

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is a discussion and analysis of the state of South Dakota's (herein after referred to as the State) financial performance and position, providing an overview of the State's financial activities for the fiscal year ended June 30, 2002. Please read it in conjunction with the transmittal letter in the Introductory Section of this report and with the State's financial statements that follow this section.

Fiscal year 2002 represents the first year in which the State is required to implement the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis--for State and Local Governments*. Therefore, this discussion and analysis provides few comparisons with the previous year. Future reports are required to include extensive comparisons.

FINANCIAL HIGHLIGHTS

Government-wide

- The assets of the State exceeded its liabilities at the close of the fiscal year by \$3.6 billion (reported as net assets), an increase of \$94.5 million from the previous year. Component units reported net assets of \$538.0 million, an increase of \$41.9 million from the previous year.

Fund Level

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$964.3 million, with \$786.8 million reported as *unreserved fund balance* and the remaining amount of \$177.5 million reserved for specific purposes (such as encumbrances, debt service, restricted funds, school perpetuity, and noncurrent assets). At the end of the fiscal year, unreserved fund balance for the General Fund was \$96.4 million, of which \$39.3 million was designated only to be used to address emergency situations without having to raise taxes or cut spending.
- Proprietary funds reported net assets at year-end of \$312.3 million, an increase of \$27.8 million during the year.

Long-Term Debt

- The primary government's total long-term outstanding loans and bonded debt totaled \$169.9 million, a decrease of \$3.7 million from the previous year. Of the total outstanding loans and bonded debt, \$44,000 is backed by the State, with the remaining balance backed by the South Dakota Building Authority and South Dakota Conservancy District. The \$3.7 million decrease represents the net difference between new issuances, and principal payments of outstanding debt. During the year, the State and South Dakota Building Authority incurred no new long-term general indebtedness under governmental and business-type activities; however, the South Dakota Conservancy District issued \$9.7 million tax exempt revenue bonds under business-type activities.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis are intended to serve as an introduction to the State's basic financial statements. The State's basic financial statements are comprised of three components: 1) government-wide financial statements; 2) fund financial statements and combining component units financial statements; and, 3) notes to the financial statements. This report also contains required supplementary information and other supplementary information in addition to the basic financial statements.

Government-wide Financial Statements (Reporting the State as a Whole)

The government-wide financial statements are designed to provide readers with a broad overview of the State's finances in a manner similar to a private-sector business. The statements provide both short-term and long-term information about the State's financial position that aids in assessing the State's economic condition at the end of the fiscal year. These statements include all nonfiduciary assets and liabilities, using the flow of economic resources measurement focus and the accrual basis of accounting. The current year's revenues and expenses are taken into account, regardless of when cash is received or paid. The government-wide financial statements include two statements:

- *The Statement of Net Assets* presents information on all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets may serve as a useful indicator of whether the financial position of the State is improving or deteriorating.
- *The Statement of Activities* presents information depicting how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave).

Both the statement of net assets and the statement of activities segregate the activities of the State into three types:

- *Governmental Activities.* The governmental activities of the State include general government; education – elementary, secondary and vocational schools; education – state aid to universities; health and human services; law, justice and public protection; agriculture and natural resources; commerce and regulation; economic resources; transportation; intergovernmental – payments to school districts; intergovernmental – revenue sharing; interest expense; and, unallocated depreciation. Taxes, fees, unrestricted investment earnings, and intergovernmental revenues (federal grants) finance most of the costs of these activities.
- *Business-Type Activities.* The State charges fees to customers to help cover all or most of the cost of certain services it provides. Lottery Fund, Revolving Economic Development and Initiative Fund, and Clean Water State Revolving Fund are examples of business-type activities.
- *Discretely Presented Component Units.* Component units are legally separate organizations for which the State is financially accountable, or the nature and significance of the unit's relationship with the State is such that exclusion of the unit would cause the State's financial statements to be misleading, or incomplete. The following entities are included in the component units columns of the State's government-wide financial statements:
 - ✓ Higher Education
 - ✓ Conservation Reserve Enhancement Program (CREP)
 - ✓ South Dakota Housing Authority
 - ✓ South Dakota Finance Authority

Fund Financial Statements and Combining Component Units Financial Statements

A fund is a grouping of related accounts used to maintain control over resources that have been segregated for specific activities or objectives. The State, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Some funds are required by law, while others are established internally to maintain control over a particular activity. All funds of the State can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds. It is important to note that these categories use different accounting approaches and should be interpreted differently.

