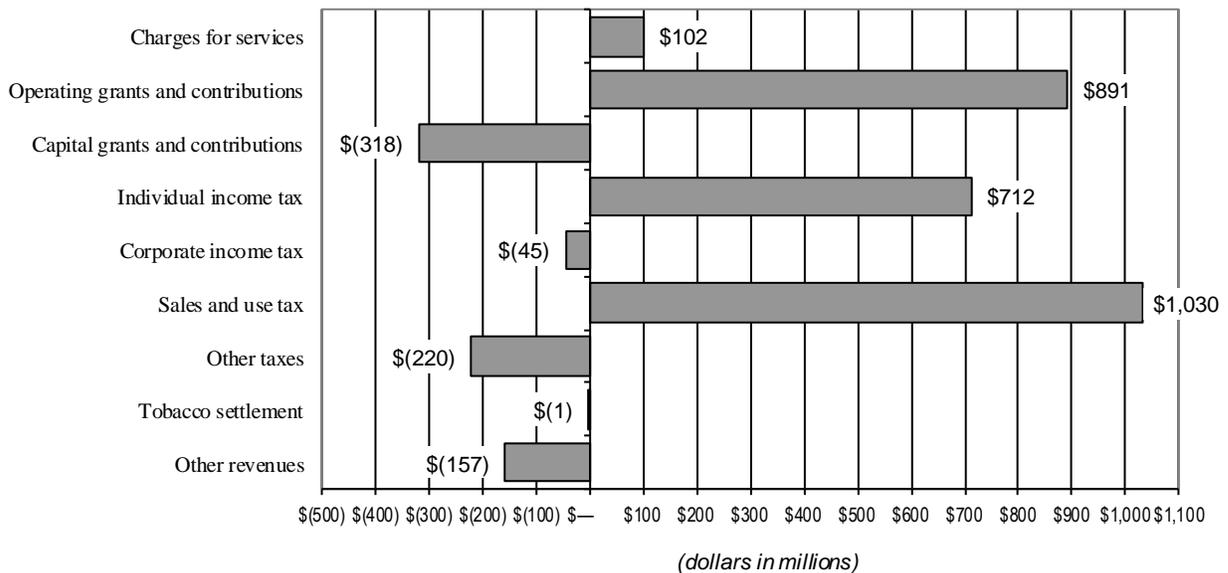
**Changes in Net Position for the Fiscal Years Ended June 30, 2015 and 2014**  
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government		Total Percentage Change 2014-2015
	2015	2014 (as restated)	2015	2014 (as restated)	2015	2014 (as restated)	
<b>Revenues</b>							
<b>Program revenues</b>							
Charges for services.....	\$ 2,304,142	\$ 2,202,085	\$ 3,726,105	\$ 3,670,399	\$ 6,030,247	\$ 5,872,484	2.69%
Operating grants and contributions.....	16,152,680	15,261,306	409,351	347,108	16,562,031	15,608,414	6.11%
Capital grants and contributions.....	942,238	1,260,306	21,251	11,942	963,489	1,272,248	(24.27%)
<b>General revenues</b>							
Taxes:							
Individual income tax.....	11,288,542	10,576,575	—	—	11,288,542	10,576,575	6.73%
Corporate income tax.....	1,272,879	1,318,091	—	—	1,272,879	1,318,091	(3.43%)
Sales and use tax.....	6,869,090	5,839,362	—	—	6,869,090	5,839,362	17.63%
Gasoline tax.....	1,945,462	1,907,803	—	—	1,945,462	1,907,803	1.97%
Franchise tax.....	556,786	888,815	—	—	556,786	888,815	(37.36%)
Highway use tax.....	653,931	596,801	—	—	653,931	596,801	9.57%
Insurance tax.....	529,927	476,402	—	—	529,927	476,402	11.24%
Beverage tax.....	360,280	342,784	—	—	360,280	342,784	5.10%
Tobacco products tax.....	279,795	273,426	—	—	279,795	273,426	2.33%
Other taxes.....	288,340	348,938	—	—	288,340	348,938	(17.37%)
Tobacco settlement.....	137,910	139,169	—	—	137,910	139,169	(0.90%)
Unrestricted investment earnings.....	20,139	19,452	—	—	20,139	19,452	3.53%
Miscellaneous.....	34,167	192,002	4	3	34,171	192,005	(82.20%)
<b>Total revenues.....</b>	<b>43,636,308</b>	<b>41,643,317</b>	<b>4,156,711</b>	<b>4,029,452</b>	<b>47,793,019</b>	<b>45,672,769</b>	<b>4.64%</b>
<b>Expenses</b>							
General government.....	1,159,012	1,080,982	—	—	1,159,012	1,080,982	7.22%
Primary and secondary education.....	10,224,967	9,772,994	—	—	10,224,967	9,772,994	4.62%
Higher education.....	3,859,549	3,901,543	—	—	3,859,549	3,901,543	(1.08%)
Health and human services.....	18,705,192	17,812,888	—	—	18,705,192	17,812,888	5.01%
Economic development.....	408,289	420,464	—	—	408,289	420,464	(2.90%)
Environment and natural resources.....	490,185	484,718	—	—	490,185	484,718	1.13%
Public safety, corrections and regulation.....	2,895,244	2,911,146	—	—	2,895,244	2,911,146	(0.55%)
Transportation.....	2,673,649	2,607,663	—	—	2,673,649	2,607,663	2.53%
Agriculture.....	165,735	191,242	—	—	165,735	191,242	(13.34%)
Interest on long-term debt.....	216,519	216,521	—	—	216,519	216,521	0.00%
Unemployment compensation.....	—	—	349,069	700,190	349,069	700,190	(50.15%)
N.C. State Lottery.....	—	—	1,450,494	1,341,219	1,450,494	1,341,219	8.15%
EPA Revolving Loan.....	—	—	22,965	27,789	22,965	27,789	(17.36%)
N.C. Turnpike Authority.....	—	—	89,004	88,278	89,004	88,278	0.82%
Regulatory programs.....	—	—	90,397	86,253	90,397	86,253	4.80%
Insurance programs.....	—	—	21,632	18,427	21,632	18,427	17.39%
North Carolina State Fair.....	—	—	14,975	13,957	14,975	13,957	7.29%
Other business-type activities.....	—	—	12,364	12,917	12,364	12,917	(4.28%)
<b>Total expenses.....</b>	<b>40,798,341</b>	<b>39,400,161</b>	<b>2,050,900</b>	<b>2,289,030</b>	<b>42,849,241</b>	<b>41,689,191</b>	<b>2.78%</b>
Increase (decrease) in net position							
before contributions and transfers.....	2,837,967	2,243,156	2,105,811	1,740,422	4,943,778	3,983,578	24.10%
Contributions to permanent funds.....	4,382	3,861	—	—	4,382	3,861	13.49%
Transfers.....	416,483	429,810	(416,483)	(429,810)	—	—	0.00%
<b>Increase (decrease) in net position.....</b>	<b>3,258,832</b>	<b>2,676,827</b>	<b>1,689,328</b>	<b>1,310,612</b>	<b>4,948,160</b>	<b>3,987,439</b>	<b>24.09%</b>
Net position - beginning - restated.....	39,602,622	36,925,795	1,476,621	166,009	41,079,243	37,091,804	10.75%
Net position - ending.....	\$ 42,861,454	\$ 39,602,622	\$ 3,165,949	\$ 1,476,621	\$ 46,027,403	\$ 41,079,243	12.05%

