

Financial Highlights — Fiscal Year 2005



I am pleased to present you with the *North Carolina Financial Highlights* for the fiscal year ended June 30, 2005. This *popular report* represents our continuing commitment in providing the highest standards of financial management and reporting, as well as fiscal accountability of the resources of the State of North Carolina reporting entity. We hope that you find this report both informative and beneficial and we welcome any questions or comments. If you need additional copies, or have questions about this report, please contact either me or our Statewide Accounting Division staff at (919) 981-5454.

Thank you for your interest in the State of North Carolina.

Sincerely,

A handwritten signature in cursive script that reads "Robert L. Powell".

Robert L. Powell
State Controller
December 16, 2005

Introduction

This popular report, *North Carolina Financial Highlights*, is intended to summarize basic financial information about our State. This information is supported in more detail in the State's Comprehensive Annual Financial Report (CAFR). The CAFR is prepared in accordance with generally accepted accounting principles and is independently audited by the North Carolina Office of the State Auditor. Much of the information in the CAFR is necessarily technical and complex. As a result, the full financial statements and note disclosures may not be as useful to the citizens of the State wishing to gain a more general understanding of the State's finances. Our report provides information at the government-wide level in addition to the major fund level, and certain selected statistical information cited in our CAFR. Coverage of legally separate, but related organizations is limited to universities and community colleges and is at a very high level.

The *popular report* is a report for the people. *North Carolina Financial Highlights* is the product of a coordinated effort on the part of state and local governments to issue simplified financial reports. It is our intent to provide you with information about the State's financial condition, without overwhelming detail and technical accounting terminology. This report contains financial information for the State's fiscal year ended June 30, 2005. The State's fiscal year starts July 1, and ends the following June 30. Information is presented in this report on the basis of generally accepted accounting principles (GAAP). This popular report and the State's complete financial statements, known as the CAFR, can be obtained on the internet at <http://www.ncosc.net>, by telephone at (919) 981-5454, or by writing to the N.C. Office of the State Controller, 1410 MAIL SERVICE CENTER, Raleigh, N.C. 27699-1410.



State Reporting Entity and Its Services

The State of North Carolina reporting entity includes all of the departments, agencies, boards, commissions and authorities governed and legally controlled by the State's executive, legislative and judicial branches of government. In addition, the reporting entity includes legally separate component units for which the State is financially accountable. The State's component units are the University of North Carolina system, the State's community colleges, and various other organizations providing specific services to the public and private sector.

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;
- ◆ transportation;
- ◆ agriculture; and
- ◆ general government services.



Lake Mattamuskeet, NC

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer*

The Economy

Recent news on the state economic front continues to be very favorable. The primary success has to do with real gains in the job market. In recent months we have begun to see "help wanted" signs for the first time during this recovery. In addition, the difficulty some employers in urban areas are having in filling some positions is exerting upward pressure on wage rates. The acceleration in withholding payments is gratifying for a couple of reasons. First, this revenue source amounts to almost 40% of the total base (personal income tax as a whole amounts to 52%). The other is that it has taken an unusually long time for us to get to this point. During the first two years of the recovery from the 1990-91 recession, withholding tax growth ranged from 8% to 11%. This time around, the range was 1% to 4% and it has taken almost three years from the "official" end of the recession to reach the 8% mark. With interest rates rising it is unlikely that we will see any double-digit quarters.

When we look at the published employment data, we have to wonder where the withholding tax base growth is coming from. According to the Employment Security Commission (ESC), net job growth in the State between August 2004 and August 2005 was only .9% (36,400 employees) and wage rate increases are probably no more than 4%. One factor might be the fact that during recoveries the preliminary ESC data understates employment growth because its employer survey does not pick up start-up firms. Another fact is that bonuses are rising due to strong corporate profit growth. Finally, improved profit margins are reflected in more stock options and some of this income shows up in withholding payments.

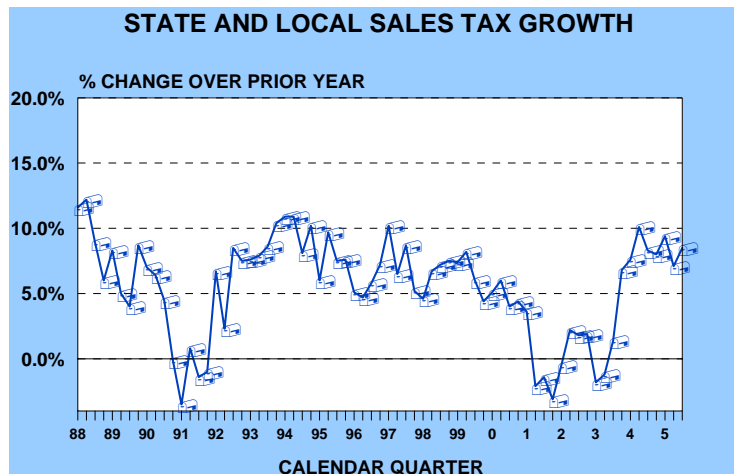
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The key to North Carolina's business cycle experience continues to be our dependence on the declining manufacturing sector (15% of all nonagricultural employment in N.C. vs. 11% for the nation). This is the reason our downturn began earlier than the national experience and why our recovery has been slow in coming. The result is that the State has lost the "recovery premium" normally experienced during a business cycle recovery. For example, the State's economy grew 33% faster than the national experience following the 1981-82 recession and 45% stronger following the Gulf War downturn. Expressed another way, North Carolina was the fifth fastest growing state during the 1992-93 period in terms of personal income. The favorable North Carolina experience was due to the fact that manufacturing employment in the State actually rose during this recovery. This time around we are continuing to shed manufacturing jobs and our turnaround has been 10% **slower** than the U.S. Problems in the manufacturing side of the economy began well before the 2001 recession.

Data indicates that manufacturing employment grew by 2.2% in 2003. After a leveling off period, manufacturing jobs began a steady decline in 1996 due to the mild national economic slowdown and the kicking in of North American Free Trade Agreement. The rate of decline began to accelerate in February 2001 and peaked at an 8.8% rate in 2002. Particularly hard hit were the textile and apparel sectors, with North Carolina jobs in these sectors dropping over 15% on a year-over-year basis by the spring of 2001. While the rate of decline has slowed due to the economic recovery, the erosion continues. The only saving grace is that the loss of traditional jobs has been so great that these sectors exert a much smaller impact on the overall economy than in the past.

While the job market typically lags overall economic trends, retail sales tell us how the economy is performing at a particular point in time. The prospects for consumer spending are important for the state budget because the sales tax makes up 30% of the revenue base. The most surprising thing about the experience of the last two years has been the resiliency of retail sales in the face of sharply higher energy prices, terrorist warnings, and the rise in interest rates. This pattern can be illustrated by looking at sales tax receipts in North Carolina:



This pattern is in stark contrast to the 1999 situation where the sales tax growth dropped from 8% to 4-5% within a few months of the uptick in prices at the pump. There are a number of different reasons for the stubbornness of retail sales:

- (1) the recovery in stock prices since 2003
- (2) gains on investment real estate, especially in resort areas
- (3) conservation efforts of consumers
- (4) additional cash generated from mortgage refinancing and home equity loans
- (5) the continued rise in consumer debt.



Grandfather Mountain, NC

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

The final factor, record debt levels, will be a problem once the economy begins to slow and job prospects worsen. In addition, while consumers and businesses have adjusted their driving habits to higher prices at the pump, we are very concerned about the potential impact of sharply higher heating bills during the next few months.

Another positive has been the prolonged strength of the housing market. The 2001-02 recession was somewhat unique in business cycle history as residential construction activity and home sales remained stable in the face of worsening economic fundamentals. The key to sustainability in this market was the lowest mortgage rates in four decades. Even the recent rise in short-term interest rates has had little impact on the long end of the yield curve. Part of the reason for stability in long-term interest rates is the supply of funds from overseas economies. However, unless energy prices and the housing markets slow their rate of increase, inflation will rise beyond the modest rate of the last few years. The acceleration in prices will eventually be factored into long-term interest rates. Higher mortgage rates, combined with the sharp drop in housing affordability (rising home prices), will eventually choke-off demand for new homes.

