

# FINANCIAL SECTION

## COMPREHENSIVE ANNUAL FINANCIAL REPORT

Tunnel Falls, Clifty Falls State Park near Madison, Indiana



Reproduced with the permission of the photographer, John Maxwell, Indiana Department of Natural Resources





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**INDEPENDENT AUDITOR'S REPORT**

TO: The Honorable Mitchell E. Daniels, Jr.  
The Members of the General Assembly, and  
The Citizens of the State of Indiana

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Indiana, as of and for the year ended June 30, 2006, which collectively comprise the State's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the State of Indiana's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of certain component units of the State, as discussed in Note I(A), which represent 27.5% and 8.8% of the assets and revenues of the colleges and universities discretely presented component units and 100% of the assets and revenues of the proprietary discretely presented component units. The financial statements of these component units were audited by other auditors whose reports thereon have been furnished to us and, our opinions, insofar as they relate to those units, are based upon the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, 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 of the State of Indiana as of June 30, 2006, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note IV(G) to the financial statements, the State of Indiana has restated certain beginning fund balances and net assets. The Housing and Community Development Authority and Indiana Comprehensive Health Insurance Association, discretely presented component units, report on a December 31, 2005, year-end.

The Management Discussion and Analysis, Schedule of Funding Progress for Employee Retirement Systems and Plans, and budgetary comparison information, as listed in the table of contents, are not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consist principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State of Indiana's basic financial statements. The introductory section, combining and individual nonmajor and discretely presented component unit fund information, and statistical section are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining and individual nonmajor and discretely presented component unit financial statements have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects, in relation to the basic financial statements taken as a whole. The introductory section and statistical section have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

December 27, 2006

STATE BOARD OF ACCOUNTS  
*State Board of Accounts*

# MANAGEMENT'S DISCUSSION AND ANALYSIS



**STATE OF INDIANA**  
**Management's Discussion and Analysis**  
**June 30, 2006**

The following discussion and analysis of the State of Indiana's financial performance provides an overview of the State's financial activities for the fiscal year ended June 30, 2006. Please read it in conjunction with the transmittal letter at the front of this report and the State's financial statements, which follow this section. Because of prior period adjustments and reclassifications as described in Note IV(G) in the Notes to the Financial Statements, fiscal year (FY) 2005 numbers have been restated.

### **Financial Highlights**

- For FY 2006, on a government-wide basis, the assets of the State of Indiana exceeded its liabilities by \$16.4 billion. This compares with \$12.4 billion for FY 2005, as restated. Of this amount, \$6.1 billion may be used to meet the government's ongoing obligations to citizens and creditors.
- At the end of the current fiscal year, unreserved fund balance for the general fund was \$1.4 billion, or 17.4% of the total general fund expenditures.
- On a government-wide basis for the primary government, the State incurred expenses net of program revenue of \$13.4 billion, which are partially offset by general revenues and a special item totaling \$17.4 billion, giving an increase in net assets of \$4.0 billion. The financial position of the State has improved as can be seen in this increase in net assets.
- Indiana's economy is improving. Although the overall unemployment rate for Indiana increased from 5.3% to 5.4% in CY 2005, the total employed labor force increased from 3,004,188 to 3,035,204 in CY 2005. The national economy is also improving. For CY 2005 Gross Domestic Product (GDP) grew at a rate of 3.2%. Growth by quarter for the first three quarters of CY 2006 was at rates of 5.6%, 2.6%, 2.2%. Growth in the National Economy has a marked effect on Indiana. Gross Domestic State Product for Indiana was at \$238.6 billion in CY 2005 as compared to \$229.5 billion in CY 2004. As can be seen in this CAFR, economic growth has resulted in increased income tax and sales tax collections for the State.
- The Indiana Economic Development Corporation (IEDC) is the State of Indiana's economic development agency. It was created in February 2005 to replace the Commerce Department. The IEDC is a public/private partnership charged with leading Indiana's economic development efforts. It has incorporated all State entities with economic development responsibilities into its organizational structure. In 2005, IEDC closed 142 competitive deals, which included commitments for 15,407 new jobs and \$2.7 billion in private capital investment. The 2006 data shows competitive commitments for 15,722 new jobs, \$3.9 billion in private capital investment and an average wage per hour of \$20.77 for new jobs commitments. This is significantly higher than Indiana's average wage of \$16.70 per hour. As of August 2006, IEDC has closed 124 deals involving competitive projects in CY 2006.
- State government cut its full-time workforce during CY 2006. As can be seen by the employee count chart on the next page, full time headcount decreased from 36,708 in December of 2005 to 35,937 in December of 2006. This was a 2.1% decrease, most of it in employees under the governor's authority. Employees other than full time decreased from 4,869 in December of 2005 to 3,904 in December of 2006. This was a 19.8% decrease. Most of this decrease in employees other than full time was in the National Guard and the Department of Natural Resources. (see pages 180-183).
- General revenue for the primary government increased by \$982.8 million, or 7.7%, from FY 2005. Income taxes and sales taxes were the driving force behind this increase, with growth rates of 6.0% and 7.8%, respectively. These grew in line with the economic growth progress of the State.
- The State of Indiana's credit outlook was upgraded from Aa1 negative to Aa1 stable by Moody's Investor Service in August, 2006 (on a scale where Aaa is the best). The State's credit outlook was also upgraded from AA to AA+ in January, 2006 by Standard & Poor's Ratings Service (on a scale where AAA is the best). According to Moody's, the positive change in the State's credit outlook was caused by the "State's diversifying economy and employment level, a balanced budget, and repayments to K-12 schools and local governments."

### Key Economic Indicators

	<u>Dec 31, 2005</u>	<u>Dec 31, 2004</u>	<u>% Change</u>
Total Employed Labor Force	3,035,204	3,004,188	1.03%
Total Goods and Service Employment	2,999,900	2,967,900	1.08%
Service-Providing Employment	2,273,600	2,241,300	1.44%
Goods-Producing Employment	726,300	726,600	-0.04%
Unemployment Rate	5.4%	5.3%	0.10%
Median Household Income	\$ 43,993	\$ 42,195	4.26%

Sources: Bureau of Labor Statistics and US Census Bureau

Salaries and benefits for State employees represent approximately 9-10% of governmental fund expenditures. The following table shows a ten year history of the count of full time State employees.