**Governmental Activities.** For fiscal year 2015, revenues outpaced expenses and when combined with transfers from the State’s business-type activities, an increase in net position of \$3.26 billion (or 8.23%) resulted for governmental activities. Total revenues increased by 4.79% (\$1.99 billion) while total expenses increased more slowly at 3.55% (\$1.4 billion). The increase in total revenues is attributable to major tax changes enacted by the General Assembly, which included a reduction in individual income and corporate income tax rates (effective January 1, 2014) and a broadening of the sales and use tax base. A significant decrease in tax refunds due to the elimination of many deductions and tax credits and taxpayers not adjusting their withholding amounts for the 2014 tax year explains the increase in individual income tax revenues. Operating grants and contributions increased because of more spending in federally supported programs, such as Medicaid. However, capital grants and contributions decreased due to a reduction in federal funding for transportation.

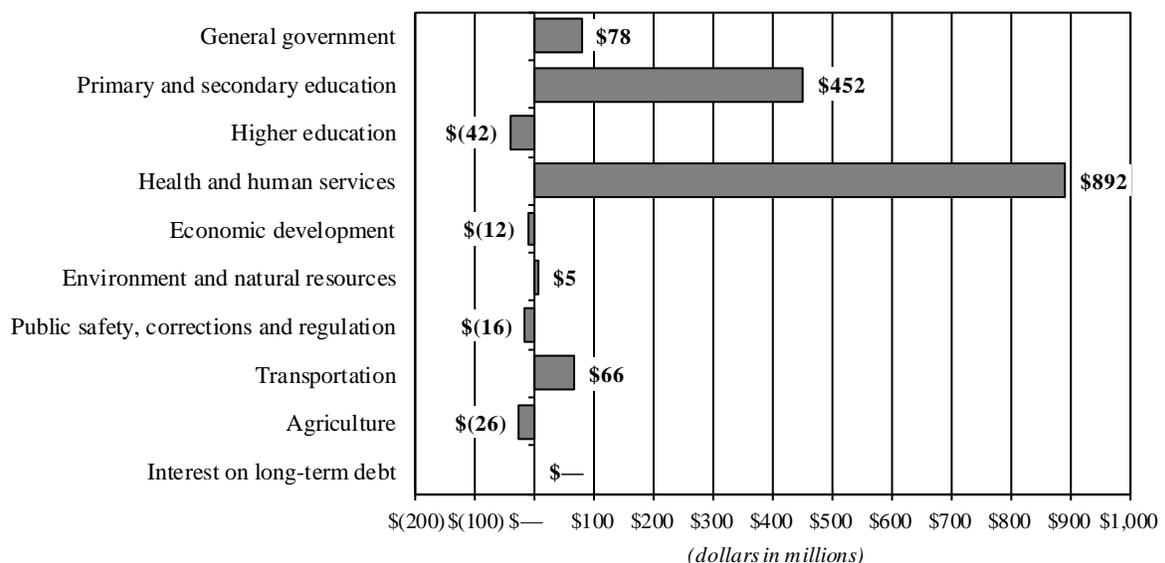
The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2014 and 2015:

**Dollar Change in Governmental Activities Revenues by Source  
Between Fiscal Years 2014 and 2015**



The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2014 and 2015:

**Dollar Change in Governmental Activities Functional Expenses  
Between Fiscal Years 2014 and 2015**

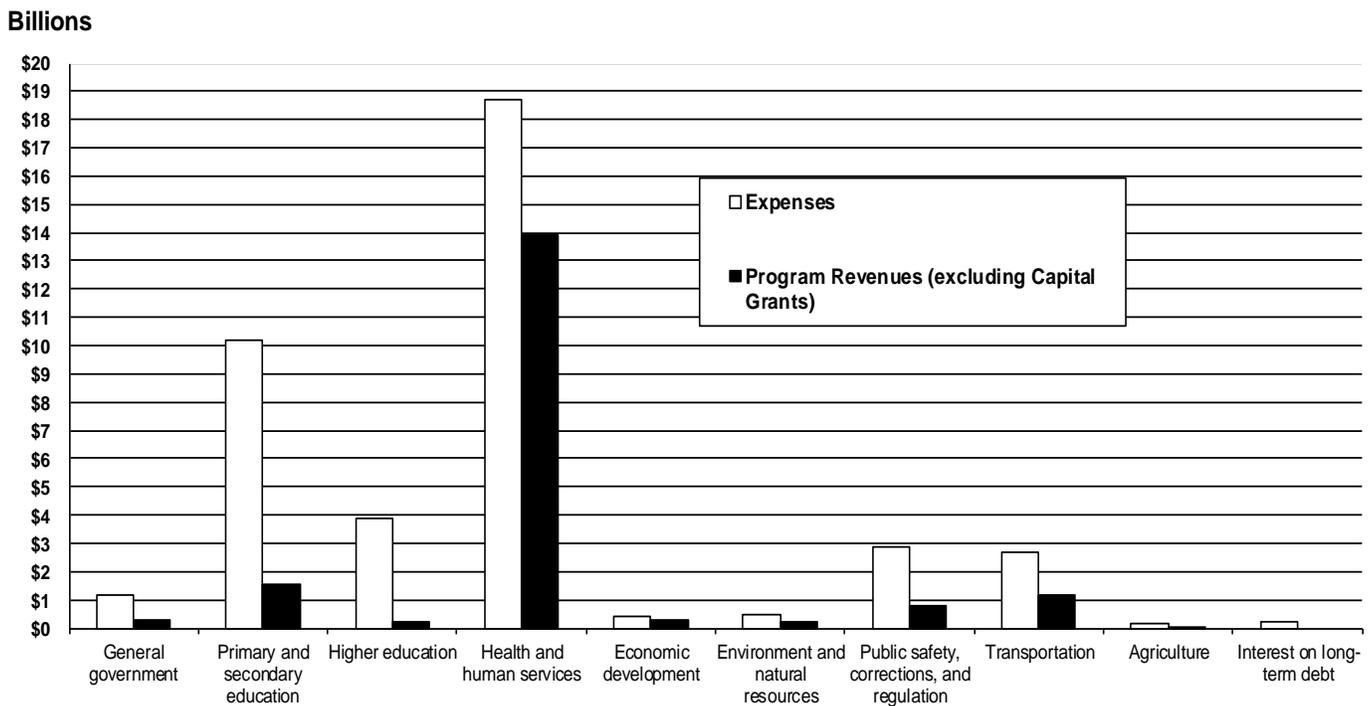


The increase in total expenses of 3.55% is attributable to spending increases in the State’s two largest functional areas, health and human services and primary and secondary education. The increase in health and human services is due primarily to increased spending for Medicaid (the State’s largest public assistance program). The growth in primary and secondary education is due to salary increases for State-funded local public school district employees, including teachers and instructional support, and other personnel. The pay for all educators was increased to at least \$33 thousand annually. Higher education spending decreased during the current period due, in part, to smaller distributions of higher education bond proceeds in fiscal year 2015 compared to the prior year. Also, escheat funding for grants, loans, and scholarships for students was lower this year.

