
**MANAGEMENT'S DISCUSSION
AND ANALYSIS—
Required Supplementary Information
(Unaudited)**

Management's Discussion and Analysis

In this section of the State of South Carolina's annual report, we provide a narrative overview and analysis of the State's financial performance for its accounting year (*fiscal year*) that ended June 30, 2004. Please read it together with (1) the Comptroller's *Letter of Transmittal* at the front of this report and (2) the financial statements, which follow this section.

Overview of the Financial Statements

This discussion and analysis provides an introduction to the State of South Carolina's basic financial statements, which include the following parts: (1) *government-wide financial statements*, (2) *fund financial statements*, (3) *component unit financial statements*, and (4) *notes to the financial statements*. This report also contains certain required *supplementary information* and other supplementary information.

Government-wide Financial Statements

The government-wide statements present a long-term view of the State's finances *as a whole*, using *accrual-basis accounting*—the same accounting methods that most businesses use. The basic government-wide financial statements are on pages 33 through 129 of this report.

There are two government-wide financial statements:

Statement of net assets: This statement presents information on *all* of the State's assets and liabilities, both short-term (*current*) and long-term (*non-current*). In addition, the statement reports the difference between assets and liabilities as *net assets*. Over time, increases or decreases in net assets may indicate whether the State's financial health (*financial position*) is strengthening or weakening. However, the statement of net assets does not tell the whole story. To assess the State's overall financial health, you would also need to consider factors such as the State's economy and the condition of its *capital assets* such as its buildings and *infrastructure* (roads and bridges).

Statement of activities: This statement presents information showing how the State's overall net assets changed during the year. The State reports a change in its net assets as soon as an underlying event occurs that would cause a change. The statement of activities accounts for all current-year revenues and expenses, regardless of when the State received or paid cash. Although governments compile the statement of activities using accounting methods similar to businesses, this statement's format is quite different from the format of a business's income statement. The statement of activities can help to show how much it costs the State to provide various services. It also can help to show the extent to which each government function covers its own costs through user fees, charges, or grants. The net *revenue (expense)* column on the far right of this statement (page 38) shows how much a particular function relies on taxes and other general revenues to finance its programs.

The government-wide statements report three different kinds of *activities*:

Governmental activities: Most of the State's basic services are included here, such as general government, education, health and environment, social services, administration of justice, and intergovernmental (State aid to local governmental entities, including aid to the State's public school system). Taxes (primarily income and sales taxes) and federal grants finance most of these services.

Business-type activities: These activities usually recover all, or a significant portion, of the costs of their services or goods by charging fees to customers. Higher education (State-supported colleges and universities), unemployment compensation benefits, financing of housing facilities, and financing of student loans are the most significant of South Carolina's business-type activities.

Component units: Although component units are legally separate from the State, the State's elected officials are financially accountable for them. The Public Service Authority (Santee-Cooper, an electric utility company), the State Ports Authority, the Connector 2000 Association, Inc. (which operates the Southern Connector, a toll road), and the Lottery Commission are the State's major component units. Some financial information for these component units is included in this report. You also can obtain complete financial statements for these component units from their respective administrative offices (see Note 1a of the notes to the financial statements).

Fund Financial Statements

The fund financial statements on pages 40 through 63 of this report provide detailed information about the State's most significant funds—not the State as a whole. Funds are accounting designations that the State uses to track specific funding sources and spending for particular purposes. South Carolina, like other governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The State reports three types of *funds*:

Governmental funds: The State reports most of its basic services in governmental funds. Governmental funds account for activities that the State reports as *governmental activities* in its government-wide statements. These funds focus on *short-term* inflows and outflows of expendable resources. The balances remaining at the end of the year help determine whether a fund has more or less financial resources available to spend in the near future. Because the governmental fund statements lack the additional long-term focus of the government-wide statements, we provide a reconciliation that explains the relationship (or differences) between the two kinds of statements. By comparing the two kinds of statements and examining the reconciliation, you may better understand the long-term impact of the State's near-term financing decisions.

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The basic governmental fund statements are on pages 40 through 47 of this report.

Proprietary funds: Proprietary funds charge customers for the services they provide—whether they are outside customers (*enterprise funds*) or other State agencies or other governments (*internal service funds*). Proprietary funds use *accrual basis accounting* like businesses. The State reports all of its enterprise funds (proprietary funds providing services to outside customers) as *business-type activities* in the government-wide statements. However, because our internal service fund operations primarily benefit other State agencies or other governments, these proprietary funds are included as *governmental activities* in the government-wide financial statements.

The basic proprietary fund statements are on pages 48 through 61 of this report.

Fiduciary funds: The State is the trustee, or *fiduciary*, for its employees’ retirement plans. The State also is responsible for other assets that, because of a trust agreement, it is to use only for trust beneficiaries. We *exclude* these activities from the State’s government-wide financial statements because the State is not to use these assets to finance its operations. The State has an obligation to ensure that the net assets it reports in fiduciary funds are used for their intended purposes.