During the next few months, we think the favorable news on the employment, retail sales, and housing front in North Carolina will begin to fade. For one thing, we have to deal with the potential impact of Hurricane Katrina. The long-term effect of the largest natural disaster in the U.S. on the economy is still very much up in the air. In the short-run, economists are concerned that the resulting rise in energy prices will shave .5-.7% of annual growth from the nation's

economy for the next two quarters. At the same time numerous studies of other large-scale natural disasters have indicated a strong positive impact from the rebuilding effort. Most of the stimulus would occur during the first half of 2006 and may offset the front-end negative impact of Katrina.

The other factor we must continue to monitor is the actions of the Federal Reserve. We expect the Federal Reserve to push interest rates up to 4.5% by early 2006. Normally, the rise in fuel prices would cause the Federal Reserve to eliminate, or at least delay, future rate hikes due to the impact of the "energy tax". However, as the markets contemplate the transition to the Greenspan replacement, the regional bank presidents are sending strong signals to say that now is the time to re-exert the Federal Reserve's independence by pushing the traditional inflation fighting posture. Our issue with this policy stance is that if we exclude energy prices from the Consumer Price Index, the resulting "core inflation" continues to be restrained. This opens the possibility that the Federal Reserve may push interest rates to an unnecessarily high level, leading to a more serious slowdown. Thus, we should be more concerned about monetary policy coming out of Washington than the effects of Hurricane Katrina.

Though the risks to the economic outlook have become heightened, our current assessment is that the final 2005-06 revenue forecast has positioned the State well for the economic slowdown that is starting to unfold.



ECONOMIC INDICATORS (STATE FISCAL YEAR BASIS) ANNUAL RATES OF CHANGE

	2003-04 <u>Actual</u>	2004-05 <u>Actual</u>	2005-06 <u>Projected</u>	2006-07 <u>Projected</u>
<u>U.S. INDICATORS</u>				
Real Economic Growth*	4.1%	3.7%	3.8%	3.1%
Nonfarm Employment	.3%	1.6%	1.8%	1.4%
Personal Income	4.6%	6.6%	5.8%	4.9%
Industrial Production	2.0%	4.0%	2.7%	2.3%
Corporate Profits (Pre-Tax)	22.0%	13.0%	25.1%	.3%
Short-Term Interest Rates				
(Actual Rate)	1.0%	2.2%	4.1%	4.7%
Mortgage Rates (Actual Rate)	5.9%	5.8%	6.5%	7.4%
Inflation (CPI)	2.2%	3.0%	2.8%	2.7%
<u>NORTH CAROLINA INDICATORS</u>				
Personal Income	4.8%	6.9%	4.8%	4.8%
Nonfarm Employment	-.5%	1.7%	1.5%	1.4%
Unemployment Rate (Actual Rate)	6.1%	5.3%	5.2%	5.2%
Average Hourly Earnings				
(Manufacturing)	4.6%	2.7%	1.5%	3.4%
Retail Sales	7.3%	8.0%	4.7%	4.3%
Housing Activity	13.1%	4.1%	-4.4%	-16.0%
Auto Sales	-6.8%	-.8%	2.0%	-4.2%

*Adjusted for inflation.

— Economic analysis prepared by David Crotts, Economist
North Carolina General Assembly Fiscal Research Division
October 18, 2005



*Oyster Bay Golf Links,
Sunset Beach*

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*



Financial Highlights

Government-Wide

- ◆ The State's total net assets increased by \$1.30 billion or 5.5% as a result of this year's operations. Net assets of governmental activities increased by \$981.8 million, or 4.3% due, in part, to higher than expected growth in tax revenues. Net assets of business-type activities increased by \$320.7 million, or 41.6% due to the improved financial results of the Unemployment Compensation Fund. At year-end, net assets of governmental activities and business-type activities totaled \$23.91 billion and \$1.09 billion, respectively.
- ◆ Component units reported net assets of \$12.11 billion, an increase of \$1.44 billion or 13.5% from the previous year. The majority of the increase (\$1.0 billion) is due to the net increase in capital assets for the University of North Carolina System and community colleges. The capital asset additions were financed in part by state debt proceeds.

Fund Financials

- ◆ The fund balance of the General Fund improved from a negative \$271.9 million at June 30, 2004 (as restated) to a negative \$78.8 million at June 30, 2005. A key factor in reducing the deficit was the General Assembly's decision to forgive repayment of the \$125 million advanced from the Highway Trust Fund during the 2002-03 fiscal year.
- ◆ The fund balance of the Highway Fund increased from \$231.2 million at June 30, 2004 to \$369.4 million at June 30, 2005, an increase of 59.8%. The fund balance growth was attributable to increases in federal billings and gasoline taxes
- ◆ The fund balance of the Highway Trust Fund decreased from \$266.1 million at June 30, 2004 to a negative \$2.9 million at June 30, 2005, a decrease of 101% because of the forgiveness of debt to the General Fund (see above).
- ◆ The net assets of the Unemployment Compensation Fund increased from \$20.1 million at June 30, 2004 to \$258.5 million at June 30, 2005. The significant increase is explained by the State's falling unemployment rate since the 2002 recession.



Sugar Mountain, Banner Elk

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

Capital Assets

- ◆ The State's investment in capital assets (net of accumulated depreciation) was \$27.566 billion, which represents an increase of 7.51% from the previous fiscal year.
- ◆ The largest component of capital assets, the state highway system, includes roadway surfaces, bridges, signage, railings, markings, traffic signals, and other structures related to the State's motor vehicle transportation system. The system includes 78,844 miles of roadway, constituting the second largest highway system in the nation. The system also includes 17,250 bridges spanning 380 miles. At year-end, the State reflected \$14.247 billion (net of accumulated depreciation) of highway system infrastructure.
- ◆ This year's major capital asset additions were for highway construction (\$1.5 billion), highway land improvements (\$556 million) and the acquisition/construction of correctional facilities (\$167 million).

Long-Term Debt

- ◆ The State had long-term debt outstanding of \$6.483 billion, an increase of 17.10% from the previous fiscal year-end. The long-term debt balance includes \$740.2 million of special obligation (non-voted) debt issued for governmental activities.
- ◆ The State maintained its AAA bond rating with Standard and Poor's and Fitch. In August 2002, Moody's downgraded the State's credit rating for general obligation debt from "AAA" to "Aa1", representing the first time since 1960 that North Carolina had less than a "AAA" rating. In September 2004, Moody's upgraded the State's outlook from stable to positive.

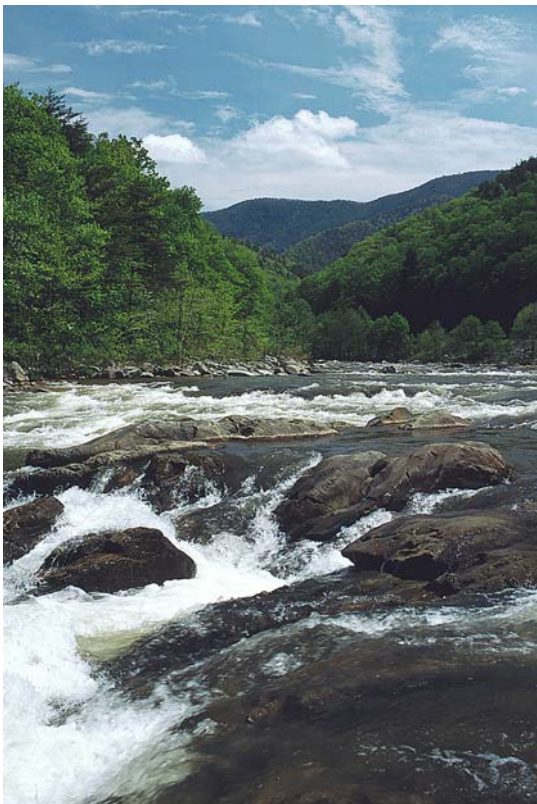
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Statement of Net Assets