- *Governmental Funds.* Most of the State's basic services are reported in governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as the balances of spendable resources available at the end of the fiscal year. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. This short-term view of the State's financial position may be useful in determining whether the State has sufficient resources to cover expenditures for its basic services in the near future.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financing decisions. Both the governmental funds balance sheet and the governmental funds statement of revenues,

expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. These reconciliations are presented on the page immediately following each governmental funds financial statement.

The State maintains several individual governmental funds. Information is presented separately in the governmental funds balance sheet and in the governmental funds statement of revenues, expenditures, and changes in fund balances for the General Fund, Transportation Fund, Social Services Federal Fund, and Dakota Cement Trust Fund, which are considered to be major funds. Data from the remaining governmental funds are combined into a single, aggregated presentation. Individual fund data for some nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

- *Proprietary Funds.* Proprietary funds include enterprise funds and internal service funds and account for State's activities that operate much like private sector businesses. Like the government-wide financial statements, proprietary fund statements are presented using the full accrual basis of accounting.

Activities (e.g., Lottery Fund) that largely involve customers outside of state government are accounted for in enterprise funds, and are the same functions reported as business-type activities in the government-wide financial statements. Activities (e.g., Fleet and Travel Management) that largely involve other state agencies are accounted for in internal service funds. The internal service fund activities are consolidated with the governmental activities in the government-wide financial statement because those services predominantly benefit governmental rather than business-type activities.

The State maintains several individual proprietary funds, of which the following three are considered major funds: Lottery Fund, Revolving Economic Development and Initiative Fund, and Clean Water State Revolving Fund. These three proprietary funds are presented separately in the proprietary funds statement of net assets and statement of revenues, expenses, and changes in fund net assets. Information from the remaining funds is combined into a single, aggregated column by proprietary fund type. Individual fund data for some nonmajor proprietary funds is provided in the form of combining statements elsewhere in this report.

- *Fiduciary Funds.* Fiduciary funds are used to report activities when the State acts as a trustee or fiduciary to hold resources for the benefit of parties outside state government. The full accrual basis of accounting is used for fiduciary funds and is similar to the accounting used for proprietary funds. The government-wide financial statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and cannot be used by the State to finance operations.

The State's fiduciary funds include pension trust funds, private purpose trust funds, and agency funds. Individual fund detail is included in the combining financial statements elsewhere in this report.

Component Units. As mentioned above, component units are legally separate organizations for which the State is financially accountable. The government-wide financial statements present information for the component units (a) in a single, aggregated column on the statement of net assets, and (b) in detail for each component unit on the statement of activities. The combining statement of net assets; combining statement of revenues, expenses and changes in fund net assets; and, combining statement of cash flows provide detail for each component unit.

Notes to the Financial Statements

The notes provide additional narrative and financial information essential to fully understand the data provided in the government-wide financial statements, fund financial statements, and combining component units financial statements. The notes to the financial statements are located immediately following the combining component units financial statements.

Required Supplementary Information

The basic financial statements are followed by a section of required supplementary information. This section includes a Budgetary Comparison Schedule, and related notes, for the General Fund and for each major special revenue fund that has a legally adopted annual budget. The only special revenue fund that fits this criterion, and where the programs and/or budgetary fund types are identifiable to a major fund, is the Social Services Federal Fund.

The Budgetary Comparison Schedule presents both the original and the final appropriated budgets for fiscal year ending June 30, 2002. The Budgetary Comparison Schedule also lists the actual outflows and balances stated on a budgetary basis. A variance column is included to compare the final appropriated budget with the actual budget results.

Because accounting principles used to present budgetary basis differ significantly from those used to present financial statements in conformity with Generally Accepted Accounting Principles (GAAP), a Budget-to-GAAP Reconciliation can be found immediately following the Budgetary Comparison Schedule. The Budget-to-GAAP reconciliation explains the differences between budgetary outflows and GAAP expenditures.

Other Supplementary Information

Other supplementary information includes combining financial statements for nonmajor governmental, proprietary, and fiduciary funds. These funds are added together, by fund type, and presented in single columns in the basic financial statements.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

As mentioned previously, new accounting standards significantly changed the content and structure of the financial statements, and much of the information is not easily comparable to prior years. Future MD&A's will include extensive comparisons.

Net Assets. As presented in the following table, total assets of the State on June 30, 2002 were \$4.3 billion, while total liabilities were \$0.7 billion, resulting in combined net assets (governmental and business-type activities) of \$3.6 billion.

The largest component of the State's net assets, 68.1%, is investments in capital assets (land; land improvements; land improvements – roads; buildings; equipment; vehicles; infrastructure; and construction in progress), less depreciation and all outstanding debt that was issued to buy or build those assets. The State uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the State's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since capital assets themselves cannot be used to liquidate these liabilities.

