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November 27, 2003

**Governor Ruth Ann Minner
Honorable Members of the 143rd General Assembly
and the Citizens of Delaware**

It is my pleasure to present the 2003 Comprehensive Annual Financial Report (CAFR) for the State of Delaware. The report for the fiscal year ended June 30, 2003 has been prepared in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports, and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting.

Responsibility for the accuracy of data, as well as the completeness and fairness of its presentation – including all disclosures – rests with the Department of Finance. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner that presents fairly the State's financial position and the results of operations of the primary government and component units for which the State is financially accountable. All disclosures necessary to enable the reader to gain an understanding of the State's financial activities are included.

The CAFR has been prepared in accordance with GASB Statement Number 34, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments and related Statements Number 37 and 38. The objective of this reporting model is to provide a clear picture of the government as a single, unified entity as well as providing traditional fund based financial statements. The State implemented these new standards in the CAFR for June 30, 2002 and this report reflects the second year of implementation.

The CAFR is presented in three sections, as outlined below.

- The Introductory Section is comprised of this transmittal letter, a list of key State officials, the State's organizational chart and the Certificate of Achievement for Excellence in Financial Reporting for the June 30, 2002 CAFR.
- The Financial Section contains the independent auditors' report on the Basic Financial Statements, Management's Discussion and Analysis (MD&A), Basic Financial Statements (Government-Wide Financial Statements, Fund Financial Statements and notes) and other Required Supplementary Information.
- The Statistical Section includes selected financial, economic and demographic information, presented on a multi-year basis.

GASB Statement Number 34 requires that management provide a narrative introduction, overview and analysis to accompany the Basic Financial Statements in the form of the MD&A. This letter of transmittal is intended to complement the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditors' Report.

PROFILE OF THE GOVERNMENT

The State of Delaware reporting entity reflected in the CAFR, which is described more fully in Note 1 to the basic financial statements, conforms with the requirements of GASB Statement Number 14, The Financial Reporting Entity. The accounting and reporting principles contained in Statement Number 14 are based primarily on the fundamental concept that elected officials are accountable to their constituents. Further, Statement Number 14 provides that the financial statements should emphasize the primary government and permit financial statement users to distinguish between the primary government and its component units. Consequently, the transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the discretely presented component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

The State budgets and controls its financial activities on the cash basis of accounting during its fiscal year. In compliance with State law, the State records its financial transactions in either of two major categories – the budgetary General Fund or budgetary Special Funds. 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. Because GAAP fund definitions for accounting purposes differ from those of the budgetary basis General and Special Funds, these differences are fully explained in Note 1 to the basic financial statements.

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 tax or other revenue allocated to such fund and is charged with the related disbursements. Examples of specific uses of budgetary Special Funds include State park operations and fees charged by the Public Service Commission and the Division of Professional Regulation. Federal payments, unemployment compensation and local school funds 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.

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. Appropriations are reduced immediately when purchase orders are issued for goods and services. The total amount of budgetary General Fund cash disbursements plus unliquidated encumbrances 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 State's primary accounting system, certain Special Funds have financial activity outside that 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 each calendar year, State agencies submit requests for operating and capital funds for the following fiscal year to the Budget Office. 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 enacted prior to July 1.

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 only 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 at the end of a fiscal year excess unencumbered budgetary General Funds must be placed in a reserve account (the "Budget Reserve Account") up to the level of 5% of the estimated budgetary General Fund revenue used to determine the appropriation limit for that fiscal year. Transfers were made which funded the Budget Reserve Account for fiscal 2003 to the maximum limit of \$136.5 million. 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.

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 is 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

The State is directly exposed to various risks or losses related to employee health care, automobile, worker's compensation, police professional malpractice and property and casualty claims. It is the policy of the State not to purchase commercial insurance to cover these risks. Instead, the State covers all claim settlements and judgments out of its budgetary General Fund. The State continues to carry commercial insurance for other risks of loss, including a portion 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, terms and conditions for 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, and 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 other tests to be met at the time of debt issuance.

Pension Plan

The Delaware State Employees' Pension Plan (the Plan) covers 31,877 active employees and approximately 17,000 retired employees. All State employees (except State Police and State judges) and all local school district employees who qualify as full-time or regular part-time employees participate in the Plan. The other plans funded by the State include the closed State Police Pension Plan, the new State Police Pension

Plan, and the State Judiciary Pension Plan. The Plan, 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 basis with the exception of the closed State Police Plan, which remains pay-as-you-go. The funding of PERS is determined by the Pension Trustees, based on annual actuarial analyses undertaken by Milliman & Robertson, Inc.

Revenue and Expenditure Forecasting

Mandated by executive order to submit to the Governor and the General Assembly revenue forecasts for the budgetary General Fund and Transportation Trust Fund, the Delaware Economic and Financial Advisory Council (DEFAC) is currently comprised of 36 members appointed by the Governor from the executive and legislative branches of State government and the private sector. Created in 1977, DEFAC, a fixture in Delaware's budget process, has been endorsed by every Governor since its inception.

DEFAC prepares revenue estimates six times each fiscal year in September, December, March, April, May and June for the current fiscal year and the succeeding two fiscal years. A revenue forecast for the current fiscal year and the succeeding four fiscal years is generated once each year, generally in September. Budgetary General Fund and Transportation Trust Fund expenditure forecasts are generated for the current fiscal year in December, March, April, May and June.