Over time, net assets serve as a useful indicator of a government's financial position. In the case of the State of North Carolina, assets exceeded liabilities by \$25 million at the close of this fiscal year. The following table was derived from the government-wide Statement of Net Assets:

Net Assets						
June 30, 2005 and 2004						
<i>(dollars in thousands)</i>						
	Governmental		Business-type		Total Primary	
	Activities		Activities		Government	
	2005	2004	2005	2004	2005	2004
Current and other non-current assets.....	\$ 11,958,784	\$ 10,572,379	\$ 1,439,494	\$ 1,232,408	\$ 13,398,278	\$ 11,804,787
Capital assets, net.....	27,511,607	25,589,324	54,645	55,173	27,566,252	25,644,497
Total assets.....	39,470,391	36,161,703	1,494,139	1,287,581	40,964,530	37,449,284
Long-term liabilities.....	7,031,391	5,961,023	13,131	12,111	7,044,522	5,973,134
Other liabilities.....	8,529,958	7,273,393	389,398	504,577	8,919,356	7,777,970
Total liabilities.....	15,561,349	13,234,416	402,529	516,688	15,963,878	13,751,104
Net assets:						
Invested in capital assets, net of related debt.....	26,434,617	24,702,120	44,007	44,512	26,478,624	24,746,632
Restricted.....	1,314,397	1,451,548	970,615	665,547	2,285,012	2,117,095
Unrestricted.....	(3,839,972)	(3,226,381)	76,988	60,834	(3,762,984)	(3,165,547)
Total net assets.....	\$ 23,909,042	\$ 22,927,287	\$ 1,091,610	\$ 770,893	\$ 25,000,652	\$ 23,698,180



French Broad River, NC

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

The largest component of the State's net assets (\$26.479 billion) reflects its investment in capital assets (land, buildings, machinery and equipment, state highway system, and other capital assets), less related debt still outstanding that was used to acquire or construct those assets. Restricted net assets are the next largest component (\$2.285 billion). Net assets are restricted when constraints placed on their use are either externally imposed or are imposed by law through constitutional provisions or enabling legislation. The remaining portion, unrestricted net assets, consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

The government-wide statement of net assets for governmental activities reflects a negative \$3.84 billion unrestricted net asset balance. The State of North Carolina, like many other state and local governments, issues general obligation debt 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 \$6.483 billion of total long-term debt outstanding at June 30, 2005, \$5.40 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 selling general obligation bonds and funneling 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 assets (reflected in the unrestricted net asset component) without the benefit of recording the capital assets constructed or acquired with the proceeds from the debt issuances. Additionally, as of June 30, 2005, the State's governmental activities have significant unfunded liabilities for compensated absences in the amount of \$327 million (see Note 7 to the financial statements). These unfunded liabilities also contribute to the negative unrestricted net asset balance for governmental activities.

Financial Highlights – Fiscal Year 2005



Statement of Activities

The following financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

Changes in Net Assets		
For the Fiscal Year Ended June 30, 2005		
<i>(In Thousands)</i>		
	Total Primary Government	
	2005	2004
Revenues:		
Program revenues:		
Charges for services.....	\$ 2,818,458	\$ 2,430,268
Operating grants and contributions.....	11,435,624	10,406,618
Capital grants and contributions.....	1,011,903	885,237
General revenues:		
Taxes		
Individual income tax.....	8,244,275	7,407,455
Corporate income tax.....	1,143,458	760,180
Sales and use tax.....	4,621,098	4,293,040
Gasoline and highway tax.....	1,934,817	1,854,973
Other revenues.....	1,999,054	2,044,421
Total revenues.....	33,208,687	30,082,192
Expenses:		
General government.....	917,209	803,830
Primary and secondary education.....	7,699,208	7,223,766
Higher education.....	3,576,384	3,140,794
Health and human services.....	13,375,794	11,722,834
Economic development.....	625,561	511,335
Environment and natural resources.....	570,241	599,575
Public safety, corrections and regulation.....	2,125,385	2,093,242
Transportation.....	1,795,490	1,870,572
Agriculture.....	81,628	82,394
Interest on long-term debt.....	249,433	191,231
Unemployment compensation.....	824,934	1,389,266
EPA Revolving Loan.....	7,170	5,342
Other business-type activities.....	60,066	68,875
Total expenses.....	31,908,503	29,703,056
Increase (decrease) in net assets before contributions and transfers.....	1,300,184	379,136
Contributions to permanent funds.....	2,288	2,068
Transfers.....	—	—
Increase (decrease) in net assets.....	1,302,472	381,204
Net assets - beginning - restated.....	23,698,180	23,316,976
Net assets - ending.....	\$ 25,000,652	\$ 23,698,180

The State's combined net assets increased \$1.302 billion or 5.5% over the course of this fiscal year's operations. The net assets of the governmental activities increased \$981.8 million or 4.3% and business-type activities increased \$320.7 million or 41.6%.

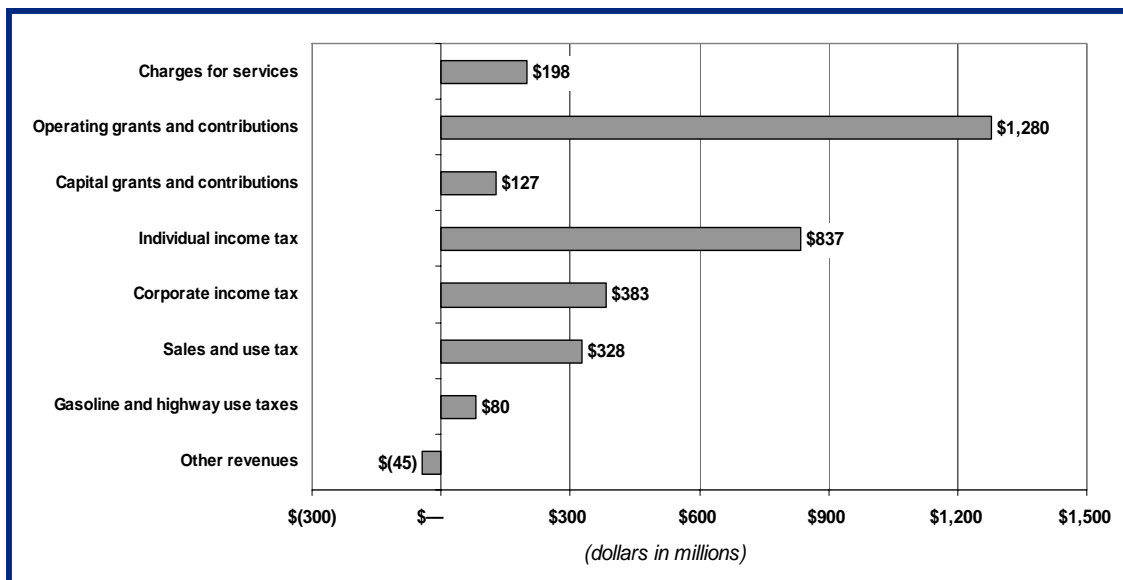
As a result of this year's operations, the net assets of governmental activities increased by \$981.8 million or 4.3%. The net asset increase is primarily related to the higher than expected growth in tax revenues (e.g., individual income, corporate income, and sales taxes) and spending reversions realized during the current fiscal year. The growth in tax revenues is explained, in part, by the State's continued emphasis on compliance and collection activities and a one-time voluntary compliance program for taxpayers. This program generated an additional \$288.6 million in corporate, franchise, and individual income tax for the 2004-05 fiscal year (Note: corporate income taxes generated \$214.5 million). Over the last several years, the N.C. Department of Revenue has increased its collection and audit personnel. Additionally, the 2005 General Assembly authorized 60 new collection positions. The growth in corporate income taxes is also due to a combination of increased product demand and efforts by companies to hold down costs.