Restricted net assets comprise 11.4% of total net assets. These net assets are subject to restrictions either (a) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws/regulations of other governments; or, (b) imposed by law through constitutional provisions on how they can be used.

The remaining balance, \$735.5 million, is unrestricted net assets that may be used to meet the State's ongoing obligations to citizens and creditors. However, certain resources within this balance have internally imposed limitations as explained below.

These assets are not reported as restricted net assets because the limitations are imposed internally by the State, not externally imposed by sources such as creditors. Internally imposed limitations on the use of unrestricted assets include, but may not be limited to, the following:

- **General Fund Budget Reserve.** The 1991 South Dakota Legislature established a General Fund Budget Reserve that would only be used to address emergency situations without having to raise taxes or cut spending. The balance in the General Fund Budget Reserve at June 30, 2002 is \$39.3 million.

State of South Dakota Net Assets June 30, 2002 (Expressed in Thousands)

	Governmental Activities	Business-type Activities	Total Primary Government
Current and Other Assets	\$ 1,400,960	\$ 338,223	\$ 1,739,183
Capital Assets	<u>2,531,962</u>	<u>2,906</u>	<u>2,534,868</u>
Total Assets	<u>3,932,922</u>	<u>341,129</u>	<u>4,274,051</u>
Long-Term Liabilities Out-			
Standing	255,872	32,324	288,196
Other Liabilities	<u>385,935</u>	<u>21,404</u>	<u>407,339</u>
Total Liabilities	<u>641,807</u>	<u>53,728</u>	<u>695,535</u>
Net Assets:			
Invested in Capital Assets, Net of Related Debt	2,433,483	2,881	2,436,364
Restricted	209,216	197,428	406,644
Unrestricted	<u>648,416</u>	<u>87,092</u>	<u>735,508</u>
Total Net Assets	<u>\$ 3,291,115</u>	<u>\$ 287,401</u>	<u>\$ 3,578,516</u>

- *Dakota Cement Trust Fund.* This fund consists of the proceeds from the sale of the State Cement Plant and all investment earnings thereon. Article XIII, section 21 of the Constitution of the State of South Dakota states as follows: "Except as provided in Article XIII, section 20 of the Constitution of the State of South Dakota, the original principal of the trust fund shall forever remain inviolate. However, the Legislature shall, by appropriation, make distributions from the difference between the twelve million dollar annual general fund transfer and five percent of the market value of the trust fund for the support of education, but not for the replacement of state aid to general education or special education, if the increase in the market value of the trust fund in that fiscal year was sufficient to maintain the original principal of the trust fund after such distributions. Beginning with fiscal year 2006, the market value of the trust fund shall be determined by adding the market value of the trust fund at the end of the sixteen most recent calendar quarters, and dividing that sum by sixteen". The fund balance in the Dakota Cement Trust Fund at June 30, 2002 was \$229.9 million.
- *Health Care Trust Fund.* This fund consists of monies that were on deposit in the Intergovernmental Transfer Fund. This fund is authorized by State law to make an annual distribution equal to 4.0% of its market value (less the investment expenses) into the General Fund for health care related programs. Article XII, section 5 of the Constitution of the State of South Dakota also states that, "the Health Care Trust Fund may not be diverted for other purposes, nor may the principal be invaded unless appropriated by a three-fourths vote of all of the members-elect of each house of the legislature". The fund balance in the Health Care Trust Fund at June 30, 2002 was \$65.6 million.
- *Education Enhancement Trust Fund.* This fund consists of monies received from the tobacco settlement agreement and any funds in the Youth-at-Risk Fund. The fund is authorized by State law to make an annual distribution equal to 4.0% of its market value (less the investment expenses) into the General Fund for educational enhancement programs. Article XII, section 6 of the Constitution of the State of South Dakota also states that, "the Education Enhancement Trust Fund may not be diverted for other purposes, nor may the principal be invaded unless appropriated by a three-fourths vote of all the members-elect of each house of the legislature". The fund balance in the Education Enhancement Trust Fund at June 30, 2002 was \$85.4 million.

Changes in Net Assets. The following table summarizes financial information derived from the government-wide statement of activities and reflects how the State's net assets changed during fiscal year 2002.