The basic fiduciary fund statements are on pages 62 and 63 of this report.

Component Unit Financial Statements

The *Government-wide Financial Statements* section on the preceding page lists the State’s major component units under the *Component units* subheading. More detailed financial statements for these component units are on pages 64 through 67 of this report.

Notes to the Financial Statements

Immediately following the financial statements are *notes* that help explain some of the information in the financial statements and provide more detailed data. The notes on pages 71 through 129 are necessary to fully understand the financial statements.

Required Supplementary Information

This section includes certain *required* reporting information that supplements the basic financial statements. Included in this section is a schedule that compares the State’s legally adopted General Fund budget with actual revenues collected and expenditures paid for the year. Note 5 to the required supplementary information is a reconciliation that helps explain differences between the changes in fund balance of certain funds when presented on the budgetary-basis and the changes in fund balance of these funds when presented on the GAAP basis as reported in the governmental fund statements. This section also includes schedules related to the State’s National Guard Pension System, a single-employer defined benefit pension plan. This required supplementary information is on pages 131 through 139 of this report.

Government-wide Financial Analysis

Exhibits 1 and *2* summarize the State’s overall financial position and results of operations for the past two years based on information included in the government-wide financial statements.

Exhibit 1
State of South Carolina's Net Assets as of June 30, 2004, with Restated Comparative Data as of June 30, 2003
(Expressed in Thousands)

	Governmental Activities		Business-type Activities		Totals— Primary Government		Total Percentage Change
	2004	2003	2004	2003	2004	2003	2003-2004
Assets							
Current and other assets.....	\$ 6,381,109	\$ 5,863,634	\$ 3,768,061	\$ 3,628,526	\$ 10,149,170	\$ 9,492,160	6.9%
Capital assets.....	11,670,170	10,973,503	2,589,266	2,430,956	14,259,436	13,404,459	6.4%
Total assets.....	18,051,279	16,837,137	6,357,327	6,059,482	24,408,606	22,896,619	6.6%
Liabilities							
Long-term liabilities.....	4,893,936	4,567,721	2,375,252	2,174,106	7,269,188	6,741,827	7.8%
Other liabilities.....	3,138,328	2,909,443	829,529	832,297	3,967,857	3,741,740	6.0%
Total liabilities.....	8,032,264	7,477,164	3,204,781	3,006,403	11,237,045	10,483,567	7.2%
Net Assets							
Invested in capital assets, net of debt....	8,534,931	8,077,945	1,695,208	1,648,504	10,230,139	9,726,449	5.2%
Restricted.....	2,445,033	2,385,607	1,186,958	1,187,558	3,631,991	3,573,165	1.6%
Unrestricted.....	(960,949)	(1,103,579)	270,380	217,017	(690,569)	(886,562)	22.1%
Total net assets.....	\$ 10,019,015	\$ 9,359,973	\$ 3,152,546	\$ 3,053,079	\$ 13,171,561	\$ 12,413,052	6.1%

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Net Assets

As we noted earlier, net assets may serve, over time, as a useful indicator of the State's financial position. For the 2003-2004 accounting year, the State's net assets totaled \$13.172 billion.

The largest portion of the State's net assets reflects its investment in capital assets (for example, buildings, roads, and bridges), 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, they are *not* available for future spending. Further, the State cannot sell the capital assets themselves to pay off the related debt because it needs the assets for its operations; so it must find other resources to pay off the debt.

Restricted net assets generally are available for future spending but are subject to external restrictions (such as bond covenants, federal government grant restrictions) or restrictions imposed by enabling State legislation or through State constitutional provisions. The State's largest restricted balances include capital improvement bond proceeds (restricted for various capital projects), and loan program funds (restricted

primarily for local government water and sewer projects).

Unrestricted net assets—resources available for future spending—reported a *deficit* balance of \$690.569 million. The overall *negative* unrestricted net assets balance resulted from the \$960.949 million deficit that the governmental activities reported. This deficit largely consisted of the following: (1) \$796.200 million in long-term debt to finance capital assets is included while the assets are not included on the State's financial statements because most of those assets belong to local governments and because some of the debt proceeds were used for non-capital purposes, and (2) a \$200.474 million deficit related to the use of Tobacco Settlement bond proceeds for operating purposes. Please see Note 3 in the notes to the financial statements for a more detailed explanation of the deficit reported for the State's governmental activities.

The State's *business-type activities*, on the other hand, reported a *positive* \$270.380 million unrestricted net asset balance. This resulted from net positive balances of \$479.285 million associated with higher education and certain other business-type activities. However, that positive balance was offset by a \$208.905 million deficit related to the State-run medical malpractice insurance program.

