

State of North Carolina

Office of the State Controller

DAVID T. MCCOY
STATE CONTROLLER

The Honorable Beverly E. Perdue, Governor
Members of the North Carolina General Assembly
Citizens of North Carolina

In compliance with G.S. 143B-426.40H, it is our pleasure to provide you with the State of North Carolina's 2011 Comprehensive Annual Financial Report (CAFR). This report has been prepared by the Office of the State Controller. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the state government and this office. To the best of our knowledge and belief, this financial report is complete and reliable in all material respects. We believe all disclosures necessary to enable you to gain an understanding of the State's financial activities have been included.

Although the State budgets and manages its financial affairs on the cash basis of accounting, G.S. 143B-426.40H requires the Office of the State Controller to prepare a Comprehensive Annual Financial Report (CAFR) in accordance with generally accepted accounting principles (GAAP) in the United States of America. Except for schedules clearly labeled otherwise, this CAFR has been prepared in accordance with GAAP.

Management of the government is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

In compliance with North Carolina's General Statutes, an annual financial audit of the State financial reporting entity is completed each year by the North Carolina Office of the State Auditor. The Auditor's examination was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the Auditor's opinion has been included in this report. In addition, the State coordinates the *Single Audit* effort of all federal funds through the State Auditor.

This letter of transmittal is intended to complement the management discussion and analysis (MD&A) and should be read in conjunction with it. The MD&A provides an overview of the State's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, the MD&A focuses on the State's major funds: the General Fund, the Highway Fund, the Highway Trust Fund, the Unemployment Compensation Fund, the EPA Revolving Loan Fund, the N.C. Turnpike Authority, and the N.C. State Lottery Fund. The MD&A can be found immediately following the Independent Auditor's Report.

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Profile of the State of North Carolina

The Old North State, The Tar Heel State

North Carolina became the 12th state of the union in 1789. North Carolina is located on the Atlantic coast and is bordered by Georgia, South Carolina, Tennessee and Virginia. The State has a land area of approximately 50,000 square miles. The State's estimated population is 9.69 million, making it the 10th most populated state in the nation. Sixty percent of the population is found in urban areas, while forty percent is found in rural areas. The North Carolina coastline is 301 miles, the greatest distance east to west is 543 miles, and the greatest distance north to south is 188 miles. The State's elevation rises from sea level on the eastern coastline to 6,684 feet at Mount Mitchell in the Appalachian mountain range on our western border. There are 79,330 miles of roads, with Interstate 40 crossing North Carolina east to west, and Interstates 85 and 95 crossing the State north to south. North Carolina's capital and central state government administration is located in Raleigh, in the central piedmont. Charlotte, Raleigh, Greensboro, Durham, and Winston-Salem are North Carolina's largest cities and there are 100 counties.

Government

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

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

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

State Reporting Entity and Its Services

The State of North Carolina entity as reported in the CAFR includes all fund types of the departments, agencies, boards, commissions and authorities governed and legally controlled by the State's executive, legislative and judicial branches. In addition, the reporting entity includes legally separate component units for which the State is financially accountable. The component units are discretely presented in the government-wide financial statements. The State's discretely presented major component units are the University of North Carolina System, the State's community colleges, Golden LEAF, Inc., North Carolina Housing Finance Agency, North Carolina State Education Assistance Authority, and the State Health Plan. The criteria for inclusion in the reporting entity and its presentation are defined by the Governmental Accounting Standards Board (GASB) in its GASB Codification Section 2100. These criteria are described in Note 1 of the accompanying financial statements.

The State and its component units provide a broad range of services to its citizens, including k-12 public education; higher education; health and human services; economic development; environment and natural resources; public safety, corrections, and regulation; transportation; agriculture; and general government services. The costs of these services are reflected in detail and in summary in this report.

Budgetary Control

In addition to internal controls discussed previously, the State maintains budgetary controls. The objective of these budgetary controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the General Assembly. Activities of the General Fund, departmental special revenue funds, and permanent funds are included in the annual appropriated budget. The State Highway Fund and the Highway Trust Fund, the State's major special revenue funds, are primarily budgeted on a multi-year basis. Capital projects are funded and planned in accordance with the time it will take to complete the project. The level of budgetary control (that is, the level at which expenditures cannot legally exceed the appropriated amount) is exercised at both the departmental and university level, with allotment control exercised by the State Controller, and on the program line-item levels requiring certain approvals by the Director of the Budget. Legislative authorization of departmental expenditures appears in the State Appropriation Bill. The certified budget is the legal expenditure authority; however, the Office of State Budget and Management (OSBM) may approve executive changes to the legal budget as allowed by law. These changes result in the *final budget* presented in the required supplementary information.