**State of South Dakota
Changes in Net Assets
Fiscal Year Ended June 30, 2002
(Expressed in Thousands)**

	<u>Governmental Activities</u>	<u>Business-Type Activities</u>	<u>Total Primary Government</u>
Revenues:			
Program Revenues:			
Charges for Services	\$ 223,596	\$ 174,673	\$ 398,269
Operating Grants and Contributions	1,043,588	40,133	1,083,721
Capital Grants and Contributions	1,784		1,784
General Revenues:			
Sales Taxes	471,025		471,025
Motor Fuel Taxes	125,252		125,252
Contractors Excise Taxes	53,449		53,449
Bank Card and Franchise Taxes	41,784		41,784
Other Taxes	198,776		198,776
Unrestricted Investment Earnings	53,422		53,422
Gain on Sale of Capital Assets	1,048		1,048
Miscellaneous	<u>31,428</u>		<u>31,428</u>
Total Revenues	<u>2,245,152</u>	<u>214,806</u>	<u>2,459,958</u>

Changes in Net Assets (Continued)

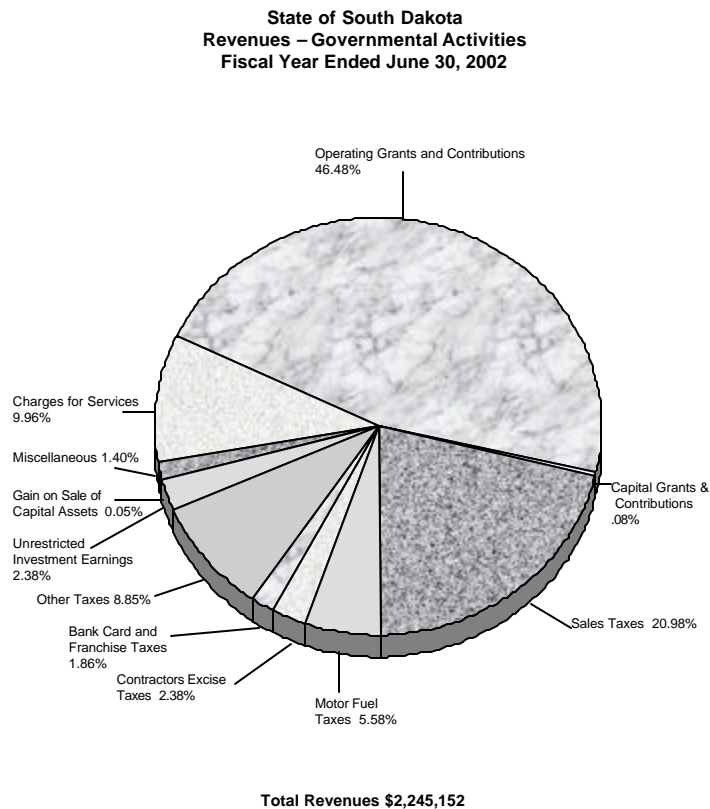
	<u>Governmental Activities</u>	<u>Business-Type Activities</u>	<u>Total Primary Government</u>
Program Expenses:			
General Government	138,637		138,637
Education – Elementary, Secondary and Vocational Schools	142,256		142,256
Education – State Aid to Universities	131,462		131,462
Health and Human Services	837,325		837,325
Law, Justice, and Public Protection	148,004		148,004
Agriculture and Natural Resources	95,732		95,732
Commerce and Regulation	13,351		13,351
Economic Resources	28,170		28,170
Transportation	340,394		340,394
Intergovernmental – Payments to School Districts	322,290		322,290
Intergovernmental – Revenue Sharing	80,434		80,434
Interest Expense	8,736		8,736
Unallocated Depreciation	70		70
Lottery		21,981	21,981
Revolving Economic Development & Initiative		858	858
Clean Water State Revolving		1,466	1,466
Other		54,269	54,269
Total Expenses	<u>2,286,861</u>	<u>78,574</u>	<u>2,365,435</u>
Excess (Deficiency) Before Special Items and Transfers	(41,709)	136,232	94,523
Transfers	<u>108,925</u>	(<u>108,925</u>)	<u>0</u>
Change in Net Assets	67,216	27,307	94,523
Net Assets – Beginning (As Restated)	<u>3,223,899</u>	<u>260,094</u>	<u>3,483,993</u>
Net Assets – Ending	<u><u>\$3,291,115</u></u>	<u><u>\$ 287,401</u></u>	<u><u>\$3,578,516</u></u>

Governmental Activities:

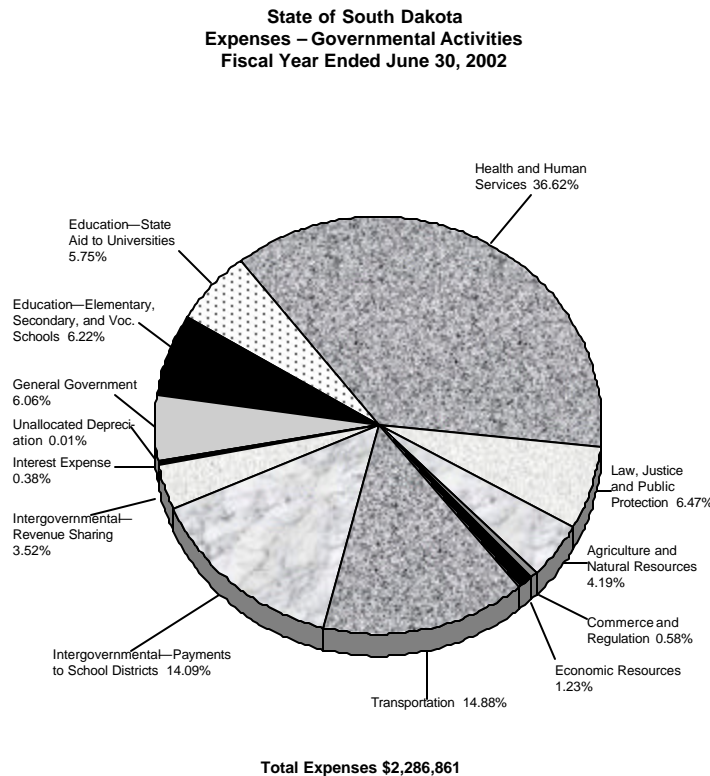
Governmental activities increased the State's net assets by \$67.2 million. Factors contributing to these results include:

- A deficiency in revenues over expenses of \$41.7 million, primarily due to the sluggish economy, lower return on investments, and the repeal of the inheritance tax; and,
- Net transfers totaling \$108.9 million. The majority of transfers in were from the South Dakota Lottery in the amount of \$109.3 million.

The following chart depicts revenues of the governmental activities for the fiscal year:



The following chart depicts expenses of the governmental activities for the fiscal year:



Business-Type Activities:

Net assets of the business-type activities increased by \$27.3 million during the fiscal year. Factors contributing to these results include:

- An excess of revenues over expenses of \$136.2 million, primarily due to South Dakota Lottery (\$109.9 million); and,
- Ongoing operating transfers from the South Dakota Lottery to governmental activities.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

As noted earlier, the State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Some funds are required by law, while others are established internally to maintain control over a particular activity.

Governmental Funds

The focus of the State's governmental funds is to provide information on near-term inflows and outflows during the fiscal year, and on balances of spendable resources as of fiscal year-end. Such information is useful in assessing the State's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year. However, this measure must be used with care because large portions of the balance may relate to internally imposed limitations, such as statutory language, which could limit resource use (e.g., General Fund Budget Reserve, Dakota Cement Trust Fund, Health Care Trust Fund, and Education Enhancement Trust Fund), unless appropriated by legislative action as defined by State law.

At the end of the current fiscal year, the State's governmental funds reported combined ending fund balances of \$964.3 million, an increase of \$11.4 million in comparison with the prior year.

Approximately 18.4%, or \$177.5 million of the combined ending fund balances, is reserved to indicate that it is not available for new spending because it has already been committed 1) to liquidate contracts and purchase orders for the prior fiscal year--\$41.9 million, 2) to pay debt service--\$82.6 million, 3) to be held in permanent trust funds with earnings distributed to primary governments and universities--\$23.1 million, or 4) for a variety of other restricted purposes--\$29.9 million.

Approximately 4.1%, or \$39.3 million of the combined ending fund balances, is designated as a General Fund Budget Reserve to indicate that it has been designated through internally imposed limitations to be used only to address emergency situations without having to raise taxes or cut spending.

The remaining 77.5%, or \$747.5 million of the combined ending fund balances, constitutes unreserved fund balance that may be used to meet the State's ongoing obligations to citizens and creditors. However, as previously mentioned, large portions of this balance relate to internally imposed limitations, such as statutory language that could limit resource use, unless appropriated by legislative action as defined by State law. Examples of funds (and reported unreserved fund balances) that are subject to internally imposed limitations include, but may not be limited to: 1) Dakota Cement Trust Fund--\$229.9 million, 2) Health Care Trust Fund--\$65.6 million, and 3) Education Enhancement Trust Fund--\$85.4 million. **Note:** For a complete explanation of these funds, refer to the previous section entitled, "Government-Wide Financial Analysis".

The only governmental fund that is a major fund and had a significant change in fund balance during fiscal year 2002 was the General Fund. The General Fund is the chief operating fund of the State. At the end of the fiscal year, unreserved fund balance of the General Fund was \$96.4 million, of which \$39.3 million was designated only to be used to address emergency situations without having to raise taxes or cut spending. Total fund balance at the end of the current fiscal year was \$114.5 million. As a measure of the General Fund's liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance (including the unreserved designated amount) represents 11.0% of the total General Fund operating expenditures, while total fund balance represents 13.0% of that same amount.

