

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the State of Delaware (the State) have been prepared in conformity with Accounting Principles Generally Accepted in the United States (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). In June 1999, the GASB issued Statement No.34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments* and Statement No. 35, *Basic Financial Statements and Management's Discussion and Analysis - for Public Colleges and Universities*. These Statements establish new financial reporting requirements for state and local governments and public colleges and universities throughout the United States. The Statements require new information and restructure much of the information that governments have presented in the past. Comparability with reports issued in prior years is affected.

The State has adopted the provisions of GASB Statements Nos. 34 and 35 for its fiscal year ended June 30, 2002. With the implementation of GASB Nos. 34 and 35, the State has prepared required supplementary information titled *Management's Discussion and Analysis*, which precedes the basic financial statements.

The State has also implemented the following GASB Statements for the year ended June 30, 2002 in conjunction with GASB Statements Nos. 34 and 35. Statement No. 37 – *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, Statement 38 – *Certain Financial Statement Disclosures* and GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*.

(a) Reporting Entity

The accompanying financial statements present the State's primary government and include all funds, elected officials, departments and agencies, bureaus, boards, commissions, and certain authorities that make up the State's legal entity. The nineteen local school districts, which are not legally separate, are included in the reporting entity of the primary government. The Delaware Transportation Authority, which includes the Transportation Trust Fund and the Delaware Transit Corporation, is also included in the reporting entity of the primary government. The State's reporting entity is also comprised of its component units, entities for which the government is considered to be financially accountable. Blended component units, although legally separate entities, are in substance part of the government's operations. Each discretely presented component unit is reported in a separate column in the government-wide financial statements (see note below for description) to emphasize that it is legally separate from the government.

Financial accountability is defined in GASB Statement No.14, "The Financial Reporting Entity." The State is financially accountable for legally separate organizations if it appoints a voting majority of the organization's board and (1) it is able to impose its will on that organization or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the State. The State may also be financially accountable if an organization is fiscally dependent on the State regardless of whether the organization has a separately elected governing board, a governing board appointed by a higher level of government, or a jointly appointed board.

Blended Component Unit

The Delaware Public Employees' Retirement System (DPERS) is a public employee retirement system, which covers substantially all State employees. The DPERS is a legally separate entity, however, as it provides services and benefits almost exclusively to the primary government, the DPERS is considered a blended component unit and is shown in the financial statements as part of the primary government as pension trust funds. The DPERS is audited by other auditors and their report dated September 27, 2002 is publicly available. The financial report of DPERS for the year ended June 30, 2002 may be obtained by writing to the State Board of Pension Trustees and Office of the Pensions, McArdle Building, Suite #1, 860 Silver Lake Boulevard, Dover, DE 19904-2402.

Discretely Presented Component Units

The following component units are entities that are legally separate from the State, but are financially accountable to the State for reporting purposes, or whose relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete. The component units column of the basic financial statements includes the financial data of these entities. Each discretely presented component unit has a June 30 year end.

Delaware State Housing Authority

The Delaware State Housing Authority (DSHA) is a public corporation whose Director is appointed by and reports directly to the Governor of the State. The Authority administers the role of affordable housing as a key aspect of State policy. The Authority's relationship with the State is such that exclusion of the Authority from the State's basic financial statements would cause the statements to be misleading or incomplete. The Authority is authorized, among other things, to (1) make mortgage, construction and other loans to not-for-profit and limited for-profit housing sponsors, (2) make loans to mortgage lenders, requiring the proceeds thereof to be used for making newly qualified residential mortgage loans, (3) purchase qualified mortgage loans from mortgage lenders, and (4) apply for and receive assistance and subsidies under programs from the Federal Government and others. The Authority

was audited by other independent auditors, and their report dated September 24, 2002 has been issued under separate cover.