Medicaid is a federal entitlement program, which means individuals found eligible for Medicaid have legal rights to receive services and cannot be denied coverage by the State. In North Carolina, Medicaid is administered by the State and counties and financed with federal and state funds. Medicaid serves as the State’s safety net program for eligible individuals who lose jobs and health insurance coverage. As such, it is sensitive to economic volatility. Higher growth rates occur during years of economic distress and when major Medicaid expansions are enacted. Lower growth rates occur when the Medicaid eligible population is stable or declining.

The following chart depicts the total expenses and total program revenues of the State’s governmental functions. This format identifies the extent to which each governmental function is self-financing through fees and intergovernmental aid or draws from the general revenues of the State.

**Expenses - Governmental Activities  
For the Fiscal Year Ended June 30, 2015**



**Business-type Activities.** Business-type activities reflect an overall increase in net position of \$1.69 billion or 114.4%, primarily because of the financial results of the Unemployment Compensation Fund. The net position increase of \$1.51 billion in the Unemployment Compensation Fund is explained by the drop in the State’s unemployment rate and the implementation of Session Law 2013-2. The net position increase of \$59.47 million for the N.C. Turnpike Authority is due primarily to transfers in from the Highway Trust Fund. The net position increase of \$97.29 million in the EPA Revolving Loan Fund is due to the recognition of federal capitalization grants. The N.C. State Lottery Fund has no net position since its net profits are distributed to the State’s governmental activities, as required by statute. A more detailed discussion of the State’s business-type enterprise activities is provided in the following section (see Enterprise Funds).

## ***FINANCIAL ANALYSIS OF THE STATE'S FUNDS***

The State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

### ***Governmental Funds***

The focus of the State's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. At June 30, 2015, the State's governmental funds reported combined fund balances of \$5.84 billion, an increase of 37.28% from the prior fiscal year-end (as restated). Of this amount, \$688.17 million is classified as unassigned fund balance in the General Fund (available for spending at the State's discretion). The remainder of fund balance is either nonspendable, restricted, committed, or assigned to indicate that it is 1) not in spendable form (e.g., inventories), 2) restricted for particular purposes by external sources, 3) committed for particular purposes by the N.C. General Assembly, or 4) assigned for particular purposes by the Office of State Budget and Management. The substantial increase in combined fund balances is explained primarily by unspent debt proceeds reported in both the Highway Fund and other governmental funds (\$559 million) and the fund balance increase in the General Fund (see below).

The major governmental funds are discussed individually below.

#### **General Fund**

The General Fund is the chief operating fund of the State. The fund balance of the General Fund increased \$954.72 million (or 61.44%) to \$2.51 billion at June 30, 2015. A significant decrease in individual income tax refunds, due to tax law changes, is the main contributor to the fund balance increase. The 2013 Session of the General Assembly enacted the *Tax Simplification and Reduction Act* (Session Law 2013-360), which created a flat personal income tax, reduced personal and corporate income tax rates, and increased sales tax revenues through an expanded base.

Individual income tax revenues increased 6.73% to \$11.29 billion. The significant decrease in tax refunds explains this increase (Note: income tax revenues are net of estimated refunds and uncollectible amounts). Tax law changes required all employees receiving wages in North Carolina to adjust the amount withheld by their employer based on a new calculation model for wages earned beginning January 1, 2014. The reduction in individual income tax refunds is due to a combination of the elimination of many deductions and tax credits as well as taxpayers not adjusting their withholding amounts for the 2014 tax year to reflect the altered withholding tables due to the tax reform. The result was more taxpayers owed taxes for the 2014 tax year than in previous tax years. Effective January 1, 2014, the State individual income tax rates changed from a multi-tiered bracket system with tax rates of 6%, 7%, and 7.75% to a flat rate of 5.8% for all individual income tax taxpayers in North Carolina. Effective January 1, 2015, the State individual income tax rate decreased to 5.75%.

Sales and use tax revenues increased 17.48% to \$6.86 billion due to an improved economy and tax law changes that broadened the sales and use tax base. The improvements in the economy over the last year, as evidenced by the growing number of jobs in the state, have increased the disposable incomes of consumers. Corporate income tax revenues, which are highly volatile over the business cycle, decreased 4.58% to \$1.27 billion. Tax law changes reduced the corporate income tax rate from 6% to 5% for tax years beginning in 2015.

One of the major budget drivers for the General Fund, historically, has been the Medicaid program. Medicaid enrollment increased 6% to 1.84 million individuals (or 18.3% of North Carolina's population). State appropriation expenditures for Medicaid increased 4.52% to \$3.56 billion. Medicaid ended the fiscal year without a budget shortfall. Prior to the fiscal year 2014-15, Medicaid experienced shortfalls of nearly \$1 billion over a three-year period. N.C. Tracks, the replacement system for the Medicaid Management Information System, went live on July 1, 2013. N.C. Tracks is the first multi-payer system in the country and the largest information technology project in North Carolina history. In April 2015, the system was certified by the Centers for Medicare and Medicaid Services.

*General Fund Budget Variances*

The original General Fund budget, including state appropriations and appropriations supported by departmental receipts, serves as a starting point or plan for the Governor to execute the General Fund budget pursuant to the powers granted by the Constitution and State Budget Act. At the state level in North Carolina, it is not unusual for the budget to change during the fiscal year in relation to budget adjustments made to accommodate departmental receipts. The General Fund budget supported by state appropriation is a subset of the General Fund financial schedule presented in the CAFR as required supplementary information. The current CAFR schedule reflects all spending required to support the State's General Fund activities and the funding to support those activities, including state tax and non-tax revenues, federal revenues, student tuition, and other fees, licenses, and fines. Under current state budget management practice, particularly related to departmental federal receipts, primary emphasis is placed on comparisons of the final authorized budget and actual spending.

At the state level, budgetary cuts related to state appropriations are implemented by decreasing allowable actual expenditures, as opposed to decreasing the state appropriation through a formal legislative process. The Governor and state agencies maintain legal authority to spend the dollars originally appropriated to them; however, in recent years the actual spending has been limited by the collection of tax and non-tax revenue. In extremely rare cases, the General Assembly has held special sessions to formally amend the authorized and certified state appropriation budget.

The portion of the original budget comprising departmental receipts is not intended to be the sole controlling point to manage the State's General Fund budget. The final budget includes amendments for departmental receipts collected during the fiscal year as allowed by law. General Fund departmental receipts are typically authorized for expenditure within the activity that generated the receipt. Historically, final estimated receipts have varied significantly from the original estimate at the beginning of the fiscal year. State agencies by law must spend departmental receipts prior to spending tax and nontax supported appropriations. If departmental receipts are higher than expected, appropriated dollars may go unspent and be re-appropriated in a subsequent fiscal year.

