

TO THE HONORABLE M. MICHAEL ROUNDS, GOVERNOR OF SOUTH DAKOTA
AND
MEMBERS OF THE SOUTH DAKOTA LEGISLATURE

It is my privilege to present the Comprehensive Annual Financial Report (CAFR) on the operation of the state of South Dakota for the fiscal year ended June 30, 2002. This report is prepared by the Bureau of Finance and Management and submitted as required by South Dakota Codified Law as revised in SDCL § 4-4-6.

The Bureau of Finance and Management assumes full responsibility for the accuracy, fairness, and completeness of this document. We believe the information, as presented, is accurate in all material aspects and that all disclosures necessary to enable the reader to gain an adequate understanding of the state of South Dakota's financial affairs have been included.

The financial statements contained in the CAFR are prepared in conformity with generally accepted accounting principles (GAAP) applicable to government as prescribed by the Governmental Accounting Standards Board (GASB), and are audited by the South Dakota Department of Legislative Audit. Effective this year, those principles without a doubt mandated the most significant changes in the history of accounting and financial reporting for state and local governments, and have been reflected in the content and format of these statements for the fiscal year ended June 30, 2002, including a section titled Management's Discussion and Analysis (MD&A). GAAP require that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of MD&A. This letter of transmittal is designed to complement MD&A and should be read in conjunction with it. The state's MD&A can be found immediately following the Independent Auditor's Report.

REPORT PRESENTATION

The Comprehensive Annual Financial Report is presented in three sections: *Introductory*, *Financial*, and *Statistical*. The *Introductory Section* includes a brief description of the state's reporting entity, audit, the Risk Management Program, the Cash Management Program, the South Dakota Lottery Fund, a short economic review of the past year, and an economic outlook summary for South Dakota. Also included are a listing of principal state officials, a listing of state government functions, and a state organizational chart. The *Financial Section* includes the Independent Auditor's Report on the Basic Financial Statements; MD&A that provides an introduction, overview, and analysis to the "Basic Financial Statements"; the Basic Financial Statements that present the government-wide financial statements, fund and combining component units financial statements for governmental funds, proprietary funds, fiduciary funds, and component units, together with notes to the Basic Financial Statements; Required Supplementary Information that includes budgetary comparison schedules; and, Other Supplemental Information that includes combining financial statements and schedules for individual funds. The *Statistical Section* presents various economic, statistical, and demographic data including labor force, education, census information, banking, taxes, farming, etc.

STATE REPORTING ENTITY

The state of South Dakota's reporting entity reflected in the CAFR, which is described more fully in Note 1 of the Notes to the Financial Statements, conforms to the requirements of GASB Statement No. 14, *The Financial Reporting Entity*. The accounting and reporting principles contained in Statement No. 14 are based primarily on the fundamental concept that publicly elected officials are accountable to their constituents. Further, Statement No. 14 provides that the financial statements should emphasize the primary government and permit financial statement users to distinguish between the primary government and its component units. Consequently, the transmittal letter, MD&A, and the basic financial statements focus on the primary government and its activities. Although information pertaining to the discretely presented component units is provided, their separately issued financial statements, excluding Higher Education, should be read to obtain a complete overview of their financial position.

AUDIT

The South Dakota Department of Legislative Audit, a division of the legislative branch of state government, performs the audit of *South Dakota's Comprehensive Annual Financial Report*. The audit is conducted in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards (GAS) issued by the Comptroller General of the United States. The Independent Auditor's Report issued by the Department of Legislative Audit includes an expression of opinion on the financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units; each major fund and the aggregate remaining fund information as of June 30, 2002 and the respective changes in financial position and cash flows, where applicable, for the fiscal year then ended.

In conjunction with the audit of the state's financial statements, the Department of Legislative Audit also performs audits of major federal and state programs and issues an opinion on the state's compliance with the requirements of major federal programs. The results of the audit of federal and state programs are presented in the South Dakota Single Audit Report.

Internal control procedures are evaluated on an annual basis by the Department of Legislative Audit to provide reasonable assurance for the safeguarding of the state's assets, and to provide reasonable assurance of proper recording of financial transactions used to prepare this report.

RISK MANAGEMENT

The Risk Management Program was created to protect the assets and resources of the state through efficient control and financing of risks inherent in government operations by ensuring a safe environment for state employees and the general public. Responsibilities include ensuring that exposures to financial loss are discovered and handled appropriately, minimizing the possible interruption of vital public services, and reducing the costs and consequences of accidents through effective loss control management.

Housed with the Risk Management Program is the Public Entity Pool for Liability (PEPL), a self-insurance program created to cover risks associated with automobile liability, and general tort liability (including public officials, errors, and omissions liability; medical malpractice liability; law enforcement liability; and, products liability).

CASH MANAGEMENT

The South Dakota Investment Council manages the state's pooled fund cash on a daily basis. The South Dakota Investment Council was established by the state legislature in 1971 and became operational on July 1, 1972. The council consists of eight voting members: five of the members are chosen by the Executive Board of the Legislative Research Council--a bipartisan board of members of both houses of

the legislature--and the other three members consist of the State Treasurer, the Commissioner of School and Public Lands, and a designee of the South Dakota Retirement Board of Trustees.

The Investment Council is responsible for the investment management for the portfolios of the South Dakota Cash Flow, the South Dakota Retirement System, Cement Plant Retirement Fund, School and Public Lands Fund, Dakota Cement Trust Fund, Education Enhancement Trust Fund, and Health Care Trust Fund.