Overall, the fund balance of the State's General Fund decreased by \$40.0 million during the current fiscal year. This is a 25.9% decrease from the prior year. The decrease primarily resulted from a slowing of the economy

throughout the fiscal year, lower return of investments, and the repeal of the State inheritance tax on July 1, 2001.

Proprietary Funds

The State's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail. The following proprietary funds are major funds and had significant changes to net assets during fiscal year 2002:

- *Lottery Fund.* At the end of the current fiscal year, the Lottery Fund reported total net assets of \$5.1 million, an increase of \$0.7 million in comparison with the prior year. During the current fiscal year, the State Lottery produced operating income (before operating transfers) in the amount of \$109.9 million on total revenue of \$131.3 million, compared to the previous fiscal year's operating income (before operating transfers) of \$100.5 million on total revenue of \$121.7 million. The increase was largely the result of increased video lottery revenue and increases in instant on-line ticket sales. During FY 2002, the State Lottery distributed approximately \$102.8 million to the Property Tax Reduction Fund, \$4.3 million to the General Fund, \$2.0 million to the Capital Construction Fund, and \$0.2 million to the Department of Human Services.
- *Clean Water State Revolving Fund.* At the end of the current fiscal year, the Clean Water State Revolving Fund reported total net assets of \$105.2 million, an increase of \$9.2 million in comparison with the prior year. This increase resulted primarily from the receipt of \$4.8 million capitalization grant monies received from the federal government, and \$4.4 million investment, interest, and other income in excess of operating expenses.

BUDGETARY HIGHLIGHTS – GENERAL FUND AND SOCIAL SERVICES FEDERAL FUND

The following analysis is based on the Budgetary Comparison Schedules included in the Required Supplementary Information that immediately follows the basic financial statements.

General Fund. Differences between the original budget and the final amended budget were relatively minor (\$2.7 million decrease in appropriations) and can be summarized as follows:

- \$1.2 million reduction of appropriated carryover amount within Dakota Public Broadcasting to be transferred to the General Fund to meet ongoing State expenditures.
- \$3.0 million reduction of appropriated carryover amount within Department of Education and Cultural Affairs to be transferred to the General Fund to meet ongoing State expenditures.
- \$0.5 million in supplemental appropriations to the Department of Corrections to upgrade the electronic security system at the Jameson Annex of the SD State Penitentiary.
- \$0.5 million in supplemental appropriations to the Department of Human Services to be used to fund higher than anticipated costs regarding case loads for adjustment training centers.
- \$0.5 million in supplemental appropriations to Higher Education to fund payout costs for South Dakota School of Medicine staff who had their contracts cancelled due to the loss of the University Physician's Program.
- Other budget adjustments in the form of FY 2002 emergency special appropriations and budget transfers were not considered to be significant variations, or to have a significant effect on future services or liquidity.

Differences between the final amended budget and actual spending (\$4.5 million) resulted from:

- Agencies controlled spending in an effort to create budgetary savings to the General Fund of \$3.5 million.
- Maintenance and repair amounts of \$0.8 million statutorily authorized to be carried forward and spent in future years.
- Special appropriation amounts of \$0.2 million statutorily authorized to be carried forward and spent in future years.

Overall, there were no overexpenditures by State departments, or line item overexpenditures of General Funds during the fiscal year.

Social Services Federal Fund. In total, the Social Services Federal Fund experienced no change between the original budget and the final amended budget. However, budget transfers did occur within the Department

of Social Services during FY 2002 primarily for the purpose of reorganization. These transfers were not considered significant, or to have a significant effect on future services or liquidity.

The difference between the final amended budget and actual spending (\$6.5 million) resulted primarily from the fact that the funds that could have been claimed from the federal government were less than anticipated when the budget was constructed.

Overall, there were no overexpenditures at the department level, or line item overexpenditures of the fund during the current fiscal year.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The State's investment in capital assets for its governmental and business type activities as of June 30, 2002 is \$2.5 billion (net of accumulated depreciation). This investment in capital assets includes land; land improvements; land improvements – roads; buildings; equipment; vehicles; infrastructure; and construction in progress.