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Exhibit 2
State of South Carolina's Changes in Net Assets
 For the Fiscal Year Ended June 30, 2004, with Restated Comparative Data for the Fiscal Year Ended June 30, 2003
 (Expressed in Thousands)

	Governmental Activities		Business-type Activities		Totals—Primary Government		Total Percentage Change 2003-2004
	2004	2003	2004	2003	2004	2003	
Revenues							
Program revenues:							
Charges for services.....	\$ 1,599,859	\$ 1,500,240	\$ 3,010,024	\$ 2,813,392	\$ 4,609,883	\$ 4,313,632	6.9%
Operating grants and contributions.....	5,656,373	5,139,624	422,971	429,283	6,079,344	5,568,907	9.2%
Capital grants and contributions.....	584,722	516,167	47,136	47,381	631,858	563,548	12.1%
General revenues:							
Individual income tax.....	2,416,437	2,282,464	—	—	2,416,437	2,282,464	5.9%
Retail sales and use tax.....	3,009,485	2,820,520	—	—	3,009,485	2,820,520	6.7%
Other taxes.....	1,390,893	1,323,521	—	—	1,390,893	1,323,521	5.1%
Unrestricted grants and contributions.....	80,333	82,721	—	—	80,333	82,721	(2.9%)
Unrestricted investment income.....	18,723	29,535	—	—	18,723	29,535	(36.6%)
Tobacco legal settlement.....	74,180	80,042	—	—	74,180	80,042	(7.3%)
Other.....	75,967	71,621	—	—	75,967	71,621	6.1%
Total revenues.....	14,906,972	13,846,455	3,480,131	3,290,056	18,387,103	17,136,511	7.3%
Expenses							
Governmental activities:							
General government.....	1,587,442	1,485,190	—	—	1,587,442	1,485,190	6.9%
Education.....	1,228,354	1,110,675	—	—	1,228,354	1,110,675	10.6%
Health and environment.....	4,588,137	4,240,170	—	—	4,588,137	4,240,170	8.2%
Social services.....	942,591	846,818	—	—	942,591	846,818	11.3%
Administration of justice.....	628,227	676,157	—	—	628,227	676,157	(7.1%)
Resources and economic development.....	192,000	202,982	—	—	192,000	202,982	(5.4%)
Transportation.....	531,667	473,086	—	—	531,667	473,086	12.4%
Intergovernmental.....	3,813,383	3,686,361	—	—	3,813,383	3,686,361	3.4%
Other.....	67,614	76,130	—	—	67,614	76,130	(11.2%)
Business-type activities:							
Higher education.....	—	—	2,527,649	2,460,589	2,527,649	2,460,589	2.7%
Higher education institution support ^a	—	—	757,252	728,103	757,252	728,103	4.0%
Unemployment compensation benefits.....	—	—	493,619	546,389	493,619	546,389	(9.7%)
Financing of housing facilities.....	—	—	137,671	133,632	137,671	133,632	3.0%
Medical malpractice insurance.....	—	—	30,733	50,113	30,733	50,113	(38.7%)
Financing of student loans.....	—	—	39,641	41,409	39,641	41,409	(4.3%)
Tuition prepayment program.....	—	—	30,620	27,208	30,620	27,208	12.5%
Patriots Point development.....	—	—	6,976	6,986	6,976	6,986	(0.1%)
Insurance claims processing.....	—	—	1,586	1,603	1,586	1,603	(1.1%)
Other.....	—	—	22,659	25,452	22,659	25,452	(11.0%)
Total expenses.....	13,579,415	12,797,569	4,048,406	4,021,484	17,627,821	16,819,053	4.8%
Excess (deficiency) before transfers and special and extraordinary items.....	1,327,557	1,048,886	(568,275)	(731,428)	759,282	317,458	139.2%
Special and extraordinary items.....	—	—	(773)	(996)	(773)	(996)	22.4%
Net transfers.....	(668,515)	(782,874)	668,515	782,874	—	—	N/A
Increase in net assets.....	659,042	266,012	99,467	50,450	758,509	316,462	N/A
Net assets, beginning of year.....	9,359,973	9,093,961	3,053,079	3,002,629	12,413,052	12,096,590	0.0%
Net assets, end of year.....	\$ 10,019,015	\$ 9,359,973	\$ 3,152,546	\$ 3,053,079	\$ 13,171,561	\$ 12,413,052	6.1%

^a The higher education institution support activity represents associations, foundations, and authorities created for the benefit of the State's higher education institutions.

Changes in Net Assets

The State's net assets increased \$758.509 million, or 6.1%, over the prior year's net assets.

Governmental Activities

Net assets of the State's governmental activities increased by \$659.042 million, or 7.0%, primarily due to increased revenues. Governmental activities' revenues are derived mostly from taxes; grants and contributions, including federal aid; and charges for goods and services. *Exhibit 3* illustrates the sources of revenues that support governmental activities.

Governmental activities' expenses were mostly associated with services provided for health and environment, intergovernmental, general government, education, and social services. *Exhibit 4* compares the cost of these services with their *program revenues*—revenues derived directly from the program itself or from parties outside the State's taxpayers or citizenry. The difference between the two represents the *net cost* of these services that taxes and other general revenues financed. Intergovernmental expenses of \$3.813 billion represent aid provided to local governments, including local school districts; taxes and other general revenues entirely supported these expenses. This aid includes formula-based State revenue sharing, aid to local school districts for public education, and subsidies to reimburse

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counties for the State's residential property tax relief program. For the accounting year ended June 30, 2004, the State used \$5.738 billion in tax and other general revenues to finance the net cost of all services that the State's governmental activities provided. Governmental activities reported \$668.515 million in net transfers to the State's business-type activities, most of which represents support provided to the State's public colleges and universities.