*Variances – Original and Final Budget*

In general, the variances between original and final budget are attributable to the timing and length of the budget preparation process and the budgeting of federal funds for the fiscal year. The original budget for fiscal year 2014-15 was prepared approximately 18 months prior to the final budget existing on June 30, 2015. The final budget reflects all budget revisions made throughout the fiscal year to adjust for known facts as well as supplemental adjustments approved in the 2014 Session of the General Assembly. Consequently, when the original budget is compared to the final budget, it would be expected that significant variances can occur.

Additional factors leading to variances between the original and final budget in fiscal year 2014-15 include the following:

- 1) Awarding of new unanticipated federal grants and/or the awarding of unanticipated increased or decreased amounts in long-standing federally supported programs. This also led to the necessity of budgeting unanticipated required state match.
- 2) Statewide encumbrance carry-forward budgeted amounts from fiscal year 2013-14 totaled \$282.17 million.
- 3) Allocation of statewide reserves to agencies and universities for the purposes of retirement and hospitalization formula adjustments, severance, salary adjustments, contingency and emergency, information technology related programs, and various other budgeted statewide reserves.
- 4) Receipt and budgeting of over-realized receipts, prior year earned revenues, and unanticipated donations and grants.

*Variances - Final Budget and Actual Results*

Actual total revenue collected (both tax and non-tax) was 2.1% above budgeted revenue amounts in fiscal year 2014-15. This result occurred due to greater than anticipated individual income and corporate income collections. As corporate taxable profits accelerated and write-offs on losses from the recession dropped, corporate income tax collections surged over 20% above forecast expectations. For individual income taxes, the forecast did not fully anticipate the timing of significant State tax law changes enacted during

fiscal year 2013-14, resulting in a shortfall in fiscal year 2013-14 and a surplus in fiscal year 2014-15. Sales and use tax collections, which comprise nearly 30% of total general fund revenue collections, finished on target in fiscal year 2014-15.

Departmental federal funds actually received by agencies were less than the final authorized budgeted federal fund revenues. A variance between the budget and actual federal funds occurs because actual federal fund receipts are reflective of the actual expenditures. Therefore, if qualifying federal costs are not incurred by an agency, the actual receipt of federal funds could be significantly less than the budget.

### **Highway Fund**

The Highway Fund dates back to 1921, when the General Assembly first imposed the gasoline tax. It accounts for most of the activities of the North Carolina Department of Transportation (NCDOT), including the maintenance and construction of the State's primary and secondary road systems, the Division of Motor Vehicles, the State Highway Patrol, transit, rail and ferry system. The primary revenue sources of the Highway Fund are federal funds, three-fourths of gasoline taxes, vehicle registration fees, and driver's license fees.

The fund balance of the Highway Fund increased from \$221.57 million at June 30, 2014 (as restated) to \$367.09 million at June 30, 2015, an increase of 65.68%. The fund balance increase is attributable, in part, to the issuance of \$264.93 million in grant anticipation revenue vehicle bonds (GARVEE's) in May 2015. This innovative financing tool was used to accelerate the funding of transportation improvement projects across the State by leveraging future federal transportation revenues. At June 30, 2015, \$193.89 million of the GARVEE proceeds were unspent.

Total revenues decreased 4.42% to \$3.4 billion, mostly due to a decrease in federal funds. Total expenditures were \$3.29 billion, a decrease of 5.67%. The Federal Highway and Transportation Funding Act of 2015 allocated federal apportionments in smaller increments spread out throughout the year, some of which were not received until the fiscal year 2016. As a result, transportation expenditures and federal revenues decreased from the previous year.

Population growth is placing an increasing demand on the State's transportation system. North Carolina's population grew from 8.53 million in 2004 to 9.94 million in 2014, an increase of 16.56%. According to the 2014 Maintenance and Operations Performance Analysis Report prepared by the N.C. Division of Highways, over a 10-year period (2004 to 2014), paved lane miles grew by 6.6% while bridge deck area grew by approximately 24%. During this same 10-year period, vehicle miles traveled increased by 11%. While the recent recession slowed the growth in vehicle miles traveled, current rates indicate a return to pre-recession levels. This increase places a heavier burden on the existing infrastructure and accentuates the need for additional capacity, safety, and maintenance funding to address the deterioration in service created by the increase in traffic. Furthermore, many of the State's highways were built as farm-to-market roads and were not designed to handle the heavy traffic volumes of today, and other highways such as the interstate highway system, which is approaching its 60th anniversary, are nearing the end of their functional life.

Transportation is fundamental in continuing North Carolina's prosperity and quality of life as the state's population continues to grow. To address the growing demand on the transportation system, increased cost of supplies, and declining funding, NCDOT continues to seek innovative solutions to meet the growing stress on the transportation system. In response to declining motor fuels tax and the decreasing purchasing power of the Highway Fund, Session Law 2009-108 repealed the cap on the motor fuels tax and set the variable portion of the tax at 12.4 cents per gallon or 7% of the average wholesale price whichever is greater, thus setting a floor of 29.9 cents per gallon. This remained in place through June 30, 2011. Subsequent legislation reinstated and continued the cap on the motor fuels tax at a rate of 37.5 cents per gallon until April 30, 2015. Session Law 2015-2 revised the motor fuel tax formula. It sets the tax rate at 36 cents per gallon until December 31, 2015, 35 cents until July 1, 2016 and 34 cents until December 31, 2017. Beginning January 2018, the motor fuel tax computation will include factors for population change and the consumer price index.

Effective beginning in fiscal year 2016, Session Law 2015-241 revised the motor fuels tax distribution formula, directing 71% to the Highway Fund and 29% to the Highway Trust Fund. However, the law also increased license, registration and other fees attributable to the Highway Fund. The law also eliminates a transfer to the General Fund for the State Highway Patrol thereby increasing funding for maintenance, system preservation and the bridge program.

### **Highway Trust Fund**

Legislation creating the Highway Trust Fund was passed by the General Assembly in 1989. It was established to provide a dedicated funding mechanism to meet specific highway construction needs in North Carolina. Additionally, the Highway Trust Fund provides supplemental allocations for secondary road construction and pays the debt service on general obligation bonds issued for highway purposes.

The principal revenue sources of the Highway Trust Fund are highway use taxes, one-fourth of gasoline taxes, and various title and registration fees. The enabling legislation also specifies that a designated amount will be transferred each year to the General Fund. The legislation was amended in 2008 to also require annual transfers to the N.C. Turnpike Authority to pay debt service or financing expenses for specified toll road construction projects (see Note 10(B) to the financial statements). The budget legislation for fiscal years 2015 and 2014 reduced the designated transfer amount to the General Fund to \$0. This did not change for fiscal years 2016 and 2017 under current legislation.

The fund balance of the Highway Trust Fund increased from \$871.43 million at June 30, 2014 (as restated) to \$1.13 billion at June 30, 2015, an increase of 29.45%. The fund balance increase was primarily due to an increase in the highway use tax. Gasoline consumption also rose slightly from the previous year contributing to the overall increase. Total revenues increased 5.56% to \$1.25 billion, primarily due to growth in the highway use tax. Continued increases in vehicle sales, especially in the new vehicle segment, led to the increase. Total transportation expenditures were \$835.52 million, an increase of 12.21%. The full implementation of the Strategic Prioritization Funding plan accounted for this increase.