**State of South Dakota
Capital Assets – Primary Government
June 30, 2002
(Expressed in Thousands)**

	<u>Governmental Activities</u>	<u>Business-Type Activities</u>	<u>Total Primary Government</u>
Land	\$ 52,719	\$ 354	\$ 53,073
Land Improvements	8,356	687	9,043
Land Improvements – Roads	554,641	0	554,641
Buildings	237,975	2,918	240,893
Equipment	114,782	2,131	116,913
Vehicles	87,349	0	87,349
Infrastructure	2,522,567	0	2,522,567
Construction in Progress	<u>176,350</u>	<u>1,214</u>	<u>177,564</u>
Total	<u>3,754,739</u>	<u>7,304</u>	<u>3,762,043</u>
Accumulated Depreciation	(1,222,777)	(4,398)	(1,227,175)
Total Capital Assets, Net	<u>\$ 2,531,962</u>	<u>\$ 2,906</u>	<u>\$ 2,534,868</u>

The most significant change during the year was a change in accounting for capital assets, resulting in the inclusion of infrastructure assets and related land, land improvements - roads, and construction in progress. Infrastructure assets are long lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure assets include roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems. This change increased the capital assets reported by \$2.2 billion (net of accumulated depreciation), which is 88.0% of total capital assets (net of accumulated depreciation).

The State's investment in capital assets (net of accumulated depreciation) changed from fiscal year 2001 to 2002 by approximately 2.0%. The change was primarily due to ongoing construction and completion of segments of infrastructure—highways, bridges, and railroads. Construction in progress for highways, bridges, and railroads increased by \$98.2 million and decreased (projects completed and capitalized) by \$106.9 million, while other projects that were begun and completed during the current year (did not run through construction in progress) totaled \$1.2 million. The land, land improvements, and buildings increased by \$25.6 million, which consisted largely of:

- The completion of a new Department of Transportation complex in Sioux Falls -- \$12.2 million;
- A new Department of Transportation lab/shop in Pierre -- \$4.1 million; and,
- Completion of a new manufacturing center for Lake Area Vocational Technical Institute -- \$4.0 million (the State reports land and buildings for the four vocational technical institutes. See Note 15 in the Notes to the Financial Statements.).

Equipment assets increased by \$9.4 million, largely due to the implementation of a new comprehensive human resource/payroll system (\$2.9 million) and replacing aged equipment. Vehicles, which include trucks, cars, pickups, and other vehicles, increased \$5.6 million, largely due to replacing aged vehicles. This increase was slightly elevated, due to some vehicles being driven longer than normal and being replaced.

More detailed information on the State's capital assets can be found in Nte 6 in the Notes to the Financial Statements.

Debt Administration

The authority of the State to incur debt is described in Article III, Section 2, of the State's Constitution. Generally, the State Constitution prohibits the State from having general obligation indebtedness in excess of \$100,000. During a prior fiscal year, the city of Pierre installed an electrical upgrade to the capitol complex. The State entered into a long-term contract with the city of Pierre to pay for the cost of the upgrade. General obligation indebtedness of the State is backed by the full faith and credit of the State, and reported as part of the governmental activities in the State's basic financial statements.

The South Dakota Building Authority was created and organized by Chapter 5-12 of the South Dakota Codified Laws. The South Dakota Building Authority issues bonds, certificates of participation, and trust certificates to finance the cost to acquire, construct, remodel, maintain, and equip buildings and other facilities of State departments and institutions. These obligations are payable from revenue generated through lease agreements between the South Dakota Building Authority and other state departments and institutions. The South Dakota Building Authority is a blended component unit of the State. At June 30, 2002, the South Dakota Building Authority had a rating of Aaa from Moody's and AAA from Standard and Poor's. The indebtedness, bonds, or obligations incurred or created by the South Dakota Building Authority may not be or become a lien, charge, or liability against the State. The bonds and all related financial transactions used to finance buildings of state departments and institutions are reported as part of governmental activities in the State's basic financial statements, except for debt of universities, which is reported as part of the discretely presented component unit information.

The South Dakota Conservancy District issues tax exempt revenue bonds for the Clean Water State Revolving Fund (CWSRF) and for the Drinking Water State Revolving Fund (DWSRF). These funds provide low interest loans, or other types of financial assistance to political units for the construction of publicly-owned wastewater treatment facilities, implementation of nonpoint source management programs, development and implementation of plans under the new Estuary Protection Program, and construction and maintenance of drinking water facilities, respectively. At June 30, 2002, the South Dakota Conservancy District had a rating of Aaa from Moody's. The South Dakota Conservancy District bonds do not constitute a debt or liability of the State, or a pledge of the faith and credit of the State. The bonds are paid solely from the interest earned on the loan repayments and bond proceeds and, if necessary, a legislative appropriation of \$1.2 million for the CWSRF only. The tax exempt revenue bonds and related financial transactions for the CWSRF and DWSRF are reported as part of the business-type activities in the State's basic financial statements.