Total expenses of governmental activities grew by 9.8% during the current period (compared to total revenue growth of 11.1%). The majority of the spending growth was the result of funding increases in the State's two largest functional areas, education and health and human services. The increase in education spending is related to enrollment increases at the State's universities and community colleges and funding increases for the State's public schools. The growth in health and human services is the result of increased spending for Medicaid, which is the State's largest public assistance program. Expenses for Medicaid program services increased 9.7% over the prior year. The principal reason for the increase was the addition of bed assessment fees, which resulted in higher payments to nursing home providers. Also, the Medicaid program experienced higher costs in several categories of service, including hospital inpatient and outpatient, long-term care facilities, prescription drugs, and medical equipment. Because the State receives federal matching funds for the Medicaid program, there was also a corresponding increase in program revenues (e.g., operating grants and contributions).

The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2004 and 2005:

**Dollar Change in Governmental Activities Revenues by Source
Between Fiscal Years 2004 and 2005**



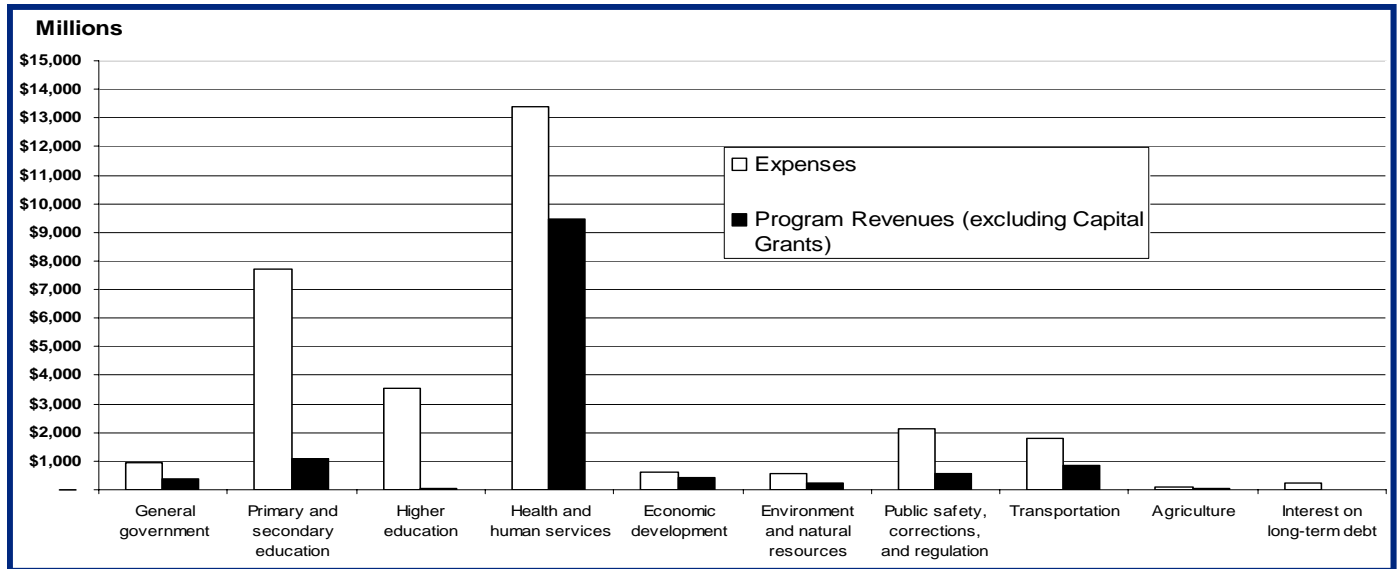
Aerial View, NC Coast

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*



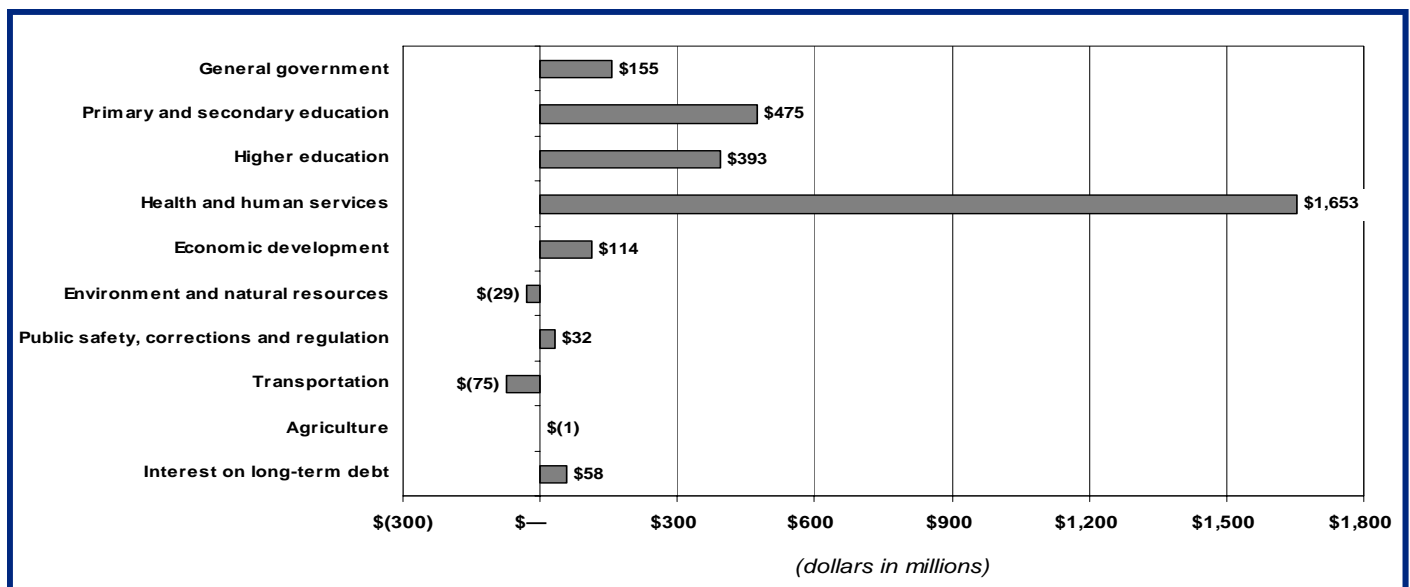
The following chart depicts the total expenses and total program revenues of the State's governmental functions. This format identifies the extent to which each governmental function is self-financing through fees and intergovernmental aid or draws from the general revenues of the State.

Expenses—Governmental Activities Fiscal Year Ended June 30, 2005



The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2004 and 2005:

Dollar Change in Governmental Activities Functional Expenses Between Fiscal Years 2004 and 2005



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Capital Assets

As of June 30, 2005, the State's investment in capital assets was \$27.51 billion, which represents an increase of 7.51% from the previous fiscal year-end (see table below).

Capital Assets as of June 30 (net of depreciation, dollars in thousands)						
	Governmental		Business-type		Total	
	Activities		Activities			
	2005	2004	2005	2004	2005	2004
Land.....	\$ 8,912,153	\$ 8,300,655	\$ 3,146	\$ 3,113	\$ 8,915,299	\$ 8,303,768
Buildings.....	1,629,882	1,578,749	15,510	16,325	1,645,392	1,595,074
Machinery and equipment.....	519,359	560,935	1,807	1,955	521,166	562,890
Infrastructure:						
State highway system.....	14,247,319	13,284,267	—	—	14,247,319	13,284,267
Other infrastructure.....	77,651	77,091	30,802	9,246	108,453	86,337
Intangible assets.....	106,038	106,506	1,569	—	107,607	106,506
Art, literature, and other artifacts.....	47,999	46,193	—	—	47,999	46,193
Construction in progress.....	1,971,206	1,634,928	1,811	24,534	1,973,017	1,659,462
Total.....	<u>\$ 27,511,607</u>	<u>\$ 25,589,324</u>	<u>\$ 54,645</u>	<u>\$ 55,173</u>	<u>\$ 27,566,252</u>	<u>\$ 25,644,497</u>
Total percent change between fiscal years 2004 and 2005	7.51 %		(0.96)%		7.49 %	

This year's major capital asset additions were for highway construction (\$1.5 billion), highway land improvements (\$556 million) and the acquisition/construction of correctional facilities (\$167 million).