Economic Condition

Overview

During FY 2010-11, the economic recovery struggled to gain traction. The weak recovery occurred despite the fact it had been a year since the Great Recession ended. The National Bureau of Economic Research officially dated the end of the recession as June 2009. Nevertheless, economic conditions in the State, as well as the nation, did not reflect a recovering economy. Employment losses were still occurring in some industry sectors, while other sectors were experiencing very little job growth. Additionally, the end of the economic recession did not mark the end of the housing recession, which was a precursor to the economic downturn.

Both employer and consumer sentiment showed little signs of an economic recovery. The structural problems in the housing and financial markets that sent us into a recession historically have taken much longer to correct and are followed by much slower, prolonged recovery phases. This recovery was proving to be no different. At best, a very modest economic expansion began during the fiscal year. In fact, at no time during the fiscal year did the annualized growth rate of the nation's Gross Domestic Product (a broad measure of economic activity) equal or exceed the long-run average of 3.1 percent. Given the severe contraction the economy went through, a more robust recovery that exceeded the long-run average might have been expected.

During the fiscal year, the State's economy added 39,200 private sector jobs and total wage and salary income increased by an estimated 2.9 percent. By the end of the fiscal year, there were still 270,000 fewer people employed than at the start of the recession. Annual growth in total wage and salary income increased by 2.3 percent the first quarter of the fiscal year and continued to improve with an estimated 2.7 percent rate of growth in the last quarter. It is anticipated that both employment and income will continue to improve for the rest of 2011, but at a slow pace. Moderate job growth is not expected until the second half of 2012. The result will be high unemployment rates for the rest of 2011 and most, if not all, of 2012.

National Economic Outlook

United States Economic Indicators	FY2009-10	FY2010-11	FY2011-12	FY2012-13
	Actual	Actual	Projected	Projected
Economic growth (GDP)*	1.90%	1.50%	2.10%	3.20%
Personal Income	-0.50%	4.10%	5.20%	6.70%
Corporate Pre-Tax Profits	42.00%	11.20%	0.10%	5.00%
Retails Sales and Food Services	1.20%	7.30%	5.20%	6.40%
CPI	1.00%	2.00%	2.40%	2.60%
30-yr Fixed Mortgage Interest Rate	5.00%	4.30%	4.90%	6.20%

**Adjusted for inflation*

The aftermath of the global financial crisis, along with the persistent declines in the housing market, assured that weak economic conditions would persist throughout the fiscal year. Subsequent economic shocks in the spring of 2011, including the rapid increase in gas prices and weather related supply disruptions, made it difficult for the recovery to gain traction. The economy remained in a below-normal growth pattern throughout the fiscal year and the nation's prospects are for subpar economic growth for 2011 and most, if not all, of 2012.

The economic indicators convey the impact the recession had on the nation and the abysmal rate of the recovery experienced during the fiscal year. Little economic growth is expected over the next year with only modest improvements the second-half of 2012. The overall economy experienced very little growth in FY 2010-11, recording only a 1.5 percent increase in GDP. The economy appeared poised to move into a strong recovery phase with annualized growth in GDP the third quarter of 2010 of 2.5 percent. By the second quarter of 2011, growth had slowed to 1.3 percent. Rapidly rising gas prices, supply disruptions from Japan's natural disaster and the weather-related problems here in the US, along with Eurozone debt problems all created a drag on economic growth that last quarter.

The ongoing problems in the housing market and stagnant employment growth, means the economy will struggle to rebound, and in FY 2011-12, is expected to grow by only 2.1 percent. The following fiscal year, FY 2012-13, economic growth is expected to be near the long-term average growth rate of 3.1 percent. The below average growth during this phase of the recovery means significant improvements in employment are going to take longer to develop. However, in FY 2010-11, despite the sluggish economic recovery and very little gain in employment, total personal income rose by 4.1 percent. Employment conditions are expected to remain weak, but will advance sufficiently enough to help personal income grow by 5.2 percent in FY 2011-12.

