

Management's Discussion and Analysis

We offer readers of the State of Delaware's financial statements this narrative overview and analysis of the financial activities of the State of Delaware for the fiscal year ended June 30, 2002. We encourage readers to consider the information presented here in conjunction with additional information that we have furnished in our letter of transmittal, which can be found on pages i-x of this report.

Because fiscal year 2002 represents the first year in which the State implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, this discussion and analysis provides few comparisons with the previous year. Future reports are required to include extensive comparisons. All amounts, unless otherwise indicated, are expressed in thousands of dollars.

Financial Highlights

- The assets of the State of Delaware exceeded its liabilities at the close of the most recent fiscal year by \$4.6 billion (net assets). Component units reported net assets of \$519.0, an increase of \$32 million from the previous year.
- The government's total net assets increased by \$125.0 million (2.8%) in fiscal year 2002. Net assets of governmental activities increased by \$129.1 million (9.5%) while net assets of the business-type activities decreased \$4.0 million (0.1%).
- As of the close of the current fiscal year, the State of Delaware's governmental funds reported combined ending fund balances of \$934.6 million, a decrease of \$118.5 million (11.3%) in comparison with the prior year.
- At the end of the current fiscal year, unreserved fund balance for the general fund was \$580.2 million, or 17.8% of total general fund expenditures. For the most part, the unreserved fund balance is not available for new spending. These funds have been committed based on State statutes.
- The State of Delaware's total general obligation debt increased during the fiscal year to \$709.9 million, an increase of \$56.2 million (8.6%).

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the State of Delaware's basic financial statements. The State's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains required and other supplementary information in addition to the basic financial statements.

Government-wide financial statements. The government-wide financial statements are designed to provide readers with a broad overview of the State of Delaware's finances, in a manner similar to a private-sector business.

The statement of net assets presents information on all of the State of Delaware's assets and liabilities, with the difference between the two reported as net assets.

Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the State of Delaware is improving or deteriorating.

The statement of activities presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave).

Both of the government-wide financial statements distinguish functions of the State of Delaware that are principally supported by taxes and intergovernmental revenues (governmental activities) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (business-type activities). The governmental activities of the State of Delaware include general government, health and children's services, judicial and public safety, natural resources and environmental control, labor and education. The business-type activities of the State of Delaware include transportation, lottery and unemployment.

The government-wide financial statements include not only the State of Delaware (known as the primary government), but also legally separate entities for which the State of Delaware is financially accountable. These entities include: The Delaware State Housing Authority, the Diamond State Port Corporation, the Riverfront Development Corporation, the Delaware State University and nine charter schools. Financial information for these component units are reported separately from the financial information presented for the primary government. The government-wide financial statements can be found on pages 19-21 of this report.

Fund financial statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The State of Delaware, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the State of Delaware can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of available resources, as well as on balances of available resources on hand at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for government funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

The State of Delaware maintains four individual governmental funds: the general fund, the capital projects fund, the federal fund and the local school district fund. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for these funds.

The State of Delaware budgets and controls its financial activities on the cash basis of accounting. 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 two funds in this report include the terms “budgetary” or “budgetary basis” to differentiate them from the GAAP funds of the same name which encompass different funding categories. The State of Delaware adopts an annual appropriated budget for its budgetary general fund. A budgetary comparison statement has been provided for the budgetary general fund to demonstrate compliance with this budget. The statement can be found on page 108 of this report.

The basic governmental fund financial statements can be found on pages 24-28 of this report.

Proprietary funds. The State of Delaware maintains one type of proprietary fund. Enterprise funds are used to report the same functions presented as business-type activities in the government-wide financial statements. The State of Delaware uses enterprise funds to account for the State Lottery, Unemployment Trust Fund and the Department of Transportation operations.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The proprietary fund financial statements provide separate information for the State Lottery, Unemployment Trust Fund and the Department of Transportation, all of which are considered to be major funds of the State of Delaware.

The basic proprietary fund financial statements can be found on pages 31-33 of this report.