Since passage of the Highway Trust Fund in 1989, the NCDOT has paved over 13,000 miles of unpaved secondary roads, leaving only 4,357 miles of secondary roads to be paved. In view of the fact that the paved secondary road system has not kept up with the demands of increased urbanization and traffic, the 2006 Session of the General Assembly approved changes in the General Statutes that govern the use of secondary road construction funds. Beginning with fiscal year 2010-11, secondary road allocations to the counties are based on the total number of secondary road miles in that county in proportion to the total state maintained secondary road mileage. Projects slated after July 1, 2015 will be prioritized on a statewide basis instead of a county-wide basis.

Session Law 2013-183 amends the Highway Trust Fund allocation of resources creating the Strategic Prioritization Funding Plan. Fully implemented as of July 1, 2015, it eliminates individually legislated projects and implements a new way for NCDOT to fund and prioritize necessary infrastructure improvements while utilizing existing revenue sources more efficiently. Effective beginning fiscal year 2016, Session Law 2015-241 revised the motor fuels tax distribution formula, directing 71% to the Highway Fund and 29% to the Highway Trust Fund. The law also increased the minimum highway use tax and certain motor vehicle fees in order to increase funding to the Strategic Prioritization Program.

## ***Enterprise Funds***

The State's enterprise funds or business-type activities provide the same type of information found in the government-wide financial statements, but in more detail. The major enterprise funds are discussed individually below.

### **Unemployment Compensation Fund**

The Unemployment Compensation Fund (Trust Fund) reported net position of positive \$1.14 billion at June 30, 2015 compared to negative \$370.52 million at June 30, 2014. The improvement in net position is explained by 1) the drop in the State's unemployment rate from 6.4% in June 2014 to 5.8% in June 2015, 2) an additional increase in the Federal Unemployment Tax Act (FUTA) tax, and 3) the implementation of Session Law 2013-2 in the prior fiscal year. The main impact of this law in the current fiscal year was the decrease to expenses due to the reduction in the maximum weekly benefit amount and the maximum duration of unemployment benefits. The Trust Fund's operating margin (operating

revenues less operating expenses) increased 19.21% to \$1.21 billion this year. Employer unemployment contributions decreased 4.83% to \$1.54 billion in 2015 due to a one-time 1% contribution rate paid by employers (per Session Law 2013-2) that was in effect for 2014 but not 2015. Unemployment benefit expenses, both State and Federal, decreased 46.42% from \$632.91 million in 2014 to \$339.14 million in fiscal year 2015, due to a reduction in the number of new claimants and the effects of Session Law 2013-2 (described above).

In fiscal year 2014-15, nonoperating revenues increased 30.43% to \$305.75 million, due to FUTA tax received in excess of outstanding debt. The excess FUTA tax does not need to be paid back to the federal government and can only be used to pay benefits.

Since February 2009, the State has borrowed from the U.S. Treasury to ensure the uninterrupted payment of State unemployment benefits. The State paid off the federal unemployment debt on April 30, 2015. At June 30, 2014, the balance of this debt was \$980.99 million. For the tax year 2014, the FUTA tax increased by an additional 0.3% for a total increase of 1.2% because the State had an outstanding loan as of November 10, 2014. The funds generated from this federal tax increase go directly towards paying down the loan (i.e., Federal unemployment account advances). The additional federal taxes paid by the State's employers this fiscal year, which were used to reduce the loan balance, was \$253.45 million (classified as gain on extinguishment of debt). A 1.5% FUTA tax increase will not be in effect for the next calendar year since the debt was paid off prior to November 10, 2015.

A 20% surcharge on State unemployment contributions, which has been in effect since January 1, 2005 as required by statute, remained in effect during the current fiscal year. The surcharge is deposited into the Unemployment Insurance Reserve Fund and one of the allowable uses is to pay the interest on the borrowing. The surcharge is still in effect because the balance in the Trust Fund has not reached the trigger "off" level. The surcharge will end in January 2016.

### **N.C. State Lottery Fund**

The N.C. Education Lottery (NCEL) first began selling game tickets in 2006. As required by the enabling legislation, net revenues of the NCEL are transferred four times a year to the General Fund. The NCEL transferred \$526.43 million to the General Fund in 2015 to support educational programs for the State. The amount transferred in 2014 was \$503.14 million. At year end, the net position of the NCEL was zero. The NCEL has no changes in the net position from year to year.

For fiscal year 2014-15, net ticket sales increased 7.23% from the previous fiscal year to \$1.97 billion. Significant financial highlights include the following: awarded \$1 million or more to an NCEL player for the 227<sup>th</sup> time; and released 50 new instant scratch-off games into the marketplace generating gross instant ticket sales of \$1.29 billion.

The NCEL's 2015-16 budget provides for a projected \$528.9 million transfer to the General Fund, representing a 1.71% increase from the previous year's budget. As established in legislation, lottery funds are to be distributed for educational purposes as follows:

1. 58.6% for noninstructional support personnel.
2. 14.8% to support reduction of class size in early grades and to support pre-kindergarten programs for at-risk four-year-olds who would otherwise not be served in high quality settings.
3. 18.9% for public school construction.
4. 7.8% to the State Education Assistance Authority to fund college and university scholarships.

### **N.C. Turnpike Authority**

The North Carolina Turnpike Authority (NCTA) was created in 2002 by the General Assembly in response to concerns about rapid growth, heavy congestion and dwindling resources. It is authorized to study, plan, develop, construct, operate and maintain up to nine turnpike projects.

Major accomplishments for the NCTA include the following:

- The Triangle Expressway System, the State's first modern toll road, is approximately 18.8 miles of new highway construction. The project was constructed and opened in three phases. The third and final phase opened to toll traffic on January 2, 2013. The Triangle Expressway project was delivered on schedule and under budget. Total operating revenues increased 24.21% to \$30.71 million primarily due to the increase in toll revenues. A possible southwest extension to the Triangle Expressway is in the study phase, and would extend the Expressway to I-40 in southern Wake County.
- The NCTA has completed the financing for the Monroe Connector System, a 19.7-mile toll road in Mecklenburg and Union counties. However, construction has been delayed due to litigation challenging the project's environmental documentation. Construction has resumed and will continue despite the notice of appeal.

Net position for NCTA increased 21.51% to \$335.96 million in 2015. Operating loss (before capital contributions and transfers) improved 66.94% due to increases in toll revenue but still remains negative at \$3.1 million. However, net position continues to increase due to continued transfers from the Highway Trust Fund for gap funding of debt service and funds for the Federal Highway Administration (FHWA) match; and capital grants (funds received from the FHWA and the Highway Trust Fund for their participation in the initial construction of toll highways and in preliminary studies to determine the feasibility of a toll facility).

Funding for administrative expenses is advanced as needed from the Highway Trust Fund to be repaid from NCTA revenue collections. Interest began to accrue on the advance on January 1, 2014 (one year after the NCTA began collecting tolls on the completed turnpike project).