Investment Council management of the South Dakota Cash Flow portfolio resulted in earnings this year of \$40.5 million, a yield of 5.5%. This fund serves as the state's checking account and has earned taxpayers \$703.3 million over the past 30 years. Total investment income for all funds invested by the Investment Council was (\$168.9) million for fiscal year 2002. Income for the most recent five years totaled \$1.7 billion and, since inception, has exceeded \$5.4 billion.

Performance for the past 29 years (since inception of management responsibilities for SDRS) has placed the council in the top first percentile against state funds for total retirement assets. For the past 29 years, domestic equities have returned 13.8%, outperforming the stock index by 1.9% annualized. For the past 29 years, fixed income has returned 9.6%, outperforming the bond index by 0.6%. The Investment Council has grown from \$133.0 million in assets at the end of its first year to \$5.831 billion at June 30, 2002.

LOTTERY

The South Dakota Lottery Fund was created during the 1987 legislative session to market instant scratch games. Video lottery was authorized during the 1989 legislative session and operations commenced in October 1989. Legislative approval to participate in a multi-state lotto game was given during the 1990 legislative session. That same year, South Dakota joined the Multi-State Lottery Association (MUSL), a consortium of 21 lottery jurisdictions that currently offer the Powerball game. South Dakota's own lotto game, Dakota Cash, began in FY1993. In FY1994, South Dakota entered into a multi-state agreement with the states of Montana and Idaho to offer the Tri-West Lotto game that began early in February 1994. On September 16, 1996, the South Dakota Lottery began selling MUSL's Daily Millions game. On February 1, 1998, Nebraska joined the Tri-West Lotto group and the group replaced the Tri-West Lotto game with a new game called Wild Card. On March 31, 1998, Daily Millions was replaced with a new MUSL daily game called Cash 4 Life. The Cash 4 Life group was made up of nine states. On May 23, 1999, Nebraska dropped out of Wild Card, leaving South Dakota, Idaho, and Montana to participate in a revised version of Wild Card called Wild Card 2. On September 10, 2000, Cash 4 Life was replaced by a new MUSL game called Rolldown. The Rolldown group was made up of ten states. On April 7, 2002, Rolldown was replaced by a new MUSL game called Hot Lotto. The Hot Lotto group is currently made up of six states. The purpose of the lottery is to provide additional monies to fund vital public programs and projects, and as of June 30, 2002, \$973.8 million has been generated to fund many public programs and projects. Lottery revenues provided during FY2002 totaled \$109.3 million.

ECONOMIC REVIEW FOR FISCAL YEAR 2002

South Dakota's economy, after enjoying strong economic growth for many years, experienced below normal growth in FY2002. A prime indication of the strength of South Dakota's economy during FY2002 was the growth in South Dakota's labor force. During FY2002, the South Dakota labor force grew 0.04%, as compared to the historical growth rate of 1.6%. The strongest sectors of the South Dakota labor force were finance, insurance, and real estate; government; trade; and construction, which grew 4.1%, 2.8%, 1.2%, and 1.2%, respectively. The sectors that experienced the greatest decline in jobs were the manufacturing and mining sectors that fell 8.2% and 15.6%, respectively. The unemployment rate decreased from 3.3% at the beginning of FY2002 to 2.9% by the end of the fiscal year.

During FY2002, nonfarm employment grew by 167 jobs, an increase of 0.04%. Nationally, nonfarm employment fell 0.8% during the same time period. Building permits issued in South Dakota for FY2002 were up 14.6%, and the value of building permits issued increased 18.2%. Finally, total personal income in South Dakota grew 3.8%, compared to the national growth rate of 2.1%. South Dakota's nonfarm income grew 4.2%.

ECONOMIC OUTLOOK

After slowing in FY2001, South Dakota's economy continued to remain soft throughout FY2002. However, it is expected to grow out of the current slowdown by the end of FY2003. Contributing to the slow economic growth has been the struggling manufacturing sector and the national recession. Although employment growth is stagnant, wages have continued to remain competitive, consumers have continued to spend, and the housing market has remained strong. A restored consumer confidence, coupled with a recovery in the manufacturing sector and growth in jobs to meet the demand, will allow the South Dakota economy to once again experience growth toward the latter half of CY2003.

ACKNOWLEDGMENTS

The preparation of this report required the collective efforts of numerous financial personnel throughout the state from various agencies and departments. I sincerely appreciate the dedicated efforts of all of these individuals. I would also like to recognize and commend the efforts of the accounting staff of the Bureau of Finance and Management and the staff of the Department of Legislative Audit for their talents in making this report possible.

This year, several new GASB standards were implemented, including Statement No. 34 requirements. For more than a decade and a half, GASB has been working on a project designed to change the framework of financial reporting (i.e., "financial reporting model") for state and local governments. In June 1999, the GASB marked the completion of this project, with the issuance of GASB Statement No. 34, Basic Financial Statements – and Managements' Discussion and Analysis – for State and Local Governments. According to a Government Financial Officers Association (GFOA) Technical Bulletin, GASB Statement No. 34 represents the most important single change in the history of accounting and financial reporting for state and local governments.

I would like to thank everyone whose time and dedication have made this report possible. I reaffirm our commitment to maintain the highest standards of accountability and financial reporting.

Sincerely,

Jason C. Dilges, Commissioner
Bureau of Finance and Management