Fiduciary funds. Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the State of Delaware’s own programs. The pension trust funds are the primary fiduciary funds for the State. The accounting used for fiduciary funds is much like that used for proprietary funds.

The basic fiduciary fund financial statements can be found on pages 36-37 of this report.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 47-106 of this report.

Other information. In addition to the basic financial statements and accompanying notes, this report also presents certain required supplementary information concerning the State of Delaware's status of the legally adopted budget and the maintenance of the State's infrastructure. Required supplementary information can be found on pages 108-116 of this report.

Statewide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the State of Delaware, assets exceeded liabilities by \$4.6 billion at the close of the most recent fiscal year.

By far the largest portion of the State of Delaware's net assets (72.4%) reflects its investment in capital assets (e.g., land, buildings, vehicles, and equipment), less any related debt used to acquire those assets that is still outstanding. The State uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the State of Delaware's investment in capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities. Restricted net assets, comprising 9.6% of total net assets, represents resources that are subject to external restrictions, constitutional provisions, or enabling legislation on how they can be used. The remaining portion, unrestricted net assets (18.0%), may be used at the State's discretion, but for the most part these funds have been appropriated based on State statutes.

Net Assets as of June 30, 2002

	Governmental activities	Business-type activities	Total
Current and other non-current assets	\$ 1,456	\$ 604	\$ 2,060
Capital assets	1,391	3,327	4,718
Total assets	<u>2,847</u>	<u>3,931</u>	<u>6,778</u>
Long-term liabilities outstanding	900	658	1,558
Other liabilities	461	158	619
Total liabilities	<u>1,361</u>	<u>816</u>	<u>2,177</u>
Net assets:			
Invested in capital assets, net of related debt	680	2,651	3,331
Restricted	129	311	440
Unrestricted	677	153	830
Total net assets	<u>\$ 1,486</u>	<u>\$ 3,115</u>	<u>\$ 4,601</u>

The following condensed financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year.

Changes in Net Assets

(Expressed in Thousands)

	<u>Governmental activities</u>	<u>Business-type activities</u>	<u>Total Primary Government</u>
Revenues:			
Program revenues:			
Charges for services	\$ 861,111	\$ 1,047,300	\$ 1,908,411
Operating grants and contributions	718,815	26,415	745,230
Capital grants and contributions		106,938	106,938
General revenues:			
Taxes:			
Personal income taxes	718,672		718,672
Business taxes	1,153,025		1,153,025
Other taxes	167,258		167,258
Real estate taxes	238,574		238,574
Investment earnings	58,624	26,915	85,539
Gain (Loss) on sale of assets		(60)	(60)
Total revenues	<u>3,916,079</u>	<u>1,207,508</u>	<u>5,123,587</u>
Expenses:			
General Government	808,574		808,574
Health and Children's Services	1,240,332		1,240,332
Judicial and Public Safety	389,806		389,806
Natural Resources and Environmental Control	111,443		111,443
Labor	60,650		60,650
Education	1,410,708		1,410,708
Interest Expense	31,576		31,576
Lottery		380,084	380,084
Transportation		448,839	448,839
Unemployment		116,538	116,538
Total expenses	<u>4,053,089</u>	<u>945,461</u>	<u>4,998,550</u>
Increase in net assets before transfers	(137,010)	262,047	125,037
Transfers	<u>266,090</u>	<u>(266,090)</u>	
Increase (decrease) in net assets	129,080	(4,043)	125,037
Net assets - Beginning of Year	<u>1,357,396</u>	<u>3,119,105</u>	<u>4,476,501</u>
Net assets - End of Year	<u>\$ 1,486,476</u>	<u>\$ 3,115,062</u>	<u>\$ 4,601,538</u>