The high cost of building, operating and maintaining a major highway facility is typically more than the revenue a new road can generate through tolls. The gap between what tolling can pay for and the cost of the road requires additional support from the State, known as gap funding. Annual transfers from the Highway Trust Fund to the NCTA are used to pay debt service and fund required reserves on bonds issued to finance turnpike projects. For fiscal year 2015, the N.C. General Assembly appropriated \$49 million for the Triangle Expressway and Monroe Connector projects.

### **EPA Revolving Loan Fund**

The Environmental Protection Agency (EPA) Revolving Loan Fund (Loan Fund) is comprised of the Clean Water State Revolving Fund and the Drinking Water State Revolving Fund established by General Statute 159G-22 and receives federal and state funds. This Loan Fund was established to provide loans and grants as allowed under federal laws for wastewater projects and public water systems to meet the water infrastructure needs of the State.

The net position of the Loan Fund increased 6.94% to \$1.5 billion in 2015. This increase in net position is due to the Loan Fund continuing to focus on streamlining its processes (requiring municipalities to follow specified timelines that resulted in more infrastructure projects being completed during the year) and prioritizing the spending of funds from the U.S. EPA (federal) capitalization grant for these projects (as opposed to funds from other sources). The amount of expenses paid (loaned) out during the year for existing infrastructure projects exceeded the total amount of principal repaid on the existing loans which resulted in an increase to notes receivable. Operating income was \$16.47 million (operating revenues less operating expenses), and net non-operating revenues were \$67.68 million. Net non-operating revenues consisted primarily of noncapital grants (federal capitalization grants). Noncapital grants decreased 3.87% to \$85.48 million. Noncapital grants decreased primarily because the U.S. EPA requested that states focus on the first-in first-out methodology of loaning and drawing down federal funds for new infrastructure projects.

**CAPITAL ASSET AND DEBT ADMINISTRATION****Capital  
Assets**

As of June 30, 2015, the State's investment in capital assets was \$47.09 billion, an increase of 3.27% from the previous fiscal year-end (see table below).

**Capital Assets as of June 30**  
(net of depreciation, dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2014		2014		2014	
	2015	(as restated)	2015	(as restated)	2015	(as restated)
Land and permanent easements.....	\$ 16,634,469	\$ 16,221,268	\$ 185,894	\$ 160,571	\$ 16,820,363	\$ 16,381,839
Buildings.....	2,757,591	2,792,625	63,288	54,232	2,820,879	2,846,857
Machinery and equipment.....	604,889	589,323	6,833	8,160	611,722	597,483
Infrastructure:						
State highway system.....	22,850,001	21,897,786	—	—	22,850,001	21,897,786
NC toll road system.....	—	—	762,446	778,576	762,446	778,576
Other infrastructure.....	160,093	163,062	4,322	4,645	164,415	167,707
Computer software.....	307,400	288,109	987	12	308,387	288,121
Art, literature, and other artifacts.....	116,223	104,296	390	209	116,613	104,505
Construction in progress.....	2,049,311	2,040,771	263,281	206,910	2,312,592	2,247,681
Computer software in development.....	324,390	290,801	—	—	324,390	290,801
<b>Total.....</b>	<b>\$ 45,804,367</b>	<b>\$ 44,388,041</b>	<b>\$ 1,287,441</b>	<b>\$ 1,213,315</b>	<b>\$ 47,091,808</b>	<b>\$ 45,601,356</b>
Total percent change between fiscal years 2014 and 2015	<b>3.19 %</b>		<b>6.11 %</b>		<b>3.27 %</b>	

The largest component of capital assets is the state highway system. North Carolina has a 79,584 mile highway system, making it the second largest state-maintained highway system in the nation. The major capital asset activity during the current fiscal year included the following:

- The N.C. Department of Transportation reported year-end construction in progress of \$1.58 billion (including land improvements) for state highway projects. Additionally, the N.C. Turnpike Authority (business-type activity) reported year-end construction in progress of \$263 million for the Monroe Connector System, a toll project in eastern Mecklenburg County.
- The Department of Health and Human Services (DHHS) is constructing new psychiatric hospitals to replace its aging state-operated psychiatric hospitals. It began construction of a new Cherry Hospital in 2010 and a new Broughton Hospital in 2012. At year-end, construction in progress for Cherry Hospital and Broughton Hospital totaled \$226 million. The new hospitals are being financed by special indebtedness bonds.
- DHHS is also replacing major legacy IT systems. NC Tracks, the new multi-payer Medicaid Management Information System, became operational on July 1, 2013 (total development cost of \$237 million). This system facilitates provider enrollment, consolidates claims processing activities, and supports healthcare administration. NC FAST, the new system for managing and administering social services benefits, will improve the way DHHS and the 100 county departments of social services conduct business. At year-end, computer software in development for NC FAST totaled \$301 million.

As further detailed in Note 21(E) to the financial statements, the State has commitments of \$3.997 billion for the construction of highway infrastructure (\$3.97 billion for governmental activities and \$27 million for business-type activities), which are expected to be financed by gasoline tax collections, motor vehicle fees, toll collections, federal funds, and debt proceeds. Other commitments of \$57 million for the construction of new mental health facilities are expected to be financed by special indebtedness bonds.

More detailed information about the State's capital assets is presented in Note 5 to the financial statements.

**Long-term  
Debt**

At year-end, the State had total long-term debt outstanding (bonds, special indebtedness, and notes payable) of \$7.91 billion, a decrease of 1.21% from the previous fiscal year-end (see table below).

**Outstanding Debt as of June 30**  
**Bonds, Special Indebtedness, and Notes Payable**  
(dollars in thousands)

	Governmental		Business-type		Total	
	Activities		Activities			
	2015	2014 (as restated)	2015	2014 (as restated)	2015	2014 (as restated)
General obligation bonds.....	\$ 3,469,220	\$ 3,607,100	\$ —	\$ —	\$ 3,469,220	\$ 3,607,100
Special Indebtedness:						
Lease-purchase revenue bonds.....	2,000	4,125	—	—	2,000	4,125
Certificates of participation.....	151,745	247,615	—	—	151,745	247,615
Limited obligation bonds.....	2,095,550	2,132,085	—	—	2,095,550	2,132,085
GARVEE bonds.....	598,165	395,275	145,535	145,535	743,700	540,810
Revenue bonds.....	—	—	1,019,588	1,039,308	1,019,588	1,039,308
Notes payable.....	34,095	39,738	390,818	392,592	424,913	432,330
Total .....	<u>\$ 6,350,775</u>	<u>\$ 6,425,938</u>	<u>\$ 1,555,941</u>	<u>\$ 1,577,435</u>	<u>\$ 7,906,716</u>	<u>\$ 8,003,373</u>
Total percent change between fiscal years 2014 and 2015		(1.17)%		(1.36)%		(1.21)%

During the 2014-15 fiscal year, the State issued \$231.36 million in general obligation bonds and \$264.93 million in grant anticipation revenue vehicle (GARVEE) bonds for its governmental activities. The general obligation bonds were issued pursuant to the Two-Thirds Bonds Act of 2014 (see next page) and will provide funds for the acquisition, construction, and various capital improvements for the State (governmental activities) and the University of North Carolina System (component unit). The proceeds of the GARVEE bonds (authorized by Session Law 2005-403) will be used to accelerate funding of various transportation projects identified in the current State Transportation Improvement Plan.