The following paragraphs highlight the most significant changes in revenues, expenses, and net transfers for governmental activities during the 2003-2004 accounting year:

- Operating grants and contributions increased by \$516.749 million, or 10.1%, over last year. This change related to increases in federal grant revenues and in contributions for education from the Lottery Commission. Federal Medicaid funding increased due to rising health costs and increased client participation. In addition, the percentage of federal funding for Medicaid expenses increased as a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003. Federal funds for food stamp benefits were greater because of an increase in households receiving these benefits. Lottery contributions increased significantly during this second full fiscal year of lottery operations.
- Capital grants and contributions increased \$68.555 million, or 13.3%, because of increased federal funding for State highway construction projects.
- State tax revenues rebounded due to improving economic conditions. Tax revenues increased \$390.310 million, or 6.1%, over last year. Individual income and sales taxes increased 5.9% and 6.7%, respectively, as the State's employment picture improved. By comparison, there was no growth in tax revenues reported during the previous fiscal year. Individual income taxes actually declined 3.2% during fiscal year 2002-2003 because of higher unemployment during that reporting period.
- Education expenses rose \$117.679 million, or 10.6%. Most of this increase was due to an increase in federal grant revenues distributed by the State Department of Education to South Carolina's school districts. Additionally, lottery-based scholarships paid to the State's colleges and universities increased during this second fiscal year of lottery-based scholarship funding.
- Health expenses increased \$347.967 million, or 8.2%. Medicaid expenses continue to climb as a result of an increase in client participants and overall higher health costs.
- Social service expenses were \$95.773 million, or 11.3%, more than last year primarily because of an increase in the number of families receiving food stamp benefits.
- Administration of justice expenses declined \$47.930 million, or 7.1%. Prior to fiscal year 2003-2004, the State's motor vehicle program was reported under the State Department of Public Safety. As a result of government restructuring, that program became a cabinet agency under the Governor's authority and its activity is now reported within the general government function.
- Transportation expenses rose \$58.581 million, or 12.4%, because of an increase in highway construction and maintenance projects.
- Net transfers to business-type activities declined \$114.359 million, or 14.6%, primarily due to a reduction in State appropriation funding to State-supported colleges and universities.

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Exhibit 3
Revenues Supporting Governmental Activities - By Source

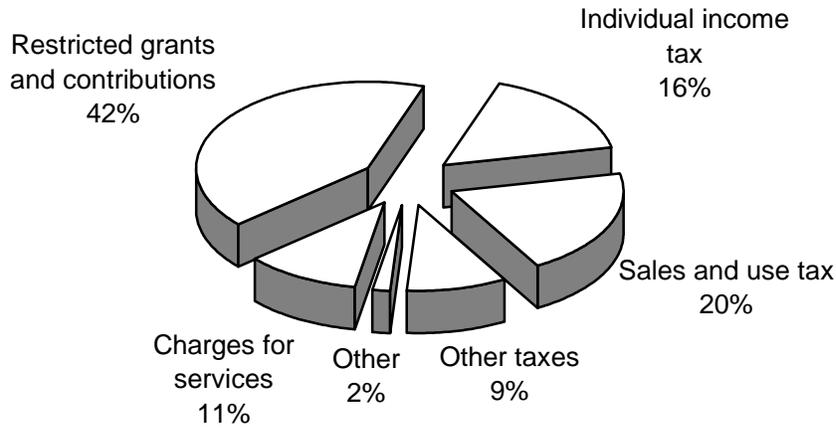
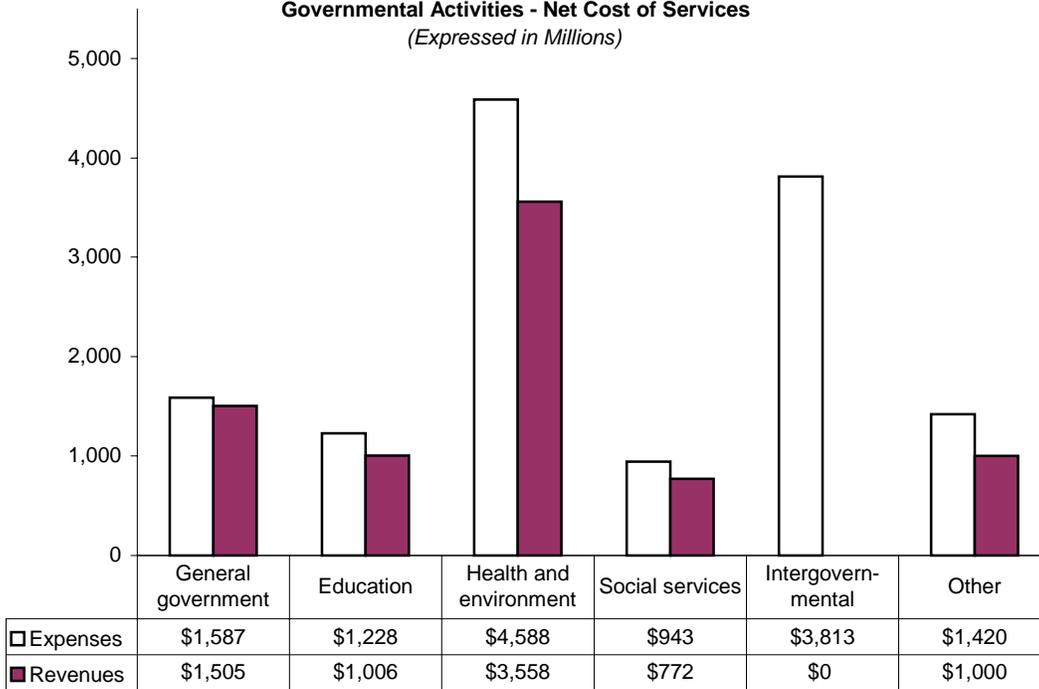