Diamond State Port Corporation

The Diamond State Port Corporation (DSPC) was organized as a body corporate and politic constituting a public instrumentality of the State. The DSPC is empowered to operate, improve and maintain the Port of Wilmington and related facilities. The Governor appoints six of the nine members of the board of directors with the advice and consent of the Senate. The DSPC's relationship with the State is such that exclusion of the DSPC from the State's general purpose financial statements would cause the statements to be misleading or incomplete. The Corporation was audited by other independent auditors and their report dated August 2, 2002 has been issued under separate cover.

Riverfront Development Corporation

The Riverfront Development Corporation (RDC) was formed to plan, develop and manage programs and projects intended to foster economic development along the Brandywine and Christina Rivers. The Governor appoints six of the 13 board members; however, five of the remaining seven directors consist of the Governor and four State officials. Authorization by the State's Budget Director and Controller General is required before funds of the RDC may be expended. The RDC was audited by other independent auditors, and their report dated October 13, 2002 has been issued under separate cover.

Delaware State University

Delaware State University (DSU) is a public institution of higher education funded primarily through State appropriations. Additional funding is derived from tuition, federal grants and private donations and grants. The Board of Trustees is comprised of 11 members, six appointed by the Governor of Delaware and five elected by the Trustees. The President of the University and the Governor of the State of Delaware serve as ex-officio members of the Board. Other independent auditors audited the University, and their report dated November 4, 2002 has been issued under separate cover.

Complete financial statements for each of the discretely presented component units may be obtained from their respective administrative offices or from the Office of the Auditor of Accounts, The Townsend Building, Suite #1, 401 Federal Street, Dover, DE 19901. Delaware Charter Schools

Delaware Charter Schools are public schools funded primarily through State appropriations. Additional funding is derived from federal grants passed through from the primary government and private donations. Charter schools are each managed

by a board of directors, which operate independently, under a charter granted by the State Department of Education with the approval of the State Board of Education. Charters are granted for an initial period of three years and renewable every five years thereafter. Financial information for Delaware Charter Schools is presented in the aggregate as they are individually immaterial. Due to their immateriality, the information relating to the Delaware Charter Schools has not been audited.

Related Organizations

Officials of the State's primary government appoint a voting majority of the governing board of the Delaware Solid Waste Authority. The primary government's accountability for the Authority does not extend beyond making the appointments. The financial activities of the Authority are not included in the State's financial statements.

Jointly Governed Organization

The Delaware River and Bay Authority, a body politic, was created with the intention of advancing the economic growth and development of those areas in the State of Delaware and the State of New Jersey, which border the Delaware River and Delaware Bay. The Authority is governed by twelve (12) commissioners: six appointed by the State of Delaware and six appointed by the State of New Jersey. The Authority is autonomous from a day-to-day operations perspective and neither State is obligated for the Authority's debt. The Authority is not included in these financial statements as the State of Delaware has no ongoing financial interest.

Government-Wide and Fund Financial Statements

The government-wide financial statements (i.e., the statement of net assets and the statement of activities) report information on all of the nonfiduciary activities of State and its component units. For the most part, the effect of interfund activity has been removed from these statements. Governmental activities, which normally are supported by taxes and intergovernmental revenues, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. Likewise, the State is reported separately from certain legally separate component units for which the State is financially accountable.

The statement of activities demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function or segment. Program revenues include 1) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or segment and 2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Taxes and other items not properly included among program revenues are reported as general revenues.

Separate fund financial statements are provided for governmental funds, proprietary funds, and fiduciary funds, even though the latter are excluded from the government-wide financial statements. Major individual governmental funds and major individual proprietary funds are reported in separate columns in the fund financial statements.

(b) Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, as are the proprietary fund and fiduciary fund financial statements. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Taxes are recognized as revenues in the year for which they are levied. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in both the government-wide and proprietary fund financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. Governments also have the *option* of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to this same limitation. The State has elected not to follow subsequent private-sector guidance.

As a general rule the effect of interfund activity has been eliminated from the government-wide financial statements. Exceptions to this general rule are charges between the State's enterprise operations and various other functions of the government. Elimination of these charges would distort the direct costs and program revenues reported for the various functions concerned.