### Full Time State Employees Paid Through The Auditor of State's Office

	<u>Governor's Authority</u>	<u>Judiciary</u>	<u>Other Elected Officials</u>	<u>On Disability Leave</u>	<u>Total</u>
1997	35,911	776	994	1,098	38,779
1998	35,284	790	1,012	1,097	38,183
1999	35,602	816	1,016	1,159	38,593
2000	36,284	836	1,014	1,235	39,369
2001	36,134	862	1,018	1,263	39,277
2002	35,907	869	1,021	1,315	39,112
2003	35,753	899	1,039	1,217	38,908
2004	36,276	899	1,039	1,288	39,502
2005	33,417	896	1,095	1,300	36,708
2006	32,759	903	1,136	1,139	35,937

For more information on people paid through the Auditor of State's Office, please see pages 176-184 in the Statistical Section.

## Overview of the Financial Statements

This Financial Section consists of four parts: management's discussion and analysis (this part), the basic financial statements, required supplementary information, and other supplementary information. The basic financial statements include two kinds of statements that present different views of the State. The first two statements are government-wide financial statements that provide both long-term and short-term information about the State's overall financial status.

The remaining statements are fund financial statements that focus on individual parts of the State government,

reporting the State's operations in more detail than the government-wide statements.

- The governmental fund statements tell how general government services such as public safety, education, and welfare were financed in the short term as well as what remains for future spending.
- Proprietary fund statements offer short and long-term financial information about the activities the government operates like businesses, such as the Unemployment Compensation Fund.
- Fiduciary fund statements provide information about the financial relationships in which the State acts solely as a trustee or agent for the benefit of

others, to whom the resources in question belong, such as the retirement plan for the State's employees.

The financial statements also include notes that explain some of the information in the financial statements and provide more detailed data. The statements are followed by a section of *required supplementary information* and *other supplementary information* that further explain and support the information in the financial statements.

## Government-wide Financial Statements

The government-wide financial statements report information about the State as a whole using accounting methods similar to those used by private-sector companies. The statement of net assets includes all the government's assets and liabilities. All of the current year's revenues and expenses are accounted for in the statement of activities regardless of when cash is received or paid.

The two government-wide statements report the State's net assets and how they have changed. Net assets, the difference between the State's assets and liabilities, is one way to measure the State's financial health, or position. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the State of Indiana is improving or deteriorating. To assess the overall health of the State, additional non-financial factors should be considered, such as changes in the State's tax base, the condition of the State's roads and the State's student population. The government-wide financial statements of the State are divided into three categories:

- **Governmental activities.** Most of the State's basic services are included here, such as the State's roads and bridges, and health and environmental programs. State sales and income taxes and federal grants finance most of these activities.
- **Business-type activities.** The State provides goods and services through these activities that are financed or recovered primarily through fees and user charges. The Unemployment Compensation Fund, the Inns and Concessions Fund, and the Indiana Residual Malpractice Insurance Authority are included here.
- **Discretely Presented Component Units.** These are legally separate discretely presented entities for which the State is financially accountable. These include, among others, the Indiana Finance Authority, the Indiana Bond Bank, the Board for Depositories, the Indiana Housing and Community Development Authority, and colleges and universities that receive State funding.

## Fund Financial Statements

The fund financial statements provide more detailed information about the State's most significant funds, not the State as a whole. Funds are accounting devices that the State uses to keep track of specific sources of funding and spending for particular purposes. The State of Indiana uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

The State has three kinds of funds: governmental funds, proprietary funds, and fiduciary funds.

1. **Governmental funds.** Most of the State's basic services are included in governmental funds, which focus on (1) cash and other financial assets that can readily be converted to cash flow in and out and (2) the balances left at year-end that are available for spending. Consequently, the governmental funds statements provide a detailed short-term view that helps the reader determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs.

*Relationship and Reconciliation.* Because the information provided in the governmental funds statements does not encompass the additional long-term focus of the government-wide statements, reconciliation pages are provided. On the page following each governmental fund's financial statement, these reconciliations explain the differences between the government-wide and the fund financial statement. Government-wide statements use full accrual accounting. Revenues are recognized when they are earned and expenses are recognized as soon as the liability is incurred, regardless of the timing of related cash inflows and outflows. Governmental fund financial statements use the modified accrual basis of accounting. Revenues are recognized when earned so long as they are collectible within the current period or soon enough afterwards to pay liabilities of the current period. Debt service payments and a number of specific accrued liabilities are recognized as expenditures when payment is due because that is when they are normally liquidated with expendable available financial resources.

Non-current assets such as infrastructure, land, and property, plant and equipment appear on the government-wide statements but not on the governmental fund statements where they are expensed as acquired rather than capitalized. Non-current liabilities such as revenue bonds payable and net pension obligations also appear on the



government-wide statements but not on the fund statements. Internal service funds are included as part of the governmental activities in the government-wide statements but not the governmental fund financial statements because they provide services to the governmental funds.

**2. Proprietary funds.** Services for which the State charges customers a fee are generally reported in proprietary funds. These funds use the economic resources measurement focus and the accrual basis of accounting. Proprietary funds, like the government-wide statements, provide both long-term and short-term financial information. In fact, the State's enterprise funds (one type of proprietary fund) are the same as its business-type activities, but provide more detail and additional information such as cash flows. The State uses internal service funds (the other type of proprietary fund) to report activities that provide supplies and services for the

State's other programs and activities. An example would be the State Employee Health Insurance Fund.

**3. Fiduciary funds.** The State is the trustee, or fiduciary, for its employees' pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State is responsible for ensuring that the assets reported in these funds are used for their intended purposes. Fiduciary funds use the economic resources measurement focus and the accrual basis of accounting. All of the State's fiduciary activities are reported in a separate statement of fiduciary net assets and a statement of changes in fiduciary net assets. These activities are excluded from the State's government-wide financial statements because the State cannot use these assets to finance its operations.