At the end of the current fiscal year, primary government had total note and bonded debt outstanding of \$169.9 million. During the current fiscal year, the State incurred no new long-term general indebtedness under governmental and business-type activities. Additionally, there were no new revenue bonds or trust certificates issued under the governmental fund type for the South Dakota Building Authority for fiscal year 2002. However, the South Dakota Building Authority issued \$5.0 million of revenue bonds in fiscal year 2002 for Higher Education that is reported as a discretely presented component unit.

During the current fiscal year, the South Dakota Conservancy District issued \$4.4 million and \$5.3 million tax exempt revenue bonds to be used to provide the funds needed for the State match required under the Federal Water Pollution Control Act and the Safe Drinking Water Act, respectively. This match is required to obtain certain federal Capitalization Grants, to provide funds for capitalized interest, and to fund certain reserves.

**State of South Dakota
Outstanding Loans and Bonded Debt
June 30, 2002
(Expressed in Thousands)**

	<u>Governmental Activities</u>	<u>Business-Type Activities</u>	<u>Total Primary Government</u>
General Indebtedness:			
Backed by State	\$ 44	\$	\$ 44
Revenue Bonds:			
Backed by South Dakota Building Authority	96,306		96,306
Backed by South Dakota Conservancy District		31,359	31,359
Trust Certificates:			
Backed by South Dakota Building Authority	42,210		42,210
TOTAL	<u>\$ 138,560</u>	<u>\$ 31,359</u>	<u>\$ 169,919</u>

Additional information on the State's long-term debt obligations is located in Note 12 in the Notes to the Financial Statements.

ECONOMIC CONDITION AND OUTLOOK

After averaging 2.5% growth annually from calendar years 1991 to 2001, South Dakota's nonfarm employment growth dropped 0.2% in 2002. Nationally, nonfarm employment growth in the United States fell 0.9% in 2002. The unemployment rate in South Dakota in 2002 was 3.0%, down from the 2001 rate of 3.3%. Nationally, the unemployment rate was 5.8% in 2002, up from the 2001 level of 4.8%.

Amendment C was passed by the voters in South Dakota on November 7, 2000, which repealed the inheritance tax in South Dakota. The full impact of the loss of the inheritance tax to the General Fund has not yet been realized as the State continues to collect receipts from the period in which the tax was in effect. However, collections will decrease significantly when all estates that were subject to the tax are finalized. By FY2004, collections will amount to only the State's share of the federal estate tax owed.

On December 9, 2002, the State received an inheritance tax remittance of \$21.4 million. In accordance with State law, ten percent of the remittance was distributed to the county of the estate, and the balance was deposited into the State General Fund.

Actions taken in the 2003 legislative session that affect ongoing receipts are:

- Increase in the cigarette tax from \$0.33 per pack to \$0.53 per pack. The tax increase is projected to provide additional revenue of \$2.0 million in FY 2003 and \$9.0 million in FY 2004;
- Broadening of the sales tax to include interstate telephone services. This tax is projected to increase revenue by \$0.2 million in FY 2003 and \$2.0 million in FY 2004;
- Increase in certain fees charged by the Secretary of State. This tax is estimated to increase revenue \$0.7 million in FY 2004; and,
- HB1104 imposed a tax of 4.0% upon the gross receipts of telecommunications services, beginning in FY 2004. Sixty percent of the revenue collected from this tax is to be deposited into the Property Tax Reduction Fund. This tax is estimated to increase revenue \$3.3 million in FY 2004.

Action taken in the 2003 legislative session that affects one-time receipts in FY 2004 is the transfer of \$15.0 million to the General Fund representing funds that were transferred to the transportation fund as authorized during the 2002 legislative session.

During the 2001 legislative session, the legislature authorized the South Dakota Building Authority to provide for the establishment of a corporation for the purpose of selling a portion or all of the State's rights, title, and interest in the proceeds of the tobacco companies' master settlement agreement. During fiscal year 2003, the Education Enhancement Funding Corporation was created. During fiscal year 2003, the corporation issued bonds, and the State gave up these rights in exchange for a lump sum payment, of which \$243.6 million was deposited into the Education Enhancement Trust Fund. These rights are terminated, while the bonds are outstanding. Further information regarding the Education Enhancement Funding Corporation can be found in Note 17 in the Notes to the Financial Statements.

REQUESTS FOR INFORMATION

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have any questions about this report, or need additional financial information, please contact the Bureau of Finance and Management, 500 East Capitol Avenue, Pierre, South Dakota 57501, (605) 773-3411.

The State's discretely presented component units, with the exception of Higher Education, issue their own separately audited financial statements. These statements may be obtained by directly contacting the Department of Legislative Audit, at 427 South Chapelle, c/o 500 East Capitol, Pierre, South Dakota 57501, (605) 773-3595.