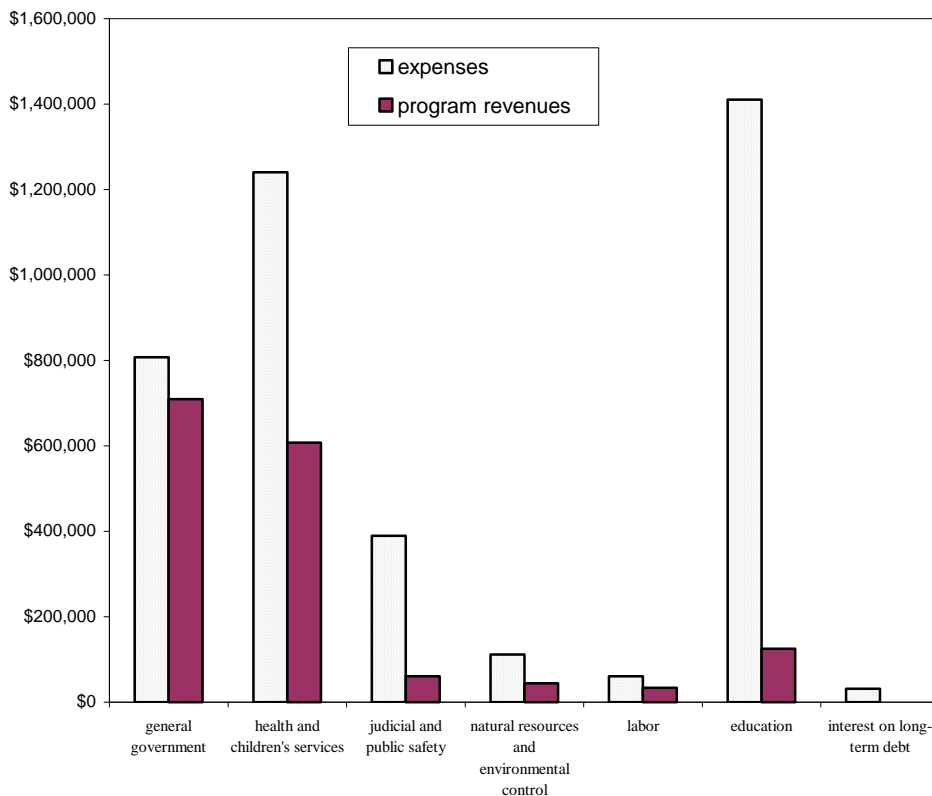
Governmental activities. Governmental activities increased the State of Delaware’s net assets by \$129.1 million, thereby accounting for more than the State’s growth in net assets of \$125.0 million. The decrease by the business-type activities is explained on the following page. A comparison of the cost of services by function for the State’s governmental activities is shown in the following chart, along with the revenues used to cover the net expenses of the governmental activities. Key elements of the increase in net assets are as follows:

Total general revenues increased \$39.9 million based on growth in corporate income tax, realty transfer tax and bank franchise tax. Lottery revenues showed continued growth of 12.4% adding \$25.4 million to the State’s General Fund. Personal income tax decreased \$77.7 (9.8%) due to various tax law changes.

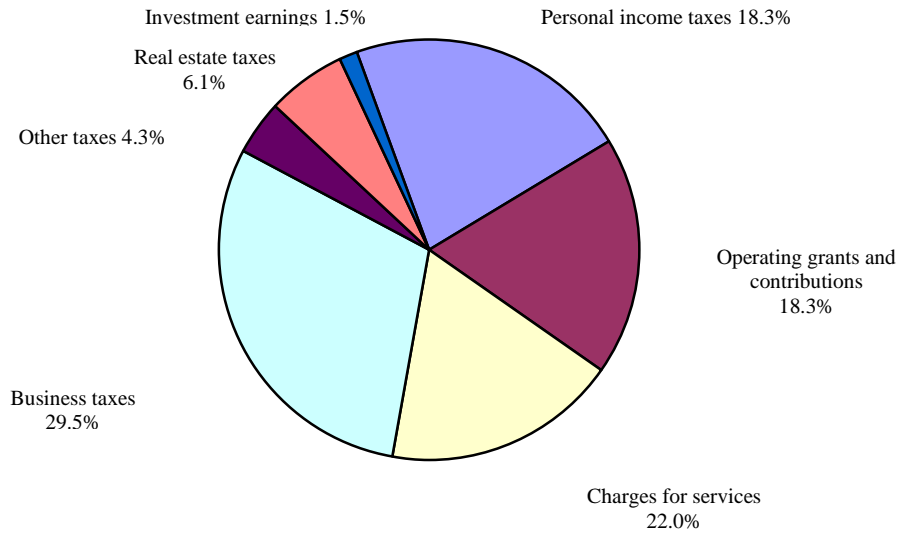
Charges for services and operating grants and contributions increased by \$55.2 million, primarily due to an increase in grant revenues.