## Financial Analysis of the State As a Whole

### Net Assets

The following is condensed from the Statement of Net Assets:

State of Indiana Condensed Schedule of Net Assets (in millions of dollars)						
	Primary Government					
	Governmental Activities		Business-type Activities		Total Primary Government	
	2006	2005	2006	2005	2006	2005
Current and other assets	\$ 13,093.1	\$ 7,235.1	\$ 511.7	\$ 502.6	\$ 13,604.8	\$ 7,737.7
Capital assets	10,060.4	9,968.3	11.2	11.9	10,071.6	9,980.2
<b>Total assets</b>	<u>23,153.5</u>	<u>17,203.4</u>	<u>522.9</u>	<u>514.5</u>	<u>23,676.4</u>	<u>17,717.9</u>
Current liabilities	5,663.8	3,813.4	19.9	15.6	5,683.7	\$ 3,829.0
Long-term liabilities	1,562.2	1,457.7	44.2	38.6	1,606.4	1,496.3
<b>Total liabilities</b>	<u>7,226.0</u>	<u>5,271.1</u>	<u>64.1</u>	<u>54.2</u>	<u>7,290.1</u>	<u>5,325.3</u>
Net assets:						
Invested in capital assets, net of related debt	8,764.1	8,708.8	11.2	11.9	8,775.3	\$ 8,720.7
Restricted	1,041.0	534.6	448.9	452.7	1,489.9	987.3
Unrestricted	6,122.4	2,688.9	(1.3)	(4.3)	6,121.1	2,684.6
<b>Total net assets</b>	<u>\$ 15,927.5</u>	<u>\$ 11,932.3</u>	<u>\$ 458.8</u>	<u>\$ 460.3</u>	<u>\$ 16,386.3</u>	<u>\$ 12,392.6</u>

At the end of the current fiscal year, net assets for governmental activities were \$15.9 billion as compared to \$11.9 billion in 2005. This increase of \$4.0 billion can be broken down into two parts, an increase of total assets of \$6.0 billion, offset by an increase of total liabilities of \$2.0 billion.

Total asset increases were as follows: Due from component units increased by \$3.6 billion due to the lease of the Indiana Toll Road, which was paid to the State in July, 2006, but accrued as a due from the Indiana Finance Authority as of June 30, 2006. Another \$1.4 billion was securities lending collateral. This \$1.4 billion increase was due to two factors. Short term interest rates increased by 2% from FY 2005 to 2006 and the average portfolio size increased by \$0.5 billion. For more information on securities lending, please see Note I(D-1) in the Notes to the Financial Statements. Another \$1.0 billion increase was cash, investments

and receivables. This was due to the improved financial position of the State.

Total liability increases were as follows: Liability for securities lending increased by \$1.4 billion, an offset to the securities lending asset increase. Intergovernmental payable increase by \$0.5 billion, while another \$0.1 billion was caused by an increase in accounts payable.

The State maintains a Counter-Cyclical Revenue and Economic Stabilization Fund ("Rainy Day Fund"). This fund was established to assist in stabilizing revenue of the State's General Fund during periods of economic recession. In other words, in good times the balance in the fund should increase, and in bad times, the money can be used to offset deficits. The fund had available assets of \$328.1 million or 5.4% of the total governmental activities unrestricted net assets.

## Changes in Net Assets

The following is condensed from the Statement of Activities:

State of Indiana Condensed Schedule of Change in Net Assets (in millions of dollars)						
	Primary Government					
	Governmental Activities		Business-type Activities		Total Primary Government	
	2006	2005	2006	2005	2006	2005
<b>Revenues</b>						
Program revenues:						
Charges for services	\$ 1,286.6	\$ 1,303.5	\$ 695.9	\$ 630.7	\$ 1,982.5	\$ 1,934.2
Operating grants and contributions	7,653.3	7,388.9	-	-	7,653.3	7,388.9
Capital grants and contributions	11.8	15.6	-	-	11.8	15.6
General revenues						
Individual and corporate income taxes	5,396.9	5,090.3	-	-	5,396.9	5,090.3
Sales taxes	5,352.1	4,963.3	-	-	5,352.1	4,963.3
Other	3,016.0	2,722.4	26.7	32.9	3,042.7	2,755.3
<b>Total revenues</b>	<u>22,716.7</u>	<u>21,484.0</u>	<u>722.6</u>	<u>663.6</u>	<u>23,439.3</u>	<u>22,147.6</u>
<b>Program Expenses</b>						
General government	4,317.5	4,028.3	-	-	4,317.5	4,028.3
Public safety	1,181.1	1,207.6	-	-	1,181.1	1,207.6
Health	333.7	426.5	-	-	333.7	426.5
Welfare	7,261.7	7,297.9	-	-	7,261.7	7,297.9
Conservation, culture and development	546.5	508.0	-	-	546.5	508.0
Education	6,971.2	6,598.6	-	-	6,971.2	6,598.6
Transportation	1,726.7	1,658.5	-	-	1,726.7	1,658.5
Interest expense	0.8	0.8	-	-	0.8	0.8
Unemployment compensation fund	-	-	692.9	713.1	692.9	713.1
Other	-	(0.3)	32.0	31.8	32.0	31.5
<b>Total expenses</b>	<u>22,339.2</u>	<u>21,725.9</u>	<u>724.9</u>	<u>744.9</u>	<u>23,064.1</u>	<u>22,470.8</u>
Excess (deficiency) before transfers and special item	377.5	(241.9)	(2.3)	(81.3)	375.2	(323.2)
Special item						
Proceeds from lease of Toll Road	3,618.5	-	-	-	3,618.5	-
Transfers	(0.8)	(1.0)	0.8	1.0	-	-
<b>Change in net assets</b>	<u>3,995.2</u>	<u>(242.9)</u>	<u>(1.5)</u>	<u>(80.3)</u>	<u>3,993.7</u>	<u>(323.2)</u>
Beginning net assets, as restated	11,932.3	12,175.2	460.3	540.6	12,392.6	12,715.8
Ending net assets	<u>\$ 15,927.5</u>	<u>\$ 11,932.3</u>	<u>\$ 458.8</u>	<u>\$ 460.3</u>	<u>\$ 16,386.3</u>	<u>\$ 12,392.6</u>

## Governmental Activities

Program expenses exceeded program revenues by \$13.4 billion. General revenues, transfers and special item were \$17.4 billion, leaving an increase in net assets of \$4.0 billion, which is 17.6% of total revenues. Last year, the State had a decrease in net assets of \$242.9 million, which was 1.1% of total revenues.