Additionally, given the persistently slow recovery, business profitability, which saw a major rebound in 2009 and 2010, is expected to level-off in 2011. Many businesses coming out of the recession were bolstered by a global economic recovery. Export demand grew significantly early in the fiscal year improving the balance sheets for many businesses. The subsequent sovereign debt crisis, which mostly affected European countries, has softened export growth and lowered expectations for continued profit growth over the next year. The result has been business investment has softened and hiring decisions continue to be put on hold.

A good indicator on the health of the economy is retail sales. This key indicator experienced a strong rebound in FY 2010-11, coming off anemic growth of 1.5 percent the preceding fiscal year. Consumers were hit hard during the economic downturn as household wealth declined, credit markets tightened, inflation-adjusted wages fell, and the employment picture remained cloudy. For consumer spending to strengthen the real estate and financial markets will need to stabilize, and an improving employment picture will need to emerge.

To summarize the national outlook, the Great Recession that began in December 2007, and ended June 2009, continued to impact economic conditions for most of the fiscal year. Part of what

was fueling economic growth, a global economic recovery, was set back with the realization of sovereign debt issues plaguing many industrialized nations. Thus, an already projected slow recovery was dragged down even further. This set the stage for a sluggish recovery with economic conditions marked by high unemployment and lower consumer spending. These conditions are expected to persist for all of 2011 and into 2012. A robust economy is not anticipated until the later part of 2012 or the beginning of 2013, five years after the Great Recession had technically ended.

North Carolina Economic Outlook

North Carolina Economic Indicators	FY2009-10	FY2010-11	FY2011-12	FY2012-13
	Actual	Actual	Projected	Projected
State Gross Product	3.40%	3.70%	3.60%	6.00%
Personal Income	1.60%	4.00%	4.20%	7.20%
Wages & Salaries	-0.90%	2.70%	5.30%	6.90%
Retail Sales	0.80%	7.70%	5.00%	4.60%
Unemployment Rate	11.10%	9.90%	10.10%	9.40%
Employment (Nonagricultural)	-4.00%	0.10%	0.30%	1.20%
Existing Single-family Home Sales	16.40%	-17.30%	16.20%	24.40%

For North Carolina, as with the nation, the end of the recession did not begin a period of strong employment gains. While the recession ended twelve months prior to the start of the fiscal year, many key economic indicators suggested recession-like conditions were enduring across the State. The State's economy only added 39,200 private sector jobs to a workforce of nearly four million and total wage and salary income increased by a modest 2.7 percent. By the end of the fiscal year, there were still 270,000 fewer people employed than at the start of the recession. Some sectors experienced modest growth, but employment in sectors tied to the housing market such as construction and home furnishings continued to decline. The employment picture in the State weakened during the fiscal year in concert with the global and national slowdown.

Projections for the State's economic indicators reflect how the recovery in the State is expected to unfold. Gross State Product, a broad measure of the State's economic activity does not return to the long-run average growth rate until FY 2012-13. This is indicative of the anticipated slow, prolonged recovery in the State. Personal income is improving. For FY 2010-11, it rose 4.0 percent, but the increase lags behind the growth of 6 to 7 percent experienced several years prior to the onset of the Great Recession. Wage and salary income rebounded from a decline the previous year and grew at 2.7 percent for the fiscal year. The modest rise in wage and salary income was consistent with the losses in total employment coming to an end. Going forward, improved growth in total income is projected. This growth will result from gradually improving employment, wage increases, and increase in the number of hours worked. A return in wage and salary income to long-term growth levels is forecast for 2012.

As with the nation, the recovery was tediously slow during FY 2010-11. The slow recovery meant few jobs were being created and the unemployment rate at the end of the fiscal year was at 9.9 percent. Despite a weak economy and high unemployment, retail sales rebounded with 7.7 percent growth. The growth, while impressive, follows a 7.8 percent drop two years earlier and almost no growth in FY 2009-10. Retail sales are expected to mirror the slow, gradual improvement of the economy, but will rise to the long-term average growth rate of 5 percent at the start of 2012. The increased projection in sales reflects the anticipated improvement in employment and household incomes.