Additionally, the State refinanced \$309.2 million of its existing certificates of participation and limited obligation bonds reported in governmental activities to take advantage of lower interest rates. The refinancing is expected to reduce future debt service payments by approximately \$21 million.

The State issues two types of tax-supported debt: general obligation (GO) bonds and various types of “special indebtedness” (i.e., debt not subject to a vote of the people). GO bonds are secured by the full faith, credit, and taxing power of the State and require approval by a majority of voters. The payments on special indebtedness are subject to appropriation by the General Assembly and may also be secured by a lien on facilities or equipment. The General Statutes (Chapter 142, Article 9) prohibit the issuance of special indebtedness except for projects specifically authorized by the General Assembly. There are different forms of special indebtedness, also known as appropriation-supported debt. One form, “financing contract indebtedness” includes lease-purchase revenue bonds and certificates of participation. The other form is limited obligation bonds, which may be issued by the State directly rather than through a conduit issuer. The use of alternative financing methods provides financing flexibility to the State and permits the State to take advantage of changing financial and economic environments. The GARVEE bonds are a revenue bond-type debt instrument where the debt service is to be paid solely from federal transportation revenues.

The State’s total long-term debt (bonds, special indebtedness, and notes payable) reported in governmental activities has increased significantly, rising from \$3.48 billion in 2002 to \$6.35 billion in 2015, in part due to large issuances of non-GO debt (special indebtedness) for higher education capital projects. Prior to 2003, the State only issued general obligation debt. The N.C. Turnpike Authority (Authority), a business-type activity, had its first debt issuance in 2010. The Authority’s long-term debt has increased from \$691.56 million in 2010 to \$1.56 billion in 2015.

The following is a summary of significant debt authorizations.

*Connect NC Bond Act of 2015*

The 2015-16 Session of the General Assembly authorized, subject to a vote of the qualified voters of the State, the issuance of \$2 billion dollars of general obligation bonds of the State to be secured by a pledge of the faith and credit and taxing power of the State. The proceeds of the bonds will be used to fund the construction and furnishing of new facilities and the renovation and rehabilitation of existing facilities for the University of North Carolina System (\$980 million), the North Carolina Community Colleges (\$350 million), water and sewer loans systems (\$309.5 million), the State's National Guard (\$70 million), the Department of Agriculture and Consumer Services (\$94 million), State parks and attractions (\$100 million), and other purposes (\$96.5 million). The question of the issuance of the bonds will be submitted to the voters at the time of the 2016 presidential primary on March 15, 2016.

*Two-Thirds Bonds Act of 2014*

The 2013-14 Session of the General Assembly authorized the issuance of up to \$306.9 million of general obligation bonds without requiring voter approval pursuant to authority in the State's constitution that permits the issuance of such bonds to the extent of two-thirds of the amount of general obligation debt that had been retired during the previous biennium. The proceeds of the bonds are to be used to fund projects that had previously been authorized to use the proceeds of special indebtedness and various other state projects. The State issued \$231.36 million of two-thirds bonds in fiscal year 2014-15, which was less than authorized. This was due both to previously realized savings on projects that have been completed and the use of bond premium in prior years to provide project financing.

*Special Indebtedness*

The 2009-10 Session of the General Assembly reduced special indebtedness authorizations for various projects by over \$115 million to generate additional debt capacity and increased authorizations for guaranteed energy savings contracts by \$400 million. The 2008-09 Session of the General Assembly authorized the issuance of \$734.03 million of special indebtedness as follows: \$512.22 million for higher education projects, \$109.09 million for correctional facilities, \$50 million for acquiring state park lands and conservation areas, and \$62.72 million for other state projects. The 2007-08 Session of the General Assembly authorized the issuance of special indebtedness as follows: \$481.14 million for higher education projects and \$188.01 million for other purposes. The 2006-07 Session of the General Assembly authorized the issuance of \$672.1 million of special indebtedness as follows: \$429.3 for psychiatric hospitals and a public health laboratory for the Department of Health and Human Services, \$132.2 million for medical and mental health centers for the Department of Correction, and \$110.6 million for other state and university projects.

*Repair and Renovation Authorization*

The 2002-03 Session of the General Assembly authorized the issuance of \$300 million of special indebtedness to finance the repair and renovation of state facilities and related infrastructure that are supported by the State's General Fund. Of the \$300 million, approximately \$157 million was allocated to the University of North Carolina (UNC) System. Each of the 16 constituent institutions of the UNC System received a portion of the proceeds for repairs and renovations. The remaining \$143 million of the proceeds was used to make repairs and renovations to various state facilities. The State has issued all of the authorized repair and renovation debt.

*Higher Education Authorization*

The 1999-00 Session of the General Assembly authorized the issuance of \$3.1 billion of higher education improvement bonds, which were subsequently approved by the voters of the State. The \$3.1 billion bond authorization represents the largest debt authorization in the State's history. The proceeds of these general obligation bonds were used solely to construct new buildings and to renovate and modernize existing buildings on the State's 58 community college and 16 University of North Carolina campuses. These improvements were needed to meet enrollment demands and to ensure that the State's college and university buildings meet modern code requirements and are equipped to prepare graduates for 21st century jobs. The bond legislation passed by the General Assembly specifies the amount of bond funding that flows to each community college and university campus. The State has issued all of the authorized higher education bonds.

*Clean Water and Natural Gas Authorization*

The 1997-98 Session of the General Assembly authorized the issuance of \$1 billion of clean water and natural gas general obligation bonds, which were subsequently approved by the voters of the State. The proceeds of these bonds were used to provide grants and loans to local governments for clean water projects (\$800 million) and to provide grants and loans for construction of natural gas facilities to facilitate the expansion of natural gas service to unserved areas of the State (\$200 million). The State has issued all of the authorized clean water and natural gas bonds.

*Highway Bond Authorization*

The 1995-96 Session of the General Assembly authorized the issuance of \$950 million of highway general obligation bonds, which were subsequently approved by the voters of the State. The bond proceeds were allocated to pay capital costs for urban loops (\$500 million), highways in the Intrastate System (\$300 million), and for paving unpaved roads of the secondary highway system (\$150 million). The State has issued all of the authorized highway bonds.

**Credit Ratings**

Credit ratings are the rating agencies’ assessment of a governmental entity’s ability and willingness to repay debt on a timely basis. Credit ratings are an important factor in the public credit markets and can influence interest rates a borrower must pay.