In May 2005, the Indiana Finance Authority (IFA) was formed, composed of five formerly independent bodies. The entities combined included the Indiana Development Finance Authority (IDFA), the State Office Building Commission (SOBC), the Indiana Transportation Finance Authority (ITFA), the Recreational Development Commission (RDC) and the State Revolving Fund (SRF). The purpose of this merger was to combine responsibility for State borrowing under one entity.

\$3.6 billion of the \$4.2 billion increase in the change in net asset from FY 2005 to FY 2006 was brought about by the IFA's lease of the Indiana Toll Road to Cintra Mcquarie, an independent company. Cintra Mcquarie made an up front lease payment of \$3.8 billion to the IFA on June 29, 2006, of which \$3.1 billion was paid to the primary government to fund the Major Moves Construction Fund and \$0.5 billion was paid to fund the Next Generation Trust Fund. The other \$0.6 billion increase was brought about by an increase of total revenues of \$1.2 billion offset by an increase in total expenses of \$0.6 billion.

Total revenues increased by \$1.2 billion from FY 2005 to FY 2006. This is due to increases in sales taxes of \$388.8 million, an increase in individual and corporate income taxes of \$306.6 million, an increase in other

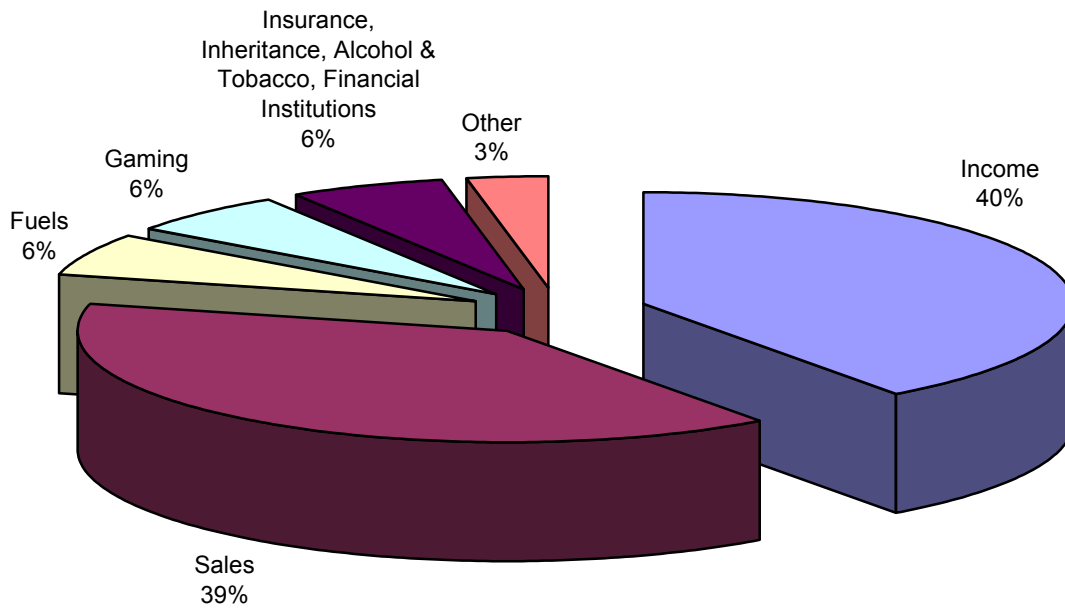
taxes of \$293.6 million, and an increase in operating grants and contributions of \$264.4 million. These taxes are both based on income and spending in the Indiana economy. The Indiana economy has improved, as described on page 6, causing these increases.

less than the growth in revenues. The increase in expenses was caused by increases in education and general government spending of \$372.6 million and \$289.2 million, respectively. These were offset by a decrease in spending for health of \$92.8 million.

Total expenses increased by \$613.3 million, which was

Tax revenues for governmental activities were broken down as follows:

### Tax Revenues - Governmental Activities

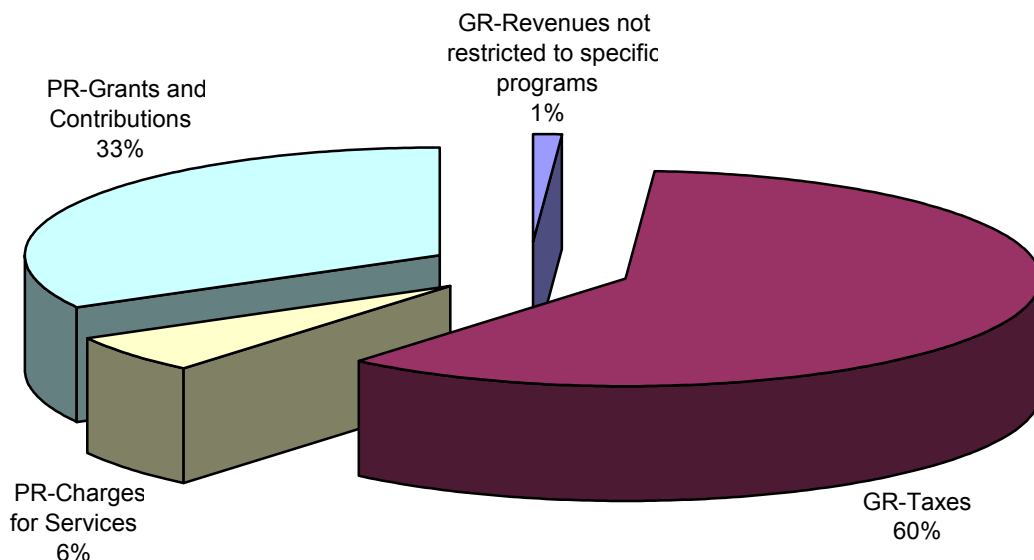


Tax revenues of \$13.6 billion represent 59.7% of total revenues for governmental activities. This compares to \$12.7 billion in FY 2005 or 59.0% of total revenues in FY 2005. Program revenues accounted for \$9.0 billion or 39.4% of total revenues. In FY 2005, program revenues accounted for \$8.7 billion or 40.5% of total revenues. General revenues other than tax revenues were \$209.7 million or 0.9% of total revenues. Of this \$153.8 million was investment earnings. This

compares to 2005, when general revenues other than taxes were \$109.6 million or 0.5% of total revenues. Of this \$109.6 million, \$73.8 million was investment earnings. Investment earnings increased by \$80.0 million from FY 2005 to FY 2006 or 108.4% due to rising interest rates. There was also a special revenue item \$3.6 billion, which was proceeds from the Indiana Toll Road leases.