The Transportation Trust Fund is a major part of the State's operating and capital budgets, and, as such, its revenue and expenditures are forecasted along with the budgetary General Fund. Its financial activities are presented as the Delaware Department of Transportation (DELDOT) as an enterprise fund in the accompanying financial statements. Certain budgetary appropriated and non-appropriated Special Funds (i.e., certain user fees and federal funds) are not forecasted through this process.

DEFAC relies on projections of national economic trends, an external econometric model, an econometric model created by the University of Delaware, projections developed by the State's Departments of Finance and Transportation, its members' knowledge of the State's particular economic strengths and weaknesses, and its members' understanding of the structure of the State's revenue system.

The revenue and expenditure forecasts are used in the State budget process to ensure State compliance with the State's constitutional limits on spending and statutory debt limitations. In addition, DEFAC advises the Governor and General Assembly on economic conditions in the State and advises the Governor and the Secretary of Finance on tax policy. DEFAC meetings are open to the public and provide a general forum for

members of the public and private sectors to exchange views on matters of economic and fiscal concern for the State.

ECONOMIC CONDITION AND OUTLOOK

Delaware enjoyed a healthy expansion throughout most sectors of its economy during the 1990's. Throughout the decade, the State consistently outperformed national growth rates. The recent economic slowdown, while relatively long in its duration, has been comparatively mild by historic standards. Delaware appears poised to participate fully in the national economic recovery and add to the gains made during the 1990's.

According to August, 2003 data, the state's personal income, the majority of which consists of labor and proprietor's income, grew by 3.3% from 2001 to 2002, compared with 2.4% for the Mideast region and 2.8% for the nation. Total state personal income in 2002 was \$26.5 billion.

Once regarded primarily as a manufacturing state with high concentrations of employment in chemicals and automobile manufacturing, more recently strong FIRE (finance, insurance and real estate) and services (including government and trade) sectors have become the two largest components of the Delaware economy, representing over 85% of all employment. This fundamental change in the economic base significantly expanded the State's capacity to weather the recessions of the early 1990's and the early part of this decade. This trend is expected to continue and will help Delaware diversify its economic base in periods of economic expansion and to diminish the State's exposure to the economy's inevitable cyclical downturns.

Delaware also continues to be the legal home of over half of all publicly traded corporations in the United States. Delaware is the legal domicile of more than 58% of the companies listed in the "Fortune 500." Since 1989, Delaware has ranked within the top five states in the number of new incorporations.

Looking to the future, Delaware is aggressively pursuing high technology industries, including life sciences research and development, pharmaceuticals, agricultural biotechnology, human biotechnology and information technology. To build on the presence of established leaders in the biotech field like AstraZeneca and DuPont, the State has made a significant investment to establish the Delaware Biotechnology Institute, a partnership involving State government, Delaware's higher education institutions and the private sector designed to expand the State's scientific base and create opportunities for the development of new technologies in the emerging life sciences field.

CURRENT DEVELOPMENTS AND MAJOR INITIATIVES

Strong Financial Management

Delaware's long tradition of handling taxpayers' dollars wisely and efficiently has been recognized by AAA bond ratings. Four principles form the core of this approach: 1) controlling base budget growth; 2) developing sound and responsible tax policy; 3) encouraging debt reduction and utilizing excess one-time cash for capital projects; and 4) maintaining sizable cash balances in reserve.

Beginning in fiscal year 2000, the three principal rating agencies, Moody's Investors Service, Fitch Ratings and Standard & Poor's have rated Delaware's General Obligation bonds Aaa, AAA and AAA, respectively. These ratings were reaffirmed in both bond issuances during fiscal year 2003. They cite such factors as sound financial management and operations, manageable debt burden and above-average wealth and income levels as reasons for awarding Delaware their highest possible ratings.

INDEPENDENT AUDIT

The accounting firm of KPMG LLP has audited the accompanying Basic Financial Statements for the State of Delaware as of, and for the year ended, June 30, 2003. The audit was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and the significant estimates made by management; and evaluating the overall financial statement presentation. KPMG LLP has concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the CAFR for the fiscal year ended June 30, 2003 is fairly presented in conformity with GAAP. The Auditor's report on the financial statements is included in the financial section of this report.

The State Auditor of Accounts performs periodic financial and compliance audits of the various State departments, agencies and institutions of higher education and has primary responsibility for conducting audits under the federal Single Audit Act of 1986, as amended. Results of these audits may be found in separately issued audit reports and may be obtained by contacting the Office of Auditor of Accounts, the Townsend Building, Suite #1, 401 Federal Street, Dover, DE 19901.

CERTIFICATE OF ACHIEVEMENT

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Delaware for its comprehensive annual financial report for the fiscal year

ended June 30, 2002. This is the eighth consecutive year that the State has received this prestigious award. To be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such a report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year. We believe our current report continues to meet the Certificate of Achievement program requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

ACKNOWLEDGEMENTS

The preparation of this Comprehensive Annual Financial Report on a timely basis was made possible by the support of all State agencies and component units that supplied data. I wish to express my special appreciation to my staff and the Division of Accounting as well as all the other individuals and agencies who assisted in the preparation of this report.

We are pleased to announce that the Delaware Comprehensive Annual Report is also available on the Internet. The address is: <http://www.state.de.us/account>.

Sincerely,



David W. Singleton
Secretary of Finance