The largest component of capital assets is the State's highway system and related right-of-ways. The State has an approximately 78,844-mile highway system, making it the second largest state-maintained highway system in the nation. The system continues to increase as roads are widened and new roads and bridges are constructed.

The 2002-2003 Session of the General Assembly authorized the issuance of up to \$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 will be allocated to the University of North Carolina System (component unit). Each of the sixteen constituent institutions of the UNC System will receive a portion of the proceeds for repairs and renovations.

The remaining \$143 million of the proceeds will be used to make repairs and renovations to various state facilities located throughout North Carolina. At year-end, the authorized but unissued repair and renovation debt was \$175 million. In addition, the most recent session of the General Assembly (2005-2006 Session) directed the transfer on June 30, 2005, of \$125 million from the unrestricted credit balance of the General Fund in fiscal year 2005 to the Repairs and Renovations Reserve Account, to be applied to the repair and renovation of state and university facilities.



Linn Cove Viaduct, Blue Ridge Parkway, NC

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

Financial Highlights — Fiscal Year 2005



In November 2004, the N.C. Infrastructure Finance Corporation (Corporation), a blended component unit of the State, used the proceeds of lease-purchase revenue bonds to acquire two correctional facilities at a total cost of \$51.4 million. Also, during the fiscal year, the Corporation issued \$188.39 million in certificates of participation to construct and equip a close security correctional facility and to construct a new state psychiatric hospital facility. The Department of Correction is undertaking construction initiatives to address a cell shortfall and to allow for the implementation of sentencing reform. The State's correctional facility population has more than doubled since 1980 to approximately 37,000 inmates. The rapid growth in inmates is attributable to increases in the State's population, increases in length of stay in correctional facilities, and changes in criminal laws.

The State has commitments of \$1.98 billion for the construction of highway infrastructure, which are expected to be financed by gasoline tax collections and federal funds. Other commitments for the construction and improvement of state government facilities totaled \$575 million, which are expected to be financed primarily by debt proceeds (certificates of participation), state appropriations, and federal funds.

Debt Administration

At year-end, the State had total long-term debt outstanding of \$6.483 billion, an increase of 17.10% from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30						
(dollars in thousands)						
	Governmental		Business-type		Total	
	Activities		Activities			
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
General obligation bonds.....	\$ 5,698,535	\$ 4,982,860	\$ —	\$ —	\$ 5,698,535	\$ 4,982,860
Revenue bonds.....	265,045	218,405	9,070	9,325	274,115	227,730
Certificates of participation.....	475,170	301,165	—	—	475,170	301,165
Notes payable.....	34,007	25,008	1,569	—	35,576	25,008
Total.....	<u>\$ 6,472,757</u>	<u>\$ 5,527,438</u>	<u>\$ 10,639</u>	<u>\$ 9,325</u>	<u>\$ 6,483,396</u>	<u>\$ 5,536,763</u>
Total percent change between fiscal years 2004 and 2005	17.10 %		14.09 %		17.10 %	



Duke Gardens

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

Financial Highlights – Fiscal Year 2005



During the 2004-05 fiscal year, the State issued

- ◆ \$1.0215 billion in general obligations bonds (excluding refunding issues)
- ◆ \$53.64 million in lease-purchase revenue bonds
- ◆ \$188.39 million in certificates of participation (COPs).

The proceeds of the lease-purchase revenue bonds were used to acquire correctional facilities in Avery County and Pamlico County and will also be used to pay the cost of design and construction drawings for up to thirteen youth development centers. The proceeds of the COPs will be used to construct and equip a close security correctional facility in Columbus County, to construct a new state psychiatric hospital facility, and to finance higher education and other capital projects.

The new general obligation debt consisted of

- ◆ \$705.5 million in public improvement bonds (consolidation of clean water bonds and higher education bonds)
- ◆ \$300 million in highway bonds
- ◆ \$16 million in natural gas bonds.

The State refinanced \$986.9 million of its existing debt in fiscal year 2005 to improve cash flow and to take advantage of lower interest rates. By refinancing the debt, the State will reduce its future debt service payments by approximately \$47 million over the next 13 years.

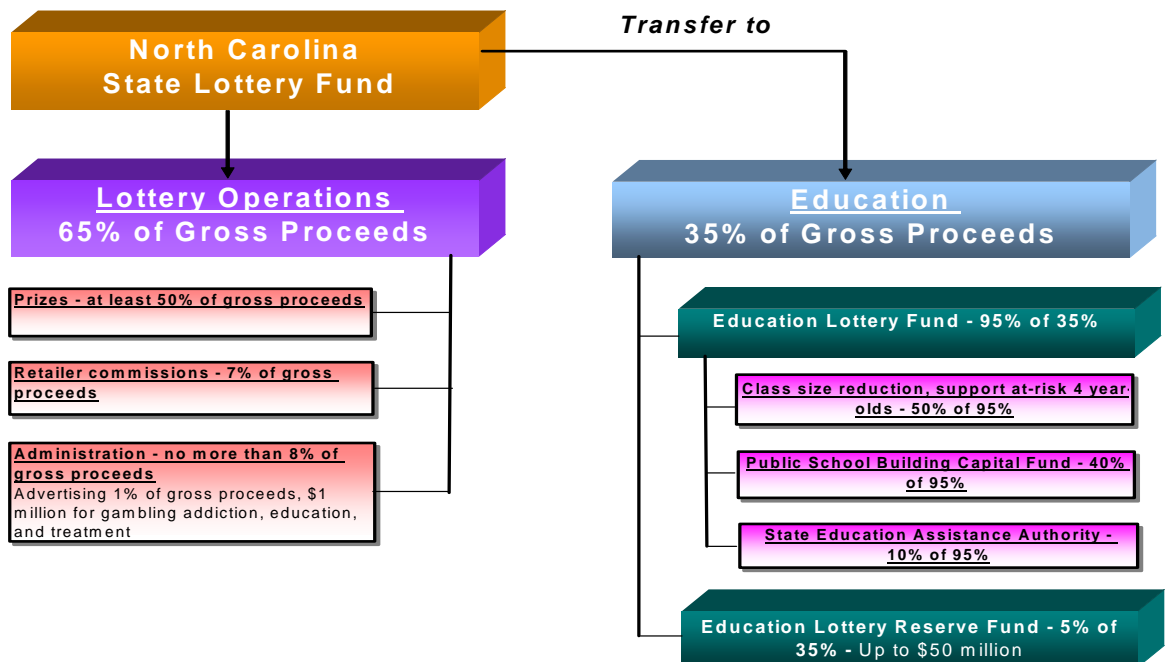
Future Highlights

On August 30, 2005 the General Assembly passed House Bill 1023, North Carolina State Lottery Act. North Carolina becomes the last state on the east coast to approve a lottery. In accordance with House Bill 1023 and Senate Bill 622, 2005 Appropriations Act, the net proceeds of the lottery will be used to further the goal of providing enhanced educational opportunities, to support public school construction, and to fund college and university scholarships.

The nine-member Lottery Commission is located in the Department of Commerce for budgetary purposes. The North Carolina Lottery (Lottery) is defined in legislation as an enterprise fund of the State of North Carolina. Lottery financial information and disclosures will be included in the CAFR for the fiscal year ending June 30, 2006, with the expectation that the Lottery will begin operations during the 2005-06 fiscal year. It is estimated that once fully operational, the Lottery will contribute over \$200 million annually to the General Fund.

The net revenues of the North Carolina State Lottery Fund will be transferred periodically to the Education Lottery Fund. From the Education Lottery Fund, the Commission will transfer 5% of the net revenue of the prior year to the Education Lottery Reserve Fund. The Education Lottery Reserve Fund will be capped at \$50 million. The Commission will distribute the remaining net revenue of the Education Lottery Fund in the following manner:

- ◆ 50% to support reduction of class size in early grades to class size allotments not exceeding 1:18.
- ◆ 40% to the Public School Building Capital Fund.
- ◆ 10% to the State Educational Assistance Authority to fund college and university scholarships.



