

FINANCIAL STRUCTURE

General

The State budgets and controls its financial activities on the cash basis of accounting for its fiscal year. In compliance with State law, the State records its financial transactions in either of two major categories – the General Fund or the Special Fund. References to these funds in this document include the terms "budgetary" or "budgetary basis" to differentiate them from the GAAP funds of the same name which encompass different funding categories. The budgetary General Fund provides for the cost of the State's general operations and is credited with all tax and other revenue of the State not dedicated to budgetary Special Funds. All disbursements from the budgetary General Fund must be authorized by appropriations of the General Assembly.

Budgetary Special Funds are designated for specific purposes. The appropriate budgetary Special Fund is credited with the tax or other revenue allocated to such fund and is charged with the related disbursements. Specific uses of appropriated budgetary Special Funds include the operations of State parks, the Public Service Commission and the Division of Professional Regulation. Federal payments and unemployment compensation are examples of non-appropriated Special Funds. Some Special Funds, such as the Delaware State Housing Authority and the State Pension Office contain both appropriated funds for operations and non-appropriated funds for specific programs, such as public housing and pension benefits.

The Transportation Trust Fund, which relies on related revenues such as motor fuel taxes, tolls and license and registration fees, is a major part of the State's operating and capital budgets. Thus, its financial activities are blended into the accompanying financial statements rather than shown separately.

The accompanying General Purpose Financial Statements (GPFS) have been prepared to conform to the standards of financial reporting set forth by the Governmental Accounting Standards Board (GASB) in its various statements and

interpretations. GAAP reporting standards allow the accurate assessment of financial condition and enable the State to present its total fiscal operation.

In GAAP reporting, operations of the primary government and component units are recorded under four main fund types – Governmental, Proprietary, Fiduciary and University, and two account groups – General Fixed Assets and General Long-Term Debt, as defined by GASB. These fund types and account groups are described in Note 1C of the accompanying financial statements. A reconciliation of budgetary General and Special Funds to GAAP is found in Note 2 of the financial statements.

Because GAAP fund definitions for accounting purposes differ from those of the budgetary basis General and Special Funds, the GAAP fund types are explained below.

The Governmental fund types include the General, Special Revenue, Capital Projects and Debt Service Funds. The General Fund is comprised of all transactions related to the State's operations which are not required to be accounted for in other funds. The General Fund includes most budgetary General and Special Funds and the operations portion of the Transportation Trust Fund. The Special Revenue Funds include all transactions relating to federal moneys and local school funds. The Capital Projects Funds account for State capital spending, including the capital portion of the Transportation Trust Fund, but exclude capital spending of the Proprietary and University fund types. The Debt Service Fund accounts for transactions relating to the payment of principal and interest on General Obligation and Revenue bonds, except as accounted for in Proprietary and University Funds.

The Proprietary fund type includes the Enterprise Fund, in which operations are similar to the transactions of a for-profit business. Operations of the Delaware State Lottery are accounted for in the Enterprise Fund.

The Fiduciary funds include: Expendable Trust, Nonexpendable Trust, Pension and Investment Trust and Agency Funds. Expendable Trust Funds, which require the State to operate in a trustee capacity in the administration of fund assets, include the Unemployment Trust Fund. Nonexpendable Trusts are those trusts or endowments that prohibit expenditure from principal; they include numerous small individual scholarships and endowments. The Pension Trust Funds account for the assets, liabilities and fund balances of the Delaware Public Employees' Retirement System. Investment Trust Funds account for the Local Government Retirement External Investment Pool, administered by the Delaware Public Employees' Retirement System. Agency Funds are custodial accounts where the State acts as an agent, accounting for receipts and disbursements. The State's Agency Funds include accounts for child support collections, court fees and restitution.

The University fund type accounts for the financial position and operations of Delaware State University and is presented as a component unit of the State along

with the operations of the Delaware State Housing Authority, Diamond State Port Corporation and the Riverfront Development Corporation in discrete format.

The Account Groups record the fixed assets and long-term obligations of the State not accounted for in the Proprietary, Fiduciary, and University fund types.