Amounts reported as program revenues include 1) charges to customers or applicants for goods, services, or privileges provided, 2) operating grants and contributions, and 3) capital grants and contributions, including special assessments. Internally dedicated resources are reported as general revenues rather than as program revenues. Likewise, general revenues include all taxes.

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the government considers all revenues to be available if they are collected within 60 days of the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, debt

service expenditures, as well as expenditures related to compensated absences and claims and judgments, are recorded only when payment is due.

Taxes, grants, fees, sales, rents, and interest income associated with the current fiscal period are all considered to be susceptible to accrual and have been recognized as revenues of the current fiscal period. All other revenue items are considered to be measurable and available only when cash is received by the State. Revenue related to expenditure driven grants is recognized when the qualifying expenditures have been incurred and all other grant requirements have been met.

Governmental Funds

The State reports the following major governmental funds:

General Fund - The general fund is the State's primary operating fund. It accounts for all financial resources obtained and used for those services traditionally provided by a state government, which are not required to be accounted for in other funds. These services include, among others, education, and health and social services.

Federal Fund - The federal fund accounts for all activities relating to the State's federal grant programs.

Local School District Fund - The local school district fund accounts for activities relating to the State's local school districts funded by locally raised real estate taxes and other revenue.

Capital Projects - Transactions related to resources obtained and used for the acquisition or construction of major capital facilities (other than those financed by proprietary and fiduciary funds) are accounted for in Capital Projects Funds. Such resources are derived principally from proceeds of general obligation bond issues, federal grants, and operating transfers from the General Fund.

Proprietary Funds

Proprietary Funds are used to account for those activities which are financed and operated in a manner similar to private business enterprises. The costs of providing services to the general public on a continuing basis are financed by or recovered primarily through user charges.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the unemployment fund, lottery fund and DelDOT fund are charges to customers for sales and services.

The Lottery recognizes revenue from on-line games the day of the drawing. Revenue from the sale of instant tickets is recognized when the book has been activated and 85% of the related prizes of an activated book is paid. Revenue from video lottery sales is recognized, net of prizes paid, at the time the public plays the game.

Operating expenses for enterprise funds include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

The State reports the following major proprietary funds:

DelDOT Fund- The DelDOT fund accounts for the activities relating to the operation of the State's Department of Transportation, including the Delaware Transportation Authority.

Unemployment Fund - The unemployment fund accounts for the activities relating to the State's unemployment insurance program.

Lottery Fund - The lottery fund accounts for the activities relating to the State Lottery program.

Fiduciary Fund Types

The accounts of the pension and investment trust funds are reported using the flow of economic resources measurement focus and are maintained on the accrual basis of accounting. For pension trust funds, employee contributions are recognized as revenue in the period in which the employee services are performed. Employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan. Agency funds are custodial in nature and do not present results of operations and therefore do not have a measurement focus.

The State reports the following fiduciary fund types:

Agency Funds - Agency funds are custodial in nature and do not involve measurement of the results of operations. They account for the receipt of various taxes, deposits, deductions, and certain property collected by the State, acting in the capacity of an agent, and for the distribution to other governmental units or designated beneficiaries.

Pension Trust Funds - Pension trust funds account for transactions, assets, liabilities and net assets available for plan benefits of the Delaware Public Employees' Retirement System (DPERS) (Note 15)

Investment Trust Funds - Investment trust funds are used to account for external investment pools where a government commingles the moneys of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio; one or more of the participants is not part of the sponsor's reporting entity. The investment trust fund accounts for the transactions, assets, liabilities and fund equity for the Delaware Public Employee Retirement System's external investment pool. (Note 15)

(c) Audit Responsibility

For the year ended June 30, 2002, financial statements of certain separately administered organizations, agencies of the State and component units, included in the reporting entity of the State have been audited by auditors other than KPMG LLP or the Office of the Auditor of Accounts. These entities include the Delaware Public Employees Retirement System, Delaware State University, Delaware State Housing Authority, the Riverfront Development Corporation, the Diamond State Port Corporation, the Delaware State Lottery and the DelDOT Fund (consists of the Delaware Department of Transportation, Delaware Transportation Authority, the Transportation Trust Fund and the Delaware Transit Corporation).