Financial Highlights – Fiscal Year 2005



Department of Correction Highlights

During fiscal year 2003-04, the Department of Correction opened three new close security single cell prisons with a capacity of 1000 cells each. After nearly a full year of operation for each of these facilities, Scotland Correctional Institution, Lanesboro Correctional Institution and Alexander Correctional Institution, records show that these facilities operate at a lower cost per day than the Division of Prisons' (DOP) other close security single cell institutions with a fewer number of cells (Foothills, Pasquotank, Marion). These cost reports confirm that the new 1,000 cell prototypical design is more cost efficient.

For fiscal year 2003-04, the average cost per day for Scotland, Lanesboro, and Alexander was \$67.09. The average cost per day for Foothills, Pasquotank, and Marion was \$71.37. The newer design saves over 6% compared to the older design of single cell institutions.

Adding 3,000 close security beds as well as their lower cost per day was most likely responsible for the fact that the cost to house all DOP close custody inmates dropped from \$82.46 (FY 2002-03) to \$74.52 (FY 2003-04).

Three 1,000 cell close security institutions of the same design are now under construction in Greene, Bertie, and Columbus counties. In the future it is expected that the per day costs for close custody inmates will continue to decrease.

Information provided by Department of Correction, Division of Prisons.



**Maury Correctional Institution,
Greene County, N.C.
(November 2005)**

Photo Courtesy of NC Department of Correction, Division of Prisons.

NC. DEPARTMENT OF CORRECTION								
Daily Cost Per Inmate								
For the Fiscal Year Ended June 30, 2005								
DOP Facility	Cost Per Inmate					Cost By Custody Level		
	Average Population	Without Overhead	Adjusted Cost Without Overhead	With Overhead	Adjusted Cost With Overhead	Total Cost Minimum	Total Cost Medium	Total Cost Close
	3720 Foothills Correctional Institution	845.65	\$ 52	\$ 16,001,389	\$ 76	\$ 23,445,870	\$ 6,128,124	\$ 1,114,204
3730 Marion Correctional Institution	788.74	50.68	14,591,290.20	74.26	21,379,736.27	2,391,447.68	244,579.88	18,751,123.82
3740 Pasquotank Correctional Institution	951.54	44.35	15,403,839.80	64.99	22,570,316.11	6,108,550.97	610,855.10	15,858,738.09
4870 Alexander Correctional Institution	837.59	48.14	14,718,478.02	70.54	21,566,086.90	0.00	931,903.96	20,641,672.68
4865 Lanesboro Correctional Institution	846.71	45.56	14,081,230.63	66.76	20,632,376.78	0.00	363,221.59	20,276,311.09
4860 Scotland Correctional Institution	961.13	43.97	15,425,356.38	64.43	22,601,843.06	0.00	23,675.06	22,586,006.97
			\$ 90,221,585		\$ 132,196,239	\$ 14,628,122	\$ 3,288,440	\$ 114,325,526



Transportation Highlights

The *North Carolina Moving Ahead* program is now in its second year and is already making a lasting impact throughout the State. This program was signed into law by Governor Mike Easley in 2003 as a \$700 million transportation and economic stimulus package. To date, the program has already helped land two new industries in Person and Buncombe counties, creating more than 270 jobs and \$140 million in investment.

Another innovative program, Senate Bill 1005, allowed the state to invest \$470 million in vital maintenance and preservation projects across the State over a three-year period. More than 1,500 miles of primary highway have been improved and 136 projects specifically for economic growth and development have been completed, according to the Secretary of the Department of Transportation, Lyndo Tippet.

Together with the *Moving Ahead* initiative, these two programs are providing more than \$1 billion in additional funds to improve the State's transportation infrastructure.



Ocracoke Ferry, NC

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

In fulfilling the North Carolina Department of Transportation's (NCDOT) core mission to bring quality transportation within reach of every citizen, NCDOT made great progress toward fulfilling its goals and commitments in the fiscal year 2005. One of the major projects completed was the U.S. 64/264 bypass. This bypass runs from I-440 in Raleigh to the existing U.S. 64 east in Knightdale and is expected to shorten the commute from Raleigh to Knightdale by at least 20 minutes. The bypass, costing nearly \$180 million will make an economic impact worth over \$1 billion for Knightdale and its surrounding communities.



Airborne & Special Operations Museum, Fayetteville

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

Another major project completed is the first segment of the Fayetteville Outer Loop, which is officially designated as I-295. This 7.5 mile segment extends from I-95 to U.S. 401 and gives motorists convenient access over the Cape Fear River to I-95. The I-295 segment is expected to save motorists an average of 8 miles and 17 minutes on their trip to I-95. The project, a \$42 million investment for the region will make an economic impact worth over \$239 million for Fayetteville, Cumberland County, and this region.

In 1989, the North Carolina General Assembly passed legislation setting up the Highway Trust Fund to finance the construction of seven urban highway loops. Funding authorized by the NCDOT for these loops to date totals \$2.8 billion, including \$6.6 million for the Fayetteville loop. In addition, approximately \$1.2 billion is allocated for loop projects in the final 2006-2012 State Transportation Improvement Program for loop projects, including

\$258 million for the Fayetteville Loop, which is more than any other loop in the State.

The Fayetteville Outer Loop will be continued in 2008, when construction will begin on the next segment, which will extend the outer loop nine miles to the All-American Freeway. This segment will cost \$200 million and will give Fort Bragg its first direct connection to an interstate route.



Education Highlights

North Carolina's public schools are improving; student achievement is up, gaps are closing, teachers are better prepared and citizen support remains high, according to Public Schools of North Carolina's September report. A few of the highlights for public schools are as follows:



- ◆ In the ninth year of the ABCs of Public Education for K-8 schools, 80.9% of students in grades 3-8 were considered at or above the proficient level in reading and mathematics, up 19.2 points from 1996-97.
- ◆ In its eighth year of the ABCs of Public Education for grades 9-12, student proficiency in core subject areas increased to 74.8%, up 17.3 points from 1997-98.
- ◆ Under the 2004-05 ABCs, 24% of all schools, or 536 schools, earned designation as Honor Schools of Excellence or Schools of Excellence, the highest recognition categories under the ABCs. Almost 27%, or 601 schools, were designated as Schools of Distinction.
- ◆ The 2005 SAT results showed North Carolina's average total SAT score increased by four points to 1,010, and participation rose by four points to 74%. The national average total SAT score grew by two points to 1,028. The state's score exceeds the Southeast score of 1,004, which increased by three

points. North Carolina ranks ninth (tied with Delaware) among the 50 states in terms of participation rate. In North Carolina, 53,314 students took the SAT.

- ◆ North Carolina accounts for 1/5 or 8,280 of the nation's National Board Certified teachers. This represents 7.5% of the State's teachers, library media coordinators, and guidance counselors. The next closest state is Florida with 6,364.
- ◆ North Carolina public schools are more of a melting pot than ever with over 150 different languages spoken. The State's Hispanic student population has increased more than any other group. In the past 10 years, (1993-94 to 2003-04), the percentage of Hispanic students has risen from 1.3% or 14,507 students, to 6.6%, or 88,355 students.

Did you know?

- ◆ There are 2,189 public schools in North Carolina and 99 charter schools.
- ◆ North Carolina was the first state to require students to study Algebra I.
- ◆ North Carolina public schools receive 65% of their funding from the State, 25% from local revenue, and 10% from the federal government.