Exhibit 4
Governmental Activities - Net Cost of Services
(Expressed in Millions)



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Business-type Activities

Net assets of the State's business-type activities increased \$99.467 million, or 3.3%.

Business-type activities' revenues included charges for services (86.5%) and grants and contributions (including federal aid) (13.5%). Business-type activities' expenses were mostly to provide higher education services and support (81.1%), unemployment compensation benefits (12.2%), and housing services (3.4%).

Most business-type activities are self-supporting. Tuition and student fees, research and other grants (both private and governmental), and other charges primarily pay for the services that the Higher Education Fund provides. The Higher Education Fund, however, receives substantial resources (primarily transfers of annual appropriations) from the State's governmental activities. Essentially, net transfers to the Higher Education Fund represent the cost of educational services that taxes and other general revenues of governmental activities support.

The following paragraphs highlight the most significant changes in revenues, expenses, and net transfers for business-type activities during the 2003-2004 accounting year:

- Charges for services increased \$196.632 million, or 7.0%. This was primarily because of increases for higher education activities. Revenues of State-supported colleges

and universities were up because of tuition and fee increases and increased enrollment. Institutions raised tuition and fees to help offset a reduction in State appropriations. Higher education revenues also increased because of lottery-funded scholarships to in-State students who met certain requirements.

- Unemployment compensation benefit expenses declined \$52.770 million, or 9.7%, primarily due to the ending of the Emergency Unemployment Compensation program.
- Net transfers received from governmental activities decreased by \$114.359 million, or 14.6%. This represents a reduction in State appropriation funding to State-supported colleges and universities.

Financial Analysis of the State's Funds

The State of South Carolina uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Within the fund financial statements, the focus is on reporting major funds.

Governmental Funds

Exhibit 5 shows the components of fund balance for the State's various governmental funds as of June 30, 2004.

Exhibit 5
State of South Carolina's Governmental Fund Balances
(Expressed in Thousands)

	General Fund	Departmental General Operating	Local Government Infrastructure	Department of Transportation Special Revenue	State Tobacco Settlement	Nonmajor Governmental Funds	Total Governmental Funds
Reserved.....	\$ 90,605	\$ 972	\$ 1,716,773	\$ 10,508	\$ —	\$ 174,737	\$ 1,993,595
Unreserved, designated.....	—	—	—	—	—	195,589	195,589
Unreserved, undesignated.....	(97,632)	353,753	(304,053)	(120,107)	498,871	516,935	847,767
Totals.....	\$ (7,027)	\$ 354,725	\$ 1,412,720	\$ (109,599)	\$ 498,871	\$ 887,261	\$ 3,036,951
Change from prior year...	\$ 139,343	\$ 58,123	\$ 82,356	\$ (112,695)	\$ (40,370)	\$ 186,369	\$ 313,126
Percentage change.....	95.2%	19.6%	6.2%	(3,640.0%)	(7.5%)	26.6%	11.5%

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At June 30, 2004, the State's governmental funds' ending fund balance was \$5.037 billion, which represents an increase of \$313.126 million, or 11.5%, from the prior year. About one-third of this total (34.4%) makes up the *unreserved* fund balance—the amount available for spending in the coming year. The remaining fund balance, or 65.6%, is *reserved* and is *not* available for future appropriation because it is accessible only for specific purposes. The following paragraphs discuss the major governmental funds that had significant changes in fund balance:

The *General Fund* is one of two large State operating funds. This fund includes resources that pay for the services that the State traditionally has provided to its citizens. These resources, such as taxes, are accounted for in the General Fund unless State law requires them to be accounted for in another fund. During the 2003-2004 accounting year, the total fund balance of the General Fund increased by \$139.343 million, or 95.2%, from last year. This increase resulted mainly from tax revenue growth because of improving economic conditions and most State agencies receiving less State appropriation expenditure authority. Total revenues grew \$283.813 million, or 4.9%, while expenditures increased by just \$59.459 million, or 1.1%. Individual income taxes increased \$116.279 million, or 5.1%, sales and use taxes increased \$128.080 million, or 6.2%, and other taxes increased \$51.107 million, or 7.4%. In contrast, tax revenues for fiscal year 2002-2003 experienced no growth from the prior fiscal year. Individual income taxes for that period actually declined 2.4% from the prior year due to higher unemployment. Growth in General Fund expenditures was nominal for most functional categories with the exception of the health and environment and administration of justice categories. Health and environment expenditures grew \$105.181 million, or 8.1%, and were attributable to increases in the State's share of matching funds associated with the federal Medicaid assistance program. Medicaid payments increased during the year due to greater client participation and higher health costs. Reported expenditures associated with the administration of justice fell \$48.379 million, or 9.6%, primarily because the Division of Motor Vehicles, previously reported within the Department of Public Safety, was restructured as a separate agency and classified as part of the general government function for fiscal year 2003-2004. Other financing sources of the General Fund declined \$78.592 million, or 13.9%, primarily because fewer bond proceeds were received this year than last year.

The *Departmental General Operating Fund* accounts for resources, other than General Fund resources, that State agencies may use for operating

purposes. These resources include significant amounts of federal grant receipts. Fund balance increased by \$58.123 million, or 19.6%, over last year, mainly because revenues were \$608.751 million, or 12.6%, higher than last year, while expenditures increased only \$569.967 million, or 11.7%. Revenues increased mostly because of increased license and fee revenues, fines and penalty revenues, and additional federal Medicaid funding under the federal Jobs Growth and Tax Relief Reconciliation Act of 2003. Health expenditures grew \$414.489 million, or 13.7%, over last year because of an increase in federal Medicaid assistance payments related to increased client participation and higher health costs.

The *Department of Transportation (DOT) Special Revenue Fund* accounts for various gasoline taxes, fees, fines, and federal grant resources. The DOT uses these resources to pay for its general operations, which include highway maintenance, regulation, and construction of public highways and bridges. Fund balance decreased \$112.695 million during 2003-2004 resulting in a total fund deficit of \$109.599 million at the end of the fiscal year. This occurred primarily because of long-term commitments by DOT to provide funding for highway construction projects administered by the State Infrastructure Bank (included within the Local Government Infrastructure Fund which is presented with the State's other major governmental funds in the basic financial statements). These commitments are recorded as interfund payables by the DOT Special Revenue Fund and as interfund receivables by the Local Government Infrastructure Fund. The commitments will be discharged (i.e., reduced) as DOT provides construction services to the Bank.

The *State Tobacco Settlement Fund* accounts for revenues received from the General Fund and from the Tobacco Settlement Revenue Management Authority, a blended component unit and nonmajor governmental fund designated to receive and manage the State's share of the multi-state legal settlement with the tobacco industry. Fund balance declined \$40.370 million, or 7.5%, during 2003-2004 because the fund's health-related expenditures for the year exceeded its interest and investment earnings.

Proprietary Funds

Exhibit 6 shows the components of net assets for the State's various proprietary funds.

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Exhibit 6

State of South Carolina's Proprietary Fund Net Assets (Expressed in Thousands)

Fund Net Assets	Enterprise Funds						Internal Service Funds
	Higher Education	Unemployment Compensation	Housing Authority	Education Assistance Authority	Nonmajor Enterprise	Total Enterprise	
Invested in capital assets (net of related debt).....	\$ 1,557,142	\$ —	\$ 65	\$ 225	\$ 137,776	\$ 1,695,208	\$ 124,730
Restricted, expendable.....	281,935	431,072	233,696	123,179	57,406	1,127,288	33,229
Restricted, nonexpendable.....	38,044	—	—	—	21,626	59,670	354
Unrestricted.....	394,413	—	1,268	1,055	(110,726)	286,010	(141,184)
Totals.....	\$ 2,271,534	\$ 431,072	\$ 235,029	\$ 124,459	\$ 106,082	\$ 3,168,176	\$ 17,129
Change from prior year..	\$ 157,173	\$ (104,602)	\$ 11,063	\$ (4,000)	\$ 43,756	\$ 103,390	\$ (93,278)
Percentage change.....	7.4%	(19.5%)	4.9%	(3.1%)	70.2%	3.4%	(84.5%)

The State has two kinds of proprietary funds: enterprise funds and internal service funds.

Enterprise funds are reported as business-type activities in the government-wide financial statements. Enterprise funds sell goods or services primarily to parties outside of State government.

The *Higher Education Fund*, an enterprise fund, accounts for the general operations of ten four-year higher education institutions and sixteen area technical colleges. Fund net assets increased \$157.173 million, or 7.4%. This total increase included a \$62.316 million, or 18.8%, increase in unrestricted net assets. Unrestricted net assets represent resources that can be used for the institutions' on-going operations. The increase in this portion of net assets primarily was due to increases in tuition and student fees, as well as increased enrollment.