Budgetary Control and Financial Management Systems

Disbursements are controlled by an encumbrance accounting system that is designed to provide information on the actual extent of the State's obligations (as determined by purchase orders issued) and to guard against over-committing available funds. Disbursements are controlled through the encumbrance system in such a way that purchase orders issued for goods and services cause a reduction in available appropriations. The total amount of budgetary General Fund cash disbursements plus unliquidated encumbrances therefore cannot exceed the amount appropriated by the General Assembly for any budget line.

Although the majority of the State's financial transactions are processed through the accounting system, certain Special Funds have financial activity, such as investments, outside the system. For example, the Transportation Trust Fund, the Delaware State Housing Authority and Delaware State University all maintain outside financial activity. This activity is governed in strict adherence to legislative regulations as well as guidelines established by their Boards. In addition, these entities are audited annually and produce published financial reports.

Budget Process

As noted earlier, all disbursements from the budgetary General Fund and certain Special Funds must be authorized by appropriation of the General Assembly. In the fall of the fiscal year, each State agency submits to the Budget Office a request for operating and capital funds for the ensuing fiscal year. Public hearings on the requests are subsequently conducted. The Governor's proposed operating and capital budgets for the General Fund and Special Funds, including the Transportation Trust Fund, are then drafted and presented by the Governor to the General Assembly in January. The General Assembly's Joint Finance and Bond Bill Committees hold hearings and mark up the Governor's proposed operating and capital budgets, respectively. As amended, the budgets are expected to be passed prior to July 1 and signed by the Governor shortly thereafter.

Federal funds are not appropriated, but are subject to the review and approval of the State Budget Office and the Delaware State Clearinghouse Committee for Federal Aid Coordination. The Committee is comprised of 10 members, including the Secretary of Finance, Budget Director, Director of the Delaware Economic Development Office, the Controller General, and six legislators.

Appropriation Limit

The State Constitution limits annual appropriations by majority vote of both houses of the General Assembly to 98% of estimated budgetary General Fund revenue plus the unencumbered budgetary General Fund balance from the previous year. An appropriation exceeding this limit may be made in the event of a declared emergency, with the approval of a three-fifths vote of the members of each house of the General Assembly, but no appropriation may be made exceeding 100% of estimated budgetary General Fund revenue plus the unencumbered General Fund balance from the previous year.

Budget Reserve Account

The Budget Reserve Account is designed to provide a cushion against unanticipated revenue shortfalls. The State Constitution provides that excess unencumbered budgetary General Funds at the end of a fiscal year must be placed in a reserve account (the "Budget Reserve Account") provided that the amount of funds in the Budget Reserve Account does not exceed 5% of the estimated budgetary General Fund revenue used to determine the appropriation limit for that fiscal year. Transfers of \$1.8 million were made during fiscal 2001 which funded the Budget Reserve Account at \$128.0 million for fiscal 2001. Money from the Budget Reserve Account may be appropriated only with the approval of a three-fifths vote of the members of each house of the General Assembly and only for use to fund an unanticipated General Fund deficit or to provide funds required as a result of the enactment of legislation reducing revenue. Since this fund was established in 1977, the General Assembly has never appropriated funds from the Budget Reserve Account.

Tax Limitations

The State Constitution was amended in May 1980 to limit tax and license fee increases or the imposition of any new taxes or fees. Any tax or license fee increase or the imposition of any new tax or license fee must be passed by a three-fifths vote of each house of the General Assembly, rather than by a simple majority vote, except for tax increases to meet debt service on outstanding obligations of the State for which insufficient revenue is available when such debt service is due.

Internal Control

The State has established and maintains internal control designed to ensure that the assets of the State are protected from loss, theft or misuse, and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with GAAP. Internal control is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that the cost of a control should not exceed the benefits likely to be derived, and that evaluation of costs and benefits requires

estimates and judgments by State officials. Determination as to the adequacy of the internal control is made within the above framework. State officials believe the State's internal control adequately safeguards assets and provides reasonable assurance of proper recording of financial transactions.