Total revenues for governmental activities were broken down as follows:

## Revenues to Support Governmental Activities



PR = program revenues  
GR = general revenues

Total revenues were 101.7% of expenses, as compared to 98.9% in FY 2005, which explains most of the increase in net assets from FY 2005 to FY 2006. Total revenues grew 5.7% from \$21.5 billion in FY 2005 to \$22.7 billion in FY 2006. Expenses grew 2.8% from \$21.7 billion in FY 2005 to \$22.3 billion in FY 2006.

The largest portion of the State's expenses is Health and Welfare, which is \$7.6 billion, or 34.0% of total expenses. This compares with \$7.7 billion, or 35.6% of total expenses in FY 2005. 69.6% is funded through operating grants, with the majority of the remainder funded from general revenues. Some of the major expenses were Medicaid assistance, \$4.8 billion, child care and development, \$131.9 million, temporary aid to needy families assistance (TANF), \$113.2 million, and Medicaid administration, \$96.5 million.

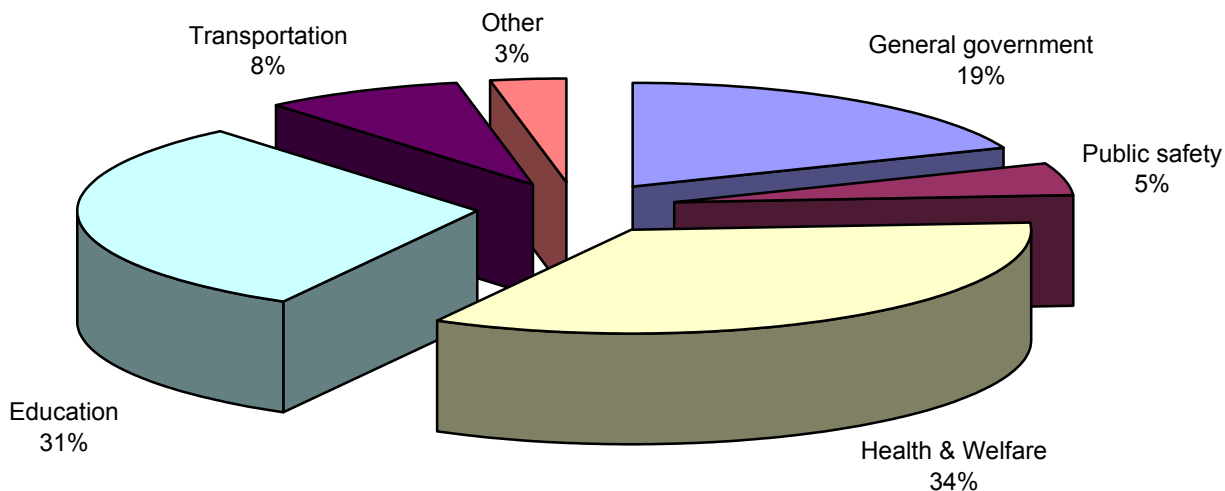
Education comprises 31.2%, or \$7.0 billion, of the State's expenses. In FY 2005, Education accounted for

30.4%, or \$6.6 billion, of expenses. All but \$869.8 million of this is funded from general revenues. Some of the major expenses were tuition support, \$3.9 billion, State colleges and universities, \$1.3 billion, Teachers' Retirement Pension, \$542.3 million, handicapped education, \$224.8 million, and the national school lunch program, \$182.1 million.

\$4.3 billion, or 19.3% of expenses, was spent for General Government. General Government comprised \$4.0 billion or 18.5% of expenses in FY 2005. General Government includes local distributions and money for State administration and those functions that serve the State as a whole. Examples of local distributions are the property tax replacement credit, which subsidizes local property tax collections, and the motor vehicle excise replacement credit, which subsidizes automobile license fees. Examples of State administration would be the executive branch of government, the State legislature, and the judiciary.

Total expenses for governmental activities were broken down as follows:

## Expenses - Governmental Activities



### Business-type Activities

Business-type activities represent 3.1% of the Primary Government's revenues and 3.1% of the expenses. The Unemployment Compensation Fund accounts for 95.0% of business-type activities' operating revenues and 96.1% of operating expenses. The change in net assets for business-type activities was a decline of \$1.5 million. The Unemployment Compensation Fund collects employer taxes and the federal share of unemployment compensation. Benefits are paid to

eligible individuals. These benefits paid exceeded revenue in the fund by \$3.8 million. This compares to FY 2005 when benefits paid exceeded revenue by \$81.4 million. Employer contributions into the fund increased by \$56.4 million from \$573.1 million in FY 2005 to \$629.5 million FY 2006. The increased total employed labor force in Indiana as explained on page 6 contributed to the improvement in the fund from FY 05 to FY 06.

<b>Net Cost of Primary Government</b> (in millions)				
	June 30, 2006	June 30, 2005	% change	
<b>Governmental Activities:</b>				
General government	\$ 3,554.6	\$ 3,363.2	5.7%	
Public safety	488.8	475.3	2.8%	
Health	136.9	116.5	17.5%	
Welfare	2,000.1	2,195.7	-8.9%	
Conservation, culture, and development	201.4	175.2	15.0%	
Education	6,101.4	5,847.9	4.3%	
Transportation	903.6	843.3	7.2%	
Other	0.8	0.8	0.0%	
<b>Business-type Activities:</b>				
Unemployment Compensation Fund	29.8	113.7	-73.8%	
Other	(0.9)	0.5	-280.0%	
<b>TOTAL</b>	<b>\$ 13,416.5</b>	<b>\$ 13,132.1</b>	<b>2.2%</b>	

This schedule shows the net expense (revenue) attributable to each function of government. Each function of Indiana government is either self-supporting (a negative number) or requires additional general revenues to cover expenses (a positive number).