The table below sets forth the proportion (%) of certain key financial information that was subject to audit by other auditors for the year ended June 30, 2002.

	Assets	Liabilities	Revenue	Expense
Government-Wide Financial Statements				
Business Type Activities	91 %	96 %	94 %	87 %
Component Units	99 %	100 %	94 %	92 %
Fund Financial Statements				
Lottery	100 %	100 %	100 %	100 %
DelDOT Fund	100 %	100 %	100 %	100 %
Pension Trust Fund	100 %	100 %	100 %	100 %
Investment Trust Fund	100 %	100 %	100 %	100 %

(d) Assets, Liabilities, and Net Assets or Equity

Deposits and investments

All highly liquid investments with a maturity of three months or less when purchased are considered to be cash equivalents. For the purposes of the statement of cash flows, restricted cash is considered to be cash equivalents. Investment securities with maturities of greater than one year are reported as long-term investments.

Investment securities are stated at quoted market prices, except that investment securities with a remaining maturity at time of purchase of one year or less are stated

at cost or amortized cost (Note 3). Investment securities with remaining maturities of greater than one year are identified as long-term investments.

Receivables and Payables

Activity between funds that are representative of lending/borrowing arrangements outstanding at the end of the fiscal year are referred to as “due to/from other funds” (i.e., the current portion of interfund loans). All trade and property tax receivables, including those for the component units, are shown net of an allowance for uncollectibles and refunds. (Note 4)

Inventories and Prepaid Items

All inventories are valued at cost using the first-in/first-out (FIFO) method. Inventories of governmental funds are recorded as expenditures when consumed rather than when purchased. Certain payments to vendors reflect costs applicable to future accounting periods and are recorded as prepaid items in both government-wide and fund financial statements.

Restricted Assets

The Delaware State Lottery’s mandatory deposit with the Multi-State Lottery and the annuities for future installment prize payments are recorded as restricted assets, as are any assets of the Delaware State University, the Diamond State Port Corporation and the Riverfront Development Corporation that are subject to external restrictions.

Capital Assets

Capital assets, which include property, plant, equipment, and infrastructure assets (which are normally immovable and of value only to the State, such as roads, bridges, sidewalks, and similar items), are reported in the applicable governmental or business-type activities columns in the government-wide financial statements, the proprietary funds and component units.

Capital assets are defined by the State as assets with an initial, individual cost of more than \$15,000 at the date of acquisition and an estimated useful life in excess of one year. Such assets are recorded at historical cost if purchased or constructed, or estimated historical cost if the original cost is not determinable. Donated capital assets are recorded at estimated fair market value at the date of donation.

All land and buildings are capitalized, regardless of cost. Equipment and vehicles are capitalized when the cost of individual items exceeds \$15,000. Building and land improvements are capitalized when the cost of the project exceeds \$100,000. Infrastructure and software is capitalized when the costs of individual items or projects exceed \$1 million.

The State possesses certain capital assets that have not been capitalized and depreciated, because the assets cannot be reasonably valued and/or the assets have inexhaustible useful lives. These assets include works of art and historical treasures, such as statues, monuments, historical documents, paintings, forts, miscellaneous capitol-related artifacts and furnishings.

The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized.