Expenses for governmental activities increased during fiscal year 2002 by \$112.2 (2.9%). Of this increase, \$66.1 million was due to increased spending in education and a \$71.0 million increase in Health and Children’s Services. The General Government function showed a decrease in spending of \$28.2 million.

Expenses and Program Revenues – Governmental Activities



Revenues by Source – Governmental Activities



Business-type activities. Business-type activities decreased the State’s net assets by \$4.0 million. This resulted from a \$9.3 million decrease in net assets by the Delaware Unemployment Insurance Trust Fund, a decrease of \$.4 million in the Delaware State Lottery and an increase in net assets of \$5.7 million by the Delaware Department of Transportation.

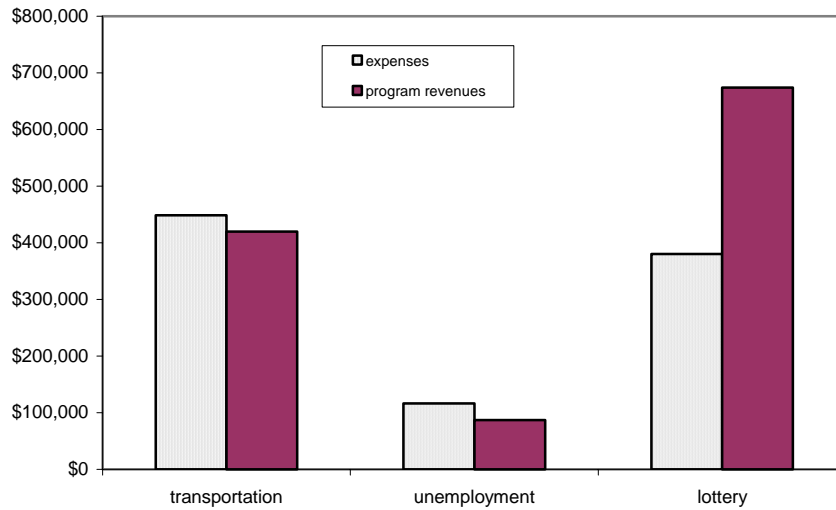
The decrease in net assets of the Delaware Unemployment Insurance Trust Fund was similar to the \$14.1 million decrease in fiscal year 2001 and can be attributed to a 27% increase in unemployment benefits, which was partially offset by a \$26 million grant from the federal government. The grant was used to pay unemployment benefits.

The Delaware Lottery increased operating income by 12% and transferred an additional \$25.4 million to the State’s General Fund in fiscal year 2002.

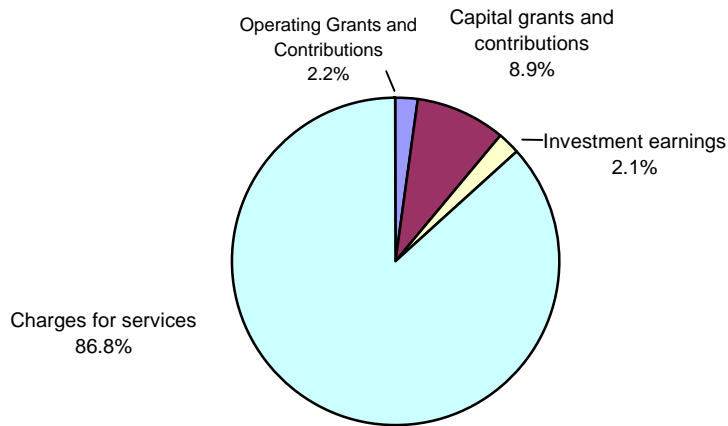
The Delaware Department of Transportation experienced an increase in revenues due partially to increased traffic on State toll roads and an increase in gasoline consumption. Contributing factors for the increase in operating expenses for fiscal year 2002 are the investments in the Diamond State Port Corporation, the spending down of excess cash reserve and increased hours and miles of transit service.