The *Unemployment Compensation Fund*, another enterprise fund, experienced a significant decline in fund balance during the accounting year ended June 30, 2004. This fund collects assessments from employers and uses these resources to pay benefits to unemployed persons who are legally eligible to receive such benefits. The fund's net assets decreased \$104.602 million, or 19.5%, primarily because unemployment benefit payments exceeded the insurance premiums and program revenues received. In addition, the fund earned less interest income than last year because it had less cash and because interest rates were lower.

South Carolina's *internal service funds* provide certain services (including maintenance, insurance, printing, data processing, and motor pool services) and some goods (such as office supplies) primarily to other State funds but sometimes to local governments as well. The objective of an internal service fund is to charge its customers for the costs of the services or goods that it provides. Because internal service funds primarily benefit State government, South Carolina reports them as

governmental activities in the government-wide financial statements.

Budgetary General Fund Highlights

The State's *Board of Economic Advisors (BEA)* is responsible for forecasting revenues for the budget. State law requires that the BEA meet at least quarterly to review revenue collections and to adjust its forecasts if necessary. If the BEA reduces revenue projections significantly once the budget year begins, the State's *Budget and Control Board* (the Board) is responsible for mandating spending cuts to keep the budget in balance.

On August 15, 2003, based on current-year and prior-year revenue collection trends, the State's Board of Economic Advisors (BEA) declared a revenue shortfall for the 2003-2004 accounting year and adjusted its revenue estimate for the Budgetary General Fund downward by \$112.976 million from the amount included in the annual Appropriation Act.

On August 20, 2003, the State Budget and Control Board ordered \$141.804 million in spending cuts for 2003-2004. In accordance with State law, the first \$98.599 million of this cut eliminated the entire 2.0% "set-aside" for capital and nonrecurring purposes. In accordance with Section 63.18 of the 2003-2004 Appropriation Act and Section 6 of Act 356 of 2002, the Board ordered an additional \$43.205 million in budget cuts for State agencies to help mitigate the Budgetary General Fund's 2002-2003 operating deficit as well as any anticipated 2003-2004 shortfall in revenue. The cuts reduced most agency budgets in 2003-2004 by approximately 1.0%.

On May 13, 2004, the BEA revised its revenue estimate upward by \$130.000 million because tax revenue collections were greater than expected as economic conditions for the State improved. The

Management’s Discussion and Analysis

Board elected not to restore the 1% agency budget cuts it had ordered in August 2003.

The 2003-2004 appropriations had to be increased by \$29.251 million during the year to fund certain State-mandated programs that were underestimated in the Appropriation Act. The Department of Corrections received \$23.700 million of these additional appropriations.

Actual revenues at June 30, 2004, were \$59.306 million more than the revised expected revenues. Furthermore, actual revenues were \$251.660 million greater than actual expenditures. Because of a better economy and actions taken by the Board to reduce agency spending, the State was able to eliminate last year’s \$131.227 million budgetary general fund *deficit*, and end the year with a budgetary general fund surplus of \$120.433 million. Also, an additional

\$25.155 million was restored to the State’s “rainy day account,” which had been fully depleted at the end of fiscal year 2002-2003. See the *Budgetary Reporting* subsection of the *Required Supplementary Information* section on pages 132 through 137 of this report for a detailed budgetary comparison schedule.

Capital Assets and Debt Administration

Capital Assets

At the end of the 2003-2004 accounting year, the State had \$14.259 billion invested in capital assets. This represented a net increase (including additions and deductions) of \$854.977 million, or 6.4%, over the previous accounting year (see *Exhibit 7*).

Exhibit 7
State of South Carolina's Capital Assets
(Net of Depreciation, Expressed in Thousands)

	Governmental Activities		Business-type Activities		Totals—Primary Government		Total Percentage Change
	2004	2003	2004	2003	2004	2003	2003-2004
Land and improvements.....	\$ 1,366,894	\$ 858,814	\$ 204,828	\$ 201,018	\$ 1,571,722	\$ 1,059,832	48.3%
Infrastructure.....	5,775,804	5,647,697	—	—	5,775,804	5,647,697	2.3%
Buildings and improvements.....	910,181	890,319	1,774,445	1,709,790	2,684,626	2,600,109	3.3%
Vehicles.....	163,472	181,426	10,575	9,099	174,047	190,525	(8.6%)
Machinery and equipment.....	110,642	112,180	202,328	198,575	312,970	310,755	0.7%
Works of art and historical treasures.....	3,667	3,667	18,913	19,029	22,580	22,696	(0.5%)
Construction in progress.....	3,326,648	3,258,002	373,483	288,409	3,700,131	3,546,411	4.3%
Intangible assets.....	12,862	21,398	4,694	5,036	17,556	26,434	(33.6%)
Total.....	\$ 11,670,170	\$ 10,973,503	\$ 2,589,266	\$ 2,430,956	\$ 14,259,436	\$ 13,404,459	6.4%

Management's Discussion and Analysis

As in the previous accounting year, the State's investment in land increased significantly during 2003-2004, because it acquired rights-of-way for highway construction and widening projects and it purchased several parcels of land and easements for conservation purposes.