Comparison of per Pupil Expenditures							
Current Expense Expenditures							
	<u>Per Pupil Expenditures, By Source</u>				<u>Percent of Total</u>		
	<u>State</u>	<u>Federal</u>	<u>Local</u>	<u>Total</u>	<u>State</u>	<u>Federal</u>	<u>Local</u>
1993-94	\$3,169.16	\$ 396.92	\$1,108.88	\$4,674.96	67.8	8.5	23.7
1994-95	3,380.94	382.45	1,129.73	4,893.12	69.1	7.8	23.1
1995-96	3,412.85	376.85	1,140.03	4,929.73	69.2	7.6	23.1
1996-97	3,554.21	390.62	1,206.87	5,151.70	69.0	7.6	23.4
1997-98	3,795.61	422.63	1,273.32	5,491.56	69.1	7.7	23.2
1998-99	4,086.62	445.91	1,366.56	5,899.09	69.3	7.6	23.2
1999-00	4,323.79	482.31	1,474.20	6,280.30	68.8	7.7	23.5
2000-01	4,532.99	514.57	1,606.54	6,654.10	68.8	7.7	24.1
2001-02	4,472.46	578.45	1,645.14	6,696.05	66.8	8.6	24.6
2002-03	4,458.51	644.98	1,637.90	6,741.39	66.1	9.6	24.3
2003-04	4,563.11	726.08	1,716.94	7,006.13	65.1	10.4	24.5

data for 2004-05 fiscal year not available

Information provided by the NC Department of Public Instruction website, www.dpi.state.nc.us.



Department of Administration Highlights



NC Mountain Biking

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

The State Surplus Property Agency, located in the N.C. Department of Administration, may be North Carolina's ultimate recycler. Through the agency, outdated computers, vehicles and other items used by state government employees find new users, and state coffers are rewarded with millions of dollars each year.

The agency had gross sales of \$23.2 million during fiscal year 2004-05. Those funds have been returned to individual state programs or the General Fund, with the exception of a 5% handling fee that maintains the self-supporting agency.

Each year, the agency disposes of thousands of items that have outlived their usefulness. Items offered for sale come from state agencies throughout North Carolina and from state universities, community colleges and public schools.

Most of the surplus property is sold to the public by sealed bids, which are

opened on a weekly schedule. Another sales outlet is retail stores, which offer items with a value of less than \$100.

Online auctions are a growing part of the agency's marketing program. In 2001, the agency started selling small items through eBay. Today, eBay buyers worldwide can purchase a vast array of items, including airplanes, helicopters, ferries, train cars and ambulances. Gross sales through eBay this past fiscal year have grown to nearly \$600,000 and are expected to increase in the future.

Information provided by the Office of the Governor at www.governor.state.nc.us.



NC Transportation Museum, Spencer

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

Crime Control & Public Safety Highlights



The North Carolina State Highway Patrol conducted Operation Slow Down 2005 from July through November to crackdown on excessive speeders on North Carolina highways. The program was conducted statewide and primarily focused on motorists exceeding the posted speed limits on the interstates and major four-lane highways. Colonel W. Fletcher Clay, commander of the NC State Highway Patrol, stated "speed is the leading cause of fatal traffic collisions and all collisions in our State." A review by the Patrol shows speeding citations in excess of 100 mph have increased 175% since 1999 and overall speeding citations have increased 147% since 1999.

As of August 24, three separate operations had been conducted and results are as follows:

- ◆ The week of July 25th - in the Charlotte area and Statesville, Hickory areas - Troopers issued 1,310 charges for speeding, of those, 700 were for speeds that exceeded 75 mph. Troopers issued a total of 2,733 charges for traffic violations during the operation.
- ◆ The week of August 8th - in the Greensboro, High Point, Asheboro, and Burlington areas and Winston Salem, Concord, and Salisbury areas - Troopers issued 2,250 charges for speeding, of those 1,354 were for speeds that exceeded 75 mph. Troopers issued a total of 4,790 charges for traffic violations during the operation.
- ◆ The week of August 15 - in the Raleigh, Durham, Wilson, Smithfield, Fayetteville, Lumberton, Wilmington, Whiteville, and Jacksonville areas - Troopers issued 2,535 charges for speeding, of those, 1,810 were for speeds that exceeded 75 mph. Troopers issued a total of 4,659 charges for traffic violations during the operation.
- ◆ Troopers issued 12,182 traffic charges during this phase of Operation Slow Down.



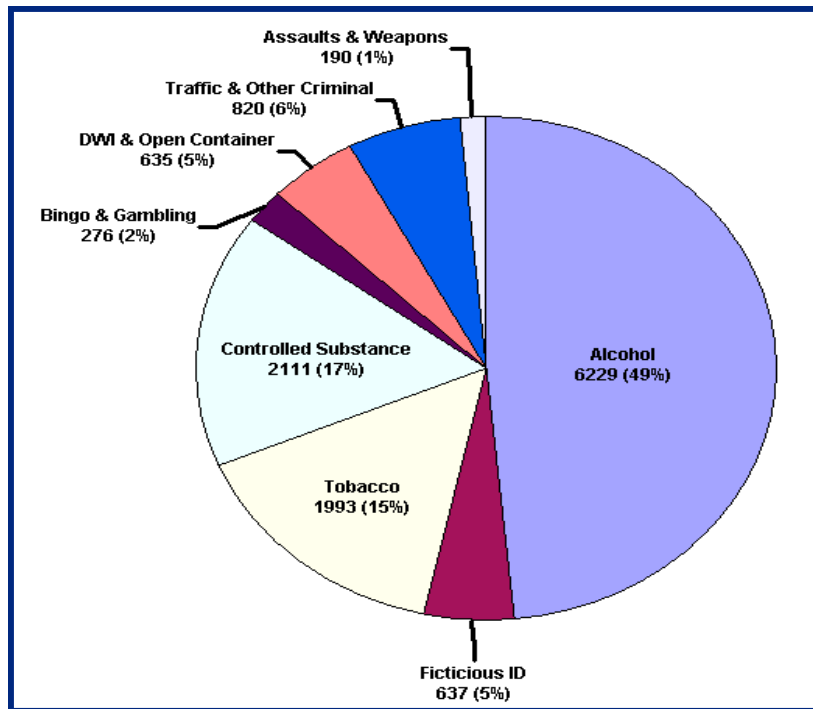
Crime Control & Public Safety Statistics

The Alcohol Beverage Commission (ABC) issues 44,000 permits to sell alcohol each year. There are 17,500 licensed ABC outlets such as restaurants or night clubs. ALE has 104 agents to make inspections and enforce the state's alcohol, tobacco, bingo and gambling laws. The following statistics show the work done each year by ALE agents. (Data for 2005 not available.)

ALE Arrest Charges	2000	2001	2002	2003	2004	ALE Underage Violations	2000	2001	2002	2003	2004
Alcohol	4,828	3,991	4,947	551	6,229	Sale to Minors (surveillance)	197	142	203	243	210
Fictitious ID	271	477	488	513	637	Sale to Minors (undercover)	148	182	698	421	516
Tobacco	887	1,032	846	2,169	1,993	Other Actions					
Controlled Substance	1,328	1,010	1,168	1,794	2,111	Violation of ABC Laws	-	648	1306	1211	1911
Bingo & Gambling	193	198	106	171	276	Official Complaints of					
DWI & Open Container	296	784	772	984	635	Non-compliance	-	1557	1423	-	-
Traffic & Other Criminal	249	357	1,417	1,019	820	Written Warnings	-	818	1135	1461	1933
Assaults & Weapons	-	-	-	-	190						
Total Arrest Charges:	8,052	7,849	9,744	7,201	12,891						

For the year 2004, ALE's cost to administer the above programs was \$8.159 million.

ALE Arrest Statistics
For January 1, 2004 to December 31, 2004
(Total = 12,891)

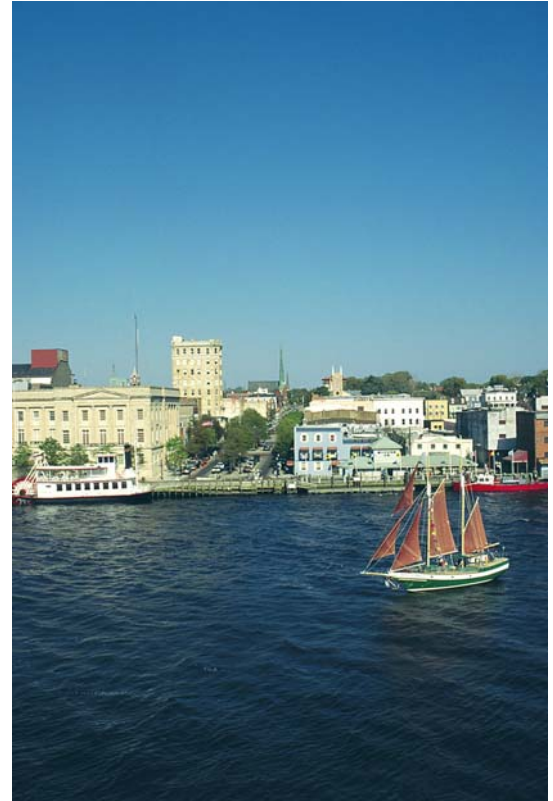


Statistical information provided by the NC Crime Control and Public Safety website, www.nccrimecontrol.org.