The Department of Transportation’s decrease of non-operating revenues, net, is primarily attributable to the decrease in federal grant revenue of \$24.1 million and a \$6.4 million reduction of income from investments solely from the economic impact of the Federal Reserve’s rate reductions.

Expenses and Program Revenues – Business-type Activities



Revenues by Source – Business-type Activities



Financial Analysis of the State’s Funds

As noted earlier, the State of Delaware uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds. The focus of the State of Delaware’s governmental funds is to provide information on near-term inflows, outflows, and balances of available resources. Such information is useful in assessing the State of Delaware’s financing requirements. In particular, unreserved fund balances may serve as a useful measure of a government’s net resources at the end of the fiscal year.

As of the end of the current fiscal year, the State of Delaware's governmental funds reported combined ending fund balances of \$934.6 million, a decrease of \$118.5 million in comparison with the prior year. Approximately one-half of the aggregate fund balances, \$467.3 million constitutes unreserved fund balances. The unreserved fund balances, for the most part are not available for new spending. These funds have been committed based on State statutes. The remainder of the fund balances are reserved to indicate that they are not available for new spending due to commitments: 1) to liquidate contracts and purchase orders of the prior period (\$252.1 million), 2) to pay debt service (\$66.0 million), 3) set aside for the budget reserve account (\$128.9 million), or 4) for inventories and other prepaid items (\$20.3 million).

The general fund is the chief operating fund of the State of Delaware. At the end of the current fiscal year, unreserved fund balance of the general fund was \$580.2 million, while total fund balance reached \$921.6 million. As a measure of the general fund's liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance represents 17.8% of total general fund expenditures, while total fund balance represents 28.3% of that same amount.

Total fund balance diminished during the fiscal year by \$82.5 million primarily as a result of lower personal and business tax collections due to a slowing economy. Based on anticipated further reductions in revenues, budget cuts were initiated and a hiring freeze was implemented early in the fiscal year to soften the impact on the fund balance. However, as of the end of fiscal 2002, general fund expenditures were below the level of appropriations and revenues exceeded budgeted amounts.

Proprietary funds. The State of Delaware's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

As discussed in the business-type activities on page 10, the State's net assets decreased by \$4.0 million as a result of operations in the proprietary funds. This resulted from a \$9.3 million decrease in net assets by the Delaware Unemployment Insurance Trust Fund, a decrease of \$.4 million in the Delaware State Lottery and an increase in net assets of \$5.7 million by the Delaware Department of Transportation.

General Fund Budgetary Highlights

The Budgetary General Fund is the chief operating fund of the State. At the end of the fiscal year, total fund balance diminished slightly (\$28.1 million). Revenues were higher (4.2 percent) than the previous fiscal year due to an increase in the collections from the corporate income tax, the realty transfer tax and the bank franchise tax, although personal income and corporate franchise taxes were down slightly. As it became apparent that the economy was slowing, measures were taken to reduce spending.

The following summarizes the differences between the final appropriated budget (the original budget in addition to encumbrances and multi-year project budgetary carry-forwards from the prior fiscal year) and actual expenditures.

- \$84.0 million in decreases in general government activities
- \$95.5 million in decreases in education
- \$32.1 million in decreases in Health and Children's services
- \$15.8 million in decreases in the Department of Natural Resources and Environmental Control.