Intangible assets decreased from last fiscal year, primarily because of depreciation expense on the Department of Motor Vehicle's Project Phoenix software system.

See Note 7 in the notes to the financial statements within this report for additional information on the State's capital assets.

Long-term Debt

At the end of the accounting year, the State had \$6.932 billion in bonds and notes outstanding—an increase of \$418.240 million, or 6.4%, over last year (see *Exhibit 8*). Note 12, in the notes to the financial statements, includes more detailed information about the State's long-term debt.

Exhibit 8
State of South Carolina's Outstanding Bonds and Notes
 (Expressed in Thousands)

	Governmental Activities		Business-type Activities		Totals—Primary Government		Total Percentage Change
	2004	2003	2004	2003	2004	2003	2003-2004
Backed by the State:							
General obligation bonds.....	\$ 2,266,261	\$ 2,239,207	\$ 242,740	\$ 208,968	\$ 2,509,001	\$ 2,448,175	2.5%
Backed by specific revenues:							
Revenue bonds and notes.....	33,686	33,429	1,750,104	1,643,188	1,783,790	1,676,617	6.4%
Infrastructure Bank bonds.....	1,725,514	1,463,582	—	—	1,725,514	1,463,582	17.9%
Tobacco Authority bonds.....	845,630	869,870	—	—	845,630	869,870	(2.8%)
Limited obligation bonds.....	23,304	27,040	—	—	23,304	27,040	(13.8%)
Bond anticipation notes.....	—	—	44,310	28,025	44,310	28,025	58.1%
Total.....	\$ 4,894,395	\$ 4,633,128	\$ 2,037,154	\$ 1,880,181	\$ 6,931,549	\$ 6,513,309	6.4%

Management's Discussion and Analysis

New debt resulted mainly from the issuance of \$275.435 million in Infrastructure Bank revenue bonds. The State Infrastructure Bank uses its own revenues to pay the principal and interest (*debt service*) on these bonds. These revenues are primarily truck registration fees and penalties that the Department of Motor Vehicles collects and transfers to the Bank.

Three bond rating services assign ratings to bonds that the State backs with its own taxing authority (*general obligation bonds*). Standard & Poor's and Fitch Ratings rate these bonds as "AAA," and Moody's Investors Service rates them as "Aaa." These are the highest ratings that these services assign. In September 2003, Moody's revised the outlook for the State from stable to negative. In announcing the change in outlook, Moody's stated: "The negative outlook reflects a trend of weakened revenues resulting from continued slowing in the State's economy, which has led to multi-year General Fund year-end deficits." Standard & Poor's and Fitch Ratings continue to recognize the State's outlook as stable.

The State limits the amount of annual payments for principal and interest on general obligation bonds and notes rather than directly limiting the amount of those bonds and notes that the State may have outstanding. At June 30, 2004, the State legally could issue additional bonds as long as the new debt would not increase the State's annual principal and interest payments by more than the following amounts: \$23.012 million in total for all institution bonds, \$23.162 million for highway bonds, \$37.059 million for general obligation bonds, excluding institution and highway bonds, and \$22.378 million for economic development bonds. (*Institution bonds* are general obligation bonds that benefit the State's Higher Education Fund.)

Economic Factors and Next Year's Budget

The "Rainy Day Account"

At June 30, 2004, the General Reserve Fund, sometimes called the *rainy day account*, had a balance of \$25.155 million rather than the \$149.034 million needed to be fully funded at that date. The State's Constitution requires restoration of the reserve to full funding within three years after a withdrawal. State law defines full funding for the reserve as 3% of the Budgetary General Fund's revenues for the latest completed accounting year.

Budgetary General Fund for the 2004-2005 Accounting Year

On November 10, 2004, based on current-year revenue collection trends, the State's Board of Economic Advisors (BEA) revised its original revenue estimate for fiscal year 2004-2005 upward by \$108.961 million, to a total of \$5.704 billion.

See the *Budgetary General Fund Highlights* subsection above for additional information about the responsibilities of the BEA and the State Budget and Control Board.

Economic Conditions

The State's Budgetary General Fund revenue collections through the first five months of the 2004-2005 fiscal year were \$114.102 million, or 5.3%, higher than the level collected in the same period in 2003. For July through November 2004, retail sales tax collections were 1.1% greater than July through November 2003 receipts, while net individual income tax collections were up 7.1% over the same period. Year-to-date net corporate income tax collections were up 62.0%, or \$19.096 million, for July through November 2004 as compared to the same period in 2003.

The BEA adopted a preliminary Budgetary General Fund revenue estimate of \$5.878 billion for the 2005-2006 accounting year. This revenue forecast represents a 3.0% increase over the revised base for 2004-2005. The BEA will review this estimate again in February 2005 and either adjust or finalize it then.

Requests For Information

The primary purpose of this financial report is to provide South Carolina's citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. Please address your questions concerning information in this report as follows:

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