As the State's economy begins to turn the corner in the recovery, employment prospects are gradually expected to improve, but a robust employment climate is not projected until 2013. Even with the improving employment picture, growth will be slow and the unemployment rate will remain elevated in the 9 to 10 percent range. By the end of calendar year 2011, only a few industries are expected to experience growth over the previous year with net growth well below 1 percent. For

2012, modest improvement is expected with total employment increasing at a rate of 1 percent by the end of year. This level of growth will not be sufficient to lower the unemployment rate significantly, and the rate is projected to average 10.1 percent for FY 2011-12, and 9.4 percent for FY 2012-13.

In the last recession, manufacturing, particularly in the furniture and textile industries, shed jobs at a rate of 10 percent per quarter. The State's manufacturing sector again was vulnerable to the recession and job losses in this industry sector reached double-digit levels. By the end of the fiscal year, the manufacturing sector had added only 2,000 jobs and employed 98,000 fewer people than at the start of the recession. Another hard hit industry has been the financial sector. The financial market upheaval had a detrimental impact on this sector's employment, but it began to rebound the first half of 2010 and is now near pre-recession levels.

The housing recession and the subsequent adjustments in the real estate market have taken a very long time to unwind. The housing recession that began in 2006, appeared to be ending at the start of 2010. Existing home sales in the State saw double-digit growth the first-half of that year. The second half of the year erased those gains and since then existing home sales have been losing ground. Tough credit conditions, exacerbated by mounting foreclosures, continue to prolong the return to a solid housing market. There has been some anticipation that low mortgage interest rates may help with the recovery, but thus far, have had little noticeable impact despite being at record lows. A turnaround in residential markets is projected by the spring of 2012 as market corrections finally start to take hold.

The slow economic recovery that persisted throughout FY 2010-11, was largely due to structural imbalances in the housing and financial sectors. These imbalances have had a profound affect on the State's economy and are taking a long time to correct. Ongoing weaknesses in the global economy have exacerbated the pace of the economic recovery both in the US and the State. A return to a full expansionary economy is not projected until the end of 2012, five years after the onset of the recession. Until then, the housing market should begin to gradually improve and steady improvements in household income and consumer spending are anticipated.

*— Economic analysis prepared by Barry Boardman, Ph.D., Staff Economist
North Carolina General Assembly, Fiscal Research Division
October 14, 2011*

Issues and Observations

Facts and Figures

North Carolina continues to grow and to be an attractive place to live, to work, and to raise a family.

- North Carolina's population has grown by 1.49 million, or 18.2 percent over the last 10 years.
- Road lane miles have grown by 1,247 miles, or 1.6 percent since 2000, with an additional 725 bridges since 2002.
- State Highway Patrol vehicles have increased from 1,956 in 2002 to 2,580 in 2011.
- Private vehicles registered have grown from 7.34 million in 2001 to 8.34 million in 2011.
- K-12 public school enrollment has increased by 14.8 percent, from 1.286 million in 2002 to 1.476 million in 2011.
- University enrollment has increased by 38,386, or 23.6 percent over the last 10 years.
- Community college enrollment has increased by 97,389, or 63.8 percent over the last 10 years.
- Medicaid beneficiaries have grown by 129,462, or 8.4 percent over the last 7 years.
- Food stamp recipients have increased by 776,331, or 98.1 percent over the last 7 years.
- Incarcerated or supervised offenders have increased by 8,174 over the last 9 years.
- The number of employed have grown by 253,293, or 6.7 percent over the last 10 years. However, the number of unemployed has grown by 250,569, or 127.3 percent. In 2011, the unemployment rate is 9.9 percent. The unemployment rate was only 4.9 percent in 2001.
- Positions funded by the State budget have increased overall by 40,430, or 14.3 percent over the last nine years. The largest areas of position growth occurred related to primary and secondary education, 17,277 (12.3 percent growth); universities, 13,303 (26.8 percent growth); community colleges, 5,787 (41.5 percent growth); and health and human services, 1,566 (8.3 percent growth).
- With an aging State workforce, accelerating numbers of retirements, lower investment rates of return, lower funded levels, and rising healthcare costs, the obligations related to State-funded pensions and retiree healthcare obligations continue to grow. For the Teachers' and State Employees' Retirement System (TSER), the number of retirees/beneficiaries has grown from 107,743 in 2001, to 163,938 in 2011, an increase of 56,195, or 52.2 percent. Active employees included in TSER have grown to 324,683, an 11.1 percent increase during the same period. There are an additional 102,149 former employees that will be eligible for retirement benefits in the future.
- State debt has increased from \$3.06 billion in 2001, to \$8.48 billion in 2011, an increase of \$5.4 billion, or 177.6 percent. Debt per capita has grown from \$373 per capita to \$890 per capita during the same period.
- The taxpayer burden related to individual income tax has shifted by 5.6 percent from those earning less than \$75,000 in taxable income, to those earning more than \$75,000 from 2000 to 2009.
- The average effective state individual income tax rate has ranged from 3.1 percent to 2.6 percent from 2000 to 2009.