Capital Asset and Debt Administration

Capital assets. The State of Delaware's investment in capital assets for its governmental and business-type activities as of June 30, 2002, amounts to \$4.7 billion (net of accumulated depreciation). This investment in capital assets includes land, land improvements, buildings, vehicles and equipment, easements, roads, highways, and bridges. The total increase in the State of Delaware's investment in capital assets for the current fiscal year was \$301.4 million (a 23.5% increase for governmental activities and a 1.1% increase for business-type activities).

Major capital asset events during the current fiscal year included the following:

- Various building system additions and improvements were completed for schools, correctional facilities and other state facilities at a cost of \$64.0 million.
- On-going construction projects continued at an additional cost of \$193.0 million and will provide new schools, a new courthouse and additional prison facilities, as well as additions and improvements to existing schools and other state facilities.
- The Department of Transportation added \$36.6 million in capital assets during fiscal year 2002. The Department is in the process of completing a 41 mile controlled access highway extending from south of Wilmington to points south of Dover. Funding for the final section of highway from south of Odessa to north of Smyrna is part of the Department's six-year Capital Transportation Program and will be finished in May 2003. SR1 is the largest public works project ever undertaken in Delaware. In addition, the Department completed construction of a new Delaware Transit Corporation administration building and a new south wing on the Department's Dover Administration complex.

State of Delaware Capital Assets as of June 30

(Net of Depreciation)

	Governmental activities	Business-type activities	Total Primary Government
Land	\$ 265,155	\$ 11,230	\$ 276,385
Land Improvements	23,160		23,160
Buildings	525,653	33,419	559,072
Easements	64,344		64,344
Equipment and vehicles	50,652	80,297	130,949
Infrastructure		3,201,814	3,201,814
Construction-in-progress	462,119		462,119
Total	\$ 1,391,083	\$ 3,326,760	\$ 4,717,843

As allowed by GASB Statement No. 34, the State has adopted an alternative process for recording depreciation expense on selected infrastructure assets. Under this alternative method, referred to as the modified approach, the State expenses certain maintenance and preservation costs and does not report depreciation expense. Assets accounted for under the modified approach include approximately 11,057 lane miles of roads and approximately 1,359 bridges that the State is responsible to maintain.

The Department of Transportation will perform condition assessments of eligible infrastructure assets at least every three years. Currently road condition assessments are conducted every year and bridge condition assessments are conducted, for the most part, every two years.

It is the Department of Transportation's policy to maintain at least 75 percent of its highways and bridge system at a good or better condition level. No more than 10 percent of bridges and 15 percent of roads should be in substandard condition.

Of the State's 1,359 bridges, 1,057 or 77.7 percent received a good or better BCR rating in 2001, 17.1 percent were rated fair, and 5.2 percent received a substandard rating. Of the 787,243 square meters of bridge deck, 97 percent or 763,388 square meters received an OPC good condition rating, 2 percent received a fair rating and 1 percent or 8,343 square meters received a substandard deck rating.

In 2002, when 4,175 centerline miles were rated, 76.6 percent received a good or better OPC rating, 13.6 percent received a fair rating, and 9.8 percent received a poor rating.

The 2002 estimate to maintain and preserve the Department of Transportation's infrastructure was \$97.3 million, but the actual expenditure was \$126.6 million, which is a \$29.2 million increase over the estimate. The variance is predominantly attributed to change orders necessary on jobs that are not estimated when the project is set up and budgeted. The increase in the estimate of maintenance and preservation costs from the previous fiscal year is primarily due to new categories of expenditures being used by the Department's Capital Transportation program.

The fiscal 2003 statewide capital budget totals \$407.2 million. Of that amount, \$182.4 million is allocated for non-transportation projects statewide and \$224.7 million for Transportation Trust Fund projects. Major projects that will to be completed during the year include the New Castle County Courthouse, various school construction projects and the new SR1 toll road.