Risk Management

In order to provide the citizens of Delaware with the service levels expected from their government, the State exposes itself to the potential for risk or losses similar to those associated with operating a business. For example, the State must provide employees with health care and protect against claims by employees or citizens. Other examples of potential risks or losses by the State include automobile, worker's compensation, police professional malpractice and a portion of property and casualty claims. It is the policy of the State not to purchase commercial insurance to cover these risks because of unnecessary cost. Instead, the State covers all claim settlements and judgments out of its budgetary General Fund. The State continues to carry commercial insurance for all other risks of loss, including general liability and the remainder of the property and casualty liability.

Cash Management

Investment of State funds is the responsibility of the Cash Management Policy Board. The Board, created by State law, establishes policies for, and the terms, conditions and other matters relating to, the investment of all money belonging to the State, except money in any State pension fund (reported in the financial statements as the Pension Trust Fund). The Board is comprised of nine members including the Secretary of Finance, the Secretary of State, the State Treasurer, the Controller General, serving ex officio, and five members from the private sector appointed by the Governor and confirmed by the State Senate.

Debt Administration

Oversight responsibility for the issuance of debt by the State and its authorities is centralized under the Secretary of Finance, and all debt issuance is subject to the approval of the State's Bond Issuing Officers (the Governor, Secretary of Finance, Secretary of State, and the State Treasurer). The State has a three-part debt limit which restricts the principal amount of new "tax-supported obligations of the State" authorized in any one fiscal year to 5% of estimated net budgetary General Fund revenue for that fiscal year and establishes certain tests to be met at the time of debt issuance.

Delaware's commitment to fiscal responsibility is widely recognized in financial markets. Beginning in fiscal 2000, each of the three rating agencies evaluating Delaware awarded the State their highest rating:

- Moody's Investors Service: Aaa

- Standard & Poors: AAA
- Fitch IBCA, Duff & Phelps: AAA

The rating agencies reaffirmed these ratings in the summer of 2001 citing Delaware's sound financial management and operations, manageable debt burden, above-average wealth and income levels, substantial budget reserves, effective debt management, and resilient economy as reasons for the reaffirmation of their highest possible rating.

The State last issued \$100.0 million of General Obligation bonds in April 2000, using proceeds to fund a portion of its capital program. No General Obligation bonds were issued during fiscal 2001. As of June 30, 2001, the State had outstanding \$653.7 million of General Obligation debt. General Obligation bonds are secured by the full faith and credit of the State.

During fiscal 2001, State Authorities issued a total of \$66.8 million of revenue bonds. A total of \$1,055.2 million of revenue debt, including \$420.3 million of component unit debt, remained outstanding at June 30, 2001. Revenue bonds are secured by specific revenue streams pledged to the repayment of debt service. The Delaware Transportation Authority issues revenue bonds to fund its capital projects. The State is neither directly nor contingently liable for debt service on any of the following indebtedness. The Delaware State University and the Delaware State Housing Authority issue revenue bonds to fund their capital and mortgage loan programs, respectively. The Delaware Economic Development Authority and Delaware Health Facilities Authority are conduit debt issuers for nonprofit entities and businesses eligible under federal tax laws for tax-exempt financing.

Pension Plan

The Delaware State Employees' Pension Plan (the "Plan") covers approximately 32,000 active employees and approximately 15,650 retired employees. All State employees (except State Police and State judges) and all local school district employees who qualify as full-time and regular part-time employees participate in the Plan. The other plans funded by the State include the old State Police Pension Plan, the new State Police Pension Plan, and the State Judiciary Pension Plan. The Plan assets, along with the other plans are known as the Delaware Public Employees' Retirement System (PERS).

The PERS is managed by a Board of Pension Trustees comprised of members from the private sector appointed by the Governor, with the Secretary of Finance and the Director of the Office of State Personnel serving as ex-officio members. The PERS provides retirement, disability and survivor benefits. The PERS is funded on an actuarially sound basis, as determined by the Pension Trustees, based on annual actuarial valuations performed by Milliman & Robertson, Inc. The State Employees

Pension Plan covering the great majority of current state employees is currently in an overfunded position.