GASB Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions

Effective for the year ended June 30, 2011, state and local governments were required to implement GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. The objective of GASB Statement No. 54 is to enhance the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. This statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds, i.e., the General Fund, Highway Fund, Highway Trust Fund, other special revenue funds, permanent funds, and capital projects funds.

A key feature of interest in this standard is a reevaluation of CAFR fund classification based on generally accepted accounting principles (GAAP) as defined by the GASB.

An area of emphasis in GASB Statement No. 54 relates to the appropriate classification of special revenue funds. Special revenue funds are used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes (other than debt service or capital projects). The term proceeds of specific revenue sources establishes that one or more specific restricted or committed revenues should be the foundation for a special revenue fund. Those specific restricted or committed revenues may be initially received in another fund and subsequently distributed to a special revenue fund. Those amounts should not be recognized as revenue in the fund initially receiving them; however, those inflows should be recognized as revenue in the special revenue fund in which they will be expended in accordance with specified purposes. Special revenue funds should not be used to account for resources held in trust for individuals, private organizations, or other governments.

Historically, state and local governments have established hundreds of separate funds, even though best practice is to strive to establish a minimum number of funds. GAAP-based financial reporting standards do not require separate fund usage for either specific revenues or specific activities. That is, GAAP does not require all restricted road and bridge taxes, for example, to be reported in separate special revenue funds. Therefore, some governments report those revenues in their general fund and while other governments may have used one or more funds. Similarly, GAAP does not require governments to report their significant activities (or any other specific function or program) in a separate fund.

The restricted or committed proceeds of specific revenue sources should be expected to continue to comprise a substantial portion of the inflows reported in the fund. Other resources (investment earnings and transfers from other funds, for example) also may be reported in the fund if those resources are restricted, committed, or assigned to the specified purpose of the fund.

The following funds previously reported as special revenue funds are the significant examples of funds reclassified to the General Fund as committed fund balance for GAAP reporting purposes in the 2011 CAFR:

1. **Clean Water Management Trust Fund**– This fund is supported mostly by appropriations transferred from the General Fund.
2. **Health and Wellness Trust Fund** – This fund is mostly supported with tobacco settlement money transferred from the General Fund.
3. **Tobacco Trust Fund** – This fund is mostly supported with tobacco settlement money that is transferred in from the General Fund.
4. **Education Lottery Funds** – The revenue support for this is the transfer from the North Carolina State Lottery enterprise fund. Since the funds go to support the General Fund operations for education, the fund will be presented in the General Fund.
5. **Public School Building Capital Fund** - This fund is funded by appropriations transferred in from the General Fund.
6. **Educational Materials and School Buses Fund** –This is mostly funded by appropriations from the General Fund.

These proposed reclassifications would have no affect on the State's budgetary basis fund availability.

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

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (effective for fiscal year 2006-07), and in June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (effective for fiscal year 2007-08).

The actuarial data for the retiree healthcare benefit plan is disclosed in Note 14, Other Postemployment Benefits, based on the disclosure requirements for a cost-sharing, multiple-employer plan, and is also presented as required supplementary information (RSI). Based on the disclosure requirements of a cost-sharing, multiple-employer plan, the unfunded actuarial liability is not recorded as an accounting liability.

The State retiree healthcare benefit is currently funded on a pay-as-you-go basis, with minimal additional accumulation of funds to pay the retiree health benefit. Based on the current funding method with limited accumulation of funds, the actuarial assumptions reflect a short-term discount rate of 4.25 percent. The December 31, 2010 actuarial valuation using the projected unit credit cost method indicated an accrued liability of \$33.495 billion for the retiree healthcare plan (\$32.839 billion unfunded), with an annual required contribution (ARC) of \$2.911 billion.