## Financial Analysis of the State's Funds

The following is an analysis of the State's major governmental funds. Please note that transfers in and transfers out for these funds are explained in much greater detail in the Notes to the Financial Statements IV(B).

### General Fund

The General Fund is maintained to account for resources obtained and used for those services traditionally provided by State government which are not required to be accounted for in another fund. The fund balance of the General Fund at June 30, 2006 was \$1,833.6 million, which is 35.2% of assets. This compares to a fund balance at June 30, 2005 of \$1,194.2 million, which was 35.5% of assets. This indicates that the State's financial position in the General Fund is better than the prior year by \$639.4 million. The fund balance of \$1,833.6 million is composed of reserves of \$396.8 million and unreserved of \$1,436.8 million. Major reserves are:

- Encumbrances of \$41.5 million, which is money set aside to pay for future obligations.
- Loans of \$33.6 million, which consists of \$20.8 million in loans to entities outside the primary government and \$12.8 million in interfund loans.
- Tuition support of \$316.6 million, which is money set aside for distributions to schools.

The State calculates a cash basis surplus balance monthly. The year-end surplus balance is combined with estimated revenue forecasts to assess and determine the State's budget. This surplus balance is contained in the General Fund. As of June 30, 2006, the surplus balance was \$1,089.4 million. The balance increased by \$339.7 million from the June 30, 2005 balance of \$749.7 million. This surplus balance is composed of:

- \$316.6 million tuition support, which is money set aside to pay for distributions to schools.
- \$328.1 million rainy day fund, which is to assist in stabilizing revenue during periods of economic recession and is part of designated unreserved.
- \$410.7 million, which represents the excess of revenues over expenditures.
- \$34.0 million which represents the reserve for Medicaid.

The \$410.7 million is on a cash basis. Accrual adjustments of \$330.1 million reconcile this to the General Fund unreserved, undesignated fund balance on a GAAP basis of \$740.8 million. The unreserved, undesignated fund balance of \$740.8 million plus the unreserved fund balance designated for appropriations

of \$261.3 million, plus the unreserved fund balance designated for allotments of \$434.7 million give the total unreserved fund balance of \$1,436.8 million. This ties to the balance sheet for the General Fund. For more information on designations of unreserved fund balance, see the chart in the Notes to the Financial Statements III(C).

The General Fund's revenues increased 8.7%, or \$734.4 million, from FY 2005, primarily due to a 7.9% increase, or \$388.0 million, in income tax revenue and a 7.0% increase, or \$168.1 million, in sales tax revenue. Revenue increases in income taxes and sales taxes were primarily caused by an improving Indiana economy. The General Fund's expenditures increased by 5.2%, or \$412.5 million, from FY 2005. Increased expenditures were caused primarily by an increase of \$407.5 million in education expenditures. The two major causes of this were an increase in tuition support of \$249.8 million and an increase in distributions to the Teachers' Retirement Fund of \$199.2 million.

The General Fund had transfers in of \$2.9 billion compared to \$2.5 billion in FY 2005. Transfers out were \$3.2 billion compared to \$3.1 billion in FY 2005. More detail on these transfers can be found in the Notes to the Financial Statements IV(B). Overall, the improved position of the General Fund in the amount of \$640 million can be attributed to an improved economy and restrained increases in spending as outlined above.

### Motor Vehicle Highway Fund

The Motor Vehicle Highway Fund receives portions of gas and special fuel tax, motor vehicle registration fees, the motor carrier surtax, federal revenue, and other revenues. These are distributed to cities and towns, counties and the State Department of Transportation and are used to help fund the State Police, the Bureau of Motor Vehicles, the Department of Revenue and others. The fund collected \$493.2 million in taxes vs \$482.1 million in FY 2005, \$53.4 million in International Registration Plan (IRP) fees from motor carriers vs \$52.8 million in FY 2005, and \$15.5 million in federal grants vs \$19.5 million in FY 2005. Current service charges, including vehicle licenses, increased from \$16.6 million in FY 2005 to \$63.5 million in FY 2005. Vehicle license fees are now being direct deposited into the fund instead of transferred in as was the case in FY 2005, causing this increase. The fund received \$232.5 million in transfers in, which are taxes and fees collected in other funds. This compares to \$267.4 million in FY 2005. The fund distributed \$308.5 million to local units of government, \$188.9 million for public safety, and transferred \$374.2 million to other funds, which include the Department of Transportation and the

Underground Petroleum Storage Tank Excess Liability Fund. These amounts compare to FY 2005 distributions of \$289.0 million to local units of government, \$180.8 million for public safety, and transfers of \$363.9 million to other funds. The change in fund balance from FY 2005 to FY 2006 was a decline of \$9.1 million.

### **Medicaid Assistance Fund**

Medicaid is an insurance program for low-income people. It is jointly funded by the Federal government and the State. The Medicaid Assistance Fund received \$3.3 billion in Federal revenue as compared to \$3.0 billion in FY 2005. State funding comes through the \$1.7 billion in transfers in. Transfer in were also \$1.7 billion in FY 2005. Transfers out were \$195.9 million compared with \$83.3 million in FY 2005. The Fund distributed \$4.9 billion in Medicaid assistance as compared to \$4.6 billion in FY 2005. The change in fund balance from FY 2005 to FY 2006 was \$32.6 million, caused principally by the increase in federal and state funding.

### **Major Moves Construction Fund**

The Major Moves Construction Fund was created this fiscal year as part of the leasing of the Indiana Toll Road to Cintra-Mcquarie, a private company. This fund will distribute money received from the Toll Road lease for new constructions and major preservation of highways and bridges throughout Indiana. The Major Moves Construction Fund received a one time revenue payment from the Indiana Finance Authority (IFA), which owns the Indiana Toll Road. The payment came from the proceeds of the Toll Road lease and was made up of a \$3.1 billion up front payment and \$3.4 million in interest earnings. This revenue was accrued as of June 30, 2006. The Fund also accrued \$355.0 million for future distributions.