N.C. Entertainment Industries Highlights

- ◆ North Carolina ranks third nationally in revenues from film, television and commercial production and has held this position for the past 20 years.
- ◆ The State's production infrastructure includes a world-class crew base of over 1,500 seasoned film professionals, six full-service studio complexes, 28 soundstages, 400 support service companies, a State Film Office in its 25th year facilitating indigenous and visiting filmmakers, four regional film commissions and the prestigious School of Filmmaking at the North Carolina School of the Arts in Winston-Salem.
- ◆ North Carolina has hosted more than 800 motion pictures, 14 network and cable television series and countless national and regional television commercials generating more than \$6 billion in revenues for local economies.
- ◆ North Carolina hosts several film festivals including the internationally acclaimed FullFrame Documentary Film festival in Durham, The RiverRun Festival in Winston-Salem, The Asheville Film Festival and The Cucalorus Film Festival in Wilmington.
- ◆ The North Carolina Film Office was established in 1980 at a time when new technology, audience demand for location and authenticity and Hollywood's need for lower production costs were driving filmmakers to search distant sites throughout the nation for fresh places to make movies.
- ◆ The Film Office has an annual budget of \$500,000 and a staff of three and is now a unit of the North Carolina Department of Commerce's Division of Tourism, Film and Sports Development.



Wilmington, NC

*Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.*

North Carolina Movie Industry Revenues							
Year	Major Productions	Estimated Revenues		Year	Major Productions	Estimated Revenues	
		From All Productions				From All Productions	
2004	88	\$ 235.0 million		1991	18	\$ 202.5 million	
2003	24	209.0 million		1990	17	426.0 million	
2002	28	230.8 million		1989	14	314.3 million	
2001	44	250.6 million		1988	19	297.0 million	
2000	68	250.0 million		1987	22	384.1 million	
1999	65	300.2 million		1986	22	266.5 million	
1998	40	323.0 million		1985	18	200.0 million	
1997	41	329.0 million		1984	12	115.0 million	
1996	53	440.0 million		1983	8	102.0 million	
1995	54	391.0 million		1982	6	86.0 million	
1994	39	357.0 million		1981	4	65.0 million	
1993	33	504.3 million		1980	11	87.0 million	
1992	17	391.0 million					

Financial Highlights — Fiscal Year 2005



Quick Facts

- ◆ North Carolina has been named the state with the “Top Business Climate” for 2005 by Site Selection magazine. North Carolina has maintained this No. 1 ranking for four out of the last five years, according to Governor Mike Easley. Site Selection credited North Carolina for providing needed incentives to lure top quality jobs to the State, specifically:

**the One North Carolina Fund has created 17,000 jobs and more than \$2 billion in investment since 2001.

**the Job Development Investment Grant (JDIG), which awards up to 25 grants annually to strategically important new and expanding businesses and industrial projects, has created more than 10,000 jobs and \$1.9 billion in investment.

Site Selection editor Mark Arend said, “Corporate site selectors indicated that North Carolina is highly responsive to the needs of an increasingly competitive marketplace. This year’s ranking shows that North Carolina’s business-friendly environment can compete and win in the challenging business climate arena.”

Information provided by the North Carolina Department of Commerce’s news releases at www.nccommerce.com.



NC Coastal Wildlife

Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.



Pinehurst Resort

Photo Courtesy of NC Division of Tourism, Film, and Sports Development.
Bill Russ, Photographer.

- ◆ North Carolina’s Alcohol Law Enforcement Division (ALE) became the first law enforcement agency in the world to achieve accreditation through the Commission on Accreditation for Law Enforcement Agencies (CALEA). CALEA evaluates law enforcement agencies based on 447 standards including all policies and procedures, organization and management, law enforcement operations, personnel, administration, and support services.

The CALEA assessment team stated, “The agency is the first of its kind to apply for accreditation which renders it unique in its mission. The agency should be commended for its determination. Assessors were impressed with the overall operation, the pride and high morale exhibited by its employees, both sworn and non-sworn.”

Information provided by the North Carolina Crime Control and Public Safety website, www.nccrimecontrol.org.

- ◆ Pinehurst Resort, home of the 2005 U.S. Open Championship has been named the “Best U.S. Golf Resort” in the *Travel + Leisure Golf’s* 2005 World’s Best Golf Resorts readers survey.

Featured on the cover of the September/October issue of the magazine, Pinehurst outranked such notables as Pebble Beach (California), The Boulders (Arizona), Kiawah (S.C.), the American Club (Wisconsin), and Bandon Dunes (Oregon).

Built in 1895, Pinehurst resort is located in the heart of North Carolina, about 70 miles southwest of Raleigh. The resort is one of more than 170 clubs and resorts worldwide owned and operated by Dallas-based ClubCorp, founded in 1957 and has approximately \$1.5 billion in assets.

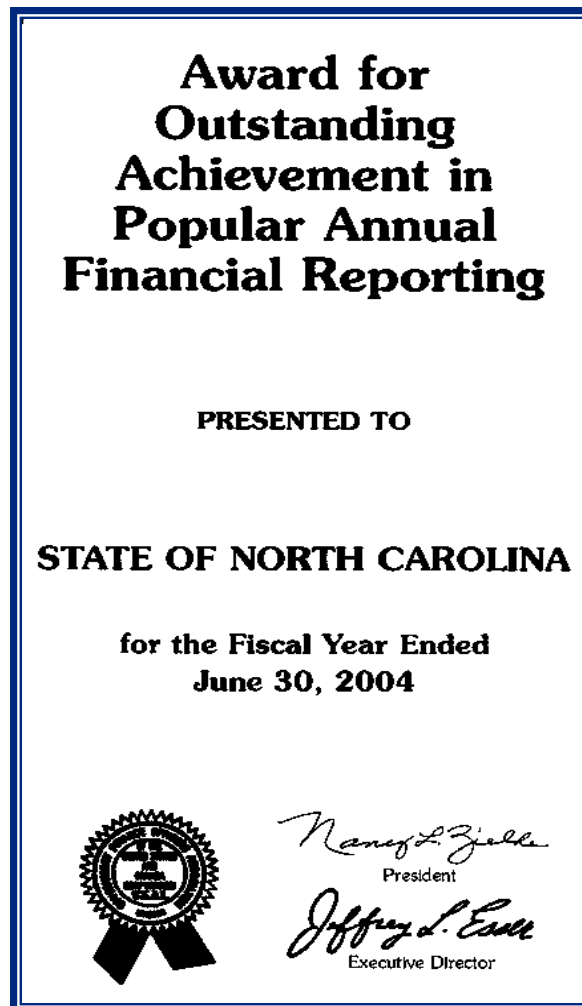
Information provided by Pinehurst News release on the www.visitnc.com website.



Award for Outstanding Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) has given an Award for Outstanding Achievement in Popular Annual Financial Reporting to the State of North Carolina for its Popular Annual Financial Report for the fiscal year ended June 30, 2004. The Award for Outstanding Achievement in Popular Annual Financial Reporting is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government popular reports.

In order to receive an Award for Outstanding Achievement in Popular Annual Financial Reporting, a government unit must publish a Popular Annual Financial Report, whose contents conform to program standards of creativity, presentation, understandability and reader appeal. An Award for Outstanding Achievement in Popular Annual Financial Reporting is valid for a period of one year only. We believe our current report continues to conform to the Popular Annual Financial Reporting requirements, and we are submitting it to GFOA.



400 copies of this public document were printed at a cost of \$3,196.00 or \$7.99 per copy.