Additional information on the State of Delaware's capital assets can be found in Note 1 on pages 55-56, Note 13 on page 87 and on pages 115-116 of the Required Supplementary Information.

Long-term debt. At the end of the current fiscal year, the State of Delaware had total general obligation bond debt outstanding of \$709.9 million, backed by the full faith and credit of the State. The Delaware Department of Transportation Fund had revenue bonds outstanding of \$675.7 million. The bonds do not constitute a debt of the State or a pledge of the general taxing power or the faith and credit of the State. The Delaware Economic Development Office has \$.4 million of industrial development revenue bonds outstanding, which are supported by the full faith and credit of the State.

**State of Delaware Outstanding Debt
General Obligation and Revenue Bonds**

	Governmental activities	Business-type activities	Total Primary Government
General obligation bonds	\$ 709.9		\$ 709.9
Revenue bonds	0.4	\$ 675.7	676.1
Total	\$ 710.3	\$ 675.7	\$ 1,386.0

The State of Delaware's total debt increased by \$56.2 million (8.6%) during the current fiscal year in part because there were no bonds sales in the previous fiscal year. The key factors in this increase were for public education facilities, prison construction, State offices and higher education facilities. During the current fiscal year, the State refinanced \$132.7 million or 18.7% of its outstanding debt to take advantage of favorable interest rates. The result is expected to save taxpayers over \$6.4 million in future interest payments.

Transportation Systems Revenue Bonds are issued with the approval of the State's General Assembly, and the State's Bond Issuing Officers (the Governor, the Secretary of Finance, the Secretary of State, and the State Treasurer) to finance improvements to the State's transportation systems. Approval by the General Assembly of the State is not required for the Authority to issue bonds to refund any of its bonds provided a present value debt service savings is achieved in such refunding.

At June 30, 2002, the Department had \$675.7 million in revenue bonds outstanding, a 6.5 percent increase from June 30, 2001. During the past year, \$85 million of new money bonds were issued in November 2001 and \$91.1 million of bonds were refunded in April 2002. The bonds were insured and are rated AAA by Standard & Poor's (S&P) and Aaa by Moody's. Of the 11 outstanding bond issues,

four have an AA rating from S&P and an A1 rating from Moody's. The remaining seven issues are rated AAA by S&P and Aaa by Moody's.

There is no Constitutional debt limit of the State; however, in 1991, the State enacted legislation to replace the previous statutory debt limits with a three-part debt limit, one of which restricts new debt authorization to 5% of budgetary General Fund revenue as projected on June 30 for the next fiscal year. Should revenue collections increase during the fiscal year, no additional authorizations are made. For further information concerning the State's debt limits, see page 125 of the Statistical Section.

Additional information on the State of Delaware's long-term debt can be found in Note 6 on pages 69-72 of this report.

Economic Factors and Next Year's Budgets and Rates

Fiscal year 2002's GDP was raised from 0.6 percent growth forecasted in March 2002 to an estimated growth rate of 1.1 percent as per the Delaware Economic and Financial Advisory Council's (DEFAC) June 2002 forecast. The real GDP forecast for fiscal year 2003 is still modest growth of 3.1 percent. Employment in Delaware has declined by 1.5 percent during the current fiscal year. This drop has mostly been in the area of service and retail jobs. Continued job losses in the chemical sector have also occurred.

The fiscal year 2003 operating and capital budgets meet budgetary spending limitations imposed by law. Although the budget reflects slowing growth in revenues, operating programs are all funded. Capital budget appropriations have decreased from fiscal year 2002 due to revenue availability and the reduction in cash contributions for one-time items.

Requests for Information

This financial report is designed to provide a general overview of the State of Delaware's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Director of Accounting, 540 South DuPont Highway, Thomas Collins Building, Suite 3, Dover, Delaware

The State's component units, with the exception of Charter Schools, publish their own separately issued audited financial statements. These statements may be obtained from their respective administrative offices or from the Office of Auditor of Accounts, the Townsend Building, Suite #1, 401 Federal Street, Dover, DE 19901.