Current plans are for the Major Moves Construction Fund to distribute \$2.6 billion for Indiana Department of Transportation (INDOT) road and bridge projects, \$800 thousand for Public Employees' Retirement Fund expenses, \$240.0 million for the seven Toll Road counties, and \$120.0 million for the Northwest Indiana Regional Development Authority. The fund will also distribute \$150.0 million to the Motor Vehicle Highway Account for the 92 Indiana counties to address local road and transportation needs.

The Major Moves Construction Fund will also receive ongoing funding from the Next Generation Trust Fund. This fund received initially \$0.5 billion from the lease of the Toll Road. The interest from this money will be transferred to the Major Moves Construction Fund once every five years.

### **State Highway Department Fund**

The State Highway Department Fund was created to fund the construction, reconstruction, operation, maintenance, and control of State highways and tollways. The fund collected \$670.1 million in grants and received \$491.4 million in transfers in, which are taxes and revenues collected in other funds, compared with \$675.3 million and \$490.3 million in FY 2005, respectively. The fund also received \$66.5 million in proceeds from a capital lease. The fund expended \$1.2 billion during the year, compared with \$1.3 billion in FY 2005. The change in fund balance from FY 2005 to FY 2006 was \$146.8 million, caused principally by the decrease in expenditures and the proceeds from the capital lease.

### **Property Tax Replacement Fund**

The Property Tax Replacement Fund collects sales taxes and receives as transfers from other funds, sales, income, and gaming taxes. These are dedicated to tuition support and to property tax replacement distribution to local units of government. This is to relieve the property tax burden for the citizens of Indiana who own property. In FY 2006, the fund collected \$2.6 billion in sales taxes, as compared to \$2.5 billion in FY 2005.

The fund received transfers in of \$624.0 million for income taxes and \$64.2 million in sales taxes collected in the General Fund. This compares to FY 2005 tax transfers of \$580.9 and \$52.2 million, respectively, from the General Fund. The fund received transfers in of \$589.9 million from the State Gaming Fund, as compared to \$584.7 million in FY 2005. The fund also received transfers in of \$56.4 million in sales taxes collected in the Tax Collection Fund.

The fund transferred out \$1.73 billion to the General Fund for tuition support, as compared to \$1.63 billion in FY 2005. \$92.3 million was transferred to the Build Indiana Fund, in contrast to FY 2005 when \$113.9 million was transferred. \$2.16 billion was distributed to local units of government for property tax relief, as compared to \$2.00 billion in FY 2005. The change in fund balance from FY 2005 to FY 2006 was a decline of \$133.1 million. This was caused principally by the increased distributions to local units of governments and by increased transfers out for tuition support.

### **Tobacco Settlement Fund**

The Tobacco Settlement Fund is used to receive and distribute revenue from the Tobacco Master Settlement Agreement entered into on November 23, 1998, by the



State and leading United States tobacco product manufacturers. During fiscal year 2006, the State collected \$119.3 million from tobacco product manufacturers as compared to \$130.0 million in FY 2005. The fund collected \$1.2 million in income from investments during FY 2006.

The State expended \$14.7 million to fund operating and capital expenses associated with community health centers. \$7.3 million was spent for land and buildings at State hospitals. \$6.1 million was spent for tobacco education, prevention, and use control. \$3.8 million was spent for the prescription drug program. \$2.8 million

was spent for the Indiana Local Health Department Trust Account for distribution to the counties, \$2.5 million for rural development, \$1.6 million for advertising, and \$1.3 million for management consultants. Transfers out of the Fund were \$129.6 million as compared to \$117.4 million in FY 2005.

The change in fund balance from FY 2005 to FY 2006 was a decline of \$47.7 million, caused by spending down investments to support the programs of the fund. Investments declined from \$125.0 million at the end of FY 2005 to \$82.8 million at the end of FY 2006.

## **General Fund Budgetary Highlights**

Actual State General Fund revenue collections for FY06 were 2.6% higher than the forecasted revenue expected at the time the budget was enacted by the Indiana General Assembly in April of 2005. This additional revenue plus other administrative actions taken by Governor Daniels allowed the State to close the books with a balanced budget for the first time in eight years. At year-end, the State had nearly \$1.1 billion in reserves. The reserves consist of \$34 million in Medicaid Reserves, \$316.6 million of Tuition Support

Reserves, \$328.1 million in Rainy Day Funds, and \$410.6 million in General Fund working balance. However, \$622.1 million is owed to local units of government, K-12 schools and public universities.

The budget enacted in April of 2005 appropriated 2.2% more funds for FY06 over FY05 and 1.4% more for FY07 over FY06. This represented the smallest rate of growth in 50 years and compares to the average annual growth rate over the past ten years of 5.7%.

## Capital Asset and Debt Administration

### Capital Assets

Capital assets were \$10.1 billion, which was 42.5% of total assets for the primary government. Related debt was \$1.3 billion. Total capital assets net of related debt for the primary government was \$8.8 billion. Related debt was 12.9% of capital assets. Total capital assets increased by \$91.4 million or 0.9%. Infrastructure grew by \$67.9 million, which was caused by an increase in the Indiana Department of Transportation (INDOT) infrastructure. This was made up of Interstate Roads,

\$39.7 million, Non-Interstate Roads, \$24.1 million, and Bridges, \$4.1 million. INDOT right of way land accounted for most of the \$43.7 million increase in land. These increases were partially offset by an increase of \$47.0 million in accumulated depreciation, caused by aging of the State's capital assets. More detailed information about the State's capital assets is presented in Note IV(D) to the Financial Statements.

The following table shows the percentage change from fiscal year 2005 to fiscal year 2006.