Participating employers in the retiree health care benefit plan include the primary government state employees, local education agencies (LEAs), the University of North Carolina System, community colleges, and several local governments. For the fiscal year ended June 30, 2011, retiree healthcare employer contributions were \$743.659 million, representing an annual increase of 9.56 percent. Retiree healthcare premium costs paid to the State Health Plan were \$652.627 million, representing an annual increase of 13.03 percent. Plan net assets of \$703.959 million represent an increase of \$97.923 million, or 16.16 percent from the prior year.

**Timeliness of
Financial
Reporting**

Over the last several years, momentum and focus has grown related to the need for improved timeliness of financial reporting for state and local governments. In addition to, and in concert with, statements made by representatives of the Securities and Exchange Commission (SEC), representatives of the Governmental Accounting Standards Board (GASB), the Government Finance Officers Association (GFOA), the National Association of State Auditors, Comptrollers, and Treasurers (NASACT), the American Institute of Certified Public Accountants (AICPA), and the municipal bond industry have begun to emphasize the need for improved timeliness. The most basic accounting principles recognize that financial information must be timely in order to be relevant and useful to decision-makers.

Currently, state and local governments, and colleges and universities, must issue their financial statements by December 31 in order to meet GFOA Certificate of Achievement for Excellence in Financial Reporting Award standards. SEC guidance requires that publicly-traded companies report within 60 to 90 days of fiscal year end. A national sample of comparable public state universities with June 30 year ends, reflect financial statements issued as early as September 10, with commonly found issue dates on or before September 30.

Various state governments have established goals for improved timeliness to span over the next two to three years. Four months following the fiscal year end has been mentioned as a target date for acceptable timeliness for state governments. With October 31 as a reference for completion, all financial information for entities falling within the state government reporting entity must be completed on an accelerated schedule as well. Each branch of reporting must accelerate in order for the top level government to have more timely reporting. Additionally, actuarial studies must be completed sooner, year-end budgets must be closed more expeditiously, accounting system processes must be streamlined, and audit contracts and schedules must be amended.

GASB continues to issue new accounting and financial reporting guidance. With limited resources to implement new standards, more lead time to implement will be necessary. As most state governments operate on a cash budgetary basis, specific emphasis must be directed towards the

year-end GAAP conversion process, data compilation from various entities outside of the State's primary accounting system, and methods of estimation.

Given this new emphasis, all aspects of the accounting and reporting functions of the State and its component units must be evaluated with timeliness in mind. The State has begun the process of review and improvement. As a triple-A rated state, and as a leader in the state government financial community, we are committed to taking the necessary steps to make our financial statements more relevant, useful, and timely.

GASB Pension Accounting and Reporting

In July, GASB issued two Exposure Drafts proposing changes to financial reporting of pensions by state and local governments: *Accounting and Financial Reporting for Pensions* and *Financial Reporting for Pension Plans*. The documents offer amendments to the existing pension standards and changes how the costs and obligations associated with the pensions that governments provide to their employees are calculated and reported. Under the proposal, all assumptions of returns and costs would be consistent with the American Academy of Actuaries' Actuarial Standards of Practice, unless otherwise specified by the GASB.

The first Exposure Draft, *Accounting and Financial Reporting for Pensions (AFRP Draft)*, primarily relates to **reporting by governments that provide pensions to their employees**. A second related Exposure Draft, *Financial Reporting for Pension Plans (FRPP Draft)*, addresses the **reporting by the pension plans** that administer those benefits.

The *AFRP Draft* provides that governments are to be required to report in their statement of financial position a *net pension liability* (the difference between the total pension liability and net assets (primarily investments reported at fair value) set aside in a qualified trust to pay benefits to current employees, retirees, and their beneficiaries). It also proposes changes to the manner in which a government would calculate its total pension liability and pension expense including:

- Immediate recognition of more components of pension expense than is currently required, including the effect on the pension liability of changes in benefit terms, rather than deferral and amortization over as many as 30 years which is common for funding purposes.
- Use of a discount rate that combines (a) the expected long-term rate of return on pension plan investments for which plan assets are expected to be available to make projected benefit payments and (b) the interest rate on a tax-exempt 30-year AA/Aa-or-higher rated municipal bond index to projected benefit payments for which plan assets are not expected to be available for long-term investment in a qualified trust.
- A single actuarial cost allocation method "entry age normal" rather than the current choice among six actuarial cost methods.
- Requiring governments participating in cost-sharing multiple employer pension plans to record a liability equal to their proportionate share of any net pension liability for the cost-sharing plan as a whole.
- Requiring governments in all types of covered pension plans to present more extensive note disclosures and required supplementary information.