The State’s general obligation bond credit ratings are as follows:

<b>State of North Carolina General Obligation Bond Credit Ratings</b>		
<b><u>Rating Agency</u></b>	<b><u>Rating</u></b>	<b><u>Outlook</u></b>
Fitch Ratings	AAA	Stable
Moody’s Investors Service	Aaa	Stable
Standard & Poor’s Rating Services	AAA	Stable

These ratings are the highest attainable from all three rating agencies. During the 2014-15 fiscal year, the State issued general obligation bonds, GARVEE bonds, and limited obligation refunding bonds. In connection with the general obligation bonds, Standard & Poor’s, Moody’s Investors Service, and Fitch Ratings, the top three rating agencies, all affirmed the triple-A bond rating for the State. A triple-A credit rating means that North Carolina has followed well-defined financial management policies and has demonstrated strong debt management practices. The ratings assigned on the limited obligation refunding bonds were one level below triple-A. The rating agencies recognized the State’s historically conservative budgeting, financial management, and debt issuance practices. North Carolina remains one of only ten states with a triple-A rating from all three rating agencies.

Special indebtedness is not subject to a vote of the people and its repayment is based on the State’s annual debt service appropriation. For these reasons, special indebtedness is rated lower than the State’s general obligation bonds and typically carries a higher interest rate.

**Limitations on Debt**

The Constitution of North Carolina (Article 5, Section 3) imposes limitations upon the increase of certain state debt. It restricts the General Assembly from contracting debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State, except for the following purposes:

1. To fund or refund a valid existing debt;
2. To supply an unforeseen deficiency in the revenue;
3. To borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 percent of such taxes;
4. To suppress riots or insurrections; or to repel invasions;

5. To meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor; and
6. For any other lawful purpose, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the preceding biennium.

The 2013-14 Session of the General Assembly enacted legislation (Session Law 2013-78) to limit the amount of special indebtedness that the State may incur. According to this law, special indebtedness authorized by legislation enacted after January 1, 2013 cannot exceed 25% of the total bond indebtedness of the State supported by the General Fund that was authorized pursuant to legislation enacted after January 1, 2013.

More detailed information about the State's long-term liabilities is presented in Note 8 to the financial statements.

## ***FUTURE OUTLOOK***

### ***Next Year's Budget and Rates***

The 2015 Session of the N.C. General Assembly enacted Session Law 2015-241 (2015 Appropriations Act), which appropriated \$21.73 billion for fiscal year 2015-16. In addition, to traditional increases to cover growth in Medicaid, public schools, and universities, the budget:

- Modified State tax law to reduce individual income and corporate income tax rates, raised the standard deduction, restored medical deductions, and expanded the sales tax base (see Tax Changes below);
- Raised beginning teacher starting pay to \$35,000 annually, provided other teacher pay increases and a \$750 bonus pay for most other State employees, and addressed select compensation needs;
- Increased funds in the Saving Reserve Account to \$1.1 billion;
- Established a Medicaid Transformation Reserve of \$225 million over the biennium to transition the Medicaid program from traditional fee-for-service to a capitated, managed care program; and
- Created two new cabinet-level departments and consolidated and reorganized other programs (see Government Reorganizations below).

#### Tax Changes

Individual income tax changes included allowing federally deductible medical and dental expenses to be deductible on state tax returns as of tax year 2015, increasing the standard deduction by 3.3% as of tax year 2016, and reducing the tax rate from 5.75% to 5.499% as of tax year 2017. Changes to the corporate income tax included repealing the sunset on the revenue “trigger” for reducing the tax rate from 4% to 3% and phasing in sales-only apportionment (the method over which multistate corporations are taxed) over three years. The budget also repealed the state privilege license tax on banks while reducing corporate tax expenditures related to banks and bank holding companies. Other significant changes to the tax code included extending the sales and use tax to include installation, repair, and maintenance of currently taxable tangible property, enacting a modified historic preservation tax credit, and implementing revenue-neutral changes to simplify the corporate franchise tax.

#### Government Reorganizations

The legislature enacted major changes for certain departments and programs:

- Natural and Cultural Resources – Roughly one-half of the budget (\$88.3 million) for the former Department of Environment and Natural Resources (DENR) is transferred to the Department of Cultural Resources, consolidating the State’s natural and cultural resources programs and services within a newly constituted Department of Natural and Cultural Resources. Programs and services remaining in DENR are now housed in the newly-named Department of Environmental Quality.
- Military and Veteran’s Affairs – Various veteran and military programs and supports are consolidated into a newly created cabinet-level Department of Military and Veterans Affairs.
- Information Technology (IT) – A new Department of Information Technology is established to begin the process of consolidating State IT functions. The new cabinet level agency is responsible for planning, security and other overall IT management functions.

### ***Escheat Fund***

North Carolina’s escheats policies date back to 1789 when the State Constitution called for transferring unclaimed property to the University of North Carolina. In 1970, voters approved a constitutional amendment moving the fund to the Department of State Treasurer. Per statutes, the interest earned on the Escheats Fund goes to the State Education Assistance Authority to pay for grants, loans and scholarships for North Carolina students attending public universities and community colleges. In addition, since 2003 the State has used the Escheat Fund’s principal to fund student financial aid. The State Treasurer has cautioned the legislature that continued principal withdrawals will have a negative impact on the fund in the near term. At June 30, 2015, the Escheats Fund carried a fund balance of \$604.54 million. However, as the custodian of these funds, North Carolina remains liable to the rightful owners for the full amount of unclaimed property reported to the Department of State Treasurer. This includes an additional \$1.06 billion which has been reported since June 1971, but has been appropriated by the legislature from the Escheat Fund principal over the last 12 years.

Session Law 2015-241 amended the North Carolina General Statutes (NCGS) with respect to the Escheat Fund. Subsection (b)(12) of NCGS § 147-69.2 now contains an express statement that “[i]t is the intent of the General Assembly that the Escheat Fund provide a perpetual and sustainable source of funding for the purposes authorized by the State Constitution.” Subsection (b)(12) was also amended by adding a provision requiring the Department of State Treasurer to annually engage a third-party professional to conduct a valuation and projection of the financial status of the Escheat Fund (“Annual Report”) in order to assess the utilization of the Escheat Fund as an educational endowment fund. From the findings of the Annual Report, the Treasurer shall recommend to the Governor and Legislative Leadership an annual amount available for the funding of scholarships, loans, and grants from the Escheat Fund.

### ***State Health Plan***

The Board of Trustees of the State Health Plan for Teachers and State Employees (“SHP Board of Trustees”) approved benefit changes to increase member choice by differentiating plan options, to further encourage member engagement in healthy lifestyles, and to constrain future State Health Plan costs. The new benefits will be effective January 1, 2016. In August 2015, the SHP Board of Trustees approved a 2.83% premium increase for most employee and dependent coverage tiers effective January 1, 2016, based on the required premium increase calculated in the Plan’s second quarter 2015 forecast. Also, Session Law 2015-241 increases the State’s employer contribution by 3.47% effective January 1, 2016. The increase was approved by the Executive Administrator based on authority delegated by the SHP Board of Trustees in August 2015.

### ***REQUESTS FOR INFORMATION***

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the State’s finances and to demonstrate the State’s accountability for the money it receives. If you have questions about this report or need additional financial information, contact the North Carolina Office of the State Controller, Accounting and Financial Reporting Section, 1410 Mail Service Center, Raleigh, N.C. 27699-1410. In addition, this financial report is available on the Office of the State Controller’s internet home page at <http://www.osc.nc.gov/financial/index.html>.