State of Indiana Capital Assets (in millions of dollars)							Total % Change
	Governmental Activities		Business-type Activities		Total Primary Government		
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	
Land	\$ 1,182.2	\$ 1,138.5	\$ -	\$ -	\$ 1,182.2	\$ 1,138.5	3.8%
Infrastructure	7,598.4	7,530.5	-	-	7,598.4	7,530.5	0.9%
Construction in Progress	426.2	428.1	-	-	426.2	428.1	-0.4%
Property, plant and equipment	1,759.4	1,730.0	22.3	23.0	1,781.7	1,753.0	1.6%
Less accumulated depreciation	(905.8)	(858.8)	(11.1)	(11.1)	(916.9)	(869.9)	5.4%
<b>Total</b>	<b><u>\$ 10,060.4</u></b>	<b><u>\$ 9,968.3</u></b>	<b><u>\$ 11.2</u></b>	<b><u>\$ 11.9</u></b>	<b><u>\$ 10,071.6</u></b>	<b><u>\$ 9,980.2</u></b>	<b>0.9%</b>

## Long-term Obligations

Major long-term obligations items are included in the following table. These items comprised 100%

of total long-term liabilities and 22.0% of total liabilities.

The following table shows the percentage change from fiscal year 2005 to fiscal year 2006.

<b>State of Indiana Long-term Liabilities (in millions of dollars)</b>							
	<u>Governmental Activities</u>		<u>Business-type Activities</u>		<u>Total Primary Government</u>		<u>Total % Change</u>
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	
Accrued liability for compensated absences	\$ 55.2	\$ 53.2	\$ 0.2	\$ 0.1	\$ 55.4	\$ 53.3	3.9%
Intergovernmental payable	95.0		-		95.0	-	0.0%
Capital lease payable	1,271.2	1,245.5	-	-	1,271.2	1,245.5	2.1%
Claims payable and benefits payable	16.3	-	44.0	38.5	60.3	38.5	56.6%
Net pension obligations	12.3	7.3	-	-	12.3	7.3	68.5%
Due to component units	112.2	151.7	-	-	112.2	151.7	-26.0%
<b>Total</b>	<b><u>\$ 1,562.2</u></b>	<b><u>\$ 1,457.7</u></b>	<b><u>\$ 44.2</u></b>	<b><u>\$ 38.6</u></b>	<b><u>\$ 1,606.4</u></b>	<b><u>\$ 1,496.3</u></b>	<b>7.4%</b>

Total long-term liabilities increased by 7.4% or \$110.1 million. The major factor contributing to this increase was an increase in intergovernmental payables of \$95.0 million. This amount represents money that is scheduled to be distributed for infrastructure construction projects from the Major Moves Construction Fund in FY 2008 and 2009. Capital lease payables increased by \$25.7 million or 2.1%. This is made up in part of an increase of \$30.8 million in the direct financing lease with the Highway Revenue Bonds Fund of the Indiana Finance Authority. This increase was offset by a decrease in other capital leases of \$5.1 million.

Claims payable and benefits payable increased by

\$21.8 million or 56.6% in FY2006. \$16.3 million of the increase was caused by benefit obligations originating from the Major Moves Toll Road lease agreement. \$5.5 million was due to an increase in the Indiana Residual Malpractice Insurance Authority's claims payable.

Due to component units decreased by \$39.5 million or 26.0% due to the decrease in payment delays to the colleges and universities. Legislation provides that the State Budget Agency may delay one month of budgeted appropriations to the colleges and universities.

More detailed information about the State's long term obligations is presented in Note IV(F) to the Financial Statements.

## Infrastructure

As required by GASB Statement No. 34, the State has capitalized its infrastructure. This amounts to \$7.6 billion in roads and bridges using the modified approach, \$1.0 billion in right of way classified as land, and \$14.2 million in dams being depreciated. In order to utilize the modified approach, the State is required to:

- Maintain an asset management system that includes an up-to-date inventory of eligible infrastructure assets.
- Perform condition assessments of eligible assets and summarize the results using a measurement scale.

- Estimate each year the annual amount to maintain and preserve the assets at the condition level established and disclosed by the State.
- Document that the assets are being preserved approximately at or above the established condition level.

Under the modified approach, the State expends certain maintenance and preservation costs and does not report depreciation expense. Assets accounted for under the modified approach include approximately 27,662 lane miles of roads and approximately 5,196 bridges that the State is responsible to maintain.

The State has consistently maintained the assessed conditions of roads over the past three years. It is the State's policy to maintain Interstate and National Highway System (NHS) Non-Interstate roads at an average Pavement Quality Index (PQI) of 75 and Non-NHS roads at an average PQI of 65. The most recent condition assessment, completed for FY 2006, indicated that the average PQI for roads exceeded the minimum acceptable standard.

The State has maintained the assessed conditions of bridges at levels which are above the established benchmarks. It is the State's policy to maintain Interstate bridges at an average sufficiency rating of

87%, NHS Non-Interstate bridges at an average sufficiency rating of 85%, and Non-NHS bridges at an average sufficiency rating of 83%. The most recent condition assessment, completed in FY 2006, indicated that the average sufficiency rating for bridges exceeded the minimum acceptable standard.

Although the actual maintenance and preservation costs for Interstate and NHS Non-Interstate roads and Interstate and NHS Non-Interstate bridges were lower than planned, this has not caused the condition level to fall below the State's policy. In total, maintenance cost for all roads exceeded plan, as did total maintenance cost for all bridges.

## **Economic Factors**

The economic forecast upon which the state budget for FY06 was based was updated in April 2005. The April 2005 updated forecast projected real Gross Domestic Product (GDP) to increase by 3.5% in FY06. The U.S. Bureau of Economic Analysis currently estimates that real GDP increased by 3.4% during FY06. The April 2005 forecast for real GDP growth is 3.5% in FY06 and 3.2% in FY07.

The April 2005 forecast projected that Indiana non-farm personal income would increase by 5.2% in FY06. The U.S. Bureau of Economic Analysis currently estimates that Indiana non-farm personal income increased by 5.2% in FY06. The April 2005 forecast for Indiana non-farm personal income growth is 5.2% in FY06 and 5.2% in FY07.

## **Contacting the Auditor of State**

This financial report is designed to provide our citizens, taxpayers, customers, and investors and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it

receives. If you have questions about this report or need additional financial information, contact the Auditor of State, 240 State House, 200 West Washington Street, Indianapolis, Indiana 46204-2793.