Major outlays for capital assets and improvements are capitalized as projects are constructed. Interest incurred during the construction phase of capital assets of business-type activities is included as part of the capitalized value of the assets constructed. Property, plant, and equipment of the primary government is depreciated using the straight line method over the following estimated useful lives:

<u>Asset</u>	Primary Government <u>Years</u>	Component Units <u>Years</u>
Buildings and Building Improvements	40	15 - 75
Land Improvements	20	N/A
Furniture and Equipment	3 - 10	3 - 40
Vehicles	7	N/A

The State has elected to use the “modified approach” to account for certain infrastructure assets, as provided in GASB Statement No. 34. Under this process, the State does not record depreciation expense nor are amounts capitalized in connection with improvements to these assets, unless the improvements expand the capacity or efficiency of an asset. Utilization of this approach requires the State to: 1) commit to maintaining and preserving affected assets at or above a condition level established by the State, 2) maintain an inventory of the assets and perform periodic condition assessments to ensure that the condition level is being maintained, and 3) make annual estimates of the amounts that must be expended to maintain and preserve assets at the predetermined condition levels.

Roads and bridges maintained by the Department of Transportation are accounted for using the modified approach.

Compensated Absences

It is the government’s policy to permit employees to accumulate earned but unused vacation and sick pay benefits. In the governmental fund financial statements, liabilities for compensated absences are accrued when they are considered “due and payable” and recorded in the fund only for separations or transfers that occur before year-end. In the government-wide and proprietary fund financial statements, the

State has accrued a liability for compensated absences, recognizing the obligation to make payments.

Long-Term Obligations

In the government-wide financial statements and proprietary fund financial statements, long-term debt and other long-term obligations are reported as liabilities in the applicable governmental activities, business-type activities, or proprietary fund statement of net assets. Bond premiums and discounts, as well as issuance costs, are deferred and amortized over the life of the bonds using the effective interest method. Bonds payable are reported net of the applicable bond premium or discount. Bond issuance costs are reported as deferred charges and amortized over the term of the related debt.

In the fund financial statements, governmental funds recognize bond premiums and discounts, as well as bond issuance costs, during the current period. The face amount of debt issued is reported as other financing sources. Premiums received on debt issuances are reported as other financing sources while discounts on debt issuances are reported as other financing uses. Issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures.

Fund Equity

In the fund financial statements, governmental funds report reservations of fund balance for amounts that are not available for appropriation or are legally restricted by outside parties for a specific purpose.

The State Constitution provides that certain excess unencumbered budgetary General Funds at the end of a fiscal year must be placed in a reserve account (the "Budget Reserve Account"). This account, designed to provide a cushion against unanticipated deficits, may not exceed 5% of the estimated General Fund revenue for the ensuing fiscal year. Total funding of the Budget Reserve Account was \$128.9 million at June 30, 2002. In the government-wide financial statements, restricted net assets represent balances that are subject to external restrictions or were created by enabling legislation. Designations of fund balance represent tentative management plans that are subject to change.

(e) Grants

Federal grants and assistance awards made on the basis of entitlement periods are recorded as intergovernmental receivables and revenues when entitlement occurs. All other federal reimbursement type grants are recorded as accounts receivable and revenue when the related expenditures or expenses are recognized. In addition to monetary transactions, Federal grants also include non-monetary transactions

related to food stamps. Food stamps inventories are reported at coupon value in the General Fund.

(f) Litigation Revenue

In 1997, several states began litigation against several defendant tobacco product manufacturers to recover certain amounts the states expended to provide health care to numerous tobacco product users. In 1998, a settlement was reached which provided that the states cease litigation against the manufacturers. As part of the Master Settlement Agreement, certain manufacturers agreed to remit periodic payments to the states (amounting to \$200 billion, according to estimates) until 2025. Amounts to be remitted are calculated based on a variety of specific settlement provisions. Future tobacco product sales are one key factor used in determining periodic payment amounts. Delaware's settlement share for fiscal year 2002 was \$29.8 million. This amount is reported in the General Fund as part of "other" revenue. Future payments will be reported as revenue when they are received. No receivable for such payments has been reported pursuant to the settlement since the amounts to be received are contingent as described above. Monies received under the Master Settlement Agreement are dedicated to health care and related programs. Expenditures of these funds are authorized by Legislation.