The *FRPP Draft*, which addresses financial reporting for plans that are administered through qualified trusts, outlines the basic framework for the separately issued financial reports of *defined benefit* pension plans. It also details proposed note disclosure requirements for *defined contribution* pension plans.

The intent of the proposed changes is to make it easier to compare the health of pension funds from one state to the next. One set of proposed changes relates to the accounting methods used by states to calculate their pension liabilities. Under GASB's current reporting standards, governments can choose from six different accounting methods. Contrary to the current process, the new rules would have all states using the same method. The current system takes a "funding-based" approach that focuses on how much states pay into the pension fund each year. The new system would take an

“accounting-based” approach that employs a longer-term view to ensure that the overall costs of providing benefits are accounted for.

Other proposed changes relate to how pension funds calculate investment returns. Differences between projected earnings on pension plan investments and actual earnings would be deferred and incorporated into the pension expense calculation over five years. In addition, governments would no longer be able to use historical rates of return to determine their long-term liabilities if they haven’t set aside enough money to pay retirees. Instead, states will have to use a combination of a historical rate of return and a lower rate pegged to the municipal bond market, which will make their long-term liabilities appear larger.

Currently, governmental reporting standards do not require that future pension liabilities be included or disclosed on a governmental balance sheet. Instead, those details can be included in the financial statements notes. Under the new rules, this information will appear in the body of a state’s balance sheet. As a result, policy makers, lawmakers, investors, the press and public would be provided with a more transparent perspective of the state’s fiscal condition.

It is very important to note that the proposals will have the effect of making a state’s long-term finances appear to be worse because the unfunded liability has not previously been on the balance sheet; it has been disclosed, but only in the notes, not on the balance sheet. Adding a large liability to the balance sheet will make the government’s net position lower, and give the appearance that it is in a weaker position. The economic reality, of course, is that nothing has changed except the presentation of the report.

Hurricane Irene

Hurricane Irene made landfall in eastern North Carolina on August 27. Early estimated losses totaled approximately \$425 million (including \$320 million related to agriculture and crop damage). Residents in 38 counties are eligible for federal individual assistance for recovery costs and 37 counties are eligible for federal public assistance including low-interest loans and grants to help individuals and public entities recover. In addition, farmers in 42 counties are eligible for disaster assistance from the United States Agriculture Department.

The State will provide funds to satisfy the matching requirement for federal assistance. This 25% match requirement is only applied to the non-agriculture damage that has occurred, which at this point is approximately \$29.66 million (based on estimates of \$139.1 million in damage to non-agriculture entities). It is anticipated the 25% match will be paid out over a number of fiscal years.

Debt Affordability

The 2004 General Assembly passed legislation creating the Debt Affordability Advisory Committee. The Committee is charged, on an annual basis, with advising the Governor and the General Assembly of the estimated debt capacity of the State for the upcoming 10 fiscal years.

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

Awards and Acknowledgements

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of North Carolina for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2010. This was the 17th consecutive year (1994 to 2010) the State has received the prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

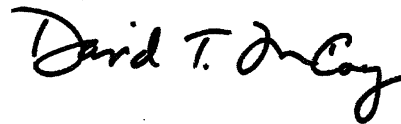
In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report, whose contents conform to program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal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

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

Acknowledgments

In conclusion, we believe this report provides useful data to all parties using it in evaluating the financial activity of the State of North Carolina. We in the Office of the State Controller express our appreciation to the financial officers throughout the State and to the Office of the State Auditor for their dedicated efforts in assisting us in the preparation of this report. Any questions concerning the information contained in this report should be directed to the Office of the State Controller at (919) 981-5454.

Respectfully submitted,



David T. McCoy
State Controller

December 8, 2011

CERTIFICATE OF ACHIEVEMENT

Certificate of Achievement for Excellence in Financial Reporting

Presented to

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



President

Executive Director